OPPORTUNITY ZONES

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What's all the Fuss After COVID-19?

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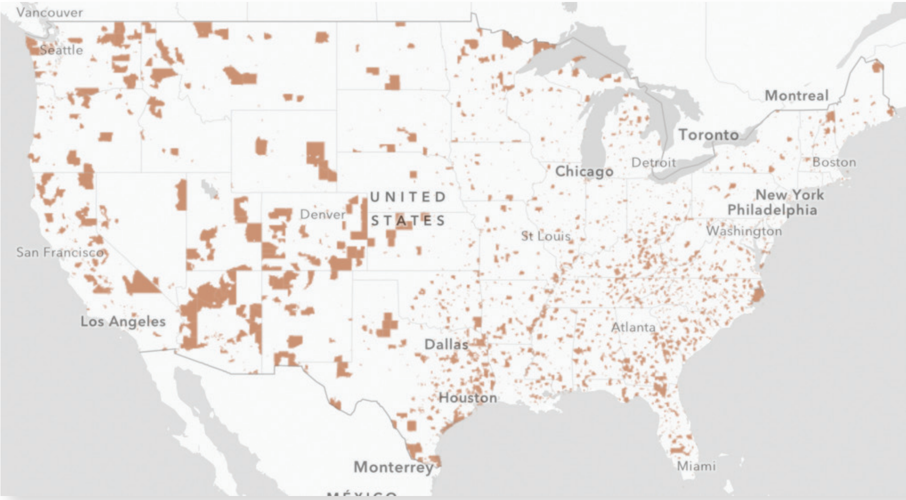
Opportunity Zones (OZs) have been in the spotlight quite frequently during 2019 and early 2020, with varied opinions and understandings of their applicability and potential. There are over 8,762 OZs in the U.S. in all 50 states and U.S. territories. Before the COVID-19 standstill, clients were inquiring about these opportunities. It's important to understand the pros and cons, as well as some soon-to-be major pitfalls of this program as states begin opening up for business.

WHAT IS AN OPPORTUNITY ZONE?

OZs were created under the 2017 Federal Tax Cuts and Jobs Act. The goal of the Act was to stimulate economic development and job creation in low-income communities by incentivizing long-term capital investment. An OZ program is a federal way to convert housing, industrial, mixed-use, office, and retail projects into strong wage jobs. These projects can be owner-occupied or investment leased. This flexibility allows for diverse opportunities.

According to the IRS, OZs provide tax benefits to investors since investors can defer tax on any prior gains invested in a Qualified Opportunity Fund (QOF) until the earlier of the date on which the investment in a QOF is sold or exchanged, or December 31, 2026. With the pandemic, it is not known if this deadline will be extended as were the 1031 tax deferred exchanges. If the QOF investment is held for longer than five years, there is a 10% exclusion of the deferred gain. If held for more than seven years, the 10% becomes 15%. If the investor holds the investment in the Opportunity Fund for at least 10 years, the investor is eligible for an increase in basis of the QOF investment equal to its fair market value on the date that the QOF investment is sold or exchanged (a 100% exclusion.)



Map of designated United States Opportunity Zones
https://eig.org/news/opportunity-zones-map-comes-focus

This is the program's most impactful advantage to an investor—having a tax-free sale. It is similar to a 1031 tax deferred exchange, but only in designated areas and if held long enough (10 years), can be completely tax free.

In April 2019, more federal regulations were published to demonstrate how leased property could benefit from the OZ program. The proposed regulations also clarified that "there is no substantial improvement requirement with respect to unimproved land nor with respect to a building that has been vacant for an uninterrupted period of at least five years." (*Site Selection Magazine*, July 2019, p. 183.) With COVID-19, will the Feds need to curb this tax benefit in order to generate tax revenues lost from the first half of 2020 and the $2 trillion stimulus package?

HOW DO YOU IDENTIFY AN OPPORTUNITY ZONE?

OZs are areas that have been nominated by the state it presides, and that nomination has been certified by the Secretary of the U.S. Treasury via delegation of authority to the IRS.

The list of designated Qualified Opportunity Zones (QOZ) can be found in IRS Notices 2018-48 (PDF)[1] and 2019-42 (PDF)[2]. Further, a visual map of the census tracts designated as QOZs may also be found at Opportunity Zones Resources[3].

CRE professionals can also find an OZ designated area by researching OZ maps on Google or by researching a county or municipal website for the OZ delineated area.

HOW DO YOU DEVELOP A PROFIT WITH AN OPPORTUNITY ZONE AND WHAT ARE THE PITFALLS?

Benefits

First, investors can temporarily defer or eliminate taxes on their previously earned capital gains. Their existing assets can be placed into an Opportunity Fund which will not be taxed until the end of 2028 or until the asset is disposed of. Second, investors benefit through a Basis Step-up in Capital Gains that are reinvested into an Opportunity Fund. The program may also encourage development in distressed areas and create economic enhancement, job creation, real estate and sales tax, and further attraction for more development.

Pitfalls

As with any new program, there are potential downfalls to the OZs. First, while the OZs are meant to help the residents, there is no requirement or guarantee that it does so. This means that OZs could solely benefit investors. Congress could also change their course of action due to COVID-19.

Second, investors do not have to include the community in their planning and are not required to follow any community rules. Therefore, investors are likely to have no knowledge of how their investments are affecting the community members. As of this writing, during the last three months, community input has been at a standstill with social distancing and no held municipal meetings.

Additionally, the tax benefits are estimated to cost $1.6 billion in lost federal revenue over a 10-year period.

Further, scholars have found that both in the U.S. and the U.K., OZs were not successful in the intended function. Of the 75 enterprise zones studied in 13 states, researchers found that the tax incentives had "little or no positive impact" on the economic growth in the zones[4].

Finally, the program phases out Dec. 31. 2026 with a full OZ designation expiration of Dec. 31, 2028. That means that by this time in 2020, an investor does not currently have 10 years to benefit for a full tax exclusion. This is by far the deepest pitfall until Congress extends this program.

OTHER ISSUES

In some cases, OZs are not in distressed areas but rather in strong markets or undeveloped markets. For instance, the entire island of Puerto Rico is considered an OZ.

Another large hurdle of the program is the Safe Harbors related 50% test. As of October 2018, at least 50% of the gross income of an OZ business had to be from the active conduct of a trade or business within the OZ. It's similar to a Foreign Trade Zone criteria.

As of early December 2019, another issue facing the program was that Senator Ron Wyden (D-OR) introduced legislation that would make alterations to the OZ program. The bill would modify some of the requirements for incentives. The legislation would mandate sun-setting of the designation of "contiguous zones" that are not low-income, but instead adjacent to low-income communities. Some wealthy landowners with large acreage of land adjacent to an OZ are trying to claim that being adjacent and contiguous qualifies their properties for OZ and capital gain exemption. This new bill would prevent multi-family developments from utilizing the incentive, unless at least 50% of the units are affordable to residents earning 50% or less of an area's median income.

For now in 2020, investors want to be cautious as the number of years (10) is not possible before OZ sunsets and expires in 2028. By 2021, the five-year holding period is no longer applicable and the gain must be recognized by Dec. 31, 2026. The investing point may be too late for a full tax exemption unless Congress extends this program. It is unclear at this point what Congress will do, especially in lieu of COVID-19.

Another pitfall is that a property located in an OZ may not be zoned for its highest and best use and many of these sites are not permitted. Changing entitlements can be pricy and time consuming. Additionally, new development can price out older neighbors as they experience new skyrocketed real estate tax assessments and/or rents. The solution—such as in Nashville—is to educate fixed income neighbors that they have the option to apply for a tax assessment freeze. Battling gentrification is important. Inclusionary zoning is a challenge too. Entitlement can be a win-win for both the developer and neighbors with frozen assessments. ▽

1. https://www.irs.gov/pub/irs-drop/n-18-48.pdf

2. https://www.irs.gov/pub/irs-drop/n-18-42.pdf

3. https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx

4. citylab.com/equity/2018/05/the-problem-with-opportunity-zones/560510

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