nerej CELEBRATING 55 YEARS

# Opportunity awaits: What opportunity zones mean for investing and tax incentives - by Jonathan Rizzo

September 07, 2018 - Northern New England

Jonathan Rizzo,
CBRE | The Boulos Company

The pricing that buildings have been trading at over the last 12-18 months has been at such a high level, many commercial real estate property owners are thinking: "Is now the time to sell?" The main concern has been where to reinvest the funds received without paying taxes on any gain from the sale. Historically, the vehicle for this was via a 1031 Tax-deferred Exchange, a provision in the Federal tax code, which lets the seller reinvest the funds without any tax implications. A new mechanism to reinvest tax free is now provided by the establishment of "opportunity zones."

These geographic zones were established to spur private investment in low-income communities and/or neighborhoods, opportunity zones were created as outlined in the Tax Cuts and Jobs Act passed in 2017. The idea behind this act was to allow for an alternative deferral of capital gains tax; unlike a standard 1031 Exchange.

How it Works

According to the Economic Innovation Group, in order to invest in an opportunity zone and qualify for the tax benefits, an "opportunity fund" must be created. A qualified opportunity fund is a privately managed investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (the vehicle must hold at least 90% of its assets in such property). In order to take advantage of the special treatment under this provision, investors must roll over capital gains of non-zone assets before December 31, 2026. Governor LePage has designated 25% of Maine's low-income census tracts as qualified opportunity zones. These designations include zones in Cumberland and Androscoggin County, including areas of the Portland waterfront which to the average observer would not be considered blighted nor low income.

There are three tax incentives for investing in low-income communities through a qualified opportunity fund:

1. Temporary deferral of capital gains.

2. Step-up in basis for capital gains reinvested in an opportunity fund. If the investment in the opportunity fund is held for at least 5 years, the basis is increased by 10%. This jumps an additional 5% if held for at least 7 years.

3. Permanent exclusion. If an investment in an opportunity fund is held for at least 10 years, investors will benefit from a permanent exclusion from taxable income of capital gains from the sale or exchange of the investment.

Let’s look at the above incentives in a scenario to see how an investment through a qualified opportunity fund differs from a standard investment.

For the sake of this example, let’s use consistent numbers for the 5, 7, and 10-year scenarios. You bought a property in 2013 for $900,000 and sell it in 2018 for $1 million. Therefore, you have a capital gain of $100,000 that you intend to reinvest. In your new investment into an opportunity fund, you will see an annual return of 7% and have a tax obligation of 30%.

In the 5-year scenario, your cost basis steps-up 10% to $90,000. If you are looking at a 30% tax obligation, you would save $3,000 by simply investing in an opportunity fund. As it typically takes 5 years for a standard investment to recoup capital gain taxes that are paid in 2018, your effective after-tax annual return is in the positive when investing in an opportunity fund versus a flat return for a non-opportunity fund investment. With a 7% annual return, your gain of $40,256 would still be taxed because you’re not waiting the full 10-year holding period to realize the permanent exclusion from taxable income of capital gains.

Let’s look at the 7-year holding period scenario. By waiting the additional 2 years, your step-up in basis goes to 15%, or your $100,000 in capital gains looks like $85,000 when it steps up. Therefore, your tax obligation goes from $27,000 in scenario 1 to $25,500 in this scenario. You are still paying taxes on the return over 7 years, which at 7% annualized on $100,000 is $60,579. That tax obligation equates to $18,173.70. Still, with the step-up in basis, there’s an effective after-tax annual rate of return that would surpass a standard investment.

Now let’s look at the 10-year holding period scenario. This is when an investment in an opportunity fund looks very compelling because you take into account the permanent exclusion from taxable income of capital gains. Not only does your cost basis go from $100,000 to $85,000, you have a gain of $96,716 over a ten year period (with 7% annual returns), that is excluded from taxes. At a 30% tax obligation, that would be $29,014.80 that you’d be saving from the permanent exclusion benefit referenced above. If you were to invest $100,000 in a standard investment, you would be leaving approximately $45,000 in savings on the table!

Lastly, and perhaps the most unique aspect of the opportunity zone, is that the capital gain does not have to be realized from real estate, but can also come from financial instruments including stocks and bonds. Never before has there been a way to shelter gains from any investments other than real estate.

Again, this investment requires patience. If you are able to find a solid investment in an opportunity zone, it could be an excellent way to defer capital gain taxes and realize additional tax benefits simply by holding onto a great investment.

Jonathan Rizzo is an associate for CBRE | The Boulos Company, Portland, ME.