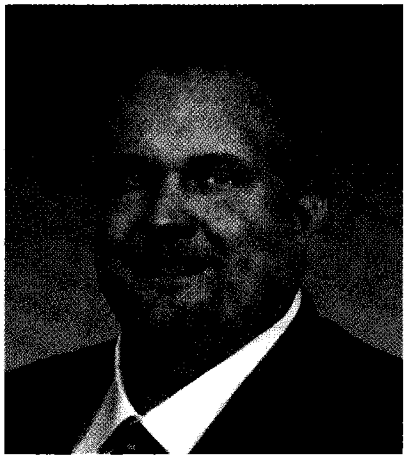

THE ROCKY ROAD FOR QUALIFIED OPPORTUNITY ZONE FUNDS

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Qualified Opportunity Zone Funds: Is it a hot tax planning strategy for the wealthy? Is it a social program to encourage investment in low income areas? Regardless of how you look at it, QOZ funds are the words on everyone's lips. But how is the real estate industry dealing with this exciting program? What does it mean for investors, funds and developers?

The Opportunity Zone program was enacted in December 2017 as part of the Tax Cuts and Jobs Act. Each state is now entitled to designate low-income census tracts to be approved as Opportunity Zones. Opportunity Zone Funds that invest in real estate or businesses in Opportunity Zones benefit the local economy by providing an influx of capital, magnified by a requirement to "double down" on most types of investments, and also provide one of the best tax deferral/avoidance strategies available to investors. It's a win-win for the community and the investors.

An investor can invest capital gain, long- or short-term, in a QOZ within 180 days of earning the gain and receive the following benefits: First, there will be no tax on the gain in the current year; tax will be deferred until the sooner of the sale of the QOZ investment or December 31, 2026. Second, if the investment is held for five years prior to 2026, 10 percent of the gain will be tax-free. If the investment is held for seven years prior to 2026, an additional 5 percent will be tax-free. Finally, if the QOZ investment is held for more than 10 years, any appreciation on the QOZ investment will be tax-free. This is arguably a better benefit than like-kind exchanges, as any gain can be deferred, not just a gain on real estate, and only the gain needs to be reinvested to enjoy the benefits, not the entire fair value.

So why aren't there more public Opportunity Zone Funds today? If you do a quick internet search, you will find several dozen funds raising capital and in the launch phase. There are significantly fewer already up and running. Why aren't more QOZs operating more than a year after the launch of the program? Let's look at the QOZ investment requirements.

QOZs must have 90 percent of assets in Opportunity Zones. There's also an original use requirement. A QOZ can't just purchase an existing building or business and operate it as is. This wouldn't create the capital influx the program was designed for, so the law requires that if existing real property is purchased, the QOZ must double its investment into the property (excluding land value) in the form of improvements or new construction. The same goes for business investments; the QOZ must double down on its initial investment in the form of new assets entering the zone. This doubling of investment must occur within a 30-month time period.

Now we start to see the hurdles that need to be jumped. From start to finish, there is a big ticking clock to watch while putting together an Opportunity Zone Fund, whether it's a small, single-asset friends and family fund, or a large public offering. First, the investor has a 180-day window to find a QOZ to take its money. This isn't just a commitment to investment but an actual transfer of cash to the fund. That assumes the investor can find a QOZ that it wants to invest in. These QOZs are investment vehicles that are required to invest in low income areas and, to get the full tax benefit, hold those investments for at least 10 years. If the QOZ doesn't have deals in the pipeline yet, how does it show the investor project or business plans that project its returns over the 10-year period? This may also be new territory for many investors unfamiliar with the real estate industry. It's certainly not as simple as stock or mutual fund investments.

The QOZ fund must quickly identify a deal and acquire it; then the 30-month requirement to double its investment starts. Anyone who has done home construction knows that permits, architecture, engineering, and other soft development can take months. Now apply that to a large project requiring government approvals, zoning changes, traffic and environmental studies: it can be years before a shovel hits the ground, let alone before construction is completed.

It's a mad dash from the day an investor earns capital gain, to investment in a QOZ, to closing on Opportunity Zone property, to construction/renovation. It's not surprising this has caused confusion as dealmakers struggle to get the stars to align to meet the strict timing required for everything to work. All the while, the tax deferral benefit and basis step-up window is closing as we move closer to December 31, 2026.