ARTIVEST

Opportunity Knocks: The Ins and Outs of Opportunity Zones

April 2019

Introduction and Key Ideas

Artivest
www.artivest.co

- Opportunity Zones (OZs) were established in 2018 to incentivize private investment in underdeveloped and disadvantaged areas of the United States.
- Investors can realize several benefits when investing in OZs, including the deferral of capital gains taxes, reduction of capital gains taxes (when due), and tax-free growth of OZ investments.
- Requirements to establish a Qualified Opportunity Zone (QOZ) fund are relatively straightforward with current guidance, but the investments have specific asset and fund structure requirements, which must be met throughout the life or term of the investment to maintain eligibility.
- There are a variety of methods to invest in OZs—including vehicles launched by fund sponsors or structures established directly by investors.
- This paper outlines the background and characteristics of OZs, how investors may benefit from investments in this new asset class, and various approaches to investing in OZs.
- Artivest continues to meticulously evaluate this new sector, and thus far recommends partnering with a fund sponsor that had identified potential pipeline opportunities prior to the implementation of the OZ regulation based on investment merit. Importantly, investors should not rely on the tax benefits alone to replace a sound underlying investment thesis.

Opportunity Zone Background

The Opportunity Zone Program was one of many changes enacted by the Tax Cuts and Jobs Act of 2017. Led by a large bipartisan effort, the program was created to stimulate long-term, private investment and job creation in low-income or underinvested communities across the U.S. The objective is to achieve this stimulus by offering tax incentives for investments made in pre-designated areas or zones.

How Were OZs Selected—and Where Are They?

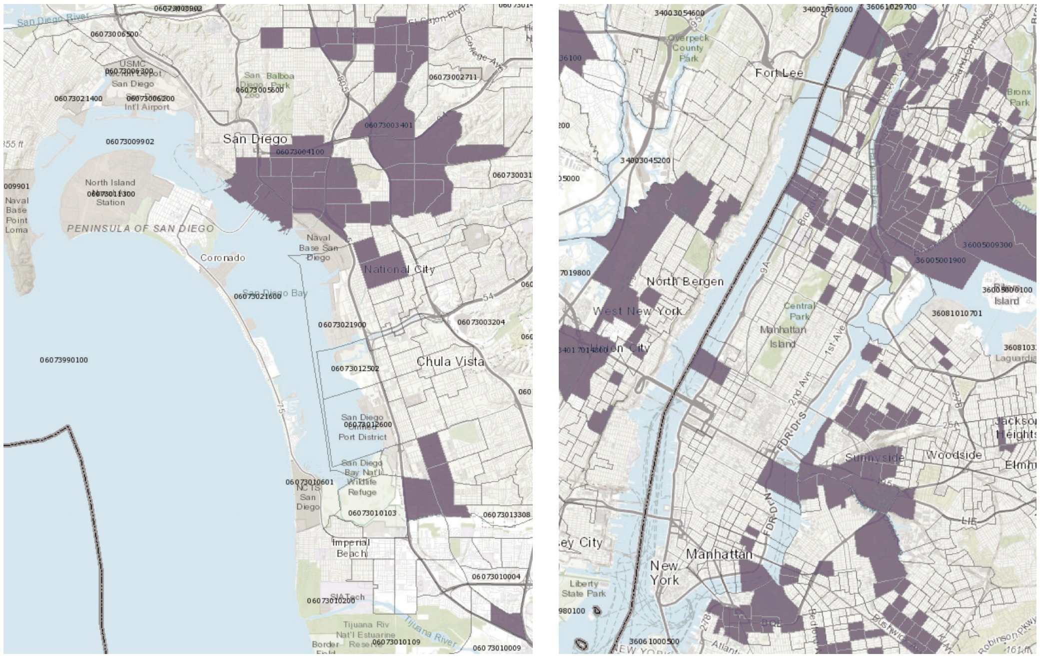
The Opportunity Zones (OZs) are made up of low-income U.S. census tracts and are situated across all 50 states and Puerto Rico. They are broadly defined as areas where the median family income represents 80% percent of statewide median family income.[1] The zones were initially selected by each state governor and have been subsequently certified by the U.S Treasury.

Broadly speaking, OZs tend to lie in:

- Urban residential areas that have historically bordered higher value commercial or business real estate, but have experienced little government or private investments;
- Former industrial areas that have fallen into disuse;
- Agricultural regions.

An interactive map of current OZs across the U.S. is available through the U.S. Treasury website. Figure 1, shown below, provides actual examples of OZs in the San Diego and New York metropolitan areas.

Figure 1. **Opportunity Zones within the San Diego and New York City Regions**



Source: U.S. Department of Treasury CDFI Fund.

Investor Incentives

We believe that the incentives for investing in Opportunity Zones are compelling and centered around three benefits: 1. deferral of capital gains taxes realized from other sources and re-invested at initiation; 2. reduction of capital gains taxes owed when payment is due; and 3. tax-free growth of all Opportunity Zone gains.

1. **Capital Gains Deferral:** If an investor realizes a large capital gain (e.g., from a stock or real estate sale) the payment of the capital gain taxes can be deferred until December 2026. The initial benefit of this is clear: it allows for more dollars to be invested up front and will compound on a higher or increased initial amount. Just as importantly, it allows for *any* type of capital gain from any asset, such as the sale of equities and real estate, but also businesses or partnership interests, and even collectibles (such as art or automobiles).

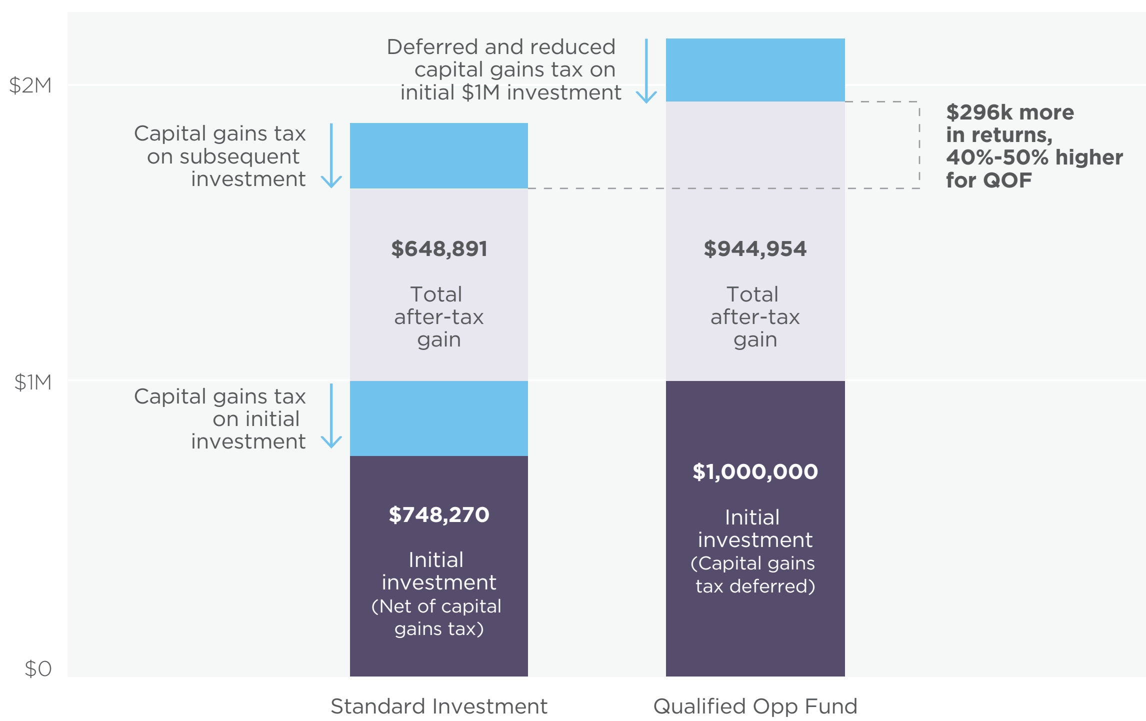
2. **Capital Gains Tax Reduction:** If an OZ investment vehicle holds its assets for five to seven years, the deferred gains tax is reduced by 10%. If held for seven or more years, the deferred gains tax is reduced an additional 5%, for a total 15% reduction of tax liability.

3. **Tax-Free Growth of OZ Gains:** If an investment is made for 10 years and (no more than 20.5 years), then any capital gains are effectively tax-free. This is a truly compelling opportunity: vehicles for capital gain deferment already exist (such as 1031 exchange funds), but tax-free capital growth has not been available until now.

Figure 2 shows visually how the three advantages combine over time to make even modest hypothetical investment returns more persuasive when factoring in the tax benefits.

Figure 2. **Potential Comparison of Standard vs. QOF Investments**

QOF May Result in ~40-50% More Gains vs. Comparable Investment



Comparative chart of return on investments for a QOZ Fund and a standard investment at an equivalent rate of return. Blue boxes represent capital gains taxes paid in each scenario. The dotted lines show that a QOF investment with comparable rates of return will result in higher overall after-tax gains. More detailed information is available in Appendix B.

Source: Artivest.

Investment Mechanism: Qualified Opportunity Funds

Any investment in an Opportunity Zone must be made through a Qualified Opportunity Fund (QOF), a specific legal vehicle, which will invest substantially all of its assets in OZs. QOFs must meet certain structural and investment criteria across each asset type. We will, however, focus on real estate for this paper, as we believe it has the most clarity based on the existing set of OZ regulations. In our continued due diligence, we have also yet to find an actionable investment opportunity in a QOF that focuses on non-real estate investments. Figure 3, shown below, provides a short list of the major requirements for QOFs.

Figure 3. **Basic Requirements for Setting up and Maintaining a QOF**

Requirement	Description
Entity formation and certification	C-corp, S-corp, or partnership structure may be used, and technical self-certification with the IRS via form 8996.
Equity investments	To reap the full tax benefits, the fund's investments within OZs must be structured as equity (either common or preferred equity); debt may also be used but has fewer benefits.
90% OZ asset test	90% of the Fund's assets must be within Opportunity Zones.
Capital gains rollover window	For investors, capital gains must be contributed to the QOZ Fund within 180 days of realization in order to qualify for the initial gain tax deferral.
Substantial Improvement	Each fund must improve the underlying property (excluding land cost) by 100% of the initial basis within 31 months of purchase.
Minimum Holding Period	Investors must stay in the QOZ Fund for 10 years to be exempt from subsequent capital gains tax.
Investment Types[2]	Real estate, local businesses, or real assets such as infrastructure. Additional requirements exist for non-real estate investments. For example, a local business must generate at least 50% of revenue from the Opportunity Zone in order to continue qualifying. This is both challenging to meet and document, and raises the risk of losing eligibility midway through the investment.

OZ Real Estate Investment Landscape

According to investment industry consulting firm Preqin, the number of Qualified Opportunity Funds has swelled from a handful in the fall of 2018 to more than 60 today. We believe the extensive range of options requires well-informed guidance to identify high-quality investment opportunities. In our experience, new sectors that quickly garner large amounts of investor interest can also produce excess supply of investable offerings to meet that interest, which may be highly experienced managers but also may be unqualified and unproven opportunists. We believe our experience in alternative manager research and selection allows us to assess and filter the variety of available options to a select number of quality partners.

Since October 2018, our team has conducted extensive diligence on several dozen OZ participants. The new OZ industry entrants hail from a wide variety of professional backgrounds, regulatory environments, and corporate structures. For example, many traditional real estate developers that are experienced in asset development may not necessarily be registered as an Investment Advisor with the U.S. Securities and Exchange Commission (SEC), and therefore are not required to meet the regulatory standards of traditional investment managers. Although this alone is not a disqualifier, it does warrant conducting additional investment and operational due diligence to assess a prospective manager's capabilities. In fact, a recent industry report from investment industry consultant Preqin found that nearly 70% of opportunity-zone managers with funds in the marketplace are considered "emerging managers."

To date, our analysis has led us to favor managers that had identified compelling project pipelines prior to the implementation of the Opportunity Zone Program legislation—and for which the OZ Program adds an additional positive attribute.

Opportunity Zones: Investment Structure Types

Through our research and diligence within the QOF manager universe, we've categorized offerings into three broad categories: Single Asset Funds, Multiple Asset Funds, or Self-Certification.

- Single Asset Funds are QOFs in the process of raising investor capital to develop one underlying real estate project. Typically, these funds are structured as limited partnerships or limited liability companies.

- Multiple Asset Funds are funds that seek to source, acquire, and develop multiple assets across varying opportunity zones. These funds may vary by property type, regional focus, or vehicle structure. Vehicle structures vary across traditional limited partnerships, limited liability companies, and corporations. The general architecture of the structure involves a commitment vehicle (parent) that calls capital from investors to invest in underlying individual special purpose vehicles (SPVs) that serve as individual QOFs.

- Given the lack of regulatory barriers to entry, individual investors can conceivably establish their own entity and self-certify as a QOF. The investor is then responsible with sourcing, acquiring, developing, managing, and maintaining a compliant vehicle over the following 10 years to maintain QOF status.

Figure 4 details some of the advantages and disadvantages of each type of investment opportunity.

Figure 4. **Advantages and Disadvantages of Various Types of QOFs**

	Single Asset Fund	Multiple Asset Fund	Self-Certify (Single or Multiple)
Partner	Typically smaller-scale opportunities with local operators ($50 million and below)	Typically larger fund raise targets operated by established real estate asset management firms with scalable sourcing and management infrastructure ($100 million plus)	Individual investor is responsible for coordinating efforts around service providers for launching and maintaining a QOF
Pros	• Asset acquisition/ target transparency • Clear and clean exit process	• Diversified risk profile, potentially across property type and geography • Diversified operating/ development partners • Potential for economies of scale	• Full control of the entire process and property • No external manager fees
Cons	• Concentrated investment risk profile • Concentrated operating/ development partner risk • Limited potential for economies of scale	• Capital calls may be challenging to match with capital gains from less liquid assets (e.g., real estate, collectibles) • Exit process can potentially be complex (dependent on vehicle structure) • Netting risk • Blind pool risk	• Significant requirements in expertise, effort, ongoing involvement • Increased risk of non-compliance to QOZ Fund guidelines, and loss of eligibility

When determining whether to select Single or Multiple Asset funds, investors must first determine their own suitability and objectives for this type of investment.

- Investors seeking to re-allocate their capital gains towards a generally higher risk-return profile may likely seek Single Asset opportunities which will be centered on the prospective economics and implementation of a single project.

- Those investors seeking to re-allocate their capital gains toward a generally lower risk profile will likely seek Multiple Asset opportunities, which may benefit from a larger, more established operator as well as diversification across project, property type, and region.

- Investors that are considering the formation of their own QOF must account for the level of resources and personnel needed to initiate and operate the vehicle on a continuous basis. We believe that this approach is likely best-suited for highly sophisticated and well-staffed family offices.

Finally, all investors must take into account the timing of capital calls, and how quickly they will be able to liquidate initial assets to both meet the capital call as well as remain within the 180 gain realization window.

Risks And Potential Pitfalls to Watch For

First and foremost, any investment that relies solely on a potential tax benefit and lacks a sound investment thesis will most likely result in disappointment. Artivest strongly believes the average investor will succeed by identifying a partner with both appropriate investment and regulatory expertise to implement and operate a QOF. Investors must assess each potential asset manager in the space for their ability to:

- Manage and operate a long duration (10-plus year) investment.

- Adequately manage, service, and provide transparency to investors.

- Fully execute their stated investment strategy and maintain appropriate development expertise, property management relationships, and an adequate property acquisition pipeline for capital deployment.

- Underwrite successful development projects.

- Demonstrate the ability to conduct an exit process.

- Interpret and abide by ongoing regulatory changes of QOFs.

From a market-risk perspective, investors need to be aware that a lot can happen over the course of 10 years and projected results can vary significantly. A substantial slowdown in the greater U.S. economy may likely be the largest driver of adverse outcomes as it relates to real estate performance. Given that many opportunity zones are located in economically stressed areas, the long-term growth in these areas may be unsustainable or never come to fruition.

Additionally, it's widely expected that the Opportunity Zone program will catalyze capital to flow in to underserved areas of the country over the coming years. Liquidity dynamics around this potential capital surge are considered to be two-fold: 1. a boost in Opportunity Zone real estate values over the near-term; and 2. excess supply in 10 years as funds seek to monetize their assets.

The Bottom Line

Given the attention and interest in this space, the due diligence we have conducted on potential partners has been even more thorough and unhurried. At Artivest, we recognize that demand can cause supply, and continued investor interest and greater regulatory clarity will drive even more products and solutions to the market in the coming year. However, at the end of the day, we are left with two important takeaways: (1) the investments themselves must make sense, regardless of any tax benefits; and (2) it will require a talented and dedicated manager to find, improve and monetize the investments in these underappreciated regions.

Appendix A

Comparison of standard investment versus QOF investment—required rates of return for equal dollar gains.

	Standard Investment	Qualified Opp Fund
Capital Gain	$1,000,000	$1,000,000
Capital Gains tax (at 25.2%)*	($251,730)	$0
Initial Capital Available for Re-investment	**$748,270**	**$1,000,000**
10 Years Later:		
Annualized Reinvestment Return Assumption	**12.1%**	**8.0%**
Cumulative Reinvestment Return Assumption (10 years)	213.7%	115.9%
Total Gross Investment Gains	**$1,599,267**	**$1,158,925**
Capital Gains tax (at 25.2%)*	($402,583)	$0
After-Tax Investment Gains	**$1,196,684**	**$1,158,925**
Initial Capital Gross Deferred Gains	$0	($251,730)
Reduced capital gain tax liability (15% reduction for +7 years)	$0	$37,760
Net Deferred Capital Gains tax	**$0**	**($213,971)**
Return of Initial Capital (after-tax)	$748,270	$786,030
Total After-Tax Investment Gains	$1,196,684	$1,158,925
Net Investment Gains plus Return of Initial Capital	**$1,944,954**	**$1,944,954**

*25.2% is the federal long term capital gains (LTCG) tax plus the average state LTCG tax at the highest bracket. Source: realized1031.com

Appendix B

Comparison of standard investment versus QOF investment—equal rates of return and resulting investment gains.

	Standard Investment	Qualified Opp Fund
Capital Gain	$1,000,000	$1,000,000
Capital Gains tax (at 25.2%)*	($251,730)	$0
Initial Capital Available for Re-investment	**$748,270**	**$1,000,000**
10 Years Later:		
Annualized Reinvestment Return Assumption	**8.0%**	**8.0%**
Cumulative Reinvestment Return Assumption (10 years)	115.9%	115.9%
Total Gross Investment Gains	**$867,189**	**$1,158,925**
Capital Gains tax (at 25.2%)*	($218,297)	$0
After-Tax Investment Gains	**$648,891**	**$1,158,925**
Initial Capital Gross Deferred Gains	$0	($251,730)
Reduced capital gain tax liability (15% reduction for +7 years)	$0	$37,760
Net Deferred Capital Gains tax	**$0**	**($213,971)**
Return of Initial Capital (after-tax)	$748,270	$786,030
Total After-Tax Investment Gains	$648,891	$1,158,925
Net Investment Gains plus Return of Initial Capital	**$1,397,161**	**$1,944,954**

*25.2% is the federal long term capital gains (LTCG) tax plus the average state LTCG tax at the highest bracket. Source: realized1031.com

Sources

1. Internal Revenue Code 45D; Enterprise Community Partners.
2. We focus on real estate in this paper because we believe it has the greatest level of clarity based on the existing regulations.

RISKS AND OTHER IMPORTANT CONSIDERATIONS

This material is being provided for informational purposes only. The author's assessments do not constitute investment research and the views expressed are not intended to be and should not be relied upon as investment advice. This document and the statements contained herein do not constitute an invitation, recommendation, solicitation, or offer to subscribe for, sell, or purchase any securities, investments, products, or services. The opinions are based on market conditions as of the date of writing and are subject to change without notice. No obligation is undertaken to update any information, data or material contained herein. The reader should not assume that all securities or sectors identified and discussed were or will be profitable.

Before making a decision, please consult with a tax professional to discuss your individual situation.

Past performance is not indicative of future results. There is no guarantee that any forecasts made will come to pass. Due to various risks and uncertainties, actual events, results, or performance may differ materially from those reflected or contemplated in any forward-looking statements. There can be no assurance that any investment product or strategy will achieve its objectives, generate profits, or avoid losses. Diversification does not ensure profit or protect against loss in a positive or declining market.

All investments carry a certain degree of risk, including the possible loss of principal. Alternative, complex, or non-traditional investment strategies may not be suitable for all investors and the value of any portfolio will fluctuate based on the value of the underlying securities.

About Artivest

Powering the Future of Alternative Investing.

Artivest is the premier alternative investment platform, offering investors and advisors digital access to institutional-quality alternative strategies, including private equity, hedge funds, managed futures, and real assets. Our enterprise solutions for asset and wealth managers include investment access, transaction processing, investment research, product structuring, and nationwide fund distribution. Artivest remains privately held by its employees and outside investors, led by KKR, Thiel Capital, Genstar Capital, and Aquiline Capital Partners. For more information, please visit artivest.co.

1635460_040819