Opportunity Zones - Ignoring This Major Shift in the Real Estate World is a Big Mistake

I am writing to you about Opportunity Zones.

Apologies if I am outspoken here, but there is a reasonable chance that this is the "biggest thing" to hit the real estate world in perhaps the past thirty or even more years. The Tax Reform Act of 2017 has made a mega-gift to the real estate world.

My proposition is that whatever you are doing in real estate you need to either:

- Get involved directly
- Consider how it will affect you even if you are not involved

Let me take you through my thinking ….

I will start with the first aspect of the "game change" for real estate that hit us in September of 2016 when real estate became a separate asset class. Instead of being one of various "alternative assets," real estate is now an asset class on its own. This means that your average garden variety investment manager is probably advising her clients to put a share of her assets into "real estate" for "diversification purposes."

This has gradually been unleashing a wall of money to the real estate world over the past two years. This is evidenced by major players – such as Blackstone and others – raising so-called "permanent capital" vehicles. And many of our clients are either raising such vehicles or talking about how to achieve permanent capital as an adjunct to their businesses. In a broad sense, "permanent capital" is generally thought to be capital that likes a current yield but once it gets that yield it is more accepting of a lower overall investment return. See my article on this from September 2016.

Now all of the sudden the Opportunity Zone initiative has hit us. For the uninitiated I think of this "**Like a 1031 on Steroids**" (my phrase). There is a "**good**" benefit, a "**great**" benefit, and an "**off-the-charts-benefit**" to the real estate world:

- The "**good**" benefit is for the investor if it has gains on a sale the investor can effectively "exchange" the gains into an opportunity zone and defer the tax on the gains for up to 8 years and even legitimately avoid some of the gains.
- The "**great**" benefit is for the investor that if it invests in an opportunity zone and holds it for ten years then the gain on the investment is tax free
- This is great stuff, but the "**off-the-charts benefit**" is to the real estate world in that gains from non-real estate assets can be exchanged into Opportunity Zones.

Taking a step back for a moment, consider how much the stock market has gone up in the past few years and created I am guessing a trillion or so. All of these are untapped capital gains. And just about every other asset class has gone up in value too in the past ten years. The Economic

Innovation Group says there are $6T – that is SIX TRILLION DOLLARS -- of untapped gains.

What does this mean for us in the real estate world? Here are my takeaways:

- For the first time people who have nothing to do with real estate are looking at it. Sergei Brin who has $50B of Google Stock might, for the first time, think about real estate? Note I have no relationship with Mr. Brin and I don't know him – he is purely a metaphor here. Normally, tech people think that real estate is kind of stodgy and they can make better returns in tech. But a lot of people in the tech world – and just about every world – are starting to wonder if markets really only go straight up and maybe it is time to diversify – to put some money into things that are stodgy but stable – so that the money might be around for the "next generation" of the family/family office. It is hard to beat an opportunity zone for this kind of thing due to the tax advantages. This is already happening as our phones have been ringing off the hook – and I predict it will turn into a stampede. Also, if the non-real-estate markets start to fall, this stampede could gain significant ground. I mean if you made a million in tech stocks and they drop 20% you might be thinking it is time to take those chips off the table and if you could avoid the tax, well, then, you get my point.

- If you are a sponsor of course the upside is obvious. If you are capable of putting together deals in an opportunity zone, you should be able to achieve a less expensive and more readily available source of capital. As a side note, I emphasize that I personally am strongly against people putting together deals "because" they are in an opportunity zone – that just encourages foolish deals. I am sure us old-timers will recall, and never forget, the "see-through" empty building built in the 1980's – ultimately, a terrible result of tax advantages run amok in the real estate world. This time, instead of just doing "opportunity zone deals," I advocate that people should put together what they believe are "good" deals that are in opportunity zones with the tax benefits just being gravy; however, my guess is people will not listen to this advice and instead that unscrupulous, over-aggressive or over-eager, players will raise opportunity zone money just to get the fees and a lot of foolish deals will get done.

- If you are a fund raiser type, there should – for the first time – be an ability to raise money from parties not in the real estate world who have never looked at real estate that intently.

- If you are just a rich gal or guy – or have friends who are such – the odds are you have gains and you might at least consider opportunity zone investments.

- If you are a rich guy or gal in the real estate world, who is not afraid of real estate development investments, it may make sense to talk to your rich friends who are not in the real estate world about teaming up to invest in opportunity zone deals. They may be less afraid of real estate development investing if they see you putting your money in side by side, perhaps with a promote or other advantage – or maybe not if they are your buddies.

- If you are an opportunity or investment fund that in your view has nothing at all to do with this since perhaps most of your investors are tax exempt, I think it is a major mistake to ignore this. This is because this wall of opportunity zone money will likely (i) divert sponsors away from you, (ii) provide competitive and cheaper sources of capital, and (iii) divert investor interest away from your business. All of these are competitive risks that should be carefully considered. Perhaps instead of being shoved around by the competition you might raise your own opportunity zone fund?

- If you are a non-profit out to do some good things – perhaps in blighted areas – this can be a way to achieve your mission without the necessity of actually raising money for it…… Hold on – what did I just say? You mean you could achieve your mission without the – intensively miserable and annoying and time consuming and expensive – process of raising money? Yes that is exactly what I just said. Just get people interested in building whatever is needed in the opportunity zone (perhaps to create jobs, etc.) and get out of the way. People can feel doubly good – they are doing good and getting a chance to make some money – and even save their taxes. Too good to be true?

- Lenders – you may not realize this, but there are some severe timing issues pertaining to how the money has to go into the opportunity zone investment in order to qualify. A quick note here is that you "cannot" put in equity for an opportunity zone deal and repatriate it back and keep the tax deduction – it doesn't work that way. However, you can put in legitimate debt and pay it off with opportunity zone investment money. This means that lenders that understand opportunity zones – and can be flexible – will become in great demand. So far no one is really planting a flag to focus on this kind of lending. If you are lender in this position give me a call!

- Lawyers, accountants, and other professionals, well, I guess that is obvious. You really don't want to answer the phone when your client calls to ask about opportunity zones to ask if that is the place inside ten yard line in a football game…

- Finally, even if after really thinking about it you don't think it will have that much effect on your business, you really should know what is going on so at the next cocktail party with your real estate friends you can be the center of attention.

To wrap this up – I have been doing this a long time now – about 35 years since 1983 – to date myself. I can't say this is the "biggest" thing I have ever seen – yet – but it might be.

I don't like to advertise for my firm in The Real Estate Philosopher – so please forgive me – but we are the industry leader in this space right now – both from the tax and the real estate sides. If you want the skinny on any of this or guidance give me a call.

Bruce