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Early Adopters Move Ahead with Opportunity Zones Funds.

The opportunity zones (OZ) incentive has been part of the federal tax code for less than a year, but early participants are setting the groundwork to facilitate and make qualified opportunity fund investments in distressed communities.

Time is of the essence. Qualified investments allow taxpayers to defer taxes on their gains until the end of 2026, but they get a step-up in basis only if they hold fund shares for at least five years–with larger step-up at seven years. That means investments need to be made by the end of 2021 to qualify for the minimum incentive to reduce their required 2026 tax payment. The Novogradac Journal of Tax Credits spoke with a few early OZ participants about their planned investments and the flexibility of the incentive.

Fundrise

One early opportunity fund manager is Fundrise, an online real estate investment platform. Co-founder and CEO Ben Miller describes Fundrise as “Blackstone meets Amazon.” Miller said Fundrise investors tend to be individuals investing through limited liability corporations or trusts.

Miller learned about OZs in April and spent the past few months consulting legal experts on how the new incentive might make sense for Fundrise investors. Miller said that Fundrise’s longtime focus on multifamily housing and urban markets made OZs a natural fit.

“We’re operating in opportunity zones already,” said Miller, referring to previous Fundrise investments in areas later designated as opportunity zones. “It wasn’t a big leap for us to then start to look at opportunity zones as its own investment strategy.”

Fundrise launched its OZ fund in early August, but posted a teaser landing page on its website two weeks earlier, which drew favorable responses by interested investors. Fundrise aims to raise $500 million for investment before the fund closes Dec. 31, 2019.

Miller said Fundrise’s OZ fund has two properties in the pipeline already. One is a historic rehabilitation of a multifamily property in Washington, D.C. The other is a creative office renovation in Los Angeles.

Virtua Capital

Phoenix-based Virtua Partners immediately began assembling a pipeline of investments as OZs were designated in spring.

“The bill as written, along with IRS FAQs that have been promulgated, suggest that capital gains dating back to 2017 were eligible for participation, as long as they were reinvested within 180 [days], so we looked to build a product for those potential investors,” said Zachary Chavez, vice president of Virtua Capital Management LLC. “Understanding that the best deals are going to be picked up first, we’ve been building our pipeline since the earliest designations were approved by Treasury in mid-April.”

Virtua's current fund has a $200 million goal and will focus on single-family and multifamily housing development, as well as some limited service hospitality investments.

Chavez mentioned three particular projects in the pipeline that will drive investment to three cities in Arizona. One is a 128-room hotel called SpringHill Suites Marriot flagged hotel in Avondale that will be located near the Banner Estrella Medical Center and University of Phoenix Stadium.

The second project is a 90-apartment multifamily rental housing development in Tempe. "As far as we know, it was the first opportunity zones zoning case that was passed and approved," said Chavez.

The third Arizona investment in Virtua's pipeline is a single-family residential development in Glendale made of 81 townhomes.

Another Phoenix-based investment management company, Caliber – The Wealth Development Company, also got a head start on building its real estate pipeline. "We don't have the luxury of waiting," said Chris Loeffler, CEO of Caliber. "We need to get our project pipeline moving and ready for capital flow–when the money comes in, it needs to be deployed quickly."

Caliber launched a $500 million OZ fund that will be leveraged to target $1 billion of hospitality, commercial and residential real estate investments in the Southwest growth markets of Arizona, Texas, Colorado, Nevada and Utah.

Loeffler describes the OZ incentive as an "accelerant" to Caliber's business model. Loeffler said the OZ tool provides patient capital that allows Caliber to pursue interesting and creative developments in areas that greatly need them.

Caliber's planned investments in Arizona include a new hotel for Tucson's convention center, a revitalization of historic downtown Mesa, energy-efficient town homes in Tempe and several investments near Grand Canyon University in Phoenix. In Texas, Caliber is planning to develop university housing in San Antonio.

Investors are already interested. "In the last decade raising and deploying over $225 million in client capital, I've never seen the level of interest in one of our funds that we've seen with this," said Loeffler.

Access Ventures

Access Ventures of Louisville, Ky., similarly found significant interest in its opportunity fund, which it founded in partnership with the Local Initiatives Support Corporation. "We've had conversations with over 100 individual investors–high-net-worth individuals or family companies that have been sitting on real estate or stock for a long time and they want to sell the assets that they've held," said Ross Baird of Access Ventures. "I think opportunity zones are probably the best fit for individuals who own significant assets that they've been wanting to sell."

Access Ventures will focus its opportunity fund on operating business. "Traditional community development has been large-scale real estate and housing," said Baird. "I think there's a real benefit in also investing in operating businesses in these communities that are building wealth."

Access Ventures expects to raise $100 million minimum in its fund and will likely focus on OZs with about six to 10 operating businesses ready for investment so that the fund can invest in all of them. Baird says the OZ incentive can benefit businesses that are too risky for debt and do not gross enough for venture capital equity.

Baird sees a lot of potential in the OZ tool, especially when leveraged with other incentives. “What will make opportunity zones successful is the ability and knowledge of how to blend different incentives, whether it’s the new markets tax credit or low-income housing tax credit,” said Baird. “It’s about being able to get that capital stack right.”

Obsidian Opportunity Fund

Allen Alley, co-founder of Obsidian Opportunity Fund, saw OZs as complementary to Obsidian’s expertise in fund management and solar development.

“It fits well into what we’re doing because there’s a large overlap between rural communities designated as opportunity zones and rural communities suited for solar development,” said Alley.

The Obsidian Opportunity Fund has a large pipeline of shovel-ready solar projects, including two solar installations in Oregon. Alley said he expects Obsidian’s opportunity fund to provide hundreds of millions of dollars initially, with later capacity to invest $1 billion in solar.

Alley said one of the benefits of the OZ incentive for renewable energy properties is providing a new source of equity. “We think opportunity zones are going to give us a chance to do these solar investments beyond the time when other [incentives] phase out,” said Alley.

As interested participants await more guidance from the IRS, Alley said Obsidian’s strategy is proceed conservatively. “We’re playing it straight down the middle,” said Alley. “We try to be conservative in every interpretation we’re using and putting together the structures we think were intended.” Alley said that if an investor invests in an opportunity fund before IRS guidance is released and the investment is no longer tenable under the new guidelines, Obsidian will refund the investment.

Blazing a New Trail

Early leaders in opportunity funds are forging ahead with cautious optimism, each recognizing it as a tool with a double bottom line: to provide a tax benefit to investors and to bring capital to economically underserved communities.

In that way, it could close the gap on investments that might not otherwise be feasible. “I think it’s a really exciting opportunity–no pun intended–for the United States,” said Alley. “I think it’s a new paradigm to do it this way. I don’t think we’ve ever seen anything like this before.”

Baird likewise sees the OZ incentive as a creative way to finance developing businesses that otherwise wouldn’t qualify for traditional debt or venture capital equity. “I think broadly we’ve needed an excuse to innovate on a number of tools to support entrepreneurs,” said Baird. “Whether or not this is the perfect tool, it is a good flash point for innovation.”

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