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Investing in an opportunity zone? Find a fund manager you can trust

By Matthew J. Ertman

Since the federal government enacted the Tax Cuts and Jobs Act last December and the U.S. Treasury Department unveiled a number of new rules and regulations last October for the "Opportunity Zones" program, investors have been scrambling to make sense of what is required of them to take advantage of the appealing tax benefits this program can offer.

An opportunity zone is an economically distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment. The new law created a new tax incentive program which encourages investors to make long-term financial investments in opportunity zones. In exchange, the investor receives a number of benefits related to the reinvestment and deferral of capital gains taxes.

The Challenges of Qualifying for Tax Benefits

To receive these tax benefits, an investor must reinvest capital gains resulting from a sale or exchange of property into a qualified opportunity fund within 180 days of the sale or exchange. A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership that utilizes the gains from a prior investment to invest in property within an opportunity zone. This property can consist of either stock or partnership interests of a business conducted in a qualified opportunity zone or personal or real property used in a trade or business conducted in a qualified opportunity zone.

As for personal or real property, the original use of the property must commence with the fund. As a result, investing in unimproved real property can be an issue because the U.S. Treasury views all real property to have had some use in its lifetime. For tangible property to count as "good" property, it must be original use property or substantially improved. Either way, it is difficult to figure out how to evaluate unimproved real property.

The short 180-day timeline may prove challenging for investors, who will have to identify a manager and fund and invest their capital gains within this window. More importantly, the manager and fund will need to rapidly reinvest the investors' capital in opportunity zone property. A fund has six months in which it must invest at least 90 percent of its capital either directly in opportunity zone property or in a subsidiary partnership, and the subsidiary partnership must generally invest at least 70 percent of its capital in opportunity zone property. To qualify as opportunity zone property, the fund (or the subsidiary partnership) must be the original user of the property or must substantially improve the property. The improvements must be performed within 30 months, and the partnership must hold the funds that will be used to improve the property as working capital through the development period.

An investor is not eligible for the benefits afforded by the program if their investment into the fund occurs after this 180-day window, and penalties are imposed if the fund does not reinvest the investor's capital within the prescribed timelines.

The risks of noncompliance are enhanced when qualified opportunity funds are formed to invest in large-scale real estate development projects or blind pool funds where the timeline for zoning or identification, acquisition, and improvement of potential investments can exceed statutory required timelines.

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Qualified opportunity funds are certified by the fund and investor filing forms with the IRS. If your client's fund meets the regulations and qualifies, they can defer paying taxes on their invested capital gains for seven years, until 2026. After five years, there is a 10 percent step-up in basis, or a 10 percent reduction in the taxes you would have owed. After seven years, there is an additional five percent, for a total 15 percent step-up in basis. If your client holds their investment in the fund for 10 years, any gains get a 100 percent step-up in basis, and zero taxes will be owed on those gains. The clock on this five/seven/10-year period starts when the money is invested in the fund, not when the fund is invested in a property.

Trust Your Fund Manager

The first step to realizing the tax benefits of investing in an opportunity zone is to find a fund manager you know and can trust. Do your due diligence to confirm that potential properties the manager plans on investing in are in fact opportunity zone properties. Make sure that the legal counsel to the fund understands the requirements of the program so you can be confident that the fund can comply with the requirements. Review the documents surrounding the qualified opportunity fund to make sure they meet the current requirements under the opportunity zone statue and the proposed regulations.

If presented with one of these investment opportunities, look at the online opportunity zone map provided by the U.S. Treasury to make sure that the property that the sponsor has identified is within an opportunity zone. We've had clients acquire properties they thought were within an opportunity zone only to find out down the line that they were not.

Trusting your fund manager is vital — if the fund doesn't meet just one requirement of the complicated opportunity zone regulations, the fund won't do what it's supposed to do, and your client won't reap the tax benefits they were hoping for. This could result in a large tax bill that your client was counting on being deferred. A typical private equity fund manager has to make a good investment and exit at the right time. A fund manager not only has to do that, but they can't get the tax rules wrong or else the investor gets hit with a penalty.

If your client is rolling over capital gains from the sale of a property into a qualified opportunity fund, they're counting on the fund manager/ sponsor to take all the right steps to qualify for the tax benefits. If they don't, the client will lose out. For real property investments, the client in some cases could have affected a 1031 exchange and rolled-over its investment into a new property and deferred its taxes. In such case, the client would have also been able defer taxes indefinitely and the client's estate would receive a basis step-up upon death. Instead, with a blown investment, the client could have a large, unanticipated tax bill on their hands.

For example: Your client has a 20 percent tax bill (the federal capital gains rate) on a $10M ROI they're rolling into a qualified opportunity fund. If they invest in a fund and the fund manager doesn't meet the opportunity zone requirements, they will have to pay that 20 percent tax bill and only have $8M to invest, when they could have rolled the whole $10M into a new property in a 1031 exchange. Bottom line, make sure that the people managing your client's qualified opportunity fund can meet all the requirements and get it done.

Only Invest Capital Gains

Capital gains from a prior investment are generally all that should be invested in a qualified opportunity fund. There are no tax benefits to be had from investing anything other than capital gains in a qualified opportunity fund, and because of the fund rules, the fund will have many attributes that aren't customary for a typical fund.

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