CommonGood Capital

Opportunity Zone Overview

Established as part of the 2017 Tax Cut and Jobs Act, the Opportunity Zone program was designed to incentivize the mobilization of unrealized capital gains, via a generous set of tax incentives, for long term impactful investment in underserved and underinvested portions of the United States.

The Why

In its 2015 report, "Unlocking Private Capital to Facilitate Economic Growth in Distressed Communities", the Economic Innovation Group (EIG) highlighted three conclusions that helped spur a bi-partisan cross section of the business and political communities to ultimately create what became known as the Opportunity Zone program:

Uneven Recovery

The current economic recovery (from 2008 to present) has been strikingly uneven from a geographical perspective, and as a result, a large portion of American families are dealing with a rising cost of living in weak local economies that have historically received an inadequate level of public and private investment.

Unrealized Gain Stockpile

The strong performance of the stock market and broader economy has created a historically large stockpile of unrealized capital gains waiting to be harvested.

Shortcomings in Prior Efforts

Prior public policy measures to incentivize private investment in disadvantaged areas have largely fallen short. Future similar efforts must leverage the learnings from prior programs.

$6.1 trillion in total US unrealized capital gains [1]

[1] Economic Innovation Group research

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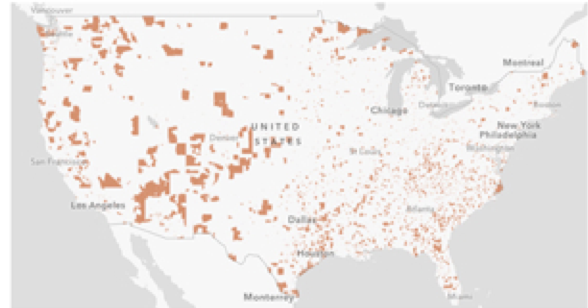
The What



Influenced by EIG's findings and following significant policy formulation, Congress authorized the Opportunity Zone program in late 2017 to incentivize investment in more than 8,700 designated census tracts across the United States, all of which have been historically underserved.

Using the tax benefits described below, Congress has made it attractive for investors – both individuals and corporates – to realize capital gains from virtually any asset and invest the harvested gain into one or more Qualified Opportunity Zone Funds ("QOZ Funds", see definition below).

The program offers the following potential benefits to investors:

Tax Savings and Deferral

Qualified Opportunity Zone Funds can provide tax benefits on both the investor's original capital gain associated with virtually any asset as well as the investment.

- On original capital gain: deferral to 2026 and basis step up
- On capital gains earned after 10 years in the QOZ Fund: capital gain tax exclusion

The tax benefits associated with QOZ Funds have the potential to drive an incremental 300bps to 400bps of IRR over 10 years as compared to a traditional real estate fund.[1]

Investment Return

While the tax benefits are attractive, they are insufficient to make up for a fundamentally bad investment. QOZ Funds will need to make sense from a financial perspective for all parties to be successful.

Impact

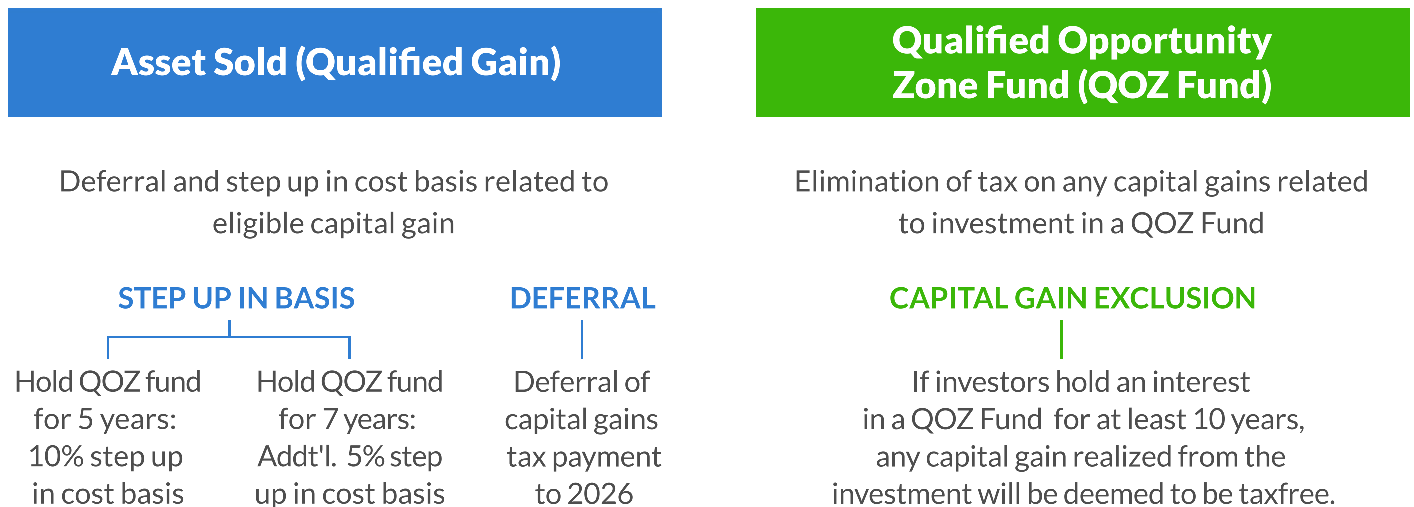
The Opportunity Zone program was created to increase the flow of patient capital into designated communities in order to increase economic and human flourishing. Investors benefit from participating in the revitalization and restoration of communities across the United States.

[1] EIG Research, assumes tax rate of 23.8%, no state income tax, and annual appreciation of 7%.

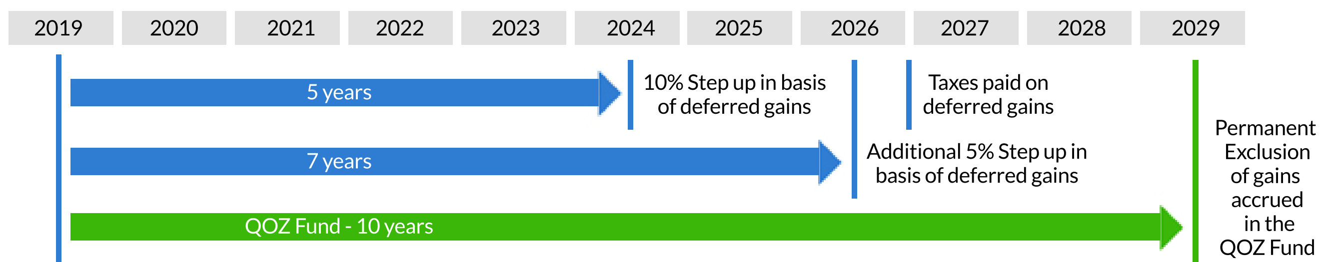
The How

While there are a number of nuanced details, the basic steps related to executing an investment into a Qualified Opportunity Fund are as follows:

Assuming these, and a handful of additional criteria, are satisfied, investors have the potential to benefit from two broad categories of tax benefits:

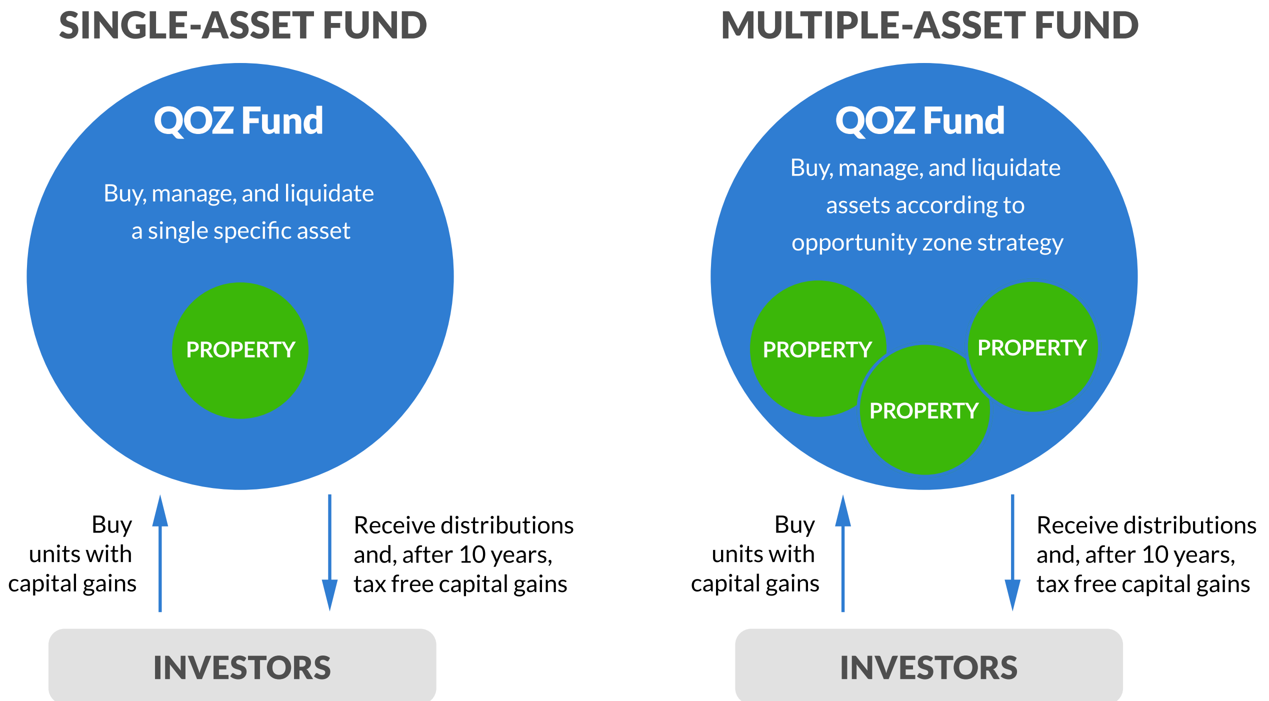


The following timeline illustrates the anticipated investor experience when investing in QOZ Funds.



In Practice: An Investment at its Core

Cutting through the details, at its core the Opportunity Zone program is based on traditional investment structures. They may take the form of a single direct investment or a traditional multiple asset fund. While they all will be supplemented with tax benefits, at their core, they are investments.



Definitions and Concepts

Opportunity Zones: low-income census tracts designated by state and federal governments. Examples include both rural communities and burgeoning lower-income urban communities like the Arts District in LA.

Qualified Opportunity Zone Fund: An investment vehicle that invests at least 90% of its assets in Qualified Opportunity Zones.

Qualifying Gains: nearly all long-term capital gains qualify for deferral under the Opportunity Zone program, including those experienced by pass-through entities.

Substantial Improvement: property must undergo 'substantial improvement' following its acquisition by a fund.

Eligible Investments: QOZ funds are able to invest in both real property and operating businesses.

Working Capital Safe Harbor: QOZ funds are allowed a 31-month safe harbor for the accumulation of cash for the development or rehabilitation of a property.

Single Asset vs. Multi-Asset: QOZ funds can be comprised of a single asset or multiple assets, just like a typical fund.

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Opportunity Zone Fund Risks

This represents an incomplete list of the risks associated with Qualified Opportunity Zone Funds. Investors are encouraged to carefully read and understand the risks associated any specific offering.

General Opportunity Zone Fund Risk: The Opportunity Zones incentive is newly created and only limited guidance has been issued. There may be significant modifications to the incentive and guidance issued to date, which, when issued, may impact planned investments in unanticipated ways. While the IRS has provided some guidance regarding the Opportunity Zones program, particularly regarding the certification process and certain investments for QOFs, it is not comprehensive. In addition to the two sets of proposed regulations that have already been issued, additional regulations, pronouncements and other guidance interpreting or clarifying the Opportunity Zone incentive are anticipated.

Failure to Invest in a QOF Within 180 Days: If an Investor does not invest gain proceeds into a QOF within the requisite 180-Day Requirement period, the Investor will be ineligible for the benefits of investing in Opportunity Zones.

Failure by the QOF to Meet the 90% Requirement: A QOF is measured semi-annually for compliance with the 90% Requirements. Failure to meet the 90% Requirement may result in penalties, interest, and additions to tax; additionally, it is possible that the IRS could deny Opportunity Zone benefits to investors in a QOF that fails to the 90% Requirement.

Disposition Prior to the Requisite Holding Period: If there is any direct or indirect disposition of a QOF investment prior to the 5-year, 7-year, and 10-year hold, that Investor may be ineligible for Reduction in Taxable Gain or 10-Year Gain Exclusion. While the Opportunity Zone regulations permit the reinvestment of proceeds of a property that has been sold prior to the end of the 10-year holding period, it is unclear how this may affect certain tax benefits.

Initial Gain Deferral Taxed in 2026: The Initial Gain Deferral will be included in income no later than December 31, 2026.

Inability to complete projects in a timely fashion: Property acquired by the QOF Funds will only comply with the criteria of the Opportunity Zone incentive if they make "additions to basis" within a 30-month period after acquisition that is greater than the basis in the property (other than land) at the start of the 30-month period. The proposed regulations include a safe harbor where if a property is newly constructed or rehabilitated by an indirect entity within a 31-month period in substantial compliance with a written plan, then cash awaiting use in the new construction or rehabilitation pursuant to a written plan would not be nonqualified financial property and the entity generally would still be considered engaged in an active trade or business during the construction or rehabilitation. While the proposed regulations include an extension due to certain delays related to getting government approvals, they do not include extensions of this 31-month for force majeure events, such as labor stoppages, weather events and acts of war or terrorism.