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## Opportunity Zones – Pending IRS Regulations Poised to Facilitate Investments

due to visa backlogs and noted how opportunity zones may provide a new source of capital for new and existing EB-5 projects. *October 2018 RCBJ, Vol. 6, Issue #2*. In the meantime, on October 19, 2018, the Internal Revenue Service (IRS) released proposed regulations (Proposed Regulations) concerning the qualified opportunity zone program (QOZ Program). Contemporaneously with the issuance of the Proposed Regulations, the IRS released a Revenue Ruling (Revenue Ruling 2018-29) addressing the application of the “original use” requirement and the “substantial improvement” requirement – two fundamental tests for real property in the QOZ Program. As discussed below, on February 14, 2019, the IRS held a public hearing on the Proposed Regulations. It is anticipated that additional proposed regulations, as well as final regulations, will be issued in relatively short order.

This article provides an overview of the Proposed Regulations and highlights the impact of certain Proposed Regulations, if adopted in their current proposed form, on opportunity zone fund investments in EB-5 projects.

This article also addresses how investments from qualified opportunity zone funds can

be made into new EB-5 projects and how investments from EB-5 new commercial enterprises can be made into qualified opportunity zones provided certain conditions are satisfied. Those conditions include that the qualified opportunity zone fund contributes cash into the newly formed entity such as a limited liability company (LLC) and the LLC qualifies as a qualified opportunity zone business, as discussed below.

### The Slowdown of EB-5 Capital Investments

As the chart below reflects, there has been a steady decline in EB-5 capital investments (calculated based on the number of I-526 Petitions filed with USCIS) from its high in 2015, including an estimated 65% year-to-year reduction from \$5.5 billion in 2017 to \$2.9 billion in 2018.

### The Rise of Opportunity Zone Funds

Since the QOZ Program was created on December 22, 2017, a growing number of opportunity zone funds have been created. According to available public reports, including from the Costar Group and the National

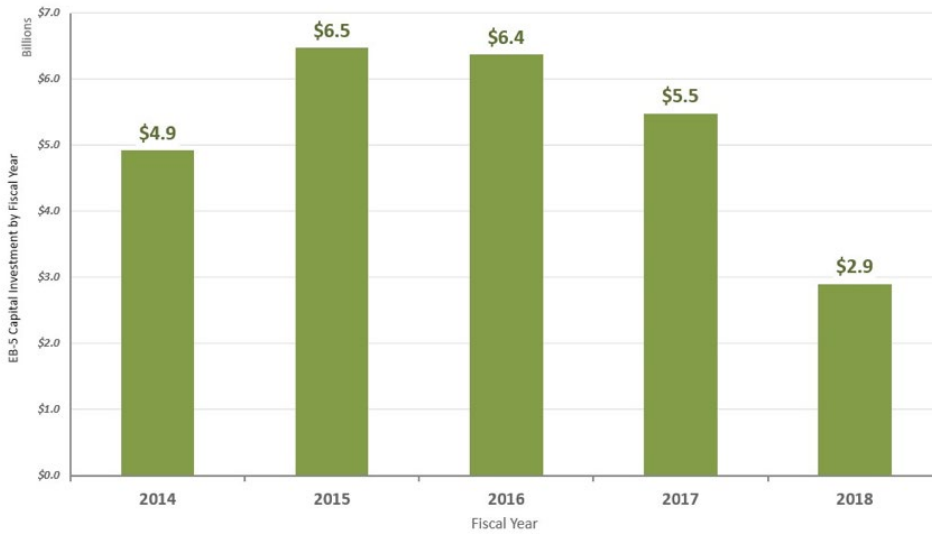
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**Introduction:** The Tax Cuts and Jobs Act signed into law on December 22, 2017 created a new capital gains deferral and exemption for taxpayers who make long-term investments in low-income rural and urban communities that have been designated by the Treasury Department as “opportunity zones.”

In the fall of 2018, this magazine reported on the decline in the amounts of EB-5 capital raised

## Estimated New EB-5 Capital Investment Inflow by Fiscal Year (in \$Billions, FY2014 - FY2018)

Note: EB-5 capital investment inflow is estimated by \$500,000 per I-526 petition filled with 90% approval rate.



Source: U.S. Citizenship and Immigration Services (USCIS).  
Prepared by: IIUSA

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Council of State Housing Agencies, there are approximately 236 funds established to invest in opportunity zones as of March 8, 2019 that represent roughly \$27.1 billion in investment capacity. A public opportunity zone REIT by Belpointe Capital has also been filed with the U.S. Securities and Exchange Commission. These newly raised funds are able to invest in any of the 8,700+ certified opportunity zones, and Yardi Systems reports that the range of commercial real estate investments in the opportunity zones is possibly between \$30-\$100 billion. Once the Proposed Regulations are finalized, we anticipate that the existing opportunity zone funds will become more active and additional opportunity zone funds will be created.

The certified opportunity zones are different from the empowerment zones created in 1993. While empowerment zones provide some similar tax exclusions for capital gains, they also provide wage credits for employers, tax deductions for expenses to train employees, tax-exempt bond financing and block grants, among other benefits. The limited number of empowerment zones and related enterprise communities, along with the fairly complex and varied types of benefits, has limited the success of the empowerment zones program.

### Proposed Regulations

The Proposed Regulations provided much-needed clarity about how the QOZ Program works. While the regulations are still

“proposed”, they clarified the following issues (among others):

- A **qualified opportunity fund (QOF)** must be an entity classified as a corporation or partnership for federal tax purposes, and must be organized in one of the 50 states, the District of Columbia, or a U.S. possession. Accordingly, a limited liability company (LLC) classified as a partnership or corporation for federal tax purposes can qualify as a QOF. The treatment of LLCs was an open issue prior to the release of the Proposed Regulations.
- A **QOF self-certifies** as such on IRS Form 8996. This form must be filed annually by the QOF and must include other pertinent information confirming the QOF’s status.
- A QOF must invest in projects that satisfy the **“original use” test** (original use of the property in the opportunity zone must commence with the QOF) or the **“substantial improvement” test** (the QOF must invest within 30 months after acquisition an amount more than the QOF’s basis in the property on the date of acquisition). Land and preexisting buildings situated thereon (which are located within a qualified opportunity zone) cannot satisfy the “original use” test, but with respect to

the “substantial improvement” test, when land and preexisting buildings thereon are purchased together, the QOF is only required to substantially improve the buildings (not the land) in order to meet the requirement of holding “qualified opportunity zone business property.” Revenue Ruling 2018-29 also addressed these issues. While these clarifications are useful, unanswered questions still remain, especially concerning the treatment of land.

- The rules about how qualified opportunity zone projects need to be structured were clarified by the Proposed Regulations. There are **two main types of structures that investors can use under the QOZ Program:**

- o The first option is to have a QOF own qualifying property and operate a business directly.
- o The second option is for the QOF to own qualifying property and operate a business indirectly through a subsidiary that is classified as a partnership or corporation. Under this structure, the subsidiary will need to meet the requirements for a “qualified opportunity zone business” (QOZB).

The Proposed Regulations outlined the requirements that apply under each structure. Notably, very different rules apply to each structure, and due to the flexibility granted to the QOZB structures, it is anticipated that **most structures will be created as QOZB structures.**

- For example, the Proposed Regulations provide that one of the main benefits to a QOZB structure is that a QOZB is permitted to hold a reasonable amount of working capital (such as cash and cash equivalents). A safe harbor provides that amounts shall be considered reasonable if the amounts are designated in writing for use in the acquisition, construction or improvement of tangible property, a written schedule provides for the

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deployment of such working capital under which the working capital must be spent within 31 months, and the working capital is actually used consistently with the foregoing. This safe harbor will enable QOZBs to better manage their cash. By contrast, a direct QOF structure currently cannot benefit from these rules.

- In addition, the Proposed Regulations provide that at least 70% of the tangible property (owned or leased) of a QOZB must be qualified opportunity zone business property. By contrast, under the direct QOF structure, the threshold is generally 90%.

The February 14, 2019, public hearing on the Proposed Regulations was held at the IRS in Washington, D.C. The IRS actually originally scheduled the hearing for January 10, 2019, but due to the partial federal government shutdown, the hearing was postponed by more than a month. Scores of comment letters were sent to the IRS in advance of the hearing. By all accounts, the hearing was well attended by industry and tax professionals and other stakeholders, and overall the IRS seemed receptive to the concerns raised in the comment letters and at the hearing.

Some of the salient open questions to which stakeholders are eagerly awaiting answers include the following:

- What is the **definition of an “active trade or business?”** One of the requirements applicable to a QOZB is that there must be an active trade or business. The Proposed Regulations did not provide a definition of this term, but “reserved” on the issue, so the IRS will be providing a definition soon. This forthcoming definition is important because it will dictate what types of projects can qualify as a QOZB.
- How will the **50 percent gross income requirement** be interpreted? Another requirement for a QOZB is that at least 50% of the total gross income of a QOZB be derived from the active conduct of a trade or business. The Proposed Regulations added to this requirement the words

“in the qualified opportunity zone.” In this respect, a bipartisan group of House and Senate legislators wrote a letter to the Treasury Department in late January requesting that the rule simply require that 50% or more of the gross income of a qualifying business come from the active conduct of a trade or business, without reference to a source within a qualified opportunity zone.

- Will a QOF be able to **sell underlying property on a tax-free or tax-deferred basis?** This is one of the most pressing questions. The prevailing interpretation under the QOZ Program is that in order for an investor to benefit from the 10-year basis step-up provision (which may result in the elimination of most, if not all, gain), the QOF equity must be sold, as opposed to the underlying property or business. The IRS and Treasury Department should be providing guidance about what happens when a QOF sells underlying property and how that impacts the QOF itself as well as the QOF investors.
- Can a QOF **refinance its property and distribute the proceeds to its partners on a tax-free basis?** Refinancing has been a routine way for investors to monetize investments in funds for quite some time. Typically, in a fund treated as a partnership for tax purposes, partners are able to receive cash proceeds of a refinancing without incurring income

tax. Unfortunately, based on the nature of the rules under the QOZ Program, there is some uncertainty about whether this same rule applies in the case of a QOF.

- Will **“carried interests” be able to qualify for any tax benefits?** There is no explicit guidance on whether a carried interest (sometimes technically referred to as a profits interest) entitles the holder to any benefits under the QOZ Program. In this respect, the Proposed Regulations merely state that a qualifying QOF interest may include a “partnership interest with special allocations.” While we await further guidance on this issue, the prevailing thought process is to ensure that the holder of such a partnership interest with special allocations has invested capital gain within the appropriate 180-day window.

[The Interplay of Opportunity Zones and EB-5 Projects](#)

**General QOF Investment Requirements**

Suppose a new project entity, such as an entity that would borrow funds from an EB-5 new commercial enterprise (NCE), was established in 2018 or later as an LLC using the QOZB structure (summarized above). The LLC can receive capital from both the NCE and from QOFs. This structure should enable the investors in the QOFs to obtain the opportunity zone tax benefits provided the following requirements are met:

- A. The QOF contributes cash into the LLC in exchange for its equity interest.
- B. The LLC qualifies as a QOZB. A QOZB is defined as a trade or business:
  - (a) in which substantially all (defined as at least 70%) of the tangible property owned or leased by the QOZB is qualified opportunity zone business property (defined below);
  - (b) in which at least 50 percent of the total gross income is derived from, and a substantial portion of the intangible property is used in, the active conduct of the business, and less than 5 percent of the average



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of the aggregate unadjusted bases of the property is attributable to nonqualified financial property (generally meaning debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property, but excluding reasonable working capital); and

- (c) that is not a private or commercial golf course, country club, massage parlor, hot tub facility, suntan 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.

Assuming these QOZ Program requirements can be satisfied, the many similarities between the QOZ Program and the EB-5 program should enable investments between the programs. Some of the program similarities include that (1) there is there is no limitation

on the amount than can be invested into an opportunity zone project, (2) investments in opportunity zones are long-term with tax benefits at 5, 7 and 10 years (which would help job creation for EB-5) and (3) like the EB-5 program, the QOZ Program applies to both investments in real estate and operating businesses.

**QOF Investments > EB-5 Projects - Given the number of tests that must be satisfied for QOF investments, new EB-5 projects, rather than older EB-5 projects, will be more attractive to QOF investments.**

QOF investments must be made in property acquired by purchase from an unrelated party in 2018 or later and must meet either the “original use” requirement or the “substantial improvement” requirement, among other requirements. Thus, pre-2018 projects may not be able to meet the applicable opportunity zone tests, at least not without significant restructuring. On the other hand, new projects started in 2018 or later which allow QOF investments and EB-5 capital to be invested simultaneously in a project will likely involve

the purchase of property in 2018 or later and can more easily satisfy the QOF investment requirements.

**EB-5 Capital > QOF Investments – Invested as either new EB-5 capital or redeployed capital.**

Assuming the QOF investment satisfies the requirements listed above, newly raised EB-5 capital can be invested along side the QOF investment (understanding that the QOF investment must be in the form of equity).

To the extent that existing EB-5 projects are permitted by law and their governing documents to redeploy their EB-5 capital pending resolution of the at-risk period, then the rise of projects in opportunity zones will create new options for such redeployed funds to be invested in.

### Conclusion

Once the Proposed Regulations are finalized and the anticipated additional proposed regulations are published, EB-5 capital and QOF investments will be further integrated as part of capital financing for new projects. ■



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