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Qualified Opportunity Zones Could Mean Tax Benefits for ESG Investors

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By Joe Zock and Al Puchala
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Due to transformational legislation contained in the Tax Cuts and Jobs Act of 2017, tax benefits and ESG principles can be achieved for private wealth and institutional clients alike within the same wealth management plan.

But before considering an investment in a Qualified Opportunity Zone (QOZ) for their clients, advisors should carefully evaluate the suitability of such an allocation, the chief prerequisite being: Does the client have, or are they likely to incur, substantial exposure to U.S. capital gains tax obligations arising from the sale of securities, real estate, businesses, art or cryptocurrency? And, are they prepared to allocate the proceeds from these capital gains into an investment strategy that may suggest a holding period of seven to 10 years in order to receive beneficial tax treatment?

If so, the Opportunity Zone program may provide an attractive solution for investors who have accumulated significant unrealized capital gains during the recent bull markets in U.S. equities and real estate and who desire to mitigate their tax exposure.

For example, if your client was fortunate enough to purchase, say, one of the FANG stocks or a beach house in Florida at a low price, but is reluctant to recognize the capital gain because they cannot rationalize paying Uncle Sam, then an investment in a QOZ may provide the answer.



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Let us begin with the fundamentals required to navigate a successful QOZ investment. First, the investment must be located in a QOZ, which is a low-income community where new investments may be eligible for preferential tax treatment. The 8,766 QOZs across the U.S. were selected by the governors of each state and certified by the IRS as “eligible” for qualified investment through December 2026. It is important to note that this bipartisan initiative is currently supported by both Republicans and Democrats, [including President Biden and former President Trump](#).

Second, the investment must be directed into a Qualified Opportunity Fund (QOF), the approved investment vehicle utilized to direct investments within the QOZ.

The QOF then deploys the investment into a Qualified Opportunity Zone Business (QOZB), which is a business that is generally favored by state and local officials for a host of different reasons, such as community redevelopment, workforce housing, water purification, job creation or other development projects intended to benefit the area. It is important to note that these underlying businesses, structured to provide a traditional rate of return for investors in the QOF, are frequently supported by government officials to promote local social and environmental goals. IRS regulations require investments in QOZs to be either new greenfield projects or significant additions to the tax basis of an already existing business, so they are not limited to real estate.

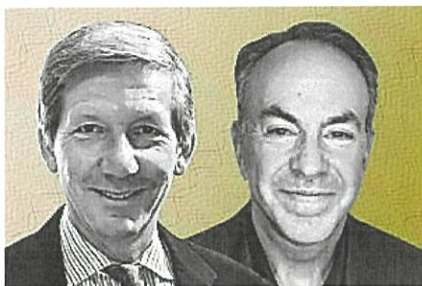
Since the inception of the national Opportunity Zone program, the initial QOZ investors, real estate participants with traditional return-on-investment expectations, have met with limited success. However a second wave of participants, ones with the dual objectives of reaping tax benefits and supporting ESG-compliant projects that foster positive social impact, have begun to change the landscape.

As a result, the scope of investments available to investors is broadening and encompassing more diverse opportunities over a range of market sectors and the QOZs that were established in 2018 to directly assist low-income areas could benefit from a supply of private capital.

Using the tools available under the Opportunity Zone program, ESG-compliant businesses are able to advance these multi-sector objectives, thereby improving these communities while mitigating environmental harm. These diversified projects may include sustainable infrastructure such as data centers, clean energy (i.e., solar) operating companies (such as agriculture) and workforce or government supported multifamily real estate developments, which are green- or ESG-friendly.

Timing is key to qualifying for a QOZ investment. Investors, foreign and domestic, with taxable U.S. gains should consult with their advisors as well as their accountants as they can defer taxes on any prior eligible gain to the extent that a corresponding amount is invested within 180 days in a QOF.

With ESG assets on a pace to reach \$50 trillion by 2025, tax-advantaged strategies aimed at Qualified Opportunity Zones should attract investors who wish to simultaneously reduce their tax burden, assist economically disadvantaged communities and promote the increasingly important principles associated with ESG.



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Photo Illustration by Staff, Tocqueville Asset Management

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