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New Proposed Tax Rules Favorable for Opportunity Funds

The Tax Cuts and Jobs Act of 2017 provided significant tax benefits relating to — and, as a result, sparked high interest in — investments in qualified opportunity funds ("Opportunity Funds"). On October 19, 2018, the U.S. Department of Treasury issued eagerly anticipated proposed regulations (the "Regulations") and an IRS ruling addressing a number of significant issues relating to the Opportunity Fund legislation, which are expected to increase the flow of new funds coming to market.

Background

Opportunity Funds are investment vehicles formed to make qualifying investments in low-income communities designated as opportunity zones ("Opportunity Zones"). A qualifying investment may either be an investment in real estate or an investment in an operating business. However, because the Regulations did not address key questions relating to non-real estate businesses and given the complexities involved with qualification of non-real estate businesses, we expect the first generation of Opportunity Funds to be focused predominantly on real estate activities. All 50 states have designated Opportunity Zones, with more than 8,700 zones having been designated.[1]

The Opportunity Fund legislation provides three primary tax benefits for taxpayers who roll gains (including gains attributable to carried interest) from a profitable investment into a qualifying investment in an Opportunity Fund:

1. deferral of tax on the eligible gains until the earlier of disposition of the acquired interest in the Opportunity Fund or December 31, 2026;

2. reduction of the gain by 10% if the investment in the Opportunity Fund is held for at least five years and an additional 5% (for a total of 15%) if the investment in the Opportunity Fund is held for an additional two years (for a total of seven years); and

3. 100% of exclusion of incremental gain (other than the deferred gain) from the investment in the Opportunity Fund if the investment in the Opportunity Fund is held for at least 10 years.

In order to qualify for these benefits, an investor must invest gain from the sale of property into an Opportunity Fund within 180 days of the sale. Importantly, the gain can be from the sale of virtually any asset (real estate, stock, bonds or other privately or publicly traded property), and only the gain proceeds (not the original principal) need to be invested. Investment of amounts other than gain proceeds is not eligible for the Opportunity Fund benefits.

In order to qualify as an Opportunity Fund, an investment vehicle must hold at least 90% of its assets in qualified Opportunity Zone property. An Opportunity Fund may invest directly in Opportunity Zone property or indirectly through corporations or partnerships (including LLCs) that are qualified Opportunity Zone businesses. Qualified Opportunity Zone property is generally (i) tangible property used in a business within an Opportunity Zone, (ii) acquired after 2017 and (iii) either (a) originally used in an Opportunity Zone by the Opportunity Fund or (b) substantially improved by the Opportunity Fund, defined as the Opportunity Fund doubling its basis in the property over a 30-month period. Given the original use/substantial improvement

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requirement, qualifying real estate investments must either be ground up development or involve significant redevelopment of existing improvements.

Prior to the Regulations, there were many important unanswered questions regarding what qualified for the statutory tax benefits, and qualification as, and treatment of ongoing operations of, an Opportunity Fund. While a limited number of funds were launched, many sponsors deferred launching funds until these questions were answered. We expect the guidance from the Regulations to result in the launch of many Opportunity Funds.

The Proposed Regulations

The Regulations offer guidance on a number of critical points. Below are summaries of these points and their significance with respect to the formation of, investment in, and operation of, an Opportunity Fund.

Qualifying Investments

- **Gains qualified for reinvestment:** All capital gains, including long-term and short-term capital gains, qualify for investment into Opportunity Funds. The expansive definition of eligible gains allows for investment of carried interest gains, although those gains will retain their character when deferral ends in 2026. Taxpayers will be permitted to elect which gains to treat as invested, enabling election of short-term gains first. Taxpayers are not required to offset gains first with losses, permitting taxpayers to preserve losses for future years.

- **Partnership and other pass-through entity gains:** When a partnership sells property, either the partnership or its partners (but not both) are eligible to invest the gain into an Opportunity Fund. Partners will need to consider whether to address this optionality in partnership agreements and with fund sponsors. If a partnership does not elect to invest gains, each partner will be able to elect to start its 180-day investment period beginning either with the partnership's sale of the asset creating the gain or the end of the taxable year in which the partnership sold the asset. In the case of a REIT or a RIC, the 180-day period begins on the shareholder's receipt of a capital gain dividend from the REIT or RIC.

- **The 180-day requirement:** Satisfaction of the 180-day investment requirement requires cash contributions to the Opportunity Fund. Capital commitments and contributions of non-cash property do not satisfy the 180-day requirement. The Regulations do not offer any flexibility on the 180-day requirement.

- **Treatment of Opportunity Fund debt:** The Regulations clarify that if an Opportunity Fund that is a partnership for tax purposes borrows money, its partners will not be treated as if they had borrowed such funds and contributed those funds to the partnership. Prior to issuance of the Regulations, commentators had been concerned that partnership borrowings would create a mixed investment for its partners (i.e., partly as qualifying for Opportunity Fund benefits and partly not). As a result of the guidance in the Regulations, investors will not be required (or permitted) to treat a deemed contribution of such amounts as contributions to the Opportunity Fund.

- **Qualified interests in Opportunity Funds:** Only equity (and not debt) interests in Opportunity Funds qualify for the legislation's benefits. Qualifying equity investments include preferred interests and partnership interests with special allocations (presumably including carried interests).

Opportunity Fund Qualification

- **Opportunity Fund certification:** An Opportunity Fund self-certifies its status (and designates an effective date) as an Opportunity Fund with its tax return filing. The Opportunity Fund's 90% asset test is under certain circumstances determined based on its financial statements and in other circumstances based on the cost of its assets. For the Opportunity Fund's first year, compliance is tested on the earlier of the six-month anniversary of becoming an

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Opportunity Fund or December 31 of the year, and thereafter is tested on each June 30 and December 31.

- **Treatment of cash held directly or indirectly by an Opportunity Fund:** Cash held directly by an Opportunity Fund does not qualify as Opportunity Zone property for purposes of the 90% test. On the other hand, an Opportunity Zone business is permitted to hold reasonable cash reserves necessary for the business' cash needs provided three requirements are satisfied: (i) the amounts are designated in writing for the acquisition, construction and/or substantial improvement of Opportunity Zone property, (ii) there is a written schedule describing the use of the funds which must be spent within 31 months, and (iii) the funds are actually used in a manner consistent with the written plan. Opportunity Funds are likely to need to form subsidiaries (regarded for tax purposes) to hold cash held for development.
- **The substantial improvement requirement:** The Regulations clarify that, if an Opportunity Fund acquires a building located on land in an Opportunity Zone, only the Opportunity Fund's basis in the building (and not its basis in the land) is required to be doubled to satisfy the substantial improvement requirement; similarly, the Regulations (at a minimum, an example in the Regulations) seem to imply that when an Opportunity Fund acquires vacant land, the basis in the vacant land will not cause the Opportunity Fund to fail the substantial improvement requirement so long as the Opportunity Fund develops the acquired property. Acquisitions of improved property will require allocation of purchase price between land and improvements to establish the basis subject to the doubling requirement. Furthermore, property is treated as qualified Opportunity Zone property from acquisition as long as the Opportunity Fund has a plan to complete the required substantial improvements within 30 months of acquisition.
- **2028 lapse of Opportunity Zone status:** The Regulations clarify a technical issue under the statute with respect to Opportunity Zone designations (which technically expire at the end of 2028) and make clear that investments in an Opportunity Fund from gains realized prior to December 31, 2026, are eligible for the exclusion from taxation for Opportunity Fund investments held for at least 10 years provided the investment in the Opportunity Fund is sold prior to December 31, 2047 (i.e., 10 1/2 years after the expiration of the last potential 10-year holding period).

Issues to be Addressed in Future Regulations

The preamble to the Regulations states that additional guidance is expected to be published in the near future, including:

- **Original use and substantial improvement requirements:** The preamble to the Regulations specifically requests comments regarding "all aspects" of these requirements. In particular, comments are requested on the original use requirement where non-real estate property has previously been used outside an Opportunity Zone, where property has been previously abandoned or under-utilized, and on the substantial improvement requirement relating to non-real estate property.
- **Substantially all requirements:** The Regulations address the substantially all requirement only in relation to the amount of qualified Opportunity Zone property required to be held by an Opportunity Zone business. The statute contains the phrase "substantially all" in several other contexts not addressed in the Regulations; the additional guidance is expected to address such other contexts.
- **Taxation of Opportunity Fund income and gains:** The Regulations do not address treatment of income earned, including from operations and gains, by an Opportunity Fund. The preamble to the Regulations notes that the statute authorizes regulations to ensure an Opportunity Fund has a reasonable period of time to reinvest return of capital. Guidance

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is expected on reinvestment and it is expected that such guidance will invite additional comment on treatment of gains on reinvested capital.

- **Transactions triggering end of deferral:** Identification of transactions which trigger income deferred by Opportunity Fund investments.
- **Penalty provisions:** The Regulations do not address the penalty provisions in the legislation. Guidance is expected on application of the penalty provisions and circumstances under which an Opportunity Fund would be de-certified.

Other Areas of Remaining Uncertainty

- **Debt of Opportunity Funds:** In the case of an Opportunity Fund that elects to be treated as a partnership, it is unclear whether debt incurred by the Opportunity Fund will be included in the tax bases of its partners in their partnership interests under the rules generally applicable to allocations of partnership debt. If debt is included, partners would be able to receive distributions (whether of operating income or the proceeds of asset sales and refinancings) on a tax-free basis to the extent of their allocable shares of debt of the Opportunity Fund.
- **Non-real estate businesses:** The Regulations focus almost entirely on real estate activities, leaving open myriad issues relating to non-real estate businesses. Clarification on those issues will likely be needed before significant activity occurs with respect to the use of Opportunity Funds for non-real estate businesses.
- **10-year hold exclusion:** In order to exclude gains for investments held at least 10 years, the Opportunity Fund legislation requires a taxpayer to sell its interest in the Opportunity Fund. Sales by an Opportunity Fund allocated to a taxpayer do not qualify. The Regulations do not provide any relief from this cumbersome requirement.
- **Fund of funds and joint ventures:** The Opportunity Fund legislation requires that an Opportunity Fund hold Opportunity Zone property; Opportunity Zone property excludes interests in other Opportunity Funds and interests in joint ventures or other enterprises unless the interest is acquired solely for cash. These constraints create substantial limitations on the practical operation of Opportunity Funds, including many practical limitations on use of a traditional commingled fund model, and it is unclear if future guidance will address these limitations.

1. An interactive map depicting the designated Opportunity Zones is available here, and additional information about Opportunity Funds can be found on the website of the Economic Innovation Group (a leading nonprofit organization which provided significant support for the legislation, and of which Kirkland & Ellis LLP is a member).

If you have questions about the topics addressed in this *Private Investment & Family Office Insights*, please contact familyoffice@kirkland.com or one of the attorneys listed below.

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