E-GUIDE

UNDERSTANDING OPPORTUNITY ZONE FUNDS
A popular tax-advantaged investment vehicle

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WEALTHFORGE

Introduction

The 2018 tax reform laws created a new investment category: Opportunity Zones. Qualified Opportunity Zone Funds join an increasingly popular group of tax-advantaged investments that allow investors to defer or avoid capital gains taxes on the sale of certain investment properties. While opportunity zones have garnered investors' interest, the IRS continues to provide guidance on the exact rules that will govern opportunity zone fund investments.

In this E-guide, we break down the basics of opportunity zone funds, compare them to other tax-advantaged investments, and highlight what financial professionals need to know before recommending opportunity zone funds to clients.

Qualified Opportunity Zone Funds 101

To better understand the pros and cons of a qualified opportunity zone fund, first we'll discuss how an opportunity zone is defined.

An opportunity zone is an economically distressed area or community designated by the state in which it resides and certified by the US Department of the Treasury. The designation was created under the 2017 Tax Cuts and Jobs Act[1] in order to stimulate growth and improvement in struggling economic areas of the country. There are approximately 8,700 designated opportunity zones nationwide, with zones in every US state and territory. A current list of opportunity zones can be found on the US Treasury's Community Development Financial Institutions Fund website.[2]

In many cases, opportunity zone properties are new construction. However, there are certain circumstances under which a pre-existing property within the zone can qualify. A fund that purchases a pre-existing property must make "substantial improvements" to the property, defined as equal to the fund's initial investment into the property over a 30-month period. Therefore, if a fund were to acquire a property for $5 million, they would have to invest an additional $5 million in improvements over the next two and a half years.

Some types of properties, such as golf courses and gambling establishments, are ineligible for opportunity zone investments.

According to the IRS, investment into an opportunity zone fund can provide investors with significant tax advantages, and even savings, depending on how long the investment is held.

Tax Advantages

Tax deferral – Taxes on capital gains that are reinvested into an opportunity zone fund can be deferred until December 31st, 2026 or until the interest in the fund is sold, whichever comes sooner.

Tax basis step up – If the investment is held for 5 years, 10% of the original gains invested become tax-free due to a step-up in tax basis. Any depreciation in the fund also decreases the tax-basis of the original investment. Originally, if the investment was held for 7 years, an additional 5% of the gains became tax-free. However, the deadline for investments to achieve that benefit passed on December 31st, 2019.

No tax on appreciation – Even with the above tax advantages, the primary goal of an investment is for it to appreciate in value and provide a return. If an investment in an opportunity zone fund is held for 10 years, investors will not have to pay taxes on gains realized from the investment in the fund.

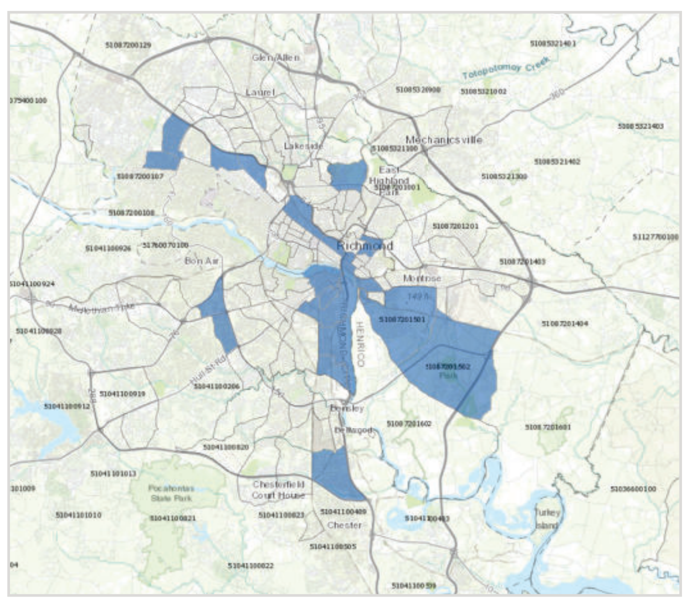

Figure 1: Sample section of the opportunity zone map on the US Treasury's Community Development Financial Institutions Fund website.

Below is an example of the potential tax benefits of an opportunity zone fund investment based upon when the interest is sold.

2019

Jessica sells her stock portfolio on January 1st, 2019 for a gain of $1 million.
Between January 1st and June 30th, 2019, Jessica is eligible to reinvest those gains in a qualified opportunity zone fund. Assume she reinvests those funds immediately.

Between January 1st, 2019 and December 31st, 2023, Jessica does not have to pay taxes on that $1 million gain, unless she sells her interest.
If within this timeframe she decides to sell her interest in the fund, she will pay taxes on the $1 million, plus taxes on any appreciation in the fund investment. If the fund depreciates, she only pays taxes on what remains of her initial $1 million.

2024

Between January 1st, 2024 and December 31st, 2025, if Jessica sells her interest in the fund, she will only have to pay taxes on $900,000 of her initial investment.
This is due to a 10% step-up in tax basis, plus taxes on any appreciation in the fund investment. If the fund depreciates, she only pays taxes on 90% of what remains of her initial investment.

2026

Between January 1st, 2026 and December 31st, 2026, if Jessica sells her interest in the fund, she will only have to pay taxes on $850,000 of her initial investment.
This is due to an additional 5% step-up in tax basis, plus taxes on any appreciation in the fund investment. If the fund depreciates, she will only pay taxes on 85% of what remains of her initial investment. **On December 31st, 2026, Jessica will have to recognize the $850,000 of her initial investment that is still taxable as a capital gain and pay taxes on it. She can continue holding her investment in the fund after this.**

2027

Between January 1st, 2027 and December 31st, 2028, if Jessica sells her interest in the fund, she will only have to pay taxes on any appreciation in the fund investment.

2029

On or after January 1st, 2029, if Jessica sells her interest in the fund, she will not have to pay any taxes on any appreciation in the fund investment.

Note: This is a hypothetical example, based on the current IRS guidance (as of March 2019) and is not representative of an experience of any particular investor. It should be noted that, while this example takes places earlier, the deadline for investments to achieve the 5% additional step-up in tax-basis already passed on December 31st, 2019. There is no guarantee that an opportunity fund investment will appreciate in value and result in a gain. Investors may lose their invested principal.

Additional Opportunity Zone Guidance from the IRS

Because opportunity zone funds are a relatively new investment vehicle, the basic rules governing them were only recently finalized. Throughout 2019, the IRS released new guidance on opportunity zone funds that amended and expanded upon prior regulations.[3,4]

Eligible Capital Gains

When investing in opportunity zones, investors rollover capital gains from one investment to another. But there are some restrictions on where those gains can come from. Only capital gains that are taxable in the United States may be invested. Non-residents and foreign corporations may still make investments, as long as their capital gains are connected to a US trade or business.

Delayed Exchanges

Like 1031 exchanges, opportunity zone funds allow for up to 180 days between the sale of an investment and the re-investment into the new fund. For certain types of investors, there are rules governing when that delay period starts. Investors that have a stake in a partnership, S corporation, are beneficiaries of an estate, or non-grantor trusts may start their investment window from the date on which that entity must hand in their tax return (excluding extensions). If investing gains from a Real Estate Investment Trust (REIT) or a Regulated Investment Company (RIC), investors may start their investment window from the end of the tax year, or the investor may elect to start their window at the date when they receive their capital gains dividends. Proceeds from installment payments may be invested even if the initial payment was before 2018.

Inheritance of Investments

Qualified opportunity zone fund investments are able to be passed on to heirs, which was unclear in previous regulations. This is a significant clarification, as the majority of tax benefits come after the investments have been held for 10 years, which leaves a lot of room for uncertainty for older investors.

Tax Exclusion of Other Gains

In addition to appreciation on the original investment, other types of gains related to the opportunity zone may be excluded from taxation only after the investment is held for 10 years. If a property within a Qualified Opportunity Zone Fund is sold, investors may choose to exclude profit from the sale. Any profit from such a sale would reduce the amount of the investors' interest in the fund, as the asset value of the fund would be reduced. Other gains, such as distributions by a corporation or partnership may qualify for exclusion if, for tax purposes, they are treated as gains from the sale of property.

Post Guidance Traction

The final IRS guidance was released in December 2019. With the rules set in stone and the fast-approaching deadline to take advantage of the full tax benefits offered by opportunity zone funds, investments began pouring in. December became the highest fund-raising month in the history of the opportunity zone fund program, with $2.24 billion invested. This accounted for a third of the total opportunity zone market of $6.7 billion across 502 funds.[5]

Opportunity Zone Funds vs. 1031 Exchanges

The tax benefits of 1031 Exchanges and investments in qualified opportunity funds have many similarities. Both 1031 exchanges and opportunity zone funds:

- Allow investors to defer recognizing the gain on the sale of an investment or property. This is one of the main reasons 1031 exchanges have historically been so popular.
- Encourage investors to reinvest their gains from previous investments, which helps keep money in the real estate market, encouraging growth.
- Mostly feature investments into real estate, a market that has a low correlation to the wider market.

Despite the similarities between 1031 exchanges and investments into qualified opportunity funds, there are also significant differences in both their tax treatment and rules around where gains may come from.

Taxes

One major difference between taking advantage of a 1031 exchange and investing into an opportunity zone is how long the investor's gain is deferred. For a 1031 exchange, the investor may defer the tax on the gain from the sale of the previous property until the sale of the replacement property. If the investor decides to once again roll their investment into yet another eligible property, gains continue to be deferred until a property is finally sold.

For a qualified opportunity zone fund, the investor may defer the tax on the gain from the sale of the previous property until either the sale of the property or December 31, 2026, whichever comes first. As a result, investors in a 1031 exchange may be able to defer recognition of their gain for a longer period than investors in a qualified opportunity fund if the 1031 property is still held after December 31st, 2026.

Participation in a 1031 exchange allows an investor to defer recognizing their gains from the sale of a property for a time. However, when a property is eventually sold for cash, the investor will have to recognize the full extent of their capital gain.

Investors in a qualified opportunity fund not only get to defer their gain but, if they hold the investment long enough, they may receive exclusions on a percentage of their gain (see example on page 3 of this e-guide for full illustration).

Perhaps the largest difference between the tax benefits of participating in a 1031 exchange and investing in a qualified opportunity fund is the stepped-up basis on the investment into a qualified opportunity fund if the investor holds it for more than 10 years. This means that when the investor sells her investment in the qualified opportunity fund, her basis (the amount of the original investment) is increased to the fair market value at the time of the sale. Since taxpayers are taxed on the difference between their basis and the sale price, this effectively means that after 10 years, the transaction will be tax-free.

In a 1031 exchange, the original basis follows the investor through the exchange and is used when the replacement property is finally sold, at which time the investor pays the tax on the difference between their basis in the original property and the sale amount of the replacement property. The stepped-up basis for investments into a qualified opportunity fund is a huge benefit for investors who are able to hold an investment for a longer period.

Property

1031 exchanges and opportunity zone funds also differ on the types of property into which an investment can be made. For a 1031 exchange, the IRS requires the replacement property to be of a "like-kind" to the property the taxpayer sold. The IRS defines "like-kind" as "property of the same nature, character or class. Quality or grade does not matter. Most real estate will be like-kind to other real estate."

Opportunity Zone Funds vs. 1031 Exchanges

Additionally, the property must be used for a trade or business or for investment. This means that any commercial real estate likely qualifies for a 1031 exchange. Opportunity zone funds are restricted to investing in properties within the geographic limits of an opportunity zone. However, considering the large number of opportunity zones in the United States, this may not be a huge hindrance for investors.

Investments into qualified opportunity funds and 1031 exchanges also differ on where the invested capital originated. While investments in a 1031 exchange must follow the “like-kind” rule, investments into qualified opportunity funds may come from the sale of any investment property, whether real estate or investments in the stock market. With the tax benefits of investing in qualified opportunity funds, this is a boon for investors.

Rollover

When rolling capital over from one investment to another, investors have some flexibility on the exact timing. Because it may be difficult to find a suitable investment that is seeking investors exactly when a currently held investment is sold, both 1031 exchanges and opportunity zone funds include a 180-day grace period. If an investment is sold, investors have 180 days to reinvest in a new rollover property.[6]

However, there are some differences. In a 1031 exchange, investors must roll over both the principal and any capital gains into the new property, whereas with an opportunity zone fund, only the capital gain is needed to realize tax benefits, and the principal does not need to be rolled over. If an investor wanted to roll over both principal and capital gains into an opportunity zone fund, only the capital gains would be eligible for tax advantages.

Another difference can be found in how funds are handled during the rollover grace period.

For a 1031 exchange, investors are required to utilize a qualified intermediary, who serves as a middle-man, holding the funds in escrow until a replacement property is found. Investors who wish to roll gains into an opportunity zone fund do not need to use an intermediary.

Liquidity

Both interests gained through a 1031 exchange and investments into qualified opportunity zones lack liquid secondary markets. As a result, investors into both must be willing to deal with long hold periods and the potential loss of their principal. One significant difference between an investment in a 1031 exchange and an investment into an opportunity zone fund comes when liquidation does occur. When an investor in a 1031 exchange sells the property or interests, either those proceeds must be invested into another like-kind property, or the investor will recognize his gain on his exchanged investment. Upon liquidation of an opportunity zone fund, investors recognize their gain on the investment and any remaining taxable gains from the previous investment that was rolled into the fund.

Investment Objectives

The primary objective for investments into both 1031 exchanges qualified property and opportunity zone funds is tax deferral. For opportunity zone funds, a secondary objective may be to invest into distressed economic areas, which is not necessarily true for 1031 exchange investments.

1031 exchanges and investments in qualified opportunity funds are both enticing opportunities for investors, but, despite their similarities, the differences between these two investment opportunities require potential investors to thoroughly review their options prior to making an investment.

CONSIDERATIONS FOR FINANCIAL PROFESSIONALS

The Opportunity Zone Market

The opportunity zone market continues to grow. In 2019, qualified opportunity funds raised more than $6.7 billion, with over $2 billion of that coming in December alone, according to data from Novogradac.[7] While overall allocations to alternative assets have largely remained unchanged over the past couple of years, increasing just 1% from 2018 to 2019, a report from Earnst & Young suggests significant shifts in what kinds of alternatives are being used in portfolios.[8] Investors are moving away from hedge funds and toward other classes. The report shows high interest in real estate, investments that offer specific benefits to investors, as well as socially responsible products. Opportunity zone funds are well suited to capitalize on these trends, as they provide a compelling set of potential tax benefits to investors, while also offering the added “feel good” factor of impact investing.

Sourcing Opportunity Zone Funds

It is estimated that there are 1 million properties contained within designated opportunity zones.[9] The National Council of State Housing Agencies (NCSHA) has a regularly updated directory of multi-project opportunity zone funds which, as of February 2020, lists 206 investment opportunities that have a national, regional, or state focus and cover industries varying from commercial real estate to sustainable agriculture and more.[10] Broker-dealers that specialize in real estate investment offerings are also likely to be familiar with sponsors who are developing opportunity zone funds.

Recommending Investments

If investor clients have expressed interest in tax-advantaged investments, financial professionals may want to consider recommending opportunity zone funds. However, it is important to inform investors that the full extent of the tax advantages offered by opportunity zones are no longer available. Because of the 2026 deadline for declaring deferred capital gains, investors would have had to make an investment on or before December 31st, 2019 in order to claim the full 15% step up in tax basis. However, up to 10% step up in tax basis is still available with no looming deadlines, which should allow financial professionals plenty of time to perform careful diligence of any available offerings.

Qualified opportunity zone funds are still in the process of being shaped by the federal government. Any and all projects are subject to be affected by possible changes in regulation. All investments in qualified opportunity zone funds are risky, with long hold periods and potential loss of principal. Additionally, failure to complete the entire investment term could potentially incur tax-related consequences.

*Note: Diversification does guarantee profits or protect against losses.

CONCLUSION

Opportunity zone investments offer investors a potential way to defer or even eliminate taxes paid on capital gains that are rolled over into a qualified opportunity zone fund.

While they provide a compelling set of benefits, it should be noted that, like any investment, opportunity zones come with risks, including illiquidity, loss of principal, real estate risks, and more.

If you'd like to learn more about our technology platform for alternative investments, please contact us:

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Note: There are material risks associated with investing in real estate and real estate securities including illiquidity, tenant vacancies, general market conditions and competition, lack of operating history, interest rate risks, the risk of new supply coming to market and softening rental rates, general risks of owning/operating commercial and multifamily properties, short term leases associated with multi-family properties, financing risks, potential adverse tax consequences, general economic risks, development risks and long hold periods. There is a risk of loss of the entire investment principal.

References

[1] 115th Congress, *H.R.1 – The Tax Cuts and Jobs Act*.

[2] Community Development Financial Institutions Fund, *Opportunity Zones Resources*, CDFI (Feb. 26, 2019), https://www.cdfifund.gov/pages/opportunity-zones.aspx.

[3] Murtha Cullina and Marc Finer, *IRS Issues Additional Qualified Opportunity Zone Regulations,* JD Supra (June 7, 2019), https://www.jdsupra.com/legalnews/irs-issues-additional-qualified-45812/.

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[5] Michael Novogradac, *Opportunity Funds Listing Shows Strong Increase in Investment*, Novogradac (January 8, 2020), https://www.novoco.com/notes-from-novogradac/opportunity-funds-listing-shows-strong-increase-investment.

[6] *Supra* Note 1.

[7] *Supra* Note 5.

[8] Ryan Munson, Jun Li, and Mike Lo Parrino, When focusing on the future, where do you look?, Earnst & Young (November 13, 2019), https://www.ey.com/en_us/wealth-asset-management/when-focusing-on-the-future-where-do-you-look.

[9] Newmark Knight Frank, *Opportunity Zones: Navigating A Path to Investment,* IPA (Dec. 2018), https://www.ipa.com/wp-content/uploads/2019/01/White-Paper_Opportunity-Zones_Dec2018-Final.pdf.

[10] National Council of State Housing Agencies (NCSHA), *Opportunity Zone Fund Directory (*Jan. 24, 2019), https://www.ncsha.org/resource/opportunity-zone-fund-directory/.