The Stars Have Aligned for Opportunity Zone Investors

Possibly the most compelling tax legislation in decades coupled with a growing sea of unrealized capital gains and the likelihood of higher capital gains tax offer investors a potentially significant opportunity.

Passed at the end of 2017, the Investing in Opportunity Act was ushered into the tax code with unprecedented broad bipartisan and bicameral support. The authors of the legislation sought to drive private sector investment into lower income communities on a long-term basis to stimulate economic activity and provide much needed infrastructure. To do so, the authors composed what many have described as the most compelling piece of tax legislation ever passed, focused specifically on capital gains.

Under the legislation, any U.S. taxpayer who realizes a short-term or long-term capital gain from any source and invests all or a portion of that gain into a designated Qualified Opportunity Zone ("QOZ") may qualify for tax deferral, tax reduction[1] and potential tax-free growth. By targeting capital gains, the authors of the legislation sought to tap a pool of investable capital that was estimated to be as large as $6.1 trillion at the end of 2017.[2] This vast pool of capital was met with an equally significant opportunity set, with the governors of each state selecting eligible communities that total 8,766 census tracts and cover approximately 12% of the total landmass of the United States.

The legislation has drawn strong interest from investors with over $20.2 billion invested in Qualified Opportunity Zone Funds ("QOFs") as of September 30, 2021.[3] Significant asset appreciation and an increasing fear of future increases to capital gains tax rates have the potential to accelerate even greater flows into QOZs in 2022 and beyond.

When the Investing in Opportunity Act was first introduced in Congress in 2016, the Economic Innovation Group conducted an analysis of the Federal Reserve's Survey of Consumer Finances and Financial Accounts of the United States data to derive that U.S. households were sitting on $2.3 trillion in unrealized capital gains in stocks and funds alone at the end of 2015. Fast forward to the end of 2017, that figure climbed to $3.8 trillion, and if you combined that amount with the unrealized capital gains of U.S. corporations at that time, the potential capital eligible for reinvestment into QOZs would total $6.1 trillion.[2] While already significant, the potential pool of capital for QOZ investment has continued to swell. From the end of December 2017 through October 2021, the S&P 500 alone returned 84.6%. Virtually all financial assets have recorded significant appreciation since the introduction of the QOZ legislation, fueled by low borrowing costs, fiscal and monetary stimulus, and increased M&A activity.

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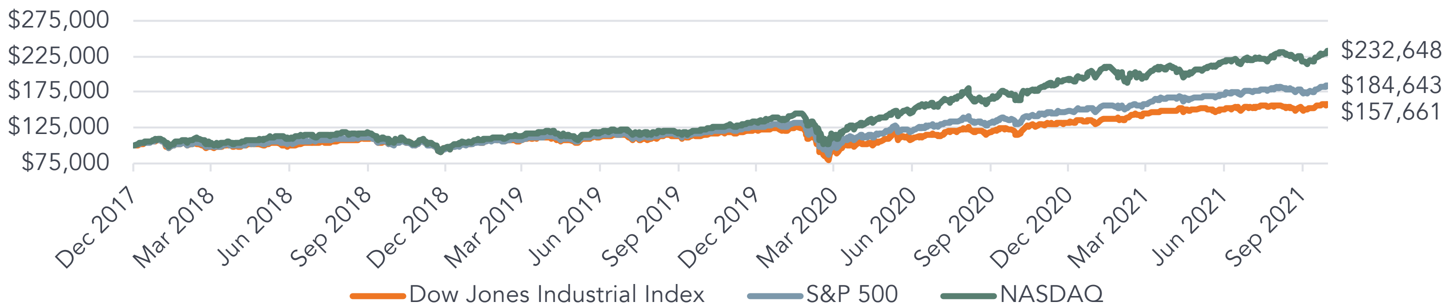
Major Stock Market Indices

(2017–2021)



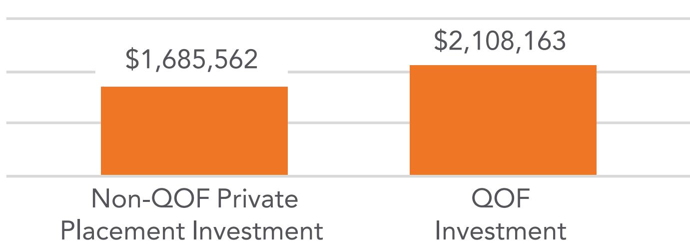
Source: Bloomberg

Not only has the magnitude of unrealized capital gains exploded, expanding the eligible pool of capital for QOZ investment, but also the discussion surrounding tax policy has shifted. As investors prepare for the prospect of future capital gains tax increases, two things are happening. One, investors who have been introduced to the Opportunity Zone concept are trying to understand if it makes sense to take their proverbial medicine now by realizing the gain today at a potentially lower rate rather than invest in a QOZ and defer gain realization until the end of the deferral period (December 31, 2026). What those investors would find is that the benefit of a QOZ investment becomes magnified as capital gains rates increase because of the single most potent tax benefit of the legislation, a full basis step-up on the underlying QOZ investment if held for 10 years. Investors who perform the analysis recognize that by investing in an QOF, they defer paying their current capital gains liability (although the future tax rate may be higher) and receive the benefit of 10 years of potential tax-free growth.[4] This far outweighs the option of paying the capital gain tax today and investing in something that is fully taxable, and then paying taxes on the growth of that taxable investment 10 years or more in the future. Second, as momentum surrounding legislation in favor of future capital gains rates increases is that investors are choosing to expedite their gain recognition, triggering additional demand for tax-planning strategies that address capital gain liabilities.

Hypothetical After-Tax Value of $1 Million Invested for 10 Years at a 9% Annually-Compounded, Pre-Tax Return[5]

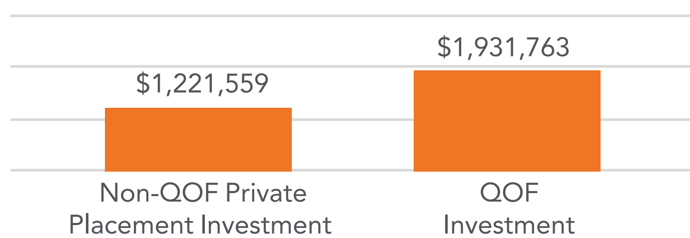
Net After-Tax Proceeds

Fed Tax 23.8% + State Tax 5.0%



Net After-Tax Proceeds

If the federal capital gains tax rate increases to 43.4% + State Tax 5.0%

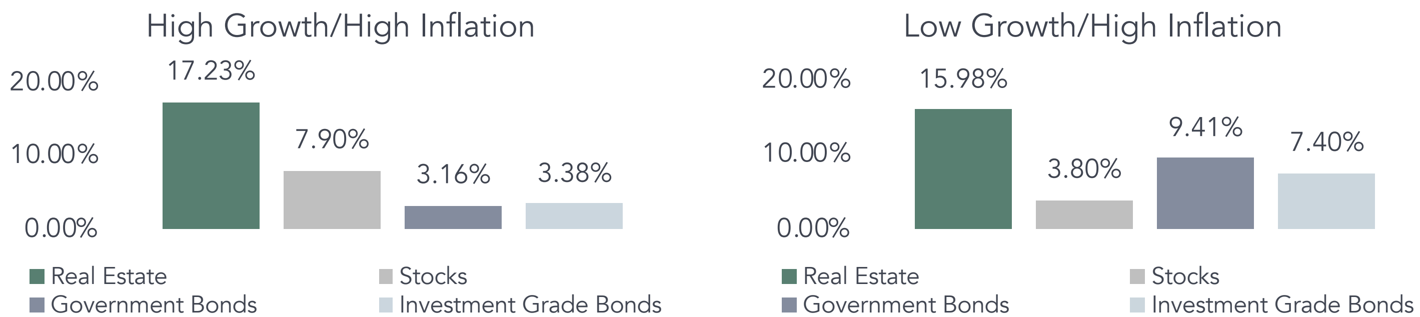


This illustration does not represent any particular QOF investment. It is merely a hypothetical illustration based on the assumptions listed to show the potential tax benefits of investing in a QOF investment. Assumes a federal capital gains tax rate of 23.8% and potential increase to 43.4%, and a hypothetical state tax rate of 5%; state taxes vary, and calculations will change based on both state tax rates and conformance with the QOZ Rules. Some states don't have any taxes or have tax rates under the 5% used in this illustration, and as such the tax benefit differential for residents of those states could be substantially lower than what is shown. Likewise, there are some states that have tax rates above 5% and residents of those states could have a substantially higher tax benefit differential than what is shown in this hypothetical illustration. The tax rates and returns used in the assumptions of this example may vary greatly and should not be construed as any results you would achieve in a QOF investment. There are no guarantees there will be a positive return in any investment. Please see footnote 5 in the endnotes for additional information on this hypothetical illustration.

At the same time, given the concerns of inflationary pressures being more enduring than transitory and anemic yields in traditional fixed income markets, investor receptivity to adding asset classes like real estate to enhance portfolio diversification continues to grow. QOZ investments, which are predominantly real estate focused, could not be in a better position to attract investor capital.

Asset Class Performance During Periods of High Inflation

12/31/2000 – 12/31/2020



Past performance is not indicative of future results. High growth and high inflation are defined as periods where the gross domestic product and the consumer price index each rise at least 2.5% annually. Data sources: BlackRock, National Council of Real Estate Investment Fiduciaries (NCREIF), Bloomberg and S&P 500. Data from December 31, 2000 to December 31, 2020. Real Estate is represented by the NFI-ODCE Index, Stocks are represented by the S&P 500 Index, Government Bonds are represented by the Bloomberg Barclays U.S. Government Aggregate Index, Investment Grade Bonds are represented by the Bloomberg Barclays U.S. Aggregate Bond Index. An investment cannot be made in an index, which is unmanaged and has returns that do not reflect any trading, management or other costs.

Stocks, bonds, and real estate as investment vehicles each have their own characteristics and each has the potential to lose value. The risks associated with an investment in real estate may materially differ from an investment in stocks, bonds, or other fixed-income instruments. Such differences include different types of expenses associated with real estate (i.e., mortgage interest, property insurance, property management, acquisition/disposition/leasing fees, etc.), the risks that a tenant defaults on their rent obligation, risks of tenant vacancies, risks associated with market fluctuations and much more. Further, a direct investment in real estate is typically less liquid than investments in stocks and bonds and as such you may not be able to sell a real estate investment as quickly as you could sell a stock or a bond. One should carefully assess all applicable risk factors before making an investment in real estate.

ICE BofA BBB U.S. Corporate Index Effective Yield

Shaded areas indicate U.S. recessions. Source: Ice Data Indices, LLC, November 19, 2021.

While investment momentum in QOZ strategies continues to grow and 2021 has been a banner year to date, 2022 is expected to be equally strong as the same underlying fundamentals driving interest in these strategies is expected to continue. The only difference in placing capital in a QOZ investment after 2021 is that benefit of the 10% exclusion on the deferred capital gain goes away as 2022 investors and beyond will not have been invested for five years prior to the end of the deferral period (which expires on December 31, 2026). Our analysis of the 10% exclusion tax benefit suggests the difference is not material in nature, and as such, industry participants do not expect the elimination of this benefit to have an impact on investor interest beyond 2021. Investors can place capital into QOZ investments until September 11, 2027, as this is the final date to invest capital gains recognized in 2026, making this the final deadline to invest in a QOF to achieve the 10-year gain exclusion.

The broad bipartisan support that ushered in the Opportunity Zone legislation continues, and the motivation provided to investors with capital gains has been as the authors hoped. What nobody could have predicted was that broader market and policy influences would come together in such a way that have created what we believe is the perfect confluence of circumstances for this program to be successful beyond expectations. Indeed, it appears the stars have aligned for Opportunity Zone investors, and most importantly, the communities that will benefit from their meaningful, long-term investment.

ENDNOTES

1. Amount of invested capital gain subject to tax at the end of the deferral period is reduced by 10% if invested by December 31, 2021 and held for at least five years.
2. Source: https://eig.org/news/opportunity-zones-tapping-6-trillion-market.
3. Source: https://www.novoco.com/notes-from-novogradac/novogradac-opportunity-fund-tracking-surpasses-20-billion.
4. Deferred taxes on capital gains invested is due in 2027.
5. **Represents the hypothetical net after-tax proceeds of a Non-QOF Private Placement and a QOF Investment.**
   - Federal capital gains tax rate of 23.8%
     - If the Non-QOF Private placement Investment and QOF Investment each were to achieve a 6.0% IRR instead of a 9.0% IRR, the resulting Net After-Tax proceeds of the QOF Investment is $1,502,848 and the Non-QOF Private Placement Investment is $1,275,084 with an after-tax difference of $227,764 instead of $393,801.
     - If each were to achieve a 3.0% IRR, the resulting Net After-Tax proceeds of the QOF Investment is $1,055,916 and the Non-QOF Private Placement Investment is $956,868 with an after-tax difference of $99,048 instead of $393,801.
   - If the federal capital gains tax rate increases to 43.4%
     - If the Non-QOF Private placement Investment and QOF Investment each were to achieve a 6.0% IRR instead of a 9.0% IRR, the resulting Net After-Tax proceeds of the QOF Investment is $1,306,848 and the Non-QOF Private Placement Investment is $924,077 with an after-tax difference of $382,770 instead of $661,804.
     - If each were to achieve a 3.0% IRR, the resulting Net After-Tax proceeds of the QOF Investment is $859,916 and the Non-QOF Private Placement Investment is $693,461 with an after-tax difference of $166,456 instead of $661,804.

   However, there are no guarantees there will be a positive return in any investment.

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An investment in a Qualified Opportunity Zone Fund program is subject to various risks, including but not limited to:

- No public market typically exists for the interest of Qualified Opportunity Fund programs. Qualified Opportunity Zone Fund programs are generally not liquid.
- Qualified Opportunity Zone Fund programs typically offer and sell interests pursuant to exemptions to the registration provisions of federal and state law and, accordingly, those interests are subject to restrictions on transfer.
- There is no guarantee that the investment objectives of any particular Qualified Opportunity Zone Fund program will be achieved.
- Investments in real estate are subject to varying degrees of risks, including, among other things, local conditions such as an oversupply of space or reduced demand for properties, and inability to collect rent, vacancies, inflation and other increases in operating costs, adverse changes in laws and regulations applicable to owners of real estate and changing market demographics.
- The acquisition of interests in a Qualified Opportunity Zone Fund program may not qualify under section 1031 of the Internal Revenue Code of 1986, as amended (the "Code") for tax-deferred exchange treatment.
- The actual amount and timing of distributions paid by Qualified Opportunity Zone Fund programs is not guaranteed and may vary. There is no guarantee that investors will receive distributions or a return of their capital.
- Qualified Opportunity Zone Fund programs generally depend on tenants for their revenue and may suffer adverse consequences as a result of any financial difficulties, bankruptcy or insolvency of their tenants.
- Disruptions in the financial markets and challenging economics conditions could adversely affect a Qualified Opportunity Zone Fund program.
- Qualified Opportunity Zone Tax Benefits may not be available under state law and some states may impose their own requirements to qualify for the equivalent of the Qualified Opportunity Zone Tax Benefits under state law.

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