connectclassroom

# Learners Guide

## Welcome to Intro to Opportunity Zone Investments - Part 2

An overview and introduction to opportunity zone investments. Topics covered include the rules and regulations of Qualified Opportunity Funds (QOF) and Qualified Opportunity Zones (QOZ) as well as how to invest in QOFs and QOZs. Additional topics covered include QOF Funds and Subfunds as well as statistics on the gentrification and Opportunity Zones.

Throughout the course, Connect Classroom has created course content, which encourages ongoing conversations rather than rote memorization. Enjoy listening to panel conversations about topics relevant to your work.

*CE Credit: 1 hour*
*Written section length: 1 hour*
*Estimated time to complete course: 1.5 hours*

**Disclaimer Statement**
*This course is approved for continuing education credit by the California Department of Real Estate. However, this approval does not constitute an endorsement of the views or opinions which are expressed by the course sponsor, instructors, authors, or lecturers.*

**INSTRUCTORS**

- David Ceniceros - Founder and CEO of Connect Commercial Real Estate

**Estimated Total Time: 1 hour**

**LESSON 1: QOF Funds and Subfunds**

- *718 words – estimated time to complete 15 minutes*
- Much of the coverage of Qualified Opportunity Funds has focused on tangible investments like development and/or renovations of commercial real estate. However, little has been discussed about the QOF sub-fund.
- A QOF might choose to invest in a sub-fund which, in turn, funnels money into Qualified Opportunity Zone (QOZ) property.
- There are several ways to protect yourself when investing in QOFs and sub-funds.
- Due diligence is required for any investment; this is especially the case for QOF and sub-fund investments.
- QOFs and sub-funds must pass an asset test every six months. Additionally, QOZ properties in which a QOF/sub-fund invests are required to be "substantially improved" within 30 months.

**Course Material:** Coverage of the Tax Cuts and Jobs Act's Opportunity Zone program and Qualified Opportunity Funds (QOF) has been thorough and intense. However, much of that coverage focuses on tangible investments — such as development and/or renovations of commercial real estate. Little has been discussed about another QOF investment vehicle: the sub-fund. QOFs and sub-funds are subject to specific guidelines. However, some requirements for QOFs and sub-funds differ.

A QOF might choose to invest in a sub-fund which, in turn, funnels money into Qualified Opportunity Zone (QOZ) property. QOFs and sub-funds have several things in common:

- Both must be formed as corporations or partnerships (such as LLCs with multiple owners). Most QOFs and their sub-funds will be formed as LLCs, with multiple owners, partnership participation and pass-through taxation.
- Both must be created in the United States, or within U.S. possessions. Regarding the latter, a QOF or sub-fund is formed in U.S. possessions only if it will invest within a designated QOZ there.
- For both QOFs and sub-funds, tax benefits only apply if the entities acquire QOZ assets after 2017.

Additionally, if it sells interest from a sub-fund or property, the QOF is allowed a "reasonable period" to reinvest the gain. However, owners will pay taxes on that gain, unless it is re-invested in the same or different fund, or used in a 1031 exchange.

Though the QOF and sub-fund have similar requirements, confusion occurs because of different guidelines, listed below:

- A QOF must hold 90% of its gross assets in QOZ property or sub-fund interests. The sub-fund in which that QOF invests only requires 70% its tangible assets be held in QOZ property.
- If the QOF doesn't meet the asset test of 90%, it pays a 5% interest penalty on the shortfall. If the sub-fund fails to meet the 70% asset test, it immediately is disqualified.
- An entity declares itself a QOF by filing an annual Form 8996 with income taxes. That entity's organizational charter must also specify it is doing business in an Opportunity Zone. The sub- of its tangible assets be held in QOZ property.
- If the QOF doesn't meet the asset test of 90%, it pays a 5% interest penalty on the shortfall. If the sub-fund fails to meet the 70% asset test, it immediately is disqualified.
- An entity declares itself a QOF by filing an annual Form 8996 with income taxes. That entity's organizational charter must also specify it is doing business in an Opportunity Zone. The sub-fund entity isn't required to file a Form 8996, or to specify a purpose.
- At least 50% of a sub-fund's gross income must come from an active trade or business within the QOZ; QOZ working capital can count as qualifying income. QOFs are not held to that 50% rule, and can't use working capital as qualifying income.
- Less than 5% of a sub-fund's assets can consist of investment/intangible property — stock, partnership interest and debt — other than QOZ working capital. This is not the case with a QOF.
- Liquid assets can count as a sub-fund's property, as long as a written plan and schedule are in place to meet the 100% of cost test. Again, this is not the case with QOFs.

Due diligence is required for any investment; this is especially the case for QOF and sub-fund investments. Complicating the issue is that the Opportunity Zone program is still so new. Still, the following can help protect those investing in QOFs and sub-funds:

- Take note of the QOF's and sub-fund's structure and holdings. Both must pass the requirements mentioned above.
- Though sub-funds are not required to state their purpose, their holdings must be consistent with guidance.
- Keep an eye on the calendar; QOFs and sub-funds must pass an asset test every six months. Additionally, QOZ properties in which a QOF/sub-fund invests are required to be "substantially improved" within 30 months.
- Work with those who know what they are doing. At Greenberg Glusker, we have staff solely dedicated to understanding guidance and rules pertaining to the Opportunity Zone program. It's important to have access to expertise like this, to protect your investments.

While the Opportunity Zone program can provide positive benefits, it is still very new. This is especially the case for Qualified Opportunity Funds and their sub-funds. As such, an understanding about the investment and requirements is extremely important.

**<u>LESSON 2: Opportunity Zones and Community Investment</u>**

- *769 words – estimated time to complete 15 minutes*
- Capital that is funneled into Qualified Opportunity Funds can also provide ample opportunity for cultivating human capital for redeveloping inner-city and lower-income neighborhoods.
- Bringing talented minorities into commercial real estate deals can help boost understanding of local markets and business practices.
- Gentrification is a concern when pouring billions of capital gains into lower-income and economically disadvantaged areas.
- The highest number of gentrified opportunity zones are located in Rust belt metros, including Baltimore, Chicago, Detroit, Philadelphia and St. Louis.
- Opportunity zones in tech hubs and hotspots are experiencing high rates of gentrification.
- Many of the least-gentrified O-Zones are in Sun Belt cities.
- Of the top 100 most gentrified Opportunity Zones, 75 are within urban areas.

**Course Materials:**

In 1948, the United States launched the Marshall Plan, with the goal of providing $13 billion of capital and assistance for rebuilding Europe following the destruction of World War II. Close to 70 years later, the Tax Cuts and Jobs Act introduced another rebuilding effort, that of the Opportunity Zone program.

On the surface, there is a huge inherent difference between rebuilding post-war Europe, and working to economically sustain lower-income areas. However, in his column, "Opportunity Zones and Human Capital: Insights from the Marshall Plan," G. Lamont Blackstone with Project REAP attempted to link these two financial projects. Specifically, he spelled out that the importance of OZ success initiatives would depend on "the importance of cultivating local human capital for a redevelopment effort."

The Marshall Plan provides a good example of such capital, he noted, as it leaned heavily on local human capital for Europe's rebuilding efforts. Throughout that effort, corporate managers from European countries "were invited to learn modern management skills through study trips to the United States," Blackstone said. As such, capital being funneled into Qualified Opportunity Funds also provide ample opportunity for cultivating human capital for redeveloping inner-city and lower-income neighborhoods.

The benefits of such cultivation are that:

1) Including women and minorities at all levels of the investment process will "maintain a favorable legislative environment for the incentives," Blackstone pointed out.

2) Bringing talented minorities into commercial real estate deals can help boost understanding of local markets and business practices.

Blackstone continued his commentary by noting that "the pools of minority talent to support the impending capital flows into Opportunity Zones already exist" — or, if they don't exist, they are out there to be hired. Project REAP (the Real Estate Associate Program) is, in fact, continuing to educate and promote minority talent to work with developing Opportunity Zones.

As funding for Opportunity Zones continues moving forward and being refined, "CRE executives should be cognizant of the role that human capital plays in redevelopment projects," Blackstone concluded.

The Opportunity Zone program tucked within the Tax Cuts and Jobs Acts of 2017 focuses on pouring billions of capital gains into lower-income and economically disadvantaged areas. There have been some questions, however, as to whether some of those government-designated zones are already undergoing the process of gentrification.

RCLCO Real Estate Advisors' Eric Willett (Vice President) and Brett Dunlavey (Analyst) opted to put numbers to the issue by identifying census tracts with the most gentrification in recent years. The researchers did this by examining changes in real estate investment, household income levels and associated demographic characteristics, from which it built a Gentrification Index. That index, in turn, was applied to every Opportunity Zone in the 25 largest metropolitan areas.

Here are some of the findings, issued in a report.

- ***Rust belt cities have the highest number of gentrified Opportunity Zones***. The report noted that 49 of the top 100 most gentrified Opportunity Zones were in Rust Belt metros, which included Baltimore, Chicago, Detroit, Philadelphia and St. Louis. Furthermore, "of the eight metros with the highest average gentrification scores, five are rust belt cities," the researchers wrote, adding that the findings show the regions' "comparatively overlooked neighborhood change and growing inequality."
- ***Opportunity Zones in new tech areas are experiencing high rates of gentrification***. The RCLCO analysts noted that, due to "high salaries, a disproportionately white workforce and increasingly urban campuses," O-Zones in metros such as San Francisco and Denver are experiencing higher rates of gentrification.
- ***Many of the least-gentrified O-Zones are in Sun Belt cities***. The RCLCO report pointed out that 55 of the 100 least-gentrified zones are in the Sun Belt cities, with different gentrification rates reflecting land use in these regions. One reason is because Sun Belt cities are, for the most part, suburban. Additionally, "the comparatively low barriers to entry and lower land prices in these metros create less pressure on local populations and fewer incentives for densification and reinvestment in contested neighborhoods," the report said.
- ***Gentrification is more common in urban neighborhoods***. Relocation of young, college-educated households into CBDs and urban cores has been a driver of gentrification. Of the top 100 most gentrified Opportunity Zones, Willett and Dunlavey said that 75 of those are within urban areas.

Overall, the RCLCO analysts found that the majority of the census tracts identified as Opportunity Zone-eligible, in that they are economically challenged. However, many of the tracts are located in more affluent communities. "We found 70 qualified Opportunity Zones in high-end neighborhoods . . . in which two out of three residents had a bachelor's degree or higher, and the current median income is $94,000," the report said.

**<u>LESSON 3: Environmental Concerns and Opportunity Zone Investment</u>**

- *809 words – estimated time to complete 15 minutes*
- How to choose sites for optimal business objectives.
- Once you have targeted some qualified Opportunity Zones for real estate development, your first objective is to evaluate how and if that parcel can accommodate your business objectives and potential building use.
- How to manage environmental and physical building risk.
- The U.S. Environmental Protection Agency recently targeted 149 communities to receive $64.6 million in funding for brownfield cleanup, almost three-fourths of which were Qualified Opportunity Zones.
- How to manage project completion and budget.
- The degree of success when investing in opportunity zones will depend on optimization of site selection for use and occupancy, understanding and pricing in all environmental and physical risks associated with the site, and ensuring timely construction progress and budget.

**Course Materials:**

*Choosing Sites for Optimal Business Objectives*
Once you have targeted some qualified Opportunity Zones for real estate development, your first objective is to evaluate how and if that parcel can accommodate your business objectives and potential building use. You must consider whether the location is optimal, if the site will require structural modifications, and whether the development is geared towards short-or long-term gains. Can you physically make your building work on the existing property? For example, will the space allow for an office, a mixed-use retail development or a logistics center for e-commerce goods? Will your proposed asset require a significant capacity, and can you provide the parking and access to make that work?

Before breaking any ground, start with a feasibility study to see what is actually possible. You might need a zoning exception for parking requirements, or a special permit for a business classification change if there is a specified zoning use for that area. Understanding the zoning requirements and what changes can be made "over the counter" without triggering a lengthy entitlement process, avoids delays and additional fees.

*Manage Environmental and Physical Building Risk*
Be aware of the potential for environmental contamination, especially if your targeted property involves industrial, brownfield or long-abandoned assets. Indeed, the U.S. Environmental Protection Agency recently targeted 149 communities to receive $64.6 million in funding for brownfield cleanup, almost three-fourths of which were Qualified Opportunity Zones. To determine the extent of these contamination risks and liabilities, you will need to invest in an environmental assessment by an experienced consultant. Should the presence of environmental concerns be discovered, a remedial cost estimate plan can help you price in the cost of cleanup and provide guidance for state and federal regulation compliance. An environmental consultant can navigate a range of remediation concerns, from vapor intrusion, mitigating contaminated soil or water, or the removal of an underground features such as storage tanks or abandoned oil wells.

For renovation or rehabilitation of older buildings, it is wise to test for asbestos and other hazards such as lead paint and mold before and/or during construction.

If you plan to repurpose or renovate an existing building, a Property Condition Assessment (PCA) report will provide in-depth understanding of any necessary repairs or replacements, and the remaining useful life of the building's systems. Big-ticket items like roofing, floors, and MEP (mechanical, electrical, and plumbing) systems must be assessed for capital planning. One of the distinguishing elements of Opportunity Zone investments is that you must improve the asset – often spending a significant amount of money – to qualify for the tax incentives. The PCA will provide a detailed opinion of costs for capital expenditures and immediate repairs necessary for transforming the asset and can even identify those items where your budget is best spent, to help you plan ahead for investment return.

If your Opportunity Zone asset is also located in a seismic zone, then certain developments or changes of use may necessitate seismic reinforcement or retrofitting to ensure building safety. Consult with a seismic expert to perform a seismic risk assessment. Engineers can help determine conditions and a scope for seismic strengthening, depending on your risk tolerance and use designation.

*Manage Project Completion and Budget*
Whether you choose to pursue a ground-up development Opportunity Zone or rehabilitate an existing asset, your Opportunity Zone project will involve some form of construction services. If not managed properly, rising costs of construction and a persistent labor shortage can drain the profit from even simple renovation projects and increase the likelihood of contractor failure or a default. Therefore, construction risk management is an important tool in managing cost and minimizing delays or defaults, particularly for projects where cost savings are priced into the return on investment.

Even when pursuing the most exciting Opportunity Zone developments, be wary of rushing a project on the front end or hiring general contractors that are overbooked or are developing projects outside their realm of expertise. Sometimes, renovation projects can incur even more risk than ground-up development because you don't know what you are dealing with until you start demolishing and opening up structural elements. In these cases, making sure that the original budget is accurate and has enough contingency built in for any unanticipated costs is key. You can minimize these risks with construction risk management oversight measures, such as a pre-closing document and cost review, contractor evaluations before hiring staff, monthly progress inspections, budget monitoring and funds control to ensure contractors and vendors are paid on time.

Opportunity Zone incentives are an attractive avenue to pursue your investment objectives in a challenging market, at least until the program expires on December 31, 2026. Your degree of success will depend on optimization of site selection for use and occupancy, understanding and pricing in all environmental and physical risks associated with the site, and ensuring timely construction progress and budget.

## LESSON 4: Opportunity Zones Myths and Facts

- *436 words – estimated time to complete 12 minutes*
- Even as billions pour into Opportunity Zone funds, there are a number of misconceptions on what exactly the Opportunity Zone program entails.
- An outline of five common misunderstandings about the Opportunity Zone program.

**Course Materials:**
Even as billions pour into Opportunity Zone funds, misconceptions persist on what exactly the Opportunity Zone program entails. "It is a great program that should pull capital into under-invested areas," said Darryl Jacobs, co-founder of law firm Ginsberg Jacobs in Chicago. "But to get the most out of the program, investors must do their due diligence.

"Deals still must pencil out," he added. "Investors also need to make sure they understand the program's rules, or they may fail to get the hoped-for tax deferrals or breaks or, even worse, face penalties."

Jacobs cited—and corrected—five common misunderstandings about the Opportunity Zone program:

- All capital gains qualify. The gains must arise from a sale between Dec. 22, 2017 and Dec. 31, 2026, and must be invested in a Qualified Opportunity Fund (QOF) within 180 days of the gain recognition date.

Furthermore, "if you own a property in the Opportunity Zone, you can sell it to anyone, but not all buyers will be eligible for the tax advantages," said Jacobs.

- Capital gains can be deployed at any time before 2027. In fact, a QOF must deploy 90% of its assets into eligible property within six months of the fund's designation or Dec. 31 of the year in which the fund is formed, whichever comes first.
- All money in a QOF has to be invested in the Opportunity Zone. In fact, as little as 63% of the fund can be invested in qualifying assets, depending on how the fund is structured. That's under the "70-30 rule" included in IRS guidelines issued last October.
- Any existing building in an Opportunity Zone qualifies. Properties must be newly- constructed or "significantly rehabbed" within 31 months. The property may be commercial or residential, but can't be a "sin property," such as a liquor store or massage parlor.
- Investors pay no taxes on capital gains after 10 years. Assuming the investor makes an investment in a QOF prior to Dec. 31, 2019, he or she is allowed to defer paying taxes on the original capital gain—i.e. the money invested into the QOF—until divestiture or Dec. 31, 2026, whichever occurs earlier. However, since the original gains are taxed no later than Dec. 31,

2026, an investor needs to invest gains no later than Dec. 31, 2019, to get the maximum tax benefit.

"The longer an investment is held, the more tax benefits the investor reaps," said Jacobs. "And if they're willing to commit a decade or more to a particular project, they are rewarded for the risk they take in the form of tax-free gains—but only if that project is successful."

**FINAL EXAM**

Please complete the following exam to receive full continuing education credit. You will be able to take the exam twice and must have a 70% score to pass.

While taking this exam, please ensure that you are in a private room to avoid distraction with a stable wi-fi connection. Once you begin the exam you will be unable to pause it or restart it. If you do not pass within 2 attempts, the course will need to be retaken.

Once you have successfully passed the course exam, you will be directed click a button to continue on to receive your certificate.

Before the learner can download their certificate, they must verify the following information:

I, NAME, certify and ensure that by written statement signed under penalty of perjury that the participant enrolled is the person completing the course.

**First Name:**
**Last Name:**
**State Recognized ID:**
**Professional License Number:**

If any of this information is missing or incorrect – STOP NOW! – and click the "**Update Information**" button.

This is important as it'll be used on your certificate!

A pop-up dialog box will give the learner an opportunity to correct erroneous information or add in missing information. When all of the information has been updated, click "**Update**" button. Finally click the "**I Confirm My Details Are Correct**" button to return to the Course home page. The course certification will be available to download from the top of the page.

Thank you for completing the Connect Classroom Introduction to Opportunity Zone Investments – Part II Course!

**FINAL EXAM – TEST BANK: 10 Questions Pulled from a Question Bank of 30 Questions**
*10 questions, 1 minute each question = 10 minutes to complete*