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Opportunity Zone Incentives – Much More Than Real Estate

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Opportunity Zone Incentives – Much More Than Real Estate

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Publisher's Insight: Opportunity Zones have been the topic of conversation so far this year. Many people think "real estate" when it comes to opportunity zones however, there are other options that can be explored when it comes to investing into these areas. This article explores some of those alternatives, and should be considered.

Whether or not the real estate investments of a family office are run independently and separate from the other operations of a family office, the fundamentals of strong risk management are the same and are critical to ensuring wealth preservation/enhancement and protection of reputation – two goals common to family offices.

As with any ongoing business entity, understanding the goals and vision of the family office is imperative to defining an appropriate risk management strategy. Additionally, ensuring that all divisions of the family office As most of us know by now, the Opportunity Zone (OZ) incentive provides that an investor can take capital gains from any other investment and, if invested on a timely basis (generally 180 days), the investor may defer the taxes on those capital gains for up to seven years, reduce the amount of that gain taxed by up to 15% and obtain tax-free upside on the investment made with these capital gains. The requirement is that the underlying investment must be in one or more of almost 9,000 geographical areas deemed left behind since the economic upturn that has now lasted more than 10 years since the "Great Recession."

The rules from the IRS are not final but there has nonetheless been significant investment leveraging the OZ incentives over the last year, all of which appears to be in real estate development. However, not everyone is aware qualified investments include more than real estate. Qualifying investments may be any tangible property and businesses that are located in these OZs that hold qualifying property.

The exclusivity of real estate investment in the OZ space relates to the history of similar programs focused on real estate, often complementary, such as tax incentives for bricks-and-mortar development. As we all know, a large industry exists that's already focused on real estate development in low-income communities.

As IRS rules are generated to clarify non-real estate investment that leverages the OZ incentives, expect a flood of new structures and concepts that enter the market. And investors will not need to rely on fund sponsors to create these new structures and concepts. The statute has wide flexibility and nothing in the rules currently prevents a family office or any taxable investor from creating its own bespoke vehicle through which to invest and gain these tax advantages.

Already, savvy investment advisors are assisting their clients in establishing controlled, bespoke investment funds and self-certifying as these funds as Qualified Opportunity Funds (QOFs). This is available because the only requirements of a QOF is that it hold the requisite investments and be structured as an entity taxed as either a partnership or corporation.

And, what investments might those controlled QOF's hold beyond real estate? Any tangible assets used in a trade or business or businesses themselves that hold such assets. As Mark Twain pointed out, there's only so much real estate, and the latest is that the OZ program has inflated the value of OZ real estate by as much as 20 to 30% over the last year. That can't help returns.

Blue ocean investments in OZs might include leasing office equipment. Either directly or through a special OZ subsidiary of an existing equipment leasing company, leasing out equipment solely to users in the OZ is a fascinating “use case”. Before the investment portion of the OZ program expires at the end of 2006 (we think it will be extended) expect to see many creative approaches to investing in non-real estate tangible assets in OZs.

More exciting than this is the ability to invest in operating businesses, either already in the OZ or relocated there from outside of it. Unlike real estate investment, the supply of venture investments is only limited by the imagination of entrepreneurs. And unlike real estate investing, these investments are not as sensitive to macro-economic downshifts and have upside potential returns that can be multiples in excess of real estate investments. In addition, these investments may track the incentives of the OZ program more accurately as they have the potential to produce less ordinary income, which does not benefit from the OZ incentives, and more capital gains, the entire focus of the OZ program.

Any investor would be wise to pay close attention as the IRS rules for OZ investment are developed and as innovators approach the space and disrupt the status quo. Investment with total tax-free upside is not to be ignored.