OPPORTUNITY KNOCKS

Towerpoint Wealth's Guide to Opportunity Zones

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While the IRS has historically provided significant tax breaks to real estate investors, the Tax Cuts and Jobs Act created another avenue of advantage for these investors through the creation of the Opportunity Zone program. By investing in an Opportunity Zone through an investment vehicle called a Qualified Opportunity Fund (QOF), investors are provided with a unique opportunity to defer, reduce, and eliminate capital gains taxes. We will discuss the specifics of Opportunity Zones and Qualified Opportunity Funds, the tax advantages of investing in Qualified Opportunity Funds, as well as other considerations for an investor contemplating a QOF.

What are Opportunity Zones?

Most investors are familiar with the Tax Cuts and Jobs Act (TCJA) of 2017, the largest overhaul of the Federal Tax Code since the Tax Reform Act of 1986. And while many provisions of the tax code have been discussed and dissected by industry experts and news media sources in depth over the last few years, one aspect of the TCJA that is only recently starting to garner attention is the creation of Opportunity Zones.

An Opportunity Zone, as described by the IRS, is "an economically-distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment." **Opportunity Zones were created to encourage economic growth in distressed and low-income communities across the United States.**

Specifically, the Opportunity Zone program aims to invest the trillions of dollars of unrealized capital gains held by investors across the United States. And importantly, it does so with no limit on the amount of capital that can be invested.

The Opportunity Zone program marks a stark departure from other existing programs that have a similar socioeconomic purpose, such as the New Markets Tax Credit (NMTC) Program and Low Income Housing Tax Credit (LIHTC), which are far more restrictive and rely heavily on government agencies to function.

How are Opportunity Zones identified?

Governors of US states (and US territories) nominate specific census tracts for Opportunity Zone candidacy. At a minimum, the tract must meet one of the following criteria[1]:

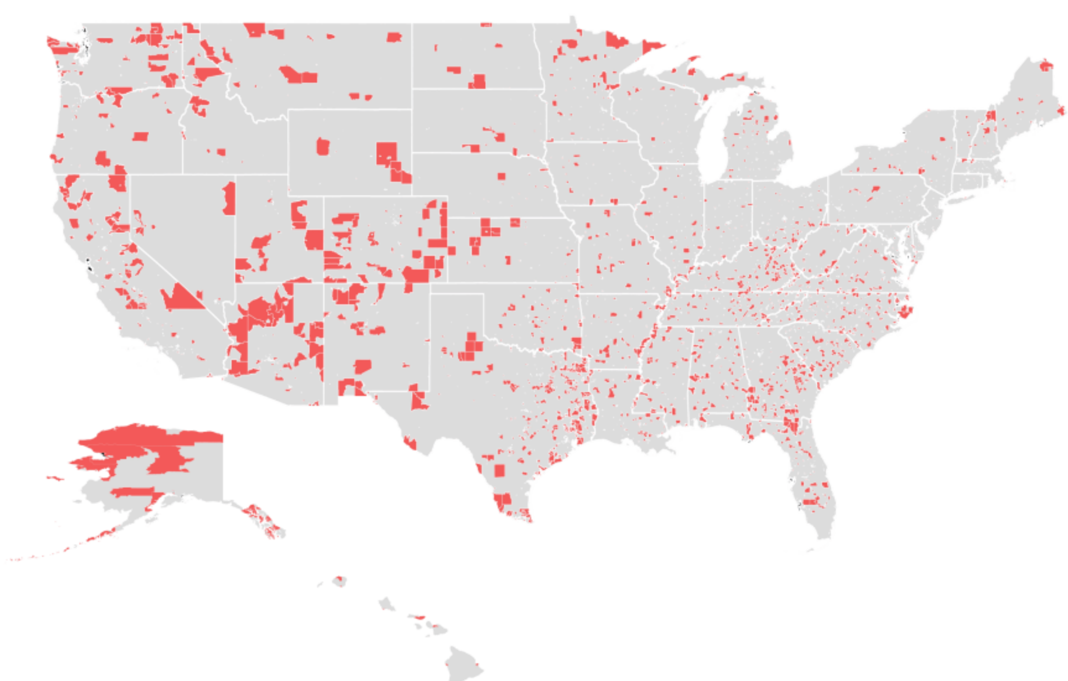
- A poverty rate of at least 20%; or
- A median family income of:
  - ➢ No more than 80% of the statewide median family income for the census tracts within non-metropolitan areas.
  - ➢ No more than 80% of the greater statewide median family income or the overall metropolitan areas.
  - ➢ No more than 80% of the greater statewide median family income or overall metropolitan median family income for the census tracts within metropolitan areas.

Opportunity Zones have now been designated in all 50 states in the US and even five US territories (most notably, all of Puerto Rico).

The US Department of Treasury officially certified more than 8,700 tracts as Opportunity Zones in June 2018, constituting roughly 12% of all census tracts in the US.

Land of Opportunity

Designated Opportunity Zone Census Tracts



Source: Fund for Our Economic Future's analysis of Qualified Opportunity Zone tracts, as designated by the U.S. CDFI Fund.

[1] Up to 25% of census tracts of each jurisdiction that meet the criteria may be nominated. An additional 5% of each jurisdiction can qualify if they meet a different set of income and geographic qualifications.

What is a Qualified Opportunity Fund?

A Qualified Opportunity Fund (QOF) is an investment vehicle created with the specific intent to invest in Opportunity Zones.

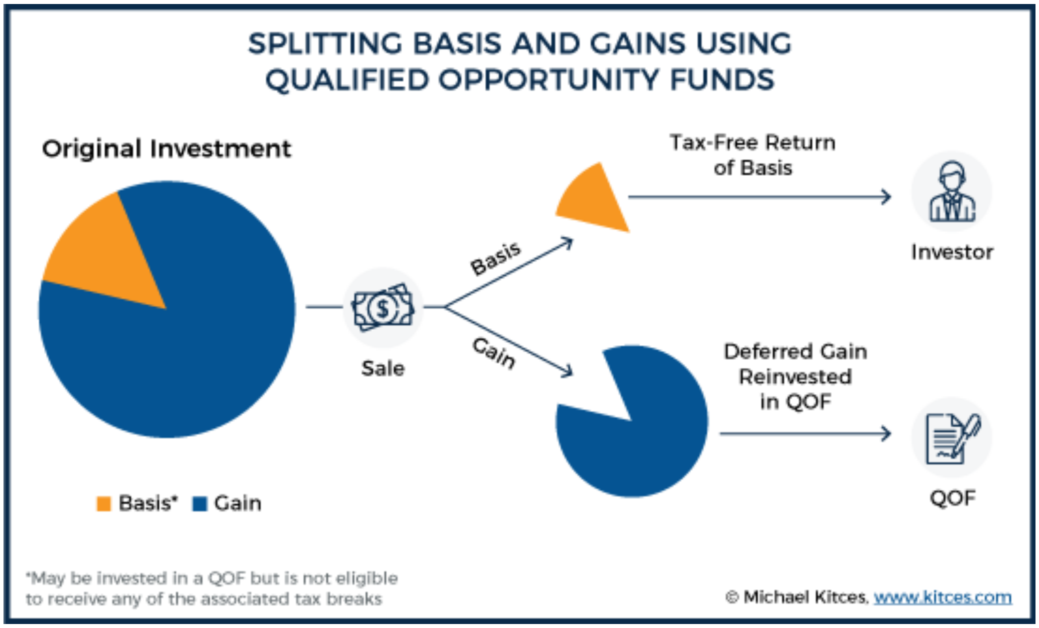
In order to be classified as a QOF, the fund must be ALL of the following:

- Certified by the U.S. Treasury Department.
- Organized as a corporation or partnership for the purpose of investing in Opportunity Zones.
- Hold at least 90% of its assets in Opportunity Zone property (this property can include newly issued stock, partnership interest, or business property).

Important! In addition to the classification requirements, QOFs are required to invest in the development of vacant land or invest an amount, at least equal to the acquisition cost, to improve the existing structure. The latter requirement must occur within 30 months of acquisition.

Example: *If a QOF acquires a building in an Opportunity Zone for $500,000, the fund must invest an additional $500,000 in improvements into that property within the first 30 months.*

What are the Tax Advantages of Investing in QOFs?

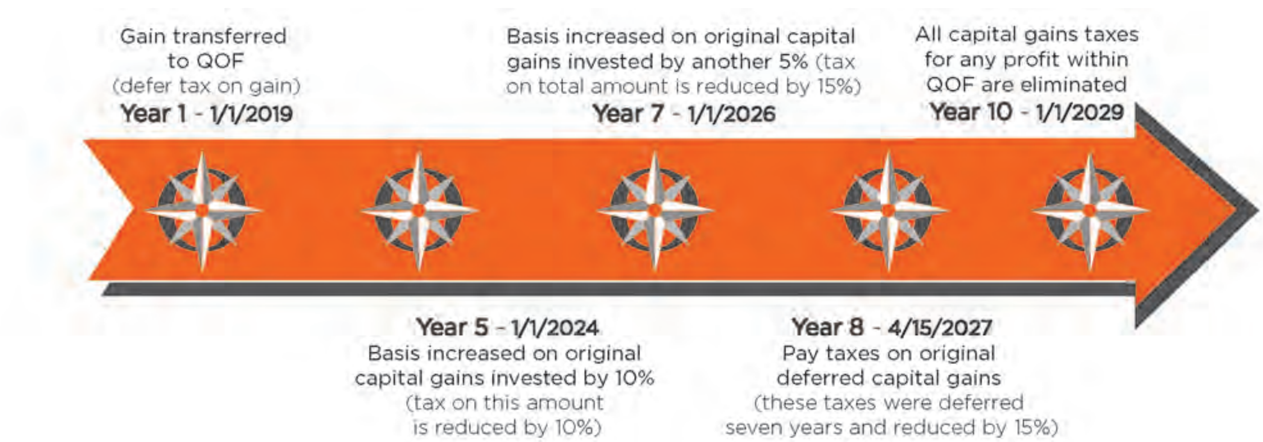


QOFs may provide an investor substantial tax breaks as follows:

- A **temporary deferral** of inclusion in taxable income for capital gains reinvested in a QOF. The deferred gain must be recognized on the earlier of the date on which the QOF is disposed of, or December 31, 2026. Gains must be invested within 180 days in order to qualify for any tax treatment available under the Opportunity Fund program.

- A [step-up in basis]() for capital gains reinvested in a QOF. The basis is increased by 10% if the investment in the QOF is held by the investor for at least five years and by an additional 5% if held for at least seven years, thereby excluding up to 15% of the original gain from taxation.

- A **permanent exclusion** from taxable income of capital gains from the sale or exchange of an investment in a QOF occurs if the investment is held for at least ten years. This exclusion only applies to gains accrued after an investment in a QOF.



An investor sells a stock with embedded gains through "traditional" means:

In 2019, an investor sells 40,000 shares of ABC stock at a price of $90 per share that they purchased in 2010 at a price of $30 per share. The federal tax rate on this gain of $2,400,000 will likely be 23.8%[2] (20% long-term capital gains tax plus 3.8% net investment income tax) for a total of tax liability of <u>$571,200</u>.

An investor rolls these same gains into a QOF and ultimately the QOF liquidates in 2028 with a value of $3 million to the investor:

By rolling the proceeds into a QOF, the investor benefited by the following:

- Investing $2,400,000 instead of $1,828,800[3] that would be remaining if the capital was not re-invested into a QOF.
- Paying $485,520 in taxes in 2026 instead of paying $571,200 in 2019. **Why?** Because the capital gains reinvested in the QOF receives a step-up of 15% if held in the QOF for at least seven years. **Important:** Not only did the investor pay less in total tax, but he deferred these taxes seven years.
- Owing no additional tax on the $600,000 of capital gains on the QOF in 2028.
- **In total, this investor saved <u>$228,480</u> by reinvesting the $2,400,000 million capital gain in a QOF and holding this investment for 10 years.**

[2] If an investor has a substantial tax loss to offset this amount, the federal taxes owed on this gain may be lower.

[3] Capital gain of $2,400,000 less the taxes owed of $571,200.

Capital Gains Tax on Capital Gains Reinvested in a QOF Investment Held for Seven Years

Traditional Investment		QOF Investment	
Original Investment	$1,200,000	**Original Investment**	$1,200,000
Proceeds	$3,600,000	**Proceeds**	$3,600,000
Capital Gain	$2,400,000	**Capital Gain Transferred to QOF**	$2,400,000
Capital Gain Federal Tax Rate	23.8%	**Increased Basis**	$1,560,000
Capital Gain Taxes Owed	$571,200	**New Calculated Gain**	$2,040,000
After-Tax Proceeds	$3,028,800	**Capital Gain Federal Tax Rate**	23.8%
		Capital Gain Taxes Owed	$485,520
		After-Tax Proceeds	$3,114,480
		Tax Savings	**$85,680**

Capital Gains Tax on Earnings in a QOF Investment Held for Ten Years

Traditional Investment		QOF Investment	
Original Investment	$2,400,000	**Original Investment**	$2,400,000
Proceeds	$3,000,000	**Proceeds**	$3,000,000
Capital Gain	$600,000	**Capital Gain**	$600,000
Capital Gain Federal Tax Rate	23.8%	**Capital Gain Federal Tax Rate**	0%
Capital Gain Taxes Owed	$142,800	**Capital Gain Taxes Owed**	0%
After-Tax Proceeds	$2,857,200	**After-Tax Proceeds**	$3,000,000
Tax Savings		**Tax Savings**	**$142,800**

Is it better to invest in a QOF in 2019?

From a purely tax perspective, the answer is yes.

The dates of December 31, 2019 and December 31, 2026 are important to investors to maximize the tax benefits of QOFs. Because the deferred gain must be recognized by December 31, 2026, in order for investors to receive the maximum basis increase of 15% for reinvested capital gains, the investment must be made at least seven years prior and at the latest by December 31, 2019.

Please note: the 10% increase of basis will still be available as long as the investment is made by December 31, 2021.

Finally, because the deferred gain becomes due by the end of 2026 without a liquidating event in the QOF, it is critical that investors plan accordingly and set aside cash for this tax liability.

Should I Invest in a QOF?

While the permanent exclusion of any gains generated, after 10 years, from an investment in a QOF is enticing to any investor, those investors that have significant unrealized capital gains in any outside investment (publicly traded securities, real estate, limited partnerships, etc.) are in the best position to fully leverage the tax advantages of a QOF. The ability to reduce and defer reinvested capital gains is an opportunity we are helping our clients take advantage of.

That said, the most important rule in deciding whether or not to invest in a QOF is recognizing that it is first and foremost a real estate investment.

If the fundamentals of the real estate investment are sound, a QOF can give an investor the opportunity to turn a good after-tax return into a great one. However, if they are not, we strongly caution an investor from moving forward simply with the hope that QOF tax incentives will "prop up" the projected returns. The old adage "do not let the tax tail wag the investment dog" rings true here.

And while the Opportunity Zone program is still in its infancy, our Investment Committee is currently investigating and conducting due-diligence on a handful of QOF funds.

In performing a deep dive into QOF candidates, some of the criteria we are utilizing to evaluate the merits of each QOF include:

- The history and reputation of the investment company offering the QOF
- The composition, real estate industry experience, and tenure of the QOF's portfolio managers and operations team
- The current and prospective economics of the tract or tracts the QOF is targeting

- The QOF's strategic plan for building value in the investment and its exit strategy
- The specific financials of the QOF as follows: the target asset size of the fund, the capital expectations for each investor, and the expected rate of return

How Can We Help?

At Towerpoint Wealth, we are a fiduciary to you, and embrace the *legal obligation* we have to work 100% in your best interests. We are here to serve you, and will work with you to decide if investing in a QOF makes sense for you. If you would like to further discuss Opportunity Zones and QOFs with us, we encourage you to call (916-405-9166) or email (spitchford@towerpointwealth.com) to open an objective dialogue.

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