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Opportunity Zones - It is all about having some patience - by Robert Meulmeester

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Who has not talked, read, analyzed or attended a seminar about the Opportunity Zones program? The Opportunity Zones program appear to be the latest phenomenon that could make a substantial impact. In fact, certain articles suggest this program may unlock $6.2 trillion of unrealized capital gains for reinvestment. Though word on the street suggests that things are not moving so fast as it remains untested. In this article, we explain the basics of the Opportunity Zones program. Per a limited analysis of a hypothetical real estate investment, we quantified the advantage as a result of the federal tax incentive for investments allowed by the Opportunity Zones program.

What it is: This program was established as part of the 2017 Tax Cuts and Jobs Act. An Opportunity Zone is an economically distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment. Localities qualify as Opportunity Zones if they have been nominated for that designation by the state and that nomination has been certified by the Secretary of the U.S. As of December 14, 2018, an updated list of designated Qualified Opportunity Zones ("QOZs") sums to 8,764 zones covering parts of all 50 states, the District of Columbia and five U.S. territories.

Investors in Qualified Opportunity Funds ("QOFs") participating within those designated QOZs can take advantage of federal tax benefits. The QOFs are self-certified investment vehicles organized as corporation or partnerships. Typically, real estate investments are structured as limited partnership or limited liability company formed under local law in order to provide flow-through tax treatment for gains and losses. The Opportunity Zone program federal tax benefit include:

• A deferral of the tax on the original gain until (a) the date the taxpayer sells or exchanges its investment in the QOF, or (b) December 31, 2026, whichever is earlier.

• A reduction of the original gain per an increase in original basis: (a) 10.0% increase basis if the QOF investment is held for five years by December 31, 2026 or the date of disposition, if earlier; (b) an additional 5.0% increase (15.0% total) if held for seven years by December 31, 2026.

• No taxable gains or recapture of depreciation on the QOF investment if held for 10 or more years as basis is assumed to equal fair market value.

How it works: The Opportunity Zones program is not for everyone. It may certainly work for investors that have a risk appetite for investments in economically distressed communities that further include a construction or renovation component considering a requirement to substantially improve the property within a 30-month window and are willing to hold for over ten years. Although the program allows for federal tax incentives, a prudent investor would consider the tax benefit merely the proverbial “icing on the cake”. Notably, state and local taxes may still apply depending on the location of the property1.

In any case, we calculated a benefit when only considering federal taxation per utilizing certain assumptions indicating an after-tax premium for investments in and by QOFs in real estate within QOZs as opposed to those done outside of QOZs. In our cash flow model, the QOZs benefit was estimated to be 143 basis points higher (2) compared to an investment outside of the QOZs.

We concluded to this overall superior QOZs investment outcome per the following case study. We assumed a hypothetical asset sale, e.g., a sale of stock in 2019 generating $20,000 in net sales proceeds with a $10,000 original basis resulting in a $10,000 capital gain. We then compared a hypothetical reinvestment strategy of the entire capital gain into a residential rental property for an investor at a 22.0% marginal income tax rate. To compare results, we prepared two scenarios: reinvestment of the $10,000 capital gain in 1) a Non-Qualified Opportunity Zone and 2) a Qualified Opportunity Zone through a QOF structured as a flow-through entity.

We assumed a 15% capital gains tax rate amounting to $1,500 in tax liabilities in 2019 for an investment into a Non-Qualified Opportunity Zone. However, the reinvestment of the capital gain into a Qualified Opportunity Zone allows a deferral and partial capital gains tax exemption if held for at least seven years and to be reported as part of the 2026 tax return. Then, a 15% increase of its original basis results in a $8,500 capital gain instead of $10,000 which amounts to $1,275 in tax liabilities.

We note that the property purchase in 2019 is assumed to be substantially improved as part of the Opportunity Zone program requirements, and therefore assumed not to generate any income during 2019 when we assume renovations. The property will be placed in service starting 2020 by when the improvements can be depreciated over a 27.5-year straight line recovery period set forth by the General Depreciation System terms conform the Modified Accelerated Cost Recovery System. In this example, the $10,000 investment includes the acquisition of real estate (i.e., land and building) as well as the cost of the renovation works; 90% is hereby allocated to the depreciable improvements and 10% to land.

We estimated a going in capitalization rate of 10.0% which is not unreasonable for investments in distressed communities. Therefore, Net Operating Income (“NOI”) is $1,000. We further assumed

NOI to trail inflation at approximately 2.0% annually. Considering the renovation work in 2019, NOI starts in 2020. The Opportunity Zone program requires a 10+ year hold, say 10 years plus one day. The sale price is estimated utilizing the one-year forward looking NOI for 2029, or year 11 capitalized per its 10.5% going-out capitalization rate which is slightly higher than the going-in rate considering wear and tear of the property and further reduced by its estimated 6.0% cost of sales as commonly applied for appraisals.

We observe that the after tax results are significantly different between the two scenarios whereby scenario 1) a Non-Qualified Opportunity Zone investment is expected to be liable for capital gains tax as well as deprecation recapture tax which is the total amount of depreciation taken over the life of the holding period assuming the property has sold for more than its adjusted basis which is the original cost basis minus the depreciation. Although capital gain is assumed to be taxed at 15%, depreciation recapture is taxed at a higher 25%, and represents the greater portion of tax at sale. For scenario 2) a Qualified Opportunity Zone investment, the adjusted cost basis is assumed to be fair market value, and therefore the sale is not taxed for capital gains or depreciation recapture.

The results

In the end, from a federal taxation perspective, the after-tax return yields to 6.17% for scenario 1 versus 7.60% for scenario 2 over a 10+ year hold, or 143 basis points higher. Also, the savings realized due to the initial capital gain deferral, partial exemption of the initial gain in 2026, and eventual exemption of capital gains tax and depreciation recapture tax on the sale of the property after 10 years, result in an estimated 11% equity premium for this QOZ investment compared to the non-QOZ investment. This was derived from discounting those savings per applying the 7.60% after-tax yield from scenario 2.

Obviously, within this limited analysis, we did not consider any other aspects that could further impact the property's risk and return such as local market changes as a result of improvements within the property's submarket, and any other regulatory, economic, demographic or any other changes. So much can happen in 10+ years! Overall, a phenomenon worthwhile investigating for those with long investment horizons and appreciation of risk.

1Throughout, state and local taxes were disregarded considering its vast geographic differences. Similarly, any additional state and local tax incentives that may be particularly relevant for economically distressed communities were not considered.

2 Our analysis is limited to federal tax implications on after tax yield utilizing certain assumptions that were explained in the article and illustrated within the enclosed exhibit for “Case Study Capital Gain Reinvestment by RJM Worldwide LLC”. However, for any investor, any outcome will further depend on the individual tax-payers' personal situation including but not limited to total earnings, applicable marginal tax rate, place of residence and marital status. A tax advisor should be consulted for each individual situation.

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