

QOZ UPDATE—COVID DISASTER DECLARATIONS MAKE QOZ EVEN MORE TAXPAYER FRIENDLY

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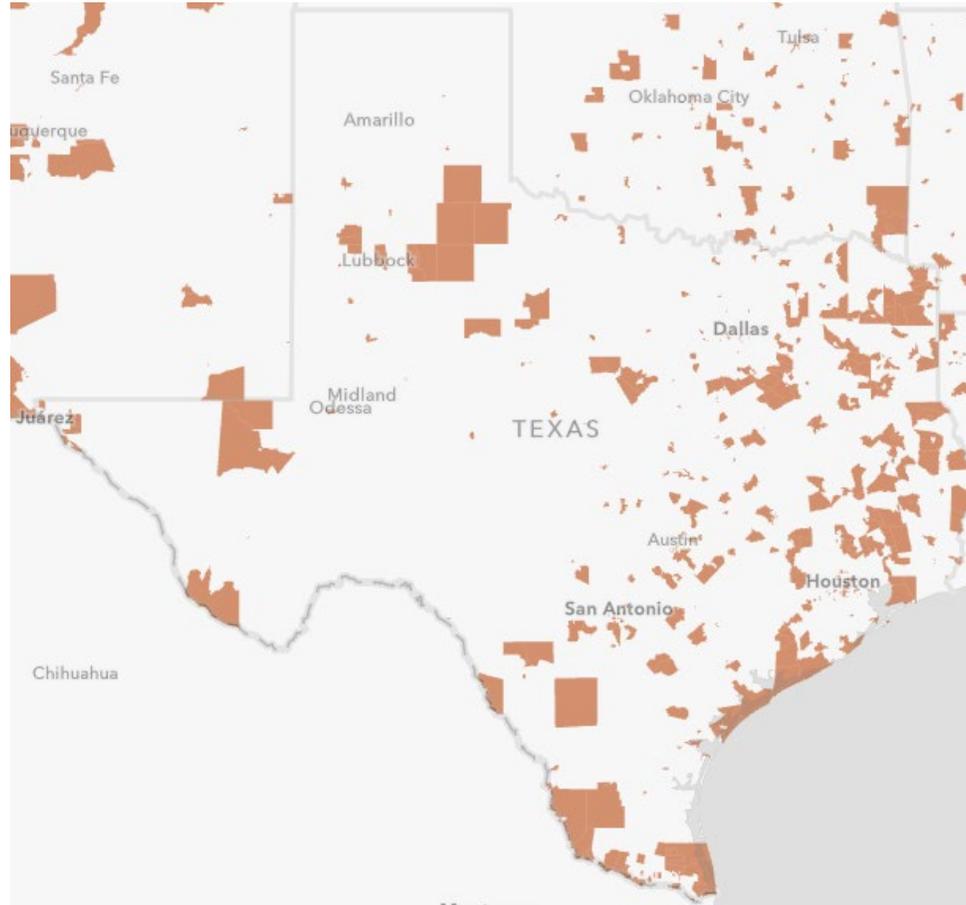


What is a “Qualified Opportunity Fund”?

- Big picture: A Qualified Opportunity Fund (QOF) is a corporation or partnership in which taxpayers can “roll over” capital gains and obtain special tax benefits.
- A QOF must invest in specific geographic regions, or Opportunity Zones. Generally, these are low-income areas that the state government has nominated.
- Interactive Opportunity Zone maps are available online (just Google “opportunity zone map”)



Texas Opportunity Zone Map



Who Benefits from QOFs?

Real Estate Sellers: May benefit from a higher selling price if selling Opportunity Zone asset that is ripe for development or redevelopment to a QOF (or QOFs) competing for opportunities to deploy tax-advantaged capital.

Real Estate Investors: May obtain tax benefits only if “rolling over” capital gains, and especially if prepared to hold 10 years.

Real Estate Developers/Sponsors: May obtain a lower cost of capital (or charge a higher promote or fees) in exchange for a promise to pursue QOF tax benefits for investors (but cannot obtain tax benefits directly for carried interest / promote / fees).



“Capital Gain Rollover” Tax Benefits for Investors

- Taxpayers can defer and reduce taxes on capital gains by rolling the gains over into a QOF
 - Taxes on such gains are *deferred* until 12/31/2026 (or an earlier “inclusion event,” such as a sale of the QOF investment)
 - Deferred gains are *reduced* (1) by 10% if the investment is held for 5 years; (2) by 15% if the investment is held for 7 years; or (3) if greater, by any diminution in value of the QOF
- In addition, any subsequent appreciation in the QOF rollover investment is tax-free if the investment is held for 10 years.



Source of Gain Rollover

- Generally, *any* capital gain from *any* source can qualify for the QOF rollover treatment. The gain being rolled over need not have anything to do with Opportunity Zones or QOFs (e.g., Facebook stock gain qualifies).
 - This includes short-term capital gain, gains from “section 1231 property,” 25% “unrecaptured section 1250 gain,” and certain mark-to-market gain (but not ordinary mark-to-market income).
 - It does not include gain recaptured as ordinary income
 - Gain may be triggered intentionally in order to qualify for a rollover
- The gain may not be triggered in a sale to a “related person”
 - Generally, this means that the seller and acquirer cannot have more than 20% common ownership
 - However, even if the seller to a QOF owns less than 20% of the QOF, gain from that sale generally cannot be rolled into that QOF because of the “circular flow of cash” problem



What about non-rollover investments?

- Taxpayers can invest amounts in a QOF that are not attributable to a capital gain rollover. This is treated as a normal fund investment and there are no QOF tax benefits.
- Investments that are partially attributable to a gain rollover get proportionate tax benefit. For example, if a taxpayer rolls over \$50 of capital gain, and invests another \$100, after a 10-year hold, one third of the gain on exit would be tax-free.



Timing Issues

- Gain must be rolled over into the QOF within 180 days of realization. In the case of gain realized in a partnership, there is the option to start this 180-day clock on the day the partnership sells; the last day of the K-1; or the due date of the tax return. Similar rules apply to S corporations and certain trusts.
- Because the deferred gains are triggered on 12/31/2026, and because of the 5- and 7-year holding period requirements to qualify for the 10% or 15% “gain cutback,” there are deadlines for achieving the gain cutbacks.
 - Investments in QOFs on or after 12/31/2019 never qualify for the full 15% cutback
 - Investments in QOFs on or after 12/31/2021 never qualify for the 10% cutback
 - However, investments right up until 12/31/2026 will still defer rollover gain recognition until 12/31/2026, and such investments that are held for 10 years may still qualify for the exclusion of all subsequent appreciation inside the QOF.
- The ability to exclude gain from QOF investments expires on 12/31/2047
- Because the gain (less any cutback) is triggered on 12/31/2026 regardless of liquidity, taxpayers must plan for that tax payment and might consider a leveraged distribution from the QOF.

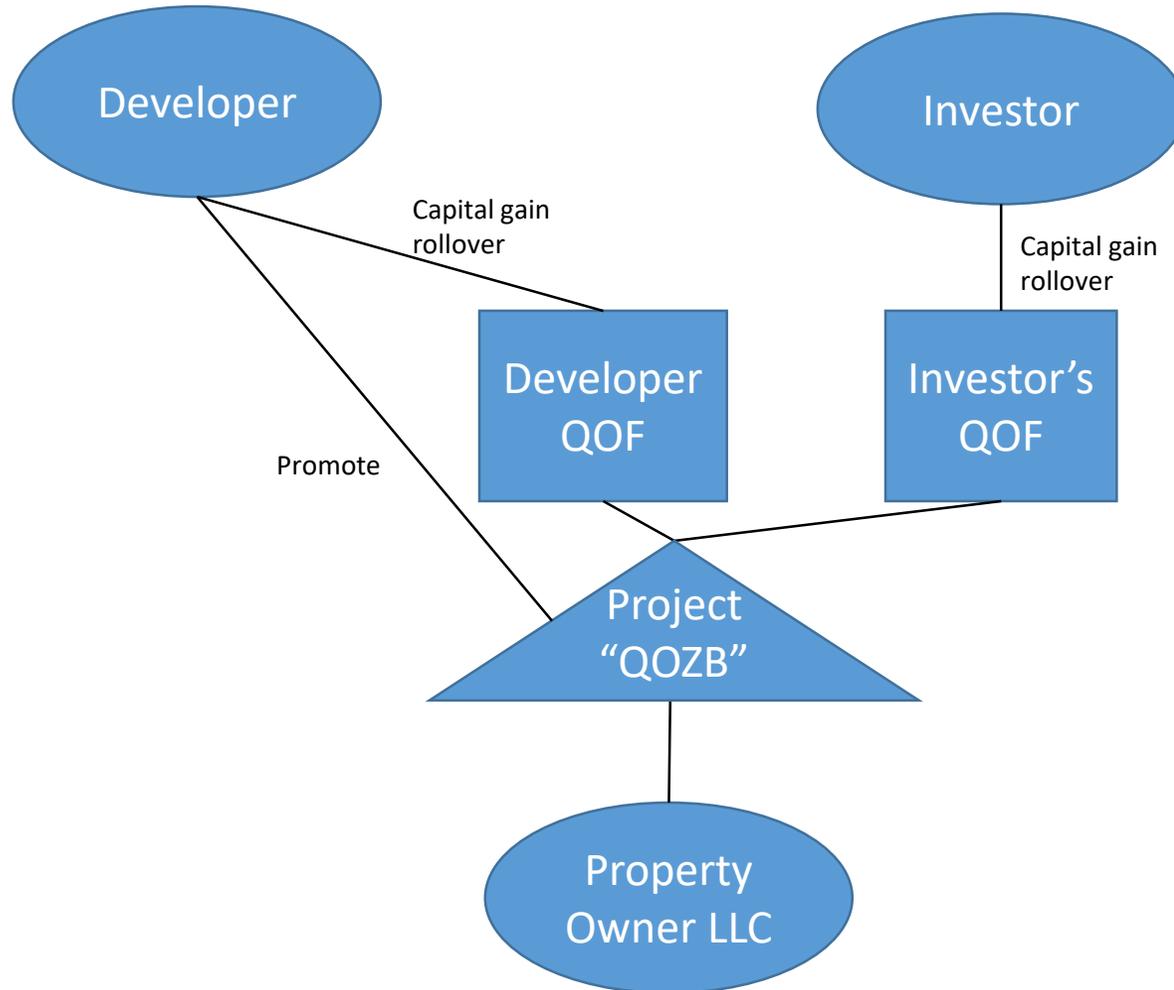


Structuring a QOF Deal

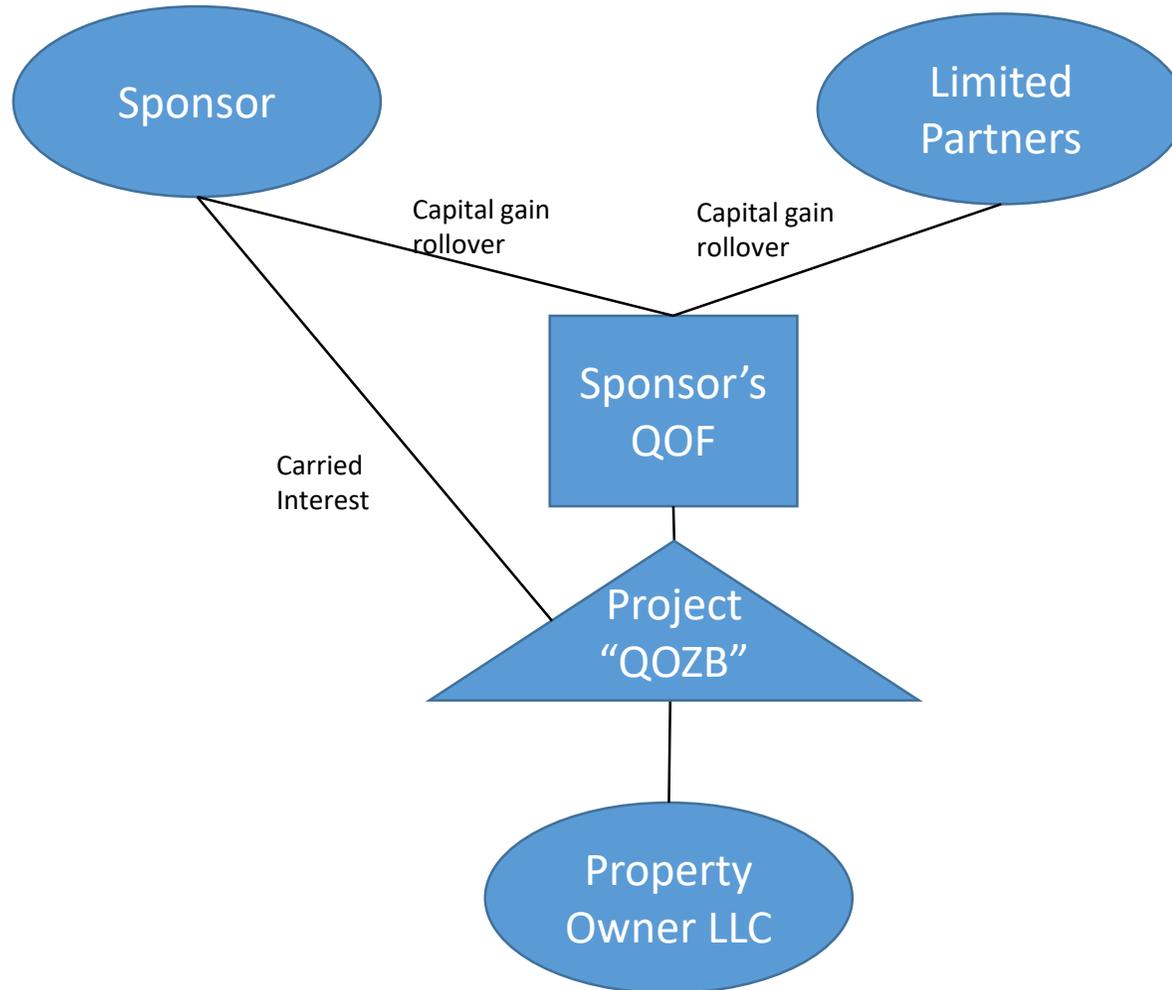
- The QOF statute contains errors and oversights that make QOF deal structuring unusually “persnickety.” There are many traps for the unwary.
- QOF real estate development generally must be done through a subsidiary “QOZB” that must be funded in cash and acquire its assets from an unrelated party.
- Tax counsel with a focus on QOFs must be involved from the outset in deal structuring.



Basic QOF JV Structure



Basic QOF Fund Structure



“Qualified Opportunity Zone Businesses”

- As a practical matter, real estate development must be done through these “QOZBs.” A QOF meets its “90% asset test” by holding QOZB interests, which are tested semiannually for qualification.
- A QOZB must be funded in cash and must meet a “70% asset test.” Good assets include (1) land underlying active real estate development or buildings in service, (2) newly placed-in-service buildings or “substantially improved” buildings, and (3) working capital and CIP that is part of a “31-month plan.”
- A QOZB must meet a “50% active income test.” This means that the QOZB must do more than merely triple-net-lease the asset (but, we think, not much more).
- The regs are focused on combating the inappropriate use of QOFs as a vehicle for speculative land investment.
- The QOZB cannot own more than a *de minimis* amount of financial assets or lower-tier entity interests (only the QOF and QOZB tiers are allowed! No regarded QOZB subsidiaries. Disregarded LLCs are OK.)



Significance of the 31-month plan

- Developing a 31-month plan is a crucial step because it permits the cash from investors to be funded in and meet various timing deadlines.
 - 180-day deadline to roll in capital gains
 - 6-month exclusion of “new capital” from QOF 90% asset test
 - Ability to convert cash (bad asset) into QOZB partnership interest (good asset) by funding into the project in cash as part of a 31-month working capital plan
 - The 31-month plan permits the QOZB to meet its asset test while working capital is consumed.
 - Income from temporary investment of the working capital is good for the 50% income test
- A “start-up” QOZB can “chain” its first 31-month plan with subsequent contemplated cash infusions (each of which is the subject of a separate 31-month plan) and push out the deadline to place the asset in service to as far as 62 months out from the first capital deployment.
- Tolling of these deadlines is allowed for government permitting issues and federally declared disasters that cause delays.
- The COVID-19 disaster effectively tolls current 31-month plans to 55 months.



Structuring for an Eventual Exit

- Under final regulations, there is full flexibility to exit via (1) a QOF interest sale, (2) a QOZB interest sale, or (3) a QOZB asset sale, and in each case achieve a similar exclusion
- Specifically, upon achieving a 10-year holding period, QOF interest holders may elect to exclude any gain from the direct or indirect sale of assets, other than inventory assets, reported to them on their K-1s.
- Based on the final regulations, it is no longer necessary to hold each investment in a separate QOF or separate QOZB in order to get the full tax exclusion (as was the case under proposed regulations)



Can the Seller/Sponsor Participate in the Deal?

- “Related Party” issues: If a QOZB buys from a “related party” (measured at a 20% ownership threshold, which must take into account any carry), the purchased asset is a “bad asset.”
 - Option 1: Keep Seller Under 20% and avoid purchasing a bad asset.
 - Option 2: Concede that the purchased asset (i.e., the land) is a bad asset, and develop a 31-month plan to construct good assets (i.e., a new building) that will be worth more than 70% of the deal.
- The sponsor cannot roll in gain from the sale of a warehoused investment to a QOF into that same QOF (but can roll in other gains to coinvest). The sponsor should hold any carried interest / promote in a separate entity that does not make a capital gain rollover on account of issues with the promote “polluting” the rollover.



Leverage and Liquidity

- Once cash goes into a QOF deal, it can be hard to get it back out without triggering the deferred gain before 12/31/2026.
- Each contribution into a QOF starts a new 10-year required holding period for the new funding portion. There is no cherry-picking which part of a QOF interest is sold.
- One option is a leveraged distribution. However, a leveraged distribution can only be done more than 2 years after the last equity funding of the QOF, or else it may trigger deferred gain.
- Deferred gain that is triggered by a distribution from a QOF can be rolled into another QOF within 180 days of the “inclusion event,” but will start a new 10-year holding period.



BRIAN DETHROW

Biography

Brian Dethrow focuses his practice on tax and business planning for the Family Office and complex corporate, partnership, family, and inter-generational transactions.

Brian has broad experience with innovative tax and business planning with a particular focus on closely held business and Family Offices. His clients have ranged from Fortune 500 to very large family-controlled businesses, as well as the families who own them. His clients include some of the largest and most sophisticated Family Offices in the country, as well as funds for real estate, qualified opportunity zones, private equity and hedge funds. He counsels on international tax, especially for very wealthy cross-border families, and estate, charitable and business succession for all the above.

Practice Experience

- Income and estate/gift tax planning for multi-billion dollar private companies and their owners
- Income tax planning for Family Office tax reduction, qualified opportunity zone gain rollover
- Create and structure funds used in real estate and private equity space
- Business and succession planning, transfer of wealth and control
- Tax controversy work for large privately held business and their families
- Charitable giving, through the use of private foundations and public charities
- Complete restructuring of multi-billion dollar family holdings in line with succession, asset and matrimonial protection and wealth generation for G4
- Develop Multi-Family Office investment structure used in deals involving billions of value, in many industries, onshore and offshore
- Facilitate the tax-free transfer of billions of value in private companies among generations of family owners



Practice Areas

- Tax
- Wealth Planning, Probate, & Trust

Experience

- Family Office Services
- International Taxation
- Tax Controversy & Litigation
- Transactional Tax Planning
- Wealth Planning

Education

- B.A., with high honors, University of Texas at Austin
 - Plan II Honors Program
 - Phi Beta Kappa
- J.D., Harvard Law School

Bar Admissions

- Texas, 1983



- Create tax-advantaged generational transfer of intellectual property for \$500 million family
- Develop Mexican / US cross-border entry point for billionaire foreign nationals in their estate planning
- Complete restructuring of large multi-generation Family Office and its oil, real estate, and equities holdings
- **Recognition & Accolades**
- *The Best Lawyers in America* (Woodward/White Inc.), Tax Law, 2017-2020
- Best Lawyers in Dallas, *D Magazine*, 2009, 2011-2012, 2014-2016, 2018-2019
- AV Preeminent, Martindale-Hubbell
- **Publications & Speeches**
- Co-Author, "Tax Benefits of Investing in QOFs: A New Tax Shelter Approved by Congress!" (February 2019)
- Co-Author, "Treasury Releases Qualified Opportunity Fund (QOF) Guidance" (October 25, 2018)
- Author, "Qualified Opportunity Zones" (July 2018)



- **Areas of Focus**

- Clients who count on Brian for their transactional and tax planning include some of the largest private enterprises in the country. Brian also represents many of the wealthiest individuals in the country – and their Family Offices — on tax planning; succession planning; charitable giving, through the use of private foundations and public charities. Clients regularly seek Brian’s advice and help to:
- Create innovative Family Office structures for maximizing investment expense deductibility and generational transfer of wealth and control
- Develop an innovative qualified opportunity zone practice as a first adopter counsel
- Multi-billion dollar combinations of family-owned businesses
- Offshore tax restructuring of billion-dollar medical technology company, patent box, licensing arrangements
- Create numerous private equity fund structures, tax planning for their founders, tax planning for acquisitions/dispositions of their portfolio companies



- Develop complex offshore structure for largest equipment distributor in the U.S.
- Multi-jurisdiction Family Office work for international tax driven changes to tax jurisdictions
- Develop U.S. tax credit investment program for private multi-billion dollar international bank client and Fortune 500 company

In the News

- [“Remember the Trump tax cut? Here’s how it might benefit low-income areas in Dallas,”](#) *Dallas News* (September 20, 2018)
- [“Q&A With Jackson Walker’s Brian Dethrow,”](#) *Law360* (December 10, 2013)

