Custody Role Critical to Success of Nascent Opportunity Zone Fund Market

CUSTODY SERVICES

Millennium Trust offers primer on Opportunity Zone Funds, a new tax-deferral investment vehicle, with the potential to transform communities.

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Introduction

As part of the Tax Cuts and Job Act of 2017, Congress introduced a new capital gains tax deferral benefit that is designed to kick start redevelopment in economically distressed regions of the country. This legislation, the Investing in Opportunity Act, is expected to open the door to a new alternative investment option for investors: Opportunity Zone Funds.[1]

As this market emerges, Millennium Trust can serve as a valued ally with the architects of these new investment vehicles. As the expert leader and trusted custodian of alternative investments, Millennium Trust has the experience and expertise you will need to successfully navigate this uncharted landscape.

What Is an Opportunity Zone?

Opportunity Zones are specially identified and certified economically distressed areas throughout the United States and U.S. territories. Included in the Tax Cuts and Job Act of 2017, the Investing in Opportunity Act established the Opportunity Zone Program.

The program authorized governors of all 50 states and five U.S. Territories, as well as the mayor of Washington, D.C., to nominate up to 25 percent of their jurisdictions' "low-income census tracts" as Opportunity Zones. To qualify, the area's poverty rate must be at least 20 percent or the median family income must be less than 80 percent of the region-wide median family income.

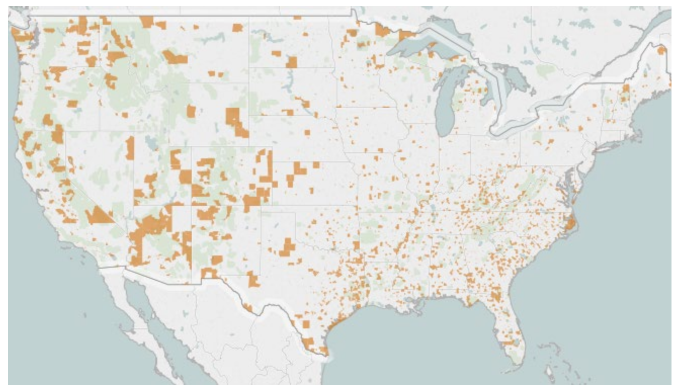
As of December 2018, the Treasury Department has certified 8,764 Opportunity Zones.[2] This classification stays in effect for 10 years. Opportunity Zones are essentially another type of "place-based economic policy," which investors have had access to previously in other forms. However, earlier programs allowed for tax credits rather than tax deferrals. This is a key difference and major shift in inducement. The Opportunity Zone Program has fewer restrictions and is expected to be easier and less costly to create and administer than established programs encouraging private investment in low-income localities.[3]

The purpose of designating areas as Opportunity Zones is to attract economic development where there may not have been otherwise. Within the nearly 9,000 Opportunity Zones certified, the average poverty rate is 32 percent. The economic idea behind the legislation is that with an influx of investment and redevelopment, jobs will come to these areas, and the reported 35 million Americans who live within these areas would benefit.[4]

It has been estimated that as much as $100 billion could be poured into Opportunity Zones[5], and the draw for investors is clear. Investors may roll over capital gains from any asset sale (real estate, bonds, stocks, etc.) and have those gains deferred for a set timeframe and reduced by up to 15 percent in certain circumstances. In addition, capital gains earned on the Opportunity Zone investment – if held for the required minimum time – are excluded from the capital gains tax.

Where Are Opportunity Zones?

The Treasury Department has certified 8,764 Opportunity Zones in all 50 states, Washington D.C., Puerto Rico, American Samoa, Guam, Northern Mariana Islands and the Virgin Islands, creating an enormous potential for real estate developers, investment managers and investors.



Source: Opportunity Zone Explorer By OPPORTUNITY360. Enterprise Community Partners. April 2019. https://www.enterprisecommunity.org/opportunity360/opportunity-zone-eligibility-tool

What Is an Opportunity Zone Fund?

Investors cannot directly invest in an Opportunity Zone; instead, they can invest in Opportunity Zone Funds. An Opportunity Zone Fund is an investment vehicle that elects to be treated as a corporation or partnership for federal tax purposes and invests in Opportunity Zone properties or Opportunity Zone businesses. At least 90 percent of the fund's holdings must be qualified as an Opportunity Zone property or business. So far, more than 100 funds whose primary investments are in Opportunity Zones have been created.

An Opportunity Zone Fund offers investors diversification with different risk and return profiles, as well as the potential for tax-deferred growth and earnings.

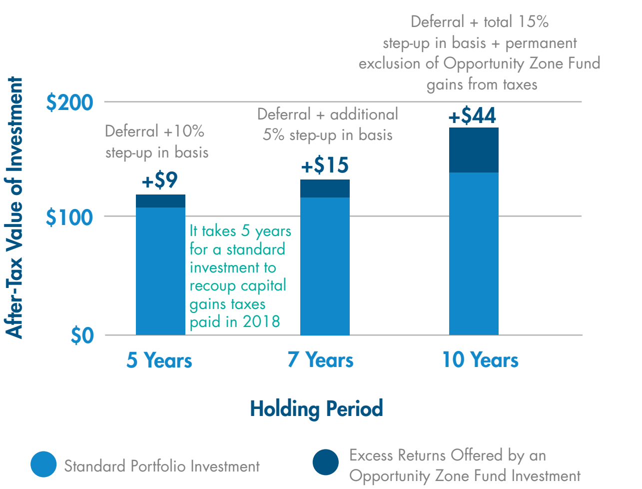
The rules for what qualifies as an Opportunity Zone property or business in which an Opportunity Zone Fund can invest are complicated. Generally, an Opportunity Zone Fund can invest in businesses that derive at least 50% of their gross income from activity in or 50% of their wages or hours from revenue earned within an Opportunity Zone. Certain businesses, such as golf courses, racetracks and liquor stores, do not qualify. There are also rules governing the timing of acquisition and improvement of property in order to be a qualified Opportunity Zone investment. Developers and fund managers should discuss these requirements with their legal and tax advisors.[6]

What Are the Potential Benefits to Investors?

The potential benefits of investing in an Opportunity Zone Fund are many. The most noteworthy are the tax benefits.

Incentives Offered by the Opportunity Zones Program

How does a capital gain of $100 reinvested in 2018 perform over time?



Note: Assumes long-term federal capital gains tax rate of 23.8%, no state income tax, and annual appreciation of 7% for both the Opportunity Zone Fund and alternative investment.

Source: Figure 1. Incentives Offered by the Opportunity Zones Program. "Opportunity Zones: A New Incentive for Investing in Low-Income Communities." Economic Innovation Group. April 2019. https://eig.org/wp-content/uploads/2019/04/Opportunity-Zones-Fact-Sheet.pdf.

Investors who realize capital gains on the sale of any asset can reinvest those gains into an Opportunity Zone Fund, deferring the capital gains tax on that sale until December 31, 2026. In addition, investors enjoy the possibility of reducing their capital gains tax under certain conditions. After the initial capital gains are invested in an Opportunity Zone Fund, the investor's cost basis can be stepped up by 10 percent. An additional 5 percent is stepped up after holding the investment seven years, totaling a potential 15 percent reduction in capital gains tax.

Finally, any capital gains earned on investments held for at least 10 years in an Opportunity Zone Fund will be excluded from capital gains tax. Investors should consult with their tax advisors to fully understand their personal tax implications.

In addition, investors play a vital role in funding the redevelopment of economically distressed areas throughout the country.

Why Opportunity Zone Funds Need a Custodian

Real estate developers are keenly interested in launching Opportunity Zone projects. Fund managers and registered investment advisors are also exploring this market.

As with any asset class, it is important to partner with reputable and experienced service providers to achieve the most success. Choosing the right custodian for the fund's assets is one of the most crucial decisions fund managers can make to help increase investor confidence through transparency and operational efficiency. In addition, a registered investment advisor for an Opportunity Zone Fund must comply with the SEC Custody Rule by maintaining client funds and securities with a qualified custodian.

Additionally, Opportunity Zone Fund investments are alternative assets, similar to other real estate-related securities, private equity or debt, and marketplace loans. Millennium Trust Company's expertise lies in the custody of alternative assets, with almost 20 years of experience and nearly 500 funds under custody.

Conclusion

The Opportunity Zone Program has the potential to benefit investors, as well as the communities in which the funds invest. With the exciting new opportunities this emerging market brings, now is the time to learn more about this investment vehicle and to analyze whether it could be the right fit for you.

Working with Millennium Trust can help you meet regulatory requirements and add an important layer of transparency to your fund, ultimately creating an environment conducive to attracting investors and achieving fundraising goals.

To learn more, visit mtrustcompany.com/fund-custody.

References

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