Opportunity Zones

Unlock new opportunities
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Qualified Opportunity Zones (QOZs) have attracted significant attention as a potential major source of untapped capital to revitalize underserved communities and as an outlet for investors to preserve capital gains by unlocking substantial tax incentives, while potentially generating additional investment yields.

Enacted as part of the 2017 Tax Cuts and Jobs Act,¹ the Opportunity Zones (OZones) program was established to encourage social advancement and private investment in low-income communities to aid job creation and new business formation. The program incentivizes investment by allowing for the deferral of capital gains, reducing tax obligations on a portion of those gains and, most notably, allowing QOZ investments to grow tax-free.

To qualify for the tax benefits, capital gains must be reinvested in a Qualified Opportunity Fund (QOF) within 180 days of the sale or exchange of almost any asset. The QOF must in turn make investments in a business or property located within a QOZ that has been designated by the U.S. Department of Treasury (Treasury). There are thousands of QOZs nationwide, in both urban and rural areas.

There are three noteworthy potential tax benefits:

— Deferral of gains until as late as December 31, 2026
— A 10 to 15 percent reduction on the gains for five- to seven-year holding periods
— No gains generated on a sale or exchange of a QOF investment after it is held for 10 years.

This program holds appeal for a broad array of taxable investors, including:

— Corporations
— Partnerships
— Family offices
— High-net-worth individuals
— Foreign investors with U.S. holdings.

Although a number of asset managers have already begun raising capital and closing deals, critical uncertainties in the first set of rules left substantial capital anxiously awaiting further guidance. On October 19, 2018, Treasury and the Internal Revenue Service (IRS) issued proposed regulations,² most of which can be relied upon immediately. Overall, the proposed rules promote versatility and have provided much needed clarity required by investors seeking to deploy capital into QOZs.

¹ Section 1400Z, H. R. 1-115th Congress (2017 – 2018)
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**Senior Lead Partner, Tax**  
**Qualified Opportunity Zone Business Lead**

Joe is KPMG’s U.S. Tax Leader in the Publicly Traded Partnerships and Master Limited Partnerships practice and KPMG’s U.S. tax co-leader in the Umbrella Partnership Corporations practice. Joe has provided tax advisory, structuring, modeling, and reporting services to investment management entities, including funds, limited partnerships, regulated investment companies, business development companies, small business investment companies, registered investment advisers, and portfolio companies. He has extensive experience with real estate investment trusts, corporate joint ventures, and closely held business organizations.

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**National Audit Leader, U.S. Building, Construction & Real Estate**  
**National Real Estate Funds Leader**

An audit partner based in New York, Phil has more than 30 years in the real estate sector. Phil has a wide range of experience in providing audit, accounting, due diligence, and advisory services to real estate, finance, parking, construction, and hospitality clients. His experience covers a wide range of client types, including public companies; owners, developers, managers, and tenants of office, retail, and residential properties; real estate opportunity funds; real estate investment trusts; private equity; government agencies; not-for-profit enterprises; lenders; syndicators; foreign investors; real estate advisers; asset managers; and construction companies. He is also a member of KPMG’s U.S. Asset Management Leadership team and the New York Financial Services Leadership team.

Richard Blumenreich  
**Principal in Charge, TCEAS, Washington National Tax**

A principal in KPMG’s Washington National Tax practice, Richard focuses on federal taxation involving partnerships, real estate, depreciation, tax credits, and amortization of intangibles and leasing. Prior to joining KPMG in 1993, Richard was in the Internal Revenue Service’s (IRS) Office of Chief Counsel where he was an assistant branch chief in the Office of the Assistant Chief Counsel and an attorney-advisor in the Legislation and Regulations Division. While at the IRS, Richard worked extensively on regulations and rulings regarding the taxation of partnerships, subchapter S corporations, depreciation, tax credits, and trusts and estates. He was Chair of the Committee on Capital Recovery and Leasing of the American Bar Association from 2004-2006 and is a member of District of Columbia Bar Association.
Do well, do good

When the Tax Cuts and Jobs Act was signed into law on December 22, 2017, there was much fanfare over features such as the new lower corporate tax rate, changes to the taxation of multinationals, and the elimination of the corporate alternative minimum tax, to name a few. But one provision, which garnered only limited attention initially, may ultimately deliver the most intriguing combination of financial and social benefits.

The OZones program offers substantial tax incentives in the form of gain deferral and exclusion for investing those gains in distressed communities across the nation, known as QOZs. The brainchild of Senators Tim Scott (R-SC), Cory Booker (D-NJ) and the Economic Innovation Group (EIG), a Washington, D.C. based public policy organization, the program encourages investors, in EIG founder Sean Parker’s words, “to put money into places where they wouldn’t normally invest.”

In fact, Treasury Secretary Steven Mnuchin went on record during late 2018 indicating his expectation that QOZs may see more than $100 billion in capital.

It’s the logical progression of mission and impact investing, where both social and economic opportunities are clear and compelling. According to EIG, between U.S. households and corporations, there were more than $6 trillion in unrealized capital gains at the end of 2017 all conceivably eligible for this program. If even a fraction of that total comes into the program, the community development benefits and tax relief could be staggering. Corporations may be particularly interested in this program to address environmental, social, and governance (ESG) objectives.

Consider this report your introduction to the OZones program. It is designed to provide investors—both corporate and individual—as well as real estate developers and businesses with an understanding of the motivation behind and functional details around this new, tax-advantaged asset class, which Senator Booker has called a “domestic emerging market.”

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3 Forbes, “An unlikely group of billionaires and politicians has created the most unbelievable tax break ever,” July 18, 2018.
6 Forbes, “An unlikely group of billionaires and politicians has created the most unbelievable tax break ever,” July 18, 2018.
What is a Qualified Opportunity Zone?

In March 2018, the heads of every U.S. state, territory, and Washington, D.C. were asked to identify 25 percent of their low-income population census tracts (which include a small percentage of tracts contiguous to low-income census tracts) to be nominated as Qualified Opportunity Zones or QOZs for purposes of applying a federal tax incentive. On June 14, more than 8,700 census tracts were certified by Treasury Secretary Mnuchin.

In general, the intent was to improve struggling communities, spur investment in new business and create job growth. Many governors, however, had a unique developmental focus for their opportunity zones, covering such themes as:

— Revitalization of blighted areas
— Affordable housing
— Research facilities
— University growth and student housing
— Hospitals and medical facilities
— Military base restoration
— Maximization of opportunities near existing transit hubs
— Social infrastructure and logistics.

Demographics

Of the certified QOZs, nearly 40 percent are in rural areas, approximately 38 percent are more urban and approximately 22 percent are suburban, as measured by population density.

Nearly 70 percent of the residents in QOZs live in “severely distressed” census tracts, which is defined by the Treasury Department’s Community Development Financial Institutions Fund as areas with poverty rates of at least 30 percent.

— A small, relatively permanent statistical subdivision of a county. Census tracts average about 4,000 inhabitants.
— National Geographic: Population density refers to the number of individuals occupying an area in relation to the size of that area.
The potential tax benefits of Qualified Opportunity Funds

Investors with taxable gains from the sale or exchange of virtually any type of property (e.g., stocks, real estate, art) may potentially defer the gain by reinvesting the proceeds in a QOF within 180 days of the sale or exchange. Initially, the tax basis of the QOF investment is zero. Incrementally, the OZones program provides a step-up in basis for reinvested gains and permanent exclusion of gains generated by the QOF if the investment is held for the required holding period.

The OZones program offers investors several potential benefits that can be realized over the course of a QOF investment period.

<table>
<thead>
<tr>
<th>Benefit 1</th>
<th>Benefit 2</th>
<th>Benefit 3</th>
<th>Benefit 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Temporary deferral of gain by investing in a QOF until the earlier of the disposition of the investment or December 31, 2026.</td>
<td>Step-up in investment of the gain. Ten percent of the gain may be excluded permanently if the investment is held for five years. An incremental 5 percent (total of 15 percent) may be excluded if held for seven years. Both holding periods are through December 31, 2026.</td>
<td>The entire gain from sale of the “interest in” the QOF may be permanently excluded if the investment is held for at least 10 years. The exclusion of this gain relates only to the value increase in the investment in the QOF.</td>
<td>Various state and local project incentives and support may also provide added value that could offset as much as 10 to 15 percent of project costs.</td>
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The investment: Qualified Opportunity Funds

Through the OZones program, investors can defer realized gains by reinvesting those gains in a QOF. For example, say an investor sells Company X stock for $110, for which she only paid $10. She can take the entire $100 capital gain and invest it in a QOF.

QOFs can make investments in almost any type of business, including commercial and industrial real estate, housing, infrastructure, and existing or start-up businesses. The QOF can be designed to hold single or multiple assets; although, additional guidance from Treasury is needed on questions such as whether cycling through assets in a multi-asset QOF during the 10-year hold period impacts qualification and the ability to achieve the tax benefits of the program.

Qualification

A QOF may be organized as a corporation or partnership and must hold at least 90 percent of its assets in qualified opportunity zone property (QOZ property). Investments of deferred capital gains in a QOF are required to be made within 180 days.

Under the proposed regulations, an eligible interest in a QOF includes preferred stock and a partnership interest with special allocations. Accordingly, it appears that a partner may receive the full benefits of a gain deferral election with respect to its partnership interest even if its share of the appreciation in partnership assets does not match its proportionate share of partnership capital.

An investment vehicle can become a QOF through a self-certification process that requires completing a form to be attached to a timely filed federal tax return. No approval or action is required by the IRS, but compliance with the 90 percent requirement and other criteria is critical and begins with an understanding of the key provisions and terminology of the OZones program.

QOZ property

QOZ Property includes QOZ stock, partnership interests, and business property. QOZ stock and partnership interests must be acquired from the corporation or partnership after 2017, solely in exchange for cash.

— QOZ stock and partnership interests must be of a U.S. corporation or partnership that is a QOZ business.

— QOZ business property must be purchased by the QOF from an unrelated party (no more than 20 percent overlapping ownership) after 2017, the original use of which begins with the QOF, or the QOF must substantially improve such property used in a trade or business of a QOF. During all of the QOF holding period for such property, substantially all of the use of such property needs to be in a QOZ.

According to proposed regulations, a property is substantially improved by a QOF only if, during any 30-month period beginning after the date of acquisition of such property, additions to the basis of the building exceed an amount equal to the adjusted basis of the building at the beginning of the 30-month period. The cost of the land is not included in the adjusted basis of the building for this purpose and the QOF is not separately required to substantially improve the land.

QOZ business

A QOZ business is a trade or business in which substantially all of the tangible property owned or leased by the business is in a QOZ. “Substantially all” is defined by the proposed regulations as at least 70 percent. Additionally, a QOZ business must comply with certain stipulations, which include:

— At least 50 percent of the business’s total gross income is derived from the active conduct of such trade or business in a QOZ

— A substantial portion of the business’s intangible property is used in the active conduct of such trade or business in a QOZ

— Less than 5 percent of the average of the aggregate unadjusted basis of the business’s property is attributable to nonqualified financial property

— The business is not a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.
The proposed regulations include a reasonable working capital safe harbor for a QOZ business that acquires, constructs, or rehabilitates tangible business property, which includes both real property and other tangible property used in a business operating in a QOZ. The safe harbor allows cash reserves to be treated as reasonable working capital held by the QOZ business for a period of up to 31 months.

In addition, if the working capital safe harbor is satisfied, the QOZ business may:

— Treat gross income from such working capital as gross income satisfying the 50 percent gross income test
— Treat the use requirement for intangible property as satisfied during the period the working capital safe harbor is in effect and
— Treat the property to which the working capital will be expended as not failing the requirements to be QOZ business property during the expenditure period.

Gains that may be deferred and types of investors

The proposed regulations clarify that all capital gains are eligible for deferral. As such, short-term and long-term capital gains qualify.

Investments in QOFs may consist of both deferred gains and other cash. Only the portion of the QOF investment that is made up of deferred gains is eligible for the tax benefits associated with the OZones program but all capital invested by the QOF is subject to applicable rules, such as substantial improvement requirements.

Proposed regulations also clarify that any taxpayer that recognizes capital gains for federal income tax purposes is eligible to participate. This includes partnerships and certain other pass-through entities.

To the extent that a partnership does not elect to defer all or a part of its eligible gain, its partners may make their own gain deferral election with respect to their distributive share of such eligible gain. The partners’ 180-day period generally begins on the last day of the partnership’s taxable year; although, partners may choose to begin their 180-day period on the same date as the start of the partnership.

In instances where a deferred gain is realized by a partnership and a deferral election is made by its partners, the 180-day period is effectively extended. Given the optionality relating to the deferral, proper consideration should be given to which level the election should be made. For example, if a partner is related to the buyer of the property that generated the partnership’s eligible gain, then the partner may not be able to make an election even though the partnership could.

Under the proposed regulations, status as an eligible interest is not impaired by a taxpayer’s use of the interest as collateral for a loan. QOFs can receive initial equity contributions and employ debt to fund the remaining portion of the construction and other costs. Additional equity contributions of eligible gains over time could be used to repay all or a portion of that debt, provided the other QOF requirements are met.

The extent of the tax benefits from Qualified Opportunity Zones can be tremendous. Some of the modeling we have completed has shown that investors can get between a 300 to 500 percent basis point improvement on their internal rate of return as a result of investing in these opportunity funds.

Richard Blumenreich
Principal in Charge, TCEAS
Washington National Tax
KPMG LLP
How QOZ investing works in the real world

Let’s look at a hypothetical example. The timeline below illustrates an investor’s potential tax benefit over the course of 5-, 7-, and 10-year holding periods. The model assumes a capital gains tax rate for corporations of 21 percent, but does not include net investment income tax.

One important detail to keep in mind in relation to QOZ investing: the tax incentives depend heavily on timing. To achieve the maximum potential tax benefit, investments of capital gains into QOFs must be made by December 31, 2019.

TRIGGER EVENT
Sale of original assets

ACTION TAKEN
Investment of capital gain into QOF

REMINDER
Act fast!
Invest in QOF by 2019 in order to capture the maximum basis step-up benefit

MILESTONE
Deferred gain recognized

MILESTONE
7-year basis step-up

MILESTONE
5-year basis step-up

MILESTONE and TRIGGER EVENT
10-year exclusion and QOF investment sale

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**Bringing the tax benefits to life**

For this example, in 2006 Company A invests $10 million in Company B, an internet start-up. In 2018, Company A sells its interest in Company B for $110 million. Under the OZones program, Company A can defer its $100 million capital gain until December 31, 2026 by investing in QOF X, which invests in a QOZ in Newark, New Jersey. If Company A holds its interest in QOF X for at least five years, on December 31, 2026, it would only be taxed on 90 percent of its original gain from the Company B investment (for a seven-year hold it would only be taxed on 85 percent of the original gain). In 2029, Company A sells its investment in QOF X for $220 million. Under the OZones program, Company A pays no federal tax on the gain from the sale of QOF X.

**Example of tax benefits**

<table>
<thead>
<tr>
<th>Hold period</th>
<th>Tax savings</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Original Investment</strong>*</td>
<td></td>
</tr>
<tr>
<td>5 years</td>
<td>$2.10 million</td>
</tr>
<tr>
<td>7 years</td>
<td>$1.05 million</td>
</tr>
<tr>
<td><strong>New QOZ Investment</strong></td>
<td></td>
</tr>
<tr>
<td>10 years</td>
<td>$25.20 million</td>
</tr>
<tr>
<td>Total tax savings</td>
<td>$28.35 million</td>
</tr>
</tbody>
</table>

*Additionally, tax on the $100M capital gain generated on the original investment will be temporarily deferred until December 31, 2026.

Three things set this program apart: First, unlike other government programs, OZones don’t have any job requirements. That allows real estate, which generally doesn’t have many employees, to be able to utilize this program. Next, the self-certification process makes it easy to set up a QOF. It can be a captive fund where you rollover your own gains—it doesn’t have to be for third-party investors. Finally, in addition to the federal incentives, we’re now seeing many states starting to add to these benefits, whether it’s conformity with all of the exclusions and benefits or even the state of Ohio saying they will be issuing tax credits for investments in QOFs.

Joe Scalio  
Senior Lead Partner, Tax  
KPMG LLP
Qualified Opportunity Fund structuring

From an investment perspective, the OZones program is inherently flexible. Investors can arrange a single-tier structure, in which a QOF holds QOZ business property directly. Alternatively, a two-tier structure can be used, in which a QOF holds an interest in a partnership or corporation (e.g., a joint venture). The joint venture entity holds the QOZ business property as part of a QOZ business.

The use of joint ventures is similar to the type of structuring employed by private equity funds and offers more flexibility than the single-tier structure. It enables investors to pool resources and invest in multiple projects, facilitating portfolio diversification and the dispersion of risk for individual investors.

The proposed regulations on the working capital safe harbor and the extension of the QOZ designation to 2047 provide for additional versatility in structuring QOFs. Further, although a QOF cannot invest in another QOF, current regulations do not prohibit a QOF from investing in other partnerships or corporations (i.e., QOZ businesses). As such, an investment manager may consider exploring structures which allow investors to invest directly into the manager’s lower-tier QOZ businesses.

Example of a QOF organizational structure—partnership interest

Step 1: Company A sells property for a gain.
Step 2: Company A forms QOF, LP.
Step 3: QOF, LP is self-certified.
Step 4: Within 180 days of sale, Company A invests cash equal to the gain into the QOF.
Step 5: The QOF contributes the cash to JV QOZ Partnership, which is operating a QOZ business.
Where are the QOZs?

In total, there are more than 8,700 qualified census tracts across all states, U.S. territories, and the District of Columbia. The selected tracts encompass areas with clear need, as well as locations with the capacity to incentivize private capital and absorb new investment. A complete list of designated QOZs and maps can be found on the Opportunity Zones Resources page on the U.S. Department of Treasury CDFI Fund website (www.cdfifund.gov/Pages/Opportunity-Zones.aspx).

Becoming familiar with the certified census tracts is the first step in identifying potential investments. The wide geographical range and attributes of QOZs offer a variety of investment opportunities, from affordable and senior housing to single and multi-family rentals, medical facilities, data centers, restaurants, warehouses, manufacturing facilities and more.

U.S. QOZs

### QOZ investments in relation to other tax credits and incentives

#### Like-kind exchanges

The like-kind exchange (LKE) provisions of section 1031 of the tax code have offered opportunities to defer taxation of gains on the sale or exchange of real estate. The OZones program provides new options for tax planning which, in many respects, is less restrictive than like-kind exchanges and offers potentially more beneficial tax incentives.

<table>
<thead>
<tr>
<th>Gains from deferred LKE</th>
<th>QOZ deferred gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>All proceeds from the original sale must be reinvested within 180 days of the sale.</td>
<td>Any gains elected to be deferred must be reinvested in a QOF within 180 days of the sale or exchange of the asset.</td>
</tr>
<tr>
<td>Deferred gain is recognized upon taxable sale of the new property.</td>
<td>The deferred gain is recognized upon the earlier of the sale or exchange of QOF interest or December 31, 2026. (Deferred gain may be reduced to the extent that fair market value of the investment is less than the deferred gain).</td>
</tr>
<tr>
<td>Basis in the new property is equal to the basis in the original property exchanged (assuming no additional amounts beyond sale proceeds).</td>
<td>Initial basis in the QOF investment is zero.</td>
</tr>
<tr>
<td>Future LKEs may be applied.</td>
<td>No future gain deferrals are allowed after the first deferred election.</td>
</tr>
<tr>
<td>Domestic LKE property may be located anywhere in the U.S.</td>
<td>QOZ property must be located in a designated QOZ.</td>
</tr>
<tr>
<td>There is no basis step-up or gain reduction as a result of holding the new property for a period of time.</td>
<td>A basis step-up of 10 percent occurs if the interest in the QOF is held for at least 5 years and another 5 percent if the interest in the QOF is held for at least 7 years. After 10 years, the basis in the QOF is equal to the FMV when sold exchanged. (Holding periods are through December 31, 2026.)</td>
</tr>
<tr>
<td>Generally, exchanges may occur between related parties (subject to anti-abuse rules).</td>
<td>Only the gain on the sale or exchange with an unrelated person are qualifying gains.</td>
</tr>
<tr>
<td>Under the Tax Act, section 1031 only applies to real property exchanges.</td>
<td>Qualified gains are gains from any property held by the taxpayer.</td>
</tr>
</tbody>
</table>
New markets tax credit (NMTC)
Most QOZs share the same geographic footprint as NMTC census tracts. Businesses that are qualified NMTC businesses also share many similar characteristics with QOZ businesses, which enhances the potential for twinning the NMTC and OZones program. While the NMTC credit period is seven years, investors may want to remain in such a transaction to take advantage of additional gain deferral and possible gain exemption the OZones program offers.

Low-income housing tax credit (LIHTC)
QOZ property can include both commercial and residential real property. Consequently, QOF investments in affordable housing could also provide LIHTC credits.

The LIHTC 10-year credit period and 15-year compliance period align with the QOF long-term investment period. The gain deferral and potential exclusion for QOF investments could lessen exit taxes for LIHTC investors as well as increase yields.

Our team has been focused on finding ways to invest in underserved neighborhoods since 2001. Following the creation of QOZs, we’ve seen heightened interest from investors and developers who are actively seeking quality projects in QOZs. Given the OZones program is not capped, unlike LIHTCs and tax exempt bonds, it has the potential to reach more areas and support more projects. As long-term investors in these neighborhoods, we are excited to see how this potential and subsequent increase in interest can lead to wider-spread, deeper impacts that chip away at long-standing challenges through appropriately risk-managed investments.

Michael Lohr
Vice President, Urban Investment Group
Goldman Sachs
We are in the early days of a unique opportunity

As a competitive real estate market in both gateway and secondary markets has triggered investor concerns over pricing and valuation, along with other concerns such as deal flow and future performance, attractive selling opportunities have surfaced. In the public capital markets, there is a belief among some investors that the market is in the late stages of its economic cycle and the bullish run could soon turn. In both instances, sell-offs may trigger large taxable gains, which may be eligible for the OZones program.

Savvy investors may be able to capitalize on the prevailing real estate trends in certain QOZs across the country to generate alpha. For example, the infrastructure present in several of the larger metropolitan areas may enable developers to take advantage of an existing network of industrial and transportation facilities and explore pursuing a variety of mixed-use projects—such as the Wharf in Washington, DC and City Point in Brooklyn, New York which have driven economic productivity and met pent-up demand for walkable development.

The recently issued proposed regulations have provided asset managers with some of the clarifications needed to begin setting up their funds. Despite certain questions remaining unanswered, QOZs will likely see capital pipelines open and also realize an immediate increase in demand. While we are in the early days, we expect QOFs to ramp up and continue to unlock new opportunities at an extraordinary pace in 2019.

A summary of the guidance and KPMG observations as to how the rules may be applied in forming and investing in QOFs has been issued in a separate publication titled, KPMG Report: New rules for Opportunity Zones.

In very efficient markets, like prime neighborhoods in most of the major metropolitan areas across the country, pricing is so accurate that it’s hard to find good deals. The places where there are opportunities to do well is in the communities where the institutional money simply has not gone. And that tends to be these qualified opportunity zones. In this instance, you can take these opportunities and turn them into investments that make very healthy returns and contribute to the community. For that reason, the OZones program is a very important piece of federal policy. It is going to create a lot of interest in neighborhoods that, at least in the past, capital has overlooked.

Seth Pinsky
Executive Vice President
RXR Realty
How KPMG can help

KPMG advises owners, managers, developers, businesses, lenders, intermediaries, construction and engineering firms, and investors in the effective execution of complex real estate transactions ranging from acquisitions and dispositions to securitization of properties and portfolios to entity-level mergers and acquisitions. We are confident that our experience and knowledge can help you successfully address today’s challenges and help you prepare for tomorrow’s opportunities.

QOZ advice is provided by knowledgeable specialists in our Tax practice, including those in our Washington National Tax – Tax Credit and Energy Advisory Services Group (TCEAS). These professionals advise on both QOZ transactional and compliance-related matters.

Our OZones services include:

- Review of gains to be deferred under OZones program for qualification purposes
- Assistance with QOF tax and organizational structuring
- Review of QOF formation documents for partnerships and corporations
- Review of contribution and partnership agreements for federal and state tax implications
- Due diligence of assets to be acquired by QOFs
- Tax modeling of QOFs and their investors
- Preparation of QOF annual tax compliance and tax return services
- Monitoring of QOFs for continuing compliance under the OZones requirements
- Audit of QOFs.
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