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Public Private Partnership (P3) Transactions Lead to QOZ Investment Opportunities

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Introduction

For Qualified Opportunity Zone (QOZ) investors seeking opportunities, the intersection of QOZ and Public Private Partnership (P3) transaction structures may be where the proverbial "X" marks the spot on the buried treasure map. Both so-called "social-infrastructure" and "transportation-infrastructure" P3 transactions are easily, and perhaps naturally, located within areas recently identified as QOZ. As a result, QOZ investors can benefit from the tax and financial incentives relating to QOZ thereby structuring transactions with lower revenue models while maintaining required return thresholds. P3 transactions are also able to better attract and leverage available federal, state and local tax, financial and public infrastructure benefits further intensifying the relationship between QOZ investments and P3 transactions.

Brief Summary of QOZ Program

Qualified Opportunity Zones are part of the Tax Cuts and Jobs Act of 2017. Investors can place capital gains into a Qualified Opportunity Zone Fund and receive the following benefits:

- Deferral of capital gain tax to 12/31/2026;
- For properties held at least 5 years, exclusion of 10% of capital gains tax due on 12/31/2026;
- For properties held for at least 7 years, exclusion of an additional 5% (15% total) of capital gains tax due on 12/31/2026; and
- For properties held at least 10 years, exclusion of all capital gains upon sale, as long as the sale is made prior to 12/31/2047.

Investors have 180 days after recognition of a capital gain to invest in a Qualified Opportunity Fund. Eligible properties must be acquired after 12/31/17 from an unrelated party (defined for QOZ as no more than 20% related). For real estate projects, the project must be an "original use" for the site, such as new construction or there must be a substantial improvement made to the property defined as at least $1 more than the current basis attributable to the existing structure. The IRS has indicated that a sale of the property prior to the 10-year hold requirement will be allowed as long as the funds are placed into a Qualified Opportunity Fund within 180 days.

Public Private Partnership Transactions

What is a P3 transaction? A P3 transaction is essentially any development or operational project that combines both public and private investment into projects that may be entirely used or occupied by governmental entities or otherwise provide public functions (e.g., a bridge, highway, waste water treatment facility, government occupied office building, port or publicly owned hospital) or used and occupied by both governmental functions and private development (e.g., a mixed use development including a public office building and garage adjacent to a sports stadium, or a "campus-edge" project with an urban university bringing retail, student housing and research facilities to campus).

P3 transactions can take many different forms and structures and are typically categorized by the specific type of asset or use created or furthered through the use of the P3.

"Social-Infrastructure" P3 transactions include hospitals, research facilities, government office buildings, police and fire stations, government owned hotels, workforce housing, K-12 schools, colleges and universities and sports stadiums. "Transportation-Infrastructure" P3 transactions are typically highways, rail, ports and bridges. There will certainly be a need to accomplish all of these types of projects in the near future, and, through creative approaches and structures, QOZ can foster both categories of P3, and both categories of P3 can benefit from QOZ.

Intersection of Public Private Partnership Transactions and QOZ

The Tax Cuts and Jobs Act of 2017 permitted state government to locate QOZ in each state. In most cases, state governments located QOZ in distressed areas of low employment rates and overall income levels. Such areas are typically not a beacon for corporate, manufacturing, hospitality or retail investment. As a result, formed and funded QOZ funds are finding it difficult to identify potential transactions and investments.

The benefits created by the QOZ program are designed, however, to create the incentive to invest and change this economic reality. As summarized above, however, the framework of the QOZ program essentially fosters long-term investment which further limits the potential projects for QOZ investors because in many cases, market driven real estate developers may not be long-term-hold players. Instead, such developers seek to create value in excess of cost, monetize the same through sale and invest in other similar projects. Of course, underlying the issue of investing in economically depressed areas is the inability of a market return driven investor to achieve the returns on equity necessary to justify the investment.

Also, in light of the short time frames for QOZ investments identified above, and the long gestational periods associated with Transportation-Infrastructure P3, Transportation-Infrastructure P3 developers, and interested QOZ investor/developers, will need to be creative and likely combine categories of P3. For example, consider a project involving a pedestrian bridge and public park being constructed on a privately-owned office building or parking garage connecting key locations within a city. The bridge and park could be owned publicly, but maintained and operated by a private developer building such costs into the business model supported by the office building and garage.

Social-Infrastructure P3 transactions, on the other hand, are often perfectly situated to be built in such economically depressed areas. In fact, public partners are best situated to stimulate investment in such areas because public partners can place social-infrastructure P3 projects in these areas by, for example, controlling and contributing land historically overlooked by private development. The value of controlling this land should not be underestimated. Brokers and developers have already reported an increase of as much of 50% in sales prices for some land and buildings in QOZ and sales of development sites in QOZ increased 80% in the first three (3) quarters of 2018 according to Real Capital Analytics.[1]

In addition to land control, public partners are able to further support Social-Infrastructure P3 transactions by entering into long term leases or revenue sharing agreements supporting financing, providing grants and forgivable loans, sharing new sales tax, real estate tax exemptions, asbestos removal or brownfield remediation, tax increment financing, and constructing supporting infrastructure such as parking garages, utility extensions or relocations and roadways. Leveraging the ability to control and contribute the sites for P3 transactions, together with the aforementioned "incentives," is extremely effective tool to minimize or eliminate the so-called "investment-gap" that plagues P3 transaction formation as discussed below.

Other than the political and legislative issues facing any creative P3 structure, the so-called "investment gap" is potentially the single largest impediment to successfully launching a P3 transaction. This gap is the difference between the returns on investment sought by private developers and the relatively low cost of funds at which a public entity can borrow for the target project. Developers need to charge a rent, service fee or availability payment, for example, that produces market returns while public debt service charges may be less than the cost of such payments to a private developer. While seasoned P3 participants understand that only looking at this investment-gap is a mistake and parties need to model and understand the entire cost of ownership, operation, maintenance, repair, replacement and decommissioning in order to fully compare a P3 structure to a purely public or private transaction, this so-called investment-gap is the initial focus for many state and local governments and their constituents.

In summary, by combining the benefits of a P3 transaction with the tax and other economic benefits created by QOZ, QOZ investors are potentially able to structure investment models with revenue demands below those necessary to produce market returns thereby minimizing the "investment-gap" and fostering the matching of P3 projects within a QOZ.

[1] Developers Look to Hit Tax-Break "Jackpot" in Opportunity Zones, Peter Grant, Wall Street Journal October 23, 2018