ACCOUNTING

OPPORTUNITY ZONE INVESTMENTS: THE NEW EMERALD CITY OF TAX LAW

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Proposed Regulations cover some, but not all, of the questions that have arisen in the course of practitioners trying to understand and structure transactions that qualify for the benefits offered by investments in Opportunity Zones.

Among the many new provisions included in the Tax Cuts and Jobs Act enacted in December 2017 (TCJA) were Section 1400Z-1 of the IRC, which created a procedure for identifying “Opportunity Zones” (aka “OZones”), and Section 1400Z-2 which introduces tax benefits associated with investments in OZones as an incentive to encourage economic growth and investment in certain economically distressed or disadvantaged communities. While overall measures of economic growth and productivity mask these trends, many communities in the United States struggle economically while others thrive. As one example, almost 75% of all venture capital was invested in just three states in 2016 (California, New York and Massachusetts).1 The concept behind the OZone provisions is that tax rules should encourage and direct capital investment into designated distressed communities with the goal of mitigating the differences in growth and investment patterns between prosperous and distressed Zip Codes.

On October 19, 2018, Treasury released its first round of Proposed Regulations under Section 1400Z-2,2 as well as a Revenue Ruling3 and a draft form to be used by entities desiring to be classified as Qualified Opportunity Zone Funds.4 These Proposed Regulations cover some, but not all, of the questions that have arisen in the course of practitioners trying to understand and structure transactions that qualify for the benefits offered by Section 1400Z-2. Recognizing this, in the preamble to the Proposed Regulations, Treasury made clear that further regulatory guidance is forthcoming.

In this article, we review the premises that led to the OZone tax provisions and address both the statutory requirements and benefits associated with OZone investments, attempt to review the newly issued Proposed Regulations and Revenue Ruling, and pose some (certainly not all) of the many questions raised by the statute and currently affecting investors and practitioners trying to take advantage of the opportunity presented by Section 1400Z-2. Our objective is to start to define the path that taxpayers must follow on the Yellow Brick Road to reach tax benefits in the Land of OZ.

IRC provisions that have encouraged geographic-based economic development including empowerment zones, enterprise communities, renewal communities, and gulf opportunity zones are nothing new.5 All of these geographic-based incentives have expired at various times over the past decade. The only remaining geographic-based incentive that survives is the New Markets Tax Credit (“NMTC”) under Section 45D which is currently set to expire on December 31, 2019, but has regularly been extended since its original enactment in 2000. The NMTC generally provides $3.5 billion of allocation each year, which translates roughly into tax credit equity of less than $1 billion per year for projects that are located in qualified census tracts, the residents of which have lower than average incomes and higher than average poverty rates. The NMTC program is administered by the Department of the Treasury’s Community Development Financial Institutions Fund (the “CDFI Fund”).

The Opportunity Zone regime has a similar sunset provision. Section 1400Z-1(f) provides that the designation of all qualified opportunity zones will expire on December 31, 2028. In adopting the Proposed Regulations, Treasury tried to assure the public that this date will not end...
the benefits available to taxpayers who make qualifying investments prior to the expiration of the program, assuming it is not extended. The mechanics of this are discussed later in this article.

Identification of OZones

The tax benefits associated with OZone investments are not intended to replace the NMTC, but potentially could be a significantly more valuable incentive that will eclipse the NMTC. The two programs share the concept that investments must be made in qualified census tracts, and the census tracts for purposes of designating OZones start with the same census tracts that are eligible for NMTC purposes. Section 1400Z-1 instructed the governors of each state to designate as “qualified opportunity zones” up to 25% of the “low income communities” designated under the NMTC provisions in Section 45D(e). A census tract that is not a “low income community” may also be designated as a qualified opportunity zone if that tract is contiguous with a low income community that is designated as a qualified opportunity zone and the median family income of residents in the census tract does not exceed 125% of the median family income of the low income community with which the census tract is contiguous. This ability to include census tracts that are not low income communities is limited to no more than 5% of the census tracts that are designated by the state.

The designation of qualified census tracts from among the low income communities identified under Section 45D(e) has now been completed for each of the 50 states, the District of Columbia, Puerto Rico, American Samoa, Guam, the Northern Mariana Islands, and the U.S. Virgin Islands. One can easily determine whether a census tract has been designated by, among other things, using a mapping function on the CDFI Fund website (https://www.cdfifund.gov). Designation of census tracts as low income communities by focusing on the income levels of the families that live within the census tract is an interesting approach to determining which census tracts lack economic investment and opportunity.

For example, a census tract located adjacent to an airport may be eligible because that is a less desirable location in which to live but might be a desirable location for an investment in an office building or hotel or other business. Similarly, in some cities where commercial districts are not popular residential communities, the income levels of the families living in those commercial districts could be quite low and the census tract could be eligible as a low income community, notwithstanding that from an economic development standpoint there is nothing about the commercial district that is distressed or economically disadvantaged. One of the things that one notices when reviewing the designated low income communities for NMTC purposes, and then the 25% of those census tracts that are designated for OZone purposes, is that many of those census tracts are already attractive locations for business investment even without the OZone designation.

Sections 1400Z-1 and -2 were not part of the House version of the TCJA. They were added by the Senate Amendment which was released on December 2, 2017, 20 days before Congress voted on the legislation. These provisions seem to have received relatively little attention during that short period of time in December 2017 because the provision was scored by the Congressional Budget Office as reducing tax revenues by a total of $1,600,000,000 over a period of 10 years, but a relatively small sum in the context of the TCJA. That scoring of the OZone provisions from a budget standpoint might have suggested that it would be of comparable scale to some of the empowerment zones, enterprise zones, and opportunity zones that had been previously part of the IRC and had expired without renewal. But 1400Z-2 may have “slipped under the radar” because most of the revenue effects of the provision would be felt after the 10-year measuring period used by the Congressional Budget Office. That structural element will be apparent from the discussion that follows and may or may not have been intentional on the part of the groups that developed and promoted the OZone provisions.

OZone Tax Deferral and Exclusion Benefits

There are two distinct tax benefits provided by Section 1400Z-2. Neither is a tax credit or a tax deduction. Both operate through adjustment of a taxpayer’s basis in a qualifying investment. The provision (a) temporarily defers tax on gains that would be recognized from the disposition of a capital asset or property used in a trade or business preceding a qualifying OZone investment (the “Deferral Benefit”), and (b) permanently eliminates tax on gains derived from a qualifying OZone investment (the “Exclusion Benefit”).

Application of the Deferral Benefit begins when a taxpayer realizes

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6 Sections 1400Z-1 and -2 were originally introduced as the Investing in Opportunity Act on 2/2/2017, as H.R. 828 and S. 293.

7 Estimated Budget Effects of the Conference Agreement for H.R. 1, the “Tax Cuts and Jobs Act,” Joint Committee on Taxation, 12/18/2017 [JCX-67-17].
gain from a sale to, or exchange with, an unrelated person of “any property held by the taxpayer.”\(^8\) Such gains are not limited by the statutory language to long-term capital gain. The Proposed Regulations make clear that the term “capital gain” will include short-term gains and gains treated as capital gain under Section 1231.\(^9\) Since gain from inventory sales is not classified as capital gain, deferral of this gain does not seem available under the Proposed Regulations. Despite the use of the potentially broader term “gain” in the statute, the Proposed Regulations chose to follow guidance from the Committee Report relating to the Section, which specifically refers to “deferral of inclusion in gross income for capital gains reinvested in a qualified opportunity fund.”\(^10\)

Capital gain so realized (the “Old Gain”) is excluded from gross income for the taxable year of the sale or exchange giving rise to the Old Gain to the extent that the taxpayer elects to invest that gain in a “qualified opportunity fund” (an “OZFund”) within 180 days after the date of the sale or exchange.\(^11\) As will be discussed in more detail below, an OZFund must be organized as a domestic corporation or a partnership.\(^12\) As a result of a qualifying investment in an OZFund, recognition of Old Gain is deferred until the earlier of the date when the taxpayer’s investment in the OZFund is sold or exchanged, or December 31, 2026.\(^13\) In addition, the amount of Old Gain that will be recognized at December 31, 2026, is reduced by 10% if the investment in the OZFund is held for at least five years\(^14\) and by an additional 5% if the investment in the OZFund is held for at least seven years.\(^15\)

As a result, if an investment in the OZFund is made before the end of 2019, holding the OZFund until December 31, 2026, will result in corresponding deferral of Old Gain until that date and when the gain is recognized on December 31, 2026, only 85% of the Old Gain will be taxable.\(^16\) Recognition of the Old Gain is not eliminated by the death of a taxpayer since the IRC expressly provides that the gain is taxed as income in respect of a decedent under Section 691.\(^17\)

In addition to providing that gain from sales or exchanges after December 31, 2026, is not eligible for the Deferral Benefit,\(^18\) the statute contains a limitation on the election, providing that, once an election is made, subsequent elections cannot be made.\(^19\) However, the Proposed Regulations apply this limitation to specific amounts of gain, not to all the gain recognized from a single transaction, allowing seriatim investments in OZ Funds to cumulate with respect to a given gain. Thus, if a given sale or exchange creates $3 of gain and an initial investment in an OZFund is for $2, deferring $2 of the Old Gain, the remaining $1 of Old Gain can be deferred by a separate investment in the same or another OZFund that otherwise meets applicable criteria.\(^20\)

It is not entirely clear how the Deferral Benefit will apply to an installment sale, but the Proposed Regulations seem to provide that in each year gain is recognized, a new deferral possibility arises with respect to that gain since “eligible gain” is capital gain that is recognized for federal income tax purposes before January 1, 2027.\(^21\) The general rule relating to the 180-day investment period provides that this period starts with the “day on which the gain would be recognized for Federal income tax purposes if the taxpayer does not elect under section 1400Z-2 to defer recognition of that gain.”\(^22\)

Consider a sale transaction subject to installment sale (i.e., Section 453) rules that creates $2 of gain where no sale proceeds are received in the year of the sale (Year 1), $1 (i.e., 50%) of proceeds are received in the following year (Year 2), and the $1 balance of proceeds are received in the next year (Year 3). Among the questions we had before issuance of the Proposed Regulations, some of which have now been answered, are the following:

1. Does an initial purchase of OZFund interests have to be for the entire $2 amount of gain associated with an installment sale or just the amount of gain being recognized in a given year? As posited above, it appears the investment need only relate to the gain recognized in a given year.

2. If a sale occurs in Year 1 but no gain is recognized in that year, does any OZFund investment have to be made in Year 1? It appears not, as only the year of gain

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\(^8\) Section 1400Z-2(a)(1).

\(^9\) Prop Reg. 1.1400Z-2(a)-1(b)(2).


\(^12\) Section 1400Z-2(d)(1).

\(^13\) Section 1400Z-2(a)(1)(B); 1400Z-2(b)(1).

\(^14\) Because there are strong incentives to hold the investment in the OZFund for at least 10 years and because it is already 2018, it is most likely that the deferral of the recognition of gain will extend to December 31, 2026, in most cases.

\(^15\) Section 1400Z-2(b)(2)(B)(iii).

\(^16\) Section 1400Z-2(b)(2)(B)(iv).

\(^17\) If the fair market value of the investment in the OZFund is less than the deferred gain, the gain recognized on December 31, 2026, will be the excess of the fair market value over the taxpayer’s basis in the investment.

\(^18\) Section 1400Z-2(a)(2)(A).

\(^19\) Prop Reg. 1.1400Z-2(a)-1(b)(2)(ii).


recognition creates a need for the OZFund investment.

3. If an election is not made in the Years 1 or 2 of the example, can the election be first made in a subsequent year (i.e., Year 3) when additional gain is recognized? It appears so, if each year’s amount of gain recognition allows an independent decision to make an offsetting OZFund investment.

The second, and in our view potentially far more valuable, tax benefit under Section 1400Z is that if the investment in the OZFund is held by the taxpayer for at least 10 years, the basis of some or all of the taxpayer’s interest in the OZFund will be treated as equal to the fair market value of such interest on the date that the interest in the OZFund is sold or exchanged.

Thus, no gain (“New Gain”) will be realized on that sale or exchange. We discuss the possible scope of this provision, and some useful clarification provided by the Proposed Regulations, below.

While Section 1400Z-2(c) does not expressly preclude an election solely of the Exclusion Benefit, the Proposed Regulations expressly provide that the Exclusion Benefit is available only to an investment in an OZFund for which the Deferral Benefit is elected.25 We agree with Treasury that the statute should be read to require this. The argument is that the reference to “with respect to which the taxpayer makes an election under this clause” can be read to refer literally to subsection -2(c). There is no indication in the legislative history that this “cherry picking” was intended.

In our minds, the real question is whether an election to take advantage of the Deferral Benefit for a de minimis amount of Old Gain should make available the Exclusion Benefit. This is made possible through use of debt to finance qualifying opportunity zone business activity. As will be discussed in more detail below, the Proposed Regulations allow an investment of minimal capital (e.g., $10) in a highly leveraged real estate project that creates deferral of $10 of Old Gain to qualify the taxpayer for ultimate exclusion of an unlimited amount of New Gain. As a technical matter, it is hard to see how to preclude this, but the direction to issue anti-abuse regulations may result in some attempt to foreclose such planning and, at least with respect to use of this technique in a partnership, the Proposed Regulations invite comments on whether this is appropriate. Of course, as a policy matter it may be concluded that if elections to apply the Exclusion Benefit will induce investment in OZFunds and thus encourage OZone economic activity there is no abuse occurring.

Whose Gain Can be Deferred?

Section 1400Z-2’s scope is not limited to any particular type of taxpayer, so the Proposed Regulations make clear that gain realized by corporations, partnerships, trusts, and other entities is eligible for both the Deferral Benefit and the Exclusion Benefit.26 The statute refers specifically to gain from the sale or exchange “of any property held by the taxpayer” as being subject to the Deferral Benefit.27 This gives rise to the question of who is the “taxpayer” where an S corporation or partnership sells assets and gain is allocated entirely to and among the entity’s shareholders or partners.

The Proposed Regulations take a very taxpayer-friendly approach by saying that either the entity or the taxpayers allocated gains from the entity may make the qualifying investment and elect to obtain the Deferral Benefit.

Prop. Reg. 1.1400Z-2(a)-1(c) establishes a procedure where a partnership may make an election and if (and, potentially significantly, to the extent) the partnership does not elect, then partners allocated capital gain can themselves elect the Deferral Benefit. Even better, while the investment period for the partnership starts with the date that capital gain is recognized, the investment period for partners with respect to gains allocated to them and not deferred by a partnership election starts with the last day of the partnership’s tax year, which can obviously be many months after a sale transaction, although partners can elect to use the date of the partnership’s recognition event as their investment period starting point.28 These rules also apply by analogy to S corporations, trusts, and decedents’ estates.29

The Proposed Regulations do not address whether similar rules apply in the context of a consolidated corporate group. In other words, must a selling entity invest in an OZFund and make the election or can any member of the group do so, since tax returns are filed on a combined basis?

The manner of making elections by partnerships and partners under this regime is not spelled out in the Proposed Regulations, with such procedures presumably to be spelled out in the form of future guidance.

23 Which means that in all cases the investment will be held beyond December 31, 2026, at which time 85% of the Old Gain would be recognized.
24 Section 1400Z-2(c).
27 Section 1400Z-2(a)(1).
that is signaled in Prop. Reg. 1.1400Z-2(a)-1(d).

Implementation Through Operation of the Basis Adjustment Provisions

As we have already mentioned, both the Deferral Benefit and the Exclusion Benefit operate through adjustments of a taxpayer’s basis in an OZFund investment, which has to be stock in a corporation or an interest in a partnership qualifying as an OZFund purchased for cash and treated as equity, not debt. Where a taxpayer elects to defer Old Gain, the taxpayer’s basis in the corresponding interest in an OZFund is reduced by the amount of gain deferred. As will be discussed below, we think that this statutory mandate must be read in conjunction with the concept that an OZFund investment might consist of two components, one having zero basis and one having basis determined under normal tax principles.

Note that there is no requirement that a taxpayer literally invest the proceeds from a sale creating Old Gain, nor a restriction on borrowing funds to make a qualifying investment, although such an approach would likely subject the taxpayer to limitations on deductions applicable to investment interest. In fact, the Proposed Regulations expressly state that use of an interest in an OZFund to collateralize a debt does not disqualify the interest from serving as the basis for the Deferral Benefit.

The 10% and 5% reductions in recognizing Old Gain that occur five and seven years, respectively, after an OZFund investment are implemented through corresponding increases in the taxpayer’s basis in the investment at the specified times. The statutory language speaks in both cases of an investment “held for at least [five or seven] years” so presumably any sale or exchange of an OZFund interest after the day on which expiration of the allotted period occurs will qualify for the applicable reduction.

A taxpayer’s initial basis in an OZFund will be split and treated as associated with two separate investments if the taxpayer invests more than the amount of Old Gain when acquiring an OZFund interest. Section 1400Z-2(e)(1) sets forth rules for what are referred to as “investments with mixed funds.” For purchases of stock this would apply when the taxpayer purchases an interest in the OZFund that costs more than the Old Gain the taxpayer elects to defer.

In partnerships the same rule would also apply, but under the Proposed Regulations the deemed contribution of money under Section 752(a) with respect to a partner’s share of partnership debt is not taken into account for these purposes. In such circumstances an investment in the OZFund is treated as a single interest. Significantly, although the amount of allocated debt does not provide Deferral Benefit, the entire New Gain associated with the interest apparently is eligible for the Exclusion Benefit. Where separate treatment of portions of a cash OZFund investment create both a Deferral Benefit portion and a portion for which no Deferral Benefit is elected or is available (e.g., because the taxpayer does not have capital gains to defer) the New Gain potentially subject to exclusion if the investment in the OZFund is held for 10 years is thus limited. Of course, this is generally inconsistent with the normal rule that a partner has a single interest in a partnership.

Treasury went to great lengths in the Proposed Regulations to deal with some consequences of the split treatment of investments in OZFunds, whether via stock or partnership interest holdings, fundamentally adopting a First In-First Out paradigm to apply when an interest is disposed of. Where it is possible to establish the order of an investment in a given OZFund that relates to either multiple Deferral Benefit elections or to a combination of Deferral Benefit and conventional investments, the order of the investments will govern. Where it is not possible to establish an order because a single investment created split interests, then a pro-rata allocation between them will govern at the time of any partial disposition. The Proposed Regulations contain several examples of how this regime is supposed to work.

In order to operate within this regime, it may become advisable for organizers of OZFunds to provide for separate classes of investments with some specifically designed to obtain deferral of Old Gain and others intended to apply where the Deferral Benefit is not being sought so taxpayers and their accountants can keep things straight. In addition, the rule that the Exclusion Benefit is available only when associated with election of the Deferral Benefit may lead organizers of OZFunds to denominate all non-Deferral Benefit interests as “preferred” capital that

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31 Section 1400Z-2(b)(2)(B)(i).
32 Section 163(d).
34 Section 1400Z-2(b)(2)(B)(iii)-(iv).
36 Id.
37 Section 1400Z-2(c)(1)(B).
40 Prop. Reg. 1.1400Z-2(a)-1(b)(8).
would be entitled to a priority return on capital and of capital, while funds invested to obtain the Deferral Benefit would hold "common" interests that would capture the bulk of appreciation in value of OZFund assets to which the Exclusion Benefit would be applicable.

Will the separateness of these two interests be respected? If the answer is potentially no, one might ask whether a taxpayer planning to invest in an OZFund would be better off to take the non-OZZone investment and lend those monies to the OZFund instead of making a capital contribution to the OZFund so that all of the investment of the investor in the OZFund would be an OZone investment with respect to which the election has been made and the "mixed funds rule" would not apply.41

Reg. 1.1400Z-2(a)-1(b)(3) defines an "eligible interest" in an OZFund to exclude any debt instrument within the meaning of Section 1275(a)(1) and Reg. 1.1275-1(d). The same regulation provides that an equity interest may be a preferred stock or a partnership interest with special allocations and that such status as an eligible investment will not be impaired even if the interest is pledged as collateral for a loan which the taxpayer uses to acquire the equity interest.

With regard to the basis adjustment regime associated with the Exclusion Benefit, the IRC, as drafted, presents a further conundrum currently perplexing most planners that is not addressed in the Proposed Regulations. Section 1400Z-2(c) reads as follows: "in the case of any investment held by the taxpayer for at least 10 years and with respect to which the taxpayer makes an election under this clause, the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged." This language seems to refer to the terms "property" and "investment" interchangeably. The taxpayer holds its "investment" in the OZFund and it would appear that it is this investment that also constitutes "such property" the basis of which will be stepped up to fair market value at the time the "investment" or "property" is sold or exchanged. If so, the basis step-up is "outside" the OZFund.

Consider the following simple example:

Taxpayer A realizes an Old Gain of $1,000,000 from the sale of publicly traded stock for $2,000,000 (i.e., A has $1,000,000 basis in the stock). $1,000,000 (not the full amount for which the stock is sold, only the gain component) is invested in an OZFund organized as a partnership and A pockets $1,000,000. The OZFund invests all its capital in "qualified opportunity zone property," which for these purposes we will assume is commercial real estate being developed in a "qualified opportunity zone" (we will discuss the parameters of this below). Assume that A invests in the OZFund in 2018 and that the OZFund invests in the "qualified opportunity zone property" before the end of 2018. We will refer to the interest in the OZFund as the "investment" and the OZFund's interest in the "qualified opportunity zone property" as the "OZProperty." The $1,000,000 of Old Gain realized by A will not be recognized in 2018 and recognition will be deferred potentially to December 31, 2026, at which time only $850,000 of the $1,000,000 of Old Gain will be recognized with the other $150,000 escaping taxation. A's basis in her OZFund interest would be $0 in 2018 but after December 31, 2026, would be $1,000,000.

Assume that the OZFund buys and improves OZProperty in 2018 at a cost of $1,000,000 using the capital from A. While it appears that OZFund's "inside" basis in the OZProperty would be its cost of $1,000,000, A's initial outside basis in the OZFund interest is zero. A's basis steps up in 2023 by $100,000, in 2025 by $50,000, and in 2026 by the $850,000 deferred gain that A will be required to recognize when the Deferral Benefit lapses. None of these events should give rise to any potential inside basis adjustment by the OZFund, assuming the OZFund already had a $1,000,000 basis in the OZProperty from the outset.

An initial question that immediately arises is what happens to the Exclusion Benefit in 2029, following expiration of the opportunity zone designations. Will investments in funds invested in areas that were, but are no longer, classified as opportunity zones qualify? The Proposed Regulations answer this by creating a 19-year period following December 31, 2028, (i.e., until December 31, 2047) in which investments made prior to December 31, 2026, can still qualify for the Exclusion Benefit.42 This date is relevant because only investments for which the Deferral Benefit is elected qualify for the Exclusion Benefit, and the Deferral Benefit ends in 2026.43

Back to the issue of entity versus investor level gain. Assume OZFund owns the OZProperty until 2030 at which time the OZProperty has appreciated in value to $5,000,000. The associated gain inside the OZFund would be the increased value of OZProperty.

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41 This could become a topic to be covered in anti-abuse regulations that could be promulgated by the IRS.
42 Prop. Reg. 1.1400Z-2(c)-1(b).
OZFund sells the OZProperty and generates gain of $4,000,000 there may not be any applicable deferral under Section 1400Z-2(c), since unless A divests herself of her interest in the OZFund it appears she will be allocated gain of $4,000,000 before she could undertake a sale or exchange of her interest that would have given rise to a mark-to-market basis increase under Section 1400Z-2(c).

Instead, if A wishes to dispose of her position in 2030, it would be wise for A to sell her interest in the OZFund for $5,000,000 and not cause the OZFund to sell the OZProperty. The purchaser of the interest in the OZFund from A could then liquidate the OZFund and take direct ownership of the OZProperty. The gain of $4,000,000 representing the excess of the fair market value of A’s interest in the OZFund over her $1,000,000 tax basis in the OZFund would never be taxed. Of course, if the OZFund is organized as a corporation, A’s sale of stock would not affect inside basis, so the buyer would still have to deal with the $4,000,000 built-in gain inside the corporation. This is likely to result in A receiving less than $5,000,000 on the sale of her interest, and is a reason why OZFunds engaged in real estate development and ownership are most likely to be partnerships for tax purposes.

Depending upon the appreciation in value of the OZProperty in the example above, the exclusion of New Gain after holding an interest in the OZFund for at least 10 years could end up being a far more significant tax benefit than the deferral and potential exclusion of 15% of the Old Gain after holding the investment for at least seven years. We note that the exclusion of the New Gain by definition will occur more than 10 years after the investment in the OZFund and, therefore, falls outside of the 10-year period used by the Congressional Budget Office to measure the revenue effects of Section 1400Z-2. Had the exclusion of the New Gain been taken into account, the revenue effect of Section 1400Z-2 likely would have been far greater and these provisions might have received significantly more attention when they were added to the TCJA by the Senate shortly before its enactment.

Now let us consider more complicated, but perhaps more realistic, fact patterns where the OZFund incurs nonrecourse debt to acquire or develop the OZProperty. If the OZFund raises the same $1,000,000 of capital as in the prior example but adds $3,000,000 of borrowed money, the inside basis of the OZFund in the OZProperty would equal $4,000,000 and the $3,000,000 of nonrecourse debt would be allocated to A under Section 752. Since normal rules apply, the allocation of $3,000,000 of nonrecourse debt to A increases her basis in her interest in the OZFund but is not treated as a “separate investment consisting of other amounts” as described in the “mixed fund rules” in Section 1400Z-2(e)(1)(A)(ii). If A contributed an additional $3,000,000 of capital to the OZFund, it is clear enough that the $3,000,000 investment would be treated as a “separate investment” under the mixed funds rules because the Deferral Benefit was not claimed.

In both situations A will have a basis in her interest in the OZFund of $3,000,000, but that basis will have been generated in two very different ways. Consider also the possibility that the OZFund is taxed as a corporation and not a partnership in which case the $3,000,000 of nonrecourse debt incurred by the OZFund would not be allocated to A and would not increase her basis in her interest in the OZFund.

What is Qualified Opportunity Zone Property?

An OZFund must be organized as a corporation or partnership. The Proposed Regulations make this a federal income tax classification issue, not one of state law formality. Thus, an OZFund may be organized as a limited liability company or, potentially, as a trust electing to be classified as a corporation. The OZFund is obligated to invest in what is defined as “qualified opportunity zone property.” Qualified opportunity zone property includes the following three categories:

1. Qualified opportunity zone stock (“OZStock”);  
2. Qualified opportunity zone partnership interests (“OZInterests”); and  
3. Qualified opportunity zone business property (“OZProperty”).

The definitions of OZStock and OZInterests refer to interests acquired by the OZFund in either a corporation or a partnership in ex-

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44 In either case, A’s outside basis (in stock or partnership interest) would increase by $850,000 if full Deferral Benefit is available and, presumably, to full fair market value at the point the Exclusion Benefit became available. What is different between the partnership and corporate alternatives is whether A can utilize depreciation deductions allocated from the OZFund prior to the Deferral Benefit basis step-up, since she will have no basis in her interest in the entity if it is a corporation but will have the allocated $3,000,000 of debt if it is a partnership. This was not addressed by the Proposed Regulations.


46 This was a live question until issuance of the Proposed Regulations because Section 1400Z-2(d)(1) refers to “any investment vehicle which is organized as a corporation or partnership . . . .”

47 Section 1400Z-2(d); Prop. Reg. 1.1400Z-2(d)-1(c)(1).
change for a capital contribution of cash. As with taxpayer interests in OZFunds, the Proposed Regulations clarify that the interest of the OZFund in the partnership or corporation must be classified as equity, not debt. There is no requirement that the OZFund be the only owner of a corporation or partnership issuing OZStock or OZInterests, so this will permit OZFunds to engage in ventures with non-OZFund parties to undertake activities in opportunity zones. However, the qualifying interest must be acquired directly from the issuing corporation or partnership. At the time the OZFund acquires the interest, the issuing corporation or partnership must be engaged in a “qualified opportunity zone business” or, in the case of a new entity, the entity is being organized for the purpose of engaging in a qualified opportunity zone business.

A qualified opportunity zone business (“OZBusiness”) is defined as a trade or business in which substantially all of the tangible property owned or leased by the business is OZProperty, substituting the term “qualified opportunity zone business” for the term “qualified opportunity fund” each place it appears in the definition of OZProperty. This definition of OZBusiness will mean that (i) the property used in the business must be acquired by the OZBusiness by purchase after December 31, 2017, (ii) the original use of such property in the OZone commences with the OZBusiness, (iii) the OZBusiness must commence with the OZBusiness's holding period for such property, substantially all of the use of the property must occur in an OZone. OZProperty is defined as tangible property used in a trade or business of the OZFund if such property is acquired by the OZFund by “purchase” (as defined in Section 179(d)(2)) after December 31, 2017, the original use of such property in the OZone commences with the OZFund or the OZFund substantially improves the property, and during substantially all of the OZFund’s holding period for such property substantially all of the use of such property occurs in an OZone. This definition applies where the OZFund will own an asset, such as real property, directly rather than through a partnership or a corporation.

There are a number of important concepts bundled into this definition. The reference to Section 179(d)(2) restricts purchases from related parties, with a reduction in common ownership percentages contained in Sections 267 and 707 from “more than 50%” to “more than 20%.” This is clearly designed to prevent obtaining benefits from recycling assets among affiliated parties. The reference to Section 179(d)(2) also results in prohibiting acquisitions in carryover basis transactions such as contributions of property other than cash in exchange for stock in a corporation or interests in a partnership under Sections 351 or 721.

The Proposed Regulations and Rev. Rul. 2018-29 make clear that the purchase of real estate from an unrelated party is permitted where substantial improvements are not contemplated, but only if the property had not yet been placed in service by the seller, so that the original use of the property in the OZone commences with the OZFund. This should permit an OZFund to directly or indirectly acquire a property that had been developed and constructed for it, provided that the acquisition occurs before the property is placed in service. It should also include a property self-developed by the OZFund since construction costs incurred by the OZFund would be treated as a series of “purchases” from an unrelated party (the general contractor).

Where the property was owned by an unrelated party and used before it is acquired by the OZFund, the Proposed Regulations and Rev. Rul. 2018-29 eliminate the prior use issue by (1) concluding that land must always be deemed to have had use prior to an OZFund acquisition, (2) existing buildings also must be so classified whether or not their use will be changed by the OZFund (in the Revenue Ruling an abandoned factory is to be converted to multi-family residential use), but (3) new substantial improvements made directly or indirectly (i.e. through a lower tier corporation or partnership) by the OZFund will qualify as satisfying the original use requirement.

If the original building was owned before January 1, 2018, and is substantially improved after December 31, 2017, the Proposed Regulations do not provide that the requirement that the property be

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48 Prop. Reg. 1.1400Z-2(d)-1(c)(2)(i) and -1(c)(3).
49 Section 1400Z-2(d)(2)(B)(i) requires that stock must be received “at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash” while Section 1400Z-2(d)(2)(C)(i) does not refer to original issuance by a partnership. However, Prop. Regs. 1.1400Z-2(d)-1(c)(3)(i) provides that the interest must be “acquired by an OZFund after December 31, 2017 from the partnership solely in exchange for cash.” It is unknown, therefore, whether a partnership interest that is redeemed by a partnership then resold to an OZFund in a transaction characterized as a disguised sale of partnership interest under Section 707(b) will be excluded from classification as an OZInterest.
50 Section 1400Z-2(d)(3)(A).
52 Section 179(d)(2)(C)(i).
acquired after December 31, 2017, is satisfied. The rehabilitation expenditures will be “purchased” after December 31, 2017, but the land and existing building would not.

There are at least four distinct “substantially all” requirements embedded in the complex definitions associated with OZFunds and the entities that will issue OZStock and OZInterests. The first is statutory and relates to the percentage of an OZFund’s assets that must be located within a qualified opportunity zone. As mentioned already, the percentage is 90%, with periodic certification required, which we discuss below. But for entities issuing OZStock and OZInterests a separate “substantially all” asset location test determines whether they qualify as an OZBusiness. “Substantially all” of their assets must be OZProperty, but the statute does not set a percentage definition of what constitutes “substantially all.” Setting this number had major implications for how flexible the rules would be in allowing non-opportunity zone investment activity (whether inadvertent or intentional) to coexist with OZone business activity in the OZFund environment.

The Proposed Regulations adopt a 70% test for purposes of testing whether entities issuing OZStock or OZInterests are considered to be engaged in an OZBusiness and thus allow the OZFund to qualify. What this means is that an OZFund must really only hold a minimum of 63% of its assets in an opportunity zone, since it can hold 90% of its assets in OZStock and/or OZInterests, the issuers of which must hold 70% of their assets as qualifying opportunity zone business property. Treasury recognized this and in the Preamble to the Proposed Regulations invited comment on whether this approach to the “substantially all” asset location requirement was appropriate.

Two other “substantially all” components of the definition of an OZBusiness are also significant but no guidance was included in the Proposed Regulations, although sections of the Proposed Regulations are specifically reserved to address these and comments were sought. These arise from the requirement that during substantially all of an OZFund’s holding period for OZStock or OZInterests, the issuer qualified as an OZBusiness by satisfying the requirement that substantially all the use of the property was in the OZone. These requirements will generally apply to moveable tangible property but not to real estate, whose location of use is fixed.

With respect to the temporal aspect relating to an entity’s holding period for OZProperty, the issue is how the test will be applied when the entity does not have existing operations or assets when the OZFund invests, but intends to use OZFund capital to fund operations or acquire assets. The Proposed Regulations take much of the pressure off of this issue by providing a “working capital” rule modeled after Section 1397C(e)(1), permitting an OZFund that is developing a new business or constructing or rehabilitating real estate (or the entity representing an issuer of OZStock or OZInterests) to deploy its capital over a 31-month period provided that it has: (a) a written plan to utilize capital to create OZProperty; (b) establishes a written schedule of how the capital will be deployed in pursuit of this end, (c) and adheres to the plan and schedule.

### Limits and Benefits of Tiered Structures

Section 1400Z-2(d)(1) includes language which makes it clear that an OZFund may not invest in another qualified opportunity fund, or to put it another way, an investment by an OZFund in another qualified opportunity fund does not constitute qualified opportunity zone property. It is not obvious why it was thought necessary to include this provision other than perhaps the possibility that because only 90% of the assets of an OZFund need to be invested in qualified opportunity zone property, creating several tiers of OZFunds could effectively water down the 90% requirement. But this rule seems to be completely obliterated by the allowance that (a) there can be multiple owners of an entity issuing OZStock and OZInterests and (b) the assets of such issuers need only consist of 70% OZBusiness property.

It is true that potential ownership structures must be limited to two tiers of corporations or partnerships and that a taxpayer with the Old Gain must invest in the upper-tier OZFund. But it can be expected that OZFunds may be created that own interests in multiple entities each holding significant (but less than 30%) non-OZone assets as a means of financial diversification and yield creation. One can, nevertheless, imagine transactions in which a number of parties are involved and...
where their participation from a business standpoint otherwise would be reflected in several different tiers of ownership. In order to qualify under the Opportunity Zone rules, those tiers of ownership might need to be compressed and more taxpayers may need to be direct partners with one another in the same partnership in order to fit within the required structures.59

Real Estate as Qualified Opportunity Zone Property

Before issuance of the Proposed Regulations, the initial thinking was that the rules might be designed to insure that the Section 1400Z-2 tax benefit is made available primarily for new investments rather than the acquisition of existing businesses or existing property. Recognizing that all land predates 2018 and all existing buildings have been previously used, the rules contemplate that an OZFund can undertake construction of improvements and satisfy the post-2017 “substantial improvement” requirement by passing two basic tests.

First, new construction must involve expenditures creating new basis exceeding the cost of the property being improved and, second, the required expenditures must occur within 30 months of an OZFund’s acquisition of the opportunity zone property.60 Those principles seem reasonable since the object of the section is to promote economic growth, and while the way in which the Proposed Regulation defines these requirements might disqualify some investments that would promote growth within an OZone, we believe that approach taken was generally favorable to encouraging OZone activity within the constraints imposed by Congress in enacting the section.

Reg. 1.1400Z-2(d)-1(v)(4) provides helpful guidance concerning the improvement of tangible property. The Regulation provides that if an OZFund purchases a building located on land located entirely within an OZone, a substantial improvement to the purchased tangible property will be measured by the OZFund’s additions to the adjusted basis of the building. It will not be necessary to separately improve the land on which the building is located and, for purposes of the mathematical test, the adjusted basis of the land that is acquired can be ignored so that the minimum expenditure requirement will be satisfied with respect only to the basis of the acquired building.61

We think it is also clear that construction of a new building on raw land or construction of additional, but physically separate, improvements on land that has existing improvements qualifies, as this constitutes additions to basis of tangible property and the Preamble to the Proposed Regulations refer to “construction or rehabilitation” of real estate in discussing the substantial improvement concept. While it might be beneficial to get express language on this topic, it is not one we believe should give taxpayers or planners great concern as it seems wholly inappropriate to limit this type of activity.

Next, OZProperty, the key asset associated with an OZBusiness, whether owned directly by an OZFund or by an intermediate corporation or partnership, must be “used in a trade or business” of the OZFund or OZBusiness.62 For this purpose, the trade or business must satisfy the requirement of Section 1397C(b)(2) that at least 50% of the total gross income of the entity derived from the “active” conduct of the trade or business. This implies that real estate not used in an active trade or business will not qualify. This could apply both to real estate considered to be held as inventory or to real estate held for investment, such as triple net leased property, that is not regarded as involving sufficient owner activity to constitute a trade or business. Treasury clearly recognizes this issue but did not issue express guidance on the question in the Proposed Regulations.

In addition, consider a developer that has owned an existing warehouse that she was intending to redevelop as office space and apartments. Because of the location of the building, financing was difficult to attract and the development plans had not come to fruition. The building is now in an OZone and it should be much easier to raise capital given the tax benefits that will be available to potential investors through an OZFund. If the developer could create a partnership to own the property and admit an OZFund that is willing to make a $10,000,000 equity investment, which will fund rehabilitation and redevelopment of the building on the required 30-month schedule and in a sufficient amount to pass the “equal to cost” requirement, one would think that this is the type of investment that the OZone rules were intended to promote. But, the property in this example was acquired by the developer before 2018 and any transfer to a new partnership would presumably be via a non-recognition transaction, so the

59 One should consider whether the common structures that are necessary in order to create bankruptcy remote entities as borrowers will be compatible with these new OZone requirements.

60 Section 1400Z-2(d)(2)(D)(ii).


asset would not constitute OZ-Property.\textsuperscript{63}

Further, consider an operating business located in what is now designated as an OZone which has operated out of leased office space with three employees. First, the Proposed Regulations make clear that this business entity is not barred from qualifying as an OZFund or an issuer of OZStock or OZInterests simply because its existence predates enactment of Section 1400Z-2, but make clear that it must satisfy all the new requirements on a go-forward basis.\textsuperscript{64} The business has now developed a product that it would like to manufacture and will acquire by purchase or lease additional space in the building in which the offices have been located, will incur substantial costs to acquire equipment and will hire an additional 10 employees to handle the manufacturing of the product.

Again, one would think that this is exactly the type of business investment in an OZone that Section 1400Z was intended to promote. However, the fact that the business owned property, whether tangible or intangible, prior to that date that will not qualify as OZProperty raises a question as to whether the business will satisfy the definition of an OZBusiness under the "substantially all" test, since the value of the intangible property as of December 31, 2017, may have been too great. These ambiguities were not clarified in the Proposed Regulations but might be clarified in future regulations. Nevertheless, in the absence of such regulations, it would appear that an OZFund must be quite careful in making an investment in an entity that owns property or has conducted a business before January 1, 2018, and in some cases that will frustrate the intent of these provisions.

Self-Certification and the 90% Requirement

OZFunds will self-certify themselves as satisfying the definition requirements to be OZFunds according to certification procedures to be set out in regulations.\textsuperscript{65} As mentioned above, the definition of a "qualified opportunity fund" includes a requirement that at least 90% of the assets of the OZFund must be in qualified opportunity zone property on the last day of the first six-month period of the taxable year of the OZFund (i.e., June 30 for a calendar year taxpayer) and on the last day of the taxable year of the OZFund (i.e., December 31 for a calendar year taxpayer).\textsuperscript{66} Presumably this will require an annual filing with the IRS confirming that an OZFund satisfies the requirements. Although this requirement is not expressly provided in the Proposed Regulations, Treasury has issued Form 8996 in draft and the form clearly contemplates an initial, and then annual, filing by entities certifying themselves as OZFunds.\textsuperscript{67}

The Regulations include a special rule for the first taxable year in which the self-certification may identify the first month in that initial taxable year in which the OZFund wants to be treated as a "qualified opportunity fund." In the first year of the OZFund’s existence, the OZFund will be tested six months after the month in which its eligibility commenced or December 31 if the eligibility began on or after July 1 of that year.\textsuperscript{68}

Some commentators have asked how the semi-annual testing periods for OZFund qualification relate to the date of an individual taxpayer's investment in the OZFund. We think the statute is clear; the testing is done at the mid and end points of the OZFund’s fiscal year and does not relate to or change with the date of a taxpayer’s investment in the OZFund.\textsuperscript{69} The Proposed Regulations make clear, however, that taxpayer investments in an OZFund prior to the first month that the OZFund qualifies as an OZFund do not qualify for the Section 1400Z-2(a)(1) Deferral Benefit.\textsuperscript{70}

If the OZFund fails to satisfy the 90% requirement, the OZFund is obligated to pay a penalty for each month that it fails to meet the requirement, but is not disqualified as an OZFund and does not lose the potential Exclusion Benefit. The penalty is calculated based on the excess of 90% of the amount of the assets in the OZFund over the aggregate amount of the "qualified opportunity zone property" held by the OZFund, multiplied by the underpayment rate established under the IRC for such month. This penalty, in effect, chips away at the Deferral Benefit until December 31, 2026, but does nothing to mitigate or take away the Exclusion Benefit. By the standards of penalty provisions in the IRC, this one is particularly gentle, as the currently applicable interest rate under Section 6621(a)(2) is about 6.0% per annum.

Further, Treasury is directed to adopt rules that provide for a reasonable cause exception to application of the penalties and to adopt rules allowing OZFunds to re-

\textsuperscript{63} There are related party rules that would prevent the existing developer who owns the building from selling the building to a new partnership in which the OZFund would invest if the developer maintains a 20% or greater capital or profits interest in the purchasing partnership.
\textsuperscript{64} Prop. Reg. 1-1400Z-2(d)-1(a)(3).
\textsuperscript{65} Section 1400Z-2(e)(4).
\textsuperscript{66} Section 1400Z-2(d)(1).
\textsuperscript{67} See Form 8996, Part I, Item 3.
\textsuperscript{68} Reg. 1.1400Z-2(d)-1(a)(iii).
\textsuperscript{69} Section 1400Z-2(d)(1).
\textsuperscript{71} Section 1400Z-2(f)(3).
main qualified after disposing of qualifying assets if they reinvest in qualifying replacement assets. The Preamble to the Proposed Regulations indicates that this issue will be addressed in future regulations. This latter provision suggests an intent to utilize some sort of rollover regime potentially akin to Sections 1031 (requiring sequestration of sales proceeds) or 1033 (no sequestration required). At present it is unknown how this reinvestment regime will operate, as the Proposed Regulations do not address the subject, including the time that will be permitted for reinvestment of sale or exchange proceeds into substitute qualifying property in order for an OZFund to retain its qualification as such.

If an OZProperty is disposed of in a taxable transaction and the gain is allocated to the OZFund and the investor, the benefit of regulations that allow the funds to be retained at the OZFund level and reinvested in other qualifying assets may be of relatively little benefit. However, it is possible that what is intended by this direction to Treasury to adopt regulations is a regime in which a taxable disposition of OZProperty would not result in the recognition of gain that would be passed through to the OZFund and the investor. This would be a very powerful tool that would make it more likely that OZFunds could be organized with the intention to own multiple assets and to have a shorter investment horizon than the 10-year period that otherwise would be required under Section 1400Z-2.

Constituencies
The OZone rules speak to at least three different constituencies that will find this new incentive to be attractive. The first is investors that have built-in gains on existing assets ("Investors") for which the strategies of deferral or avoidance of tax on the gain would otherwise be limited to the basis step-up upon death pursuant to Section 1014 or like-kind exchanges under Section 1031, for certain types of property. Like-kind exchange transactions are not geographically limited as the OZone provisions are. However, in order to defer all gain using a like-kind exchange transaction taxpayers must reinvest the full amount realized from the disposition of property, rather than just the gain component that is realized. Further, in the post-TCJA world, Section 1031 offers deferral only for certain real property assets while OZone transactions will apply to gain realized from the disposition of all sorts of assets that would never have been eligible for a like-kind exchange transaction, such as the sale of marketable securities, or that are no longer eligible, such as aircraft or art.

The second constituency is the owners of businesses located in OZones ("Sponsors") that are expected to find it easier to raise capital, and presumably will find that the cost of such capital will be significantly reduced. One would expect that the necessary preferred returns that would be paid on private equity coming into investments in qualified OZones will be reduced from current levels to take into account the fact that the returns can be delivered on an after-tax basis to Investors. The extent to which that tax benefit is captured entirely by Sponsors, rather than Investors, will depend upon the way in which the markets for OZone investments develop. An additional benefit to a Sponsor is that its own equity participation in the business or real estate project may also be eligible for the avoidance of tax on New Gain, to the extent that the business owner contributes capital to its own business after it has disposed of property on which Old Gain was realized.

The third constituent category consists of the intermediaries who are in the business of raising funds and investing those funds ("Fund Organizers"). In OZone transactions, Fund Organizers could raise funds from Investors and the OZFunds would invest in projects that are located in OZones. The typical taxpayer who might realize Old Gain from the disposition of marketable securities is probably not well positioned to identify investment opportunities in operating businesses or real estate projects that will be located in OZones. There are several different categories of Fund Organizers that could find these transactions attractive, but each of them will have to adjust to some of the peculiarities of the OZone program. First, there are tax credit syndicators, who are already involved in raising capital for investment in projects that generate low income housing tax credits, historic tax credits, or various types of state tax credits, who will be familiar with many of the developers of projects into which an OZFund might want to invest. However, these syndicators generally have raised capital from large financial institutions, particularly where Community Reinvestment Act benefits are sought. Large financial institutions are probably not the ideal target market as Investors in an OZFund. That will be a disadvantage for the tax credit syndicators who will need to raise capital from a different class of investors.

72 Section 1400Z-2(e)(4).
Second, there are private equity funds that have traditionally raised capital from high net worth individuals. But private equity funds are not traditionally accustomed to investing in projects that are located in disadvantaged communities and may not have initially the relationships with potential Sponsors for the type of projects that the OZFund must invest in. Further, taking advantage of the Exclusion Benefit will require patience from private equity funds that are not typically accustomed to holding their investments for at least 10 years.

A third category of Fund Organizer may be the current (or in some cases former) organizers of tenancy-in-common and Delaware Statutory Trust transactions targeted to property sellers looking for replacement property qualifying under Section 1031. The advantage here is that there already has been a focus on the deferral of gain from one investment into a new investment that may provide a segue into the OZone sector.

Opportunity Zone Funds With Multiple Assets

One of the potential impediments for any Fund Organizer will be the complications that would result from having a single OZFund own multiple investments. Without regard to the specific OZone rules, the ability to raise large sums of capital from numerous investors and have the OZFund invest those monies in a diversified portfolio of investments likely will be the most desirable model for Fund Organizers. However, recall that under the OZone rules the Exclusion Benefit is not available when gain is realized from the disposition by the OZFund of its investment in a property or an entity, since the OZFund's investment itself is not eligible for the Deferral Benefit. Rather, the Investor in an OZFund will realize the Exclusion Benefit when disposing of its interest in the OZFund and that disposition ideally will occur before there has been any disposition of property on which gain was realized below the OZFund level.

This means that unless regulations provide a reinvestment route that avoids current gain recognition on asset sales, a multi-asset OZFund would not be able to sell its investments and reinvest those proceeds or distribute the net proceeds to the Investors. Instead, all of the original Investors will want to dispose of their interests in the OZFund before the OZFund disposes of any of the properties owned by the OZFund. When this is combined with the requirement that the investments in the OZFund must be held for a total of 10 years before the significant tax benefits can be realized, it creates an investment model that is very different from today's typical private equity fund market. Investments in the OZFund will need to be more patient money with an expected investment period of more than 10 years and the OZFund's investment in various properties will also need to be long-term investments of at least 10 years.

As with conventional real estate or other investments, there is the possibility that some of the value created on appreciation of the OZone business properties held by the OZFund could be realized by an OZFund through a refinancing transaction during the 10-year pre-Exclusion Benefit period that will not trigger gain but would generate net proceeds that could be either re-invested by the OZFund in other OZProperty, or perhaps could be distributed to its investors as a partial return of their capital.

The latter approach raises the tax issue of whether the distribution of refinancing proceeds from an OZFund to an Investor will be treated as a partial return of the initial capital investment made by the Investor in the OZFund prior to the expiration of the 10-year Exclusion Benefit period so that the Investor will not be eligible for the step up in basis pursuant to Section 1400Z-2(c). The language in that subsection refers to an investment held by the taxpayer for at least 10 years and it is possible that the position of the IRS will be that the entire investment has to be held for the applicable period even though one could argue that the investment in the OZFund continues to be held even if cash distributions are made by the OZFund to the Investor, provided that the Investor's ownership stake in the OZFund has not been reduced.

We presume that refinancings will not be possible during the first two years following an investment in an OZFund since distribution of cash could be viewed as a partial redemption of the OZFund interest held by an Investor, which would disqualify the investment pursuant to the limits incorporated into Section 1400Z-2 by its inclusion of the qualified small business stock definition found in Section 1202(c)(3) and the express application of these principles to both OZStock and OZInterests.

But what of distributions that are made from operating cash flow of the OZProperty where the OZFund is a partnership? If the OZFund were a corporation and the distribu-

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73 There is no apparent benefit to another category of investors in private equity funds: tax-exempt pension and endowment funds.

74 Section 1400Z-2(d)(2)(B).
tion would be treated as a dividend, presumably the dividend would not be treated as a partial redemption of the OZFund interest held by an investor. Distributions of operating cash flow by a partnership that are akin to a dividend should be treated the same way. What about refinancing proceeds generated after the first two years following an investment in an OZFund? Absent regulations, it would seem that the safer course would be to assume that such distributions could not be made without jeopardizing the full Exclusion Benefits. Perhaps regulations that address the potential reinvestment of assets will provide a useful mechanism for reinvesting excess refinancing proceeds which are not immediately distributed by the OZFund to its Investors.

**Single Asset Funds**

Because the trigger of the Exclusion Benefit is the disposition of the Investor’s interest in the OZFund, and not a disposition by the OZFund of its interest in the OZProperty, at least initially it will be easiest to create OZFunds that hold single assets so that the underlying properties can be disposed of after 10 years by a sale of all of the interests in the OZFund to an unrelated party. It is not uncommon for asset acquisitions to be structured for other purposes as the acquisition of all of the interests in an entity that owns the asset and, while acquiring interests in an entity may be somewhat less desirable for a prospective purchaser because it will be taking on potential liabilities of the entity, this is a common enough transaction structure that we would assume that it would not pose any significant problems for OZone transactions.

From a federal income tax standpoint, the acquisition of all of the interests in a limited liability company taxed as a partnership in a single transaction will be treated as an asset acquisition for the purchaser pursuant to Rev. Rul. 99-6, Situation 2. From the standpoint of the Investor in the OZFund, it will be treated as selling its partnership interest in the OZFund in accordance with Section 741. The purchaser of the interest in the OZFund from the Investor will be treated as acquiring the asset owned by the OZFund if the purchaser acquires all of the interests in the OZFund simultaneously. In transactions in which the Sponsor will invest some of its own capital and unrelated outside investors will invest capital as well, it is likely that the Sponsor will create its own OZFund and the outside investors will invest through a separate OZFund. In this way, after the 10-year period, the Investors would have the opportunity to sell their interests in their OZFund even if the Sponsor intended to continue its ownership interest in the OZ-Property owned by the OZFund.

**Potential for “Mid-Co” Accommodation Structuring**

It is also possible that a market will develop 10 years from now where financial institutions will, for a fee, act as accommodation parties to acquire an Investor’s interest in an OZFund before the OZFund disposes of its investment in OZ-Property in a taxable transaction. The accommodation party would be a partner in the OZFund when gain is realized from the disposition of the OZProperty, such gain would be allocated in part to the accommodation party, and the basis of the accommodation party in its interest in the OZFund would be increased accordingly. The gain that is realized by the accommodation party could then be offset by a loss that would be triggered from the liquidation of the OZFund after the qualified OZ-Property had been sold.76

Section 1400Z-2(e)(4) instructs the IRS to prescribe regulations that may be necessary or appropriate, including anti-abuse rules and rules that would provide an OZFund with a reasonable period of time to reinvest a return of capital that it receives from investments that are sold or disposed of. The latter issue is a somewhat odd one because, to the extent the OZFund makes a taxable disposition of its interest in OZProperty during the 10-year period, the gain that is realized is not protected by the step up in basis that is generally provided under Section 1400Z-2(c). In other words, a taxable disposition by the OZFund spoils the potential tax benefit that would be realized by a disposition by the Investor of its interest in the OZFund. Nonetheless, there could be circumstances in which there is a sale or disposition that does not generate significant gain and where the OZFund would like the opportunity to reinvest the cash proceeds into a new OZProperty which could...

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75 Nevertheless, the authors are aware that several multi-property OZFunds are currently being marketed and have received widespread press coverage, so it is clear that such multi-asset funds will also be available. At present it is not clear how they intend to handle the issues associated with fund-level sales, either before or after the 10-year mark, that are discussed in this article.

76 The liquidation of the OZFund that would trigger the offsetting loss to the accommodation party would be facilitated if the OZFund owned an interest in a single OZProperty and was not a multi-asset OZFund. There would obviously be tax issues raised by this structure including how long the accommodation party would need to hold its interest in the OZFund in order to be respected as the owner of that interest at the time that the OZ-Property is disposed of, and whether at the time the accommodation party purchased the Investor’s interest in the OZFund, the OZProperty could be marketed for sale or perhaps even be under an agreement of sale.
then continue to be held by the OZFund through the end of the 10-year period.77

Section 1400Z-2 does not specifically address how an OZFund should operate as a partnership for tax purposes and it would seem that one should assume that whatever business arrangement is agreed to among the members of the OZFund, or between OZFunds that are partners in a qualified opportunity zone partnership, will be respected for federal income tax purposes. For example, if the Sponsor has negotiated with potential equity Investors to allow the Investors to receive a return on their capital and a return of their capital with the residual cash flow and gain from sale to be shared 50% to the outside Investors and 50% to the Sponsor, if the Sponsor holds its 50% residual interest through an OZFund into which the Sponsor contributed cash equal to its Old Gain from the taxable disposition of assets and makes the election, it is quite possible that the amount of New Gain that would be avoided by a later disposition of the Sponsor’s interest in its OZFund could be quite disproportionate to the Old Gain that was deferred by the Sponsor via its investment in the OZFund and quite disproportionate to the amount of capital that was contributed to an OZFund by the unrelated equity Investors in the Sponsor’s project.

One would assume that an investment in an OZFund of perhaps $100,000 by the Sponsor would be respected as substantial enough for federal income tax purposes and it is possible that the New Gain that would be realized by the Sponsor after 10 years from the disposition of its interest in the OZFund representing a 50% residual interest in the OZProperty owned by the OZFund could be many millions of dollars. There is nothing in Section 1400Z-2 that would prevent this result or impose any sort of limitation on the amount of New Gain that could be avoided by the step up in basis that is provided under Section 1400Z-2(c).

Utilizing Losses

Section 1400Z-2(b)(2)(B)(i) provides that the tax basis of the Investor in its interest in the OZFund will be $0. To the extent that the capital contributed to the OZFund equals Old Gain where the recognition of that Old Gain is being deferred until December 31, 2026, it is easy to see why the Investor should not be given basis credit for a capital contribution by including the amount of the contribution. But, as noted earlier, there are at least two circumstances where OZFund Investors will have positive basis. First, they will obtain basis from the increases of 10% and 5% of their Old Gain when holding an OZFund investment beyond seven years and the remaining 85% of Old Gain when it is recognized on expiration of the Deferral Benefit Period. Second, when the OZFund is a partnership that makes direct or indirect (i.e., through an OZInterest) investment in OZProperty which could be financed with debt, the OZFund’s share of the debt would be included in the outside basis of an Investor.

The Proposed Regulations seem to confirm Treasury’s view that Section 1400Z-2(b)(2)(B) was not intended to say that no basis is available to the Investor in the OZFund with respect to its share of partnership debt, but rather that the provision was intended to refer only to the basis that would be generated from the cash capital contribution itself because of the deferral of the Old Gain. Therefore, to the extent that the OZFund is a partnership that is allocated tax losses with respect to its investment in OZProperty, and those losses pass through to its Investors, one would think that the Investors will be able to utilize those losses against the tax basis of their interests in the OZFund derived from a share of partnership nonrecourse debt.

This leads to a further conundrum. After a period of 10 years and having claimed tax losses that pass through from the OZFund, Investors may have significant negative capital account balances with respect to their interests in an OZFund. When they dispose of these interests in the OZFund after 10 years, how are we to interpret the provision in Section 1400Z-2(c) which says “in the case of any investment held by the taxpayer for at least 10 years and with respect to which the taxpayer makes an election under this clause, the basis of the property shall be equal to the fair market value of such property.”

Will this step up in basis eliminate gain only on the economic appreciation of the investment in the OZFund or will it, in effect, wipe out the gain that would be realized with respect to the negative capital account balance of the Investor in deferral of gain so that a multi-asset OZFund would be permitted to reinvest sale proceeds in a new investment without allocating gain realized from the sale to the taxpayers who are investors in the OZFund.

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77 The Preamble to the Proposed Regulations indicates that future regulations will provide guidance on the reinvestment of the return of capital from investments in OZStock, OZInterests and proceeds received from the sale or disposition of OZProperty. The Preamble mentions that these rules may be helpful in allowing an OZFund to bring itself into compliance with the 90% asset test, but there is probably much more at stake with these rules as they would apply to the potential
the OZFund? If the answer is that the negative capital account would be wiped out as well by the basis step up, the OZone rules will be particularly favorable for investments in OZProperty that is debt financed real estate that generates tax losses during the 10-year holding period. Those investments will receive even greater tax benefits than an investment that would be made in an OZProperty that does not generate tax losses, that is made in an operating business that does not generate significant depreciation deductions, or is made in an OZFund that is a corporation.

4. How are the various references in Section 1400Z-2 to “substantially all” to be interpreted?

5. What “reasonable cause” will allow an OZFund to avoid imposition of penalties for failure to meet the 90% test?

6. What is the effect of cash distributions by an OZFund, either from operating cash or debt financing, on continued availability of the Deferral Benefit or availability of the Exclusion Benefit?

Conclusion

We are at the very beginning of the process of creating markets for the use of OZones and there are certainly a number of significant questions as to how these markets will develop and how some of the technical issues under Section 1400Z-2 will be resolved. We would submit, however, that for a brand-new provision that received virtually no attention during the very short period of time between its introduction in the Senate Bill and its enactment about 20 days later, Section 1400Z-2, as implemented through the first round of guidance promulgated by the Treasury Department, appears to be workable and well thought out. It has borrowed certain concepts from other provisions of the IRC, including the NMTC, but much of its structure is novel. As a result, tax and investment planners will have to learn to travel on the Yellow Brick Road with regard to some of the questions that will hopefully be addressed in future regulations or other published guidance. Time will tell whether the OZone rules will unleash significant additional capital investment in OZones in a way that will equalize the economic fortunes of different geographical locations within our country. Time will also tell whether the promises of deferral and exclusion available in the Emerald City of OZones will be utilized largely by syndicators who will find that capital is easier to raise by utilizing single asset OZFunds or whether in time the fund organizers in the business of amassing capital for investment will figure out ways in which to pool the resources of many Investors in multi-asset OZFunds. The latter approach may require some helpful regulations from the IRS but, ultimately, we expect to see both types of investment vehicles finding a place in the array of investment options that will doubtless be spawned by the OZone tax regime.

Recap of Issues for Regulations

In preparing this article, we identified a plethora of questions about what gain and whose gain can be deferred through investment in OZFunds, how to structure OZFunds, and how to monitor their operations to preserve both the Deferral Benefit and qualify for the Exclusion Benefit. Some of these have been answered by the Proposed Regulations and others will be addressed in future regulations. Among the open issues worthy of future guidance are:

1. Is it possible that the gain realized from the disposition of an OZBusiness can be reinvested without the gain being allocated to the taxpayers who invested in the OZFund?

2. What limits will apply to create classes of interests in an OZFund designed to give losses to non-Deferral Benefit investors and gains to Exclusion Benefit investors?

3. What circumstances, if any, allow qualified investments to be made to improve property owned prior to January 1, 2018?

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In order to qualify . . . tiers of ownership might need to be compressed and more taxpayers may need to be direct partners with one another in the same partnership in order to fit within the required structures.

The rules contemplate that an OZFund can undertake construction of improvements and satisfy the post-2017 “substantial improvement” requirement by passing two basic tests.

OZFunds will self-certify themselves as satisfying the definition requirements to be OZFunds according to certification procedures to be set out in regulations.

The OZone rules speak to at least three different constituencies that will find this new incentive to be attractive.

At least initially it will be easiest to create OZFunds that hold single assets so that the underlying properties can be disposed of after 10 years by a sale of all of the interests in the OZFund to an unrelated party.

It is possible that a market will develop 10 years from now where financial institutions will, for a fee, act as accommodation parties to acquire an Investor’s interest in an OZFund before the OZFund disposes of its investment in OZ-Property in a taxable transaction.