OPPORTUNITY ZONES

A New Way to Tackle Economic Equality Challenges in America

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Tucked away in the 1,000+ page Tax Cuts and Jobs Act, is a very interesting section on something called "Opportunity Zones." Seemingly overlooked due to some of the headline-grabbing changes to income tax rates and deductions, the creation of Opportunity Zones has begun to generate buzz not only in the tax planning world, but also the Environmental, Social and Governance (ESG) community. Given our interest in both areas, we took a deeper look. This paper explores the tax benefits, positive social ramifications, and potential investment opportunities of the Opportunity Zone program.

Opportunity Zones Explained

Opportunity Zones are a new community development program designed to expand economic development and create jobs in distressed communities. The Investing in Opportunity Act was created by Congress as part of the Tax Cuts and Jobs Act of 2017. The purpose is to encourage long-term investment in low-income urban and rural communities around the country by incentivizing patient capital investments.

According to the IRS, Opportunity Zones are designed to spur economic development by incentivizing investments primarily through tax benefits. The concept was originally developed by the Economic Innovation Group (EIG) in 2015 as an idea to address persistent poverty in many American communities.[1] The idea gained interest from a number of different constituents and the Opportunity Zones Program was taken to Congress by Senators Tim Scott (R-SC) and Cory Booker (D-NJ), and Representatives Pat Tiberi (R-OH) and Ron Kind (D-WI).

Under the Act, Congress authorized the governors of each state to select up to 25% of their state's low-income community census tracts to be designated as opportunity zones, providing federal tax incentives to investors. The first set of Opportunity Zones are located in 18 states and were designated on April 9, 2018. Enterprise Community Partners has created an interactive map to find Opportunity Zone census tracts across the U.S. Once a zone is qualified by the Treasury, it will remain qualified for 10 years. As of May 18, 2018 the Treasury has certified almost 8,000 low-income and contiguous communities as Qualified Opportunity Zones.[2]

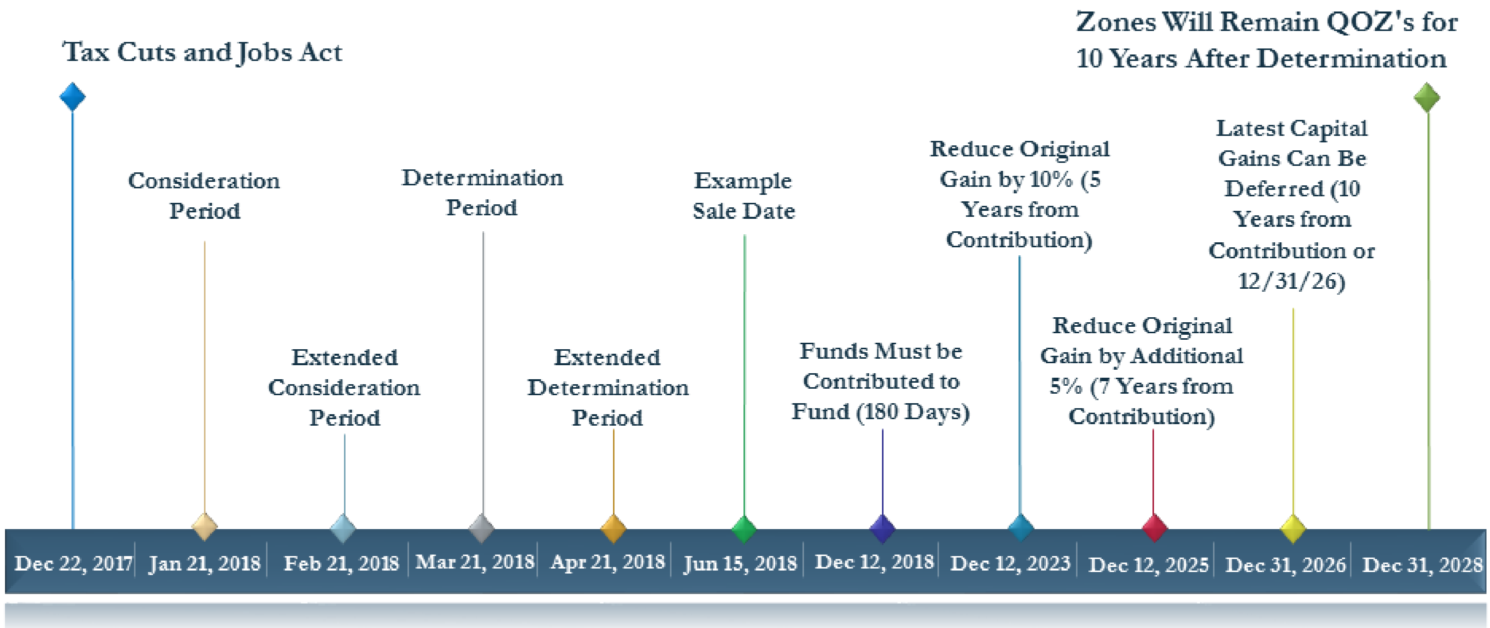
How will investments in Qualified Opportunity Zones be structured?

Investors may contribute proceeds from sales or exchanges of appreciated property to a partnership or corporation called Opportunity Zone funds. These funds will then invest in businesses located in Qualified Opportunity Zones. Funds must invest 90% of total assets in qualified opportunity zone property. This property can be a direct ownership of a trade or business in a zone, or it can be an indirect ownership of a

[1] http://eig.org/wp-content/uploads/2015/04/Unlocking-Private-Capital-to-Facilitate-Growth.pdf
[2] https://www.cdfifund.gov/Documents/Copy%20of%20Designated%20QOZs.6.14.18.xlsx

trade or business through a partnership interest or corporate stock. Loans to businesses do not qualify as an investment in a business. Furthermore, several types of businesses are excluded (golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks or other gambling facilities, or any store that primarily sells alcoholic beverages for consumption off premises).

If a fund fails the 90% requirement, it will owe a monthly penalty equal to the amount of assets under the 90% requirement, multiplied by the underpayment penalty rate of the short term federal rate, plus three percentage points. Moreover, if the 90% requirement is not met, the property that was previously qualified may become disqualified. If this occurs, the property will be treated as qualified for the 90% requirement for 5 years or the date the fund disposes of the property, whichever is less.



The IRS is currently working on guidance under the new tax act, including the certification of Qualified Opportunity Funds and eligible investments in Qualified Opportunity Zones. The IRS website currently states that "To become a Qualified Opportunity Fund, an eligible taxpayer self certifies." Therefore, no approval or action by the IRS is required. To self-certify, a taxpayer merely completes a form and attaches it to the taxpayer's federal income tax return for the taxable year. The return must be filed in a timely fashion, taking extensions into account.

What are the incentives to invest in Qualified Opportunity Zone Funds?

From a tax perspective, there are three main advantages:

- Capital gain deferral
- Increases to tax basis
- Tax-free growth

Taxpayers can defer capital gains from a sale or exchange if the taxpayer makes an election and contributes the proceeds from the sale to a Qualified Opportunity Zones fund within 180 days of the sale. The gain is deferred until December 31, 2026 or the date the investment in the Qualified Opportunity Zones Fund is sold, whichever is earlier. The gain deferral is limited to the fair market value of the assets contributed. An example of where a gain may be limited is the sale of an asset with a negative basis. Taxpayers will not be required to contribute all of the proceeds from a sale to receive the capital gain deferral benefit.

In addition to deferring capital gains, investors can generate basis in an asset sold if the proceeds are contributed to a fund and held for a certain time period. If an investment is held in a Qualified Opportunity Zone fund for 5 years, the originally deferred gain will be reduced by 10%. This benefit increases to 15% if the investment is held for 7 years.

The final benefit of such investments is derived from the fact that appreciation in the fund is not taxed when sold, if it is held for 10 years. Below is an example of the different tax savings a contributions to a Qualified Opportunity Zone fund could provide. In addition to these savings, the original gain could be deferred as late as 2026.

Summary of Tax Savings		
Proceeds $200,000		
Original Basis $100,000		
Realized Gain $100,000		
	Example 1	**Example 2**
Growth Rate	4%	7%
Proceeds Contributed to QOZ Fund	$200,000	$200,000
Original Gain Deferred	$100,000	$100,000
Basis Increase After 5 Years	$10,000	$10,000
Basis Increase After 7 Years	$5,000	$5,000
Tax-free Growth After 10 Years	$96,000	$193,000
Total Benefit	**$111,000**	**$208,000**
Federal Tax Savings	**$26,000**	**$50,000**

Summary above gathered by Pathstone. Tax savings assumes the current maximum federal tax rate on long-term capital gains, plus the federal tax on net investment income.

What about social impact?

In addition to the tax benefits available through investments made in Opportunity Zones, we also believe that there is potential for significant social impact that can be created through investing in these areas.

At Pathstone, we have long been believers that investors can successfully align their portfolios with their values through incorporating Environment, Social and Governance (ESG) factors into the investment process. We also believe considering ESG factors, including resource efficiency, labor practices and board diversity, can actually be additive to an investment process by providing insight in certain company risks and opportunities that may otherwise be overlooked or ignored. As long time practitioners in this space, we have helped our clients execute values-aligned portfolios using a variety of tools, including ESG factor incorporation, screening, shareholder engagement and impact investing. Opportunity Zone funds potentially create another avenue through which investors can create positive impact through their investment portfolios, adding to the overall toolkit.

By IRS definition, Opportunity Zones were created to attract long-term capital that would spur economic development and job creation in distressed communities (or low income community census tracts).[3] Low income community census tracts are communities that have at least a 20% poverty rate or a median family income that is less than 80% of the surrounding areas. A small portion of the total state designated communities can include adjacent communities that may not otherwise qualify as low-income. The adjacent community must not have a median income over 125% of the low-income community's median income. The Economic Innovation Group (EIG) has helped to put more specific numbers around the demographics. They analyzed about 87% of the expected total number of Opportunity Zones and found[4]:

- 57% of population is non-white
- The actual average poverty level for this sample is 31%, well above the 20% minimum threshold
- Median family incomes are only 59% of the area median, which is well below the 80% minimum threshold
- 59% of the population resides in an area that is considered "severely distressed" (over 30% poverty rate, unemployment rates at least 1.5x the national average or median family incomes lower than 60% of the area median, per the Treasury's CDFI Fund)
- 38% of the prime working age population is out of work (10% above the national average)

Per the above, it is obvious how investments in these areas might help address systemic issues facing the country including poverty, unemployment, and overall economic inequality. These are among the many issues that value-conscious investors often seek to help resolve.

What might investment opportunities look like?

The actual investment opportunity set is expected to be extremely flexible, creating the potential for Opportunity Zone funds to touch many different impact areas. Many investors are beginning to adopt the UN Sustainable Development Goals (SDGs) as an impact allocation framework.[5] The SDGs are a set of 17 global goals for sustainable development that span a number of diverse issues. When applying the SDG framework to Opportunity Zones (and investments in them), there are some obvious areas of overlap including:

- No Poverty
- Decent Work
- Economic Growth
- Sustainable Cities and Communities

But we expect the impact spectrum will include more indirect areas, such as:

- water infrastructure (SDG: Clean water and Sanitation)
- access to healthy food (SDG: Zero Hunger, Good Health and Well-Being)
- renewable energy access (SDG: Affordable and Clean Energy)

All of these are speculation at this point, but the options are numerous and potentially highly impactful.

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[3] https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions
[4] http://eig.org/news/joint-economic-hearing-promise-opportunity-zones
[5]https://www.un.org/sustainabledevelopment/sustainable-development-goals/.

Further, there is substantial evidence that minority entrepreneurs tend to be overlooked when it comes to funding.[6] With an inflow of capital to areas with primarily minority populations, this historically underserved demographic of the market should be better recognized. Great value from diverse ideas and businesses that otherwise may not receive an opportunity can be unlocked.

Finally, Opportunity Zones and corresponding funds create an opportunity to be targeted with investments. Oftentimes we find that investors that are interested in investing in low-income communities, prefer to do so in areas close to where they live, close to where they grew up, or within a specific geographic area of interest. By clearly defining the location of Opportunity Zones, investors will have a better sense of where and how their money is used and the outcome it generates.

How big of an opportunity are we talking about?

According to EIG, there is about $6.1 trillion worth of unrealized gain within investments held by households and corporation in the U.S.[7] Clearly all of that will not find its way into an Opportunity Zone Fund, but a portion of that would certainly go a long way. We still have a ways to go in terms of better understanding and building this investment space and we will be following the progress closely and keep you updated along the way.

[6] https://www.fastcompany.com/3060169/one-of-the-biggest-challenges-of-getting-funding-for-minority-owned-business
[7] https://eig.org/news/joint-economic-hearing-promise-opportunity-zones