What’s Trending:

ALERTS & UPDATES

QUALIFIED OPPORTUNITY ZONES

Tax legislation adopted in 2017 established the “opportunity zone” program to provide tax incentives for long-term investment in designated economically depressed areas. On Dec. 19, 2019, the IRS released final opportunity zone regulations, which relaxed some of the rules set forth in proposed regulations to encourage greater use of Qualified Opportunity Funds (“QOFs”). Fueled by these IRS actions, QOFs have now moved to the short list for both investors seeking favorable returns on investments and fund organizers seeking favorable equity investment terms.

CONSIDERATIONS FOR FUND ORGANIZERS AND MANAGERS

The tax benefits for investing in QOFs have created opportunities for investment fund organizers, developers and others. However, simply buying a property in an opportunity zone is not enough. QOF status requires the fund organizer and manager to navigate the numerous technical requirements. As a result, diligence is needed in structuring and operating in compliance with IRS requirements.

A QOF must meet eligibility requirements on certain annual testing dates (generally, June 30th and Dec. 31st), and it should maintain records to show those requirements are met. While many QOFs can manage these reporting and compliance obligations internally or together with their outside accountants, when a QOF has a significant number of investors, complex structures or other unique features, it is prudent to utilize a third-party administrator for record-keeping, reporting and compliance purposes.

A QOF that purchases opportunity zone property must construct substantial improvements to the property within 30 months of acquisition of the property, which requires the QOF to spend more on improvements than the cost of the purchased property. The IRS has clarified this substantial improvement requirement only applies to the depreciable real estate (i.e., the building) and not to the land. However, the final regulations indicate land still needs to be improved by more than an insubstantial amount, which is a factual inquiry. As a result, QOFs should obtain an appraisal to determine how much of the purchase price is allocable to the building and the land.

In another favorable move, the final regulations provide that if a building was vacant for at least one year prior to the designation of the area in which it is located as a qualified opportunity zone (“QOZ”) and remains vacant through the date of purchase, there is no need to substantially improve the property. A three-year vacancy period is otherwise required for property that was not vacant at the time of the QOZ designation. The IRS also indicated that leased property is not subject to any substantial improvement requirement. Finally, the final regulations allow an aggregation of the substantial improvements of separate parcels if they meet certain requirements including being operated exclusively by a single business.

Cole Schotz P.C.

There are, however, limits on the purchase, rental and sale of property. Property purchased from a related person (e.g., a person who owns more than 20% of the QOF) does not qualify, which can cause loss of QOF status. While a triple net lease is not an active trade or business, an example in the final regulations indicates that a three story building with only one floor subject to a triple net lease and the taxpayer's employees materially participating in the operation and management of the other two leased floors qualifies as an active business. However, the regulations do not answer the question of whether multiple triple-net leases may be permissible without jeopardizing being engaged in an active trade or business, which is to be determined based on all the facts and circumstances.

The QOF also cannot invest in sin businesses, which include liquor stores, gambling facilities, race tracks, golf courses, country clubs, massage parlors, and hot tub or suntan facilities. The QOF has to actively manage, maintain and/or operate the property. In addition, fund investors may seek to restrict the QOF from selling the property until 10 years or more in order to fully benefit from the tax advantages.

The IRS has confirmed that a QOF can generally conduct active trade or business, with the exception of certain "sin businesses," provided the QOF has physical presence and employees working in the zone

QOFs may not have more than five percent of the assets of a QOZ business held in cash or financial instruments, which must be met on each testing date. The IRS permits investors' cash contributions to be disregarded on the first testing date after the contribution, but the fund needs to invest in the zone by the second testing date, which includes investing in a qualified opportunity zone partnership ("QOZ partnership").

Cash held for reasonable working capital (e.g., acquisition or construction of QOZ property) that is expected to be spent within 31 months of receipt, will not jeopardize QOF status. The final regulations clarified that there are overlapping working capital safe harbors, which allow for multiple cash infusions to each benefit from a 31-month period for investment but subject to the requirement that such extension cannot extend beyond 62 months from the date of the first contribution. Documentation must be prepared at the time the cash is invested detailing how and when the cash will be used. Also, this working capital exception cannot, generally, be used by the QOF itself. The QOF needs to become a partner in a QOZ partnership that operates in the zone, and that QOZ partnership may use this working capital exception. The final regulations provide an expansion of the scope of the safe harbor if the QOZ business is located in a QOZ designated federally declared disaster area and allow for an additional 24 months to consume its working capital assets.

While QOFs are generally used for acquisition and construction of rental real estate located in a QOZ, the IRS has confirmed that a QOF can generally conduct active trade or business (such as a high-tech business) provided the QOF has physical presence and employees working in the zone meeting the active trade or business requirement. The rules allow some flexibility in having staff work from home or outside the zone if certain guidelines are met, but fund managers need to be vigilant to ensure the business does not stray past the zone borders in any significant way, which can cause the loss of QOF status. For example, more than 50% of wages paid to employees or hours worked must be for work performed in the zone. As the business grows, the managers need to monitor where work is being performed to ensure this requirement continues to be met.

The QOF's LLC Operating Agreement or Limited Partnership Agreement is likely to be carefully scrutinized by investors and their advisors to make sure the QOF (and any QOZ Partnership in which the QOF invests) is obligated to continually comply with these rules. Even loan documents and other agreements need to be prepared with an eye on maintaining QOF status. For the fund's organizer and manager, this adds more complexity than for non-QOZ investments.

While this discussion highlights some of the major requirements for QOF status. There are numerous details and other requirements that need to be met. As a result, fund organizers and managers should seek legal and tax advice in structuring and ensuring ongoing compliance with these QOF requirements.

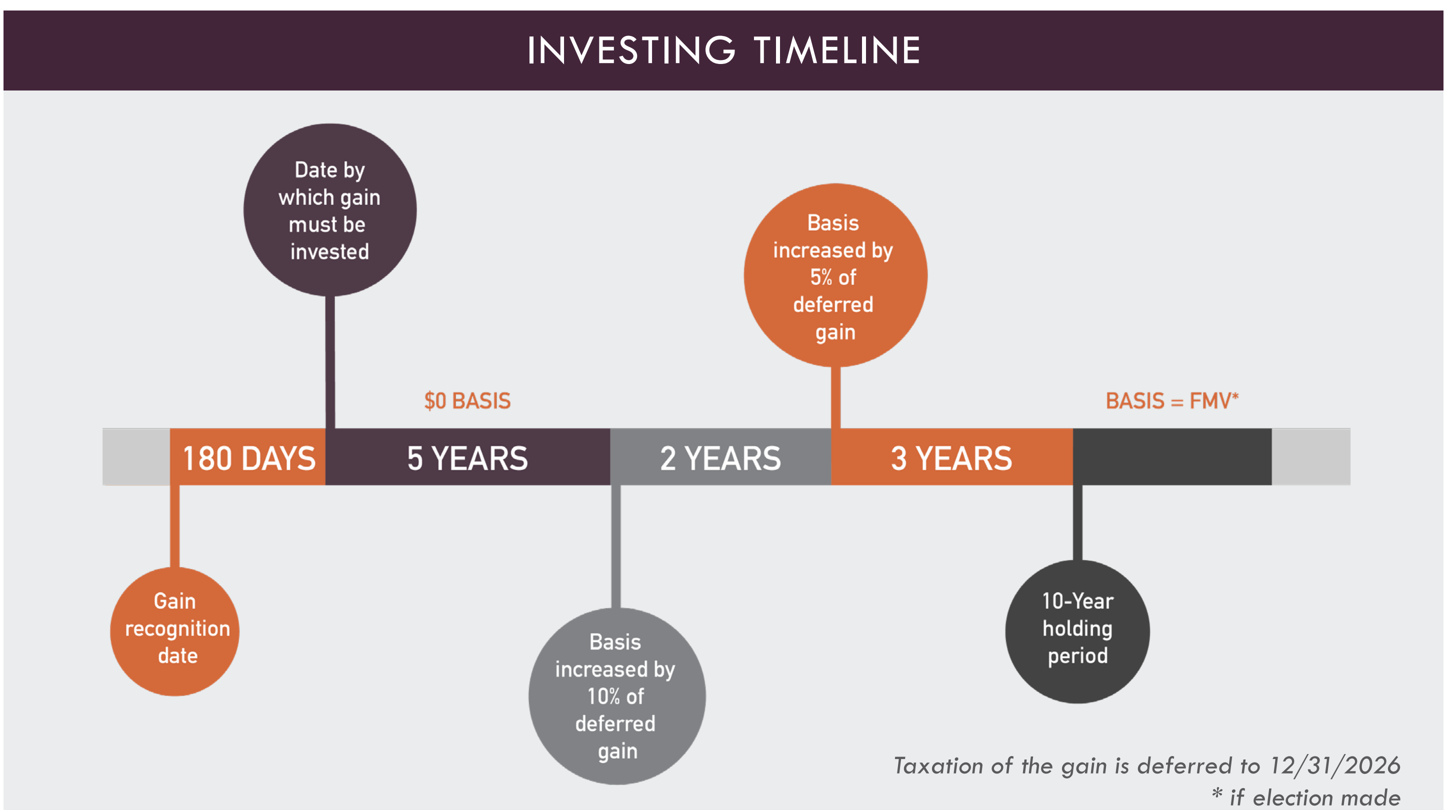
CONSIDERATIONS FOR INVESTORS

Prospective investors in QOFs may be lured by the following tax benefits:

- Deferral of paying tax on capital gains invested into the fund until the earlier of Dec. 31, 2026 or the date they sell their QOF investment.
- Permanent exclusion of 10% or 15% of the capital gain if the investment is held for at least 5 years or 7 years, respectively. Since the 5 year and 7 year holding periods are determined as of Dec. 31, 2026, investments made in 2020 and 2021 can only qualify for the 10% exclusion.
- Exclusion from tax on sale of the QOF investment if held for at least 10 years before sale. The final regulations also allow an investor to exclude from taxation the gain from the sale of property by the QOF if the investment has been held for 10 years or more.

However, investors should be aware of the many requirements and potential traps that underly to ensure the anticipated tax benefits are achieved.

An investment in a QOF must generally be made within 180 days of the sale that generated the capital gain. However, IRS guidance allows investors added time to invest if the capital gain was generated by a partnership or an S Corporation or a sale of business real estate or certain other assets, but there are deadlines that must be met. Under the final regulations, the 180-day period begins on the last day of the partnership taxable year, but the partner may elect to instead use: (i) the same 180-day period as the partnership; or (ii) the due date for the partnership's tax return, without extensions (i.e., March 15).



The impetus behind this change was to allow partners with additional time to receive Schedules K-1 that list their share of capital gains. Similar rules were adopted for S Corporations. If the partnership or S Corporation had a capital gain in 2019 and did not invest in a QOF then the investment must be made by the partner or shareholder on or before Sept. 14, 2020.

The final regulations offered other helpful changes. Gain from a sale of business property (referred to as a Section 1231 gain) can be fully invested in a QOF even if the investor has losses from other business property in the same taxable year. Gains from installment sales can be invested when received. If the QOF requires staged or multiple capital contributions, however, care is still needed since each capital contribution must be funded by an investor's timely capital gain in order to preserve full QOF benefits.

A distribution of cash by a QOF to its investors will generally not result in taxable income to the investor to the extent the distribution does not exceed the investor's tax basis for their QOF interest (including their share of QOF debt). To combat abusive transactions, IRS guidance provides that a distribution to investors of cash obtained from a refinancing would generally cause loss of QOF tax benefits if made within two years of the contribution to the QOF. By contrast, distributions of refinancing proceeds made more than two years after the contribution generally would not cause loss of QOF benefits as long as there was no binding commitment or stated intent to make such distributions.

Investors should confirm that the operating agreement or other governance documents include protections to ensure the QOF will be compliant with all applicable QOF regulations, tax benefits are not jeopardized and that there are favorable investment terms independent from tax savings.

OZ issuers are subject to Federal and State securities laws in soliciting investors

SECURITIES CONSIDERATIONS

Many QOFs are established in connection with the acquisition or development of opportunity zone property funded by equity investments. Federal and State securities laws define "securities" broadly to include shares of stock, limited partnership interests, membership interests in a limited liability company, notes, bonds, and investment contracts. As such, interests in a QOF will typically constitute securities, and, as a result be subject to applicable Federal and State laws relating to securities issuances, broker-dealer rules and investment company registration or exemption, as well as anti-fraud protections. The staff of the SEC and NASAA issued a Staff Statement on Opportunity Zones: Federal and State Securities Law Considerations, in which the SEC and NASAA staff confirmed the applicability of Federal and State securities laws to offers and sales of interests in QOFs, in the manner in which they are typically structured, except in the limited circumstances where the QOF is established and operated as a general partnership and each partner has a substantial role in management[1].

When interests offered or sold are securities, under the Securities Act of 1933, as amended (the "Securities Act"), and State securities laws, all offers and sales of securities must be either (1) registered with the SEC and the applicable State regulatory authority or (2) compliant with an exemption from both Federal and State registration. QOF issuers may utilize the frequently-used exemptions from registration available under Rule 506(b) or Rule 506(c) of the Securities Act. Rule 506(b) offers an exemption from registration for a private offering to accredited investors and up to 35 sophisticated investors and Rule 506(c) offers an exemption from registration for an offering to the public (including by general solicitation or advertising), so long as the issuer takes reasonable steps to verify each investor's accredited investor status. Rule 506 also requires satisfaction of certain additional conditions, including, filing of a Form D with the SEC within 15 days of the issuance, State notice filings, transfer restrictions and, if there is any investor which is not an accredited investor, disclosure requirements similar to a publicly registered offering. Further, any issuer which is a "bad actor" is not permitted to utilize Rule 506. Other applicable exemptions may also be available, including under Rules 504, 147 or 147A under the Securities Act, subject to the conditions of such exemptions.

OPPORTUNITY ZONE SECURITIES CHECKLIST

Check all boxes before issuing a "SECURITY"

- ☑ The offering and sale are exempt or registered under the Securities Act and applicate State securities laws.
- ☑ Any broker-dealer or finder soliciting investments is exempt or registered under the Securities Exchange Act and applicable State laws.
- ☑ Issuer is exempt from the Investment Company Act.
- ☑ Issuer is exempt from the Investment Advisers Act.
- ☑ There is adequate disclosure, no misrepresentations and no omissions regarding the investment.

QOF issuers are also subject to restrictions from soliciting investors by broker-dealers, unless they satisfy applicable broker-dealer registration requirements under the Federal and applicable State securities laws. Absent an available exemption, a person engaged in the business of effecting transactions in securities for the account of others is required to register with the SEC and comply with applicable State laws. Securities regulatory authorities have often determined that transaction-based (or success-based) compensation is a strong-indicator that broker-dealer registration is required. Even

1 The Staff Statement expresses the views of the SEC's and NASAA's staff and are not rules or official statements of the SEC, NASAA or any state securities regulators.

sponsors should be sensitive to these requirements as they are not permitted to hire anyone to market or solicit to investors, unless they are: (1) associated with the issuer and have substantial duties for the issuer "otherwise than in connection with transactions in securities," (2) participate in no more than one offering every twelve months and (3) do not receive compensation based on the success or issuance of securities to investors. Similarly, any third party is also subject to these restrictions if serving as a finder or broker to solicit investments, unless registered as a broker-dealer.

QOF issuers can also implicate registration provisions of the Investment Company Act of 1940 and potentially the Investment Advisers Act of 1940 and related applicable State securities laws, which absent an exemption would require registration. There are common exemptions and exclusions, but issuers should be mindful of these applicable laws and ensure compliance.

Any issuance of securities in a QOF is subject to the Federal and State anti-fraud provisions.

Lastly, any issuance of securities in a QOF is subject to the Federal and State anti-fraud provisions. As such, whether or not disclosure is specifically required to be delivered to a prospective investor under the Federal and State securities laws, issuers should ensure the accuracy and adequacy of their disclosure, to avoid any material misstatement or omission and the related liabilities and potential sanctions.

CONTACT

Jennifer L. Horowitz
Co-Chair, Corporate, Finance & Business Transactions
201.525.6214
jhorowitz@coleschotz.com

Leo V. Leyva
Co-Chair, Real Estate & Litigation
646.563.8930
lleyva@coleschotz.com

Marc P. Press
Member, Corporate, Finance & Business Transactions
201.525.6271
mpress@coleschotz.com

Jeffrey H. Schechter
Chair, Tax Controversy
Member, Tax, Trusts & Estates
201.525.6315
jschechter@coleschotz.com

Philip R. Hirschfeld
Associate, Tax, Trusts & Estates
646.563.8955
phirschfeld@coleschotz.com

www.coleschotz.com

New Jersey | New York | Delaware | Maryland | Florida | Texas