Music to Opportunity Zones

By Michael McKeown, CFA, CPA

What does music sharing have to do with economic redevelopment?
Sean Parker founded Napster, the file and music sharing service in the 1990s. In the mid-2000s, he served as the first President of Facebook (and a large investor). In the next decade, he went on to create the Economic Innovation Group, which partnered with several congressmen to create the Opportunity Zone legislation. This was originally based upon a 2015 paper, "**Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas**."

The goal of the legislation was to unlock the estimated $6 trillion in unrealized capital gains and put funds to work in underserved economic areas. For this, investors would receive three benefits. First, investors receive a seven-year deferral on the capital gains of any asset type, to be paid in tax year 2026. Next, investors receive a 15% reduction in those capital gains. Finally, *the big one*, there are no capital gains taxes on any investment held in a qualified opportunity zone fund, if held for ten years or more.

The Investing in Opportunity Act was put into the Tax Cuts and Jobs Act of 2017. It went into effect so quickly that there were few rules around the implementation of Opportunity Zone investments. Governors had just 90 days to designate low income areas as opportunity zones, which would be the areas where investors could take advantage of the tax benefits of this new law. The U.S. Treasury also released several rounds of guidance. The latest came out this past April.

The timing of the guidance was critical. Many individuals are looking to roll gains from 2018 into opportunity zone funds. The latest guidance clarified several items and hit all the right notes.

Importantly, investors have 180 days from the tax-year end date (usually 12/31) to roll gains into a qualified opportunity zone fund.

Our search for funds focused on multiple-asset funds, to maximize diversification benefits across multiple regions, sectors, developers, and managers. Guidance clarified that multi-asset funds structures would be treated favorably. Underlying sales of assets would not trigger a capital gain for fund investors. In addition, the testing of funds for compliance was loosened (for rules around working capital and timing aspects).

Treasury also clarified that partnership (LP or LLC) structures would be more favorable than REITs. A partnership format would be permitted to refinance properties and return capital to investors without triggering a capital gain, up to the basis in the fund. In addition, accelerated depreciation would shield more income from tax.

Guidance set parameters around how operating businesses could comply with the rules, with tests based upon sales and presence of employees located in opportunity zones.
The Investing in Opportunity Act has so far made it easier to fund projects that were likely going to occur regardless. Hopefully, it will spur more capital to start businesses and redevelop areas that have not participated in the economic recovery.

We estimate the benefits of investing in opportunity zones to be 2% to 5% annually to investors. Compared to investments outside of opportunity zones, investors can realize a cumulative 41% increase in total return for investments held ten years. Extending the time horizon to take advantage of the step-up in basis could increase the benefits even further.

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