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Opportunity zones: What's all the fuss?

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Opportunity Zones have been the focus of discussion nationally at conventions and within trade publications. I had the honor to serve on a panel at The Counselors of Real Estate's Fall Nashville Conference this past November. We had guest speakers and a room of experienced attendees that rounded out a packed hour and half discussion about the pros and cons of Opportunity Zones and some soon to be major pitfalls. This blog is serving as an opportunity to share with SIORs what advice they might offer to their clients.

What is an Opportunity Zone?

OZ was created under the 2017 Federal Tax Cuts and Jobs Acts. The first set of OZ's was designated on April 9, 2018. According to an article in Site Selection, its function is 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. An OZ project can be owner-occupied or investment leased. This flexibility allows for diverse opportunities.

According to the IRS, Opportunity Zones provide tax benefits to investors. 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. If the QOF investment is held for longer than 5 years, there is a 10% exclusion of the deferred gain. If held for more than 7 years, the 10% becomes 15%. If the investor holds the investment in the Opportunity Fund for at least ten 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).

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 of 2019, more federal regulations were published in order to illustrate how the Opportunity

Zones will be beneficial. Clear rules were created to demonstrate how leased property could benefit from the Opportunity Zone program. The April 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.” There are over 8,762 OZs in the U.S. in all 50 states and the U.S. territories.

How do you identify an Opportunity Zone?

Opportunity Zones 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 his delegation of authority to the Internal Revenue Service.

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

An SIOR can also find an OZ designated area by researching OZ maps on google. Or 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. Third, the program may encourage development in distressed areas and create economic enhancement, job creation, real estate and sales tax and further attraction for more development.

Pitfalls: There are potential downfalls to the Opportunity Zone program. First, while the OZ’s are meant to help the residents, there is no requirement or guarantee that it does so. This means that OZs could solely benefit investors. 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. Third, the tax benefits are estimated to cost $1.6 billion in lost federal revenue over a ten year period. Fourth, scholars have found that both in the U.S. and the U.K., Opportunity Zones were not successful with its 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. Fifth, the program phases out Dec. 31. 2026 with a full OZ designation expiration of Dec. 31, 2028. Therefore an investor does not currently have ten years to benefit for a full tax exclusion. This is by-far the deepest pitfall unless Congress extends this program.

Other Issues: In some cases, OZ’s are not in distressed areas but are in strong markets or undeveloped markets. For instance the entire island of Puerto Rico is considered an Opportunity Zone.

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

Another issue, as of early December, 2019, Senator Ron Wyden (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 wealth landowners with large acreage of land adjacent to 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 investors want to be cautious in 2019 as the number of years (ten) does not exist before OZ sunsets and expires in 2028. By 2021, the five year holding period is no longer applicable. The gain must be recognized by Dec. 31, 2026. Investing point may be too late for a full tax exemption unless Congress extends this program which is unclear at this point.

Another pitfall is that a property in an OZ may not be zoned for its highest and best use. Nor are many of these sites permitted. Changing entitlements can be pricy and time consuming. Additionally new development can price out older neighbors that see their real estate tax assessments skyrocket and/or rents. The solution, such as in Nashville, is that to educate fixed income neighbors that they can 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.

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