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Opportunity Zones: A good bet, but still a bet - by Daniel Calano

October 18, 2019 - Appraisal & Consulting

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Most of you probably know what an opportunity zone is. I'll do a brief rundown and then focus on the opportunities for real estate development and the potential risks. Briefly, opportunity zones were created by the 2017 Tax Cuts and Jobs Act. They are physical zones established for investors, business operators and real estate owners and developers. The hope is to provide these people opportunities to invest in "distressed" areas, which should promote job and income growth therein.

Zones are created through applications, which have to be approved by the U.S. Treasury based upon their ability to spur economic development. According to a recent Kiplinger report, there are currently 8,700 such zones in the United States. As a result of the zones, REIT-type opportunity zone funds are being created for general investors; active businesses are interested in participating; and real estate investors and developers are plying their trade as well.

The benefit to these groups are tax deferred income and gains over a period, with the potential for tax exemption. The rules are complicated, and in their infancy, hire one of the many firms sprouting up who specialize.

As a rule, project returns are deferred in a tiered manner, depending on how long one owns the project. Actual gains exemption are modest up until seven years, with a 15% reduction, but if the project is held and sold after ten years, potentially 100% of capital gains can be exempted. This number alone provides the obviously greatest benefit and most likely reason to invest in otherwise distressed areas.

Remember the word "distressed," since it suggests why developers have not gone there without this incentive. Among these zones, there are obviously variations in degree as to how distressed areas might be. In the worst case, there may be no reason for economic infusion by real estate developers and investors, regardless of the incentive. In other words, adding supply to a "no demand" area is clearly not a good idea. Remember the historic tax credits, an excellent idea for immediate benefits to investors, but in the long term, many projects simply weren't marketable or sustainable. On the other side of the spectrum, a Wall Street Journal article recently chronicled where opportunity zones can exist in already very stable areas, such as university towns. This is because the average income metric is brought down by students, thus adding to the potential for opportunity zone categorization, where otherwise the areas could be thriving retail and office areas already. Clearly, investing in these "distressed" areas is less risky than others.

If you research it, it is clear that specialists in creating zones, REIT-like funds created for investing in zones, and zones themselves are being pedaled relentlessly. This is and of itself could create an oversupply, as opportunity zone funds, for example, are reimbursed with fees regardless of how projects do. In other words, there appear to be a lot of zones, a lot of investment capital being generated, and a lot of buzz.

Opportunity zones are a great concept which can really help distressed areas, while benefiting qualified investors. There is often a good reason why certain zones need a little capital and development to get a boost to attract others. On the downside, sometimes an influx of capital like this can produce supply in chronically low demand areas, thereby setting up more problems than potentially existed prior to investment. And in some areas, as the Wall Street Journal indicated, opportunity zones are being created where they are needed least. In the end, we won't know on a zone by zone basis, whether it worked until 5-10 years have passed. A long time where investment can continue without indications of success. Definitely a good opportunity, a potentially good bet, but a bet it is.

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