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[Sanity Check for Qualified Opportunity Zone Investments.]

A deadline is looming to maximize the stepped-up basis afforded to realized capital gains invested in qualified opportunity zone properties and businesses.

To get the full 15 percent step-up in basis, investment must be made by the end of 2019. There has been a corresponding surge of offerings, primarily real estate investment trust-like investments in commercial and residential properties, offered by the same firms that have offered such private offerings in the past and through the same channels. The difference is that these funds are being promoted to individuals who are inexperienced in investing as a limited partner or minority shareholder in a private REIT, or a private equity fund, which could be a disaster both for those advising such investors and those who are managing qualified opportunity zone funds. To avoid making mistakes, here is a sanity check to see if investing in a QOZ property or business makes any sense.

The opportunity zone concept has been around since the Clinton administration; the qualified opportunity zones, however, are new, having been formed in 2018 (based on 2010 census data) by the 2017 Tax Reform Act. The rationale is that private investments, now held in highly appreciated assets, will help economically distressed locations if those private investors: 1) sell their existing assets, and 2) reinvest the proceeds into new or newly renovated properties and new businesses in those locations. To encourage this sale and reinvestment, a deferral of the tax on realized capital gains for up to seven years, a stepped-up basis of up to 15 percent and the exclusion from capital gains of any appreciation on the QOZ investments held for more than 10 years is offered. The details of how a QOZ fund or investment must be managed are too complex to go into here. Suffice it to say, that qualification depends on strict compliance with the new, and sometimes ambiguous, regulations.

Private investors, individuals or institutions have not sold appreciated assets to invest in distressed communities in the past. Indeed, 75 percent of all private equity investments goes to just three states: Massachusetts, California and New York. This is because they believe they will not get a greater than market rate of return for their investment at equal or lower relative levels of risk by investing in such communities and properties relative to the high tech and biomedical investments that have proven to be such good investments in the past. By offering a significant financial incentive for such an investment, the government is boosting the implied rate of return on the reinvestment of realized gains by allowing the investor to use the amount otherwise needed to pay the tax (anywhere from 15 to 28 percent, plus the 3.8 percent investment tax) for up to seven years, and, if kept in the QOZ investment for more than 10 years, excluding the appreciation on that investment.

What is uncertain is whether any experienced investor will find these financial incentives sufficient to change the way they allocate their investment dollars. What is certain is that many inexperienced investors will be pitched the QOZ funds as a way of deferring capital gains taxes.

1. What are the investor’s objectives?

Success is achieving an investor's objectives. The selection of a specific property or business investment as a limited partner or minority equity owner means the investors have a common objective in making the investment. Saving taxes is not an objective; it is just one way of reducing the friction incurred when making an investment. Other objectives include return on investment, security both in withdrawing funds during the 10 years and exiting the fund after 10 years, and the satisfactory results in short and long term.

Whether a QOZ is worth it depends on the specific situation. Since it is so new, QOZ funds are uncertain and may be costly. The advisor must weigh the net benefit to the investor of deferring capital gains against the likely costs and risks of such an investment and educate the investor of those risks and costs. Said a different way, is it worth spending $20,000 in fees over 10 years to save $20,000 of capital gains taxes on a $100,000 gain today, with only a 50/50 chance of getting a positive return on your investment?

2. Is investing in new or rehabilitated property, or growth of a private business, the best way to achieve the Investor's objectives?

To qualify, investments must be realized capital gains that are equity investments in new or rehabilitated property or the growth of a business (sufficient to double the cost basis of the rehab property or growth of the existing business) in the QOZ. Deploying new investment capital into new or existing properties and businesses is not as simple as buying the stock of a publicly traded growth company. The management of the fund and the management of the property or business must work hard together to not waste time and money, and getting that experience and expertise is not cheap. The private investment landscape is littered with the wreckage of properties and businesses that failed less because they were a bad idea, but rather because too much new money came into the firm and not enough talent to deploy it.

3. Does the investor have the right team of professionals?

Because the QOZ program was created by recent legislation, both understanding and complying with the regulations is critical. For example, the calculations in Forms 8949 and 8996 seem straightforward, but failure to correctly prepare and file these forms in a timely manner is fatal to qualifying for the tax deferral. Additionally, the tax deferral only works to achieve the client's goals if that deferral is leveraged with the rest of the client's planning and administration. The client needs to have access to a financial advisor, a real estate investment advisor, a private equity investment advisor, a CPA and an attorney with corporate and estate planning experience — all of whom are familiar with the requirements and effects of investing in a QOZ fund or business. Relying on just one professional leaves the client open to that professional's blind spots: their natural bias to do what they already know how to do. This includes going with 1031 exchanges for the real estate investment advisor, the promoted QOZ funds for the financial advisor and so on.

4. Is QOZ investment even necessary to achieve the investor's objectives?

There are alternatives to QOZ for deferring realized capital gains, so the client needs to examine whether the QOZ investment is really necessary to achieve their goals. As mentioned above, the 1031 like-kind exchange remains available for real estate investments, but there are other alternatives, including charitable remainder trusts, charitable lead trusts, deferred sales trusts, et al. Each has their own advantages and their own drawbacks, but each should be considered a way of achieving the client's objectives as they may make investing in a QOZ unnecessary.

5. Is what the promoters claim even possible, considering this has never been done before?

Any passive investment in a private equity fund or REIT will be promoted. The claims of the promoters need to be verified as being possible since the newness of this program means that any claims made in their promotional materials is even less likely to be true than the usual “puffing” that goes with promoting a new venture. This is doubly so for QOZ investments. This requires a more detailed investigation into the structure of the fund, the underlying assets, the periodic liquidity and exit strategy, who the managers of the fund or business are, as well as the focus, strategy and terms of the investment and so forth. Even if the offerings comply with the SEC regulations, most commonly Reg A and Reg D, it is very likely that a passive investor will give up most, if not all, control over their investments in the QOZ funds. Before you invest is the time to have second thoughts.

6. Is a QOZ investment currently viable?

Considering the uncertainty of the actual implementation and management of QOZ investments, and the hostility many of the Democratic candidates have toward the 2017 tax cuts in general, is a long-term investment in a QOZ a viable strategy anyway? This depends on the client’s objectives, but the viability of QOZ tax deferral in the future needs to be considered. Even if the underlying legislation does not come under attack, the capital gains rates could be changed so that in 2026, when tax on 85 percent of the realized gains invested in the QOZ fund are due, the net tax is greater than if the client has paid the capital gains tax at the 2019 rates to begin with.

The corollary to this question is what will be “Plan B” if the QOZ deferral is no longer a viable option?

7. Is the investor ready to deal with the worst possible outcome?

Is your client really ready to deal with the worst possible outcome? For some, it is the loss of the entire value of the invested gains in the first seven years of the investment. For others, it is being caught up in the social and political blame of gentrification of low-income neighborhoods. Whichever it may be, have you informed your clients of the possible downsides of passively investing in an equity position in a property or business located in economically distressed locations? Do they understand the risks?

Qualified opportunity zone investments are an important strategy for experienced private investors to leverage their investments in real estate properties and direct equity investments in new and growing businesses. They will need to be as skeptical of the promoted investments as they always should be when making a long-term investment in private equity funds and REITs. For clients who are new to passive or direct investing in such properties and businesses, who suddenly find themselves holding significant realized gains from the liquidation of their business, real estate holdings, or even such things as artwork and other tangible property, investing in a QOZ fund or business is perilous. Expect that QOZ funds, especially the REIT model funds, will be promoted heavily between now and the end of the year to these inexperienced investors. If you are an advisor, these questions will help your clients avoid a mistake. For fund managers, these questions will help you avoid getting saddled with minority investors who turn out to be more trouble than they are worth.

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