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Opportunity zone funds

What sponsors need to know

In association with Gemini

A road map to setting up and operating a QOF

Filing date and timeline considerations

Legal, accounting and fund operating perspectives

Are you a fit for opportunity zone funds?

What sponsors need to know

In 2017, US Congress established the Federal Opportunity Zones Program, which was in many ways a stroke of genius. This Program provides investors tax relief while at the same time gives a serious capital injection to deprived and under-served communities across the country. US Secretary of the Treasury Steven Mnuchin expects opportunity zones to attract USD100 billion in investment.

With approximately 8,700 opportunity zones certified by the US Department of the Treasury, the potential for real estate and private equity investors to revitalize communities has huge appeal, as this type of 'impact investing' has gained major traction recently. Investors can invest in these designated areas and receive preferential tax treatment by forming a Qualified Opportunity Fund ('QOF').

The tax benefits of this new program are well documented, but for those looking closely at this space, there are a lot of nuances, and indeed risks, that need to be considered. After all, no one can yet possibly know how successful a new real estate asset (such as a shopping mall) will be, or what the internal rate of return on a fund investment might be after 10 years, at which point any appreciation of underlying assets in a QOF becomes tax-free.

In this report, consideration will be given to some of those nuances, to help fund managers determine, in the first instance, whether such a product is actually a right fit for their business.

This will then be followed by key insights from various players in the service chain – the tax/accounting specialist, the legal counsel, the fund manager – to lay out a road map for how to set up and operate a QOF.

First order considerations

1. Filing Dates

As mentioned, the tax relief associated with opportunity zones has dominated the headlines but the reality is this is a new, largely untested area of the market. As such, many potential fund sponsors are still unsure as to what the ecosystem looks like: who services it? What are their roles and responsibilities?

One of the first points to consider is that there are two different filing dates that need to be adhered to. In principal, a QOF is required to hold at least 90 percent of its assets (real estate or private equity) in Qualified Opportunity Zone Property.

However, as Steve Rosenthal recently wrote for *Forbes*, the IRS now provides additional flexibility to those Funds "who make qualifying investments in a business where a minimum of 70 percent of its assets ('tangible property') is in the Zone."

Assuming this is a standard QOF, it must reach the 90 percent mark by the last day of the Fund's initial six months, at which point the sponsor must do an initial filing with the IRS. It is then necessary to do a second filing at the end of the tax year. Here's where the nuance comes in.

"As I recently discovered," says David Young, President of Gemini, a leading US fund administrator, "if that opportunity zone fund holds an interest in a subsidiary operating company, the fund sponsor can move cash into the subsidiary, in which case they then have 31 months to deploy the cash, so long as the deployment is pursuant to a plan and the Fund reasonably complies with the plan.

"That's a world of difference: a real estate developer can do a tremendous amount of work in that time, compared to six months. There are numerous tax nuances that one needs to be aware of. In addition, before considering this type of fund, it is important to clarify what each person's role and responsibility is, either as a fund manager or a property developer. What does legal counsel need to focus on and prioritize? What does the fund administrator need to excel at?"

"This will likely be a really hot asset class for the next 2 or 3 years, and I think you're going to see a lot of fund activity over that period."

David Young, Gemini

Certainly, laying out these considerations can make it a lot easier for fund managers to understand the moving parts and ultimately determine whether a QOF is suitable for their business or not.

"Ongoing communication with the fund administrator, tax/accounting team, and the fund manager is crucial to ensure seamless tracking of investments and reporting in order to adhere to filing deadlines mentioned above," advises Skyler Steinke, Gemini SVP of Business Development, Alternative Funds.

2. Timelines

As mentioned, there are over 8,700 opportunity zones across every US state, offering multiple investment opportunities for property developers, PE/RE investment managers and other businesses. In order for QOF assets to qualify under the opportunity zone statute, the business property on which the building/development work is being done must be located within an opportunity zone.

Young says that the initiative was created by the US government to get private capital moving quickly. "They want funds to be deployed and put to work right away. This will likely be a really hot asset class for the next 2 or 3 years, and I think you're going to see a lot of fund activity over that period," asserts Young.

As such, anyone considering a QOF should have a very clear idea of where and what they wish to invest in. Whether it is to build a new car park, or simply to re-energize the fortunes of a failing company or piece of commercial real estate, the fund sponsor should have a well-defined investment strategy at the pre-investment stage so that when it comes to raising capital, it is able to deploy it swiftly, in keeping with the spirit of the initiative.

"Some of the considerations relate to how quickly you need to deploy the capital and where it needs to be deployed," says Young. "What opportunity zones do you intend to focus in on? What kind of projects will the capital be used for? One cannot, for example, use an opportunity zone fund to build a casino."

"It is important for the investor to communicate with the manager where they are at in the 180-day window."

Skyler Steinke, Gemini

Other assets that do not qualify for a QOF include private or commercial golf courses, liquor stores, country clubs and racetracks.

The investor has 180 days after realizing a capital gain to roll it into a QOF in order to defer the taxes on that capital gain. "It is important for the investor to communicate with the manager where they are at in the 180-day window," says Steinke, "in order to make sure their capital investment is moved into the QOF on time within the 180 days."

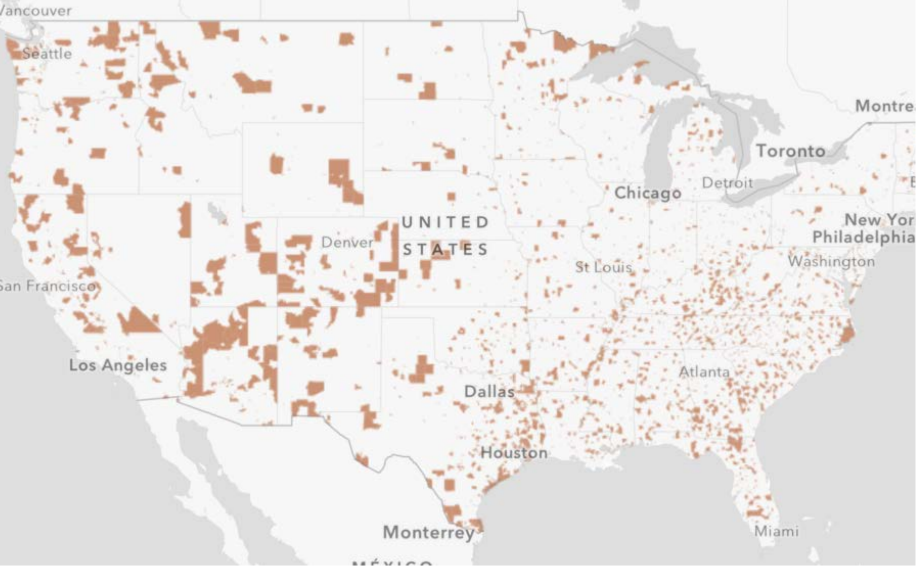
From an investor's perspective, these are clearly long-term multi-year investments, and as such should be regarded as highly illiquid. An investor's capital will need to be locked up for several years in order to benefit from certain aspects of the tax relief.

"You may receive distributions but those are going to be taxed, whereas the appreciation of the assets in the fund will not be," says Young. "If you invest for more than seven years in one of these funds you can defer your tax gains, through to 31st December, 2026 and effectively reduce your total tax liability on capital gains to 85 percent."

Young's view is that, because of the nuances of QOFs, potential sponsors have to appreciate that there are "time sensitive elements" to setting one up. If someone does not have the appetite for complexity, he says, it may not be the right path to follow, despite the obvious tax benefits.

"This may not be suitable for smaller fund managers who don't have the resources, the governance framework in place, etc," comments Young. "There is a clear level of sophisticated fund management and compliance that needs to be applied to one of these Funds."

In short, anyone considering one of these products needs to have the resources and framework in place to manage a professional investment fund. ■



Fund execution – legal, accounting and fund operating considerations

1. A legal perspective

The way one thinks about a QOF, operationally, will largely depend on the Fund's underlying strategy. A real estate fund strategy will differ from a private equity strategy, and there will be structural differences as to how these are run.

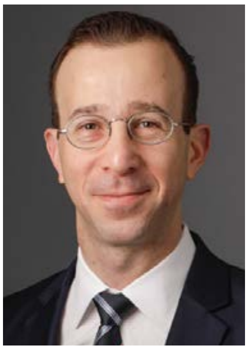
A private equity sponsor, for example, would likely manage investments through an intermediate corporate or partnership entity, which will itself qualify as an opportunity zone business.

"These businesses are going to be conducting activities within the opportunity zone, acquiring the relevant hard assets, and generally the model is going to work through the use of operating subsidiaries, either for an existing business or a new business," explains Richard Shamos, Counsel, Financial Services Group, Sadis & Goldberg LLP.

"If it is a real estate sponsor, we would expect to see more of a clean acquisition. Those investments could be held indirectly through one or more holding companies or they could be held directly by the client," he continues.

The most common vehicle for those raising outside investor capital will likely be a closed-ended limited partnership.

If there is a substantial income component, it is possible that sponsors may want to structure the QOF as a corporation, where the corporation pays the tax on that income so that it doesn't get passed through to the investors. Investors may get some great benefits from the opportunity zone regime, but if the only return that is being generated by the target properties is income, then this is going to pass straight through; it doesn't get any beneficial tax treatment. It gets taxed at the investor's ordinary income rate.



Richard Shamos, Counsel, Financial Services Group, Sadis & Goldberg LLP

While there are undoubtedly many reasons to take advantage of investing in opportunity zones, getting the structure right on day one is paramount.

In particular, developers should note that the statute requires that real estate, in order to qualify, be substantially improved.

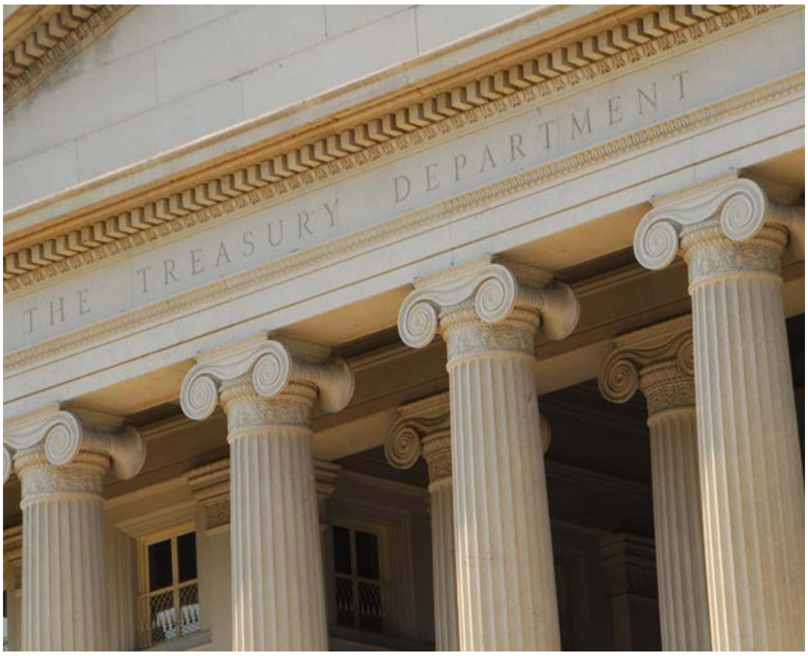
If the investment is not large enough to constitute a substantial improvement of the relevant property, companies may look to set up separate operating subsidiaries to handle a bespoke portion of the opportunity zone investment which alone would qualify.

"That new business entity could hold a more limited pool of assets which qualify under the tax and not be tainted by the existing assets held by the much larger company," explains Shamos.

"We think there will be a number of qualified opportunity zone businesses, especially in the private equity context, which can be structured specifically for executing PE strategies, either because they are acquiring something and plan to do a reverse merger, the PE sponsor plans to move something into an Opportunity Zone, or they are setting up an operating subsidiary which they know can be 'clean' for the purposes of meeting the statutory requirements," Shamos continues.

Shamos says that one question being asked concerns the timing of the property acquisition. Developers who already own property located in a designated opportunity zone often want to develop such property by raising an QOF; however, the statute requires that the relevant qualified opportunity zone property be acquired after 31st December 2017.

"Most of the industry has been looking towards other forms of transfer, such as a lease, as a mode for the QOF to acquire the underlying property," says Shamos.



"At the moment, industry participants are still waiting for further guidance from the Treasury on how the IRS is going to treat such transfers as acquisitions for purposes of the QOF regime.

"We expect that this is going to be an important mode for a fund representing different investors to invest in OZ projects. A lot of people who are sitting on real estate realize that these opportunity zone designations are a potential valuation boon for their RE investments and they want to capture some of that.

"They are less likely to sell them outright but if the Treasury were to come out with a strict interpretation and prohibit leases then it could put a serious damper on the regime."

Investment rollover

Another question that comes up relates to recycling, or more specifically the rollover of investments in a QOF. In the proposed legislation the US Treasury has indicated that a partnership can elect to defer gains and thereby prevent the underlying partners from realizing the gains.

Funds that are set up as partnerships to invest in a number of underlying assets are going to want to take advantage of this so they can roll one investment into the next.

To become a QOF the fund is required to make a tax election: Form 8996.

This has to be filed with the US Treasury, at which point the clock starts on meeting the qualifying assets test. "I imagine the Treasury may spend some resources to examine some of these businesses so it will absolutely be important for fund managers to have good compliance programs in place that are built around those qualifying assets," advises Shamos.

One thing to be aware of, from the investor perspective, is that they have six months to get the money into a QOF.

A lot of eligible gains available for investment in QOFs are going to derive from larger investors, such as family offices and other vehicles that are engaged in business activities that have multi-million dollar gains. As such, there is precious little flexibility on when investors can invest. The capital drawdown mechanics don't really work as compared to someone committing capital to a traditional PE/RE fund.

"The investor has to get the money in the fund and the only way the US Treasury has provided some flexibility to the fund is by allowing for a 31-month period for working capital. The investors themselves do have some flexibility, however, on when they realize their gains. If the investor has invested through a partnership they can either elect to have the gain realized on the date the relevant asset is sold or it can be realized at the end of the partnership's tax period," comments Shamos.

Careful due diligence

He further advises that the due diligence on the initial investment into the asset is going to be vital.

"A lot of people say, 'We've got an asset in one of these opportunity zones let's do a deal', but there are some key technical requirements. If you're purchasing the property through a business, the business investment has to be a cash investment. The underlying businesses need to be correctly set up and so does the fund, for the purpose of investing into an opportunity zone.

"In addition, you need to make sure the LLC or Partnership Agreement of the relevant entity reflects this opportunity zone investment purpose.

"These are all things that could potentially trip up a fund manager if they are examined by the Treasury Department or the IRS and the repercussions are potentially massive."

2. A fund manager's perspective

JMA Ventures LLC is a full-service investment and development firm focusing on real estate and leisure/lifestyle assets. It currently operates one QOF with assets in Phoenix, Arizona and recently launched its second QOF, which will focus on investment opportunities across the Western United States.

With respect to the first fund, the underlying asset owned by the fund is called The Battery – a multi-family development in the Warehouse District, a fast-growing tech hub within Phoenix. The asset will consist of two four-story apartment buildings and 4,500 square feet of retail space.

"The Opportunity Zone Program is a great incentive for investors to focus on under-developed areas/communities that they might otherwise not have paid much attention to," says Jake Werrett, General Counsel & Acquisitions. "We have projects lined up in opportunity zones, which are low income census tracts, located in various US States.

"We are a value-add real estate investment and development firm so we naturally tend to focus on these areas because a lot of value can be added. I think the Opportunity Zone Program will help the investment community better focus on these underserved areas, and will make the post tax returns stronger for investors who might have otherwise been hesitant to invest in these 'up and coming' areas."

Do your homework – is the project viable?

From a fund manager's perspective, Werrett thinks there are a couple of reasons that the program is unique.

First, unlike some of other government programs, this program has a clearly advantageous tax benefit if the underlying investment provides strong cash flows and increases in value over time.

"The OZ program doesn't turn a bad investment into a good investment, what it does is take a good investment that has solid returns, and make those returns slightly better because the investors' original tax gains are deferred and benefit from various step ups in basis. After 10 years, the investors' basis in the underlying asset is

Jake Werrett, General Counsel & Acquisitions, JMA Ventures LLC

subject to a full market step up and can be sold free of capital gains tax.

"That's the real benefit that investors should be targeting," says Werrett, who stresses that picking the right project and selecting a fund manager qualified to execute on the investment thesis for the project is vital. A good investment in an opportunity zone must be viable on its own merit, regardless of whether or not it is located in an opportunity zone.

Which leads to the second consideration. As this is a complicated program, unless a deal is above a certain threshold it may not be worth the hassle of creating a QOF.

"The Opportunity Zone Program is complicated, and owners of a single small project may find that it is not worth the hassle. Fund managers must create a fund, form a second layer entity underneath the fund, comply with the 90 percent asset test twice a year at the fund level, satisfy certain tests at the subsidiary level, adopt a written plan at the subsidiary level stating how the funds will be spent, and make certain filings to the IRS and SEC.

"There are also capital deployment restrictions, such as the requirement that the fund must allocate its cash prior to the twice-a-year 90 percent asset test and, generally speaking, the project must be completed within 30 months," explains Werrett.

JMA Ventures plans to continue reviewing all projects individually, on their own merits, regardless of whether projects are located inside an opportunity zone. The team runs each potential project through the same metrics to determine whether they think it is a good deal or not. If it is a good deal, and it is in an opportunity zone, then there is an added bonus of getting the after-tax benefits.

Cash management

Unlike PE/RE funds, which may sit on dry powder for months or even years at a time, a QOF must deploy cash promptly into qualified opportunity zone property. Qualified opportunity zone property ('QOZP') includes: (1) qualified opportunity zone stock ('QOZ stock'); (2) qualified opportunity zone partnership interests ('QOZ partnership interests'), and (3) qualified opportunity zone business property.

The 90 percent asset test must be applied on the last day of the first six-month period of the fund's tax year, and on the last day of the fund's tax year. The fund can hold up to 10 percent non-QOZP property and is penalized for any excess.

"Many fund managers are used to raising capital through capital commitments and sitting on those commitments for a period of time, with the intention of making capital calls along the way. Under the current statute, that model doesn't work for QOFs because the statute requires capital gains to be contributed to a QOF within 180 days. This doesn't fit the traditional PE/RE fund model.

"Cash is not regarded as qualified opportunity zone property ('QOZP') so the fund cannot hold cash at the fund level for a long period of time. The fund must contribute the cash to the portfolio entity level in order to take advantage of the safe harbor for working capital. Otherwise, the IRS imposes certain penalties on the cash," says Werrett.

Operationally speaking, therefore, the fund manager must be clear at all times that they have qualifying assets in the fund and at the subsidiary level during the lifetime of the fund. The deployment timeframe and the moving of money according to the right schedules and having all the paperwork tied together are just some of the many considerations for people to be aware of.

Caveat emptor

From an investor's perspective, while the tax benefits are enticing, they should be careful not to allocate to managers who may be entering this arena for the first time and have little or no track record in executing on real estate deals.

These are long-term investments. Manager selection will be a key priority. Otherwise, one might invest in an QOF that fails, leaving the investor with a bunch of fines from the IRS and no tax benefits because the timeframes were not adhered to.

"Investors should be careful to ensure that they are placing money with fund managers that are committed to stay on top of all of the requirements of the program in order to preserve the investors' benefits under the Opportunity Zone Program," emphasizes Werrett.

"The Opportunity Zone Program may lead to many new funds managed by developers with little or no track record. It may be difficult for a new or inexperienced developer to deploy capital on the strict timelines required, while also abiding by the many other capital holding requirements imposed by the program. This is a data point that investors should consider."

3. A fund accountant's perspective

Robert Nowak, Partner, Baker Tilly Virchow Krause LLP

Robert Nowak is a Partner at Baker Tilly Virchow Krause LLP and has more than 20 years' tax consulting experience. From his vantage point, there are two principal concerns, operationally, that fund sponsors need to be mindful of at all times.

One is whether or not the QOF meets the 90 percent asset test requirements on periodic dates "so the first thing to stress is that the manager has to meet compliance obligations on each of the required testing dates," says Nowak.

"Second, with respect to real estate development projects, the manager must ensure that he substantially improves the qualified opportunity zone property.

"Those are the two primary mechanical accounting considerations, in my view."

Substantial improvement condition

By definition, unless it is a new development, any type of real estate in an opportunity zone is going to be "used property".

Therefore, in order for it to be considered an opportunity zone property, it has to be substantially improved. This is defined as meaning that 100 percent of the cost basis of the property has to be reinvested into the property, and that substantial improvements are made to it.

Say you purchase a derelict shopping mall for USD1 million, and of that USD1 million purchase price you allocate 60 percent to the building and 40 percent to the land.

"During the 30-month investment period," says Nowak, "that property must be substantially improved by increasing the adjusted basis of the building by whatever the adjusted basis was at the time of purchase. So, in this example, for the first 30-month period after purchase, an additional USD600K must be spent on making improvements.

"At the same time, the QOF has to maintain a balance sheet of qualified opportunity zones assets on the balance sheet, such that 90 percent of the assets are opportunity zone property."

This is to prevent QOFs from being used as tax shelters by businesses that are not truly involved in the zones.

Squaring the circle

The intersection of these two conditions, however, creates a problem. During the 30-month window, it is likely that cash on the balance sheet will be in excess of the 30 percent limit and cause the QOF to fail the 90 percent asset test; even though the manager is holding cash to satisfy the purposes of satisfying the substantial improvement test.

Nowak confirm that the IRS has said that there will be a look-back approach, whereby if those cash reserves are used to meet the substantial improvement test, even though they are being held on the balance sheet, it would nevertheless allow the fund to still qualify and meet the requirements of the 90 percent test.

It wouldn't be possible to square the circle if this look-back were not taken into consideration. A sponsor would be holding cash on the balance sheet specifically to make substantial improvements to the property, yet by doing so they would automatically fail the asset test.

Be transparent

Depending on the project, Nowak says he expects that sponsors of QOFs will need to use additional footnote disclosures (when it comes to reporting to the IRS) relative to properties that are under development, such as working capital reserves. "For example, an explanation as to why there are working capital reserves and that they are in place to meet with substantial improvement requirements, and an explanation as to how those working capital reserves still fit within the testing rules."

From the investor side, being mindful of the 180-day rollover is a hard and fast requirement. As Nowak puts it, "there's no get out of jail card; if it's 181 days, you don't have a qualified rollover. If that happened, you would recognize the gain and you wouldn't get to defer it."

Get your pricing right

In conclusion, Nowak also stresses the importance of how sponsors price opportunity zone assets. He is adamant that one should determine whether the price of the asset has been influenced by virtue of the fact that it sits within a designated opportunity zone. This is vital because at the end of the opportunity zone horizon, as the program sunsets, how will future values be affected?

"The value may be higher today but what happens at the end of 10 years? If it was artificially inflated, is it realistically deflated, such that you are left with an asset that hasn't appreciated according to what your model predicted?

"What we have explained to clients is that the deal should make sense, without the opportunity zone; this should simply be the icing on the cake. If it can't stand on its merits maybe it's not the right opportunity to pursue. It's an important consideration that not all investors are thinking through." ■