Opportunity Zones: A $500 Billion Investment Opportunity for US Insurance Companies

At yearend 2019, US insurance companies held more than $300 billion in net unrealized gains. Gross unrealized gains (prior to netting) held by US insurance companies likely exceeds $500 billion.

Background

The 2017 Tax Cuts and Jobs Act created a tax incentive to defer capital gains (and potentially permanently exclude certain future capital gains) by investing in designated Opportunity Zones.

The new U.S. tax law provides for:

i) the temporary deferral of capital gains reinvested in a Qualified Opportunity Fund for up to 10 years,

ii) a step-up in basis for capital gains reinvested in an Opportunity Funds (10% if the investment in the Qualified Opportunity Fund is held by the taxpayer for at least 5 years, and an additional 5% if held for at least 7 years), and

iii) a permanent exclusion from taxable income of capital gains from the sale or exchange of an investment in a Qualified Opportunity Fund, if the investment is held for at least 10 years. (Note: this exclusion applies to the gains accrued from an investment in an Opportunity Fund, not the original gains).

A Qualified Opportunity Fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in and holding at least 90% of its assets in Qualified Opportunity Zone Property.

Qualified Opportunity Zone Property includes any Qualified Opportunity Zone Stock, any Qualified Opportunity Zone Partnership Interests, and any Qualified Opportunity Zone Business Property.

Qualified Opportunity Zone Stock is stock in a domestic corporation that is an Opportunity Zone Business during "substantially all" of the applicable holding period.

Qualified Opportunity Zone Partnership is a partnership interest in a domestic partnership that is an Opportunity Zone Business during "substantially all" of the applicable holding period.

Qualified Opportunity Zone Business Property is tangible property used in the trade or business of an Opportunity Zone Business if the original use of the property commences with the qualified opportunity fund or the fund "substantially improves" the property.

"Substantially improves" is defined as, making additions to basis equal to the acquired basis during the 30-month period beginning on the date of the acquisition.

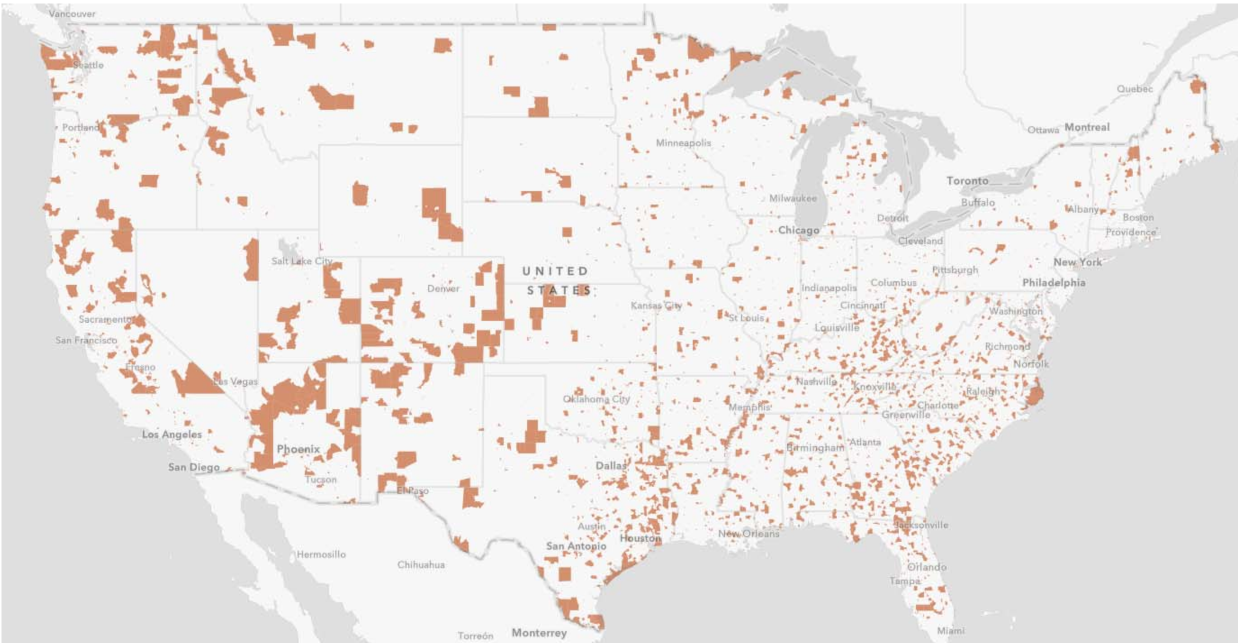
Qualified Opportunity Zone Business is a trade or business in which:

- Substantially all of its tangible property, owned or leased, is Qualified Opportunity Zone Business Property;
- At least 50 percent of its total gross income is derived from the active conduct of its business;
- A substantial portion of its intangible property is used in the active conduct of its business;
- Less than five percent of the average of its aggregate unadjusted bases of the property is attributable to nonqualified financial property; and
- No portion of its proceeds is used to fund certain types of businesses: a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

Debt investments are not eligible for this tax benefit, but most forms of preferred equity would be eligible.

Opportunity Zones

The Governors of US states and territories were authorized to designate certain low-income communities and a limited number of non-low-income communities as Opportunities Zones. Approximately 9,000 Opportunity Zones were designated consisting of 12% of the census tracts in the US.



Additional Opportunity Zones designated in American Samoa, Guam, Northern Marianas Islands, Puerto Rico and the Virgin Islands.

The information in this brochure is not intended to represent the rendering of investment, accounting, tax, legal or regulatory advice. The ultimate responsibility for the decision on the appropriate application of accounting, tax, legal and regulatory treatment rests with the client and its' accountants, tax and regulatory counsel. This is not an offer to sell or a solicitation of an offer to buy securities.

Additional Tax Considerations

The Opportunity Zone tax incentive can be combined with other incentives for investment in distressed communities, such as the New Markets Tax Credit (NMTC), Low-Income Housing Tax Credit (LIHTC) and historic rehabilitation tax credit programs.

Ordinary income received on an Opportunity Zone investment is taxable. Depreciation recapture upon sale of an investment is not taxable.

Statutory Accounting and Capital Considerations

For life insurers, realizing fixed income related gains will create an offsetting interest maintenance reserve ("IMR") resulting in the gain amount being realized into income and capital over the remaining life of the sold asset. In the event a substantial IMR balance is generated from an insurers Opportunity Zone investment strategy it may be worthwhile to investigate strategies to accelerate IMR include third party and hybrid reinsurance transaction and IMR financing transactions.

Insurers will likely have to book a deferred tax loss on the deferred gain. Since many insurers have non-admitted net deferred tax assets, this deferred tax loss may have no effect on admitted net deferred tax asset thus resulting in the entire gain being booked into capital (less any IMR impact).

Opportunity Zone investments may be made through a fund booked as a Schedule BA investment, equity booked as a Schedule BA investment, or preferred equity booked as a Schedule D investment.

Other Considerations

The Opportunity Zone investments may generate credit with Federal Home Loan banks for subsidized advances (e.g. Community Development Advance).

While debt is not an eligible investment for the tax incentive, attractive debt investment opportunities may arise to finance Opportunity Zone equity investments.

Roughly 20% of US insurance companies are headquartered in an opportunity zone. These companies should consider structuring new business expansions and related services businesses as opportunity zone affiliates.

Investment Targets

Opportunity Zone investment targets may include:

- Commercial and multifamily real estate – new construction and transitional*
- Single family rental properties*
- Infrastructure including renewable energy (wind, solar, biofuel, etc), water treatment, and data centers.
- Oil and gas exploration
- Private equity in businesses with an Opportunity Zone nexus;

An optimal Opportunity Zone investment strategy will be unique to each insurer taking into considerations their specific tax, accounting, capital, investment and other objectives. Montshire Advisors can assist you in developing your Opportunity Zone investment strategy.

In the coming months, Montshire Advisors will identify and introduce to you select Opportunity Zone investment opportunities for your consideration.

*Note the "substantially improvement" test requires improvements equal to at least the original acquired basis.

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