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Client Alert

Qualified Opportunity Funds: A Work in Progress

April 9, 2019 – In December 2017, the Tax Cuts and Jobs Act (the "Act") created a new tax incentive for investments in low-income communities. Under the Act, investors can obtain substantial tax benefits by investing otherwise taxable gains in new investment vehicles called Qualified Opportunity Funds ("QOFs") that invest in opportunity zones. After a lengthy review process, the U.S. Treasury Department has designated 8,764 census tracts, with over 500 in New York State alone, as opportunity zones.

In a previous Client Alert, we provided a high-level summary of the tax benefits of investing in opportunity zones and the requirements for qualifying as an opportunity zone fund. In this article, we take a closer look at these requirements and discuss current structuring issues as we await a second anticipated round of proposed regulations.

Tax Benefits of Investments in Opportunity Zones

The opportunity zone regime creates significant tax benefits for taxpayers who reinvest their realized capital gains from a sale to an unrelated person within 180 days ("Eligible Gain") into a QOF. Only reinvestments of Eligible Gains qualify for the tax benefits associated with opportunity zone investments. While investors can contribute capital in addition to their Eligible Gains, such additional investments will not qualify for tax benefits. Investors may elect to defer the recognition of the Eligible Gain until the earlier of the investor's disposition of its interest in the QOF or the end of 2026. Additionally, when the investor does recognize the Eligible Gain, it is entitled to reduce such deferred gain by 10% (for QOF interests held for at least 5 years) or 15% (for QOF interests held for at least 7 years). Because the deferral only extends to the end of 2026, investors only benefit from the 15% reduction of taxable gain for investments made before the end of 2019.

Additionally, investors who hold their QOF interest for at least 10 years (and sell the interests by December 31, 2047) can sell their QOF interest free of tax on the post-acquisition gain. The exclusion of post-acquisition gain only applies to QOF interests purchased with reinvested Eligible Gain.

Requirements for Qualification

Any corporation or partnership (including an LLC taxed as a corporation or partnership) that meets the requirements below may self-certify as a QOF. However, for a QOF that was a pre-existing entity, only investments made on or after the effective date of the self-certification are eligible for the associated tax benefits. To qualify, at least 90% of the QOF's assets must be "qualified opportunity zone property," which includes (i) qualified business property and (ii) qualified portfolio company interests.

Qualified business property generally includes tangible property purchased from an unrelated party after 2017 where "substantially all" of the use of the property is in the opportunity zone during "substantially all" of the QOF's ownership period. The QOF must either place the property into service in the opportunity zone or make capital improvements in the property at least equaling the acquisition cost within a 30-month period.

Qualified portfolio company interests include equity in a U.S. corporation or partnership (including an LLC taxed as a corporation or partnership) if (i) the QOF acquired such equity for cash at its issuance after 2017 and (ii) the portfolio company is – and, during substantially all of the QOF's ownership period, remains – a "qualified opportunity zone business" (i.e. a business that meets certain income and asset tests, and is not in a prohibited line of business, such as golf courses, casinos, and liquor stores).

Investor Structuring Issues

Any taxpayer may elect to roll Eligible Gains into a QOF. In the case of a QOF investment by a partnership or other pass-through, either the partnership or the partners may elect to defer their Eligible Gains, but not both. Partners, partnerships, and fund sponsors alike should therefore take steps to avoid duplicative reporting for investments from pass-through entities.

Investors should also plan for the realization of gain. Investors will recognize the deferred gain in 2026 (less the 10% or 15% reduction discussed above, as applicable), assuming they have not sold their QOF interests before then. This may produce substantial phantom income that typical tax distributions do not cover. Moreover, even if the QOF is willing to make additional distributions, it is doubtful that the QOF will have sufficient cash flow to make such distributions absent financing. Investors should therefore consider other options for addressing this future tax liability.

Further, investors should carefully consider their QOF structure before selling the property that generates Eligible Gain. Only the Eligible Gains of the taxpayer investing in the QOF qualify for tax benefits. Thus, if several subsidiaries of a common parent sell property that generates Eligible Gain, they would each need to contribute such gains to the QOF to qualify for tax benefits. They could not aggregate their investment by distributing the gains to their common parent before having the common parent contribute cash to the QOF.

Sponsor Structuring Issues

Additionally, there are complicated structuring decisions for QOF sponsors. Sponsors will need to consider whether each QOF should invest in a single business or whether it should hold a portfolio of investments. Multi-investment QOFs present complex challenges around the timing of capital calls and investments. Because investors must roll Eligible Gains into a QOF within 180 days, investors will likely require more certainty than funds typically provide as to the timing of capital calls. In the context of a multi-investment fund with broad discretion to pursue investment opportunities, the fund's need for prompt access to capital may be at odds with the investors' need for sufficient time to sell property that will generate Eligible Gains that they can invest in the QOF.

Moreover, because cash is not generally eligible property, sponsors must take care to ensure that the cash that the QOF raises will not disqualify the fund or its portfolio companies. In practice, QOFs that hold cash for a significant amount of time will need to qualify for the safe harbor under the proposed regulations to treat such cash as working capital. Under the working capital safe harbor, a QOF's qualified portfolio companies may hold cash as working capital (including for the acquisition, construction, or improvement of tangible property) for up to 31 months. The QOF must have a written plan in place for investing the cash pursuant to a schedule and must use the working capital consistently with the written plan. The QOF's need to identify the use of funds raised in a capital call to fall within the safe harbor further complicates this issue. The challenge of giving investors sufficient notice of capital calls while giving the QOF sufficient flexibility to respond quickly to investment opportunities therefore weighs in favor of restricting QOFs to a single investment.

Additionally, multi-investment QOFs present unique challenges when structuring an exit. The exclusion from tax for gains on sales of QOF interests held for 10 years only applies to a sale of the QOF interest. It does not apply when a QOF sells its assets. Because of this, it may be more difficult for investors to maximize their sale proceeds (while obtaining the available tax benefits) if the QOF holds a diverse portfolio of investments.

Regardless of whether sponsors choose to aggregate investments in a single QOF or to use single-investment QOFs, most sponsors will likely choose to structure QOF investments through qualified portfolio companies rather than to have the QOF invest directly in qualified business property. In addition to being a familiar structure for fund sponsors, the opportunity zone regime provides portfolio companies with substantially more flexibility in holding non-qualified property (including cash) as opposed to the requirements applicable to QOFs. While at least 90% of a QOF's assets must be qualified opportunity zone property, only 70% of a qualified portfolio company's assets must be in qualified assets. Further, it appears that only qualified portfolio companies will be eligible for the working capital safe harbor. Thus, unless the QOF can promptly invest its raised capital in qualified business property, it will be impractical for a QOF to invest directly rather than through a portfolio company. On the other hand, qualified portfolio companies are subject to the stringent income and asset tests that are not applicable to direct QOF investments. Thus, when the QOF intends to make only a single investment and it can deploy its capital promptly after a capital call, it may make sense in some cases to invest directly through a QOF rather than through a portfolio company.

Further Clarity Needed

Because of the significant ambiguity in the statutory language, numerous issues remain to be resolved by the Treasury. In particular, we hope to see further clarification about the types of property that qualify as qualified business property and the mechanics of the various asset and income tests, particularly as they relate to the timing of capital calls. In addition, further clarification is needed as to the character and applicable tax rates for Eligible Gains realized in 2026 or upon sale.

Opportunity zone investments present unique opportunities for investors and fund sponsors. However, the rules surrounding them are exceedingly complex and continually changing. Investors and sponsors alike should carefully consider the structuring concerns discussed above and other potential issues before investing in opportunity zones. If you would like to discuss investments in an opportunity zone, or any other tax issues, please reach out to our tax department, which has been closely following developments in this area.

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