OPPORTUNITY ZONES: AN UPDATED OVERVIEW AND LOOK AT WHAT'S AHEAD

OVERVIEW

The Opportunity Zones concept was originally introduced in the Investing in Opportunity Act (IIOA), and enacted in 2017 as part of the Tax Cuts and Jobs Act. At its essence, it offers special treatment on capital gains in a way that's designed to drive long-term investment in a diverse range of low-income communities throughout the nation. Various tax incentives are provided to encourage investment through privately- or publicly-managed (or in some cases joint public-private) Opportunity Funds.

AT A GLANCE

Governors had 90-120 days from the date of enactment (December 22, 2017) to nominate a set of eligible census tracts to be designated as Opportunity Zones.

In June 2018, Treasury finalized approvals for Opportunity Zone designations in all 50 states, five territories, and Washington, D.C.

Opportunity Zones are low-income communities and adjacent census tracts which are now eligible to receive private investment through Opportunity Funds.

Individuals and businesses are eligible to receive graduated tax benefits - temporary tax deferral, tax reduction, and/or tax exemption - when they invest capital gains from a prior investment into Opportunity Funds.

Opportunity Funds are a new class of investment vehicle set up as a partnership or corporation to aggregate and deploy private investment into Opportunity Zones.

Opportunity Funds are authorized to make equity investments that benefit Opportunity Zone Businesses.

The three categories of eligible investment types are collectively called Opportunity Zone Property:

- Stock in a domestic corporation
- Capital or profits interest in a domestic partnership
- Tangible property used in a trade or business of the Opportunity Fund that substantially improves the property.

Look for additional resources and coverage on Enterprise's website – www.OpportunityZonesInfo.org

Background

In April 2015, the Economic Innovation Group (EIG) first made the case for Opportunity Zones in its white paper Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas. In that paper EIG highlighted the shortcomings of previous federal policies created to attract private investment in disadvantaged regions of the United States and offered the design for Opportunity Zones as a more effective tool for stimulating economic growth based on lessons learned from past efforts. , The Opportunity Zones concept was originally introduced in the Investing in Opportunity Act (IIOA) during the 114th Congress. IIOA was reintroduced in February 2017 at the beginning of the 115th Congress by Senators Tim Scott (R-S.C.) and Cory Booker (D-N.J.) and Congressmen Pat Tiberi (R-Ohio) and Ron Kind (D-Wis.), gaining nearly 100 congressional cosponsors before it was enacted through the Tax Cuts and Jobs Act of 2017.

OPPORTUNITY ZONES - A DETAILED OVERVIEW

Opportunity Zones Basics

Recent estimates suggest that upwards of $6 trillion in unrealized capital gains currently sit on the books of U.S. taxpayers. The Opportunity Zones tax benefit was designed to capture a portion of those passive holdings and redirect that capital into distressed communities through equity investments in businesses and real property.

Opportunity Zones tax benefits are available to individuals and businesses using eligible capital to make equity investments in newly-designated Opportunity Zones. Benefits are structured to incent long-term investment. This special treatment of capital gains allows investors to realize tiered benefits; an immediate temporary tax deferral, a reduction of tax liability in years five and seven, as well as a full exemption on any new gains earned on the investment after year 10.

The intent of Opportunity Zones is to spur economic growth and revitalization in distressed communities by providing an incentive for investors to look beyond the locations in which the majority of investment capital is typically concentrated.

This is the first time a federal public policy has been established to tap unrealized capital gains for economic and community development purposes. The design is meant to place risk with private investors, thereby minimizing potential costs paid by the taxpayer. The Joint Committee on Taxation estimates that the benefit will cost the federal government $7.7 billion between 2018 and 2022 in forgone revenue. As taxes on deferred gains are paid through 2026, the ultimate “cost” of the benefit is estimated to be reduced to $1.6 billion as the tax revenue is collected by the federal government. However, its important to note that since this is an uncapped tax benefit, total forgone revenue could exceed this estimated amount. Similarly, the full exemption of new gains earned after year 10 was not factored into this estimate, which may also ultimately increase the cost to the federal government.

Neither tax credits nor appropriated dollars are involved in offering Opportunity Zone tax benefits, Opportunity Fund investments may be aligned with these sources of public financing. Additionally, states and localities are assessing the value in offering additional place-based and investor-level incentives to attract investment and/or motivate certain investment activities. States that conform to the federal Internal Revenue Code will mirror the federal Opportunity Zones tax benefits as it applies to state-level treatment of capital gains as well.

Opportunity Zones have been dubbed ‘domestic emerging markets’ and Opportunity Funds described as having the potential to become a new asset class, yet the law and market are both very much still in formation eight months after enactment. While Opportunity Funds have begun to form, many potential investors and fund managers remain on the sideline awaiting further guidance from Treasury and the Internal Revenue Service (IRS). At the same time, cities and states around the nation continue to assess their strategies for balancing concerns around displacement and inclusive growth with competition for attracting investment capital.

Qualified Opportunity Zones

After enactment, Governors had up to 120 days (first deadline: March 21, extended deadline: April 20) to submit a list of eligible census tracts to Treasury to be approved as Qualified Opportunity Zones. By delegating this authority to governors, the intent was to ensure that local investment needs and opportunities were considered as part of the nomination process.

Once approved by Treasury, these census tracts carry a 10-year designation, signaling to investors that investments made in these areas are eligible for Opportunity Zones tax benefits if other requirements are met. Census tracts eligible for designation had to meet certain criteria, outlined below, and only a certain percentage of eligible tracts could be designated as Opportunity Zones.

Low-income community census tracts [IRC Section 45D(e)] were used as the basis for determining whether an area was eligible to be designated as an Opportunity Zone. This is the same definition used for Qualified Census Tracts (QCT) through the New Markets Tax Credit program, and thus, there is overlap in census tracts that are both QCTs and designated Opportunity Zones. However, the alignment is not exact because there was an allowance for "contiguous tracts" and caps were put on the number of both types of tracts that could ultimately be designated.

Census Tract Eligibility and Caps:

- Low-income community census tract – a defined geographic area with an individual poverty rate of at least 20 percent and median family income no greater than 80 percent of the area median.
- Contiguous census tract – a defined geographic area that is not a low-income community but may be designated as a Qualified Opportunity Zone if it is contiguous with a low-income community designated as a Qualified Opportunity Zone. The median family income of an eligible contiguous tract cannot exceed 125 percent of the median family income of that adjacent low-income community.
- Up to 25 percent of the total number of eligible census tracts in each state/territory could be designated as a Qualified Opportunity Zone. Up to five percent of that 25 percent could be comprised of census tracts eligible based on contiguity. This approach was intended to encourage the concentration of investments in a geographically targeted manner based on a critique of previous capital programs where resources were too diffuse to achieve transformative impact.

Enterprise's Opportunity360 tools can be used to locate and learn about the 8,762 newly designated Opportunity Zones. Further information such as national statistics and state profiles have been provided by the Economic Innovation Group.

Definitions

High-level definitions of key terms.

Qualified Opportunity Zone: A census tract which has been designated as eligible to receive investments through Opportunity Funds.

Qualified Opportunity Fund: Investment vehicle set up as a partnership or corporation, authorized to aggregate capital and then deployed as equity investments in Opportunity Zones for eligible uses defined as Opportunity Zone Property.

Qualified Opportunity Zone Property: The three categories of eligible investment types.

Qualified Opportunity Zone Business: Recipients of investments must be an Opportunity Zone Business or organized for the purpose of becoming one; sometimes referred to as investees.

Qualified Opportunity Funds

Opportunity Funds are a newly-authorized class of investment vehicles formed to aggregate and deploy investments in Opportunity Zones. Eligible capital gains must be invested through Opportunity Funds in order to receive the associated tax benefits. There are numerous ways public and private fund managers can choose to structure Opportunity Funds, as the statute provides only two requirements for eligibility:

- Investment vehicle which is organized as a corporation or a partnership for the purpose of investing in Qualified Opportunity Zone Property
- At least 90 percent of its assets is held in Qualified Opportunity Zone Property

In April 2018, the IRS determined that Qualified Opportunity Funds can self-certify. This means that funds do not need approval from the IRS or any level of certification prior to receiving or deploying capital, but instead will need to submit a form with the federal income tax return for the taxable year in order to self-certify.

Opportunity Funds will be tested to ensure that they meet the 90 percent deployment test. Per statute, compliance will be determined by the average of the percentage of Qualified Opportunity Zone Property held in the fund as measured-

- on the last day of the first six-month period of the taxable year of the fund, and
- on the last day of the taxable year of the fund

Policymakers envisioned Opportunity Funds as a market solution for investors who had an interest in supporting distressed communities but lacked the information and wherewithal to execute these investments. Pooling capital through a fund structure provides an opportunity to engage a broad array of investors. Given the varied nature of eligible activities and designated Opportunity Zones flexibility was key.

The statute does not limit the number of Opportunity Funds that can be created, nor does it provide instruction as to the nature of investments, such as return requirements. Funds can be structured to invest in multiple assets, or as a single-asset special purpose vehicle. However, Opportunity Funds cannot be structured to invest in other funds, thereby prohibiting a ‘fund-of-funds’ model. Additionally, there are no requirements regarding the number of Opportunity Zones a single fund can invest in, or how many investments an Opportunity Zone may receive.

Qualified Opportunity Zones Property

Opportunity Funds make investments that meet the criteria of Qualified Opportunity Zone Property; defined as:

- Qualified Opportunity Zone Stock
  - Stock in a domestic corporation acquired in cash after December 31, 2017
  - Investment must be made in a Qualified Opportunity Zone Business (or a business newly formed for this intent) which remains as such for substantially all of the Qualified Opportunity Fund's holding period
- Qualified Opportunity Zone Partnership Interest
  - Capital or profits interest in a domestic partnership acquired in cash after December 31, 2017
  - Investment must be made in a Qualified Opportunity Zone Business, or a business newly formed for this intent, which remains as such for substantially all of the Qualified Opportunity Fund's holding period
- Qualified Opportunity Zone Business Property
  - Tangible property used in a trade or business of the Qualified Opportunity Fund, where substantially all of the property use occurred within an Opportunity Zone during substantially all of the Opportunity Fund's holding period
  - Acquired from an unrelated party after December 31, 2017
  - The original use of the tangible property must commence with the Qualified Opportunity Fund or the Qualified Opportunity Fund must substantially improve such property, thus meeting the substantial improvement test
    - Substantial improvement test - 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 30-month period

Qualified Opportunity Zone Business

Only a Qualified Opportunity Zone Business is eligible to receive investment from an Opportunity Fund. There are restrictions to financing certain activities, commonly referred to as "sin businesses" and outlined in IRC Section 144(c)(6)(B). To be a Qualified Opportunity Zone Business, a trade or business must meet the following criteria.

- Substantially all of the tangible property owned or leased must be Qualified Opportunity Zone Business property
- At least 50 percent of the total gross income of the entity must be derived from the active conduct of such business
- Less than five percent of the average of the aggregate unadjusted basis of the property of such entity is attributable to non-qualified financial property

Tiered Tax Benefits for Investors

Recent estimates suggest that upwards of $6 trillion in unrealized capital gains currently sit on the books of U.S. taxpayers. The Opportunity Zones tax benefit was designed to capture a portion of those passive holdings and redirect that capital into distressed communities through equity investments in businesses and real property. Effectively it aims to activate capital currently sitting on the sidelines to boost lagging local economies while providing no upfront subsidy to investors. The design encourages long-term deployment of capital in distressed communities, and hence the tiered benefit structure ties to the duration of the investment in the Opportunity Fund.

Individuals and businesses that sell an asset – for example stocks, bonds or real estate – which is subject to capital gains taxation can receive tax benefits if gains are invested in an Opportunity Fund within 180 days of disposition. There is no cap on the amount of capital gains invested into an Opportunity Fund, and the gain can be invested in part or in whole. By investing in an Opportunity Fund, you can temporarily defer - and in some cases reduce - taxation on that gain. Further, any appreciation realized while invested in the Opportunity Fund (earned gain) could be fully excluded from taxation depending on how long the deferred gain is invested.

Deferred Gain – The capital invested into the Opportunity Fund which is eligible to receive the Opportunity Zones tax benefits. The deferred gain may immediately be temporarily deferred from inclusion of gross income as stipulated in the statute, and depending on the duration of investment, may benefit from an increase in basis (reduced tax liability). The original gain must eventually be recognized as income in part or in whole at the prevailing tax rate and is never fully exempt from taxation.

Earned Gain – The gain earned from the investment in the Opportunity Fund; the appreciation of the asset. If an investor holds their investment in an Opportunity Fund for a minimum of 10 years, then the earned gain is effectively tax exempt.

Here's how the tax benefits accrue based on the duration of investment:

Day One: Temporary Deferral of Capital Gain - Allows for the temporary deferral of inclusion in gross income for capital gains that are reinvested into Opportunity Funds within 180 days after sale of an asset. An investor can defer their original tax bill until December 31, 2026 or until they sell their Opportunity Fund investment, whichever occurs first.

Years Five and Seven: Reduction in Taxation of Deferred Gain - At the same time the existing gain is being temporarily deferred (if invested prior to December 31, 2026), investors could benefit from a reduction in tax liability if the investment is held for a minimum of five years. There is a 10 percent step up in basis if an investor holds an Opportunity Fund investment for five years and an additional 5 percent step up in basis if the Opportunity Fund investment is held for seven years. This means that an investor will owe taxes on either 90 percent or 85 percent of the deferred gain invested in the Opportunity Fund after five years or seven years respectively.

Year 10: Full Tax Exemption on Earned Gain - If an investment is held in an Opportunity Fund for a minimum of 10 years, the appreciation realized on the investment is excluded from taxation.

This is how all Opportunity Zone tax benefits could work together.

In order to take full advantage of the tiered tax benefits – based on the seven-year time horizon between December 2019 and December 2026 -- investments in Opportunity Funds need to be made by the end of 2019. The scenario below aims to explain why that is the case and incorporates all Opportunity Zones tax benefits.

An investor sells a property in August 2019, realizing $500,000 in capital gain. Within 180 days, the $500,000 capital gain must be invested in part or in whole into a Qualified Opportunity Fund, or otherwise recognized as income for 2019. The full $500,000 capital gain is invested into the Qualified Opportunity Fund in December 2019 and held as an investment in the fund for 10 years.

Per the statute, deferred gains must be recognized by December 31, 2026, so for the seven-year period between December 2019 and December 2026 the gain is deferred. Further the investor benefits from the 15 percent step-up in basis associated with holding an investment for at least seven years, thereby reducing the taxable amount of the deferred gain. December 2019 is the last month in which an investment can be made into a fund and receive the higher tax reduction rate associated with the seven-year term, while also maximizing the amount of days taxes can be deferred prior to the December 31, 2026 deadline.

The investor pays tax on the deferred gain by December 31, 2026 at the prevailing tax rate and reduced taxable amount. Because the investment was held for a minimum of seven years, $75,000 is eliminated from gain, and the deferred gain taxed at $425,000 (85 percent of $500,000). In February 2030, the investor decides to exit the fund selling their interest for $560,000 - $500,000 capital gain originally invested with an appreciation of $60,000.

Since the investor already paid taxes in 2026 on the deferred gain and held the investment for 10 years, there is no taxable event in 2030 when the investor exits the fund. Therefore, the appreciation of the original investment in the Opportunity Fund - $60,000 - is effectively excluded from taxation.

STEPS TOWARD IMPLEMENTATION

Post-enactment, there were multiple efforts happening in tandem as the Administration and states worked to implement Opportunity Zones. Those activities included:

1) Designating Opportunity Zones,

2) Providing guidance on Opportunity Fund certification, and

3) Issuing regulations to provide clarity around the rules governing the new law.

Designating Opportunity Zones

After enactment in December 2017, Governors had up to 120 days to submit a list of eligible census tracts to Treasury for approval as Qualified Opportunity Zones. By statute, Treasury had 30 - 60 days from the date of submission to approve nominations. As of June 2018, Treasury had approved Opportunity Zones in all 50 states, five territories, and Washington, D.C.

During the nomination process, Governors used a number of different strategies to prioritize census tracts and engaged the public to various degrees. If governors failed to submit a list of census tracts for nomination within the allotted timeframe, states would have been effectively opted out, rendering communities ineligible to receive investment encouraged through the Opportunity Zones tax benefit over the next decade. However, all eligible jurisdictions met the appropriate deadlines.

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Providing Guidance on Opportunity Fund Certification

In April 2018, the IRS released Frequently Asked Questions in which they clarified that, to become a Qualified Opportunity Fund, "an eligible taxpayer self certifies. (Thus, no approval or action by the IRS is required.) To self-certify, 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.)"

It had been anticipated that the process for certifying as an Opportunity Fund would follow a process similar to that of certifying as a Community Development Entity for the New Markets Tax Credit program. This would have required that Opportunity Funds secure some level of approval or verification prior to operations. However, with the self-certification process, no approval is needed prior to aggregating and/or investing capital in Opportunity Zones.

Issuing regulations to provide clarity around the rules governing the new law

It is unclear how Treasury will issue or propose additional rules to govern the ongoing administration of Opportunity Zones and how investors, fund managers, and investees engage with the tax benefit. In July 2018, Treasury Secretary Mnuchin testified before Congress that regulatory guidance on Opportunity Zones may be available by the end of 2018. We would typically expect either a proposed rule making process or an interim rule making process. However, the IRS could simply continue to provide additional guidance and clarity through FAQs and revenue procedures as it has already done.

In March 2018, Enterprise submitted recommendations to Treasury providing insights on implementation, as have a number of other stakeholder groups, community development practitioners, and jurisdictions. In May 2018, Enterprise CEO Terri Ludwig underscored our recommendations on implementation during her testimony to the Congressional Joint Economic Committee. Ludwig stated that with the right regulations and guardrails in place, Opportunity Zones have the potential to catalyze inclusive economic growth in some of the nation's most distressed neighborhoods. Enterprise continues to emphasize the need for transparency, accountability, clarity, and a focus on defining and monitoring abuse of the tax benefit.

There have been efforts in recent months from stakeholder groups urging the IRS to provide additional guidance where there is ambiguity in the statute. A number of these items have been prioritized as critical in removing barriers to accessing investor capital and finalizing fund models. However, given that Treasury has approved all designated Opportunity Zones and the IRS has stated that Opportunity Funds can self-certify, some investors and fund managers are moving forward absent additional guidance.

QUESTIONS

Please contact Rachel Reilly if you have any questions.