Opportunity Zones: The Promise and the Pitfalls

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Given the big rise in stock and real estate prices in the past decade, many people are wondering: how do we lock in some gains while taking advantage of new investment opportunities? There's a new answer, thanks to the 2017 tax law: sell and invest the gains in Opportunity Zones, some 8,700 low-income areas across the US, including many in and around Seattle.

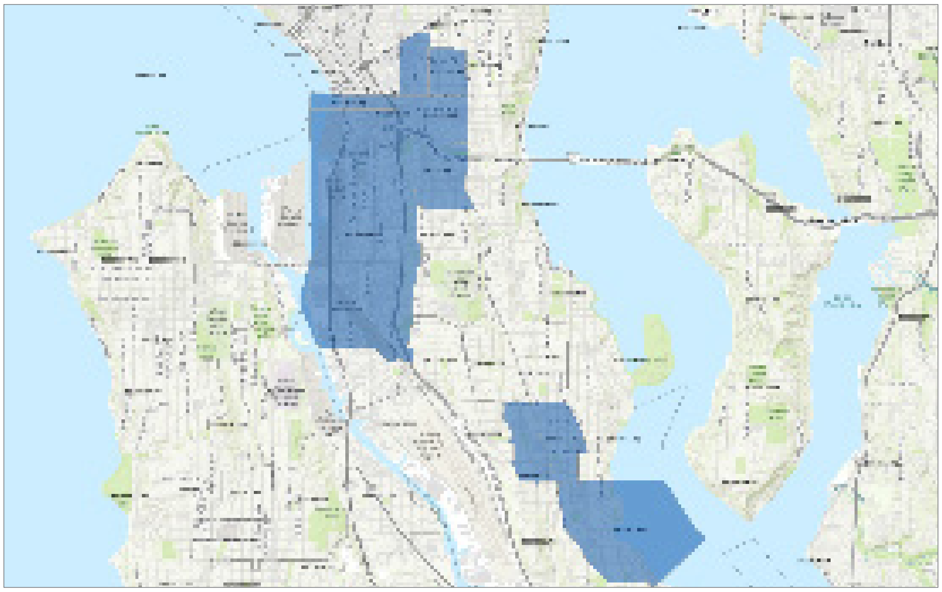
To find out about the possibilities presented by Opportunity Zones, we sat down with LNWM's Carla Wigen and Kristi Mathisen.

Q: Why is there is so much interest in Opportunity Zones?

CARLA: Opportunity Zones can provide a win-win: deferring, lowering and eventually eliminating some capital gains taxes while helping to revitalize low-income neighborhoods, including those near bustling urban areas where there's a shortage of affordable housing.

According to the US government website, there are 22 Opportunity Zones just in King County. Nationwide, about 75% of the Opportunity Zones are within dense urban areas, including for example, Seattle's Pioneer Square, the Arts District in downtown LA, and sections of Queens where Amazon's new HQ 2 is going to be built.

Opportunity Zones in the Seattle Area



Source: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx\

Because Opportunity Zones were designated based on the 2010 US Census, many of these neighborhoods have already seen a fair amount of development. In other words, investors already see the potential. Given the many possibilities for investment and the tax benefits, the excitement is understandable. But there remain many questions and misinformation out there since regulations are not yet finalized, and investment options are still quite murky.

Q: How can people invest in Opportunity Zones?

CARLA: You must buy into a Qualified Opportunity Fund (QOF), which can then invest in one of these two ways:

- Directly, in which case 90% of the QOF's investments must be in Opportunity Zones; or
- Indirectly by buying an equity interest in partnerships or corporations that are at least 70% invested in Opportunity Zones.

This means investors could set up their own partnership or corporation to buy property in the Opportunity Zone or invest through one of the many funds now being marketed.

It is not enough for the QOFs to just buy existing properties. If a QOF buys a 2-star hotel in an Opportunity Zone for $1.5 million, for example, it must then invest at least $1 million more (the cost of the building) within 30 months of the purchase in improvements and renovations. Another example is if the QOF buys a plot of land and builds a new manufacturing plant on it. The idea is to encourage major investment in the Opportunity Zones that will spur business activity, employment and make the area a more attractive place to live and do business.

We suspect that most QOFs will make indirect investments that are structured as real estate deals, many of which will be single-asset funds.

Q: What do you have to do to defer capital gains taxes?

KRISTI: There are two steps to this, and timing is very important:

1. Sell an asset that generates a capital gain – it can be stock, real estate or even a business.
2. Generally, within six months (180 days) of the sale, reinvest the gain in a Qualified Opportunity Fund (QOF). The amount you invest does not have to be the entire capital gain. So if your long-term gain on Amazon stock is $1 million, you can reinvest half that in a QOF and pay the capital gains tax on the other half.

Also, you can sell out of one QOF to invest in another and continue to get the tax benefits.

Q: What else should people know?

KRISTI: It is important to realize that you will eventually be taxed on the capital gains you deferred by investing in a QOF. There are some key dates to keep in mind:

Dec. 31, 2026. At this time, you will owe taxes on your invested capital gains, even if you're still holding the QOF. However, if you've been invested in the QOF for at least five years (since 2021), you'll be taxed on just 90% of the gains invested (if you invested $1 million in gains, you'll be taxed on $900,000). And if you have been invested in a QOF for seven years (since 2019), you'll be taxed on 85% of gains invested.

10 Years after you invest in a QOF. If you sell out of a QOF after being invested for 10 years, there is an extra tax benefit. Any profit on gains invested in a QOF for 10 years is effectively wiped out for tax purposes (on that, the cost basis equals fair market value at the time of sale). The chart below shows what happens if you invest $1 million in gains in 2020 in a QOF vs. a regular investment. If your investment in the QOF gains 50% in value over the next 10 years, you will pay much less in capital gains taxes investing through a QOF, assuming all goes as planned.

Dec. 31, 2047. All investments in QOFs must be sold as of this date to capture the tax breaks. You may want to sell well before this date to avoid the risk of fire sale prices.

	Invested in a Qualified Opportunity Fund (QOF)	Invested in Other Assets
Capital gain realized in 2020	$1 million	$1 million
Capital gain taxes due in 2021*	none	$238,000
Proceeds invested in 2020 (post-tax)	$1 million in QOF	$762,000
Capital gains taxes levied Dec. 31, 2026	$214,000 Assuming a cap gains tax rate of 23.8%* and 10% drop in gains taxed due to 5-year holding period.	None
Investment sold in 2031 for 50% profit	$1.5 million (of which $500,000 in new capital gains)	$1.14 million
Capital gains taxes	NONE	$90,678 (23.8% of $378,000 profit)
Total Capital Gains Taxes Paid	**$214,000**	**$328,678**

*20% capital gains tax plus the 3.8% surtax on annual income above $250,000 for married filing jointly ($200,000 for individuals).

Q: How do people find out about Qualified Opportunity Funds?

CARLA: Since this legislation was announced, thousands of funds have registered as QOFs. But as of now, there is no centralized database for looking up all these funds. Here at LNWM we have been meeting with and evaluating QOFs to see which might work for our clients. You have to be very careful in vetting these funds because this is a long-term investment we are talking about and a new structure for investing.

Q: Who should consider investing in a Qualified Opportunity Fund?

KRISTI: It is worth evaluating the merits of a QOF if you have sold appreciated assets within the past six months (180 days) or plan to do so in the near future. However, investing for the tax benefit should not be the main driver of the decision. There are other ways to defer capital gains taxes, such as a Section 1031 real estate exchange or establishing a charitable trust. Also, simply holding on to assets until death means heirs will inherit them at prevailing market prices (a "step-up in cost basis"), significantly lowering their capital gains taxes if/when they sell. By contrast, the deferred gain invested in a QOF does not get a step-up in cost basis should the investor pass away. His/her heirs will report the same gain in 2026 as the investor would have reported.

CARLA: Our position here at LNWM is that Opportunity Zones can work well for some people. But certainly not all. A great deal depends on your finances, time horizon, and the specific QOF through which you invest. We cannot emphasize that enough.

What you invest in a QOF should be money that you can lock up for at least 10 years, and be willing to invest in riskier assets. In many of the more promising Opportunity Zones, prices have already risen by what we estimate to be 10% to reflect potential demand. Because of the risk, the intermediary you use to invest – the QOF– must be capable of investing wisely and making sure the numbers pencil out in terms of return given the higher risk involved, not just raising capital. Fees must be reasonable. And also meeting all the regulations and deadlines.

Our Investment Strategy & Research team is currently applying the deep level of due diligence we do on all our recommended funds to find QOFs that might serve our clients well in terms of the potential investments, fees, exit strategy and other considerations.

Real Estate and the 2017 Tax Law

In addition to introducing Opportunity Zones, the 2017 tax law kept most of the tax benefits of investing in real estate:

- Real estate taxes remain deductible for those who itemize, but only up to $10,000 a year.
- Home mortgage interest is also still deductible for those who itemize. But for mortgages issued after Dec. 14, 2017, only the interest on $750,000 worth of mortgage debt is deductible (previously $1 million).
- Investment real estate and business real estate can still be exchanged tax-free via a Section 1031 Exchange (but not other types of assets).
- On the sale of a primary residence, up to $500,000 in capital gains for a married couple ($250,000 for singles) can be excluded if you lived in the residence for two of the last five years.
- Most dividends received from Real Estate Investment Trusts (REITs) qualify for the new 20% deduction on business income. Other net income from a real estate business may also qualify for the 20% deduction but this is subject to limitations: the deduction cannot be more than 50% of the wages paid by the business OR 25% of wages plus 2.5% of the cost (unadjusted) of the business' tangible property, such as real estate, machines, etc.

ABOUT THE AUTHORS

Carla C. Wigen is Chief Operations Officer at Laird Norton Wealth Management. In this key role, Carla works to ensure that the full strength of LNWM's services is being applied strategically to achieve the goals of each client, and to develop new connections, resources and programs that help clients thrive in all aspects of their lives. To her work, Carla brings 25 years of experience as an industry leader in comprehensive wealth management, including investments, planning, trusts and estate strategies, and tax law. Carla earned a Juris Doctorate at the Seattle University School of Law and a Master's of Law at the University of WA School of Law. She has a Bachelor's in Business Administration from the University of WA and is a Certified Public Accountant.

Kristi Mathisen serves as Laird Norton Wealth Management's in-house expert on tax and estate planning issues. She provides advice on philanthropic strategies to the firm's client service team and to clients directly. She is an attorney and CPA and has more than 20 years of finance-related experience, much of it in accounting. Kristi has a bachelor's degree in business administration with an accounting concentration from the University of Washington and a Juris Doctor from the University of Washington School of Law. She is a member of the Washington State and King County Bar Associations, the Washington State Society CPA and the American Institute of CPAs.

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