‘Long and low J-curves’ await opportunity zone investors

Expectations should be managed appropriately, experts warn, especially for real estate newcomers.

By Kyle Campbell - 4 hours ago

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The qualified opportunity zone program carries the potential for many things, but a fast return is not one of them.

Offering tax relief for capital gains that are rolled into investments in low-income neighborhoods, the incentive has piqued the interest of investors – from the institutional to the high net worth. Excitement around the program should be tempered, though, professionals well versed in it warn.

Chad Briggs, chief financial officer of Utah-based manager Bridge Investment Group, said those using the program would be wise to set expectations carefully. While investors do benefit immediately from the capital gains tax deferral, it will take years for them to see dividends.

“There are going to be long and low J-curves, it’s going to take some time for that to come out,” Briggs said, adding that investors expecting to see distributions within the first year will be disappointed.

> ***Opportunity zone deadlines***
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> ***Dec. 31, 2019*** *– Eligibility cutoff for 15 percent basis step-up for rolled over capital gains.*
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> ***Dec. 31, 2021*** *– Eligibility cutoff for 10 percent basis step-up for rolled over capital gains.*
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> ***Dec. 31, 2026*** *– Last chance to realize gains, roll them into opportunity funds.*
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> ***Dec. 31, 2047*** *– Last chance to sell opportunity zone investments and pay no capital gains tax.*

Opportunity zones offer three tax benefits. The initial gain qualifies for a deferral through 2026 and a basis reduction of up to 15 percent. Gains from the new investment can be realized tax free – though only after a 10-year hold. In addition to longer lifecycles, these investments have significant upfront costs. The legislation requires that investors either build from the ground up or meet a “substantial improvement” standard, meaning they must double the non-land value of existing buildings.

Many opportunity zones are in parts of major cities that have experienced significant economic growth in recent years, but leasing will not always be easy. Borne from the US 2017 Tax Cuts and Jobs Act, the program stipulates that zones be in low-income communities, so demand for new commercial space will vary.

While experienced real estate investors are familiar with such variables, Briggs noted that opportunity funds are likely to draw attention from an array of individuals and institutions, many of whose gains are derived from corporate stocks. These investors will need to be educated about the workings of the real estate industry and nuances of the program, he said.

Thomas Mayrhofer, chief financial officer with EJF Capital, a fund manager that is pursuing opportunity zone investments, cautions against chasing opportunity zone deals for short-term tax benefits. Investors have only 180 days from the time they realize a gain to roll it into an opportunity fund. Also, investments must be made before the end of this year to qualify for the full 15 percent basis step up. After that, investors still have two years to achieve a 10-percent reduction, but building a strategy around any of those deadlines alone is a foolish approach, he said.

The greatest benefit, Mayrhofer explained, is the ability to realize gains from the investment tax-free. Ultimately, that is predicated on making a savvy investment that will appreciate over time. "The tax deferral on prior gains is driving investors' interest in opportunity zones, but our analysis shows that the elimination of tax on these investments enhances investor returns even more than the initial deferral," he said.

A path for tax-exempts

Another common misconception about the opportunity zone program is that tax-exempt entities cannot participate, noted Philip Marra, national audit leader for US building, construction and real estate at professional services firm KPMG. While US taxpayers stand to gain the most, there is room for pensions, endowments and foreign corporations to capitalize on the initiative too.

Many tax-exempt entities and foreign investors use C corporations – also known as "blockers" – when participating in private equity funds. These ad hoc companies are subject to capital gains taxes that can be avoided through an opportunity fund investment. "We've always focused on typical taxpayers, but there are opportunities for pension funds and other tax-exempt entities too," Marra said.

Qualified opportunity zones figure to be a boon to developers and cash-strapped communities alike. Private investors and their managers also stand to benefit from the program, but only if they can look through the hype and see the potential pitfalls that lie within.

*For more on the qualified opportunity zone program, see **PERE's recent coverage**.*

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