Opportunity Zones

A New Way to Tackle Economic Equality Challenges in America

PATHSTONE

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Tucked away in the 1,000+ page Tax Cuts and Jobs Act, is a very interesting section on something called "Opportunity Zones." Seemingly overlooked due to some of the headline-grabbing changes to income tax rates and deductions, the creation of Opportunity Zones has begun to generate buzz not only in the tax planning world, but also the Environmental, Social and Governance (ESG) community. Given our interest in both areas, we took a deeper look. This paper explores the tax benefits, positive social ramifications, and potential investment opportunities of the Opportunity Zone program.

Opportunity Zones Explained

Opportunity Zones are a new community development program designed to expand economic development and create jobs in distressed communities. The Investing in Opportunity Act was created by Congress as part of the Tax Cuts and Jobs Act of 2017. The purpose is to encourage long-term investment in low-income urban and rural communities around the country by incentivizing patient capital investments.

According to the IRS, Opportunity Zones are designed to spur economic development by incentivizing investments primarily through tax benefits. The concept was originally developed by the Economic Innovation Group (EIG) in 2015 as an idea to address persistent poverty in many American communities.[1] The idea gained interest from a number of different constituents and the Opportunity Zones Program was taken to Congress by Senators Tim Scott (R-SC) and Cory Booker (D-NJ), and Representatives Pat Tiberi (R-OH) and Ron Kind (D-WI).

Under the Act, Congress authorized the governors of each state to select up to 25% of their state's low-income community census tracts to be designated as opportunity zones, providing federal tax incentives to investors. The first set of Opportunity Zones are located in 18 states and were designated on April 9, 2018. Enterprise Community Partners has created an interactive map to find Opportunity Zone census tracts across the U.S. Once a zone is qualified by the Treasury, it will remain qualified for 10 years. As of May 18, 2018 the Treasury has certified over 8,700 low-income and contiguous communities as Qualified Opportunity Zones.[2]

How will investments in Qualified Opportunity Zones be structured?

Investors may re-invest all or a portion of their realized capital gain from sale or exchange of appreciated property to partnerships or corporations that operate as Opportunity Zone Funds ("QOF"). These funds will then invest in businesses located in Qualified Opportunity Zones. Funds must invest at least 90% of

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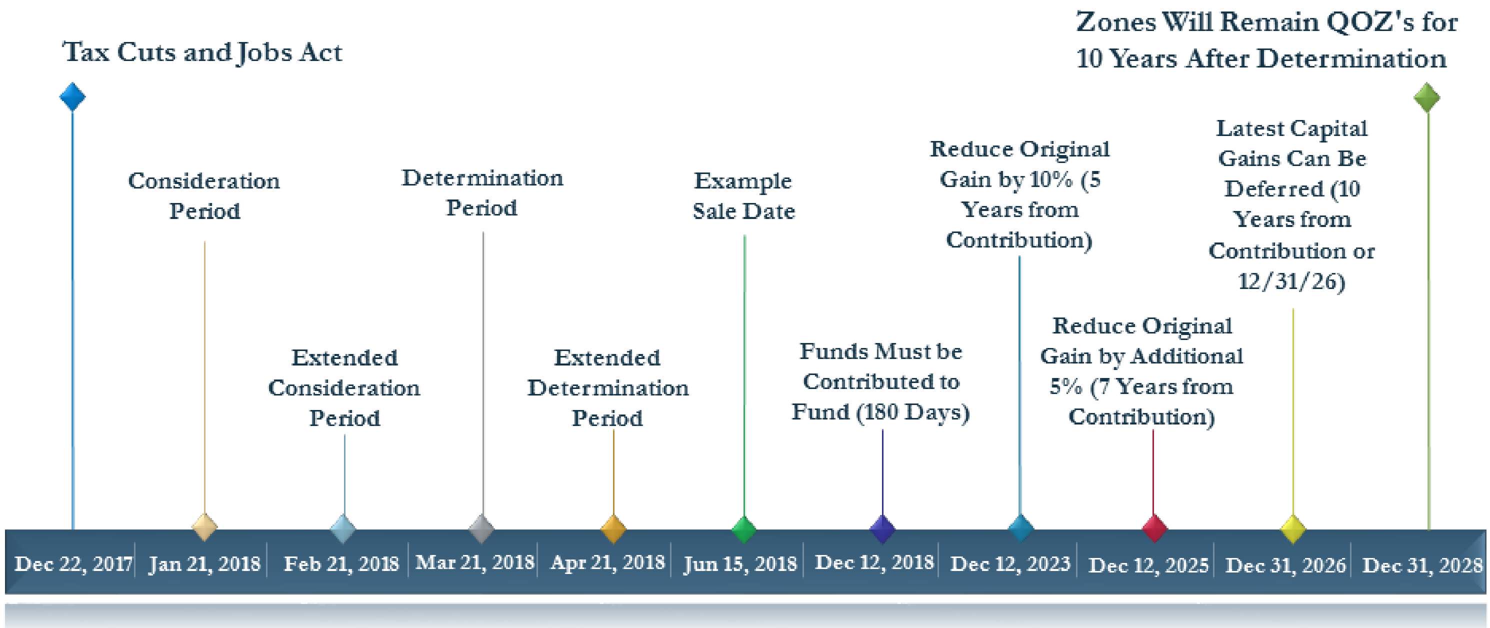
[1] http://eig.org/wp-content/uploads/2015/04/Unlocking-Private-Capital-to-Facilitate-Growth.pdf
[2] https://www.cdfifund.gov/Documents/Copy%20of%20Designated%20QOZs.6.14.18.xlsx

total assets in qualified opportunity zone property. This property can be a direct ownership of a trade or business in a zone, or it can be an indirect ownership of a trade or business through a partnership interest or corporate stock. Loans to businesses do not qualify as an investment in a business. Furthermore, several types of businesses are excluded (golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks or other gambling facilities, or any store that primarily sells alcoholic beverages for consumption off premises).

If a fund fails the 90% requirement, it will owe a monthly penalty equal to the amount of assets under the 90% requirement, multiplied by the underpayment penalty rate of the short term federal rate, plus three percentage points. Moreover, if the 90% requirement is not met, the property that was previously qualified may become disqualified. If this occurs, the property will be treated as qualified for the 90% requirement for 5 years or the date the fund disposes of the property, whichever is less.



The IRS is currently working on guidance under the new tax act, including the certification of Qualified Opportunity Funds and eligible investments in Qualified Opportunity Zones. The IRS website currently states that "To become a Qualified Opportunity Fund, an eligible taxpayer self certifies." Therefore, no approval or action by the IRS is required. To self-certify, a taxpayer merely completes a form and attaches it to the taxpayer's federal income tax return for the taxable year. The return must be filed in a timely fashion, taking extensions into account.

What are the incentives to invest in Qualified Opportunity Zone Funds?

From a tax perspective, there are three main advantages:

- Capital gain deferral
- Increases to tax basis
- Tax-free growth

On October 19, 2018, the IRS issued much anticipated proposed regulations to provide clarity on many significant points in the initial draft of the law. The initial draft caused many investors, potential fund managers and tax professionals to sit on the sidelines until such clarification was provided before proceeding in taking advantage of investing in Qualified Opportunity Zone funds. One of the most important clarifications is that only capital gains, as opposed to ordinary gains, are eligible for the special tax breaks. Therefore, taxpayers can defer only capital gains from a sale or exchange to an unrelated party if the taxpayer makes an election and contributes either a portion of or the entire realized capital gain from the sale to a Qualified Opportunity Zone fund within 180 days of the sale. This is a unique circumstance where taxpayers are not required to re-invest all of their proceeds from a sale, but rather only a portion of or the entire realized capital gain. This important distinction introduces greater flexibility for investors who want to re-invest their funds in other projects while still enjoying the tax benefits of capital gain deferral. The gain is deferred until December 31, 2026 or the date the investment in the Qualified Opportunity Zone Fund is sold, whichever is earlier. The gain deferral is limited to the fair market value of the sales proceeds contributed. An example of where a gain may be limited is the sale of an asset with a negative basis.

Additionally, taxpayers are not limited to investing only the realized capital gain. A taxpayer may re-invest the entire amount of proceeds but only the "invested capital gain" portion is eligible for the tax benefits. The portion of the proceeds in excess of the invested gain portion is accounted for as a separate investment in the Qualified Opportunity Zone fund which will have a cost basis equal to the amount invested and will be taxed on any appreciation same as any traditional investment.

In addition to deferring capital gains, investors can generate basis in an asset sold if the proceeds are contributed to a fund and held for a certain time period. If an investment is held in a Qualified Opportunity Zone fund for 5 years, the originally deferred gain will be reduced by 10%. This benefit increases to 15% if the investment is held for 7 years.

The final benefit of such investments is derived from the fact that appreciation in the fund is not taxed when sold, if it is held for 10 years. Below is an example of the different tax savings a contributions to a Qualified Opportunity Zone fund could provide. In addition to these savings, the original gain could be deferred as late as 2026.

As an example of the mechanics described above, assume that a taxpayer holds an investment in a property with a basis of $100,000 and the taxpayer sells the property for $200,000. The realized capital gain is $100,000. The taxpayer invests their realized capital gain into a Qualified Opportunity Zone fund and affirmatively elects to defer the gain within 180 days of the sale. The taxpayer's initial basis in the Qualified Opportunity Zone fund is zero. The taxpayer continues to hold the investment and after five years, the taxpayer receives an increase in basis of $10,000 (10% of the deferred gain). After year seven, the taxpayer's basis is increased again to $15,000 (15% of the deferred gain). On December 31, 2026, the taxpayer will recognize a capital gain of $85,000, even though the taxpayer continues to hold the interest After twelve years, the taxpayer sells their interest for $150,000. Since the taxpayer held the interest for greater than ten years, the taxpayer can make an election to have the basis equal to the fair market value of the interest on the date of sale and will recognize no gain on the appreciation of the interest.

Further assume the taxpayer also invests the remaining $100,000 of proceeds from the sale into the Qualified Opportunity Zone fund. This amount is in excess of the realized capital gain amount and will be accounted for as a separate investment within the fund. The taxpayer's initial basis would be $100,000 and the realized gain would be $50,000 upon the sale after year twelve for $150,000. The below chart highlights these mechanics.

Summary of Tax Savings		
Proceeds $200,000 from Sale of Capital Asset in 2018		
Original Basis $100,000		
Realized Gain $100,000		
	Opportunity Zone Investment	**Traditional Investment**
Proceeds Contributed to OZ Fund/Investment	$100,000	$100,000
Tax Liability in 2018	$0	$23,800
Basis After Year 5 (10% of Original Investment)	$10,000	$100,000
Basis After Year 7 (15% of Original Investment)	$15,000	$100,000
Gain Recognized on 12/31/2026	$85,000	$0
Tax Liability Generated on 12/31/2026	$20,230	$0
Proceeds from Sale of OZ Interest/Investment on 12/31/2029	$250,000	$250,000
Tax Liability Generated on 12/31/2029	$0	$35,700
Total Tax Liability on Investments	**$20,230**	**$59,500**
Total Net After-Tax Profit on New Investments	**$129,770**	**$90,500**
Cumulative Net Profit as %	**130%**	**91%**
Annualized Net Profit as % (Assuming 11 year holding period)	**7.9%**	**6.0%**

**Summary above gathered by Pathstone. Tax savings assumes the current maximum federal tax rate on long-term capital gains, plus the federal tax on net investment income for a total rate of 23.8%.*

Additionally, the proposed regulations also provided clarity on the following:

- The character of the original gain (i.e. short-term vs long-term gains) retains the character on the realization date on the earlier of disposition date or December 31, 2026. This is to say that the election to defer the gain via an investment into a Qualified Opportunity Zone fund cannot convert short-term capital gain to more tax preferential long-term capital gain.
- Taxpayers may elect to defer their allocable share of capital gains from pass-through entities. Likewise, the pass-through entity may also make the election at the partnership level. If the pass-through entity makes the election to defer the gain, the 180 day period begins on the date the asset is sold. If the partner elects to defer the gain, the 180 day period to re-invest the gain begins on the last day of the taxable year of the partnership in which the sale of the asset occurs. The taxpayer may also elect to have the 180 day period begin on the same day that the asset was sold.
- Taxpayers have the ability to make multiple deferral elections with respect to a single realized capital gain as long as the elections are made within the 180 period after the sale. For example, if a taxpayer

realizes a capital gain of $100,000 they can elect to have $50,000 placed into fund 1 and $50,000 placed into fund 2 on a later date, but no later than 180 days from the original date of sale.

- Taxpayers are allowed to re-invest a previously invested deferred gain in a Qualified Opportunity Zone fund without triggering a realized gain as long as the re-investment is made within 180 days of selling their previously deferred interest and the previous interest is disposed of entirely. The re-investment can be made to a new fund or to the original fund.
- The proposed regulations provide that a taxpayer who owns an interest in a Qualified Opportunity Zone fund that qualifies for the deferral of capital gains may use that interest as collateral on a loan.
- In order to qualify for the deferral of capital gains the interest in the Qualified Opportunity Zone fund must be an equity interest, thus debt cannot qualify for the tax advantages.

There remain a number of questions yet to be answered with the first set of regulations which is causing further hesitance from potential investors to move forward in terms of major investment. One thing that is clear from the evolution of this new area of development is that the IRS and government fully intend to interpret the laws in such a way that ensures investors receive the tax benefits in order to further this initiative. The IRS and Treasury are currently meeting with interested parties to field questions and solicit feedback as they work to release a second set of regulations in the coming months in order to address any outstanding issues that remain unclear.

What about social impact?

In addition to the tax benefits available through investments made in Opportunity Zones, we also believe that there is potential for significant social impact that can be created through investing in these areas. While offering tremendous potential benefits, if investments within these zones are not intentionally designed to achieve specific impact, there is a risk they will have little to no positive impact. It is important that investors review the investment merits while also considering how these investments may impact various stakeholders in the community.

At Pathstone, we have long been believers that investors can successfully align their portfolios with their values through incorporating Environmental, Social and Governance (ESG) factors into the investment process. We also believe considering ESG factors, including resource efficiency, labor practices and board diversity, can actually be additive to an investment process by providing insight to certain company risks and opportunities that may otherwise be overlooked or ignored. As longtime practitioners in this space, we have helped our clients execute values-aligned portfolios using a variety of tools, including ESG factor incorporation, screening, shareholder engagement and impact investing. Opportunity Zone funds potentially create another avenue through which investors can create positive impact through their investment portfolios, adding to the overall toolkit.

By IRS definition, Opportunity Zones were created to attract long-term capital that would spur economic development and job creation in distressed communities (or low income community census tracts).[3] Low income community census tracts are communities that have at least a 20% poverty rate or a median family income that is less than 80% of the surrounding areas. A small portion of the total state designated communities can include adjacent communities that may not otherwise qualify as low-income. The adjacent community must not have a median income over 125% of the low-income community's median income. The Economic Innovation Group (EIG) has helped to put more specific numbers around the demographics. They analyzed about 87% of the expected total number of Opportunity Zones and found[4]:

[3] https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions
[4] http://eig.org/news/joint-economic-hearing-promise-opportunity-zones

- 57% of population is non-white
- The actual average poverty level for this sample is 31%, well above the 20% minimum threshold
- Median family incomes are only 59% of the area median, which is well below the 80% minimum threshold
- 59% of the population resides in an area that is considered "severely distressed" (over 30% poverty rate, unemployment rates at least 1.5x the national average or median family incomes lower than 60% of the area median, per the Treasury's CDFI Fund)
- 38% of the prime working age population is out of work (10% above the national average)

Per the above, it is obvious how investments in these areas might help address systemic issues facing the country including poverty, unemployment, and overall economic inequality. These are among the many issues that value-conscious investors often seek to help resolve.

Investors will naturally seek strategies and funds that are intentional and thoughtful by design, and opportunity zone funds should integrate positive impact on community stakeholders as part of their design. An investment strategy that is intentionally designed to achieve specific positive impact for the benefit of stakeholders in an opportunity zone, by taking specific actions and measuring outcomes, may be expected to have a positive impact on the communities the tax act legislation is designed to benefit. Absent intentionality, actions and measurement, an investment may have a negative impact if it simply extracts profits from an opportunity zone, without sharing the value creation with community stakeholders. As an example, a luxury real estate developer that does not offer subsidized units for lower income residents living within the zone (such as police officers, firefighters and teachers) may merely accelerate gentrification that had already been unfolding within the zone.

What might investment opportunities look like?

The actual investment opportunity set is expected to be extremely flexible, creating the potential for Opportunity Zone funds to touch many different impact areas. Many investors are beginning to adopt the UN Sustainable Development Goals (SDGs) as an impact allocation framework.[5] The SDGs are a set of 17 global goals for sustainable development that span a number of diverse issues. When applying the SDG framework to Opportunity Zones (and investments in them), there are some obvious areas of overlap including:

- No Poverty
- Decent Work
- Economic Growth
- Sustainable Cities and Communities

But we expect the impact spectrum will include more indirect areas, such as:

- water infrastructure (SDG: Clean water and Sanitation)
- access to healthy food (SDG: Zero Hunger, Good Health and Well-Being)
- renewable energy access (SDG: Affordable and Clean Energy)

All of these are speculation at this point, but the options are numerous, and each offers the potential to deliver a large and positive impact within the zones.

[5]https://www.un.org/sustainabledevelopment/sustainable-development-goals/.

The Opportunity Zone provisions with the Tax Cuts and Jobs Act also offer a unique path for family foundations and other non-profit entities, such as Community Development Financial Institutions, to achieve material and positive impact. These "impact-oriented financiers" are able to provide financing at below-market interest rates to incentivize developers to integrate specific impact objectives within their business plans.

Although a tax advisor should be consulted for guidance, it is apparent that the new legislation allows an Opportunity Zone property or business to obtain financing, or leverage, outside of the tax-advantaged construct, without jeopardizing tax benefits of taxable investors. Concessionary financing at below-market rates, provided by impact-oriented financiers, has a clear and calculable economic benefit to investors in an Opportunity Zone fund. On the flipside, there is a clear and calculable cost to investors to adding specific positive impacts within a zone, in the form of lower expected revenue and a corresponding reduction in the return on investment.

As outlined earlier, there are a wide range of positive impacts and benefits that may be provided to stakeholders residing or working within the zone that align with one of the 17 SDGs. Within an Opportunity Zone fund, a specific impact or benefits may take the form of subsidized housing units, additional open space, community meeting rooms, or worker training programs. Successful negotiations between stakeholders, market-oriented financiers, impact-oriented financiers and investors can boost the likelihood that the Opportunity Zone fund investment will deliver material positive impact to all stakeholders.

Further, there is substantial evidence that minority entrepreneurs tend to be overlooked when it comes to funding.[6] With an inflow of capital to areas with primarily minority populations, this historically underserved demographic of the market should be better recognized. Great value from diverse ideas and businesses that otherwise may not receive an opportunity can be unlocked.

Finally, Opportunity Zones and corresponding funds create an opportunity to be targeted with investments. Oftentimes we find that investors who are interested in investing in low-income communities prefer to do so in areas close to where they live, close to where they grew up, or within a specific geographic area of interest. By clearly defining the location of Opportunity Zones, investors will have a better sense of where and how their money is used and the outcome it generates.

How big an opportunity are we talking about?

According to EIG, there is about $6.1 trillion worth of unrealized gain within investments held by households and corporation in the U.S.[7] Clearly all of that will not find its way into an Opportunity Zone Fund, but a portion of that would certainly go a long way. We still have a ways to go in terms of better understanding and building this investment space and we will be following the progress closely and keep you updated along the way.

[6] https://www.fastcompany.com/3060169/one-of-the-biggest-challenges-of-getting-funding-for-minority-owned-business
[7] https://eig.org/news/joint-economic-hearing-promise-opportunity-zones

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