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OPPORTUNITY ZONES, CREATED BY THE 2017 TAX ACT, DESIGNATE ECONOMICALLY DISTRESSED COMMUNITIES FOR INVESTMENTS THAT MAY BENEFIT FROM CERTAIN TAX ADVANTAGES. THESE TAX ADVANTAGES ARE SIGNIFICANT AND SHOULD BE ON THE RADAR OF INVESTORS WITH CAPITAL GAINS TO DEPLOY.

The Opportunity Zone opportunity

What are Opportunity Zones and how can investors use them to mitigate taxes on capital gains?

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There is a new investment opportunity out there, and a strongly tax-favored one at that, known as Opportunity Zone Funds ("OZ's" or "O-Zones" for short). The purpose of this paper is to explain this new investment category, with a particular focus on the tax and investment implications for investors.

OZ's were created by last December's American Tax Cuts and Job Act (ATCJA), and while we are still in the early innings and investments funds around these new rules are just now taking shape, let's try and stay ahead of the curve. We will attempt here to share a high-level summary of just what an OZ is and where the opportunities may lie.

To begin, an opportunity zone is an economically distressed community where new investments may be eligible for preferential tax treatment. Localities qualify if they have been nominated for that designation by the governor of their state and that nomination is then certified by the IRS. As of June, 2018, there were OZ's in all 50 states.

The law establishes a vehicle called a Qualified Opportunity Fund as the investment by which the investor can access these tax benefits. To qualify, these funds must use at least 90% of their capital to make equity investments in businesses, real estate and business assets in a qualified opportunity zone.[1]

To encourage investment in these funds, there are three levels of tax benefits available to investors:

Temporary deferral of gain If you have gains from the sale of capital assets[2] and reinvest them within 180 days in a qualified OZ fund, taxation of the gain will be deferred. The deferral extends until the earlier of the date the investment in the OZ fund is sold or, December 31st 2026. This applies to both long- and short-term capital gains. Also, a deferred gain can be "rolled over," by electing to re-invest the gain in another OZ fund.

Step-up in basis Those deferred capital gains will experience a step-up in cost basis of 10%, provided your OZ Fund investment is held at least 5 years, and another 5% if held at least 7 years. So a step-up by as much as 15%.

A *permanent exclusion of capital gains tax* on the disposition of an investment in an OZ Fund if it is held for 10 years And if a fund is still in existence after the "sunset" of these provisions on 12/28/2028 (assuming

1. There are many other technical aspects to the compliant establishment of these funds which are outside the scope of this paper.
2. However, probably not gain that is subject to recapture rules, e.g. as the result of previously taken depreciation deductions. Also, when the gain is realized it will be realized in its initial character, for example, short-term gain would remain short-term gain no matter how long the deferral period. Prop. Treas. Reg. 1.1400z.

they are not extended), the "ten year rule" will continue to apply until the sooner of the fund's liquidation or through 2047.

FOR EXAMPLE

With that background, let's walk through an example. Dorothy owns $1 million of Facebook with a basis of $100,000. She decides to sell it and within 180 days invests the gain (not the full proceeds) of $900,000 in an OZ Fund in (because why not) rural Kansas. She stays invested in the fund for a full ten years, until 2028, at which point its value has doubled to $2,000,000. She then sells her interest in it.

The results to her, because she rolled her Facebook gains into the OZ Fund and left them there, are that she will not have to report a taxable event until 2026. And at that time, because she stayed invested in the fund for over 7 years and thereby enjoyed the 15% step-up in basis, she will report the gain calculated as a discount of 15% on the deferred gain of $900,000, and so a taxable gain of $765,000. Finally, she sells her fund interest in 2028; she will owe zero capital gains on that transaction, because she was invested in it for the full ten years.[3] Without this provision the taxable gain would be $1,100,000!

These are attractive tax attributes. Having said that, there is a tried and true adage: tax should never be the tail that wags Toto. First and foremost, any OZ fund must stand on its own merits. A 100% exemption from capital gain does little good if there is none!

PortfoliOZ

While it is still early and OZ funds are just beginning to take shape, from what we have seen thus far they are – not surprisingly – focused on real estate. Considering this, we will share here a high-level look at the role of a real-estate-oriented OZ fund in an investor's overall portfolio.

The key motivations for real estate investing are current income, price appreciation, inflation hedge, diversification, and tax benefits. The introduction of OZ markedly amplifies the tax benefits.

Though, broadly speaking, real estate investments can take the form of equity or debt, qualified OZ funds must consist exclusively of equity participation. Equity investors using the OZ wrapper should expect a higher return, all else being equal, than a non-OZ investment, due to the array of tax benefits.

ASSET ALLOCATION AND REAL ESTATE

There's a lot to like about real estate. It has the lowest volatility and the lowest correlation with other asset classes. It provides the highest return-to-risk ratio and may provide an inflation hedge. Most investors expect real estate to offer an expected return that is higher than fixed income but lower than equities.

However, an important consideration of real estate in a portfolio is its inherent illiquidity. Anyone who has spent six months selling a property and six seconds trading a stock has experienced this. While real estate funds may offer the advantage of greater liquidity than direct real estate investments, OZ funds do introduce a similar illiquidity consideration: to take full advantage of their tax benefits (a permanent exclusion of tax on the capital gain invested), an OZ fund must be held for ten years.

ARE WE IN KANSAS?

For those who have (or anticipate having) capital gains that would benefit from the tax advantages of opportunity zone investments, the nascent category of OZ funds bears watching. In doing so, the quality of the manager and underlying investments is still paramount – regardless of the tax benefits. Fieldpoint Private's research team is investigating these new offerings carefully, and with the risk-sensitive eye that you would expect. Stay tuned. ■

3 The ten-year rule reads as only applying to the sale of the taxpayer's interest in the fund. As such, any capital gains incurred by a fund structured as a pass-through entity, over its life, would likely not qualify for the capital

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