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Opportunity Zone Funds – Part II: Due Diligence Required

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As with any investment, due diligence is required. Investing in an Opportunity Zone Fund ("OZF") is not any different.

Historically, we have seen taxpayers go to great lengths to attain tax deferral. In some instances, the efforts have resulted in significant losses. With proper due diligence, many of these losses could have been prevented.

A TALE OF IRC § 1031 EXCHANGES GONE WRONG

Tax deferral efforts under IRC § 1031 have often resulted in significant losses for unwary taxpayers. The best examples of these losses resulted from the mass Qualified Intermediary failures we saw over the last two decades.

The entire industry of Qualified Intermediaries was created from the requirements of Treasury Regulations. While financial service providers (e.g., banks, brokers, trust companies and escrow companies) are highly regulated, there is little regulation of Qualified Intermediaries. The cost to enter the Qualified Intermediary service industry is rather nominal. There are generally no minimum capital requirements or bonding/insurance requirements for these businesses. Further, there are generally no annual reporting requirements. Consequently, the significant appreciation in real estate values in the United States during the past several decades has allowed the number of these businesses to multiply significantly. Torrid growth in the Qualified Intermediary industry, like in any emerging industry, created significant problems.

Given that Qualified Intermediaries have the task of holding and investing large amounts of their customers' exchange proceeds, it seems somewhat preposterous that the industry is largely unregulated. As a result of the lack of regulation and/or insignificant cost of entry, we saw a number of taxpayer losses over the years.

- In Minnesota, it was reported in 2001 that a Qualified Intermediary invested exchange proceeds in the stock market. Its investments resulted in a $3,000,000 loss of exchange proceeds.

- In Hawaii, it was reported in 2002 that a Qualified Intermediary filed bankruptcy when it was short by approximately $2,000,000 of exchange proceeds. Apparently, some of its owners borrowed from the exchange proceeds bank account, but could not repay the loans.
- In Utah, it was reported in 2002 that a Qualified Intermediary, which also operated a title insurance company, came up short by well over $1,000,000 in exchange proceeds. It held its escrow funds and exchange funds in the same account. The Qualified Intermediary had little or no assets from which the taxpayer could recover the loss. In a desperate effort to minimize its loss, the taxpayer filed a claim against the title insurance company's underwriter. The claim was denied because the loss related to exchange activity of the affiliate intermediary company; not title or escrow activity of the title insurance company. As a result of this case, the Utah Department of Insurance promoted legislation prohibiting title insurance companies from holding exchange proceeds in their escrow accounts. The legislation, however, was never enacted into law. While such law may protect title insurance company underwriters from claims resulting from activities of title insurance company affiliate exchange companies, it would not give much, if any, protection to taxpayers embarking on Code Section 1031 exchanges.
- In Nebraska, it was reported in 2002 that a Qualified Intermediary was involved in an elaborate check-kiting scheme over a long period of time. The activity involved both the exchange company's accounts and its affiliate title insurance company's accounts. Upon discovering the illegal activity, the Qualified Intermediary's bank contacted the police. Four days later, the sole-owner of the exchange company committed suicide. The resulting losses exceeded $10,000,000, with approximately $1,500,000 in shortages from exchange proceeds. As a result of this case, state regulatory legislation was proposed by the Nebraska Department of Insurance. The legislation was never passed.

A String of Failures Ensues

Unfortunately, the Qualified Intermediary failures noted above were just the tip of the iceberg. In the years before the collapse of the U.S. real estate market (2006-2009), we saw several additional significant failures, including losses in the states of California, Washington, Nevada, Colorado, Idaho and Oregon.

1031 Inc. In December 2006, 1031 Inc., a Bellingham, Washington Qualified Intermediary owned by Carl N. Zaremba, filed for bankruptcy protection when it failed to relinquish thousands of dollars of taxpayers' exchange funds. Mr. Zaremba was charged with five (5) counts of felony theft for stealing $873,000 of client funds, much of which appears to have been spent in a lavish manner, including $34,000 spent in Las Vegas casinos, $40,000 worth of wine, $21,000 for custom-tailored suits, and $20,000 in political contributions.

Mile High Capital Group / Replacement Property Solutions. In December 2006, Colorado-based real estate investment firm, Mile High Capital Group LTD. ("MHC"), and its Qualified Intermediary affiliate, Replacement Property Solutions Inc. ("RPS"), were forced into bankruptcy. The principals behind MHC and RPS have some interesting backgrounds. Fredric "Rick" Dryer, founder of MHC, was indicted on 67 felony charges ranging from theft to securities fraud. Dryer is well known for his books and seminars on building real estate wealth. He even had an "advertorial" show on XM Satellite Radio called "Real Estate Wealth Myths Facts and Strategies," until it was pulled due to his pending legal matters.

Reports indicated that MHC and its affiliates collected about $44 million from 882 investors, who put down earnest money on residential properties, most of which were never built. A later audit of MHC uncovered less than $5 million in assets, even though it had supposedly recorded $175 million in sales during the prior year. The *Charlotte Business Journal* reported in December 2006, following the court-ordered closure of MHC and RPS, that Dryer was hired as a real estate consultant and had started his own company in Charlotte while criminal charges were pending. Wow!

Southwest Exchange. In February 2007, another exchange company, Southwest Exchange, closed its doors amidst allegations of fraud and taxpayer losses. Southwest Exchange (which also did business as Southwest 1031 Exchange) and its affiliates, Qualified Exchange Services and Arrow 1031 Exchange, were all owned by Capital Reef Management, which was in turn owned by Donald K. McGhan and several associates.

An April 23, 2007, *Forbes* article reported on McGhan's interesting background and the failure of Southwest. McGhan founded a string of unsuccessful companies, including breast implant maker Inamed, which removed him from its board in 1998 for misuse of company funds. In 2004, McGahn founded another breast implant maker, MediCor, in the hopes of seeking federal approval to reintroduce silicone breast implants into the U.S. McGhan purchased Southwest for $3 million and funneled its clients' excess exchange funds to MediCor and other companies. At the time of the purchase, Southwest had $108 million of exchange funds on deposit, but needed only $30 million at any given time to fund its clients' purchases.

Over $95 million of client deposits were lost, including $68 million that went to MediCor to fund its operating expenses and to purchase smaller implant manufacturers. McGhan also spent lavishly on travel, friends, and family, including $1,000 steak dinners and $3,000 hotel rooms. Both Southwest and MediCor filed for bankruptcy protection. Southwest's trustee sued MediCor to recover $37 million in fraudulent transfers. MediCor subsequently filed for Chapter 11 protection, listing debts of $121 million. Various criminal investigations and civil lawsuits were commenced against the various principals and entities involved in the Southwest collapse. Southwest's clients lost millions of dollars and eventually recovered little if any of their money. Although Southwest's website prominently advertised that it maintained a $50 million fidelity bond, a February 13, 2007 report by *Las Vegas Business Press* indicated that the bond had lapsed.

Tax Group, LLC. In May 2007, the granddaddy of Qualified Intermediary frauds came to light, when Tax Group, LLC ("Tax Group") and 15 other entities controlled by Edward Okun ("Okun"), including 1031 Advance, Atlantic Exchange Company, National Exchange Services, Real Estate Exchange Services, and Security 1031 Services, and Investment Exchange Group all filed for Chapter 11 bankruptcy protection in the U.S. Bankruptcy Court for the Southern District of New York citing "liquidity issues."

After the bankruptcy filing by Okun's entities, a lot of interesting information came to light about Okun and his empire. At the time of the bankruptcy filing, the entities' 20 largest creditors were owed more than $65 million, there were over 300 open exchange contracts representing over $151 million, and only about $20 million had been found, and frozen, in the entities' bank accounts. Okun apparently viewed his companies as an unregulated bank from which exchange funds could be used for other purposes.

According to the bankruptcy filings, Investment Properties of America ("IPA"), another Okun entity, began borrowing funds from the various exchange accommodators using a series of promissory notes, which totaled $132 million, and Okun himself borrowed another $29 million in this manner. The promissory notes constituted over 87% of the debtor's combined assets. The *Indianapolis Business Journal* reported that Okun also used some of the money to fund a lavish lifestyle, including four mansions, a helicopter, three airplanes, twenty automobiles, and a 130-foot yacht. Okun apparently was a fan of auto racing, as IPA was a sponsor of A.J. Foyt's auto racing team.

On March 19, 2009, a jury found Okun guilty of conspiracy to commit mail fraud and wire fraud, conspiracy to commit money laundering, money laundering, bulk cash smuggling, and perjury. A federal judge subsequently sentenced Okun to 100 years in prison. Lara Coleman, Tax Group's former Chief Operating Officer, also pleaded guilty to conspiracy and making false statements to investigators.

The Slowdown Leads to a Shakeout

The financial crisis and the slowdown in the real estate market created havoc among real estate developers and lenders, many of which were directly or indirectly involved in IRC § 1031 exchanges. The result was obvious—exchanges came to a screeching halt! They only began to pick back up in late 2012 and the beginning of 2013. They appear to be going strong today (or at least for the time being!

The slowdown in the volume of exchanges led to a shakeout in the Qualified Intermediary industry, as many smaller players simply went out of business due to lack of business. More importantly, the slowdown revealed deeper problems lying under the surface of other Qualified Intermediaries. Some were skating on thin financial ice, and eventually collapsed into bankruptcy. Others were involved in taxpayer fraud, which only came to light due to the collapse of the real estate and credit bubbles. At least three bankruptcies by Qualified

Intermediaries are worth noting, as they are related to the bursting of the bubble in the housing and credit markets.

LandAmerica 1031 Exchange Services. LandAmerica 1031 Exchange Services Company, Inc. ("LAE") filed bankruptcy and terminated all operations on November 24, 2008. LAE promptly issued a statement that the total value of funds in its customers' Code Section 1031 exchange accounts was sufficient to cover the balance due to its customers; however, portions of customers' exchange funds were invested in illiquid auction rate securities backed by federally guaranteed student loans.

Auction rate securities are debt instruments (corporate or municipal bonds) with long-term nominal maturities for which the interest rates are regularly reset through a Dutch auction. Auctions are typically held every 7, 28, or 35 days. Many auction rate securities are AAA rated and tax exempt. For buyers, auction rate securities typically provide a slightly higher after-tax yield than money market instruments due to their complexity and increased risk over other money market securities.

An auction fails if there are not enough orders to purchase all of the securities being sold at the auction. In that scenario, the interest rate is set to the maximum rate defined for the issuer (typically a multiple of LIBOR). The purpose of the higher rate is to compensate the holders who have not been able to sell their positions. During the credit market crisis of 2008, the auction market froze and many auctions failed when investment banks declined to act as bidders of last resort.

Because of the frozen market for auction rate securities, LAE stated that it was unable to sell or borrow against the value of the usually-liquid securities. Under the circumstances, LAE was forced to seek bankruptcy protection as it was unable to meet the liquidity requirements created by its customers' withdrawal demands. Its customers' exchange funds were frozen and claims had to be filed with the bankruptcy court.

During the bankruptcy proceedings, hundreds of customers filed claims against LAE, many of which were determined to be unsecured creditors since their money was technically the *property* of the exchange company. In September 2009, LAE proposed a plan of reorganization. An overwhelming majority of creditors, 97 percent, approved the plan. A few months later, November 2009, the Bankruptcy Court confirmed LAE's plan of reorganization. Under the plan, unsecured creditors were estimated to receive between 2 cents and 81 cents on the dollar owed. In the end, many LAE customers could not timely complete their pending exchanges and many lost a substantial amount of their exchange funds.

Summit Accommodators. Summit Accommodators, Inc. ("Summit"), which operated under the name "Summit 1031 Exchange," filed for bankruptcy on December 19, 2008. Several days prior to filing bankruptcy, Summit issued a statement that it had ceased funding open exchanges and had curtailed daily operations to address significant financial issues.

Summit explained that it had $27.8 million of open exchanges for customers, but only $13.6 million in its exchange accounts, a shortfall of $14.2 million. Summit explained that it had other assets which it hoped would be sufficient to make up the shortfall; however, those other assets were illiquid and not immediately available to fund open exchanges.

As it turns out, Summit had been lending roughly a quarter of its exchange funds to Inland Capital Corporation ("Inland") which, in turn, loaned money to parties involved in real estate investments in central Oregon. Inland and Summit were owned by the same principals and, in many cases, Inland loaned money to entities owned by its principals. Inland owed Summit over $13.7 million, but was unable to repay the loans. News reports indicated that Summit's customers were led to believe that Summit had deposited their exchange funds in FDIC-insured bank accounts rather than investing their exchange funds in this manner.

Summit's customers' exchange funds were frozen and claims had to be filed with the bankruptcy court. The Oregon Division of Finance and Corporate Securities investigated Summit's activities. Criminal prosecutions of the Summit principals followed. Customers filed lawsuits against the Summit principals and others involved in the business activities. Recoveries appear to be small.

DBSI / For 1031. On November 10, 2008, DBSI Inc. ("DBSI"), a national real estate firm based in Idaho, filed for bankruptcy along with numerous affiliates. DBSI was a national leader in sponsoring TIC transactions. For 1031 LLC ("For 1031") was DBSI's Qualified Intermediary affiliate, and was utilized in numerous 1031 exchanges in which investors purchased TIC properties as replacement property. A November 24, 2008 report of the Idaho Business News indicated that the lack of lending and frozen capital markets caused DBSI to discontinue acquisitions and sales. The Idaho Department of Finance sued DBSI, For 1031, several affiliates and one of their principals for securities laws violations and sought $9.75 million in lost investor funds, penalties, and a permanent injunction. As in the other cases, little was recovered. Lawsuits and criminal actions followed.

Regulation Is *Not* a Proxy for Due Diligence

The vast industry taint created by a relatively small number of exchange companies has created a movement for government regulation of the Qualified Intermediary industry. Some states have jumped on the bandwagon, but the government regulation remains nominal.

Even if adequate industry regulation is ever adopted by all states, it is no substitute for a taxpayer's due diligence in the selection process of a Qualified Intermediary. Most taxpayers would be reluctant to allow an investment advisor to manage their retirement funds (millions of dollars) without a thorough due diligence review of the advisor and his/her investment company. Why shouldn't the same logic apply when taxpayers park their IRC § 1031 proceeds with a Qualified Intermediary and ask the Qualified Intermediary to facilitate a very complex transaction?

OZF DUE DILIGENCE WARRANTED

This same logic should apply to taxpayers investing in OZFs that are established by others. Among the items needing careful review and consideration include but are certainly not limited to:

- What is the available tax deferral? The taxpayer and his/her tax advisors need to evaluate whether the tax deferral is sufficient to warrant the taxpayer embarking upon an OZF investment.
- Does the OZF and the underlying property (including the improvements) qualify for OZF deferral?
- Who created the OZF fund? Is the creator reliable and trustworthy? Is the creator backed by substantial financial assets?
- Is an investment in the underlying OZF property (as improved) a good investment? Tax deferral may be a good goal, but if the investment in the fund is not a sound investment, regardless of tax deferral, the investment should not be made.
- What are the ongoing costs of the OZF and management and/or leasing of the underlying property?
- Does the taxpayer lose control over his/her investment? If so, is tax deferral and the investment itself worth it?
- Who has conducted the due diligence review of the underlying OZF property, including title, zoning, environmental, quality of investment, physical condition, cost of improvements, return on investment and potential upside?
- Does the OZF allow the taxpayer a viable exit strategy?
- Is the investment in the OZF securities law compliant? Most interests in OZFs will certainly be considered securities under both state and federal securities laws.
- Are promotors and sales people receiving fees for selling interests in the OZFs? If so, such cost is not being invested in the OZF and must be considered by the taxpayer investor.
- Who are the other investors in the OZF? Taxpayers may not be able to control who they are going into business with in the case of an OZF.
- Taxpayers may not be able to control OZF tax compliance. Is the acquisition of the underlying property compliant with the Code, and are the improvements proper and made in a timely fashion? If not in either case, tax deferral may not exist.
- Who controls the improvement of the OZF property?

Some taxpayers will avoid some of these questions by forming their own private OZF (i.e., a vehicle that will solely be used by the taxpayer for his/her own tax deferral). Most definitely, this approach avoids many of these thorny questions, but it does not eliminate them. Still, taxpayers need to wrestle with some of these issues, namely:

- Does formation and investment in an OZF warranted given the amount of tax deferral at issue? Nobody has a crystal ball, but one must consider whether tax rates will be higher when the tax deferral goes away, and whether it may be wiser to simply pay the tax resulting from the sale of the capital asset giving rise to the OZF investment opportunity.
- Is the underlying property located in an Opportunity Zone (and the improvement thereof) a good investment?
- Does the OZF and the underlying property (including the improvements) qualify for OZF deferral?

THE NEED FOR THE THIRD PARTY CREATED OZF EXISTS

Many taxpayers, for one reason or another, will find themselves looking at investing in OZFs established by third parties. These reasons include:

- The taxpayer may not be able to locate satisfactory OZF qualifying property within the 180-day statutory requirement.
- The taxpayer may not want to oversee or manage the improvements to the OZF qualifying property as required for tax deferral.
- The taxpayer may want to re-invest the qualifying capital gain in a much bigger property that the taxpayer can individually afford.
- The taxpayer may not want the continuing responsibility of managing the property.

All of these reasons lead to what will likely be a commonly traveled road -- investing in a third party created and managed OZF. For tax advisers that practice in the real estate arena, this story should sound familiar. Back in the mid to late 1990s, an industry was created to serve taxpayers desiring to embark upon or complete an already commenced IRC § 1031 exchange. The industry, the tenancy-in-common ("TIC") industry was created to serve the many taxpayers that could not locate satisfactory replacement property within the stringent statutory timeframe, did not want to oversee or manage the replacement property, and/or wanted to invest in a more expensive replacement property.

Typically, members of the TIC industry, commonly referred to as "TIC Sponsors," would:

- Purchase large properties.
- Lease the properties on a triple net basis under long-term leases to high credit tenants, or lease the properties to a master tenant who then leases the properties on a triple net basis under long-term leases to high credit tenants.
- Arrange and have readily available financing for buyers.
- Divide the properties into a large number of tenancy-in-common units.
- Establish the price of the property on a per unit basis.

The prepackaged arrangement allowed taxpayers to easily identify replacement property within the statutory identification period and conclude the transaction within the statutory timeframe. A TIC interest can easily be tailored to meet a taxpayer's needs.

- Cost (a taxpayer may usually acquire fractional units so the cost could be tailored to meet any exchange needs).
- Debt (the TIC Sponsor usually had prepackaged loan funding available).
- Due diligence (the TIC Sponsor usually had already completed a due diligence review of the underlying property).

TIC interests, if they qualify as real property for purposes of IRC § 1031, generally come with advantages and disadvantages.

Advantages may include:

- TIC interests allow taxpayers to acquire ownership in a bigger property without the management problems associated with small individually owned properties.
- TIC interests are easily identified and acquired within time frames allowed by IRC § 1031.
- Management of TIC properties is done by a third party.
- TIC properties usually are leased to high quality tenants.
- Negotiations relative to the acquisition and closing of TIC interests are generally eliminated.

Disadvantages may include:

- Potential lack of marketability of TIC interests. There is generally no established secondary market for TIC interests.
- Reliance on a TIC Sponsor to conduct due diligence, etc.

- Practical inability to sell the underlying property.
- Lack of control over the underlying property.
- Ongoing management fees.
- Co-ownership (owning the replacement property with others).
- Lack of discount for fractional ownership of the underlying property in the TIC pricing.

As with any rapidly growing industry going through an explosive "boom" cycle, the lure profits and growth often attracts operators that tend to cut corners when the going gets tough. It is absolutely clear the rapid growth in the TIC industry led to pervasive problems as the United States real estate market took a downturn in 2007 and 2008. Numerous TIC arrangements turned out bad for the investors, including the DBSI investors (as noted above). Many investors went from positive cash-flow properties to highly leveraged TIC arrangements that fell into financial ruins, including bankruptcy. Several of the taxpayers caught up in the disaster of failed TIC investments were not free of fault. In the quest to attain tax deferral, they failed to properly and carefully review the TIC investment. There is no substitute for proper and complete due diligence.

We need to remember history. It has a way of repeating itself. Taxpayers need to work with solid advisers and carefully review any OZF investment before releasing the funds from their capital gain generating transactions. Tax deferral or no tax deferral – a bad investment is a bad investment.

The advantages and disadvantages of TICs as they relate to IRC § 1031 exchanges likely apply to taxpayers wishing to defer taxable capital gain by investing in third party created OZFs. Caution is advised. Taxpayers investing in a third party created OZF have to carefully review the investment like they would do with any other investment. The quest for tax deferral should not get in the way!

CONCLUSION

As OZFs are created and marketed to the masses, we will likely learn of problems like taxpayers have historically experienced in the quest for tax deferral under IRC § 1031. Caution is needed.

We will continue to report on OZFs. Stay tuned.

Tags: auction rate securities, bankruptcy, corporations, deferred gain, due diligence, exchange funds, formation, fraud, Internal Revenue Code, Internal Revenue Service, Investment, IRC Section 1031, IRC § 1031 Exchanges, IRS, Opportunity Zone Funds, Qualified Intermediaries, real property, regulation, stock, Tax Cuts and Jobs Act, Tax Deferral, Taxpayer, tenancy-in-common (TIC), third party created OZF, Treasury Regulations