Bond Case Briefs

Municipal Finance Law Since 1971

Opportunity Zone Investing: Is It for You?

A new type of fund that invests in low-income communities gives some investors a tax break, but it's not for everyone.

The prospect of investing in dilapidated inner-city neighborhoods or tumbleweed-ridden rural towns may not excite most investors. But a program embedded in the 2017 Tax Cuts and Jobs Act offers investors a tax incentive to do just that. As a result, a new type of fund that invests in low-income communities has popped up, and investors and institutions alike are starting to take notice. You've probably heard of opportunity zones. If you're wealthy enough, you may have received a pitch to invest in an opportunity zone fund. These new investments sound appealing, but they're not for everyone.

The new OZ funds pool money from multiple investors and invest in businesses and real estate development projects located in economically distressed communities that the federal government has designated as in need of investment. The more than 8,700 opportunity zones include parts of nearly every major American city, including Chicago and Los Angeles, as well as all of Puerto Rico and remote towns in Alaska. Investors who put money in OZ funds can defer and eventually reduce taxable capital gains, depending on how long they stay invested.

Triple tax break. The tax benefits apply only to capital gains, but it's a threefold incentive. First, you can defer federal capital gains tax on money you have earned from another investment by putting it into an OZ fund. Say you sell shares in a stock and realize a $100,000 capital gain (though a gain on almost any kind of investment qualifies). If, within 180 days, you roll over the $100,000 gain into an OZ fund, you can defer paying capital gains tax on it until you sell your stake in the fund or until December 31, 2026, whichever comes first. (The idea is to encourage investors to sell existing investments and invest the proceeds in an OZ fund.)

Second, the longer you hold your investment in the fund, the more you can reduce the amount of rolled-over gain that will be subject to tax. Investors who hold the fund for five years get a 10% reduction on the gain they'll owe taxes on; hold for seven years, and you'll get another 5% reduction. For example, an investor who rolls $100,000 of capital gains from a previous investment into an OZ fund in 2019 would owe capital gains tax on only $90,000 if she sold after five years and on only $85,000 after seven years.

No matter when you invest, however, "the December 2026 date is set in stone," says Frazer Rice, senior wealth strategist at Calamos Wealth Management. For the 2026 tax year, whether you sell or hold your investment in the OZ fund, you must pay any federal capital gains tax you owe on the profits you rolled into the OZ fund.

Hold for 10 years or more and a third benefit kicks in: Any gain in your investment in the fund is tax-free—as long as your outlay was made with capital gains from a prior investment. Some funds require that you hold for 10 years, but the vast majority allow you to sell at any time.

Since the tax act passed, 130 qualified OZ funds have opened, according to the National Council of

State Housing Agencies, a nonprofit group focused on affordable housing (it maintains a directory of OZ funds on its website, www.ncsha.org). The funds, which range in asset size from less than $1 million to $3 billion, are run mostly by money-management firms and real estate developers.

A fund from the developer HHKirby Real Estate Ventures, for example, aims to transform a former cotton mill in Burlington, N.C., into a complex with a live event center, restaurants and sports facilities. The North Country Opportunity Zone Fund, run by American Ag Energy, a company that builds greenhouses, invests in agricultural facilities in Berlin, N.H.

As interest ramps up, high net worth investors may see OZ funds offered at bigger money-management firms, such as Charles Schwab or Merrill Lynch, says Tim Steffen, of Baird Private Wealth Management.

But not everyone can buy in. With most OZ funds, you must be an accredited investor—that is, you must have a net worth of $1 million, excluding your primary residence, or have two consecutive years of at least $200,000 in annual income if you're a single tax filer ($300,000 for married filers). Most funds come with a six-figure investment minimum, too.

Fee structures tend to mimic those of hedge funds and private-equity investments: Investors pay an annual fee of 1.5% to 2.0% in expenses and, when they sell, fork over another 20% of any excess return a fund earns above an amount promised to the investor. The typical promised rate of return is between 6% and 10% for funds with diversified portfolios, and more for funds that invest in a single project, says Quinn Palomino, CEO of Virtua Partners, a private equity real estate development firm that offers opportunity zone funds.

Not ready for prime time. It's too early to say what kind of gains, if any, these OZ funds will deliver, or which OZ funds are worthy investments. In fact, the rules on what an OZ fund can invest in and how it should operate are still evolving. That can pose a problem: An OZ fund must comply with myriad IRS guidelines. If it doesn't, it may have to pay a penalty or, worse, the fund's investors won't be eligible for the capital gains tax breaks.

In general, an OZ fund must invest at least 90% of its assets in businesses located within a qualified opportunity zone. Many kinds of businesses qualify under the current guidelines, but a few, including golf courses, massage parlors, casinos and liquor stores, are excluded. Even so, real estate development projects, such as single- or multifamily housing and commercial real estate, are typical investments, says Neil Faden, a partner at Manatt, Phelps & Phillips, a law firm that advises OZ fund managers.

If you qualify and you want to invest in an OZ fund, first consider whether the investment is a good one, regardless of the potential tax benefit. "Don't let the tax tail wag the investment dog," says Bill Smith, a managing director at CBIZ MHM, an accounting and consulting firm.

Understand, too, that distressed real estate deals are inherently risky. "There isn't a lot of beachfront property in Malibu in these funds. You're buying into an area that people otherwise weren't willing to invest in," says Steffen.

The bigger concern, however, is whether the manager is new or inexperienced. Many OZ fund managers, it turns out, are untried, according to a survey from alternative investment research firm Preqin.

Some research is also required on the contractors and developers who will execute the investment projects. Ideally, you want to see that an OZ fund is working with established developers that have experience in the kinds of planned projects laid out in the fund's documents. "Maybe a developer has experience in hotels but not in multifamily homes. If you can ask about these things before you invest, you can help mitigate some of the risks," says Rice.

But with little track record, inexperienced managers, high fees and a high hurdle to entry, OZ funds are not right for retirement savings or money you can't stand to lose or lock up for the required holding periods. They're geared more for deep-pocketed, savvy investors than mom-and-pop savers. "If you've never invested in private equity or a closely held investment in which you're a minority investor," says Smith, "these probably aren't for you."

Kiplinger's Personal Finance

By Ryan Ermey

June 5, 2019