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Qualified Opportunity Zone Investing: A Life Saver For Tax Reform

The Biden tax reform proposals target many tax benefits associated with real estate investing. If adopted, the ability to do tax free like kind exchanges may be eliminated and the maximum long term capital gains rates on sale may rise from 20% to 43.4% (marginal rate of 39.6% plus NIIT of 3.8%). Also, the ability to step-up the tax basis of assets at death may be eliminated. If all or any portion of this new tax landscape is adopted, investing in qualified opportunity zone funds ("QOFs") may become of greater value and should be explored by all real estate investors.

Taxpayers facing higher taxes on capital gains can defer taxation of those gains until 2026 if they timely invest those gains into a QOF. If that investment is made before the end of this year, ten percent of that gain would be forgiven. While that still leaves 90% of the gain to be taxed in 2026, the QOF offers the ability to avoid paying any tax on a sale of the interest in the QOF or its underlying investments after holding it for at least ten years. Unlike LKEs, elimination of gain does not require finding a suitable replacement property and the need to invest all the sales proceeds to acquire that property. The cash from sale can be used for any purpose.

Use of leverage by a QOF substantially magnifies the tax savings. If investors contribute $2M to a QOF that incurs $8M of debt to buy and improve the real estate, and that $10M investment grows in value by only six percent per year then after 10 years, the real estate will be worth more than $17.9M. On sale, the $7.9M economic gain will not be taxed. Each year, depreciation deductions can be taken to shelter from taxation rental income from the property. While those deductions reduce the tax basis of the property and increase the taxable gain realized on sale, none of that added depreciation recapture income is taxed on sale after holding the investment for 10 years. If a taxpayer passes away before ten years, their heirs can step into their shoes and eliminate tax on a sale ten years or more after the investment was made.

Some investors may believe that a QOF must be structured as a traditional investment fund created by an investment manager and others who may charge fees that can reduce their economic yield. However, a QOF includes any partnership formed between two or more investors to invest in an opportunity zone. Two investors or a family group can pool their resources to invest in an opportunity zone as long as they have competent advisers who can ensure they comply with the technical qualification requirements that apply throughout the life of the fund.

Some investors may believe that investments can only be made in economically blighted areas where the chance for economic reward from operations and sale may be remote. However, there are more than 8,760 opportunity zones around the nation, and many have already started the transition to highly promising and profitable sites.

Some investors may think the technical requirements for operating a QOF can become overwhelming. However, in principle, a fund that buys existing real estate must improve it by investing cash greater than the purchase price of the building over a 30-month period, which gives them time to complete their project. The QOF will usually form a subsidiary partnership to acquire the real estate and construct the improvements to allow it to retain cash for working capital, but the added burden of having a second partnership and an added tax filing is usually manageable with the right set of tax accountants.

Some investors may fear that opportunity zone benefits may also be scrapped by Congress. However, no proposal has yet been made to eliminate them. While some criticism has been leveled as to whether the QOF program is producing as much new jobs as expected, the program's focus on aiding communities in need makes the chance of elimination seem small especially compared to other more visible targets such as LKEs and capital gain preferential taxation.

The bottom line is that the closer we get to tax reform becoming a reality, the more prices may climb in opportunity zones. As a result, now is the time to start considering investing in a QOF, whether formed by an investment manager or a small group of investors.

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