Opportunity Zones

Strength Matters Meeting
October 16, 2018

What are Opportunity Zones?

The Opportunity Zone tax incentive was established by Congress in the 2017 Tax Cuts and Jobs Act as an innovative approach to spur long-term private investment in low-income urban and rural communities. This new initiative is based on the **bipartisan Investing in Opportunities Act**, championed in large part by senators Tim Scott (R) and Cory Booker (D).

U. S. investors currently **hold $2.3 trillion in unrealized capital gains**, representing a significant untapped resource for economic development

What are Opportunity Zones?

Opportunity Zone: A low-income census tract **(LIC)**, as determined within New Markets Tax Credits legislation, is designated as an Opportunity Zone **(OZ)** by the governor of the of the state or territory in which it is located. Designations will stay in place for 10 years.

Up to 25% of LICs in a U.S. state or territory may be designated as OZs.

States or territories in which there are fewer than 100 LICs may designate up to 25 LICs as OZs.

Up to 5% of census tracts contiguous to LICs may be designated as OZs, if the median family income of the census tract does not exceed 125% of the median family income of the LIC to which the tract is contiguous.

Designated Opportunity Zones

All states and territories have officially designated their Opportunity Zones, as of June 14, 2018.

8,762
census tracts designated

24 million
current jobs in designated tracts

1.6 million
businesses in designated tracts

Rural census tracts	1,858
Average poverty rate	31%
Average unemployment rate	14.4%
Average family income in OZ census tracts relative to area median income (AMI)	60%

OPPORTUNITY360: A TOOL FOR UNDERSTANDING OPPORTUNITY ZONES

Use our Opportunity Zone Explorer to learn more about Opportunity Zones across the country

OPPORTUNITY360: A TOOL FOR UNDERSTANDING OPPORTUNITY ZONES

Opportunity360 provides a comprehensive approach to understanding and addressing community challenges using cross-sector data, community engagement and measurement tools.

Key Definitions

Opportunity Fund: An investment vehicle organized as a corporation or partnership for the purpose of investing in Opportunity Zone property.

Opportunity Funds will be self-certified per IRS guidelines. They must be organized for the purpose of investing in Opportunity Zones

Opportunity Funds are required to invest 90% or more of their capital as EQUITY in Opportunity Zone property

Opportunity Zone property includes stock, partnership interest, or business property in an Opportunity Zone

OPPORTUNITY ZONES

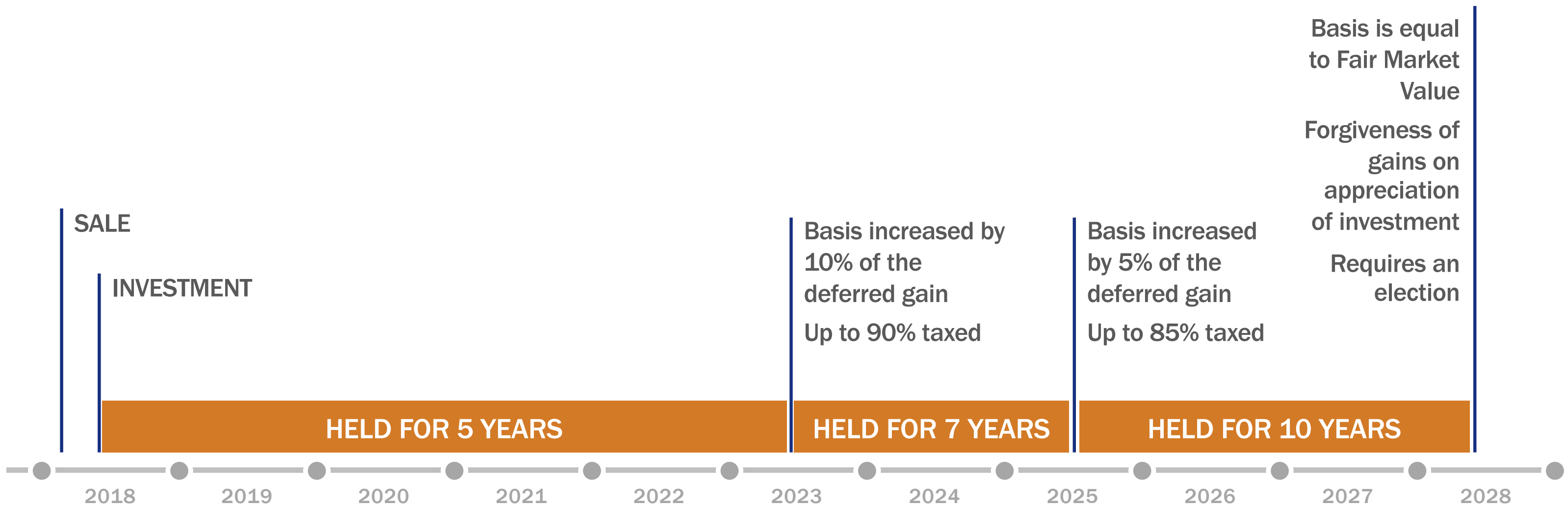
Investor **Incentives Review -**

Deferral of taxes paid on capital gains when invested in Qualified Opportunity Zone Fund within 180 days of gain being realized.

10% **Reduction** of taxes paid on capital gains for investments held over 5 years and additional 5% if investment held 7 years. BUT capital gains tax must be paid 2026.

No Capital Gains tax on New investment if investments held 10+ years.

Partial Forgiveness and Forgiveness of Additional Gains



Partial Forgiveness and Forgiveness of Additional Gains

Jan. 2, 2018
Taxpayer enters into a sale that generates $1M of capital gain

June 30, 2018
(Within 180 days), Taxpayer contributes entire $1M of capital gain to a Qualified Opportunity Fund

- Taxpayer is deemed to have a $0 basis in its QOF investment
- QOF Invests the $1MM in Qualified Opportunity Zone Property

2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024

Partial Forgiveness and Forgiveness of Additional Gains

June 30, 2023
(After 5 years), Taxpayer's basis in investment in QOF increases from $0 to $100k

June 30, 2025
(After 7 years), Taxpayer's basis in investment in QOF increases from $100k to $150k

Dec. 31, 2026
$850K of the 1MM of deferred capital gains are taxed and the basis in QOF investment increases to $1MM.

June 30, 2028
(after 10 years) , Taxpayer sells its investment for $2.0MM. Basis in the investment is deemed to be FMV. The effect is no tax on appreciation in investment.

2022 2023 2024 2025 2026 2027 2028

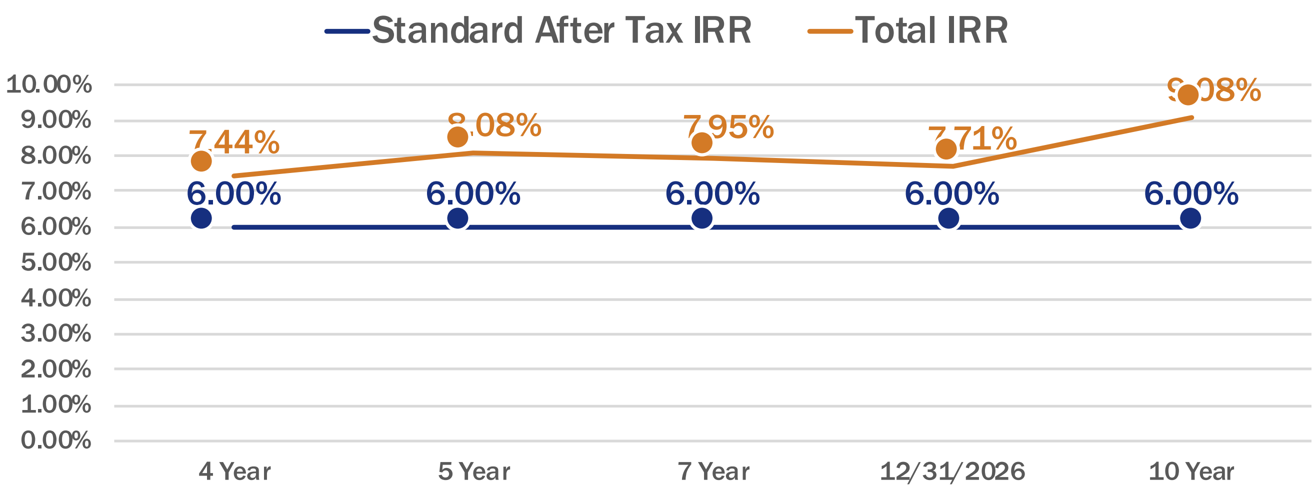
Ex. 10 Year Investment: **Fully Taxable vs. Opportunity Zone Fund**

Assumptions:
- 10% annual investment appreciation
- 24% capital gains tax (federal only)

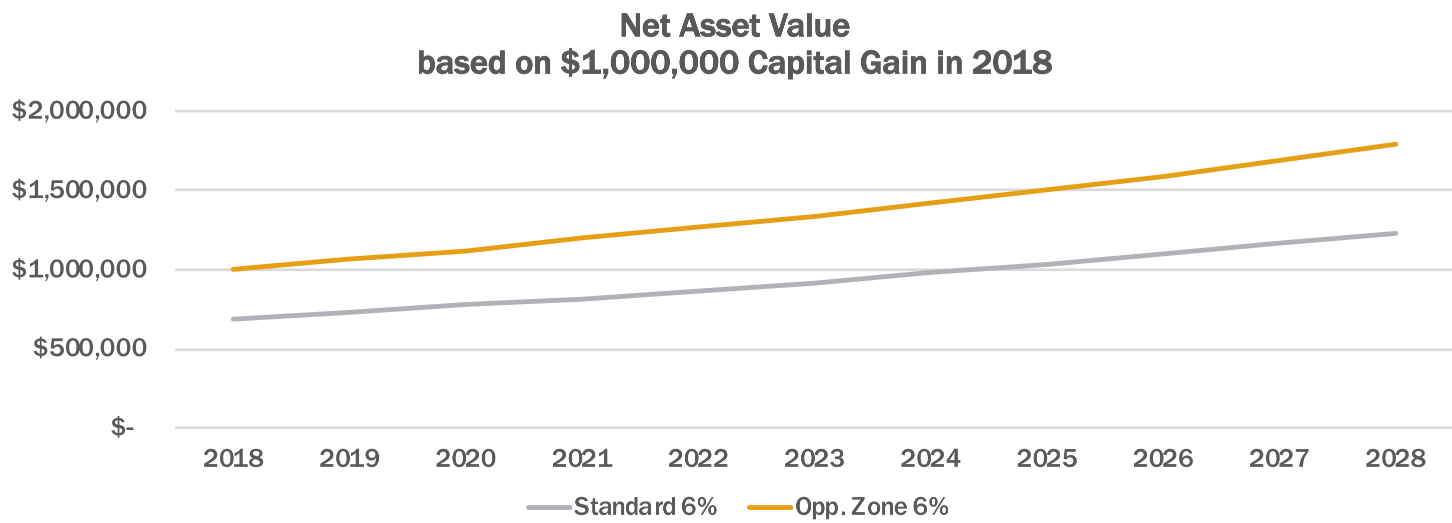
Fully Taxed Investment		
Capital Gain		$100,000
- Tax payable (24%)		$24,000
Total Capital to Invest		$76,000
Sales Price after 10 years		$197,000
- Tax on Appreciation (24%)		$29,070
After Tax Funds Available		$168,054

Opportunity Zone Investment		
Capital Gain		$100,000
- Tax payable		$0
Total Capital to Invest		$100,000
Sales Price after 10 years		$259,374
- Tax on Appreciation		$0
Deferred Capital Gain Tax (24%) paid in 2026		$20,480
After Tax Funds Available		$238,974

Opportunity Zone Incremental Benefit



23.8% Tax Rate	4 Year	5 Year	7 Year	12/31/2026	10 Year
Standard After Tax IRR	6.00%	6.00%	6.00%	6.00%	6.00%
Incremental OZ Benefit	1.44%	2.08%	1.95%	1.71%	3.08%
OZ Investment IRR	7.44	8.08%	7.95%	7.71%	9.08%
Percentage Increase		35%	32%	29%	51%



Year	Standard 6%	Opp. Zone 6%
2018*	$ 685,500	$ 1,000,000
2019	726,630	1,060,000
2020	770,228	1,123,600
2021	816,441	1,191,016
2022	865,428	1,262,477
2023	917,354	1,338,226
2024	972,395	1,418,519
2025	1,030,739	1,503,630
2026	1,092,583	1,593,848
2027	1,158,138	1,689,479
2028	1,227,626	1,790,848

*Standard 6%: Initial investment is net of taxes paid on the capital gain.
Opp. Zone 6%: Initial investment is full $1M with tax deferred until 12/31/26.

DISCUSSION QUESTIONS

- What percentage of Low Income Census tracts in a state could be designated as opportunity zones?
- How long does an Opportunity Zone Census Tract Designation remain in place?
- What are the three main benefits of an Opportunity Zone Investment
- How many days does an investor have to place Capital Gains in an Opportunity Zone Fund in order to take advantage of the Ozone Benefits?

DISCUSSION QUESTIONS

- What percentage of Low Income Census tracts in a state could be designated as opportunity zones?
    - **25%**
- How long does an Opportunity Zone Census Tract Designation remain in place?
    - **10 years**
- What are the three main benefits of an Opportunity Zone Investment?
    - **DEFERRAL of taxes, REDUCTION of taxes, NO CAPITAL GAINS > 10 years**
- How many days does an investor have to place Capital Gains in an Opportunity Zone Fund in order to take advantage of the Ozone Benefits?
    - **180 days**

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Opportunity Fund Structure

Qualified Opportunity Fund - Purpose

- An **investment vehicle** organized as a **corporation** or a **partnership** for the purpose of investing in **Qualified Opportunity Zone Property (QOZP)**.

- Funds Must be **Certified**

Certification Process

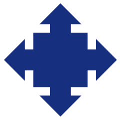
- An eligible taxpayer self-certifies to become a certified qualified opportunity fund.
- No approval or action by the IRS is required.
- A taxpayer merely completes a form (which will be released in the summer of 2018) and attaches that form to the taxpayer's federal income tax return for the taxable year.
- The return must be filed timely, taking extensions into account.


Qualified Opportunity Zone Property (QOZP)
Qualified Opportunity Zone Partnership Interest (Qualified Opportunity Zone Business)
Qualified Opportunity Zone Stock (Qualified Opportunity Zone Business)
Qualified Opportunity Zone Business Property

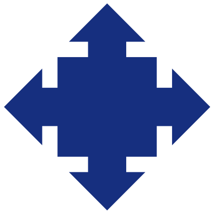
Readily Identifiable Investment Types in Opportunity Zones

Commercial Real Estate Development and Renovation in Opportunity Zones

Opening New Businesses in Opportunity Zones



Expansion of Existing Businesses into Opportunity Zones



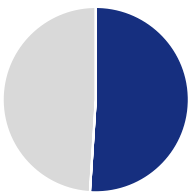
Large Expansions of Businesses already within Opportunity Zones

Qualified Opportunity Zone Stock and Partnership Interests

- The investment must be **acquired after December 31, 2017** in exchange for cash;
- Must be a **qualified opportunity zone business**, or is being organized for the purpose of being a qualified opportunity zone business;
- Must remain a qualified opportunity zone business for **substantially all** of the qualified opportunity fund's holding period

Qualified Opportunity Zone Businesses (QOZB)

A trade or business in which **substantially all** of the tangible property owned or leased by the taxpayer is **qualified opportunity zone business property** (QOZBP) and:



At least 50% of income derived from Active Conduct

Substantial portion of intangible property used in active conduct of business

< 5 percent unadjusted basis of property is nonqualified financial property

QOZB: Excluded Businesses

Can’t be a “Sin Business”

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.

Qualified Opportunity Zone Business Property (QOZBP)

- ✓ **Tangible property** used in a **trade or business**
- ✓ Acquired by **purchase from an unrelated party** (20% standard) after **December 31, 2017**
- ✓ During **substantially all** of holding period, substantially all the use is **in a QOZ**
- ✓ **Original use in the QOZ** commences with the taxpayer

  OR

  - ✓ Taxpayer **substantially improves** the property
    - ✓ during any 30-month period after acquisition, additions to basis exceed an amount equal to the adjusted basis of such property at the beginning of such period

Key Points

Investors

- Tax incentive is most valuable for 10 year investments in appreciating assets
- Six months to invest after realizing a capital gain
- Another six months to deploy 90% of capital in Zones
- Capital is required to be an equity investment – loans from investors are not eligible for the tax incentive

Funds

- All capital must flow through an Opportunity Fund to be eligible for the tax incentive
- Funds are self-certified via an IRS tax form
- Fund must be established for the purpose of investing in Opportunity Zones
- 90% of fund assets must be invested in Zones to maximize the tax incentive

Eligible Investments

- Must be equity investments
- Real estate investments must include substantial rehabilitation – doubling basis within 30 months
- “Sin businesses” are not eligible
- Other requirements include property use in “active conduct of business” and limits on assets held in cash

DISCUSSION QUESTIONS

- Can an Opportunity Zone Investment be structured as a loan?
- Would a moderate-rehab project be a qualified Opportunity Zone project?
- What percentage of a business's income must be derived from **operations in the opportunity zone**?
  - Would a **landscaping business** meet this criteria?
  - Would a **call center** meet this criteria?
  - Would a **health care c**enter meet this criteria?
  - Would a **micro-brewery** meet this criteria?

DISCUSSION QUESTIONS

- Can an Opportunity Zone Investment be structured as a loan?
  - **NO – has to be equity**
- Would a moderate-rehab project be a qualified Opportunity Zone project?
  - **NO**
- What percentage of a business's income must be derived from **operations in the opportunity zone**?
  - **50%**
  - Would a **landscaping business** meet this criteria? **TBD**
  - Would a **call center** meet this criteria? **TBD**
  - Would a **health care c**enter meet this criteria? **TBD**
  - Would a **micro-brewery** meet this criteria? **TBD**

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Examples of Potential Projects

Economic Development Examples

1. **Business infrastructure real estate funds:**
   - *Industrial*
   - *Retail*
   - *Mixed use*
   - *TOD*

2. **Venture capital funds:**
   - *Seed stage investments*
   - *Series A investments*

3. **Operating business private equity:**
   - *Equity recapitalizations*
   - *Growth capital investments*

4. **Enhancement for other federal tax credit transactions:**
   - *NMTCs*
   - *LIHTCs ???*
   - *Historic Tax Credits*

ECONOMIC DEVELOPMENT EXAMPLE

Commercial Real Estate development in QOZ – pairing with New Markets Tax Credits (NMTCs) - investment into a Low-income-census tract/opportunity fund

- $3,120,000 NMTC investment
- $6,880,000 third party lender
- QEI of $10,000,000 (with a *$5,900,000 OZ Gain Deferral Election)*

CDE would make an <u>equity</u> QLICI in a QALICB/Qualified Opportunity Zone Business

- $3,900,000 in NMTCs generated to investor with a
- $1,239,000 tax deferral benefit ($5,900,000 x 21% tax rate)

7 year investor return profile

- Standard NMTC deal approx. 6% NMTC with opportunity zone – 22%

ECONOMIC DEVELOPMENT - Structure Issues

Structure issues:

1. Community Development Entity (CDE) would need to be a QOF
2. QALICB would need to meet the definition of QOZB
3. QLICIs would need to be an "equity" investment – may not be consistent with CDEs investment strategy
4. Investor may have concern over NMTC recapture risk since an "equity" investment vs a loan.
5. Investor basis issues – would need to use leverage structure for investment to solve this issue
6. Exit timing 7 years vs. 10 years

Economic Development Projects – Issues to Consider

Technical Issues -

- 50% of the QOZB's gross income must be derived from the active conduct of a trade or business in the Opportunity Zone
- A substantial portion of its "intangible property" must be used in the operation of the business in the opportunity zone.

Business Issues –

- Investors will require a preferred annual return from cashflow – non NMTC project
- Investor will want a return of capital and added return after year 10 – so need ability to refinance or sell project in year 11. - non NMTC project

Affordable Housing Examples

1 Pairing with LIHTC or the HTC

- Effective for providing housing for families at or under 60% AMI
- Issues: Many traditional LIHTC investors do not have capital gains or they have minimal capital gains. Will they invest those into LIHTC deals in Ozones?
- Timing of capital contributions will be different than in traditional LIHTC deals

2 Focus on Workforce Housing

- Providing Housing for families at 80 – 120% AMI
- Anticipate a 10 year investment
- No ongoing compliance regulations unless required through local funding or zoning
- Ability to attract High Net Worth Individuals or Corporations as investors

Sample Workforce Housing Deal

- 116 units for families with rents at 100% AMI
- Prior NEF LIHTC developer
- Proven project in market (prior phases in non-Ozone locations)
- Support of municipality
- Expect this to be Single Asset Opportunity Fund with High Net Individuals as investors
- Capital Stack: Between 40 – 60% from equity?

Housing: **Expectations & Issues to Consider**

- **Project must cashflow : Opportunity Zone investors will want an annual cash return**
  - Therefore, project will have a higher DCR than typical LIHTC deal
- **Rents at 90 – 120% AMI?**
  - Unless there is an investor willing to take a lower return or city or state willing to provide soft secondary financing to allow for lower rent structure
- **Preference for Perm debt to be structured as non-recourse**
- **Project to be refinanced or sold after year 10 so that investor can obtain a return of capital and obtain their required return**

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Investors in Opportunity Zones

Investors in Opportunity Zones

Because of the way the Opportunity Zones tool is structured, there is a wide range of potential investors, including:

- Banks and institutional investors that have previously invested in other tax credits
- Insurance companies
- High net worth individuals
- Social impact investors
- QUESTIONS - return parameters?

Investors Expectations & Issues to Consider

Investor appetite is strong and developing,

Scalability expected with successful fund launches / track record

- Investing own capital gains
- CRA considerations
- PWM distributions -- fiduciary concerns / getting on the platform
- Social impact investors – impact thesis / intentionality
- Parallel investor paths – philanthropy, CDFIs and other debt investors, other government subsidies / incentives

Fund Activity – Recent Announcements

- **FUNDRISE**
  - Creating a **$500 million Opportunity Fund.** First project announced – a partially-vacant property in Washington, DC's LeDroit Park, will fill the building's ground-level retail space.
- **BRIDGE HOUSING**
  - **$500 million Opportunity Fund** for affordable housing projects on the West Coast.
- **VIRTUA PARTNERS**
  - **Raising $200 million Opportunity Fund** primarily investing in residential rental property development, hospitality and offices in high growth sunbelt markets.
- **PNC Bank**
  - **Planning an Opportunity Fund** to finance mixed-use, multi-family naturally occurring affordable housing, commercial rental and owner-occupied housing.
- **OTHER EARLY MOVERS**
  - **Enterprise, LISC, Access Ventures** and **Village Capital**

AUDIENCE DISCUSSION QUESTIONS

1. What type of projects are you considering for Ozone investments?

2. What types of structures are you seeing emerge in your zones?

3. What investor appetite and considerations are you encountering?

4. What are the operational challenges that you foresee with the management of Opportunity Funds?

5. What other partnerships and resources are or would be helpful scale Ozone investment?

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What's Next

Opportunity Zones: **What's Next**

1. Treasury expected to publish regulations and additional guidance by the end of September.

2. We expect to see a number of Opportunity Zone Funds with a variety of products by the end of the year.

3. What will be built? What is the social impact? There is much to be determined from a community development perspective.

Guidance Requested: **Questions for the IRS**

1. Does Affordable Housing qualify for Qualified Opportunity Zone Investing?

- Do the businesses of (1) developing affordable housing, and (2) renting affordable housing qualify as "the active conduct" of a business per the definition of a QOZ business?

2. What type of gains are eligible for Reinvestment and Deferral?

- Do they have to be Capital Gains? Or do Ordinary Gains work as well?
- Short term and Long Term Capital Gains?

3. What does the statute mean by "Substantially All"?

- Qualified Opportunity Zone partnerships and corporations must qualify as a QOZ business for "substantially all" of the qualified opportunity fund's holding period.
- QOZ business is one in which "substantially all" of the tangible property owned or leased is a QOZ business property.

Strengths of the Program

Local	Flexible	New Investor Class	Potential	Straightforward
Designations are made by states and localities, rather than Federal agencies, ensuring more local buy in and coordination.	The flexibility of the investment tool can support investments in any type of asset class.	The incentive has the ability to attract high net worth individual investors to community development finance.	The incentive could attract hundreds of billions of private sector capital into low-income communities (compared with about \$10 - \$12 billion annually under LIHTC and \$3.5 billion annually under NMTC).	The tool is relatively straightforward from an investment and compliance standpoint, in comparison to LIHTC and NMTC.

Potential Concerns

Lack of Oversight

Lack of oversight from government entities could lead to program abuses.

Lack of Impact Incentives

Incentives focus on back-end returns, rather than investments that will result in community impacts.

Gentrification and Displacement

The tool might aid in the gentrification and displacement of residents and businesses in Opportunity Zone communities.

Future of Other Tax Incentives

The new incentive might be used as an excuse to diminish or eliminate other community development tax incentives, such as the NMTC program.

Impact: **Metrics and Data**

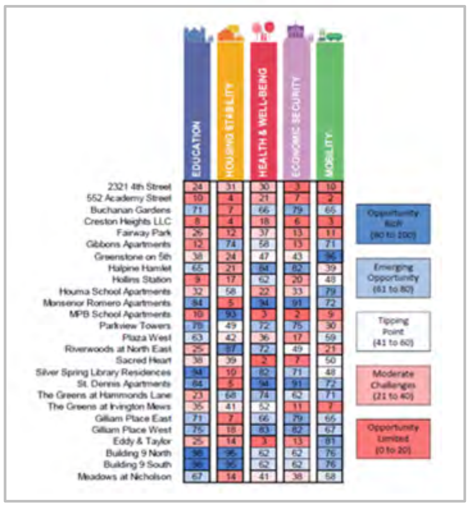
1. Defining and Measuring "Success"
2. Creating Accountability and Developing Market Standards
3. Supporting Transparency and Robust Market Formation
    - Type of qualifying property
    - Location
    - Value of investment
4. Intentional Investing / Underwriting

OPPORTUNITY360: A TOOL FOR UNDERSTANDING OPPORTUNITY ZONES

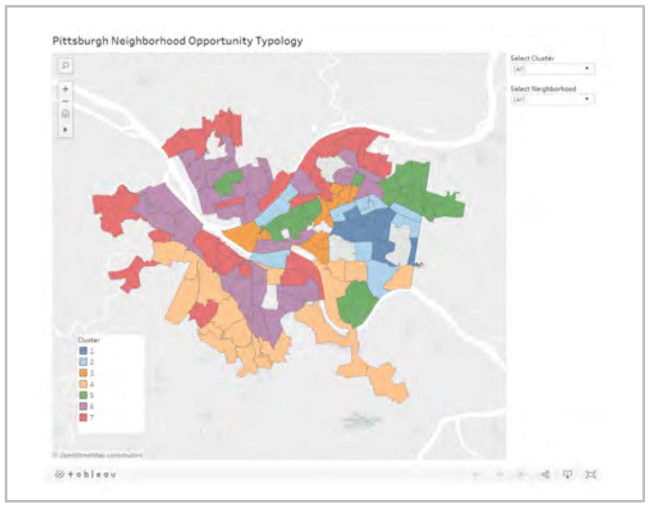
Download a 25 page report for each Opportunity Zone to learn about the populations, homes and neighborhoods located there

OPPORTUNITY360: SOLUTIONS

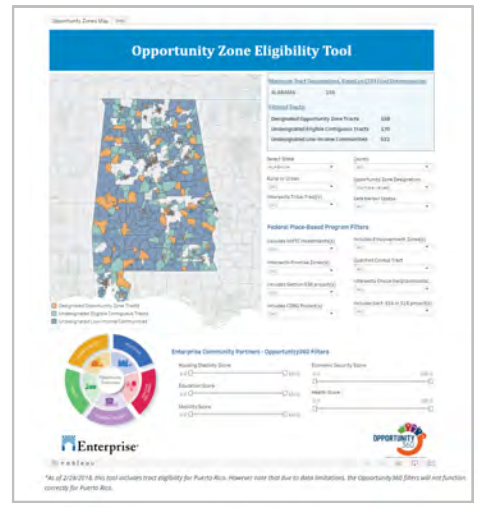
Here are some examples of how others have used **OPPORTUNITY**360 to tackle complex issues.



Portfolio Assessment



Neighborhood Typologies



Custom Dashboards

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