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Finding Good Real Estate Investments in Opportunity Zones

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There are more people with significant capital gains seeking investments in the low-income census tracts that have been so designated as Opportunity Zones (“OZ”)¹ than there are available real estate projects that will provide an acceptable rate of return. But identifying the right project, often found in established redevelopment plan areas, is well worth the effort in order to achieve the benefits of the deferral of current capital gains and the complete avoidance of tax on any gain from an OZ investment. In our experience, sophisticated investors early to the OZ space have recognized that sound real estate investment principals are the drivers for investment in an OZ, rather than the capital gain deferral under the OZ program. Successful investors under the OZ program (which includes those developers who have capital gains to invest in their own development projects) will be those who can identify OZ compliant real estate projects that will appreciate over time. Critical to this task are the following: (1) finding the right OZ property – a property in an area where prior projects have already started to turn the neighborhood and with state and local support; (2) establishing an appropriate legal structure for an OZ real estate project that addresses key regulatory, tax and business issues – a structure that

¹ It has been estimated that unrealized capital gains – or capital gains on assets that have not been sold yet – totaled \$6.1 trillion at the end of 2017. <https://eig.org/news/opportunity-zones-tapping-6-trillion-market>

allows an investor to invest capital gains in its own development project to the extent permitted or to team up with a developer open to a financing structure that will enable an investor(s) to take a significant equity participation; (3) selecting an investment that is managed by the right developer/manager – a company with a proven track record; and (4) investing in a project that avoids regulatory uncertainties – a project that fits well within the requirements of the developing IRS regulations rather than one that requires clarification through new regulations.²

This article explores these critical elements of OZ real estate investment.

Finding OZ Property Appropriate for Investment.

Finding properties that are in qualified opportunity zones (“QOZs”) is easy.³ Once a property within a QOZ is found, investors will have to be sure that they are investing in a corporation or partnership that meets the requirements of a qualified opportunity fund (“QOF”), and that the QOF is an investment vehicle that will own a qualified opportunity zone property or business.

However, the initial task of finding available QOZ property (in a State like New Jersey) at a purchase price that reflects the developmental challenges often associated with these properties is more challenging.⁴ Moreover, almost by definition, developing property that is in a census tract that qualified the area to be designated as an OZ, is a challenging business. Many of the properties that might be available in OZs present difficult development issues, such as

² Notably, not on the above list is a requirement that a real estate project be “shovel ready.” It is true that in order to take full advantage of the deferral of current capital gains until December 31, 2026, and the reduction of up to 15% of current capital gains if an OZ investment is held for seven years, one must act by year end 2019. However, the complete avoidance of tax on any gain from an investment in an OZ is still available as long as the investor is willing to hold an ownership position in a Qualified Opportunity Fund (“QOF”), the vehicle for investment in an OZ property or businesses, for ten years. 26 U.S.C § 1400Z-2(b) (2) (B). While the 10 year hold requirement could be called another critical element of a successful OZ play, finding the right project seems to be the more challenging issue and hence the focus of this article.

³ New Jersey’s OZ mapping tool can be found at:

<https://njdca.maps.arcgis.com/apps/webappviewer/index.html?id=96ec274c50a34890b23263f101e4ad9b>

⁴ Further, landowners now may feel emboldened to sell assets in an OZ at a premium to capitalize on the tax advantages associated with the program.

dealing with contamination and geotechnical issues, which is why those sites have yet to be developed. As the New York Times noted recently, “While the tax benefits are enticing, investors should consider that property development has its own risks, and zones targeted by the new funds are, by definition, intended to be in areas where development generally hasn’t occurred on its own.”⁵

The good news is that New Jersey public policy and legislative support favor redevelopment of older urban and suburban areas of the State, with many municipalities already having taken steps to encourage redevelopment. Many have adopted redevelopment area or rehabilitation area designations and have adopted redevelopment plans. Public private partnerships are often critical to the success of OZ projects. Investors should look for those municipalities that have a track record of assisting developers in their efforts to turn around areas that evidence the need for redevelopment. Targets are those municipalities that have set development priorities for such areas within the OZ zones and prioritized OZ neighborhoods and projects. The willingness of a public partner to undertake condemnation for the hold out property can often be a critical component of success when it comes to acquiring hole in the doughnut properties.

Capital should flow to those OZ projects that will draw upon clear municipal policies with respect to local tax incentives. Incentives beyond the OZ program will play a large role for projects located in challenged areas, because capital afforded by OZ investment often will not be enough to attract traditional financing and make an OZ project pencil. Thus, projects with existing local tax incentives, such as redevelopment projects utilizing payments in lieu of taxes

⁵ “Opportunity Zones Offer Tax Breaks, and Maybe, Help for Communities”, <https://www.nytimes.com/2019/02/15/business/opportunity-zone-tax-break-controversy.html>

or "PILOTs" under New Jersey's tax abatement statutes, may be particularly attractive to OZ investors.⁶

Successful OZ projects will have municipal support to create a stable, streamlined approval and development process. Investor capital should flow to those municipalities that foster inter-departmental planning and coordination so that economic development, planning and zoning, code and construction departments are all informed and on the same page with respect to OZ development projects. The designation of a local OZ program coordinator can evidence a commitment to accomplishing such a task. Also important is coordination with non-municipal stakeholders such as state, county and community development organizations to make sure project impacts meet articulated community needs.

One early example of the use of Opportunity Zones is the Yard 56 project located in Greektown, Baltimore.⁷ Yard 56 recently received an OZ investment from a subsidiary of Prudential Financial called Prudential Financial Impact Investments. To incentivize outside investment and help deals work for private developers, the City of Baltimore created a Neighborhood Investment Fund and invested nearly \$52M in City money (now up to \$80M with private contributions) for OZ projects throughout the City. The City parleyed its investment into a \$35M grant from the Department of Housing and Urban Development for the redevelopment project.⁸ In addition to Baltimore's efforts, the State of Maryland has set up a virtual meeting

⁶ Long-term tax abatements under N.J.S.A. 40A:20-1 and short-term tax abatements (N.J.S.A. 40A:21-1) may last up to 30 years from completion of a project, are typically utilized for larger redevelopment projects, and require a municipality to declare an area as being in need of redevelopment. The PILOT is then set based on a percentage of project costs or revenue generated by the project, depending on the type of project. Short-term tax abatements (N.J.S.A. 40A:21-1) typically lasting five years are used to encourage rehabilitation of existing buildings and structures, but can also be used for larger scale new construction.

⁷ While not a New Jersey project, this project is discussed because it combines various incentives to support OZ real estate projects, and a similar potential exists were multiple tools are available for such projects.

⁸ <https://www.bisnow.com/baltimore/news/opportunity-zones/baltimore-opportunity-zones-its-a-race-we-hope-we-win-97221>

place and public website to help potential investors identify projects and learn about the incentives available to businesses located in opportunity zones. The State also established a ten year tax credit to businesses in OZs and exempted those businesses from property taxes and business fees. The State also set aside \$3M dollars for a competitive grant program for businesses in OZs to train workers.⁹

Establishing Legal Structures for OZ Real Estate Projects That Address Regulatory, Tax and Business Issues

How OZ real estate projects are structured has a major impact on the availability of tax benefits under the OZ program. One of the biggest issues with which developers are currently struggling in structuring OZ transactions is the “related party” provisions of the OZ legislation. The OZ statute provides that in order to achieve the tax benefit on the gain from investment in an OZ, the gain must be a “gain from the sale to, or exchange with, an unrelated person.” (26 U.S.C. Section 1400Z-2(e) (2)). A related person is defined based on Section 267(b) and 707(b) (1) of the Internal Revenue Code, but the OZ statute substitutes 20% in place of 50% as the definitional threshold.¹⁰ Accordingly, the gain cannot include gain from the sale to or exchange with a person who owns more than 20% of the QOF. Similarly, a QOF or Qualified Opportunity Zone Business (“QOZB”) owned in part (or wholly) by a QOF in which the seller owns more than a 20% interest in cannot acquire tangible property from that seller. Caution should be taken by developers or real property owners that plan to sell those assets to a QOF or QOZB. The related party provisions of the OZ statute must be analyzed in detail in the context of the specific facts and circumstances of particular proposed transactions taking into account the capital contributions imputed to developer members for pre-formation costs and contributions.

⁹ https://www.washingtonpost.com/local/md-politics/hogan-to-bolster-trumps-opportunity-zones-with-state-investments/2019/01/03/2322de48-0f71-11e9-84fc-d58c33d6c8c7_story.html?utm_term=.e94b5c9da515

¹⁰ 26 U.S.C. § 1400Z-2(e) (2).

Investors and developers need to ensure that their joint venture operating agreements are drafted in a way that will address not only OZ issues but also the regulatory, tax and business issues such projects present. Promotes (sometimes referred to as “carried interest”)¹¹ must be structured in such a way so as to comply with OZ regulations. Creative structuring for the payment of development fees and management fees may be a way to help developers/owners recoup the “soft costs” of OZ projects¹². Developer members typically oversee construction and manage day-to-day operations of a completed project through an affiliated management company, and operating agreements should provide the developer with the authority to fulfill such obligations. Operating agreements should also establish an appropriate series of thresholds or waterfalls and provide for appropriate restrictions on investor members such as not being permitted to withdraw funds, transfer interests, or participate in management and having to maintain the investment for the ten year statutory hold period.

Finding The Right Developer/Property Manager

Developers who can help make OZ real estate projects a reality are perhaps the most important piece of the OZ equation. Savvy investors know that a builder or property manager can make or break a project. Those investors recognize that in OZs, they are not investing in a proven real estate market. Thus, they must look for developers that have the knowledge, reputation and ability to effectively and efficiently deploy capital and/or get debt to match QOF dollars, much like the qualities municipalities look for in designating a redeveloper.

¹¹ Promotes incentivize the developer member by granting it a disproportionate share of distributions after the preferred returns are achieved. In the OZ context, promotes are generally 20% of the fund’s net capital appreciation and fees, while the limited partners will receive 80%.

¹² Notwithstanding the foregoing, when negotiating these provisions in an operating agreement, developers should take into account the potential variations in the federal income tax treatment such fees.

In order to be considered a QOZB property, a property must be substantially improved after purchase of the property¹³, the costs of constructing, renovating or expanding the property during the thirty-month period beginning after the date of the acquisition of the property must exceed 100% of the adjusted basis of the property at the start of the thirty-month period.¹⁴ Thus, the "substantial improvement" clause requires a QOF to double its investment in the property within thirty months of acquisition. Further, the proposed OZ regulations tie in the QOZB property qualification to compliance with the reasonable working capital safe harbor ("Safe Harbor"). The Safe Harbor for QOF investments applies to QOZBs that acquire, construct or rehabilitate business property used in a business operating in an OZ. The Safe Harbor allows QOZBs to treat all working capital (cash and debt instruments) as reasonable for a period of thirty-one months as long as there is a written plan that states that the working capital is being held for the acquisition, construction or substantial improvement of property in an OZ, and a schedule for the expenditure of the working capital and the working capital is used in accordance with that schedule.¹⁵

The obligation to deploy QOF funds within 6 months, and the substantial improvement requirement and the Safe Harbor provisions of the regulations require QOZB projects to be complete, operational and market ready within the thirty and thirty-one month timeframes, respectively. The ability to deploy capital and complete construction within the thirty month and thirty-one month windows permitted are not easy tasks. This places significant

¹³ The requirement that the property be substantially improved applies unless the "original use of such property in the [QOZ] commences with the [QOF]." 1400Z-2(d) (2) D (i).

¹⁴ 26 U.S.C. § 1400Z-2(d) (2) (D) (i). Alternatively, if a QOF obtains property for a new and original use, it does not have to substantially improve the property. *Id.* Original use remains entirely undefined so far in QOF guidance. Many people have been asking whether original use has to be ground up development or whether other sorts of projects may qualify. What happens if property acquired by a QOF was abandoned for a substantial period of time before the purchase? Would the original use relate back to the last time the property was in use, or is any new use of the property considered the original use? This is a topic expected to be covered in the second round of proposed regulations.

¹⁵ 26 U.S.C. § 1400Z-2(d) (2) (D) (ii).

responsibility on developers/managers for capital deployment and development. Investors must partner with those developers who have the experience, track record and band-with to “de-risk” a project by locking down entitlements and financing early and providing property management services so as to enhance the likelihood of asset appreciation over time.

Avoiding Regulatory Uncertainties.

Lastly, while investors and developers are moving fast to raise dedicated funds and deploy capital, they do so amidst substantial regulatory uncertainty. The recent government shutdown has created a major delay on achieving clarity with the OZ program. The public hearing scheduled to discuss the first round of proposed regulations issued in October of 2018 was cancelled in January and was just recently held on February 14, 2019. The Department of the Treasury had been working on a second set of proposed regulations which were anticipated to be released back in January, but the government shutdown also delayed progress on the publication of those regulations. Thus far, investors in early OZ real estate projects have deployed capital into simple, straightforward OZ real estate projects that avoid the vast array of regulatory uncertainty inherent in a program based on a new IRS statute with no final regulations.

Investors have avoided project structures where a QOF uses eligible cash proceeds to directly acquire and hold a QOZ business property (such as land and an existing building which it intends to substantially improve within the requisite 30 month period). This “single-tier” direct investment structure is not favored within the current OZ regulations.¹⁶ Rather, the OZ regulations virtually mandate the use of a two-tier/indirect investment structure, where the QOF

¹⁶ Under a single-tier / direct investment structured deal, 90% of all of the QOF’s assets must be QOZB property and the QOZB property must be used in the QOF’s trade or business. 26 U.S.C. § 1400Z-2(d) (1). Under this structure, intangible property is not considered QOZB property for purposes of the 90% asset test. 26 U.S.C. § 1400Z-2(d) (3).

holds an interest in a lower-tier partnership or corporation and that entity holds the property. Under a single tier/direct investment structure, the QOF is not afforded reliance upon Safe Harbor for QOF investments. However, the proposed regulations do allow two tier/indirect investment structured projects to take advantage of the Safe Harbor. Further, the regulations allow for a lower 70% asset test at the lower-tier partnership or corporation level (as opposed to the 90% asset test) and only 50% of the gross income of the QOZB has to be derived from the active conduct or business within the OZ.¹⁷ Finally, although it is not currently clear under the regulations how QOZB property requirements will be applied to leased property, a QOZB is able to lease property which might possibly qualify as a QOZB property.¹⁸ Thus, even when an investment might just as easily be set up using a single-tier/direct investment structure, the current regulations force investors into two-tier/indirect investment structured deals. Perhaps future rounds of regulations will align some of the rules for single-tier and two-tier structures so as to eliminate the need for unnecessary structuring.

Investors have also avoided large scale, heavy development oriented projects and those with multi-phased takedowns of land. The regulations have yet to clarify how land will be treated under the QOF asset tests. In Revenue Ruling 2018-29, the IRS stated “given the permanence of land, land can never have its original use in a QOZ [qualified opportunity zone] commencing with the QOF.”¹⁹ Accordingly, land must be substantially improved in order to qualify as QOZ property. This prohibits phased development projects containing large tracts of vacant land from taking advantage of the tax incentives of the program. If

¹⁷ Id.

¹⁸ This is important because currently landowners who acquire property prior to December 31, 2017 are unable to take advantage of the tax incentives. Leasing arrangements might be established which would allow owners of the land to set up separate land and construction joint ventures to meet regulation requirements.

¹⁹ Section 1400Z-2.--Special Rules for Capital Gains Invested in Opportunity Zones- Rev. Rul. 2018-29

vacant land is not considered to be QOZ property, the inclusion of such land in a QOF's asset test might cause it to flunk the test, even if the QOF is actively developing another "phase" of the project. For example, if a QOF plans to invest \$6,000,000 in a project that contains \$4,000,000 worth of vacant land for future phased development, even if the entity has taken steps to meet the reasonable working capital requirements, the \$6,000,000 is only 60% of the entity's \$10,000,000 in assets and the QOF would fail its asset test.²⁰ It is possible that future regulations may contain some sort of percentage test, requiring that a certain percentage of the land must be developed to be included in the asset test, but that remains to be determined.

As noted above, the substantial improvement clause and the Safe Harbor provisions of the regulations require projects to be complete, operational and market ready within the thirty and thirty-one month timeframes. This raises significant issues for large, complex real estate or redevelopment projects because of the timing considerations for development and capital deployment associated with such projects. As of now the regulations do not provide accommodation for unforeseen delays that often accompany such projects.

The proposed regulations potentially open the door to more rehabilitation projects within OZs by clarifying that the value of the land is excluded in calculating whether the value of the property has been doubled. However, like large scale projects, the timing associated with rehabilitating and improving existing buildings may make it difficult for such projects to avail themselves of the tax advantages of the OZ program. It is likely that much of the early projects moving forward under the OZ program will be ground up development simply because it is easier to develop new construction than it is to go into an existing building and improve it.

²⁰ This same analysis would apply if the property in the project was not vacant land but was acquired prior to December 31, 2017. It would also not be considered QOZ property.

Many of the comments submitted to Treasury regarding the proposed regulations focused on the seemingly arbitrary timeframes set forth for substantial improvement and capital expenditure of cash contributed by a QOF. It remains to be determined whether future regulation will provide extensions of these timeframes to account for the delays that often accompany these projects, a reality all too common for commercial real estate transactions.

Conclusion

Because OZ real estate projects will take years to build and because an investment in an OZ must be held for ten years, to reap the tax benefit offered by the new legislation, we won't know whether OZ real estate projects will pencil out for developers and achieve the tax benefits for investors promised by the new statute. For those who get it right, there will be capital gain deferral and significant rates of return. However, all too common unforeseen delays and complications accompany commercial real estate transactions. The complexity of developing in these challenged areas and the complexity of the OZ program has served to filter out some investors who aren't quite ready to parse through such an uncertain regulatory environment.

While a surge of investor interest (and concurrently a surge of available capital) is expected for redevelopment and real estate projects in OZ areas over the next year,²¹ investors would bode well to take the necessary time to find those OZ projects demonstrating the above attributes. The proposed regulations provide that an OZ investment can be held until 2047 in order to meet the ten year hold period. The inability to claim an additional 5% stepped up basis on an existing gain because you did not invest a full seven years prior to the December 31, 2026 deadline is minimal compared to finding the right real estate investment that will appreciate

²¹ The deadline for investors to receive the full tax benefit of a 15% reduction in capital gains is the end of 2019 as existing gains deferral only runs until December 31, 2026.

significantly over time. Accordingly, investors should consult with experienced counsel and tax advisors to navigate the very specific and changing regulations that surround the OZ program.

This article discusses a very complex program under the tax code, the regulations for which have not yet been adopted. You should consult with an attorney and a tax advisor for the law's particular application to your circumstances.