Real estate markets

Opportunity knocks in tax-advantaged Opportunity Zones in the US

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Jonathan Woloshin, CFA, Head Americas Equities, jonathan.woloshin@ubs.com; **Thomas McLoughlin**, Head Americas Fixed Income, thomas.mcloughlin@ubs.com; **Andrew Lee**, Head of Sustainable and Impact Investing, andrew.lee@ubs.com

- The creation of Opportunity Zones provides the private sector with a generous tax incentive to invest capital in economically distressed communities.
- Investments in Qualified Opportunity Funds will allow investors to defer some or all of their capital gains from federal taxation.
- Opportunity Fund investments potentially provide another alternative for investors seeking to allocate a portion of their portfolio to place-specific impact investments.

One of the least publicized, and yet significant, provisions of the Tax Cuts and Jobs Act (the Act) was the creation of an incentive program for community reinvestment and development known as Opportunity Zones (OZ). The OZ program is designed to promote private sector investment in economically distressed communities throughout the nation. Investors in the OZ program would be eligible for the deferral of taxation on realized capital gains, and depending upon the duration of the holding period, a reduction in their total tax liability.

The OZ program allows investors to defer an unlimited amount of their realized capital gains from the sale of assets to an unrelated party by investing those gains in a vehicle designated as a Qualified Opportunity Fund (QOF). The program is currently designated to run through 31 December 2026.

Under the OZ program, only the capital gain need be reinvested, rather than the sum of the original investment. This is a key difference between an OZ investment and a 1031 exchange.[1] Some may view the OZ program as similar to the New Markets Tax Credit (NMTC) Program from 2016. Although there are some similarities, the key difference is that the OZ program does not place any annual limitations on the total dollar amount of investment. As such, the OZ program has the potential to raise significantly more capital than the NMTC Program.

In effect, the law now allows investors to apply their capital gains from the disposition of other property, which otherwise might be subject to taxation, to finance investments in distressed communities in an effort to stimulate economic activity.

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[1] Price Waterhouse Coopers, *Tax Insights*, 21 March 2018.

There is no residency or work location requirement associated with the QOF investment. Taxpayers are simply required to self-certify to the IRS that their capital gain was reinvested within a specific time frame (discussed below). The taxpayer is required to complete a form (expected to be available in June 2018) and attach that form to their federal income tax return.

Multiple potential tax benefits for investors
Investors in a QOF may defer an unlimited amount of capital gain provided the gains are reinvested in a QOF within 180 days of the asset sale (similar to a 1031 exchange). Investors have the option of investing all or a portion of their capital gains from each specific asset sale. The deferred tax on the original gain is due on the earlier the QOF investment is sold/exchanged or 31 December 2026. In addition, the investment's tax basis is the lesser of the original capital gain invested in the QOF or the fair market value of the QOF investment at the time it is sold/exchanged. As such, should the QOF's value decline, the investor is able to reduce their basis in the original capital gain.

The OZ program also provides incentives for investors to target longer-term projects. An investor holding an OZ investment for at least five years will be entitled to a 10% increase in the tax basis of their investment. If the holding period is extended to seven years, the tax basis increase expands to 15%. Should the taxpayer hold the investment for at least 10 years, their tax basis is limited to the value of their original investment. This means that should the value of the QOF exceed the original deferred gain, the investor's basis cost may be increased to the fair market value on the date of liquidation; the tax would be limited to the amount owed on their originally deferred gain.

A deferral of some taxation may be available for investments held by the taxpayer for shorter periods of time. Some details about OZ's are still being ironed out as we await regulations from the Department of Treasury, expected to be released this summer, and those regulations are worth keeping an eye on. Investors are urged to consult their tax and legal advisors regarding the specific details of the tax implications of the OZ program.

How are Qualified Opportunity Zones Designated?
The chief executive office of each state, which the law defines to include the District of Columbia and US territories, must define the geographic boundaries of the Qualified Opportunity Zone (QOZ). The designated zones are linked to US population census tracts and must meet certain thresholds for resident income and poverty levels. By law, governors can designate up to 25% of the low-income census tracts within their jurisdiction for inclusion in the program. Under the Act, a low income community is defined as having a poverty rate of at least 20% or has a median income not greater than the highest 80% of either the specific metropolitan region or the statewide median income. To the extent that a particular state or territory has fewer than 100 such census tracts, it may still designate 25 tracts as QOZs. In addition, if a specific census tract is not considered a low income community but is contiguous to a low income community, it may be designated as a QOZ as long as the median family income of the specific tract is not in excess of 125% of the median family income of the contiguous tract.

States and territories were required to nominate their QOZs by 21 March, 2018 or to request a 30-day extension. Subsequent extensions were granted but the final approved list is expected to be published before the end of May 2018. Based on submissions thus far, the Department of the Treasury has designated Opportunity Zones in 20 states and 4 territories. Bipartisan Budget Act of 2018 offered additional assistance to Puerto Rico by removing the restriction on the maximum number of QOZs that may be designated on the island.

What constitutes a Qualified Opportunity Fund?
Funds must be structured as either corporations or partnerships and be invested after 31 December 2017. Only cash contributions are acceptable. The contribution of physical property, equivalent in value to the capital gain, would not qualify. At least 90% of the assets held within those vehicles must be dedicated towards property ownership within a designated OZ. A QOF may invest in QOZ stock, partnership interests or business property. Further, the Department of the Treasury must certify that each QOF meets the final requirements.

- If the QOF invests in stock or partnership interests, the issuing entity must be a designated a QOZ business and the interest must be acquired after 31 December 2017. In addition, the business must remain a QOZ entity effectively for the duration of the QOF's targeted holding period.
- If the QOF invests in business property, several conditions exist: 1) the property must have been acquired after 31 December 2017 from an unrelated entity; 2) the property must be tangible property that has direct trade of business uses; 3) the target property must be significantly improved by the QOF and 4) the target property must remain in the QOZ for the duration of the investment.

The IRS is working on more detailed guidance regarding requirements for certification of QOFs and for eligible investments in the QOZs, which is anticipated to be issued in summer 2018.

Opportunities for location-specific impact
The new tax provisions related to Opportunity Zones are unusual in that they are designed to incentivize investors to roll over their existing gains into neighborhoods which may not otherwise capture their attention. The law is all about leveraging 'patient capital' to stimulate the redevelopment and revitalization of urban brownfields and rural areas lagging behind the national rate of economic expansion.

While more detailed guidance from the Department of the Treasury remains outstanding, investors and fund managers are now actively evaluating potential investment vehicle structures and underlying investments. There are multiple potential investment types that could qualify and directly benefit both needy communities and investors seeking to make new impact investments in a tax efficient manner. Eligible underlying investments are expected to include affordable housing, commercial real estate development, infrastructure, energy (renewable or traditional), startup businesses and expansion of existing business, among others.

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In order to ensure that QOFs achieve the intended impact on designated areas and that capital is invested into projects and businesses where it is most needed by the local community, more specific guidelines from the Department of the Treasury will be important to ensure accountability for each QOF to establish specific impact objectives ex-ante, measure, and report regularly on progress.

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Addressing the critics

Critics of the new program warn that the tax breaks will accelerate the pace of gentrification in urban areas, displacing low income residents and unintentionally harming the very individuals the law was designed to help. Neighborhoods adjoining prestigious universities may be eligible for inclusion as a candidate for Opportunity Zone designation because of the abundance of students on limited incomes. Fortunately, a preliminary analysis by the Brookings Institution concludes most of the census tracts designated by the nation's governors thus far are deeply impoverished and will benefit from incremental investment.[2]

A smaller percentage of the Opportunity Zones, under 20%, were determined to already be in the process of gentrification.

The use of antiquated data is another potential shortcoming. Census tract information is often derived from data generated during the last decennial census. Subsequent economic development may not be captured in the data sets used by state agencies to designate new Opportunity Zones. So there is a risk that deteriorating neighborhoods may be overlooked while resurgent ones are included. Fortunately, the law allows state officials, who presumably possess more knowledge about local real estate trends, to make that decision.

We expect the Opportunity Zone program to capture considerable interest among investors whose existing investments have appreciated along with the nation's economic recovery. The program allows private sector investors to exercise fiscal discipline in choosing the location of their investment and thereby increases the probability of favorable outcomes. It also implicitly promotes a longer-term investment perspective by offering the biggest tax break to investors willing to commit capital for at least a decade.

The Trump Administration has encountered challenges in moving traditional infrastructure legislation through the Congress due to the absence of a dedicated revenue source to pay for the public works. We believe the Tax Cuts and Jobs Act, through the Opportunity Zone program, will leverage private sector capital very efficiently. The rehabilitation of distressed neighborhoods and communities may well represent the current Administration's most significant contribution to infrastructure investment to date.

[2] Adam Looney, The early results of states' Opportunity Zones are promising, but there's still room for improvement, Brookings, 18 April 2018.

Appendix