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QUALIFIED OPPORTUNITY ZONE FUNDS

Isolating the Tax Benefits

By Kevin A. Shields

INVESTMENTS & WEALTH INSTITUTE®

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Qualified Opportunity Zones were created by the 2017 Tax Cuts and Jobs Act. These zones are designed to spur economic development and job creation in distressed communities throughout the country and they have gained attention due to their favorable tax treatment. The Act gave rise to Subchapter Z of the Internal Revenue Service Code and Sections 1400Z-1 and 1400Z-2 thereof (collectively, Subchapter Z). Since such time, much has been written about Subchapter Z with deference accorded the tax benefits associated therewith. This article will briefly recapitulate the legislative construct of Subchapter Z, the critical timing elements related thereto, and isolate the specific tax benefits and the relative value of those tax benefits associated with the legislation.

In broad brush, Subchapter Z stipulates that if an investor triggers a capital gain (long-term or short-term) through the sale of an asset (real estate, an operating business, low-basis appreciated stock, a coin collection, art collection, etc.) and invests that capital gain in a Qualified Opportunity Fund (QOF) within 180 days of the realization of that gain, then the following benefits may be realized (see figure 1):

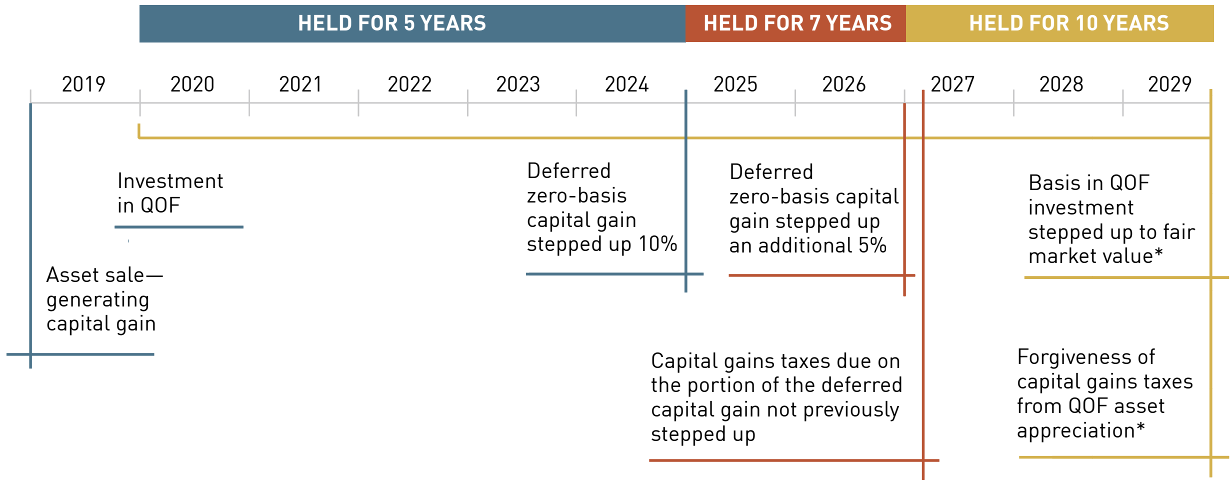
- Should the investor remain invested in the QOF for a period of five years prior to December 31, 2026, the investor's zero-basis capital gains will be "stepped-up" 10 percent;
- Should the investor remain invested in the QOF for a period of seven years prior to December 31, 2026, the investor's zero-basis capital gains will be stepped-up an additional 5 percent, for a total of 15 percent;
- The tax payable on the portion of the capital gains not otherwise stepped-up is due and payable on the investor's tax filing date in either April or October 2027, resulting in a deferral of the capital gains tax liability through year-end 2026; and
- Should the investor remain invested in the QOF for a period of 10 years following the initial investment, any gains realized by the QOF on assets it either develops or substantially renovates (defined as doubling the basis of the property exclusive of the value allocated to the land), above the initial investment of capital gains, is generated tax-free to the investor as a function of a 100-percent fair market value basis step-up upon the point of sale of the QOF or its assets.

Several nuances are associated with Subchapter Z that have been addressed largely in regulations proposed and promulgated by the Treasury and Internal Revenue Service, the first set of which was released in October 2018, the second in April 2019, and the third in December 2019. Whereas a detailed discussion of all such nuances and the regulations addressing the same are beyond the scope of this article, there are a few to bear in mind:

- The current majority of QOF sponsors view the Qualified Opportunity Zone (QOZ) legislation through the lens of a real estate developer and operator; real estate investment alternatives have generated the greatest level of interest from those that have created QOFs and those interested in investing therein. There is, however, a whole world of private equity QOFs in which business investment is entitled to the same array of tax benefits. For purposes of the tax examples provided below, the focus is on real estate investments.
- If an investor generates a capital gain through the sale of, say, low-basis, highly appreciated stock, the investor could invest the entire proceeds of the sale (basis and capital gain) into the QOF if he or she likes the investment thesis. However, the legislation was intended to motivate Americans with embedded capital gains on their balance sheets to monetize those gains and redirect those gains into "low-income communities," designated Qualified Opportunity Zones. As such, the tax benefits attach to the capital gains only.
- When the investor generates the capital gain, such gain "maintains its character" throughout the deferral cycle. That is, if the capital gain is short-term in nature, the applicable tax rate will be the short-term capital gains tax rate (ordinary income) at the time the taxes are due in 2027. The same applies should the gains be long-term in nature at the time of sale; the long-term capital gains tax applicable in 2026, payable in 2027, will apply.
- The tax benefits articulated above only apply to taxes at the federal level. The states are all over the map, as it were, relating to whether each has conforming legislation. Some

Figure 1

QUALIFIED OPPORTUNITY TAX BENEFIT TIMELINE



**Basis step-up to fair market value and elimination of long-term capital gain taxes on QOF asset appreciation are applicable to federal and most state taxes; however, some states have not conformed to this federal legislation. Investors should consult their own tax advisors to determine their individual benefits in a QOF investment.*

have a rubric that conforms with the federal legislation (e.g., Illinois and New York), some have partial conformity (e.g., Alabama and Arkansas), and some have no conforming state legislation (e.g., California, North Carolina, and Massachusetts). State conformity is fluid and an investor should check periodically to assess the current state legislation.

- Included in Subchapter Z and the Treasury's regulatory guidance are a plethora of other key issues that need to be understood by potential investors, including, but not limited to:
  - Endorsement of debt-financed distributions;
  - Sale of the QOF interests versus the sale of QOF assets and potential implications for an asymmetric outcome relative to recapture tax liability (this issue, legal pundits believe, will be addressed by the Treasury and resolved);
  - "Original Use" and the ability to acquire a near-completed asset prior to receipt of a certificate of occupancy;
  - Interim asset sales inside the 10-year holding period and the ability to rotate capital;
  - Working capital safe harbor as a solution to holding cash earmarked for development; and,
  - Timing associated with recognizing and ultimately investing Internal Revenue Code Section 1231 gains.

Clearly, several issues need to be digested and understood with respect to Subchapter Z. A fund sponsor needs to also understand Subchapter Z's various requirements at the QOF level and wrap a detailed compliance protocol around the legislation to avoid a regulatory foot fault. Countless experts have weighed in with respect to these issues, the legislation, and its benefits and prospective pitfalls. Frankly, there has rarely been a collection of tax benefits as powerful as those provided by Subchapter Z. Thus, if you are a potential investor considering a QOF investment and like the fundamentals of the real estate transaction you are contemplating, there is no reason to not take advantage of all that Subchapter Z has to offer. To reiterate and re-emphasize, the prudent investor should consider a QOF investment as primarily a real estate transaction—this is not a tax trade. An investor needs to understand and underwrite the real estate and the QOF sponsor, and only on that basis does the rest fall into place. The tax benefits lend significant incremental value to the investment but are not, themselves, determinative of the investment merit. So, how do we quantify the incremental tax benefits?

The best manner in which to comprehend and analyze the tax benefits of an investment in a QOF, relative to an investment in some other alternative, is to craft a side-by-side comparison where the only difference between the two investment alternatives, in this case both real estate developments, is that one is in a QOZ and the other is the same investment not located in a QOZ.

In order to isolate this difference, the following examples assume:

- A $1-million investment of capital gains;
- An investment made prior to or on December 31, 2019, so that the investor captures the full benefit of the 15-percent basis step-up in his or her zero-basis capital gains;
- A holding period of 10 years following the initial investment;
- No interim distributions of debt-financed proceeds or operating

income (which should not be the case generally, but such an assumption will isolate the tax differential);

- An investment internal rate of return, in both instances, net of all fees and expenses, of 9 percent;
- Federal capital gains tax rate of 23.8 percent, inclusive of the 3.8-percent Affordable Care Act tax;
- Two different scenarios in which the investor resides in California, a non-conforming state with a capital gains tax rate of 12.3 percent, versus a Texas resident with no state income tax; and
- The capital gains tax due and payable by the investor for the initial realized capital gain is paid from sources outside of the hypothetical transaction and, as such, the entire $1-million capital gain is invested in the QOF.

In the case of a California resident, the return metrics and tax impact are as follows (see table 1):

- In the QOF scenario, the investor pays the 12.3-percent California state taxes from the transaction that generated the capital gain, or $123,000.
- In the same hypothetical development, not in a QOZ, the investor pays $361,000 in taxes (23.8-percent federal taxes plus the 12.3-percent state taxes).
- Assuming a 15-percent basis step-up, the QOF investor pays an additional $202,300 in 2027 (deferred through December 31, 2026).
- The QOF taxpayer pays $168,186 in state taxes in 2030 following the 10-year holding period, for a total tax payment of $493,486, against a total net gain of $1,367,364.
- The non-QOF taxpayer pays $493,618 in federal and state taxes, for a total tax payment of $854,618, against the same total net gain of $1,367,364.
- Over the course of the 10-year investment, the QOF investor generates a total return of $361,133 in excess of the non-QOF investor ($1,873,878 versus $1,512,745 in net after-tax proceeds for the QOF and the non-QOF investor, respectively), or 23.87 percent of additional net after-tax proceeds.
- On a present value basis, the QOF investment generates an additional 255 basis points in after-tax internal rate of return (IRR) relative to the non-QOF investment.
- As a general proposition, depending upon the investor's personal tax attributes, the net after-tax IRR increase equates to a pre-tax equivalent IRR of 12.99 percent, or 399 basis points in excess of the pro-forma 9-percent IRR.

Using the same methodology for the Texas investor (see table 2), given there

Table 1

QOF AFTER-TAX COMPARATIVE BENEFIT, CALIFORNIA RESIDENT

Assumptions	
Capital Gain Proceeds from Sale	$ 1,000,000
Long-Term Gap Gains Rate (Federal + ACA)	23.80%
Investment Duration prior to 12/31/26	7.00
Percent of Capital Gains Taxes Stepped Up	15.00%
Taxpayer's State: California	12.30%
Conforming State Legislation?	No
Traditional Portfolio Return (annual IRR)	9.00%
QOF Pro-Forma Return (annual IRR)	9.00%

	Traditional Investment	QOF Investment
Investment Year	**2019**	**2019**
Capital Gain	$1,000,000	$1,000,000
Capital Gain Tax Paid in 2020	(361,000)	(123,000)
End of Deferral Period	**2026**	**2026**
Capital Gains Taxes Payable in 2027	—	($202,300)
End of 10-Year Investment Period	**2029**	**2029**
Future Value of Investment	$2,367,364	$2,367,364
Taxes Due	(493,618)	(168,186)
Net After-Tax Sales Proceeds	$1,873,745	$2,199,178

Summary of QOF Tax Benefit Differential		
Initial Capital Gain	$1,000,000	$1,000,000
Gain on Investment	1,367,364	1,367,364
Taxes Paid	(854,618)	(493,486)
Net After-Tax Proceeds	**$1,512,745**	**$1,873,878**
Net After-Tax Cash Benefit of QOF Investment		$361,133
Relative Increase in Distributable After-Tax Cash		23.87%
Net After-Tax IRR Benefit of QOF Investment		2.55%
Pre-Tax Equivalent of IRR Benefit of QOF Investment		3.99%

Note: This illustration does not represent any particular QOF investment. Table 1 is merely a hypothetical illustration based on the assumptions listed to show the potential tax benefits of investing in a QOF investment. The tax rates and returns used in the assumptions of this example may vary greatly and should not be construed as any results you would achieve in a QOF investment. This information should not be construed as tax advice. Investors should consult their own tax advisors to determine their individual benefits in a QOF investment.

are no applicable state taxes, such investor also generates an additional after-tax distribution for a QOF investment of $361,133 ($2,165,064 versus $1,803,931 in net after-tax proceeds for the QOF and the non-QOF investor, respectively), or 20.02 percent more than he or she would have earned for an investment in the same asset not located in a QOZ. That equates to an additional after-tax IRR of 273 basis points. Further, again depending upon the investor's personal tax characteristics, this generally equates to a pre-tax IRR of 12.59 percent, or 359 basis points in excess of the 9.0-percent pro-forma IRR.

As previously noted, if the investor is enamored with the real estate offering and the sponsor, the tax benefits provided by Subchapter Z are very compelling and there is no reason to not therefore invest in 2019. What if, however, the investor has either not generated a capital gain in 2019 and/or simply has not identified a suitable QOF investment? What impact does investment in 2020, in which the investor will receive only a 10-percent basis step-up (as opposed to 15 percent) for his or her zero-basis capital gains, have on the overall return profile?

Whereas we view the deferral and up to 15 percent basis point step-up as motivating, it is the 100-percent fair market value basis step-up after 10 years that is the more impactful economic driver behind the QOZ legislation. As such, and as you may expect, the incremental 5-percent loss in basis step-up for an investment made in 2020 is not material for a 10-plus-year investment duration.

In the case of the California QOF investor, the total net after-tax investment proceeds drop from $1,873,878 to $1,861,978, which reduces the after-tax IRR approximately 14 basis points. The relative difference between a QOF investment versus a non-QOF investment drops from 255 basis points to 241 basis points.

The impact in Texas is comparable: The total net after-tax investment proceeds drop from $2,165,064 to $2,153,164, which reduces the after-tax IRR approximately 16 basis points. The relative difference between a QOF investment versus a non-QOF investment drops from 273 basis points to 257 basis points.

As discussed, this is a rudimentary example intended to highlight the difference in the after-tax IRR from two identical assets, one in a QOZ and the other outside of a QOZ. In our simple example, the return differential increases meaningfully if the internal rate of

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Table 2

QOF AFTER-TAX COMPARATIVE BENEFIT, TEXAS RESIDENT

Assumptions	
Capital Gain Proceeds from Sale	$ 1,000,000
Long-Term Gap Gains Rate (Federal + ACA)	23.80%
Investment Duration prior to 12/31/26	7.00
Percent of Capital Gains Taxes Stepped Up	15.00%
Taxpayer's State: Texas	0%
Conforming State Legislation?	Yes
Traditional Portfolio Return (annual IRR)	9.00%
QOF Pro-Forma Return (annual IRR)	9.00%

	Traditional Investment	QOF Investment
Investment Year	**2019**	**2019**
Capital Gain	$1,000,000	$1,000,000
Capital Gain Tax Paid in 2020	(238,000)	—
End of Deferral Period	**2026**	**2026**
Capital Gains Taxes Payable in 2027	—	($202,300)
End of 10-Year Investment Period	**2029**	**2029**
Future Value of Investment	$2,367,364	$2,367,364
Taxes Due	(325,433)	—
Net After-Tax Sales Proceeds	$2,041,931	$2,367,364
Summary of QOF Tax Benefit Differential		
Initial Capital Gain	$1,000,000	$1,000,000
Gain on Investment	1,367,364	1,367,364
Taxes Paid	(563,433)	(202,300)
Net After-Tax Proceeds	**$1,803,931**	**$2,165,064**
Net After-Tax Cash Benefit of QOF Investment		$361,133
Relative Increase in Distributable After-Tax Cash		20.02%
Net After-Tax IRR Benefit of QOF Investment		2.73%
Pre-Tax Equivalent of IRR Benefit of QOF Investment		3.59%

Note: This illustration does not represent any particular QOF investment. Table 2 is merely a hypothetical illustration based on the assumptions listed to show the potential tax benefits of investing in a QOF investment. The tax rates and returns used in the assumptions of this example may vary greatly and should not be construed as any results you would achieve in a QOF investment. This information should not be construed as tax advice. Investors should consult their own tax advisors to determine their individual benefits in a QOF investment.

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return from the underlying investment increases. For example, in the California scenario, the spread between the QOF and non-QOF investment increases from 255 basis points to 299 basis points should the investment IRR increase from 9 percent to 11 percent.

Further, these examples assume no interim distributions from the investment. In the case of, say, a $100-million multifamily development commenced in January 2020 (investment made in 2019), it generally takes approximately two years to deliver a completed development and another 12–18 months to stabilize that asset to, say, 90-percent occupancy. At that time, the sponsor can recapitalize the property, slightly increase the leverage ratio, and, given the property appreciation generated over the three to three-and-one-half years required to stabilize the multifamily community, generate excess financing proceeds and provide the investor a tax-free distribution from the debt-financed proceeds. Also at such time, the sponsor can commence providing the investor distributions from operating cash flow—both of which serve to increase the investor's internal rate of return and provide a return of capital necessary to mitigate the investor's capital gains tax liability required to be paid in 2027, resulting from the tax due on the original $1-million investment for that portion not otherwise stepped up.

In the final analysis, and this cannot be emphasized enough, this is a real estate transaction. If you like the transaction, property(ies), and sponsor, the potential tax benefits provide a powerful supplement to enhance after-tax returns.

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