

A Guide to Key Opportunity Zone Regulations For Real Estate Transactions

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On October 19, 2018, the Department of Treasury (**Treasury**) and the Internal Revenue Service (**IRS**) released the highly anticipated regulatory guidance (**Guidance**) concerning the Opportunity Zone tax incentives (**OZ Incentives**) that were passed earlier this year as part of the Tax Cuts and Jobs Act of 2017.

The key tax benefits afforded by the OZ Incentives include (1) a deferral of capital gains that are timely invested Qualified Opportunity Zone Funds (**QOZ Funds**) in accordance with the OZ Incentives until the earlier of the date an investment in a QOZ Fund is disposed of or December 31, 2026; (2) a 10% basis step-up for capital gains held in QOZ Funds for five years and a 15% basis step-up for capital gains held in QOZ Funds for seven years; and (3) the permanent elimination from income of additional capital gains earned on investments held in QOZ Funds for at least ten years.

The Guidance is comprised of the following:

- Proposed [Treasury Regulations](#) (**Regulations**);
- An IRS issued [Revenue Ruling](#) (2018-29) (**Revenue Ruling**);
- Drafts of [IRS Form 8996](#) and related [instructions](#) (i.e., the Qualified Zone Opportunity Fund self-certification form); and
- Updates to the [IRS's Frequently Asked Questions](#) on its webpage.

The Guidance clarifies points of ambiguity in the OZ Incentives and underscores the objectives of the OZ Incentives. Those objectives include driving new economic investments in low income, disadvantaged communities located within the designated Opportunity Zones (**OZs**) that were approved by Treasury earlier this year. A list of all of the OZs can be found through the [Department of Treasury's website](#).

The Guidance is being viewed favorably by the real estate industry. It provides answers to key questions raised by real estate professionals concerning the OZ Incentives. This paves the path for them to make meaningful investments through QOZ Funds in the acquisition, development, redevelopment, ownership and/or operation of real property located within the designated OZs while remaining eligible for the key tax benefits afforded by the OZ Incentives.

If utilized in a manner consistent with the legislative intent of the OZ Incentives, real estate investments in OZs by developers, asset managers and private equity players through QOZ Funds can serve as an impactful and powerful tool for beneficial community development in underserved areas.

This guide outlines selective provisions of the Regulations that have key implications for real estate investments in designated OZs.

1. Permitted QOZ Fund Entities.

Any entity that is a corporation or partnership “for tax purposes” may serve as a QOZ Fund if it satisfies all of the applicable requirements of the OZ Incentives (**OZ Entity Requirements**). A limited liability company (**LLC**) is eligible to serve as a QOZ Fund if it is taxed as a partnership for federal income tax purposes, or if it elects to be taxed as a corporation, and satisfies the OZ Entity Requirements. A single member LLC would generally not qualify as a QOZ Fund unless it elects to be taxed as a corporation for federal income tax purposes, since a single member LLC is otherwise disregarded for federal income tax purposes. Similarly, REITs and RICs may be established as QOZ Funds if they satisfy the OZ Entity Requirements.

2. Certification Process for a QOZ Fund.

A QOZ Fund must self-certify that it meets the requirements of the OZ Incentives. The guidance includes a draft self-certification form (IRS Form 8996 and related instructions) for the initial self-certification by a QOZ Fund (**Self Certification Form**). This Self Certification Form is also to be used for the QOZ Fund to comply with the annual reporting requirements of the OZ Incentives and to confirm the QOZ Fund’s satisfaction of the 90% Asset Test (described below). The Self Certification Form is to be attached to the QOZ Fund’s federal income tax return for each relevant tax year.

3. QOZ Fund Organizational Documents.

The Self Certification Form explicitly provides that by end of the QOZ Fund’s first year, the QOZ Fund’s governing documents (i.e., its articles of incorporation, articles of organization, certificate of limited partnership) must include a statement indicating its purpose to invest in Qualified Opportunity Zone Property (**QOZ Property**) and include a description of the Qualified Opportunity Zone Business (**QOZ Business**) that the QOZ Fund expects to engage in. While this specific requirement does not appear in Section 1400Z-2 of the OZ Incentives, the Regulations, or the Revenue Ruling, we recommend that specific “OZ purpose” provisions satisfying the requirements of the Self Certification Form be included in the QOZ Fund’s governing documents at the time the QOZ Fund is formed.

4. Existing Entities.

Neither the OZ Incentives nor the Regulations include a prohibition on using a pre-existing entity as a QOZ Fund as long as the OZ Entity Requirements are satisfied. The date that the pre-existing entity becomes a QOZ Fund must be provided as part of the self-certification process on the Self Certification Form. Since the Self Certification Form specifically permits an entity to identify the initial month and tax year in which it becomes a QOZ Fund, entities that were formed prior to the issuance of the Guidance and that satisfy the OZ Entity Requirements can now elect to become QOZ Funds. It is important to note, however, that only funds invested in QOZ Funds after the month in which the self-certification is in effect will be eligible for the OZ Incentives.

5. Type of Gain that Can be Invested in QOZ Funds.

The Regulations clarify that only capital gains (including both short-term and long-term capital gains) arising from an unrelated party transaction can be rolled into QOZ Funds and qualify for the OZ Incentives’ tax benefits. Specifically, the Regulations define an eligible gain as any gain treated as a capital gain for federal income tax purposes that would be recognized for tax purposes prior to January 1, 2027, if not deferred under the terms of the OZ Incentives. Ordinary gain is not eligible to qualify for the OZ Incentives.

6. Eligible Investors in QOZ Funds.

The Regulations spell out the eligible investors that can defer gain by investing in QOZ Funds, which include individuals, C corporations, REITs, partnerships, S corporations, trusts and estates. Specifically, partnerships (even though they are pass-through entities) can defer and invest gain in QOZ Funds. Further, the Regulations confirm that a partner can invest his/her distributive share of a partnership’s capital gain if the partnership does not elect to do so.

7. Timing for Investment of Gains in QOZ Funds.

The OZ Incentives require investors to roll their capital gains into a QOZ Fund within 180 days of the recognition of the capital gains for federal income tax purposes. For partners investing partnership gains into a QOZ Fund, this 180 day period begins on the last day of the partnership's taxable year. For publicly traded stock, this 180 day period begins on the trade date. For REIT undistributed capital gain, the period begins on the last day of the REIT's taxable year. For REIT capital gain dividends, the period begins when the dividend is paid.

8. Types of Permitted Interests into QOZ Funds.

Only equity interests held in QOZ Funds are permissible investments. In addition to common stock, membership interests and partnership interests, eligible equity investments in QOZ Funds can include preferred stock in a corporation, profits interests in an LLC or partnership, or LLC or partnership interests with special allocations. While a QOZ Fund or QOZ Business may incur debt, the use of debt as an investment in a QOZ Fund is not eligible for OZ Incentives. Investments in QOZ Funds that are eligible for OZ Incentives may only be acquired for cash. However, a QOZ Fund investor can use his/her equity interest in a QOZ Fund as collateral for a loan (whether a purchase-money borrowing or otherwise) without adversely affecting the eligibility to defer his/her capital gains that are invested in the QOZ Fund.

9. 90% Asset Test.

For an investment vehicle to qualify as a QOZ Fund, at least 90% of its assets (**90 Asset Test**) must constitute qualified "Opportunity Zone Business Property" (**QOZ Business Property**) which can include an investment in a QOZ Business that owns such property, or a direct investment in such property. The Regulations clarify that the QOZ Business Property will generally be valued based on book value listed in the financial statements of the QOZ Fund or the QOZ Business. If no financial statements exist, value is generally determined by looking at the cost of the property. Although, it is not expressly addressed in the Regulations, it appears that the land value is to be taken into account in the 90% Asset Test, even though it is excluded in the substantial improvement test (as described below).

The testing dates for the 90% Asset Test are (i) the last day of the first 6-month period of the QOZ Fund's taxable year and (ii) the last day of the QOZ Fund's taxable year. If an entity becomes a QOZ Fund in a month other than the first month of its taxable year, then the first 6-month period for purposes of the 90% Asset Test is comprised only of the months in that initial tax year during which the entity is a QOZ Fund.

A QOZ Fund is afforded a "reasonable period" to reinvest proceeds it receives from a sale or return of capital from a QOZ Business to reinvest the proceeds and again comply with the 90% Asset Test. The Regulations do not include a definition for this "reasonable period," but it is anticipated that the next set of guidance to be issued will address this issue.

10. Timing for QOZ Funds' Investment of Capital into OZs.

The Regulations create a "working capital safe harbor" that allows a QOZ Fund to attract investment capital, invest it in an QOZ Business in satisfaction of the 90% Asset Test, and allow the QOZ Business to evaluate OZ investment opportunities and deploy capital in a responsible, effective and efficient manner. For QOZ Businesses that satisfy the specific requirements of this provision (see below), it affords QOZ Businesses a period of 31 months to invest their working capital in qualified QOZ Property and will reduce the risk of penalties for a failure by the QOZ Fund to meet the 90% Asset Test. There is no similar safe harbor available for a QOZ Fund that invests directly in QOZ Property other than a QOZ Business.

11. Specific Requirements to Fall within Working Capital Safe Harbor.

To take advantage of the “working capital safe harbor” included in the Regulations, the QOZ Business must (i) have a written plan for how it will spend its capital (including cash on hand) that expressly specifies that its capital is designated for the acquisition, construction or substantial improvement of property in an OZ (and must act in good faith to do so); (ii) have a written schedule for the expenditure of the capital within 31 months of the QOZ Business’s receipt of the capital; and (iii) substantially comply with that 31-month schedule. The working capital must be utilized by the QOZ Business in a manner consistent with these requirements. The Regulations do not provide further insights about how detailed this written “safe harbor” plan must be. To take advantage of this timing safe harbor, QOZ Funds investing in real estate assets should consider investing through an entity that constitutes a QOZ Business and that would directly own the real estate assets.

12. Permitted Types of Real Estate Investments by QOZ Funds.

Except for the “sin” businesses that are expressly prohibited by the OZ Incentives, there are no limitations in the OZ Incentives or the Regulations on the types or size of the tangible real estate assets that may be owned or invested in by QOZ Funds. Consequently, permissible tangible real estate investments by QOZ Funds include residential, multifamily, office, industrial and hospitality assets.

13. Use of Debt and Incentives by QOZ Funds.

The Regulations clarify that QOZ Funds can improve real property constituting QOZ Property that they invest in with non-capital gains dollars. While only capital gains are eligible for the OZ Incentives, the Regulations allow QOZ Funds to utilize other funds, including the proceeds from debt financings, so long as they are accounted for separately. In addition, the Regulations do not contain restrictions on the use by QOZ Funds of other federal, state or local incentives, including Low-Income Housing Tax Credits, Historic Tax Credits and New Markets Tax Credits.

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 a QOZ 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 and eligible for the OZ Incentives.

14. Definition of Original Use.

Under the OZ Incentives, QOZ Business Property must either have its original use in the OZ or it must be substantially improved. In Revenue Ruling 2018-29, the IRS indicates that “given the permanence of land, land can never have its original use” in an OZ commencing with its acquisition by a QOZ Fund. Consequently, neither an existing building nor the underlying land on which it is built can be put to “original use” by a QOZ Fund.

The Revenue Ruling also provides that “the fact that the cost of the land upon which an existing building is located is not included in a [QOZ Fund’s] adjusted basis in the building does not mean that [the QOZ Fund] is required to separately substantially improve such land for it to qualify as [QOZ Property].”

In the Regulations, Treasury seeks further comments as to whether tangible property that has been abandoned or underused, or that will be adaptively repurposed in an OZ, should be included within the meaning of the phrase “original use.”

15. Substantial Improvement Test.

If QOZ Property is not put to its original use in an OZ, a QOZ Fund must “substantially improve” the property in order for it to be a permissible investment. The OZ Incentives define “substantial improvement” as the QOZ Fund investing into the QOZ Property an amount in excess of the adjusted tax basis of the property. The Regulations clarify that the substantial improvement test only need include the basis of the existing improvements on the property and not the land value. This clarification facilitates investments by QOZ Funds in existing properties while enabling them to benefit from the OZ Incentives. In the Revenue Ruling, the IRS makes clear that undeveloped land need not be substantially improved. However, in order for land to qualify as QOZ Property, it appears that it will be required to be used actively in a trade or business directly or indirectly owned by a QOZ Fund. As a result, it appears that undeveloped land will likely need to be developed with new improvements that are used actively in a trade or business directly or indirectly owned by a QOZ Fund.

For example, a QOZ Fund acquires an apartment community in an OZ for \$5,000,000 with the intention of materially rehabilitating the community. \$2,000,000 of the purchase price is allocated to the land value and the remaining \$3,000,000 is allocated to the value of the existing buildings. Under the Regulations and pursuant to the Revenue Ruling, the substantial improvement test requires that the QOZ Fund invest an additional \$3,000,001 in the rehabilitation of the community. However, the QOZ Fund is not required to also invest additional capital for the related \$2,000,000 land value.

Open questions remain about how the allocation of a purchase price between the value of the land and the improvements is to be determined. The choices likely include a determination by the buyer and seller in an arms-length transaction as to how this allocation is to be achieved. Alternatively, it can be accomplished based on the real estate tax assessment for the property, a broker opinion of value or a formal appraisal.

16. 30 month timing requirement under Substantial Improvement Test.

The OZ Incentives require and the Regulations confirm that the required expenditures by the QOZ Fund to satisfy the substantial improvement test must be completed within any 30-month period beginning after the date of the acquisition of the QOZ property. The Regulations do not specify what triggers the beginning of the 30-month period nor do they address whether there are permitted breaks or pauses in the specified 30-month period.

17. Clarifications to the “Substantially All” Requirements for Tangible Property Holdings of QOZ Funds.

The OZ Incentives require that “substantially all” of the tangible property owned or leased by an OZ business must be QOZ Business Property. The Regulations clarify that if at least 70% of the tangible property is QOZ Business Property (70% Test), the QOZ Business will satisfy the “substantially all” test.

Since a QOZ Business need only meet the 70% Test, and a direct investment in QOZ Business Property by a QOZ Fund must contribute to the QOZ Fund meeting the 90% Asset Test, the Regulations provide an incentive for QOZ Funds to structure investments through lower-tier QOZ Businesses in order to reduce the burden of meeting the higher 90% Asset Test.

For example, if a real estate focused QOZ Fund raises \$50,000,000 in capital for direct investment in real property assets, then at least \$45,000,000 of the QOZ Fund’s assets must be invested in QOZ Business Property to satisfy the 90% Asset Test. Alternatively, if the QOZ Fund establishes a subsidiary entity meeting the OZ Entity Requirements and invests \$45,000,000 in the subsidiary, only \$31,500,000 of the assets owned or leased by the subsidiary must be qualified QOZ Business Property (i.e., 70% of \$45,000,000).

Note that the Regulations only provide guidance on the “substantially all” threshold for tangible property owned or leased by QOZ Businesses. Definitions for the other uses of the “substantially all” threshold in the OZ Incentives will require further guidance from Treasury.

18. Timing for Exits from QOZ Funds.

Pursuant to Section 1400Z-1(f) of the OZ Incentives, the designations of all OZs will expire on December 31, 2028. Nonetheless, the Regulations clarify that investments in a QOZ Fund at any time after the QOZ Fund self-certifies will qualify for the exclusion from gains under Section 1400Z-2(c) of the OZ Incentives as long as investments in the QOZ Fund are held for at least 10 years and disposed of prior to January 1, 2048.

Cautionary Notes:

- **Related Party Transactions:** Caution should be taken by real property asset owners that plan to sell those assets to a QOZ Fund or QOZ Business and then reinvest the capital gains from that sale into that purchasing QOZ Fund (or the QOZ Fund that has invested in the purchasing QOZ Business). The OZ Incentives and the Guidance both include prohibitions on related party transactions. Those related party provisions should be analyzed in detail in the context of the specific facts and circumstances of this type of proposed transaction to ensure that it is structured in a way that complies with these requirements.
- **Securities Law Compliance:** Sales of interests in QOZ Funds constitute the sales of securities. Caution should be taken by real estate professionals engaged in raising QOZ Funds to comply with all applicable securities law requirements, including Regulation D exemption requirements applicable to sales of securities to accredited investors. Depending on the amount to be raised, the QOZ Fund manager may also have to register as an investment advisor and seek exemptions from registration under the Investment Company Act.

Although the Regulations are in a proposed form, Treasury has indicated that QOZ Funds and investors may rely on them, so long as the rules are applied in their entirety and in a consistent manner.

The Regulations indicate that Treasury anticipates issuing additional guidance prior to the end of this year. Those additional regulations are expected to address the following issues:

- The meaning of “substantially all” in each of the various places where it appears in the statute (other than with respect to QOZ Business Property held by an QOZ Business);
- The transactions that may trigger the inclusion of gain that has been deferred under an QOZ Fund election;
- The “reasonable period” for a QOZ Fund to reinvest proceeds from the sale of qualifying assets without paying a penalty;
- Administrative rules for when an QOZ Fund fails to meet the 90% Asset Test;
- As raised in the Regulations, whether tangible property that has been abandoned or underused, or that will be adaptively repurposed in an OZ, be included within the meaning of the phrase “original use;” and
- Additional information reporting requirements.

For the real estate industry, several additional clarifications by Treasury and the IRS would be helpful, including as to the following questions:

- How are carried interests taxed in a QOZ Fund?
- What happens if extenuating, unforeseeable circumstances (i.e., force majeure) cause delays in the deployment of working capital or in meeting the substantial improvement test?
- Will Treasury provide additional safe harbors for funds that are making good faith efforts to complete a project?
- In light of the Revenue Ruling and the fact that undeveloped land is not taken into account for purposes of the substantial improvement test, does undeveloped land constitute QOZ Property for purposes of the 90% Asset Test or the 70% Test?
- Must undeveloped land owned by a QOZ Fund be developed in order to constitute QOZ Property (i.e., so that it is directly or indirectly actively used by the QOZ Fund in its trade or business)?
- How detailed must the written “working capital” plan be to satisfy the “working capital safe harbor requirement?”

Our award-winning [Impact Business Group](#) and our multi-disciplinary [Opportunity Zone Team](#) are here to answer any questions you might have and help guide your Opportunity Zone pursuits.