

Using a Qualified Opportunity Fund to Invest in Non-QOZ Property

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Qualified opportunity funds, or QOFs, were designed to serve low-income communities, but they can also own assets that don't serve this purpose. Andrew Gradman, principal at the Law Office of Andrew L. Gradman, shares how to maximize a non-QOZ property.

Qualified opportunity funds, or QOFs, were designed to serve low-income communities. However, they can also own assets that don't serve this purpose. This non-QOZ property is also eligible for the basis step-up at year 10. This article explains how to maximize this kind of property.

Good and Bad Property

In the context of a qualified opportunity zone, or QOZ, all property is either “good” or “bad.” The characterization depends on the property in question—tangible, intangible, or financial—and the entity that owns it.

- For a tangible asset to be good, it must be bought from a non-related party, used in a qualified opportunity zone, and either new or substantially improved. These good tangibles are called QOZ business property, which is good for both QOFs and for their subsidiaries—QOZ businesses, or QOZBs.
- For intangibles to be good, they must be used by a QOZB in a trade or business in a QOZ.
- Financial assets—e.g. entity interests, cash, and debt—are generally bad. However, the following is good:
 1. For QOZBs, “reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less,” which includes property covered by the 31-month working capital safe harbor, plus accounts or notes receivable acquired in the ordinary course of business from services rendered or sale of inventory. In real estate, this is rare.
 2. For QOFs: Interests in subsidiary QOZBs and any property held continuously as cash/cash equivalents/18-month notes, for the first testing period after the property was contributed.

Each year, a QOF calculates the percentage of its property which was good. If this is less than 90%, the fund owes a penalty, as seen in TR 1.1400Z2(a)1(b)(4).

To determine whether a subsidiary is a QOZB and thus is a good asset in a fund's hands:

- Of its tangible property, no more than 30% can be bad.
- Of its intangible property, no more than 60% can be bad.
- Of its total assets, no more than 5% can be bad financial assets.

Owning Bad Tangible Property

Based on these rules, there are two ways a fund can hold “bad” tangible property. First, 10% of the fund can consist of any type of property, without restriction. In addition, if QOZBs comprise the remaining 90% of the fund, then of that amount, 30%—i.e., 27% of total fund assets—can be bad real estate. At the extreme, 37% of total fund assets—i.e., 10% of the QOF and 27% of the remaining 90% at the QOZB level—can be bad real estate.

Assets are valued as follows:

70%/90% Tests. To value tangible property for the 90% investment standard for QOFs and the 70% tangible property standard for QOZBs:

- For leased property, value equals the present value of the future payments under the lease discounted using the short-term applicable federal rate. This is calculated only once, when the lease is entered into, as noted in TR 1.1400Z2(d) 1(b)(4)(iii). Otherwise, value equals unadjusted cost basis, as noted in TR 1.1400Z2(d) 1(b)(4)(ii). And if it has an audited statement based on GAAP or a similar statement, it can instead choose the valuation shown in that statement. See TR 1.475(a) 4(h).
- Taken literally, unadjusted cost basis excludes improvements, as seen in TR 1.1016-2(a). But that makes no sense; the basis of self-constructed property consists of nothing but improvements. Treasury probably meant cost basis plus all capitalized costs, which is the same as adjusted basis without regard to depreciation. For an example, see IRC § 42(d)(4)(D), applying this method for the low-income housing tax credit, or TR 1.168(k)-1(a)(2)(iii) similar definition for unadjusted depreciable basis.

5% Test. For determining whether a QOZB’s bad financial assets are less than 5% of total property, we determine the average of the aggregate unadjusted bases of both classes, as seen in 1.1400Z2(d) 1(d)(3) (iv). Again, I understand the phrase “unadjusted basis” to mean cost basis plus all capitalized costs. For this purpose, GAAP valuation is not an option. For the meaning of “average of,” see BNA Portfolio 585-1st, New Markets Tax Credit.

40% Test. The regs do not say how to value intangibles for the 40% test. See TR 1.1400Z2(d)1(d)(3)(ii)(A). I use “unadjusted basis,” as that is what we use for the 5% test.

QOZBs. Interests in QOZBs held by a fund are valued like tangible property, i.e., unadjusted cost basis, as seen in TR 1.1400Z2(d)-1(b)(4)(ii). Again, this is unclear. I assume this also includes amounts contributed, even though this is not a cost, strictly speaking, as seen in IRC §§ 1011(a) and 1012(a). Also, I assume cost is not increased by debt, nor reduced by contributions.

Summary: How to Calculate Max Amount of Bad Real Property

With this in mind, here is how you calculate the theoretical maximum amount of “bad” real property that can be owned.

- First, for each QOZB, determine how it will value its property for the year—generally, cost basis plus all capitalized costs—and value all its tangible property which qualifies as QOZBP.
- Second, solve for three-sevenths of that amount. This tells you how much “bad” tangible property it can own.
- Third, choose an interval for the 5% test—e.g. daily, monthly, annual—and determine the average cost basis plus all capitalized costs of all the QOZB’s assets.
- Fourth, solve for one-nineteenth of that amount; this tells you how much cash or securities the QOZB can own. For example, cash etc. will equal 5% of total property.
- Fifth, as to all QOZB entity interests in the fund’s hands, determine cost plus amounts contributed.
- Sixth, solve for one-ninth of that amount. This tells you how much other bad property the fund can own.
- Seventh, decide how much cash each entity will need for reasonable working capital, cash reserves, tenant deposits, etc.
- Eighth, determine whether this cash can be held entirely at the QOZB level—i.e., under the 5% test. If yes, the QOF can devote a full 10% of its balance sheet to bad real property. If no, it must devote part of this 10% to working capital.

Caution: Don’t Push the Limit

Don’t try this unless you know what you’re doing. A few things can go wrong:

- Your projections might be off. You might underestimate the costs charged by vendors or wrongly capitalize a cost.
- Assuming you value property using GAAP, its value may fluctuate after you complete construction, causing you to fail the 90% test in the future.
- These fluctuations are less likely if property is valued at cost basis plus improvements. However, if property needs unexpected improvements, this could also push you over the line.
- QOZBs cannot own partnership interests.
- The QOF’s 10% margin was intended as a cushion for working capital, cash reserves, deposits, etc. If you allocate this to other property, you might face a cash crunch.

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