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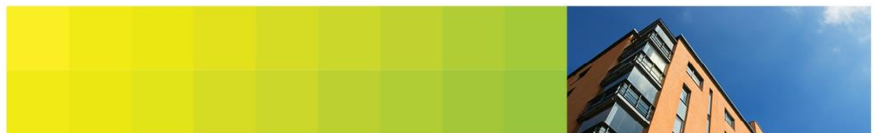

Opportunity Zones – An Overview

An examination of what Opportunity Zones are, and potential risks for both communities and investors

As part of the Tax Cuts and Jobs Act (TCJA) passed in December 2017, Congress approved the creation of Opportunities Zones, which are economically depressed communities characterized by high poverty and subpar employment opportunities. The importance of these designated areas comes from the tax benefits associated with qualifying investments in them, which, in theory, will help transform these economically blighted communities into areas of opportunity for their residents. Some industry analysts predict that the magnitude of this tax break will be one of the largest in U.S. history.

There are over 8,700 Opportunity Zones[1] (classified at the census tract level) throughout the country with roughly 35 million current residents. Each state's governor was responsible for recommending Opportunity Zones and designated 25 percent of their low-income communities to be certified by the IRS as Opportunity Zones.

The goal of this initiative is to leverage private capital to revitalize communities that struggle with high rates of poverty and underinvestment. To attract capital, the program allows for capital gains related to a current sale or transaction to be deferred until December 31, 2026 if investors place their capital gains into a fund that provides qualified equity investments in Opportunity Zones. This fund is referred to as an Opportunity Fund, and both individuals and institutions can contribute to these funds. Investors have roughly $6 trillion in unrealized capital gains, which provides the opportunity for an immense amount of potential investment under this initiative.[2]

Investors who make qualifying investments in Opportunity Zones will receive preferential tax treatment in three ways:

1. Tax deferment on capital gains until the year 2026 (the year in which some TCJA provisions expire) or until the fund is sold
2. A 10 percent reduction in the amount of taxes owed if the investment is held for five years, or a 15 percent reduction if held for seven or more years
3. Potential tax-free growth on the Opportunity Fund so long as the investment is held for at least 10 years

Opportunity Funds can be invested in a wide variety of qualified equity investments. These include real estate, operating businesses and business assets, but exclude businesses such as golf courses, massage parlors and liquor stores. Opportunity Funds have the potential to generate a relatively attractive return for investors with existing capital gains, as seen in Exhibit 1 on the following page.

Exhibit 1: Opportunity Zone Investment vs. Traditional Investment

Transactions	10 Years		5 Years	
	Traditional Investment	Opportunity Fund	Traditional Investment	Opportunity Fund
Initial Capital Gains	$10,000,000	$10,000,000	$10,000,000	$10,000,000
Capital Gains Tax	- $2,380,000	- $0	- $2,380,000	- $0
Funds Available for Reinvesting	$7,620,000	$10,000,000	$7,620,000	$10,000,000
Before-Tax Reinvestment Proceeds (Assuming a 13% return)	$25,866,604	$33,945,674	$14,039,356	$18,424,352
Capital Gains Tax (on Initial Capital Gains)	- $0	- $2,023,000	- $0	- $2,142,000
Capital Gains Tax (on Reinvestment)	- $4,342,692	- $0	- $1,527,807	- $2,004,996
Total Return (Relative to Initial Capital Gains)	**$11,523,912**	**$21,922,674**	**$2,511,549**	**$4,277,356**
Illustrative Annualized Return	**8.0%**	**12.3%**	**4.6%**	**7.4%**

Source: Freddie Mac interpretation of Opportunity Fund investment structure. Note that this example is intentionally simplistic and intended only to illustrate the relative benefit of an Opportunity Fund investment. As such, this is not meant to be investment advice. Opportunity Fund returns assume that debt is not used in financing of the fund's assets. Additionally, total returns are after-tax calculations based on initial capital gains before tax, which explains why all returns are lower than the assumed 13% annual return.

If proceeds from the capital appreciation of an asset are diverted into an Opportunity Fund, then the investor avoids capital gains tax immediately following the sale of the asset. This means that more funds are available for a subsequent investment, as seen in the third line of the table ("Funds Available for Reinvesting").

Assuming a constant annual return for both investment types, Opportunity Funds earn substantially more return at the five- and ten-year mark. For both investment horizons, investors in Opportunity Funds pay the initial tax liability when the gains of the subsequent investment are realized, or in the year 2026, whichever comes first. The tax liability is 15% less for the ten-year investment and 10% for the five-year investment, as illustrated below.

Capital Gains Tax Comparison[i]

$$Traditional\ Investment: \$10{,}000{,}000 * 23.8\% = \$2{,}380{,}000$$

$$Five\ Year\ Opportunity\ Fund: \$10{,}000{,}000 * 23.8\% * 0.90\% = \$2{,}142{,}000$$

$$Ten\ Year\ Opportunity\ Fund: \$10{,}000{,}000 * 23.8\% * 0.85\% = \$2{,}023{,}000$$

The difference between the five-year and ten-year Opportunity Fund is that the ten-year fund does not have to pay taxes on capital gains from the reinvestment (as seen by the zero value in the "Capital Gains Tax (on Reinvestment)" line). As seen in this example, regardless of the investment horizon, Opportunity Funds outperform a traditional fund by a meaningful margin.

i As a reminder, capital gains on Opportunity Funds are only paid when the fund is sold or in the year 2026, whichever comes first.

Market-rate rental housing will be one of the most popular outlets for Opportunity Zones. As of March 8, 2019, there are 105 Qualified Opportunity Funds with funds totaling over $19 billion. Of these 105 funds, 70 (representing roughly $15 billion in assets or about 75 percent) have an investment focus of multifamily residential development, however only eight of these funds focus solely on multifamily housing. Of all funds that have a multifamily investment focus, 28 (40.0 percent) also have an explicit focus on affordable housing and 27 (38.6 percent) focus on student housing. 26 of the 70 fund portfolios have a national footprint, while the majority either focus on specific states or general regions of the country (e.g. the Northeast).[3]

Looking ahead, Opportunity Zones may experience some increased Low-Income Housing Tax Credit (LIHTC) activity, but it's not likely to be substantial. Financial institutions are the primary LIHTC investors, whereas Opportunity Fund investors are more likely to be high-net-worth individuals, managed investment funds, life insurance companies, and mutual funds. Banks will have limited involvement because they are generally not allowed to make equity investments and, as a result, they do not have capital gains to reinvest. The Michigan State Housing Development Authority plans to incentivize Opportunity Zones in the allocation of tax credits, and other housing finance agencies may follow suit. Boston Financial Investment Management estimates that Opportunity Funds will provide 2 percent to 4 percent of the total equity in LIHTC projects.[4]

A tax break of this size and type is not without risks. For one, the program is not population-based, but instead location-based. Population-based incentive programs work by providing enough funding to make an otherwise infeasible project possible. On the other hand, location-based programs don't directly provide an incentive to subsidize a specific population, but instead make the cost of development cheaper in a defined area, regardless of whom it serves. While overall investment activity could increase, there is no industry consensus that these programs work as intended.[5]

There is concern that, in some cases, an Opportunity Zone designation could negatively impact current residents of these areas since there is no established safeguard to prevent displacement of current residents. Even for communities that could benefit from this investment, viable opportunities may be scarce since areas must be stable enough to attract investor demand, but also be in enough need that they qualify for the program.

From an investor's perspective, risks include limited IRS regulation and guidance, asset performance, the investment timeline and the eventual payment of capital gains taxes. For maximum tax benefit of the deferred tax incentive, an investment in an Opportunity Zone must be held for seven years. The sunsetting of certain provisions in 2026 means that investments must be placed by the end of 2019 to gain all of the benefits of the Opportunity Zone program. This may create a rush to invest in these zones, which may create additional risks for the investors. In addition, the vast majority of capital gains taxes that were initially deferred must be paid on December 31, 2026 regardless of the whether or not the fund investment is sold.

Whether Opportunity Zones can revitalize communities and enhance the economic opportunity of their residents is not yet known. Whatever the eventual outcome, Opportunity Zones will influence multifamily market activity in low-income markets across the country in the coming years and will likely be a focus area of researchers, developers, investors and policymakers.

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[1] https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx
[2] https://www.forbes.com/sites/jenniferpryce/2018/08/14/theres-a-6-trillion-opportunity-in-opportunity-zones-heres-what-we-need-to-do-to-make-good-on-it/#5896c5fa6ffc
[3] https://www.ncsha.org/resource/opportunity-zone-fund-directory/
[4] https://www.housingfinance.com/finance/opportunity-zones-and-tax-credits-a-match-made-in_o
[5] https://www.marketwatch.com/story/a-tax-break-to-hasten-gentrification-housing-markets-opportunity-zones-may-miss-their-target-2018-11-23