



Qualified Opportunity Funds: “I realized the capital gain. Now what?”

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Objectives of a Qualified Opportunity Fund



- Long-term capital appreciation through investment in qualifying opportunity zone property
- **Target investments in projects:**
 - with potential for strong cash flow for duration of 10 years
 - with the prospect for appreciation of residual values
- Provide opportunity to investors to defer capital gains invested in the Fund within 180-days of a sale or exchange

See The Tax Cuts and Jobs Act of 2017

(now codified at Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code)

Overview:



How to raise capital?

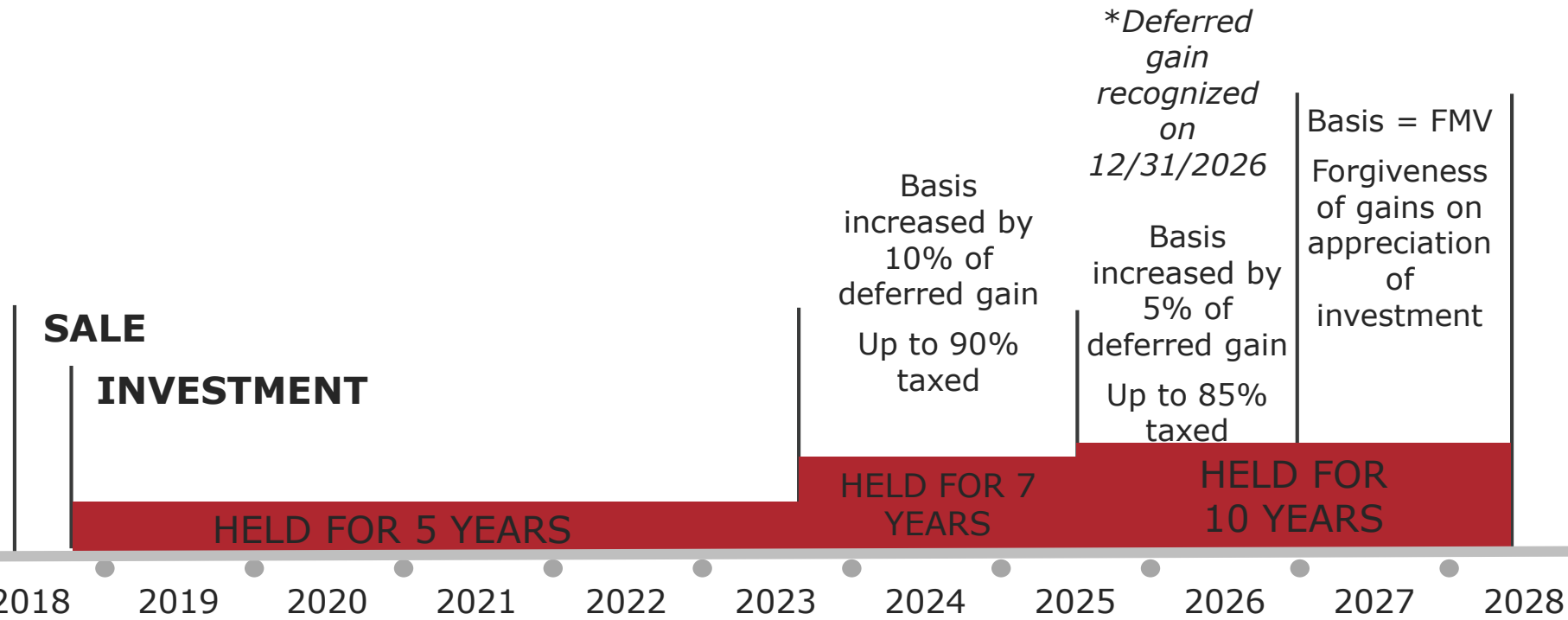
- Benefits to Investors?
- Costs of setting up a Qualified Opportunity Fund?
- Timing considerations?
- Direct vs Indirect Structure?
- Similarities/Differences from a 1031 Exchange?
- Guidance from Treasury?
- Raising Money?
- Risk Factors?

Formation of a Qualified Opportunity Fund



- An entity classified as a **corporation or partnership** for Federal income tax purposes which is organized in:
 - any State, the District of Columbia, or a U.S. possession
 - may be organized as a limited liability company.
- **Purpose:** Must be organized for the purpose of investing in QOZ property (other than another QOF)
- **QOF self-certification and Annual Compliance Form 8996**
 - Annually attach to timely filed federal income tax return (including extensions)
- It is anticipated that individual investors will make deferral elections on Form 8949
 - To be attached to that investor's federal income tax return for the taxable year in which the gain would have been recognized if it had not been deferred

Long-term Investment: Temporary Deferral and Permanent Exclusion Benefits



Source: Novogradac & Company LLP

The Ultimate Tax Break

Source: Forbes

\$10,000,000

Long-term gain realized on stock sale

Conventional Investment

O-Zone Investment

2018

Pay tax on \$10 million gain

Texan: -\$2,380,000 **New Yorker:** -\$3,649,600

Invest \$10 million gain in opportunity fund.

First tax break: Tax on gains is deferred until 2026

Funds left to invest

Texan: \$7,620,000 **New Yorker:** \$6,350,040

Buy new taxable investment that appreciates @ 8% a year

2026

Second tax break: \$10 million initial taxable gain is reduced to \$8,500,000

Leave money in O-fund and, from outside funds, pay deferred tax on \$8,500,000

2028

After 10 years, it grows to:

Texan: \$16,451,010 **New Yorker:** \$13,710,040

After 10 years of appreciating at 8% a year, \$10 million O-fund investment is now worth: **\$21,589,250.**
Third tax break: Appreciated O-fund holding is sold with no capital gains tax due

Sell investment to pay long-term capital gains tax

Texan: -\$2,101,780 **New Yorker:** -\$2,685,970

Subtract tax paid in 2026 and lost earnings on those 2026 payments

Texan: -\$2,277,160 **New Yorker:** -\$3,425,370

Conventional investor is left with:

Texan: \$14,349,230 **New Yorker:** \$11,024,070

Investor in O-fund is left with:

Texan: \$19,312,090 **New Yorker:** \$18,163,880

Potential Advantages of a QO Fund over a 1031 Exchange

	Section 1031	QO Fund
Classes of Assets	Real Estate Property	Any Assets in a QO Zone
Investment Requirements?	All proceeds must be invested	Only gains must be invested
Qualified Intermediary?	Yes	Not required
Timing Requirements?	Within 180 days	Within 180 days
Treatment of Capital Gains?	May defer gains indefinitely, but fully taxable upon sale, absent any intervening basis step-up event	Gains may be deferred until 12/31/2026
Other Tax Benefits?	For Heirs: Step-up in basis to market value	After 5 years: <ul style="list-style-type: none"> • 10% reduction in deferred gain After 7 years: <ul style="list-style-type: none"> • 15% reduction in deferred gain After 10 years: <ul style="list-style-type: none"> • Permanent exclusion from tax on built-in gains in excess of deferred gain

Potential benefits of investing in a Qualified Opportunity Fund



Gain Deferral: Company defers capital gains tax on gains invested in the QOF

Estimated Benefit: Capital gains deferred until 2026

Benefit Description: Time-value of money until 2026

Basis Step-Up: Company steps-up its basis in the capital gains invested in QOF

Estimated Benefit: Potential 15% basis step-up reduces amount of deferred gain recognized

Benefit Description: Basis in capital gains stepped-up 10% after 5 years and additional 5% after 7 years of QOF investment

Appreciation Exclusion: Company excludes appreciation gain through basis step-up upon disposition of investment after 10 years

Estimated Benefit: 100% basis step-up

Benefit Description: Full basis step-up on appreciation of QOF investment after 10 years

Source: KPMG

Timing Consideration: “Substantial Improvement” of Property



- Property is considered to be substantially improved if additions to basis to such property **within 30 months** after being acquired by a QO Fund exceed 100%

HYPO:

XYZ Fund is formed on June 30, 2018

- XYZ Fund acquired land that is located in a QOZ for \$1 million on December 15, 2018
 - XYZ Fund must make substantial improvements to the land in the amount of at least \$1 million by June 15, 2021



Timing Considerations: 90% Asset Test for a QO Fund



Must hold at least 90% of assets in Opportunity Zone Property, determined by the average of the percentage of Opportunity Zone Property held on:

The last day of the first six month period of the fund's taxable year

And

The last day of the fund's taxable year

June 30th

December 31st

JAN FEB MAR APR MAY JUN JUL AUG SEPT OCT NOV DEC

Source: Novogradac & Company LLP

Timing Consideration: “Treatment of Working Capital” (Parameters)

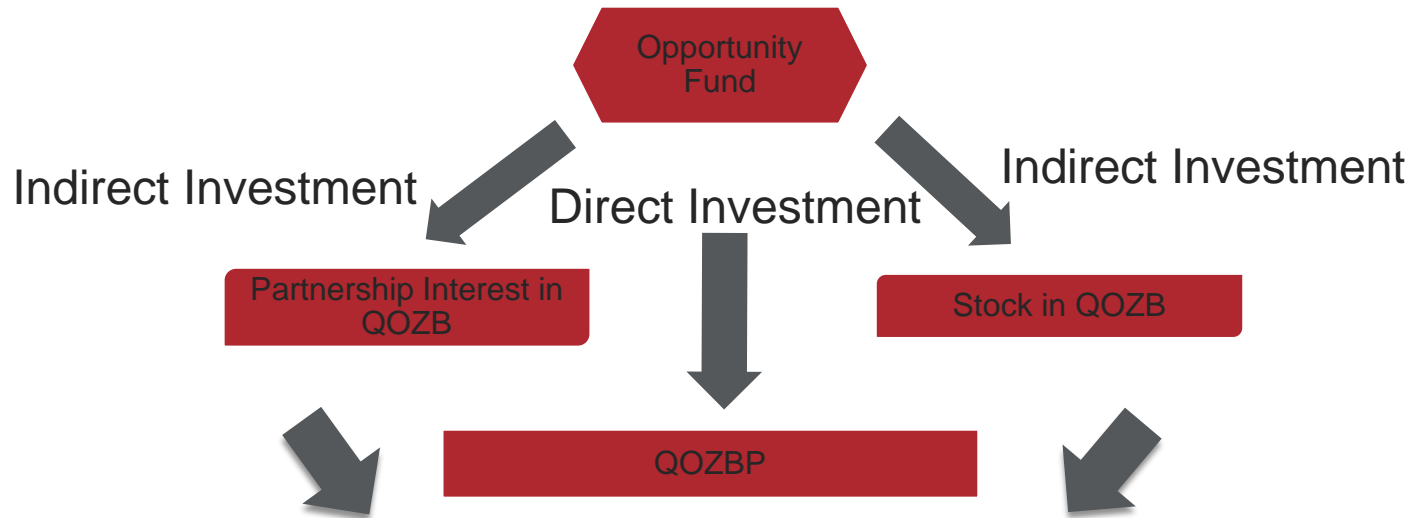


- Safe harbor for QOZB expenditures used in the development of an active trade or business in a QOZ (includes acquiring, constructing or rehabilitating property)
- How long can a QO Fund hold cash reserves?
 - May hold the working capital for up to 31 months
 - There must be:
 1. a **written plan** that identifies the working capital as held for the acquisition, construction, or substantial improvement of tangible property in a QOZ
 2. Such written plan must **identify a schedule of expenditures** that is consistent with the ordinary business operations of the business
 3. The business must **actually comply with the written plan**
The QO Fund must retain this written plan in their records.

Qualified Opportunity Zone Property Direct vs. Indirect Investment



- **Indirect:** Equity Investment in a QOZB
- **Direct:** Direct Purchase of QOZBP



Direct vs Indirect Approach

Source: KPMG



Direct Ownership (Single-Tier Structure)	Indirect Ownership (Two-Tier Structure)
QOF directly owns QOZB Property used in a trade or business	QOF owns QOZB Property through a QOZB
90-Percent Asset Test 90% of the all of the QOF's assets is QOZB Property	Substantially All (70%) of the tangible property owned or leased by the business is QOZB Property
QOZB Property is used in the QOF's trade or business	50% of gross income of the QOZB from <i>active conduct of trade or business</i> within the QOZ
Intangible Property is not QOZB Property for the 90- Percent Asset Test (instead, it counts towards the remaining 10%)	A substantial portion of the business' intangible property is used in the active conduct of the trade or business in the opportunity zone
No additional restrictions on financial property	<5% of the average of the aggregate unadjusted bases of the property is attributable to the non-qualified financial property* (except for reasonable amounts of working capital)
No Working Capital Safe Harbor?	Working Capital Safe Harbor
No prohibition on "Sin Businesses"?	QOZB can NOT be a "Sin Business"
No specific reference to the lease of property by a QOF	A QOZB is able to lease property and could possibly qualify as QOZB Property. ** However, it is not yet clear how the QOZB Property requirements are applied to leased property.

Costs of setting up a Qualified Opportunity Fund



- Offering expenses include legal, accounting, marketing, and other expenses
- Costs of organizing the Partnership and its subsidiaries, as well as offering related expenses
- Sales commissions?
- Sample Fees (negotiable)
 - Management Fee (i.e. % of capital)
 - Acquisition Fee (i.e. % of acquisition costs)
 - Developer Fee (i.e. - % of project costs)
 - Disposition Fee (i.e. % of gross net proceeds upon a sale)



TREASURY GUIDANCE

Guidance from IRS/Treasury Was Needed!

(initially issued October 2018; recently issued April 17, 2019)



- **Types of “gain” eligible for QOZ benefits?**
- **Safe Harbor for meeting the 90% asset test?**
- **Treatment of cash reserves?**
- **Clarification re “substantial improvement” test?**
- **No limits on how much a QO Fund can borrow?**
- **Meaning of “substantially all”?**
- **Self-certification of a QO Fund?**
- **Guidance for acquisition/rehab projects?**
- **“Active Conduct” of a QOZ Trade or Business?**
- **Treatment of Leases?**
- **Special Allocations (i.e. Promoted/Carried Interests)?**
- **Back-end Issues? Interim Gains?**
- **Reasonable period for QO Fund to reinvest sales proceeds?**

Potential Penalty for Noncompliance with the 90% Asset Test requirement



Source: Novogradac & Company LLP

Failure to meet the 90% Requirement:

Monthly penalty for failing to meet the 90% Requirement

$x \frac{\% \text{ Shortfall Underpayment Rate}^*}{\text{Penalty}}$

No penalty if it is shown failure is due to “reasonable cause”

*Federal short-term rate plus 3%) –
Currently 5% Annually

Favorable Guidance from Treasury



- **90% Asset Test and Recent Investments.**
 - Although a QOF is required to maintain 90% of its assets in a QOZ Property (90% Asset Test) as of certain measuring dates,
 - QOF can exclude cash on hand from the QOF made during the prior 6 month period from that calculation.
 - Relieves concern that accepting investments near a 90% Asset Test measuring date could disrupt compliance.

Favorable Guidance from Treasury



- **Leased Tangible Property.**
 - Leased tangible property can qualify as QOZ business property.
 - Real estate projects on leased land (i.e. tribal land) in QOZs is eligible
 - Leased equipment could qualify as QOZ business property
 - There is no original use requirement or substantial improvement requirement imposed on leased tangible property due to the nature of the property.
 - Property may be leased from a lessor that is a related party
 - if certain requirements are met for this to be a valid option under the QOF rules.

Favorable Guidance from Treasury



- **Disposition of Fund Assets.**
 - A QOF may sell its assets without disrupting the investor's deferral of capital gains or their holding period
 - so long as QOF reinvests the proceeds into another qualifying investment within **12 months**, and
 - so long as the investor does not sell his interest in the QOF.
- **Investor Sale of Interest and Reinvestment.**
 - An investor who sells his interest in a QOF may reinvest the proceeds into another QOF within 180 days without ending their deferral period.
 - However, the 10-year holding period starts over as of the date of the second investment (i.e., there is no tacking).

Favorable Guidance from Treasury



- **Active Trade or Business.**
 - Unlike QOFs, which only have to be engaged in a “trade or business”
 - a QOZB must be engaged in an “active trade or business”.
 - For purposes of qualifying for treatment as a QOZ Business (QOZB), an “active trade or business” must be:
 - a business eligible to deduct ordinary business expenses under IRC 162
 - regular and continuous business activity with a profit motive.
 - Certain rental real estate qualifies as “active trade or business”
 - **Triple-net-lease** is **NOT** an active trade or business.

Favorable Guidance from Treasury

Working Capital “Safe Harbor” Period



- Only applies to QOZBs and not to QOFs.
- If a QOZB fails to expend its working capital within the 31-month safe harbor as a result of governmental delays (e.g., timely approval of plans and issuance of permits)
 - QOZB will not be penalized so long as the application for that action was completed during the 31-month safe harbor period.
- May include expenditures used in the development of an active trade or business in the QOZ (in addition to acquiring and/or improving tangible property).
 - May include inventory, occupancy costs, and possibly payroll relating to the start-up of a business.
 - This is especially beneficial for QOZBs formed to engage in an active trade or business other than real estate.

Favorable Guidance from Treasury

50% Income Test



- **3 safe harbors** for calculating whether or not a QOZB has satisfied the 50% gross income test
 - (i.e., that 50% of its gross income is derived from its activity in the QOZ.
 - The safe harbor allows testing based on:
 - (1) the number of relative hours worked by employees and service providers in the zone is at least 50% of the total number of service hours of the ; or
 - (2) the compensation paid to employees and service providers in the zone is at least 50% of the total compensation paid by the QOZB; or
 - (3) that the tangible property in the zone plus the operations and management in the zone are necessary to produce at least 50% of the gross income of the QOZB

Favorable Guidance from Treasury

Original Use Test



- The “original use” of tangible personal property begins on the date when it is first placed in service inside the QOZ for purposes of the depreciation or amortization rules.
- Certain used property can satisfy the original use requirement
 - so long as the property has not been previously used in the applicable opportunity zone in a manner that would allow it to be depreciated or amortized.
- Property can be treated as “originally used” by a QOF or QOZB if it was unused or vacant for an uninterrupted period of at least five years prior to being placed in service by the QOF or QOZB.
 - If a QOZB acquired an abandoned building that has been vacant for 5+ years that needs some rehabilitation before being placed in service
 - the “substantial improvement” test would not have to be satisfied

Favorable Guidance from Treasury



- **Property straddling census lines.**
 - Some businesses may operate in parcels that straddle (partially located inside and partially outside) a QOZ.
 - If a QOF or QOZB holds and uses such a contiguous parcel and if the square footage inside the QOZ is substantial relative to the square footage outside the QOZ
 - the entire parcel would be deemed to be inside a QOZ.
 - Real property located within a QOZ should be treated as “substantial” if:
 - the unadjusted cost of the ***portion inside a QOZ*** is **GREATER** than the unadjusted cost of the ***portion outside a QOZ***

Guidance from Treasury

Gain Inclusion Events



- **Gain Inclusion Events.** Several transactions would cause an early recognition of deferred gain including:
 - Distribution to a partner of a QOF partnership of cash or other property that has a value in excess of basis of the partner's qualifying QOF partnership interest.
 - Partnership distributions in the ordinary course of partnership operations may, in certain instances, be considered inclusion events.
 - Debt that is allocated to a partner (such as from a refinancing) provides basis to that partner for distribution purposes.
 - Example 10 of the new proposed regulations specifically approves a debt-financed distribution so long as the distribution does not exceed the investor's basis (as increased by the investor's share of the debt) in its QOF.

Guidance from Treasury

Limitation of benefits for “promoted” equity



- If an investor has “promoted” equity
 - **ONLY** the portion attributable to his capital contribution is eligible for exclusion from capital gains after a 10-year hold

Example -- If an individual managing member of a QOF:

- contributes 10% of the capital to the QOF and
- also receives 20% of the profits above a specified internal rate of return plus the 10% pro-rata participation with other capital investors
 - his 10% pro-rata participation would be eligible for capital gains exclusion, but
 - his 20% promoted interest would not
- Sponsors/developers will need to classify which portion of their interests in a QOF is being issued in exchange for services (such as a development fee and management fees) and treat those as non-qualifying investments.

Further Guidance Needed



- **Reporting requirements?**
- **Clarification regarding Penalties?**
 - **Meaning of “Reasonable cause” exception (i.e. re: satisfying 90% Asset Test)?**
 - **Are investor benefits subjected to Fund-level penalties?**
- **Sunset of QOZ Incentive?**



RAISING MONEY

Who should invest in a QO Fund and why?



- Types of Asset Categories to consider
 - Multifamily
 - Retail
 - Industrial
 - Other?
 - Is there a preference between residential, industrial, retail or other commercial development?
 - Strategies being deployed?
- Who is investing in QO Funds?
 - Role of the Wealth Management industry?

Strategies of a QO Fund?



- Strategies to maximize tax advantages over the ten years?
- When should funds be deployed?
- What are best practices to avoid penalties?
- How can returns for investors be maximized?
- Exit strategy for investors?

An Investor's Perspective – QO Funds



- Creditability of Opportunity Fund Sponsor
 - Single Asset vs Pool Fund
 - Focused vs Diversified
 - Deal Pipeline
- Creditability of Developer
 - Experience/Qualifications
 - Relationships with Authorities & Community
- Payment of Deferred Taxes
 - December 31, 2026 – End of Deferred Tax Period
 - Monetizing the investment to pay taxes
 - Impact to interest deductibility

An Investor's Perspective – QO Funds



▪ Project Viability

- **Economically Sound**
 - Cash Flow Economics & IRR Expectation
 - Appropriate Risk Adjusted Return
- **Appreciation Potential**
- **Lease-Up Risk**
- **Community Receptivity**
- **Competitive Landscape**

▪ Investor Outlook

- Long-Term Investment Horizon
- Threshold of Risk
 - **Development Risk**
 - **Lease up Risk**
 - **Interest Rate Risk**
 - **Refinance Risk**

Risk Factors for Investors



- General Market Conditions
- Competition for O-Zone Properties
- Rising Construction Costs
- Rising Interest Rates
- Timing Challenges
- Illiquidity
- Lack of Diversified Investment Portfolio
- Further Changes in Tax Laws/Regulations
- Additional Guidance Needed From Treasury/IRS

Federal Securities Laws



- **Securities Act of 1933:**
 - Regulates the Offering of the Fund's Interest
- **Investment Company Act of 1940:**
 - May Regulate the Fund
 - "Investment Company": An issuer that is engaged primarily in the business of investing in securities
- **Investment Advisers Act of 1940:**
 - May Regulate the Fund's Manager / General Partner
 - "Investment Adviser": Any person who, for compensation, engages in the business of advising others as to the advisability of investing in, purchasing, or selling securities

Broad Definition of a “Security”



Securities Act of 1933:

The term “security” means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing

Securities: Investment Company Act



- Investment Company Act of 1940 Requires “investment companies” to register with the SEC
 - **Common Exemptions:**
 - Private Funds
 - 3(c)(1) – Fewer than 100 investors
 - 3(c)(7) – Only “qualified purchasers” (e.g., \$5m+ in investments)
 - Mortgage Related Companies
 - 3(c)(5) – Primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Not available if the interest is an interest in the nature of a security in another issuer engaged in the real estate business.
 - Venture Capital Funds

Securities: Investment Advisers Act



- Federal and State Laws require registration of “investment advisers”
- Arizona’s definition excludes persons “engaged in selling interest in entities that invest in real property”
- But SEC requires (generally)
 - Filing as “Exempt Reporting Adviser” if AUM >\$25m;
 - Registration as “investment adviser” if AUM >\$110m (unless a “Private Fund Adviser”, then >\$150m)
- Advisers solely to “venture capital funds” are exempt (subject to Exempt Reporting Adviser reporting)

Securities Offering Exemption



- Securities Act of 1933 exempts offers of securities “not involving any public offering” (§4(a)(2))
 - **Safe Harbor – Rule 506 – Only Accredited Investors***
 - R. 506(b) – No General Solicitation. Preempts state law registration requirements for both the issuer and the issuer as a dealer of its own securities
 - R. 506(c) – Permits General Solicitation IF all investors are “accredited investors” and the issuer takes reasonable steps to verify accredited status
 - does NOT preempt state issuer dealer registration requirements
 - must either sell the offering through a registered broker-dealer, or the issuer (company) must register as a dealer

**Technically you could have up to 35 non-accredited investors in a 506(b) offering but much higher disclosure obligations*