A ROUNDTABLE DISCUSSION

OPPORTUNITY ZONES:

WHAT INVESTORS NEED TO KNOW

>>Created as part of the 2017 Tax Cuts and Jobs Act, opportunity zones (OZs) are economically distressed communities where new investments, under certain conditions, are eligible for preferential tax treatment. While they're a hot topic currently in commercial real estate, the simple concept can become complicated quickly.

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KOSTAS POULAKIDAS is a partner and co-chairs the public finance and economic development practice at Taft Stettinius & Hollister LLP, a full-service law firm with offices in Chicago and throughout the Midwest. He focuses on strategies for combining private equity and economic development incentives, project financing credit enhancement structures, tax-exempt financing, tax increment financing, private-public partnerships, investment strategies related to OZs, forming private equity OZ funds and other forms of project financing. In May, he was recognized by Opportunity Zone Magazine as one of the top 25 most influential OZ attorneys in the country.

Taft/

>>How is your organization involved with OZs?

Kostas Poulakidas: Taft is a full-service law firm that's structured and closed OZ funds for real estate projects throughout the country, including hotels, residential apartments, mix-used projects, data centers and other real estate projects, as well as advised clients on legal, compliance and tax issues related to OZs, established OZ businesses for clients and structured OZ joint ventures. We've also advised private equity funds on how to incorporate other economic development incentives into their OZ project structures to provide additional security and return for their investors. The work we're doing on OZ social impact funds is very exciting and rewarding, including one targeted to support women, minority and veteran business investment.

>>What's the most common question or concern you're hearing about OZs?

Poulakidas: Real estate developers and investors are assuming that by being in an OZ somehow makes a bad project a desirable project. Regardless of the benefits they may provide, the fundamentals of the underlying project remain the same—a bad investment is still a bad investment in an OZ, but a good investment in an OZ has the potential to become a better one.

>>What are some of the potential benefits for OZ investors?

Poulakidas: There are also other tax strategies, estate planning and investment structures that can enhance OZ benefits. However, investors can only do so for amounts invested that are capital gain recognized within 180 days prior to investment in a Qualified Opportunity Fund. It's important for investors to understand OZs and how to take advantage of them. They should not rush into making an investment in order to meet the 180-day requirement.

>>What types of investments are available?

Poulakidas: New OZ regulations published in April allow more flexibility for investing in non-real estate-based businesses. The requirements are that at least 50% of the hours the employees or contractors work are spent within the OZ; or that half of the company's services are within the area; or that the management and operations are based in the designated zones. Vacant property and projects that are outside, but contiguous to, the OZ can also qualify. The law is also clear in what you can't invest in, including private or commercial golf courses, country clubs, massage parlors, hot tub and suntan facilities, racetracks or other facilities used for gambling, and liquor stores.

>>Where are the OZs in the Chicago area?

Poulakidas: The Illinois Department of Commerce and Economic Opportunity has a helpful online map of OZs in Illinois, including Chicago, which you can download from its website. Keep in mind that OZs are set, and can't be amended or changed like TIFs or other incentive geographic areas.

>>What are some considerations in evaluating an OZ fund as an investment?

Poulakidas: Analyze your investment as though it were not in an OZ—a bad investment is still a bad investment in an OZ. Also consider if the fund is investing in a single-purpose project, or plans to spread your investment within different real estate development projects that may have different timelines to meet the OZ substantial improvement test and other OZ-specific requirements. Since investment funds typically don't like to turn away money, you should ask whether the OZ fund is taking non-OZ money and how that will affect your rights as an investor. For example, what happens if the fund wants to sell the asset you invested in before you reach the five, seven or 10-year periods that trigger the tax benefits for OZ investors?

>>Why should fund managers and investors consider using a custodian?

Poulakidas: OZ fund managers may want to have a custodian who understands the timing and compliance requirements unique to OZ investment to track how these requirements affect each of their investors. That being said, small OZ funds may not have the sophistication and resources to have a custodian but these same OZ compliance issues apply. We suspect in a few years we'll start seeing OZ legal actions that result from funds and unhappy investors who didn't ask these questions or determine who was responsible for keeping their project in compliance.

>>What types of due diligence questions should be asked of fund managers or developers before investing in an OZ project?

Poulakidas: They also need to know—and fund managers need to be able to answer—questions related to the fund structure and whether investors have rights that protect them from not realizing the full tax benefits of an OZ investment. Significant due diligence should also be spent on compliance issues and who's responsible to ensure an OZ fund and business remain in compliance so that investors don't lose their tax benefits. If the fund fails to meet these requirements, it may be subject to disqualification and penalties may be imposed. In short, asking these questions can be an ounce of cure that will avoid a pound of litigation.

>>As we approach year-end, what are some considerations for potential OZ investors?

Poulakidas: Investors need to have accumulated capital gains and be willing to realize those gains relatively soon. Because an OZ investment must be maintained for seven years to qualify for the 15% step-up in tax basis, and tax payments on the deferred capital gain are due in December 2026, an investor's capital gains will need to be realized in 2019 and reinvested this year to also qualify for the 15% tax break.

>>What else would you like our readers to know about investing in OZs?

Poulakidas: The program was specifically designed to channel more equity capital into overlooked markets—U.S. investors currently hold an estimated $6.1 trillion in unrealized capital gains after this historic 10-year bull market. Some of the challenges of the program relate to how to ensure that OZ capital is going to low-income communities rather than simply fund investments that would have otherwise received capital investment regardless of the OZ program. There's also a question about what role nonprofits and the government can play in bringing their resources to OZ investments to encourage investing in low-income communities and spur long-term private sector investment in projects that are otherwise not able to access private capital markets.