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Five Key Insights From the Opportunity Zone Guidance

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Opportunity Zones

Real Estate Finance

Industries

Financial Services & Capital Markets

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Professionals

REBECCA H. MITICH
MILWAUKEE:
414.978.5367
REBECCA.MITICH@HUSCHBLACKWELL.COM

JONATHAN W. GIOKAS
ST. LOUIS:
314.480.1713
JONATHAN.GIOKAS@HUSCHBLACKWELL.COM

JOSEPH E. BREDEHOFT
ST. LOUIS:
314.480.1721
JOSEPH.BREDEHOFT@HUSCHBLACKWELL.COM

Created last year as part of the Tax Cuts and Jobs Act, the Opportunity Zones (OZ) incentive encourages investment in certain designated, economically distressed areas in each state. The guidance, consisting of proposed regulations, a revenue ruling and responses to FAQs and a tax return form for qualified opportunity funds, provides clarity on several key points, including:

Either a partnership or its partners can elect to designate capital as an OZ investment. In the event a partnership would be subject to a capital gain, either (i) the partnership may elect to defer that capital gain and, in doing so, exclude the gain from the distributive share of its partners, or (ii) if the partnership does not make the election, any individual partner can make its own deferral election with respect to its distributive share.

OZ investments can be financed with debt. An OZ investor is permitted to finance the acquisition of its qualified opportunity fund equity interest, and can pledge that equity interest as collateral for a loan.

A qualified OZ business will need at least 70% of its qualifying tangible assets to be located in an OZ. The statute contains a requirement that "substantially all" of the tangible property owned or leased by a qualified OZ business is qualified OZ business property. The guidance clarifies this "substantially all" standard is satisfied if 70% of these qualifying assets are in a qualified OZ. The guidance indicates the Treasury and IRS considered several standards for "substantially all," including a requirement than 90% of the qualifying assets would need to be located in a qualified OZ.

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By setting a 70% standard, the Treasury and IRS allow significantly greater flexibility and encouragement for investments in operating businesses.

Qualified OZ businesses can avail themselves of an important safe harbor by creating and executing on a plan for working capital expenditures. The OZ statute requires a business receiving an OZ investment to maintain no more than five percent of its assets in nonqualified financial property. The initial guidance provides a safe harbor for reasonable working capital held for a period of up to 31 months to avoid characterization as nonqualified financial property, if: (1) the intended uses of the reasonable working capital are designated in writing, (2) the business creates a written schedule for consumption of those funds consistent with the ordinary start-up of a trade or business, and (3) the working capital is used in a manner substantially consistent with the anticipated uses and schedule.

For qualification of a real estate development as a "substantial improvement," land is excluded from the basis calculation. With respect to real estate development consisting of the redevelopment of an existing building, the OZ statute requires the real estate to be "substantially improved" within a 30-month period. The guidance excludes the basis of the underlying land from the calculation.

The initial guidance provides significant direction for potential investors, fund managers, developers, entrepreneurs and other market participants, many of whom sought clarification regarding the parameters of the OZ program before deploying capital. That said, it is worth noting the October 19 regulations are only in proposed form at this point, and changes may be made upon final adoption. The IRS has also indicated additional guidance is in process, and some of the issues open for possible interpretation include:

Whether investors must recognize interim capital gains incurred as the result of the sale of qualified OZ business stock or partnership interests. To the extent any qualified property is sold during the OZ investment period, interim capital gains may be recognized. Additional guidance would provide comfort to OZ investors and fund managers with respect to the ability to sell and reinvest in new qualified assets within the same fund without compromising programmatic benefits.

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What actions of a qualified opportunity fund lead to decertification. In addition to noncompliance penalties, the guidance indicates the Treasury and IRS intend to publish additional proposed regulations to address conduct that leads to decertification of a qualified opportunity fund.

The definition of "substantially all" as applied to several provisions of the statute. The statute uses the undefined term "substantially all" to describe the holding period of a qualified opportunity fund in a qualified business and the usage of tangible property by a qualified opportunity fund in an OZ. The Treasury and the IRS requested comments on how the "substantially all" definition should be used for these concepts.

Contact Us

Husch Blackwell's Opportunity Zones team continues to evaluate this initial round of guidance and its potential impact on our clients. For additional information, please do not hesitate to contact any member of our group.

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