Private Fund Opportunities: Opportunity Zone Funds, Sustainability & Impact Investment Management
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IMPACT INVESTING
“OUR DUTY IS TO LEAVE SOMETHING GOOD BEHIND”

- Impact investing is arguably one of the fastest growing areas in the average family office investment portfolio.
- Global Sustainable Investing Alliance reports that $23 trillion in assets around the world have been committed to socially responsible investing strategies.
- The 2018 GIIN Annual Impact Investor Survey estimates that 229 of the world’s leading impact investor organizations collectively manage over USD $228 billion in impact assets across the globe.
Once again this year, education remains the number one area to invest in, with over half (51%) of impact investors targeting this cause. Housing and community development became a greater focal point, as it shifted from ranking in ninth place last year to second place this year, with 49% of investors now concentrating on this area. Women’s empowerment also garnered greater attention this year, moving from seventh place to fourth (or to 43%) (figure 1.29).
Measurement is the most common challenge

The greatest challenges for impact investing include difficulties in measuring the level of impact, as reported by over half of respondents (52%), due diligence (43%), difficulties identifying attractive deals/funds or lack of deal flow (40%) and market immaturity (32%) (figure 1.30). In relation to supporting the measurement of impact investments, whilst it is relatively straightforward to ascertain profit margins on investment returns, calculating the extent of social or environmental impact can however be trickier.

To aid investors, the Stanford Social Innovation Review (2016) broadly outlines four measurements which are often used – ‘expected return’, ‘theory of change’, ‘mission alignment’, and ‘experimental and quasi-experimental’ methods*. While it is noted that these processes all carry their advantages and disadvantages, each reportedly accomplishes their objective to aid in the calculation of social investment returns. It may therefore be fruitful for those involved in impact investing to explore these and other such methods used, such as the Bridges Impact Management Framework, to ensure that they have a robust process for measuring success.

### Figure 1.30 Most common challenges faced in impact investing

<table>
<thead>
<tr>
<th>Challenge</th>
<th>%0</th>
<th>%10</th>
<th>%20</th>
<th>%30</th>
<th>%40</th>
<th>%50</th>
<th>%60</th>
</tr>
</thead>
<tbody>
<tr>
<td>Difficulties measuring social / environmental impact</td>
<td>52.0%</td>
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<tr>
<td>Due diligence challenges</td>
<td>43.0%</td>
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<tr>
<td>Difficulties identifying attractive deals / funds or lack of deal flow</td>
<td>40.0%</td>
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<tr>
<td>Market at early stage / immature</td>
<td>32.0%</td>
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<tr>
<td>Lack of track record data on performance</td>
<td>31.0%</td>
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<td>Lack of supportive / knowledgeable advisers</td>
<td>29.0%</td>
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<tr>
<td>Returns don’t meet expectations</td>
<td>22.0%</td>
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<tr>
<td>Lack of government support</td>
<td>22.0%</td>
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<tr>
<td>Lack of time / staff resources</td>
<td>20.0%</td>
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<tr>
<td>High levels of risk</td>
<td>20.0%</td>
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<tr>
<td>Insufficient knowledge / skills</td>
<td>20.0%</td>
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<tr>
<td>Scale of the deals (too big / too small)</td>
<td>17.0%</td>
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<tr>
<td>High costs</td>
<td>11.0%</td>
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</tr>
</tbody>
</table>

Source: The UBS / Campden Wealth Global Family Office Report 2018
Note: Respondents were able to select multiple options
UNITED NATIONS CAPITAL DEVELOPMENT FUND
UNCDF: DEVELOPMENT-FOCUSED INVESTMENTS AND TECHNICAL ADVISORY VIA MULTI-SECTOR APPROACH

- **What is UNCDF?** UNCDF is the United Nations’ capital investment organization primarily serving the world’s poorest 47 countries. With its capital mandate, it designs and implements various financial instruments to reduce poverty and support local economic development.

- UNCDF investments and TA have primarily centered around supporting financial service providers (FSPs), small and medium enterprises (SMEs) and project developers across four thematic areas:

  - **Goals (2030)**
    - Food Security & Nutrition
    - Green Economy
    - Financial Inclusion & Innovation
    - Infrastructure

- **Why these sectors?** (1) Private Donor and Member State Priorities; (2) Sectors that can potentially achieve most market creation and development gains in LDCs.
UNCDF GEOGRAPHIC PRESENCE

UNCDF Global Presence in 2017 | Active programs (boots on the ground)
NEW INITIATIVE: PRIVATE INVESTMENT FUND

Reasons

- Increase the support to the implementation of the SDG objectives
- To better support UNCDF’s pipeline of investment opportunities
- To raise additional funds – reach another set of capital provider
- To be able deploy equity into the companies
- To find a revenue model for UNCDF’s sourcing and post investment support
- To be an agent to refer investment opportunities from other UN agencies to the fund

Main sourcing tool of private sector investment opportunities

- Open competitions (RFPs, EOIs, Challenge funds etc) give UNCDF
  - Sector knowledge
  - Map companies
  - Innovative and early stage company knowledge
  - Grants
UNCDF IN THE ECOSYSTEM OF PRIVATE INVESTMENTS

Y:-3
1. Grant (seed money)
2. Co-investing domestic bank

Y:-2
3. Grant (seed money)
4. Direct investment opportunity
5. Co-investment opportunity

Y:-1
6. Loan
7. Co-invest Loan

Y:0
8. Investment into Fund
9. Impact Fund (managed by independent Fund Manager)
10. Commercial Fund

UNCDF TECHNICAL ASSISTANCE (TA) CAPABILITY and PROVISION

- from UNCDF Balance Sheet
- from external party’s Balance Sheet
THE POLICY

- The Opportunity Zones (OZ) program was created by the Tax Cuts and Jobs Act enacted in December 2017.
- The purpose of the OZ program is to help direct economic resources to low-income communities, spurring economic growth and job creation.
- A descendant of Empowerment/Enterprise Zones, and New Markets Tax Credit.
THE DEFINITIONS

- **Opportunity Zone:**
  - Low-income census tract nominated by a state’s governor and certified by the Treasury Secretary as an OZ eligible to receive private investments through Qualified Opportunity Funds (QOFs)
  - Designations are finalized and expire at the close of the 10th calendar year after the designation (2028).
THE DEFINITIONS

- **Opportunity Fund:**
  - Any investment vehicle classified as a corporation, partnership (which can include LLCs) for the purpose of investing in Opportunity Zone property
  - Funds can be a mix of capital gains, non-capital gains and borrowed funds (but only capital gains share qualifies for special tax treatment)
  - Funds self-certify to Treasury that they meet requirements to comply with the OZ program
THE DEFINITIONS

- **Opportunity Zone Business:**
  - Substantially all the tangible property owned or leased is OZ business property
  - At least 50% of gross income derived from active trade/business
  - Substantial amount of any intangible property is used in the active trade or business
  - Limits on financial property (deter passive investment)
  - No “sin” businesses
QUALIFYING BUSINESSES

- Capital intensive best suited
- Active, not passive
- Real estate
  - Residential
  - Commercial
- Manufacturing
- Distribution/warehouse
- Research
- Energy
THE DEFINITIONS

- **Opportunity Zone Property:**
  1. OZ stock in an OZ business
  2. OZ partnership interest (capital or profits) in an OZ business (includes LLCs)
  3. OZ business property
     - Tangible property used in a trade or business of the QOF
     - Acquired by purchase (capital lease) after 12/31/2017
     - Original use in the OZ begins with the QOF
     - Substantially improved property (at least match adjusted basis)
     - Substantially all the use is in an OZ
THE PLAYERS

- Investors with capital gains
- Urban and rural economic development authorities, developers, entrepreneurs, innovators, businesses and others
- Fund developers and managers
- “People *with* money, people who *need* money, and people who can *manage* money”
THE MECHANICS

CAPITAL GAINS

Individuals and businesses invest unrecognized capital gains in Opportunity Funds

Tax on capital gains deferred as late as 12/31/2026

OPPORTUNITY FUNDS

Opportunity Funds hold at least 90% of assets into Opportunity Zone Property

10% increase in basis after investment held 5 years; 15% total increase in basis if held 7 years

OPPORTUNITY ZONE PROPERTY

Opportunity Zone property is stock, partnership interest or Opportunity Zone business property

Gains on OF investments held at least 10 years are tax free
OTHER TERMS AND CONDITIONS

- Investors must invest in QOF within 180 days of transaction.
- Stock/partnership interest must be acquired post 12/31/2017
- Related party rules apply
- Failure of OF to meet 90% holding test results in penalties
- Basis in QOF investment increased by gain recognized on deferred capital gains (deferral less increase in basis)
- May be able to “twin” with New Markets Tax Credit
### How the 5, 7 and 10 year tax benefits work

<table>
<thead>
<tr>
<th>No investment in OZ</th>
<th>5 year investment in OZ Fund</th>
<th>7 year investment in OZ Fund</th>
<th>10 year investment in OZ Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ $500,000 capital gains</td>
<td>$500,000 capital gains tax deferred</td>
<td>$500,000 capital gains tax deferred</td>
<td>Basis deemed equal to fair market value of investment at time of sale or exchange; disposition is federal income tax free.</td>
</tr>
<tr>
<td>* 23.8% (20% capital gains + 3.8% NIIT)</td>
<td>* 90% (10% increase in basis)</td>
<td>* 85% (15% increase in basis)</td>
<td></td>
</tr>
<tr>
<td>$119,000 tax owed 2018</td>
<td>* 23.8%</td>
<td>* 23.8%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$107,100 tax owed year 5</td>
<td>$101,150 tax owed year 7</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Basis in OF is $450,000 ($500K*90%)</td>
<td>Basis in OF is $425,000 ($500K*85%)</td>
<td></td>
</tr>
</tbody>
</table>
HOT OFF THE PRESS – OZ REGULATIONS!

- Substantial improvements do NOT include land costs – more projects will qualify
- 180 day investment period extended in some cases – more time for investors
- More liberal treatment of “dead” cash – will help avoid penalties
- Can hold investments until 2047 – fosters long-term commitment
- LLCs OK
OTHER QUESTIONS ABOUT OZ ANSWERED BY THE PROPOSED REGULATIONS

- Can an existing entity become a QOF?
  - Yes, an otherwise eligible entity may delay QOF status until a later date.

- What is the process for investors to disclose to the IRS that they have invested in the OZ program?
  - Investors will attach Form 8949 to their tax returns for the year in which the gain would have been recognized.

- May pass-through entities invest directly in a QOF?
  - Pass-through entities may invest directly in a QOF. Capital gains invested by a partnership are not included in the partners' distributive shares of taxable income for that taxable year.

- How much time does a QOF have to meet the 90-percent asset test after receiving capital gains from investors?
  - 18 months for cash moved down to an OZ business or 31 months provided that the cash is for the acquisition, construction or substantial improvement of tangible property and the OZ business has a plan in place to deploy the capital and uses it in a manner consistent with the plan.
PENDING QUESTIONS ABOUT OZ

- Draft regulations state that further regulatory guidance is expected from Treasury in coming weeks.
- What constitutes “original use” of property?
- Do capital gains arising from transactions by the Opportunity Fund or businesses owned by the Opportunity Fund stay at the Opportunity Fund level or do they flow up to the Fund investors?
- Is a trade or business operated by the Opportunity Fund required to be a qualified Opportunity Zone Business?
WHAT YOU SHOULD DO NOW TO PREPARE

- Don’t wait to get started
- Understand the mechanics, the math, and the potential of the program and how it can work for you to attract investors/reduce capital costs
- Identify locations of designated OZs
- Identify suitable projects and potential investors
- Consider terms, fund structure, complementary incentives, financing, and other factors - build in resiliency for Q&A results
- Be staged to go!
Stay Informed
Please visit klgates.com and search Opportunity Zones (OZs) to contact one of our leading Opportunity Zones team members and learn more about our capabilities.

Next K&L Gates OZs Events:
- Washington, D.C.
  Tuesday November 6, 2018

Additional Opportunity Zones events are being planned around the K&L Gates platform. Please visit klgates.com and search Opportunity Zones (OZs) to connect at our next event.

Our tax, tax policy, investment management, real estate, renewable energy, and tax-exempt organizations/nonprofit institutions practices coordinate to advise and provide full-service guidance to educate clients about the OZ program.
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