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# **The Road Map to OZ: Just Follow the Yellow Brick Road**



**D&S Opportunity Zone Practice Group**  
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The long-awaited and much-anticipated Proposed Regulations on investing in Qualified Opportunity Funds were released by Treasury on Friday, October 19, 2018. They did not answer every open question (and, in fact, they raised a few new ones), but overall the Proposed Regulations did contain a number of helpful clarifications. The D&S Road Map has a few more guardrails in place – follow the signs carefully and pay attention! It is going to be quite a ride over the coming months as these regulations are finalized and new guidance emerges.<sup>1</sup>

### **A QUICK REVIEW**

There is a bundle of tax benefits available to investors who invest in Opportunity Zones (the “OZ Program”). As a quick reminder, the OZ Program was introduced into the Internal Revenue Code (the “Code”) as part of the 2017 Tax Reform. Here is the timeline and the associated tax benefits:

1. An investor sells an existing appreciated asset.
2. The investor invests the gain portion of the sale proceeds into a Qualified Opportunity Fund (“QOF”) within 180 days.

**TAX BENEFIT #1** – The investor defers the entire amount of the gain that is reinvested into the QOF.

3. The investor pays tax on the deferred gain at the earlier of (i) the sale of its interest in the QOF, or (ii) December 31, 2026.

**TAX BENEFIT #2** – If the investor has held its QOF interest for at least 5 years, 10% of the deferred gain is permanently forgiven. If the investor holds its QOF interest for at least 7 years, an additional 5% (for a total of 15%) of the deferred gain is permanently forgiven. (Note that to get the 7 year benefit, an investor must invest in a QOF no later than December 31, 2019.)

4. The investor sells its interest in the QOF at exit.

**TAX BENEFIT #3** – If the investor holds its QOF interest for at least 10 years, there is no tax at all on the gain realized by the investor at exit.

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<sup>1</sup> Our May 2018 White Paper (to read, please click [here](#)) explains the OZ Program generally, with numerical examples to illustrate the tax benefits. Our subsequent August 2018 White Paper (to read, please click [here](#)) addresses many of the timing and structuring considerations relevant to QOFs given the nature of the IRS requirements.

## YOU NEED A TICKET TO RIDE: INVESTING IN A QOF

The only way into the OZ Program is to have an entry ticket. An investor can only take advantage of the OZ Program tax benefits if that investor has sold an existing appreciated asset to trigger a gain. The Proposed Regulations included some fine print for ticketholders:

*You Must Be This Tall to Ride: Capital Gains Only Please*

The Proposed Regulations clarified that only capital gains are eligible for reinvestment into a QOF, so any income treated as ordinary (dealer income, etc.) does not qualify. However, both short-term capital gain and long-term capital gain will get you in. Any amount treated as capital gain should qualify (including capital gain from an actual or deemed sale or exchange), so “1231 gain” from the sale of real estate used in a trade or business would be eligible. Note that some of the timing elements involved in calculating 1231 gain will require clarification, so stay tuned for further updates here.

*Not So Fast: Depreciation Recapture Likely Not Eligible for Reinvestment*

Although the Proposed Regulations did not specifically address depreciation recapture, those amounts are included as ordinary income so assume for now they will not be eligible for reinvestment.

*You Can Leave Your Partners Behind: Reinvesting Partnership Gains*

Perhaps the biggest win on the investor side in the Proposed Regulations is the flexibility for partnerships that sell an asset. The language in the Code was not clear on whether the selling partnership had to reinvest the gain into a QOF or whether an uptier partner would be allowed to do so. The Proposed Regulations generously said... either one!

Keep some timing elements in mind though:

- If the partnership wants to reinvest capital gain from a sale into a QOF, the 180-day period for the partnership begins on the date that the partnership sells or exchanges the asset and realizes the gain.
- If the partnership does not want to reinvest the capital gain into a QOF, any of the partners can invest their share of the capital gain into a QOF to defer tax on that gain. In that case, the default rule is that the partner’s 180-day period does not begin until the last day of the partnership taxable year in which the realization event occurred. Alternatively, if the partner knows that the capital gain was realized by the partnership and knows that the partnership is not going to invest that gain into a QOF, the partner may elect to treat its own 180-day period as being the same as the partnership’s 180-day period (thus, it would begin on the date of the realization event).

For example, if Partnership ABC has a calendar year taxable year and realizes a capital gain on February 1, 2019, Partnership ABC could invest that gain into a QOF within 180 days of February 1, 2019. If Partnership ABC decides not to invest the gain into a QOF, any of the partners in Partnership ABC can invest their shares of the gain into a QOF within 180 days of December 31, 2019 (the end of Partnership ABC's taxable year).

Alternatively, if the partners know about the capital gain and they know Partnership ABC is not going to invest the gain into a QOF, any of the partners can invest their share of the gain into a QOF within 180 days of February 1, 2019 if they want to invest sooner.

Either of these timeframes could still be tight if partners do not know about capital gains realized by the partnership, so increased communication between partnerships and their partners will be key to making this work.

#### *You Can Go Your Own Way: QOFs vs 1031*

There are plenty of differences between a 1031 exchange and a QOF investment, but one point to note here is that QOFs now have an edge over 1031's for partnerships that sell assets when the partners want different outcomes. The 1031 rules only permit the partnership to do a 1031 exchange, but the QOF rules allow each partner to choose on its own whether to invest its share of the gain into a QOF. Breaking up has never been easier.

### **CHECK YOUR MIRRORS: SETTING UP A QOF**

The OZ Program requires investors to invest into a QOF. None of the tax benefits are available if you invest directly in property in an Opportunity Zone. Luckily, the Proposed Regulations made it a bit easier to get your QOF up and running.

#### *Choose Your Path: LLCs are Okay*

One of the easy crowd-pleasers in the Proposed Regulations is an acknowledgement that LLCs can be used as QOFs, and also as lower tier partnerships or corporations (as long as the LLC makes any required "check the box" elections).

#### *Removing Some Roadblocks to Puerto Rico: Local Law Entities are Okay Too*

There was some uncertainty on how to structure QOF investments into Puerto Rico (and the other US territories), since the Code required that domestic entities be used in certain instances. The Proposed Regulations make clear that you can use local law entities as long as the underlying investment is in an Opportunity Zone in that jurisdiction.

### *This Way to Self-Certification: IRS Form 8996*

The QOF self-certification form and draft instructions were also released with the Proposed Regulations. An entity self-certifies as a QOF, so there is no initial approval process by the IRS.

Another big win from the Proposed Regulations is that an eligible entity can choose which month in its initial taxable year that entity wants to start being a QOF, which does not have to be the first month in which the entity is created. So, an entity can be created and can begin certain tasks (getting permits, maybe zoning applications, etc.) and then choose a later month that year just before admitting QOF investors to be considered a QOF. This allows a QOF to delay the start of its first 6-month testing period until it has investors and can put their cash to use.

The form doubles as a reporting tool, so the QOF will need to file IRS Form 8996 every year to report compliance with the 90% asset test.

### *Pump the Brakes! December 31st is Always a Testing Date*

If you certify your QOF at any time in the first half of the year, you have a full six months before the first 90% asset test is measured. However, the last day of the taxable year is always a testing date. So, do not rush into setting up a QOF in the next few months unless you have a plan to invest those QOF dollars into an eligible project in an Opportunity Zone before the end of the year.

### *Don't Veer Off Course: Penalties and Possible Decertification*

We can expect additional guidance in the next round of regulations on penalties for a QOF's failure to meet the 90% asset test, but the preamble did flag a new element to the rules – a QOF can lose its status as a QOF. Previously, the only consequence of failing to meet the 90% asset test was a monetary penalty and there was no indication that a QOF could ever “blow up”, so this has the potential to be a significant issue.

Given the critical tax benefits at stake, the introduction of a QOF decertification concept is alarming to say the least. If you are marketing a QOF and its tax benefits to investors, this could be a crucial disclosure point. Until we know more, use best efforts to comply with the OZ Program rules. Future regulations will specify what conduct may lead to decertification, so we will monitor this closely.

## **DON'T FIX WHAT ISN'T BROKEN: STICK WITH THE “TWO TIER” STRUCTURE**

As we explained in our [August 2018 White Paper](#), there are two basic structures set out in the Code. The first is a single tier structure where the QOF holds the property directly. The second is the “two tier” structure, where the QOF holds an interest in a lower tier partnership or corporation (in either case, a “JV Entity”), and the JV Entity holds the property. A QOF cannot own another QOF.

The Proposed Regulations retained the benefits and flexibility of the two tier structure, so stick with it. Here are some of the highlights.

- Rather than the strict 90% asset test that applies at the QOF level, only 70% of the JV Entity's tangible property needs to be qualifying property.<sup>2</sup>
- The JV Entity is permitted to have intangible property, as long as a substantial portion of that intangible property is used by the JV Entity in its trade or business.
- The JV Entity can have a reasonable amount of working capital (more on that below).

The major reveal in the Proposed Regulations was benchmarking the JV Entity's tangible property requirement to 70%, since the Code contained a vague reference to "substantially all".

## **SETTLING IN FOR THE RIDE: DEVELOPING YOUR OPPORTUNITY ZONE PROJECT**

Once your investors are lined up, your structure is in place and you have a site in an Opportunity Zone, it is time to get to work. The JV Entity (or QOF if you have a single tier structure) has to pick one of two paths: Original Use or Substantial Improvement.

### *Nothing But Empty Road Ahead: Ground Up Development as Original Use*

Despite the fact that ground up development should be a clear winner in the OZ Program, Treasury punted to future regulations any clarification on exactly how to meet the original use test. Although no one believes that ground up development will be problematic under the OZ Program, the lack of guidance on the original use test is troublesome, especially with respect to timing requirements.

In light of these uncertainties, each project will have to be evaluated individually for compliance with the original use test.

### *Construction Ahead: Substantial Improvement*

If the property acquired in an Opportunity Zone includes land and a building, you will have to meet the substantial improvement test. That test is defined in the Code to require the JV Entity (or QOF in a single tier structure) to double its basis in the property in a 30-month period. The Proposed Regulations (along with a Revenue Ruling that was released the same day) softened up the requirements so that only the basis in the building needs to be doubled. The basis in the land does not need to be doubled, and the land does not need to be separately improved.

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<sup>2</sup> The OZ Program definitions, both in the Code and in the Proposed Regulations, can be cumbersome and tedious to work through. We have simplified the analysis here for purposes of this white paper, but please be mindful that there are plenty of nuances to the analysis.

For example, assume a QOF buys a property consisting of land and a building for a total of \$100. If 60% of the purchase price is attributable to the building and 40% is attributable to the land, the QOF only needs to invest an additional \$60 in the building to meet the substantial improvement test.

The acquisition cost basis of the property will need to be allocated between the land and the building on arm's length terms to avoid any abuse in application of the rules.

#### *Fueling Up: Reasonable Working Capital*

One of the big concerns for real estate deals was how to meet some of the OZ Program tests in the early years of a development project. Both ground up development and significant renovations take time and money, which are two potentially problematic factors for the OZ Program requirements. Although the Code baked in a rule that permits a JV Entity to keep a reasonable amount of working capital, no one was sure what that would mean in practice.

The Proposed Regulations helpfully included a Working Capital Safe Harbor specifically for real estate projects. There are three requirements for cash or other financial property held by the JV Entity to qualify as reasonable working capital:

- First, there must be a written plan that designates the funds as being held for the acquisition, construction, or substantial improvement of tangible property in an Opportunity Zone.
- Second, there must be a written schedule for the planned use of the funds in a commercially reasonable manner within 31 months of receipt by the JV Entity.
- Third, the JV Entity has to actually use the funds in a manner that is substantially consistent with the schedule.

There is a corresponding OZ Property Safe Harbor which says that, if the JV Entity meets the requirements of the Working Capital Safe Harbor, the property which is being constructed or improved with that working capital will be considered to meet certain qualifying tests (such as the original use test or the substantial improvement test) while the construction or improvements are still in progress.

Comments were specifically requested by Treasury on these safe harbors, so we suspect they will be flooded with comments and suggestions to make this workable for the real estate industry. Until we know more, be mindful of these timeframes.

#### **YOUR EXIT IS COMING UP: CLAIMING THE 10 YEAR BENEFIT**

The brass ring for investors in the OZ Program is the so called "10 Year Rule" mentioned above as tax benefit #3. Under the 10 Year Rule, if the investor holds its QOF interest for at least 10 years, there is no tax at all on the gain realized by the investor at exit.

The 10 year mark is the minimum hold, and before last week no one knew just how long you could let appreciation sweeten your upside. The Proposed Regulations included a finite end-date though – you have to cash out of your QOF by 2047 to claim the benefits of the 10 Year Rule. Treasury specifically noted that they were open to suggestions in case anyone wants to hold their QOF interest past 2047, so this may get an update when the regulations are finalized.

### **KEEP YOUR SEAT BELT FASTENED: OPEN QUESTIONS AND FUTURE GUIDANCE**

The Proposed Regulations were the first round of guidance out of Treasury, so these rules may change, and additional regulations will be issued. However, Treasury very helpfully included provisions permitting taxpayers to rely on the Proposed Regulations as drafted as long as the Proposed Regulations are implemented consistently. This means you can set up a QOF structure according to the guidelines set out in these Proposed Regulations and you are protected even if future regulations change the rules.

Here are some of the open questions and issues still swirling around:

- The Proposed Regulations did not modify the general rule in the Code that investors must sell their QOF interests in order to claim the benefits of the 10 Year Rule. For now, we strongly suggest that you continue to assume that an entity sale will be required. As a result, a traditional fund structure with multiple properties is not a straightforward fit for the OZ Program (since then all of the properties would need to be sold at once to a single buyer of the QOF itself at exit), but we are working with our clients regarding how to achieve similar outcomes given these constraints.
- Another set of “soon-to-be-released” proposed regulations will provide guidance on the ability of a QOF to reinvest the return of capital and proceeds if interim sales of property occur, and the taxation of those gains to the QOF or its investors.
- A QOF is permitted to be a partnership with special allocations, so presumably a partner in a QOF can be paid a promote through the QOF. There has been a lot of chatter about whether the 10 Year Rule benefits can apply to a promote that is tied to a QOF interest, in which case the entire promote could be tax-free. There were no explicit anti-abuse rules included in the Proposed Regulations, so the ability to claim the benefits of the 10 Year Rule on the promoted interest is still a question mark. We do expect future regulations to include anti-abuse rules, so stay tuned on this point.
- Another favorite pre-Proposed Regulations question was whether a QOF would be permitted to refinance its property and send cash back to investors. The Proposed Regulations did not explicitly address the treatment of refinancings and the ability of QOF investors to receive distributions of refinancing proceeds. The preamble however did acknowledge the general tax basis rules that apply to debt of a partnership, so it appears that distributions of refinancing proceeds should be permitted, but additional clarity on this point would be welcome.



- The timing implications of the OZ Property Safe Harbor need to be clarified. As discussed above, that safe harbor allows a JV Entity to meet certain qualifying tests with respect to its property while that property is being constructed or improved. However, a narrow reading of the language of the OZ Property Safe Harbor might mean that the project has to be completed within the 31 month time period for the Working Capital Safe Harbor, and it is not clear whether Treasury intended to impose this restriction. It is unclear how likely this reading is to be accepted; however, in view of the potential downside, we recommend additional care to comply with the 31 month time period, just in case.
- As noted above, the original use test remains undefined.

The Proposed Regulations covered a lot of issues, and we have not elected to hit every topic in this summary. Instead, we have chosen some of the more important ones for this update. If you have specific questions on the Proposed Regulations, especially for topics that we did not cover here, please reach out to us to for additional information.

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