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Opportunity Zones

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What is the Opportunity in Opportunity Zones?

Back in early 2018, few people outside of specialty economic development and real estate finance circles had heard of Opportunity Zones. Today, there is a national rush to raise money to invest in Opportunity Zones amongst high net worth individuals, economic developers and real estate investors. The Opportunity Zone incentives are being cited as potentially the largest economic development initiative in our country's history. What are Opportunity Zones, and how did they come to be the most talked-about topic in real estate in 2019?

Opportunity Zones History

Slipped inside the 2017 Tax Cuts and Jobs Act, the Opportunity Zones incentives were the brainchild of the Economic Innovation Group, a public policy-focused nonprofit. The intents of the incentives are to "free up" the estimated $2.3 trillion in capital that is currently subject to capital gains taxes and to nudge investors to invest that capital on a long-term basis in low-income communities.

The areas now designated as "Opportunity Zones" were nominated by individual state governors and designated by the Treasury in the first half of 2018. Each state could nominate up to 25% of its eligible low-income census tracts as Opportunity Zones. While each state could follow its own process in selecting the particular tracts to nominate, each tract had to be a low-income community as defined by the federal New Markets Tax Credit Program, which is a community with a poverty rate of at least 20 percent or that has a median family income that does not exceed 80 percent of the area median income.

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Opportunity Zone Benefits

The law offers three distinct benefits related to federal taxes. If an investor realizes a capital gain, they have 180 days from the date of the realization to invest the realized gains in a Qualified Opportunity Fund (QOF) and earn the following benefits:

- Temporary deferral of tax on previously earned capital gains. Deferral of capital gains until the earlier of December 31, 2026 or the sale of the investment.
- Step-up in basis of previously earned capital gains invested. A portion of the deferred gain may be subject to permanent nonrecognition:
  - ◊ 10% reduction in the gain if the investment held for 5 years if investment is made by 12/31/2021.
  - ◊ 15% reduction in the gain if the investment held for 7 years if investment is made by 12/31/2019.
- Permanent exclusion of taxable income on new gains. The subsequent gain from increases in the value of a qualified opportunity fund interest will be completely exempt from federal capital gains tax if the investor holds their interest for at least 10 years.

Independent assessments of the impact of Opportunity Zone incentives show the potential for it to improve the after-tax internal rate of return on a given investment by as much as 30 to 40%.

How Does Investing in an Opportunity Zone Work?

How does an investor actually create a Qualified Opportunity Fund (QOF) or invest in one? On its face, it's very simple to do and presents far fewer administrative or bureaucratic difficulties than other federal economic development incentive programs. A creator of a QOF simply needs to create a corporation or partnership, then self-certify as a QOF by filing Form 8996 with its federal income tax return. Similarly, the IRS has indicated that investors in a QOF will need to complete and attach Form 8949 to their tax return to obtain the benefits.

A QOF must invest 90% of its assets in Qualified Opportunity Zone Property, which includes stock, partnership interests, or business property in a Qualified Opportunity Zone business. Investments are limited to equity investments in businesses, real estate, and other business assets located in a Qualified Opportunity Zone.

QOFs can be a single asset fund, like an investment in a single piece of land, a building, or a business, or they can be a multi-asset fund, such as a real estate partnership with several holdings diversified by geography and property type.

The permissible businesses are nearly all-encompassing, and only exclude investment in a so-called "sin businesses", which are defined in the legislation as a "private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises."

However, while the top-level guidelines for QOFs are broad and straightforward, the requirements for the investment of QOF assets have become significantly more complex as the Treasury has clarified the rules. For example, some of rules include detailed requirements for "substantial improvement" of real estate property and for the amount of business activity conducted in an Opportunity Zone by a Qualified Opportunity Zone Business. As a result, those creating or investing in an Opportunity Zone fund need to retain expert assistance to navigate the requirements safely.

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Investor Considerations

Opportunity Zone Funds are considered private alternative investments and share many risks with other private alternative strategies. For example, most Opportunity Zone investments will likely be in private real estate in non-core markets or in early-stage private companies, which are inherently speculative and illiquid. The requirement to remain invested for at least ten years to achieve the maximum tax benefits means that investors are expected to have a very long time horizon when investing in QOFs. Additionally, there are meaningful operational and execution risks associated with the investment activities of QOFs, and the underlying investments in a QOF are likely more concentrated exposures than an investor would have within traditional publicly-traded equity or fixed income strategies.

There also are a number of investment considerations that are unique to Opportunity Zones. By definition, Opportunity Zones are low-income areas, which means areas of high poverty that are often located outside of major hubs of economic activity. Not only do these characteristics add to the speculative nature of the investments, these investments may also be subject to highly localized and idiosyncratic risks. Opportunity Zone fund investments also have a higher regulatory or compliance risk. They are subject to a new and unique set of regulations that may be difficult for a developer or entrepreneur to meet, especially if they are somewhat inexperienced. What's more, some of the regulations are not yet promulgated, which requires something of a leap of faith on the part of the investor and confidence that your partners and the fund structure will be able to handle any changes in the regulatory environment that may occur.

Importantly, Opportunity Zone investments are subject to a number of requirements that lead to unique timing considerations. These requirements range from the 180-day window the investor has from the realization of gains to placing the money in a QOF, to QOF operator-specific rules regarding the timing of investments in underlying property, to the investor having to be prepared to pay their original (potentially reduced) Federal tax bill in year seven of the investment, to the potential for there being a QOF-driven glut of similar real estate being sold just after the ten year investment holding requirement is met.

Advice for Investors: Know Thyself!

Before investing, make sure you thoroughly understand your risk tolerance and tolerance for liquidity. Make sure you are comfortable with the particulars of the law and their ramifications for your tax and overall liquidity position.

Seeking Deal Flow? Make Some Calls.

Many investors have an interest in investing in Opportunity Zones, but aren't quite sure how to get connected with opportunities. Law firms and accounting firms are a great source of information, as they are often working directly with developers and entrepreneurs and can put you in touch with them. Additionally, it is helpful to reach out to local economic development agencies, as they have been attempting to coordinate Opportunity Zone investing activities and are aware of development plans in their respective regions.

Get some Guidance!

Finally, as several industry practitioners have observed, the Opportunity Zone incentive can make a good deal better, but it does not turn a bad deal into a good deal. In many cases, the expected financial benefit of the incentive may not outweigh the incremental risks of a given deal or the difficulty of investing in it. The quality of the deal, its benefits and its risks are likely difficult for a nonprofessional to discern, and guidance from advisors such as attorneys and accountants is a must. It also helps to have an independent wealth manager, such as Greenleaf Trust, who can help you understand how your proposed investment fits into your overall wealth picture.