How to Avoid Securities Pitfalls in the Opportunity Zone Program

By Maureen B. Gershanik

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The Qualified Opportunity Zone (QOZ) program is a new win-win investment opportunity poised to benefit economically distressed communities while enabling taxpayers to defer tax on capital gains. The program has the potential to become one of the most significant economic development programs in US history. More than 8,700 census tracts across the country have now been designated as QOZs, including tracts in the District of Columbia and five US territories.

Households and businesses throughout the United States hold several trillion dollars' worth of unrealized capital gains that could be invested in QOZs. Jennifer Pryce, *There's a $6 Trillion Opportunity in Opportunity Zones; Here's What We Need to Do to Make Good on It*, Forbes (Aug. 14, 2018), https://bit.ly/2lLdMv8. When weighing the benefits against other investment options, participants need to know that the program involves issuing securities that are subject to federal and state securities laws. Failure to comply with those laws can trigger enforcement actions and private lawsuits against the QOZ participants, including sponsors, promoters, developers, and others.

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QOZ Investments Involve Securities

Under the program, taxpayers can temporarily defer capital gains taxes on some or all of the proceeds of a sale of any type of asset to the extent that they invest such proceeds in a Qualified Opportunity Fund (QOF). IRC § 1400Z-2; Prop. Treas. Reg. § 1.1400Z2(b)-1. Those investments are made in exchange for the QOF's equity interests, which in most cases are likely to be securities. (Interests in QOFs structured as general partnerships or LLCs in which all partners or members are actively involved in the management of the fund may not constitute "securities" under federal law.) The QOF, in turn, invests in QOZ projects, which are also likely to involve equity interests in LLCs or limited partnerships purchased by the QOF. Any taxpayer, including individuals and entities such as partnerships, C corporations, S corporations, trusts, and estates, can invest in the program.

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Investors Weigh Tax Benefits

QOFs provide capital gains deferral and forgiveness benefits to their investors by either operating a qualified QOZ business or doing so through a subsidiary. Qualifying businesses include real estate and most types of operating businesses. Investors can defer their capital gains on their original asset sale until the earlier of the date on which they sell their QOF investment or December 31, 2026. IRC § 1400Z-2(b)(1); Prop. Treas. Reg. § 1.1400Z2(b)-1(b). Investors who hold their investment for five years or more will receive a step-up in their tax basis by 10 percent, and investors who hold for seven or more years will received a step-up by 15 percent instead. IRC § 1400Z-2(b)(2)(B). After 10 years, capital gains tax on any new net gain in the value of the QOZ investment will be forgiven. IRC § 1400Z-2(c); Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(1)(i).

States Consider Additional Incentives

In addition to federal incentives, taxpayers in states whose state income tax structures conform to the federal QOZ tax provisions may be able to defer and reduce their state capital gains taxes. States are also considering offering additional incentives for projects located in QOZs. Missouri was the first state to pass QOZ-specific legislation, setting aside a pool of $30 million from its historic preservation tax credit program for projects located in QOZs. Mo. Rev. Stat. § 143.091; see also Toby Rittner, Katie Kramer and Tim Fisher, *CDFA Opportunity Zones Report—State of the States,* Council of Development Finance Agencies (Aug. 2018), https://bit.ly/2MszBt6. A number of other states have followed by enacting state tax incentives tied to investments in QOZs. See, e.g., Ark. Code §26-51-460; Md. Code Ann., Econ. Devel. § 6-1001 et. seq.; 2019 Conn. Acts no. 19-54; 44 R.I. Gen. Laws §§ 44-11-11(e), 44-30-12 (c)(10).

Key Securities Considerations

As more investors eye lucrative investment opportunities in QOZs, the SEC and state regulators will be monitoring securities activities associated with the program. Indeed, on July 15, 2019, the staffs of the SEC and the association of state securities regulators issued a statement addressing the federal and state securities laws that may affect the QOZ program. Staffs of the SEC and NASAA, *Staff Statement on Opportunity Zones: Federal and State Securities Law Considerations*, https://bit.ly/2kK8mQP. At the federal level, compliance with the following four areas will help avoid costly violations that could delay or even prevent a transaction.

Securities Offering Regulation

Offerings of QOF interests that are securities must be either registered with the SEC or exempt from registration. 15 U.S.C. § 77e. Most QOFs will likely offer their securities under an exemption provided by Rule 506 of SEC Regulation D for "private placements," which are transactions not involving a "public offering." 17 C.F.R. § 230.506. The Rule 506(b) exemption prohibits the issuer from finding investors through a "general solicitation" or advertising. From an SEC viewpoint, this means issuers may offer securities only to investors with whom they have a prior, substantive business relationship.

QOFs can also reduce regulatory cost and risk by selling fund interests only to "accredited investors" who have investment savvy and experience. See SEC Rule 502(b)(1); 17 C.F.R. § 230.502(b)(1) (providing that the issuer is not required to provide written disclosures to accredited investors). An "accredited investor" is an individual with:

- a net worth over $1 million, not including the value of the individual's residence; or
- annual income exceeding $200,000 (or $300,000 with a spouse) for the preceding two years and an expectation of earning the same income for the current year.

17 C.F.R. § 230.501(a)(5), (6).

Although QOFs are not always required to give investors a written disclosure document, they should be prepared to respond to investor requests for a prospectus. QOFs may want to voluntarily disclose the most significant risks of the investment along with appropriate legal disclaimers. It is also important to remember that any oral or written disclosure to investors, even if not required by law or SEC rules, will be subject to fraud laws. QOFs should ensure that those disclosures do not contain material misstatements or omissions (essentially, falsehoods or half-truths).

Broker-Dealer Regulation

Investors, QOFs, or developers may need the help of an intermediary to find investors or investments and negotiate QOZ transactions. Only licensed securities brokers may perform these services. Anyone considered a broker must first register with the SEC, applicable state securities regulators, and a self-regulatory organization like FINRA. Using an unregistered broker in a transaction can have serious consequences, such as entitling investors to rescind their investment. 15 U.S.C. § 78cc(b).

The SEC views the receipt of transaction-based compensation, like a commission or success fee, as the hallmark of broker activity. Although many people think they are not acting as a broker if they are a mere "finder" of investors, it is rare for the SEC to conclude that a finder is not required to register as a broker, especially if the finder receives transaction-based compensation.

Investment Adviser Regulation

A QOF with passive investors is a pooled investment vehicle like a hedge fund or other private fund. Investors contribute capital to the fund, and the fund's general partner or manager analyzes and selects the fund's securities investments, in exchange for a fee. Any person who receives compensation for these services may need to register as an investment adviser with the SEC or state securities regulators. A general partner or manager of a QOF could be considered an investment adviser if it:

- advises the QOF about securities in QOZ projects (for example, equity interests in businesses that are QOZ properties), or
- has the discretion to make investments in securities.

15 U.S.C. § 80b-2(a)(11); see also *Abrahamson v. Flescher*, 568 F.2d 862, 871 (2d Cir. 1977), cert. denied, 436 U.S. 913 (1978);

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related representations and covenants of investors in its LLC or partnership agreement.

In addition, section 3(c)(5)(C) of the act provides that, generally, an issuer will not be an investment company if it is not engaged in the business of issuing redeemable securities and if, among other things, it is primarily engaged in acquiring mortgages or other liens on, and interests in, real estate. QOZ participants should note, however, that the 3(c)(5)(C) exclusion may not apply when the QOF's assets are primarily securities of one or more other issuers that are engaged in the real estate business.

Suitability of Investment Advice Provided by Investment Advisers, Advisers Act Rel. No. 1406 (Mar. 16, 1994) at n.12.

Any economic benefit will be considered "compensation," whether in the form of a cash advisory fee, a carried interest, a commission, other equity participation, or a combination of the above. Anyone providing these advisory services to a QOF for a fee should consult a securities lawyer about the need to register or qualify for an exemption from registration.

The SEC has indicated that certain professionals and brokers may qualify for an exclusion from the definition of "investment adviser" if they are:

- lawyers, accountants, engineers, or teachers whose advisory services are "incidental" to their profession, or
- brokers or dealers whose advisory services are incidental to their business and who do not receive special compensation for their advice.

See 15 U.S.C. § 80b-2(a)(11)(B), (C); *Applicability of the Advisers Act of 1940 to Financial Planners, Pension Consultants, and Other Persons Who Provide Others with Investment Advice as a Component of Other Financial Services*, Advisers Act Rel. No. 1092, Oct. 8, 1987.

Investment Company Act Regulation

If a QOF is structured properly from the outset, it will avoid having to register with the SEC as an investment company. Generally, an "investment company" is a company that is engaged primarily in the business of investing, reinvesting, or trading in securities. 15 U.S.C. § 80a-3(a)(1). A QOF is likely to meet the definition of an investment company because it will regularly purchase equity interests in businesses that are considered QOZ property or equity interests in other entities that purchase QOZ property.

Fortunately, the Investment Company Act of 1940 provides private funds exclusions to help QOFs avoid falling under the definition of an investment company. Section 3(c)(1) states that any fund that does not make a public offering of its interests, and whose outstanding securities are beneficially owned by no more than 100 persons, is not an investment company. Id. § 80a-3(c)(1). A fund that offers its equity interests through a private placement exemption, discussed above, meets the "no public offering" requirement. Even though the 100-owner limit sounds simple, the SEC's rules may require that a fund look through investor entities to count the individual owners of the entity toward the limit.

The Investment Company Act also provides that funds issuing their securities privately only to "qualified purchasers" (a 3(c)(7) fund) are not investment companies. Id. § 80a-3(c)(7). Qualified purchasers include individuals who own $5 million or more of investments. Id. § 80a-2(a)(51). Different tests apply to entity investors.

A QOF should include a questionnaire for investors in its subscription agreements to ensure that it is a 3(c)(1) or 3(c)(7) fund. The QOF should also include

Looking Ahead

At this point, commercial, residential (including affordable housing), mixed-use, and industrial developments are the primary beneficiaries of the QOZ program. However, established and start-up businesses in the energy, transportation, agriculture, and manufacturing sectors should be looking closely at the opportunities arising as QOZ infrastructures expand. The QOZ program's flexible structure means that the program can be layered with other economic and community development initiatives, including disaster recovery and other HUD programs, workforce development programs, small-business lending, tax increment financing districts, brownfield redevelopment, and private activity and industrial development bonds. The tax incentives available under the QOZ program can also be used in conjunction with tax credit programs, including low-income housing tax credits, new markets tax credits, state job tax credits, and state and federal historic rehabilitation tax credits.

As communities, developers and investors navigate the QOZ program, the potential to make a measurable impact on those communities will grow. Understanding the securities laws and regulations that apply to QOZ transactions, and taking precautions to avoid costly and time-consuming mistakes, are paramount to the program's success. ■

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