FEG INSIGHT

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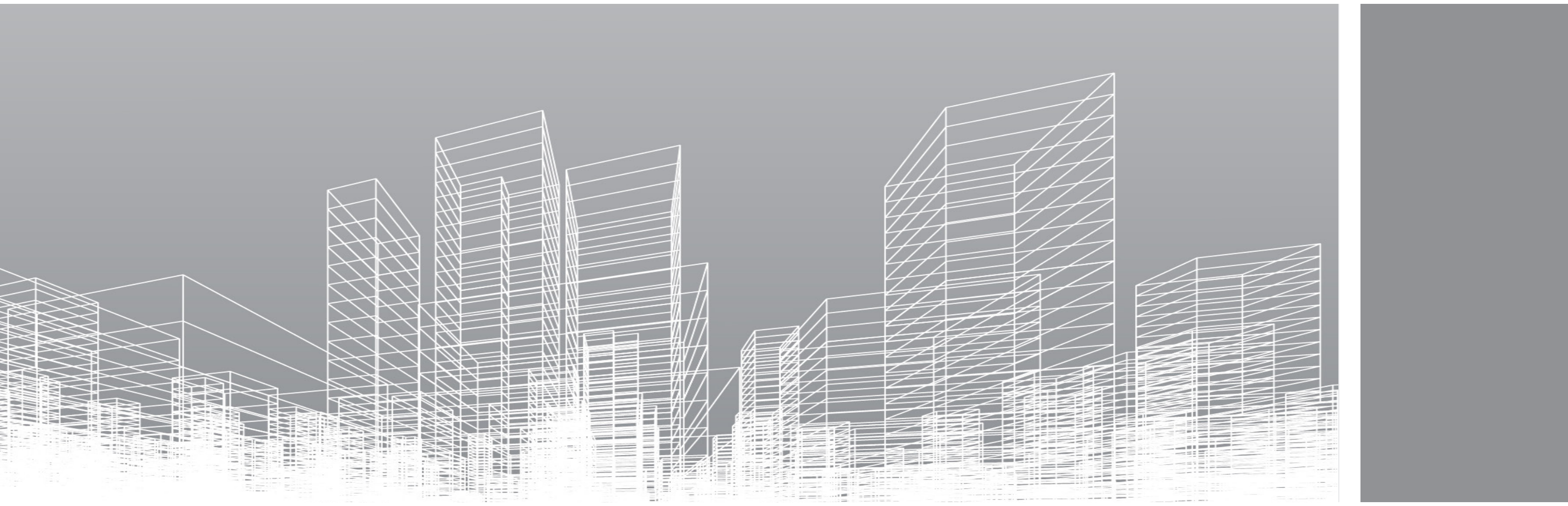

OPPORTUNITY ZONES

Cutting Through the Hype to Understand the Real Risks and Rewards of the Latest Investment Craze

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Opportunity Zones have captured the attention of the investing world; even the name itself impels a sense of urgency and excitement, the potential to make a great investment. The hype surrounding substantial tax benefits, paired with the notion of doing good in underdeveloped and economically challenged areas, has unleashed a torrent of interest from advisors, investment managers, and select institutional investors. But what is the real story? Are Opportunity Zones all they are made out to be? And how should investors be evaluating these "opportunities"?

We will examine the real potential for Opportunity Zone investing and highlight the key risks. Additionally, we will outline the current legislation, including the timeline for making Qualified Opportunity Zone investments and the most recent guidance from the Treasury Department. While FEG does not provide regulatory or tax advice, we understand this is a focus area for many clients and want to provide our perspective and opinions.

HOW DID OPPORTUNITY ZONES COME TO BE?

While the post-recession economy has delivered economic growth and rising prosperity for many, the median American community has not kept pace, and distressed communities continue to lose jobs, businesses, and people.[1] The Tax Cuts and Jobs Act of 2017 created the Qualified Opportunity Zones (QOZ) program to spur investment in these economically distressed communities. Opportunity Zones were nominated by state and local officials and ultimately certified by the U.S. Department of the Treasury for economic development. Generally, these are areas where the poverty rate is at least 20% and the median family income is less than 80% of the statewide or metro area.[2] There are over 8,700 defined Opportunity Zones across the U.S. and Puerto Rico, and they represent a mix of urban, suburban, and metropolitan areas.[3]

HOW DOES INVESTING IN OPPORTUNITY ZONES WORK?

Investors can make investments through Qualified Opportunity Zone Funds (QOZFs) that must operate within Opportunity Zones and make investments in both real estate and businesses. The funds themselves will be registered investment partnerships or corporations—including Real Estate Investment Trusts—established in the market.

There are trillions of dollars in unrealized capital gains in the U.S. To attract capital, the program provides potentially significant tax benefits to taxable investors who reinvest realized capital gains within 180 days into QOZFs. Consequently, taxable individuals are anticipated to be the majority of investors in these funds.[4]

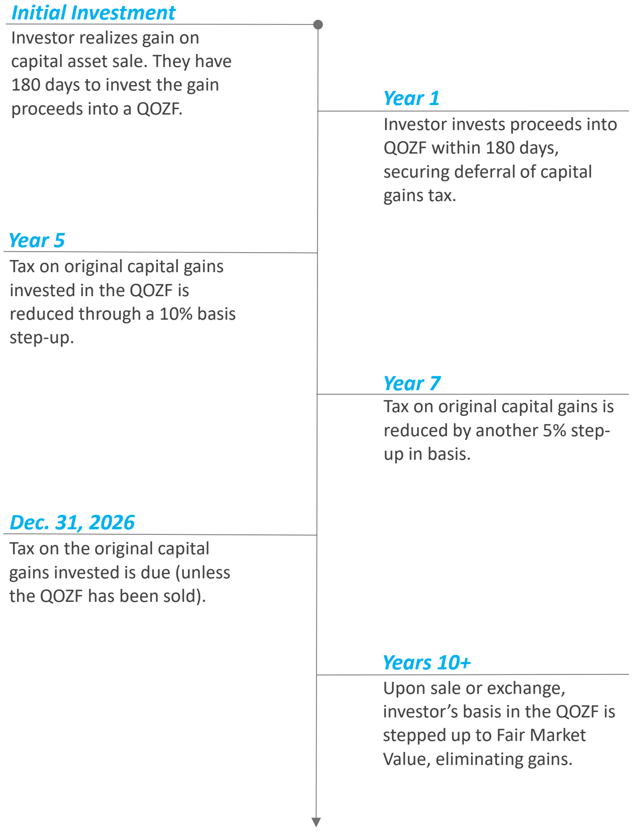
QOZF benefits accrue to investors in three ways:

1. Deferral
   Investors can realize gains on appreciated assets and may defer the payment of those capital gains taxes until as late as December 31, 2026.

2. Reduction
   Those deferred gains will receive increases in basis: 10% after five years invested in the QOZF and a further 5% after year seven. This effectively lowers the taxes due by 15%.
3. Forgiveness
   The appreciation of the QOZF investment itself is tax-free if held for ten years or more.

Most QOZFs will have terms of at least ten years to take advantage of these tax incentives and are structured as private investment companies or partnerships.

HYPOTHETICAL QOZF INVESTMENT TIMELINE



Initial Investment
Investor realizes gain on capital asset sale. They have 180 days to invest the gain proceeds into a QOZF.

Year 1
Investor invests proceeds into QOZF within 180 days, securing deferral of capital gains tax.

Year 5
Tax on original capital gains invested in the QOZF is reduced through a 10% basis step-up.

Year 7
Tax on original capital gains is reduced by another 5% step-up in basis.

Dec. 31, 2026
Tax on the original capital gains invested is due (unless the QOZF has been sold).

Years 10+
Upon sale or exchange, investor's basis in the QOZF is stepped up to Fair Market Value, eliminating gains.

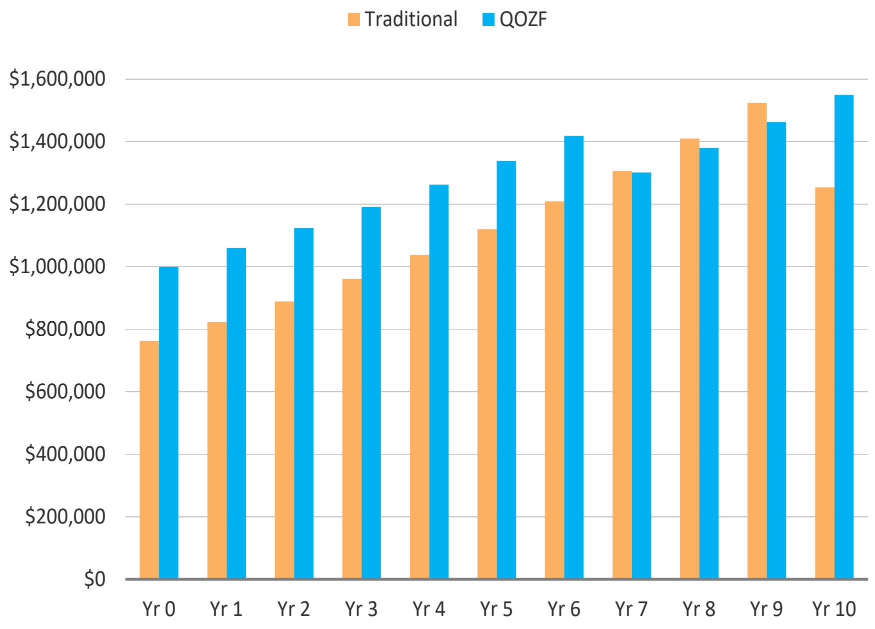
Data source: FEG.

HOW MUCH WILL THIS BENEFIT INVESTORS?

The tax savings afforded by reinvesting gains into QOZFs is the program's most popular feature with potential investors, and for good reason. Even with modest return expectations for QOZF investments, taxable investors could stand to save substantial amounts. The greatest value comes at the end of the investment horizon, when the QOZF basis is "stepped up" to the fair market value.

Investment managers will be quick to highlight these savings in graphs, like the one below, where $1M of gain can be reinvested in a QOZF to achieve a higher after-tax return than other—maybe even higher returning—investment options.

AFTER-TAX INVESTMENT VALUES OVER TIME



Data source: FEG.

However, these analyses hinge on a critical assumption beyond the rates of return for each investment and investors' tax rates; Investors may not actually need to realize the gains on their new investments—QOZF or otherwise—after ten years, or even twenty or thirty. This example's full details are available at the end of this report.

While there are many variables that would impact a real-life scenario, one fact remains clear: Investors should not realize gains within taxable portfolios solely for the purpose of investing into QOZFs. All else being equal, paying less in taxes is still worse than paying no taxes at all.

WHAT ARE THE RISKS?

Investing in real estate development—even optimal locations—is inherently risky. The lingering regulatory uncertainty and the outright novelty of the QOZ program will pose ongoing risks for early investors, especially as investment managers rush to build funds and raise capital before the rules are finalized. We've outlined some of the other risks specific to QOZFs:

LOCATION

Opportunity Zones are not traditionally desired locations for real estate. While there will be some Opportunity Zones with prime development potential, we anticipate that capital will be deployed in earnest to these areas first, thereby limiting both the tenure and attractiveness of these opportunities. Opportunity Zones are no great secret, and informed sellers will look to extract a "QOZ premium" from tax-motivated buyers.

PROPERTY DEVELOPMENT

Investors will need QOZFs to put all their deferred gain capital to work within the first 31 months, while making substantial investments into individual assets within the funds. Managers without substantial development experience or an adequate pipeline of properties and value-add projects could be unable to meet QOZF investor requirements.

PROPERTY MANAGEMENT

QOZFs may generally be owning properties in excess of ten years, far longer than traditional new construction or value-add developments. Hence, QOZFs must provide property management capabilities for their investments, either internally or through established relationships with local providers.

CAPITAL FLOWS AND IMPLICATIONS ON ACQUISITION AND EXIT PRICING

QOZFs will look to raise and deploy capital over the next few years, potentially increasing competition for deals and inflating prices for what would otherwise be “value” investments. Development site acquisitions within QOZs have surged since the law’s unveiling and continue to accelerate.[5] However, ten years from now, investors could face the same scenario in the reverse, as QOZFs all try to sell assets in the same timeframe and depress exit prices for investors.

WILL OPPORTUNITY ZONES BENEFIT CHALLENGED COMMUNITIES?

Making sense of the potential social impact and benefits to the QOZ communities is difficult. Many QOZFs will focus on urban areas that could provide the greatest upside for investors, leaving distressed rural areas that much further behind. Research also suggests that “place-based” incentive programs like Opportunity Zones mostly benefit landowners and higher-skilled workers with the ability to travel for employment, leading to displacement of local populations these programs were intended to benefit.[6]

Investors wanting to “do good in the neighborhood” may create more impact by contributing directly to local communities. This is particularly true for tax-exempt institutions and investors unable to enjoy the tax benefits discussed above. Taxable investors can also consider gifting appreciated securities to charity or a donor-advised fund if they want to make an impact and avoid taxes.

SO, ARE PEOPLE REALLY INVESTING? OR IS THIS MUCH ADO ABOUT NOTHING?

Investment into QOZFs has been limited so far, especially considering the potential windfall this could provide to high net worth investors with staggering amounts of unrealized gains from the market’s decade-long bull run. With little initial direction on how the actual fund mechanics work, many investment managers and potential investors were unable to gain comfort with a strategy or structure that checked all the boxes, prompting rounds of Treasury and IRS publications to answer questions.

In April, the Treasury issued their latest regulations, which helped bring clarity to several open items regarding how funds should be structured and make investments.

QOZFs now have greater latitude to invest in operating businesses and increased clarity around their ability to “recycle” interim gains on invested capital into other projects without triggering recognition of gains to their investors.

While these releases have not satisfied every open question and QOZFs remain a “first time” program, we feel managers and investors are in a far better place to evaluate investment opportunities than in early 2019. In addition, we anticipate fundraising will increase meaningfully as investors digest the new regulations and we approach the June 28th deadline for investors to reinvest gains from 2018 Schedule K-1s.

HOW SHOULD INVESTORS EVALUATE QOZFS?

Investors should proceed cautiously and maintain their focus on the investment merits of each opportunity. Compelling tax benefits will encourage a lot of capital to potentially chase too few deals for returns that will not compensate investors for the risk. Any proposed QOZF investment must provide an after-tax, risk-adjusted return that outperforms the opportunity cost of other alternatives.

Having cleared that hurdle, investors should also gain confidence that the manager has the necessary expertise to invest and manage a portfolio in compliance with QOZ rules. QOZFs will vary in fund structure and strategy, and investors should consult with their advisors to confirm they are adhering to the regulations.

In our view, manager selection will be crucial for Opportunity Zone investing success. As such, investors should focus on managers with a track record of success in QOZ property development and management. The investment strategy and deal process should be consistent and repeatable, and managers should have a full pipeline of attractive QOZ deals in which to deploy capital. Given the uniqueness of the QOZ investment universe and the program’s implementation constraints, investors should be skeptical of QOZFs looking to raise and deploy large amounts of capital.

For those investors who are looking to make private real estate investments and defer incurred capital gains from their broader portfolio, the right Opportunity Zone fund may offer an attractive opportunity. Investors should consider the elevated risk of making late-cycle real estate investments in secondary or tertiary market locales and ultimately size their investments according to their total portfolio’s risk and illiquidity tolerances.

Footnotes

[1] Economic Innovation Group, “From Great Recession to Great Reshuffling: Charting a Decade of Change in American Communities,” last modified October 2018, https://eig.org/wp-content/uploads/2018/10/2018-DCI.pdf.

[2] Local Initiatives Support Corporation (LISC), “Opportunity Zone Fact Sheet,” accessed May 24, 2019, https://ofn.org/sites/default/files/resources/PDFs/Opportunity_Zone_fact_sheet.pdf.

[3] Economic Innovation Group, “Opportunity Zones: The Map Comes into Focus,” last modified June 15, 2018, https://eig.org/news/opportunity-zones-map-comes-focus.

[4] United States Joint Economic Committee, “The Promise of Opportunity Zones,” last modified May 17, 2018, https://www.jec.senate.gov/public/_cache/files/73b66af4-9963-435e-a599-cee753616ba3/the-promise-of-opportunity-zones.pdf.

[5] RCA, “US Opportunity Zones: A Baseline,” last modified 2017, https://www5.rcanalytics.com/opportunityzones.

[6] David Neumark and Helen Simpson, “Section 2.6, Equity Motivations for Place-Based Policies,” NBER Working Paper Series: Place-Based Policies, April 2014, https://www.nber.org/papers/w20049.pdf.

APPENDIX

The graph from page three examines the after-tax value generated with $1,000,000 gain reinvested in either a non-tax advantaged investment earning an 8% net return, or a QOZF earning a 6% net return with all of the benefits (the initial tax deferral, a 15% basis increase on their initial gains, and forgiveness of all future QOZF appreciation).

Investor outcomes will vary given their individual tax rates, the investment returns—both in size and series—and the initial unrealized gain amounts as a percentage of asset values.

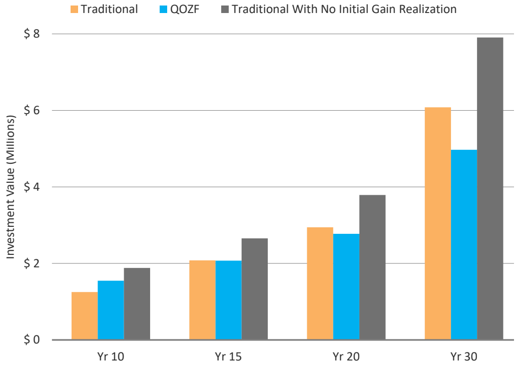
AFTER-TAX INVESTMENT VALUES OVER TIME

		Traditional Investment		QOZF Investment
Original Investment Value	$	2,000,000	$	2,000,000
Less: Original Investment Tax Basis		(1,000,000)		(1,000,000)
Capital Gain Available for Reinvestment		1,000,000		1,000,00
Less: Initial Capital Gain Taxes*		(238,000)		0
		762,000		1,000,000
Investment Net Rate of Return		8%		6%
Investment Value in Year 7	$	1,305,934	$	1,503,630
Less: Deferred Capital Gain Taxes on Original Investment**		0		(202,300)
		1,305,934		1,301,330
Investment Value in Year 10	$	1,645,101	$	1,549,905
Less: Capital Gain Taxes on Traditional/QOZF Investment*		(391,534)		0
Total Year 10 After-Tax Value***	$	1,253,567	$	1,549,905

** Assumes a long-term capital gains tax rate of 23.8%. ** Assumes QOZ investment is held for 7 years and the adjusted tax basis in the QOZ investment is increased by 15% of the amount original capital gain that was invested. *** Assumes that investors would dispose of assets at the end of the ten year hold period. Investors may not want or need to do this, which would diminish the purported tax benefits of QOZF investing.*
Data source: FEG.

Most crucially, these examples assume investors will realize gains in Year 10 on their investments, which may not be necessary. Below is a chart similar to page three, demonstrating the same example but with gain realizations at different points in time. In this example, the after-tax benefit of the QOZF is entirely offset by the higher returning investment at year 15. Investors who can avoid realizing gains at the outset (presuming a comparable return expectation), would enjoy the greatest results. In the end, we believe long-term investors should continue to first focus on making the best investments possible.

AFTER-TAX INVESTMENT VALUE AT DIFFERENT REALIZATION TIMING



Data source: FEG.

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