# Q&A: The Basics of Qualified Opportunity Zone Funds

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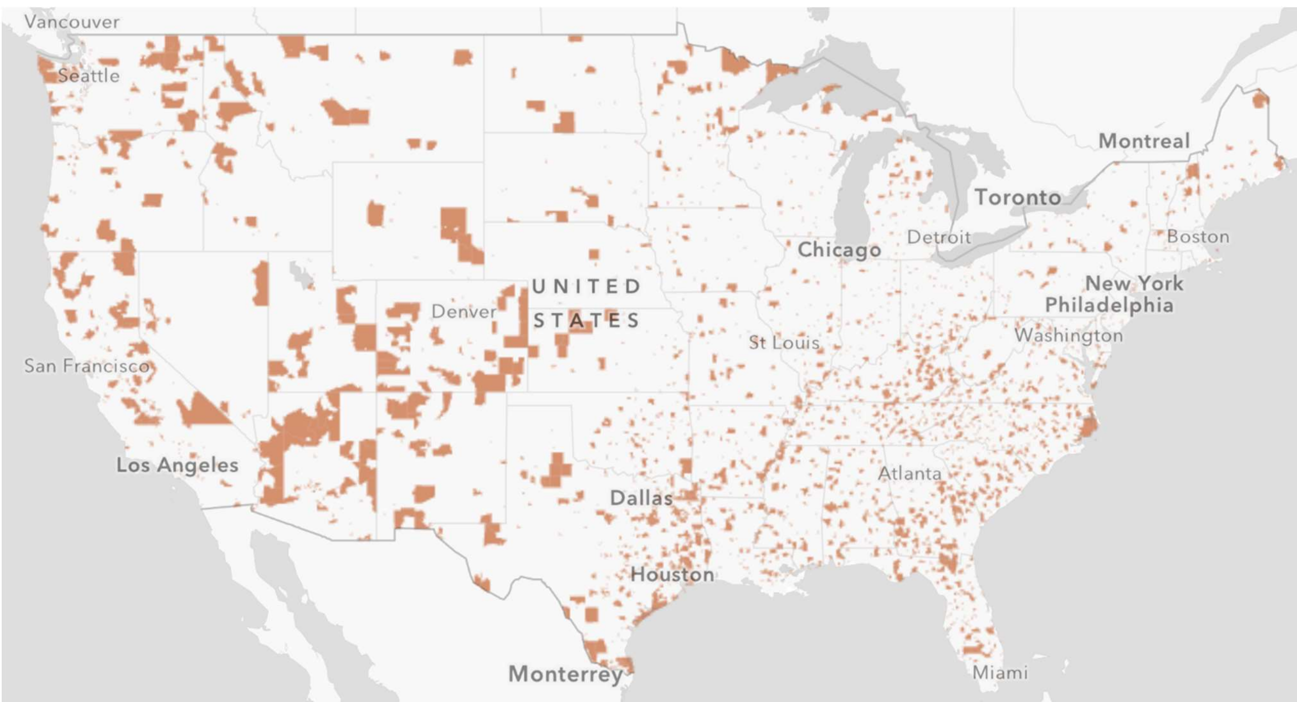


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## Introduction

The 2017 tax reform legislation, the Tax Cuts and Jobs Act ("TCJA"), has created a significant new income tax incentive for taxpayers to make investments in designated low-income areas, known as Qualified Opportunity Zones ("QOZ"). The new tax provisions (Internal Revenue Code Sections 1400Z-1 and 1400Z-2) provide for a deferral of capital gains realized on sales of "any property" to an unrelated party where an amount equal to such gain is reinvested in a Qualified Opportunity Fund ("QO Fund") within 180 days, as well as other substantial tax preferences, as discussed below. In addition, certain amounts of the capital gains tax attributable to the reinvested money may be permanently exempted from tax if the investment in the QO Fund is held for longer than 5 or 7 years (10% and 15%, respectively), and if the investment in the QO Fund is held for at least 10 years, any gain from post-investment appreciation in the QO Fund is permanently excluded from tax. You may review the provisions of the tax code enacted by the TCJA. The Department of the Treasury is currently in the process of making a number of clarifications regarding the application of the opportunity zone provisions, which are expected to be made available for public comment in the fall of 2018.

With decades of experience in structuring private fund vehicles and experts in fund structuring, real estate and international taxation, the opportunity zone team at Sadis stands ready to guide you through any concerns relating to structuring a fund, executing a QOZ investment strategy, and handling any tax and commercial considerations.

## What is a Qualified Opportunity Fund?

A QO Fund is an investment vehicle classified as a partnership or a corporation for federal tax purposes, and which is required to invest at least 90% of its assets in one or more QOZ designated by state governments and approved by the Department of the Treasury. QO Fund investments in a QOZ can be in either or both of the equity (both corporate stock and partnership interests) or the tangible property of businesses operating in the QOZ (a "QOZ Business"). In order to be a QOZ Business, substantially all of the tangible property of the business must be used in the QOZ and the business may hold only a small amount of financial assets for investment. Where a QO Fund purchases property, in order to qualify towards the 90% test, either the original use of such property in the QOZ must begin upon acquisition, or substantial improvements must be made to the property within 30 months (generally consisting of an additional investment equal to the property's original adjusted tax basis).

## What are the Tax Benefits of Investing in a Qualified Opportunity Fund?

The tax benefits for investing in a QO Fund are substantial: any realized gain on an investment which has been reinvested in the QO Fund will be deferred until the investment in the QO Fund is realized, or December 31, 2026 (whichever is first). In addition, any QO Fund investment held for at least 5 years will experience a 10% step-up in basis; and at 7 years, the basis is stepped up to 15%, bringing an investor's total potential tax savings to around 50%. In the event the QOZ investment does not perform, any losses in the QO Fund will reduce the amount of gain ultimately realized by the investor (assuming long-term capital gains rates and net investment income tax apply, this represents an effective 23.8% government subsidy on the downside). Furthermore, long-term investments in a QO Fund bring an added incentive: after 10 years, the tax basis of the QO Fund investment is stepped up to equal its fair market value. As a result, the returns on the QO Fund investment are effectively tax-free if held for 10 years or longer.

## Where are Opportunity Zones?

The process for designating and approving the areas which qualify as a QOZ has now been completed by state governments in all 50 states and the Department of the Treasury, and can be reviewed online.

## How do I Qualify to Elect the Capital Gains Tax Deferral?

In order to take advantage of the federal income tax deferral on capital gains, investors must invest in a QO Fund which meets the requirements under the Code within 180 days of realizing the capital gain which they wish to defer. As a result, fund managers will need to efficiently structure their investment vehicles and businesses to satisfy the statutory requirements applicable to investments by a QO Fund.

## How Should a Qualified Opportunity Zone Fund be Structured?

Due to the specific tax considerations surrounding investment in a QOZ, a QO Fund will require bespoke structuring to ensure the fund's subscription, liquidity, valuation and withdrawal terms are designed to take advantage of the tax benefits available to investors and provide the underlying manager with the ability to raise and deploy capital within the statutory requirements. Because QO Funds are required to purchase QOZ Business equity or property, fund assets will likely include either (or both of) private equity securities or real assets. In order to satisfy the statutory requirement that such assets are acquired in a cash transaction, fund managers will have to carefully manage the acquisition process to ensure their mode of financing the acquisition does not inadvertently invalidate the favorable tax treatment.

The type of fund structure, in particular with respect to liquidity, will likewise present an important consideration for managers. While hard-to-value, Level 3 assets are generally held in a closed-ended structure, valuations may prove important for demonstrating compliance with the 90% requirement, and so hybrid or permanent capital vehicles may be desirable for a number of fund managers. Where private equity-style waterfalls are used, the term of such funds will need to be sufficiently long to enable the fund to surpass the 10-year mark and engage in an orderly wind-down, with the flexibility to terminate early in the event an investment is not profitable. In addition, subscriptions terms of such funds will need to accommodate the limited 180-day window in which investors must invest, which may require a hedge-fund style capital contribution mechanism rather than private-equity style draw-down of capital commitments. In order to provide investors greater flexibility to dispose of QOZ investments or facilitate transfers, managers of funds may likewise seek to unitize partnership interests.

## What Other Tax Considerations Should I be Aware of?

In determining an efficient fund structure, it is vital that investors and managers alike assess any tax concerns and potential tax liabilities created by the underlying investments. In particular, the QOZ statute provides its tax benefits through the deferral of gain and various adjustments of an investor's tax basis in the investment. These tax benefits are designed for investments which provide a return in the form of capital gain. Income-producing investment strategies, however, may create current tax liabilities for underlying investors that are not covered by the legislation. As a result, such income may offset the tax benefits afforded investors under the statute and result in substantial tax losses to investors. Effective structuring around such tax issues is therefore vital, and certain strategies may wish to consider a corporate fund structure in order to achieve tax efficiency for the underlying investors.

Additionally, investors should consider the effect that state tax obligations may have on their expected returns. In particular, the TCJA provides federal tax relief for investments in a QOZ, though it does not directly affect state tax legislation. Many states which impose an income tax conform to the federal state laws either automatically as federal laws are amended, or selectively by separate state tax amendments, certain states may decide not to allow the federal income tax gain deferral to apply for state income tax purposes. Therefore, investors seeking to make a QO Fund investment for tax planning reasons may wish to assess the effect that non-conforming state taxes may have on their expected returns and liabilities.

The tax considerations for non-U.S. investors will likewise present unique considerations, as investment in certain assets by non-U.S. persons may produce various types of tax liabilities to such non-U.S. investors, including substantial withholding taxes and real-estate related taxes, and require that such non-U.S. persons file tax returns in the United States.

With decades of experience in structuring private fund vehicles and experts in fund structuring, real estate and international taxation, the financial services team at Sadis stands ready to guide you through any concerns relating to structuring a fund, executing a QOZ investment strategy, and handling any tax and commercial considerations.

For more information regarding opportunity funds, reach out to one of our practice contacts.

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