US Real Estate: Land of Opportunity?

As US Opportunity Zones approach a landmark date, Gulsey Torenli at Vistra in New York, examines how they have been received, the uptake of Qualified Opportunity Funds, and issues around the legislation itself

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When Opportunity Zones were added to the tax code by the US Federal Tax Cuts and Jobs Act in December 2017, the intention was to spur economic development and job creation in distressed communities across the country.

From a financial perspective, they were created to enable investors to allocate capital gains to qualified investments in opportunity zones in order to gain access to a number of tax incentives, including temporary tax deferral, tax reductions and exemptions.

In the summer of 2018, the US Department of the Treasury certified 8,766 individual census tracts as Opportunity Zones across the US. These communities were chosen by governors on the basis that they demonstrated higher levels of distress across nearly every available social and economic measure.

Under the Opportunity Zones programme, US taxpayers who have or will have capital gains from selling investments in real estate, securities or other appreciated assets, can defer taxes until as late as 31 December 2026 by investing in a Qualified Opportunity Fund (QOF).

The longer they hold the investment in the QOF, the greater their benefit.

After five years, 10% of the deferred gain is excluded from taxes. After a total of seven years, another 5% is excluded. While 15% is the maximum amount that can be excluded, if a taxpayer holds the investment for a total of 10 years or more, none of the gains earned from the QOF will be taxed.

So, as we approach the end of 2019 and, therefore, the closing of the seven-year window, exactly how have Opportunity Zones, and QOFs in particular, been received and what have we seen here at Vistra?

QOF interest on the rise

According to the Opportunity Zones Database, as at 27 August 2019, a total of 109 funds had listed as QOFs, accounting for a total investment capacity of $37.4bn. While this performance may not necessarily be perceived as stellar, it is perhaps understandable – especially when considering the fact that the federal government only issued its first set of legislation during October 2018, and its second set in April 2019.

It is that second round of legislation that provided a lot more clarification. A large percentage of asset managers and developers, as well as auditors, tax advisers and legal counsel, had concerns about – and a measure of confusion around – the first set. So there may well have been some reluctance to consider QOFs until that clarity was provided.

In recent months, we have noticed an uptick in the interest in QOFs – indeed, we have been increasingly talking to clients and prospects who are considering or are already embarking on an investment. Whether that is as a result of the latest legislation or the approaching end-of-year 'deadline' isn't quantifiable, but we are anticipating a definite surge in business towards 31 December.

And, of course, action leads to action. As investors see an increase in the number of QOFs and become more familiar with the tax benefits, as well as the ability to have a social impact, the more we expect the interest in QOFs to rise.

The need for reporting

While Opportunity Zones and their associated funds were created with the intention of spurring economic development and job creation in distressed communities, the programme has had its fair share of detractors.

As recently as August 2019, the *New York Times* published a damning article questioning whether they were being used as intended, or if the programme was 'fuelling a wave of developments financed by and built for the wealthiest Americans'.

It is hoped that the new guidance released in April will help clarify the necessary qualifications for a QOF. It also highlights a request for information on data collection from QOFs, specifically related to job creation, poverty reduction and new business start-ups, to demonstrate that they are complying with the intended purpose. Gathering this information and correlating it to QOFs may be a challenge, however.

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As an industry, real estate funds are used to complex and demanding reporting rules, so we will have to see how the recording process for QOFs plays out, along with the filing process with the IRS and the data that the funds must provide to the treasury department. Understandably, we haven't yet seen those outputs, so the next two years should be particularly interesting.

Expertise meets social impact

When it comes to the areas that we are actually able to measure, or at least talk about anecdotally, one of the most interesting observations we have made is around the type of real estate development that is being undertaken.

From our own observations, as well as taking into account our clients who are actively involved in QOFs, there is a clear tendency to focus on the sectors in which they already operate. So, for instance, an asset manager who has expertise in healthcare will actively seek out potential healthcare opportunities within the zones.

What's more, there is a real sense among the clients and prospects with whom we work of doing something for the greater good, despite any cynicism that might exist around Opportunity Zones. Take those asset managers with expertise in healthcare – if they see an impoverished healthcare facility within that area, they can go in and make the improvements on it. So, not only do you have improved facilities for residents, but that also leads to businesses opening up for people in that area too.

And it's worth noting that these are sizeable investments. From our standpoint, and the asset managers we are talking to, investments are ranging from $100 million up to $250 million.

It's also gratifying that these asset managers are genuinely focusing on areas that really do need the investment. We are seeing that Utah, North Carolina, parts of the South and the Midwest are favoured. And it's also interesting to note that many asset managers are staying close to home – for instance, one Utah-based asset manager is investing predominantly in Utah and North Carolina.

Work yet to be done

On the surface, QOFs are a compelling proposition – tax benefits allied with social good. However, as with any financial structure, the devil is in the detail. The legislation introduced in April 2019 has certainly provided some clarity in a number of important areas, but there are still certain parts that could benefit from additional clarification.

As a new offering, QOFs haven't yet been robustly tested – and that is something that will only be done once statistically significant reporting has taken place. QOFs, for example, have to keep 90% of their assets in Opportunity Zone properties – but what will the penalty be should they fail to comply? Will they have to pay all taxes and penalties from day one? Exactly what will the IRS put into place?

It is something of a balancing act. The need to incentivise investors has to be offset with stringent regulation and reporting, without putting people off.

There is political pressure to rigorously measure initiatives such as the Opportunity Zones programme, and it's true that social programmes are often short on intensive data collection. Still, a capital-based investment in disadvantaged areas, and one that could keep the capital working for at least a decade, has a good chance of showing positive results for both investors and the affected communities. ■

What constitutes an Opportunity Zone?

The US government has outlined certain Opportunity Zones, or low-income areas, in need of real estate investment. Qualifying areas have an individual poverty rate of at least 20% and a median family income of no greater than 80% of the area median.

At least 50% of the gross income of a business created with Qualified Opportunity Funds (QOFs) must be derived from operations in a qualified Opportunity Zone. This requirement was meant to control abuses, but it also limited the types of possible business to exclusively local ones.

Recent changes to the legislation include three safe harbour provisions and other tests that a business can use to qualify. These changes also allow for expanding opportunities for internet, export and service businesses.

Investments that qualify for tax breaks are intended to encourage job creation. So-called 'sin-oriented' businesses, such as casinos and liquor stores, are ineligible to qualify as Opportunity Zone businesses.

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