STROOCK
SPECIAL BULLETIN

Qualified Opportunity Funds: Tax Strategies and Opportunities for Real Estate and Other Investors

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I. Overview

The 2017 Tax Cuts and Jobs Act created a new incentive for investment in qualified low-income communities known as qualified opportunity zones ("QOZs"). The process of opportunity zone designation and IRS approval[1] occurred in early 2018, and the Treasury Secretary has now certified the final list of QOZs.[2] The new Tax Code provisions, under Sections 1400z-1 and 1400z-2 of the Internal Revenue Code,[3] are designed to promote long-term growth in economically distressed areas by providing special tax benefits to taxpayers that would recognize taxable gain from a sale or exchange, provided that the amount of such gain is reinvested into special entities known as Qualified Opportunity Funds ("QO Funds") (as defined below). This bulletin provides an overview of the QOZ provisions and tax strategies pertaining to such provisions, with a principal focus on opportunities and caveats for real estate developers.[4]

II. Tax Benefits

An electing taxpayer may reinvest an amount equal to the amount of taxable gain recognized on a sale or exchange (the "deferred gain"), within 180 days of such sale or exchange, into a QO Fund (the interest received in such QO Fund pursuant to such investment, a "QO Investment"). The

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1 As a general matter, for a geographic area to be eligible as a Qualified Opportunity Zone ("QOZ"), the area must be either a "low-income" census tract or adjacent to such a tract (provided certain requirements are satisfied). Once eligible, the zone must be designated as a QOZ by the governor of the state in which the zone is located, and such designation must be approved by the IRS. Governors of each state were permitted to select up to 25% of their states' eligible zones as potential QOZs. Of New York's more than 2,000 eligible zones, Governor Andrew Cuomo recommended 514 zones based on a variety of factors, including regional economic development councils, local input, prior public investment and the ability to attract private investment. See https://esd.ny.gov/opportunity-zones for a map of New York QOZs.

2 https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx (full list of QOZs for all states).

3 References herein to the Internal Revenue Code (or the "Code") refer to the Internal Revenue Code of 1986, as amended.

4 See https://www.stroock.com/siteFiles/Publications/QualifiedOpportunityFunds.pdf for a prior Stroock bulletin on the QOZ rules and opportunities.

taxpayer will thereby become eligible for the following tax benefits:

1. Deferral of tax until the earlier of (i) the sale of the QO Investment or (ii) December 31, 2026.[5]

2. An increase in the QO Investment's tax basis (of 10% of the deferred gain) after holding the QO Investment for 5 years, and an additional increase (of 5% of the deferred gain) after holding the QO Investment for 7 years. These basis increases (often referred to as "step-ups") reduce the amount of gain subject to tax in (1) above.

3. If the QO Investment is held for 10 years or more, elimination of any taxable gain on ultimate sale of the QO Investment – i.e., no tax would be owed on the appreciation in value of the QO Investment after its initial acquisition by the taxpayer.[6]

Note that, absent regulations to the contrary, it would appear that the taxpayer that owns the QO Investment must be the same individual or entity that recognized the gain. That is, an eligible taxpayer must directly invest into a QO Fund, rather than investing the proceeds into another entity (even a pass-through) which would then invest into the QO Fund. As discussed *infra*, this requirement may limit the ability to use tiered structures to hold interests in QO Funds.

A table providing a summary of the tax benefits and an example may be found in **Appendix A**. Further details regarding the mechanics of how these benefits are derived may be found in the **Tax Mechanics** section below.

III. QO Fund Qualification: General Requirements

Organization: A QO Fund is either a corporation or a partnership[7] established for the purpose of investing in Qualified Opportunity Zone Property ("QOZ Property") (as defined below), **other than** another QO Fund.[8]

Certification: Eligible taxpayers wishing to form a QO Fund will likely be able to have the QO Fund self-certify. The IRS is expected to release guidance on self-certification within the next month.[9]

Asset Requirement ("90% Test"): At least **90% of the assets** of a QO Fund must be QOZ Property, or the QO Fund must pay a penalty (based on the degree of failure).[10] The QO Fund's

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[5] We note that while deferral of gain is generally beneficial, investors should be aware of the risk of any increase in capital gain rates, as, if no grandfather provision were offered, the tax ultimately owed might end up being a greater amount than it would have had it been immediately paid.

[6] Note that the deferred gain is still taken into income in December 31, 2026; accordingly, this special benefit only applies to any further appreciation of the QO Investment above the amount of the deferred gain.

[7] We note that there may be a question as to whether a QO Fund may be formed as a limited liability company ("LLC"). As multi-member LLCs are generally taxed as partnerships absent an election to the contrary, or as corporations if they elect to "check the box," we expect that LLCs should be permissible, but it may be safer to use a limited partnership ("LP") structure until confirmation or guidance is received. We note that a single-member LLC treated as a disregarded entity for federal income tax purposes likely could not itself be a fund, but, as a disregarded entity, should be permissible in an ownership chain underneath a qualifying fund that is a corporation or partnership.

[8] A QO Fund may not meet its investment requirements by investing in another QO Fund. The impact of this is discussed in the **Tax Mechanics** section.

[9] In an FAQ, the IRS indicated that eligible entities will merely need to self-certify as a QO Fund using a form scheduled to be released in the summer of 2018, but such form has yet to be released. https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions (An IRS FAQ page should not be relied on as legal authority. Information provided is subject to change via future Treasury Regulations).

[10] In general, the penalty is equal to the underpayment rate of Code Section 6621(a)(2)

assets are evaluated both at the end of the first six-month period of the fund's taxable year as well as on the last day of its taxable year, and the average of these two percentages must be at least 90% to satisfy this requirement.

QOZ Property: QOZ Property includes both QOZ Business Property and stock or partnership interests in an entity that is a QOZ Business (and thus meets certain statutory requirements,[11] a significant one of which is that the QOZ Business itself own QOZ Business Property).[12]

QOZ Business Property: QOZ Business Property is generally defined as tangible property (i) used in a trade or business of the QO Fund,[13] (ii) **acquired by purchase** from unrelated parties after Dec. 31, 2017, **and** (iii) (A) the **original use** of which begins with the QO Fund **or** (B) to which the QO Fund makes **substantial improvements**.

IV. Tax Mechanics

A. Investor Basis

- Only reinvested gain proceeds are eligible for the QOZ tax benefits. It is permissible for other investments (i.e., other than QO Investments) to be made into a QO Fund, but such investments are treated separately from any QO Investments. No guidance has yet been issued as to how the separate interests are treated for purposes of holding period, operating tax attributes, etc.

- An investor takes a **zero** basis in its QO Investment. It is unclear, in the event that the QO Fund is a tax partnership, whether this zero basis could be increased by allocations of operating income or share of liabilities. It seems likely that regulations may provide that such amounts would be treated as part of a separate investment (as would be the case for a non-QO Investment).

- The investor receives a basis step-up of 10% after 5 years and an additional 5% after 7 years. After the investor's deferred gain (reduced by such basis step-ups) is recognized, the basis is increased by the amount of the deferred gain recognized. It is unclear whether the investment basis can be depreciated when calculating operating income, even after such step-ups.

- The ultimate sale must be of the QO Investment, i.e., the interest in the QO Fund

(generally AFR plus 3%) multiplied by the shortfall, i.e., the difference between the value of 90% of the QO Fund's assets and the value of the QO Fund's QOZ Property. For example, if a QO Fund's assets consisted of 83% and 87% QOZ Property on the six-month and one-year measuring dates, respectively, that would be an average of 85% and thus 5% of the QO Fund's assets (90% minus 85%) would be the amount multiplied by the underpayment rate. The penalty must be paid each month that the QO Fund fails to meet the requirement. No guidance has yet been issued as to the interaction between the monthly nature of the penalty and the six-month interim periods between measuring dates.

[11] QOZ Businesses are subject to several additional statutory requirements: for example, excluded from QOZ Businesses are certain types of "sin" businesses listed in Section 144(c)(6)(B). This prohibition includes golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks or other facilities used for gambling, and any store principally engaged in the sale of alcoholic beverages for consumption off premises.

[12] As noted, certain differences do exist in the requirements for QO Funds owning QOZ Business Property directly and QO Funds owning an interest in a QOZ Business. With respect to the latter, the requirements for a QOZ Business may potentially provide a small amount of additional leeway: "substantially all" of the business's assets must be QOZ Business Property (but not necessarily *all*), and there are certain definitional carve-outs for working capital, etc. It remains to be seen whether this leeway will drive structures in the market, or, conversely, whether amendments or regulations will conform to these statutory distinctions.

[13] In the event that a QO Fund owns a QOZ Business, the same requirements for business property ownership and use are generally applied to the QOZ Business instead.

entity. If a QO Fund that is a partnership for tax purposes were to sell property directly, such a sale might result in recognition of gain which would be passed through to the partners, even QO investors. Accordingly, a QO Fund may be limited in its ability to dispose of property without nullifying some of the tax objectives of its investors.

B. Qualification of QOZ Business Property

- For property to qualify for a QO Fund, the property must be **purchased** after December 31, 2017, and must meet either the **original use** or **substantial improvement** requirement.
- To meet the original use requirement, the property must be placed in service by the QO Fund. Absent guidance to the contrary, this would seem (i) not to include land, except perhaps vacant land, and (ii) not to include refurbishing abandoned buildings (although such refurbishment could potentially qualify under the "substantial improvement" prong if sufficient improvements are made).[14] Commenters have requested guidance from the IRS on both of these points, but such guidance has not yet been issued. However, a developer could purchase a near-complete property development, finish constructing such property, and place it in service, all in compliance with this requirement.
- To meet the substantial improvement requirement, property must be improved by the QO Fund, over a 30-month period, so as to effectively **double the adjusted tax basis** of the property in the hands of the QO Fund.[15] It is unclear whether basis in land would be treated separately for this purpose. In general, however, it should be permissible for a QO Fund to take $100 of investment proceeds, purchase land worth $50, and construct a building with the other $50 to qualify the entire land-and-building plot as QOZ Business Property under the "substantial improvement" test.
- One additional requirement is that the property be acquired by purchase. This requirement may create complications for developers that already own property in a QOZ, particularly given that acquiring property from a related party does not qualify under the QOZ statute. As noted above, however, a QO Fund could purchase a near-complete property and place such property in service in a QO Fund. Developers who, as of the beginning of 2018, already own partially-constructed property in a QOZ may find QO Funds interested in purchasing such property, and should consider looking to market the property before the improvements have even been completed.

C. QO Fund Structuring

- While a QO Fund can own multiple properties, provided that such combination of properties permits the QO Fund to meet the 90% test, it may as a practical matter be difficult to structure a flexible exit in such circumstances. As noted previously, each investor must sell its interest in the QO Fund to reap the tax benefit. On the other hand, a QO Fund may wish to sell a parcel of appreciated property: if the QO Fund does sell such parcel at a gain (and is treated as a tax partnership),[16] a portion of that gain

[14] A concept of treating abandoned real property as newly placed in service for original use purposes may be found in similar provisions of the tax code, suggesting that it may be a possibility for the IRS to grant a similar treatment in the QOZ context.

[15] Note that this requirement pertains to the tax basis of the *property*, as owned by the QO Fund entity, and does not have to do with the basis taken by an investor in its QO Investment.

[16] The vast majority of real estate joint ventures are conducted in partnership form; accordingly, much of the analysis herein focuses on circumstances in which a QO Fund is a tax partnership.

would be passed through to the QO Fund's investors (and would not be subject to any reduction under the QOZ provisions). Accordingly, there may be adverse tax consequences to selling a single property (without a full exit by the investors). As a result, developers wishing to structure a QO Fund may wish to create a separate entity (and thus a separate QO Fund) for each property.[17]

- A QO Fund can be effectively "wholly-owned" – although technically it must be a partnership for tax purposes, this could be achieved through the use of a relatively *de minimis* partner, even if only a single investor were to own the remaining interest.

- As noted previously, many are of the view that the taxpayer recognizing gain on a sale or exchange must be the same taxpayer to reinvest such proceeds. Accordingly, taxpayers who recognize gain through a partnership may wish to have the partnership itself reinvest, similar to a like-kind exchange context under Code Section 1031. There is no requirement that the taxpayer be an individual; an entity selling property and recognizing gain would be permitted to "roll over" such gain into a QO Investment.

- One result of the above mechanics is that certain obstacles may impede the ability of a standard investment fund (that regularly receives capital contributions and makes distributions, and regularly purchases and sells assets) to become a QO Fund. Even if the 90% asset test is met, it may be difficult to pass the desired benefits on to investors, since sales of property by the investment fund may trigger taxable gain for the investors that would not be protected by the QOZ provisions. Additionally, investors in a typical "fund," where there are periodic capital calls, may not have qualifying capital gain proceeds each year, which may limit the benefits that could be obtained by investing in a QO Fund rather than a standard (non-QO) fund or investment vehicle.

V. Developer Outlook

There is currently no limit on the amount one may invest in a QO Fund, nor is there an aggregate limit on the investments that the QO Fund itself can make. Additionally, there is no prohibition on combining QO Investments with other tax incentives such as Low Income Housing Tax Credit (LIHTC) programs, Historic Tax Credit (HTC) programs and New Markets Tax Credit (NMTC) programs, as long as the investment is in a QOZ.

There has been limited IRS guidance to date, and further guidance is expected from the IRS regarding the certification of QO Funds as well as many of the nuances discussed herein.

As we near the end of the summer and await the release of the IRS certification form, Stroock's Real Estate and Tax advisors are available to consult with developers and investors and determine how best to structure a QO Fund for their specific needs.

Additionally, fund organizers who wish to take capital from third party investors through private placement or other methods of issuing securities should begin to explore potential SEC registration issues, as the window for the maximum 15% basis increase will close at the end of 2019,[18] and thus it

[17] Note that a QO Fund may not itself own interests in another QO Fund, and it is unclear whether an investor may invest in a QO Fund indirectly through other entities: accordingly, this precludes the ability to use tiered partnerships to achieve multiple QO Funds within a single umbrella entity.

[18] Unless extended by Congressional action, the QOZ reinvestment rules do not allow for deferral of gain beyond December 31, 2026. Accordingly, if an investment is acquired in 2020 or later, the deferral period will expire before the investment can be held by the taxpayer for 7 years, thus limiting the taxpayer's basis step-up to 10% (provided the property has been held for 5 years). Similarly, if an investment is acquired in 2022 or later, the deferral period will expire before the investment

is likely that investors will want to roll over these gains as soon as possible in order to take advantage of the QOZ tax benefits to the fullest extent possible.

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can be held by the taxpayer for 5 years, thereby precluding any basis step-up.

APPENDIX A

Investment Length	Tax Benefit (assuming investment in 2018).
< 5 years	Deferred payment of capital gains tax.
5 – 7 years	Deferral as above, and basis increased by 10% of initial QO Fund investment.
7 – 10 years	Additional 5% basis increase (15% total). Deferred payment of capital gains tax until investment is sold or Dec. 31, 2026 (whichever comes first). Note: Tax on 85% of deferred gain is due even if the taxpayer does not realize the gain. A taxpayer may continue to hold the investment after the year 2026 (see below).
10+ years	Above benefits, plus basis increased to fair market value of investment at the time sold (i.e., further gain on the investment is exempt from capital gains tax).

Example:

Joe, an investor, acquired 100 shares of X Corporation stock in 2015 for $5,000. In 2018, Joe sells the 100 shares of stock for $7,000, realizing a $2,000 long-term capital gain. Rather than paying federal taxes on this gain in 2018, Joe decides to reinvest the $2,000 in a QO Fund within 180 days of the sale. Joe is now able to defer payment of capital gains tax on this $2,000 until he sells his QO Investment (or until December 31, 2026).

After holding the investment for 5 years, Joe receives a basis step-up of $200 (10%), which reduces the amount eventually subject to tax to $1,800. Similarly, after holding it for 7 years, Joe receives another basis step-up of $100 (5%) and would ultimately owe tax only on $1,700. On December 31, 2026, Joe has not yet sold his investment, and must pay capital gains tax on $1,700. After paying tax on this amount, Joe receives a step-up in basis equal to this $1,700, bringing his basis up to the full $2,000. If Joe were to sell the investment for $3,000 in 2027 (i.e., before he has held it for 10 years), Joe would recognize $1,000 of gain at long-term capital gains rates. If, however, Joe were to continue to hold the investment beyond 2028 (i.e., 10 years after he acquired it), Joe would be exempt from any further tax on the ultimate disposition of the investment (or, more precisely, Joe's basis would be stepped up to fair market value on the date of the disposition). That is, if Joe sold the investment in 2029 for $8,000, Joe's basis would, on the date of the eventual sale in 2029, be stepped up to the fair market value on such date (i.e., $8,000), such that the sale would not result in any taxable gain.

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