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Deadline For 15% Capital Gains Break On These Investments Fast Approaching

OCTOBER 14, 2019 - JEFF STIMPSON

A new type of real estate investment can come with big tax breaks – and a lot of catches.

Tax reform set up the qualified opportunity zone (QOZ) program to provide tax incentives for long-term investments in certain communities. “An investor can defer recognized capital gains by investing these gains into an Opportunity Fund, which is designed to invest in businesses in lower-income areas,” said Jim Brandenburg, a tax partner at Sikich in Milwaukee.

The Treasury Department has designated more than 8,700 QOZs, which in general have a poverty rate of at least 20 percent and a median income no more than 80 percent of the statewide or metropolitan average, according to a recent statement from the Securities and Exchange Commission.

“If you hold your fund investment for five years, the tax on your original gains will be reduced through a 10-percent step-up in cost basis,” said Avy Stein, founder and co-chair of Cresset Capital Management in Chicago, which in 2018 partnered to launch a QOZ fund. “If investors stay in the fund for seven years, the tax on the original capital is reduced another 5 percent.”

Investors can defer paying capital gains until Dec. 31, 2026 (earlier if the fund investment is sold). Investments must be made this year to receive the 15-percent benefit, or by Dec. 31, 2021, for the 10-percent benefit, Stein added.

So far, said John Mezzanotte, office managing partner at Marcum LLP, Greenwich, Conn., the concept attracts developers/investors who have the skills and funds to seek out projects and execute the developments on their own, perhaps with bank financing, and fund managers

looking at the concept as an offspring to hedge funds, private equity funds and real estate syndications.

“The added risk here is that fund managers will need to select developers and contractors to execute the projects professionally and cost efficiently,” Mezzanotte said. “They’ll need real estate managers to run these projects for at least 10 years. If you put all your gain into an OZ fund, you’ll also need another source of cash to pay the deferred capital gains tax in 2026.”

“The most recent regulations make it clear that the investment can make debt-financed distributions, which allows funds more flexibility to allay investor concerns that there will be no money to pay taxes in 2027,” Smith said.

“The most important fact that finally investors/developers are starting to understand is that the OZ legislation does not give any immediate economic or tax benefits,” Mezzanotte said, adding that these zones don’t come with such incentives as reduced property or income taxes or aggressive depreciation rates for property.

Stein reported that only an estimated $2.5 billion has been raised by QOZ funds and that only a percentage of that has been deployed to projects.

“It took the government more than 15 months to provide enough guidance for any opportunity zone funds to get off the ground, and that was only six months ago, in April,” said Bill Smith, Bethesda, Md.-based managing director for CBIZ MHM’s national tax office. Investors, Smith added, don’t like the 10-year hold period and assume all QOZ locations are bad and not ripe for investment (“a fallacy,” Smith said).

“They should be skeptical about any investment they get into,” he added, “but they seem to be more so with OZ opportunities. In the real estate world, there’s a thought that the market will drop in 10-plus years. Investors want to know what exit strategies and alternative plans the operators have in place.”

“Particularly for the significant benefits, it’s difficult for clients to plan for 10 years out,” said Steve Wittenberg, director of legacy planning in SEI’s Private Wealth Management group in Oaks, Pa. “Despite an attempt by professionals to make the opportunity zone investment understandable, it is still extremely complex, with potential issues kicking in down the line.”

Older census data was also used to determine what zones were “distressed.” “There’s a running debate whether the program will provide the impact it intends,” Wittenberg said, and “only a small amount of clients have shown any interest.”