Opportunity Zone Investments: A Wealth Management View

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January 24, 2019

The Tax Cuts and Jobs Act (TCJA) was enacted in December 2017 and created a new tax-advantaged investment opportunity through Qualified Opportunity Zone Funds (QOF). These funds are legal entities; partnerships or corporations who self-certify on a one-page IRS form, hold at least 90% of its business properties in a qualified opportunity zone, and invest to substantially improve its qualified property. The gist of the program is that the federal government will allow favorable tax treatment of realized capital gains that are invested in qualified opportunity zones throughout the country to spur economic development in impoverished areas. The rules and requirements are numerous and complex but with helpful planning with an investor's advisors, the tax benefits can be generous. Many CPA firms, attorneys, and investment firms have provided educational information for investors to understand these achievable tax benefits. As a wealth management firm, the area of focus that we specialize is in exercising our fiduciary duty by evaluating the suitability of these investment opportunities for our clients.

At SevenBridge, we are a registered investment advisory firm required to make recommendations that are in our clients' best interest. Part of this duty is assisting our clients in understanding risk and expected return. The opportunity to invest in QOF's for significant tax deferral and savings is clear but we cannot overstate the importance of careful planning around portfolio construction, diversification, and risk management.

The foundation of QOF investment evaluation is built on asset allocation and specifically the suitability of a real estate investment allocation. While opportunity zone investing may present a significant tax savings opportunity for some investors, the reality is that many investors do not have the level of net worth, risk tolerance, or time horizon suitable for us to be able to recommend an investment in real estate funds where the underlying assets are owned in underdeveloped areas of the country. On the other hand, there are many investors who are set to experience a liquidity event in 2019 and/or those investors who will have to plan to deal with large capital gains. These investors could have a need for a real estate allocation as a part of the post-sale investment portfolio. Another example could be an investor with current real estate holdings that have unrealized capital gains that an investor could realize and invest in a QOF, keeping the exposure to the asset class while taking advantage of the new tax law. For those investors, an investment in a QOF may be in their best interest.

As we help our clients evaluate a QOF investment, the topic of risk is front and center. Real estate investing has certain risks associated that require high tolerances and high degrees of investment experience. The most impactful risks in this evaluation are liquidity risk, market risk, and concentration risk. Liquidity risk is straightforward. Depending on the method of investment, capital can be locked in QOF projects for many years and any investment in an opportunity zone should be planned as a long-term investment as the maximum benefits are not achieved until a ten-year holding period is reached. Market risk covers many aspects of a potential QOF investment including the risk that any tax benefit received will be spent in the initial purchase of QOF property as property owners may price the sale of the property accordingly to capture these tax benefits themselves. Additional market risk includes the availability of tenants. If housing costs increase within the opportunity zone, will businesses and/or families living there be able to afford the cost? If not, will the demand from tenants be strong enough to meet profit goals? Finally, concentration risk is the risk that an investment in a QOF property results in a lack of proper diversification within the investor's portfolio.

Diversification is a way to minimize non-systematic risk where a loss experienced from one investment will not derail the entire portfolio and financial plan.

After the evaluation of appropriate asset allocation and risk in an investor's circumstances, the next step for those seeking to invest is to consider how to invest in Opportunity Zone property. This can be achieved in several ways including creating your own fund or investing in a closely held legal entity and self-certifying as a QOF. Additionally, one could also invest in an existing QOF fund offered by venture capital and private equity firms. The first option offers advantages such as the ability to control capital investments, directly evaluate projects and control project management. The disadvantages are an increase in the investment of time, a potential lack of expertise in real estate project evaluation, and a higher cost of administration and compliance. The second option requires less time and cost and has the potential benefit of outside professional management but is disadvantaged by a loss of control over capital, project evaluation, and decision making. An investor's decision on how to invest depends on many factors and ultimately a weighting of the advantages and disadvantages of each option.

All in all, the TCJA created a very interesting opportunity for investors to take a fresh look at real estate investing within their portfolios. Client preferences, risk tolerance, time horizon, and experience are all personal factors that result in a unique portfolio specific to a client. All factors need to be considered when evaluating whether an investment in a QOF is in our client's best interest.

Contact us at SevenBridge for more information.

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