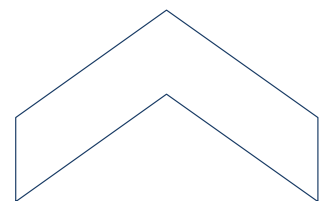
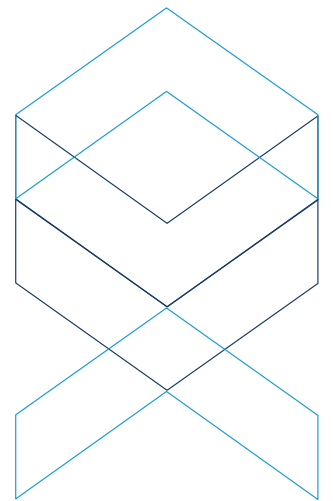


IRS and Treasury Issue Proposed Opportunity Zone Regulations



IRS and Treasury Issue Proposed Opportunity Zone Regulations

I. Introduction.

On October 19, 2018, the Internal Revenue Service (the “IRS”) and the U.S. Department of the Treasury (the “Treasury”) issued proposed regulations (the “proposed regulations”) under section 1400Z-2 of the Internal Revenue Code (the “Code”) regarding the qualified opportunity zone program, which was enacted as part of the law commonly referred to as the “Tax Cuts and Jobs Act” (“TCJA”).¹

The qualified opportunity zone program is designed to encourage investment in distressed communities designated as “qualified opportunity zones” (“opportunity zones”), by providing tax incentives to invest in “qualified opportunity funds” (“opportunity funds”) that, in turn, invest directly or indirectly in the opportunity zones. The statute left many uncertainties regarding the fundamental operations of the program. The proposed regulations answer the most pressing questions with mostly taxpayer-friendly answers. However, some important questions remain unanswered and additional proposed regulations are expected to be issued in the near future.

The proposed regulations generally are proposed to be effective on or after the date of publication of final regulations. Nevertheless, taxpayers and opportunity funds may rely on a number of the rules in the proposed regulations, so long as the taxpayer and/or the opportunity fund applies the proposed regulations in their entirety and in a consistent manner.

Part II of this memorandum summarizes certain of the most significant provisions of the proposed regulations, Part III describes the opportunity zone program, and Part IV discusses outstanding issues.

¹ All section references are to the Internal Revenue Code of 1986, as amended, and the proposed regulations.

II. Summary of the Proposed Regulations

1. Working Capital Safe Harbor

The statute permits an opportunity fund to invest directly in an opportunity zone or indirectly through a partnership (a “zone partnership”) or a corporation (a “zone corporation” and collectively, “zone entities”). However, an opportunity fund that invests directly in property must be engaged in a trade or business and no more than 10% of its assets may consist of cash. A zone entity in which an opportunity fund invests must also be engaged in a trade or business and less than 5% of the unadjusted basis in its assets may be attributable to financial property, other than a reasonable amount of working capital. One of the most serious concerns raised by these limitations is that they do not allow a sufficient period of time for opportunity funds or the zone entities in which they invest to receive capital and develop new businesses or construct or rehabilitate real estate and other tangible property. The proposed regulations partially address this concern by providing that a zone entity that acquires, constructs, and/or substantially rehabilitates tangible business property may treat cash, cash equivalents and debt instruments with a term of 18 months or less as a reasonable amount of working capital for a period of up to 31 months if certain conditions are satisfied.² In addition, under the safe harbor, tangible property that is being acquired, constructed and/or substantially improved with the working capital and that is expected to qualify as zone property after the expenditure of the working capital will be treated as being used in the active conduct of a trade or business during the construction and improvement period.³ Accordingly, if a zone entity raises cash that satisfies the working capital safe harbor and uses that cash to construct a building that is expected to qualify as zone property, the partially completed building will qualify as zone property during the

² Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(5)(iv) (safe harbor for reasonable amount of working capital).

³ Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(5)(v), (vii) and (viii) (Example).

construction phase. Notably, this safe harbor does not apply to an opportunity fund that directly holds working capital or constructs property.

2. The 70% Rule for Zone Businesses

Under the statute, 90% of the assets of an opportunity fund must consist of “qualified opportunity zone stock” (“zone stock”), “qualified opportunity zone partnership interests” (“zone partnership interests”) or “qualified opportunity zone business property” (“zone business property”) (collectively “zone property”).⁴ Also, under the statute, a trade or business operated by a zone entity qualifies as a “qualified opportunity zone business” (“zone business”) if “substantially all” of the tangible property owned or leased by the zone entity is zone business property.⁵ The proposed regulations provide a generous rule that treats the substantially all requirement as having been satisfied if at least 70% of the tangible property owned or leased by the zone entity is zone business property.⁶ If a zone entity satisfies this test, then the entire value of the opportunity fund’s zone stock or zone partnership interest is treated as zone property for purposes of the requirement that at least 90% of an opportunity fund’s assets consist of zone property (the “90% test”).⁷ Accordingly, an opportunity fund could hold as little as 63% of its assets within an opportunity zone (*i.e.*, 70% of 90%) and still provide tax benefits to investors.

3. Special Rules for Land and Improvements on Land

In order for property to qualify as zone business property, the “original use” of the property in an opportunity zone must begin with an opportunity fund or a zone entity or, if property that existed in the zone is purchased, an amount equal to the purchase price of the property must be used to improve the property.⁸ Commentators were concerned that land might

⁴ Section 1400Z-2(d)(2).

⁵ Section 1400Z-2(d)(3).

⁶ Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(3).

⁷ Section 1400Z-2(d)(1).

⁸ Section 1400Z-2(d)(2)(D).

not qualify as zone business property because the original use of land can never begin with an opportunity fund or zone entity and, technically, land is never improved. However, Revenue Ruling 2018-29, issued along with the proposed regulations, provides a very taxpayer-favorable rule, to the effect that, if an opportunity fund or zone entity purchases an existing building located on land that is wholly within an opportunity zone, the “original use” and “substantial improvement” requirements under the statute do not apply to the land and a substantial improvement to the building is measured by the additions to basis of the building (and the basis attributable to the land on which the building sits is not taken into account). Thus, if an opportunity fund purchases a property wholly within an opportunity zone for \$800, consisting of land worth \$480 and a building worth \$320, and the opportunity fund invests at least \$320 to improve the building, then the original \$800 purchase price plus the \$320 of improvements to the building may all qualify as zone business property.

The preamble to the proposed regulations implies that vacant real property purchased by an opportunity fund or zone entity does not qualify as zone business property. Nevertheless, the IRS and Treasury have requested comments as to whether vacant real property that is productively utilized after some period of abandonment could qualify as zone business property.

4. Capital Gain as Eligible Gain for Deferral

The statute permits taxpayers that realize gain from the sale or exchange of property to defer the tax on that gain and receive up to a 15% basis step-up with respect to the gain by investing the gain in an opportunity fund. The proposed regulations clarify that only gain that would be capital gain (short-term or long-term) is eligible for deferral and a basis step-

up.⁹ Moreover, capital gain from a position that is or has been part of an “offsetting-positions transaction” (*i.e.*, a straddle or other transaction that substantially diminished the taxpayer’s risk of loss) is not eligible for deferral.

5. Additional Deferral of Previously Deferred Gains

Under the proposed regulations, a taxpayer that sells its entire interest in an opportunity fund and invests the proceeds in a new opportunity fund within 180 days of the date on which the prior gain would be includible in income (but not later than December 31, 2026) can continue to defer tax on the gain with respect to the original property.¹⁰ A taxpayer that sells only a portion of its investment in an opportunity fund cannot continue to defer gain. Under the statute, the availability of certain tax benefits of investing in an opportunity fund depends upon the taxpayer’s holding period. The proposed regulations do not indicate whether a taxpayer is permitted to tack its prior holding period on to its holding period for its new opportunity fund investment in order to enjoy these benefits. Accordingly, it is unclear whether an investor can continue, or must restart, its holding period for purposes of determining the investor’s eligibility for the 5, 7 and 10 year basis-step ups (described below).

6. Types of Taxpayers Eligible to Elect Gain Deferral

Under the proposed regulations, individuals, C corporations (including regulated investment companies (RICs) and real estate investment trusts (REITs), partnerships, common trust funds, qualified settlement funds, and disputed ownership funds are eligible for deferral.¹¹ If a partnership does not elect deferral, partners in that partnership may elect deferral under

⁹ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(2)(i).

¹⁰ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(4)(ii), Example 4.

¹¹ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(1).

special rules for pass-through entities.¹² Analogous rules apply to S corporations, estates and trusts.¹³ The IRS and Treasury have requested comments regarding whether the special rules for partnerships and other flow-through entities are sufficient.

7. Only Equity Investments Can Qualify

Under the proposed regulations, only equity (including preferred stock and partnership interests with special allocations) in an opportunity fund entitles the taxpayer to deferral of tax on gain with respect to the original property.¹⁴ A taxpayer that invests in a debt instrument issued by an opportunity fund does not qualify for deferral.¹⁵ The equity interest in an opportunity fund can, however, be used as a collateral for a loan without jeopardizing the taxpayer's deferral.¹⁶

8. Attributes of Deferred Gains Are Preserved

Under the statute, the deferred gain is included in income no later than December 31, 2026.¹⁷ The proposed regulations provide that all of the deferred gain's tax attributes are preserved.¹⁸ Thus, it appears that if a non-U.S. person has gain from the sale of U.S. real property that would be subject to tax under section 897 (or "FIRPTA" tax),¹⁹ and invests the gain in an opportunity fund, the non-U.S. person would recognize gain subject to FIRPTA tax no later than December 31, 2026. The proposed regulations also provide a first-in-first out (FIFO)

¹² Prop. Treas. Reg. §1.1400Z-2(a)-1(c)(2).

¹³ Prop. Treas. Reg. §1.1400Z-2(a)-1(c)(3).

¹⁴ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(3).

¹⁵ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(3).

¹⁶ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(3)(ii).

¹⁷ Section 1400Z-2(b)(1).

¹⁸ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(5).

¹⁹ Section 897. The disposition of a United States real property interest by a foreign person (the transferor) is subject to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) income tax withholding.

method for recognizing gain if a taxpayer sells less than all of its interest in an opportunity fund prior to December 31, 2026 and does not reinvest the proceeds in another opportunity fund.²⁰

9. Net Gains from Section 1256 Contracts

Taxpayers may defer only the capital gain net income from “section 1256 contracts”²¹ on an aggregate basis (and not on a per contract basis) for each taxable year.²² The 180-day period for section 1256 contracts begins on the last day of the taxable year.²³ In addition, taxpayers are not permitted any deferral of gain from a section 1256 contract that is part of an offsetting-positions transaction where one or more offsetting positions are not section 1256 contracts.²⁴

10. Availability of Exclusion after Opportunity Zones Expire

The statute permits a taxpayer that holds an interest in an opportunity fund for 10 years or more to elect to step up its basis in its interest in the fund and avoid all tax with respect to appreciation on its interest in the fund.²⁵ However, the designation of opportunity zones expires no later than December 31, 2028.²⁶ The proposed regulations provide that the ability to make the 10 year basis step-up election is available until December 31, 2047.²⁷ Accordingly, it appears that the only consequence of the expiration of the opportunity zone designation is that new investments made after December 31, 2028 will not be considered zone business property. The IRS and Treasury have requested comments on this rule.

²⁰ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(6).

²¹ A 1256 contract is any regulated futures contract, foreign currency contract, non-equity option, dealer equity option or dealer security futures contract. Section 1256(b).

²² Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(2)(iii).

²³ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(2)(iii).

²⁴ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(2)(iv).

²⁵ Section 1400Z-2(c).

²⁶ Section 1400Z-1(f).

²⁷ Prop. Treas. Reg. §1.1400Z-2(c)-1(b).

11. Valuation of Assets for the 90% Test

For purposes of satisfying an opportunity fund's 90% test, the valuations in certain "applicable financial statements" are required to be used or, in the absence of an applicable financial statement, an opportunity fund's cost of an asset is treated as its value.²⁸

12. Opportunity Funds Can be Organized as LLCs

Under the proposed regulations, any entity classified as a partnership or corporation for federal tax purposes, including a limited liability company, is eligible to be an opportunity fund.²⁹

13. Additional Proposed Regulations and Remaining Questions

Although the proposed regulations answer some of the most important questions with respect to the opportunity zone program, several issues remain unresolved. According to the preamble, the IRS and Treasury are working on additional proposed regulations that are expected to be published soon. Items likely to be covered in the forthcoming guidance include: (i) transactions that may trigger the inclusion of deferred gain, (ii) the period of time that opportunity funds have to reinvest proceeds from the sale of underlying assets without violating the 90% rule, (iii) the meaning of the term "substantially all" as used in various places throughout the statute and that are not addressed by the proposed regulations, (iv) the consequences to taxpayers of an opportunity fund's failure to satisfy the 90% test (*e.g.*, whether the taxpayer loses its tax benefits), and (v) the information reporting requirements for opportunity funds.

²⁸ Prop. Treas. Reg. §1.1400Z-2(d)-1(b).

²⁹ Prop. Treas. Reg. §1.1400Z-2(d)-1(a)(1). A list of frequently asked questions published by the IRS clarifies that an LLC that is treated either as a partnership or corporation for federal tax purposes can organize as an opportunity fund. Available at: <https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions>.

A number of other questions about opportunity fund investing remain unanswered. It is unclear whether these uncertainties will be addressed by the upcoming IRS and Treasury guidance, including, (i) the tax treatment of gains realized and reinvested by an opportunity fund (*i.e.*, whether a taxpayer may permanently avoid tax on gain realized by an opportunity fund from the sale of underlying property if the opportunity fund reinvests the gain), (ii) the definition of a trade or business, (iii) the interaction of the opportunity fund basis rules with the general partnership basis rules, and (iv) whether intermediate pooling entities can invest in opportunity funds. These are discussed in Part IV.

III. Overview of the Opportunity Zone Program

1. Tax Benefits to Investors in an Opportunity Fund

1. Summary

The qualified opportunity zone program, which was enacted on December 22, 2017, as part of the TCJA, provides three potential tax benefits to taxpayers who invest in an opportunity fund.

First, a taxpayer may elect to defer gain (which the proposed regulations provide means only capital gain) from the sale or exchange of property with an unrelated person (generally under a 20% relatedness test)³⁰ by investing all or part of its gains in an opportunity fund within 180 days after the sale or exchange.³¹ The deferral ends December 31, 2026, or

³⁰ Section 1400Z-2(e)(2).

³¹ Section 1400Z-2(a)(1). Only an amount equal to the gain from the sale, and not the entire amount of the proceeds, needs to be invested in the opportunity fund, and the tax benefits are available only to the extent of the gain. That is, no tax benefits are available to the extent that a taxpayer invests amounts in an opportunity fund that exceed its gains realized from sales or exchanges of property with unrelated persons during the 180-day period.

sooner if the taxpayer sells its interest in the opportunity fund, and at that time the taxpayer must recognize gain (and pay tax) with respect to the original property.³²

Second, if the taxpayer holds its interest in the opportunity fund for five years, it can eliminate 10% of the deferred gain with respect to the original property and, if the taxpayer holds its interest in the opportunity fund for seven years, it can eliminate an additional 5% of the deferred gain with respect to the original property (for a total of 15%).³³

Finally, if the taxpayer holds its interest in the opportunity fund for 10 years, it can sell its interest in the opportunity fund without being subject to tax attributable to appreciation in the value of the taxpayer's interest in the opportunity fund.³⁴ The balance of this section describes these benefits in greater detail.

2. Temporary Deferral of Tax on Gains from the Sale of Property

Under the proposed regulations, only capital gain is eligible for deferral and, under the statute, the capital gain must be realized from the sale or exchange of property with an unrelated person, and the gain generally must be invested by the taxpayer in an opportunity fund within 180 days from the date of the sale or exchange (the "180-day period").³⁵ A taxpayer makes the election on Form 8949, which is attached to the taxpayer's federal income tax return for the taxable year in which the gain would have been recognized if it had not been deferred.³⁶

Type of Gain Eligible for Deferral. Under the proposed regulations, only capital gain from an actual, or deemed, sale or exchange, or any other gain that is required to be

³² Section 1400Z-2(b)(1). The obligation to pay tax with respect to deferred gain from the sale or exchange of the original property by the end of 2026 will create "phantom income" for opportunity fund investors: the investors in the fund will have tax liability for these prior gains without cash to pay the tax.

³³ Section 1400Z-2(b)(2)(B).

³⁴ Section 1400Z-2(c).

³⁵ Section 1400Z-2(a)(1); Preamble to the proposed regulations.

³⁶ Preamble to the proposed regulations.

included in a taxpayer's computation of capital gain, is eligible for deferral.³⁷ In the case of capital gain from section 1256 contracts, the proposed regulations provide that only a taxpayer's capital gain net income for a taxable year on an aggregate basis (and not on a per contract basis) is eligible for deferral.³⁸ The 180-day period for investing capital gain net income from section 1256 contracts begins on the last day of the taxable year.³⁹ In addition, gain deferral from a section 1256 contract is unavailable if the contract is, or has been, part of an "offsetting-positions transaction" (*i.e.*, a straddle or other transaction that substantially diminished the taxpayer's risk of loss) unless all positions in the transaction are section 1256 contracts.⁴⁰ Capital gain realized from any other position that is or has been part of an offsetting-positions transaction is not eligible for deferral.⁴¹

Eligible Taxpayer. The proposed regulations clarify that any person that recognizes capital gains for federal income tax purposes, including individuals, C-corporations, RICs, REITs, partnerships, S-corporations, and trusts and estates, are eligible for deferral.⁴² Partnerships and other pass-through entities are subject to special rules discussed in more detail below.

The 180-Day Period. The 180-day period generally begins on the date of the unrelated sale or exchange giving rise to the capital gain.⁴³ However, the proposed regulations provide that for deemed gains, the 180-day period begins on the date on which the capital gain would otherwise be recognized for federal income tax purposes (*e.g.*, for undistributed capital

³⁷ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(2)(i).

³⁸ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(2)(iii).

³⁹ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(2)(iii).

⁴⁰ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(2)(iv).

⁴¹ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(2)(iv).

⁴² Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(1).

⁴³ Section 1400Z-2(a)(1); Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(4).

gains of a RIC or REIT shareholder, the 180-day period begins on the last day of the RIC's or REIT's taxable year).⁴⁴

End of Deferral Period. The gain is deferred until the earlier of (i) the date on which the taxpayer sells, exchanges, or redeems its interest in the opportunity fund or (ii) December 31, 2026 (the “deferral period”).⁴⁵ However, the proposed regulations provide a helpful rule that permits a taxpayer that disposes of its entire initial opportunity fund investment for which a deferral election had been made, to invest the proceeds from the disposition into another opportunity fund within the 180-day period and elect to continue deferring gain from the original property.⁴⁶ As discussed below, it is unclear whether the taxpayer may tack its holding period with respect to the initial opportunity fund investment to its holding period in the new opportunity fund, or whether the taxpayer's holding period resets.

If a taxpayer sells some, but not all, of its interest in an opportunity fund prior to December 31, 2026, the proposed regulations generally require the taxpayer to use a first-in-first-out (FIFO) method to identify the interests that have been sold (and in circumstances where the FIFO method does not provide for a complete answer, a pro-rata method).⁴⁷ At the end of the deferral period, the taxpayer must include in its gross income an amount equal to the excess of: (x) the amount of the deferred gain (or, if lower, the fair market value of the interest in the opportunity fund as determined as of the end of the deferral period)⁴⁸ over (y) the taxpayer's basis in its interest in the opportunity fund, which is treated as zero unless increased as described

⁴⁴ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(4).

⁴⁵ Section 1400Z-2(b)(1).

⁴⁶ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(4), Example 4.

⁴⁷ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(6), (7).

⁴⁸ Thus, if an investment in an opportunity fund declines in value, the amount of gain required to be recognized by the taxpayer will decline as well.

below.⁴⁹ When deferred gain is included in income, all of the deferred gain's tax attributes are preserved.⁵⁰ Thus, if the deferred gain was short-term capital gain, then short-term capital gain will be eventually included in income.⁵¹

No election may be made to defer gain with respect to any sale or exchange of property after December 31, 2026 or with respect to gain that would not otherwise be recognized on or before December 31, 2026.⁵²

Special Rules for Pass-Through Entities. Under the proposed regulations, if a partnership makes an election to defer gain, the partnership does not recognize the gain at the time it otherwise would recognize the gain, the deferred gain is not included in any partner's distributive share of partnership income, and the deferred gain does not increase any partner's basis in its partnership interest.⁵³ At the end of the deferral period, an electing partnership must include the deferred gain in income and the deferred gain is included in the distributive share of the income of the partners in the partnership at that time (and also increases the partners' basis).⁵⁴ This rule could have adverse tax consequences to persons who were not partners at the time the

⁴⁹ Section 1400Z-2(b)(2).

⁵⁰ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(5).

⁵¹ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(8), Example 1. Similarly, it appears that if a non-U.S. person has gain from the sale of U.S. real property that would be subject to FIRPTA tax under section 897, invests the gain in an opportunity fund, the non-U.S. person would recognize gain subject to FIRPTA tax no later than December 31, 2026. However, it does not appear that withholding would apply to the non-U.S. person.

⁵² Section 1400Z-2(a)(2); Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(2)(i)(B).

⁵³ Prop. Treas. Reg. §1.1400Z-2(a)-1(c)(1)(i).

⁵⁴ Prop. Treas. Reg. §1.1400Z-2(a)-1(c)(1)(ii).

deferral election was made, but are partners during the year of inclusion.⁵⁵ In addition (as discussed further below), if a non-U.S. person is a partner in a partnership that sells U.S. real property and reinvests the gain in an opportunity fund that itself does not own U.S. real property, the non-U.S. person appears to be able to sell its partnership interest at a later time, but before the income inclusion is triggered, without being subject to FIRPTA tax because there is no rule that preserves the character of the deferred gain with respect to a partnership interest.

If a partnership does not make a capital gain deferral election, then a partner in the partnership may make its own election to defer tax on the gain (so long as the capital gain did not arise from a sale or exchange with a person related to the partner or partnership).⁵⁶ In this case, the partner's 180-day period begins on the last day of the partnership's taxable year.⁵⁷ However, if the partner knows or receives information regarding both the date of the partnership's sale or exchange triggering the gain and that the partnership will not elect to defer the gain, the partner may choose to begin its 180-day period on the date that the partnership's 180-day period begins. Analogous rules apply to other pass-through entities, such as S-corporations, trusts and estates, and their shareholders and beneficiaries.⁵⁸

⁵⁵ For example, assume that Ann, Bob and Carl are 1/3 partners in a partnership and each has a zero basis in its partnership interest. Assume that in 2019, the partnership has \$300 of capital gain, elects to defer the gain, and invests the gain in an opportunity fund. Assume the partnership's only asset is the \$300 interest in the opportunity fund and assume the interest in the opportunity fund does not appreciate. Assume that in 2023, Ann sells her partnership interest to Donna for \$100. Ann should recognize \$100 of gain (she started with a zero basis in her partnership interest, and when the partnership realized the \$300 of gain she did not include it in income and it didn't increase her basis). For the taxable year ending December 31, 2026, the partnership will recognize the deferred gain and each partner, including Donna, will be allocated \$100 of taxable capital gain by the partnership. It does not appear that a section 754 election will prevent Donna from recognizing her share of the deferred gain. As a result of the capital gain inclusion, each partner's basis in his or her partnership interest will increase by the amount of gain and, therefore, Donna's basis in her partnership interest will increase to \$200. Accordingly, Donna may eventually be able to claim a loss with respect to her partnership interest. However, this may be little consolation to Donna who, for the 2026 taxable year, would have to pay tax on phantom gain.

⁵⁶ Prop. Treas. Reg. §1.1400Z-2(a)-1(c)(2)(ii).

⁵⁷ Prop. Treas. Reg. §1.1400Z-2(a)-1(c)(2)(iii).

⁵⁸ Prop. Treas. Reg. §1.1400Z-2(a)-1(c)(3).

3. Basis Step-Up for Extended Holding Period

A taxpayer's basis in its interest in an opportunity fund is initially deemed to be zero.⁵⁹ If the taxpayer holds its interest in the opportunity fund for at least five years, the taxpayer's basis in the opportunity fund increases by 10% of the amount of the deferred gain.⁶⁰ If the taxpayer holds the interest for at least seven years, the taxpayer's basis in the opportunity fund increases by an additional 5% of the amount of the deferred gain.⁶¹

As a result, once a taxpayer has held its interest in an opportunity fund for seven years, the taxpayer's basis in the opportunity fund would equal 15% of the taxpayer's deferred gain, and the amount of gain the taxpayer would recognize at the end of the deferral period would be no greater than 85% of the deferred gain.

Thus, to receive the full benefit of the 15% basis increase, a taxpayer would have to invest in an opportunity fund on or before December 31, 2019, and for the 10% basis increase, on or before December 31, 2021. Nevertheless, it appears that a taxpayer that purchases an interest in an opportunity fund after these dates and attains the five and seven year holding periods after the end of the deferral period still receives a step-up basis in the opportunity fund,⁶² although this step-up would provide a benefit only if the taxpayer fails to hold its interest in the

⁵⁹ Section 1400Z-2(b)(2)(B)(i).

⁶⁰ Section 1400Z-2(b)(2)(B)(iii).

⁶¹ Section 1400Z-2(b)(2)(B)(iv).

⁶² The statute on its face does not require the five and seven year holding periods to be satisfied before the end of the deferral period.

opportunity fund for ten years (in which case all gain would be exempt from tax), or sells at a loss.⁶³

4. Permanent Exclusion for Investments in an Opportunity Fund Held Ten Years

If a taxpayer holds a qualifying interest in an opportunity fund for more than 10 years, the taxpayer may elect to treat its basis in the opportunity fund as an amount equal to the fair market value of the interest in the opportunity fund on the date of its sale or exchange of the interest.⁶⁴ As a result, all of the gain attributable to appreciation in the value of the taxpayer's investment in the opportunity fund is permanently excluded from income. Thus, if a taxpayer invests capital gain from the sale of property in an opportunity fund, timely makes an initial election to defer tax on the gain from the original sale of property, and holds its interest in the opportunity fund for at least 10 years, then the taxpayer would recognize gain (subject to the 15% basis step-up) with respect to the original sale of property in 2026, but would have no further taxable gain and owe no tax in connection with the sale or exchange of its interest in the opportunity fund.

The statute provides that the designation of all opportunity zones now in effect will expire on December 31, 2028.⁶⁵ As a result, many investors were concerned that the expiration of the opportunity zone designation could imperil an investor's ability to make the 10

⁶³ For example, assume that in 2023, an investor purchases an opportunity fund investment with \$100 of deferred gain. On December 31, 2026, the investor will recognize the full \$100 of deferred gain because the investor will not have held for five years. The investor will increase its basis in the opportunity fund by the amount of the gain recognized. If the investor's interest in the opportunity fund appreciates to \$300 and the investor sells its interest in 2034, then the investor will have held its interest in the fund for at least 10 years, can elect to step up its basis and will not have any additional tax. However, if the investor sells its interest in 2031, the investor will not have held its interest in the opportunity fund for at least 10 years and will be subject to tax on the appreciation in its interest. However, because the investor will have met the seven year holding period, it appears that the investor will increase its basis by \$15 (15% of its original deferred gain), which would reduce the amount of tax paid with respect to the sale in 2031.

⁶⁴ Section 1400Z-2(c).

⁶⁵ Section 1400Z-1(f).

year basis step-up election for sales of investments after this date. The proposed regulations permit a taxpayer to make the 10 year basis step-up election after the opportunity designation expires through December 31, 2047 (which is 20-1/2 years after the latest date on which a deferral election can be made, June 2027).⁶⁶ Accordingly, it appears that the only consequence of the expiration of the opportunity zone designation is that new investments made after December 31, 2028 will not be considered zone business property.

2. Qualifications for an Opportunity Fund

1. Summary

Very generally, an opportunity fund is a partnership or corporation organized for the purpose of investing in zone property. The opportunity fund must meet the 90% test and self-certify as to its opportunity fund status and compliance with the 90% test on its tax return (no IRS approval or action is required).⁶⁷

Under the proposed regulations, an opportunity fund may identify the first taxable year and month for which it elects to be an opportunity fund (and if no month is specified, then the first month of the fund's initial taxable year as an opportunity fund will be the first month that the entity is an opportunity fund).⁶⁸ If an investor invests in an opportunity fund prior to the month designated as the opportunity fund's "initial month", any deferral election made by the investor with respect to that investment would be invalid.⁶⁹ Accordingly, any investor considering an investment in an opportunity fund should ensure that its investment is made during or after the month specified by the fund as its first taxable month as an opportunity fund.

⁶⁶ Prop. Treas. Reg. §1.1400Z-2(c)-1(b).

⁶⁷ Section 1400Z-2(d). Opportunity funds will use IRS Form 8996, Qualified Opportunity Fund, both for initial self-certification and for annual reporting of compliance with the 90% test in section 1400Z-2(d)(1) and attach the form to their federal income tax return for the relevant tax years.

⁶⁸ Prop. Treas. Reg. §1.1400Z-2(d)-1(a)(1).

⁶⁹ Prop. Treas. Reg. §1.1400Z-2(d)-1(a)(1)(iii)(B).

As mentioned above, one property includes: (i) zone stock in a zone corporation, (ii) zone partnership interests in a zone partnership, and (iii) zone business property.⁷⁰ Under the proposed regulations, the 90% test is determined based on the average of the percentage of zone property held in the opportunity fund as measured semi-annually on (x) the last day of the first six month period of the taxable year of the opportunity fund; and (y) on the last day of the taxable year of the opportunity fund (*e.g.*, June 30 and December 31 would be relevant testing dates for a calendar-year opportunity fund).⁷¹ The proposed regulations provide that the first six month period of the taxable year of the opportunity fund is the first six months composed entirely of months which are within the taxable year and during which the entity is an opportunity fund (*e.g.*, if an entity is formed in February and chooses April as its first month as an opportunity fund, then the testing dates for the 90% test would be the end of September and December).⁷²

The statute does not indicate the methodology to determine the value of an opportunity fund's assets for purposes of the 90% test. However, the proposed regulations require an opportunity fund to use the asset values reported on the fund's applicable financial statements for the year as defined in Treasury regulations 1.475(a)-4(h) for purposes of the 90% test, or if the fund does not have an applicable financial statement, to use the fund's cost of the asset.⁷³

If an opportunity fund fails to satisfy the 90% test, the opportunity fund will be subject to a penalty for each month that it does not meet the requirement in an amount equal to

⁷⁰ Section 1400Z-2(d)(2).

⁷¹ Section 1400Z-2(d)(1).

⁷² Prop. Treas. Reg. §1.1400Z-2(d)-1(a)(2).

⁷³ Prop. Treas. Reg. §1.1400Z-2(d)-1(b).

the amount of the shortfall multiplied by the federal short-term rate plus three percentage points, unless the failure is due to reasonable cause.⁷⁴ The penalty does not apply before the first month in which the entity identifies as an opportunity fund.⁷⁵ The IRS and Treasury intend to publish additional proposed regulations addressing the application of the penalty and the conduct that could lead to revocation of opportunity fund status.⁷⁶

2. Eligible Entities

The proposed regulations clarify that a pre-existing entity may qualify as an opportunity fund so long as its zone property is acquired after December 31, 2017.⁷⁷ The preamble to the proposed regulations provides that a pre-existing entity may also qualify as a zone entity (*i.e.*, a zone corporation or zone partnership), but the proposed regulations do not contain such a rule, leaving the eligibility of a pre-existing zone entity unaddressed (although the preamble provides that a pre-existing entity should be able to qualify as a zone entity if it satisfies the other requirements of the statute). The Treasury and IRS have requested comments on whether there is a statutory basis for additional flexibilities that might facilitate qualification of a broader number of pre-existing entities.

The statute provides that any investment vehicle organized as a corporation or partnership may be an opportunity fund so long as the other statutory requirements are met, suggesting that an opportunity fund could be organized as a foreign corporation or partnership.⁷⁸ However, the proposed regulations limit the ability of a foreign corporation or partnership to qualify as an opportunity fund by requiring the fund entity to be organized in one of the fifty

⁷⁴ Section 1400Z-2(f).

⁷⁵ Prop. Treas. Reg. §1.1400Z-2(d)-1(a)(2)(ii).

⁷⁶ Preamble to the proposed regulations.

⁷⁷ Prop. Treas. Reg. §1.1400Z-2(d)-1(a)(3).

⁷⁸ Section 1400Z-2(d)(1).

states, the District of Columbia, or a U.S. possession.⁷⁹ An entity organized in a U.S. possession may qualify as an opportunity fund only if it is organized for the purpose of investing in zone property that relates to a trade or business operated in the U.S. possession in which the entity is organized.⁸⁰

3. Qualified Opportunity Zone Property

Zone Stock and Zone Partnership Interests. Zone stock or zone partnership interests generally include stock in a domestic corporation or partnership interests in a domestic partnership acquired by an opportunity fund solely for cash from the zone entity after December 31, 2017.⁸¹ The proposed regulations provide that zone stock or zone partnership interests must be issued by an entity organized under the laws of one of the fifty states, the Districts of Columbia, or a U.S. possession, provided that any interests issued by an entity organized in a U.S. possession may only be treated as zone stock or zone partnership interests if the entity conducts a zone business in the U.S. possession in which it is organized.⁸²

At the time an opportunity fund purchases an interest in a zone entity, the zone entity must be engaged in a trade or business that is a zone business or, in the case of a new entity, the zone entity must be organized for the purpose of being engaged in a zone business.⁸³ In addition, during “substantially all” of the opportunity fund’s holding period for the zone stock or partnership interest, the zone entity must qualify as a zone business.⁸⁴ The proposed regulations do not define “substantially all” for these purposes.

⁷⁹ Prop. Treas. Reg. §1.1400Z-2(d)-1(e).

⁸⁰ Prop. Treas. Reg. §1.1400Z-2(d)-1(e).

⁸¹ Section 1400Z-2(d)(2).

⁸² Prop. Treas. Reg. §1.1400Z-2(d)-1(e)(2).

⁸³ Section 1400Z-2(d)(2)(B), (C).

⁸⁴ Section 1400Z-2(d)(2)(B), (C).

Zone Business Property. Zone business property generally includes tangible property used in a trade or business of an opportunity fund (or in a zone business operated by a zone entity) and acquired by purchase from an unrelated person after December 31, 2017, so long as (i) the original use of the property in the opportunity zone begins with the opportunity fund (or a zone entity) or the opportunity fund (or a zone entity) “substantially improves” the property, and (ii) during the opportunity fund’s (or a zone entity’s) holding period, “substantially all” of the use of the property is in an opportunity zone.⁸⁵

Property is considered “substantially improved” for these purposes only if during any 30-month period beginning after the property is acquired, an opportunity fund’s (or a zone entity’s) additions to basis in the property exceed the adjusted basis of the property at the beginning of the 30-month period (*i.e.*, a greater amount must be used to improve the property than was used to purchase it).⁸⁶

The statute is unclear as to whether land may qualify as zone business property because the statute requires that the original use of property in an opportunity zone commence with an opportunity fund (or a zone entity) or that the opportunity fund (or a zone entity) substantially improve the property and, by reason of land’s permanence and the fact that, technically, land is never “improved”, land cannot literally satisfy this requirement. The proposed regulations and Revenue Ruling 2018-29, which was issued concurrently with the proposed regulations, provide that land with a building on it that is wholly within an opportunity zone can qualify as zone business property if the opportunity fund (or a zone entity) invests at

⁸⁵ Section 1400Z-2(d)(2)(D). Under these rules, persons are considered to be related to each other through the application of complex attribution rules, which generally treat certain entities and individuals as related if there is a 20% beneficial ownership overlap between the entity and its owners. Section 1400Z-2(e)(2).

⁸⁶ Section 1400Z-2(d)(2)(D)(ii).

least the value of the building to improve the building (with no requirement that the land be improved).⁸⁷ Thus, if an opportunity fund purchases a property for \$800, consisting of land worth \$480 and a building worth \$320, and the opportunity fund invests at least \$320 to improve the building, then the original \$800 purchase price plus the \$320 of improvements to the building may all qualify as zone business property. This is a very taxpayer favorable rule because it treats the land as zone business property and requires the amount of the improvement to exceed only the value of the building and not also the value of the land. On the other hand, the preamble to the regulations implies that vacant real property does not qualify as zone business property, but the IRS and Treasury have requested comments as to whether vacant real property that is productively utilized after some period of abandonment could qualify as zone business property.

The preamble also indicates that the IRS and Treasury are seeking comments on all aspects of the terms “original use” and “substantial improvement” as applied to real property and other tangible property. In particular, the IRS and Treasury have requested comments on possible approaches to, and the appropriate metrics for, defining the “original use” requirement, including whether the use of abandoned or under-utilized tangible property that exists in the zone could, after some period of inactivity, qualify as “original use”.

4. Qualified Opportunity Zone Business

A zone entity must be engaged in a “zone business”.⁸⁸ In contrast, an opportunity fund that directly holds zone business property is required to use the property in a trade or business, but that trade or business is not required to be a “zone business”. There is no apparent policy rationale for subjecting businesses operated directly by an opportunity fund and those operated by a zone entity to different requirements. These incongruities provide opportunities

⁸⁷ Prop. Treas. Reg. §1.1400Z-2(d)-1(c)(8)(ii).

⁸⁸ Section 1400Z-2(d)(2)(B), (C).

for investors and opportunity funds, but also may require elaborate structuring, as discussed below.

A zone business is a trade or business conducted by a zone entity in which “substantially all” of the tangible property owned or leased by the business is property that it acquired by purchase after December 31, 2017, so long as the original use of the property in the opportunity zone begins with the business or the business “substantially improves” the property, and during the business’ holding period, “substantially all” of the use of the property is in an opportunity zone.⁸⁹

In addition, in order to be a zone business, the trade or business of a zone entity must meet the following requirements:

- (1) “Substantially all” of the tangible property owned or leased by the entity must constitute zone business property;
- (2) At least 50% of the gross income of the entity must be from the active conduct of the zone business;
- (3) A substantial portion of the intangible property of the entity must be used in the active conduct of the zone business;
- (4) Less than 5% of the average of the aggregate unadjusted bases of the entity’s property can be attributable to “nonqualified financial property,” such as debt, stock, partnership interests, options, future contracts, forward contracts, swaps, annuities, and similar property (excluding reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or ordinary course trade or business notes receivable); and

⁸⁹ Section 1400Z-2(d)(3)(A).

(5) The entity’s trade or business cannot be a private or commercial golf course, country club, massage parlor, hot tub facility, sun tan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.⁹⁰

The 70% rule for the “substantially all” requirement. Under the statute, a trade or business qualifies as a zone business if “substantially all” of the tangible property owned or leased by the trade or business is zone business property.⁹¹ The proposed regulations generously provide that, if at least 70% of the tangible property owned or leased by the trade or business is zone business property, the trade or business will be treated as satisfying the substantially all requirement.⁹² Accordingly, a trade or business that holds up to 30% of non-qualifying property will nevertheless still qualify as a zone business provided it meets the other zone business requirements (*e.g.*, the nonqualified financial asset test, the 50% gross income test, etc.). Moreover, because an opportunity fund need invest only 90% of its assets in zone property, and interests in zone entities qualify as zone property, only 63% of the indirect assets of an opportunity fund need qualify as zone property. (*i.e.*, 70% of 90%).

In the preamble to the proposed regulations, the IRS and Treasury acknowledge that the 70% requirement provides opportunity funds an incentive to invest in a zone entity rather than owning zone business property directly. For example, if an opportunity fund has \$10 million of cash to invest and it buys and holds property directly, the fund would have to invest at least \$9 million in qualifying property within an opportunity zone to satisfy the 90% test. On the other hand, if the opportunity fund invests through a zone partnership, the fund could invest \$9

⁹⁰ Section 1400Z-2(d)(3)(A).

⁹¹ Section 1400Z-2(d)(3)(A)(i).

⁹² Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(3).

million in the zone partnership. The zone partnership could satisfy the substantially all requirement by investing at least \$6.3 million in property within the opportunity zone (*i.e.*, 70% of \$9 million). Accordingly, by reason of the 70% “substantially all” threshold, investors in an opportunity fund are able to obtain the tax benefits of the opportunity zone program even though only 63% of the fund’s assets are required to be invested in property located within an opportunity zone. This benefit of investing through a zone partnership will create pressure to establish that a partnership that is almost entirely owned by an opportunity fund is treated as a partnership that benefits from the substantially all rule, rather than a disregarded entity of the opportunity fund that does not.

The IRS and Treasury indicated that they had considered setting the substantially all threshold at 90% in order to reduce the incentive to invest through zone entities and have requested comments regarding the proposed meaning of “substantially all” for this purpose.

While the regulations propose a 70% “substantially all” threshold for purposes of the zone business requirement, the term “substantially all” is also used in several other places throughout the opportunity zone statute. The preamble to the regulations warns that the 70% threshold is intended to apply solely for purpose of the zone entity tangible property ownership requirement and should not be interpreted as applying to the other uses of the term “substantially all” in the statute, which remain undefined. The preamble also provides that in certain places in the statute, the term substantially all is used multiple times in a row and that this compounded use must be interpreted in a manner that does not result in a fraction that is too small to implement Congress’ intent. Thus, the IRS and Treasury are continuing to consider the appropriate thresholds for the term substantially all in other contexts of the statute and have requested additional comments regarding its definition.

Finally, the calculation method for determining whether the 70% substantially all standard has been met depends on whether a zone entity has an applicable financial statement (within the meaning of Reg. 1.475(a)-4(h)). If it does, then the value of each asset of the zone entity as reported on the entity's applicable financial statement for the relevant reporting period is used for determining whether a trade or business of the entity owns at least 70% of its tangible property as zone business property. If it does not, then the zone entity may value its assets using the same methodology its opportunity fund owner uses to value the zone entity for purposes of the fund's 90% test, unless the zone entity has another owner that is a "five-percent zone taxpayer" (*i.e.*, another opportunity fund that holds 5% of the vote and value of a zone corporation or 5% of the profits and capital interest in a zone partnership). In that case, the value of the entity's assets is determined using the methodology used by any five-percent zone taxpayer of the zone entity to value the zone entity for purposes of its 90% test and that produces the highest percentage of zone business property for the entity.⁹³

Five-Year Grace Period. For purposes of the definition of zone business, tangible property that ceases to be zone business property will nonetheless continue to be treated as such for the lesser of: (1) five years after the date such property ceases to be qualified as zone business property; and (2) the date on which the tangible property is no longer held by the zone business.⁹⁴ This rule is especially generous for property that is movable, such as vehicles. As long as the initial use of a vehicle is in the opportunity zone, the vehicle may leave the zone and remain zone business property for five years.

Working Capital Safe Harbor. One of the biggest concerns raised by opportunity fund sponsors is the need for adequate time to appropriately invest capital raised from investors.

⁹³ Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(3).

⁹⁴ Section 1400Z-2(d)(3)(B).

Because an opportunity fund must hold 90% of its assets in zone property by its first six-month testing date, and since cash is not considered zone property, opportunity funds have little time between receiving capital and making qualifying investments. According to the preamble to the proposed regulations, commentators have recommended a rule that would allow cash that is intended to be invested in zone business property to be considered zone business property.

In response to these concerns, the proposed regulations adopt a working capital safe harbor.⁹⁵ However, the safe harbor applies only to businesses operated by zone entities and is not available to an opportunity fund directly engaged in a business. Accordingly, no more than 10% of the assets of an opportunity fund that directly conducts a business may consist of cash (and other non-qualifying assets).

The safe harbor contained in the proposed regulations generally provides that solely for purposes of applying the zone business “nonqualified financial property” rule mentioned above, working capital assets will be considered reasonable if three requirements are satisfied.⁹⁶ First, the working capital amounts must be designated in writing in a plan for the acquisition, construction, and/or substantial improvement of tangible property in an opportunity zone. Second, the business must have a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets and under the schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets. Finally, the working capital assets must actually be used in a manner substantially consistent with the plan and schedule.

Although the proposed regulations provide that the safe harbor rule applies only for purposes of the nonqualified financial property rule, any income earned on the working

⁹⁵ Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(5)(iv).

⁹⁶ Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(5)(iv).

capital counts toward satisfying the 50% gross income test described above and the intangible property use requirement is generally deemed satisfied during the working capital safe harbor period.⁹⁷

In addition, under a very helpful rule, any tangible property that is being acquired, constructed and/or substantially improved with the working capital and that is expected to qualify as zone business property at the end of the safe harbor period, is treated as being used in the active conduct of a trade or business during the construction and improvement period (for up to 31 months).⁹⁸ Accordingly, if a partnership raises cash that satisfies the working capital safe harbor and uses that cash to construct a building that is expected to qualify as zone business property, the partially completed building will indefinitely qualify as zone business property during the construction phase.

An example in the proposed regulations demonstrates the operation of this rule by treating an opportunity fund's interest in a partnership that satisfies the working capital safe harbor as a zone partnership interest, implicitly holding that the partnership was engaged in the active conduct of a trade or business and satisfied the 70% substantially all test during the time it held only the working capital and the property under construction.⁹⁹

The IRS and Treasury have requested comments on the adequacy of the working-capital safe harbor and whether there is a statutory basis for any additional relief, including the appropriateness of expanding the safe harbor beyond the use of funds for the acquisition, construction, and/or substantial improvement of tangible property.

⁹⁷ Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(5)(v), (vi).

⁹⁸ Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(5)(vii).

⁹⁹ Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(5)(viii).

5. Opportunities Arising from Differing Requirements for Opportunity Funds and Opportunity Businesses.

As mentioned above, the requirements for a business operated directly by an opportunity fund differ from those for a business conducted by a zone entity. As a result, opportunity funds can choose to operate a business directly or indirectly depending upon which produces more favorable results.

For example, as mentioned above, an opportunity fund that only holds zone entities could invest as little as 63% of its tangible property in an opportunity zone and still provide investors with the expected tax benefits, whereas an opportunity fund that operates its businesses directly would have to invest up to 90% of its assets in tangible property within the opportunity zone. Thus, an opportunity fund that seeks to make investments outside of opportunity zones would generally invest through zone entities. However, zone entities are not permitted to engage in sin businesses. Thus, an opportunity fund desiring to operate a racetrack or other sin business would have to do so directly. However, it appears that a zone entity could build and own the racetrack and lease it to its opportunity fund owner to run. This structure would allow the zone entity to use the favorable working capital safe harbor and 70% substantially all threshold (which are available only to zone entities).

As mentioned above, a special rule treats zone business property used in a zone business of a zone entity as qualifying zone business property for a period of five years after the date on which the property ceases to be zone business property (or on the date no longer held by the business if earlier). The special rule is not available for zone business property held directly by an opportunity fund. The five year rule would appear to allow a zone entity to operate a transportation business out of an opportunity zone. So long as the vehicles (whether cars, trucks,

ships or airplanes) are initially used in the zone, they could leave the zone permanently and retain their status as zone business property for five years.

6. Investments with Mixed Funds

If a taxpayer makes an investment in an opportunity fund with a combination of funds attributable to capital gains for which a deferral election has been made and other funds for which no deferral election is in effect, then the investment is treated as two separate investments consisting of (i) one that includes only deferred gain amounts, and (ii) a separate investment of other amounts.¹⁰⁰ The tax benefits only apply to the deferred gain amount.¹⁰¹ The proposed regulations reiterate that a taxpayer may only obtain the 10 year basis step-up with respect to the investment for which a deferral election was made.¹⁰² Finally, according to the preamble of the proposed regulations, commentators have questioned whether deemed contributions of money by a partner to a partnership under section 752(a) (*i.e.*, due to an increase in a partner's share of liabilities) could result in investments with mixed funds. The proposed regulations clarify that deemed contributions of money under section 752(a) do not constitute an investment in an opportunity zone and therefore a deemed contribution does not result in a partner having a separate investment under the mixed funds rule.

7. Potential Abuse of the Opportunity Zone Rules by Non-U.S. Investors

One inadvertent consequence of opportunity funds is that they make it easier for non-U.S. investors to avoid their U.S. tax liabilities. One of the challenges for the IRS and Treasury will be how to prevent this.

¹⁰⁰ Section 1400Z-2(e)(1).

¹⁰¹ Section 1400Z-2(e)(1)(B).

¹⁰² Prop. Treas. Reg. §1.1400Z-2(c)-1(a).

Generally, when a non-U.S. person sells U.S. real property (or a “United States real property interest”¹⁰³) or an interest in a partnership that is engaged in a trade or business in the United States,¹⁰⁴ the non-U.S. person is subject to U.S. federal income tax on the gain, which is enforced through a withholding tax on the proceeds of the sale.¹⁰⁵ However, if that non-U.S. person were to invest capital gain realized from the sale of U.S. real property or the partnership interest that is engaged in a U.S. trade or business into an opportunity fund, the non-U.S. investor should be entitled to a refund of the amount withheld. Under the proposed regulations, when the deferred gain is recognized and subject to tax in 2026 (or earlier upon a sale of the non-U.S. person’s interest in the opportunity fund), it appears that the non-U.S. person’s gain will retain its character as income effectively connected to a U.S. trade or business (“ECI”) or as FIRPTA gain and be subject to tax at that time.¹⁰⁶ However, no withholding tax will apply to enforce the tax at that time. In addition, if the opportunity fund is organized as a corporation that is not a “United States real property holding company”,¹⁰⁷ no withholding would be imposed on the sale by the non-U.S. person of its interest in the fund.¹⁰⁸ At the end of the deferral period (*i.e.*, the earlier of December 31, 2026, or when the opportunity fund interest is sold), it may be difficult for the IRS to enforce the collection of the tax.

¹⁰³ Section 897. Generally, a “United States real property interest” includes an interest in real property located in the United States and an interest in a United States real property holding corporation. Section 897(c).

¹⁰⁴ Section 864(c)(8). See also section 875(1) (a non-U.S. partner of a partnership that is engaged in a U.S. trade or business will also be treated as engaged in a U.S. trade or business).

¹⁰⁵ Section 1445 (withholding tax on FIRPTA gain); section 1446 (withholding tax on non-U.S. partner’s share of effectively connected income).

¹⁰⁶ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(5).

¹⁰⁷ See section 897(c)(2).

¹⁰⁸ Generally, a non-U.S. person who is not a resident in the United States is exempted from withholding tax on gain from a sale of stock or securities, unless the stock or securities constitute a United States real property interest. Treas. Reg. § 1.1441-2(b)(2)(i). See also section 871(a)(2) (requiring a 30% withholding tax on the net capital gains for a nonresident alien who is physically present in the United States for at least 183 days during a taxable year). In addition, under most U.S. tax treaties, gains from the sale of stock or securities are generally taxable exclusively in the country of the seller’s residence, except where the stock or securities constitute a United States real property interest.

Second, if a non-U.S. person is a partner in a partnership which sells U.S. real property or sells an interest in a partnership that is engaged in a trade or business in the United States, and the partnership invests the capital gain into an opportunity fund and elects to defer the gain, under the proposed regulations, the partnership does not recognize the gain at that time and the deferred gain is not included in any partner's distributive share of partnership income.¹⁰⁹ If the non-U.S. partner sells its partnership interest prior to the end of the deferral period and at that time the partnership is no longer engaged in a trade or business in the United States (*e.g.*, if the partnership invests in an opportunity fund that is organized as a corporation for federal income tax purposes) or no longer holds any United States real property interests, then under the proposed regulations, there does not appear to be U.S. tax or withholding due with respect to the non-U.S. partner's sale of the partnership interest. The proposed regulations do not provide that the partnership's prior status as engaged in a U.S. trade or business is preserved with respect to a selling partner. Accordingly, the non-U.S. partner could sell its interest in the partnership and apparently legally avoid U.S. federal income tax on the deferred gain.

8. Effective Dates and Retroactivity of the Proposed Regulations

The proposed regulations generally are proposed to be effective on or after the date of publication of final regulations. However, taxpayers and opportunity funds may rely on (i) the gain deferral rules with respect to eligible gains that would be recognized before the final regulations' date of applicability, (ii) the rules relating to investments held for at least 10 years with respect to dispositions of opportunity fund investments in situations where the 180-day period for the gain invested in the opportunity fund began before the final regulations' date of applicability, and (iii) the rules relating to mixed funds and deemed contributions with respect to

¹⁰⁹ Prop. Treas. Reg. §1.1400Z-2(a)-1(c)(1)(i).

investments and deemed contributions of money that occur before the final regulations' date of applicability retroactively so long as the opportunity fund or taxpayer applies the proposed regulations in their entirety and in a consistent manner. In addition, an opportunity fund may rely on the rules relating to opportunity funds for taxable years that begin before the final regulations' date of applicability if the opportunity fund applies the rules in their entirety and in a consistent manner.

IV. Remaining Questions

While the proposed regulations have addressed the most pressing issues regarding the opportunity zone program, many questions remain unanswered.

Treatment of Gains Realized by an Opportunity Fund. The statute authorizes the IRS and Treasury to issue regulations to ensure that an opportunity fund has a reasonable period of time to reinvest return of capital and sales proceeds from investments in zone property to ensure compliance with the 90% test.¹¹⁰ The preamble to the proposed regulations provide that “soon-to-be-released” proposed regulations will provide guidance on an opportunity fund’s reinvestment of return of capital and sales proceeds in zone property. However, the statute provides no guidance regarding the tax consequences to investors when an opportunity fund disposes of its investment in zone property before the investor disposes of its investment in the opportunity fund. The preamble states that many stakeholders have requested guidance on the tax treatment of gains reinvested by an opportunity fund, and that the preamble to the soon-to-be released proposed regulations will invite additional public comment on the statutorily permissible policy alternatives, suggesting that even the soon-to-be-released proposed

¹¹⁰ Section 1400Z-2(e)(4)(B).

regulations will not address the tax treatment of investors in an opportunity fund that realizes gain.

Cash and the 90% Test. An opportunity fund must hold at least 90% of its assets in zone property, determined based on the average of the percentage of zone property held in the fund as measured on two annual testing dates.¹¹¹ Accordingly, an opportunity fund can hold no more than 10% of its assets in cash and cash equivalents. The working capital safe harbor contained in the proposed regulations addresses only the treatment of cash held by a zone entity and provides no relief to opportunity funds for purposes of satisfying the 90% test.¹¹² There is no suggestion in the proposed regulations that the IRS and Treasury intend to provide any relief from the 90% test. Until relief is granted, cash in excess of 10% of an opportunity fund's assets would have to be held in zone entities.

Trade or Business Requirement. Zone business property (whether held by an opportunity fund or by a zone entity) must be used in a "trade or business",¹¹³ and a zone entity must derive at least 50% of its gross income from the active conduct of a trade or business.¹¹⁴ The proposed regulations contain an example that expressly provides that when a partnership owned by an opportunity fund holds cash in satisfaction of the working capital safe harbor and uses that cash to construct property that will be used in an active trade or business, the opportunity fund's interest in the partnership constitutes zone property during the entire period, which necessarily implies that the partnership meets both the trade or business test (by virtue of holding zone business property) and the active conduct of a trade or business test.¹¹⁵ However,

¹¹¹ Section 1400Z-2(d)(1).

¹¹² Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(5)(iv) (safe harbor for reasonable amount of working capital).

¹¹³ Section 1400Z-2(d)(2)(D).

¹¹⁴ Section 1400Z-2(d)(3)(A)(ii) (cross-referencing a requirement under section 1397C(b)(2)).

¹¹⁵ Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(5)(viii).

there is no guidance as to whether an opportunity fund is treated as engaged in a trade or business during construction of property that will be used in a trade or business directly by the opportunity fund before the business has commenced. Until this guidance is issued, it may be more prudent for opportunity funds to engage in construction through zone entities rather than directly.

Basis Questions. Investors will have an initial outside basis of zero with respect to their interest in an opportunity fund.¹¹⁶ There is no guidance regarding the opportunity fund's basis in its property. Moreover, there is no guidance on how the pre-existing partnership basis rules apply in the context of an opportunity fund or a zone partnership. For example, we would assume that partners in an opportunity fund (that is organized as a partnership for federal income tax purposes) increase their outside basis in the fund as they recognize income from the fund, and that they receive basis for debt of the fund in accordance with the partnership tax rules. We would also assume that opportunity funds (that are organized as partnerships for federal income tax purposes) and zone partnerships obtain basis in the property they purchase and construct, which they can expense and depreciate, although the proposed regulations are silent on this.

Investments Through Intermediate Entities. The proposed regulations provide helpful guidance regarding the type of taxpayer eligible to invest in an opportunity fund.¹¹⁷ For example, the proposed regulations permit any person that recognizes capital gain for federal income tax purposes, including partnerships and their partners, to elect to defer tax on unrelated gain. However, there is no guidance regarding whether eligible taxpayers could pool their funds and invest in an opportunity fund through an intermediate entity. For example, could an

¹¹⁶ Section 1400Z-2(b)(2)(B)(i).

¹¹⁷ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(1).

opportunity fund establish a feeder partnership to pool investments of investors and invest in the opportunity fund? Under the current rules, feeder funds do not appear permissible.

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