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Window for Opportunity Zones Is Narrowing

By Scott Hendon and Marla Miller

As the end of 2019 approaches, so does the deadline to receive specific tax benefits for Opportunity Zone investments.

Congress created the Opportunity Zone program as part of 2017 tax reform, also known as the Tax Cuts and Jobs Act of 2017 (P.L. 115-97). Opportunity zones are census tracts in low-income communities across the country that have been identified for preferential tax treatment: Investment in these communities, through what is called a Qualified Opportunity Fund (QOF), could result in permanent exemption of up to 100% of capital gains taxes. For private equity investors and asset managers looking for certain capital gains deferrals, the deadline to invest and receive all of the tax incentives is December 31, 2019.

The Opportunity Zone program is structured to entice investors to shift capital from existing assets to these distressed, low-income areas: They can defer taxes by reinvesting capital gains from an asset sale into a QOF. The capital gains will be tax-free until the QOF is divested or the end of 2026, whichever comes first.

In addition to the deferral, if an investment is held for five years, investors receive a 10% exclusion of the deferred gain. If it is held for seven years, that exclusion steps up to 15%. This means that December 31 is the deadline to be able to qualify for an exclusion that would allow investors to pay tax on only 85% of the original capital gain.

However, if an investment is held for 10 years, then the basis in the investment will equal its fair market value—that is, the gain on the investor's appreciation on the original investment is permanently excluded. In this case, if investors are only interested in the 10-year, 100% basis step-up election, they can make a QOF investment as late as June 28, 2027 (see below for the 180-day investment window requirement).

QOF sponsors that receive carried interests in the fund are not eligible for Opportunity Zone tax benefits.

Who's Best Positioned for the Opportunity

The Opportunity Zone program falls into familiar areas for private equity and venture capital firms, family offices and asset managers. For tax purposes, a QOF is treated as a partnership or corporation, classifications private equity is fluent in. By turn, venture capital firms have experience with all types of businesses, start-ups, technology, healthcare, and so on—the Opportunity Zone program originally was real estate-focused, but tax benefits extend to investments in the businesses that operate within opportunity zones, too.

Many family offices gravitate toward investing for impact, making opportunity zones natural complements. And while a 10-year holding period could feel risky to some investors, family offices tend to be more comfortable with longer-term investments, as well as real estate investments in general (10%–12% of family office investments are in real estate).

Much has been made of the hundreds of billions—by some estimates, trillions—of dry powder the private equity industry has to deploy. It is one of the reasons that deal multiples remain high despite heavy competition. One strategy being discussed in the industry is a kind of paradigm shift to longer hold periods, allowing funds to grow their investments rather than turn them over for a profit that might yield inferior returns. As such, the 10-year holding period required for opportunity zone investments to receive a 100% step-up in basis may sit more comfortably with some shops exploring more creative ways to deploy capital.

So far, $43 billion of investment is expected to be raised among 163 qualified opportunity funds, according to a July analysis by the National Council of State Housing Agencies (NCSHA). That's up from $29 billion (48%) in June and is nearly half of the $100 billion that Treasury Secretary Steven Mnuchin last year predicted the program would raise.

Opportunity Zone Parameters

The Opportunity Zone program was created through the 2017 tax reform and while the concept sounded intriguing, the information needed for confident investments to be made was essentially nonexistent. Since 2017, the Treasury and the IRS have issued two rounds of opportunity zone proposed regulations, first in October 2018 and then in April 2019. The October 2018 guidance focused on provisions relating to real estate. The April 2019 guidance focused on the statutory requirements for a qualified opportunity zone business (QOZB).

For an investment to qualify for opportunity zone tax benefits, a QOZB must meet the following requirements:

1. A taxpayer must invest capital gains in a QOF within 180 days of a sale; if the capital gain is from a pass-through entity (e.g., partnership), then the taxpayer has 180 days from the year-end of the pass-through entity to invest in a QOF.
2. Substantially all QOF property must be located in the opportunity zone (from 70% indirect to 90% direct ownership).
3. At least 50% of the gross receipts must be from the active conduct of the business in the opportunity zone—the April 2019 guidance provided three safe harbors to meet this requirement.
4. A substantial portion (at least 40%) of the intangible property must be used in the active conduct of a trade or business in the opportunity zone.
5. The business does not include certain types of **enterprises** such as golf courses, country clubs and liquor stores

Though lack of guidance may have stalled some investment, for those who already had capital gains when the Opportunity Zone program was announced, or had them soon after, the 180-day window precipitated a decision: For some, the lack of clarity or guidance did not necessarily outweigh the potential benefits of a deferment. Then there were investors who had been considering projects that ended up falling within opportunity zone boundaries, which only made these projects more attractive.

Real estate, a long-term asset class by nature, has shown strong performance amid the longest bull market, and QOFs are marketed as a safe place for longer-term investments. But to date, funds largely comprise single investments or focus on certain classifications of real estate, such as student housing or beachfront property, which may also deter some investors looking for a more diversified portfolio. Furthermore, given the retail industry's recent challenges and their impact on real estate, some developers are having trouble finding tenants for their properties.

Considerations: Opportunity Zones' Unstable Ground

The results of the 2020 presidential elections could gum up the gears of the program before it gets going. Should Democrats take the executive and legislative branches of government, it's possible that certain aspects of tax reform could be rolled back, or that the capital gains tax rates change. For example, it is possible that the capital gains rates change so that in 2026, when tax on 85% of the realized gains invested in the QOF is due, the change would result in a net tax **greater** than if the client had paid the capital gains tax at the 2019 rate.

Also, a natural by product of investment into underinvested communities is real estate prices: Could they rise enough that they diminish the benefits from investing in Opportunity Zones?

And lastly, as has been widely speculated, the economy could be flirting with recession. Should there be one, developers having trouble finding tenants now will likely not have an easier time finding tenants then.

To provide more clarity on the program, Treasury and the IRS are expected to release final regulations in the fall of 2019 and will likely release additional opportunity zone guidance on reporting requirements, calculation of penalties and other matters. For those still on the sidelines, this guidance may provide investors with the clarity they need to decide whether to participate in a QOF. However, the end-of-year deadline is fast approaching for taxpayers to maximize their tax benefits in the Opportunity Zone program.