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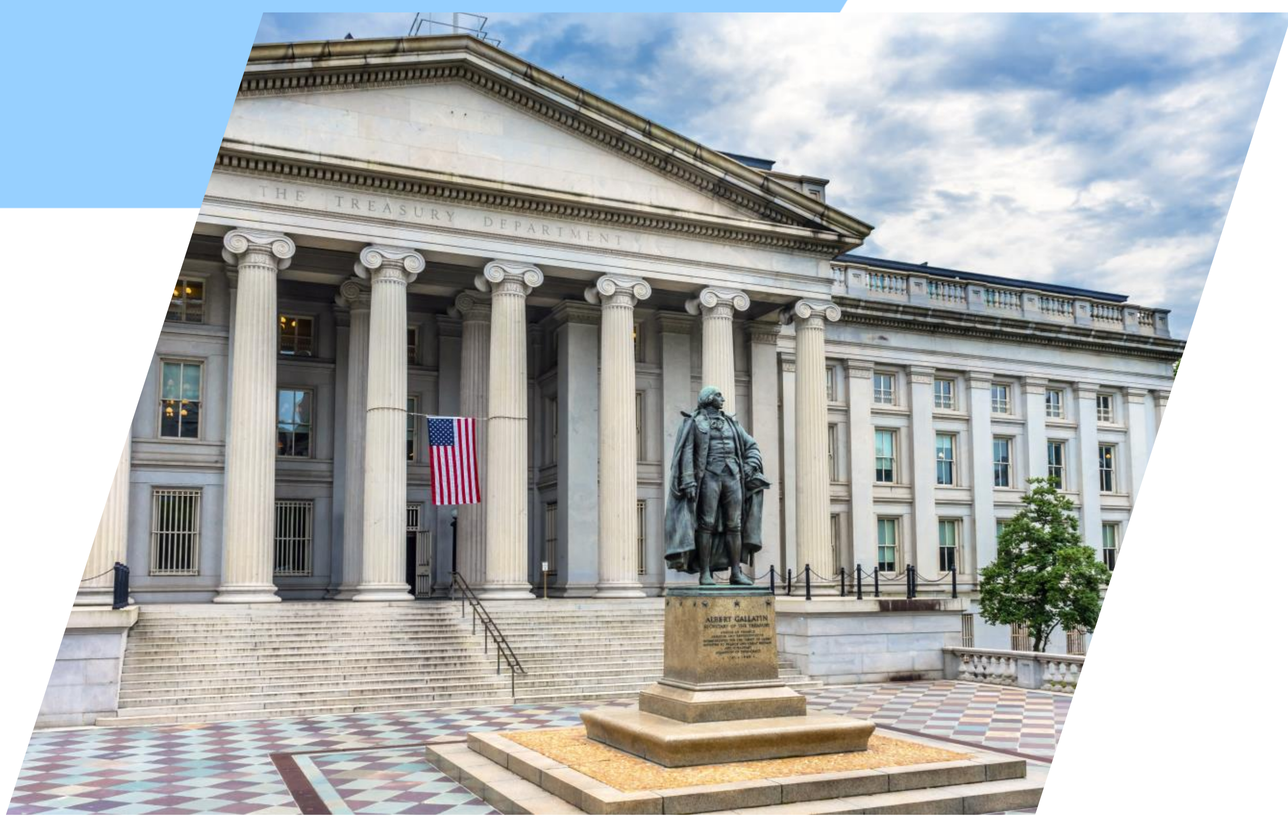
How to set up a Qualified Opportunity Fund (while waiting for IRS guidance)



A&S Opportunity Zone Practice Group
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How to set up a Qualified Opportunity Fund (while waiting for IRS guidance)

If you are in the real estate industry, you have probably heard about Opportunity Zones (the "OZ Program"). If you haven't, you should get up to speed (very!) quickly since these two unassuming sections of the Internal Revenue Code of 1986, as amended (the "Code"), which were added as part of 2017 Tax Reform, have cracked wide open a new investment structure that results in significant tax benefits to investors. There is a narrow window to get the maximum tax benefits though, and the clock is already ticking…

In a nutshell, here is the timeline and the associated tax benefits:[1]

- **First**, an investor sells an existing appreciated asset.
- **Second**, the investor invests the gain portion of the sale proceeds into a Qualified Opportunity Fund ("QOF") within 180 days.
    - TAX BENEFIT #1 – The investor defers the entire amount of the gain that is reinvested into the QOF.
- **Third**, the investor pays tax on the deferred gain at the earlier of (i) the sale of its interest in the QOF, or (ii) December 31, 2026.
    - TAX BENEFIT #2 – If the investor has held its QOF investment for at least 5 years, 10% of the deferred gain is permanently forgiven. If the investor holds its QOF investment for at least 7 years, an additional 5% (for a total of 15%) of the deferred gain is permanently forgiven. *(Note that to get the 7 year benefit, an investor must invest in a QOF no later than December 31, 2019.)*
- **Fourth**, the investor sells its interest in the QOF at exit.
    - TAX BENEFIT #3 – If the investor holds its QOF investment for at least 10 years, there is no tax at all on the gain realized by the investor at exit.

So naturally, everyone's next question is: How do I do this?

1- Moving Ahead, Whether You Want To or Not

While some people have the luxury of kicking the tires on the OZ Program a little while longer and waiting for additional guidance from the IRS, others have to forge ahead now. Maybe you have to close on an asset in an Opportunity Zone and you can't delay the acquisition. Maybe you sold an asset and your 180 day clock is about to run out. Maybe you want to be first out of the gate to set the market in terms of fees and promote calculations.

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[1] Our May 2018 White Paper explains the OZ Program in detail, with numerical examples to illustrate the tax benefits. That White Paper can be found here.

Either way, if you want to (or need to) set up a QOF now, consider this your roadmap: stick closely to the aspects of the OZ Program that we know for sure, and take reasoned steps to deal with the unknowns.

2- What We Know: Follow the Roadmap

Given the drastic uncertainties surrounding the OZ Program, close off as many pitfalls as possible by focusing on what we know.

a) Each investor has its own clock

Any investor in a QOF that wants to take advantage of the tremendous tax benefits of the OZ Program will have sold an existing investment to generate the gain that will be reinvested in the QOF. Consequently, each investor's 180 day clock will likely be expiring at a different time. If you are targeting multiple investors to invest in your QOF, you should permit investors to buy into your QOF over as long a period as possible (subject to the QOF's own clock – see Part 2(b) below).

For example, if you know that you will be closing on the acquisition of a property on December 1st, allow investors to subscribe for a QOF interest from September 1st until November 30th. This way, an investor who sold an asset at the end of March could acquire a QOF interest in early September before its 180 day clock runs out at the end of September. If you wait and only permit investors to acquire their QOF interests immediately before closing, you may be limiting your investor pool.

b) The QOF has its own clock too

The QOF needs to meet a 90% asset test twice a year. Although there is some uncertainty in how that test applies in the QOF's first taxable year, the last day of each taxable year of the QOF is definitely a testing date. For QOFs that use the calendar year as their fiscal year, this means that the 90% asset test must be met on December 31st. Since cash is not considered a good asset, a QOF formed in 2018 must use its cash and invest in something by December 31, 2018.

If you take our advice in Part 2(a) above and give investors a window in which to invest in the QOF, you need to think strategically about what that window should be given the QOF's investment timing. For example, if you are closing on the acquisition of a property on April 1, 2019, ideally you should set up your QOF in January 2019 and permit investors to subscribe for a QOF interest from January 1, 2019 until March 31, 2019. If you set up your QOF in 2018 and accept cash from investors prior to

December 31, 2018, the QOF would flunk the 90% test on the December 31, 2018 testing date since it would not own any good assets.

c) <u>The QOF has to be a newly incorporated corporation or a newly formed partnership</u>

The Code defines a QOF as "any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property…" Given the "purpose" clause, use a new entity and make sure that the QOF's organizational documents include a purpose clause referencing its status as a QOF.

Can a QOF be an LLC? The Code is silent on this point, but since LLCs with multiple members default to partnership status for tax purposes (and since an LLC can elect to be a corporation for tax purposes), hopefully guidance will clarify that LLCs are a permitted type of legal entity for QOFs. However, if you are moving ahead now before additional guidance and you want to eliminate a possible uncertainty, use a limited partnership or a corporation if you can.

Also note that if your QOF will be a partnership, make sure it is a partnership for tax purposes when it is formed. This means it must have two distinct partners. If there is only one partner, the entity will be a disregarded entity for tax purposes and that could be problematic.

d) <u>The Code tells us the possible structures</u>

There are two basic structures set out in the Code. The first is the "single tier" structure where the QOF holds the property directly. The second is the "two tier" structure, where the QOF holds an interest in a lower tier partnership or corporation (in either case, a "JV Entity"), and the JV Entity holds the property. A QOF cannot own another QOF.

The two tier structure offers more flexibility than the single tier structure by permitting the JV Entity to hold reasonable amounts of working capital and using a "substantially all" test (although there are uncertainties in how that will be measured – see Part 3(d) below) rather than a strict 90% test. Set up your QOF under the two tier structure if you can.

Another big question making the rounds is whether the QOF (in the single tier structure) or the JV Entity (in the two tier structure) can hold the property through a wholly-owned single member LLC. The Code is silent on this point, but since single member LLCs are disregarded for tax purposes generally, guidance will hopefully clarify that using single member LLCs is permissible. Given that most sophisticated real estate transactions use a "propco" single member LLC for mortgage financing, and also possibly a "mezzco" single member LLC for mezzanine debt, not allowing the use of single member LLCs would create significant hurdles for financing these transactions.

e) <u>December 31, 2019 is the first big deadline</u>

If investors want to capture the maximum tax benefits of the OZ Program, they must invest in a QOF by December 31, 2019. Since the original deferred gain comes due on December 31, 2026, investors who want to benefit from the 15% reduction in taxable gain must have held their QOF interest for 7 years by then (meaning they must invest in a QOF by the end of 2019).

The second big deadline will be December 31, 2021, for investors that want to benefit from the 10% reduction in taxable gain, so you're not out of the running if you miss the 2019 cutoff.

3- What We Don't Know (and How to Deal with Some of the Unknowns)

Unfortunately, the number of questions and unknowns gets longer by the day as people scrutinize the Code. Here are the big sources of worry at the moment.

a) <u>What kind of gain qualifies?</u>

The Code says that taxpayers can defer tax on "gain from the sale… or exchange… of any property…" However, the heading of Section 1400Z-2 of the Code is "Special Rules for Capital Gains Invested in Opportunity Zones." It seems clear that capital gains, whether long-term or short-term, should be eligible. It is less clear whether ordinary income qualifies and whether Section 1231 gains (which technically are not capital gain, but instead are treated like capital gain) get the benefit of deferral. The treatment of depreciation recapture and mark-to-market income of dealers are other open questions. The safe bet is to only invest capital gains into a QOF until we know more.

b) <u>Who is the "taxpayer"?</u>

An individual who sells an asset and realizes a gain can defer paying tax on that gain by investing the gain into a QOF. What about an individual partner in a partnership when the partnership sells the asset which triggers an allocation of gain to the partner?

If the IRS comes back with flexibility on this point and permits an individual partner to reinvest the gain into a QOF, that would create a major advantage over 1031 transactions for investors in this fact pattern. If a partnership sells property, the partnership itself is the entity which must reinvest the proceeds in like kind property under Section 1031. This is often problematic when partners have differing desires about the use of proceeds from a sale, so the ability of individual partners to reinvest their share of the gain into a QOF would be a helpful alternative in those situations.

On a practical level, assuming that the partners themselves can reinvest their share of the gain into a QOF and claim the tax benefits, there will need to be increased communications from investment funds to their partners when a sale occurs at the partnership level so the uptier partners can reinvest their share of the gain on a timely basis.

c) <u>How does the original use test work?</u>

Whether you use the single tier structure or the two tier structure, the QOF or the JV Entity, as applicable, needs to meet either the "original use" test or the "substantial improvement" test. Both tests are lacking sorely in explanation.

The sum total of guidance that exists with respect to the original use test is the language in the Code, which says that the test is met if "the original use of [the property acquired by the QOF or the JV Entity] commences with the [QOF or the JV Entity]."

First of all, what is original use? Does it need to be ground up development? Can a complete renovation which includes a change of use qualify? For example, if you buy an industrial property and you redevelop it as multifamily housing, does that work?

Second, how will original use be measured? It would be helpful if IRS linked this requirement to something concrete such as obtaining a certificate of occupancy.

Third, what is the timeframe in which the test must be met? Ground up development takes years to complete, so how can a QOF or JV Entity meet the test in the early years before the property is complete?

Fourth, how is this test applied to land? Just about all land has been used before in some way or another (agriculture, etc.) so it is not clear if a QOF can ever meet the original use test with respect to an acquisition of land.

d) <u>How does the substantial improvement test work?</u>

The substantial improvement test is equally vexing. A QOF or JV Entity, as applicable, can meet the substantial improvement test if it doubles its initial basis (acquisition cost) of the property "during any 30-month period".

First, how must cash be used in order to meet the requirement that you double your basis? Technically the Code says that "additions to basis with respect to the property" must exceed the initial basis at the beginning of the 30-month period. If the QOF or JV Entity acquires a property and can do enough structural work and renovations to meet the test, that seems like a path to victory. There may be other possible ways to meet the test too though. For example, if the QOF or JV Entity acquires an office building and the surrounding land, additions to basis might include landscaping work or constructing retail next to the office building.

Second, since the Code says "any" 30-month period, which 30-month period should you choose? If you can meet the test in the first 30 months, that is a route with less open questions. But if the QOF or JV Entity acquires property and wants to wait a few years before starting the improvement process, how can it meet the test in those early years? There might be some requirement to show a plan for improvements, but that would be difficult to monitor.

e) <u>What is a reasonable amount of working capital?</u>

As mentioned above, the two tier structure permits the JV Entity to hold a reasonable amount of working capital. However, it is not clear what will be considered reasonable under these rules. Until we know more, possible ways to manage excess cash include only accepting subscriptions from investors for current cash needs and being creative with debt (perhaps close all cash with QOF funds and then use a revolving credit facility to manage ongoing costs, or alternatively acquire the property with third party financing which can be repaid with QOF contributions).

f) <u>What does "substantially all" mean?</u>

As mentioned above, under the two tier structure the JV Entity is subject to a "substantially all" test rather than the 90% asset test imposed on the QOF. The JV Entity must be conducting a trade or business in which <u>substantially all</u> of the JV Entity's tangible property is (i) acquired by the JV Entity by purchase from an unrelated party after December 31, 2017, (ii) property which meets the original use or substantial improvement tests, and (iii) property which, during substantially all of the JV Entity's holding period of the property, is substantially used in an opportunity zone.

While it appears that this test should offer more flexibility than the QOF's 90% asset test, the meaning of "substantially all" is not clear.

g) What do you mean the exit needs to be an entity sale?

The brass ring for investors to reach for at the end of 10 years is the ability to cash out of the QOF without paying any tax at all on the gain. However, the current language in the Code implies that investors will need to sell their interest in the QOF directly to capture this benefit. This means that the exit must be structured as an entity sale rather than an asset sale. For this reason, we advocate setting up any QOF structures to hold only a single property. Entity sales get complicated for a number of reasons, but if future guidance does not loosen this requirement, QOF investors must be willing to deal with the complications of an entity sale if that is what it takes to pay no tax on the gain in their QOF investment.

Some players currently in the fund-raising market are counting on flexibility in how the 10-year rule will be applied by setting up large funds to acquire multiple properties. Until the application of the 10 year rule is clarified, this seems like a pretty big gamble.

h) And the list goes on…

Other areas of uncertainty include how ground leases should be treated, how the OZ Program basis rules interact with the basis rules under the Code generally and for partnerships in particular, how the reasonable cause exception to the 90% asset test will be applied, and what the anti-abuse rules will target. From a commercial perspective, it remains to be seen how the economics in the QOF deal differ from a traditional real estate transaction and how the parties will allocate the risk of an uncertain QOF structure before guidance is issued.

The A&S Opportunity Zone Practice Group brings together a 50-person team, including lawyers, paralegals, and our business professionals providing a unique value add for clients. The OZ team is led by:

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