M&S DEVELOPMENT
EMPOWERING COMMUNITY REVITALIZATION

OPPORTUNITY FUNDS: A PRIMER

OVERVIEW: The Tax Cuts and Jobs Act of 2017 created a new class of private investment vehicles called Opportunity Funds to encourage capital investments in projects located in economically disadvantaged census tracts. These funds must be invested in the following:

- Projects that are in census tracts designated as Opportunity Zones
- Substantially all (90%) of the fund's holdings must be invested in a Qualified Opportunity Fund (QOF)

HOW OPPORTUNITY FUNDS WORK: Taxpayers may reinvest the untaxed capital gains from a recently liquidated prior investment (180 day reinvestment window), into a QOF. The QOF must invest in Qualifying Opportunity Zone property or business stock which is expected to achieve substantial improvement as a result of the newly invested capital. The tax benefits of a QOF investment are:

1. Temporary deferment of Capital Gains tax on the invested capital for the life of the QOF investment or until December 31, 2026, whichever is sooner. This deferment increases the taxpayer's investable dollars, providing leverage to the QOF investment returns.
2. Step-up in the basis of the original prior investment of 10% if the QOF investment is held for at least 5 years, increasing to 15% if held for at least 7 years. This step-up on basis reduces the real tax obligation on the original investment.
3. No Capital Gains tax on investment returns from the QOF if held for at least 10 years.

HOW OPPORTUNITY FUNDS CAN BENEFIT A PROJECT: If we assume that the qualified project has a need for a $1,000,000 investment and can pay a 4% return, the following table shows the effect of the tax benefits if all three of the above criteria are met. The project benefits from an equity return similar to debt and the investor realizes an effective after tax return that is closer to market rates. The following tables show a combined investment return and tax advantage for an Opportunity Fund investment and traditional investment that are roughly equal after tax.

Untaxed Capital Gains:	**$1,000,000**
Return:	4%
Assumed Tax Rate:	23.8%
Initial Tax Liability:	$238,000
Investable Gains:	$1,000,000

	YEAR									
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Investment Value	762,000	802,000	843,600	886,864	931,859	978,653	1,027,319	1,077,932	1,130,569	1,177,220
Deferred Tax	238,000	238,000	238,000	238,000	238,000	238,000	238,000	238,000	35,700	35,700
Return	40,000	41,600	43,264	44,995	46,794	48,666	50,613	52,637	46,651	48,517
Basis Step-Up								150,000		
Actual Tax								202,300		
After Tax Cash Flow	(762,000)	0	0	0	0	0	0	0	0	1,261,437
IRR	5.8%									

Untaxed Capital Gains:	**$1,000,000**
Return:	6.3%
Assumed Tax Rate:	23.8%
Initial Tax:	$238,000
Investable Gains:	$762,000

	YEAR									
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Investment Value	762,000	810,006	861,036	915,252	972,944	1,034,240	1,099,397	1,168,659	1,242,285	1,320,548
Return	48,006	51,030	54,245	57,663	61,295	65,157	69,262	73,626	78,264	83,195
Tax on Original	238,000									
Tax on Gain										141,309
After Tax Cash Flow	(762,000)	0	0	0	0	0	0	0	0	1,262,434
IRR	5.8%									

HOW OPPORTUNITY FUNDS CAN WORK WITH NEW MARKET TAX CREDITS:

New Markets Tax Credit (NMTC) projects are often in Qualified Opportunity Zones and result in the requisite substantial improvement. In an NMTC project, the sponsor company invests in an NMTC fund together with a tax investor. This fund then loans the combined investment to the tangible property company. The tax investor is repaid in tax credits based on a percentage of the total initial investment, and their initial cash investment in the loan fund is written off as a net benefit to the project.

An Opportunity Fund, on the other hand, is required to invest directly into a tangible property company. Therefore, Opportunity Funds cannot be used to leverage the benefits of the NMTC program. Only when an NMTC project cannot secure enough tax credits can some of the investment be directly invested into the tangible property company. This amount will vary by project. Generally the NMTC subsidy is of far greater benefit to the project than any equity or debt, however, in cases where not enough NMTC allocation is available, the tax benefits of the Opportunity Fund mechanism can help bridge the gap by providing an incentive for investors to support worthy projects at what would otherwise be significantly below-market rates.

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