Qualified Opportunity Zone Legislation Updates

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It has been almost six years since Sections 1400z-1 and 1400z-2 of the U.S. Internal Revenue Code (the "QOZ Legislation") were enacted as part of the 2017 Tax Cuts and Jobs Act. Despite the highly partisan political environment at the time, the QOZ Legislation had strong support on both sides of the aisle as it was viewed as one of the most meaningful tax-incentivized efforts ever enacted to promote investment in low-income communities. If capital formation is one of the barometers for success, proponents of the legislation have much to celebrate, as QOZ Funds have seen significant demand from investors since the legislation was enacted. According to data compiled by Novogradac & Co. LLP, QOZ Funds have raised approximately $36.1 billion in capital as of June 30, 2023, but they note that the actual amount of capital raised in the QOZ space is likely three to four times that amount, or $108.3 billion to $144.4 billion, since many QOZ Funds do not report their capital raise. The communities that were eligible for QOZ investment were not defined until the middle of 2018, and real-time data about the impact of the investment in these communities is not currently available. However, a research paper authored by David Coyne and Craig Johnson, two economists with the U.S. Department of Treasury, that looked at data as of December 31, 2020, found that QOZ Funds held $48 billion in assets and approximately 3,800 communities out of the 7,800 designated QOZ communities saw investment over just a two and a half year time span. In addition, a working paper by University of California-Berkeley economist Harrison Wheeler that analyzed QOZ census tracts in 47 cities found that the designation led to a 20% increase in the probability of new commercial and residential development. The study also found that the QOZ designations led to positive spillover effects in non-QOZ census tracts by increasing development on a city-wide scale.

While the meaningful impact of the QOZ Legislation is becoming more evident, the current deadline for new investors to take advantage of the significant tax benefits[1] it provides expires in a few years. Under the legislation as it stands today, there were three primary benefits.

1. **Deferral:** Any realized capital gain that was timely invested in a QOZ Fund can be deferred until December 31, 2026.

2. **Reduction:** The capital gain that was subject to tax at the end of the deferral period can be reduced by 10% if held for at least five years before the end of 2026 and a total of 15% if held for at least seven years before such date, which would have required that the investment be made by the end of 2019 and 2021, respectively.

3. **Elimination:** Potentially, the most impactful QOZ tax benefit is that investors[1] are able to grow their investment in the QOZ Fund tax free as long as they hold their interest for at least 10 years.

While QOZ investors will be able to take advantage of the most meaningful QOZ incentive (i.e. potential for tax-free growth until as long as December 31, 2047, the legislation currently limits qualified investments into QOZ Funds to realized capital gains that occurred on or before the 2026 tax year. Therefore, stakeholders and politicians on both sides of the aisle have been working hard to amend the QOZ Legislation so that it can continue to drive capital into designated communities.

Investments involve risks, including possible loss of principal.

Opportunity Zones Transparency, Extension and Improvement Act

Of the proposals that have been introduced to amend the QOZ Legislation, the Opportunity Zones Transparency, Extension and Improvement Act (the "Extension Act") is by far the most sweeping and viable. The proposal was introduced in April 2022 with strong bipartisan sponsorship from members of both the House and Senate. Most notably, the amendment was sponsored by the two main proponents of the original QOZ Legislation, Republican Senator Tim Scott and Democratic Senator Cory Booker. The Extension Act had six key provisions:

1. **Extend the capital gains deferral deadline,** and in turn, the deadline to invest eligible gains into a QOZ Fund for two years to December 31, 2028.

2. **Renew eligibility for the cost basis step-up** that was previously available for capital gains invested in QOZ Funds. By extending the gain deferral date to the end of 2028, the Extension Act would have reinstated eligibility for the 10% cost basis step for any investment made before the end of 2023. It also sought to modify the required holding period for the 15% basis step up from seven years to six years, which would make any investment made prior to the end of 2022 eligible.

3. **Early sunset for QOZ census tracts that do not meet the eligibility criteria according to more recent data.** In 2018, the governors of each state were tasked with selecting the greater of 25 census tracts, or 25% of all census tracts within their state, as Qualified Opportunity Zones as long as they exhibited a poverty rate of at least 20% or a median household income of more than 80% of the metropolitan or statewide median household income. However, the data available to make such a determination was several years old and, since then, many of the designated census tracts have seen meaningful economic improvement. As a result, the Extension Act sought to replace, on a one-for-one basis, QOZ census tracts that were no longer considered low-income communities with those that are based on updated data. To the extent a QOZ Fund already held or targeted investments in the eliminated census tracts, they would be grandfathered such that those investments would continue to be eligible QOZ property.

4. **Permitting QOZ Fund of Funds.** Under the current QOZ Legislation, a QOZ Fund cannot invest in another QOZ Fund, which can create challenges for smaller Funds that don't have the capital to invest in meaningful QOZ projects. The Extension Act would remove this barrier and allow smaller QOZ Funds to invest in other Funds in order to collectively increase the size, scale and diversification of their investments.

5. **Reinstate and Expand QOZ Reporting Requirements.** The Extension Act sought to reimpose reporting requirements that were included in the original QOZ Legislation but removed during the Senate budget reconciliation process. The proposed reporting requirements include various statistics about QOZ Funds, including their total assets, value of their qualifying assets, and the total number of people employed by their projects.

6. **Establish a State and Community Dynamism Fund** that would support public and private investment into QOZ Tax Cuts & Jobs Act that are set to expire in 2025.

The Extension Act represented the culmination of the most widely supported changes that both Democrats and Republicans have been seeking to make to the QOZ Legislation. As a result, it was widely believed to have a strong potential to get passed in 2022. However, the bill itself was viewed as too small on its own to get to the floor of the House and Senate for a vote and thus required that it be subsumed by a larger piece of legislation, which never materialized. The overall structure of the Extension Act is still viewed as the most appropriate form by which the QOZ Legislation should be amended and there is a general expectation that such a proposal will gain renewed traction as Congress seeks to address several provisions of the Tax Cuts & Jobs Act that are set to expire in 2025.

Small Business Jobs Act

In June 2023, the House Ways and Means Committee passed the Small Business Jobs Act, paving the way for it to go to the floor of the House of Representatives for a vote later this year. Unlike the Extension Act, the proposal is not limited to QOZs and instead seeks to institute more sweeping tax incentives to support independent contractors and small businesses. However, it does seek to significantly expand the map of eligible QOZ census tracts and provide additional benefits in order to promote increased capital investment into rural areas of the United States that exhibit persistent poverty. If passed, any census tract with a poverty rate of 20% or greater over the last 30 years that is located in a rural county would be deemed a "qualified rural opportunity zone". Per the Economic Innovation Group, this would result in 1,242 new QOZ census tracts and a total of 1,926 qualified rural opportunity zone census tracts. In addition, any QOZ Fund with at least 90% of its assets comprised of qualifying property within these rural census tracts would be considered a "qualified rural opportunity zone fund" and would provide its investors with the ability to defer the capital gain invested in the Fund until December 31, 2032. By extending the deferral period by an additional six years relative to the original legislation, these investors would be eligible for the 15% and 10% reduction in their deferred capital gain as long as they invest before 2025 and 2027, respectively, and would of course still be eligible for the tax-free growth of their investment in the rural QOZ Fund as long as they hold their interest for at least 10-years. In addition to these tax benefits, the Small Business Jobs Act seeks to reinstate QOZ Fund reporting requirements in a similar fashion to those proposed in the Extension Act.

The proposed legislation includes a variety of incentives that have the potential to provide significant stimulus and capital support for small businesses and economically distressed communities across the country. In addition, the proposal could lead to a meaningful increase in the amount of QOZ Fund capital invested in rural areas, which have seen significantly less capital flows from the original legislation relative to urban tracts. This proposal fails to address urban communities that are in need of the capital investment that could be spurred through a broader extension of the QOZ Legislation like the Extension Act. Therefore, there is strong support amongst members of Congress and other stakeholders to incorporate various aspects of the Extension Act into the Small Business Jobs Act to address this fact.

Conclusion

Though only a few years old, the QOZ Legislation has proven to be a highly effective tool to drive capital into designated communities, the benefits of which will become increasingly more evident and impactful as the projects they have funded advance. However, the ability to make new investments into QOZ Funds will soon sunset, and the key to durable economic growth is sustained investment. As one of the most successful pieces of tax-incentivized legislation in recent history, the QOZ tax-benefits represent a mechanism by which we can improve the lives and opportunities available to those that live and work in low-income communities. It is imperative that Congress work quickly to extend the legislation for the benefit of these communities and to provide clarity for market participants. In addition, incorporating the reporting requirements that were absent in the original QOZ Legislation will result in increased transparency and awareness of the sizeable impact of QOZ Funds. While the Extension Act was deemed too small to pass on its own, the Small Business Jobs Act is exactly the type of larger legislation that could warrant the necessary attention to reach the floor of the House and Senate for approval. We are hopeful that Congressional members on both sides of the aisle coalesce to either expand the Small Business Jobs Act or separately pass a bill similar in form and substance to the Extension Act for the benefit of the constituents and stakeholders they serve.

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1. In order to be eligible for QOZ Tax benefits, investors must invest realized capital gains into a Qualified Opportunity Zone Fund, make required elections in their annual tax returns, and comply with other timelines and requirements as specified under Section 1400z-2 of the U..S. Internal Revenue Code

THIS IS NEITHER AN OFFER TO SELL NOR A SOLICITATION OF AN OFFER TO BUY ANY SECURITIES. AN OFFERING IS MADE ONLY BY A PRIVATE PLACEMENT MEMORANDUM. THIS LITERATURE MUST BE READ IN CONJUNCTION WITH A PRIVATE PLACEMENT MEMORANDUM IN ORDER TO UNDERSTAND FULLY ALL OF THE IMPLICATIONS AND RISKS OF SECURITIES TO WHICH IT MAY RELATE. A COPY OF A PRIVATE PLACEMENT MEMORANDUM MUST BE MADE AVAILABLE TO YOU IN CONNECTION WITH AN OFFERING. THIS MATERIAL DOES NOT CONSTITUTE TAX ADVICE TO ANY PERSON. A PERSON MUST CONSULT WITH HIS OR HER OWN TAX ADVISORS REGARDING THE TAX CONSEQUENCES TO THEM OF ACQUIRING AND OWNING AN INVESTMENT IN MULTIFAMILY PROPERTIES.

Not all investors are suitable or qualify to invest into a QOF. You should always read the offering memorandum of any QOF and consult with your financial professional before investing into a QOF.

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, including as a result of a pandemic such as the outbreak of COVID-19, could adversely affect a Qualified Opportunity Zone Fund.
- Investing in a QOF is considered speculative involving substantial risks. Federal and State regulations to real estate, investment portfolios, and investors are subject to change at any time. There are a number of criteria that must be met for the investor to receive a benefit. Read a fund's private offering memorandum fully, and understand the risks involved.

Before purchasing interests, prospective investors should review a fund's offering memorandum, as may be supplemented from time to time, for a more complete description of the risks and other disclosure related to participating in the offering.

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