What are Opportunity Zones and how can I invest in them?

by Ryland Moore
Investment Advisor, Director of Business Development, Principal

Join us on December 11 to learn more about investing in Opportunity Zones

Arnerich Massena and Perkins & Co. are hosting an evening event for investors interested in learning more about Opportunity Zone investing and Opportunity Fund opportunities. An expert panel of speakers will discuss existing opportunities and answer investors' questions.

When: Dec. 11, 2018, 4:30 p.m.

Where: Perkins & Co., 1211 SW 5th Avenue, Suite 1000

Speakers:
Eric Cress, Urban Development Partners
Trent Baeckl, shareholder at Perkins & Co. on the real estate team

What are Opportunity Zones?

The Tax Cuts & Jobs Act encourages investors to increase economic development in underserved areas through new tax incentives. The passing of the Act in December 2017 created a new section of the Tax Code that incentivizes investing in certain designated areas throughout the United States, called "Opportunity Zones" (nicknamed "O-Zones"), through investment vehicles called "Opportunity Funds."

In exchange for investing in Opportunity Funds and promoting economic development in O-Zones, investors are offered significant federal tax incentives, including the ability to defer capital gains realized from the sale of a previous investment and the forgiveness of future capital gains generated by the Opportunity Fund.

> "Each state can designate up to 25% of its eligible census tracts, based on factors like median income and job growth, as Qualified Opportunity Zones. By encouraging investors to direct what would otherwise be capital gains taxes into investments in these struggling areas, the O-Zone Fund will ideally help revitalize these areas by encouraging new development through tax-deferred investment dollars."
> ~ Sean Lyons, *Forbes*

How do Opportunity Funds work?

- ***Capital Gains Tax Deferral*** – If an investment is sold and the capital gains generated from that sale ("Original Gains") are rolled into an Opportunity Fund within 180 days of the original sale (for partnerships and S-corporations, the 180-day deadline is triggered from the calendar year-end after the sale), then the tax owed on the Original Gains is deferred to the earlier of December 31, 2026 or the date the investor sells its interest in the Opportunity Fund, with the capital gains tax payment due the following April 15.
- ***Capital Gains Tax Reduction*** – After holding an Opportunity Fund for five years, the investor's basis in the Original Gains is increased by 10%. If the Opportunity Fund is held for seven years, the basis is increased by an additional 5%. So, if the Fund is held for at least seven years before December 31, 2026, the original capital gains owed will be effectively reduced by 15%.
- ***No Capital Gains Tax on Opportunity Fund Gains*** – If the Opportunity Fund is held for at least ten years, the investor's basis in the Opportunity Fund itself will be increased to the fair market value at the time of a sale, resulting in zero federal capital gains tax.

Why invest in Opportunity Funds?

Opportunity Funds could prove extremely beneficial to investors who have realized significant capital gains recently. For example, take the case of an investor who sells an investment for a gain of $100,000. If she pays the 23.8% capital gains tax (federal and net investment income tax) and reinvests the net proceeds into a portfolio that generates 7% per year annualized, she would earn a net $32,357 over a ten-year period (paying capital gains again at the end of that period), for a total of $132,357 after ten years. She will have paid a total of $41,340 in capital gains taxes. If, on the other hand, she directs the $100,000 in gains into an Opportunity Fund that generates the same 7% annualized return, the net return after ten years would be $73,554, or a 41% greater ROI. Her portfolio would grow to $173,554, and she would only have paid capital gains on her original gains at a 15% discount, totaling $20,230. (See the chart on the following page.)

(cont. on next page)

What are Opportunity Zones and how can I invest in them? (cont.)

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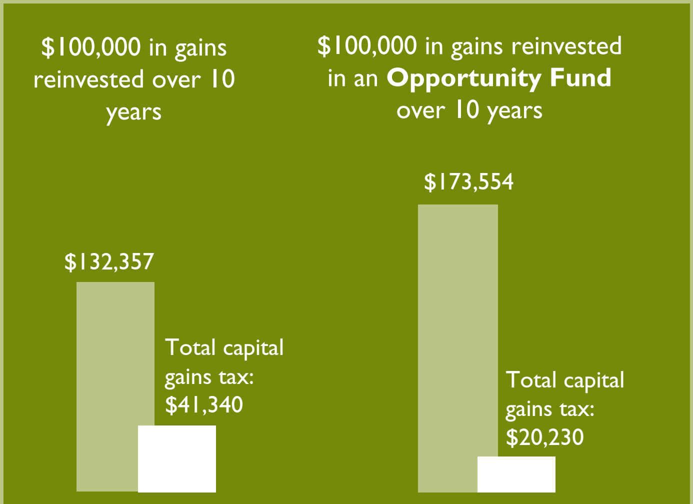
What else should investors consider before investing in Opportunity Funds?

While potentially rewarding both financially and philosophically, there are some considerations when investing in Opportunity Funds. First of all, keep in mind that the capital gains tax rate may change between the sale of the original investment and when the tax becomes due. Investors will also need to be aware of the importance of maintaining proper records. There will be new forms available from the IRS which must be filed the year in which the gains are deferred. Investors should make sure their tax planners understand the intricacies of Opportunity Funds.

Finally, due to the unique opportunity of O-Zone investing, there are many real estate investors who may want to create their own funds for the very first time. Wade in cautiously and pay attention to how much experience these investors have in fund management outside of Opportunity Funds. Investing with someone who is using the Opportunity Zones as their first foray into fund management may not be wise.

If you have additional questions about Opportunity Zones or would like to know more about Opportunity Funds available for Arnerich Massena clients, please speak with your investment advisor.



This example is hypothetical and for illustration only

Assumptions: 7% annual average return on investment, capital gains tax rate of 23.8%, assumes original investment is sold 1/1/19 and rolled into an Opportunity Fund and remains invested in the Opportunity Fund until 1/1/29

Past performance is no guarantee of future results.

Sources:

"Opportunity Zone Investing Guide – A new tax-advantaged investment strategy," Fundrise, July 2018; https://s3.amazonaws.com/fundrise-content/website-documents/e5abd171-0ad1-4951-9c04-33bb27834c0c/opportunity-zone-investing-guide.pdf

"How Investors Can Realize Significant Tax-Deferred Gains Through OZ Investments," by Sean Lyons, Forbes Magazine, October 15, 2018; https://www.forbes.com/sites/forbesrealestatecouncil/2018/10/15/how-investors-can-realize-significant-tax-deferred-gains-through-oz-investments/#3be2f4504e47