Q: Why are investors looking to qualified opportunity funds for US real estate investment opportunities?

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A: The Opportunity Zone (OZ) programme offers investors significant tax incentives to invest in economically distressed areas within the US and its territories.

Investors can defer federal income tax on their gains by rolling over capital gains into vehicles known as qualified opportunity funds (QOFs). A portion of such gains can be permanently excluded from tax and the future appreciation in the value of a QOF can potentially escape US federal income tax altogether.

This new investment regime is intended to tap into an estimated $6tn in unrealised capital gains and government officials expect it to generate $100bn in private capital targeting opportunities in these areas.

Investments eligible for preferential treatment under the OZ programme are investments made in QOFs which must, through the activities they conduct or investments they make, have a substantial geographic and economic nexus with designated opportunity zones.

OZs are geographical areas that have been certified by the US secretary of the Treasury as qualifying low-income communities. Over 8,700 communities in all 50 states, the District of Columbia, and five US territories have been designated as OZs.

The OZ programme offers the following tax benefits for those investing in QOFs:

- A temporary tax deferral for certain capital gains from the sale or exchange of property that are reinvested in a QOF within 180 days.
- The elimination of tax on 10% or 15% of deferred gains for taxpayers who hold interests in a QOF for at least five or seven years.
- The exclusion of tax on gains from the disposition of interests in a QOF held for at least 10 years – meaning no US federal income tax will be owed with respect to appreciation in the value of a QOF investment.

Structure and benefits

QOFs may be corporations, partnerships or limited liability companies, and must hold at least 90% of their assets in "qualified opportunity zone property". They need not be structured as typical investment funds and can be thought of as more like holding companies.

A QOF may have multiple investors or a single investor and can hold multiple assets or a single asset. Investors seeking to defer capital gains can use the OZ programme themselves to organise a qualifying entity to hold their rolled-over capital gains, comply with the applicable rules, and make eligible investments directly.

Perhaps the most significant way in which QOFs differ from a traditional investment fund is the requirement that an investor dispose of QOF interests to secure the most meaningful of the available tax incentives – the permanent exclusion from tax of gain following a 10-year hold.

Given this requirement, we anticipate fund sponsors may seek to impose transfer restrictions and drag rights in order to facilitate a group sale of QOF interests.

The OZ programme is well suited to real estate investment. Given the strong geographic focus the potential application of the OZ regime to real estate and real-estate related deals – property development, rehabilitation, infrastructure, renewables, agriculture –is clear.

Significantly, even investors that may enjoy some form of US tax exemption – whether by reason of being a sovereign investor, a qualified foreign pension fund, an ordinary non-US investor, or otherwise – may still benefit.

Many such investors may be sitting on unrealised effectively connected income with a US trade or business, gains that, upon realisation, could be rolled over into a QOF with the result that a portion of such gains can be deferred and permanently excluded from tax.

Many open questions remain. The OZ programme is new, and guidance is lacking in several key areas. Recently proposed regulatory guidance and related administrative guidance are welcome, but much remains to be clarified, especially as the rules relate to cash management, the treatment of debt, the development of raw land, dealing with start-ups and the treatment of businesses with sales or activities that fall outside the geographic boundaries of a designated OZ.

Investors would be well advised to watch this space.