

## Tax Risks (Cont.)

**Tax risks when you invest**

**Eligible gains.** To enjoy OZ tax benefits, you must invest eligible capital gains in QOF shares. Eligible capital gains are gains from the sale of a capital asset, such as stock or real estate held for investment, other than gains arising from a position that is or has been part of a so-called "offsetting-positions transaction," but do not include capital gains that are re-characterized as ordinary income.

**Investment within 180 days.** To enjoy OZ tax benefits, you must invest in the QOF within 180 days of a taxable sale or exchange. The QOF's capital call, however, may not occur within the 180-day period following your recognition of gain.

**Deferral election.** You may lose OZ benefits if you do not properly make a deferral election on IRS Form 8949, which must be attached to your federal income tax return for the taxable year in which the gain would otherwise have been recognized.

**Tax risks while you hold the QOF investment**

**Loss of tax benefits if fund does not qualify as QOF.** The OZ tax benefits are available when you invest in a QOF. If the fund loses this status – as discussed further below – your tax benefits may be reduced or eliminated. The proposed regulations make clear that the Ten-Year Benefit will be available through 2047 even if a census tract's designation as a qualified opportunity zone expires, but do not address other disqualification issues.

**Fund terms may differ from typical investment fund.** For example, OZ investments may be structured as separate entities, with no netting of carried interest, to facilitate exit after 10 years. This means that the sponsor may be compensated for gains in one QOF without any reduction for losses in another QOF.

**Investment is otherwise taxable.** The OZ rules primarily provide a tax deferral upon entry and a tax benefit upon exit; the normal tax rules generally apply to a fund's operations. As with many investment funds, you may need to pay tax on your share of a QOF's income each year even if the fund does not make distributions. In addition, the way that basis rules apply to QOFs is unclear in many respects.

**Taxable distributions.** You cannot enjoy the Basis Step-Up or Ten-Year Benefit on any QOF shares that you sell before meeting the applicable holding period requirement. A QOF distribution can be treated as a sale of a portion of your shares if the distribution is taxable, which would occur if a QOF distribution is greater than your basis. A reduction in your share of partnership liabilities is also treated as a distribution for this purpose. It is not clear whether a taxable distribution would be treated as a sale of your QOF shares for purposes of the OZ rules or, if so, what portion of your shares you would be treated as selling. A QOF may be unwilling to foreclose entirely the possibility of such a taxable distribution, so that it can sell or refinance an underlying investment when market conditions are favorable.

**Tax risks upon exit**

**Exit through sale of QOF shares.** Under current guidance, the Ten-Year Benefit is only available if you sell your QOF shares. Such a sale to a third party may result in a lower than expected purchase price. The sponsor generally expects to effect the sale of each investment through a sale of all the QOF shares (including yours), but there is no guarantee that the fund will be able to do so, particularly in 10 years when other QOFs will also be pursuing similar objectives.

**QOF may structure exit so that Ten-Year Benefit is not available.** A QOF may sell a property earlier than 10 years and distribute the proceeds, or otherwise structure an exit in a manner that would not permit you to enjoy the Ten-Year Benefit.

**Calculation of Ten-Year Benefit is unclear.** You obtain the Ten-Year Benefit by adjusting the basis in your QOF shares to equal fair market value. It is not clear how fund income, gain and liabilities should be reflected in this calculation, or how the fund's depreciation recapture should be treated. For example, even if you qualify for the Ten-Year Benefit, you may still recognize taxable income on a sale of your QOF shares to the extent the value of the fund's assets exceeds depreciation taken on those assets. In addition, it is not clear whether the fair market value should be net of QOF liabilities.

**Fund must qualify (and maintain qualification) as QOF**

As noted above, if a fund loses its status as a QOF, your OZ tax benefits will be lost. This qualification faces the following risks:

1. **90% QOF asset test.** For a fund to qualify as a QOF, every 6 months, it must have at least 90% of its assets invested in qualifying investments, which consist of interests in subsidiary qualified OZ businesses and direct investments in qualified OZ business property. The proposed regulations favor a two-tier structure in which the QOF invests cash in a subsidiary (interests in which are immediately treated as qualifying investments for the QOF), which must invest at least 70% of its assets in qualifying OZ business property and has up to 31 months to deploy the cash, pursuant to a written plan, in acquiring, developing or rehabilitating a qualifying property. These requirements place a premium on deal flow.
2. **Commercial issues.** A fund may fail to qualify as a QOF for non-tax reasons beyond its control, such as financing issues, zoning issues, disputes with co-investors, etc. A co-investor in a subsidiary may have divergent interests if it is not seeking OZ tax benefits.
3. **Penalty or Disqualification.** The statute provides for a monthly penalty, based on the underpayment rate (6% per annum for the calendar quarter beginning January 1, 2019), to the extent of QOF assets that do not meet the 90% test. It is unclear whether continued non-compliance by a QOF or an asset-holding subsidiary would at some point disqualify the fund.
4. **Interim sales and recycling.** It is unclear to what extent the Ten-Year Benefit and other OZ benefits will be affected if the QOF sells an asset before an investor has held its QOF shares for at least 10 years. It is also unclear under what conditions reinvestment of original capital and/or proceeds will be permitted. These issues may be addressed in future regulations.
5. **Qualification until exit.** The fund must qualify as a QOF until the date on which the investor sells its QOF shares. A fund may maintain QOF status only for 10 years beyond the last investment by an investor seeking OZ tax benefits; this could effectively force you to sell, regardless of the market at that time.