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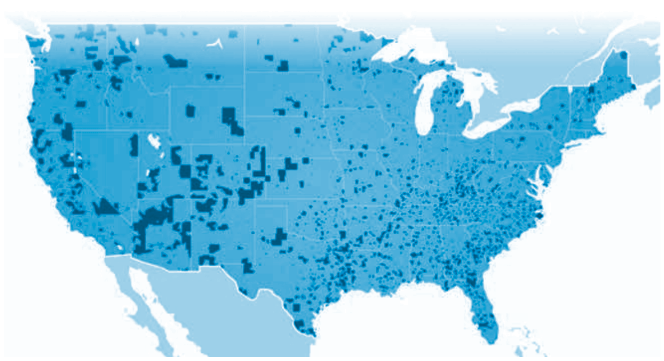
Qualified Opportunity Zones: What Investors Need to Know

The Qualified Opportunity Zone (QOZ) program was created in 2017 as part the Tax Cuts and Jobs Acts, with a focus on economically challenged communities and census tracts across the country. Opportunity zones provide an incentive for investors to allocate funds to help spur development and job creation in exchange for a temporary tax deferral and, ultimately, complete tax elimination. Opportunity zones – which were initially based on 2010 census data and remain the same with 2020 census data – are a subset of the country's low-income census tracts and certain adjacent census tracts. Investments in opportunity zones are typically expected to be held for ten years or more and may require further tax advice during the hold period and exit. The opportunity zone program's tax benefits are scheduled to end in December 2047.[1]

Approximately 8,700 Identified Opportunity Zones Nationwide[2]



Defer Taxes on Capital Gains Until 2026

The tax benefits of investing in QOZs may be enticing for those with capital gains. Investors with realized gains must place the realized gains into a qualified opportunity fund within 180 days from the date of the sale or exchange of the appreciated asset. The cost basis of the property is determined to be equal to the fair market value of the date of sale and no tax is calculated on the appreciation of the asset. The original capital invested in a QOZ (the realized gains) will not be taxed until year-end 2026, or until the fund is sold or exchanged, whichever occurs first. In addition, investors can receive full capital gains tax elimination on the QOZ investment after a 10-year hold.

QOZs are Impactful Investments

QOZs experienced a 16 percent increase in equity raise from December 31, 2021 to March 31, 2022, to $28.37 billion.[3] With approximately 8,700 identified opportunity zones nationwide, a development in a QOZ is meant to produce growth and revive the immediate economy affected. The U.S. Census data and analysis data supports the concept that investments into QOZs would generally expect to deliver new job creation, affordable housing options and an array of ventures in both rural and urban areas. According to the U.S. Census, the median family income (MFI) for the average opportunity zone is two-thirds the national MFI ($50,000 versus $77,000) with a poverty rate of 26.4 percent, compared to 13.4 percent for the average U.S. census tract. A total of 31.5 million people across the United States live in areas that have been designated as opportunity zones.[4]

Illustration of a QOZ Investment

The following example illustrates an investment realizing capital gains from an asset sale and related tax assumptions when making a QOZ investment. In this example, $1 million in capital gains is realized and an annualized 8 percent return on the investment is assumed. There is a noticeable difference on the QOZ investment taxes paid as compared to other investments, which speaks to the amount of taxes paid over the term of the new investment and the timing of the tax payments due.

Explanation of Calculations Used in the QOZ Investment Illustration

Q. How is capital gains tax calculated for the QOZ investment in year 2026?

A. The tax is calculated by taking 26% of the $1,000,000 capital gains (1,000,000 x 26% = $260,000).

Q. What happens after the 10-year hold period on the new QOZ investment?

A. The QOZ investment benefits from complete tax elimination.

Illustration of QOZ Investment

Capital Gain from Sale of Asset **$1,000,000**
Long-Term Capital Gains Rate (Federal & State) **26%**
Annualized Return 8%*

*NCREIF Index representing direct real estate returns.

The return assumption for direct real estate is represented by the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index (NPI), an index of quarterly returns reported by institutional investors on investment grade commercial properties owned by those investors. The NPI is used as an industry benchmark to compare an investor's own returns against the industry average. While not a measure of QOZ performance, the NPI is an appropriate and accepted index for the purpose of evaluating real estate growth rates. The NPI does not reflect management fees and other investment-entity fees and expenses, which lower returns. Indices are not available for direct investment. Index performance may differ significantly from a QOZ. Additionally, a QOZ has fees and expenses not found in an index. Past performance does not guarantee future returns.

2022	
	Asset Sale and Intention to Defer Taxes
Gain	$1,000,000
Taxes due	$0
After-tax gain	$1,000,000
QOZ investment	**$1,000,000**
2026	
Investment's potential value in year four assuming an 8% annualized return	**$1,360,489**
Pay tax on deferred gain	$1,000,000
Taxes due	($260,000)
2032	
Investment's potential value in year 10 assuming an 8% annualized return	**$2,158,925**
Taxes due	$0
Total taxes paid since 2021	($260,000)
Potential investment value after taxes paid	**$1,898,925**

Sources:

[1]https://news.bloombergtax.com/tax-insights-and-commentary/opportunity-zones-in-2021-taking-stock-four-years-on
[2]https://eig.org/opportunity-zones-map-comes-focus/
[3]https://www.novoco.com/notes-from-novogradac/bullish-opportunity-zones-equity-raising-continues-despite-end-basis-step-benefit
[4]https://eig.org/opportunityzones/facts-and-figures

Disclosure

The views expressed herein are subject to change based upon economic, real estate and other market conditions. These views should not be relied upon for investment advice. Any forward-looking statements are based on information currently available to us and are subject to a number of known and unknown risks, uncertainties and factors which may cause actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by these forward-looking statements.

Risk Factors to Consider

An investment in an IPC-sponsored program is subject to various risks, including but not limited to:

- No public market currently exists, and one may never exist, for the interests of any IPC-sponsored program. The purchase of interests in any IPC-sponsored program is speculative and is suitable only for persons who have no need for liquidity in their investment and who can afford to lose their entire investment.
- IPC-sponsored programs offer and sell interests pursuant to exemptions from the registration provisions of federal and state law and, accordingly, those interests are subject to restrictions on transfer.
- There is no guarantee that the investment objectives of any particular IPC-sponsored program will be achieved.
- The actual amount and timing of distributions paid by IPC-sponsored programs is not guaranteed and may vary. There is no guarantee that investors will receive distributions or a return of their capital.
- Investments in real estate are subject to varying degrees of risk, including, among other things, local conditions such as an oversupply of space or reduced demand for properties, an inability to collect rent, vacancies, inflation and other increases in operating costs, adverse changes in laws and regulations applicable to owners of real estate and changing market demographics.
- IPC-sponsored programs depend on tenants for their revenue, and may suffer adverse consequences as a result of any financial difficulties, bankruptcy or insolvency of their tenants.
- IPC-sponsored programs may own single-tenant properties, which may be difficult to re-lease upon tenant defaults or early lease terminations.
- Disruptions in the financial markets and challenging economic conditions, including those resulting from the novel coronavirus and resulting pandemic, could adversely affect the operating results of properties owned by IPC-sponsored programs and the ability of such programs to service the indebtedness on their properties.
- The prior performance of other programs sponsored by IPC should not be used to predict the results of future programs.
- Certain of the programs previously sponsored by IPC have experienced adverse developments in the past.

QOZ Risk Factors to Consider

There are substantial risks associated with the U.S. federal income tax aspects of a purchasing interests in a qualified opportunity fund. The following risk factors summarize some of the tax risks to an investor. All prospective investors are strongly encouraged to consult with and rely on their own tax advisors. The tax discussion here is not intended, and should not be construed, as tax advice to any potential investor.

- There is a lack of precedent and limited guidance related to qualified opportunity funds.
- A program intended to qualify as a qualified opportunity fund may not constitute a qualified opportunity fund for a variety of reasons, including a failure to substantially improve the property within the first 30 months of its operation. If a fund does not qualify as a qualified opportunity fund, then no deferral or elimination of taxable gain will be available to the its members.
- Investors who hold interests in a qualified opportunity fund through December 31, 2026, and who have deferred gain through that time by acquiring such interests, will automatically recognize some or all of the federal income tax gain that they deferred on December 31, 2026.
- The state, local and other tax implications of a qualified opportunity zone investment are unclear.

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