NorthMarq

Opportunity Zones

MAY 2019

OVERVIEW

Opportunity Zones have captured headlines in recent months, as commercial real estate investors, developers, and Opportunity Zone funds look to identify ways to take advantage of the favorable tax treatments associated with investments in these areas across the country.

The primary reason for all the discussion of Opportunity Zones is the favorable tax treatment associated with reinvesting gains. Another reason is the urgency of making the investments in time to capture the full tax benefit.

Investments in Opportunity Zones must have been held for at least five years by the end of 2026, meaning the investment must be made by the end of 2021 to qualify.

Furthermore, the tax reduction is more significant the longer the investment is held. The potential tax liability is reduced for investments with a seven-year hold, and accrued capital gains on investments held for at least 10 years become tax free.

In addition to the favorable tax treatment, one of the unique characteristics of the Opportunity Zone program is that the gain does not have to be limited to a capital gain from real estate to benefit from the program. In this way, the Opportunity Zone is different from the 1031-exchange.

Investors who have realized a capital gain from other investments—likely in the stock market—could take those proceeds and allocate assets into an investment in an Opportunity Zone project or fund for preferential tax treatment. This could prove particularly beneficial given the gains realized in the stock market's bull run of the past few years and the uncertainty of the economic outlook in the next few years.

One note of caution: The program continues to evolve as the Internal Revenue Service and the Treasury Department work to clarify the regulations surrounding Opportunity Zones. Consult a qualified tax professional for the most recent updates.

QUALIFIED OPPORTUNITY ZONES RETAIN THE DESIGNATION FOR 10 YEARS

HOW THE PROGRAM WORKS

There are approximately 9,000 Opportunity Zones across all 50 states. These designated zones encompass a population of approximately 35 million Americans and more than 1.6 million businesses.

To qualify for the program, the Opportunity Zones had to meet certain poverty and income criteria. First, the census tract must have a poverty rate of at least 20 percent, and the median income in the area must not exceed 80 percent of the metro or state figure. In addition, only 25 percent of the census tracts in a particular state could be designated as an Opportunity Zone.

Upon investing in a property in an Opportunity Zone, the buyer must make capital investments to substantially improve the property, either through redevelopment of an existing property or through development of raw land into a commercial/residential use. The investor has 31 months from acquisition to make the substantial improvement.

≈9,000

DESIGNATED OPPORTUNITY ZONES IN THE U.S.

Find the Opportunity Zones in your state here: http://bit.ly/2UUpDDH

HISTORY

Opportunity Zones were included in the far-reaching Tax Cuts and Jobs Act of 2017, the tax reform that went into effect in December 2017. The Zones are designed as an economic development tool, with the favorable tax treatment intended to spur investment, economic development, and job creation in distressed communities.

The first set of Opportunity Zones—which covered parts of 18 states—were designated in April 2018. During the second quarter of 2018, governors of all 50 states submitted Opportunity Zones to the Treasury Department for designation.

CURRENT ESTIMATES SUGGEST MORE THAN 1.6 MILLION BUSINESSES ARE CURRENTLY OPERATING IN DESIGNATED OPPORTUNITY ZONES

LOCAL KNOWLEDGE IS ESSENTIAL

While there are some general criteria that a site or census tract must meet to qualify for the program, the governors throughout the country held significant power in nominating the particular sites for the program. As a result, local market knowledge will be key in determining what acquisition/development strategies will be successful in a particular market. **This Opportunity Zone program is not one-size-fits-all.**

PROGRAM HIGHLIGHTS

- Allows for **more time** and **more flexibility** than the traditional 1031-exchange program
- Allows for **180 days** to identify the replacement property
- Investment in both **raw land** and **real property** are allowed
- The investment **does not need to be made** in a **"like-kind" asset**

DESIGNATED OPPORTUNITY ZONES ARE LOCATED IN ALL 50 STATES, THE DISTRICT OF COLUMBIA AND U.S. TERRITORIES

STRATEGIES THAT FIT

Some strategies seem to be a natural fit for the Opportunity Zone program, given the general criteria of the eligible census tracts.

DEVELOPMENT OF VACANT PARCELS

This will allow the investor to easily clear the substantial improvement hurdle. The challenge will be in assessing the demand for what is to be developed, working within any zoning/planning restraints, and getting the project through the development pipeline in the 31-month period allotted.

INDUSTRIAL OR DATA CENTER DEVELOPMENT

The high build-out costs for data centers, or heavy manufacturing facilities, or even for distribution centers as online retailers try to solve the last-mile movement of goods, would likely satisfy the substantial improvement criteria.

MANUFACTURED HOUSING COMMUNITIES

The demand for affordable housing has tightened vacancy levels in manufactured housing, and some investors may choose to add spaces to meet the substantial improvement demands of the program. Another potential option would be to redevelop manufactured housing communities into higher-density apartment projects.

OLDER CLASS B OR CLASS C MULTIFAMILY COMMUNITIES

Properties that have not been through significant renovations could also be a target of investors seeking to leverage the high demands for rental housing and the tax benefits of Opportunity Zones. Given the capital investment required to meet the substantial improvement criteria, investors may have to add density to some projects if possible.

AVERAGE POVERTY RATE

U.S. AVERAGE = 17%

OPPORTUNITY ZONES = 32%

MEDIAN HOUSEHOLD INCOME IN DESIGNATED CENSUS TRACTS AVERAGED 37% BELOW THE AREA OR STATE MEDIAN

TAX BENEFITS

The tax benefit to investing in an Opportunity Zone is the deferral or elimination of a capital gain on an earlier investment. In order for an investor to qualify for a tax deferral benefit, the investor must place the amount of a realized capital gain into an Opportunity Zone investment—or an Opportunity Zone fund—within 180 days of realizing the gain.

There is a scaled system of tax benefit when investing in a property within the Opportunity Zone framework. Investors who hold the investment for at least five years receive a reduction in the tax due of 10 percent. Investments maintained for seven years qualify for a 15 percent reduction in the amount of the taxed capital gain.

Finally, in addition to the deferred payment and 15 percent reduction in tax liability for invested capital gains, investments held in Opportunity Zones for 10 years or more receive an the added benefit of having accrued capital gains from the Opportunity Zone investment itself become fully tax free.

If an investor holds an investment in the Opportunity Fund for at least **10 YEARS,** the investor would be eligible for an increase in its cost basis equal to the fair market value of the investment at the time of sale—effectively **ELIMINATING TAX** from the gain in the fund

INVESTORS CAN DEFER TAX ON PRIOR CAPITAL GAINS UNTIL NO LATER THAN DECEMBER 31, 2026, IF THE GAIN IS REINVESTED IN A QUALIFIED OPPORTUNITY FUND

TIMELINE

DECEMBER 2017
The Tax Cuts and Jobs Act passes on December 22, 2017. As part of the tax package, the Opportunity Zone program is established.

MARCH 2018
First deadline for states to nominate low-income communities to be designated as Qualified Opportunity Zones

APRIL 2018
The Treasury Department and the IRS designate the first round of Opportunity Zones in 18 states/territories

JUNE 2018
Treasury and the IRS announce the designation of the final round of Opportunity Zones in all 50 states, the District of Columbia and five U.S. territories

DECEMBER 2019
Year-end 2019 is the deadline to maximize the tax deferral benefit for invested proceeds held less than 10 years

CONTACT: PETER O'NEIL | DIRECTOR OF RESEARCH | 602.508.2212 | poneil@northmarq.com

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