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HOW TO INVEST IN OPPORTUNITY (ZONES)

New tax incentives are designed to broaden real estate investors' horizons.
Rebecca Lake, Contributor | Nov. 2, 2018, at 10:27 a.m.

To qualify for tax incentives, opportunity zone investments must be made through a qualified opportunity fund. **(GETTY IMAGES)**

OPPORTUNITY IS KNOCKING for real estate investors, thanks to the Tax Cuts and Jobs Act of 2017. A provision of the act allows investors to enjoy preferential tax treatment when investing in economically-distressed communities.

“The basic idea is that the governors of each state designated specific geographic areas to be opportunity zones, based on economic need and desired paths of growth,” says Derek Uldricks, president of Virtua Capital Management in San Diego. He says the program is designed to encourage investors to inject capital into these opportunity zones, potentially spurring economic growth.

Blake Christian, a certified public accountant in Long Beach, California, says investors will pour hundreds of billions of dollars into the 8,700-plus census-designated economically challenged communities in the U.S. In return, they stand to reap generous tax rewards.

“The opportunity zone program allows individuals and businesses to liquidate a wide variety of appreciated capital assets and to reinvest all or a portion of the gain into qualified opportunity

funds within 180 days of triggering the gain," Christian says. "The gain can then be deferred up until Dec. 31, 2026."

In addition to deferring gains, taxpayers can reduce their recognized gain by 10 percent after holding the asset for five years, and by an additional 5 percent after holding it for seven years, Christian says. The biggest benefit comes at the 10-year mark.

"At that point and into the future, the investor will be exempt for any gain that accrued after the original re-investment," he says.

Christian offers an example of what that benefit is worth. Under those guidelines, an investor who invests $1 million in an opportunity fund in 2018 and sees their investment appreciate to $1.8 million by 2028 would be able to sell at any time after that without paying federal income tax on proceeds in excess of $1 million.

"Ultimately, the tax benefits act as subsidies," Uldricks says, "making projects that were not economically feasible into projects that are now feasible, as well as accelerating the inflow of capital to real estate development."

Opportunity zones are new territory for investors. Here's what you need to know if you're considering taking the plunge.

Investment structure matters. To qualify for tax incentives, opportunity zone investments must be made through a qualified opportunity fund, which can be established as a partnership or corporation.

After selling or exchanging an asset, "the taxpayer rolls over cash equal to its gain for an interest in the fund," says Erik Loomis, tax partner at Cox, Castle & Nicholson in Los Angeles. "The fund then has to own qualified opportunity zone property, which is either another corporation or tax partnership that runs a qualified opportunity zone business, or the fund invests in the qualified assets directly."

Loomis says it's important for investors to note that the fund you're investing in owns the qualified property, "because it is the taxpayer's interest in the fund that receives the benefit under the statute, not the underlying qualified opportunity zone property."

He goes on to say that "while the statute posits a very simple rollover of gains into this interest, the devil is very much in the details as to the exit strategy with respect to the interest in the fund."

Not every property is eligible for tax benefits. Know the rules for what you can – and can't – invest in with opportunity funds. "An opportunity zone fund is required to invest, directly or indirectly, in an income-producing business located in a qualified opportunity zone," says Jamie Null, an attorney at London-based global law practice Eversheds Sutherland.

Whether a business is eligible may be open to interpretation, depending on its use.

“If the fund holds an apartment building and triple net leases it, is it a business? Maybe not,” Loomis says. On the other hand, “if the fund instead holds and operates an apartment building, it has a much better case for holding qualified opportunity zone property.”

Similarly, if a fund holds a shopping center it most likely qualifies, except for some kinds of property that might be present. There are specific categories of businesses that can’t qualify for indirect investment, including private and commercial golf clubs, tanning salons, country clubs, massage parlors, hot tub facilities, gambling facilities and liquor stores.

Christian says opportunity zones can also include developed or undeveloped land investments. Regarding the list of excluded businesses, he notes that “the statute simply precludes investing in businesses that operate in such industries, but an opportunity zone fund can still start such businesses.”

Investors should be focused on long-term ownership when choosing properties, says Scott Meyer, managing principal and chief investment officer of Kairos Real Estate Advisors in South Miami, Florida.

“An investor cannot benefit from the tax incentives if their plan is to buy a stabilized asset, throw a new coat of paint on it and call it a day,” Meyer says. Properties must meet the substantial improvement test, excluding land value, set forth by the Internal Revenue Service.

To pass the test, Meyer says, investors must double their adjusted basis in their investment after the initial purchase and during any 30-month period that they hold a qualified opportunity zone property.

Think long-term and keep risk in perspective. Investing in distressed properties isn’t a new concept but opportunity zone investors shouldn’t skip due diligence. That includes choosing the appropriate fund structure, such as a real estate investment trust.

“Limited liability companies taxed as partnerships will likely produce the best tax results during the operating phase, as well as upon disposition,” Christian says. “Real estate investment trusts are an allowable legal structure for opportunity zone funds, so REITs will gain more advantage by investing in opportunity zone properties.”

Null says more sophisticated investors may not appreciate that certain tax benefits found in typical investments, such as losses from depreciation shielding income, may not be available for qualified opportunity zone investments. Taxpayers also need to be mindful of state tax consequences and whether their state follows federal taxation rules for opportunity funds.

In terms of risk, Uldricks says opportunity zone investing is not materially different from other types of real estate investing. He believes that capital will flow primarily to ground up real estate development, which carries a unique set of risks. As such, “it’s imperative to partner with program sponsors that are sophisticated in the underlying investment strategy of the fund or asset.”

One final consideration is how opportunity zones fit into your larger portfolio picture and your window for investing.

“To reap the full tax benefits, investors need to invest in the opportunity zone fund for 10 years,” Uldricks says. “Therefore, it’s important for investors to consider their liquidity needs carefully before investing.”