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Practice Group(s):

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Worth the Wait: Second Round of Opportunity Zone Proposed Regulations Clears the Way for Many OZ Investments

Delayed regulations favorably address key concerns; could lead to a surge in OZ operating business investments and OZ real estate projects

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After a lengthy drafting and protracted review process, the Department of Treasury (“Treasury”) has released its second set of proposed regulations (the “Second Round Regs”) providing guidance on the implementation of the Opportunity Zone (“OZ”) tax incentive enacted in the Tax Cuts and Jobs Act. Designed to maximize the number and types of projects and businesses that will qualify for OZ benefits, the regulations reflect the administration’s strong desire to establish rules that will encourage investments in disadvantaged areas designated as OZs. The guidance focuses on issues related to operating businesses and also resolves several questions pertaining to real estate and other project finance investments that carried over from the first set of OZ regulations released on October 19, 2018 (the “First Round Regs”), which are discussed in the alert titled [‘Opportunity Zone Proposed Regulations Provide the Certainty Anxious Investors, Developers, and Entrepreneurs Have Been Seeking’](#).

This alert provides a summary in Q&A format of the issues addressed — or not — in the Second Round Regs. It is not intended to be an exhaustive analysis. Even with the Second Round Regs the OZ incentive remains complex, with the potential for missteps that could result in the loss of the benefits offered under the OZ incentive, penalties for qualified opportunity funds (“OZ Fund”), and other unexpected tax consequences. Our K&L Gates cross-practice OZ team is prepared to help clients understand and implement the OZ incentive and maximize its benefits and provide input to the Treasury and Capitol Hill, whether you are an investor, a developer or entrepreneur, or interested in setting up an OZ Fund. For more detailed information to assist you in determining whether your idea for a project or business will qualify for OZ benefits, please contact any of the authors of this alert or any member of our K&L Gates [OZ team](#). See our [webpage](#) for more information about our team and background information about the basics of OZs.

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WHAT ARE OPPORTUNITY ZONES AND WHY IS THERE SO MUCH INTEREST IN THEM?

The Tax Cuts and Jobs Act created the OZ incentive offering significant tax benefits for investors to attract funding for development and businesses in low income areas. Qualifying activities include housing, commercial real estate, retail, manufacturing, distribution, hospitality, startups, incubators, research, energy, day-care, farming, and other active trades or businesses. Individuals, family offices, and businesses can delay paying federal income tax until 2026 — and enjoy up to a 15% increase in basis (resulting in an exclusion) — on capital gains invested in OZ Funds that hold at least 90% of their assets in qualifying businesses or tangible property located in low income areas designated as OZs. In addition, capital gains on investments in the OZ Funds can be federal income tax-free if an investment is held for at least 10 years. The OZ incentive can reduce the cost of capital to make projects more viable and works well with impact investment objectives.

WHAT QUESTIONS DO THE PROPOSED REGULATIONS ANSWER?



PROVISIONS RELATED TO OPERATING BUSINESSES

Q. How is the 50% gross receipts test applied? Does the 50% gross receipts test mean that at least 50% of receipts must be from sales within the OZ?

Background: In order for an operating business to be a qualified opportunity zone business, (“OZ Business”) a number of tests must be met, including that at least 50% of the gross income of the OZ Business must be derived from the active conduct of a trade or business in an OZ (the “50% gross receipts test”). Prior to the Second Round Regs, many OZ investors were reluctant to invest in OZ operating businesses because of the lack of clarity around the 50% gross receipts test, what constitutes the active conduct of a trade or business and whether the working capital safe harbor would apply to operating businesses. The Second Round Regs provide clarity on each of these issues, all of which are addressed in this alert.

- A. The Second Round Regs clarify that 50% of sales are not required to occur within the OZ to meet the gross receipts test. They provide three safe harbors, any one of which may be met by an OZ Business to meet the 50% gross receipts test. The safe harbors are as follows:
- Hours test. At least 50% of the hours worked by employees or independent contractors (or their employees) of the OZ Business (collectively, “service providers”) are performed in the OZ.

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- Compensation test. At least 50% of the compensation paid to service providers is for services performed in the OZ.
- Property/management test. Both the tangible property of the OZ Business that is located in an OZ and the management or operational functions performed by or for the OZ Business in the OZ are each necessary to generate 50% or more of the OZ Business's gross income.

If the business cannot meet any of the safe harbors, facts and circumstances may be considered to determine if the 50% threshold is met, although relying on circumstances outside of the safe harbors presents risks. While the safe harbors are expansive and likely beneficial to a wide variety of businesses from med-tech startups to rental real estate and many others in between, different safe harbors may be suitable for different businesses. Treasury may consider whether particular efforts to meet these safe harbors are abusive.

Q. Does the working capital safe harbor written plan apply to operating businesses?

Background: An OZ Fund must invest at least 90% of its assets in qualified OZ property, including qualified OZ stock, a qualified OZ partnership interest or qualified OZ business (tangible) property (the "90% test"). An OZ Business must meet certain requirements, including that less than 5% of its assets be held in nonqualified financial property, with an exception for reasonable amounts of working capital held in cash, cash equivalents, and short-term debt. The First Round Regs included a working capital safe harbor allowing OZ Businesses 31 months to deploy working capital if it is used for the acquisition, construction, and/or substantial improvement of tangible property according to a written plan, provided certain other requirements are met.

- A. The Second Round Regs extend the working capital safe harbor written plan to include the development of a trade or business, which will allow more operating businesses to take advantage of the OZ incentive. A business may have multiple tranches of working capital with a new written plan attributable to each tranche. The 31-month safe harbor is not violated if the delay is attributable to waiting for government action (e.g., permits) the application of which is complete prior to the expiration of the 31-month period.

Q. Does inventory qualify as qualified OZ property?

Background: Section 1400Z-2 [1] and the First Round Regs were silent as to whether inventory could qualify as qualified OZ property and, more specifically, whether inventory in transit would be qualified OZ property.

- A. Inventory can be qualified OZ property, including inventory in transit. For example, inventory purchased by a retailer operating in an OZ that has not arrived at the retailer's location prior to a biannual OZ Fund testing date should be qualified OZ property.

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PROVISIONS RELATED TO REAL ESTATE

Q. Can unimproved land be qualified OZ property?

Background: The eligibility of unimproved and vacant land as qualified OZ property was unclear from the statute, the First Round Regs, and Rev. Rul. 2018-29.

Unimproved land is an important business asset for numerous types of operating businesses aside from real estate development. Certain commentators noted the potential for abuse in allowing unimproved or vacant land to be qualified OZ property.

- A. The Second Round Regs restate the position taken in Rev. Rul. 2018-29 that the original use requirement is not applicable to land, whether it is improved or unimproved, due to the permanent nature of land. They also clarify that unimproved land is not required to be substantially improved for it to be qualified OZ property. However, the land must still meet the requirement that it is used in the trade or business of an OZ Fund or OZ Business. The acquisition and holding of unimproved land is not a trade or business if the OZ Fund or OZ Business that acquired the land did not plan as of the date of purchase to improve the land by more than an insubstantial amount (not defined) within 30 months.

In the preamble to the Second Round Regs, Treasury expressed concern that unimproved land may meet the technical requirements of the OZ incentive but fall short of its intended purposes (e.g., the purchase of land used for agricultural purposes without any increase in economic activity or new capital investment in the land). Rather than incorporate a minimum investment threshold, the Second Round Regs propose a general anti-abuse rule (“GAAR”), discussed later in this alert, that permits the Internal Revenue Service (“IRS”) to disqualify an OZ Fund or OZ Fund related transaction, which could disqualify land purchases perceived to be abusive.

Q. Can real property straddling multiple census tracts, some of which are OZs and others that are not, be qualified OZ property?

Background: The purpose of the OZ incentive is to encourage economic growth and investment in designated distressed communities (i.e., OZs). As expected, to accomplish this purpose Section 1400Z-2 and the First Round Regs were drafted to focus investment within OZs. This left in question to what extent an investment that spanned an OZ and a non-OZ could qualify for the OZ incentive.

- A. When an OZ Business straddles multiple census tracts that are not all designated as OZs, the Second Round Regs clarify that based on a combined cost and square footage test the property outside of an OZ may satisfy certain requirements related to an OZ Business. This applies for purposes of determining whether the OZ Business meets the 50% income test (including the location of services, where tangible property is located, and where business functions occur), the substantial use of intangibles test, and the limitation on nonqualified financial property threshold (but not whether the real estate is qualified OZ property). If the cost of the square footage in the OZ exceeds the cost of the square footage outside the OZ, the amount of real property within the qualified opportunity zone is considered to be substantial and all of the real property will be

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treated as being inside the OZ. In the preamble to the Second Round Regs, Treasury requested comments about whether this rule should be extended to other criteria.

Q. May land parcels be aggregated for purposes of meeting the substantial improvement test?

Background: Improvements on the various assets of a business may progress at differing speeds. This may be due to several factors, such as general economic conditions, industry-specific events, the location of the assets, etc. Allowing an aggregate standard for determining compliance with the substantial improvement test would allow flexibility in compliance.

- A. The Second Round Regs provide that the substantial improvement test is determined on an asset-by-asset basis. However, acknowledging that aggregating properties may make sense for property in the same or a contiguous OZ, Treasury has asked for comments on the potential advantages of doing so.

PROVISIONS APPLICABLE TO BOTH REAL ESTATE AND OPERATING BUSINESSES

Q. What constitutes an active trade or business? How will “active management” thresholds apply for purposes of determining if rental activity is an active trade or business?

Background: Section 1400Z-2 and the First Round Regs did not define “trade or business” for purposes of the OZ incentive. There was some concern that trade or business could be defined narrowly, thus excluding certain businesses from the OZ incentive.

- A. The Second Round Regs provide that for purposes of the OZ incentive, a trade or business is defined within the meaning of section 162. Generally, this means that a trade or business is an activity carried on with continuity and regularity with the primary purpose of earning income. This broad definition should enable OZ incentive eligibility for a wide range of businesses, including startups. Solely for purposes of the OZ rules, the ownership and operation (including leasing) of real property is the active conduct of a trade or business. Merely entering into a triple-net-lease with respect to real property owned by a lessor is not the active conduct of a trade or business by such lessor, but that does not mean triple net leases do not qualify in any circumstances. Depending on the level of management, oversight, and other business activity conducted, triple net leases combined with other activities may qualify as the active conduct of a trade or business. Therefore, OZ investors wanting to enter into triple net lease transactions will need to carefully plan their structures.

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Q. Must OZ Funds and investors currently recognize gains from the sale or disposition of assets by an OZ Fund or OZ Business?

Background: While tax deferral on deferred gains invested in an OZ Fund is one of the cornerstone tax benefits of the OZ incentive, Section 1400Z-2 has generally been interpreted as requiring the recognition of gains from the sale of assets by an OZ Fund or OZ Business.

- A. As a general rule (but see the next Q&A for a notable exception when OZ Fund interests have been held for at least 10 years), the Second Round Regs require OZ Funds and investors in partnership OZ Funds to currently recognize gains from the sale or disposition of assets by an OZ Fund or OZ Business. Such dispositions do not affect the holding period of investments by investors in the OZ Fund or trigger any reporting of gain of the original capital gains invested in the OZ Fund. Treasury continues to study this issue and has asked for comments that might identify authority to avoid current taxation. In addition, Treasury has asked for comments regarding potential burdens arising from imposing new holding periods when gains are reinvested in OZ Funds.

Q. Are OZ investors in OZ partnerships always required to sell their interests in OZ Funds in order to be eligible for the 10-year gain elimination?

Background: Upon the enactment of Section 1400Z-2, there was concern that the OZ incentive too strictly limited the flexibility for exiting an investment in qualified OZ property. The First Round Regs failed to provide relief on this issue. This restriction would limit the ability to create diversified funds and raises privacy concerns for investors who would be required to sign sale agreements.

- A. The Second Round Regs provide a special election available to direct investors in OZ Fund partnerships and OZ Fund S corporations that allow investors to exclude from income some or all of the capital gain from the disposition of qualified OZ property by the OZ Fund provided that the disposition occurs after the investor's 10-year holding period is met. The OZ Fund K-1 must separately state the capital gains arising from capital assets. The election must be made for the year that the gain would otherwise need to be reported. For basis purposes, the excluded income is treated as an item of income and thus causes an increase in the investor's basis in the partnership or S corporation. Similarly, OZ Fund REITs can designate special capital gain dividends which are tax free to shareholders who have held their investments in the OZ Fund for at least 10 years. This election provided in the Second Round Regs should allow for diversified OZ Funds. The Second Round Regs do not expressly refer to OZ Business assets, raising questions whether Treasury intends that the election is available only for OZ Fund assets.

Q. Does a distribution from an OZ Fund trigger the inclusion of the originally deferred gain? Can an OZ Fund make leveraged distributions?

Background: Prior to the publication of the Second Round Regs, the rules were unclear with respect to whether distributions from an OZ Fund would trigger inclusion

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of the originally deferred gain. It should be expected that most active trades or businesses would generate regular operating income, and some businesses, such as real estate, would generate proceeds from a borrowing. Clarity was needed to determine specifically which distributions may trigger the inclusion of originally deferred gain.

- A. With a number of exceptions, generally, a distribution from an OZ Fund will trigger the inclusion of deferred gain (an “inclusion event”). However, a distribution from an OZ Fund partnership will only be treated as an inclusion event to the extent the fair market value of the distributed property (or amount of cash) exceeds the recipient OZ Fund partner’s basis in its OZ Fund partnership interest. Therefore, an OZ Fund partner that is allocated net taxable income should be able to take a distribution from the OZ Fund partnership to the extent of such taxable income without accelerating recognition of deferred capital gain. A partnership OZ Fund or OZ Business that borrows generally should be able to distribute the proceeds to the OZ investors to the extent the investors are allocated basis as a result of the borrowing. However, while this provision is favorable to OZ investors, the Second Round Regs have borrowed from the so called partnership disguised sale rules and imply that a leveraged distribution within two years of an OZ investor’s capital contribution to an OZ Fund partnership may be an inclusion event.

Q. Can leased property be qualified OZ property?

Background: While section 1400Z-2 and the First Round Regs generally stated that property “owned or leased” by the taxpayer may be qualified OZ property, they did not provide additional details specific to the eligibility of leased property as qualified OZ property.

- A. Leased property may be qualified OZ property provided it meets certain requirements. Under rules similar to those applicable to purchased property, the leased property must be acquired under a lease entered into after December 31, 2017, and substantially all of its use must be in an OZ during substantially all of the lease period. (See below for a discussion of the “substantially all” tests that appear in section 1400Z-2.) Unlike purchased property, leased property does not have to meet the “original use” requirement, it does not have to be substantially improved, and leases are allowed between related parties subject to significant restrictions on prepayments and other limitations. Lease rents must be at a market rate, that is, reflective of the arms-length market practice in the locale including the OZ. In addition, options for the OZ Fund or OZ Business to acquire the leased property may not be exercised for an amount less than fair market value. Notably, this rule is extended to any evidence of intent that the OZ Fund or OZ Business plans to acquire the leased property for less than fair market value.

The leasing provisions are beneficial to businesses with changing needs for physical space, e.g., startups and growing businesses, as well as many smaller manufacturing and distribution businesses. It also creates possibilities for dividing OZ investments into real estate and operating businesses, which may facilitate operations, compliance, and exit planning. Furthermore, since leases may be between related parties, leases may be a path to OZ Fund qualification for taxpayers that already own land and want to develop it through an OZ-qualified vehicle.

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Q. What constitutes the “original use” of property?

Background: OZ property must be originally used by an OZ Fund or OZ Business or be substantially improved by the OZ Fund or OZ Business within a specified period. Prior to the Second Round Regs, potential OZ investors did not know how or when the original use of a property began. It was unclear whether used property could qualify under the original use requirement, whether the use of property in one OZ would preclude the property from being “original use” in another OZ, or when original use begins.

- A. The original use of tangible property begins when the property is first placed in service by any person in a specific OZ for purposes of depreciation or amortization. This means that tangible property located in a certain OZ that is depreciated or amortized by a person other than an OZ Fund or OZ Business does not meet the original use requirement with respect to that particular OZ (and therefore must be “substantially improved”). This does not mean that the property must be new. Used tangible property will still satisfy the original use requirement with respect to an OZ so long as it has not been previously used — by anyone — within that OZ in a manner that would have allowed it to be depreciated or amortized. Construction in progress acquired by an OZ Fund, housing converted from personal use to rental property, and leasehold improvements may satisfy the original use requirement.

An exception exists for tangible property like a building or equipment that was previously placed in service in the OZ and that has been unused or vacant for an uninterrupted period of at least five years. In this case, the original use in the OZ begins on the first date after the vacancy period when any person uses or places the property in service in the OZ. Moreover, this property qualifies for original use and does not need to be substantially improved to qualify as OZ property.

Q. What is the allowable time period for an OZ Fund to reinvest proceeds from a sale of qualified OZ property in replacement qualified OZ property without triggering the 90% penalty?

Background: As discussed above, at least 90% of an OZ Fund’s assets must be held in qualified OZ property. If an OZ Fund were to sell certain qualified OZ property for cash and temporarily fall below the 90% threshold, there was a question as to whether the OZ Fund would immediately fail this test and be subject to potential penalties or whether the OZ Fund would be permitted to reinvest the proceeds within a defined time period and avoid penalties.

- A. An OZ Fund has 12 months beginning on the date of the transaction to invest proceeds from the sale of qualified OZ property into another qualifying investment. During this time, the proceeds must be held in cash, cash equivalents, or debt instruments with a term of 18 months or less to be treated as qualifying property for purposes of the 90% asset test. These rules do not apply to sales and dispositions by an OZ Business, but Treasury is requesting comments as to whether an analogous rule should be provided for an OZ Business. As discussed earlier, with certain exceptions, any sale, disposition, or other transaction generating such proceeds will be subject to federal income taxation under the normal rules of taxation. However, an OZ investor may be able to elect to

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defer such gains in connection with a new OZ Fund investment if the gains would be taxed on or before the tax year including 2026. The mere reinvestment of proceeds by the OZ Fund would not be a qualifying election on behalf of an investor.

Q. Are there any changes to the 180-day period for investors to invest capital gains in an OZ Fund?

Background: The general rule established by Section 1400Z-2 is that investors have 180 days including the date of the sale or exchange of property to invest the resulting capital gain in an OZ Fund. An exception applies to gains from pass-through entities, in which case the investor has 180 days from the last day of the pass-throughs taxable year to invest in an OZ Fund.

- A. The Second Round Regs clarify that the 180-day period for section 1231 capital gains begins on the last day of the taxable year because the capital gain income from section 1231 property is determinable only as of the last day of the taxable year. Other than this limited provision, the 180-day period remains unchanged.

Q. Can property other than cash be a qualifying investment in an OZ Fund?

Background: There may be occasions where a contribution of property to an OZ Fund is more beneficial than a contribution of cash, such as if an OZ Business owned by the OZ Fund needed that specific property in the conduct of its trade or business in an OZ. Clarity was needed after the First Round Regs regarding how a contribution of noncash property to an OZ Fund would be treated.

- A. Qualifying investments in an OZ Fund can be in cash or property other than cash as long as the aggregate investment does not exceed the amount of capital gains eligible to be deferred. As a general matter, when property is contributed the amount of the investment is the lesser of the investor's basis in the contributed property or the fair market value of the property. Amounts in excess of the qualifying investment are treated as a separate, nonqualifying investment, resulting in a mixed fund. Contributions of property could occur when investors are concerned about cash flow or have property that could be used by the OZ Fund or the OZ Business. However, such property will not be qualified opportunity zone property because it was not acquired by purchase or lease by the OZ Fund.

Q. Can an investor make a qualifying OZ investment by purchasing an OZ Fund interest from an existing OZ Fund investor rather than investing directly in an OZ Fund?

Background: Section 1400Z-2 and the First Round Regs did not provide a potential OZ Fund investor with the flexibility to acquire an OZ Fund interest directly from a current OZ Fund investor as opposed to making a direct investment in the OZ Fund.

- A. For purposes of making an election under section 1400Z-2(a), if a taxpayer acquires a direct investment in an OZ Fund from a direct owner of the OZ Fund, the Second Round

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Regs provide that the taxpayer is treated as making an investment in an amount equal to the amount paid for the eligible interest. This provision does not extend to purchases of interests in an OZ Business from OZ Business owners. The purchaser will not inherit the holding period that the seller had in the OZ Fund.

Q. Are there any changes to the 90% test for OZ Funds?

Background: For investors in an OZ Fund to qualify for the OZ incentive, at least 90% of an OZ Fund's assets must be qualified OZ property.

- A. For purposes of the 90% test, OZ Funds may elect to disregard investments received within the preceding six months. These investments must be held only in cash, cash equivalents, or debt instruments with a term of 18 months or less. This substantially eases the pressure to immediately invest new capital in an OZ Business, which is subject to a separate limit on nonqualified financial property, including cash.

Q. How is "substantially all" defined for purposes of the various OZ thresholds?

Background: Variations of the term "substantial" appear multiple times in Section 1400Z-2 and the First Round Regs. In order to understand the meaning of "substantial" or "substantially" in these various contexts, additional clarification was needed from Treasury.

- A. The Second Round Regs define "substantially all" differently depending on the context. They define "substantial use" in the OZ to be 70% (i.e., if property is used at least 70% in the OZ it will meet the substantial use test). This percentage is consistent with the 70% threshold established in the first round of proposed regulations for tangible property. A "substantial portion" of intangibles that must be used in the active conduct of the trade or business is defined as 40% or more. For purposes of the amount of time that tangible property or an equity interest in an OZ Business must be qualified opportunity zone property, the substantially all threshold is 90% of the OZ Fund's holding period. Treasury applied the higher holding period percentage in part to avoid a cumulative substantially all percentage that could dip below 50%.

Q. How does an OZ investor account for basis in a partnership OZ Fund? Why does basis matter?

Background: When only capital gains are invested, an OZ investor's initial basis in an OZ Fund interest is zero. When the OZ Fund is a partnership, the investor's zero basis in its interest limits the investor's ability to claim U.S. federal income tax credits and depreciation deductions or withdraw cash from the structure and means that many of these benefits (and cash) must be allocated to a non-OZ investor or be accumulated in the OZ Fund. The investor's basis can be increased by causing the OZ Fund (or an OZ Business that is treated as a partnership) to borrow. Basis is also increased when taxable income is earned by the OZ Fund (or a partnership OZ Business) and allocated to the investor.

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A. Section 1400Z-2 provides that an OZ investor that holds its OZ Fund interest for at least five years prior to recognizing deferred gain can increase its basis in its OZ Fund interest by 10% of its initial investment in the OZ Fund that was eligible for deferral. Another 5% increase is available if the investor holds its OZ Fund interest for at least seven years. The Second Round Regs clarify that these basis increases are available before deferred gain is recognized, which will occur upon the earlier of a disposition of the OZ Fund interest or the 2026 tax year. In addition, the Second Round Regs clarify that these basis increases can be used for any purpose under applicable law.

Q. For an investor investing a combination of deferred gain and other funds or property in an OZ Fund partnership (i.e., a mixed investment), is the partner treated as making multiple investments with separate value and basis tracking?

Background: Section 1400Z-2 and the First Round Regs provide that an investor may make an OZ Fund investment from mixed funds. This raised questions about how these investments would be tracked from a partnership perspective and an OZ perspective.

A. An OZ investor that invests gains eligible for deferral and other funds or property will be treated as holding a single partnership interest with a unitary basis and capital account for partnership tax purposes. However, solely for OZ purposes, the partner will be treated as holding two partnership interests and all partnership items would affect the separate investments proportionately based on the relative allocation of percentages of each interest. As such, investors considering mixed investment of deferred capital gains and noncapital gains may consider investing deferred capital gains directly in the OZ Fund and noncapital gains in an OZ Business.

Q. Are there special rules for OZ Funds organized as corporations?

Background: An OZ Fund may be organized as an entity treated as a partnership or a corporation for federal income tax purposes. There may be certain contexts where a corporation is the preferred entity of choice for an OZ Fund. Due to the differing systems of taxation applicable to partnership and corporations special rules are needed for each entity classification.

A. OZ Fund corporations are subject to separate and equally complex rules as those applicable to OZ Fund partnerships. Since most OZ Funds are expected to be in partnership form, this alert focuses on the implications of OZ and partnerships. As with most aspects of the OZ incentive, readers are encouraged to seek qualified tax counsel with respect to OZ Fund corporation rules.

Q. How are gains of an OZ Fund treated upon the investor's death?

Background: Due to the long term nature of investments in OZ Funds, investors may be looking further into the future than with other investments. This may include the

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consideration of the effect of an investor's death on the tax treatment of the deferred gains.

- A. Neither the transfer of an OZ Fund interest to the investor's estate nor the distribution by the estate to the investor's heir is an inclusion event with respect to the capital gains invested in an OZ Fund and deferred for federal tax purposes. The recipient of the OZ Fund interest is required to recognize the deferred gain in the event of any subsequent inclusion event, such as a transfer of the OZ Fund interest by the recipient.

Q. Does a carried interest qualify for OZ benefits?

Background: Carried interest is a common component in funds and joint ventures as a mechanism for sharing income with management. Prior to the Second Round Regs, there was uncertainty as to whether carried interests invested into OZ Funds were eligible for OZ benefits.

- A. The Second Round Regs state that the receipt of an OZ Fund interest in exchange for services, including a carried interest, is a non-qualifying investment. The Second Round Regs do not clarify when an interest has been issued in exchange for services.

Q. What unique information reporting requirements will be imposed upon OZ Funds or other OZ entities?

Background: Since the OZ incentive is a completely new and distinct program, new information reporting requirements and forms must be developed for purposes of OZ compliance. Concerns about whether OZ investments will meet the goals of helping low income communities have led to calls for a report card-type information reporting regime to track investments.

- A. An OZ Fund must file Form 8996 with the IRS annually to self-certify as an OZ Fund or to figure the penalty if it fails to meet the 90% requirement. The preamble to the Second Round Regs states that a revised Form 8996 may also require an OZ Business's Employer Identification Number and the amount invested by the OZ Fund and OZ Business to be reported. Investors must file Form 8949 with the IRS in the year they elect to defer capital gains invested in an OZ. Treasury and the IRS state that they intend to address information-reporting requirements for eligible taxpayers within a few months in separate regulations, forms, or publications. These information reporting rules could apply both to reporting the social impact of investing in OZs (e.g., amount of funds invested in an OZ Fund, location and types of investments, number of jobs created) and information returns to assist the IRS in administering and enforcing OZ.

Q. What anti-abuse rules will Treasury impose?

Background: The OZ statute requires Treasury to develop rules to prevent abuse. Due to the potential the OZ incentive presents for facilitating investment and growth in designated distressed communities, the OZ incentive has drawn considerable

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attention and support. In order to ensure that the OZ incentive accomplishes its intended purpose, many sectors have called for anti-abuse rules.

- A. The Second Round Regs include the GAAR, i.e., a generally applicable anti-abuse rule, as discussed above. The GAAR provides that if based on the facts and circumstances a significant purpose of a transaction is to achieve a result inconsistent with the purpose of the OZ initiative, the IRS may recast the transaction or series of transactions as it deems appropriate, which could include disqualifying an OZ Fund. The scope of the GAAR is unclear. The regulations do not address to what extent an investment or increase in economic activity or output is sufficient to survive scrutiny. For example, the acquisition of unimproved land, followed by a de minimis investment on the land (such as a storage shed), followed by a prolonged period of little to no business activity, may be considered “land banking” and be subject to IRS attack under the GAAR. Similarly, a small business like a food stand that sells meals on a ten acre parcel of land, or a ground lease of land used by an OZ Business to operate a farming or ranching business in one or more OZs, may be abusive.

Q. What could trigger an IRS determination that an OZ Fund is not a qualifying OZ Fund? What happens to investors if that happens?

Background: The OZ incentive operates based on an incredibly complex collection of statutory and regulatory guidance. As a result, without careful and intentional planning in all phases of an OZ Fund lifecycle, the OZ Fund may fail to meet one or more of the numerous requirements imposed by law.

- A. Treasury and the IRS stated that they intend to address the administrative rules applicable to an OZ Fund that fails the 90% test within a few months in separate regulations, forms, or publications.

**WHAT QUESTIONS
DON'T THE SECOND
ROUND REGS ANSWER?**



Q. What triggers the beginning of the 30-month period for purposes of the substantial improvements test? Is the 30-month period continuous?

Background: Section 1400Z-2 provides that, when applicable, tangible property must be substantially improved within any 30-month period beginning after the date of acquisition of such property. It is unclear when the 30-month period begins and if it is continuous. Currently, the general consensus is that the 30-month period

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beginning on the date of acquisition and it runs continuously, but this is not entirely clear.

- A. The Second Round Regs do not address these questions.

Q. What activities constitute a “sin” business?

Background: Certain businesses referred to as “sin” businesses are ineligible as OZ Businesses. By reference to section 144, Section 1400Z-2 outlines a short list of so-called sin businesses.

- A. The Second Round Regs do not elaborate on the characteristics of sin businesses listed in the statute, including private or commercial golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetrack or facilities, and stores with the principal business of alcoholic beverage sales. It is unclear, for example, what constitutes a country club for purposes of this rule. Questions remain whether a cannabis business that is legal at the state level but illegal at the federal level can be a qualifying OZ Business.

Q. What is the IRS penalty procedures process?

Background: Considering the possibility of failure to satisfy certain OZ incentive requirements, in the absence of careful planning penalties may arise. Guidance on the penalty procedure process will be required to navigate potential OZ penalties.

- A. The First Round Regs state that Treasury and the IRS intend to publish additional proposed regulations that address penalties, but no further guidance is offered in the Second Round Regs. To-date, Treasury has not defined what constitutes reasonable cause in order for an OZ Fund to avoid penalties for purposes of the 90% test.

WHAT HAPPENS NEXT?

The clarifications and certainly provided in the Second Round Regs are expected to trigger a wave of new operating business and real estate investments in OZs, particularly as investors rush to maximize their OZ benefits by investing in an OZ Fund by December 31, 2019. Although the Second Round Regs are proposed and not final, Treasury has stated that taxpayers may rely on them as they proceed with OZ investments, projects and businesses.

Treasury is asking for stakeholder input as the department continues to develop guidance to address lingering technical questions and establish administrative procedures. Treasury has provided until July 1, 2019, 60 days following publication of the Second Round Regs in the Federal Register, for interested parties to submit comments. A public hearing is scheduled for July 9, 2019 for Treasury and the IRS to hear public remarks.

As Treasury and the IRS focus on regulatory and other guidance, President Trump’s White House Opportunity and Revitalization Council, established by Executive Order 13853, continues its work to cut the red tape on OZs by identifying barriers among federal, state and

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local agencies that impede the ability to maximize OZ benefits. See our alert titled [‘Trump Executive Order Cuts the Red Tape for Opportunity Zones’](#).

Congress continues to work on fine-tuning the OZ incentive. Legislation has been introduced in the House and the Senate to extend OZ benefits to a limited number of census tracts designated as disaster areas in the wake of recent hurricanes and wild fires. Information reporting to address the social impact of OZ activity is pending in the Senate. Additional legislative proposals to enhance the OZ incentive, including extending the deadline to invest in an OZ Fund and receive the maximum 15% step-up in basis, are expected.

The K&L Gates OZ team intends to publish a series of targeted alerts to address the applicability of OZ incentives to particular industries and areas of interest.

Please contact the K&L Gates OZ team for assistance in implementing any aspect of the OZ incentive or if you wish to provide comments, input and ideas to the White House, Treasury and Congress. For more information, please contact the authors or visit our [website](#).

[1] Except as otherwise indicated herein, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”) and all Regulation section references are to the U.S. Treasury Regulations issued thereunder.

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