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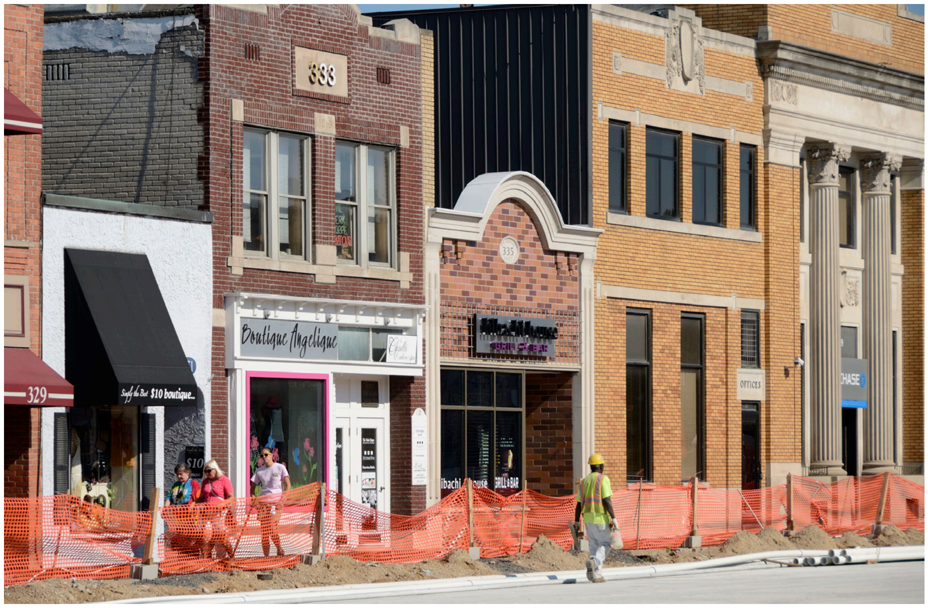


Tax Break Creates New Frontiers of "Opportunity"

A program created by tax reform could pave the way for a flurry of investment activity in struggling communities nationwide.

The Tax Cut and Jobs Act of 2017 contained a provision that allows investors to defer or avoid taxes on capital gains if the money is reinvested in designated "Opportunity Zones." The goal is to generate economic activity in areas that once thrived but have fallen on hard times. More than 8,700 areas in the U.S. have been certified by the Treasury Department as opportunity zones.

Although activity has been limited by the many unanswered questions about the program, fund managers are starting to raise capital for opportunity funds and momentum is expected to pick up once regulators provide guidance on details that were not included in the bill.

The nature of the program makes it unlikely to move the needle for institutional investors or core commercial real estate, but opportunity zones have the potential to draw capital from non-traditional sources—such as high-net-worth individuals, family offices and endowments—and to spur revitalization in blighted urban areas and tertiary markets.

How It Works

The heart of the program is to incentivize investors to reinvest capital gains. The gains can come from any investment, including the sale of stocks, bonds, real estate or partnership interests. The gain dollars must be invested in a qualified "Opportunity Fund Zone" within 180 days of the event—money cannot be invested directly into a property. Funds must invest 90 percent of their capital into opportunity zone properties.

Shareholders are rewarded for keeping their interest in the funds over the long term. Shareholders who hold their investments for five years will pay no taxes on 10 percent of the gains. After seven years, 15 percent of the gains will not be taxed. Shareholders who hold investments for 10 years can avoid paying taxes on all gains.

However, because the tax bill was passed quickly through a partisan budget process called reconciliation—which requires that any fiscal legislation be tax neutral after 10 years—there is a hitch. As of Dec. 31, 2026, opportunity zone investments will have a "deemed disposition" that requires investors to pay taxes as of that date as if the funds were sold. That means investors may be forced to pay taxes on gains that have not yet been realized. It is possible that a future Congress could clarify the bill, but the disposition part of the bill is one of the issues that could limit participation.

Opportunity zone funds can be invested in a variety of assets, such as property, land, energy infrastructure, startup businesses and equipment. Given the structure, commercial property is likely to be one of the major recipients of opportunity zone funds. Residential real estate, for example, is not usually held long-term, and the chief lure of opportunity zones is the tax-free appreciation gains after the 10-year hold period.

Even so, there are questions surrounding investments in commercial properties. The law requires that funds have a 30-month period in which to double the basis in the property. In other words, the funds must spend as much on improvements as they paid for the asset. It often takes more than 30 months to build from the ground up, given the time for entitlements and construction. In the case of an existing property, the basis requirement necessitates a substantial amount of renovation, which limits the type of property that would qualify for investment. Few stable, well-leased and well-located assets will qualify as investments for opportunity zone funds.

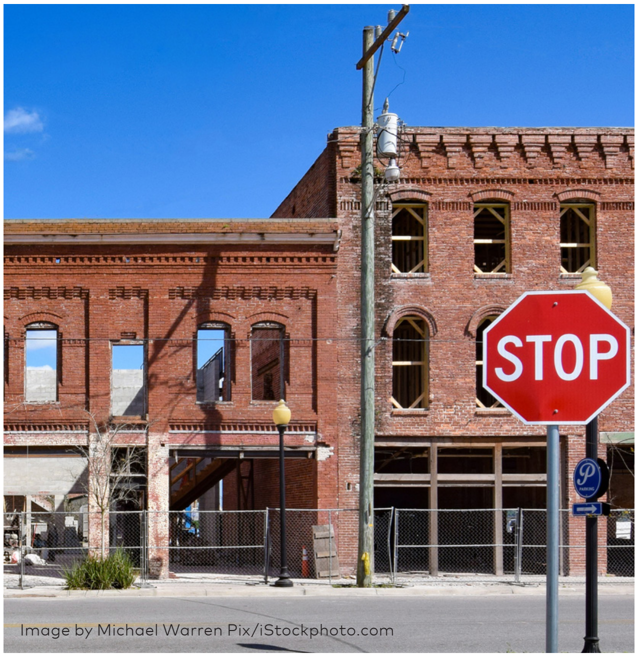
The National Multifamily Housing Council has written a letter asking regulators to clarify questions about opportunity zone investments. Some of the questions include:

- How soon do deferred capital gains contributed to an opportunity fund have to be invested in qualified properties?
- Can limited liability companies and REITs set up opportunity funds, or can REIT stock be considered a qualified investment?
- Is land a qualified asset?
- Is there a deadline for funds to make investments and still qualify for the 10-year tax exclusion on gains?

The Treasury department is expected to answer questions in coming weeks, although official guidance can't be made until the public is given a chance to comment. Regulators are expected to be lenient and not question fund managers because they want to encourage investments in opportunity zones.

Investment Vehicles Off to the Races

Despite the unanswered questions, fund managers are beginning to jump into the fray. At least 15 managers have announced capital-rais-



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ing efforts, including PNC Bank, Goldman Sachs, Fundrise, RXR Realty, and a partnership of Beekman Advisors, Rivermont Capital and Enterprise Community Partners

These funds have stated goals of upwards of $2 billion to $3 billion in capital combined, but there are probably a variety of smaller funds being raised that are flying under the radar. Given the fluidity of the brand-new market, any estimate of the impact of the legislation is a guess. However, some market players calculate that over the next few years, opportunity zone funds could draw as much as $30 billion of capital.

As important as how much capital opportunity funds will draw is where the money will come from and in what it will be invested. Major markets and most downtown areas that are performing well in the current commercial real estate boom are exempt as destinations of opportunity fund capital. That means capital will be concentrated in small and middle-market projects and transitional properties that need substantial upgrading.

Since institutions tend to focus on stable assets, core markets and properties in which large sums can be invested, opportunity zone funds are more likely to be attractive to high-net-worth individuals and family office investors, which have not been a major capital source in commercial real estate.

There was a thought a few years ago that crowdfunding would create a way to bring accredited investors into the sector, but crowdfunding never gained momentum as a vehicle to buy commercial property. Among other things, it proved difficult to raise large enough sums from individual investors to create a meaningful portfolio. Crowdfunding firms that know how to raise money lack the expertise in buying, managing and operating properties. If opportunity zone funds managed by experienced commercial real estate operators can raise capital, it could crack what has always been a tough nut in the industry: getting significant pools of money from small investors.

Revitalizing Hard-Luck Areas

The other major potential impact from opportunity zone funds—and one of the main purposes of the provision—could be to help inject life into markets that may have once thrived. The idea is to incentivize investors to rehabilitate buildings in areas that have fallen on hard times. The designated zones were submitted by state governments and include a mix of urban, suburban and rural areas.

Successfully rehabilitating a submarket, though, requires more than just a facelift, although that's a good and necessary part of the plan. To operate and increase in value, commercial properties need income from tenants. Demand is derived from a strong economy where people feel safe and have amenities and access to work.

The Beekman/Enterprise fund, for example, is aimed at redeveloping downtowns of small cities in the Southeast, communities that may have once had as an economic center major employers such as manufacturing facilities that are no longer there. Shekar Narasimhan, managing partner of Beekman, said that his firm began working on the investment strategy targeted at value-add and socially conscious investors before the opportunity fund legislation was passed, but the tax break could be a good incentive to draw long-term capital.

The fund is scouting out dozens of small communities that have the potential for growth, which involves not only real estate that can be rehabilitated but also partnerships from governments and the business community. Key to the redevelopments will be commitments from the government and local businesses to spend money on things such as education, transportation and infrastructure to stimulate economic activity, Narasimhan said.

Huge Potential, Albeit Risks

Opportunity zone legislation has created a flurry of activity by fund managers. Among its attractions are the potential to draw from a new base of largely untapped investors and the potential of new markets that were seen as too small or risky as investment strategies. While there is a potential for funds to make money while injecting much-needed capital in markets that have been too long ignored, to be successful funds need to be prepared to be in it for the long haul and have a holistic approach to development. Otherwise, funds could find themselves rehabilitating properties that are underused.

—**Paul Fiorilla,** *Director of Research*