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The Opportunity Zones Program Provides High Returns on Investments

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1. Introduction

The Opportunity Zones Program is a new tax incentive established in the Tax Cuts and Jobs Act of 2017. The program aims to direct investors towards low-income communities in the United States by providing more attractive investment prospects. The end goal of the program is to disrupt the unhealthy trend of geographic inequality caused by a disproportionate number of investments being funneled to a select few areas of the U.S. On a large scale, the benefits include a more balanced economy across the entire nation, while also providing tax benefits for investors, which can contribute to a higher return on investments.

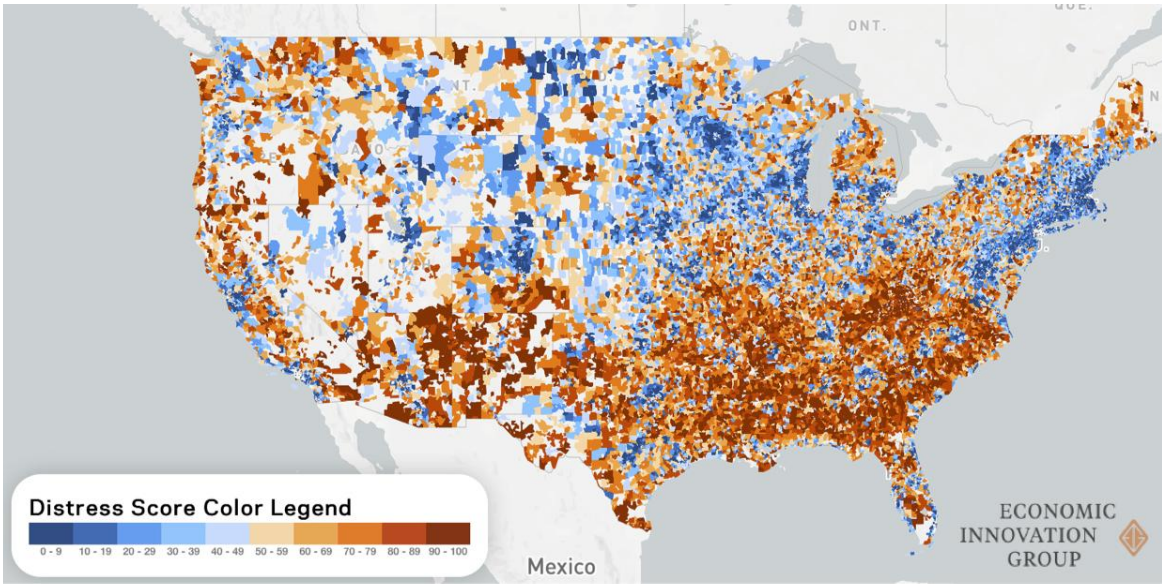
2. Economic Background

2.1 Economic Climate in the United States

Geographic inequality has been an ongoing issue in the United States. We are starting to see the gap between the rich and the poor widen even more while middle-class neighborhoods decline, splitting the country into areas of concentrated advantage, juxtaposed with areas of concentrated disadvantage. The Opportunity Zones Program has been introduced as a way to engage investors to help with this spirally, nationwide issue.

A common economic outlook is that any business growth in the Unites States will have a knock-on effect and cause growth all over the country. However, if we look at current economic indicators, we see 4% unemployment, a 25,000-point stock market, and a 3% GDP growth since the recession in 2008 (which is the fastest among industrialized countries). These statistics should suggest that the entire nation is thriving, however, because of geographic inequality the benefits of this growth is being unequally distributed to only a handful of areas in the country.

Figure 1- Opportunity Zone Distressed Area Breakdown



As we can see from Figure 1, around 40% of the U.S has been labelled as a "distressed area" by the Economic Innovation Group. Over 52 million Americans are living in distressed areas and in the recovery years of the economic downturn in 2008, these areas have seen a 15% decrease in jobs and a 15% loss of businesses on average. In contrary, the blue, non-distressed areas, have gained a 7.5% increase in jobs and businesses on average which highlights the disproportionate economic growth based on the different physical locations of the United States.

Before the recession in 2008, 80% of metropolitan areas nationwide were gaining business each year on net, however, current statistics show that 60% of metropolitan areas are now losing business each year. We know that the economy is currently booming, so the net loss of businesses across a majority of the country doesn't quite make sense. Again, this is a result of geographic inequality. Five metropolitan areas alone- Miami, Houston, Dallas, Los Angeles and New York account for the same amount of businesses as the rest of the United States combined. This disproportionate economic strength accentuates the truth of the U.S being built up of two economies.

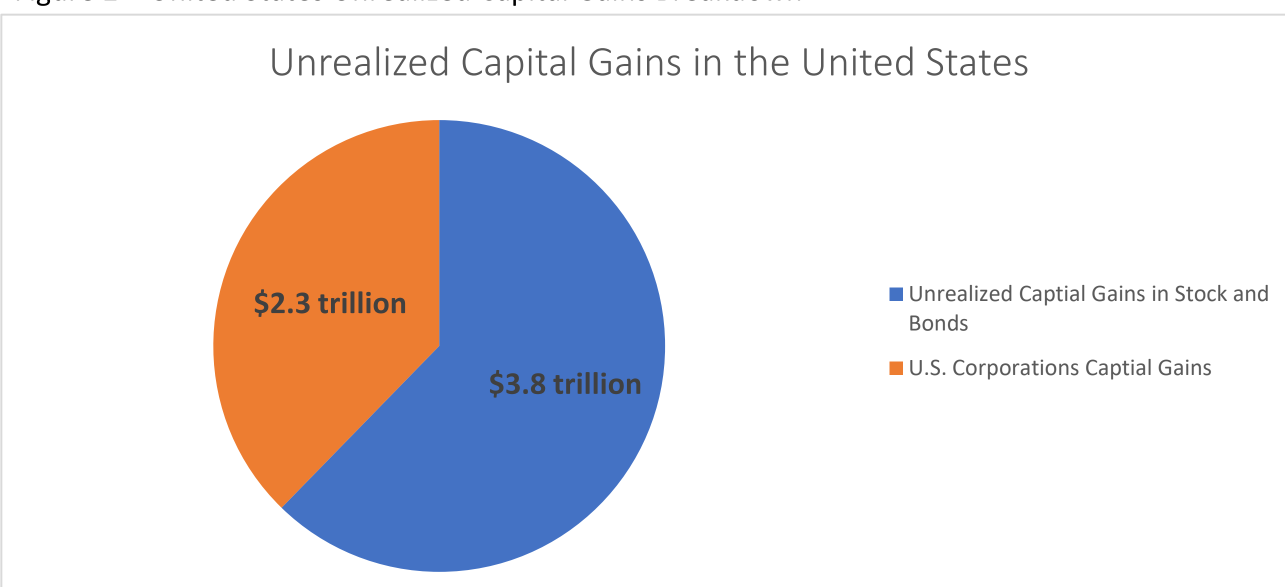
In order to promote business growth, capital is necessary. Job creation is a result of businesses scaling and through their expansions are in turn providing more jobs. That being said, there is a fundamental flaw that disadvantages those in distressed areas. 75% of venture capital nationwide goes solely to three states- New York, Massachusetts and California. Recently, bank branches have seen a decline, consequently providing less opportunity for businesses to access capital. In an attempt to connect this disparity, President Trump has proposed the Opportunity Zones Program to tackle this head on by engaging private investors and subsequently signed an executive order on opportunity zones in December 2018 to promote the tax incentive. The goal of opportunity zones is to utilize the enormous resource that the U.S has- capital gains.

3. Opportunity Zones Details

3.1 Opportunity Zones Background

The purpose of the Opportunity Zone Program is to incentivize investors to invest their capital gains into "distressed areas". In return, investors are offered tax breaks in order to create value by investing in areas that are less conventional and in turn stimulate business growth and decrease the geographic inequality across the country. Currently, the United States has $6.1 trillion in unrealized capital gains and the goal of the opportunity zones program is to target this source of capital to help create a more sustainable and equal economy.

Figure 2 – United States Unrealized Capital Gains Breakdown



In order to become eligible to be a part of the Opportunity Zone Program, investments must be made through an Opportunity Zones Fund. There are several restrictions and guidelines that need to be met in order to be certified under the rules set by the Treasury Secretary. One of the regulations is the Opportunity Zone Funds must invest at least 90% of its resources into one or more of the designated Opportunity Zones. Further, because the purpose of the Opportunity Zones Program is to aid positive, sustainable growth in distressed communities, there are also limitations on the types of investments that can be made.

There are three major categories of investments that can be made in order to be eligible for the Opportunity Zone Program. The first is partnership interests in incumbent-businesses that are operating in an opportunity zone. 70% of tangible assets of the business are required to be used in an opportunity zone, at least 50% of gross income is to derive from operations within an opportunity zone and can only hold a limited amount of investment assets. With the exception of "sin businesses" such as casinos, almost all businesses can qualify. Another alternative allows funds to invest in stock ownership in organizations that conduct most of their operations within the designated opportunity zones.

Finally, property investments such as real estate located within opportunity zones can be another qualified investment alternative. The real estate investment option will be the most commonly utilized strategy because the Opportunity Zone Program model suits the long holding period, relatively lower risk and high asset appreciation characteristics associated with real estate investing. However, in order to qualify as an Opportunity Zone Program investment, a "substantial improvement" must be made to the property. A "substantial improvement" is defined as capital injected into the development of the property that exceeds the original appraisal of the property value.

> For example, suppose a commercial real estate investment is available for \$8 million, \$5 million of which is the building value and \$3 million is land value. In order to ensure the investment meets the criteria of the Opportunity Zone Program, an amount exceeding \$5

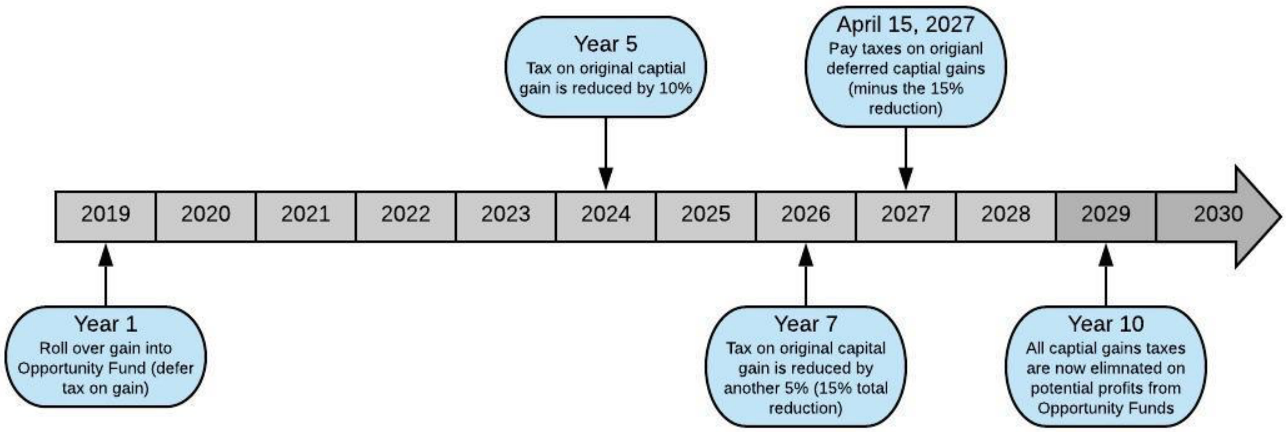
million must be invested in the improvements of the property. Additionally, the IRS has specified that undeveloped land does not require any improvements.

3.2 Tax Advantages of Investing in Opportunity Funds

If an investor realizes a capital gain after selling an appreciated asset, they are subject to tax on the net gain. The Opportunity Zone offers investors a tax reduction on the capital gain and potentially on future capital gains on other investments that are made through a Qualified Opportunity Zone Fund. The program offers the prospect of deferring tax due on any current capital gains, a reduction on the amount of capital gains tax due in the future, and an exemption on capital gains tax for any investment made through a Qualified Opportunity Zone Fund.

An investor has the ability to leverage capital gains made through any form of appreciated asset such as real estate or stocks and defer the tax payments made on these gains until December 31, 2026 if they reinvest it in a qualified Opportunity Zone Fund. The gains must be invested within 180 days in order to qualify for the tax exemptions available through the program.

Any investor that has held their investment in an Opportunity Zone Fund for at least 5 years as of December 31, 2026, will see a reduction on their liability on the deferred capital gain principal invested in the Opportunity Zone Fund by 10%. If the investment position is held for at least seven years as of December 31, 2026, the tax liability is reduced by 15%. Further, for those investors that hold their investment in an Opportunity Zone Fund for a minimum of 10 years, will be exempt from any future capital gains tax on appreciation made in their Opportunity Zone Fund Investment. A timeline is provided on the different tax advantages that could be expected for any investor that invests in 2019:



Investors looking for the highest return on investments would most likely invest their capital gains into an Opportunity Zone Fund in 2019. This is to ensure that they hold their investment for at least seven years by the time deferred taxes are due in December 31, 2026 and are able to receive their 15% reduction on their deferred capital gains tax. However, with that said, investors should also hold their position in the investment for at least 10 years so that they are exempt from any capital gains tax made from their Opportunity Zone Fund investment.

3.3 Prospects within Opportunity Zones- Quincy Concentration and BPV Expertise

The purpose of the Opportunity Zone program is to improve the geographical equality across the U.S, however there are additional favorable allocations that provide further incentives to take advantage of this program. 40% of the U.S has been labeled as ‘low-income’ and this includes most rural areas across the entire country. 25% of these areas have been selected to qualify to be a part of the Opportunity Zones. However, there are a number of areas that have qualified that are not the typical low-income communities and are in fact high growing areas, which have generated significant investor attention even before the Opportunity Zone Program was introduced.

Quincy, Massachusetts has been officially listed as a part of the Opportunity Zones and although technically is labeled as a low-income community, it is a rapidly growing city with several investors already endowing resources in the area over the last few years. There have been revitalization efforts that has provided transformations of this historic city into a new hub on the fringes of Boston. Currently, there is great variety of housing, commercial space and a vibrant retail and dining scene that is taking shape, with new residences and restaurants opening throughout the past year. The combination of the growth and development with the favorable location overlooking Boston makes Quincy a perfect area to invest in. However, with it qualifying as a part of the Opportunity Zone Program, demand for real estate may drastically rise, making it even more important to invest in an Investment Fund and start to capitalize on investment prospects before the capital inflow traffic becomes too high and competitive.

Boston Property Ventures (BPV) has been investing heavily in Quincy over a number of years which has contributed to their successful and diverse portfolio. A recent example of a development in Quincy was the acquisition of three stand-alone buildings on 23-31 Bridge Street. Along with the construction team, the company transformed this space into 60 luxury rental units. This project was adjacent from a previous BPV development which was completed in 2016. The combination of the two development projects presented a rare opportunity to control and develop nearly three acres of contiguous land in downtown Quincy.

With Quincy becoming an obvious choice that will attract a lot of focus for Opportunity Zone Funds, it is important that funds are handled by investors and developers with local expertise and knowledge of the area. The Opportunity Zone Program is still a relatively unknown investment avenue, however, with 2019 being the final year to fully take advantage of the tax incentives and receive the 15% discount on deferred taxes due December 31, 2026, BPV is starting its own Opportunity Zone Fund. This provides a huge potential for investors to become involved in a sound investment with the potential of achieving high returns through the combination of management expertise and tax incentives.

3.4 Potential Risks

Although the Opportunity Zone Program offers a number of tax incentives that can greatly benefit investors, there are potential risks associated with the program. For example, although some of the locations that qualify as a part of the program and offer potential great returns, there is a reason why some of these areas are listed as low-income communities. Not every location has growth and development potential, and some have seen a loss of business growth because of factors that cannot be cured without an extreme injection of capital. A lot of areas in advantageous locations with potential to grow and attract businesses are valuable because investments can be made for low prices and the combination of future business growth potential and tax incentives will see return on investments increase dramatically. However, simply injecting capital into a location because of the short-term gain of discounting taxes and then owning an investment in a depreciating area can be catastrophic for future returns. Ensuring that the investment will appreciate over time and is a thoroughly researched investment should not be clouded by short term greed of receiving tax breaks.

Furthermore, the introduction of the Opportunity Zone Program offers significant potential for investors to improve return on investments on current and future investments made within qualified areas. Opportunity Zone Funds will be formed in order to take advantage of this great potential; however, the fund managers may not have the expertise in the investment area and may be forming a fund to become an early adopter in a lucrative field with high potential. It is extremely important to ensure that the fund managers are experts in the field of business that they are aiming to enter.

The final risk involved with investing in an Opportunity Zone Fund is not correctly forecasting cash flows on future investments that need to be made in order to compensate for the deferred tax on the original unrealized capital gains. It can be financially detrimental if the future Opportunity Zone Fund investment does not provide enough future cash flow to cover the deferred capital gains which is due on December 31, 2027. Again, a team of experts must be managing the fund in order to ensure that all future financial demands and obligations are met for the safety of the investor rather than rushing into a potentially dangerous financial position.

4. Hypothetical Investment Comparison

Attached are two separate examples of investments being made over a 20-year period. Each investment in this hypothetical example produces a pre-tax return on investment of 300% of the initial investment made after a 10-year hold. This return is consistent in each example for ease of presentation and comparison.

Each example includes an initial investment of $1 million and all capital gains are then reinvested into a secondary investment for another 10 years producing the same return. The first example includes separate investments where none include an Opportunity Zone Fund investment. The second example reflects the same process, however, including the benefits gained from utilizing an Opportunity Zone Fund as the secondary investment.

The third table shows a basic hypothetical basic cash flow model that should considered when ensuring that cash flows from an Opportunity Zones Fund investment cover the deferred gains.

5. Conclusion

Subsequent research supports the original hypothesis that the Opportunity Zones Program provides high return on investments. Geographic inequality is a major issue in the U.S., and this initiative not only addresses this nation-wide matter but also provides an immense opportunity for investors to receive capital gains tax incentives. The Opportunity Zones Program will most likely aid the disproportionate economic growth and formation of two separate economies with in U.S. by dispersing unrealized capital gains through these incentives. If an Opportunity Zone Fund is formed correctly and meets all guidelines and regulations, current return on investments can be improved by reducing capital gains taxes by up to 15%. This partnered with tax exemption on all future capital gains for investments through an Opportunity Zones Fund provides staggering potential to greatly improve further investment returns. If all parameters are met and ~~all~~ precautions are taken regarding the risks involved in becoming an Opportunity Fund investor, the tax reductions can help increase the investment input as well as reduce the capital gains due upon selling the investment which can lead to significant increases in returns.

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The following tables show two indentical $1,000,000 investments at different tax rates. All net gains are reinvested into a secondary investment.

No Opportunity Zone Program Investment Example

Initial Capital Investment at 40% Tax Rate	
Initial Capital Injection	$1,000,000
Sale of Investment	3,000,000
Pre Tax Profit	$2,000,000
Pre Tax ROI	200%
Tax Bracket	40%
Post Tax Profit	$1,200,000
ROI	120%

Initial Capital Investment at 20% Tax Rate	
Initial Capital Injection	$1,000,000
Sale of Investment	3,000,000
Pre Tax Profit	$2,000,000
Pre Tax ROI	200%
Tax Bracket	20%
Post Tax Profit	$1,600,000
ROI	160%

10 Year Reinvestment of Short Term Capital Gain	
Number of years held	10
Reinvested profits from initial investment	$1,200,000
Sale of investment	3,600,000
Pre Tax Profit	$2,400,000
Pre Tax ROI	200%
Tax Bracket	20%
Post Tax Profit	$1,920,000
ROI	160%

10 Year Reinvestment of Short Term Capital Gain	
Number of years held	10
Reinvested profits from initial investment	$1,600,000
Sale of investment	4,800,000
Pre Tax Profit	$3,200,000
Pre Tax ROI	200%
Tax Bracket	20%
Post Tax Profit	$2,560,000
ROI	160%

Combined Investment Summary	
Number of years held	10
Total Capital Invested	$1,000,000
Total Post Tax Profits	$1,920,000
Post Tax ROI	192%
Effective Annual Return	19.20%

Combined Investment Summary	
Number of years held	10
Total Capital Invested	$1,000,000
Total Post Tax Profits	$2,560,000
Post Tax ROI	256%
Effective Annual Return	25.60%