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PKF O'CONNOR DAVIES FAMILY OFFICE

Opportunity Zones: The Family Opportunity Zone Fund

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Over the years, PKF O'Connor Davies has striven to remain at the forefront of financial solutions for our global as well as domestic family office (FO) clients. From the concept of the "family bank" some years ago, through Internal Private Equity (IPE) and more recent innovations in structuring precipitated by the *Lender Management* decision, we have continued to seek out and implement creative approaches that generate meaningful impact without undue risk. Our most recent focus has been on how the recently enacted Opportunity Zone (OZ) legislation can be used in the context of a large multi-generational FO to meet bespoke investment and tax objectives.

In this the second article in our ongoing series of OZ-related topics, we introduce the concept of the "Family Opportunity Zone Fund."

Overall Approach

The basic mechanics of the Opportunity Zone (OZ) legislation have been thoroughly parsed in published articles and by speakers nationwide, so we will not undertake another detailed tutorial. Instead, our focus will be upon unique aspects of the OZ legislation, and how they can be applied with maximum efficiency in the context of a large multi-generational FO.

The legislative approach of the OZ program is novel in that it contemplates large pools of already recognized and otherwise taxable capital gains first being aggregated into OZ investment funds, where the subject gains initially escape taxation altogether. These gains are instead immediately recycled by the OZ funds, on a pre-tax basis, into new business startups and/or redevelopment of pre-existing OZ property. Stated another way, the all-pervasive U.S. investment fund model will, for the first time, be harnessed and used as the engine for redirecting pre-tax investment gains into new investments into economically depressed areas. The potent cocktail of economics and tax benefits offered by the OZ legislation is indeed compelling, and understandably investor interest is running high.

Qualified Capital Gains

As alluded to above, the entire process typically begins with a recognized and taxable capital gain, which absent any further action on the part of the taxpayer, would result in federal and state taxation at applicable capital gain rates. In an overall family context, subject gains will typically be generated from the family's jointly managed investment portfolio(s), as well as from individual family member's personal assets and/or investments.

Subject capital gains can result from the sale of capital assets, which can include gains from the sale of a personal asset such as a piece of art or a home, or the sale of an investment asset such as stock or a bond. But qualified gains are not limited to those from asset sales. For example, a distribution from a partnership which exceeds outside tax basis can result in a qualified gain. Again, generally any taxable capital gain, generated from any source, is eligible.

Once an otherwise taxable capital gain is recognized, the taxpayer has 180 days to invest that amount or some portion thereof into an OZ fund organized as either a corporation or partnership and which meets the various requirements specified within the OZ legislation. To be clear, the eligible OZ investment is the amount of the gain only, not the proceeds (or sale price) from the gain transaction.

Public OZ Funds

Currently there have been a plethora of large OZ funds established which are open to the public, many of which have or are in the process of taking in significant amounts of capital gain re-investment dollars. The OZ fund legislation is complex, and as one might imagine some of these funds come with significant front-loaded and/or back-end levies, promotes, etc. in addition to annual management fees, carried interest allocations, etc. Such charges are allowed by the OZ legislation, subject only to what we anticipate in future guidance to be a reasonableness standard. Similar to any FO portfolio investment, rigorous due diligence is recommended.

The Family OZ Fund

In light of the fee and/or cost structure associated with some of the large public OZ fund platforms as referenced above, families are inquiring as to the availability of a lower cost alternative. Does one exist? Yes — a Family Opportunity Zone Fund (FOZF). An OZ fund can be formed by the family itself to accept pre-tax capital gain investment from any and all family members and from any generation, while being managed within the existing FO structure. A family friendly fee/cost structure would be anticipated, incorporating carried interest provisions as appropriate.

Certain Operational Considerations

Setting up a FOZF is a relatively straightforward undertaking. It entails setting up an investment fund (typically a pass-through entity) under an appropriate operating agreement, and self-certifying as a qualified OZ fund using Form 8996 attached to the fund tax return filed for the relevant tax year. The entire process can be completed in a matter of weeks. Once self-certified, the FOZF can begin accepting pre-tax capital gain investments from other family investment vehicles or from individual family members themselves. Investments into the FOZF would be reflected on Form 8449 filed with and attached to the tax returns filed by the respective contributor(s) in the appropriate tax year.

The portfolio of a FOZF can be made up of either pre-existing legacy OZ assets (typically real estate) or OZ domiciled operating businesses, either incubated in the OZ itself, or relocated there from outside the zone. Several of our FO clients, especially those already managing significant portfolios of private equity and/or venture capital investments, either through an IPE structure or otherwise, have managed to relocate operating business investments into an OZ and thus extract the benefits of the legislation without having preexisting assets there.

With respect to family qualified capital gains, the OZ legislation contains “related party” prohibitions which would prevent such gains from being generated from transactions between and/or among family members themselves. However, and pending future guidance to the contrary which we do not anticipate, there does not yet appear to be a prohibition against gain contributors and OZ fund management being related parties.

Coordination with Other FO Programs

The use of a FOZF can dovetail nicely with certain other techniques that are commonly utilized in FO planning; for example, a Family Bank. As the name implies, a Family Bank is essentially a vehicle set up to loan money to family members. Typically, such loans are made to family members to provide money for home purchases, business formations, etc. A Family Bank can itself be funded by family members or from third party banking sources.

Recall that earlier we discussed that eligible capital gains can be generated from any source which could include non-cash gain allocations from partnerships or other vehicles. Where a family member has a qualified capital gain to invest but no associated cash, the OZ legislation allows for a potential investor to borrow against the OZ fund interest to fund the investment. In this set of circumstances, a Family Bank can provide that loan at family friendly rates.

Lender Management

If a FO already utilizes a *Lender Management* type structure, the FOZF can be set up to remit management fees and/or carried interests similar to any other investment silo in the structure. If such a structure is not currently in place, now may be a good time to review your structure accordingly.

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.

PKF O'Connor Davies Family Office, a division of PKF O'Connor Davies, provides a full range of family office, accounting, tax, administration, advanced planning and advisory services to high-net-worth individuals, families and their closely held businesses in the United States and abroad. The Firm's single point-of-entry model captures the entire universe of holdings and transactions for a family enterprise, and provides customized reporting based on family needs.

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

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