

Opportunity Zones Program

The Opportunity Zones program passed as part of the 2017 Tax Cut and Jobs Act (TCJA) in December, the federal program gives investors a tax break in exchange for investments in underserved communities.

Promulgated by Senator Tim Scott and Representative Pat Tiberi, The legislation heralded by TCJA promulgates a new and potentially unrecognized geographically-targeted investment incentive program.

The inclusion of Qualified Opportunity Zones appears in the new Section 1400Z of the Internal Revenue Code (IRC) of 1986, as amended (the Code).

Due to the broad base of potential investors and eligible projects, property, and transactions, this program has the ability to provide substantial returns to investors, administrative opportunities for funds, and subsidy for eligible projects and businesses.

The establishment of these zones allowed governors to designate up to 25% of their state's low-income Census tracts as tax-favored opportunity zones where investors can defer taxes by taking capital gains from other investments and reinvesting them in these areas.

Specifically, the program allows investors to defer taxes on capital gains income until 2026 so long as 90 percent of their investment stays in designated low-income communities via properties or businesses.

For Metropolitan New York, many real estate professionals would take the view that the migration of investment dollars to Bronx and East New York, for example, has already been set in motion and that the Opportunity Zone program will only turbo-charge investor's drive for commercial real estate yield in the areas – and it looks as though it even applies to business, etc. – on top of other tax credits which are by no means inapplicable (Low Income Housing Tax Credit - LIHTC and New Markets Tax Credit – NMTC, see attached). Still Treasury has not released much in the way of details on the program.

The reconciled tax legislation does not materially alter this array of existing tax credits.

The implementation of TCJA will result in revisions of tax policy that indirectly affect them such as the lowering of corporate rates, provisions

regarding international repatriations and provisions related to real estate investments will all impact the pricing of tax equity.

But the Treasury Department has yet to set out the rules of using the program, leaving it open for interpretation—for the time being at least—and prompting a nationwide head-scratching on what, exactly, constitutes an eligible gain, what types of assets and businesses are eligible vehicles for the re-investment and even where, exactly, these assets must be located.

The potential benefits can also accrue to investors, developers and nonprofits.

The established and verified definition an eligible Opportunity Zone Fund has yet to be formally tried and tested.

To date, “qualified opportunity funds” are set to be reviewed and approved by the Community Development Institutions Fund of the Treasury Department along similar lines to allocation of New Markets Tax Credits to “community development entities.”

Once determined, such “qualified opportunity funds” are held to the standard of maintaining 90% or more of assets in “qualified opportunity zone property.” This threshold includes investments in “qualified opportunity zone partnership interest”, “qualified opportunity zone business property” and “qualified opportunity zone stock”.

The qualifications as “qualified opportunity zone stock,” “qualified opportunity zone partnership interest,” and “qualified opportunity zone business property” Potentially eligible investments include investments in tangible property such as multi-family and commercial real estate assets, equipment so long as the investments are made in geographic areas prescribed as qualified opportunity zones.

The hope is to generate economic energy in these areas, and with as little guidance as there is, investors are excitedly gearing up to deploy capital in opportunity zones.

Many of the interested parties are raising funds to construct affordable housing Both capital “A” “Affordable” or simply “affordable”) projects in these areas where previously projects did not make financial sense.

Municipalities are rightfully anticipating renewed economic examination and reinforced economic support. On top of a relatively high national economic tide, investors are, collectively and in mass, analyzing and assessing potential investment opportunities in a new, tax-free light - and

opportunities in areas not commonly viewed as commercially viable investment arenas or, alternatively, adding fuel to a development market already racing ahead of national peers.

The idea is to lure development to low-income areas — around 8,700 communities were selected by governors across the country as possible opportunity zones.

The state of New York suggested 514 census tracts to become zones, including parts of the five boroughs, Long Island and rural areas of the state.

The Opportunity Zone Program works as follows:

As part of the 2017 Tax Cuts and Jobs Act, Opportunity Zones were designed to create incentives for long-term, private investment allocation into U.S. communities that needed such capital investment the most. Substantial and favorable tax relief following investors transferring a realized capital gain into an Opportunity Zone investment.

Such investors have 180 days to re-invest an eligible gain into an Opportunity Fund. In turn, and through the Opportunity Zone Fund vehicle.

On its face, the Opportunity Zone program affords a provides a flexible tax exposure postponement utensil for both long term and short term capital gains taxes for current investments in a yet-unqualified pool of asset types.

The program is notably unique to the real estate investment tool Section 1031 “like-kind” exchange. Unlike the 1031, Opportunity Zone investments will ostensibly offer investors:

1. the option to transfer just the gain on their exchange as opposed to the entire original investment.
2. a wide gamut of potential investment asset types and categories eligible for favorable IRS tax treatment.
3. A possible 15% step-up in basis which could constitute materially more of the initial extended capital allocation.
4. Eligibility to reduce entirely all taxation on capital gain exposure post-investment after a 10 year hold period.

The intent of the Opportunity Zone program is to inject into commercial property, development and entrepreneurial projects and business of all sorts viable financing alternatives equating to a lasting financial appropriation and economic development spur.

Since a reading of the current Act 2017 Tax Cut and Jobs Act as currently written financially incentivizes both individuals corporates a unique opportunity to defer and eventually mitigate altogether capital gains and materially step-up the basis of an investment in the meantime.

Most dramatically, the Opportunity Zone program is dual-pronged in that it both prompts and maximizes private subsidy for asset and business investing in these jurisdictions, it also maximizes the return for investors, entrepreneurs and project developers in those same areas and others.

Developers, Project Managers, Entrepreneurs and Investors of all kinds yet prescribed with any meaningful precision benefit from the following:

Day 1: Since the otherwise-taxable capital gain is invested into an Opportunity Zone Fund, the capital gains tax liability is deferred until the earlier of (i) December 31, 2016 or (ii) Opportunity Zone Fund investment exit.

Year 7: 15% Step-up in basis is afforded to the investment, such that if \$100,000 of capital gains is invested for example, the investor will only owe \$85,000.

Year 10: All post-investment appreciation is considered by the IRS to be tax-free after 10 years because, upon sale of the asset after 10 year holding period, the investor receives a step-up in basis to Fair Market Value (FMV). By way of example above, if the \$100,000 investment holds a FMV of \$175,000. The \$75,000 in appreciation over the life of this 10-year holding period is not subject to any capital gains liability whatsoever upon disposition of the investment asset.

Under the previous IRS tax regime, proceeds would be taxed as a capital gain carrying a maximum federal rate of 20% with an additional surtax of 3.8%. Re-deployed into an Opportunity Fund, the IRS tax liability on this profit can be deferred altogether.

In sum, the tax advantage offered in an Opportunity Zone grows the longer the investment asset is owned by the investor.

Holding the investment asset for 7 or more years will see the capital gains tax otherwise due and payable to the IRS diminish by 15%.

If the holding period exceeds 10 years, capital gains taxes on any proceeds are avoided altogether.

Given the meteoric rise of the equity markets of late, the Economic Innovation Group estimates that at least \$2 trillion on balance sheets across the U.S. is in the category of unrealized capital gains.

New York State proposed 514 Census Tracts as potential opportunity zones that included not just rural areas of the State but parts of Long Island and areas of Metropolitan New York and the five boroughs.

Even though the Census Tract nomination process was concluded in April, the specific regulations have yet to be released by U.S. Treasury.

This ambiguity currently leaves investors in the dark, not only in connection with the precise regulations and tax ramifications of investments in these particularly areas, but also the areas themselves and which areas are eligible for favorable tax treatment.

So investors are still scratching their heads on what, exactly, qualified as an eligible gain on an investment and also what types of eligible investments can be made with this gain, once verified and, furthermore, where such investments can be made.

Clearly the ambiguity around the Opportunity Zones has generated unprecedented interest, although this very ambiguity is what pre-empts or at least mitigates and precise action plan on behalf of investors looking to deploy capital into an area that they cannot be certain will qualify. The U.S. Treasury or other governmental branches have yet to provide much in the way of guidance on any of these particular, yet exceedingly critical, prongs.

On the other hand, numerous are the would-be investors looking to both capitalize on this unique incentivization structure and also afraid of missing the boat on, say, asset pricing in a particularly compelling opportunity zone – especially in circumstances where the investment would be considered.

Pravina Raghavan, Executive Vice President of the Empire State Development spearheaded the creation of New York's zones, notes that early investors reached out prior to the Census Tract nomination process and possibly made their investments then and there while they seek further clarification on exact developmental plans, for example.

Shorewood Real Estate Group, for example, recently announced it had closed on a 27K SF development site in Jamaica, Queens. The investment was touted as the firm's first Opportunity Zone Fund platform acquisition – although what this means, the benefits expected and the tax treatment afforded to such an acquisition is much less clear and likely to be ambiguous for some time, certainly long after closing.

Through the provision of tax incentives to private investors which make long-term equity capital investments in relatively low-income communities, the U.S. Treasury intends to catalyze the injection of investment allocation in these jurisdictions that have been investment-disadvantaged or at least meet their State's low-income Census tract thresholds.

Qualified Opportunity Funds are the special funds designated by U.S Treasury as the eligible recipients of investor's realized capital gains. These deferred gains can be re-invested for the long-term to the tune of advantageous tax treatment to the extent that capital gains exposure is mitigated altogether (after a 10 year hold period), appreciation on that step-up basis is tax-free.

The Qualified Opportunity Funds are obligated to invest in "Permitted Investments" which currently appear to include an array of business and real estate assets, development and entrepreneurial projects, infrastructure development and projects, mixed-use and residential projects and development and seemingly most investment projects in between.

Since the U.S. Treasury looks to each state to individually nominate up to 25% of its low-income census tracts to be designated and certified by the U.S. Treasury as Qualified Opportunity Zones, states have been quick to deliver, and New York is no exception.

Of the 514 low-income Census tracts for designation as Opportunity Zones by the Empire State Development and Regional Economic Development Councils, 306 of the low-income Census tracts are located within the five boroughs of New York City.

Manhattan: Inwood, Harlem (125th Street corridor)

Brooklyn: Sunset Park, Brooklyn Navy Yard

Queens: Long Island City, Jamaica (select areas), Southeast Queens, Far Rockaway

Bronx: Hunts Point, South Bronx (select areas)

Staten Island: Bay Street Corridor, North Shore

Building on immediate capital asset tax expensing while maintaining current and existing tax credit programs is intended to drive economic growth and positive community impact across an array of industries in specific sectors.

Among Congressional aims in the Opportunity Zone program implementation:

- Expanding affordable housing design, development, construction, maintenance and operation
- Facilitating and encouraging low-income community investment and favorable social impact investing
- Fostering and enhancing private capital asset investing, including equipment with the aim of ongoing and lasting expanded income production
- Development of specific renewable energy technologies such as solar and wind and environmentally conscious design, development and construction

Conclusion

Due to the broad base of potential investors and eligible projects, property, and transactions, The Opportunity Zones program has the ability to provide substantial returns to investors, administrative opportunities for funds, and subsidy for eligible projects and businesses.

The program is likely to afford unheralded tax and investment return advantages for an array of investors in a wide variety of assets and, most importantly, ultimately succeed in Congressional intent of generating additional, long-lasting and tangible social impact investment in areas most in need of infrastructure, redevelopment and business growth.

Qualified businesses, entrepreneurial endeavors, renewable energy technology concerns, commercial property, businesses, and projects new and existing will benefit from incentive as a low-cost subsidy for growth and private investment.

For any individual, business or investment fund the Opportunity Zone program should prove a marvelously useful tool in capital gains deferral and for anyone, really, considering investments in low-income communities – and interestingly should provide a little-needed boost in some areas already experience redevelopment renaissance.

On its face, the legislation seems to transplant and replace in these areas a utensil to defer capital gains for short term investments in a form more favorably than the current Section 1031 “like kind” exchanges.

In any event, the Opportunity Zones program provides both short and long term capital gains deferral, substantial step up in tax basis, and tax abatement of all post-investment appreciation which is both unprecedented in the tax code and difficult for the return-conscious investor to argue with.

The Economic Innovation Group suggests that 1 in 6 Americans reside in a “distressed community” with median household incomes are stagnant and at a level well beneath the national average of \$59,000 a year.

These communities are also characterized by a poverty rate exceeding the average on a national basis. According to Census data, these distressed communities lost 6 percent of their jobs and a similar share of their business establishments from 2011 to 2015.

While the economy of course grew generally during these years and jobs overall have been added in abundance, most of this growth was disconcertingly evidenced in large metropolitan areas.

The Metropolitan Policy Program at the Brookings Institution in Washington suggests that in 2010, about 1/2 of the job growth stemmed from roles in U.S. metropolitan areas. Yet in the subsequent 5 years from 2010 to 2016 this proportion rose to almost 75% of job growth.

Meanwhile, areas in the rural U.S. saw only 3% of job growth in these years and commercial business activity actually shrank. How best to incentivize business, investors and entrepreneurs to these areas than make it much cheaper for them to come and even cheaper for them to stay?

The Opportunity Zone program is not the first federal effort at attracting investment dollars into distressed communities. The Clinton administration introduced the Enterprise Zones to mixed results.

By most accounts, the effectiveness of these previous efforts has been lackluster. Economic Development professionals Lambert and Coomes, for example, found in 2001 that the enterprise zone established in Louisville, KY did not benefit local neighborhoods in a tangible way despite having a goal of community re-development. Instead, the effort benefitted larger corporations over less established entrepreneurs.

The New Markets Tax Credit, on the other hand, is alive and well if more granular tax incentive program and benefit investors concurrently in with the Opportunity Zone program.

However, critics suggest that if the wrong areas are designated as Opportunity Zones for the wrong reasons, the U.S. taxpayer would be in effect footing the tax bill for an investment allocation already made or at least planned.

This is particularly the case in Metropolitan New York where the legislation seems to be lagging behind organic migration and naturally-occurring economic development. In designated Opportunity Zones like the 125th Street corridor in Manhattan and parts of and Greenpoint, Brooklyn, this concern resonates loudly.

Particularly for those already seeking to deploy capital into an urban investment asset such as East New York or the South Bronx, or in any one of of about 8,700 other examples, any compelling investment opportunity has just made to look a lot more enticing with yet another reason (or 3 or 4) to act before January 2020 with a triple-pronged tax break:

- An otherwise immediately due and payable tax on a capital gain is automatically deferred for as long as the re-investment is held for up to December 2026.
- 15% reduction on those capital gains when they are eventually taxed in 2026.
- Tax free appreciation on the Opportunity Zone investment asset itself.

The designated Opportunity Zones run the gamut from inner cities (125th Street corridor in Manhattan) to anywhere in Puerto Rico.

Once the investment is in a designated area, just about anything goes as far as qualifying investments – could be real estate although certainly no limitations – businesses, start-ups, restaurants, renewable energy concerns. The one limitation is that Congress cannot consider the business a vice (liquor stores, massage parlors, etc.).