akerman

Private Equity Funds Should Consider the Qualified Opportunity Zone Program

Featured Story

March 26, 2019

By Alexandre M. Denault and Ira B. Stechel

Not only can private equity (PE) funds and their investors take advantage of the federal tax benefits under the new qualified opportunity zone (the QOZ) program, in many cases they are uniquely positioned to do so better than any other type of investor. The extent to which Qualified Opportunity Zones will be of value to (corporate) private equity funds will be dependent on the regulations that have yet to be promulgated.

This stems from the fact that the QOZ program is not just for real estate projects, but can apply to a wide variety of business types with which PE funds are familiar, including traditional manufacturing and sales-based businesses, as well as technology-based businesses and start-ups. However, there are some unique issues that PE funds (in this case, meaning an entity, such as an LP or LLC, that is treated as a partnership for federal tax purposes) should consider

Related People

Alexandre M. Denault

Carl D. Roston

Ira B. Stechel

Related Work

Corporate

Tax

when deciding whether to take advantage of the QOZ program. Because the QOZ program is in its infancy, with several rounds of Treasury Regulations forthcoming, investors could face some degree of legal and tax uncertainty prior to the issuance of further guidance in certain cases depending on their structure and investments.

Brief Background of the QOZ Program

A qualified opportunity fund (QOF) is generally an entity treated as a partnership or corporation for tax purposes (which can include an LLC) formed for the purpose of investing in qualifying opportunity zone businesses or property. A QOF must meet several other tests and timing requirements in order to qualify under the QOZ program. Anyone can create a QOF, including a PE fund or its partners.

Under the QOZ program, a taxpayer that reinvests capital gains in exchange for equity in a QOF within 180 days may elect to defer the income inclusion of the capital gain (known as the deferral election) until the earlier of the date they sell their interests in the QOF or December 31, 2026. In addition, an investor of capital gain that holds an interest in a QOF for at least five years can increase its basis by 10% of the deferred capital gain, with another 5% increase after a sevenyear holding period, effectively eliminating the eventual inclusion of up to 15% of the initial capital gain invested into the QOF.

And, most importantly, provided the taxpayer made the deferral election, then after a 10-year holding period, the taxpayer is entitled to elect to step-up its basis in the equity of the QOF to fair market value, which may have the effect of excluding from federal income tax all of the post-investment gain from the sale of the QOF investment. However, under current guidance, capital gain or ordinary income may arise on exit when a QOF that is treated as a partnership has debt or “hot assets” (such as inventory and depreciation recapture) when the QOF equity is sold even after a 10-year hold. Also, whether these benefits apply for state income tax purposes depends on whether a state conforms to the federal law and is determined on a state-by-state basis. Operating income earned by the QOF during the holding period is generally subject to income tax under normal income tax principles.

> “This flexibility requires timely communication between the PE fund and the partners to ensure that there is coordination about whether the PE fund or the partners will take advantage of the QOZ program.

Who Should Invest? The PE Fund or Its Partners?

If a PE fund sells assets and realizes a capital gain, the parties have the flexibility to choose whether the PE fund or the partners are going to make the deferral election to take advantage of the QOZ program. If the PE fund makes the deferral election, it has 180 days from the date of the sale to reinvest funds into a QOF. Alternatively, if a PE fund does not make the deferral election for itself, the partners of the PE fund may do so on a partnerby- partner basis. In this case, partners have more timing options.

The partners have 180 days from (i) the date of the realization of the capital gain by the PE fund or (ii) from the end of the taxable year of the PE fund, in which to invest their allocable share of the capital gain into a QOF. This flexibility requires timely communication between the PE fund and the partners to ensure that there is coordination about whether the PE fund or the partners will take advantage of the QOZ program.

In addition, if a partner makes the deferral election, the partner will need to ensure it has adequate liquidity to make the actual monetary investment into a QOF. In certain cases, this may require the PE fund to make distributions to the partners.

The Q1 2019 Akerman PErspectives Report: 2018 in Review and Observations for 2019

Explore this report.

Practical Limitations on a Business Choice

A QOF must carefully choose what type of business to acquire to ensure that it meets all of the requirements under the QOZ program. Because qualifying businesses generally need to have a link to the geographic area comprising a qualified opportunity zone, this may limit what types of businesses can be acquired as well as the ability of the business to expand outside of the opportunity zone. Specifically, the QOZ statute requires that at least 50% of the gross income of a QOZ business be derived from the active conduct of a trade or business.

To date, the Treasury has provided no definition as to what constitutes the "active" conduct of a trade or business. For example, will a start-up period or a research and development phase be permissible and count as "active" conduct? Equally frustrating is the guidance on the sourcing of income for purposes of the 50% test, so as to differentiate between "good" income derived from sources within the QOZ, as opposed to "bad" income derived from sources outside the QOZ – a determination relatively easy to make in the case of income derived from real estate operations but much less so in the case of a manufacturing or service business. In this respect, a bipartisan group of 16 House and Senate legislators wrote a letter to Treasury in January requesting the amelioration of the sourcing rule to simply require that 50% or more of the gross income of a qualifying business come from the active conduct of a trade or business.

Similarly, the 31-month working capital safe harbor period provided within the Proposed Regulations for QOFs investing in a subsidiary conducting a qualifying business that acquires, constructs or rehabilitates tangible business property is an extremely useful provision for real property development projects but much less so for non-real estate businesses. Accordingly, the ABA Tax Section has recommended to the Treasury that the working capital safe harbor period be revised to permit the use of working capital assets to fund the operating costs of a new or expanding non-real estate business, as well.

When a PE fund acquires abusiness, part of the consideration is typically allocated to goodwill. Goodwill is an intangible asset, and the PE fund typically amortizes the goodwill over 15 years, providing valuable income tax deductions during the holding period of the goodwill and the business. How goodwill affects a QOF structure depends on the structure of the QOF investment and the relative value of the goodwill in relation to the other property of the QOF. In general, a QOF may directly own goodwill provided the value is less than 10% of the overall value of all of the QOF's property. For a QOF which indirectly owns the goodwill through a subsidiary entity treated as a partnership or corporation for tax purposes, the subsidiary may own an unlimited amount of intangible assets (including goodwill) provided that a substantial portion of the intangible property is used in an active trade or business

The Proposed Regulations provide that the intangible property must be used "in the qualified opportunity zone;" however, the statute does not clearly require this. It is an open question whether Treasury will retain this requirement in Final Regulations.

> “The Proposed Regulations also have yet to deal with the manner or timing of the reinvestment of proceeds from the sale or other disposition of QOF subsidiaries or business assets.

Structure and Carried Interest

A QOF needs to ensure that it structures the acquisition of a business in a way that qualifies under the QOZ program. For example, if a PE fund creates a QOF and seeks to purchase a business which is treated as a C corporation for tax purposes, the QOF cannot simply purchase the stock. Instead, the acquisition would need to be structured to comply with the QOZ program. One way to accomplish this is for the QOF to form a subsidiary C corporation, make an equity funding of the C corporation with cash, and then have the C corporation acquire the assets of the business. Careful planning is also needed when acquiring a business treated as a partnership for tax purposes.

Moreover, a QOF should consider whether to invest only in a singlebusiness as opposed to having multiple businesses under the same QOF. Using a single-business model should make it easier to sell the QOF equity interests to a buyer on exit, but would come at the expense of diversification. While there are still some open issues about the extent to which a carried interest can qualify for the income tax benefits under the QOZ program, if a QOF deal will be structured with a carried interest, it is important to ensure that the person or entity receiving the carried interest will invest capital gain into the QOF within 180 days just like the other investors. The existence of the capital gain investment is a critical element to qualify for any income tax benefit under the QOZ program. PE funds will also need to consider whether their QOF deal will permit or require distributions over time (especially to cover the investors' deferred income inclusion on December 31, 2026), how to deal with structured or delayed capital raises, and what limitations on investor-level QOF disposition rights (such as drag, tag, and buy-sell rights) are acceptable to ensure the investors can qualify for the maximum income tax benefits under the QOZ program.

The Proposed Regulations also have yet to deal with the manner or timing of the reinvestment of proceeds from the sale or other disposition of QOF subsidiaries or business assets. The statute clearly anticipates the reinvestment of such proceeds and specifically authorizes the promulgation of regulations to insure that a QOF has a reasonable period to effectuate such reinvestment, but provides no guidance as to whether such reinvestment maintains ongoing deferral, such that no gain is recognized. Presumably, the legislative intention was to permit ongoing deferral on the part of investors, who neither sell their interest in the QOF before meeting the 10-year holding period nor receive distributions from the QOF which essentially cash out their interests. The next set of Proposed Regulations will likely address these issues.

> “ PE funds should carefully consider whether the long-term holding periods required to obtain the tax benefits under the

QOZ program are realistic.

Takeaways

Non-real estate heavy businesses, including traditional manufacturing and sales-based businesses, as well as most types of start-up businesses and technology companies, have largely been overlooked as potential QOF investments primarily because most of the discussion has centered on real estate projects. PE funds are in a unique position to invest in operating and start-up businesses under the QOZ program due to their industry knowledge and experience in acquiring those types of businesses. However, PE funds need to be aware of the special QOZ program requirements that, in many cases, will change the way in which deals are selected and structured.

Finally, PE funds should carefully consider whether the long-term holding periods required to obtain the tax benefits under the QOZ program are realistic. The most significant tax benefit is that after a 10-year hold, an investor can make an election to step-up the basis of the investment in the QOF to fair market value, which could result in no taxable gain upon the exit (exit being a sale of the QOF equity interests). PE funds will need to determine whether such a holding period is consistent with its investment objectives and philosophy, as well as whether to invest in a QOF through the existing PE fund structure or through a separate, standalone structure.

Akerman LLP is a top 100 U.S. law firm recognized by *Financial Times* as among the most forward thinking firms in the industry. Its more than 700 lawyers and business professionals collaborate with the world's most successful enterprises and entrepreneurs to navigate change, seize opportunities, and overcome barriers to innovation and growth. Akerman is known for its results in middle market M&A and complex disputes, and for helping clients achieve their most important business objectives in the financial services, real estate, and other dynamic sectors across the United States and Latin America.

The Akerman Corporate Practice Group advises public and private companies, including private equity funds, on M&A, capital markets, financings, and other transactional matters, with a strong focus on the middle market. Akerman is top-ranked nationally for mergers, acquisitions and buyouts: middle market by *The Legal 500* and is recognized as a leading U.S. law firm by *U.S. News – Best Lawyers* for corporate, M&A, private equity, securities/capital markets, securities regulation, and banking and finance law, and is listed in PitchBook league tables as among the most active law firms in the United States for M&A and private equity deals.

You may also be interested in...

Report

Akerman PErspectives on U.S. Middle Market Private Equity

Press Release

Akerman Continues Strong Performance in *PitchBook*'s 2018 Global League Tables

March 25, 2019