

Qualified Opportunity Fund Investing: 15% Deadline Rapidly Approaching

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Time is ticking. To take advantage of the full 15% tax discount offered by the Opportunity Zone program, you'll need to get your ducks in a row quickly to meet the December 31, 2019 deadline. Unless you're investing only your capital gain income into your qualified opportunity fund, you'll need enough time to form your fund, a possible lower-tier entity and offering documents, present them to potential investors and receive equity investment in the fund.

Those active in the real estate industry are, by now, well-aware of the Opportunity Zone provisions contained within the 2017 Tax Cuts and Jobs Act. Effective January 1, 2018, the Opportunity Zone program incentivizes investment in certain low-income communities around the country designated as "qualified opportunity zones" ("QOZs") by rewarding investment in QOZs through a qualified opportunity fund ("QOF"). By investing capital gains in a QOF, an investor may:

- defer paying taxes on capital gain,
- permanently exclude up to 15% of the capital gain from federal taxation, and
- if the investment is held in the QOF for at least 10 years, permanently exclude federal capital gain taxation on the appreciation of the QOF investment.

On April 17, 2019, Treasury released its second tranche of proposed Opportunity Zone regulations, which addressed some rather significant items that had previously been left unanswered. Subsequent posts will address many of the more significant second tranche guidance.

All good things must eventually come to an end.

While the Opportunity Zone program offers significant incentives for investing in real estate and operating businesses located in Opportunity Zones, the incentives do not last forever. The program provides a timetable that reduces, and eventually eliminates, its tax benefits. So, for those desiring to maximize the program's tax benefits, sitting on your hands is not an option.

Significant Deadlines:

Deferred capital gain must be included in income on the earlier to occur of:

- the date the investor's interest in the QOF is sold or exchanged, or
- December 31, 2026.

For an investor to realize the full 15% discount on deferred capital gain invested in a QOF, the investment must be made no later than December 31, 2019. Why? Because the full discount is applied in two phases. The first discount amounts to 10% of the deferred capital gain, and is applied for investments held for at least 5 years. The remaining 5% discount tacks-on if the investment is held for at least 7 years. Therefore, because the deferred federal tax on the invested capital gain must be paid, at the latest, on December 31, 2026, if an investor desires to take advantage of the entire 15% discount, it must make its investment in a QOF on or before December 31, 2019 (i.e., at least 7 years prior).

Similarly, unless capital gain is invested in a QOF on or before December 31, 2021, the second (i.e., 5%) discount will be lost to the investor.

Finally, QOZ designations remain in effect until December 31, 2028. Therefore, unless Congress extends the deadline, if an investor desires to exclude recognition of federal capital gain tax on the appreciation of its investment in a QOF, it must make its investment no later than December 31, 2028; provided, however, the QOF investment must be sold no later than December 31, 2047.

The bottom line is that to maximize the federal tax benefits of the Opportunity Zone program, the earlier the investment, the greater the reward.

What do developers need to do?

If you're investing only your capital gain income, in general, you'll need to create a QOF and a lower-tier entity to acquire the property. The only way to take advantage of the favorable capital gains tax treatment offered by the program is by investing in a QOF, which would either directly, or indirectly (through a lower-tier entity, the equity interests of which it has purchased) purchase the QOZ property.

If, however, your goal is to attract other capital gain equity from third-party investors, then, depending upon the make-up of those investors, you'll likely also need to prepare a private placement memorandum ("PPM"), which provides a full, transparent disclosure of the investment to potential investors. Generally, offerings of less than \$5,000,000 do not require a PPM. If the offering is anticipated to be \$5,000,000, or more, a PPM is a virtual necessity. While a PPM's purpose is to inform potential investors, it is equally important for protection of the developer/sponsor of the QOF offering. Drafted correctly, a PPM can protect the developer/sponsor from claims by the Securities and Exchange Commission or unhappy investors of incomplete, fraudulent or misleading disclosure.

Regardless of whether you decide to use a PPM, the transaction and offering should be carefully reviewed by legal counsel to determine the minimum level of disclosure that must be provided to prospective investors under applicable federal and state securities laws, and to catch and correct any compliance issues.

Caveat: Do not draft your own QOF documents and assume they are legally compliant.

In sum.

Time is ticking. You'll need to act with all deliberate speed to meet the December 31, 2019 deadline, and there are many considerations to be weighed. Stay tuned for future posts detailing further guidance from Treasury on the Opportunity Zone Program.

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