



Opportunity Zones

BACKGROUND

- 52.3 million Americans live in economically distressed communities. Over half of these areas contained fewer jobs and businesses in 2015 than they did in 2000.
- Three-quarters of net job growth from 2010 to 2016 occurred in a small number of metropolitan areas, resulting in inequalities across the country. Two-thirds of new job growth comes from small businesses. The most important variable contributing to the success of a small business is whether or not it has access to capital.
- The market of unrealized capital gains on stocks and mutual funds held by U.S. households alone was estimated at \$2.3 trillion in 2015. Even if only 0.1 percent of this value is invested in Opportunity Zones, that would result in \$2 billion. More recent estimates put the total unrealized capital gains from real estate, stocks, and mutual funds held by corporations and households in the United States combined at a value exceeding \$6 trillion.

OVERVIEW

The U.S. Opportunity Zones program was established in the 2017 Tax Cuts and Jobs Act, P.L. 115-97, with the goal of spurring economic development and job creation in distressed communities. The program is designed to enable investors to re-invest unrealized capital gains into state-designated zones while providing significant tax incentives for investors choosing to do so.

What is an Opportunity Zone? A census tract which has been designated by each state or territory and certified by the U.S. Treasury as eligible to receive private investments through Qualified Opportunity Funds.

A census tract can be designated as a Qualified Opportunity Zone if it falls into one of two categories:

- It satisfies the definition of a low-income community (LIC) in § 45D(e) of the U.S. Code.
- It is a non-LIC tract that is contiguous with an LIC designated as a Qualified Opportunity Zone and the median family income of the non-LIC tract does not exceed 125 percent of the median family income of the contiguous LIC Qualified Opportunity Zone.

Over 8,000 Opportunity Zones have been designated across all 50 states, the District of Columbia, and five U.S. territories. Once certified, an Opportunity Zone retains its designation for 10 years.

What is a Qualified Opportunity Fund? An investment vehicle set up as a partnership or corporation for the purpose of investing in eligible property that is located in an Opportunity Zone. An Opportunity Funds is capitalized by realized capital gains and deploys 90 percent of its capital into Opportunity Zones.

Investment in the fund receives preferential tax treatment, of which there are three aspects:

- A temporary capital gains tax deferral for all capital gains reinvested in an Opportunity Fund. The deferral lasts until the investment in an opportunity fund is sold or December 31, 2026, whichever is sooner.
- A reduction in taxes owed on the original capital gains, if held for five or more years (10 percent increase on the basis of the original investment if the investment is held for a minimum of five years; an additional 5 percent reduction if the investment is held for a minimum of seven years).
- If an investor holds the investment for more than 10 years, the investor permanently avoids capital gains taxes on any proceeds from the Opportunity Fund investment (the original capital gains do not receive this exclusion).

Properties eligible for investment by an Opportunity Fund generally fall into three categories:

- Tangible property used by the fund's trade or business in an Opportunity Zone.
- Stock of a corporation operating a trade or business in an Opportunity Zone with substantially all of its tangible property in an Opportunity Zone.
- An interest in a partnership operating a business with substantially all of its tangible property in an Opportunity Zone.



RECOMMENDATIONS

Eligibility of different capital gains for investment

1. Although it is clear that a taxpayer may temporarily defer capital gains from the sale of or exchange of property for the purposes of inclusion as gross income if s/he takes advantage of Qualified Opportunity Funds within 180 days of realizing said gains, clarification is required on whether both short-term and long-term capital gains are eligible for investment into these funds.

Proposed Recommendation: Given that the intent of the legislation is to spur investments into low- and moderate-income communities, both short-term and long-term gains, as long as they are invested into a Qualified Opportunity Zone within 180 days of the realized gain, should be eligible for the tax incentives.

2. Clarification is required regarding when the Qualified Opportunity Fund investment/fundraising period will be in effect. Can a taxpayer use gains from sales of or exchanges of property in 2017, as long as s/he adheres to the 180 day requirement? Additionally, will the investment/fundraising period remain open through 2026, and beyond 2026, as long as an investment is made in a fund within 180 days of realizing the gain? For example, can an investor use gains from 2027, invest in a Qualified Opportunity Fund within 180 days, and hold for 10 years for 100 percent tax free new gains, notwithstanding expired benefits from deferrals and basis step-ups?

Proposed Recommendation: Given that the Tax Cuts and Jobs Act, P.L. 115-97 was enacted December 22, 2017, realized gains from 2017, as long as all other requirements are met, should be eligible for Opportunity Zone tax incentives. In addition, given the intent of the legislation is to maximize the flow of capital into underserved communities, the window of time for eligible gains should be maximized. Thus, at a minimum, realized gains up until 2026 should be eligible for inclusion.

3. If a taxpayer in a given year has a gross capital gain from one sale or exchange of property and a gross capital loss from another sale or exchange of property, would the initial gross capital gain be eligible for investment into a Qualified Opportunity Fund or are only net capital gains within a tax year considered? Clarification is required on whether eligibility rests with gross capital gains (at the property level) or net capital gains (at the taxpayer level).

Proposed Recommendation: We believe the legislative intent of the Opportunity Zone provision applies to each and every capital gain realization transaction effected by a taxpayer (gross capital gain), provided the gain is rolled over into a Qualified Opportunity Fund within 180 days. Accordingly, there should be no requirement for specific gain transactions to be netted with unrelated capital loss transactions occurring during the same tax year. To require losses in a year to be netted would require investors to wait until the end of their fiscal year to determine eligible (net) capital gains, and thus, would both compress and potentially frustrate the 180-day requirement to invest in a Qualified Opportunity Zone, as well as, limit the potential to mobilize investments into targeted communities.

Establishment of a Qualified Opportunity Fund and timing of capital deployment

1. Given the program's intent to generate meaningful economic development, additional clarification is needed on timeframes surrounding capital deployment, or the time between injection of capital into a Qualified Opportunity Fund and the fund's investment in an Opportunity Zone asset. Investors require adequate time to identify appropriate investment opportunities; this is important to supporting a healthy balance between prudent investments in small businesses and real estate. There is concern that a deployment timeframe that does not provide investors sufficient time to properly assess viable opportunities either in real estate or in operating businesses, will unintentionally limit investment in small businesses and risk a gentrification effect.

Proposed Recommendations:

- Similar to a 180-day timeframe for rolling over gains into a Qualified Opportunity Fund, defining a deployment window of up to three years (36 months) for when Qualified Opportunity Funds must invest will provide adequate time to source prudent transactions and conduct proper due diligence on investment targets. Accordingly, having compliance with the 90 percent investment rule begin at the end of the deployment period, rather than after the initial six-month period of the fund's existence, will further support adequate time for investor due diligence.



- The beginning time for the deployment window should be calculated proportional to each investment into a Qualified Opportunity Fund and not based on establishment of the fund. Over a period of time, where a Qualified Opportunity Fund may seek more investors, a misalignment of investor incentives and fund deployment timing would create disincentives for more capital to flow to disadvantaged communities.
 - Allowing investors to invest capital into short-term, low-risk instruments during the period between capital commitment and capital deployment would enable Qualified Opportunity Fund managers time to properly vet investment options. For example, we believe managers should be able to invest capital awaiting deployment into U.S. Treasuries and retain any capital gains attained from such limited investment.
2. Clarification is needed regarding how soon after a Qualified Opportunity Fund's establishment it will need to demonstrate compliance with the 90 percent investment in eligible assets requirement and further detail is needed regarding its calculation methodology. Similarly, after capitalization of the fund, some transactions may require Qualified Opportunity Funds to invest or allocate cash equity into a real estate development entity at the outset of a project (during design, permitting, and initial milestones) as a condition to securing debt financing, even though those funds may not be expended for many months. Effectively, third party financing may require minimum cash on hand (cash or cash equivalent) and has implications for regulatory oversight of such financing. Clarification of how cash is treated in such instances is required.

Proposed Recommendations:

- We recommend that the calculation of the 90 percent compliance test be done at the Qualified Opportunity Fund level and refer to investments made by the fund and not at the taxpayer-level (as related to investments into a Qualified Opportunity Fund).
- The 90 percent rule should not have any application to the mix of funds investing into the Qualified Opportunity Fund (i.e., a mix of funds generated from both qualifying capital gains and non-qualifying funds), and thus, as long as the Qualified Opportunity Fund invests 90 percent of its funds into Opportunity Zones, it would be able to self-certify and not run afoul of the 90 percent test, regardless of the composition of funds that capitalized the fund.
- We believe that in some instances, cash would be an appropriate Qualified Opportunity Fund property, provided that such cash is held with the intent of investing in Opportunity Zone property and not included in the calculation of the 90 percent threshold. Further, it should not be deemed "nonqualified financial property," provided such presumption applies only to the extent it represents reasonable amounts of working capital, including cash intended to be invested in Opportunity Zone property, similar to the provision of Code Section 1397C(e)(1).

Eligibility criteria of Opportunity Zone investments

1. Given the requirement to substantially improve any existing property acquired by a Qualified Opportunity Fund (i.e., if not meeting the 'original use' criteria) defined as, "during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the Qualified Opportunity Fund exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period," managers will thus select investments based on their belief that they can improve the property. Clarifications are required on how "substantial improvement" is calculated. For example, current language has basis adjustment of original gains realized at the taxpayer level, while the improvement is conducted at the Qualified Opportunity Fund level, which is a misalignment and could create difficulties. Similarly, in areas where land value is high and building value is low, having to put in 100 percent of the cost basis (land and building) could discourage capital from entering these areas. Lastly, in high-leverage transactions conducted by a Qualified Opportunity Fund, uncertainty of whether the improvement test is calculated at 100 percent of the leveraged purchase price or the proportion of the fund capital could create difficulties.

Proposed Recommendation: We recommend the improvement test be calculated on the proportion of the Qualified Opportunity Fund assets utilized rather than the overall purchase price. For example, if a Qualified Opportunity Fund purchases property utilizing 40 percent of its funds and 60 percent borrowed funds, the calculation of the improvement should be on the 40 percent, as sourced from qualified funds, rather than the entire purchase amount. This will enable the Qualified Opportunity Fund to identify opportunities and structure capital appropriately.



2. How does a Qualified Opportunity Fund demonstrate that a potential investment target is geographically eligible as a Qualified Opportunity Zone Business, beyond the "tangible property owned or leased" language included in the Act? Investors will seek to understand the importance of the geographical location of the Qualified Opportunity Fund itself vs. the investee when evaluating potential investments. Primarily, clarification is needed regarding how to evaluate where a business operates (proportion of revenue vs. expenses).

Proposed Recommendations:

- For the avoidance of doubt, we recommend there be clarity between which criteria are eligible [e.g., (a) headquarters location; (b) corporate domicile; (c) percent of business sales vs. revenue vs. expenses incurred within Opportunity Zone] for Qualified Opportunity Zone Businesses.
 - Certain infrastructure-related investments (e.g., transportation networks) will naturally cross multiple census tracts and thus both Opportunity Zones and non-Opportunity Zones. In order to ensure a competitive landscape, the U.S. Treasury should clarify how to evaluate the treatment of such cases for the program. Leaving this determination to the local/state level could lead to various approaches resulting in reduced investor confidence in understanding the mechanics and thus a loss of investor appetite for these investments.
 - Clarification should be made that companies domiciled in U.S. territories qualify under the program as current language seems to exclude them, and thus, might discourage investors from investing in these areas.
3. All or most projects in Opportunity Zones will require debt capital, and historically, many national debt providers/lenders have been unwilling to lend in distressed areas. Ensuring that Qualified Opportunity Fund investments are appropriately capitalized with both debt and equity will mean that viable financial services and lending businesses are available within the zones. Historically, Community Development Financial Institutions (CDFIs), as designated by the U.S. Department of Treasury, must provide at least 60 percent of their total lending or investing activities for the benefit of qualified target markets (e.g., low income or underserved people and places); and have been vital economic engines in distressed communities. The reference to paragraph (8) of 26 USC section 1397C(b) is inconsistent with the vital role that is played by CDFIs in the development of low-income areas. This provision defines a Qualified Business Entity to mean "with respect to any taxable year, any corporation or partnership if for such year within an opportunity zone ... less than 5 percent of the average of the aggregate unadjusted basis of the property of such entity is attributable to nonqualified financial property." Nonqualified financial property is defined in 26 USC 1397C(e) as "debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property specified in regulations; except that such term shall not include (1) reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or (2) debt instruments described in section 1221(a)(4)." All financial institutions, including CDFIs, have more than 5 percent of their assets in the form of nonqualified financial property. We believe that the intent of this Opportunity Zone provision was to exclude conventional financial institutions or market-rate investment vehicles that are viable without subsidy from benefiting from federal tax incentives. CDFIs, however, are different, and precedent (as shown in the New Markets Tax Credit program) suggests they should be eligible for the benefits of the Opportunity Zone program.

Proposed Recommendation: We recommend that an exemption be placed in the definition of Qualified Opportunity Zone Businesses, whereby CDFIs are eligible for investment from Qualified Opportunity Funds, similar to the provision of Code Section 45D(c)(2)(B).

4. There is an opportunity to strengthen the initiative ability to create sustainable development by implementing standards on qualification criteria and metrics to monitor the program. These could include coordinating with state and municipal government bodies to provide additional benefit to investments in institutions, such as schools and technology training centers where the jobs multiplier effect is maximized. Other elements for determining qualifying businesses, such as their ability to produce quality jobs or provide health care to their workers within the Opportunity Zones, could also be considered.

Proposed Recommendation:

- We recommend a return to the initial Senate drafts of the act, whereby the Secretary designates impact guidelines which would be reported to Congress. A defined social impact approach could increase the likelihood



of sustainable community transformation and development. Clarification of any potential data collection measures for Qualified Opportunity Funds to adhere to (such as mandatory reporting by the Qualified Opportunity Fund manager and the assets owned), should be defined at the outset. Further, we recommend that the U.S. Treasury consider collecting transaction-level data for Qualified Opportunity Funds that reach a certain level of assets under management, if not all (i.e., at least the largest funds should be required to do so). The U.S. Treasury should define for investors at the outset whether any, or which components, of collected data points will be made available to Congress and/or the public.

- In forming monitoring criteria, which will be utilized to maintain the program going forward, we recommend Treasury consider forming an Advisory Council—composed of professionals in fields such as economic development, urban planning, tax policy, social impact, and small businesses—to help guide formation of these metrics and their subsequent oversight, including modifications to appropriate businesses, beyond Code Section 144(c)(6)(B).

Subsequent capital injections to a Qualified Opportunity Fund, reinvestment, and investment exit

1. If we assume two types of investments as they pertain to Qualified Opportunity Funds, investments into a fund and investments made by a Qualified Opportunity Fund into Qualified Opportunity Zone Businesses, clarification is required on the time period for determining both the five- and seven-year step up in basis for the taxpayer's original gains, and the 10-year capital gain exclusion.

Proposed Recommendation:

Time periods for determining the five- and seven-year step up in basis as well as the 10-year capital gain exclusion should be determined from initial investment into a Qualified Opportunity Fund rather than investment by the fund into a Qualified Opportunity Zone Business. As some investors may decide to exit a Qualified Opportunity Fund, this will enable managers to maintain positions within investments. This would more effectively keep other investors from being dragged along in taxability with exiting investors.

2. In determining the length of time for the investment in a Qualified Opportunity Fund held by the taxpayer, clarification is required regarding potential financing based on interests in these funds. For example, if a taxpayer obtains financing by leveraging an interest in a Qualified Opportunity Fund as collateral, would this be deemed as triggering a gain? In addition, within a fund, would an underlying investment in a Qualified Opportunity Zone Business used by a Qualified Opportunity Fund as collateral for additional financing be deemed as triggering a gain? In both instances, the investment “holding” would remain with the taxpayer or the Qualified Opportunity Fund, however, clarification is required in terms of how that would be treated as either a sale or transfer for the purposes of determining a new gain.

Proposed Recommendation:

We recommend that the determination of holding an investment in a Qualified Opportunity Fund be inclusive of an interest in a Qualified Opportunity Fund that was pledged as collateral for other financing. Given that the intent of the Opportunity Zone provision is to spur investment in distressed areas, as long as fund investments remain in Opportunity Zones, additional investments secured through financing should not affect tax benefits or trigger a taxable gain for either the Qualified Opportunity Fund or the taxpayer.