EXCERPT

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Looming Expiration Date Slows Enthusiasm for Opportunity Zones Incentive

NICK DECICCO, SENIOR WRITER, NOVOGRADAC

Professionals working in opportunity zones (OZ) are feeling the effects of seeing the incentive's Dec. 31, 2028, date to delay paying on eligible gains approach on the horizon.

The date has helped cool enthusiasm for the incentive, with $3.53 billion in equity raised in 2023, according to qualified opportunity funds (QOFs) tracked by Novogradac. That's less than each of the three previous calendar years, when Novogradac accounted for more than $9 billion annually.

There's the perception that the incentive is "past its peak," said Stephanie Copeland, managing partner of Four Points Funding based in Steamboat Springs, Colorado. Four Points Funding thrives on an intimate knowledge of the Colorado landscape, targeting multifamily housing development in some of the state's smaller communities such as Buena Vista, Durango and Grand Junction.

Image: Courtesy of Four Points Funding
Stephanie Copeland of Four Points Funding.

"I think that, generally, what we're hearing across the market is less interest in seeking opportunity zones funds," said Copeland. "I think the perception that the benefit has passed is there, although you can still take advantage of the bulk of the incentive by investing through the end of 2026. But I think there's a lot of perception that it's not really a strategy people are going to form now, given the fact that you only have another three years to deploy capital."

Keith Lampi, president and CEO of Inland Real Estate Investment Corporation, said that, from a pure investment standpoint with interest rate increases and market volatility, investor demand in OZs began to moderate in 2023.

"While the rate hike trend began to dissipate in the fourth quarter of 2023, 'higher for longer' is the current market sentiment, which will likely mute transaction volumes into 2024," said Lampi. "That said, the feeling that we've hit a ceiling on rates removes a lot of the uncertainty we were dealing with at this time in 2023, which should help the sustainability of current market inflows. Today is very different when compared to 12 months ago, which offers some degree of optimism."

Image: Courtesy of Inland Real Estate Investment Corporation
Keith Lampi of Inland Real Estate Investment Corporation.

Keeping it Real

Multifamily housing development remains the primary investment type for QOFs, according to Novogradac's latest quarterly OZ report, with more than $20.56 billion of the $37.62 billion known investments identified to be invested in multifamily housing. The number of apartments built in OZs tripled from 2016 to 2022 and then doubled again in 2023, according to RealPage Market Analytics.

For Four Points Funding, OZs have presented an opportunity to flex their market muscle in rural Colorado communities when it comes to developing multifamily housing.

"It's a market that requires a really intimate knowledge of where and what to build," said Copeland. "If you're operating in the Denver Metro area, there's getting to know that area is worthwhile because you would probably do repeat projects in the area."

Lampi said seeing underserved markets such as rural communities benefit from capital formation is one of the upsides of OZs. Inland has been in the investment business for six decades and has acquired more than $55 billion across virtually every sector of the commercial real estate market. The firm was an early adopter in OZs and continues to see possibilities in the real estate market, including multifamily housing, Lampi said.

"Thinking about investment through a development lens, a big part of your total return analysis anchors projecting rent growth and income growth," said Lampi. "Multifamily volumes have carried the day and continue to be a good long-term strategy, however growth trends have begun to moderate in certain markets as a result of the recent wave of new supply. Over time, however, as we begin to see new construction starts thin out in certain markets, I believe the opportunity for long-term rent growth will continue."

Headwinds Versus Tailwinds

Spiking interest rates brought volatility and uncertainty to OZ investing in 2023. However, during the year, those were countered by volume returning as a result of the gains generated from the equities market. OZs are coming off of another strong year, Lampi said, with Inland raising more OZ capital in 2023 than it did in 2022.

"Looking back, there was a lot of buzz leading up to the 15% step up burn off and then the 10%," said Lampi. "A lot of participants thought once those tax benefits burned off, capital formation would drop off as a result. What that sentiment overlooked was the power of the biggest tax benefit of all–the 100% fair market basis value step up after 10 years."

Lampi said Inland has shifted its focus to nontraditional OZ strategies such as self-storage and student housing.

Though the 2026 expiration looms, Lampi said there is still utility to the incentive.

"I think that most real estate investors subscribe to the theory that you never make an investment purely based on the tax benefits," said Lampi. "The substance behind the underlying investment has to make sense, first and foremost. Tax incentives are an additional driver of return on investment, but should always be a secondary consideration."

Legislative Horizon

Copeland and Lampi said much of the future of OZs hinges on legislation.

With 2024 as a presidential election year, Lampi does not anticipate changes this year, but expects the concept will be revisited in 2025.

"We're not running the business expecting any near-term changes," said Lampi. "I doubt many investment managers are anchoring their business plans to an extension, which I think is prudent. Several tax-related topics will be evaluated in 2025, however OZ legislation is only one spoke in the wheel of tax reform, so it's going to be connected to a broader discussion."

Lampi said an extension could come with revisitation of nuances of the incentive, including reporting requirements. The Opportunity Zones Transparency, Extension and Improvement Act, introduced in September 2023 in the House of Representatives, extended the deferral date for OZ investment from the end of 2026 to the end of 2028, expands reporting requirements, allows "funds of funds" to invest in other QOFs and more.

Copeland welcomed those and other changes.

"I do love the reporting requirements that are in the legislation and some of the things to make sure that it's having the intended consequences of revitalization and inclusion that was meant to come alongside these investments," said Copeland. "We think everything that's in the bill is beneficial to sustaining the program and improving it. I think that a renewal would certainly start to fortify opportunity zones."

Given Four Points Funding's mission to work in smaller Colorado communities, Copeland said the ability of the OZ to pinpoint locales for investment has been "a powerful way to direct capital into particular geographies."

"We feel like given the lack of friction in deploying, it's the quickest way to really impact reinvestment in some of these areas," said Copeland. "We think that it's pretty strong."

The Future Is Now

Lampi said that while step-ups have passed and the incentive's expiration looms, there's still value in the OZ incentive.

"Despite that runway narrowing, there's still runway," said Lampi. "High-net worth investors are still looking for opportunities to defer payment of taxes and the value of the 100% step up after 10 years cannot be understated."

Copeland drove the point home when it came to the possibilities presented by the OZ incentive, saying that Four Points Funding would have taken a different tactic to building housing in the Centennial State without it.

"Would we have done what we've done without the opportunities on legislation?" said Copeland. "The answer is, frankly, no. We were catalyzed through this legislation and we brought 1,000 units of multifamily units into supply. … Absent the OZ legislation, we would not have done that."

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