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In The (Opportunity) Zone: How To Avoid Diligence Pitfalls

By **Andrew McIntyre**

Law360 (October 29, 2019, 1:38 PM EDT) -- Developers are increasingly eyeing the possibility of doing projects in opportunity zones as they seek to reap tax deferral benefits from the program, but lawyers say developers have a host of due diligence issues to consider as they set up or contemplate doing projects.

Timing, for one, is a major hurdle to getting opportunity zone deals done, and developers need to do significant planning and analysis before raising a fund or buying a property, since missing key timing milestones can negate the tax deferral benefits the program affords. And there are also income requirements that must be satisfied.

Opportunity zones were created by the federal tax overhaul signed by President Donald Trump in 2017. (AP)

Congress signed opportunity zones into law as part of President Donald Trump's Tax Cuts and Jobs Act of 2017. The program allows investors to defer payment of capital gains tax for 10 years if gains are put in an opportunity zone project and the investor holds the position for 10 years. Gains on that opportunity zone investment are tax-free if the investment is held for 10 years.

When it comes to the question of timing, experts say developers need to do significant legwork before closing an opportunity zone deal in order to make sure the project is fully built or substantially completed within 30 months after the opportunity funds have been deployed, a requirement in the federal law.

"A lot of developers are very wary now. They have to be careful on when their closing date is, since the closing date could potentially trigger the 30-month time frame," said Keith Poliakoff of Saul Ewing Arnstein & Lehr LLP, referring to the requirement that developers get a certificate of occupancy within 30 months.

"If you close on the property before you are ready to submit building permits, chances are you will miss your 30-month window," Poliakoff added.

There are various other considerations for developers, though.

For one, a 90-10 requirement sets out rules for so-called bad assets. That rule says that a developer can't hold more than 10% in bad assets when the project and other assets held by the developer entity are analyzed as a whole. Cash qualifies as a bad asset under the law, and thus if developer entities hold more than 10% in cash, they would have to pay a penalty to the IRS.

Also, just where the project lies in the opportunity zone is important. The law says that at least 70% of the tangible project must be in an opportunity zone. And there is also an income test: At least half of the gross income at the property needs to be earned within the opportunity zone.

Lawyers say that while well-established real estate players may have the systems in place and experience necessary to make sure projects satisfy those and other requirements of the law, new developers in the real estate space may not.

"Brookfield, Starwood, Silverstein, some of the major players … that have reporting and internal controls set up already, it's very comforting that they'll meet all the timelines," said Alan Cohen of Akerman LLP.

While developers need to be aware of the ins and outs of the federal law, they also have to do significant financial planning and analysis to weigh the tax benefit against the cost of building in an opportunity zone and complying with the law.

As construction costs rise across the country, developers may take initial losses during construction, and they need to carefully pencil out the tax gains they'll realize against the potential short-term loss, lawyers say.

"In an opportunity zone deal on new construction these days, an investor could potentially lose money for the initial years of the investment while the apartment complex stabilizes at rent that would warrant its development," Poliakoff said, speaking about the prospect of building a multifamily project in an opportunity zone.

And developers also need to be aware of tax bills coming due. Sometimes that's taken into consideration when funds are structured, and sometimes not.

"Some of the funds … may provide some liquidity for investors to pay taxes," said Jay Blaivas of Morrison & Foerster LLP, referring to the issue of investors needing to make sure they have capital down the road to take care of the tax bills they've deferred by making the opportunity zone investment.

And, of course, no project gets built if it doesn't have the required capital, so developers also need to figure out how to get financing in a timely fashion.

That's particularly tricky when it comes to opportunity zone projects. In a reversal from the typical equation of investors with capital looking for projects to invest in, where opportunity zone projects are concerned, it's often the project and developer that go out and look for the capital once the project is ready to proceed within the opportunity zone timing framework.

"In this market, what's more practically happening is as deals are investment-ready and prepare to take on that capital, those deals are identifying capital," said Bo Kemp of Faegre Baker Daniels LLP. "There's a structural issue around the ecosystem."

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