OPPORTUNITY ZONE FUNDS: KEY CONSIDERATIONS FOR PRIVATE FUND MANAGERS—PART 1

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U.S. Opportunity Zones Alert

By: Ed Dartley, Adam J. Tejeda, Mary Burke Baker

In December 2017, Congress enacted The Tax Cuts and Jobs Act (the "Tax Cuts Act"). Included in that tax legislation is what has come to be called the opportunity zone incentive ("OZ Incentive"): a host of dramatic new tax incentives designed to promote the infusion of capital into low-income areas in all fifty states and U.S. territories. In a breathtakingly short time by funds-world standards, the OZ Incentive has spurred the creation of a new private funds asset class that is focused on taking advantage of these tax benefits. The OZ Incentive has generated excitement across a range of industry participants: traditional private fund sponsors, real estate and merchant banking firms, family offices, and impact and sustainability investors, to name just a few.

The implementing legislation regarding the OZ Incentive under the Tax Cuts Act contains significant uncertainty regarding implementation of the program. Proposed regulations were issued in October 2018 providing sufficient guidance to enable industry participants to engage in transactions under the OZ Incentive, and additional proposed regulations are expected in the near future. Based on the current guidance, jumping into this space requires an appreciation that accessing the OZ Incentive's benefits requires a number of modifications to the structuring and running of private funds that invest in this asset class. This article is the first installment of a multi-part series that highlights some of these key considerations for opportunity zone fund ("OZ Fund") sponsors seeking to launch funds. In this article, we address some of the key general considerations for structuring OZ Funds.

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The Tax Cuts Act added several new incentives for taxpayers to invest in low-income communities designated as qualified opportunity zones ("QOZs"). First, an investor that makes an investment in a qualified opportunity fund ("OZ Fund") within 180 days of realizing capital gains may defer recognition of capital gains on those invested amounts until 2026 for U.S. federal income tax purposes. Second, the investor may have up to 15% of those capital gains permanently excluded from being taxed. Third, the investor has the ability to exclude any post-investment appreciation in the value of an investment in an OZ Fund from U.S. federal and potentially state income tax if it is held for at least ten years.

With these significant new advantages comes a new set of statutory and proposed regulatory rules that will govern fund investments in opportunity zones ("OZs"). It should come as no surprise that these new rules are complex in nature and hold some uncertainty as to how they will apply to the structuring and operations of OZ Funds. Traditional private equity and real estate structuring and operations may need to be adapted in order to securely achieve the full benefits of the OZ Incentive. Nevertheless, with thoughtful guidance, OZ Fund sponsors can navigate through the OZ Incentive to a successful fund launch.

GENERAL STRUCTURING CONSIDERATIONS

There are different considerations at work with OZ Funds, based on OZ-specific rules, that distinguish these funds from traditional private equity funds. Private funds, depending on the types of investors and assets targeted, may be structured as a single fund, a master-feeder arrangement, a parallel fund structure, or in the case of a fund-of-funds strategy, employing these structures to invest in underlying private funds. In the case of the OZ Incentive, the tax incentives are attractive to U.S. taxable investors in part because of the ability to take recognized capital gains and invest them directly into an OZ Fund, thereby deferring capital gains taxes that would otherwise be due. Because U.S. tax-exempt investors or non-U.S. investors are generally not subject to capital gains tax, the OZ Incentive may not hold the same benefits for them, and accordingly these types of investors may not find OZ Funds attractive. This means that OZ Fund sponsors may avoid master-feeder arrangements and other tax structuring required by tax-exempt and non-U.S. investors (unless the fund sponsor seeks to target such investors because the merits of the investment is attractive independently of the OZ tax advantages). Further, the OZ Incentive generally does not permit fund-of-fund investing.

Exit events for OZ Funds also require special consideration. A private equity or real estate fund seeking to dispose of an investment will typically structure this as a sale by a fund of the underlying portfolio company or a sale by the underlying portfolio company of its business or assets. However, as currently contemplated, the OZ Incentive requires that the investor itself dispose of its interest in an OZ Fund to receive tax-free treatment, rather than the OZ Fund disposing the underlying investment and distributing the proceeds up to the investor.

This requirement has a number of practical implications for OZ Fund sponsors. Based on current guidance, the OZ Fund sponsor may need to structure the OZ Fund as a quasi-fund of funds, so that when the underlying investment is sold, the OZ Fund sponsor can effectuate it as a sale of an OZ Fund interest. Structuring becomes even more complex in cases where the OZ Fund sponsor wants to launch an OZ Fund that will invest in multiple assets, as opposed to a single-asset OZ Fund. OZ Fund sponsors may need to structure multiple-asset funds so as to have each separate OZ investment held in separate parallel or "mirrored" funds, thereby allowing for exits based on sales of underlying OZ Funds rather than sales of the underlying investments themselves. The Internal Revenue Service and Treasury Department are aware of this issue and hopefully further guidance will correct this anomaly so that OZ Funds can be structured in way that comports with market standards insofar as exit event planning goes.

The OZ Incentive also drives a departure from traditional notions of how long a private fund term should last before wind-down begins. Most private equity fund terms range from eight to ten years, depending on the investment strategy of the fund, investor preferences, and other factors. By contrast, the term of an OZ Fund will typically be at least twelve to fourteen years from either the final closing date of the OZ Fund or the final date in which capital contributions are made to the OZ Fund to allow investors to obtain the maximum OZ benefits available. This longer term is due to the requirement that, in order for an investor to receive a basis step-up (and therefore exclude all post-investment capital gains from U.S. federal income) upon disposing of its OZ Fund interest, the OZ Fund interest must be held for at least ten years. This requirement for a longer term may present challenges in a variety of situations, for example when, for nontax business reasons, the OZ Fund sponsor believes that the OZ Fund would maximize the non-OZ returns by disposing of the investment sooner than ten years.

CAPITAL CONTRIBUTIONS AND COMMITMENTS

The investment period of a private equity fund typically ranges from four to six years, depending on the investment strategy of the fund. Over the life of the investment period, the manager may draw down capital from investors as needed, in its discretion, typically upon ten to twelve business days' prior written notice to the limited partners.

One of the most significant differences between OZ Funds and traditional private equity funds is that cash attributable to capital gains must be contributed to an OZ Fund within 180 days of when the investor recognizes such capital gains. OZ Fund sponsors need to carefully evaluate and plan for this timing issue when developing and implementing the capital call procedures. Investors must be provided with adequate notice of when to schedule capital gain events in order to make a timely contribution to an OZ Fund or the OZ Fund should systematically call capital (e.g., quarterly or all at once commensurate with the final closing). In certain circumstances where the timing of an investor's capital gains cannot be made to match the OZ Fund's capital call schedule, the OZ Fund sponsor may wish to consider allowing investors to contribute to the fund before capital would otherwise called, or borrowing to fund an investment and allowing the investor to fund its portion of the investment at a later date.

If an OZ Fund sponsor allows an investor to prefund its capital contributions to comply with the 180-day rule, there are a number of additional issues that the sponsor needs to consider. For instance, allowing prefunding will impact the calculation of the preferred return. The OZ Fund sponsor also needs to determine whether such capital will be invested in temporary investments pending deployment, and if so, what those investments will be. The OZ Fund sponsor must also consider how such capital may be allocated to particular projects without jeopardizing the tax status of the OZ Fund.

The general partner commitment to an OZ Fund also raises special issues. Investors typically expect that a fund manager will make a significant capital commitment to the fund to align its interest with the limited partners and show that the fund manager has skin in the game. Often, the general partner commitment will come from several sources among the sponsor owners and senior management. For the OZ Fund sponsor, this requires planning in order to obtain the tax benefits for the sponsor under the OZ Incentive. As with any other investor, individual members of an OZ Fund sponsor will only be eligible for OZ benefits if they contribute cash within 180 days of recognizing a capital gain, and this investment must be made directly into the OZ Fund in order to qualify for OZ benefits. Accordingly, the OZ Fund sponsor may need to require its members to make investments directly rather than aggregating capital on behalf of its members and making a corresponding capital commitment. An OZ Fund may also segregate qualifying and nonqualifying investments for tax reporting purposes, and so an OZ Fund sponsor which invests nonqualifying cash in an OZ Fund may be required to invest through a separate vehicle.

A fund typically has an offering period of one to two years from its first closing so that it can raise its desired capital over time. Throughout the offering period, an equalization process occurs so that investors that subscribe for fund interests in each subsequent closing are, in effect, treated as if they were investors from the first closing. In such a case, a rebalancing of capital among early and later investors often occurs and the newly admitted investors pay an admission interest, which is distributed to previously admitted investors. Rebalancing among OZ Funds and payment of catch-up interest by later investors may cause early investors to receive distributions from the OZ Fund, which may disqualify a portion of the investors' OZ benefits (unless the OZ Fund engages in fund-level borrowing or takes other corrective action). Therefore, an OZ Fund must carefully consider how, if at all, investor rebalancing will be structured.

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These are just a few of the structuring considerations that an OZ Fund sponsor needs to address in the course of setting up an OZ Fund to take advantage of this new legislation. Please stay tuned for Part 2 in our OZ Fund series.

Jay L. Buchman and Amanda Katlowitz Strickler, Associates in the New York office, assisted with the preparation of this article.

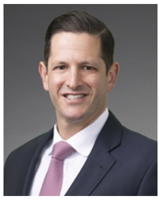
KEY CONTACTS

ED DARTLEY
PARTNER

NEW YORK
+1.212.536.4874
ED.DARTLEY@KLGATES.COM

JAY L. BUCHMAN
PARTNER

NEW YORK
+1.212.536.4820
JAY.BUCHMAN@KLGATES.COM



ADAM J. TEJEDA
PARTNER

NEW YORK
+1.212.536.4888
ADAM.TEJEDA@KLGATES.COM

MARY BURKE BAKER
GOVERNMENT AFFAIRS COUNSELOR

WASHINGTON DC
+1.202.778.9223
MARY.BAKER@KLGATES.COM