Structure Matters:

The Benefits of Choosing a Limited Partnership Over a REIT for Your QOZ Fund Investment

Under the Qualified Opportunity Zone ("QOZ") legislation, a Qualified Opportunity Zone Fund ("QOZF") may be structured as either a partnership or a corporation. Most QOZ investments have focused on real estate investment strategies and a majority of these QOZFs are structured as Limited Partnerships. Some investment managers, however, have chosen to offer funds wrapped in a Real Estate Investment Trust ("REITs"). While both structures allow investors to take advantage of the capital gain tax deferral and potential elimination of future tax liability provided under the QOZ legislation, there are important differences for investors to understand before making an investment decision.

SIMILARITIES BETWEEN REITS AND LIMITED PARTNERSHIPS

Typically, corporations are taxed on any earnings they generate at the current federal tax rate of 21%, in addition to the applicable state corporate tax rates. When these net after-tax earnings are distributed to investors, they may be taxed as either ordinary income or qualified dividends depending on the nature of the dividend and the amount of time the investor has held their shares. Both REITs and Limited Partnerships allow investors to avoid double taxation because they are exempt from paying taxes on the earnings they generate, which allows 100% of their earnings to pass-through to investors, provided REITs meet certain requirements as discussed later.

DIFFERENCES BETWEEN REITS AND LIMITED PARTNERSHIPS

Compliance Structures

Both Limited Partnerships and REITs are subject to the same compliance requirements regarding the QOZ legislation. However, REITs also must comply with several other requirements under the US tax code to avoid corporate income tax on their earnings. These complexities can result in additional administrative costs and impose restrictions on the types of investments that a REIT can make.

Passive Income/Loss Passthrough

REIT investors are taxed on the dividends received, while investors in a Limited Partnership structure are allocated their respective pro rata share of passive gains and passive losses. This is an important distinction since both structures could potentially generate similar levels of income or loss at the fund level. Given most QOZF strategies are focused on real estate development, material passive losses are particularly likely in the early years of such funds' life cycles since development properties generally do not generate taxable income until the properties are built and substantially occupied by tenants. Furthermore, real estate properties are depreciable for tax purposes once the asset is built and placed into service. This non-cash expense may therefore result in net passive losses to investors even if the properties themselves are generating positive cash flows.

Again, REITs are only able to pass-through income in the form of distributions to investors, while investors in Limited Partnerships are able to recognize their pro rata share of both income and losses regardless of whether any distributions are made. This means investors in Limited Partnerships can recognize their pro rata share of passive losses from the fund and use those losses to offset passive income it may be generating from other sources, thereby reducing their tax liability. Alternatively, these passive losses may be carried forward to offset passive income in future years once the fund's properties are built and begin generating positive net income. As a result, the ability to pass through losses in a Limited Partnership structure creates a powerful tax advantage that REIT investors do not benefit from.

Basis Recognition

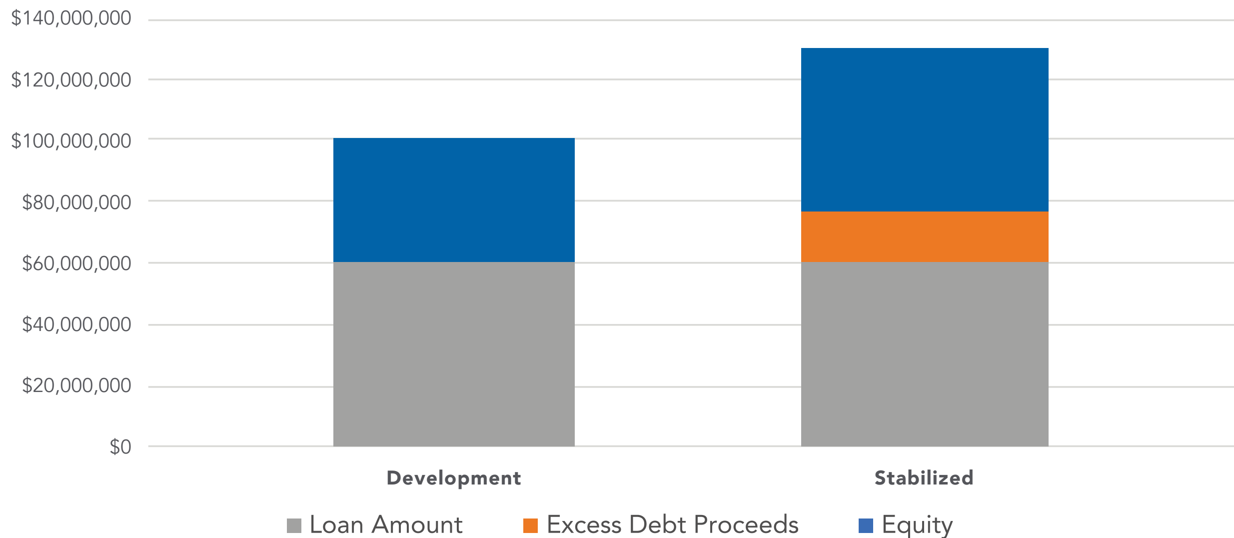
Regardless of whether the structure is a REIT or a Limited Partnership, investors in a QOZF will be investing realized gains that will be deferred until December 31, 2026. As a result, the investment will not have a tax basis unless (a) the investment was made prior to January 1, 2022, in which case the investor would receive a 10% basis step-up in year 5 under the QOZ legislation, (b) the investment was made prior to January 1, 2020, in which case the investor would receive an additional basis step-up of 5% in year 7 of the investment (resulting in a total basis step-up of 15%), or (c) basis is established in some other way. Prior to establishing tax basis, any distributions paid to investors in a QOZF will typically be recognized as a capital gain and fully taxable to the investor.

Fortunately for investors in a QOZF Limited Partnership, there are other ways in which an investor can establish tax basis. Most importantly, investors' pro rata share of qualified nonrecourse debt (i.e. debt secured by real estate properties) is eligible for basis recognition. As a result, a QOZF Limited Partnership can make a distribution to its investors up to such basis prior to December 31, 2026, without triggering capital gains tax liability to the investor.

Unfortunately for investors in a QOZF REIT, they are unable to recognize basis for their pro rata share of a REIT's borrowings. Therefore, these investors won't establish basis until they either qualify for the 10%/15% basis step-up or their deferred gain becomes taxable on December 31, 2026. If a QOZF REIT makes distributions to investors prior to those dates, it will likely be fully taxable.

This difference in basis attribution is particularly meaningful for funds that seek to generate debt-financed distributions for their investors. As properties are built and achieve a stabilized occupancy, many QOZFs will seek to recapitalize the asset and replace the construction debt used to fund development costs with new permanent debt. This exercise may result in excess refinance proceeds that may be distributed to investors and thereby create liquidity for them in advance of the tax liability on the deferred capital gain coming due at the end of 2026. Such a scenario is presented below.

Hypothetical Debt Financed Distribution From a Development Property



In this illustration, a property was built for $100 million and financed using $60 million of debt and $40 million of equity. Once the property is built and achieves a stabilized occupancy, the hypothetical value of the property increases to $130 million. The construction loan is then refinanced with a new loan at 60% of the stabilized value, which results in $78 million of loan proceeds. $60 million of the new loan is used to pay off the construction loan, leaving $18 million of excess debt proceeds (representing 45% of the investors' original equity investment in the development) that can be distributed to investors.

If the above example were to occur within a REIT structure, any distribution of the proceeds prior to December 31, 2026, would likely be taxable to investors. However, investors in a Limited Partnership structure would establish basis from the debt on the property and would therefore be able to receive an immediate distribution of $18 million, tax free. While debt-financed distributions would typically result in investors paying capital gains tax on such amounts if the property is sold at a value in excess of their adjusted basis in the investment in the future, an investor's basis in a QOZF is stepped-up to its fair value at the time of sale, as long as the investors held their interest for at least 10-years. As a result, such distributions are ultimately tax-free to QOZF investors.

An investor's basis in relation to distributions it may receive is clearly an important consideration under the current QOZ legislation, but it will become even more important if the recently proposed Opportunity Zones Transparency, Extension and Improvement Act is approved by Congress. This bi-partisan legislation seeks to extend the gain deferral period from December 31, 2026, to December 31, 2028. Should it pass, investors in a REIT would have to wait an additional two years before they could receive distributions without a tax consequence.

K-1 vs. 1099

Investors in a Limited Partnership are issued annual K-1s, which report their pro rata share of the partnership's income or loss for the year. K-1s are also issued for states in which the fund owns properties, if required, and tax returns must be filed in those respective states as well. On the other hand, REIT investors are taxed on distributions they receive, which are reported on a 1099-DIV. 1099-DIVs are less complex than K-1s and require that an investor only file a tax return in the state in which it resides. However, Limited Partnerships may be able to simplify the state tax filing process by issuing a composite tax return, in which the fund will file a tax return in each state on an investors behalf and thus eliminate the requirement that the investor file a return in states other than their state of residence.[1]

IN SUMMARY

The differences outlined above are just some of the many factors an investor should consider before choosing the structure it deems most beneficial to access an Opportunity Zone Fund investment. It is important that an investor weigh these considerations and consult with both its financial advisor and tax professionals when evaluating the impact of these different structural characteristics as the nuances may create significant differences in how distributions are managed and the associated benefits investors may or may not realize as a function of the structure of the investment vehicle.

1. Certain restrictions apply and the ability to file a composite tax return is not available in every state.

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IMPORTANT RISK FACTORS

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

- No public market typically exists for the interest of Qualified Opportunity Fund programs. Qualified Opportunity Zone Fund programs are generally not liquid.
- Qualified Opportunity Zone Fund programs typically offer and sell interests pursuant to exemptions to 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 program will be achieved.
- Investments in real estate are subject to varying degrees of risks, including, among other things, local conditions such as an oversupply of space or reduced demand for properties, and 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 program 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 Qualified Opportunity Zone Fund programs is not guaranteed and may vary. There is no guarantee that investors will receive distributions or a return of their capital.
- Qualified Opportunity Zone Fund programs generally 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 economics conditions could adversely affect a Qualified Opportunity Zone Fund program.
- Qualified Opportunity Zone Tax Benefits may not be available under state law and some states may impose their own requirements to qualify for the equivalent of the Qualified Opportunity Zone Tax Benefits under state law.

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