Advanced Considerations When Thinking About Qualified Opportunity Zone Funds

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Qualified Opportunity Zone Funds ("QOF(s)" or "Fund(s)") combine powerful benefits that can help create tax planning, financial planning, and potential investment alpha in a singular solution for investors with capital gains. A QOF can be a terrific tool for a variety of reasons, but each underlying Fund has a different strategy and there are some important factors for financial professionals to consider when selecting the right strategy for their respective clients.

Investment Strategy

Most Funds focus on real estate, but not all real estate is created equal. The dispersion of returns across sectors is wide. One must determine what makes sense given the current economic outlook and the duration of the strategy, which in the case of QOFs is 10+ years. Suppose you want to avoid certain real estate sectors because fundamentals and outlook are weak. Should an investor compromise that view when selecting the appropriate strategy for this portion of their portfolio?

Does it make sense to invest in parts of the real estate market that have empirically delivered compelling risk-adjusted returns over long durations with demand drivers that are necessity-based, such as apartments, or does it make more sense to invest in cyclical sectors that are typically more volatile, such as office, retail and hospitality? Is there an acceptable risk/reward expectation to invest in asset types with a critical technology component to their use and diminishing value given the rapid change in technology, risk for obsolescence or vulnerability to potential regulatory changes such as solar fields and data centers? Should an investor put more emphasis on the perceived tax benefits or the merits of the underlying investment?

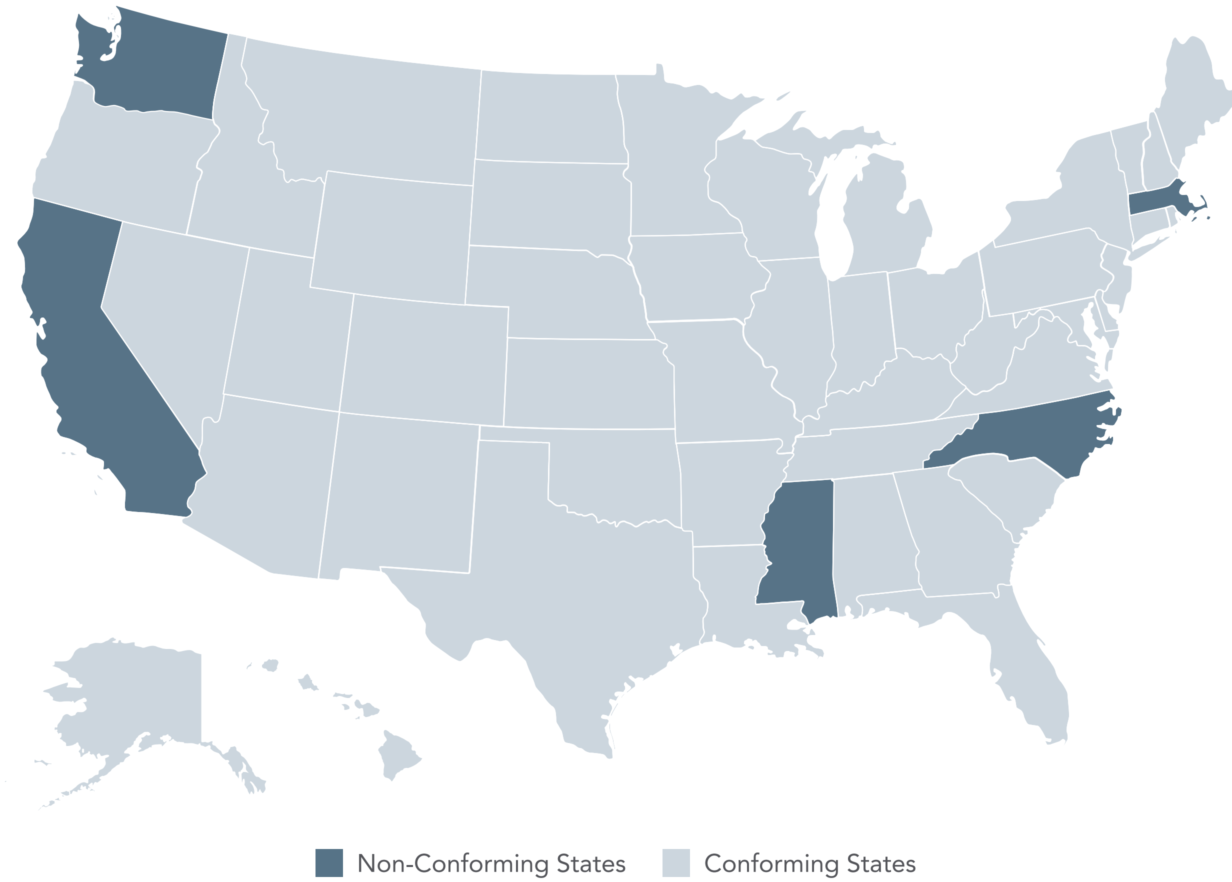
Are You Maximizing the Benefit of the Strategy?

Conformity vs. Non-Conformity and Other Issues

The most powerful benefit available to QOF investors is the ability to grow capital tax-free on a long-term basis.[1] Many QOFs are structured as partnerships. In such a structure, if a state does not conform to the QOF regulations and a Fund owns investments in that state, the taxpayer will not enjoy the benefit of tax-free growth at the state level even if the taxpayer resides in a conforming state. Does it make sense if you live in a low-tax or conforming state to invest in a portfolio with a high concentration of its investments in a non-conforming state? As an example, would a Texas resident want to own a portfolio with a high concentration of California assets? The net tax impact of doing so could currently be as high as 13.3%. Further, are there other factors that impact returns to investors, such as transfer taxes imposed by states or municipalities where investments reside, that further reduce an investor's after-tax return?

1. Refers to the ability to elect for a fair-value basis step up if an investor makes a qualifying investment in a QOF and holds their interest for 10 years or more. There are exceptions for missed elections or an earlier Inclusion Event.

State Conformity with QOZ Legislation[2]



Liquidity Optionality

When investing, it is important to understand how an exit might work, even if the intent is not to exit for several years. There are multiple contemplated exit strategies across different QOF strategies. Some, including a portfolio sale, selling assets individually, an institutional recapitalization, a public market listing, a 721-Exchange into a Real Estate Investment Trust ("REIT"), or even strategies that offer interim liquidity after the deferral period expires on December 31, 2026.

If interim liquidity is an option being advertised, it is important to understand how viable that option is before it becomes a focal point for investors. Importantly, what is the cost and availability of the capital needed to provide that liquidity? Suppose the intent is to receive outside capital from institutional investors to Fund redemptions at the expiration of the deferral period on December 31, 2026. In that case, one must consider why an institutional investor would want to own that portfolio if it does not get any of the QOF tax benefits once the deferral period expires. Additionally, one must consider the price that such institutions would be willing to pay to own a partial, non-controlling interest in the Fund. If the intent is to use leverage to redeem investors, how many investors would this satisfy and how would the risk profile of the investment change for remaining investors after the leverage is taken out? Every QOF investor has the same expiration of their deferral date regardless of the investment date. If the intent is to make capital available at that time, one must consider if there would be enough to meet the potential demand, and if not, how will that be handled?

2. Reflects those states that do not conform to Section 1400z-2 of the U.S. Internal Revenue Code (the "QOZ Legislation") with respect to personal capital gains as of March 31, 2024 per Novogradac & Co LLP. Certain states may only partially conform to the QOZ Legislation and/or not conform to the with respect to corporate capital gains. Please consult your tax advisor to determine your state and federal tax consequences from investing in a QOZ Fund.

Lastly, one must consider the terminal exit strategy. While no Fund is generally forced to sell at a specific time, it is good to understand how an investor might exit after their 10-year investment anniversary. Given the potential exit strategies (e.g., a portfolio sale, selling assets individually, an institutional recapitalization, a public market listing, a 721-Exchange to a REIT), it is important to understand the types of opportunities that various Fund constructs could feasibly pursue and the degree to which such opportunities could result in a successful outcome for investors.

A **portfolio sale** is generally executed by sector-specific strategies that transact with a buyer that wants exposure to that sector at scale and will pay a premium for the work done to accumulate assets. Examples of potential buyers include foundations, endowments, life insurance companies and both private and public REITs. **Individual asset sales** can be a liquidation strategy for both a diversified portfolio and a sector-specific portfolio. Historically, diversified sector **REITs** have generally traded at discounts to net asset value ("NAV") when listing on a public stock exchange. On the other hand, though it varies by asset class, sector specific REITs have generally traded at better valuations relative to their NAV and, in many instances, at meaningful premiums to their NAV. As a result, publicly listed REIT exits are typically a more attractive opportunity for many sector-specific strategies relative to diversified Funds. This logic would also follow for **721-Exchanges**, where investors exchange their interest in a limited partnership for operating partnership units in a REIT. If structured appropriately, such exchanges do not trigger a taxable event for investors participating in the exchange and may permit a continuation of the investor's QOZ tax benefits. However, the likely exit from such exchange would be a public-market listing and thus entail the same portfolio considerations. **An institutional recapitalization** is a potential liquidity strategy for both a diversified Fund and a sector-specific strategy. Still, one must contemplate what kind of portfolio an institutional investor would want to own and why. If they want to own a diversified portfolio, why the QOF with no tax benefits? The institutional investor's considerations would include asset mix, quality, location, and price.

The last issue to highlight relative liquidity timing and optionality is whether investors in the QOZ strategy have similar 10-year time horizons to one another. This is important because no Fund wants to create adverse tax consequences for their investors. Returning capital via asset sales prior to 10 years from admitting the last investor may create a negative tax consequence for investors that have not yet met the required holding period. If a Fund raised its equity capital in a relatively tight timeframe, the first and last investor admitted have a similar time horizon, and the exit strategy becomes easier to manage. Conversely, suppose the Fund has admitted investors over a long duration. In that case, the first and last investor admitted may have a significant delta relative to when they can receive capital back from asset sales while ensuring both are eligible for the most powerful benefit of the QOZ legislation.

Opportunity Zone Funds are great tools, but they are investments first and foremost. The success of the strategy is going to be largely predicated on the merits of the underlying investments, tax benefits aside. Your diligence process should consider first, which strategy provides the superior opportunity for the best risk-adjusted outcome over a long duration based on asset type, location, quality, diversification, exit strategy and other factors. The tax benefits will be additive and potentially incredibly useful, but only if the underlying Fund performs. The considerations articulated herein should be at the forefront of the Fund selection process.

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IMPORTANT RISK FACTORS

An investment in a Qualified Opportunity Zone Fund is subject to various risks, including but not limited to:

- No public market currently exists, and one may never exist, for the interests of any Qualified Opportunity Zone Fund. Qualified Opportunity Zone Funds are not liquid.
- Qualified Opportunity Zone Funds offer and sell interests pursuant to exemptions from the registration provisions of federal and state law and, accordingly, those interests are subject to restrictions on transfer.
- There is no guarantee that the investment objectives of any particular Qualified Opportunity Zone Fund will be achieved.
- Investments in real estate are subject to varying degrees of risk, including, among other things, local conditions such as an oversupply of space or reduced demand for properties, an inability to collect rent, vacancies, inflation and other increases in operating costs, adverse changes in laws and regulations applicable to owners of real estate and changing market demographics.
- The acquisition of interests in a Qualified Opportunity Zone Fund may not qualify under Section 1031 of the Internal Revenue Code of 1986, as amended (the "Code") for tax-deferred exchange treatment.
- The actual amount and timing of distributions paid by a Qualified Opportunity Zone Fund is not guaranteed and may vary. There is no guarantee that investors will receive distributions or a return of their capital.
- Qualified Opportunity Zone Funds depend on tenants for their revenue and may suffer adverse consequences as a result of any financial difficulties, bankruptcy or insolvency of their tenants.
- Disruptions in the financial markets and challenging economic conditions could adversely affect a Qualified Opportunity Zone Fund.
- Qualified Opportunity Zone Tax Benefits may not be available under state law and some states may impose their own requirements to qualify for the equivalent of the Qualified Opportunity Zone Tax Benefits under state law.

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