

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.

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. 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.