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SAXUM INSIGHTS

Opportunity Zones: A Historic Tax-Efficient Mechanism to Leverage Real Estate

September 2018

Historic and Relatively Unknown

It is our belief that we have just witnessed the passing of one of the most innovative and impactful bi-partisan sponsored tax legislations in recent history. While the impact will be wide reaching, it is difficult to fully appreciate the potential benefits that will be directly attributed to the Opportunity Zone Program, including economic growth, job creation, social impact, financial profit and increased future municipal tax revenues. Surprisingly the program remains relatively unknown to both retail and institutional investors despite the impressive opportunity surrounding the recent legislation.

The Land of OZ

The Opportunity Zones Program ("OZ Program") was legislation originally included by Congress as part of the *Tax Cuts and Jobs Act of 2017*. The legislation was championed by Democratic Senator Corey Booker and Republican Senator Tim Scott to form a bi-partisan national coalition of nearly 100 congressional co-sponsors. The OZ Program is an innovative approach to spurring long-term private sector investments in qualifying designated areas. Following the passing of OZ legislation in December 2017, state governors had the responsibility to elect tracts in their state that fit into the pre-determined criteria[1] for submission to the U.S. Treasury. Those selected census tracts were named "Opportunity Zones", and will hold that designation for 10 years. Approximately 8,760 unique tracts were approved by the U.S. Treasury nationwide on June 14, 2018, representing all 50 states and multiple U.S. territories (for ex. all of Puerto Rico is labeled an OZ).

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The innovative portion of the bill is that the federal government is incentivizing the free market to invest in qualified areas via tax incentives which encourage the realization and reinvestment of approximately $2.3 trillion[2] in untapped capital gains currently held by U.S. investors. In short, the government passed legislation that leverages tax incentives to encourage investors to take unrealized capital gains and redeploy those gains into OZ investments, which include both real estate and some operating businesses to spur development activity in qualifying areas. OZ investments qualify for multiple tax incentives, which are both historic and substantial, and we believe they will drive the next wave of real estate investing over the coming decade.

1031 Exchange on Steroids

The OZ Program is historic given that it creates an exchange vehicle mechanism that allows investors to unlock gains in <u>any</u> asset class to achieve significant tax advantages through new investments. Investors may reinvest gains upfront and tax-deferred[3] from the sale of any existing investments (stocks, bonds, real estate, operating businesses, art, collectables, etc.) into an Opportunity Zone Fund ("OZ Fund")[4]. In addition to deferring taxes of gains upfront, investors can also potentially reduce the deferred capital gains taxes based on the holding period of the new investment. For example, after the new exchange investment is held for 5 years, investors can achieve a 10% reduction on the capital gains taxes from the original investment, and after 7 years, investors can receive a 15% reduction. While deferred taxes from the original investment are reduced, they are still due to the government by 12/31/2026 at the latest[5]. We believe that while deferring and reducing taxes is meaningful, what is most significant about the program is that after 10 years investors pay <u>zero</u> federal capital gains taxes on the new gains earned through the new investment made into an OZ Fund. This is extremely attractive to any investor with a longer-term time horizon[6].

Investors may be familiar with Traditional 1031 Exchanges which are referred to as like-kind exchanges, with the main stipulation being that proceeds from the real estate investment being sold needs to be redeployed into a similar real estate investment that preserves the initial ownership structure. The benefit of a Traditional 1031 Exchange is that 100% of the proceeds can be deployed into a new asset with taxes being deferred until an indefinite future capital event date. The benefit is similar to that of a retirement account where taxes are paid in arrears and the basic math of compounding on a larger principal amount magnifies returns substantially over longer period of time.

For comparison, the OZ Program allows for tax deferred benefits somewhat similar to a Traditional 1031 Exchange, but without all of the complicated structuring and transfer provisions. Also consider the added financial benefits of the reduction in capital gains taxes from the original investment, and most importantly the complete elimination of federal capital gains taxes on the profits from the new investment if held over 10 years. The capital gains elimination for horizons over 10 years is where the "steroids" truly kick in and provide an environment where OZ Fund investments can outperform a similar yielding non-OZ investment by **20%-40%** on an after-tax basis.

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It's worth noting again that any asset can be sold and invested into an OZ Fund and receive tax-advantages. This is historic given that Traditional 1031 Exchanges have exclusively required like-kind exchanges, which primarily are real estate into real estate assets only. The fact that the government is opening the cross-asset tax incentivized door is unprecedented, remarkable and a testament to the potential strength of the program.

Win/Win

So far, we've discussed the OZ Program's advantages mostly from the point of view of the investor, but it's equally worth discussing the attributes from the government's perspective which adds to the innovative thought process and credibility surrounding the legislation passing.

One of the obvious advantages for the government is that the legislation establishes a mechanism to guarantee future tax revenues by 12/31/2026 at the latest. Without incentives those gains may have remained unlocked into perpetuity as investors have been unwilling to realize the capital gains and often look to pass on (gift) those investments to future generations. The future tax revenues being referred to will materialize when investors are required to pay the reduced and deferred capital gains taxes from the original investment in 5 to 7 years.

In addition to locking in future tax revenues, the most significant benefit to the government is related to potential fundamental growth in the qualifying areas due to the substantial rehabilitation requirement for OZ Fund investments. This requirement is an important aspect to the legislation and was a very thoughtfully crafted portion of the bill. The OZ Program requires real estate investors to double the basis of the investments within an OZ Fund within 30 months of acquisition. For example, if a fund buys an asset for $10 million, then the fund will need to invest another $10 million into the property within 30 months of closing. In other words, a substantial amount of work and investment needs to be done for an asset to qualify for the OZ Program. The substantial rehabilitation requirement does not allow investors to buy a fully stabilized asset without significantly improving it. Heavy value-add renovations and ground-up development deals are the only real estate projects which will realistically qualify for the program.

The social impact and economic development attributes associated with the OZ Program are preserved and reinforced by the substantial rehabilitation requirement for a variety of reasons. Foremost, it obligates the actual investment in and development of qualifying areas, which will lead to the immediate creation of lasting value in those markets. Local economies will see an increase in growth, which will include near-term construction jobs along with long-term job creation in those areas. The investments will also allow for further gentrification of areas that will directly correlate to notable increases in property values and real estate tax revenue at the state and local levels. All of these factors will provide a stable foundation for significant growth within the qualifying OZ tracts.

We applaud the government for the thoughtfulness around this program. It's akin to the old saying, "Give a man a fish and feed him for a day; teach a man how to fish and feed him for life." As opposed to the government providing grants or bonds that may or may not work long-term, they are encouraging the free market to make entrepreneurial value-add investments into areas in need. In essence, the local municipalities are allowing the private sector to create value and pick the winners based on where they choose to invest with the only assistance coming from a federal level through unlocking unrealized gains in a tax incentivized manner for substantial development projects.

Long for the Wrong Reasons

Without going into a deep dive of our current fundamental and technical views on the state of the market, we would note the following from a macro level prior to briefly discussing asset allocation. The economy is chugging along with quarter over quarter GDP breaching 4% for the first time in 4 years. The unemployment rate dipping below 4% is also noteworthy given that the 2018 average to date is 3.99% and only 2 other years over the last 49 years averaged a sub 4% unemployment rate[7]. Additionally, the U.S. NFIB Small Business Optimism Index also remains at the historical highs of the last 40 years.

Despite these positive attributes there are reasons for caution including rising interest rates, yield curves at ~10 year lows and approaching inversion, all-time high domestic equity prices, China's equity market entering bear territory, trade wars, and impending volatility surrounding mid-term elections. Market price action remains a momentum-based trend that is gradually increasing at a decelerating rate, leaving investors to wonder how much of the good news is already priced into the market, and more so what direction does risk-reward favor.

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We have determined from frequent conversations with investors that their investment views are cautiously long given current pricing and risk factors on the horizon. The most common reasoning we hear from investors for staying long the market is two-fold. First, investors claim that their unrealized gains are too high and therefore they can't stomach paying "Uncle Sam." The second obstacle is uncertainty relating to reinvestment risk. If an investor did sell a holding with significant gains, then where would they reinvest the capital at a similar or better return after transaction costs given that asset prices are likely elevated across multiple asset classes. Therefore, the investor's default rational for staying long results in doing nothing, with their present portfolio asset allocation remaining unchanged. Clearly, that's not the best investment strategy in terms of risk management.

As a personal note from my trading days, I once received the advice that in order to stay disciplined, one should evaluate each trading position each day given the present facts at hand. The key to the exercise was that being neutral was not an option. If you were long a position at the open from the prior's day trading and stayed long, you were not neutral, you were still long. By carrying a position into the next day's trading session, a trader was implicitly buying that position again at the prior day's closing price each day regardless if an actual trade was executed. In other words, if you are not a buyer, then you are a seller[8]. We strongly suggest that all investors should follow this philosophy with their own portfolio with each investment position on a regular basis.

The OZ Program provides an alternative release valve for investors currently following the "long by default due to no better option" investment strategy as previously described. In my opinion, now is an opportune time where the government is giving a tax advantaged free pass to investors to defer capital gains taxes and reallocate into an alternative asset class that is likely to outperform over the next 5-10 years in our view.

Conclusion
The purpose of this Saxum Insights is to provide a general introduction to the OZ Program while noting its financial highlights to serve as a basis for a thoughtful investment discussion. In no way is this paper meant to serve as a deep dive into every tax and legal intricacy of the OZ Program. It's worth noting that the limited media focus to date on the program is partially due to the fact that the IRS and U.S. Treasury have not issued finalized regulations and guidance for fund managers to fully adhere to. Final guidance is expected over the next few months.

With that said, Saxum is fully committed to the OZ Program and is serving as a thought-leader during the infant stages of the legislation's roll-out. While regulations and guidance are not yet fully complete, a substantial amount of information is already known to allow for the initial stages of the fund creation process to responsibly commence. Therefore, Saxum has recently announced the launching of the "Saxum Opportunity Zone Fund," which is regarded as one of the first funds to announce nationally. Our targeted capital raise is $100 million, with a focus on investing in value-add and development projects located in OZ tracts throughout the Northeast and Mid-Atlantic regions with a focus on transient orientated and/or urban-centric markets.

RE-NJ Article: Saxum Announces New 100 Million Fund For Opportunity Zones

Chad DeBolt
Director of Investments

Our Saxum team has a broad range of experiences, and we believe that analyzing real estate through a variety of lenses brings multiple perspectives to focus which fit an asset class that is in itself so inherently complex. No individual real estate deal is the same given the multiple levers that can be pulled throughout numerous stages of an asset's life cycle. Saxum Insights covers a wide range of topics from extremely technical and analytical in nature, to simple thought driven concepts based on sentiment and anecdotal observations. Sometimes the most thought-provoking ideas are simple concepts which are misunderstood or overlooked. Feedback and thoughts are always appreciated.

APPENDIX

Sources

(1) OZ tracts must have a median family income <80% of the area median and >=20% poverty rate
(2) Economic Innovation Group
(3) OZ Program gains tax incentives relate to federal taxes only
(4) Only partnerships or corporations are eligible for OZ Program investments
(5) Phantom taxes in 5 to 7 years will require prudent fund managers to build reserves or refinance a portion of the portfolio to return to investors to meet their tax need
(6) Note that only the gains portion of the investment exchange receive the program's tax incentives
(7) Bureau of Labor Statistics
(8) Note that this simple analysis assumes a liquid market with minimal transaction costs