San Francisco Chronicle
https://www.sfchronicle.com/business/networth/article/Tax-questions-answered-Opportunity-Zone-fund-13992079.php

Tax questions answered, Opportunity Zone fund rush begins

Kathleen Pender June 14, 2019

The rush to create Opportunity Zone funds, one of the biggest federal-tax-saving opportunities in decades, is on.

The zones were created in December 2017 in the Tax Cuts and Jobs Act. The law gave investors two separate but related federal tax breaks when they reinvest the capital gain from one investment into a fund that invests in property or businesses in designated low-income census tracts called Opportunity Zones.

It's designed to spur investment in neglected areas, but many of the zones are in neighborhoods ripe for development, including parts of San Francisco, Oakland, Berkeley and San Jose. There are 8,700 zones nationwide, equal to 12% of all census tracts. California has 879 of them, spread across every county except Mono.

Opportunity Zones, or O-zones for short, got off to a slow start because the law left many unanswered questions. But interest exploded in mid-April, after the IRS released a second set of proposed rules that answered many of them, in mostly favorable ways for developers.

"Congress in the past has offered incentives to invest in geographic areas. This is by far the most generous incentive they have come up with. The tax upside is incredible," said Dustin Stamper, a managing director with accounting firm Grant Thornton. But the investment "still has to make economic sense."

Patrick Kennedy, owner of Panoramic Interests, plans to raise an $85 million fund to help finance construction of the first phase of a giant mixed-use complex with more than 1,000 apartments next to the West Oakland BART Station.

His firm purchased the land in 2016, before O-zones were a thing. The new tax breaks will let him raise capital on a more favorable basis. "It was like buying a piece of real estate that could have an oil deposit underneath it we knew nothing about," Kennedy said.

He’s been approached by large, out-of-state investors who say, “We want to invest in your project in West Oakland. And by the way, where is West Oakland?” he said. “This is one way to induce the haves to invest in the neighborhoods of the have-nots.”

Critics say the tax break is unlikely to help people living in the areas that need it the most.

“Because of the way it’s structured, the best places for developers to put their money is in neighborhoods that are already gentrifying,” said Howard Gleckman, a senior fellow with the Tax Policy Center think tank. “Building a Hilton Hotel in the middle of a dying rural city just doesn’t make sense, even with the tax subsidy.”

To get any tax break, investors must first own an asset — such as stocks, real estate, artwork or a business — in which they have a capital gain. They must sell that asset and within 180 days reinvest it into a qualified Opportunity Zone fund.

They can defer paying federal tax on the reinvested profit until Dec. 31, 2026, or whenever they sell the O-zone investment, whichever comes first. At that point, they must pay tax on the original investment, but 10% or 15% of their gain will be exempt from federal tax if they have held the O-zone for at least five or seven years, respectively.

The second and bigger tax break comes when they exit the O-zone fund. If they’ve held it at least 10 years, the entire profit is exempt from federal tax. “It’s the big enchilada at the end,” Kennedy said.

California has not conformed to the federal law, so profits on both investments are taxed as usual by the state.

To get the 15% discount on the first investment, investors must reinvest the profit into an O-zone fund by the end of this year. That’s spurred a bit of a rush, even though the IRS still has not published final regulations.

The fund itself must meet complicated rules and deadlines for investing the money. “These rules are nuts, they’re crazy,” said Michael D'Addio, a principal with the accounting firm Marcum.

A big one: If the fund buys property with an existing structure, it must “substantially improve” it within a certain time. That generally means it must spend at least what it paid for the property, minus the land value, on renovation or new construction. It can’t just buy a rental property in a zone and lease it out without making major improvements.

If the fund buys empty land, “there is no requirement to improve it,” D’Addio said. However, it must be used in a trade or business. It can’t be held purely for investment, but it’s unclear how much development is required.

A fund could also start or expand a business in an Opportunity Zone, even if it rents space there, but it also has to contend with crazy rules. Venture capitalists are setting up incubators in Opportunity Zones in places like Austin, Texas, said Andy Hart, CEO of wealth management firm Delegate Advisors in San Francisco.

Most of the funds being raised today are for real estate investment. They are generally private placements, although some are open to the public and more may be coming. To invest in a private fund, you usually need to be an accredited investor, meaning you earn at least $200,000 a year ($300,000 if married) or have more than $1 million in net worth excluding your home.

The funds typically require minimum investments in the six or even seven figures. “Our minimum is $250,000, but our average investment size is closer to $750,000 or $800,000,” said Erik Hayden, president of Urban Catalyst.

His firm is raising a $250 million fund to buy properties in downtown San Jose’s Opportunity Zone. It has already purchased one in the Fountain Alley area for $6.9 million that will be redeveloped for office and retail.

The fund’s investors range from a venture capitalist to a mother and daughter who inherited a condo in San Diego and sold it because they didn’t want to rent it out, Hayden said.

Kennedy said the Bay Area could miss out on some Opportunity Zone investments because of its notoriously long entitlement process. His West Oakland project goes before the city Planning Commission next month. Once it’s approved, he plans to raise $85 million in equity capital and borrow $100 million to build the first phase, with 311 apartments and retail space.

Do-it-yourself investors can form their own funds, but because of the complexity, “if you are just a person with a capital gain and no experience (developing real estate), that’s a heavy lift,” Stamper said.

That didn’t discourage John Sun, who runs hedge fund Aperte Capital Partners in San Francisco. He formed his own fund to buy a small property in an Opportunity Zone just north of Sonoma. He paid about $1.1 million for two parcels that include a brake shop, tuxedo-rental store and a vacant lot, on which he plans to build a two- to four-unit residential property.

Sun has a second home nearby and knows that developers have been buying property there. Ten days after he closed on the property, one offered him 20% more than he paid.

Hart said he gets at least one email a day from companies pitching these funds, but his clients “aren’t pounding the table” to invest.

One problem is that no one has a track record running O-zone funds. Before investing, Hart said, he'd make sure the promoter has "deep experience" developing real estate or running successful incubators. And he'd scrutinize the fees, which can be steep.

Like other private-equity funds, most O-zone funds are charging 2% of assets per year to manage the fund, plus 20% of profits, sometimes over a certain hurdle rate such as 7 or 8% a year. Some levy more fees for things like property acquisition, financing, management and liquidation.

"Make sure you do your math: How many dollars are you going to get paid after they've gotten paid six different ways," he said.

If everything goes perfectly, Hart said, the tax break could increase your return by 3% a year. But that's a big if.

"The investment has to pencil on its own," said Jeff Diener, a partner with law firm DLA Piper. "If you don't have a fundamentally sound investment to begin with, I would not rely on this tax treatment to get you over the tipping point."

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