Client Alert

Akin Gump
STRAUSS HAUER & FELD LLP

Opportunity Zones: How Communities Can Leverage This New Provision to Jumpstart Investment

September 19, 2018

Contact

Susan H. Lent
Partner
slent@akingump.com
Washington, D.C.
+1 202.887.4558

John J. Marciano III
Partner
jmarciano@akingump.com
Washington, D.C.
+ 1 202.887.4450

Amy S. Elliott
Senior Practice Attorney
aelliott@akingump.com
Washington, D.C.
+1 202.887.4039

Key Points

- Even though practitioners are awaiting proposed regulations on the new opportunity zone provision, interested parties are already starting to set up qualified opportunity funds to pool investor capital.
- States, cities, and communities with qualified opportunity zones within their boundaries should take action now so that their projects attract the attention of fund managers.
- By providing complementary tax benefits, developing a marketing strategy that includes a targeted OZ website, and partnering with major local employers and anchor institutions, jurisdictions can better attract the tax-fueled economic stimulus promised by the new program.The SDN list to which these parties have been added is the strictest list OFAC maintains—it generally bans all activities between these parties and U.S. persons and imposes a complete block on these parties' property and interests in property that are or become subject to U.S. jurisdiction.

State and local governments around the country are anxious to position themselves for the influx of investment dollars expected as a result of the new opportunity zone (OZ) provision signed into law in December 2017 as part of the Tax Cuts and Jobs Act (TCJA, P.L. 115-87).

Found in Internal Revenue Code Sections 1400Z-1 and 1400Z-2, the OZ provision gives individuals and corporations with investment gains the ability to roll those gains into struggling communities in exchange for multiple tax benefits. Proponents of the provision anticipate that the tax benefits are significant enough—and the amount of eligible gains is large enough—that the provision could result in tens of billions of dollars of new capital flowing into eligible communities each year.

What can your community do now to attract this capital? Experts are saying early movers should have more success when the money starts coming in at scale. Even though the provision raises significant as-yet unanswered questions, some advisors think certain funds can be launched today with little risk. State and local leaders need to develop a strategy now to increase the chances that the OZ provision will benefit their communities.

Conform State Tax Code to IRC

The tax benefits of the OZ provision may not sway investors to direct their capital to communities in a state if that state's tax code does not conform to the Federal Internal Revenue Code (IRC). For states that have adopted "rolling conformity"—such as Louisiana—or for states that do not tax capital gains—such as Texas—this is not an issue.[1] But nonconforming states—such as Arkansas—may want to reconsider. Some even suggest that states may want to provide additional tax incentives targeted at OZ businesses such as excluding business profits from state income taxes altogether. States or localities that enter into public-private partnerships so that they have some skin in the game with investors may also find that they have an easier time attracting interest from funds.

Create a Targeted OZ Website

Why has it been challenging for some communities to attract investment? According to one of the champions of opportunity zones—Steve Glickman, formerly of the Economic Innovation Group—it is because many investors have a herd mentality, sending their dollars to safe, familiar locations. The OZ provision is designed to systemically change the flow of capital so that it can migrate to places that might otherwise have been overlooked.

Experts say that one of the best way to ensure that projects in OZ-eligible communities are not passed over is to create an OZ-focused website.[2] It could include a map showing what areas in your community are designated as qualified opportunity zones. It could include ways in which the efficiency and desirability of the project can be supercharged through easing of zoning rules/population dispositions and various other business incentives. But most importantly, it should include details of OZ-ready projects, ideally ones that were already in the pipeline as part of a master plan.

Examples include:

- District of Columbia Opportunity Zones
- Colorado Opportunity Zones
- City of Norfolk Opportunity Zones (which includes a link to a 38-page site presentation)
- Washington Opportunity Zones
- Pennsylvania Flagship Opportunity Zone (in development, although Erie, PA, is also working on a prospectus outlining the ways in which the city plans to promote the zones to investors)[3]

---

[1] http://www.opportunityzonesresourcecenter.com

[2] Be aware that whatever material the community puts on a website should include an appropriate disclaimer that the information is not intended to be, nor should it be, construed as an offer to sell or a solicitation of an investment in any securities, nor should it be construed as investment, tax or financial advice. Please consult an attorney to ensure that you do not inadvertently violate federal securities or other laws.

[3] http://www.goerie.com/news/20180824/erie-develops-opportunity-zone-website#

If your community or state has not already done so, it should institutionalize its OZ strategy by identifying staff who are dedicated to working on opportunity zones. They could be housed in your state's Department of Community Affairs, Department of Community and Economic Development or a similar office.

Providing marketing materials showing where the deals are and getting that information in front of investors is critical to attracting the herd's attention. If you wait too long get in the game, you risk getting crowded out of the market, especially in cases where the OZ projects are not expected to reap outsized returns. By doing the legwork to develop a brand and getting the word out now, your OZ projects have a better chance of attracting attention. Enterprise Community Partners has developed a tool that will automatically generate a 25-page report for every census tract that has been designated an opportunity zone. For example, click here for the report for the portion of Houston containing the Toyota Center and Minute Maid Park.[4]

Which brings us to an important point: the OZ provision will not change the performance of an underlying investment. It just sweetens the tax treatment of the returns. What returns are investors expecting? According to Rachel Reilly of Enterprise Community Loan Fund Inc., a community development financial institution, investors will generally expect their OZ investment to generate a 9 percent to 13 percent return (cash-on-cash). Investors are looking for deals, and communities can play an important role in helping investors find the deals.

Host Investor Tours

Community leaders can connect the capital market to their OZ projects by offering fund managers the opportunity to tour their communities, understand the local pressures and view the project sites. Not only will such tours give fund managers a better sense of how your projects might fit into their investment strategy, but also they can show how committed your community is to ensuring the success of the projects.

If your community has any publicly-owned parcels of land that fall within an opportunity zone (as is the case in places such as Lorain, OH,[5] and Duluth, MN), it might consider offering land grants to OZ fund developers (although that could raise issues with respect to the OZ provision's substantial improvement requirement, which is tied to the value of the property, irrespective of whether it was transferred for much less, although the starting point for cost basis is usually the sales price).

By sharing with investors your community's master plan, providing market data on population growth, level of education, etc., you can help set your opportunity zone apart. You can also get started on the due diligence legwork that investors will require before deciding on a particular project.

While the first OZ investment will likely be tied to real estate development (either commercial—such as office, warehouse, or retail; residential, including affordable housing; or mixed-use), there are many other types of assets and businesses that can benefit from the OZ provision. For example, consider energy infrastructure (water, solar, wind); entrepreneurship (start-ups, business expansion, and franchises), and

[4] Additional reports can be accessed by identifying a census tract on the Opportunity Zone Eligibility Tool on this page https://www.enterprisecommunity.org/opportunity360/opportunity-zone-eligibility-tool and then hovering over it until the report link pops up in a window.

[5] http://www.naiopnorthernohio.com/event/opportunity-zone-lorain-county-black-river

brownfields redevelopment (the development of property that is considered blighted due to environmental contamination).

While commercial real estate may be a relatively easy first investment, in order to benefit from the sweetest tax advantage of the OZ provision (the fact that tax on the appreciation of the investment is wiped away if the investor stays in for at least 10 years), investors will likely want their OZ funds to have stakes in businesses and not just property. And because, in many cases, opportunity zones located outside of major cities represent a sizable portion of the downtown of a community, opportunities for such business investment should be readily available.

Invest in Workforce Training

States and localities can provide workforce development programs to draw employers to opportunity zones. The government should be willing to invest in skills training so that there are qualified professionals to fill the new jobs businesses will be bringing to the community. Such programs will not only enhance your community's attractiveness for OZ investment, but also provide a way to ensure that the new capital coming into your community has a real and positive impact on people's lives.

Consider this: about 35 million people live in a designated qualified opportunity zone and 56 percent of them are minorities. Facilitating OZ investments that hold real potential to create new jobs and increase wages is a great way to get the community to rally behind a development.

Partnering with major employers and anchor institutions in the communities adjoining an opportunity zone can also help generate momentum in this respect. There may be a way for existing small businesses that are equity constrained but want to grow and hire to benefit from the OZ provision by expanding their business in an opportunity zone.

Target Your Incentives

According to early research conducted by the Council of Development Finance Agencies (CDFA), OZ fund capital will only meet between 5 percent and 30 percent of the dollars needed for a project. While the shortfall could be filled by debt financing in some cases, in other cases, communities may want to make available additional incentives to bridge the gap.

Development finance tools that exist today and that might be aligned with the OZ provision—taking up a piece of the capital stack— include:

- Tax Increment Financing (TIF) grants
- Low Income Housing Tax Credits (LIHTCs)
- Historic Tax Credits (HTCs)
- Private activity and industrial development bonds
- New Markets Tax Credits (NMTCs)
- Community Development Financial Institution (CDFI) loans
- Community Development Block Grant (CDBG) loans
- Section 108 loan guarantees

According to CDFA, 33 percent of states are considering offering additional incentives for OZ projects. For example, Missouri (the first state to pass OZ-specific legislation, S.B. 773) decided to set aside $30 million from the state's historic preservation tax credit program for projects located in opportunity zones.[6]

Creating new incentives to boost an OZ fund's return could also give states and localities the opportunity to require reporting on the social impact of the OZ investment, such as new jobs or increased access to healthcare. Other data points might involve housing accessibility, reduced poverty, improvements in wage inequality and labor force participation, and the extent to which the census tract's gross domestic product has increased.

The new OZ statute does not require OZ investors, funds or businesses to collect and report data on the social and economic impact their capital investments are having. But your community may be falling behind in certain areas and might be able to benefit from offering specific incentives designed to change outcomes. By extending those incentives past the 10-year window associated with the OZ provision, you increase the chances that the impact any OZ capital has had on your community will not disappear, ensuring sustainability.

(Note that there is an effort to convince the IRS to collect and publish—anonymously or using aggregation—data on OZ funds, given that they are already required to self-certify that they meet the statute's requirements. On September 6, a group of investors wrote to the Treasury Department requesting that it impose a data reporting requirement that would include value of capital, type of OZ property acquired, industry, location, job creation, poverty reduction, etc. However, early indications are that Treasury is not prepared to impose such a requirement that goes over and above what is provided for in the statute.)[7]

In addition, some of your community's best sources for OZ investment may be its residents. High net worth families that reside near opportunity zones may be interested in investing their gains locally (they may be looking for returns, but they have an emotional bond to a particular community). Local private developers may also want to roll their capital gains into OZ funds that are committing their dollars to the communities near those the developers serve.

OZ Funds Are Launching Now

There are uncertainties in the way the OZ statute was drafted—uncertainties that make it somewhat risky to set up an OZ fund that pools gains from multiple investors and leverages them to invest in multiple OZ projects absent additional guidance. Nevertheless, funds are being established now.

Practitioners say the funds being created today are largely indirect funds (where the OZ fund invests in an OZ business that holds OZ property). And those funds that have already closed are largely single purpose, single investor, single project funds. But that

[6] CDFA Opportunity Zones Report "State of the States" (August 2018)

[7] https://static1.squarespace.com/static/539e71d9e4b0ccf778116f69/t/5b904f864ae237af12ea6fc0/1536184200546/US-Impact-Investing-Alliance-Comments-on-Opportunity-Zone-Metrics.pdf

is changing, and the amount of capital getting steered toward opportunity zones is increasing dramatically. Some of the larger funds in development include:[8]

- **Fundrise Opportunity Fund LP** (a $500 million fund that will invest in office and mixed-use projects, its first of which will involve the restoration of a building in the LeDroit Park neighborhood of Washington, DC)[9]
- **RXR Realty's OZ Fund** (a $500 million fund that is expected to invest in a $319 million office development adjacent to Brooklyn Navy Yard, a $170 million mixed-use development in downtown New Rochelle, and an $83 million mixed-use development in Nassau County)[10]
- **Youngwoo Opportunity Fund** (a $500 million fund expected to launch on the EQUITYMULTIPLE platform with a focus on OZ projects in New York, Oakland, Seattle, Detroit, Los Angeles, and Portland)[11]
- **Emergent Communities Fund** (a $250 million fund that will invest in live-work-play-stay developments in small cities and towns with an initial focus on North Carolina and Virginia)[12]
- **Virtua Opportunity Zone Fund I** (a $200 million fund that will primarily invest in residential rental property development, hospitality and office in cities such as Austin, Phoenix, Atlanta, Dallas, San Antonio and Orlando)[13]
- **Somerset Partners OZ Fund** (the planned $200 million fund will invest in projects in South Bronx, New York City)[14]
- **Golden Door Asset Management** (this private equity firm that manages capital for high-net-worth individuals and family offices is focused on launching a $100 million fund that invests in small businesses in opportunity zones, especially those around Newark, N.J.)[15]
- **Shorewood Opportunity Zone Fund** (a fund focused on investing in multifamily, mixed-use, affordable housing and value-add renovation projects in New York City)[16]

---

[8] The bulleted list is just a selection. Other fund announcements that we have come across include: Enterprise Community Partners, Bridge Housing, PNC, North Coast Partners, Revolution, LISC/Access Ventures/Village Capital, LIIF, TPP Capital Management, Impact Finance Center/LegacyWorks, Rural Colorado Opportunity Zone Fund, Obsidian Opportunity Funds

[9] https://fundrise.com/opportunity-fund and https://s3.amazonaws.com/fundrise-content/website-documents/f33c5253-d483-4377-8548-1c2a134b1b02/Fundrise%20-%20Qualified%20Opportunity%20Fund%20PPM%20-%20FINAL.pdf

[10] https://hughesinstituteofrealestate.com/rxr_realty_to_launch_qualified_opportunity_zone_fund/

[11] https://therealdeal.com/2018/09/11/youngwoo-equitymultiple-plan-to-launch-500m-national-opportunity-zone-fund/ and https://www.prnewswire.com/news-releases/youngwoo--associates-and-equitymultiple-partner-to-create-opportunity-zone-fund-300710333.html

[12] https://www.enterprisecommunity.org/financing-and-development/opportunity-zones-program/rivermont-enterprise-emergent-fund

[13] https://www.businesswire.com/news/home/20180620005782/en/Virtua-Partners-Debuts-Opportunity-Zone-Fund

[14] https://therealdeal.com/2018/07/15/introducing-opportunity-zones-the-little-known-little-regulated-program-buried-in-trumps-tax-overhaul/ and http://www.somersetpartnersllc.com/opportunity-fund/

[15] http://www.goldendoorasset.com/

[16] http://shorewoodgrp.com/shorewood-opportunity-zone-fund/

- **American Opportunity Fund**,[17] **Puerto Rico Opportunity Fund**[18] and **Detroit Opportunity Fund**[19] (launched on the Wefunder platform, these funds have all committed to invest in small business start-ups in qualified opportunity zones)

In addition, some states and cities are working to launch their own OZ funds. New Hampshire has reportedly already launched an OZ fund and Nebraska and Erie, Pa., are reportedly close to launching their own OZ funds. According to CDFA, about one-third of states say they are considering launching their own funds (generally the states that feel they will otherwise be overlooked by investors), while the majority of states will likely end up in partnerships with fund managers to get a geographically-targeted OZ fund launched.

The Need for Guidance

The IRS and the Treasury Department have drafted an initial tranche of regulations currently under review by the Office of Information and Regulatory Affairs (OIRA) at the Office of Management and Budget. Once OIRA has signed off on the proposed regulations, which is expected to happen before the end of September, they will soon be released to the public for review and comment.

Some of the most critical outstanding questions that practitioners hope will be addressed in the regs (although there are already murmurings that the tax community should prepare to be underwhelmed by the guidance), include:

- Will all gains from the sale of property be eligible for the OZ tax benefits (including short-term, Section 1231 and ordinary gains) or only long-term capital gains? (Right now, most folks in the market are generally taking the position that the deferral is limited to long-term capital gains.)
- Will the government take an expansive interpretation of the deployment period to give funds additional time to invest the capital into qualified OZ business property? Absent additional guidance, the conservative view is that a fund only has 6 months to satisfy the 90 percent investment standard. Early proponents of the OZ provision have said that the original intent was never that there would only be a 6-month runway. If the runway is not made longer, it could be a challenge to launch funds with multiple OZ projects. Instead investors may find themselves rolling their OZ dollars into only single-purpose vehicles with little diversification. Investors are hopeful that this guidance will help create a market, not limit it.
- A related point, will the government provide working capital relief so that any temporary cash reserves that a fund has accumulated but not yet had the chance to deploy could be set aside in a controlled account dispersed only for reasonable working capital, and count towards the 90 percent investment test?
- Will vacant land have a substantial improvement requirement?
- The substantial improvement amount is likely tied to the full value of the property on acquisition (even if it was acquired with both equity and debt). But hopefully guidance will make this clear.

---

[17] https://wefunder.com/american-opportunity-fund

[18] https://wefunder.com/puerto-rico-opportunity-fund

[19] https://wefunder.com/detroit-opportunity-fund

- On what date is a qualified opportunity fund constituted? If your business previously owned assets located in an opportunity zone, can you take advantage of the OZ provision by navigating the related party rules?
- Does a qualified opportunity zone business have to operate in the opportunity zone, or can it simply have substantially all of its tangible property located for use in a qualified opportunity zone? (Although the statute does not appear to require OZ businesses to operate in an opportunity zone, advisors generally take the position that businesses should in order to avoid being perceived as abusive.)

The two officials in the government working most closely to develop this and future guidance on the OZ provision are Dan Kowalski (Counselor, Office of the Secretary, Department of Treasury) and Scott Dinwiddie (Associate Chief Counsel, Internal Revenue Service).

A limited amount of guidance has already been released on the OZ provision—the most useful of which is a set of frequently asked questions and answers available on the IRS website. We expect that additional guidance will be released in the coming months and years as the OZ provision gains more market attention.