November 12, 2018

11 Key Features of the Opportunity Zone Program That You Might Have Overlooked

by Andrew B. Sachs , Katherine A. McCurry , Alexandra M. Fenno , John I. Sanders

---

Last month, the Treasury Department released proposed regulations (the "Regulations"). The Regulations included a number of important clarifications and guidance for investors seeking to take advantage of the opportunities offered by the program.[1] For a thorough discussion of the Opportunity Zone program, please see our white paper, linked here. If you haven't had a chance to read our white paper yet, below we discuss eleven key features of the Opportunity Zone program that you may have overlooked:

- **Some Opportunity Zones are prime investment locations.** By definition, an Opportunity Zone is an area with either: (i) a poverty rate of 20%, or (ii) a median family income lower than 80% of the area average.[2] An examination of Opportunity Zone maps reveals that some opportunity zones are situated in attractive areas for development, including many central business districts. For example, large tracts outside Seattle and Winston-Salem's fast-growing innovation quarter are both Opportunity Zones. [3]
- **Capital gains are key**. The tax benefits offered by the Opportunity Zone program are only triggered by the reinvestment of capital gains into a qualified opportunity zone fund ("QOF"). The tax advantages of the program do not apply for investments of ordinary income in a QOF.[4]
- **But ordinary income can be invested too.** While they won't get the tax benefits of a capital gains investment, investments of ordinary income are permitted in QOFs.
- **Timing Matters.** In order to maximize the tax benefits offered by the program, investments in QOFs should be made by December 31, 2019.
- **Beware of "related person" transactions.** Related party transactions can run afoul of the Opportunity Zone program in two key ways: (1) capital gains generated in a related party transaction do not qualify for the tax benefits of the Opportunity Zone program[5]; and (2) real estate (or other business property) acquired by a QOF in a related party transaction is not considered an eligible investment by the QOF (*i.e.*, it would not count towards the 90% test for qualifying as a QOF).
- **Be wary of cash.** To qualify as a QOF, a fund must generally have at least 90% of its assets invested in Opportunity Zone business property or equity interests issued by an Opportunity Zone business.[6] Thus, a QOF must take care to appropriately limit its cash holdings. There are also significant limitations on the amount of cash that can be held by an Opportunity Zone business in which a QOF invests, and, while the Regulations do provide for a 31-month working capital safe harbor, there are a number of steps that must

be taken in order for cash held by the business to qualify for the safe harbor.

- **Passive real estate investments are not sufficient.** An investment in real estate located in an Opportunity Zone qualifies as an investment in Opportunity Zone business property only if (1) the property's original use begins after the investment is made; or (2) the QOF "substantially improves" the property. [7] This means a fund must do more than simply acquire and passively hold a real estate property in an Opportunity Zone to qualify.
- **Only the building needs to be improved, not the land.** The Regulations clarified that, with respect to a real estate property acquired by a QOF, if the property includes a building, only the building must be "substantially improved," [8] not the land. In most cases, this clarification will significantly reduce the amount that must be spent on improvements by a QOF to qualify as having substantially improved a property.
- **QOFs are likely to be structured as private funds**. We anticipate that virtually all QOFs will be structured as private funds issuing partnership interests under Reg D. Accordingly, they'll sell interests primarily, though not exclusively, to accredited investors. QOFs will have to decide which Reg D exemption to use based on their need to reach such investors through a general solicitation.
- **Certain QOF managers may need to register as investment advisers.** Those planning to launch QOFs need to consult with legal counsel to determine whether they qualify for an exemption to registration as an investment adviser. An exemption exists for certain private fund advisers, but can be easily forfeited without careful planning.
- **The Opportunity Zones program requires a support network.** Investment managers who launch QOFs will need to partner closely with sophisticated tax professionals, private fund administrators, and attorneys experienced with private fund offerings. They may also need to partner with real estate developers and brokers or businesses and entrepreneurs, depending on the focus of the QOF.

If you have any questions about the Opportunity Zone program, please feel free to contact us. ***Andrew B. Sachs*** *is a partner with the firm's Winston-Salem office.* ***Kate McCurry***, ***John I. Sanders***, *and* **Ali Fenno** *are associates based in the firm's Winston-Salem office.* [1] For specific details and background information on the Opportunity Zone Program, please see our recent blog post, "Opportunity Zones Present Incredible Opportunity for Private Fund Managers." [2] 26 USC 45D(e)(1). [3] *IRS Issue Proposed Regulations on New Opportunity Zone Tax Incentive*, Internal Revenue Service, https://www.irs.gov/newsroom/treasury-irs-issue-proposed-regulations-on-new-opportunity-zone-tax-incentive (containing a complete list of Opportunity Zones). [4] 26 USC 1400Z-2. [5] Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54280-01 (Oct. 29, 2018). [6] 26 USC 1400Z-2(d)(1). [7] 26 USC 1400Z-2(d)(2)(D)(i). [8] Investing in Qualified Opportunity Funds, 83 FR 54279-01 (Oct. 29, 2018).