

# Opportunity Zone Regulations Provide Clarity on New Economic Development and Investment Tool

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On October 19, 2018, the U.S. Treasury Department (“Treasury”) and the Internal Revenue Service issued proposed regulations for the new Opportunity Zone tax incentive. Opportunity Zones are a powerful new economic development and real estate investment tool designed to mobilize investment in underserved communities across the nation. The Opportunity Zone program was established by Congress as a part of the Tax Cuts and Jobs Act of 2017.

Opportunity Zones are designed to encourage long-term private investments in low-income communities through a two-fold strategy: using temporary benefits to bring the investment in, and using long-term benefits to keep it there. This strategy not only results in increased savings for those making the investment, but also brings the possibility of job creation and economic growth for these traditionally underserved communities.

As of June 2018, Treasury had certified the final round of states’ nominations for Opportunity Zone census tracts, bringing the total number of qualified tracts to more than 8,700 across all states, territories, and the District of Columbia. These Opportunity Zones retain their designation for 10 years. The sites are spread across the nation and across each state, offering numerous sites new economic development opportunities for underserved communities. A list of all of the sites can be found through the [Department of Treasury’s website](#).

The [proposed regulations](#) issued by the federal government provide clarification on a number of key points:

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## 1. Eligible Taxpayers and Capital Gains

- a. The regulations clarify that nearly all taxpayers, including pass-through entities, are eligible for the tax benefits provided by the Opportunity Zone program. Special rules are set forth regarding elections by partnerships and partners in those partnerships.
  - b. Gains eligible for deferral are limited to nearly all types of recognized capital gains, with some specific exceptions. Eligible capital gains include short term capital gains, collectibles gains, capital gain dividends from RICs and REITS, and “unrecaptured Section 1250 gain” from the sale of real estate. The character of those gains (which might be subject to varying tax rates) will be preserved through their deferral.
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## 2. Opportunity Fund Structure

- a. The regulations provide that any entity classified as a domestic corporation or a domestic partnership for U.S. federal income tax purposes can qualify as an Opportunity Fund. This should include funds structured as limited liability companies, REITs or S Corporations, as well as typical C Corporations or partnerships.

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## 3. 90% Test and Working Capital Safe Harbor

- a. For an investment vehicle to qualify as an Opportunity Fund, at least 90% of its assets must constitute “Opportunity Zone Business Property” which can include an investment in an Opportunity Zone Business that owns such property, or a direct investment in such property. The new regulations clarify that Opportunity Zone Business Property will generally be valued based on book value listed in the financial statements of the Opportunity Fund or the Opportunity Zone Business. If no financial statements exist, value is generally determined by looking at the cost of the property.
- b. The regulations adopt a working capital safe harbor that permits an Opportunity Fund to invest in an Opportunity Zone Business, which will be permitted to hold cash and other “financial property” and count it toward the 90% asset test if:
  - i. The Opportunity Zone Business has a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the Opportunity Zone;
  - ii. The Opportunity Zone Business has a contemporaneous written schedule consistent with ordinary business operations of the business that the working capital will be used within 31 months of acquisition; and
  - iii. The Opportunity Zone Business actually uses its working capital consistently with its plan and written schedule.

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## 4. Opportunity Zone Business and 70% “Substantially All” Safe Harbor

- a. “Substantially all” of the tangible property owned or leased by an Opportunity Zone Business must be Opportunity Zone Business Property. The regulations provide a clear rule that if at least 70% of the tangible property is Opportunity Zone Business Property, the Opportunity Zone Business will satisfy the “substantially all” test.
- b. Because an Opportunity Zone Business need only meet the 70% safe harbor, and a direct investment in Opportunity Zone Business Property by an Opportunity Fund must meet the 90% asset test, it is likely that many Opportunity Funds will structure investments through lower-tier Opportunity Zone Businesses in order to reduce the burden of meeting the higher asset threshold.

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## 5. “Substantial Improvement” Applies Only to Property Other than Land

- a. A major part of the legislative mandate for tax benefit qualification is that either the original use of Opportunity Zone Business Property commences with the Opportunity Fund, or that the Opportunity Zone Business Property be “substantially improved,” which requires expenditures that exceed the initial tax basis in the property within any 30 month period after acquisition.
- b. The regulations and [Rev. Rul. 2018-29](#), issued in conjunction with the regulations, clarify that where there is an acquisition of land with an existing building located entirely within an Opportunity Zone, the tax basis attributable to the land is not taken into account in determining the amount of capital investment needed to meet the substantial improvement test. This should reduce the financial burden of meeting the legislative requirements for many Opportunity Funds.

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## 6. 180-day Rule

- a. The regulations clarify that eligible capital gains must be invested in an Opportunity Fund within the 180-day period that begins on the date on which a taxpayer would otherwise be required to recognize that gain.

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## 7. FIFO Rule

- a. Where investments of gains are made on more than one date and/or from more than one underlying transaction on the same date, the regulations generally provide for a “first in first out” (“FIFO”) ordering rule to determine the Opportunity Fund interests that are disposed.

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## 8. Partnerships that Incur Debt

- a. Typically, partnerships that incur debt allocate the liability to the partners, who are deemed to make a cash contribution of the same amount to the partnership. If an Opportunity Fund is classified as a partnership for federal income tax purposes, the regulations provide that any deemed contribution resulting from the partnership’s debt will be ignored for purposes of determining the percentage of an investment subject to deferral.

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## 9. Self-Certification

- a. The Treasury issued a new [Form 8996](#) to be filed by Opportunity Funds, with their federal income tax returns in order to elect Opportunity Fund status. The form allows an entity to elect which month (in the first year) the Opportunity Zone Fund status will apply, providing extra flexibility to prepare the Opportunity Fund and meet the statutory requirements.

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## 10. More Regulations Expected

- a. The preamble to the regulations indicated that the Treasury will be issuing additional regulations, likely before the end of this year. Those regulations are expected to address the following issues:
  - i. The meaning of “substantially all” in each of the various places where it appears in the statute (other than with respect to Opportunity Zone Business Property held by an Opportunity Zone Business);
  - ii. The transactions that may trigger the inclusion of gain that has been deferred under an Opportunity Fund election;
  - iii. The “reasonable period” for an Opportunity Fund to reinvest proceeds from the sale of qualifying assets without paying a penalty;
  - iv. Administrative rules for when an Opportunity Fund fails to meet the 90% test; and
  - v. Additional information reporting requirements.

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The proposed regulations are subject to a 60-day notice and public comment period. Many expect the regulations to be finalized next spring. We will continue to follow the guidance on Opportunity Zones to best inform our clients about this exciting new economic development program. Please contact our experienced [Opportunity Zone Team](#) if you are interested in learning more.