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Why "Qualified Opportunity Zones" May Be the Next Hot Thing in Investing

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Illustration by Tim Peacock

At a Los Angeles conference last week, AOL co-founder Steve Case and *Hillbilly Elegy* author J.D. Vance described their work funding start-ups in the American heartland, far from Silicon Valley. They were about to take questions when an audience member popped up from his seat.

The young man couldn't wait in the lines forming at the microphones. He needed to know *now:* How can we help?

Well, Case replied, people could invest directly in start-ups, growing local companies, or "the opportunity zones I've been an advocate for over several years."

Case was referring to "qualified opportunity zones," or designated low-income neighborhoods. At that moment, he sat just blocks from a zone. On one side of the downtown L.A. boundary sits The Lash, an "edgy, urban nightlife spot, catering to a trendy crowd," and The Association, a cocktail bar with "secured parking." On the other is a Pizza Hut, a police station, and a Los Angeles

Mission homeless shelter.

In these zones, investors can buy equity in a business or real estate and reap "significant tax benefits," Case said. "Maybe that's something you can do."

How significant? If you roll the capital gains from the sale of anything—your home, shares of Amazon.com , a Modigliani—into a "qualified opportunity fund," and hold for 10 years, you get to defer paying capital-gains tax until the end. Then you're taxed on just 85% of the original investment, and 0% on any money generated by that initial money.

These generous tax benefits have investors excited. When the zones were created by Congress, in a measure supported by both Democrats and Republicans, the rules were murky. But after recent clarifications from the Internal Revenue Service, it's all anyone can talk about.

"The reason there's so much hype is because it's really something new; it's got bipartisan support, which is amazing; and if carefully structured and planned for, it could really serve a lot of greater good for the communities," Lisa Knee, a lawyer and tax partner at accounting firm EisnerAmper, tells *Barron's*.

Some wealthy investors are still waiting for a few details to be ironed out—for example, whether debt will count toward reducing the tax basis—before jumping in. But many others are not. Cresset Capital Management already has $1 billion of real estate deals in the pipeline, according to co-founder Avy Stein.

Here's how it works: Own something worth money and sell it. Within 180 days of a capital gain, an investor can put that money into a qualified opportunity fund—a partnership or corporation investing at least 90% of its assets in "property" in designated qualified opportunity zones. Property can mean stock, partnership interests, or business property, like a building, which you have to have purchased after 2017, or that you substantially improve.

Say an investor sells stock today for a $1 million gain and puts it in a qualified opportunity fund. She would have nothing due now, but in 2026, she would have to pay taxes on 85% of the original $1 million. Then, if she sells the fund interest in 2028 for, say, $10 million, she would pay no taxes on the $9 million gain.

"Any gain you have during the hold period of the fund, that's tax-free, which is pretty remarkable," says Marla Miller, tax managing director in BDO's National Tax Office. "The 10-year hold is very enticing for a lot of investors."

The potential supply of capital is huge: the Economic Innovation Group, a think tank founded by Napster's Sean Parker, estimates that there are $6 trillion of capital gains. The possible investment opportunities are also large. There are eligible zones in all 50 states.

"You're enticing a lot of money off the sidelines into opportunity zone areas," says Neal Wilson, a co-founder of EJF Capital, a $10 billion asset manager. "If you can realize some of those gains; if even a small percentage of that goes into opportunity zones, it will have an impact."

The lines are drawn imperfectly. Some of New York's affluent Brooklyn Heights is a qualified opportunity zone, with 7% of its census tract living in poverty and a median household income of $94,224. So is Puerto Rico's $1,000-a-night Dorado Beach Ritz-Carlton Reserve.

There are few funds yet available to investors. RXR Realty is exploring raising money, and EJF Capital is looking to raise $500 million for an opportunity zone strategy, according to people familiar with their strategies. On the venture side, Case's Revolution, Hypothesis Ventures, and Mucker Capital have signaled interest. But that area may be harder to sell.

"Depending on how many hoops there are to jump through, it just may not be practicable for venture investments the way it will be for real estate investments," Mucker's Erik Rannala says.

There are requirements to getting the tax benefit. Effectively all of the use of the property has to be within the zone during the holding period. And a business in a qualified zone has to derive at least 50% of its gross income from active business in a qualified opportunity zone. And the investment cannot be in a "sin business," like a country club or golf course, liquor store, massage parlor, racetrack, or any gambling venue. Nor can it be a facility that furthers the use of hot tubs or tanning.

The opportunity zone program is Parker's baby. A decade ago, he started working on an idea to get money back into U.S. communities that increasingly offered fewer economic opportunities. The gap between rich and poor had improved for decades but reversed course in the 1980s. Big-box stores started displacing local businesses, and then they were displaced by online juggernauts with lower expenses. The 2008 financial crisis exacerbated these trends, as jobs became more scarce; regions without finance or tech hubs struggled to replace lost industry.

More investment in communities that need it would mean more jobs and safer streets. The criticism of this program is that it will force out longtime residents and businesses, depriving them of the benefits of the neighborhood's improvements. It may also help further fuel a bubble in commercial real estate.

There is also an irony in that it is billionaires like Case and Parker who are leading the charge for this program. Those who were instrumental in the internet and tech revolutions that hollowed out many of these communities now want to put some money back. Can tax incentives really do anything to fix the entrenched inequality and economic strain in the U.S.? Investors may soon be able to find out—all while generating tax-free returns.

An earlier version of this article misspelled the name of the accounting firm where Lisa Knee, a lawyer and tax partner, works. It is EisnerAmper, not EisnerAmpner.

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