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Tax Benefits of Real Estate Development/Investment with "Qualified Opportunity Funds"

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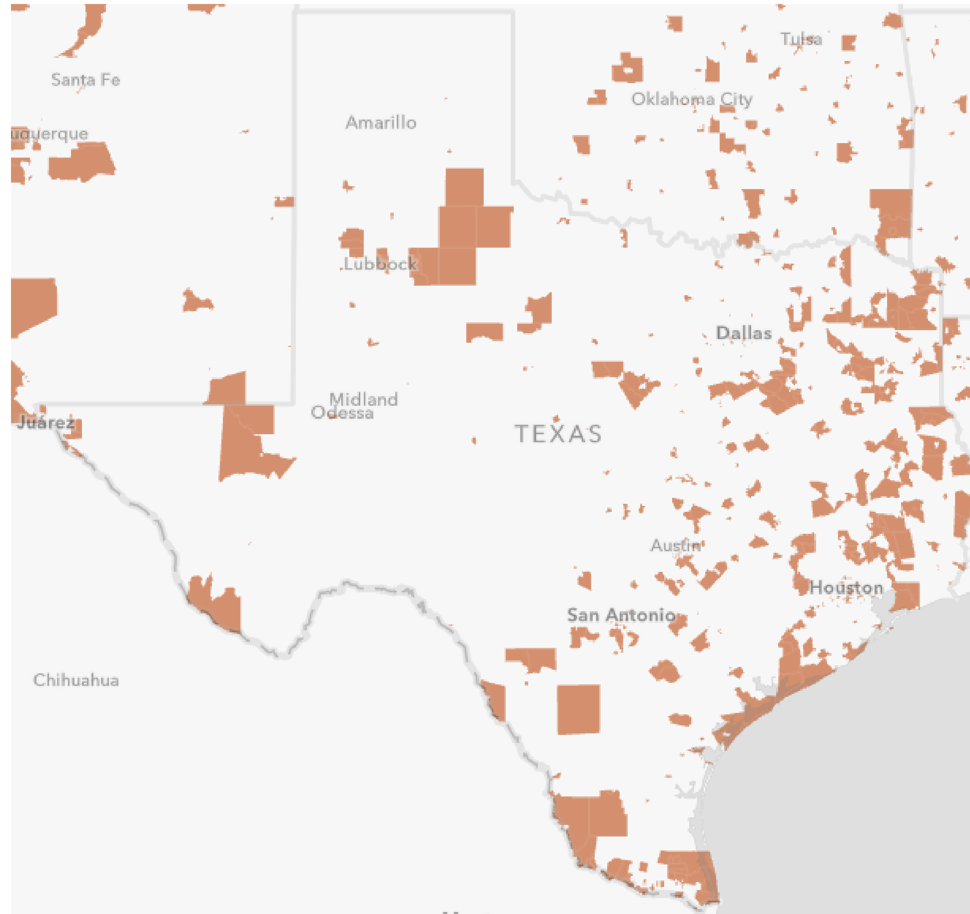
What is a “Qualified Opportunity Fund”?

- Big picture: A Qualified Opportunity Fund (QOF) is a corporation or partnership in which taxpayers can “roll over” capital gains and obtain special tax benefits.
- A QOF must invest in specific geographic regions, or Opportunity Zones. Generally, these are low-income areas that the state government has nominated.
- Interactive Opportunity Zone maps are available online (just Google “opportunity zone map”)

Texas Opportunity Zone Map



Who Benefits from QOFs?

Real Estate Sellers: May benefit from a higher selling price if selling Opportunity Zone asset that is ripe for development or redevelopment to a QOF (or QOFs) that are competing for opportunities to deploy capital.

Real Estate Investors: May obtain tax benefits only if "rolling over" capital gains, and especially if prepared to hold 10 years.

Real Estate Developers/Sponsors: May obtain a lower cost of capital (or charge a higher promote) in exchange for a promise to pursue QOF tax benefits for investors (but cannot obtain tax benefits directly for carried interest / promote).

Tax Benefits for Investors

- Taxpayers can **<u>defer and reduce</u>** taxes on capital gains by rolling the gains over into a QOF
  - Taxes on such gains are *deferred* until the earlier of (1) when the QOF investment is sold or (2) 12/31/2026
  - Deferred gains are *reduced* (1) by 10% if the investment is held for 5 years; (2) by 15% if the investment is held for 7 years; or (3) if greater, by any diminution in value of the QOF
- **<u>In addition, any subsequent appreciation in the QOF is tax-free if the investment is held for 10 years.</u>**

Source of Gain Rollover

- Generally, *any* capital gain from *any* source can qualify for the QOF rollover treatment. The gain being rolled over need not have anything to do with Opportunity Zones or QOFs (e.g., facebook stock gain qualifies).
  - This includes short-term capital gain, 1231 gains, 25% "unrecaptured section 1250 gain," and certain mark-to-market gain (but nor ordinary mark-to-market income).
  - However, it does not seem to include gain recaptured as ordinary income
  - Gain may be triggered intentionally in order to qualify for a rollover
  - Note that exchanges of real property must be structured to avoid a 1031 like-kind exchange if the goal is to trigger gains to use in a QOF. Section 1031 is not elective.
- The gain may not be triggered in a sale to a "related person"
  - Generally, this means that the seller cannot own more than 20% of the acquirer (and the seller and acquirer cannot have more than 20% common ownership)
  - These rules would permit, for example, a QOF rollover of gain on the sale of a warehoused investment to the QOF itself, so long as the transferor owns less than 20% of the QOF.
- There is no problem with investing more than the amount of the capital gain rollover in a QOF; it is just that non-rollover portion of the investment will not qualify for the QOF tax benefits.

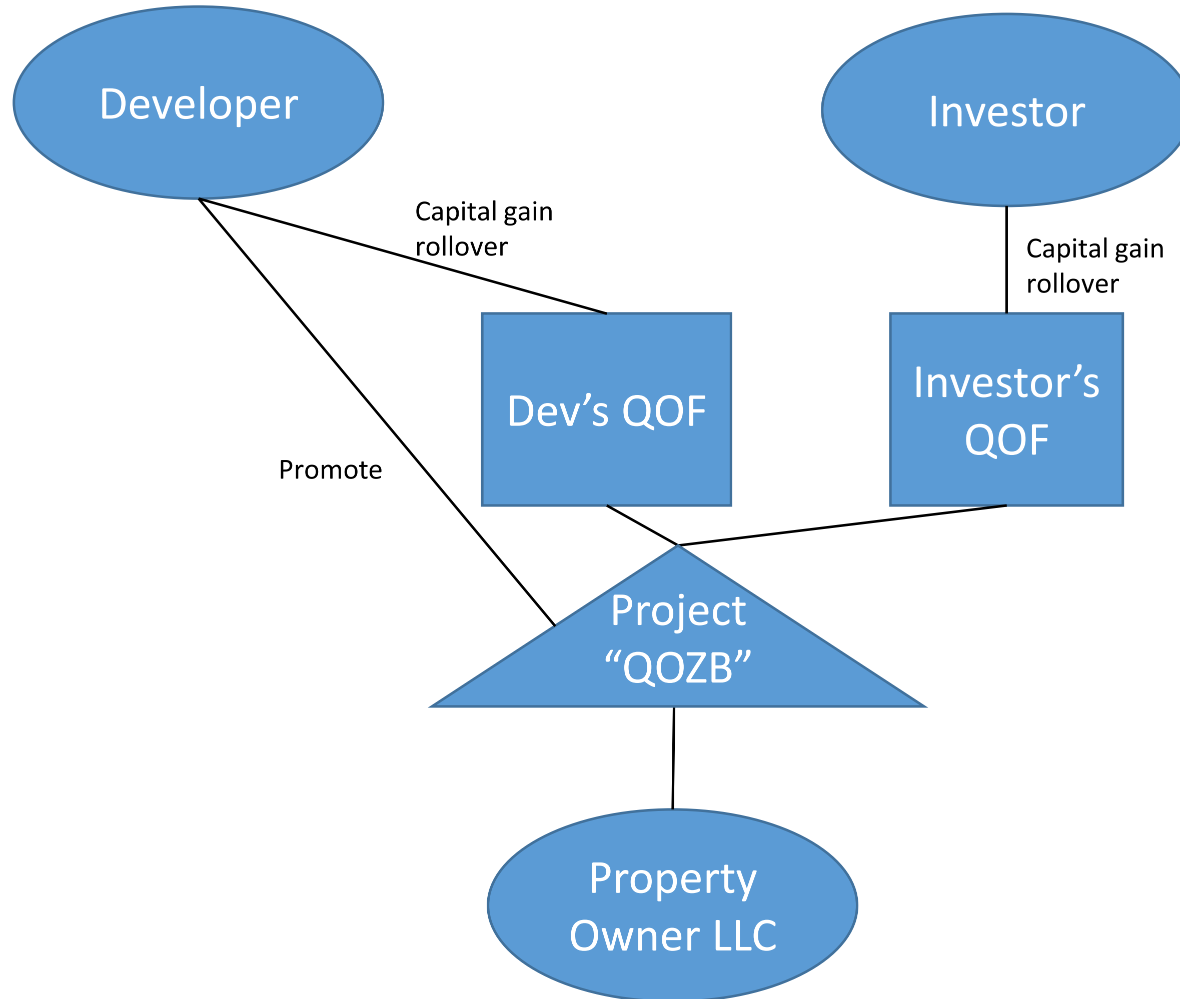
Timing Issues

- Gain must be rolled over into the QOF within 180 days of realization. In the case of gain realized in a partnership, there is the option to start this 180-day clock on the day the partnership sells or the last day of the K-1.
- Because the deferred gains are triggered on 12/31/2026, and because of the 5- and 7-year holding period requirements to qualify for the 10% or 15% “gain cutback,” there is an incentive to invest *NOW*.
  - Investments in QOFs on or after 12/31/2019 will never qualify for the full 15% cutback
  - Investments in QOFs on or after 12/31/2021 will never qualify for the 10% cutback
  - However, investments right up until 12/31/2026 will still defer rollover gain recognition until 12/31/2026, and such investments that are held for 10 years will still qualify for the exclusion of all subsequent appreciation inside the QOF.
- Because the gain (less any cutback) is triggered on 12/31/2026 regardless of liquidity, taxpayers must plan for that tax payment. The QOF generally could borrow and make a tax-free distribution to fund the tax payment.

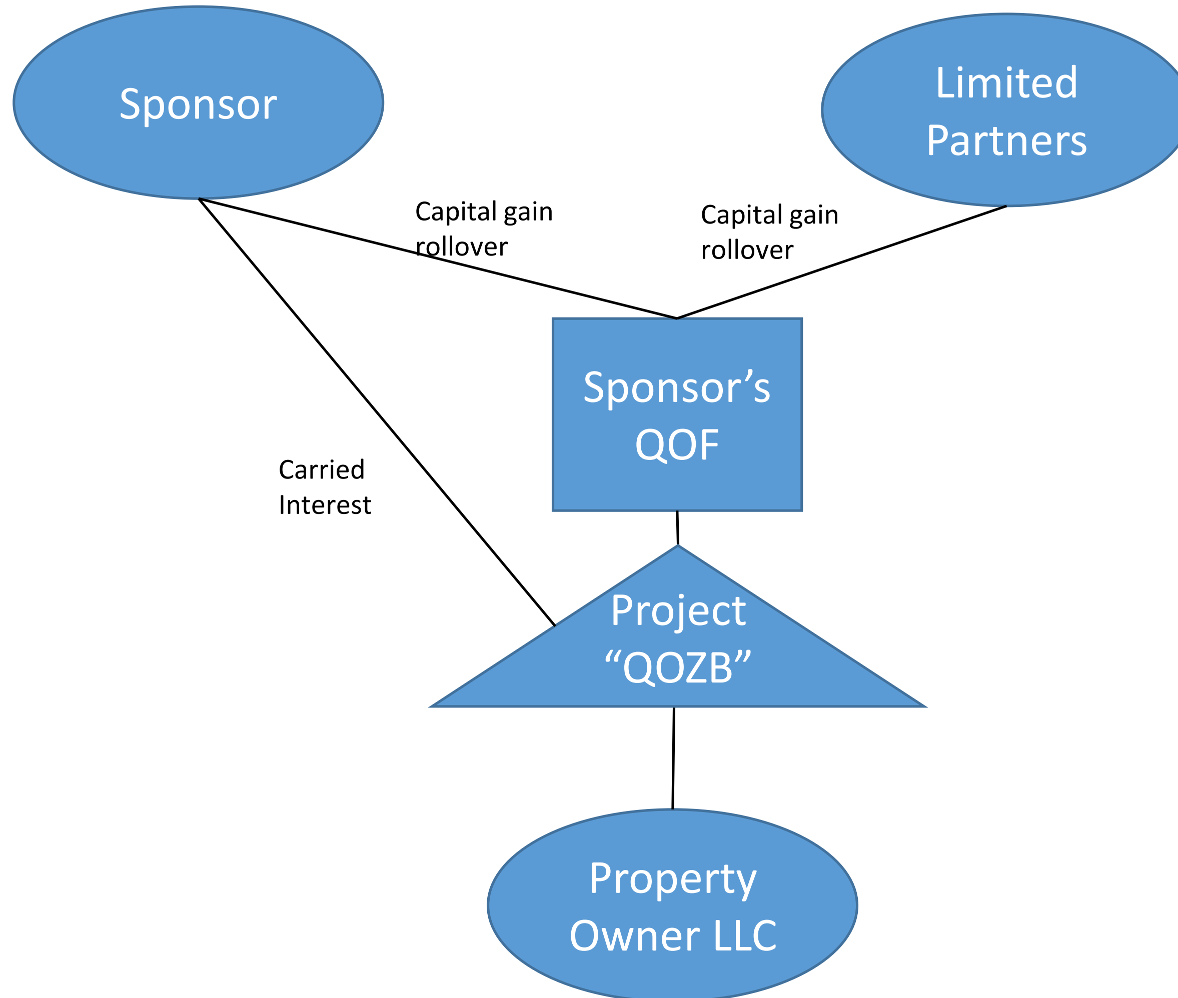
Structuring a QOF Deal

- The QOF statute contains errors and oversights that make QOF deal structuring unusually “persnickety.” There are many traps for the unwary.
- QOF real estate development generally must be done through a subsidiary “QOZB” that must be funded in cash and acquire its assets from an unrelated party.
- Tax counsel with a focus on QOFs must be involved <u>from the outset</u> in deal structuring.

Basic QOF JV Structure



Basic QOF Fund Structure



“Qualified Opportunity Zone Businesses”

- As a practical matter, real estate development must be done through these “QOZBs.”
- A QOZB must be funded in cash and must meet a 70% asset test. Good assets include (1) land underlying real estate development, (2) new buildings or “substantially improved” buildings, and (3) working capital that is part of a “31-month plan.” The regs are focused on combating “land banking.”
- A QOZB must meet a 50% active income test. This means that the QOZB must do more than merely triple-net-lease the asset (but, we think, not much more).
- The QOZB cannot own more than a *de minimis* amount of financial assets or lower-tier entity interests (only the QOF and QOZB tiers are allowed! No regarded subsidiaries. Disregarded property owners are OK.)

Significance of the 31-month plan

- Developing a 31-month plan is a crucial step because it permits the cash from investors to be funded in and meet various timing deadlines.
  - 180-day deadline to roll in capital gains
  - 6-month exclusion of “new capital” from QOF 90% asset test
  - Ability to convert cash (bad asset) into QOZB partnership interest (good asset) by funding into the project in cash
  - The QOZB will not fail to meet its asset test on account of a 31-month plan being incomplete, i.e., while consuming the working capital the QOZB is a good asset for the QOF if the end result of the plan is that the QOZB qualifies.
- Tolling currently for government permitting issues, but not for force majeure

Structuring for an Eventual Exit

- Under current regulations, full QOF tax benefits can be achieved only by selling QOF interests themselves.
- However, a QOF can sell the QOZB after a 10-year hold, and the investors can exclude capital gains (but not recapture).
- If the QOZB sells the asset, some firms take the position that no exclusion is allowed.
- IRS is considering whether to allow recapture to be excluded from sales below the QOF level, and whether to clarify that a QOZB may sell assets.
- Consider a separate QOF and/or a separate QOZB for each asset that may be the subject of a separate exit in 10 years.

Can the Seller Participate in the Deal?

- “Related Party” issues: If a QOZB buys from a “related party” (measured at a 20% ownership threshold, which must take into account any carry), the purchased asset is a “bad asset.”
  - Option 1: Keep Seller Under 20% and avoid purchasing a bad asset.
  - Option 2: Concede that the purchased asset (i.e., the land) is a bad asset, and develop a 31-month plan to construct good assets (i.e., a new building) that will be worth more than 70% of the deal.

Leverage and Liquidity

- Once cash goes into a QOF deal, it can be hard to get it back out without triggering the deferred gain before 10 years.
- Each contribution into a QOF starts a new 10-year required holding period for the new funding portion. There is no cherry-picking which part of a QOF interest is sold.
- One option is a leveraged distribution. However, under current regulations, a leveraged distribution can only be done more than 2 years after the last equity funding of the QOF, or it may trigger deferred gain.
- Deferred gain that is triggered by a distribution from a QOF probably cannot be rolled into another QOF.