IN THE ZONE

What you should know about opportunity zones

— BY CARRIE ROSSENFELD

The commercial real estate industry has been abuzz lately with talk about opportunity zones, regions that developers are being incentivized through tax breaks to revitalize in order to create more areas of economic opportunity across the country.

As Adam Hooper, founder and CEO of RealCrowd Inc., says in his recently released e-book on the subject, "The tax code now encourages long-term, patient private capital to invest in eligible low-income rural and urban communities, called opportunity zones, all across the United States." According to Hooper, more than half of America's most economically distressed communities contained both fewer jobs and businesses in 2015 than they did in 2000.

Hooper also says new business formation is near a record low, with the average distressed community seeing a 6 percent decline in local businesses during the prime years of the national economic recovery. "The U.S. economy is increasingly dependent on a handful of places for growth. Five metro areas produced as many new businesses as the rest of the country combined from 2010 to 2014. Now is the time to diversify."

Qualified Opportunity Zones (QOZ) and Qualified Opportunity Zones Funds (QOF) represent a new source of equity for real estate, Bryan Shaffer, principal/managing director of George Smith Partners, tells *SoCal Real Estate*. He says the big-picture goal is to spur economic development in exchange for federal tax benefits.

"Our main involvement will most likely be helping our clients structure the equity investment into their development or project that is located in a QOZ," Shaffer says. "We will bring together the developer and QOF so the fund can invest in the developer's projects as well as lenders to

Bryan Shaffer

> "Investors need to understand that there is inherent risk associated with investing in properties located in low-income areas, so regardless of the allure of opportunity zones and the tax benefits, the risks should be underwritten appropriately." —BRYAN SHAFFER

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The Opportunity Zones Program has been introduced as an innovative approach to unlocking long-term private investment to support low-income urban and rural communities in every U.S. state and territory, Shaffer explains. "Ten percent of the commercial real estate in the United States is located in an opportunity zone. This is especially relevant now because it will likely facilitate an influx of equity capital into projects in opportunity zones and funds. Given the tax incentive of the program, these exchanges can create more liquidity for equity investments."

He adds that the final policies have not been released, but several groups have started setting up funds to make equity investments in properties located within opportunity zones.

Investors are eligible to receive certain tax benefits on unrealized capital gains reinvested in opportunity zones through pooled opportunity funds, Shaffer says. "The program is designed to minimize cost and risk to the taxpayer. Investors bear the risk on all their originally deferred capital gains, minus a modest reduction for long-term holdings, regardless of whether subsequent investments have increased or decreased in value."

According to Shaffer, the OZ incentive was part of the tax-reform legislation passed December 2017. Since enactment of OZs, many investors and fund managers have been identifying and underwriting investments, organizing funds, and otherwise preparing to invest in distressed areas. But additional guidance released by the U.S. Treasury Department in mid-October 2018 is expected to lead many investors and fund managers to begin to invest capital in OZ businesses and OZ business property.

Shaffer says investors, fund managers, real estate developers, operating businesses, and others involved in the blossoming OZ community received news they were waiting for in October when the U.S. Treasury Department issued its first tranche of guidance for the new community-development incentive. That guidance included 74 pages of proposed regulations, a five-page revenue ruling, an updated Q&A document, and both a draft of Form 8996 for qualified opportunity funds and instructions for that form.

"The OZ incentive was part of the tax-reform legislation passed in December 2017," Shaffer says. "Since enactment of OZs, many investors and fund managers have been identifying and underwriting investments, organizing funds, and otherwise preparing to invest in distressed areas. But many remained on the sidelines, eagerly anticipating tax guidance from Treasury."

While the regulations are proposed, the guidance provides

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answers to many questions and includes information that will help guide investors, fund managers, and others, Shaffer explains. "What is most important is that the announcement provided enough information for the OZ community has actionable clarity on significant tax issues to be able to get started."

Shaffer believes release of this guidance will lead many investors and fund managers to begin to invest capital in OZ businesses and OZ business property. "The Economic Innovation Group estimates that there is as much as $6 trillion in gains that could be invested in OZs. Treasury Secretary Mnuchin predicted that over $100 billion of private capital investment would occur in QOZs."

At the end of October, it became clear that there are some issues for which we are still awaiting guidance, which could come in a second tranche or third tranche. But one of the most important issues clarified by the announcement was that land should not be included as basis, Shaffer says. So, on projects that are not ground-up construction, the land cost does not count toward the day-one basis requirement that an investor would have to add 100 percent of the original basis in the first 30 months, allowing for both rehab and ground-up projects to move forward.

"This was done as part of Revenue Ruling 2018–29 which was simultaneously released and provides clarity on the substantial improvement of a building," says Shaffer. "The bottom line of the ruling is: If a QOF purchases an existing building, the original use of the building in the QOZ is not considered to have commenced with the QOF. The requirement that the original use of tangible property in the QOZ commence with a QOF is not applicable to the land on which the building is located. A substantial improvement to the building is measured by the QOF's additions to the adjusted basis of the building, excluding the land. The QOF does not have a separate requirement to substantially improve the land upon which the building is located."

This ruling is significant for many reasons, including that it lowers the bar for the substantially improved test, since it reduces the adjusted basis threshold by excluding land, Shaffer explains. "It also includes an example that implies that residential rental property is eligible."

Among other takeaways, the guidance addressed significant issues that many investors and fund managers have been waiting for, according to Shaffer. Too numerous to mention in this article, they can be found at https://www.irs.gov/newsroom/treasury-irs-issue-proposed-regulations-on-new-opportunity-zone-tax-incentive.

A multitude of areas in SoCal that could make for ideal OZs, Shaffer says, include L.A.'s Koreatown, East Hollywood, and parts of downtown Los Angeles, and San Diego's Golden Hill, South Park, and Barrio Logan. A map of the OZs in California is available at http://dof.ca.gov/Forecasting/Demographics/opportunity_zones/.

So, what do opportunity zones mean for players in this market? Shaffer says developers have the opportunity to get more equity capital for properties that come from a tax-incentive source.

"The project could also be better priced than would otherwise for an opportunity in such neighborhoods due to more equity in the capital structure."

Investors who buy property in OZs will benefit from a deferral of capital gains realized from the sale of stock, business, or real estate that would be reinvested in an opportunity zone and subsequently no capital gains tax on their investment in a QOF, he adds. And OZs create new opportunities for lenders to lend to groups preparing properties to be sold into QOFs and to lend to properties that are better capitalized because of equity originated in the QOFs.

But there are caveats. "For investors, the benefits are limited to people who are avoiding capital gains," Shaffer says. "They need to understand that there is inherent risk associated with investing in properties located in low-income areas, so regardless of the allure of opportunity zones and the tax benefits, the risks should be underwritten appropriately."

Shaffer also points out that the guidance offered by the Treasury at the end of October merits and will receive significantly more examination and will require follow-up guidance and clarification from Treasury and the IRS. "As mentioned earlier, Treasury announced that it would accept comments on the proposed guidance for 60 days, so stakeholders should weigh in, particularly on some issues that may need addressing. The OZ Working Group will certainly be doing so."

The areas for which comments are being sought, he says, include what metrics should be used to determine whether tangible property has "original use" in an opportunity zone and whether the use of tangible property should be based on its physical presence in the opportunity zone or some other measure.

Developers, investors, and lenders are likely to benefit from a tremendous influx of capital in the months ahead, according to Shaffer. "The Treasury Department and the Internal Revenue Service are due to provide further details, including additional legal guidance, on this new incentive. While the recent guidance answers some important questions, there are still significant unanswered questions and areas that need additional guidance or clarification. The good news is with the new information, investors can safely start investing, and fund managers can now start raising capital for their funds." ■