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Tax Notes

Opportunity Zone Funds: Structuring and Operational Considerations

By Thomas J. Riggs, JD, CPA, MAS, Partner, Director Financial Services Tax

Everyone seems to be talking about Opportunity Zones these days and understandably so. Not only does the new legislation provide for the deferral and partial forgiveness of tax on capital gain income from any source, it also allows for investment of those gains to grow tax free if held for a minimum of ten years. However the legislation is complex, and at this early stage uncertainties remain.

To date PKF O'Connor Davies has been involved in a significant amount of Opportunity Zone (OZ) related deal flow, and over the coming weeks and months we will be publishing an ongoing series of topical articles. This first article will address certain operational mechanics of an OZ fund itself. As this discussion is predicated solely upon the existing legislation and proposed regulations, but without the benefit of future anticipated guidance, certain observations may change as further clarity emerges.

As noted above, there are numerous issues that can arise in the structuring and ongoing operation of an OZ fund. The still-evolving statutory roadmap must be heeded with precision, including the proper sequencing of events as well as meticulous record keeping. Also, one must keep in mind that no two fact patterns are the same, and structuring from fund to fund can vary considerably. Thus far we have been involved with fund platforms that range from special purpose vehicles (SPVs) with one investment and one set of static investors, to large funds anticipating multiple investors, investments, and ongoing turnover. Each set of OZ related facts poses its own unique set of challenges; a "one size fits all" approach simply will not work.

OZ Investment in Assets versus Businesses

One of the misperceptions we continue to run across is that the OZ fund program is all about real estate located in the zones. However, the statute allows for an OZ fund to invest in either qualified assets (typically real estate) or in qualified ***businesses***. Incubating a new business in an OZ or even moving your existing business there can yield better economics and yield greater tax savings than merely buying and/or developing OZ domiciled real estate.

Pending further guidance, however, at this time a measure of uncertainty exists with respect to the requirement(s) for an intervening equity interest to qualify as an eligible OZ asset, as opposed to direct asset ownership. For example, as currently written the 50% gross income requirement is not applied uniformly between the two forms of OZ investment. We expect future Treasury guidance to provide further clarity.

Choice of Entity

The statute allows for an OZ fund to be formed as either a corporation or a pass-through entity. Where the target portfolio is OZ real estate and the platform envisions multiple investors and a broad based portfolio with anticipated turnover, we have seen a corporate REIT format used. But in the context of a smaller real estate targeted portfolio, and particularly where the fund owns one asset housed in a SPV, we have seen the pass-through entity format used almost exclusively.

Alternatively, where the target portfolio is made up of interests in OZ *businesses*, here again the pass-through entity format appears to predominate over corporate venture capital approaches. This is likely due to a number of factors, including the lack of need for Section 1202 Qualified Small Business Stock in a tax free context, ease of carried interest remuneration for managers and/or promoters, and the flow through of early stage start-up losses.

Raising Capital: Cash as an OZ Fund Asset

Raising OZ fund capital is complicated by the fact that cash and liquid investments generally do not constitute qualified OZ assets and thus do not count toward the various numerical thresholds that must be met in order to avoid penalties. However, capital raised and kept on hand in connection with a contemporaneous and well-documented capital deployment schedule (CDS) can avoid these penalties. The future capital expenditure(s) must adhere to the CDS (within limits) and be reasonable with respect to nature, timing, and amount. An effective CDS strikes a working balance between compliance constraints and investment flexibility.

Pre-Existing OZ Real Estate

We have received numerous inquiries with respect to appreciated property already located in an OZ. While fortuitous, this is not automatically the windfall that one would presuppose. Certain parcels of OZ situated real estate have undoubtedly enjoyed appreciation in value due to increased interest from investors and/or promoters. However, a qualified OZ investment must constitute an already realized and taxable capital gain, and the legislation prohibits generating a qualified gain by dealing with a “related party” (which could conceivably include an OZ fund itself). Consequently, already owning a piece of appreciated OZ property confers no immediate or direct tax benefit to the owner without proper structuring. Under these facts, an optimal structure could allow for the unrealized gain on the legacy OZ property to be monetized, and the gain deferred into an OZ fund managed by the legacy property owner.

“Mixed Funds”

In order to be eligible for the statutory OZ tax benefits, the investment must represent an already realized and taxable capital gain. However, the legislation does allow for traditional non-capital gain related investment to be contributed alongside reinvested capital gains, and this is referred to in the statute as a “Mixed Funds” situation. Where there are “Mixed Funds” present, fund accounting and administration can be complicated, especially if both types of investment come from the same investor. The differing pools of capital must be bifurcated and accounted for separately, with partial investments and/or dispositions requiring particular care.

Contact Us

The Financial Services Tax Group at PKF O’Connor Davies is available to assist with all aspects of the new Opportunity Zone legislation. We also offer a full slate of structuring, audit, tax, and administration services for Opportunity Zone funds and their Investors.

For more information, please contact your client services partner or either of the following:

Thomas Riggs, JD, CPA, MAS
Partner, Director Financial Services Tax
triggs@pkfod.com | 646.449.6317

Eric Gelb, CPA
Director Financial Services Business Development
egelb@pkfod.com | 914.341.7049

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