How EDOs can use Opportunity Zones to Promote Economic Development

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by Camoin Associates

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So, your community has an Opportunity Zone.

Now What?

A practical guide to leveraging Opportunity Zone benefits to get deals done in your community.

The Tax Cuts and Jobs Act of 2017 can provide powerful incentives to certain taxpayers to invest in property in low-income communities or districts designated as Opportunity Zones (OZs).

For economic development practitioners, the immediate question is, “How do I actually get projects done in my community using these OZ benefits?” On the next page, we outline how you can identify projects, establish OZ Funds, attract investors, and get new capital deployed in your community.

Then, we describe how a potential investor would benefit from making an investment in your community’s OZ versus a non-OZ.

As the local practitioner, your main role will be to identify and cultivate worthy real estate projects in your community that require an infusion of equity or near-equity dollars to realize, and then connect those projects to specific OZ investors. We see those steps as:

Step 1

Educate regional property owners, developers, and investors on the availability and benefit of OZ incentives.

Step 2

Solicit proposals from your property owners/developers for real estate projects that have progressed through the local approval process but require additional equity or near-equity investors to make them bankable. What is key to convey to this target market is that OZ benefits are "sweeteners" to the deal and the underlying projects themselves must be sound investments.

Step 3

Vet and flesh out the real estate project proposals to minimize the time and effort investors have to spend to evaluate the deal. Compile this information in a presentable format like a "sell sheet" with key data such as the dollar value of investment sought, type of project, relevant market data, project timeline, and anticipated return. This would be an excellent time to highlight other financing tools available for project success, such as Tax Increment Financing, New Market Tax Credits, Historic Rehabilitation Tax Credits, or local incentives.

Step 4

Build your "investor pool." This can either be large local developers/investors or institutional investment pools that are currently in the formative stage across the country.

Step 5

Promote your vetted projects to your identified investor pool. Update regularly. Perhaps a familiarization tour would be helpful if you have enough projects to interest your pool.

Once the match is made, the investor can itself create the official OZ fund and self-certify with the IRS. Because of the timeframes and requirements of the OZ program, we anticipate that many certified OZ funds will be single-purpose vehicles for specific projects. Therefore, rather than creating and certifying an OZ fund, you time is better spent cultivating projects and potential investors.

How do you sell this to your developers/investors?

The mechanics of the program are complicated, but the benefits ultimately boil down to this:

- Investors that have a big capital gains tax bill today get to defer payment of that bill until 2027 and pay a reduced amount, if they invest those gains in an OZ, and

- That investment in the OZ is itself sheltered completely from the capital gains tax if held for ten years.

So, the investor saves money on today's tax bill and pays no tax on future gains. What does this translate to for your potential OZ investor? The exact value of the benefits depends primarily on how long the investor holds the investment, how the investment fairs, and the tax rates that the investor is subject to. With those caveats, the OZ benefits would likely boost a project's annual rate of return by between 2 and 3 percent, which, in many situations, could tip the balance in favor of a real estate project moving forward.

How does it work for the investor?

1 Investor ABC Corp has an unrealized capital gain of $2M in a shopping mall asset and is looking for a project into which it can invest the net proceeds of the anticipated sale of the mall.

2 ABC Corp finds a mixed-use project in your community's OZ that looks solid, needs a $2M equity investment, and offers a good, but not great, anticipated return.

3 In 2018, ABC Corp sells the shopping mall, realizes a $2M gain and files IRS Form 8949 with its tax return on which it elects to defer payment of the tax on the capital gain. ABC Corp has 180 days from the date of sale to invest $2M in a Qualified Opportunity Fund (QOF).

4 ABC Corp forms XYZ, LLC, whose purpose is to invest in Qualified OZ property, and invests all $2M of its previous gain in XYZ, LLC within the 180 days. XYZ files IRS Form 8996 to self-certify as a QOF. ABC Corp gets to defer payment of $400,000 in capital gains tax until Dec 31, 2026. Furthermore, instead of paying $400,000 in tax in 2027 (when it files its 2026 return), it would only pay $340,000, because it gets to step up its basis by 15% for holding the OZ investment for seven years. At a 9% discount rate, this is the equivalent gain of $214,000 on the tax benefits alone as of the date of the investment.

5 XYZ has 30 months from the date of the investment by ABC to complete the mixed-use property in your community's OZ. XYZ issues debt, builds the property and completes the project. XYZ maintains it ownership in the property for ten years and operates exclusively within the OZ.

6 After ten years from the date of its investment in XYZ, ABC sells its interests and realizes a gain of $2M on its OZ investment. Since it has held the qualified OZ property for 10 years, ABC can exclude its entire gain and reap a tax benefit of $400,000. At a 9% discount rate, that equates to $184,000 in present value benefits as of the date of the investment.

7 Combining the two benefits means ABC Corp realizes around $400,000 in present value dollars on the day it makes its $2M investment in the mixed-use development via its QOF. That's a 20% return on invested capital related solely to OZ benefits as compared to a non-OZ project.

Disclaimers: OZ regulations are in draft form currently and there remain many questions to be answered in the final regulations. Note that our examples are highly simplified and are provided purely for illustrating the general mechanics of the process. There are many terms and conditions essential to reaping the tax benefits described.

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