Opportunity Fund Structures: An Overview

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On March 1, 2019, Developer, a real estate developer, recognizes a $1 million capital gain.

On August 1, 2019, Developer invests the proceeds into a newly formed qualified opportunity fund (“QOF”).

On April 1, 2020, the QOF contributes $1 million into a newly-formed qualified opportunity zone business (“QOZB”).

On April 30, 2020, QOZB purchases land in a QOZ from an unrelated party for $50,000.

QOZB borrows another $1 million and has a written schedule for a ground-up development of a commercial building that will be completed by March 31, 2022.

What if Developer owned the land prior to January 1, 2018?

What if Developer anticipated the project to take 4 years to complete?
Example 1 – Considerations

• Investment timeline.
  • 180-day period for eligible gain.
  • 6-month option to disregard property contributed to QOF.
  • 30-month substantial improvement safe harbor.
  • 31-month working capital safe harbor.
• One vs. two tier structure.
• Application of 70% tangible property test.
  • What property counts?
  • Related-party limitations.
  • Lease work-around.
• Active conduct of a real estate trade or business.
• Treatment of operating income and distributions.
  • Flow-through of income and deductions.
  • Debt-financed distributions.
Investor Timeline

Capital Gain Realized
3/1/19

QOF Investment
8/1/19

180-Day Period
9/1/19

5 year – 10% Basis Step-up
8/1/24

7 year – 5% Basis Step-up
8/1/26

Deferred Gain Recognized
12/31/26

10 year – Sale of QOF Interest
9/1/29

Deferred Gain Recognized
12/31/26

Deferred Gain Recognized
12/31/26
Investment Timeline

Initial Investment in QOF
8/1/19

Initial Investment in QOZ Business
4/1/20

(Second) QOF Asset Test Date
6/30/20

(First) QOF Asset Test Date
12/31/19

31-Month Working Capital Safe Harbors

30-Month Substantial Improvement Period

Purchase QOZ Business Property
4/30/20

Additional Investment in QOZ Business
10/1/22

QOF Asset Test Date
12/31/22

Active Conduct of QOZ Business?

Additional Investment in QOF
9/1/22
Example 2 – Investment in a New Operating Business

• The facts are similar to Example 1, except that QOZB invests in the creation of a restaurant located in a QOZ.
  • With the $2 million contributed/borrowed, QOZB enters into a lease for space and builds it out, obtains the proper permits (including a liquor license), and purchases kitchen equipment, tables/chairs, and office equipment necessary to operate a restaurant.
  • What if QOZB acquired an existing restaurant and renovated and expanded it?
  • What if Restauranteur already operated the restaurant in the QOZ?
Example 2 – Considerations

• Compliance with various tests is more challenging for an operating business than a real-estate development project.

• 70% tangible property test.
  • Original use vs. substantial improvement tests.
  • Application of substantial improvement test.
  • Property leasing rules.

• Gross income test – application of safe harbors.

• Sin business limitation.
Example 3a – Multi-Investor Fund

- The facts are similar to Example 1, except that Developer opens up the fund to investment from a range of other LP investors.

- What if some of LP investors are foreign?
• The facts are similar to Example 3a, except that Developer forms QOF and sells QOF interests to LP investors as they recognize eligible gains.

• What if Developer’s QOF interest is not an eligible interest?
Example 3 – Considerations

• Traditional funds vs. QOFs.
  • Additional pressure on investment timeline because timeline for raising capital from investors may not coincide with timeline for QOF to deploy capital.
    – Limitations on feeder funds/potential use of secondary sales (see Example 3b).
  • Investor time horizon.
  • Compliance costs.
  • Management compensation.
  • Planning interim distributions.

• Mixed-funds investments – contribution of eligible gains and non-eligible gains.

• Foreign investors – limitations on use of blockers.
• Sponsor establishes a QOF to invest in various businesses in various opportunity zones. These businesses could be real estate developments, operating businesses, or a combination of both.

• QOF will establish a separate QOZB partnership for each business in which it invests.
• Sponsor plans to invest in various businesses in various opportunity zones. These businesses could be real estate developments, operating businesses, or a combination of both.

• Sponsor will establish separate QOFs (or a series partnership or LLC), and each QOF will establish a QOZB partnership, for each business in which it invests.
Example 4 – Considerations

• Exit Issues
  • Sale of QOF interest vs. sale of QOF assets vs. sale of QOZB assets.
  • Treatment of hot assets.
  • Exit before vs. after 10 years.