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DEMYSTIFYING OPPORTUNITY ZONES

Exploring private investments that stimulate economic growth and improve low-income areas.

In his role at The Summa Group, Robert Dalie oversees wealth-planning capabilities, one of the core pillars the group is founded on. Dalie's specific expertise and experience lend themselves to entrepreneurs, senior executives, fiduciaries, and founders who have recently experienced or are about to experience a life-changing financial event. This proficiency has allowed him to play an integral role within the core advisory teams that deal with pre- and post-liquidity events. He has developed a reputation for specialized work with sudden wealth from inheritance, divorce, stock sales, estate planning, and closely held business sales. To effectively offer this depth of service and experience, his practice is limited to a select group of individuals and families for maximum impact. Forbes, Barron's, and Research Magazine have recognized The Summa Group in their annual advisor rankings as a top wealth management team. Dalie has been a central part of The Summa Group since its founding in 2003.

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It's been quite some time since we have seen as much excitement and confusion over a single investment topic as we recently have regarding opportunity zones. The Opportunity Zones Program has created a tremendous amount of buzz throughout the real estate, legal, accounting, and wealth management communities over the last year. I seek to demystify what these zones are and explain the basics of how they are designed to work.

Under the Tax Cut and Jobs Act of 2017, opportunity zones were created as a development tool to improve low-income areas by generating economic growth and jobs through private investments. Investments in these economically distressed regions create tax benefits for investors. The eligibility criteria included locations within certain ZIP codes that have poverty rates of at least 20 percent and median family incomes less than 80 percent of median statewide family income levels. The community development program's incentives target an estimated $6.1T in unrealized capital gains to invest in certain economically challenged areas to stimulate economic development. The program allows investors to defer capital gain taxes, provided those gains are invested in qualified opportunity zone funds. Timing is paramount. Once capital gains are realized, those proceeds must be invested within 180 days into a qualifying opportunity zone investment or fund. Tax benefits are dependent on the length of the investment holding period and the date of investment. It's interesting to note that this was one of a few bipartisan tax legislation pieces added into the 2017 tax bill.

The Opportunity Zones Program offers three potential tax benefits for investing in low-income communities through a qualified opportunity zone fund.

A temporary deferral of capital gains reinvested in an opportunity zone fund. The deferred gain must be recognized on the earlier of the date on which the opportunity zone investment is disposed of or December 31, 2026.

A step-up in basis for capital gains reinvested in an opportunity zone fund. The basis is increased by 10 percent if the investment in the opportunity fund is held by the taxpayer for at least five years and by an additional 5 percent if held for at least seven years, thereby excluding up

QUOTE:

UNDER THE TAX CUT AND JOBS ACT OF 2017, OPPORTUNITY ZONES WERE CREATED AS A DEVELOPMENT TOOL TO IMPROVE LOW-INCOME AREAS BY GENERATING ECONOMIC GROWTH AND JOBS THROUGH PRIVATE INVESTMENTS.

to 15 percent of the original gain from taxation. For the maximum 15 percent step-up in basis, the investment must be made by the end of 2019.

A permanent exclusion from taxable income of capital gains from the sale or exchange of an investment in an opportunity fund if the investment is held for at least 10 years. This exclusion only applies to gains accrued after an investment in an opportunity fund.

When these zones were first being created, each state governor was allowed to choose 25 percent of their eligible census tracts based on 2010 census data. As a result, opportunity zones are now located in 50 states, Puerto Rico, and Washington, D.C., of which 8,700 neighborhoods currently have been approved. Approximately 10 percent of US land rests within opportunity zones, with a concentration in urban areas. Clearly, the investment set is quite large with a multitude of assets from which to choose.

Opportunity zone investments have several distinguishing characteristics. First, they must derive at least 50 percent of their gross income from an active trade or business located in an opportunity zone. Second, they must have at least 70 percent of their tangible assets in a qualifying opportunity zone property. Third, an opportunity zone property must be acquired in a taxable purchase after December 31, 2017.

Real estate within opportunity zones must also adhere to an improvement test. It must be improved by 100 percent, but the criteria will now exclude land, which makes it easier to pass the test. If a property was purchased for $10M and the land value is $6M, then the fund only has to improve the property by $4M. They must also follow an asset test. An opportunity zone fund must hold at least 90 percent of assets in opportunity zones. The asset test can be satisfied if cash is designated as working capital for specific investments, as long as investments are completed within 30 months.

The purpose of the program is to incentivize investors with large capital gains to make investments in certain economically challenged areas to stimulate economic development. The program is open to any qualified investor, whether retail or institutional. All US taxpayers can make deferrals by putting money in opportunity zone funds, including individuals, partnerships, C corporations, S corporations, trusts, REITS, estates, and other pass-through entities. For example, investors with a low-cost-basis stock that they would like to monetize represent very viable candidates. All capital gains are eligible for deferral, including short-term and long-term capital gains. Additionally, investors who seek to align their portfolios with socially responsible principles may find that the economic impact on the community (potential job growth, better housing, and support for small businesses) would meet their objectives.

Opportunity zone investments have proliferated since the program was launched. Some examples include purchasing undeveloped land or an office complex. The key is that it meets the above-mentioned criteria, but with every worthwhile opportunity comes a level of complacency with regard to the quality of the underlying investments. We encourage anyone considering an investment in opportunity zones to understand not only the tax benefits, but the quality of the underlying real estate investments. Investors can reinvest capital gains in several ways to take advantage of the opportunity zone program, the two most common being via a fund or direct investment.

Opportunity zone fund: A portfolio of 2 to 20 qualified opportunity zone investments. This vehicle could provide diversification across geographies and investment types.

Private real estate investment: Investments in a singular qualified opportunity zone investment such as a multifamily or mixed-use real estate development project or undeveloped land.

The window of opportunity is relatively short, and many firms are still conducting due diligence on opportunity zone funds and singular investment properties before the end of 2019. A fund structure may allow diversification across geographic locations and investment types while we are seeing family offices more receptive to direct investment. Many of these products are likely to be available exclusively to qualified purchasers and accredited investors, depending on the nature of the transactions. We believe it's a great time to explore these investments, but we advise anyone to first talk with their CPA and/or lawyer about the myriad of complexities and specific state rules.