Opportunity zones: A 'once-in-a-generation' chance for both investors and Colorado cities

Jan 17, 2019, 7:14am MST

KATHLEEN LAVINE, DENVER BUSINESS JOURNAL
Jeff Romine, the chief economist for Denver, is guiding the city's effort to find partners for investments in the city's 10 opportunity zones. One of the zones includes the former PT's strip club at 8315 E. Colfax Ave. that the city bought a few years back (after it shut down), and now it thinks the tax credits from the OZ program will be able to attract a developer.

The long-term impact of the 2017 federal tax reform law remains up for debate, usually in very partisan fashion. But tucked almost innocuously into that bill is a new development incentive that is just beginning to attract wider attention and that Colorado leaders across the political spectrum believe could be a game-changer for the state's disadvantaged communities, both urban and rural.

Opportunity zones are newly created districts — 126 of them in Colorado and about 8,700 nationwide — where investors can put capital-gains windfalls, leave them for five to 10 years and get substantial tax reductions on both their current earnings and future earnings from their new projects, whether they be real-estate holdings or operating businesses. The zones that benefit are those in which the average income is 80 percent of the state's median family income or lower, and Colorado leaders who crafted them made sure to put 60 percent of them in rural areas in order to drive development in places that haven't experienced the boom of the Front Range.

While some investors are still warming to the new incentive as the federal government slowly rolls out final regulations on the types of properties and businesses that will qualify for the tax boosts, the potential of this newly created program is staggering. Marc Shultz, a tax attorney and co-chairman of Snell & Wilmer's opportunity zones practice group, estimated there is $6.1 trillion worth of potential eligible capital that could be put into the zones in the coming years, enough to spur significant investment in areas of the country that have been left behind and to deliver benefits to deep-pocketed entrepreneurs in ways that few federal programs have.

"To me, this is looking like a once-in-a-generation opportunity. It is a very robust incentive," Shultz said. "If you look around the country, there are very few areas where you can't find a zone nearby."

However, some officials are leery that the incentive — which allows investors to reap its benefits without working with local governments or community groups on anything other than potential building permits — could spur unfettered development and gentrification, and could push out some of the very community members that it is intended to help. At worst, it could be a taxpayer-funded repeat of the transformations that have changed traditional areas of Denver into more attractive but also much more expensive neighborhoods since the end of the Great Recession and that have led to the city trying to fight back against that trend.

Thus, the Colorado Office of Economic Development and International Trade has deployed about $1.5 million of its resources to work with cities throughout the state to teach them how to take advantage of the opportunities afforded by the new zones but also how to direct potential investors into building the kinds of facilities — say, a manufacturing plant or affordable housing — that the community desperately needs. Denver, for one, is trying to combine the opportunity-zone tax breaks with other incentives so that it can place measurable outcomes on any new project.

“People call this a program. But at its base level, it’s just an incentive that people can take advantage of without government involvement,” said Jana Persky, the OEDIT strategic initiatives manager who estimated the majority of her time is dedicated now to opportunity zones. “The theory that we’re operating under is that if we just took a hands-off approach, this would be the Wild West. You wouldn’t know any results.”

How it works

Before it was part of the Tax Cut and Jobs Act, the opportunity-zone incentive was an idea conceived partly by Napster founder Sean Parker that became a bipartisan stand-alone bill. When it became part of the tax-reform package, it caught the attention of states, which had 90 days to nominate as much as 25 percent of their eligible Census tracts to become opportunity zones — a move that Colorado made quickly, with an eye on bringing development not to semi-impoverished areas on the fringes of hot neighborhoods but to places that now-former Gov. John Hickenlooper and now-former OEDIT executive director Stephanie Copeland saw as having potential but also having barriers to attracting the attention of investors.

Denver, for example, has 10 zones that encompass eight neighborhoods — Clayton, Elyria/Swansea, West Colfax, East Colfax, Northeast Park Hill, Montbello, Sun Valley and the northeast corner of Westwood. There were nearly 40 tracts that qualified under income definitions for the program, but city officials were careful to exclude from consideration areas like Globeville that remain lower-income for now but are seeing a swell of new development, chief city economist Jeff Romine said.

Under the incentive, investors who have made a significant capital gain have 180 days after the sale that generated the gain to turn around and put all or part of it into a fund that is deploying capital into an opportunity zone. Some funds that are being created are specific to a piece of land or a business that someone is looking to add or expand in a designated zone. Others can be multi-party funds that receive money and then look for a way to deploy it, said Shultz, a partner in Snell & Wilmer’s Phoenix office who has spoken at a number of seminars on the topic in the Denver area.

Those who invest before 2020 get a reduction of 15 percent on the tax base for the gains. So, if they were going to have to pay 20 percent on a $2 million gain, they now could be paying 20 percent on a $1.7 million gain instead, Shultz explained. If you wait until 2022 or later, you don’t get a reduction, but you can defer your taxes until the end of 2026. If the investment made with the gains is held for longer than 5 years, there is a 10 percent exclusion of the deferred gain, which rises to 15 percent if it’s held for seven years, according to Internal Revenue Service guidelines. And if the investor keeps the money in that investment for 10 years or more, the capital gains become tax-free.

Plus, the opportunity-zone incentives can be combined with other local incentives, such as enterprise-zone tax credits, to lower the cost of a project even more, said Jason Brinkley, a real estate partner at Snell & Wilmer in Denver and part of the opportunity-zone practice group

“It’s really designed for people with patient capital,” said David Brenner, a partner at Husch Blackwell in Denver.

While federal guidelines for investment in businesses in the zones still are being developed, at least 50 percent of the income from businesses eligible for the tax incentives must come from activity within the zone. It remains unclear what qualifies as “activity” within the zone. Persky notes, for example, do solar-panel installers have to install the majority of their instruments within the activity zone? And what happens if the business expands and begins doing more activity outside the zone? Persky estimates those final guidelines will come by mid-2019.

Brenner — who is advising investors, developers and people interested in setting up funds — said he believes the potential investor pool is “unlimited.” Anybody with a capital gain and a willingness to take a risk in a previously underdeveloped area can receive it, with the potential benefit of future appreciation of their investment in a tax-free manner.

'It's really just gravy'

One of those investors is Southwest Property Corp., a company located in the Denver Tech Center that is raising money to buy a manufacturer of after-market pump parts located in Denver near Hampden and Santa Fe drives and to expand the company's warehouse and line of products. Jackson Givens, vice president of development for the company, declined to name the business, as he is still in the process of rounding up investors to complete the transaction.Givens, who also is working on opportunity-zone projects in the range of $5 million to $20 million in the Phoenix and Salt Lake City areas, said that while the opportunity-zone incentive hasn't changed his pool of investors radically, it has made some people more interested in buying into certain projects because of the tax benefits. And that should help to speed up the projects, as well as potential future developments he may consider in other opportunity zones.

"It's just really gravy on top of our deals. It helps investors who have those large gains," he said. "There's plenty of people we can market [the projects] to without that being a factor. But the more we market these with the opportunity-zone [incentive], the more we think we will find people coming to us."

The developers of the proposed Porteos master-planned community — a 1,287-acre mixed-use tract just south of Denver International Airport — also are taking advantage of the incentive after Aurora designated the large open area that includes the development as one of its five opportunity zones.

Jim Howard — the CEO of Phoenix-based DV Financial Services, which is working with the Porteos landowners to try to find investors for the project — said he has seen increased interest in the project in part because of the opportunity-zone incentives, which are garnering much greater interest across the country in recent months. The increased visibility is likely to accelerate the project, mirroring a trend that Howard is seeing with other opportunity-zone projects across the country with which he is working.

"I have not seen an economic-development incentive receive so much attention in my 20 years of experience in the space as opportunity-fund investments," Howard said. "So, 2019 will be a pivotal year to see how much investment activity occurs."

Bill Wichterman, a partner in the Porteos project along with Phoenix-based A&C Properties and Scottsdale, Arizona-based Investment Management, noted that one of the companies that has purchased part of the property already — J.A. Green Development Corp. of Greenwich, Connecticut — did so with an opportunity-zone fund that it launched. Other portions of the property have been sold to Denver International Airport, Walmart and Kärcher North America, though those sales were unrelated to the incentives.

Wichterman, who splits his time between Arizona and Aurora and is the managing agent for Porteos, predicted that the property will spawn thousands of jobs, from multiple hotels and from a variety of other businesses that he anticipates being set up on the land. He lauded Aurora's choice to nominate it to the state as an opportunity zone because it has infrastructure in place and a road connecting it directly to DIA, making it one of the most turnkey properties among opportunity zones.

"I think we have maybe one of the best opportunity-zone properties anywhere because we're really shovel-ready," Wichterman said. "And the opportunity-zone legislation will actually accelerate that development because you provide the incentive to put people out here."

Concerns and challenges

Still, Romine said Jan. 4 that he hadn't yet had any specific developers of opportunity-zone projects come to talk to him, meaning that he had not communicated yet with Givens. And therein lies one of the concerns about the program.

The federal tax incentive comes with no performance-based outcomes that developers and investors are required to achieve in order to get their substantial tax breaks. If the business fails to create many jobs or if the project is a residential property with above-market rents, it still gets its money as if it were a major community benefit.

Copeland — who left OEDIT on Jan. 1 to become CEO of The Governance Project, a national organization that is working with communities to empower them to take advantage of the federal program to achieve the ends that they want — said that as more local leaders learned about opportunity zones in 2018, they swamped her office with calls about what they could do to get the kind of development they needed in their areas. She received permission from the Colorado Economic Development Commission to hire as many as three staffers to work with communities on the process — and to put together a database, which should be online in the next few weeks, that can match up investors interested in developing in an opportunity zone with the wishes of the communities within the identified zones.

In Denver, where city leaders are about to launch a series of community conversations with the eight neighborhoods in opportunity zones, Romine wants to use additional tax incentives to help guide potential development, including federal Community Development Block Grants and HOME funding for housing partnerships. Doing so would allow him to offer near-equity gap funding that could close the deal on a property while also permitting the city to use the prerequisites of those other programs to establish some sort of measurable outcomes.

And Denver is coming to the table not just with funding but with properties that could entice developers. It is marketing, for example, the former PT's II strip club that the city bought along East Colfax Avenue but for which it has yet to find a partner or a specific plan. The tax incentives, Romine believes, could be used to entice someone to redevelop the property, while the community meetings could give a potential developer the idea of what residents want there, from housing to specific retail to an employer that can take advantage of existing worker skills.

“This is an investment tool made for people who have made a lot of money on investments,” Romine said. “They don't have to talk to us. But the savvy investor minimizes risks.”

Aurora City Council members also had concerns about development leading to gentrification in a municipality that is home to a number of immigrant communities. So, they took a different approach, focusing on lower-income Census tracts that featured a lot of commercial space, in order to minimize the potential for displacement of residents, deputy city manager Jason Batchelor said.

That meant including higher-poverty areas in the city's five zones such as the south side of East Colfax Avenue, where the city plans to work closely with landowners and developers to create inclusive projects that can serve as centers of employment without wrecking the residential areas of the city. But it also meant including several areas that had large swaths of open property, such as land just south of Denver International Airport that included the Porteos community and on the Fitzsimons portion of the Anschutz Medical Campus, Batchelor said.

With that done, the first outreach that city officials made was to landowners in those areas, explaining the opportunity-zone incentives and encouraging them to pitch them as they looked for development opportunities.

Batchelor doesn't expect the opportunity-zone incentives to be game-changers, but he believes they might speed up development or even help to bring in better opportunities than they might have gotten without the financial help.

“We tried to focus on areas with a lot of commercial activity to minimize the amount of direct displacement that would occur,” Batchelor said. "I think it's a valuable tool, depending on the user."

Evaluating the impact

Persky declined to guess at what percentage of the 126 opportunity zones will see activity in the next decade because of the incentive.

But she said there is enough interest already that she gets two to three calls per day from investors, developers and community leaders about specific projects. And she noted that when Montrose's opportunity zone was featured in a Forbes magazine article, the Western Slope city received several inquiries from New York City investors who did not know before about the 20,000-person hamlet.

Brenner speculated that the zones that are on the edge of more prosperous areas or that are in already booming cities probably will generate projects first. But he expects that investments will continue to come in, and some of those developers will look to more rural areas in the coming years to snap up chances to grow there.

Shultz and Brinkley were operating three opportunity-zone funds at the time they gave a seminar in late September — two focused on specific real-estate projects and a third looking to raise money and then figure out where to deploy it. Reached again three months later, they were working on five additional funds, three with specific plans for development such as a manufacturing plant or hotel and two more with no identified projects.

For all the success that Denver and Fort Collins have had in recent years attracting investment and jobs, elected officials from Hickenlooper down to city council members have bemoaned that boom has not spread into smaller areas on the plains or in the mountains or in southern Colorado. Suddenly, there is a true tool that can spread that economic prosperity — while making a lot of money for private investors at the same time.

Persky identified two specific changes in behavior that are occurring because of the opportunity-zone incentives. First, investors are broadening the scope of places they are looking, making inquiries to her about Durango, Trinidad and Walsenburg that the office had gotten only rarely before.

Second, those local communities are actively organizing plans to determine what they need and how they are going to try to raise money for it. And that too could lead to significant growth in the longer term, even if not with the aid of these specific tax incentives.

“We are right now only in the first phase of education, and we can’t keep up with it,” Copeland told EDC commissioners back in November. “What we’re hearing from investors is they believe this is the first time equity is really driving real-estate investment.”

Ed Sealover
Reporter
Denver Business Journal