Sankala Group

Wizards of Oz (Opportunity Zones)

Harold Hallstein IV

I'm more inspired to be writing to clients than usual this year, driven by serious personal reflection. There are implications in this letter for your kids. There are implications here for your money. There are implications here for our society, and there are certainly implications here for my peace of mind.

This letter will educate you on a new and unusual IRS tax matter, and it will also illustrate the challenges we sometimes face personally as investment advisors. It will touch on social responsibility, and it will balance that against individual advantage. I can only hope you will respect the candor and detail of the content.

The topic is *Opportunity Zones*. Specifically, *Section 1400Z*, Subchapter Z, of the new *Tax Cuts and Jobs Act* ("TCJA") of 2017. Page 353 to be exact.

While tax is not our primary bailiwick, we have some credibility in this space after our analysis of the impact of the TCJA on equity markets proved to be fairly accurate. We pay close

attention to investment taxes because subtle policy changes are amplified in securities prices, which requires us to understand the ramifications well before tax time.

Section 1400Z appears to have been invented by the *Economic Innovation Group,* a think-tank/lobbying house started by Sean Parker, Facebook's first outside president, and more notoriously, the founder of Napster. Napster was an internet service used to steal music and software before artists and software developers figured out how to re-secure their intellectual property after the tech boom.

What the new code does is fairly simple to understand, but more complex to quantify. First, it allows any investor with existing capital gains (stocks, bonds, real estate, etc.) to sell that asset and submit an IOU on the capital gains tax to the IRS which then comes due in 2026. (The IOU's value may even be reduced by 15% at that future date if certain criteria are met.)

Those capital gain assets must then be put into a "Qualified Opportunity Fund" (basically an LLC, partnership or corporation via IRS Form 8896) which must then invest in real estate developments or operating businesses in select census tracts (mapped zones) nationwide. 90% of the fund assets must be in actual zone property/businesses. If that investment is then held for 10 years it is *completely exempted from capital gains tax*. Lesser hold periods receive lesser benefits. Additionally, any real estate investment must improve the built basis (basis ex. land) of the property by 100%, which practically speaking means it must be developed or redeveloped significantly.

In one final wrinkle for the accounting minded, it also appears that barring a clarifying IRS ruling, the part of the capital gains tax code that is used to re-capture annual depreciation deductions (a non-cash tax deduction that may not have actually occurred) will also be overridden at the time of final sale, making this policy especially attractive to those in the highest tax brackets during that 10 year period.

In practice, after running the detailed math through our commercial real estate model, we see a historically average real estate investment performing between 2.1% to 2.9% better per annum inside an OZ vs. outside an OZ. That is a lot of regulatory juice which will certainly impact investment choices and it has already started to. How much of that benefit will accrue to new investors, and how much will accrue to existing zone property owners as an immediate windfall is now beginning to play out in commercial brokerage offices. Our modeling suggests current owners of prime re-developable property asking for an immediate listing price increase of 25%-41% is not unreasonable based on the present value of the tax benefits.

So you might ask, how is this different from any other complex corner of the tax code? As someone paid to pay attention, the only corner I've seen that is nearly as problematic to society is the so-called "carried interest loophole" which is more popularly understood as the loophole

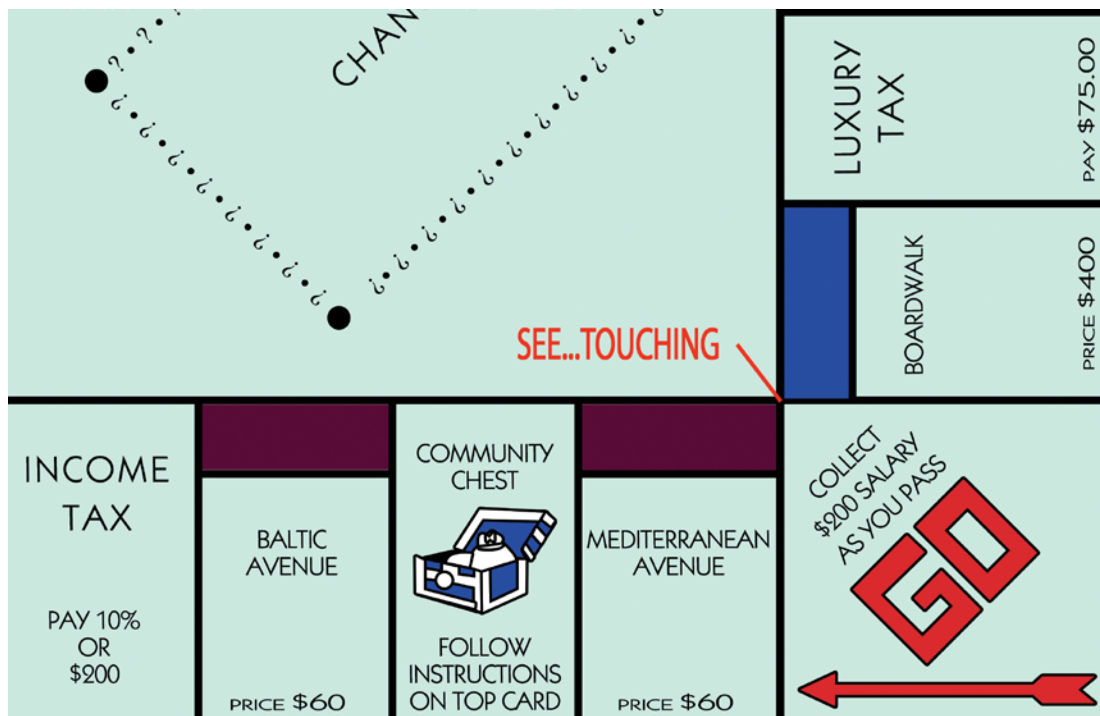
that allows hedge fund and private equity managers to pay effective tax rates below that of their housecleaner. This new code incentivizes the existing wealthy in similar glaring and, frankly, unneeded ways. As investors we simply know this. I'll tell you the big secret right here: *Inflation is the only incentive we need to invest.*

How did such a bill pass? First, congresspeople were coaxed on board by requirements that the actual mapped zones would represent "distressed" areas with lower median incomes, where new investment might have social benefit. I use the word "might," because Congress somehow decided at the final hour to cut out the measurement requirements for the social benefits that had been previously included.

The mapping and tract selection process itself is also deeply flawed; my own city illustrates just how badly. The segment of Boulder that contains Google's new "Googleplex" was somehow qualified because most of the area is commercial and many residents there happen to live in mobile homes and condo developments in one corner of the census tract. The result? What may be one of the most desirable and wealthiest investment corridors in all of Colorado—without incentives—is now also a so-called social opportunity zone. Who is this opportunity for? Not the people living in the condos and mobile homes paying regular income tax rates, who don't have meaningful title to the land below them or capital gains to reinvest.

I won't go too far into the details of the more specious "contiguous exception" that allowed New York City officials to designate the area that Amazon is moving into as an Opportunity Zone. Suffice it to say, the zone did not meet the social requirements, but somehow gets to claim the social distress of the tract next to it, which has actual poorer people. The code allowed State Governors to unilaterally perform this magic trick for selected audiences. Perhaps the thinking was that people with capital gains are distressed by proximity to distressed communities?

All joking aside, it is best visualized by thinking of the Monopoly board. The contiguous exception is like a political pork magic wand that allowed Governors who really had Mediterranean Avenue ($60) to give Boardwalk ($400) to the player of their choice. The corners do actually touch. They even get to Collect Salary ($200) as they Pass Go. The metaphor is very helpful. See the diagram on the next page.



More personally, *Section 1400Z* of the *Tax Cuts and Jobs Act* is actually keeping me awake at night. It makes me feel bad about both the direction of tax policy and also my work. For a decade now I've been telling my clients that my job is not to comment on the lines drawn on the field, but to play a beautiful game within those lines. But I'm a reflective human being. I hope I'm a good and fair human being. And that's why I'm sleepless. This is not about fair competition, or social outcomes. In fact, Treasury Secretary Mnuchin repeated the following to a group of investors:

"It's not about the zone. It's about the opportunity."

This is really about regulatory windfalls to insiders. The lobbyists who invent these policies make people in our industry look bad. They make otherwise good business people feel bad, and they steal meaning from my work. I don't want to live my life inside the wake of corporate lobbyists. I certainly don't want to feel like we need to start doing our own lobbying simply to compete. There is no beauty or pride in that.

So where does that leave us? Let me give you a few very direct answers to the questions I have received:

- Do we understand the practical mechanics and return implications of this loophole?
  Yes, and we are a happy to help model them for you.

- Have we spoken with people building Opportunity Funds?
  Yes, multiple, and some are very sharp.

- Does this policy present any unique risks to investors?
  Yes. Each deal must still have organic demand, and the census tract approach is inorganic by nature and may cause loss of sight of pre-tax fundamentals. It would not be the first time the tax cart was put in front of the horse, leading to a leveraged accident. Since windfalls have accumulated to current property owners, the new pricing even with the tax benefits may be problematic for investors. Also, it remains to be seen what price appreciation assumptions might be appropriate because after 10 years the asset will need to be sold back into a world paying taxes.

- Is the Sankala Group considering starting an Opportunity Fund itself?
  No. My peaceful sleep calls, and real estate development is not our core competency.

- Has the Sankala Group taken any action yet?
  Yes. We are mapping client asset locations, informing clients who own zone property, and suggesting they contact their brokers to ask for material listing price increases or to explore re-development opportunities.

- Will your firm be syndicating Opportunity Fund deals with other managers?
  That can only be decided in collaboration with clients, our quantitative model, and with reflection on individual projects and their unique goals and pricing. We are actively speaking with managers of both real estate and venture capital OZ funds in order to start separating the wheat from the chaff. Time limited investment windows such as this often lure unscrupulous players, so additional diligence is critical.

- Do I think this policy serves the next generation of Americans, our clients and their families longer-term?

  Emphatically, no.

At all times, as your fiduciary, we will try to show you the landscape we are covering to the best of our understanding. That certainly focuses on *after-tax* returns on your capital, but we also

need to paint the broader picture related to policy quality, policy architecture, and the lobbyists driving such programs. Not only so each client can make their own informed social determinations, but so they can accurately assess long-term fiscal risks that may impact their family and investments in future generations. Policies like this stand to impact interest rates, inflation, and ultimately your bond portfolio. Opting the wealthiest among us out of the tax code for long periods of time has implications for the national debt and deficit.

As an investment rule of thumb, we want to be careful anytime we get near the wake of corporate lobbyists. It can be a void feeling place. The boat can turn or be shut off as unexpectedly as it was turned on. Once one lobbying group has delivered spoils one place, another tends to form and push back. In the case of opportunity zones, we see some unique challenges to rollback on this particular policy since it will predicate significant property purchases. We can, however, imagine ways it becomes more complex and problematic for investors. Not adequately respecting those cross currents is unwise.

We look forward to discussing all this with you in person as we plan for 2019.

Best,

Harold A. Hallstein
Sankala Group LLC
T: (720) 310-0605

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