What You Need To Know Now

by Kevin A. Shields
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In December 2017, the Tax Cuts and Jobs Act was passed, which, among other things, incorporated the "Invest in Opportunities Act." The latter embodies the new Sections 1400Z-1 and 1400Z-2, commonly referred to as "Subchapter Z," of the Internal Revenue Code of 1986. Subchapter Z effectively gave birth to a new economic development initiative known as a Qualified Opportunity Zone ("QOZ"). Essentially, if an investor sells an asset (real estate, an operating business, appreciated stock, collectibles, etc.) and generates a capital gain (either short term or long term), that investor, subject to some nuances to be discussed herein, has 180 days after the realization of that gain to invest all or a portion of the gain into a Qualified Opportunity Zone Fund (a "QOZF"). If the investor complies with this investment timeline, he or she stands to benefit from the following:

- The tax payment due on the realized gain is deferred through the end of 2026, payable in 2027;
- If the investment is made between now and the end of 2021, the gain is stepped up 10% such that the investor will only pay taxes on 90% of its realized gain; and,
- If the investor remains invested in the QOZF for a period of 10 years or more, upon liquidation of the fund, or the assets therein, the investor will receive a 100% fair market value ("FMV") basis step-up in such assets – meaning no taxes will be assessed on any capital gains generated by the fund. Of all the Subchapter Z tax benefits, this FMV basis step-up is the most compelling and the overwhelming economic driver.

Much has been written about what constitutes a QOZ and the requirements to maintain compliance with the Subchapter Z legislative framework, all of which is beyond the scope of this article. Here, I intend to focus on four topics: (i) timing of the investment; (ii) investment options; (iii) for whom a QOZF investment may be appropriate; (iv) and what the future looks like from a legislative perspective given the new administration. Note, this discussion is focused on investments in real estate as opposed to operating businesses, which have other rules associated therewith.

TIMING OF THE INVESTMENT

Generally, any capital gain realized from any source must be reinvested into a QOZF within 180 days of such realization. The one critical nuance to that timing is the situation in which the gain is realized by a pass-through vehicle (e.g. a partnership or limited liability company) and distributed to its partners or LLC members. In this case, the investor may choose to have its 180-day investment timeline begin on any of the following dates:

1. The date the gain is realized;
2. The pass-through vehicle's tax year-end (typically December 31); or,
3. The pass-through vehicle's tax filing date (generally March 15 of the following year). This also means any pass-through gains distributed to investors realized at any time in 2020 may be reinvested as late as September 11, 2021 and such investor can reap the benefits of Subchapter Z.

For example, if the pass-through vehicle sells an asset and generates the capital gain on July 4, 2021, and distributes such capital gains to its investors, the first option allows the investor to redeploy those gains on or before December 31, 2021 (the last day following 180 days from realization). The second option allows the gains to be redeployed on or before June 29, 2022 and the third option allows for the investment to be made on or before September 11, 2022. That said, the investor is best served utilizing the first option, to the extent he or she is able to identify an appropriate investment alternative, given December 31, 2021 is the last day the investor can deploy those gains and capture the benefit of the 10% basis step-up.

INVESTMENT OPTIONS

QOZF investment options run the proverbial gamut from identified assets to blind pools, single versus multiple assets, and various legal structures for the fund itself. There are fund sponsors offering investment alternatives in which all or some of the properties will be identified in the future – a full or partial blind pool. In this instance, the sponsor/investment manager effectively shifts the risk of appropriate property identification to the investor. Note, this is not equity capital that can be returned should the sponsor be unable to identify suitable investments given the fact the equity has significant tax incentives attached via Subchapter Z. Thus, as the sponsor approaches the date at which the investment capital must be deployed, it could lead to poor decision making to the detriment of the investor. As such, I believe a more appropriate approach would be for the investor to focus on QOZFs with properties that are fully identified, or in which the fund will upsize the equity offering over time, but only when appropriate additional assets are identified and controlled. In this manner, the funding risk is shifted to the QOZF sponsor in that the sponsor must commit to an investment and assume the risk of raising the equity after the fact.

In the first 18 months after the QOZ legislation was passed, in response to a lack of clarity regarding several key elements of how QOZFs and QOZF investors would be treated, fund sponsors chose a wide variety of QOZF structures. During those early months, the two most common structures were those focused on single assets or real estate investment trusts (a "REIT"). Part of the reason for that focus was the uncertainty associated with the fair market value basis step-up after the 10-year holding period. Based upon the first set of proposed

QOZ regulations, released by the U.S. Treasury in December 2018, it was clear the investor would gain the benefit of the step-up for selling its interest in the "fund," but unclear, in a portfolio context, whether the basis would be stepped up if the fund were to sell a single asset inside the fund. Thus, if an investor sought portfolio diversification, it would either have to invest in multiple single asset funds or a REIT. That uncertainly was put to rest with the second set of proposed regulations the Treasury released in April 2019. That set of proposed regulations made it clear that if the QOZF sponsor utilizes a "two-tier" structure in which the investor invests in the "parent" limited partnership (by way of example), which partnership drops the equity down into subsidiary LPs or LLCs that are developing the individual properties, a sale of one of the properties ten years forward is deemed tantamount to a sale of the investors' investment in the fund and, as such, the step-up in basis would be honored.

In order to comply with QOZ rules, QOZF real estate investments are generally either ground-up developments or "substantial renovations" (as such term is defined in the propose regulations in which the basis in the asset must at least double through additional investment, exclusive of the land value). New development and/or substantial renovation of a property is the riskiest end of the real estate investment spectrum. As such, the investor must consider whether it is more appropriate investing in one or more single asset QOZFs, or a QOZF that includes multiple properties. In either event, the investor should seek some element of portfolio diversification to mitigate risk. Whereas it may be entirely suitable to invest in a series of single-asset QOZFs, it may be more efficient to identify a QOZF that includes a diversified portfolio of properties.

With respect to the REIT structure, I would submit to you it is challenging to wrap a compliance protocol around the rigors of Subchapter Z. To also be required to simultaneously comply with the REIT rules adds undue and unnecessary complexity. Now that the IRS has released guidance clearing up the confusion in the use of a two-tiered partnership, there is little reason to utilize a REIT structure as the legal envelope unless the sponsor is seeking to secure smaller dollar investors given the suitability standard is lower than that required to invest in a private placement. Further, upon stabilization of a multi-property QOZF, such fund can always convert to a REIT structure in the future.

FOR WHOM IS A QOZF INVESTMENT APPROPRIATE?

This question addresses both suitability and the source of the capital gains. The preponderance of equity capital that has been raised in the QOZ environment has been through private placements relying on a registration exemption pursuant to Regulation D. At a minimum, therefore, the investor must be "accredited." To be deemed an accredited investor, the investor must certify he or she either:

- Has a net worth of at least $1 million, either individually or jointly with a spouse, exclusive of home and furnishings; or,
- Has annual income exceeding $200,000 ($300,000 for joint income) for the last two years with an expectation of earning the same or a higher income for the current year; or,
- Has total assets exceeding $5 million if the investor is an entity.

Certain QOZFs utilize an even higher standard including:

- "Qualified Client," an individual with a net worth in excess of $2.1 million (either individually or jointly with a spouse) or one that maintains at least $1 million under management with an investment advisor; or,
- "Qualified Purchaser," an individual or business that owns $5 million or more in investments – an asset-level test.

Aside from suitability, there are a variety of client types that may be interested in investing in a QOZF, including:

- **Securities Sale:** An investor with highly appreciated securities may want to rebalance its portfolio to be more consistent with its stated risk tolerance. By selling securities and reinvesting all or a portion of the realized gains into a QOZF, the investor can defer and reduce its tax liability and generate tax free growth* on the QOZF investment while reallocating the remaining capital (the investor's basis and any gain not otherwise invested in the QOZF) to a more diversified asset allocation.
- **Business Sale:** A QOZF may provide an efficient means by which an investor can defer and reduce capital gains from a business sale while generating tax-free growth* and, in some QOZF strategies, future tax-advantaged income from its investment in a QOZF. Generally, investors realizing its capital gain through a pass-through entity have a longer time horizon from the date the gain is realized and distributed to the investor to invest in a QOZF (extended look-back period) as they have flexibility to start their 180-day clock to invest in the QOZF in a number of different times, as discussed above.
- **Retirement Planning:** Certain QOZF investments provide for meaningful tax-advantaged income for future generations of the investor's devisees. Clients nearing retirement may lock in gains in taxable accounts and invest those gains into a QOZF strategy in order to generate significant tax benefits and provide both income and additional diversification upon retirement. Because most QOZF real estate strategies focus on development followed by a stabilized holding period, target return profiles generally include both tax-advantaged growth and income.
- **Sale of Real Estate:** A QOZF provides an alternative set of benefits than that available through an IRC Section 1031 Exchange ("1031 Exchange"):
  - A QOZF investment only requires reinvestment of capital gains allowing for the separation of basis from gain. A 1031 Exchange, on the other hand, requires reinvestment of both basis and capital gain to avoid triggering gains through "cash boot," and includes rules regarding the use of debt in order to avoid triggering gains through "mortgage boot;"
  - A QOZF may invest in a variety of properties or businesses whereas a 1031 Exchange requires reinvestment into "like-kind" property – specifically the replacement property must be a real estate asset;
  - A QOZF does not require the use of a qualified intermediary. An investor can take receipt of its capital from the real estate sale and elect to invest in a QOZF as long as they do so within the eligible window using capital from any source. Note: certain restrictions will apply if the investor consummates the sale of its "relinquished property" and deposits the funds with a qualified intermediary. The decision to subsequently invest in a QOZF must then be made prior to the conclusion of the 45-day identification period; and,

* Provided there is a gain in the QOZF investment and is held for at least 10 years. There is no guarantee of a positive gain in any QOZF investment.

- Along with tax deferral, QOZF investors may receive a 10% basis step-up in the deployed capital gains (assuming the investment is made prior to December 31, 2021) and tax-free growth* on its investment in a QOZF.

THE FUTURE OF THE LEGISLATION

This final topic has stimulated significant discussion given the change in administration as well as defacto democratic control of both the Senate and House. With the recent passage of the $2.3 trillion infrastructure bill, coupled with all of the pandemic stimulus payments, all eyes are now focused on how this will be paid for given our country's overall debt-to-GDP ratio has now outstripped historic highs set following World War II. My quick take is as follows:

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1. The Invest in Opportunities Act garnered substantial bipartisan support at the outset, which, I believe, continues to be the case;
2. To that point, on February 11, 2021, U.S. Representatives Tim Burchett (Republican, TN-02) and Henry Cuellar (Democrat, TX-28) introduced the Opportunity Zone Extension Act of 2021. This bipartisan legislation would extend the Opportunity Zone program until the end of 2028 to continue to attract private sector investment in underserved communities. Though it is unlikely this House bill will pass on a standalone basis, it could likely be folded into other proposed tax legislation;
3. The Internal Revenue Service and Treasury Department deferred wrapping a robust reporting protocol relating to how program sponsors should articulate the social and economic benefits that inure to the local communities in which they are developing properties. The United States Government Accountability Office has commenced a detailed study as to how it evaluates "Tax Expenditure Performance." As such, we expect additional guidance in the near term relating to reporting requirements, but I do not anticipate any material retraction of the legislation currently in place; and,
4. Even if the current administration was inclined to cut back on the tax benefits associated with Subchapter Z, given the level of capital formation around this program, any changes would likely be prospective such that the existing legislation would be grandfathered for investments that have already been made.

I have been a real estate investment banker and principal for over 35 years and, in my opinion, the QOZ legislation, embodied in Subchapter Z of the Internal Revenue Service Code, is the most powerful combination

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of beneficial tax legislation I have seen in my career. According to Novogradac & Company, which among other things, tracks capital formation by QOZFs, over $16 billion of equity has been raised to date by over 1,000 QOZFs, which capital gains have been redirected into low-income communities as defined by the legislation. As noted above, December 31, 2021 is the last day to invest and benefit from the 10% basis step-up on the original capital gain investment, so I anticipate 2021 will be an active year for investment into QOZFs. Even when this benefit expires, I further expect QOZFs investments will continue to attract significant capital because, as previously mentioned, the 100% fair market value basis step-up effectively eliminates capital gains generated upon liquidation the QOZF and/or its properties and this, again, is the overwhelming economic benefit associated with Subchapter Z of the IRC.

I have been a real estate investment banker and principal for over 35 years and, in my opinion, the QOZ legislation, embodied in Subchapter Z of the Internal Revenue Service Code, is the most powerful combination of beneficial tax legislation I have seen in my career.

ABOUT THE AUTHOR

Mr. Shields is the Chairman and CEO of Griffin Capital Company, LLC, which he founded in 1995. Griffin Capital is a privately held alternative investment manager with approximately $19 billion in AUM across a number of verticals including two public non-traded REITs ($5.8 billion of net lease office and industrial and $4.2 billion of clinical real estate), two '40 Act interval funds (one focused on private and public real estate securities with approximately $3.9 billion of equity and the other on high yield corporate securities in partnership with Bain Capital Credit, with approximately $481 million in equity), tax advantaged strategies including a qualified opportunity zone fund which closed last September after having raised $460 million in equity to fund the ground-up development of nine multifamily communities with six best-in-class joint venture development partners, representing just shy of $1 billion in development cost, and a series of closed DST transactions all of which were investments in core multifamily properties.

Mr. Shields is a three-time graduate of the University of California having earned a BS in Business Administration, graduating with Phi Beta Kappa distinction, a Masters in Business Administration from the Haas Graduate School of Business, graduating with Beta Gamma distinction and a Juris Doctorate Degree from the Boalt Hall School of Law.

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IMPORTANT RISK FACTORS

An investment in a Qualified Opportunity Zone Fund is subject to various risks, including but not limited to:

- No public market currently exists, and one may never exist, for the interests of any Qualified Opportunity Zone Fund. Qualified Opportunity Zone Funds are not liquid.
- Qualified Opportunity Zone Funds offer and sell interests pursuant to exemptions from the registration provisions of federal and state law and, accordingly, those interests are subject to restrictions on transfer.
- There is no guarantee that the investment objectives of any particular Qualified Opportunity Zone Fund will be achieved.
- Investments in real estate are subject to varying degrees of risk, including, among other things, local conditions such as an oversupply of space or reduced demand for properties, an inability to collect rent, vacancies, inflation and other increases in operating costs, adverse changes in laws and regulations applicable to owners of real estate and changing market demographics.
- The acquisition of interests in a Qualified Opportunity Zone Fund may not qualify under Section 1031 of the Internal Revenue Code of 1986, as amended (the "Code") for tax-deferred exchange treatment.
- The actual amount and timing of distributions paid by a Qualified Opportunity Zone Fund is not guaranteed and may vary. There is no guarantee that investors will receive distributions or a return of their capital.
- Qualified Opportunity Zone Funds depend on tenants for their revenue and may suffer adverse consequences as a result of any financial difficulties, bankruptcy or insolvency of their tenants.
- Disruptions in the financial markets and challenging economic conditions could adversely affect a Qualified Opportunity Zone Fund.
- Disruptions in the financial markets and challenging economic conditions, including as a result of a pandemic such as the recent outbreak of COVID-19, could adversely affect a Qualified Opportunity Zone fund.

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