SNJ AND THE OPPORTUNITY ZONE PROGRAM – STRIKE WHILE THE OZ IS HOT!

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On October 19, the U.S. Treasury Department issued proposed regulations for the federal Opportunity Zone tax incentive program created under the 2017 Tax Cuts and Job Act.

These regulations were highly anticipated by the real estate development and fund creation communities, which have been eagerly awaiting clarity from Treasury since the creation of the Opportunity Zone program earlier this year.

The program could become the most impactful federal incentive for equity capital investment in low-income and distressed communities ever. It offers significant capital gains tax benefits for taxpayers who invest in projects and businesses in low-income areas, allowing investors to delay, reduce and potentially eliminate capital gains taxes on appreciated assets or business located in and on Qualified Opportunity Zone investments.

Qualified Opportunity Zones are census tracts located in all 50 states in a low-income community. A detailed interactive map by state identifying the applicable opportunity zones is available, https://eig.org/opportunityzones.

As Forbes magazine indicated, there is likely $6 trillion of capital gains in the U.S. that represent potential available investment capital that could use this program to drive investment into applicable Qualified Opportunity Zone businesses or real estate.

The program is not limited to any specific product type nor does it mandate any job creation requirements as part of the investment in a Qualified Opportunity Zone. Thus, the program is applicable to any type of investor with capital gains from the sale of personal property or real property and to developers/owners of all property types including multi-family rental, retail, hotels, industrial, commercial, office, industries, self-storage, assisted-living, affordable housing, etc.

GENERAL OVERVIEW:

Under the Opportunity Zone program, individuals and other entities can delay paying federal income tax on capital gains until as late as December 31, 2026 – provided those gains are invested in Qualified Opportunity Funds investing 90 percent of their assets in businesses or tangible property located in a Qualified Opportunity Zone. In addition, the gains on investments in Qualified Opportunity Funds can be federal income tax-free if the investment is held for at least 10 years. These tax benefits could reduce the cost of capital for these projects, making them more viable, especially when paired with other development incentives like the New Markets Tax Credit or Low-Income Housing Tax Credit.

Specifically, appreciation on investments within Qualified Opportunity Funds that are held for at least 10 years are excluded from gross income. Thus, the longer one has an investment within a Qualified Opportunity Fund within an Opportunity Zone, the more one can reduce its capital gain – either by 10 percent or 15 percent, and if one stays in the zone for 10 years or more and the property or qualified business appreciated in value, the appreciation is not subject to capital gains tax at the federal level. The regulations as proposed give the investor/owner until December 31, 2047 to sell the business or property in order to take advantage of the no capital gains to be paid on the sale of appreciated assets rules.

Additionally, owners of low tax basis properties can sell their properties and defer the capital gains to the extent the gains are invested in a Qualified Opportunity Zone, which will likely attract investor capital that is looking to defer capital gains, thereby making the Qualified Opportunity Zones potentially more valuable than non-Qualified Opportunity Zone properties.

DEADLINES:

While the benefits of the program can be advantageous, investors and developers seeking to capitalize on the Opportunity Zone program need to move quickly in order to take full advantage of the tax benefit as demand increases and the time period diminishes.

In other words, as the program only lasts until 2026, the seven-year ability to reduce capital gains by 15 percent will disappear if investments are not made by 2019 and the five-year ability to reduce capital gains by 10 percent will disappear if not made by 2021. Therefore, if one is interested in maximizing the value of the program and its value to investors, investors and developers need to move quickly to commence development and acquisitions in order to maximize the time periods available to invest their capital gains inside the program windows provided within the program.

Additionally, in order to defer short- and long-term capital gains realized on the sale of property, the capital gain portion of the sale or disposition has to be reinvested within 180 days in a Qualified Opportunity Fund.

Also important to note that gains are required to be recognized on the earlier of a disposal of the Qualified Opportunity Fund investment or by December 31, 2026, and are reduced over time.

The basis of the Qualified Opportunity Zone investment increases by 10 percent of the deferred gain if the investment is held for five years from the date of reinvestment and by 15 percent of the deferred gain if the investment is held for seven years from the date of reinvestment. In other words, the gain on which capital gains is paid is reduced to 85 percent of the original gain.

While the recently announced regulations provided clarity on specific time period for self-certification as an Qualified Opportunity Zone fund, for what constitutes a Qualified Opportunity Zone business and for what structures now qualify as Qualified Opportunity Zone Funds (i.e., limited partnerships, C-corporations, limited liability companies, REITs, RICs, etc.), investors need to be aware that certain rules regarding related parties and original use property still need to be clarified by Treasury in additional regulations.

IN SOUTHERN NEW JERSEY:

In Southern New Jersey, the program will drive investment from all types of developers and investors seeking to place their capital gains into funds and seeking to place applicable businesses into Qualified Zones in order to potentially defer and reduce applicable capital gains. Developers will seek to purchase land in order to build with their own capital and/or equity from Opportunity Zone investment vehicles in order to utilize cheaper sources of capital and drive development returns.

Atypical real estate investors who are looking to defer and reduce capital gains may not be looking for typical real estate like returns due to the fact that they will be able to defer and reduce their capital gains via the Opportunity Zone program which will likely create a healthy dynamic for capital flows. Sectors such as multifamily, warehouse, self-storage, grocery anchor retail, and assisted living will see substantial interest from investors and developers.

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In Camden County, areas such as Cinnaminson, Pennsauken, Deptford, Camden, Pine Hill, Glassboro and Lindenwold will likely be hot spots for focused/targeted Opportunity Zone investment. In Atlantic County, parts of Atlantic City, Pleasantville, the Atlantic City International Airport, Somers Point and in Cumberland County a large swath of Vineland has been designated as an Opportunity Zone and will likely see interest for focused/targeted Opportunity Zone investment.

As Confucius once said, it is good to live in interesting times. Not a day goes by without an article or post online regarding Opportunity Zones and the ability to utilize them for development and capital gains deferral.

Now is the time to optimize your capital gains deferrals and reductions if you have them vis-à-vis the sale of personal property or real property. Interested investors are already focusing on deploying capital in New Jersey and elsewhere in substantially improving various asset classes and in creating funds to deploy in investing in various asset classes.

Brad Molotsky is a real estate attorney and partner in Duane Morris' New Jersey and Philadelphia offices. He advises clients on commercial leasing (including a specialty in cannabis leasing), acquisitions, opportunity zone fund creation and fund deployment, financing, public private partnerships and real estate joint ventures. He can be reached at BAMolotsky@duanemorris.com.

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