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YOUR COMPLETE

OPPORTUNITY ZONE GUIDE BOOK

FORWARD BY:

DANIEL KOWALSKI

FORMER COUNSELOR TO THE SECRETARY OF THE TREASURY

Your Complete

Opportunity Zone Guide Book

Revised 03/23/2022

Forward,

March 23, 2022

Welcome Reader,

The Opportunity Zone incentive has enormous potential to promote positive change. Opportunity Zones encourage private capital to invest long-term in community growth and will result in superior economic benefits compared to traditional Federal grant programs alone. That's why I asked to lead Treasury's development of Opportunity Zones regulations during the Trump Administration.

With the release of final regulations in December 2019, the Administration had begun to take the message of Opportunity Zones to the communities where it could be used, but the emergence of COVID-19 stopped that work just as it was getting started. It is now left to us to continue to promote and undertake the good work that can be done using the Opportunity Zone incentive.

This guide book will give you the tools you need to make a difference in low-income communities using Opportunity Zones. The Chapters will give you the understanding you need to begin to use Opportunity Zones in your work – whether sponsoring OZ investment funds, devising business opportunities to create jobs and growth in the community, or advising investors on how they can use their investments to lift up communities. The testing and certification process will give you the confidence in your knowledge to be a leader in this ecosystem.

I thank you for your interest in the mission of bringing life-changing capital investment, jobs and growth to communities that in some cases have been disinvested for generations. I hope that you find the work deeply rewarding, both from the personal satisfaction that comes from making a difference, and from the financial benefits that could come from the diligent practice of the skills you will learn in this book.

Wishing you every future success,

Dan Kowalski
Former Counselor to the Secretary of the Treasury
Wizard of OZ

About The Authors

David Sillaman Jr. is the founder and CEO of Eazy Do It Inc. An Opportunity Zone agency based in Virginia Beach, Va. Eazy Do It works with clients to develop a structured turn-key solution for business owners, real estate development projects, high net worth individuals and family offices looking to set up an opportunity fund. David is recognized as one of the leaders in the Opportunity Zone industry, David is also a member of the Forbes Real Estate Counsel. Eazy Do It Funds have been recognized by the LA. Times, Business Journal, The American Recorder FinTek News, Business Insider, Market Insider, Senior Housing News, Silicon Review to name a few. David is a frequent speaker at Opportunity Zone events

Anna Kopperud, EazyDoIt Opportunity Zone Funds' new Vice President of Strategic Alliances, joined the company after serving in the Trump Administration as Senior Advisor to the Administrator on Opportunity Zones at the U.S. Small Business Administration. In this role, she served as a key advisor for the SBA's national efforts in support of Opportunity Zones, having built the program and serving on the leadership team. A liaison with the White House and the SBA's lead on presenting OZ speeches and webinars, she was also the principal for external outreach with fund managers/investors, social impact groups and local economic development officials. She brings nearly 15 years of experience in public policy and strategy to her role.

She sharpened her leadership skills on President Donald J. Trump's Advance team, traveling with him on more than 60 trips domestically and internationally during both the 2016 and 2020 campaigns and throughout the first year of his presidency. She previously served as a media operations executive conducting multicultural outreach and organizing large-scale media events and also served as a national leader on a 2016 presidential primary campaign. Anna was a congressional staffer for a U.S. Senator and U.S. Congressman with her legislative portfolio consisting of trade, foreign policy and defense issues. Her portfolio expertise led to data intelligence work in Afghanistan's northern mountains during wartime.

Mark Politi is CFO of Eazy Do It, Inc. A Former CFO of a publicly traded company and SVP of a private equity funded entertainment firm. Mark's history of managing and building successful companies and his work in private equity, has positioned him perfectly in the Opportunity Zone QOZRE and QOZB marketplace. His financial acumen has enabled him to work with his clients and provide a unique understanding and analysis of their Opportunity Zone Fund development, often simplifying the frequently complex nature of property transactions. Mark was formerly Senior Vice President and Chief Financial Officer of Zanart Entertainment (ZANA). Zanart was a licensing company that produced licensed consumer products for over 175 feature films and TV shows such as Star Wars, Batman, and Superman. He was formerly VP of Licensing and Media Relations private equity funded Planetwide Games publisher of RYL: Path of the Emperor MMORPG and Marvel & Spore Comic Book Creator software. Mark was formerly CEO of MPA Publishing that produced licensed products for Titanic, The Simpsons, and Star Trek among many others. He holds a Bachelor's degree in Economics from California State University's school of Business. He resides in Southern California.

Joseph Luna, Managing Partner of OZ Invested, LLP specializes in Opportunity Zone investments. His ability to analyze complicated areas of the tax code and develop creative solutions allow him to thrive as an Opportunity Zone attorney, despite being one of the younger attorneys practicing in this area. Joseph created OZ INVESTED to provide clients a firm designed to manage every aspect of their Opportunity Zone investment. He advises clients from a wide variety of backgrounds on their Opportunity Zone investments. Joseph applies his knowledge of business taxation to help clients determine their optimal investment structure and helps clients create their Qualified Opportunity Fund and Qualified Opportunity Zone Business. After capital contributions occur, Joseph utilizes his expertise in data analytics to advise clients on potential Opportunity Zone investments that would thrive if added to the area. Upon acquiring the property, Joseph helps clients make deferral elections and ensure Opportunity Zone investment compliance. Joseph also provides clients with an Opportunity Zone investment simulator, which allows them to test performance and compliance under any scenario. When it is time to sell, Joseph utilizes his expertise in M&A taxation to help clients determine a sale structure that maximizes returns.

Joseph pursued a career in taxation after he realized his work ethic and statistical modeling abilities would allow him to become a leader when changes to the tax code occurred. In his last semester of law school, Joseph focused on mastering tax law and corporate taxation. He also created a Section 199A tax simulator to show taxpayers who own specified service trades or businesses with incomes over the threshold amount their optimal tax strategy. Upon graduation, Joseph was admitted to the Georgia Bar and attended Boston University for his LL.M. in Taxation.

Joe Wolf is a licensed finance attorney with a Juris Doctor degree. Joe has enjoyed the position of Finance Attorney for McDonald's Corporation securing funding through various financial instruments for the company, working closely with Ray Kroc. Joe was also a Regional Real Estate Attorney for McDonald's Corporation which included approval of all new projects, approval of all costs associated with new units and acquisitions including their financing, and the leasing, purchasing, and franchising documentation for two regions.

Additionally, Joe was General Counsel for Tiffany's Bakeries, Inc. Most recently Joe was responsible for the approval of all documentation for new AAmco Transmission locations throughout the United States and Canada before joining Eazy Do It, Inc. as their Chief Legal Counsel.

In his role as Counselor to the Secretary of the Treasury, Daniel Kowalski's many duties included spearheading development of IRS guidelines and reporting for the Opportunity Zone program. He also advised Treasury's efforts to drive the Administration's domestic policy agenda. His particular areas of focus are budget and fiscal policy; health, education and welfare policy; tax policy; and infrastructure policy. From June through November, 2016, he served in several roles in the Trump campaign in New York City, with an emphasis on these domestic policy issues.

Kowalski's 30 years of experience include positions such as Deputy Staff Director of the Republican staff of the Senate Budget Committee. He also served as the Director of Budget Review for the Republican staff of the House Budget Committee. In those two positions, he helped shepherd several balanced budgets and reconciliation bills through the U.S. Congress.

His Washington, DC experience began in 1995, as Principal Analyst with the Congressional Budget Office. Previous to that, Kowalski was Director of the Legislative Budget Office for the Missouri General Assembly, and as senior individual income tax analyst with the Republican staff of the Finance Committee for the New York State Senate. He started his career as a management analyst for the Deputy Commissioner

for Audit in the New York City Department of Finance.

Kowalski earned a master's degree in Public Policy from Harvard's Kennedy School of Government in Cambridge, MA, and a bachelor's degree from St. John's College in Annapolis, MD. Daniel is also recognized as the #1 OZ Expert in America.

Chris Pilkerton is a former Cabinet member and head of the US Small Business Administration (SBA). He currently serves as the Chief Legal and Regulatory Strategy Officer for the nation's largest non-profit Community Development Financial Institution (CDFI) concentrating on small business support for underserved communities. Pilkerton is also an Executive-In-Residence at Johns Hopkins University's Carey School of Business (JHU), where he researches, writes and conducts practical implementation of programs focused on small business and local economic impact issues.

Previously, Pilkerton served as a White House Senior Policy Advisor and former Acting Administrator of the SBA. He led the Jobs and Economy Pillar of the WH Domestic Policy Council and served as the Executive Director of its Opportunity Now initiative, a government-wide program to support economic empowerment for underserved communities working directly with mayors and governors on local economic initiatives and federal actions such as the Paycheck Protection Program and Opportunity Zones. In his role as SBA Acting Administrator (2019-2020), he served as a member of the President's Cabinet, advocating across government and the private sector on behalf of America's 30 million small businesses, with a focus on increasing access to capital and workforce initiatives in distressed areas and populations. During his time at the SBA, he was also the agency's General Counsel (2017-2020), overseeing legal operations across all of its financial programs.

Prior to his time with the SBA, Pilkerton was a compliance director at JP Morgan Chase, advising both the business and corporate functions on matters related to enterprise compliance risk and regulatory change management. While there, Pilkerton was named one of the "Heroes of the Fortune 500" by Fortune Magazine, in recognition of his efforts in support of orphans in Liberia impacted by ebola.

Pilkerton began his legal career as an Assistant District Attorney in Manhattan, working as a trial lawyer in both the Office of the Special Narcotics Prosecutor and the Office of Money Laundering and Tax Crimes. He later went on to become Senior Counsel at the U.S. Securities and Exchange Commission, investigating numerous cases related to insider trading and accounting fraud.

Pilkerton has since been a partner in two law firms, representing clients in various transactions and regulatory matters, as well as providing general counsel services to early-stage companies and clients in the financial services industry. He has served on the Board of Directors of NASDAQ Futures Exchange and was the Associate Director of the Law and Public Policy Program at the Catholic University of America Columbus School of Law, where he has also taught a course on enterprise risk management and financial controls. He has published several legal and policy articles and op-eds and has appeared on various news programs, including CNBC's Squawk Box and Fox Business News.

Pilkerton was a Fulbright Teaching Scholar in Poland and holds a master's degree in public administration from Columbia University's School of International and Public Affairs. He earned his J.D. from the Catholic University of America, a bachelor's degree from Fairfield University, and a certificate in data analytics from Cornell University's College of Business. Pilkerton also serves as Vice Flotilla Commander and Legal Officer in the US Coast Guard Auxiliary.

Jack Brewer was raised in Grapevine, Texas, and serves as the Chair of the Center for Opportunity Now, and Vice-Chair of the Center for 1776 at AFPI. Recently, Brewer was an Advisory Board Member of Black Voices for Trump. In 2004, he started his own firm, the Brewer Group, where he serves as Chief Executive Officer and Portfolio Manager. His global charity efforts have delivered millions in emergency aid and currently provide programs to thousands living in extreme poverty. He is a White House appointee on the Congressional Commission for the Social Status of Black Men and Boys, and is currently a Professor at Fordham Gabelli School of Business, where he has created curriculum tailored for transitioning athletes and prisoners. Brewer was a team captain for the NFL's Minnesota Vikings, New York Giants and Philadelphia Eagles. Brewer attended Southern Methodist University where he was a two-sport athlete, breaking the Disney World Classic record in triple jump, and was an All-American candidate as a wide receiver in football. He later transferred to the University of Minnesota, where he continued as an All-Big Ten athlete in track and football and served as the team captain. He earned both his bachelor's and master's degrees from the University of Minnesota by the age of 22. Brewer resides in Florida with his wife, Cortney, and has four children: Jared, Laesha, Jackson, and Zayah.

Definitions

Affiliate. Shall mean, with respect to any specified Person, a Person that directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with, the Person specified, provided that (i) Portfolio Companies shall not be deemed to be "Affiliates" of the Manager, the Investment Manager, or the Fund, and (ii) each Key Person, the Manager and the Investment Manager shall not be deemed to be an Affiliate of the others. As used in this definition, "control" means the power to direct the management or policies of a Person, directly or indirectly, whether through the holding of Securities by contract or otherwise.

Applicable Law. Shall mean any applicable law, regulation, ruling, order or directive, or license, permit or other similar approval of any Governmental Authority, now or hereafter in effect, to which a Member (or any of its Affiliates) is or may be subject.

Bankruptcy Code. Shall mean Title II of the United States Code entitled "Bankruptcy," as the same may be hereafter amended from time to time, and any successor statute or statutes thereto.

Book Value. Shall mean with respect to any Fund asset, the asset's adjusted basis for Federal income tax purposes, except that the Book Values of all Fund assets shall be adjusted to equal their respective Fair Market Values, in accordance with the rules set forth in Treas. Reg. 1.704-1(b)(2)(iv)(f), except as otherwise provided herein, immediately prior to: (i) the date of the acquisition of any additional Units by any new or existing Member in exchange for more than a de minimis Capital Contribution; (ii) the date of the actual distribution of more than a de minimis amount of Fund property (other than a pro rata distribution) to a Member; or (iii) the date of the actual liquidation of the Fund within the meaning of Treas. Reg. 1.704-1(b)(2)(ii)(g); provided, that adjustments pursuant to clauses (i) and (ii) above shall be made only if the Manager determines in its sole discretion that such adjustments are necessary or appropriate to reflect the relative economic interests of the Members. The Book Value of any Fund asset distributed to any Member shall be adjusted immediately prior to such distribution to equal its Fair Market Value. The Book Value of any Fund asset shall be adjusted to reflect any write-down which constitutes a Disposition.

Capital Contribution. Means, with respect to each Member the amount contributed to the Fund or the aggregate amounts so contributed (as the context may require) by the Members pursuant to the terms of the Operating Agreement.

Carried Interest. Means the Manager's right to receive cumulative distributions pursuant to this equal to 20% of the amount of distributions made or being made to Members after Members receive their Preferred Return, plus 20% thereafter.

Cash Inflows. Means the Fund's top-line GAAP gross revenue and return of capital from Fund Investments.

Closing. Shall mean, with respect to any Member, the sale to, subscription for, and purchase by, such Member of its Units and its admission as a Member pursuant to its Subscription Agreement.

Code or IRC. Shall mean the Internal Revenue Code of 1986, as the same may be hereafter amended from time to time and any successor statute or statutes thereto as set forth in the Preliminary Statements.

Distributable Cash. Shall mean for any Fiscal Year, the gross cash proceeds received from Fund operations, including sales and dispositions of property and all refinancing of property, reduced by the portion thereof used to pay or establish reserves for all Fund expenses, capital investments, debt payments, capital improvements, replacements, and contingencies, as determined by the Manager in its sole and absolute discretion; but subject, however, to the Manager's consideration and evaluation of the fact that a Qualified Opportunity Fund must hold at least 90 percent of its assets in Qualified Opportunity Zone Property based on an averaging on certain periodic testing dates under Code § 1400Z-2(d)(1) or risk the assessment of penalties. Withdrawals from reserves previously established pursuant to the first sentence of this definition shall be considered Distributable Cash.

ERISA. Shall mean the United States Employee Retirement Income Security Act of 1974.

Exchange Act. Shall mean the Securities Exchange Act of 1934, as the same may be hereafter amended from time to time.

Fair Market Value. Shall mean: (i) as to any Securities which are listed or admitted to trading on any national securities exchange on any trading day, an amount equal to the last sale price of such Securities, regular way, on such date or, if no such sale takes place on such date, the average of the closing bid and asked prices thereof on such date, in each case as officially reported on the principal national securities exchange on which such Securities are then listed or admitted to trading; (ii) as to any Securities which are not then listed or admitted to trading on any national securities exchange, but are reported through the automated quotation system of a registered securities association, the last trading price of such Securities on such date, or if there shall have been no trading on such date, the average of the closing bid and asked prices of such Securities on such date as shown by such automated quotation system; or (iii) as to any other business on any date, the fair market value of such business on such date as determined in good faith by the Manager in accordance with valuation procedures approved by the Manager with input and non-binding recommendations from the Advisory Committee,

provided, that if a Majority-in-Interest so requests in writing, the fair market value of such business shall be determined by an independent, nationally recognized investment banking firm, accounting firm or an appraisal firm selected by the Manager.

Final Closing. Shall mean latest date as determined by the Fund.

Fund. Shall mean a OZ Fund, LLC formed on to operate as a "Qualified Opportunity Zone Fund" pursuant to IRC 1400Z-2(d)(1).

Fund Investments*.* Shall mean the aggregate of the Fund's investment into Portfolio Investments, other Securities, and real estate.

Fund Management. Shall mean the Investment Manager and the Manager, as applicable.

GAAP. Shall mean generally accepted accounting principles in the United States of America as in effect from time to time.

Governmental Authority. Shall mean any nation or government, any state or other political subdivision thereof and any other Person exercising executive, legislative, judicial, regulatory or administrative functions of or pertaining to government.

Initial Closing. Shall mean the first closing under which any Member (other than the Manger) has acquired a Unit pursuant to a Subscription Agreement.

Investment Management Agreement. Shall mean the agreement between the Fund and the Investment Manager

Investment Manager. Shall mean Management Company thereafter, any other individual or entity selected by the Fund.

Investor**.** Shall mean any Person that purchases Stock or Units of the Fund.

IRS. Shall mean the United States Internal Revenue Service or its successor.

Majority-in-Interest. Shall mean the Members owning more than one-half of the aggregate Voting Interests of all Members.

Manager. Shall mean Management Company and its replacement or successor from time to time as permitted by the Operating Agreement***.***

Members. Shall be any Person who holds Units of the Fund.

Minimum Offering Amount. Shall mean the minimum aggregate subscription proceeds that must be received from the sale of the Units before the Final Closing Date.

Net Income and Net Loss. Shall mean, for each Fiscal Year or other period, the taxable income or loss of the Fund, or particular items thereof, determined in accordance with the accounting method used by the Fund for Federal income tax purposes with the following adjustments: (i) all items of income, gain, loss, deduction or expense specially allocated pursuant to the Operating Agreement (including Section 5.2) shall not be taken into account in computing such taxable income or loss; (ii) any income of the Fund that is exempt from Federal income taxation and not otherwise taken into account in computing Net Income and Net Loss shall be added to such taxable income or loss; (iii) if the Book Value of any asset differs from its adjusted tax basis for Federal income tax purposes, any gain or loss resulting from a disposition of such asset shall be calculated with reference to such Book Value; (iv) upon an adjustment to the Book Value of any asset pursuant to the definition of Book Value, the amount of the adjustment shall be included as gain or loss in computing Net Income or Net Loss; (v) if the Book Value of any asset differs from its adjusted tax basis for Federal income tax purposes, the amount of depreciation, amortization or cost recovery deductions with respect to such asset for purposes of determining Net Income and Net Loss shall be an amount which bears the same ratio to such Book Value as the Federal income tax depreciation, amortization or other cost recovery deductions bears to such adjusted tax basis (provided that if the Federal income tax depreciation, amortization or other cost recovery deduction is zero, the Manager may use any reasonable method for purposes of determining depreciation, amortization or other cost recovery deductions in calculating Net Income and Net Loss); and (vi) except for items in (i) above, any expenditures of the Fund not deductible in computing taxable income or loss, not subject to capitalization and not otherwise taken into account in computing Net Income and Net Loss pursuant to this definition, shall be treated as deductible items.

Non-U.S. Person. Shall mean a beneficial owner that is not a United States Person and that is not a partnership.

Offering. Shall mean the Fund's offering of an aggregate to prospective Investors.

Offering Memorandum. Shall mean this Confidential Private Placement Memorandum, as amended, supplemented or modified.

Opportunity Zone. Shall mean as defined in Code Section 1400Z.

Organizational Expenses. Shall mean all costs and expenses of the Fund relating to the organization of the Fund and the offer and sale of Units.

Percentage Interest. Shall mean, with respect to any Member, the ratio of such Member's Capital Contributions to the total Capital Contributions of all Members.

Person. Shall mean an individual, partnership, corporation, limited liability company, joint venture, business trust or unincorporated organization, Governmental Authority or any other entity.

Portfolio Company(ies). Shall mean corporations, partnerships, limited liability companies and other qualified opportunity zone business entities into which the Fund has made a Portfolio Investment.

Portfolio Investment. Shall mean a Fund investment in Qualified Opportunity Zone Property which has been acquired, directly or indirectly, in whole or in part, by the Fund.

Principal. Shall mean each manager of the Manager, as set forth in the governing documents of the Manager.

QOZ. Shall mean a qualified opportunity zone as defined and pursuant to IRC 1400Z-1(a).

QOF. Shall mean a qualified opportunity fund as defined and pursuant to IRC 1400Z-2(d)(1).

QOZB. Shall mean qualified opportunity zone business as defined and pursuant to IRC 1400Z-2(d)(3)and issues to the QOF private stock or membership units for investments made into the QOZB.

QOZP. Shall mean qualified opportunity zone property as defined and pursuant to IRC 1400Z-2(d)(2).

QOZBP. Shall mean qualified opportunity zone business property as defined and pursuant to IRC 1400Z-2(d)(2)(D).

Schedule K-1. Shall mean IRS Schedule K-1.

Securities. Shall mean any: (i) privately or publicly issued capital stock, bonds, notes, debentures, commercial paper, bank acceptances, trade acceptances, trust receipts and other obligations, choses in action, partnership or limited liability interests, instruments or evidences of indebtedness commonly referred to as securities, warrants, options, including puts and calls or any combination thereof and the writing of such options; and (ii) claims or other causes of action, matured or not matured, contingent or otherwise, of creditors and/or equity holders of any Person against such Person, including, without limitation, "claims" and "interests", in each case as defined under the Bankruptcy Code, and all rights and options relating to the foregoing.

Securities Act. Shall mean the Securities Act of 1933, as amended from time to time.

Subscription Agreement. Shall mean, as to any Member, the subscription agreement between such Member and the Fund in connection with its purchase of Units.

Subscription Documents. Shall mean the Subscription Agreement and Accredited Investor Questionnaire.

Subsequent Closing. Shall mean any Closing which occurs subsequent to the Initial Closing.

Treasury Regulations or Treas. Reg. Shall mean the Income Tax Regulations promulgated under the Code, as the same may be hereafter amended from time to time or any successor or successors to such Regulations.

Units. Shall mean the entire Units owned by a Member in the Fund at any particular time, including the right of such Member to any and all benefits to which a Member may be entitled as provided in the Operating Agreement, together with the obligations of such Member to comply with all the terms and provisions of the Operating Agreement.

United States Person. Means a person who is eligible to be the beneficial owner of a Unit, and both a citizen of the United States and is an accredited investor.

U.S. Dollars. Shall mean lawful money of the United States of America.

Voting Interest. Shall mean, for the purpose of any vote or consent right of the Members, at any time: (i) prior to the first investment by the Fund in a Portfolio Investment, the interest of each Member as determined by reference to the amount of such Member's Capital Contribution and (ii) after the first investment by the Fund in a Portfolio Investment, the Percentage Interest of each Member.

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Chapter 1: Opportunity Zones – An Introduction

What is the Opportunity Zone Program?

The increasingly globalized economy has meant prosperity for many, yet millions of Americans have been overlooked, devoid of the same benefits or the potential for upward mobility that comes from widespread investment. Fifty-two million Americans live in economically distressed communities, including the thirty-five million who reside in Opportunity Zones. A lack of investment has contributed to this economic distress, and a lack of access to economic opportunity can lead to negative outcomes in the vital measures that matter to all communities, including high unemployment rates, stagnant wages, low graduation rates, unsafe neighborhoods, and shorter life expectancy. To help these communities, Opportunity Zones were Included in the Tax Cuts and Jobs Act, which President Donald J. Trump signed into law in December of 2017.

Why the Opportunity Zone Program?

The Opportunity Zone tax incentive provides a tremendous way to bring investments, jobs, business expansion, and new business development to your community. Qualified Opportunity Zones were created by the 2017 Tax Cuts and Jobs Act. These zones are designed to spur economic development and job creation in distressed communities throughout all 50 States, the District of Columbia, and the five U.S. territories by providing tax benefits to investors who invest eligible capital into these communities.

What is an Opportunity Zone?

Opportunity Zones are economically distressed communities, defined by individual census tracts, nominated by America's governors, and certified by the U.S. Secretary of the Treasury via his delegation of that authority to the Internal Revenue Service. Under certain conditions, new investments in Opportunity Zones may be eligible for preferential tax treatment. There are 8,764 Opportunity Zones in the United States, many of which have experienced a lack of investment for decades. The Opportunity Zones initiative is not a top-down government

program from Washington but an incentive to spur private and public investment in America's underserved communities.

The goal of this program is to encourage long-term investment in low-income neighborhoods. Since its implementation, the program has sought to foster job creation and economic stimulus in undercapitalized areas.

Fact- Twelve percent of U.S. census tracts are Opportunity Zones.

Understanding The Deeper Why Behind The Opportunity Zone Program

Fifty-two million Americans live in economically distressed communities. These urban, rural, and suburban communities are located in every corner of the United States and its territories. Despite the growing national economy, these communities are plagued by high levels of poverty, failing schools, job scarcity, unsafe neighborhoods, and a lack of investment capital. In response, the historic Tax Cuts and Jobs Act included a powerful new tax incentive—Opportunity Zones—to spur economic development and job creation by encouraging long-term investment in low-income communities nationwide.

Opportunity Zones provide incentives for long-term private sector investment in economically distressed communities. State executives nominated census tracts to become Qualified Opportunity Zones to the U.S. Department of the Treasury, which then certified the tracts as Opportunity Zones.

The Opportunity Zone designation encourages investment in these census tracts by granting investors extensive Federal tax advantages for using their capital gains to finance new projects and enterprises (or substantially improve existing projects and enterprises) located within Qualified Opportunity Zones. There are more than 8,700 designated Qualified Opportunity Zones located in all 50 States, the District of Columbia, and five United States territories. Of these, approximately 40 percent are located in rural census tracts, 38 percent in urban census tracts, and 22 percent in suburban census tracts. Opportunity Zones represent significant investment opportunities. This is emphasized by the following facts:

- **Nearly 35 million Americans live in communities designated as Qualified Opportunity Zones;**
- **Unemployment rates are 1.6 times higher in Opportunity Zone census tracts than the average United States census tract;**
- **Median family incomes in Opportunity Zones are 37 percent lower than their respective area's or state's median;**
- **The average poverty rate across Opportunity Zones is more than 32 percent, almost double the rate of approximately 17 percent for the average United States census tract;**

- **One in four Opportunity Zones have a poverty rate over 40 percent, compared to one in 15 census tracts nationwide;**
- **The homeownership rate in Opportunity Zones is approximately 15 percentage points lower than the national average;**
- **Life expectancy is on average three years shorter for Opportunity Zone residents than it is nationally; and**
- **Approximately 22 percent of Opportunity Zone adult residents have not attained a high school diploma, compared to 13 percent nationally.**

The Opportunity Zone's priority is to help the forgotten men and women of America—particularly those living in economically distressed communities—facing an uphill battle to opportunity. More than one in five Opportunity Zones have a poverty rate higher than 40 percent, compared to just one in twenty census tracts nationwide. Of all Opportunity Zones, 71 percent meet the U.S. Department of the Treasury's definition of "severely distressed." In order to combat these staggering numbers, on December 12, 2018, President Donald J. Trump signed Executive Order 13853, establishing the White House Opportunity and Revitalization Council (Council). The Council was chaired by the Secretary of the U.S. Department of Housing and Urban Development, Benjamin S. Carson, Sr., and led by Executive Director Scott Turner. The Council carried out the Administration's plan to encourage public and private investment in urban and economically distressed areas, including Opportunity Zones. In April of 2019, the Council published an Implementation Plan, which assigned Council member agencies to specific work streams and objectives.

The Council member agencies proposed a total of 223 recommendations, which aimed to encourage public and private investment in urban and economically distressed communities, including Opportunity Zones; and to help State, local, and tribal governments to better identify, use, and administer Federal resources in urban and economically distressed communities, including Opportunity Zones.

8700+

Opportunity Zones

(Nationwide, Guam, Puerto Rico & US Virgin Islands)

900+

New Opportunity Zone Funds Created In The Last 2.5 Years

$7+ Trillion Dollars

Average Amount Of US Capital Gains Eligible For This Program

$90+ Billion Dollars

Have Already Been Reinvested Into Community Revitalization Because Of The Program

How Investors Benefit

The Opportunity Zone tax incentive will spur capital investment and economic development in low-income communities. First, investors can defer the taxation of certain prior gains invested in a Qualified Opportunity Fund (QOF) until the earlier of the date on which the investment in the QOF is sold or exchanged, or December 31, 2026. Second, if the QOF investment is held for at least 5 years, 10% of the gain that was originally deferred is eliminated completely. (This benefit expired on 12/31/2021). Third, if the investor holds the QOF investment for at least ten years, when the investor sells or exchanges the investment, the investor is eligible to eliminate the gain on the QOF investment from any increase in value of the QOF investment during the investor's holding period.

Sample Investment Highlight

23.8% Capital Gains Tax Rate*	10 Year Hold – Standard Tax Scenario	10 Year Hold – Opportunity Zone Funds
Capital Gains	$1,000,000	$1,000,000
Tax Payable	$238,000	$0
Capital to Invest	$762,000	$1,000,000
Value After 10 Years	$2,286,000	$3,000,000
Tax on Appreciation	$2,286,000	$0
Deferred Capital Gain Tax	N/A	$202,300
Equity Multiple	1.92	2.80
After Tax Funds Available	$1,923,288	$2,797,700

*20% Capital Gains Tax + 3.8% Net Investment Surtax

In the example (above), the $1,000,000 of capital gains invested in a standard tax scenario would eventually pay $600,712 in taxes if their investment tripled in value over 10 years. The total taxes paid would equate to 26.28% of the eventual value of $2,286,000.

If you invest the same capital in our Qualified Opportunity Zone Fund (QOF), not only is the overall investment larger, as all $1,000,000 would be at work, but the permanent exclusion of gains on the appreciated value mean that the investment pays a total of $202,300 in taxes, or just 6.74%, on an investment that is eventually worth $3,000,000.

The 4 Pillars of the Opportunity Zone Program

1.) Job Creation

Entrepreneurs form the fabric of any vibrant community. By promoting American entrepreneurship and engaging with small businesses, we can accelerate the revitalization of our economically distressed communities. The Opportunity Zone program is committed to leveraging government resources to help reinvigorate entrepreneurship in our nation's Opportunity Zones.

The 30 million small businesses across the United States create two out of three net new jobs each year. These businesses serve as the engines that drive our economy, and their expansion into Opportunity Zones will uplift economically distressed areas by providing new investments, new jobs, and dynamic economic systems. The data confirm entrepreneurship's importance: America's engine of job creation is new businesses. High-growth businesses—which on average are disproportionately young compared to all businesses—comprise nearly 50 percent of job creation; entrepreneur-led companies less than five years old account for essentially all net new job creation.

According to the 2018 Global Entrepreneurship and Development Index, the United States provides the best environment for cultivating entrepreneurship in the entire world. We can

continue to build upon this success by encouraging the formation of businesses in the areas that need them most.

When businesses are formed and grow in an economically distressed area, the benefits are exponential. Once more, investment and entrepreneurship can take root in these Opportunity Zones, and the resulting economic activity will lead to better school systems, improved public resources, and other businesses that create a sustainable ecosystem for a safe and prosperous community.

The White House Opportunity and Revitalization Council aimed to accelerate the formation of businesses in Opportunity Zones and other economically distressed communities. This will be achieved by coordinating efforts among Federal agencies and programs to spur meaningful economic activity in these areas. Economic growth and entrepreneurship are crucial for driving down unemployment and promoting greater economic stability. This initiative aims to improve access to capital and government contracts in Opportunity Zones by integrating Opportunity Zones into existing programs that target business formation and economic development. As part of their outreach, Federal agencies will also use their field networks across the country to increase awareness of the benefits of Opportunity Zones.

2.) Community Revitalization

Economic development programs inspire local communities to build upon two economic drivers—innovation and regional collaboration. Innovation is essential to global competitiveness, a resilient economy, and new and better jobs—including advancing industries for the future. Regional collaboration is also vital to economic recovery, as regions and communities are centers of competition. Successful regions must work together to leverage strengths and resources in order to overcome obstacles. Federal resources also serve an important role in fostering this innovation and regional collaboration. Diversification is paramount for experienced investors. Thus, investments in real estate, small businesses, or agriculture in underserved communities provide the advantage of industry diversification while also supporting local business retention and expansion. Through stronger businesses, communities are better equipped to withstand economic downturn and, in turn, protect those same investments. Targeted public investment in infrastructure, transportation, public spaces, and housing will help Opportunity Zones attract private capital to withstand periods of economic distress.

The economic benefits that new and innovative developments bring to communities are tremendous. The Bureau of Labor Statistics estimates that in 2012, 14 million people had jobs in fields directly related to infrastructure, and infrastructure accounts for almost 11 percent of the nation's workforce. Infrastructure-related occupations provide meaningful salaries, having a median wage over $37,000.

Over the past decade, America's growing population has been concentrated in the 50 largest metropolitan areas, placing new demand on existing, overstrained infrastructure. As a majority

of the world's economic growth in the coming years takes place outside of the United States—and concentrated in cities—concrete, steel, and fiber-optic cable will continue to serve as key building blocks to American business success, offering better opportunities for exporting goods, services, and access to complex supply chains.

As the United States GDP grows at more than three percent and unemployment drops below four percent, modernizing infrastructure and development will be necessary to support the changing workforce. Large metropolitan areas, in addition to low-income and rural communities, will depend on public investment in seaports, freight railroads, broadband networks, energy projects, and transportation.

The Federal Government presently manages numerous grant-based and other revitalization programs aiming to support state, tribal, local, and territorial government, nonprofit providers, and private investment. State, tribal, and local governments—being the primary stewards of United States infrastructure—own more than 90 percent of America's public capital. Though state and tribal investment in economic development varies by state and locality, as a result of differing and unique community needs, a majority of the capital dollars are spent on schools, transportation, water infrastructure, and distribution.

As the Federal Government focuses, prioritizes, and redirects Federal aid, it can encourage and leverage state, tribal, and local government capital to stimulate greater investment in Opportunity Zones. This will be important for inclusive growth that does not leave low-income communities behind. For example, though more than 80 percent of Americans are now connected to broadband—connecting them to new jobs, customers, and supply chains—less than 60 percent of low-income households have access. Similarly, only nine percent of Opportunity Zones have at least one public transit station. Thus, Federal programs focusing on economic development, innovation, and regional collaboration in Opportunity Zones can magnify and supplement increased investment and benefit diverse segments of the United States population.

3.) Safe Neighborhoods

Crime and the perception of an unsafe neighborhood are detriments to any revitalization effort. Without safe neighborhoods, communities struggle to keep and attract new residents and businesses. Crime reduction and community engagement strategies have the potential to restore confidence in neighborhoods and business development.

Tax incentives offered to businesses in the 1980s were sufficient to attract investment in high crime and poverty areas, but proved to be unsustainable. Enterprise Zones, a tax incentive-based business investment strategy championed by the late Secretary of Housing and Urban Development Jack Kemp, experienced success in bringing new business to distressed

communities, but high crime and a lack of corresponding investment in public safety drove many businesses to leave.

Today's Opportunity Zones continue to experience many of the same problems that existed in the 1980s. According to the Economic Innovation Group, poverty in Opportunity Zones remains nearly twice the national average. Along with it, crime continues to be a big problem in these cities. Most of these communities are similar to Los Angeles, where overall crime is 20 percent higher than the national average, and violent crime is 99 percent higher.

What has changed in Opportunity Zones is the amount of money available for law enforcement, crime prevention, and victim services. The Department of Justice (DOJ) currently spends in excess of $6 billion annually on state, tribal, and local law enforcement programs. In order to maximize this benefit to distressed communities, DOJ has prioritized grant applications that provide resources within Opportunity Zones.

Likewise, it is vital that Opportunity Zones and other distressed communities receive the resources necessary to address drug addiction and remediate environmental contamination sites that hinder safe development. Similarly, we must understand that areas struggling with environmental contamination may face barriers to economic development, and by working with communities to remedy these environmental conditions, economic growth will follow. These actions help ensure a healthy workforce and environmentally safe areas for development – both key to attracting private investment.

4.) Education & Workforce Development

Central to improving the economic circumstances of urban and distressed communities including Opportunity Zones is the tenet of enhancing resident access to—and success in—education, including further learning beyond high school. Wage premiums and job security continue to be associated with postsecondary education or skills development. Improved skills development, labor market alignment, and use of industry-recognized credentials will improve regional economic competitiveness and the earnings of students and job seekers alike. Recent research also has demonstrated that community college certificates in high-demand fields significantly improve employment and earnings.

Workforce skill-building is also essential to maximizing the impact of the new investment that will be flowing into these communities and ensuring that Opportunity Zone residents are trained and ready to assume the newly created jobs. Without complementary actions to boost the education and skills of Opportunity Zone residents, many of the new jobs will be filled by individuals who reside elsewhere—or they will go unfilled altogether, inhibiting economic growth. Moreover, improved educational outcomes are likely to have a positive compounding

effect with companies choosing to locate and expand operations in communities with high educational attainment.

The residents of Opportunity Zone communities have significant educational needs. According to the Economic Innovation Group, more than one-fifth of the adults living in economically distressed communities (including Opportunity Zones) lack a high school diploma or equivalent. Many of these adults possess neither the necessary literacy or numeracy skills required to capitalize on training opportunities for skilled and semi-skilled jobs—jobs that pay wages adequate to support a family.

While the Federal Government invests significant resources in expanding access to workforce development and training opportunities, too often these programs fail to effectively provide Americans the skills needed to succeed in the modern economy. Recognizing the need to reform this broken system, the Trump Administration previously convened the National Council for the American worker and charged this body with developing a national strategy to ensure that America's students and workers are equipped with the skills needed to compete and win in the global economy.

Breaking Down the Opportunity Zone Timeline

2015-16 **The Birth of the Opportunity Zone Program**

The concept of Opportunity Zones is drafted in a 2015 paper co-authored by a bi-partisan pair of economists, Kevin Hassett and Jared Bernstein. The policy as we know it today is based on the bipartisan *Investing in Opportunity Act*, which was championed by Senators Tim Scott (R-SC) and Cory Booker (D-NJ) and Representatives Pat Tiberi (R-OH) and Ron Kind (D-WI), who led a regionally and politically diverse coalition of nearly 100 congressional cosponsors in the House and Senate. The bill was first introduced in 2016 and reintroduced in 2017.

2017 **The Opportunity Zone Program Is Passed on Capitol Hill by Congress and Signed Into Law by the President.**

The Tax Cut & Jobs Act (TCJA) is officially signed into law on December 22nd, 2017. The 900+ page bill includes the legislative language establishing the Opportunity Zone program.

2018 **April**

The IRS issued the first Opportunity Zone press release to the public as an advance draft of proposed regulations later published in the Federal Register in June.

Late June

Official Internal Revenue Code guidance is released by the IRS. Thus pulling the trigger for the Opportunity Zone program to officially start across America.

December 12th

On December 12, 2018, President Donald Trump signs Executive Order 13853, establishing the White House Opportunity and Revitalization Council (Council), to carry out the Administration's plan to target, streamline, and coordinate Federal resources to be used in Opportunity Zones and other economically distressed communities.

2019

January

GOVERNMENT SHUTDOWN delays 1st tranche of guidance being released to the public.

April

April regs proposed further changes to the 2018 proposed regulations and added additional newly proposed regulations.

Tranche 1 guidance officially released. (500+ pages) Primarily focuses on answering the questions around real estate usage from developers. Establishes the 31 month working capital safe harbor provisions for real estate assets.

December 19th

All regulations were finalized and released on December 19, prior to their publication in the Federal Register in January 2020.

Tranche 2 guidance officially released. (500+ pages) Primarily focuses on answering the questions around business usage from startups and zone businesses. Establishes the 60 month working capital safe harbor provisions for qualified opportunity zone businesses.

December 31st

5% additional step up in basis on the tax due on the deferred capital gains expires for investors.

2020

January

President Trump talks about Opportunity Zones during the State Of the Union Address, specifically mentioning an Opportunity Zone business.

January - March

Opportunity Now events happening across the country promoting Opportunity Zones by the White House, HUD & SBA, Treasury and other agencies.

March-April

Covid-19 hits the world as a global pandemic, causing a massive shutdown across the country. Forcing the entire focus of the government to shift away from Opportunity Zones. Massive stock market exit creates $700B in new capital gains. 65+ million Americans unemployed. Massive business shutdowns.

November

White House releases an official announcement. $75+Billion has been invested into Opportunity Zones. Over 1 Million people have been impacted so far.

Additionally, the Community Reinvestment Act guidance was updated to reflect CDFI tracks and Opportunity Zones for purposes of the CRA credits for banking institutions.

December

Several announcements are made by the SEC in regards to Crowd Fundraising, who has to register as a broker dealer, new accredited investor thresholds are released and changes to the Volker rule all have behind the scenes positive impact on Opportunity Zones and funds.

2021 **Change in U.S. President**

President Biden acknowledges keeping the Opportunity Zone program but wants enhanced reporting requirements.

March

A 2 year extension bill on the tax deferment due date is introduced in Congress to extend to 2028 vs 2026.

Additionally, new Census data was updated and is showing changes in extensions to designated opportunity zones. We are currently waiting on additional guidance on how this will impact the opportunity zone program.

March 31st

Program Extensions due to Covid19 expire for investors with capital gains dating back to 2019.

December 31st

10% step up in basis for capital gain investors investing in opportunity funds expires.

The Full Weight of the United States Government

On December 12, 2018, President Donald J. Trump signed Executive Order 13853, which established the White House Opportunity and Revitalization Council (Council), to carry out the Administration's plan to target, streamline, and coordinate Federal resources to be used in Opportunity Zones and other economically distressed communities. With fifty-two million Americans living in economically distressed communities, including thirty-five million in Opportunity Zones, the Council's work was indicative of the Administration's commitment to the forgotten men and women of America.

The Former Council—composed of 17 Federal agencies and Federal-State partnerships—was meant to identify and disseminate best practices for utilizing the Opportunity Zones tax incentive and existing Federal resources to stimulate economic growth and revitalization, especially in America's distressed areas. This public sector commitment overlayed the Opportunity Zones tax incentive (created through the Tax Cuts and Jobs Act), which itself encourages long-term private capital investment in economically distressed communities. Together, private capital and public investment will stimulate economic opportunity, encourage entrepreneurship, expand educational opportunities, develop and rehabilitate quality housing stock, promote workforce development, as well as promote safety and prevent crime in economically distressed communities.

A Very Long Term Program

Measurement & Analysis

Evidence is essential for maximizing the positive impact of policy. Carefully benchmarked and monitored outcomes can provide policy makers with the evidence base needed to make informed decisions and demonstrate policies that work and those that do not. The Trump Administration was committed to the importance of evidence for improving policy decisions. For example, President Trump signed into law the Foundations for Evidence-Based Policymaking Act of 2018, which emphasizes the importance of data collection and program evaluation.

Measuring the outcomes of Opportunity Zones is especially important. Academic researchers and policymakers have increasingly recognized that geographic inequality is a pervasive and growing problem, that communities have important ramifications for individual outcomes, and that place-based policies could play an important role in improving the well-being of Americans in distressed areas. Unfortunately, there is a general lack of evidence regarding the types of tools that can lift up these communities and the people who live in them.

Opportunity Zones represent an unprecedented commitment to restoring distressed areas by providing flexible investment incentives to spur development in the communities that most

need it. Thus, Trump's Administration found it imperative to pair these powerful efforts with a full-scale commitment to measuring their outcomes.

Evaluating the outcomes of Opportunity Zones transcends simply an academic pursuit. Due to the wide scope of Opportunity Zones in terms of geographic coverage and the types of investment encouraged, the Council will gather available evidence on what types of areas and which demographics of the population benefit from varying forms of efforts. These lessons can inform the implementation of policies that complement Opportunity Zones, as well as future place-based policies. Committing to evidence-based policies to empower Americans left behind in distressed communities is not only the most responsible approach, but also the most compassionate response to one of the biggest challenges facing our country today.

Chapter 2: Rules & Regulations

Understanding The Opportunity Zone Rules & Regulations.

The ins and outs, dos and don'ts of Opportunity Zones.

Since the inception of the Opportunity Zone program, created as part of 2017 Jobs Act, there have been over 2,700.Funds raising $75 Billion in total.

- 85% of the Funds have been for Real Estate
- 15% of the Funds have been for Non Real Estate

The Opportunity Zone Market Space has only scratched the surface of impact within the 8700+ Opportunity Zone regions of the US States, Guam and Puerto Rico. The Opportunity Zone program, created through bipartisan legislation has evolved over the past few years.

4 Key Investor Requirements

Opportunity Zone investors must meet four requirements to qualify for the Opportunity Zone tax incentives.

First, they need to be an eligible taxpayer. Second, they need eligible gain. Third, they must invest their eligible gain into a Qualified Opportunity Fund (QOF) within 180 days from the date the eligible gain would be recognized for federal income tax purposes. Fourth, they must make a valid deferral election.

Only Opportunity Zone investors who meet these four requirements can qualify for the tax incentives by making their Opportunity Zone investment.

1ST REQUIREMENT

The first Opportunity Zone investor requirement is that you must be an eligible taxpayer. Reg §1.1400Z2(a)-1(b)(13) defines an eligible taxpayer as a person that is required to report the recognition of gains during the taxable year under Federal income tax accounting principles. Thus, for example, eligible taxpayers include individuals; C corporations, including RICs and

REITs; organizations subject to the unrelated business income tax; and partnerships, S corporations, trusts, and decedents' estates.

2ND REQUIREMENT

The second Opportunity Zone investor requirement is that you must have eligible gain. §1400Z-2(a)(1) defines eligible gain as gain from the sale of any property to, or exchange with, an unrelated person. Additionally, three requirements must be met to be considered eligible gain. First, the gain must be either a capital gain for federal income tax purposes (including both short term and long term capital gains, collectables gains, and unrecaptured §1250 gain) or a qualified § 1231 gain (gains resulting from the sale of property in a trade or business), not taking into account any losses and taking into account any other Code provisions that require the potential capital gain to be treated as ordinary income.

Second, the gain must be subject to tax that the taxpayer would recognize for federal income tax purposes before January 1, 2027 if there was no deferral election under § 1400Z-2.

Third, the gain must not have arisen from a sale or exchange with a person related to either (1) the eligible taxpayer that would recognize the gain in the taxable year in which the sale or exchange occurs if there was no deferral election under § 1400Z-2, or (2) any pass-through entity or other person recognizing and allocating the gain to this eligible taxpayer.

For purposes of this related-party rule, the modified 20% definition of a related person in § 1400Z-2(e)(2) applies. Additionally, only amounts invested into a QOF equaling the eligible taxpayer's eligible gain will qualify for the tax incentives. (Related parties are covered in more detail in Chapter 4)

3RD REQUIREMENT

The third Opportunity Zone investor requirement is that you must invest your eligible gain into a QOF within 180 days from the date the eligible gain would be recognized for federal income tax purposes. Generally, this will be the day an eligible taxpayer sells the property giving rise to their eligible gain. In such instances, the eligible taxpayer will have 180 days from the date of the sale. However, for RICs, REITs, and pass-through entities (such as a partnership, S corporation, or grantor trust), special rules apply for determining when the 180 day period begins. For RICs and REITs, shareholders with distributed capital gains dividends can choose from two applicable 180 day testing dates:

(1)a 180 day period for capital gain dividends beginning at the close of the shareholder's taxable year in which the capital gain dividend would otherwise be recognized by the shareholder; or

(2) the 180 day period beginning on the day each capital gain dividend is paid., The aggregate amount of a shareholder's eligible gain with respect to capital gain dividends received from a RIC or a REIT in a taxable year cannot exceed the aggregate amount of capital gain dividends that the shareholder receives as reported or designated by that RIC or that REIT for the shareholder's taxable year.

For undistributed capital gain dividends, the shareholder can elect to begin the 180 day period on either:

(1) the last day of the shareholder's taxable year in which the dividend would otherwise be recognized, or
(2) the last day of the RIC or REIT's taxable year.

For pass-through entities there are three potential 180 day testing dates. If the entity wants to make the opportunity zone investment.

(1)The entity will have 180 days from the date the property is sold. If the entity does not want to make the Opportunity Zone investment, the partner, shareholder, or beneficiary can elect either:

- (2) 180 days from the end of the entity's tax year (usually December 31), or
- (3) 180 days from the date the entity's tax return is due (March 15).

4TH REQUIREMENT

The fourth Opportunity Zone investor requirement is that you must make a valid deferral election with respect to an eligible gain before January 1, 2027. To make a valid deferral election, the eligible taxpayer must make an election by filing a Form 8997 with their timely federal income tax return for the taxable year in which the gain would be included if not deferred under § 1400Z-2.

Additionally, eligible taxpayers are required to file a Form 8997 with their timely federal income tax return each year they hold an opportunity zone investment. If a taxpayer fails to report this information, there is a rebuttable presumption that the taxpayer had an inclusion event during that year.

Opportunity Zone Fund Requirements

The gateway to the Opportunity Zone program and tax incentives happens through a "qualified opportunity fund" (QOF). According to §1400Z-2(d)(1), the term QOF means any investment

vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (QOZP) that holds at least 90 percent of its assets in QOZP, determined by the average of the percentage of QOZP held in the fund as measured-

- (A) on the last day of the first 6-month period of the taxable year of the fund, and
- (B) on the last day of the taxable year of the fund.

Additionally, Reg §11400Z2(d)-1(a)(2) requires self-certification of an entity as a QOF by filing a Form 8996 with the IRS where the QOF identifies the first taxable year for which the self-certification takes effect and the first month (in that initial taxable year) in which the self-certification takes effect.

According to Form 8996 and the accompanying instructions, by the end of the first QOF year, the organizing documents of the QOF are also required to include a statement that the purpose of the entity is to invest in QOZP and to include a ‘‘description of the qualified opportunity zone business(es) that the QOF expects to engage in either directly or through a first-tier operating entity.’’

In order to qualify for the opportunity zone tax incentives, eligible taxpayers must invest their eligible gains into the QOF within 180 days from the date the gain would be recognized for federal income tax purposes, and in exchange for an eligible interest in the QOF. According to Reg §1400Z2(a)-1(b)(12), **eligible interest in a QOF is an equity interest issued by the QOF, including preferred stock or a partnership interest with special allocations**.

Thus, the term eligible interest excludes any debt instrument including those within the meaning of section 1275(a)(1) and § 1.1275–1(d).

As previously mentioned, QOFs only have one mandatory test to comply with, §1400Z-2(d)(1) which requires QOFs to hold at least 90 percent of assets in QOZP (the “90% investment standard), determined by the average of the percentage of QOZP held in the QOF as measured-

- (A) on the last day of the first 6-month period of the taxable year of the fund, and
- (B) on the last day of the taxable year of the fund. For first year QOFs, the date on which the QOF tests compliance with the 90% investment standard will vary depending upon when the QOF certifies its first month as a QOF.

For QOFs certifying as a QOF in a month that occurs before July, the QOF will have to test compliance with the 90% investment standard twice. The first testing date will be on the last day of the month that occurs 6 months from the month the QOF certified as a QOF.

For example, a QOF that certifies in January will first be required to test compliance six months later on June 30, and a QOF that certifies in February will first be required to test compliance six months later on July 31. The second testing date for QOFs that certify before July will always be

December 31. This means that if a QOF certifies in June, the QOF will be required to test compliance with the 90% investment standard for the first taxable year on November 30 and December 31. For QOFs that certify as a QOF in a month that occurs after July, the QOF will only test compliance with the 90% investment standard once in the first taxable year, on December 31. After the first taxable year, QOFs will always test compliance semi-annually on the same dates each year, June 30, and December 31.

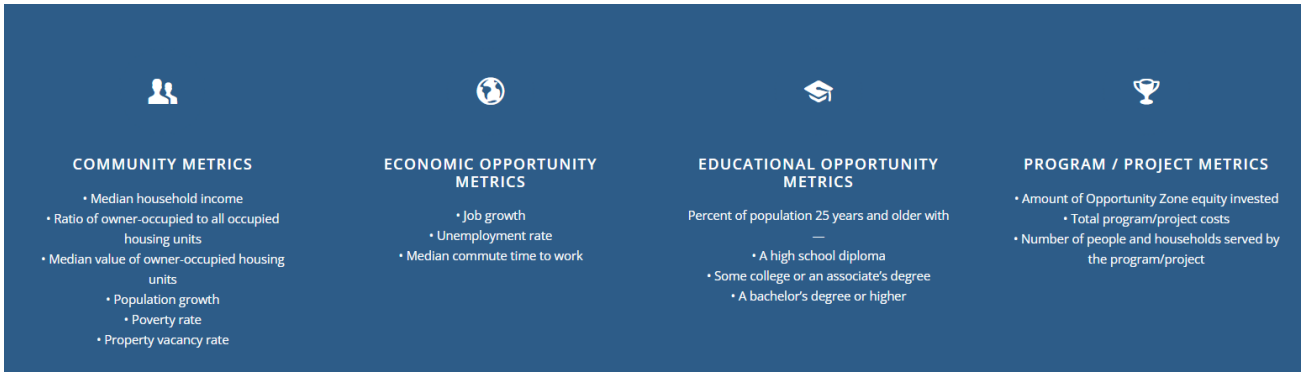
According to §1400Z-2(d)(2)(A), QOZP means property which is:

- (i) qualified opportunity zone stock,
- (ii) qualified opportunity zone partnership interest, or
- (iii) qualified opportunity zone business property (QOZBP).

According to §1400Z-2(d)(2)(B)(i), the term "qualified opportunity zone stock" means any stock in a domestic corporation if- (I) such stock is acquired by the QOF after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash, (II) as of the time such stock was issued, such corporation was a qualified opportunity zone business (QOZB) (or, in the case of a new corporation, such corporation was being organized for purposes of being a QOZB), and (III) during substantially all of the QOF's holding period for such stock, such corporation qualified as a QOZB.

According to §1400Z-2(d)(2)(C), The term "qualified opportunity zone partnership interest" means any capital or profits interest in a domestic partnership if- (i) such interest is acquired by the QOF after December 31, 2017, from the partnership solely in exchange for cash, (ii) as of the time such interest was acquired, such partnership was a QOZB (or, in the case of a new partnership, such partnership was being organized for purposes of being a QOZB), and (iii) during substantially all of the QOF's holding period for such interest, such partnership qualified as a QOZB.

According to §1400Z-2(d)(2)(D), The term QOZBP means tangible property used in a trade or business of the QOF or QOZB if- (I) such property was acquired by the QOF or QOZB by purchase (as defined in section 179(d)(2)) after December 31, 2017, (II) the original use of such property in the qualified opportunity zone commences with the QOF or QOZB, or the QOF or QOZB substantially improves the property, and (III) during substantially all of the QOF's or QOZB's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone.



Chapter 3: Qualified Opportunity Funds

The Bridge To Make Opportunity Zone Investments Work!
The Only Door into the Opportunity Zone tax incentives.

The entry point to the Opportunity Zone:

For real estate investors and investors looking to start a qualified opportunity zone business, all investments initially happen through the Qualified Opportunity Fund level. That is the front door to the program. That is the bridge in. This cannot be stressed enough!

Part A: The Qualified Opportunity Fund ("The only door")

The gateway to the Opportunity Zone tax incentives happens through a "qualified opportunity fund" (QOF). According to § 1400Z-2(d)(1), the term QOF means any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (QOZP) that holds at least 90 percent of its assets in QOZP, determined by the average of the percentage of QOZP held in the fund as measured- (A) on the last day of the first 6-month period of the taxable year of the fund, and (B) on the last day of the taxable year of the fund.

Thus, a QOF effectively has four core requirements that it must meet to be considered a QOF:

1) The QOF must be investment vehicle classified as a partnership or corporation for federal income tax purposes;

2) The QOF must be an entity organized under the laws of the United States, the laws of one of the 50 states, a government of a federally recognized tribe, the District of Columbia or a U.S. territory;

3) The QOF must self-certify on an annual basis that it satisfies the requirements applicable to QOF;

4) The QOF must hold at least 90% of its assets in QOZP determined by the average of the percentage of qualified opportunity zone property held in the fund as measured- (A) on the last day of the first 6-month period of the taxable year of the fund, and (B) on the last day of the taxable year of the fund.

A. Classified as a partnership or corporation

The first requirement for a QOF is that it must be an investment vehicle classified as a partnership or corporation for federal income tax purposes. This means that for federal income tax purposes your QOF can be taxable as a C corporation under IRC Subchapter C, as an S corporation under IRC Subchapter S, or as a partnership under Subchapter K. Note that a QOF cannot be a single member LLC because it would be a disregarded entity federal income tax purposes and not an entity classified as a partnership subject to Subchapter K for federal income tax purposes.

B. Entity organized under the laws of the United States, the laws of one of the 50 states, a government of a federally recognized tribe, the District of Columbia or a U.S. territory.

The second requirement for a QOF is that it must be an entity organized under the laws of the United States, the laws of one of the 50 states, a government of a federally recognized tribe, the District of Columbia or a U.S. territory.

The simplest way for a QOF to become a legal entity is by: (i) becoming a corporation by filing articles of incorporation with the Secretary of State of any of the 50 states; (ii) becoming a partnership (limited partnership or limited liability limited partnership) by filing a certificate of limited partnership with the Secretary of State of any of the 50 states; (iii) or by becoming a limited liability company (remember to be multi-member LLC) by filing articles of organization with the Secretary of State of any of the 50 states.

Additionally, the QOF can be an entity organized under the laws of the United States, a government of a federally recognized tribe, the District of Columbia or a U.S. territory. U.S. territories include American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, the U.S. Virgin Islands, and any other territory not under the jurisdiction of one of the 50 states, an Indian tribal government or the District of Columbia where a QOZ has been designated. However, if a QOF entity is organized in a U.S. territory and not in one of the 50 states, the QOF may only invest in QOZP that relates to a trade or business operated in the U.S. territory in which the entity is organized.

C. The QOF must self-certify on an annual basis that it satisfies the requirements applicable to QOF.

The third requirement for a QOF is that it must self-certify on an annual basis that it satisfies the requirements applicable to QOF. A QOF can self-certify as a QOF by annually filing a self-certification form (Form 8996) and attaching the form to its timely filed federal income tax return (taking into account extensions) for the taxable year. The IRS expects that a QOF will attach this form to its federal tax return for all relevant tax years and will use this form to self-certify and also to annually report compliance with the 90% asset test. An entity does not need to go through any specific approval process or vetting process in order to be considered a QOF. The Form 8996 is due by the due date of the tax return (including extensions) and must be filed by the due date of the tax return (including extensions).

When completing the Form 8996 the QOF will be required to identify the first taxable year for which the self-certification takes effect and the first month (in that initial taxable year) in which the self-certification takes effect. A QOF cannot begin accepting eligible gains from investors prior to the first month (in that initial taxable year) in which the self-certification takes effect.

For example, a QOF that selects February as the month for which the self-certification takes effect cannot accept eligible gains from investors in January but can start doing so in February. Additionally, by the end of the first QOF year, the organizing documents of the QOF are also required to include a statement that the purpose of the entity is to invest in QOZP and are also required to include a "description of the qualified opportunity zone business(es) that the QOF expects to engage in either directly or through a first-tier operating entity."

D. The QOF must hold at least 90% of its assets in QOZP on the applicable semi-annual testing dates;

The fourth requirement for a QOF is that it must hold at least 90 percent of its assets in QOZP (the "90% investment standard), determined by the average of the percentage of qualified opportunity zone property held in the QOF as measured- (A) on the last day of the first 6-month period of the taxable year of the fund, and (B) on the last day of the taxable year of the fund. This means that a QOF does not have to meet the 90% investment standard on each testing date. Instead, IRC § 1400Z-2(d)(1) provides that a QOF is required to hold at least 90% of its assets in QOZP, determined by the average of the percentage of QOZP held on the two testing dates.

Determining valuation of QOZP.

Under the regulations, for each tax year, a QOF can value its assets using the Applicable Financial Statement Valuation Method (if it has an applicable financial statement within the meaning of Reg. § 1.475(a)-4(h)) or the Alternative Valuation Method, which generally requires valuation based on the unadjusted cost basis of the asset under IRC § 1012 (with exceptions). All of a QOF's assets ''cognizable for federal income tax purposes'' are required to be valued for purposes of determining compliance with the 90% QOZP requirement on each applicable testing date.

A. Applicable Financial Statement Valuation Method

A QOF can use the Applicable Financial Statement Valuation Method to value assets only if the QOF has an applicable financial statement within the meaning of Reg. § 1.475(a)-4(h). In no instance will valuing assets under the Applicable Financial Statement Valuation Method be mandatory for a QOF, as the QOF can only use the Applicable Financial Statement Valuation to the extent it has an applicable financial statement within the meaning of Reg. § 1.475(a)-4(h). Should a QOF be eligible to value assets under the Applicable Financial Statement Valuation Method, the QOF will value property that it owns or leases based on the value of each asset as reported on the applicable financial statement for the relevant reporting period. If the QOF leases assets, it is able to use the applicable financial statement method of valuation only if the

financial statement is prepared according to U.S. GAAP and assigns a value to the lease of the asset.

B. Alternative Valuation Method

The default rule for a QOF to value its property will be to apply the Alternative Valuation Method. Under the Alternative Valuation Method, the value of property owned by a QOF that the QOF acquired by purchase for fair market value or constructed for fair market value is the QOF's unadjusted cost basis of the asset under IRC § 1012 or § 1013. If the QOF leases assets, the value of each asset leased by a QOF is equal to the present value of the leased asset

There is also a special rule for valuing "bad property," meaning property that is not purchased or constructed. "Bad property" will often include property that is contributed to the QOF by an investor. The value of "bad property" that is not purchased or constructed for fair market value is the asset's fair market value, as determined on each testing date.

For example, if a QOF is applying the Alternative Valuation Method and owns both contributed property (''bad property") and QOZP, on each testing date the value of the QOZP will remain at unadjusted cost basis but the value of the contributed property will fluctuate based upon its fair market value.

a. Special Rule for Cash

A QOF has the option (under either the Applicable Financial Statement Valuation Method or the Alternative Valuation Method) to exclude certain property from both the numerator and denominator when applying the 90% QOZP requirement. Property may be excluded only if the following three requirements are met:

- (1) the property was received by a QOF partnership as a contribution or by a QOF corporation solely in exchange for stock of the corporation;
- (2) the contribution or exchange occurred not more than 6 months before the relevant testing date; and
- (3) between the date of the fifth business day after the contribution or exchange and the semiannual testing date, the amount was held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less. This special rule creates flexibility for a QOF that receives cash from investors by effectively allowing the QOF to ignore the cash they received for one 90% QOZP testing period.

Determining the testing dates for a QOF.

As previously discussed, the QOF is required to hold at least 90% of its assets in QOZP determined by the average of the percentage of QOZP held in the QOF as measured- (A) on the last day of the first 6-month period of the taxable year of the fund, and (B) on the last day of the taxable year of the fund. The date(s) on which the QOF tests compliance with the 90% QOZP requirement will depend upon whether the QOF is in its first year as a QOF.

If the QOF is in its first year as a QOF, the date(s) on which the QOF tests compliance with the 90% QOZP requirement will depend upon the self-certification month selected on the Form 8996. For QOFs certifying as a QOF in a month that occurs before July, the QOF will have to test compliance with the 90% investment standard twice. The first testing date will be on the last day of the month that occurs 6 months from the month the QOF certified as a QOF.

For example, a QOF that certifies in January will first be required to test compliance six months later on June 30, and a QOF that certifies in March will first be required to test compliance six months later on August 31. The second testing date for QOFs that certify before July will always be December 31.

This means that if a QOF certifies in June, the QOF will be required to test compliance with the 90% investment standard for the first taxable year on November 30 and December 31. For QOFs that certify as a QOF in a month that occurs after July, the QOF will only test compliance with the 90% investment standard once in the first taxable year, on December 31.

After the first taxable year, the QOF will always test compliance with the 90% QOZP requirement on the same two dates each year, on June 30, and again on December 31.

Conclusion

Opportunity Zone investments have to go through a QOF. The QOF is the front door. There is no back door. There is no side window to open. It is through a QOF. Either you are setting up your own or you are collecting outside investor money into one. If I own property that I'm looking to develop, and I've got capital gains that I can put into a QOF, I can also raise capital from investors and invest into a larger development of that property or business. And that is why the QOF is the front door because it takes a collective group of investors, puts it into basically a bridge, for lack of better words, because it is all they are. It comes in. The QOF then has a timeline. It has to get out the door out of the QOF bank account and into QOZP.

Part B: Rules or restrictions around what assets the funds are allowed to invest in to qualify for all the tax benefits

First and foremost, you have the 90% QOZP requirement, a 90/10 rule, a high-level ruling which

says generally 90% of what comes in must go back out into QOZP. 10% can go toward anything. QOZP includes three types of assets:

Remember, there are three ways for the QOF to acquire QOZP:

(1) qualified opportunity zone stock,
(2) qualified opportunity zone partnership interest, or
(3) QOZBP.

The term “qualified opportunity zone stock” or “qualified opportunity zone partnership interest”, means either stock or partnership interests in a domestic (U.S.) corporation or partnership if-

- (I) acquired by the QOF after December 31, 2017, at its original issue (directly or through an underwriter) from the domestic corporation or partnership solely in exchange for cash,
- (II) as of the time such stock or partnership interest was issued, such corporation or partnership was a “qualified opportunity zone business” (a “QOZB”) (or, in the case of a new business, such business was being organized for purposes of being a QOZB), and
- (III) during substantially all (90%) of the QOF’s holding period for such stock or partnership interest, such corporation or partnership qualified as a QOZB. Stay tuned for a lengthy QOZB discussion shortly.

The term "qualified opportunity zone business property" (“QOZBP”) means tangible property used in a trade or business of the QOF if-

- (I) such property was acquired by the QOF by purchase from an unrelated party after December 31, 2017,
- (II) the original use of such property in a qualified opportunity zone (a “QOZ”) commences with the QOF, or the QOF substantially improves the property, and
- (III) during substantially all (90%) of the QOF’s holding period for such property, substantially all (70%) of the use of such property was in an opportunity zone. Stay tuned for a lengthy QOZB discussion shortly.

Basically, what all this means is that for a QOF to comply with the 90% investment standard, the QOF must hold at least 90% of its assets in QOZB stock or QOZB partnership interests, or QOZBP. It is designed to either go into investments being made into zone stock, where one QOF is purchasing stock from, let us say, XYZ widget business in an opportunity zone.

Or a QOF is taking a partnership position as an investor into typically a real estate development because most of the real estate deals are typically partnership-based structures. So, it is taking some sort of partnership position in that.

Or it is going to directly purchase and own [and operate] the QOZBP itself [as the principal]. And then that is where you then become subject to the "substantial improvement" versus "original use" rules. But most of these investments are not directly owning the property themselves. What they are doing is they are making an investment into a partnership, like a development, coming in as a limited partner, or they are taking a stock position in a company.

Part C: Understanding who in the community is already organizing funds and projects

Many investors and developers are actually interested in the community impact in addition to the financial rewards of opportunity zone projects. This means that if your organization has insight to provide and ways to measure impact, you could make a difference by contacting fund managers or project developers and explaining how you could work with them.

For example, a lot of brokers and developers are great at measuring financial outcomes and returns on investment (ROI), but they are not as familiar with how to evaluate effectiveness from a community-wide standpoint.

Chapter 4: Opportunity Zones & Real Estate

(Qualified Opportunity Zone Business Property)

Part A: Qualified Opportunity Zone Business Property

Qualified Opportunity Zone Business Property (**QOZBP**) is one of the most important concepts in Opportunity Zone investment compliance. Remember, a QOF is required to hold 90% of its assets in Qualified Opportunity Zone Property (**QOZP**). QOZP includes only three types of assets:

- (i) qualified opportunity zone stock;
- (ii) qualified opportunity zone partnership interest; and
- (iii) QOZBP.

A QOF can always meet compliance with the 90% QOZP requirement simply by acquiring QOZBP directly. Should the QOF instead acquire qualified opportunity zone stock (stock in a QOZB) or qualified opportunity zone partnership interest (partnership interests in a QOZB), the

QOZB will be required to hold at least 70% of assets in QOZBP in order to meet one of its own five tests. Thus, QOZBP will always be an integral part of an Opportunity Zone investment and understanding the rules of QOZBP is absolutely necessary.

What is QOZBP?

According to IRC §1400Z-2(d)(2)(D), the term QOZBP means **tangible property** used in a trade or business of the QOF or QOZB that meets the following three requirements:

> (1) the property must be acquired by the QOF or QOZB by purchase from an unrelated party after December 31, 2017,
>
> (2) the original use of such property in the qualified opportunity zone commences (**QOZ**) with the QOF or QOZB; **or** the QOF or QOZB substantially improves the property, and
>
> (3) during substantially all of the QOF's or QOZB's holding period for such property, substantially all of the use of such property must be in a QOZ.

1) **QOZBP must be acquired by purchase from an unrelated party**

With regards to the first QOZBP requirement, it must be tangible property that is acquired by purchase from an unrelated party after December 31, 2017. Determining compliance is relatively straightforward. First, the property must be tangible property that was acquired by the QOF or QOZB after December 31, 2017. Tangible property purchased before December 31, 2017, will never be considered QOZBP.

Second, the tangible property must be acquired from an unrelated party. Relatedness will be determined by applying the rules of IRC § 179(d)(2), which incorporates the related party relationships identified in IRC § 267 and IRC § 707(b).

However, IRC § 1400Z-2(e)(2) contains one critical distinction for Opportunity Zone investments that reduces the relatedness test for entities down from 50% to 20% when applying IRC § 267 and IRC § 707(b).

a. **§267(b) Related Parties**

IRC §267(b) contains a long list of related party relationships that present traps for the unwary. Notable related party transactions include transactions between: (Numbered as appearing in IRC §267(b))

- (1) Members of a family,
- (2) An individual and a corporation more than 50% (20% for Opportunity Zones) in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
- (3) Two corporations which are members of the same controlled group…
- (10) A corporation and a partnership if the same persons own—
    1. more than 50% (20% for Opportunity Zones) in value of the outstanding stock of the corporation, and
    2. more than 50% (20% for Opportunity Zones) of the capital interest, or the profits interest, in the partnership.

Recommended - You should review IRC §267(b), as the code section contains more obscure related party relationships that are beyond the scope of our discussion, but may be applicable. When reviewing IRC §267(b), always remember the relatedness test for entities is reduced from 50% to 20% for Opportunity Zones.

b. §707(b) Related Parties

IRC §707(b) contains a shorter list of related party relationships. The related party relationships covered by IRC §707(b) include transactions between

- (1) a partnership and a person owning, directly or indirectly, more than 50% (20% for Opportunity Zones) of the capital interest, or the profits interest, in such partnership; or
- (2) two partnerships in which the same persons own, directly or indirectly, more than 50% (20% for Opportunity Zones) of the capital interests or profits interests.

2) QOZBP must be original use or substantially improved

With regards to the second QOZBP requirement, compliance can be achieved through two different avenues. First the property can be of original use. Otherwise, the property can be substantially improved. Thus, tangible property must be original use or substantially improved in order to meet the second QOZBP requirement.

a. Original Use

To meet the original use requirement, Reg §1.1400Z2(d)-2(b)(3) provides that tangible property is original use if the QOF or QOZB is the first to place the property in service in the QOZ for purposes of depreciation or amortization, or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner. This rule commonly applies to new tangible property such as equipment or machinery, and also to new structures

or buildings built on vacant land. It also includes used tangible property (such as equipment or machinery) if the QOF or QOZB is the first to place in the QOZ for purposes of depreciation or amortization.

Let's say for example my QOZB buys a brand new equipment for usage in my business located in a QOZ. The equipment I purchased will meet the original use requirement because my QOZB will be the first one to place the property in the QOZ for purposes of depreciation or amortization.

Similarly, let's say I buy a tract of vacant land in a QOZ and construct a new building that I intend to use as an apartment complex. Again, the building the QOZB constructed will meet the original use requirement because this is the first one to place the building in the QOZ for purposes of depreciation or amortization.

However, let's say a QOZB buys a piece of land in a QOZ with an existing building. Unfortunately, someone will have already placed the property in service in the QOZ for purposes of depreciation or amortization and the QOZB will be required to substantially improve the property since it will not be considered original use.

b. Substantial Improvement

If tangible property is not going to be considered original use, then the QOF or QOZB must substantially improve the property. To meet the substantial improvement requirement, Reg §1400Z–2(d)(2)(D)(ii) provides that property has been substantially improved when the additions to basis of the property in the hands of the QOF or QOZB exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period. What the heck does that mean?

The substantial improvement test is relatively straightforward.

Say for example a QOF purchases property in a QOZ for $1,000,000. Well in order to substantially improve the property the QOF must make additions to basis of the property in an amount that exceeds the adjusted basis of such property at the beginning of such 30-month period, or $1,000,000. Thus, the QOF will need to make $1,000,000 worth of additions to basis of the property, and do so in a 30-month period, in order to meet the substantial improvement requirement.

A QOF can subtract out the land value from real estate property when the adjusted basis at the beginning of the 30-month period. Going back to the previous example, let's say QOF purchases real estate in a QOZ for $1,000,000 and allocates $400,000 of the value to the land and $600,000 of the value to the building. The QOF can exclude the $400,000 of the value to the land when determining the adjusted basis at the beginning of the 30-month period. Thus, the

QOF will meet the substantial improvement requirement if it makes $600,000 worth of additions to basis of the property in a 30-month period.

A QOF's or QOZB's additions to basis will be determined under §1012. For purposes of determining what types of activities and expenses count toward the substantial improvement requirements, the Final Regulations provides that ''betterment'' expenses under Reg. § 1.263(a)-3(j)(1)(i)) are included for purposes of the substantial improvement requirement, even if those expenses are properly chargeable under code to the basis of land on which the property is located (which does not need to be doubled).

The final regulations for Opportunity Zones permit all capitalized costs to be counted as additions to basis, which includes (i) equipment installed in a building and used in a trade or business, (ii) demolition costs, (iii) reasonable capitalized fees for development, (iv) required permits, (v) necessary infrastructure, (vi) brownfield site assessment and remediation, (vii) professional fees, and (viii) necessary site preparation costs (including remediation and utility upgrades).

The substantial improvement requirement also has some unique twists to the rule. A QOF or QOZB can start it's 30-month substantial improvement period whenever it wants. However, the QOF and QOZB have their compliance rules that always accelerate the 30-month substantial period.

This is because Reg. § 1.1400Z2(d)-2(b)(4)(ii) provides that property that a QOF or QOZB is substantially improving but has not yet placed in service or used in a trade or business is treated as meeting all of the QOZBP requirements over the property's 30-month substantial improvement period if it is reasonably expect that the property will be substantially improved and used in the trade or business in a QOZ by the end of that 30-month period. **However, no such rule applies to property being constructed as original use.**

3) QOZBP must meet the 90% Holding Period and 70% Use Test

With regards to the third QOZBP requirement, during ''substantially all'' of the QOF's (or QOZB's) holding period for such property, ''substantially all'' of the use of such property was in a qualified opportunity zone (QOZ). There are two distinct parts of this third QOZBP requirement:

- (i) a "substantially all" relevant to holding period; and
- (ii) a "substantially all" relevant to use.

The word "substantially all'' means at least **90% when applied to holding period**. The word "substantially all'' means at least at least **70% when applied to use**. These two requirements

are more commonly known as the “90% Holding Period Test'' and “70% Use” Test. Thus, to meet the third QOZBP requirement, for at least 90% of the time a QOF or QOZB holding holds the property, the property must be used in a QOZ at least 70% of the time.

a. 70% Use Test

Tangible property used in a trade or business of a QOF or QOZB satisfies the 70% Use Test if, and only if, the tangible property is considered “qualified tangible property”. “Qualified tangible property” is property that meets one of the following three requirements:

General 70% Use Test: Property can meet the 70% Use Test if the property is tangible property held by a trade or business and, based on the number of days between two consecutive semi annual testing dates, not less than 70% of the total utilization of the tangible property by the trade or business occurs at a location within the geographic borders of a QOZ.

i. Safe Harbor for Property Used in Rendering Services Inside and Outside of a QOZ: Property can meet the 70% Use Test if the property is tangible property used by a trade or business in rendering services inside and outside of QOZs and all of the following requirements are met:

(i) The tangible property directly generates gross income for the trade or business both inside and outside of the geographic borders of a QOZ;

(ii) The trade or business has an office or other facility located within the geographic borders of a QOZ (referred to as the ‘‘QOZ office’’);

(iii) The tangible property is operated by employees who (a) regularly use a QOZ office of a trade or business in the course of carrying out their duties; and (b) are managed directly, actively, and substantially on a day-to-day basis by one or more employees of the trade or business who carry out their duties at a QOZ office; and

(iv) The tangible property is not operated exclusively outside of the geographic borders of a QOZ for a period longer than 14 consecutive days for the generation of gross income for the trade or business.

Note, however, that for purposes of a QOZB’s 70% tangible property test (which is the asset test applicable at the QOZB level), this safe harbor cannot be used to treat more than 20% of the tangible property of the trade or business as qualified tangible property. *See* Reg. § 1.1400Z2(d)-2(d)(4)(iv).

ii. Safe Harbor for Tangible Property Owned by Short Term Leasing Businesses: Property can meet the 70% Use Test if the property is tangible property used in a trade or business and all of the following requirements are met:

(i) The employees of the trade or business use a QOZ office of the trade or business to regularly lease the tangible property to customers of the trade or business;

(ii) Consistent with the normal, usual, or customary conduct of the trade or business, when not subject to a lease to a customer of the trade or business, the tangible property is parked or otherwise stored at a QOZ office; and

(iii) No lease under which a customer of the trade or business acquires possession of the tangible property is for a duration (including extensions) longer than 30 consecutive days.

b. 90% Holding Period

As previously discussed, in order to be considered QOZBP, both purchased and leased property must meet both the 90% Holding Period Test and the 70% Use Test. In order to meet the 90% Holding Period Test, during 90% of the QOF or QOZB holding period for such property, 70% of the use of such property has to have been in a QOZ.

The holding period requirement is applied on a semiannual basis, based on the entire amount of time the QOF or QOZB has owned or leased such property. On each semiannual testing date of an entity, tangible property satisfies 90% holding period test if, during at least 90% of the period during which entity has owned or leased the property, the property has satisfied 70% use test.

Here is a good way to remember the 90% Holding Period Test and a 70% Use Test in order to meet the third QOZBP requirement.

- Step 1 (70% Use Test): Have I used the property in a QOZ at least 70% of the time to apply the General 70% Use Test or one of the two safe harbors?

- Step 2 (90% Holding Period Test): Has property met the 70% Test for at least 90% of the time that I've owned the property?

Conclusion

The general rule for property to be considered QOZBP is found under IRC § 1400Z– 2(d)(2)(D)(i), which provides that QOZBP means tangible property used in a trade or business of a QOF or QOZB if-

- (I) such property was acquired by the QOF or QOZB by purchase from an unrelated party after December 31, 2017,
- (II) the original use of such property in the opportunity zone commences with the QOF or QOZB, or the QOF or QOZB substantially improves the property, and
- (III) during substantially all (meaning 90%) of the QOF or QOZB's holding period for such property, substantially all use (meaning 70%) of such property was in an opportunity zone.

As you have seen, there is more to the QOZBP requirement to consider than buying property in a QOZ.

Part B: Special Rules for QOZBP

A. Land and Opportunity Zones

Raw or unimproved land located in a QOZ is eligible to be treated as QOZBP. Interestingly, the final regulations provide that raw or unimproved land located within an opportunity zone is not subject to either the original use or the substantial improvement requirement when determining compliance with the QOZBP rules. Instead, the final regulations apply a special rule for land that allows land to be considered QOZBP if the land is located in a QOZ and improved by "more than an insubstantial amount" within 30 months after the date of purchase.

The final regulations state that if the land is unimproved or minimally improved and the QOF or QOZB purchased the land with an expectation or an intention to not improve the land by more than an insubstantial amount within 30 months after the date of purchase, such land will not be considered QOZBP.

For purposes of determining whether improvements to land are considered "more than an insubstantial amount", unfortunately the final regulations do not provide any guidance on the dollar amount of improvements that must be made to land in order for improvements to be considered "more than an insubstantial amount". Instead, the final regulations provide two examples intended to provide guidance on this issue.

In the first example, improvements to land were not considered "more than an insubstantial amount" when there was a plan to pave the land for use as a parking lot, including installing a gate to the parking area, constructing a small structure that would serve as an office for a parking attendant, and installing two self-pay stations for use by customers.

In the second example, improvements to land were considered “more than an insubstantial amount” when the land was previously used for hog and pig farming, and there was a plan to conduct sheep and goat farming activities on the land that required significant capital improvements to the land, including improvements to existing farm structures, constructing new farm structures, and installing a new irrigation system.

The key distinction between these two examples appears to be improvements made to land that substantially increase the economic productivity of the land and the business activities that occur on the land. Thus, improvements to land should be considered “more than an insubstantial amount” if they are made with the intent to increase the economic productivity of the land for usage in a trade or business. This corresponds with the final regulations prohibition against “land banking” where land is purchased in a QOZ as a speculative investment that qualifies for tax-free growth.

Raw or unimproved land is frequently purchased for the purpose of constructing new buildings on the land. While land is not subject to either the original use requirement or the substantial improvement requirement, the new buildings or structures built upon the land will meet the original use requirement upon completion of construction because the QOF or QOZB will be the first to place the property in service in an opportunity zone for purposes of depreciation or amortization. Additionally, the land itself will be considered QOZBP because the buildings or structures built on the land will increase the economic productivity of the land for usage in a trade or business, and therefore improve the land by “more than an insubstantial amount”.

However, opportunity zone investors looking to construct new buildings on raw or unimproved land must be keenly aware that neither the money set aside for construction, nor the building undergoing construction, will be considered QOZBP until construction is completed and the building is placed in service.

While the final regulations allow buildings undergoing construction during the 30-month substantial improvement period to be considered QOZBP during the construction period, no such rule exists for property that is being constructed for the purpose of being original use property after construction is completed. Thus, opportunity zone investors looking to construct original use property upon raw or unimproved land must be sure to do so through a QOZB and not through the QOF.

This is because the QOZB can utilize a working capital safe harbor to suspend compliance with its 70% QOZBP requirement during the working capital safe harbor period. The working capital safe harbor will provide the QOZB the time it needs to complete construction on the building and place the building in service as original use QOZBP by the end of the working capital safe harbor period.

B. Qualifying Previously Acquired Assets as QOZBP

Real estate located in a QOZ that an investor already owns will generally never meet the QOZBP requirements because QOZBP requires property "acquired by purchase from an unrelated party". Should the investor contribute the real estate to a QOF or QOZB, it would not be considered "acquired by purchase" because the real estate was contributed to the QOF or QOZB by the investor. Should the QOF or QOZB instead attempt to purchase the real estate from the investor, it will be subject to the strict related party rules contained in IRC § 267 and IRC § 707(b).

However, there is one notable potential workaround for previously acquired land that is vacant. That will never allow the land to be considered QOZBP but will allow the structures built upon the land to be considered QOZBP.

To utilize this workaround, the land must be truly vacant and not have an existing building. The final regulations allow vertical improvements made upon vacant land to meet the QOZBP requirements so long as:

- (i) it is intended to be used in a trade or business in an opportunity zone;
- (ii) the materials used to construct new buildings were QOZBP; and
- (iii) it is treated as acquired after 2017.

However, the final regulations do not apply this special exception for previously acquired land with a building that would otherwise be a substantial improvement. Additionally, even if the vertical improvements are made upon vacant land to meet the QOZBP requirements, the land itself however will not be considered QOZBP for any reason.

Ultimately, structuring any Opportunity Zone investment around previously acquired land is extremely dangerous from a compliance perspective and should only be attempted by experienced legal and tax professionals that have a profound and complete understanding of the Opportunity Zone rules. If you have questions on how to structure or attempt to structure an Opportunity Zone investment around previously acquired land in light of the applicable QOF or QOZB requirements, you should never attempt to do so alone.

C. Real Estate Outside Opportunity Zones

While the general rule is that real estate located outside of a QOZ is not considered QOZBP (because it will fail the 70% Use Test) real estate located across the street from a QOZ may potentially be considered QOZBP when additional requirements are met. Specifically, Reg. §1.1400Z2(d)–2(d)(4)(vii) creates this possibility by explicitly stating that the rules of Reg. §

1.1400Z2(d)–1(d)(3)(ix) apply for determining whether real estate is situated in a QOZ for purposes of meeting the 70% Use Test of QOZBP.

To comply with the rules of § 1.1400Z2(d)–1(d)(3)(ix), four requirements must be met:

- (i) The trade or business uses the portion of the real estate located in a QOZ in carrying out its business activities;

- (ii) The trade or business uses the real estate located outside a QOZ in carrying out its business activities;

- (iii) The amount of real estate located within a QOZ is substantial as compared to the amount of real estate located outside a QOZ; and

- (iv) The real estate located in the QOZ is contiguous to part, or all, of the real estate located outside the QOZ.

For purposes of complying with the first and second requirement of § 1.1400Z2(d)–1(d)(3)(ix), the rules are relatively straightforward. Basically, the QOF or QOZB must use both the real estate located in a QOZ and the real estate located outside of the QOZ as part of its business activities.

For purposes of complying with the third requirement of § 1.1400Z2(d)–1(d)(3)(ix), the amount of real estate located within a QOZ must be substantial compared to the amount of real estate located outside a QOZ. A QOF or QOZB can choose between two methods when determining whether the amount of real estate located within a qualified opportunity zone is “substantial”.

The first method is based upon square footage, and the square footage requirement is met if at the time the real estate is acquired, the square footage of real estate located in a QOZ is greater than the square footage of contiguous real estate located outside the QOZ.

The second method is based upon the unadjusted cost of the real estate, and the test is met if at the time the relevant real estate is acquired, the unadjusted cost of the real estate located inside a QOZ is greater than the unadjusted cost of the contiguous real estate outside the QOZ.

These two methods look at the cost or size of the real estate located inside the QOZ compared to the cost or size of the real estate located outside of a QOZ. If the real estate located outside of an QOZ is smaller or purchased for less than the real estate located inside the QOZ, then the real estate located within the QOZ will be “substantial” and the third requirement of § 1.1400Z2(d)–1(d)(3)(ix) will be met.

For purposes of complying with the fourth § 1.1400Z2(d)–1(d)(3)(ix) requirement, the real estate located in the QOZ must be contiguous to part, or all, of the real estate located outside

the QOZ. Two or more tracts are considered ‘‘contiguous’’ if they share common boundaries or would share common boundaries but for the interposition of a road, street, railroad, stream or similar property. This requirement limits the scope for real estate located outside of a QOZ to only those real estate tracks that are literally across the street or “stream” from the property located inside the QOZ. The status of real estate located across a river remains unknown at this time.

The significance of § 1.1400Z2(d)–1(d)(3)(ix) cannot be understated. If a QOF or QOZB meets the four requirements of § 1.1400Z2(d)–1(d)(3)(ix), then real estate located outside of a QOZ will be considered “used” in a QOZ for purposes of meeting the 70% Use Test. Thus, even real estate located outside of a QOZ can potentially qualify as QOZBP, but always remember that the real estate will still need to meet all other QOZBP requirements.

C. Leased QOZBP

Leased tangible property will be QOZBP (at either the QOF or QOZB level) if: (1) the lease is entered into after December 31, 2017, (2) the terms of the lease are market-rate (as determined under § 482) at the time it is entered into (although there are certain exceptions to this requirement) and (3) during substantially all of the QOF’s (or QOZB’s) holding period for the property, substantially all of the use of the property was in a QOZ. For leased property, there is a general anti-abuse rule applicable to all leases of real property and additional requirements applicable to related-party leases, which are generally allowed. Leased property also does not have an original use or substantial improvement requirement like purchased QOZBP.

With regards to the first lease requirement for QOZBP, the property must have been acquired under a lease entered into after December 31, 2017. This is the most straightforward OZ rule that exists.

With regards to the second lease requirement for QOZBP, the terms of the lease must generally be market-rate (as determined under § 482) at time the lease is entered into. There is a rebuttable presumption that the terms of a lease are market rate if the lease is between unrelated persons (determined under § 1400Z-2(e)(2)) and thus, no § 482 analysis is necessary. For purposes of the market-rate requirement, tangible property acquired by lease from a state or local government, or an Indian tribal government, is not considered a related party lease.

For related party leases, the regulations apply two additional requirements that must be met in order for the lease to be considered “market-rate”. First, the lessee cannot, at any time, make a prepayment of rent relating to a period of use that exceeds 12 months.

Second, if the original use of **leased tangible personal** property does not commence with the lessee, the lessee must become the owner of an equal amount (in value, as determined under the valuation method chosen by the QOF or QOZB) of tangible property that is QOZBP within

the relevant testing period and there must be substantial overlap in the QOZs in which the lessee uses the leased tangible personal property and the acquired tangible property.

The 'relevant testing period'' begins on date a lessee receives possession of the leased tangible personal property and ends on a date that is the earlier of: (1) the date 30 months after the date a lessee received possession of leased tangible personal property or (2) the last day of the term of the lease (which will include periods during which the lessee may extend the lease at a predefined rent).

There is also a general anti-abuse provision applicable to all leases of real property, including both related party leases and non-related party leases. That rule provides that if there is a lease of real property and, at the time the lease is entered into, there is a plan, intent or expectation that the QOF or QOZB will purchase the real property for an amount other than the fair market value of the property as determined at the time of purchase without regard to prior lease payments, the leased real property is not QOZBP at any time.

With regards to the third lease requirement for QOZBP, during substantially all (meaning 90%) of the QOF's holding period for the property, substantially all (meaning 70%) of the use of the property was in a QOZ. This third requirement for leased QOZBP is the same rule as the 90% Holding Period Test and 70% Use Test that we've previously discussed above for purchased QOZBP.

D. Inventory

Inventory also has special rules that need to be considered in any QOZBP analysis. Just like any other asset, inventory will be subject to the QOZBP requirements in order to be considered QOZBP, with two important exceptions. First, inventory produced by a QOF or QOZB after December 31, 2017, will be considered to meet the original use or substantial improvement requirement.

Second, inventory or raw materials that are in transit either (1) from a vendor to a facility of a trade or business that is in a QOZ or (2) from a facility of the trade or business that is in a QOZ to customers of the trade or business that are located outside a QOZ will not fail to be treated as used in a QOZ solely because they are in transit for purposes of the 70% Use Test.

Additionally, a QOF may choose to exclude all inventory (including raw materials) of the trade or business from both the numerator and denominator when applying the 90% investment standard. Similarly, a QOZB may choose to exclude all inventory (including raw materials) of the trade or business from both the numerator and denominator when applying its 70% QOZBP requirement. Note that if a QOF or QOZB chooses to make this election, it must apply the election consistently within a taxable year but may change the election year to year.

Part C: Opportunity Zone Investments Compared to Other Real Estate Investments.

A. Opportunity Funds vs. 1031 Exchanges

IRC § 1031 - "Exchange of real property held for productive use or investment," aka the "1031 Exchange," aka the "like-kind exchange" has been around for close to a century. Originally initiated as a tool to help farmers better establish land borders, the code allows investors to defer real estate capital gains taxes, by allowing them to "exchange" property into other like-kind investments.

Meanwhile, Opportunity Zones were passed as part of the Tax Cuts and Jobs Act of 2017. The program's purpose is to encourage investment of capital gains from the sale of assets into federally designated lower-income communities.

Both initiatives have one thing in common, which is tax deferral on the sale of assets. But that's about it.

Because these programs have different purposes and requirements, the answer to the question, "can I 1031 into an Opportunity Zone?" or rather, "can an investor use the 1031 Section to exchange into a QOZ?" is a resounding NO. The main reason is because the like-kind exchange has a like-kind requirement. Exchanging from a real estate property (a real asset) into a Qualified Opportunity Fund (a fund) does not fit the "like-kind" definition. In addition, the vast differences between the two programs make a direct exchange from one to the other very difficult. One thing is not like the other. Upon closer examination, other major differences make it impossible to exchange from a real property into a QOF.

1. **What's The Difference Between Investing in An Opportunity Zone (Or Fund) And A Section 1031 Exchange?**

When you invest in an opportunity zone or fund, you can tap into tax-deferral options. Additionally, you can enjoy tax-free growth in perpetuity if you reach the 10-year milestones in your investment.

Unlike an opportunity zone or opportunity fund investment, Section 1031 exchanges only defer taxes so the investment can continue to grow, but outside of an opportunity zone, capital gains taxes will come due whenever the property is sold.

For example, let's say you invest $100,000 in an opportunity fund. You enjoy the tax deferral options and a full step up at exit. But you choose to hold onto the investment for 10 years. At that point, you can sell the investment and pay zero taxes on capital gains created by your initial investment.

On the other side, if you pursue a Section 1031 exchange, you'll have to pay capital gains taxes when you eventually sell your property.

Gains versus forward roll. QOF investors put their gains into a fund, whereas with a 1031 exchange, investors are required to leave in their original principal, their gains, and even roll forward their debt. With a QOZ investment, investors can keep their original basis to do with as they want.

2. **QIs versus QOFs**

One major requirement of the 1031 Exchange is that investors are not allowed to handle the sale of the original property, and the purchase/exchange into the replacement property. Rather, the investor is required to go through a Qualified Intermediary -- QI -- for that purpose. The QI is responsible for a lot of activities, ranging from holding the exchange proceeds, to preparing relevant exchange documents, to advising the investor on specific exchange requirements. Per the IRS, there is no 1031 Exchange without a great deal of input from the QI.

Investment in a QOZ requires another intermediary, this one being the Qualified Opportunity Fund (QOF) and its manager/s. The QOF also must follow several rules set up by the IRS, but the purpose is very different from the QI. The fund is an active investment vehicle, while the QI is an advisor that is in place to facilitate a like-kind exchange.

3. **Timelines and Deadlines.**

Both programs have deadlines, but both deadlines are very different. Specifically, an investor working within the 1031 program has 45 days to identify a replacement property and has 180 days to complete the like-kind exchange. Meanwhile, the QOZ investor has 180 days to invest their gains into a QOF. Furthermore, if an investor's 45-day deadline has come and gone without finding an appropriate like-kind property, the investor can invest the capital gains from the asset sale into a QOZ, as long as the investment is within that 180-day timeline from realizing the gains.

4. **Step-Ups and Holding Periods**

Qualified Opportunity Zone investments tend to come with a specific timeline, as it pertains to taxes. Specifically, if the investment is held for at least 10 years, the investor won't have to pay taxes on the portion of the property gain generated by the fund. This is because the investor receives a step-up on the basis of the property, increasing it to the fair-market value.

5. **Avoid confusion, know your investment target**

While the 1031 Exchange and QOZ programs both provide tax-deferral benefits to investors, their purposes and requirements are vastly different. As such, it would be close to impossible to "exchange" from a real estate original property into a Qualified Opportunity Fund. This literally would be an apples-to-oranges comparison.

Having said all of this, neither of these programs or processes are "better" than the other. The decision as to which one might be more beneficial rests on portfolio structures, timing, and, as always, investment goals.

QOZB Use of Debt & Incentives

Like traditional real estate investment vehicles, Qualified Opportunity Zone Business (QOZB) may strategically use financing to help maximize returns. Using debt or leverage has its pros and cons; it has the first priority of payment, it magnifies returns in both directions, and it also provides income tax shelter. All else equal, more debt offers a higher risk/return ratio for investors.

QOZBs will be financed similarly to traditional development or redevelopment projects. Any previous experience that you may have with commercial real estate financing will be applicable here. Most QOZBs focusing on ground-up development projects and plan to use debt are expected to obtain short-term financing for the construction period and refinance into longer-term debt once the property is stabilized.

While many local communities provide incentives to attract investments into their QOZBs, lenders do not. Lenders still must evaluate the risks of the investment. Lenders will evaluate the QOZBs investment strategy and business plan as they would any investment opportunity; the QOZB designation is not expected to impact the financing terms.

Debt Financed Distributions

The Regulations allow for debt-financed distributions from refinancing or recapitalization events. To avoid recognizing taxable income, any fund that is taxable as a partnership can distribute loan proceeds to investors but cannot exceed the investor's partnership interest cost basis.

Two conditions can trigger recognition of deferred gains:

- Debt-financed distributions occurring in the first two years after an investment in the Fund.
- Any debt-financed distributions considered as a disguised sale as defined under Internal Revenue Code Section 707.

In other words, once the QOZF Sponsor refinances the initial short-term debt on the property, they can distribute the proceeds to investors, up to a certain threshold. Investors could potentially receive a sizable portion of their initial investment in the first couple of years of the investment. Those funds may come in handy to investors when the capital gains tax deferral ends in December 2026, and investors need to pay the tax bill while maintaining their investment in the QOZF.

REITS and Opportunity Zones

Real Estate Investment Trusts (REITs) can be combined with opportunity zone tax incentives to create unrivaled tax savings for investors who invest eligible gains into a REIT Qualified Opportunity Fund (QOF). REIT QOFs provide the ability to pair typical REIT tax incentives, such as tax-free returns of capital and the 199A deduction for ordinary REIT dividends, with the ability to defer paying capital gains tax on amounts invested until December 31, 2026, and sell opportunity zone investments tax free after 10 years.

REITs are a unique investment vehicle considering they must be formed as a corporation, but they are not actually subject to the corporate income tax, and dividends are generally taxed as ordinary income to investors.

Additionally, there are special rules to qualify as a REIT, including that they must be owned by more than 100 investors, must have at least 75% of gross income derived from rents from real property or sales of real estate, and must have at least 95% of gross income derived from sources such as rents from real property, sales of real estate, or dividends. REITs must also dividend at least 90% of its gross income each year to investors.

To combine REITs with the opportunity zone tax incentives, the REIT will also have to follow all Opportunity Zone code provisions, which will require REITs to be considered a Qualified Opportunity Fund (QOF).

In order for a REIT to qualify a QOF, the REIT will have to hold at least 90% of its assets in Qualified Opportunity Zone Property (QOZP) on the applicable semi-annual testing dates, generally each June 30 and December 31. QOZP includes Qualified Opportunity Zone Business

Property (QOZBP) and stock or partnership interests in a Qualified Opportunity Zone Business (QOZB). QOZBP is tangible property used in a trade or business that satisfies the following three tests:

- (1) acquired by purchase from an unrelated party after December 31, 2017;
- (2) the original use of such property in a Qualified Opportunity Zone (QOZ) commences at purchase, or such property is substantially improved by making additions to basis by an amount equal to at least the portion of the purchase price allocated to existing buildings during a 30-month period; and
- (3) during substantially all (meaning 90%) of the holding period for such property, substantially all use (meaning 70%) of such property was in a QOZ.

QOZBs are legal entities taxable as a corporation or a partnership that are engaged in the active conduct of a trade or business, that satisfy the following five tests at the end of each taxable year:

- (1) Substantially all (at least 70%) of tangible property owned or leased must be QOZBP;
- (2) At least 50% of total gross income must be derived from the active conduct of a business in a QOZ;
- (3) At least 40% of intangible property must be used in the active conduct of a business in a QOZ;
- (4) No more than 5% of the average of the aggregate unadjusted basis of property may be attributable to nonqualified financial property, which includes cash; and
- (5) No more than 5% of gross income can come from operating a prohibited sin business. Start-up QOZBs can utilize a working capital safe harbor to automatically qualify with the first four QOZB requirements for a period of up to 31 months with a single working capital safe harbor, and up to 62 months with overlapping working capital safe harbors.

To operate a REIT as a QOF, there are several opportunity zone pitfalls that await the unwary. The most obvious issue is the interplay between the REIT requirement that it must distribute 90% of its income each year to investors in cash, and the opportunity zone limitations on holding cash.

Specifically, the QOF must hold at least 90% of its assets in QOZP on the applicable testing dates, and cash will not be considered QOZP, and QOZBs are limited to holding no more than 5% of its average of the aggregate unadjusted basis of property in cash upon the expiration of the working capital safe harbor period.

Thus, it will be critical to ensure the timing of cash distributions made to REIT investors comply with the opportunity zone testing dates. Additionally, the opportunity zone rules make it difficult for REITs to purchase and redevelop real estate after the expiration of a working capital safe harbor period, as QOZBs are limited to a maximum 62-month period before they must begin testing compliance with each QOZB requirement, which limits the potential for future developments in a single QOZB.

Furthermore, opportunity zone investors looking to qualify for complete tax free growth on their investment will be unable to receive return of capital dividends from the REIT QOF until they recognize their gain on December 31, 2026, because investors will hold a $0 basis in their REIT equity, and any return of capital in excess of basis converts part of their investment into a non-qualifying investment ineligible for the opportunity zone tax incentives.

The optimal way to structure a REIT QOF that maximizes tax incentives for investors, and complies with all REIT and opportunity zone requirements.

- First, you will need to create a REIT as a corporation. Doing so will allow the REIT to qualify with both the REIT and QOF entity requirements.
- Second, the REIT will elect a certification month and start its time clock for the testing compliance with the QOF requirement that it hold at least 90% of its assets in QOZP on the applicable semi-annual testing dates.
- Third, the REIT QOF will begin receiving cash from investors with eligible gains.
- Fourth, before the first 90% QOZP testing date, the REIT QOF will create separate QOZBs for each real estate asset it seeks to acquire and purchase 100% of the QOZB stock solely in exchange for cash. Cash invested into each QOZB should be sufficient to acquire the real estate and make substantial improvements when necessary.
- Fifth, upon receiving the cash, each QOZB will utilize a working capital safe harbor to purchase real estate located in opportunity zones and begin making substantial improvements to ensure the real estate meets the QOZBP requirements.
- Sixth, assuming all cash received by the REIT QOF has been invested into QOZBs, the REIT QOF will test compliance with the 90% QOZP requirement on the applicable testing dates and hold 100% of its assets in QOZP, its QOZB stock.
- Seventh, upon the expiration of the working capital safe harbor period, QOZBs will begin business operations and generate income by renting out their real estate assets.
- Eighth, each year on June 29 and December 30, QOZBs will distribute cash equaling gross income during the period to the REIT QOF, and the REIT QOF will dividend 90% of cash received from the QOZBs to investors.
- Ninth, each year on June 30 and December 31, QOZBs will test the amount of nonqualified financial property they hold, and the REIT QOF will test compliance with the 90% QOZP requirement. Both tests should easily be satisfied.
- Tenth, when the cash held by the REIT QOF begins to comprise 10% of its assets, it will use the cash to create additional QOZBs that will acquire other types of real estate properties and repeat the process. Additionally, on December 31, 2026, investors will step up their basis in their REIT QOF equity to the amount of gain recognized and the REIT QOF can also begin making return of capital dividends.

Chapter 5: Qualified Opportunity Zone Business Requirements

As we've previously discussed, a Qualified Opportunity Fund (**QOF**) is required to hold at least 90% of its assets in qualified opportunity zone property (**QOZP**) on its applicable semi-annual testing dates. QOZP includes three types of assets: (i) qualified opportunity zone stock; (ii) qualified opportunity zone partnership interest; and (iii) qualified opportunity zone business property (**QOZBP**). Last chapter we talked about QOZBP and how tangible property can qualify. Now we will focus our attention on qualified opportunity zone stock and qualified opportunity zone partnership interest, the other two types of QOZP.

Part A: Qualified Opportunity Zone Stock & Qualified Opportunity Zone Partnership Interests

1) Qualified Opportunity Zone Stock

According to IRC § 1400Z-2(d)(2)(B)(i), the term "qualified opportunity zone stock" means any stock in a domestic corporation if:

(I) Such stock is acquired by the QOF after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash;

(II) As of the time such stock was issued, such corporation was a qualified opportunity zone business (**QOZB**) (or, in the case of a new corporation, such corporation was being organized for purposes of being a QOZB); and

(III) During substantially all of the QOF's holding period for such stock, such a corporation qualified as a QOZB.

With regards to the first requirement for qualified opportunity zone stock, the stock must be acquired by the QOF after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash. This first requirement for qualified opportunity zone stock has two critical requirements for acquiring the stock that often go overlooked.

First, a QOF must acquire the stock directly from the QOZB corporation (or through an underwriter). This means that a QOF cannot acquire the stock in a QOZB from a third party, it must be acquired directly from the corporation (or through an underwriter).

Second, the QOF must acquire the stock from the QOZB solely in exchange for cash. This means that the QOF cannot contribute property, other than cash, to a QOZB corporation in exchange for stock.

With regards to the second requirement for qualified opportunity zone stock, the QOF must acquire stock in a business that was either a QOZB at the time such stock was issued, or in the case of a new corporation, such corporation was being organized for purposes of being a QOZB.

The second requirement for qualified opportunity zone stock effectively requires the business issuing the stock to be a QOZB, or a brand new entity being created for the purpose of becoming a QOZB. Part B of this Chapter 5 will cover what you need to know about QOZBs.

With regards to the second requirement for qualified opportunity zone stock, during substantially all of the QOF's holding period for such stock, such corporation qualified as a QOZB. The final regulations provide that ''substantially all'' means at least 90% when applied to holding periods. Thus, for 90% of the time the QOF owned the stock, the corporation must qualify as a QOZB.

2) Qualified Opportunity Zone Partnership Interests

According to IRC § 1400Z-2(d)(2)(C), The term "qualified opportunity zone partnership interest" means any capital or profits interest in a domestic partnership if-

(I) Such interest is acquired by the QOF after December 31, 2017, from the partnership solely in exchange for cash;

(II) As of the time such interest was acquired, such partnership was a QOZB (or, in the case of a new partnership, such partnership was being organized for purposes of being a QOZB); and

(III) During substantially all of the QOF's holding period for such interest, such partnership qualified as a QOZB.

With regards to the first requirement for qualified opportunity zone partnership interests, the partnership interests must be acquired by the QOF after December 31, 2017, at its original issue (directly or through an underwriter) from the partnership solely in exchange for cash. This first requirement for qualified opportunity zone partnership interests has two critical requirements for acquiring the partnership interests that often go overlooked.

First, a QOF must acquire the partnership interests directly from the QOZB partnership (or through an underwriter). This means that a QOF cannot acquire the partnership interests in a QOZB from a third party, it must be acquired directly from the partnership (or through an underwriter).

Second, the QOF must acquire the partnership interests from the QOZB solely in exchange for cash. This means that the QOF cannot contribute property, other than cash, to a QOZB partnership in exchange for partnership interests.

With regards to the second requirement for qualified opportunity zone partnership interests, the QOF must acquire partnership interests in a business that was either a QOZB at the time such partnership interests were issued, or in the case of a new partnership, such partnership was being organized for purposes of being a QOZB. The second requirement for qualified opportunity zone partnership interests effectively requires the business issuing the partnership interests to be a QOZB, or a brand new entity being created for the purpose of becoming a QOZB. Part B of this Chapter 5 will cover what you need to know about QOZBs.

With regards to the third requirement for qualified opportunity zone partnership interests, during substantially all of the QOF's holding period for such partnership interests, such partnership qualified as a QOZB. The final regulations provide that ''substantially all'' means at least 90% when applied to holding periods. Thus, for 90% of the time the QOF owned the partnership interests, the partnership must qualify as a QOZB.

Do these requirements seem familiar? The rules for qualified opportunity zone partnership interest are identical to the rules for qualified opportunity zone stock, except you replace the word stock with partnership interests and corporation with partnership.

There are also special rules related to mergers, redemptions and reissuances of qualified opportunity zone stock and qualified opportunity zone partnership interest that may apply to your circumstances but are beyond the scope of this discussion.

Part B: Qualified Opportunity Zone Businesses (QOZBs)

As you have seen, qualified opportunity zone stock and qualified opportunity zone partnership interest require the business issuing the stock or partnership interests to be a QOZB, or be a new entity organized for the purpose of becoming a QOZB.

QOZB Definition

According to IRC § 1400Z-2(d)(3)(A), the term "qualified opportunity zone business" (**QOZB**) means a trade or business-

(I) In which substantially all of the tangible property owned or leased by the taxpayer is QOZBP (determined by substituting "qualified opportunity zone business" for "qualified opportunity fund" each place it appears in paragraph 1400Z-2(d)(2)(D));

(II) Which satisfies the requirements of paragraphs (2), (4), and (8) of section 1397C(b); and

(III) Which is not described in section 144(c)(6)(B).

Reg §1.1400Z2(d)-1(d)(1) further defines the IRC §1400Z-2(d)(3)(A) definition for QOZBs, and requires that the QOZB also be an eligible entity, taxable as a corporation or partnership, and engaged in a trade or business within the meaning of section 162. Thus, to be considered a QOZB, there are three core requirements:

- (i) The QOZB must be an eligible entity taxable as a partnership or corporation;
- (ii) The QOZB must be engaged in the active conduct of a trade or business within the meaning of §162; and
- (iii) The QOZB must satisfy all Reg §1400Z2(d)-1(d) requirements at the end of its taxable year. If a QOZB meets these requirements at the end of its taxable year, its status as a QOZB applies for the entire taxable year.

With regards to the first QOZB core requirement, to be considered an "eligible entity" there are two things the QOZB must do.

First, the QOZB must be an entity organized under the laws of the United States, the laws of one of the 50 states, a government of a federally recognized tribe, the District of Columbia or a U.S. territory. This eligible entity requirement for the QOZB is identical to the rule for the QOF. Similarly, if a QOZB entity is organized in a U.S. territory and not in one of the 50 states, the QOZB may only conduct a trade or business in U.S. territory in which it is organized.

Second, the QOZB must be classified as a partnership or corporation for federal income tax purposes. Note that a QOZB cannot be a single member LLC (because it would be a disregarded entity), or an S corporation because of the applicable S corporation shareholder rules.

With regards to the second QOZB core requirement, to be "engaged in the active conduct of a trade or business" the QOZB must actively conduct a trade or business. Because neither the Code nor the regulations define the meaning of a ''trade or business'' under §162, courts have established requirements to determine the existence of a trade or business. The Supreme Court has set forth a two-pronged test, providing that, ''to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit.'' Commissioner v. Groetzinger, 480 U.S. 23, 25 (1987). Note that triple-net leasing is not "engaged in the active conduct of a trade or business" for purposes of §162.

With regards to the third QOZB core requirement, there are five separate tests that the QOZB must meet at the end of each taxable year into to comply with Reg §1.1400Z2(d)-1(d)(1), and be considered a QOZB:

1. Substantially all (at least 70%) of the tangible property owned or leased by the QOZB must be QOZBP;

2. Pursuant to IRC § 1397C(b)(2), at least 50% of total QOZB gross income must be derived from the active conduct of a business in a Qualified Opportunity Zone (QOZ);

3. Pursuant to IRC § 1397C(b)(4), at least 40% of QOZB intangible property must be used in the active conduct of a business in a QOZ;

4. Pursuant to IRC § 1397C(b)(8), no more than 5% of the average of the aggregate unadjusted basis of property held by the QOZB may be attributable to nonqualified financial property (NQFP); and

5. Pursuant to IRC § 1400Z– 2(d)(3)(A)(iii), the QOZB must be engaged in a trade or business that is not described in IRC § 144(c)(6)(B).

QOZB Definition

According to IRC § 1400Z-2(d)(3)(A), the term "qualified opportunity zone business" (**QOZB**) means a trade or business-

(IV) In which substantially all of the tangible property owned or leased by the taxpayer is QOZBP (determined by substituting "qualified opportunity zone business" for "qualified opportunity fund" each place it appears in paragraph 1400Z-2(d)(2)(D));

(V) Which satisfies the requirements of paragraphs (2), (4), and (8) of section 1397C(b); and

(VI) Which is not described in section 144(c)(6)(B).

The Five Tests the QOZB must meet each year

a. 1st QOZB Test

To meet the first QOZB test, Reg §1.1400Z2(d)-1(d)(2)(i) provides at the end of each taxable year at least 70% of the tangible property owned or leased by the QOZB must be QOZBP. Reg §1.1400Z2(d)-1(d)(2)(ii) further provides determining whether a QOZB meets the 70% tangible property requirement is determined by using a fraction, the numerator of which is the total value of all QOZBP owned or leased by the QOZB and the denominator of which is the total value of all tangible property owned or leased by the QOZB.

Under the regulations, for each tax year, a QOZB can value its assets using the Applicable Financial Statement Valuation Method (if it has an applicable financial statement within meaning of Reg. § 1.475(a)-4(h)) or the Alternative Valuation Method. A QOZB can change methods year to year but must apply a single method consistently during each taxable year to all of its assets.

b. 2nd QOZB Test

To meet the second QOZB test, Reg §1.1400Z2(d)-1(d)(3)(i) provides at the end of each taxable year at least 50% of the QOZB's gross income must be derived from the active conduct of a business in a QOZ. There are four separate safe harbors for a QOZB to meet this 50% gross income test, and any way works.

The first safe harbor looks at the number of hours of services performed by employees, partners that provide services to a partnership, independent contractors, and employees of

independent contractors, and the test is met if at least 50% of all of those services performed for a QOZB are performed in a QOZ.

The second safe harbor looks to the total amount paid by the entity for services performed by employees, partners that provide services to a partnership, independent contractors, and employees of independent contractors, and the test is met if at least 50% of all services performed for a QOZB are performed in a QOZ.

The third safe harbor looks to the location of business management, and the test is met if tangible property located in a QOZ, and management or operational functions performed in a QOZ are each necessary for the generation of at least 50% of the gross income.

The fourth safe harbor looks at, if based on all the facts and circumstances, at least 50% of the gross income of a QOZB is derived from the active conduct of a trade or business in a QOZ. Never rely on this 4th safeharbor!!!

c. 3rd QOZB Test

To meet the third QOZB test, Reg §1.1400Z2(d)-1(d)(3)(ii)(A) provides at the end of each taxable year a substantial portion of the intangible property of a QOZB must be used in the active conduct of a trade or business in a QOZ. For purposes of the preceding sentence, the term substantial portion means at least 40%. Reg §1.1400Z2(d)-1(d)(3)(ii)(B) further provides intangible property of a QOZB is used in the active conduct of a trade or business in a QOZ if—(1) The use of the intangible property is normal, usual, or customary in the conduct of the trade or business; and (2) The intangible property is used in the QOZ in the performance of an activity of the trade or business that contributes to the generation of gross income for the trade or business.

d. Reg Test 4

To meet the fourth QOZB test, Reg §1.1400Z2(d)-1(d)(3)(iv) provides at the end of each taxable year less than 5% of the average of the aggregate unadjusted bases of the property of a QOZB is attributable to nonqualified financial property (**NQFP**). IRC 1397C(e)(1) otherwise defines NQFP as ***debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, accounts receivable, and other similar property.***

IRC 1397C(e)(1) which defines the term NQFP for purposes of IRC § 1397C(b)(8), notably excludes from that term reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less (working capital assets). This NQFP exception creates the ability for a QOZB to utilize a working capital safe harbor, which will be discussed shortly. However, cash, debt instruments with a term of 18 months or less, and cash

equivalents will always be considered NQFP if such amounts are not protected by a working capital safe harbor.

The 5% NQFP limitation can pose substantial challenges for businesses that are required to maintain cash reserves (e.g., banks, insurance companies). Similar concerns exist for cryptocurrency activities at the QOZB level because of its potential status as NQFP. Thus, reserves of cash and other types of NQFP will always be subject to the less than 5% NQFP limitation unless they are protected by a working capital safe harbor.

e. 5th QOZB Test

To meet the fifth QOZB test, Reg §1.1400Z2(d)-1(d)(4)(i) provides at the end of each taxable year the following IRC 144(c)(6)(B) trades or businesses, and businesses leasing to the following trades or businesses, cannot qualify as a QOZB:

- (A) a private or commercial golf course;
- (B) a country club;
- (C) a massage parlor;
- (D) a hot tub facility;
- (E) a suntan facility;
- (F) a racetrack or other facility used for gambling; or
- (G) any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

These types of businesses are more commonly known as “sin businesses''.

It is worth noting there is a narrow exception that allows a QOZB to derive a de minimis amount of gross income from prohibited sin businesses. The term de minimis amount of gross income, means less than 5% of the gross income of the QOZB may be attributable to operation of a sin business.

Additionally, a QOZB is allowed to lease a “de minimis amount of property” to sin businesses, with the term “de minimis amount of property” meaning less than 5% of the net rentable square feet for real property and less than 5% of the value for all other tangible property.

Part C: Working Capital Safeharbor.

How could a new start up business that receives a $50,000,000 investment from a QOF possibly be expected to qualify as a QOZB if it is required to hold less than 5% of its assets in NQFP at

the end of its year? Does the QOZB need to spend all the cash that it receives from the QOF immediately and operate a compliant QOZB by the end of its taxable year?

Fortunately, Reg §1.1400Z2(d)-1(d)(3)(v) addresses this issue and provides a tremendous benefit to start up QOZBs by allowing them to utilize through a working capital safe harbor (**WCSH**). By having a WCSH in place, a brand new start up QOZB is allowed to do four things.

First, a valid WCSH prevents a QOZB from failing its 70% QOZBP requirement.

Second, any gross income derived from working capital assets that are subject to a WCSH counts toward satisfying the 50% of gross income requirement.

Third, intangible property purchased or licensed by the QOZB pursuant to a valid WCSH satisfies the use in a QOZ requirement.

Fourth, a valid WCSH treats property that would otherwise be NQFP as being a reasonable amount of working capital for purposes of the 5% NQFP limitation, and allows the QOZB to exclude cash, cash, cash equivalents, or debt instruments with a term of 18 months or less from its NQFP calculation.

To qualify for a WCSH, any amounts received by a QOZB must meet the following requirements:

(A) These amounts are designated in writing for development of a trade or business in a qualified opportunity zone, including when appropriate the acquisition, construction, and/or substantial improvement of tangible property in such a zone.

(B) There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets;

(C) The working capital assets are actually used in a manner substantially consistent with the writing and written schedule described in (A) and (B).

Effectively, a WCSH is a written business plan that demonstrates how a QOZB will spend the cash it receives from a QOF to develop a business in an opportunity. In order for a WCSH to apply, a QOZB must use working capital assets in a manner that is ‘‘substantially consistent’’ with the written plan and schedule.

What happens if a QOZB spends some of the working capital in a manner that is different from what is outlined on the plan or needs to change its plan? The IRS has yet to finalize their stance on this issue, but does allow deviations or modifications from a WCSH plan in limited instances (i.e federally declared disasters).

The four benefits provided to a QOZB with a WCSH apply only during its WCSH period. A single WCSH period can cover up to 31-months from the date a QOZB receives, or expects to receive, a cash infusion from the QOF or elsewhere.

For "start-up" QOZBs, the final regulations allow the QOZB to utilize an additional 31-month WCSH at the end of the initial 31-month WCSH, or to utilize multiple overlapping or sequential applications of WCSHs to cover a total WCSH period that does not extend beyond 62 months from the date of the first capital infusion.

To qualify for multiple WCSHs three requirements must be met:
(1) The subsequent cash infusion must be independently covered by an additional working capital safe harbor that meets all the requirements necessary to create a WCSH (see above);

(2) The working capital safe harbor plan for the subsequent cash infusion must form an integral part of the working capital safe harbor plan that covered the initial cash infusion; and

(3) The 62- month working capital safe harbor cannot extend past the 62 month-period beginning on the date of the first cash infusion covered by a WCSH.

Part D: QOF ownership of the QOZB.

A QOF is required to hold at least 90% of its assets in QOZP on its applicable semi-annual testing dates. QOZP includes three types of assets: (i) qualified opportunity zone stock; (ii) qualified opportunity zone partnership interest; and (iii) QOZBP. One of the requirements for qualified opportunity zone stock and qualified opportunity zone partnership interests is that for "substantially all" of a QOF's holding period for interests in a QOZB partnership or corporation, the QOZB must satisfy all of the requirements to be a QOZB. For this purpose, "substantially all" means 90% of the QOF's holding period, but it still effectively requires a business to be considered a QOZB each year in order to meet the requirement.

There is an disconnect between the opportunity zone testing requirements for the QOF and QOZB because a QOF is required to test compliance with its 90% QOZP semiannually and a QOZP tests its compliance with the 5 QOZBs annually (on December 31). Tax professionals believe that if a business qualifies as a QOZB at the end of its taxable year, the QOF should treat the business as a QOZB both on QOF's December 31 testing date and on the following June 30 testing date. However, more guidance on this issue is needed from the IRS or treasury.

Additionally, the Final Regulations afford an entity a six-month period to cure a defect that prevents its qualification as a QOZB for purposes of the 90% holding period requirement, without penalty to the investing QOF. The six-month period corresponds to testing periods for both the QOZB and the QOF. At the end of the six-month period, if the entity fails to qualify as a QOZB, the QOF must determine if it satisfies the 90% test, taking into account its ownership in the non-qualifying entity, and if it does not, penalties apply to all months in which the QOF failed the 90% test (even months during and prior to the six-month cure period). The six-month cure period may only be applied once to a QOZB.

Sin Businesses

The statute prohibits a QOZB, but not a QOF, from operating a 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. These businesses are commonly referred to as "sin businesses''. According to the Preamble, commentators expressed concern that taxpayers could circumvent Congress' clear intent to prohibit QOZBs from operating sin businesses by having a QOZB lease property to a sin business. These commentators recommended that QOZBs be prohibited from leasing property to sin businesses. Treasury and the IRS agreed and the Final Regulations prohibit a QOZB from leasing more than a de minimis amount of its property to a sin business. However, the Final Regulations also provide that de minimis amounts of gross income (*i.e.*, less than 5% of gross income) attributable to a sin business will not cause the business to fail to be a QOZB (*e.g.*, a hotel with a spa that offers massage services).

Tangible property that ceases to be zone business property.

The statute provides a special rule that permits a QOZB to treat tangible property that ceases to be zone business property as zone business property for the lesser of five years after (i) the date on which such tangible property ceases to be so qualified, or (ii) the date on which such tangible property is no longer held by QOZB. The Final Regulations prohibit a QOZB from relying on this rule unless the zone business property was used by a QOZB in a QOZ for at least two years, not taking into account the period during which the property was covered by the 31-month working capital safe harbor or the 30-month substantial improvement period.

Six-month cure period for failure to qualify as a QOZB.

For “substantially all” of a QOF’s holding period for interests in a QOZB partnership or corporation, the QOZB must satisfy all of the requirements to be a QOZB. For this purpose, “substantially all” means 90% of the QOF’s holding period. The Final Regulations afford an entity a six-month period to cure a defect that prevents its qualification as a QOZB for purposes of the 90% holding period requirement, without penalty to the investing QOF. The six-month period corresponds to testing periods for both the QOZB and the QOF. At the end of the six-month period, if the entity fails to qualify as a QOZB, the QOF must determine if it satisfies the 90% test, taking into account its ownership in the non-qualifying entity, and if it does not, penalties apply to all months in which the QOF failed the 90% test (even months during and prior to the six-month cure period). The six-month cure period may only be applied once to a QOZB.

Lesson 6: Qualified Opportunity Zone Investors & Inclusion Events

In addition to the Opportunity Zone structural requirements, there are rules for opportunity zone investors to follow in order to qualify for the tax incentives. Although anyone can invest into an Opportunity Zone, only investors that meet certain requirements from the outset will be able qualify for the Opportunity Zone tax incentives. Additionally, even an investment that originally qualifies for the Opportunity Zone tax incentives can lose its eligibility should any inclusion events occur with respect to the investment. Learning the nuances associated with owning an Opportunity Zone will ensure that investors qualify their investments for tax free growth.

Part A: Opportunity Zone Investor Requirements.

Opportunity Zone investors must meet four requirements to qualify for the Opportunity Zone tax incentives. First, they need to be an eligible taxpayer. Second, they need eligible gain. Third, they must invest their eligible gain into a Qualified Opportunity Fund (QOF) within 180 days from the date the eligible gain would be recognized for federal income tax purposes. Fourth, they must make a valid deferral election. Only Opportunity Zone investors who meet these four requirements can qualify for the tax incentives by making their Opportunity Zone investment into a QOF.

1st Opportunity Zone Investor Requirement (Eligible Tax Payer)

The first Opportunity Zone investor requirement is that the investor must be an eligible taxpayer. Reg §1.1400Z2(a)-1(b)(13) defines an eligible taxpayer as a person that is required to report the recognition of gains during the taxable year under Federal income tax accounting principles. Thus, for example, eligible taxpayers include individuals; C corporations, including RICs and REITs; organizations subject to the unrelated business income tax; and partnerships, S corporations, trusts, and decedents' estates.

2nd Opportunity Zone Investor Requirement (Eligible gain)

The second Opportunity Zone investor requirement is that the investor must have eligible gain. IRC §1400Z-2(a)(1) defines eligible gain as gain from the sale of any property to, or exchange

with, an unrelated person. Additionally, three requirements must be met to be considered eligible gain.

- First, the gain must be either a capital gain for federal income tax purposes (including both short term and long term capital gains, collectables gains, and unrecaptured §1250 gain) or a qualified IRC § 1231 gain (gains resulting from the sale of property in a trade or business), not taking into account any losses and taking into account any other code provisions that require the potential capital gain to be treated as ordinary income.

- Second, the gain must be subject to tax that the taxpayer would recognize for federal income tax purposes before January 1, 2027, if there was no deferral election under IRC § 1400Z-2.

- Third, the gain must not have arisen from a sale or exchange with a person related to either (1) the eligible taxpayer that would recognize the gain in the taxable year in which the sale or exchange occurs if there was no deferral election under IRC § 1400Z-2, or (2) any pass-through entity or other person recognizing and allocating the gain to this eligible taxpayer.

For purposes of this related-party rule, once again IRC §267(b) and IRC §707(b) will apply to provide the related party relationships. Additionally, IRC § 1400Z-2(e)(2) will once again modify the IRC §267(b) and IRC §707(b) definitions of related persons and reduce the 50% relatedness test down to 20% with respect to entities.

3rd Opportunity Zone Investor Requirement (180 Day Rule)

The third Opportunity Zone investor requirement is that the investor must invest their eligible gain into a QOF within 180 days from the date the eligible gain would be recognized for federal income tax purposes. Generally, this will be the day an eligible taxpayer sells the property giving rise to their eligible gain. In such instances, the eligible taxpayer will have 180 days from the date of the sale. However, for RICs, REITs, and pass-through entities (such as a partnership, S corporation, or grantor trust), special rules apply for determining when the 180 day period begins.

For RICs and REITs, shareholders with distributed capital gains dividends can choose from two applicable 180 day testing dates:

- (1)a 180 day period for capital gain dividends beginning at the close of the shareholder's taxable year in which the capital gain dividend would otherwise be recognized by the shareholder; or

- (2) the 180 day period beginning on the day each capital gain dividend is paid. The aggregate amount of a shareholder's eligible gain with respect to capital gain dividends received from a RIC or a REIT in a taxable year cannot exceed the aggregate amount of capital gain dividends that the shareholder receives as reported or designated by that RIC or that REIT for the shareholder's taxable year.

For undistributed capital gain dividends, the shareholder can elect to begin the 180 day period on either:

- (1) the last day of the shareholder's taxable year in which the dividend would otherwise be recognized, or

- (2) the last day of the RIC or REIT's taxable year.

For pass-through entities there are three potential 180 day testing dates. If the entity wants to make the opportunity zone investment, the entity will have 180 days from the date the property is sold. If the entity does not want to make the Opportunity Zone investment, the partner, shareholder, or beneficiary can elect either:

- (1) 180 days from the end of the entity's tax year (usually December 31), or
- (2) 180 days from the date the entity's tax return is due (March 15).

4th Opportunity Zone Investor Requirement (Deferral Election)

The fourth Opportunity Zone investor requirement is that the investor must make a valid deferral election with respect to an eligible gain before January 1, 2027. To make a valid deferral election, the eligible taxpayer must make an election by filing a Form 8949 with their timely federal income tax return (with extensions) for the taxable year in which the gain would be included if not deferred under IRC § 1400Z-2.

Additionally, eligible taxpayers will also be required to file a Form 8997 with their timely federal income tax return (with extensions) each year they hold an opportunity zone investment. If a taxpayer fails to report this information, there is a rebuttable presumption that the taxpayer had an inclusion event during that year. Ultimately, both the Form 8949 and Form 8997 must be filed by the investor in order for the investor to make their deferral election.

Part B: Investing into a QOF.

Eligible Interest and Qualifying Investment

Should an investor meet the requirements necessary to qualify for the Opportunity Zone tax incentives, next they will need to make sure they hold a "qualifying investment" in a QOF. The general rule is that a QOF is able to issue "eligible interests".

An ''eligible interest'' is simply an equity interest issued by a QOF, including preferred stock or a partnership with special allocations. Note that an ''eligible interest'' is not the term used to describe an interest to which the Opportunity Zone tax benefits apply (i.e "qualifying investment"), but rather is simply an interest in the QOF that is eligible to be considered a "qualifying investment".

To the extent that the investor meets the applicable Opportunity Zone investor requirements, the ''eligible interest'' in the QOF will be considered a ''qualifying investment''(an investment qualifying for the Opportunity Zone Tax benefits apply).

It is also worth mentioning that an investment in a QOF must be an equity interest in order to be considered an eligible interest. The proposed regulations define an ''eligible interest'' as an equity interest issued by a QOF, which includes preferred stock or a partnership interest with special allocations.

Additionally, an investor may use eligible gain to purchase an eligible interest in a QOF from another person in a secondary transaction and qualify for OZ benefits. This rule applies regardless of whether the seller's interest was a qualifying investment –in other words, it does not matter whether or not the seller was an eligible taxpayer that had originally invested deferred gain subject to a § 1400Z-2(a)(1) election.

There is also nothing in the regulations that precludes a secondary acquisition of a QOF interest from a related person. Thus, it appears that a taxpayer can make a non-qualifying equity investment in a QOF, hold that interest for a period of time and then sell it to a related taxpayer who is investing deferred gain pursuant to § 1400Z-2.

Mixed Funds Investment

As previously discussed, an investor is required to invest eligible gains in order to qualify for the Opportunity Zone tax incentives. Let's say for example an investor has $1,000,000 in eligible gains. What happens if the investor invests only $500,000 into a QOF? What happens if the investor invests $2,000,000 into a QOF?

i. Investing less than the full amount of an eligible gain

Should an investor with eligible gains invest less than the full amount of their eligible gains into a QOF, the tax implications are relatively straightforward. Assuming an investor with $1,000,000 in eligible gains invests only $500,000 of their eligible gains into a QOF, the investor will be able to defer paying capital gains tax on $500,000 of their $1,000,000 capital gains by making the Opportunity Zone investment and the remaining $500,000 will be fully taxable in the year the gain was recognized. Additionally, the investor will hold a $500,000 qualifying investment in the QOF that will qualify for the Opportunity Zone Tax incentives upon exit.

i. Investing more than the full amount of an eligible gain

Should an investor with eligible gains invest more than the full amount of their eligible gains into a QOF, the tax implications are more complicated. Assuming an investor with $1,000,000 in eligible gains invests $2,000,000 into a QOF, the investor will hold a "mixed funds investment". The investor will be able to defer paying capital gains tax on the full $1,000,000 of their $1,000,000 capital gains by making the Opportunity Zone investment.

However, the investor will hold a "mixed funds investment" with a $1,000,000 qualifying investment in the QOF that will qualify for the Opportunity Zone Tax incentives upon exit after 10 years, and a $1,000,000 non-qualifying investment that will not qualify for the Opportunity Zone Tax incentives upon exit after 10 years.

A ''mixed-funds investment' refers to an investment in a QOF a portion of which is a qualifying investment and a portion of which is a non-qualifying investment (an investment that doesn't qualify for the Opportunity Zone Tax benefits). IRC § 1400Z-2(e)(1) provides that if a taxpayer makes investments in a QOF and only a portion of the investment is a qualifying investment, the taxpayer is treated as owning two separate investments in the QOF — a qualifying investment (equal to the deferred gain invested) and a non-qualifying investment.

The regulations provide that if a taxpayer holds a mixed-funds investment in a QOF partnership, the taxpayer is treated as owning two separate interests only for purposes of § 1400Z-2, and not for purposes of the general application of Subchapter K. A mixed-funds investment can result from several different circumstances including a taxpayer contribution to a QOF of an amount of cash in excess of the taxpayer's eligible gain, a taxpayer contribution of appreciated property, or a taxpayer contribution of services.

Investment Basis

A taxpayer's initial basis in a qualifying investment in a QOF is zero. However, to the extent the QOF is taxable as a partnership or S corporation, the taxpayer's basis in a qualifying investment will increase based upon their share of income allocations. Additionally, a taxpayer's basis will increase by any debt allocated to the partner to the extent the QOF is taxable as a partnership.

If a QOF investor has held its QOF qualifying investment for five years prior to December 31, 2026, the investor is entitled to a basis increase in that investment equal to 10% of the amount of gain deferred by reason of a § 1400Z-2(a)(1) election. If a QOF investor has held its QOF qualifying investment for seven years If a QOF investor has held its QOF qualifying investment for five years prior to December 31, 2026, the investor is entitled to an additional basis increase equal to 5% of the amount of gain deferred by reason of a § 1400Z-2(a)(1) election. The increases in basis under § 1400Z-2(b)(2)(B)(iii) (5- year holding period) and § 1400Z-2(b)(2)(B)(iv) (7-year holding period) only apply to that portion of the qualifying investment that has not been subject to previous gain inclusion.

If, and to the extent that, a QOF investor is required to include some or all of the deferred gain (related to a qualifying investment in the QOF) in income, the QOF investor increases its basis in the qualifying investment by the amount of the inclusion. Thus, regardless of whether or not an inclusion event occurs, all taxpayers will recognize any gain that has been deferred through a qualifying investment in a QOF by December 31, 2026 at the latest. A taxpayer may recognize all or a portion of that deferred gain prior to December 31, 2026 if an inclusion event occurs.

There are also special rules for mixed-funds investments. The investor will hold a zero basis in their qualifying investment and a basis in the non-qualifying investment equaling the amount of the non-qualifying investment. The following example will help demonstrate this concept

> Example 1. On August 1, 2019, Taxpayer sold stock for $150 million. Taxpayer's adjusted basis in the stock is $50 million. The amount realized is $150 million; the gain realized is $100 million. The $100 million is eligible for the tax benefits afforded investment in a QOF. If the Taxpayer invests all $150 million into a QOF, only $100 million of it is eligible for the tax benefits. The Taxpayer will be treated as having two separate investments in the QOF — a $100 million investment with a basis of zero (which is eligible for the basis step-ups at 5 and 7 years and the post-acquisition gain exclusion at 10 years) and a $50 million investment with a cost basis of $50 million (which is not eligible for any special tax benefits).

Mixed-funds investments can be quite complicated because the investor is treated as holding two separate interests in the partnership and the basis of each interest is computed separately. For purposes of this rule, in allocating income, gain, loss, or deduction between these separate interests, § 704(c) principles apply to account for any value-basis disparities attributable to the qualifying investment or non-qualifying investment The allocation percentages are determined based on the relative capital contributions attributable to each investment. If either or both of the partner's interests are increased (e.g,, the partner makes an additional contribution to the QOF), the partner's interests are valued immediately prior to the event and the allocation percentages are adjusted accordingly to reflect the relative values of the separate interests and the additional contribution, if any.

Investment Holding Period.

The holding period for a QOF investment is extremely important because the OZ tax benefits are dependent upon an investor holding a qualifying investment for five, seven and 10 years. If a taxpayer receives a qualifying investment in a QOF in exchange for property, the taxpayer's holding period for the qualifying investment is determined without regard to the taxpayer's holding period in the property that was exchanged for the investment. This rule applies regardless of whether the taxpayer's holding period in the property that was exchanged for the investment would be relevant for purposes of determining the length of time the taxpayer held the investment for other federal income tax purposes.

Part C: Inclusion Events.

Opportunity Zone investors holding qualifying investments must be aware of the potential inclusion event traps that could require inclusion of their previously deferred gain and disqualify their investment from the Opportunity Zone tax incentives. One of the major tax incentives offered by the Opportunity Zone legislation is the ability to defer paying capital gains tax until December 31, 2026.

However, IRC § 1400Z-2(b)(1) provides that if eligible gain is properly invested under § 1400Z-2 in a QOF, the tax on that gain is deferred until the taxable year that includes the earlier of: (1) the date of an inclusion event; or (2) December 31, 2026.

Additionally, the final regulations clarify that an eligible interest in a QOF ceases to be a qualifying investment of the owner upon, and to the extent of, the occurrence of an inclusion event with regard to that eligible interest, or portion thereof. Thus, any inclusion event that occurs prior to December 31, 2026 will require the Opportunity Zone investor to recognize their eligible gains on the date the inclusion event occurs and convert any otherwise qualifying investment into a non qualifying investment with respect to the portion of the eligible gains

The concept of ''inclusion'' under IRC § 1400Z-2 refers to a taxpayer's eventual inclusion in gross income of the capital gain that it has previously deferred under IRC § 1400Z-2(a)(1)(A). The regulations state that the guidance in Reg. § 1.1400Z2(b)-1 relevant to inclusion of deferred gain applies to a QOF owner only until all of such owner's gain deferred pursuant to § 1400Z-2(a)(1)(A) has been included in income, subject to the limitations described in Reg. § 1.1400Z2(b)-1(e)(5) (which relates to the decrease in the amount of the qualifying investment for basis adjustments after 5- and 7-year holding periods) and except as otherwise provided in Reg. § 1400Z2(b)-1(c) (guidance on specific types of inclusion events).

Reg. § 1.1400Z2(b)-1(c)(1) provides that, subject to certain exceptions, an event is considered an ''inclusion event'' if and to the extent that:

- (1) The event reduces an eligible taxpayer's direct equity interest for federal income tax purposes in the qualifying investment;

- (2) An eligible taxpayer receives property in the event with respect to its qualifying investment and the event is treated as a distribution for federal income tax purposes, whether or not the receipt reduces the eligible taxpayer's ownership of the QOF;

- (3) An eligible taxpayer claims a loss for worthless stock under § 165(g) or otherwise claims a worthlessness deduction with respect to its qualifying investment;

- (4) A QOF in which an eligible taxpayer holds a qualifying investment loses its status as a QOF.

A. **Inclusion Event #1: The event reduces an eligible taxpayer's direct equity interest for federal income tax purposes in the qualifying investment.**

i. **Transfer of Qualifying Investment (Inclusion)**

Subject to certain exceptions, a taxpayer's transfer of all or a portion of a qualifying investment in a QOF is an inclusion event (i.e., triggers recognition of some or all of the deferred gain) to the extent that there is a reduction in the taxpayer's equity interest. Thus, if a taxpayer sells or exchanges part or all of its qualifying investment in a QOF prior to having recognized all of the deferred gain associated with that investment, the sale or exchange is an inclusion event.

ii. **Contribution to Entity. (Inclusion)**

A taxpayer's contribution of all or a portion of a qualifying investment in a QOF to another entity is an inclusion event regardless of whether the transfer is taxable or tax-free. Thus, for example, a transfer of a QOF interest in a § 351 exchange is an inclusion event. In the Preamble to the final regulations, Treasury and IRS clarify that § 351 transactions are inclusion events regardless of whether the transaction decreases the transferor's QOF interest. However, there are a few exceptions to this general rule, such as a transfer of a qualifying investment to an entity that is disregarded as separate from the taxpayer for federal income tax purposes is not an inclusion event because the transfer is disregarded for federal income tax purposes.

iii. **Transfer of Qualifying Investment by Gift (Inclusion)**

A taxpayer's transfer of a qualifying investment in a QOF by gift is generally an inclusion event. This rule applies regardless of whether the gift is outright or in trust and regardless of whether the transfer is a completed gift for federal gift tax purposes. The rule also applies regardless of the taxable or tax-exempt status of the donee.

iv. **Transfer of Qualifying Investment Between Spouses (Inclusion)**

Transfer of a qualifying investment in a QOF between spouses or incident to divorce as provided in § 1041 is an inclusion event. Section 1041 transactions are non recognition events for federal income tax purposes but the transfer is treated as a disposition of the qualifying investment in the QOF for purposes of § 1400Z-2(a)(1)(B) and § 1400Z-2(b). Thus, upon a § 1041 transfer of a qualifying investment, the transferor's deferred gain is recognized and the transferee's interest in the QOF is not a qualifying investment.

v. **Grantor Trusts — Contributions and Changes in Trust Status (No Inclusion generally):**

If the owner of a qualifying investment contributes it to a trust and, under the grantor trust rules, the contributing owner of the investment is the deemed owner of the trust, the contribution to the grantor trust is not an inclusion event. Similarly, if a grantor trust transfers a qualifying investment to its deemed owner, the transfer is not an inclusion event. For purposes of rule, a contribution includes a gift or any other type of transfer between grantor and the grantor trust that is a nonrecognition event as a result of application of grantor trust rules.
However, a change in the status of a grantor trust, whether it is a termination of grantor trust status or the creation of grantor trust status, is an inclusion event. Termination of grantor trust status due to death of the owner of a qualifying investment is not an inclusion event, but the guidance in Reg. § 1.1400Z2(b)-1(c)(4) (related to transfers by reason of death) apply to any distributions or dispositions by the trust.

vi. **Transfer by reason of death (no inclusion)**

A transfer of a qualifying investment by reason of a taxpayer's death is generally not an inclusion event and is able to transfer by reason of death without triggering inclusion of the deferred gain.

Transfer by reason of a taxpayer's death'' includes the following: (i) A transfer by reason of death to the deceased owner's estate; (ii) A distribution of a qualifying investment by the deceased owner's estate; (iii) A distribution of a qualifying investment by the deceased owner's trust that is made by reason of the deceased owner's death; (iv) The passing of a jointly owned qualifying investment to the surviving co-owner by operation of law; and (v) Any other transfer of a qualifying investment at death by operation of law.

However, "transfer by reason of death" does not include the following transfers: (i) A sale, exchange, or other disposition by the deceased taxpayer's estate or trust, other than a distribution described in Reg. § 1.1400Z2(b)-1(c)(4)(i) (related to transfers by reason of death); (ii) Any disposition by the legatee, heir, or beneficiary who received the qualifying investment by reason of the taxpayer's death; and (iii) Any disposition by the surviving joint owner or other

recipient who received the qualifying investment by operation of law on the taxpayer's death. These transfers are considered inclusion events.

According to §1.1400Z2(b)-1(d)(1)(iii), a grantor trust will tack the holding period of the deemed owner if the grantor trust acquires the qualifying investment from the deemed owner in a transaction that is not an inclusion event, and the taxpayer's holding period for the qualifying investment includes the time that the donor or deceased owner held the interest. In other words, the holding period tacks. Similarly, If a taxpayer receives a qualifying investment in a QOF by reason of the prior owner's death, the investment continues to be a qualifying investment in the recipient taxpayer's hands under Reg. § 1400Z2(a)-1(b)(34) and the taxpayer's holding period for the qualifying investment includes the time that the deceased owner held the interest. In other words, again, the holding period tacks.

According to §1.1400Z2-(b)-1(c)(4), with respect to any gain that the decedent elected to defer under § 1400Z-2 but has not yet recognized, the person described in § 691(a)(1) (i.e., the person in receipt of the qualifying investment from the decedent at the time of an inclusion event) will include that gain in gross income for the taxable year in which an inclusion event occurs. The basis of a qualifying investment in a QOF, transferred by reason of a decedent's death in a transfer that is not an inclusion event, is $0 under § 1400Z-2(b)(2)(B)(i), as adjusted for increases in basis as provided under § 1400Z2(b)(2)(B)(ii) through (iv) (increases for recognized inclusion gain and step-ups after 5- and 7-year holding periods) and § 1400Z-2(c) (step-up after 10-year holding period).

Furthermore, Section 1014 provides the general rule basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent is the fair market value of that property at the date of the decedent's death, as long as the property is not sold, exchanged, or otherwise disposed of before the decedent's death by that person. However, with respect to a qualifying investment in a QOF, this is not the case. The basis of the investment in the hands of a person acquiring the property from a decedent is a carryover basis. This is true even if the transfer by reason of death occurs after December 31, 2026.

The following examples are illustrative of the Opportunity Zone rules related to inheritance.

Example (1): On August 1, 2019, Taxpayer, an individual, contributes $500,000 of eligible gain to a QOF in exchange for a qualifying investment in the QOF and makes a valid deferral election under § 1400Z-2. Taxpayer's initial basis in the qualifying investment is $0. In 2021, Taxpayer dies and Taxpayer's heirs inherit the qualifying investment in the QOF. The transfer by reason of death is not an inclusion event. The heir's basis in the qualifying investment in the QOF is $0.

Example (2): On August 1, 2019, Taxpayer, an individual, contributes $500,000 of eligible gain to a QOF in exchange for a qualifying investment in the QOF and makes a valid deferral election under § 1400Z-2. Taxpayer's initial basis in the qualifying investment is

$0. On August 1. 2024, Taxpayer's basis in the qualifying investment is increased by $50,000 under § 1400Z-2(b)(2)(B)(iii). Thus, as of August 1, 2024, Taxpayer's basis in the qualifying investment is $50,000. Taxpayer dies in 2025 and Taxpayer's heirs inherit the qualifying investment in the QOF. The transfer by reason of death is not an inclusion event. The heir's basis in the qualifying investment in the QOF is $50,000. This is true regardless of the fair market value of the qualifying investment at the time of Taxpayer's death.

Example (3): On August 1, 2019, Taxpayer, an individual, contributes $500,000 of eligible gain to a QOF in exchange for a qualifying investment in the QOF and makes a valid deferral election under § 1400Z-2. Taxpayer's initial basis in the qualifying investment is $0. On August 1, 2024, Taxpayer's basis in the qualifying investment is increased by $50,000 under § 1400Z-2(b)(2)(B)(iii). Thus, as of August 1, 2024, Taxpayer's basis in the qualifying investment is $50,000. Taxpayer dies in 2025 and Taxpayer's heirs inherit the qualifying investment in the QOF. The transfer by reason of death is not an inclusion event. The heir's basis in the qualifying investment in the QOF is $50,000. This is true regardless of the fair market value of the qualifying investment at the time of Taxpayer's death.

Example (4): On August 1, 2019, Taxpayer, an individual, contributes $500,000 of eligible gain to a QOF in exchange for a qualifying investment in the QOF and makes a valid deferral election under § 1400Z-2. Taxpayer's initial basis in the qualifying investment is $0. On August 1, 2024, Taxpayer's basis in the qualifying investment was increased by $50,000 under § 1400Z-2(b)(2)(B)(iii). On August 1, 2026, Taxpayer's basis in the qualifying investment is increased by an additional $25,000 under § 1400Z2(b)(2)(B)(iv). On December 31, 2026, Taxpayer recognizes $425,000 of previously deferred gain ($500,000 minus $75,000 previous basis adjustments). The $425,000 recognition of gain increases Taxpayer's basis under § 1400Z-2(b)(2)(B)(ii). Thus, as of December 31, 2026, Taxpayer's basis in the qualifying investment is $500,000. Taxpayer dies in 2028 and Taxpayer's heirs inherit the qualifying investment in the QOF. The transfer by reason of death is not an inclusion event. The heir's basis in the qualifying investment in the QOF is $500,000. This is true regardless of the fair market value of the qualifying investment at the time of Taxpayer's death.

B. **Inclusion Event #2: An eligible taxpayer receives property in the event with respect to its qualifying investment and the event is treated as a distribution for federal income tax purposes, whether or not the receipt reduces the eligible taxpayer's ownership of the QOF;**

If a taxpayer receives property in a transaction that is treated as a distribution for federal income tax purposes, the distribution is an inclusion event regardless of whether the receipt of the distribution reduces the taxpayer's ownership of the QOF. For QOFs taxable as a partnership or S corporation, distributions from a QOF partnership are generally

excepted from this rule to the extent that they do not exceed the distribute partner's adjusted basis in the qualifying investment (which starts at $0, but can be increased by allocations of income or debt). Note however, that distributions made within two years of a qualifying investment in a QOF may require inclusion of the eligible gain to the extent the transaction is characterized as a "disguised sale". For QOFs taxable as a C corporation, distributions from a QOF C corporation are generally excepted from this rule to the extent that they do not exceed the amount treated as a dividend or return of the shareholder's basis in the stock.

Similarly, a distribution of a qualifying investment in a complete liquidation of a QOF owner is generally an inclusion event, unless the liquidation is tax free under IRC § 332 and IRC § 337 Thus, a liquidation of a QOF owner is an inclusion event to the extent that IRC § 336(a) treats the distribution as if the qualifying investment were sold to the distributee at its fair market value, without regard to IRC § 336(d). However, a distribution of a qualifying investment in a complete liquidation of a QOF owner is not an inclusion event to the extent § 337(a) applies to the distribution (i.e., a distribution to an 80-percent distributee).

C. **Inclusion Event #3: An eligible taxpayer claims a loss for worthless stock under § 165(g) or otherwise claims a worthlessness deduction with respect to its qualifying investment;**

If and to the extent that a taxpayer claims a loss for worthless stock under § 165(g) or otherwise claims a worthlessness deduction with respect to its qualifying investment in a QOF, there is an inclusion event.636 The taxpayer is treated as having disposed of that portion of its qualifying investment on the date it became worthless and neither § 1400Z2(b)(2)(B)(iii) or § 1400Z-2(b)(2)(B)(iv) (the 5- and 7-year basis adjustments) nor § 1400Z-2(c) (the basis step-up on sale or exchange after 10 years) applies to that portion of the taxpayer's qualifying investment after the date it became worthless.

D. **Inclusion Event #4: A QOF in which an eligible taxpayer holds a qualifying investment loses its status as a QOF.**

There are three ways for QOF can lose its status as a QOF. First, the decertification of a QOF, whether it is a self-decertification or an involuntary decertification, is an inclusion event. Second, if a QOF ceases to exist for federal income tax purposes, a taxpayer has an inclusion event with respect to all of its qualifying investment in the QOF. Third, if a QOF Partnership converts to a QOF C corporation, or vice versa, the conversion is an inclusion event for all QOF owners to the extent of their entire QOF qualifying investment. The same would be true if a QOF C corporation or QOF partnership converted to a disregarded entity.

E. **Ability to reinvest gains following an inclusion event**

If eligible gain is recognized because of an inclusion event that occurs prior to December 31, 2026 can be further deferred through investment in a QOF (it is ‘‘eligible gain.’’). Final regulations provide that gain that a QOF investor would otherwise have to include in gross income under Reg. § 1.1400Z2(b)-1(e)(1), whether from disposition of an entire interest in a QOF or a disposition of a partial interest, eligible for deferral under § 1400Z-2(a)(1), provided that all of the requirements to elect to defer an eligible gain are met. Note, for purposes of determining the applicable 180-day period within which to invest inclusion gain, that gain is treated as if it were originally realized upon the occurrence of the inclusion event rather than on the date of the of the sale or exchange that gave rise to the eligible gain to which the inclusion event relates.

F. **Consequences of an Inclusion Event.**

As an overall limitation, the total amount of gain included in gross income on the date of an inclusion event is limited to the remaining amount of deferred gain reduced by any increase in basis made under § 1400Z-2(b)(2)(B)(iii) (the 10% step-up in basis after 5 years) or § 1400Z-2(b)(2)(B)(iv) (the 5% step-up in basis after 7 years).

Additionally, when the deferred gain is eventually included in income (on December 31, 2026, or earlier upon the occurrence of an inclusion event), the gain is treated as having been recognized on the inclusion date for purposes of applying federal income tax provisions and rates. Thus, the gain may be subject to a different capital gains rate once it is included in income if the tax rates have changed. Section 1400Z-2(b)(2)(B)(ii) also provides that a taxpayer is able to increase the basis in a qualifying investment by the amount of gain recognized under § 1400Z-2(a)(1)(B)(which is the amount of gain recognized on an inclusion event, including inclusion of any remaining deferred gain on December 31, 2026).

i. **General Rule Inclusion Event**

For most inclusion events, subject to the overall limitation, the amount of remaining deferred gain included in gross income is determined as follows (unless the special rule applicable to a QOF partnership or S corporation applies *discussed below*):

(1) Multiply the fair market value (on the date of the inclusion event) of the taxpayer’s entire qualifying investment in the QOF by the percentage of the taxpayer’s qualifying investment that was disposed of in the inclusion event = the fair market value of the portion of the qualifying investment that was disposed of in the inclusion event (‘‘x’’);

(2) Determine the ratio of x/y where ‘‘y’’ is the fair market value of the total qualifying investment immediately prior to the inclusion event;

(3) Multiply that ratio (x/y) by the remaining deferred gain, which gives you an amount that bears the same proportion to the remaining deferred gain as the fair market value of the portion of the qualifying investment that was disposed of bears to the fair market value of the total qualifying investment;

(4) Take the lesser of the amount determined under (3) and ''x'' (the fair market value of the portion of the qualifying investment that was disposed of in the inclusion event); and

(5) Determine the excess, if any, of the amount determined under (4) over the taxpayer's basis in the portion of the qualifying investment disposed of in the inclusion event = amount of deferred gain included in gross income.

Example 1: On June 30, 2019, X, a C corporation, sells a capital asset to an unrelated party and realizes $500,000 of capital gain. On December 1, 2019, X transfers $500,000 to a QOF in exchange for a qualifying investment. On December 15, 2021, X transfers 50% of its qualifying investment in the QOF to Z, a newly formed C corporation, in exchange for Z stock in a transfer to which § 351 applies. X's transfer of 50% of its qualifying investment to Y reduced X's direct qualifying investment and is, therefore, an inclusion event to the extent of that reduction. Assume that at the time of the § 351 transaction, the fair market value of X's qualifying investment in the QOF is $750,000.

The amount that X is required to include in gross income is $250,000, determined as follows:

(1) $750,000 (fair market value (on the date of the inclusion event) of the taxpayer's entire qualifying investment in the QOF) × .50 (percentage of the taxpayer's qualifying investment that was disposed of in the inclusion event) = $375,000 (fair market value of the portion of the qualifying investment that was disposed of in the inclusion event);

(2) Ratio = $375,000/$750,000 (ratio of the fair market value of the portion of the qualifying investment that was disposed of in the inclusion event over the fair market value of the total qualifying investment immediately prior to the inclusion event);

(3) $500,000 × ($375,000/$750,000) = $250,000 (amount of remaining deferred gain that bears the same proportion to the remaining deferred gain as the fair market value of the portion of the qualifying investment that was disposed of bears to the fair market value of the total qualifying investment);

(4) $250,000 = lesser of the amount determined in (3) above and the fair market value of the portion of the qualifying investment that was disposed of in the inclusion event ($375,000); and

(5) $250,000 = excess of $250,000 over the taxpayer's basis in the portion of the qualifying investment disposed of in the inclusion event ($0)

There is a special rule applicable to QOF partnerships and S corporations with regards to general inclusion events Reg. § 1.1400Z2(b)-1(e)(4) provides that in the case of an inclusion event involving a qualifying investment in a QOF partnership or S corporation as well as for purposes of computing gain recognized with respect to qualifying investment in a partnership or S corporation on December 31, 2026, the amount includible is equal to the lesser of

- (1) the product of: (a) the percentage of the qualifying investment that gave rise to the inclusion event and
- (b) the remaining deferred gain, less any basis adjustments under § 1400Z-2(b)(2)(B)(iii) (5-year holding period) or § 1400Z-2(b)(2)(B)(iv) (7-year holding period) or (2) the gain that would be recognized on a fully taxable disposition at fair market value of the qualifying investment that gave rise to the inclusion event. Thus, the computation of the amount includible in gross income is determined as follows:

(1) Determine the remaining deferred gain (taking into consideration any basis adjustments that have been made under § 1400Z-2(b)(2)(B)(iii) (5-year step-up) or (iv) (7- year step-up));

(2) Multiple the amount determined in (1) by the percentage of the qualifying investment that gave rise to the inclusion event; and

(3) Compare the amount determined in (2) to the gain that would be recognized on a fully taxable disposition at fair market value of the qualifying investment that gave rise to the inclusion event; the lesser amount is the deferred gain included in gross income.

Example (1): On January 15, 2019, Taxpayer A realizes $500,000 of capital gain that it can defer through investment in a QOF. On June 1, 2019, A invested the $500,000 into a QOF partnership in exchange for a 50% equity interest. On August 1, 2020, the QOF borrowed $200,000 on a nonrecourse basis. A's allocable share of the debt is $100,000. On July 15, 2024, A sells 50% of its qualifying investment in the QOF for $400,000 cash. At the time of the sale, the fair market value of the QOF's property is $1,600,000.

Assume that there are no other inclusion events, distributions, allocations, or changes in the amount or allocation of outstanding debt. At the time of the sale, A has held the qualifying investment for over 5 years and, therefore, there is a 10% increase in the basis of the interest. A's basis in its qualifying investment immediately prior to the sale is, therefore, $150,000 (original zero basis plus $100,000 liability share plus $50,000 5-year step-up in basis).

The sale of 50% of A's interest requires A to recognize $225,000 of previously deferred gain (the lesser of $225,000 (remaining deferred gain ($450,000) × the percentage of the qualifying

investment that A sold (50%)) or $325,000 (the gain A would recognize on a fully taxable disposition of 50% of A's interest ($400,000 – $75,000 basis)). A also recognizes $100,000 of gain with respect to the appreciation in the interest sold.

ii. **Certain Enumerated Inclusion Events**

There are also special inclusion event rules for certain enumerated inclusion events. If one of the enumerated inclusion events occurs the amount of deferred gain included in gross income is equal to the lesser of (1) the remaining deferred gain or (2) the amount that gave rise to the inclusion event.

The enumerated inclusion events include an inclusion event due to any of the following:

(i) a distribution by a QOF partnership in excess of a partner's basis (see Reg. § 1.1400Z2(b)-1(c)(6)(iii));

(ii) application of the remaining deferred gain reduction rule (see Reg. § 1.1400Z2(b)-1(c)(6)(v));

(iii) a distribution by a QOF S corporation (see Reg. § 1.1400Z2(b)-1(c)(7)(ii));

(iv) a distribution of property by a QOF C corporation (see Reg. § 1.1400Z2(b)-1(c)(8)(i));

(v) a dividend-equivalent redemption or redemption of § 306 stock (see Reg. § 1.1400Z2(b)-1(c)(9));

(vi) a § 304(a) transaction (see Reg. § 1.1400Z2(b)- 1(c)(13));

(vii) the receipt of boot in a qualifying § 355 transaction (see Reg. § 1.1400Z2(b)-1(c)(11)(i)(B)(3)); or

(viii) the receipt of boot in a recapitalization or the receipt of property in § 1036 exchange (see Reg. § 1.1400Z2(b)- 1(c)(12)(ii))

G. **Gain Recognition on December 31, 2026.**

Section 1400Z-2(b)(2)(A) provides that the amount included in gross income on December 31, 2026 is equal to the lesser of (a) the gain excluded under § 1400Z-2(a)(1) or (b) the fair market value of the qualifying investment over the taxpayer's basis in the investment. The regulations provide a special rule applicable to a qualifying investment in a partnership or S corporation. The regulations provide a more specific description of this computation by providing that, subject to a special rule applicable to partnerships and S corporations, the amount included is

equal to the excess of (1) the lesser of (a) the remaining deferred gain or (b) the fair market value of qualifying investment on December 31, 2026 over (2) the taxpayer's basis in the qualifying investment as of December 31, 2026, taking into account only § 1400Z-2(b)(2)(B)

Example : On January 15, 2019, Taxpayer A realizes $500,000 of capital gain that it can defer through investment in a QOF. On June 1, 2019, A invested the $500,000 into a QOF partnership in exchange for a 50% equity interest. On August 1, 2020, QOF borrowed $200,000 on a nonrecourse basis. A's allocable share of the debt is $100,000. Assume as of December 31, 2026, there have been no inclusion events, distributions, allocations, or changes in the amount or allocation of outstanding debt. For purposes of determining amount includible by A on December 31, 2026, A's basis in the qualifying investment is increased by 15% ($75,000) because A held its investment for at least 7 years. A recognizes $425,000 of gain on December 31, 2026.

Chapter 7: CDFIs & Opportunity Zones

What is a CDFI? A CDFI is a private-sector organization that attracts capital from private and public sources. Private sector funds come from many sources: corporations, individuals, religious institutions, and private foundations.

Background on CDFI:

Credit unions, especially smaller credit unions, can find substantial benefits from becoming certified as Community Development Financial Institutions, and the application process is becoming easier.

CDFIs are specialized organizations providing financial services and products in low-income communities to people and businesses who lack access to financing. The Community Development Financial Institutions Fund, a division of the U.S. Treasury Department, determines CDFI certification.

The CDFI Fund's mission is to generate economic growth and opportunity by assisting people and businesses in economically distressed communities in accessing financial products and services. The fund offers tailored resources and innovative programs that invest federal dollars alongside private capital.

The CDFI Fund and NCUA signed a Memorandum of Understanding to streamline the CDFI application process. The change will increase the number of CDFI-certified credit unions, primarily from the ranks of existing low-income-designated credit unions.

NCUA's Office of Small Credit Union Initiatives will identify and reach out to eligible credit unions. It’s been estimated that since 1999, the Community Development Financial Institution (CDFI) Fund has provided Opportunity Fund a total of $149.5 million in awards and allocations to support its microlending and community facility investment program through the New Markets Tax Credit (NMTC).

How many CDFIs are there?

There are over 950 CDFIs certified by the CDFI Fund. CDFIs operate in every state and the District of Columbia, serving both rural and urban communities.

Who is eligible for a CDFI?

CDFI Eligibility Requirements

Primarily serve one or more target markets, have a primary mission of promoting community development, provide development services in conjunction with its financing activities.

CDFI Eligibility Requirements

An organization must meet seven criteria to be certified as a CDFI:

- Be a legal entity,
- Be a financing entity,
- Primarily serve one or more target markets,
- Have a primary mission of promoting community development,
- Provide development services in conjunction with its financing activities,
- Maintain accountability to its defined target market, and
- Be a non-governmental entity and not be under the control of any government entity (typically excluding tribal governments).

CDFIs Role To Play In Opportunity Zones

There is indeed a role for CDFIs in the emerging Opportunity Zones space – or, more accurately, several potential roles, both financial and nonfinancial alike.

The Opportunity Zones legislation was designed to mobilize new levels of capital into low- and moderate-income (LMI) communities – areas that have historically been overlooked and underserved by mainstream capital markets. As long standing financial partners to LMI communities, Community Development Financial Institutions (CDFIs), it would seem, are positioned to play a pivotal role in the Opportunity Zones ecosystem.

Yet the legislation presents a challenge on that front. As the law dictates, the mechanism through which Qualified Opportunity Zone Fund investments must be made are equity instruments, while CDFIs tend to operate more on the lending side. For this reason, the CDFI industry has struggled to determine exactly how it can harness the potential power of the Opportunity Zones tax incentive to advance their efforts to support LMI communities.

The Challenge For CDFIs

Opportunity Zones open up community development to the mainstream equity investor, who is, for the most part, new to community development. The majority of the institutional investors who manage his or her money are new as well. For both, the mission, the metrics and operations of CDFI will not only be new, but will run contrary to the way they view the market and how they perform in it. The same holds true for CDFIs. CDFIs are familiar with the credit and investment parameters for banks, insurance companies, impact investors and a range of investors involved in programs like LIHTC, NMTC, and the SBA 7a secondary market. However, that mainstream investor and the institution that manages his or her money is new, and their expectations will present material challenges that CDFIs must address.

The mainstream equity investor is looking for a target yield that consists of either dividends or appreciation, most often a bit of both. Common equity is a financial instrument that does not fit easily into the world that CDFIs serve.

- Your asset is smaller.
- It is located in a community where economic activity, asset values, appreciation in asset values are all comparatively lower.
- You do not have a policy of maximizing value and/or "charging what the market will bear."
- Your cost of funds must be in low single digits to keep things affordable.
- You are in the investment for the long term and our success is measured in achievement of economic and social objectives rather than ROI.

So on the face of it, a difficult match. The following is a road map of those challenges with some recommendations on how CDFIs might address them.

Challenge 1: Debt vs Equity

CDFIs are traditionally lenders rather than equity investors. In the big picture, the most notable difference is that debt carries a fixed rate of return, a fixed maturity and seniority in liquidation, while common equity has no contractual rate of return or maturity and comes at the bottom in liquidation. Equity is a much riskier and expensive form of financing. In order to mitigate this risk, the equity investor seeks greater control of the project or business than does the lender.

There are also material differences between the two funding disciplines in terms of due diligence, underwriting, monitoring, reporting, remedies and pricing. There is a reason that, except in special situations—nobody ever provides both debt and equity to a project: The interests of the two are in opposition, operationally as well as in liquidation.

In order for CDFIs to bridge this gap, the best strategy is to explore the wider range of equity instruments. In addition to common equity there are a number of different kinds of preferred equity instruments. Preferred equity instruments are eligible in Op-Zone investing, and because they can have debt-like attributes, will be more aligned with CDFI experience and mainstream investor risk tolerance.

Challenge 2: The cost of Equity vs Grants

The financing gap that occurs when a community development project cannot get conventional financing derives either from the appraisal or the cash flow or both. In theory, the CDFI fills this financing gap through the use of grants. CDFIs sometimes view the grant as free money. It is not true, of course: in addition to carrying requirements that actually cause the CDFI to spend more, it often costs a lot of money to obtain the grant in the first place.

Nevertheless, when a CDFI sees the ROI target for common equity in a QOF, the CDFI's response is likely to be that it is unaffordable for the QOF and/or the ultimate user of the underlying property or business. Part of the sticker shock derives from the dividends that must be paid, and the other part derives from the expected appreciation of the asset. Those are the two sources of the ROI for the equity investor. For the CDFI, the high dividends represent a cost that adds to the cash flow burden of the project, and appreciation is not always expected or achievable in a low-income community.

On the face of it, the CDFI may be right to back off from obtaining this apparently high cost form of financing. And, indeed, there will be projects and businesses for which it does not make sense. There is a distinction to be made, however: Where the CDFI is trying to fill an appraisal gap rather than a cash flow gap, the transaction may very well be feasible. By this we mean that the need for equity as part of the capitalization is more important than cheap funding. In low income—particularly rural—communities one can find examples where the appraisal or valuation is low even though the ongoing cash flow is adequate. In these situations, the addition of equity, even high cost equity, can be used to recapitalize the property or business with a view to reducing the cost of the debt, and perhaps even increasing the cash flow.

Challenge 3: Exit Strategies

Mainstream investors want to be sure there is an "exit strategy"—a way to get their money out of the investment. They particularly like the option to get their money out at any point. This is in direct conflict with the CDFI approach, which is to stay with the business or the property until it can stand on its own, and to be sure that it continues to fulfill the community development mission thereafter. This conflict in itself could cause some CDFIs to avoid the Opportunity Zone initiative, but that would be a mistake.

One of the breakthrough parts of the Opportunity Zone regulations is the inclusion of Preferred stock or interest as an eligible form of equity. With the proper use of Preferred stock, the CDFI can reduce the operating risk, improve the likelihood of an exit for the investor and retain community ownership and/or adherence to the mission.

Challenge 4: Reporting & Valuations

In analyzing data for the purpose of establishing a risk profile, mainstream investors rely on established regulatory and accounting rules and procedures as well as benchmarks by asset class. The mission of a CDFI predisposes it to try to make its community projects succeed, and to take whatever time is necessary to achieve that result. This predisposition results in a more accommodative approach to accounting and valuation than that which predominates in the conventional sector. A good example of this is how delinquencies in small business loans are handled: it is not uncommon that a CDFI will modify a loan in order to assist a borrower in avoiding delinquency—as part of the mission— Without adjusting the loan or loss reserves.

In the mainstream, a modification would result in an adjustment of the value of the loan and/or the reserves reflecting the pressures that caused the modification. Both approaches are right in the context of their missions, but they are in direct conflict. This kind of conflict is less of an issue in real estate development than in lending, so it may not be as much of an impediment for the Opportunity Zone investment.

However, in order to attract mainstream investors, CDFIs must be prepared to align their asset management, reporting and valuations with conventional protocols.

Meeting The Challenges

Some CDFIs are already bridging the gap. For the most part, they have experience in the kinds of regulations, reporting requirements and investor relations that are required in the equity markets. They also have experience with different kinds of equity instruments. These CDFIs are large and have the resources and staff skill sets to manage an Opportunity Zone proposal and a QOF properly.

Perhaps the most effective way to enable the broader field of CDFIs to participate in Opportunity Zones is for these CDFIs, together with the trade groups, to establish platforms that apprentice CDFIs in the creation and management of the QOFs. Successful apprenticeships could produce QOFs that are part of single asset partnerships with the large CDFIs or institutional investors familiar with the CDFI sector.

Alternatively, perhaps even more impactful, the successful apprenticeships could be assembled in CDFI sector-based Co-Funds.

Opportunity Zone Non-Financial Strategies for CDFIs

Not all CDFIs have the staff, resources or partnerships to participate in the financing of a Qualified Opportunity Fund. But that does not mean that they cannot play a role, one that can generate fee income as well as investment in their communities. The fact that there is a tight time frame on the Opportunity Zone investing means that the value of the information that

CDFIs have, and their relationships in the community are valuable. Likely CDFI non-financial activities that promote Opportunity Zone investment include:

Knowledge of the community

CDFIs hold a really valuable commodity: information. They know their communities, and they know the needs and the investment opportunities in them. They have relationships with the entrepreneurs, the city officials and the community leaders. That knowledge is likely to become a valuable commodity. Providing that kind of community information and providing introductions can save investors and syndicators considerable time. These services could be and should be provided on a fixed fee or retainer basis.

Prospectuses are already being developed by various municipalities to promote investment (Louisville, KY provides a good example). Based on the work that they have already developed in the context of fund-raising, CDFIs may be well equipped to assemble similar prospectuses that can be of assistance in investor presentations. CDFIs may wish to provide these for free as they are of a promotional nature.

Origination of Suitable Transactions

Because they know the communities and market opportunities, CDFIs would be good originators of transactions. They have experience in structuring deals in the communities and they know who is doing what. Again, the quick turnaround time required by the Op-Zone investing schedule for the deferral of the capital gains makes speed a priority, and the development of a pipeline of potentially attractive QOF transactions is a priority for the

investing public. CDFIs will have easy and quick access to the information on the properties and businesses that are eligible. Origination fees could be a fixed percentage of the overall transaction.

Facilitation of Transactions With Community Leaders & Officials

Another role that CDFIs could perform is mediating investor plans with community needs. Large real estate transactions, for example, often encounter local citizen and community objections and associated delays. CDFIs are experienced with convening community leaders and public officials for negotiating solutions with developers and/or project and business owners. This may or may not be a fee-generating activity due to the potential for conflicts of interest, but it does provide the CDFI with the opportunity to play a leadership role.

Due Diligence & Project Monitoring

One of the key characteristics that differentiate CDFIs from conventional lenders and investors is the experience with, and commitment to, due diligence and project monitoring. Both of these are costs which CDFIs are willing to bear, and which many of the typical participants in a private development deal are attempting to minimize or avoid. The fact that the CDFI is already in the target community is a significant cost-saver for both functions. This could be a fee-generating activity.

Opportunity Zone Debt & Tax Credit Strategies for CDFIs

CDFIs can play a critical financial role in the Opportunity Zone QOFs even if they are not involved in raising the equity or managing the QOF. The regulations enable the leveraging of a QOF, which can dramatically improve the ROI for the equity investor. The fact that a CDFIs contribution to the leveraging may involve longer-term lower cost financing means that the CDFIs participation provides an additional incentive to the equity investor. This opens up a wide range of possible debt and equity instruments and incentives in which CDFIs are already engaged.

Below Market Rate Senior Debt

The CDFI can provide senior debt to the transaction. Since banks may also be looking to provide senior debt, the CDFI may be willing to provide the debt at or below prevailing market rates, or have a longer term of more liberal underwriting standards in order to participate in the mission. This is a benefit to all involved.

Subordinated Debt

In order to fill in gaps around bank lending constraints, the CDFI may be willing to provide subordinated debt to the transaction. This does not have to be at a concessionary rate.

"Twinning" of Tax Credit Equity Investments

Investors in tax credit equity programs are natural partners in Opportunity Zone QOFs. They could enhance their return on existing projects if the syndicator establishes a QOF to invest tax credit equity in qualified Opportunity Zone businesses or projects. CDFIs should explore how this layering of incentives could be achieved for each of the following tax credit programs:

- Low Income Housing Tax Credit
- Historic Tax Credit
- New Markets Tax Credit
- Solar Investment Tax Credit
- Historic Preservation Tax Credit

Federal Credit Agency Programs

The residential, community facility, infrastructure and small business programs at HUD, the SBA and the USDA all bring credit enhancement and essential metrics to the transaction, both of which are attractive to investors. To the extent a CDFI is actively engaged in one of these programs, it will be a welcome addition to any QOF financing.

The Blended Cost of Funds

Because the cost of equity is so high—and so different from the grant funding that CDFIs traditionally use to close the capital gaps—CDFIs need a way of determining how to make it affordable.
The following is a chart that shows the amount of a QOF proposal and the amounts and rates of the various tranches of financing.

This is essentially a "scratch sheet" to calculate the cost of the financing. The information is often used as the basis for pricing assets to ensure that a project will pay for itself. But it is also used by Syndicators to determine how much of which kind of financing is best for the success of the enterprise.

In this example, the CDFI is injecting $1,000,000 in "junior" equity. The reason is that the cost of the externally sourced equity (from Opportunity Zone investors) requires such a high ROI—as expressed here in the dividend yield of 13%–that the QOF can't afford to have $3 million of it.

At the same time, in order to keep the senior and subordinate lenders happy, there has to be at least $3,000,000 in equity overall. The CDFI is in a position to step up, and puts its non-dividend earning equity at the bottom where it will do the most good.

The result is an average cost of debt at 4.86%, an average cost of equity at 8.67% with an average cost of funds at 6.0%. The exercise shows how equity with a 13% yield can be raised and still fit within a more or less affordable capital structure. There are, however, quite a few ways to drive those debt and equity costs down.

The Opportunity Zone investment parameters allow investors to buy Preferred stock, which, because of its fixed dividend, fixed maturity, and seniority to common stock, carries a significantly lower dividend. If we let the preferred investor share in the appreciation of the asset at maturity, we can drive the dividend down further.

If we lower the leverage, and hence the overall risk by raising the amount of preferred stock we are issuing and paying down debt, the dividend can go down even further. If, at the same time, we can consolidate and renegotiate our senior debt to reflect the lower leverage and pay off any expensive debt—such as our 7% subordinate debt—then we can produce a truly affordable capital structure.

FINANCING TYPE	AMOUNT	RATE	EXPENSE
TOTAL ASSETS	$10,000,000		
SENIOR DEBT			
Short Term Debt A	$1,000,000	3.50%	$35,000.00
Short Term Debt B	$500,000	4.00%	$20,000.00
Short Term Debt C			$0.00
Short Term Debt D			$0.00
Long Term Debt A	$3,750,000	5.00%	$187,500.00
Long Term Debt B	$500,000	4.00%	$20,000.00
Long Term Debt C			$0.00
SUBORDINATED DEBT			
Long Term Sub Debt A	$1,000,000	7.00%	$70,000.00
Long Term Sub Debt B	$250,000	3.00%	$7,500.00
Long Term Sub Debt C			$0.00
PREFERRED STOCK		8.00%	$0.00
OTHER EQUITY SENIOR		0.00%	$0.00
COMMON EQUITY	$2,000,000	13.00%	$260,000.00
OTHER EQUITY JUNIOR	$1,000,000	0.00%	$0.00
AVERAGE COST OF DEBT	4.86%		$340,000.00
AVERAGE COST OF EQUITY	8.67%		$260,000.00
AVERAGE COST OF FUNDS	6.00%		$600,000.00
TOTAL DEBT	$7,000,000		
TOTAL EQUITY	$3,000,000		
TOTAL ASSETS	$10,000,000		
DEBT TO EQUITY	233.33%		
SENIOR DEBT TO EQUITY+SUB DEBT	135.29%		

In the following example, we show how this set of alterations can lower the cost of debt to 3.71%, the cost of equity to 4.5% and the overall cost of funds to approximately 4.0%.

This ability to put low cost long-term money anywhere into the transaction is one of the reasons that CDFIs are so well positioned to participate financially in Opportunity Zone transactions. This puts them potentially in the driver's seat for syndicating or helping syndicate the transaction. Hence, while they may not be able to directly access the mainstream investor,

they can prove to be a vital—and compensated—part of the syndicating and management team for the QOF.

FINANCING TYPE	AMOUNT	RATE	EXPENSE
TOTAL ASSETS	$10,000,000		
SENIOR DEBT			
Short Term Debt A	$1,500,000	3.00%	$45,000.00
Short Term Debt B	$0	4.00%	$0.00
Short Term Debt C			$0.00
Short Term Debt D			$0.00
Long Term Debt A	$4,250,000	4.00%	$170,000.00
Long Term Debt B	$0	4.00%	$0.00
Long Term Debt C			$0.00
SUBORDINATED DEBT			
Long Term Sub Debt A	$0	7.00%	$0.00
Long Term Sub Debt B	$250,000	3.00%	$7,500.00
Long Term Sub Debt C			$0.00
PREFERRED STOCK	$3,000,000	6.00%	$180,000.00
OTHER EQUITY SENIOR			$0.00
COMMON EQUITY	$0	12.00%	$0.00
OTHER EQUITY JUNIOR	$1,000,000	0.00%	$0.00
AVERAGE COST OF DEBT	3.71%		$222,500.00
AVERAGE COST OF EQUITY	4.50%		$180,000.00
AVERAGE COST OF FUNDS	4.03%		$402,500.00
TOTAL DEBT	$6,000,000		
TOTAL EQUITY	$4,000,000		
TOTAL ASSETS	$10,000,000		
DEBT TO EQUITY	150.00%		
SENIOR DEBT TO EQUITY+SUB DEBT	135.29%		

Innovative Equity Instruments & Strategies

Even with the benefit of the blended cost of funds and the CDFI's own capital injection, the cost of market equity may be viewed as too high for some of the eligible properties and businesses in a CDFI's neighborhood. The Preferred stock instrument, which is an allowed form of equity under the Opportunity Zone investment parameters, is an optimal tool for tailoring the cost of

that equity to the cash flows and asset valuation of the property or business that underlies the QOF.

• Because of the lower risk profile of preferred stock, the dividend payment is materially lower as is the expected ROI.
• This rate can be lowered further by way of a sinking fund.
• There is tremendous flexibility in the way that the dividend rate can be traded off against participation in cash flow and/or asset appreciation to keep the rates low.
• The CDFI can contribute equity that is subordinate to the preferred.
• The investor does not have voting control over the QOF, and may not have an interest in owning the underlying property.
• The structure enables easier transfer of the property at maturity.

In the following scenarios, we will show examples of how the different equity structures can be used to mediate the expectations of the investors with the cash flows from the assets and the mission of the CDFIs. The assets can be properties of any kind or businesses of any kind.

The Key Factors

- **VALUE OF ASSET**
  The value of the asset at the time the investment is made.
- **APPRECIATION OF THE ASSET**
  The average annual appreciation in value of the asset over the expected period of the investment.
- **CASH AVAILABLE FOR DIVIDENDS & OTHER**
  This is the amount of annual cash flow that the asset should be producing minus all of the operating needs, debt service and taxes. It is the amount that is available before dividends or distributions and extraordinary costs.
- **INFLATION OF CASH**
  How much the Cash Available will rise on an annual basis.
- **AMOUNT OF THE INVESTMENT**
  The dollar amount of the investor's investment derived from capital gains.
- **DIVIDENDS ON THE INVESTMENT**
  The dividend yield on the investment. This yield percentage is inverse to the rate of appreciation of the asset: The higher the expected appreciation of the asset, the lower the dividend yield can be in order for the investor to hit his/her expected ROI target.
- **DISCOUNT RATE FOR NPV**
  This calculation (or similar calculations) are used by the investor to determine todays' value of the future dividends (or distributions) plus the appreciated value of the building at the time of its sale or the redemption of the preferred shares at the targeted maturity. The discount rate is selected by the investor based on what he/she thinks about the risk of the financial instrument (bond vs preferred stock vs equity), the term, the likelihood of achieving the cash flows over the term, the property or business value, the likelihood

of appreciation of the property or business value and similar considerations. It is important to note that this discount rate is often the same as the expected ROI but that is entirely up to the investor.

The rate the investor chooses to discount the cash flows back to the present is typically based off of the rates in the marketplace for equivalent investments; bonds, preferred shares, or common equity. The investor will take these rates and raise them up or down based on differences in perceived risks between the Opportunity Zone investment and the alternate investment options in the marketplace.

The biggest distinctions between investment options in the marketplace and the Opportunity Zone investment are:

• The Opportunity Zone investments are illiquid. This is a critical issue which will raise the investor's ROI target.

• The Opportunity Zone investments come with a material benefit in the context of reducing capital gains taxes. Whether the investor will count this benefit in the overall calculation of the discount rate is yet to be determined.

For the purposes of the following examples, we will assume that there is a higher ROI requirement on Op-zone investments due to the illiquidity of the instruments. However, we do NOT assume that the capital gains benefit is being included by the investor in his/her ROI calculation.

For each investment instrument there is a range of yields in the marketplace. These yields change daily and they can change dramatically. Speaking very generally, we see investments in 10 year bonds in the 2-4% range, preferred shares in the 3-5% range and the total return on equities in the 7-8% range. These ranges, however, are for investments in mainstream creditworthy companies, and the instruments are highly liquid and often actively traded.

Investments in predevelopment property and small businesses generally bear higher risk and are illiquid. As a result, the investor will require significantly higher ROIs. Again speaking very generally, and just for the purpose of the following examples, we are assuming the following ranges for the target ROIs by financing type. These rates are for a predevelopment property or significant business expansion where there is a 70/30 debt to equity ratio:

10 year Bonds: 5%
Preferred shares: 8%
Equities: 15%

Note: These are indicators for the purposes of these examples only. These figures should not be used in the forecasting or negotiation of rates on live Opportunity Zone capitalization transactions.

Because of the high cost of the equity instruments, the QOFs in the examples below are not capitalized in full by the common or the preferred equity. In the examples, we assume only $1 million dollars of Opportunity Zone equity in our $10 million transaction.

Our example is 70% debt and 30% equity so it means that we have to put in $2 million in equity to bring full capitalization of $3 million. In the first two examples where the Op-Zone investor is providing common equity, we assume that our equity is in the form of preferred stock or junior common stock and that the dividend is zero. In the last four examples where the Opportunity Zone investor is investing in Preferred stock, our CDFI provides the $2 million in common equity, again for the sake of consistency, without a dividend. In both instances, our interest is in (1) filling the capital gap; (2) ensuring stabilization of the entity in the early years; and (3) obtaining control of the property at the end of the period.

There is one more item that must be considered, and it is reflected in the scenarios below: At some point within the first 10 years of an Opportunity Zone investment, the investor will need to pay the deferred capital gains tax on his/her original investment. CDFIs negotiating a QOF around an asset will, more than likely, have to arrange payouts from the operating cash flows to accommodate this requirement.

Scenario 1: Common Equity for a Low-Appreciating Asset

In this scenario, we have a $10,000,000 asset that is expected to appreciate at a 1.5% annual rate. We are presenting the opportunity to an investor who is looking to get the money back right after the 10 year target by selling the building at fair market value.

The investor is also looking for an ROI in the 15% range. The primary reasons: (1) the investment is illiquid; (2) the investor isn't sure it will generate revenue and positive cash flow as projected; (3) the investor isn't sure that the building will appreciate in value; (4) the investor isn't sure that we will be able to buy it; (5) the investor isn't sure that anyone else will be able to buy it.

Unfortunately, the ROI comes in at 12.61%. If we paid out 100% of the cash flow, it would not be much better—we would hit 13.71%. This deal would not work. However, if we lowered the investment from $1,000,000 to $800,000, and kept everything else the same, there would be an ROI of 16.5%–more than acceptable. We would have to put up an additional $200,000 of our own money.

There are two things to keep in mind here (1) the investment only represents 10% (or 8%) of the total funding, so the actual cost of funds for the project as a whole is a lot lower; and (2) if there's an unforeseen problem with cash flow we don't have to actually pay the dividend. It is

equity after all, and that is often what happens with equity—which is one of the reasons the target ROI is so high.

1) COMMON STOCK -Low Appreciation	THEY OWN THE BUILDING AND WE HAVE TO BUY IT AFTER 10 YEARS							
		Initial Investment	1	7	8	9	10	Sale in Year11
Value of the Asset	$10,000,000		$10,150,000	$11,098,449	$11,264,926	$11,433,900	$11,605,408	
Compound Appreciation Rate - Asset	1.50%							$11,605,408
Cash available for Dividends & Other	$120,000		$120,000	$135,139	$137,842	$140,599	$143,411	-
Inflation of CAFD	2.00%							
CFAD Payout Ratio To QOF	90.00%		$108,000	$121,626	$124,058	$126,539	$129,070	-
(All passed through to QOF Investor)								
Sale Proceeds								$1,605,408
Amount of Capital Gains Invested	$1,000,000	($1,000,000)						
Capital Gains Tax Paid in Year 7	17.00%			($170,000)				
Net Cash Flow to QOF Investor		($1,000,000)	$108,000	($48,374)	$124,058	$126,539	$129,070	$1,605,408
Internal Rate of Return to QOF Investor	12.61%							

*(Note that above computations were calculated considering a step up in basis that has since expired)

Scenario 2: Common Equity for a More Rapidly Appreciating Asset

In Scenario II, our asset has a very strong prospect of appreciating at double the rate of Scenario I. In order to hit the 15% target ROI, the dividend is more than adequate.

This example shows us how the CDFI will be encouraged to look for rapidly appreciating assets in order to free up cash flow for reinvestment in the property or business and to reserve against unforeseen circumstances. It may be contrary to mission, but the lower appreciating asset in a more distressed area may have to carry a higher current dividend payment than a higher appreciating asset in an area with greater economic growth prospects.

One of the logical consequences of this is that CDFIs may introduce assets that are closer to market and more likely to gentrify or convert to market pricing than assets in distressed areas.

2) COMMON STOCK -High Appreciation	THEY OWN THE BUILDING AND WE HAVE TO BUY IT AFTER 10 YEARS							
		Initial Investment	1	7	8	9	10	Sale in Year11
Value of the Asset	$10,000,000		$10,300,000	$12,298,739	$12,667,701	$13,047,732	$13,439,164	
Compound Appreciation Rate - Asset	3.00%							$13,439,164
Cash available for Dividends & Other	$120,000		$120,000	$135,139	$137,842	$140,599	$143,411	-
Inflation of CAFD	2.00%							
CFAD Payout Ratio To QOF	90.00%		$108,000	$121,626	$124,058	$126,539	$129,070	-
(All passed through to QOF Investor)								
Sale Proceeds								$3,439,164
Amount of Capital Gains Invested	$1,000,000	($1,000,000)						
Capital Gains Tax Paid in Year 7	17.00%			($170,000)				
Net Cash Flow to QOF Investor		($1,000,000)	$108,000	($48,374)	$124,058	$126,539	$129,070	$3,439,164
Internal Rate of Return to QOF Investor	18.32%							

*(Note that above computations were calculated considering a step up in basis that has since expired)

Scenario 3: Perpetual Preferred for a Reasonably Appreciating Very Long Term Asset

An instrument that may better suit the CDFI asset needs is the Perpetual Preferred stock. First, the Preferred investor is targeting a lower ROI than on common equity. Here, instead of looking for 15% the investor is looking for an 8% ROI, which can be achieved by setting a dividend rate, in this case, of 9%.

Preferred stock has debt-like features in that the investor gets a set dividend rate—the 9.0%–which is paid prior to any common equity dividends. But it is also like equity in that it can be postponed if there is insufficient cash available for dividends. Most preferred stock dividends are “cumulative”—which means that if a dividend payment is missed, it must be paid before any common equity dividends are paid. Preferred stock is also like debt in another respect: the preferred investor does not own the asset, and is entitled only to the principal invested (plus dividends) over the life of the investment.

One of the great benefits of the preferred stock is the flexibility it provides to the Opportunity Fund relative to managing cash flows: If the QOF needs to reduce the amount of the dividend in the early years, it can negotiate a larger payout to the investor at the end. This could be a percentage of the appreciation in the value of the asset, or a dividend formula that captures greater cash flows in the later years for payment to the investor.

For example, in this Scenario III, if the CDFI shared 50% of the appreciation in value with the investor at the end of the 30 years, the dividend could be reduced to 6.5% and still generate an ROI in the 8%+ range. This “Perpetual” Preferred stock can go on for as long as the investor wishes, though a 25 to 30 year term is generally targeted. In this example, the CDFI would

redeem the preferred shares from the investor in the 30th year for the amount of the original investment. The CDFI can raise the funds to make the redemption from any source, including borrowing against the higher value of the asset at that time.

Investors who may be interested in this would be the traditional long-term investors like insurance companies. The one caveat: the only way the Preferred investor can end up owning the asset is through convertible preferred stock.

If they don't want to own the asset, that is just fine for our CDFI, but the investor will be giving up one of the prime benefits of the Opportunity Zone tax treatment: The elimination of capital gains taxes on the appreciated value of the QOF asset when it is sold.

3) PERPETUAL PREFERRED STOCK	WE OWN THE BUILDING WHEN THE SHARES ARE REDEEMED IN 30 YEARS							
		Initial Investment	1	7	8	9	10	11	30
Value of the Asset	$10,000,000		$10,200,000	$11,486,857	$11,716,594	$11,950,926	$12,189,944	$12,433,743	$18,113,616
Compound Appreciation Rate - Asset	2.00%								$1,000,000
Cash available for Dividends & Other	$120,000		$120,000	$135,139	$137,842	$140,599	$143,411	$146,279	$213,101
Inflation of CAFD	2.00%								
Dividends on the Investment	9.00%		$90,000	$90,000	$90,000	$90,000	$90,000	$90,000	$90,000
Redemption of Preferred Stock in Year 30									$1,000,000
Amount of Capital Gains Invested	$1,000,000	($1,000,000)							
Capital Gains Tax Paid in Year 7	17.00%				($170,000)				
Net Cash Flow to QOF Investor		($1,000,000)	$90,000	$90,000	($80,000)	$90,000	$90,000	$90,000	$1,090,000
Internal Rate of Return to QOF Investor	8.18%								

*(Note that above computations were calculated considering a step up in basis that has since expired)

Scenario 4: Redeemable Preferred for a Reasonably Appreciating Medium Term Asset

This is similar to the Perpetual Preferred in every respect except the term and the ROI. Here the investor might lower the ROI from 8 to 7% because of the likely shorter term of the instrument. But if not, we would simply restructure the transaction with a lower amount of investor equity and a higher amount of subordinate debt or other CDFI capital injection.
This structure may be the first stop in negotiation with investors who are looking for a shorter term investment for their capital gains, and who like having common equity below them and a fixed maturity and dividend, don't want to be involved in owning the asset. Although the dividend is relatively high—the same as the common stock dividend in Scenario I—this is due to the investor getting no asset appreciation. All the Preferred stock investor is getting in this Scenario at maturity is the principal back. Hence there is much less pressure on the CDFI to propose an asset with high appreciation potential.

Again, as with the Perpetual and Redeemable Preferred, the CDFI can own the building, and faces repayment of the original investment instead of the purchase of the whole asset at the end of the term.

However, if the investor would like to get the benefit of any asset appreciation and a tax-free capital gain when the shares are redeemed, they might want to get a look at the next Scenario— Convertible Preferred. Doing this could enable them to reduce the dividend rate significantly.

4) REDEEMABLE PREFERRED STOCK	WE OWN THE BUILDING WHEN THE SHARES ARE REDEEMED AFTER 10 YEARS							
		Initial Investment	1	7	8	9	10	Redemption - Yr 11
Value of the Asset	$10,000,000		$10,200,000	$11,486,857	$11,716,594	$11,950,926	$12,189,944	
Compound Appreciation Rate - Asset	2.00%							
Cash available for Dividends & Other	$120,000		$120,000	$135,139	$137,842	$140,599	$143,411	
Inflation of CAFD	2.00%							
Dividends on the Investment	9.00%		$90,000	$90,000	$90,000	$90,000	$90,000	
Redemption of Preferred Stock in Year 11								$1,000,000
Amount of Capital Gains Invested	$1,000,000	($1,000,000)						
Capital Gains Tax Paid in Year 7	17.00%				($170,000)			
Net Cash Flow to QOF Investor		($1,000,000)	$90,000	$90,000	($80,000)	$90,000	$90,000	$1,000,000
Internal Rate of Return to QOF Investor	7.12%							

*(Note that above computations were calculated considering a step up in basis that has since expired)

Scenario 5: Convertible Preferred for a Reasonably Appreciating Asset

Convertible Preferred is the "Hybrid's Hybrid." This could be set up like a Redeemable Preferred but with one big difference: it enables the investor to convert all or a portion of his/her investment from a debt-like instrument with a fixed dividend and maturity to an equity-like instrument that enables the investor to own all or a portion of the asset and to capture all or a portion of the appreciation in value at the end of the term. This option is important to the CDFI because it tends to reduce the dividend rate in the early years.

In the example, the dividend drops from 9% in Scenario IV to 2% here. In order to get to a targeted return in excess of 8% (8.16% in this example), the CDFI gives the investor sufficient ownership of the property—and the appreciation of it—to materially reduce the dividend.

The way this works is that the CDFI projects an asset value, and sets a price at which the investor can convert to equity ownership. The price is set at the origination of the transaction,

and the investor makes the determination as to whether he/she wants to convert if and when the target value/price is hit.

This option increases opportunity for the investor while mitigating risk—a combination of attributes which will be attractive to many investors and which should lead to a lower ROI target and cost of funds on the transaction overall. The major shortcoming is that when the investor decides to sell the asset and capture the Opportunity Zone benefit that eliminates the tax on the capital gain, the CDFI has to buy the asset.

Unless there are agreements at the outset as to the maximum price the CDFI would have to pay, this could produce a hardship for the CDFI. Nevertheless, this structure can be very useful with those assets that have low initial cash flow, but show solid potential for appreciation.

5) CONVERTIBLE PREFERRED STOCK	THEY OWN THE BUILDING AND WE HAVE TO BUY IT AFTER YEAR 10							
		Initial Investment	1	7	8	9	10	Conversion Yr 11
Value of the Asset	$10,000,000		$10,200,000	$11,486,857	$11,716,594	$11,950,926	$12,189,944	
Compound Appreciation Rate - Asset	2.00%							$12,189,944
Cash available for Dividends & Other	$120,000		$120,000	$135,139	$137,842	$140,599	$143,411	-
Inflation of CAFD	2.00%							
Dividends on the Investment	2.50%		$25,000	$25,000	$25,000	$25,000	$25,000	
Conversion of Preferred Stock in Year 11								$2,189,944
Amount of Capital Gains Invested	$1,000,000	($1,000,000)						
Capital Gains Tax Paid in Year 7	17.00%				($170,000)			
Net Cash Flow to QOF Investor		($1,000,000)	$25,000	$25,000	($145,000)	$25,000	$25,000	$2,189,944
Internal Rate of Return to QOF Investor	8.16%							

*(Note that above computations were calculated considering a step up in basis that has since expired)

Scenario 6: Sinking Fund Preferred for a Low-Appreciating Asset

This may be the most conservative and safest form of preferred stock. The reason is that the CDFI commits to paying a dividend as well as setting aside funds on a scheduled basis to redeem the Preferred shares at maturity. Each year, the investor receives a dividend while a cash sinking fund builds available cash to cover any shortfalls in dividends.

In this example, this enables the investor to lower the ROI target to the 5% range, because the risk of the transaction is now lower: At any point in the cycle there will be liquid collateral to support the investment.

In this example, the CDFI sets aside all of the cash flow after Preferred dividend payment in the escrowed sinking fund. The amount of cash in the cumulative sinking fund is shown in the gray row above and by the 10th year, it covers over 50% of the investor's principal. This materially reduces the investor's credit risk – as the lower 5.5% ROI indicates.

There is a downside however: instead of reinvesting the cash available after Preferred dividend payment in the asset, it is put in the sinking fund. By taking all of the residual cash out of the asset and putting it in the sinking fund, the asset may not be getting all of the upkeep and reinvestment it needs.

For this example, this diversion of cash is reflected in the lower rate of asset appreciation—1%. The primary reason this structure should be of interest is that it helps the QOF maintain the 90% deployment test over the life of investment by capturing principal at the property level, while reducing the risk – and therefore the discount rate, the target ROI and the dividend rate.

The big negative here is that the asset must generate sufficient cash flow to cover both the dividend and the sinking fund. This may steer the CDFI away from assets that need the investment the most.

6) PREFERRED STOCK WITH SINKING FUND	WE OWN THE BUILDING		1	7	8	9	10	Redemption - Yr 11
Value of the Asset	$10,000,000		$10,100,000	$10,721,354	$10,828,567	$10,936,853	$11,046,221	
Compound Appreciation Rate - Asset	1.00%							
Cash available for Dividends & Other	$120,000		$120,000	$135,139	$137,842	$140,599	$143,411	
Inflation of CAFD	2.00%							
Cumulative Sinking Fund			$45,000	$367,114	$429,956	$495,555	$563,967	Sinking Fund 56.40% of Redemption
Dividends on the Investment	7.50%		$75,000	$75,000	$75,000	$75,000	$75,000	
Redemption of Preferred Stock in Year 11								$1,000,000
Amount of Capital Gains Invested	$1,000,000	($1,000,000)						
Capital Gains Tax Paid in Year 7	17.00%				($170,000)			
Net Cash Flow to QOF Investor		($1,000,000)	$75,000	$75,000	($95,000)	$75,000	$75,000	$1,000,000
Internal Rate of Return to QOF Investor	5.62%							

*(Note that above computations were calculated considering a step up in basis that has since expired)

Chapter 8: Puerto Rico & Opportunity Zones

Disaster Recovery & A New Era

Puerto Rico, Guam and the US Virgin islands all have opportunity zones.

In September 2017, Maria, a deadly category 5 hurricane devastated much of Puerto Rico leaving over 1.5 million people without power. Power was not fully restored for almost one year, making this the second largest black-out in history and exposing a colossal weakness in the Island's distribution of power and its ability to mitigate and recuperate from natural disasters. Opportunity Zones are now playing a critical role in the rebuilding of Puerto Rico from the ground up, literally.

Why Puerto Rico Opportunity Zones?

Virtually the entire island is an opportunity zone. Most Opportunity Zone communities face systemic challenges, including poverty, unemployment, public safety, and overall economic decline. These are the barriers to business formation and investment that the Opportunity Zones incentive is designed to overcome. Success will require mutual understanding by all stakeholders of the unique challenges, assets, and opportunities present in their community.

Without the Opportunity Zones incentive, some investors might shy away from these communities. With the incentive, investors will scrutinize every opportunity carefully and pose a series of hard-edged business questions: Is this community a place where reinvested capital can be preserved safely during the required holding period? Is it a place with the opportunity to achieve additional capital gains that can be sheltered from future taxation?

A clear understanding of a community's needs and assets will allow local leaders to highlight promising investment opportunities and ensure that the investments made align with the community's highest priorities.

To attract more investments to Qualified Opportunity Zones in Puerto Rico, Act 21-2019, known as the Act for the Development of Opportunity Zones of 2019 (PR-QOZ Act), was enacted on May 14, 2019 (now part of the Act 60 of July 1, 2019 – Puerto Rico Incentives Code). As a local counterpart to the U.S. QOZ provisions, the PR-QOZ Act provides for additional incentives for investment in Puerto Rico. Final PR OZ Regulations were issued in October 2020. Additionally, Amended the PR Internal Revenue Code to provide the same federal tax incentives in the local tax jurisdiction for PR taxpayers with capital gains that invest in a QOF (that invest only in PR).

Local Opportunity Zone Tax Benefits For Priority Projects

Some of the additional benefits provided by the Puerto Rico OZ Law for Priority Projects

- 18.5% FLAT INCOME TAX RATE ON INCOME DERIVED FROM ELIGIBLE ACTIVITIES BY AN EXEMPT BUSINESS.

- 100% TAX EXEMPTION ON DIVIDEND DISTRIBUTIONS FROM EARNINGS AND PROFITS GENERATED FROM ELIGIBLE ACTIVITIES.
- 100% TAX EXEMPTION ON SUBSEQUENT DIVIDEND DISTRIBUTIONS.
- 100% EXEMPTION FROM TAX FOR INTEREST INCOME RECEIVED ON BONDS, PROMISSORY NOTES OR OTHER OBLIGATIONS OF AN ELIGIBLE BUSINESS FOR THE DEVELOPMENT, CONSTRUCTION OR REHABILITATION OF, OR IMPROVEMENTS TO AN ELIGIBLE BUSINESS.
- 18.5% WITHHOLDING TAX RATE ON ROYALTIES, RENTS AND LICENSE FEES PAID BY THE EXEMPT BUSINESS TO A NON-RESIDENT INDIVIDUAL OR ENTITIES NOT ENGAGED IN TRADE OR BUSINESS IN P.R.
- 25% EXEMPTION ON I) MUNICIPAL LICENSE TAX, II) PERSONAL PROPERTY TAX, III) REAL PROPERTY TAX, AND IV) MUNICIPAL CONSTRUCTION EXCISE TAX (MAY BE INCREASED BY THE MUNICIPALITY UP TO 75%).
- UP TO 25% TRANSFERRABLE INVESTMENT CREDIT BASED ON THE CASH INVESTMENT CONTRIBUTED IN THE QOF.
- 15 YEARS EXEMPTION PERIOD WITH FLEXIBLE EXEMPTION.

Puerto Rico Incentives Code

Tax Incentives For Portfolio Companies.

The Incentives Code consolidates the tax incentives formerly granted under separate incentives laws, such as Act 73-2008 (manufacturing); Act 83-2010 (renewable energy); and Act 21-2019 (development of Opportunity Zones), among others. An eligible business must request and obtain a tax exemption grant under the Incentives Code to benefit from the tax incentives afforded by such Act. To the extent Portfolio Companies in the sustainable and renewable energy and manufacturing industry and have a grant of tax exemption under the Incentives Code, its net income associated to the activities covered under the Incentives Code generally would be subject to a corporate income tax rate of 4%, while Portfolio Companies with a grant of tax exemption as Priority Projects will be subject to a corporate tax of 18.5%. If Portfolio Companies do not operate under the Incentives Code, they would be subject to a corporate income tax rate of up to 37.5%, and if organized under a State of the U.S., they would also be subject to a 10% branch profit tax.

Qualified Opportunity Zones In Puerto Rico – Priority Projects

Eligible businesses may benefit from additional tax incentives in P.R. by investing in Priority Projects. To qualify for these incentives, the business must meet the following requirements:

- Perform its activities in an eligible zone;

- The business activity performed is not eligible for tax exemption benefits under former incentive laws, such as Act 20-2012, Act 73-2008, Act 74-2010, Act 83-2010, Act 27-2011, or any similar succeeding legislation;
- The business activity is performed by a QOF or an entity in which a QOF invests in; and
- The business activity performed is a Priority Project.

A Priority Project in PR-QOZ is defined as a trade or business or any other activity performed to produce income that will contribute to diversification, recuperation or social and economic transformation of the community in the eligible zone. The following activities have been listed as eligible Priority Projects:

- Development of residential real property that is a low-income housing project for sale or rent;
- Development of residential and/or commercial real property for sale or rent;
- Development of industrial real property for sale or rent; and
- Substantial improvement of an existing commercial property for sale or rent.

If the Portfolio Companies were to obtain a tax exemption grant as a Priority Project under the Incentives Code, they will enjoy some of the benefits conceded to Priority Projects in P.R., as follows:

- 18.5% flat income tax rate on income derived from eligible activities by an exempt business.
- 100% tax exemption on dividend distributions from earnings and profits generated from eligible activities.
- 100% tax exemption on subsequent dividend distributions.
- 100% exemption from tax for interest income received on bonds, promissory notes or other obligations of an eligible business for the development, construction or rehabilitation of, or improvements to an eligible business.
- 18.5% withholding tax rate on royalties, rents and license fees paid by the exempt business to a non-resident individual or entities not engaged in trade or business in P.R.
- 25% exemption on i) Municipal License Tax, ii) Personal Property Tax, iii) Real Property Tax, and iv) Municipal Construction Excise Tax (may be increased by the Municipality up to 75%).
- Up to 25% transferrable investment credit based on the cash investment contributed in the QOF.
- 15 years exemption period with flexible exemption.

Energy Incentives

Under the Infrastructure and Green Energy Chapter of the Incentives Code, a bona fide business with a bona fide office or establishment located in P.R., that is or may be engaged in an eligible

green energy or highly efficient activity may apply for a tax exemption grant to benefit from the following P.R. tax incentives:

- 4% FIXED INCOME TAX RATE ON INCOME GENERATED FROM THE ELIGIBLE GREEN ENERGY OR HIGHLY EFFICIENT ACTIVITY.
- 12% WITHHOLDING TAX RATE ON ROYALTY PAYMENTS, CREDITABLE AGAINST THE 4% FIXED TAX RATE.
- 100% EXEMPTION FROM INCOME TAX ON DISTRIBUTIONS TO SHAREHOLDERS, PARTNERS, OR MEMBERS.
- 50% EXEMPTION FROM MUNICIPAL LICENSE TAXES, AND OTHER MUNICIPAL TAXES.
- 75% EXEMPTION ON PROPERTY TAXES, REAL AND PERSONAL.
- 100% EXEMPTION FROM EXCISE AND SALES AND USE TAXES ON CERTAIN RAW MATERIALS, AND MACHINERY AND EQUIPMENT.
- 75% EXEMPTION FROM MUNICIPAL TAXES, EXCISES AND OTHER TAXES TO CONTRACTORS AND SUBCONTRACTORS, NOT INCLUDING MUNICIPAL LICENSE TAXES.
- SPECIAL DEDUCTION FOR INVESTMENTS IN BUILDINGS, STRUCTURES, AND MACHINERY AND EQUIPMENT USED IN THE ELIGIBLE GREEN ENERGY/HIGHLY EFFICIENT ENERGY ACTIVITY.
- TAX CREDITS AVAILABLE.
- TAX EXEMPTION GRANT HAS A TERM OF 15 YEARS, RENEWABLE FOR AN ADDITIONAL 15 YEARS.

Manufacturing Incentives

Under the Manufacturing Chapter of the Incentives Code, a bona fide business with a bona fide office or establishment located in P.R., that is or may be engaged in an eligible manufacturing activity may apply for a tax exemption grant to benefit from the following P.R. tax incentives:

- 4% FIXED INCOME TAX RATE ON INCOME GENERATED FROM THE ELIGIBLE MANUFACTURING ACTIVITY.
- 4% FIXED INCOME TAX RATE ON GAINS DERIVED FROM THE SALE OR EXCHANGE OF ASSETS DURING THE TAX EXEMPTION PERIOD.
- 12% WITHHOLDING TAX RATE ON ROYALTY PAYMENTS MADE BY THE ELIGIBLE MANUFACTURING BUSINESS, CREDITABLE AGAINST THE 4% FIXED TAX RATE.
- 100% EXEMPTION FROM INCOME TAX ON DISTRIBUTIONS TO SHAREHOLDERS, PARTNERS, OR MEMBERS.

- 50% EXEMPTION FROM MUNICIPAL LICENSE TAXES, AND OTHER MUNICIPAL TAXES.
- 75% EXEMPTION ON PROPERTY TAXES, REAL AND PERSONAL.
- 100% EXEMPTION FROM EXCISE AND SALES AND USE TAXES ON CERTAIN RAW MATERIALS, AND MACHINERY AND EQUIPMENT.
- SPECIAL DEDUCTION FOR INVESTMENTS IN BUILDINGS, STRUCTURES, AND MACHINERY AND EQUIPMENT USED IN THE ELIGIBLE MANUFACTURING ACTIVITY.
- TAX CREDITS AVAILABLE.
- TAX EXEMPTION GRANT HAS A TERM OF 15 YEARS, RENEWABLE FOR AN ADDITIONAL 15 YEARS.

Interplay Of P.R. And U.S. Federal Tax Rules

Additional Considerations For U.S. Investors Considered U.S. Persons For Portfolio Companies Organized In P.R.

The following section provides a high-level discussion of potential U.S. federal tax implications to U.S. Persons (as defined below) if Portfolio Companies are organized in P.R. and are considered corporations for U.S. and P.R. tax purposes. The tax implications discussed ahead are circumscribed to the Fund, other owners of Portfolio Companies, and the Investors, in connection to the tax structure assumed herein.

Entities organized in P.R. are considered foreign for U.S. federal tax purposes. The Code imposes additional filing requirements and U.S. federal taxes to certain U.S. persons holding interests in foreign corporations. The applicable filings and taxes will vary depending on the ownership interest held by the U.S. Person.

As Portfolio Companies will elect to be taxed as corporations in the U.S. federal tax jurisdiction, they may be considered Controlled Foreign Corporations (“CFCs”) if more than 50% of their stock total combined voting power or value, is directly, indirectly, or constructively owned by U.S. Shareholders. The Code defines U.S. Shareholders as any U.S. person. For these purposes, a U.S. Person is defined as any of the five persons listed below, who owns directly, indirectly or constructively 10% or more of the total combined value or voting power of the foreign corporation:

- (1) U.S. citizen or residents;
- (2) U.S. domestic partnerships;
- (3) U.S. domestic corporations;
- (4) any estate (other than foreign estate as defined in the Code); and

- (5) any trust if a court within the U.S. is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust.

There is an exclusion from the U.S. person definition with respect to P.R. bona fide residents owning interests in corporations organized in P.R. Therefore, P.R. bona fide residents indirectly or constructively owning interests in the Portfolio Companies are not considered U.S. persons for CFC purposes.

As a result of the above discussion, the Fund and other owners of Portfolio Companies that fall into the U.S. Person definition may be required to comply with additional U.S. federal tax filings to disclose certain information of the Portfolio Companies. Additional U.S. federal tax filings may include, but are not limited, to the following:

- Form 5471 – Information Return of U.S. Persons with Respect to Certain Foreign Corporations
- Form 8992 – U.S. Shareholder Calculation of Global Intangible Low-Taxed Income ("GILTI")
- Form 8938 – Statement of Specified Foreign Financial Assets
- Form 926 – Return by a U.S. Transferor of Property to a Foreign Corporation

Furthermore, to the extent Portfolio Companies are treated as foreign corporations for U.S. tax purposes, the Fund and other owners of Portfolio Companies considered U.S. persons may be subject to the GILTI provisions. For U.S. persons that are taxed as individual taxpayers, in simplified terms, the GILTI would imply that the excess net profits of the Portfolio Companies are treated as a deemed dividend taxed at 40.8%, assuming the current highest marginal tax rate. On the other hand, U.S. persons that are taxed as corporations that are subject to the GILTI, would be taxed at a U.S. effective tax rate of 10.5% (until December 31, 2025) and 13.125% (from January 1, 2026 onwards) on the excess net profits of the Portfolio Companies. U.S. Persons taxed as corporations may also benefit from a foreign tax credit for taxes paid by Portfolio Companies in P.R., limited to an 80% without carryback or carryforward.

Other Puerto Rico Taxes

Municipal License Taxes

Distributions by the Opportunity Zone Fund made out to Puerto Rico Resident Investors and Non-Puerto Rico Resident Investors are not subject to Municipal license taxes in P.R. to the extent the Fund's interest is held as an investment.

Property Taxes

Under the provisions of the Municipal Code, the limited partnership interests are not subject to P.R. personal property taxes.

Estate And Gift Taxes

Estate and gift taxes imposed by the Puerto Rico Code have been repealed with respect to transfers by inheritance or gifts made after December 31, 2017.

Chapter 9: Tribal Nations & Opportunity Zones

A Guide For Tribes To Opportunity Zones

30% of all eligible tribal tracts are opportunity zones

Many Tribal communities have assets they can use to support Opportunity Zone investments, such as land, plans & limited zoning requirements. Additionally, investments can be used to support expansion of or creation of new businesses. Investments can also support development and redevelopment of real property with no limit to the amount of investments being made.

A Challenging Investment Landscape For Indian Country

The goal of attracting private investment for housing and economic development in Indian Country is not new. One of the primary objectives of the Native American Housing Assistance and Self-Determination Act (NAHASDA) of 1996 was to promote the development of private capital markets in Indian Country and to allow such markets to grow.

Although investment vehicles are available to attract private funds, such as the low-income housing tax credit (LIHTC) and New Markets Tax Credits, there are challenges to accessing private capital in Indian Country.

The barriers most frequently reported included lack of interest from other organizations or financial institutions; lack of availability of programs; political tensions between the tribe, the housing administrative entity, and other organizations; administrative constraints; and differing priorities.

A New Tool For Tribes To Attract Capital Investment

Opportunity Zones offer Indian Country an important new tool with which to attract investments in a wide range of projects to improve the economic conditions on tribal lands. There are potentially millions of dollars in investments which could be attracted to areas throughout Indian Country that have been designated as Opportunity Zones. As stated earlier, Opportunity Funds must hold at least 90 percent of their assets in Opportunity Zone property, which can include stock or equity in businesses. Tribally owned businesses already operating within an Opportunity Zone could seek new investments to further expand, or new businesses could be established.

Opportunity Funds can also choose to hold their assets in tangible property within an Opportunity Zone, which could lead to the development or redevelopment of properties within Indian Country. This could attract new investments for the construction of new buildings or the redevelopment of existing buildings, such as warehouses, office buildings, hotels, or apartment buildings, thereby leading to an increase in jobs in the Opportunity Zone area.

The potential impacts of constructing or redeveloping properties in Indian Country might include the creation of other, new secondary businesses, such as coffee shops or restaurants, that while not direct recipients of Opportunity Funds, support Opportunity Zone businesses. One can foresee that the construction of an office park, for example, could lead to new businesses, such as coffee shops or dry cleaners, being established nearby to serve the persons working there.

Finally, since there is no fixed ceiling on the number of Opportunity Zones that can receive investments in any given year, all eligible zones can receive any amount of capital through Opportunity Funds during the year. This represents a new way for Indian Country to attract financing for projects that would improve the economic outlook of the Opportunity Zone area, and, by extension, the tribe and its members.

Attracting Opportunity Fund Investors

How Opportunity Zones Could Attract More Investment To Tribal Areas

Opportunity Zones differ from existing programs that provide tax incentives for community and economic development. They are promising for Indian Country because of tax incentives, eligibility period, and flexibility.

To attract investment in low-income and undercapitalized communities, tax benefits are available to corporations and individuals that invest capital in Opportunity Zones. These benefits defer or reduce taxes on capital gains and favor long-term investment. Once selected, Opportunity Zones keep the designation for 10 years.

Capital for eligible projects is directed to Opportunity Funds, which are organized as partnerships or corporations and certified by the US Treasury. There is no limit to the number of Opportunity Funds that can be established, and they can be created to invest in a single project or multiple projects.

With less complex rules and regulations than economic development tax credit programs and greater flexibility in the range of projects that can be undertaken, tribes could engage with Opportunity Funds and influence their development decisions.

Tribes Are Already Building Capacity For Development Projects

Opportunity Zones hold promise for addressing the lack of interest from other organizations or financial institutions. After more than 20 years of working with NAHASDA, tribes and economic development organizations in Indian Country have gained experience at leveraging funding and planning for new development.

The LIHTC (Low Income Housing Tax Credit) was cited as the program that tribes most often used other than the NAHASDA block grant for housing construction and rehabilitation in our study, and Opportunity Zones can build on that investment momentum.

- Bad River Reservation (Wisconsin) uses the LIHTC for new development and appointed a project manager for tax credit projects.

- White Earth (Minnesota), a tribe working on its fifth LIHTC project, noted an increase in investors and developers interested in LIHTC projects.
- The Lumbee Tribe has worked with its community partners, the local bank, and the city (Pembroke, North Carolina) to develop funding packages for housing that serves tribal members. Using the LIHTC and other programs, the tribe is providing new, energy-efficient housing and accommodating the needs of elders and members with disabilities.

These and similar experiences at other tribes have built capacity for managing development projects, forming partnerships, and attracting investors in Indian Country.

Governors have taken notice of tribal lands in their Opportunity Zone designations. Now tribes can use their experience to package development projects in Opportunity Zones to attract new corporate and private investors.

Better Position A Designated Opportunity Zone

Steps that Indian Country leaders could take to better position a designated Opportunity Zone within or adjacent to the "reservation" or jurisdictional area of an Indian tribe ("Tribe") for such opportunity fund investment.

Identifying Opportunity Zone Funds with a Focus on Indian Country Investments

In addition to identifying any Indian Country-focused Opportunity Zone funds, tribal leaders looking to stimulate Opportunity Zone investments should also consider collaborating with prospective investors to form a special purpose Opportunity Zone Fund. Such special purpose funds are already being formed for other Opportunity Zone investment projects.

Notably, the statute requires that Opportunity Zone Funds be organized as a corporation or partnership. Although it would not make sense for a tax-exempt tribe to take a substantial ownership position in Opportunity Zone Fund, there is nothing to prevent a tribe or tribal organization from holding a small ownership interest in an Opportunity Zone Fund or from serving as a manager of such a fund.

Evaluating Business Prospects in an Opportunity Zone

Once a Tribe has confirmed that an Opportunity Zone includes a tribal jurisdictional area, it may want to conduct its own evaluation of the prospects for specific types of business investment in the zone. In recognition of the fact that investment will be driven by market forces (and not government mandates), tribes and other governments should work to present the case for why

business investment in a specific location is likely to be successful and to address any perceived limitations, such as availability of a ready workforce. Some of these efforts may need to be done in collaboration with local or state governments—particularly if the Opportunity Zone includes both tribal and non-tribal land. Some municipal governments are already hosting business forums aimed at highlighting the potential projects within designated Opportunity Zones.

Under the Opportunity Zone legislation, there are very few legal limitations on the types of investments that can be made by an Opportunity Zone Fund. However, the statute does provide—by cross-referencing Section 144(c)(6)(B) of the Code–that investments in a golf course, massage parlor, hot tub facility, suntan facility , racetrack or other gambling facility, or a liquor store –do not qualify. Therefore, tribes should identify which businesses are needed (e.g., market demand for a grocery store or affordable rental housing) and be prepared to show potential investors how investment in such a business could be successful over a five to ten-year period.

Tribal Investments in Infrastructure and Complementary Businesses

While a tribal government is not a taxpayer eligible for the Opportunity Zone tax incentives, appropriate tribal investments within a tribal Opportunity Zone could materially increase the likelihood of attracting private investors eligible to make investments in such an Opportunity Zone. Appropriate infrastructure investments might include:

- Road work
- Site preparation and grading
- Utility improvements
- Water/sewer upgrades

Complementary businesses that a tribe might invest in to attract additional private investment could include the establishment of certain types of public entertainment venues, housing and public accommodations, and gas stations and convenience stores. Tribal casinos that have already become destination resorts will be in a good position to attract private investment—and the designation of nearby areas as Opportunity Zones will enhance their attractiveness to investors if the tribe is seeking such investment.

Reviewing and Updating Tribal Legal Infrastructure to Attract Private Investment

A final critical step in preparing for Opportunity Zone Fund investments in an Opportunity Zone within a tribal jurisdictional area is the review and updating of tribal legal infrastructure relevant to private investment, lending and leasing. Private investors will be most comfortable investing in a tribal Opportunity Zone if the host Tribe has adopted secured transaction and other commercial codes that are comparable to state codes.

This can easily be done by using model codes. Tribes should also look at whether their leasing authority has been updated and streamlined to avoid excessively time-consuming BIA regulation and approval processes. Tribes that have HEARTH Act leasing ordinances in place will have an easier time attracting private investment to trust land where investors will need to execute land leases to establish an Opportunity Zone business.

Chapter 10: ESG / Minority Utilization of Opportunity Zones

What is an ESG?

Environmental, Social, and Governance
ESG stands for Environmental, Social, and Governance. Investors are increasingly applying these non-financial factors as part of their analysis process to identify material risks and growth opportunities.

2020 was a watershed year for Environmental, Social and Governance (ESG) investing in real estate as pandemic- and climate-related disruption, along with growing recognition of social inequity, prompted investors to adopt a more robust approach to sustainability-related risks.

What makes an ESG investment?

ESG Investing (also known as “socially responsible investing,” “impact investing,” and “sustainable investing”) refers to investing which prioritizes optimal environmental, social, and governance (ESG) factors or outcomes.

Environmental

Environmental criteria include an investment's policies when it comes to things like:

- Climate change.
- Carbon footprint.
- Water conservation.
- Renewable energy usage.
- The safe disposal of waste.

For example, ESG stock investors might want to see companies that get 100% of their energy from renewable sources.

Social Aspect of ESG

The social aspect of ESG investing has to do with human issues, such as company culture.
A few criteria for socially conscious companies include:

- Treating their employees well.
- Paying reasonable wages to all employees.
- Offering great benefits.
- Encouraging personal development.
- Ethically sourcing their materials.

Governance

ESG investors want to know that management cares about all stakeholders, not just themselves. For example, an ESG investor might want to know that the majority of management compensation is incentive-based in ways that drive shareholder returns. Diversity of the board is also a common ESG criteria that falls into the governance category.

To be clear, ESG criteria all by themselves do not help you determine if an investment is financially sound. They should be used to find socially responsible investment opportunities, but it is still important to use traditional methods of evaluating each investment to determine whether it is a good opportunity.

Minority ownership and why:

Collective Action to Build Wealth

So much of the Black experience in America has been about the organizations that connect our community, such as churches, Black fraternities and sororities, and service clubs. These groups have played crucial roles in various social movements throughout our history.

The Opportunity Zone legislation offers a unique opportunity for these organizations to make strategic investments aimed at both financial return and social impact. The law in its design incentivizes pooling of resources: for an Opportunity Zone investment to receive tax benefits, it must be made through an Opportunity Fund, which is defined as a corporation or a partnership. (Limited liability corporations taxed as partnerships also qualify).

Collective action to address systemic barriers to advancement is often discussed within these communities. With Opportunity Zones, incentives for collective action are actually built into and align with the legislation.

Along with collective investing, the Opportunity Zone program allows for cycling of investment dollars and the second set of regulations served to confirm this.

Although the Opportunity Zones program will almost certainly lead to gentrification as property values increase in areas targeted for investment, it can also offer new paths to Black economic empowerment. With innovative approaches, a solid understanding of the risks and rewards of Opportunity Zone investing, and careful attention to regulatory requirements for maximizing tax benefits, we can leverage the Opportunity Zone program to build wealth for Black families and revitalize our communities.

Setting The Stage To Create Community Ownership

What you can do to engage opportunity zone funds.

Local leaders play a key role in ensuring the success of the Opportunity Zones initiative. Community residents, faith leaders, small business owners, and elected officials all have unique knowledge and input to share. For this reason, it is essential that local Opportunity Zone strategies engage all stakeholders to attract revitalizing investments.

The Opportunity Zone tax incentives provide a tremendous way to bring investments, jobs, business expansion, and new business development to your community. In order to amplify the impact of this tax incentive, the White House Opportunity and Revitalization Council has identified more than 270 Federal programs whereby targeting, preference, or additional support can be provided to Opportunity Zones. These action items should be considered by local leaders as additional tools to revitalize their Opportunity Zones.

A Strategy For Community Ownership of Opportunity Zones

A Road Map Of Steps For Complete Success.

The Opportunity Zones incentive was created to attract long-term capital that will spur economic development and job creation in designated low-income census tracts. Multiple stakeholders have a responsibility to ensure that newly incentivized investments achieve inclusive and equitable outcomes for the selected community, in addition to benefits for investors.

Public officials, nonprofits, and community development organizations in cities and neighborhoods seeking to attract new investments must partner with QOF managers, and these managers' decision-making will heavily involve financial considerations. This dynamic may present a challenge to local leaders who have an in-depth understanding of their own community and its needs, but who may not be familiar with the process of promoting those needs to the private sector. Likewise, private investors looking for ways to invest in QOFs may not be familiar with the incentives and support that local leaders can mobilize to make community-based investing less costly, less risky, or more profitable.

A QOF's managers and investors must ensure they meet the key timing requirements in the regulations, and they may press local leaders for fast decisions on the actions or supports that a project requires, such as permitting, land use decisions, or financial support.

Consequently, it is important that community leaders always be guided by a long-term view of how Opportunity Zone investments will fit with the community's overall vision for economic and community development to benefit local residents. In addition to attracting private capital through QOFs, communities across the nation have found that being designated as an Opportunity Zone can catalyze additional public and private investments. In fact, the initiative has spurred people to reconsider how economic development intersects with wealth building in a community.

The excitement and focus created by this designation offers local leaders the opportunity to identify and, in some cases, develop innovative approaches to local economic development. Federal, State, and local government agencies have realigned many existing programs and created new incentives to reinforce the Opportunity Zone designation, creating the opportunity to strategically focus attention and resources on distressed communities in a way that will yield benefits well into the future.

The following sections detail a multi-step approach that local leaders should take to maximize the community and economic development impacts of their Opportunity Zone designation: understand, align, establish, partner, and measure.

Assess Housing Needs

Increasing the stock of quality affordable housing is a common community priority. A variety of housing options at different price points promotes stronger and more inclusive communities. Housing is a critical component of a community's economic ecosystem, and quality affordable housing should be a consideration in any local economic development strategy.

Local officials should periodically assess the local housing stock and housing needs in their communities. Undertaking a current housing needs assessment will allow local leaders to develop or update a comprehensive housing plan to better align future public and private investment with local needs. Informed by a comprehensive housing plan, leaders should be prepared to work with investors on a list of target areas for housing development within their jurisdictions Opportunity Zones.

In addition, local leaders should work with the residents to both assess housing needs and plan for new housing development. Engaging with residents, especially those who are either in need of housing or vulnerable to displacement, is critical to understanding the most urgent needs of the community and to ensuring that new public and private investments are deployed effectively to address these needs.

Evaluate Commercial Market Conditions

In addition to understanding housing needs, local leaders should understand the current conditions of the local commercial real estate market. Local leaders should conduct a commercial real estate assessment to better understand current office, retail, hotel, and industrial uses within Opportunity Zones. This assessment should include analyzing overall trends in supply and demand, including how quickly empty space is likely to be "absorbed" or taken off the market by being rented; how significant unplanned vacancies are expected to be over time; and, of course, current and projected rents or prices.

This assessment should involve conversations with local real estate brokers and developers to learn about development barriers and opportunities. Communities should compile a list of active or planned projects in and around their Opportunity Zones. Understanding the commercial real estate market will allow communities to target investments to specific market sectors or geographic areas of greatest need or opportunity.

Identify Key Economic Drivers And Growth Sectors

Developers who want to serve commercial markets and investors who finance new business enterprises both need to understand the overall economic strategy and trajectory of the region,

county, or city. Some regions may already have a Comprehensive Economic Development Strategy (CEDS) recognized by the U.S. Economic Development Administration (EDA), or an equivalent document developed by a regional business partnership.

Additionally, local economic development organizations already may maintain plans that include a comprehensive description of business-support systems, such as entrepreneurship programs, incubators, and accelerators. Finally, any community that receives Community Development Block Grants (CDBG) from HUD already maintains a Consolidated Plan that discusses housing needs, economic development goals, neighborhood improvement and social service needs, and a roster of specific projects slated for CDBG support. Leaders should have a deep understanding of economic drivers, ensure that their planning efforts are up to date and share them with other stakeholders. Planning and engagement around economic drivers and available support systems will enable local leaders and community partners to target opportunities for business investment within Opportunity Zones.

Conduct Workforce Analysis

The status and prospects of the local workforce are two of the most important determinants of success in the Opportunity Zone process, for both communities and investors. Companies being recruited as tenants by commercial developers need to know that a skilled workforce is available nearby. Likewise, community residents need to know that training opportunities will allow them to qualify for newly created well-paying jobs.

As in the case of housing, a comprehensive workforce plan that refers to incentives for workforce education and training is needed and should be made available to residents. Subsidies and incentives for workforce training generally are coordinated through State-level and regional Workforce Investment Boards. These public–private boards usually are well known to local economic development entities, which work closely to apply such incentives to the needs of new or expanding businesses in exchange for jobs and economic benefits for the community.

Many counties and municipalities with designated Opportunity Zones already work closely with their associated Workforce Investment Boards to monitor current and anticipated matches between workforce supply and employer needs.

Identify Available Tools For Economic Development

Investors in new business enterprises need to know not only where growth is coming from but also how the community supports it. Local leaders should be prepared to explain to QOF

managers and investors the full range of economic development tools available to support economic and business development in Opportunity Zones.

This inventory should include local, regional, and statewide incentive policies and financing tools, as well as Federal and even philanthropic programs. These may include financial incentives, such as tax credits and abatements, or local programs to support workforce development or business incubation. Community leaders should be able to convey to all investors how existing or newly created economic development tools will complement or enhance QOF investments.

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Scan For Existing Partnerships

Communication and collaboration among local jurisdictions, community development corporations (nonprofit community based organizations focused on local revitalization), other nonprofits, philanthropic foundations, and educational institutions are critical to fostering a strong economic ecosystem in Opportunity Zone communities. An active and engaged network of local stakeholders not only makes communities more attractive for investment, but also fosters alignment of these investments with shared community priorities.

Local leaders should make available to investors a comprehensive scan of the local economic ecosystem that includes a description of all relevant actors and information about how investors should engage with them (e.g., one-on-one or collectively). The goal of local leaders should be to develop the best possible understanding of existing organizations' capacity to provide economic development and social services in and around Opportunity Zones.

An understanding of the ecosystem of community partners will allow local leaders and investors to target public and private resources strategically to achieve the greatest community and economic development impact. In addition, this understanding will help QOFs and other investors engage with established local partnerships to ensure that their investment is aligned with and benefiting local residents and organizations.

Understand Investor Priorities And Interests

Local leaders should seek to understand the priorities and interests of different types of investors, as well as how investors evaluate opportunities and risks. Hosting investor networking events and consulting available QOF directories are among the ways that communities can learn more about investor priorities and interests.

Many traditional investors seek to reduce risk by raising non-dilutive capital — that is, a capital source that does not require equity in exchange. Examples of non-dilutive capital include grants and low-cost loans. In addition to understanding the risk and opportunity considerations of

traditional investors, local leaders should understand the landscape of “impact investors” with a potential interest in their community.

Impact investments are those made by private actors (either not-for-profit or for-profit) with the intent of generating a measurable social or environmental impact, in addition to financial returns. Many QOFs have already been formed by impact investors, and the Opportunity Zones initiative may encourage the creation of new pools of impact-investing capital. Local leaders should understand the types of projects being sought by impact investors and the potential for aligning the goals of these investors with the goals of their community.

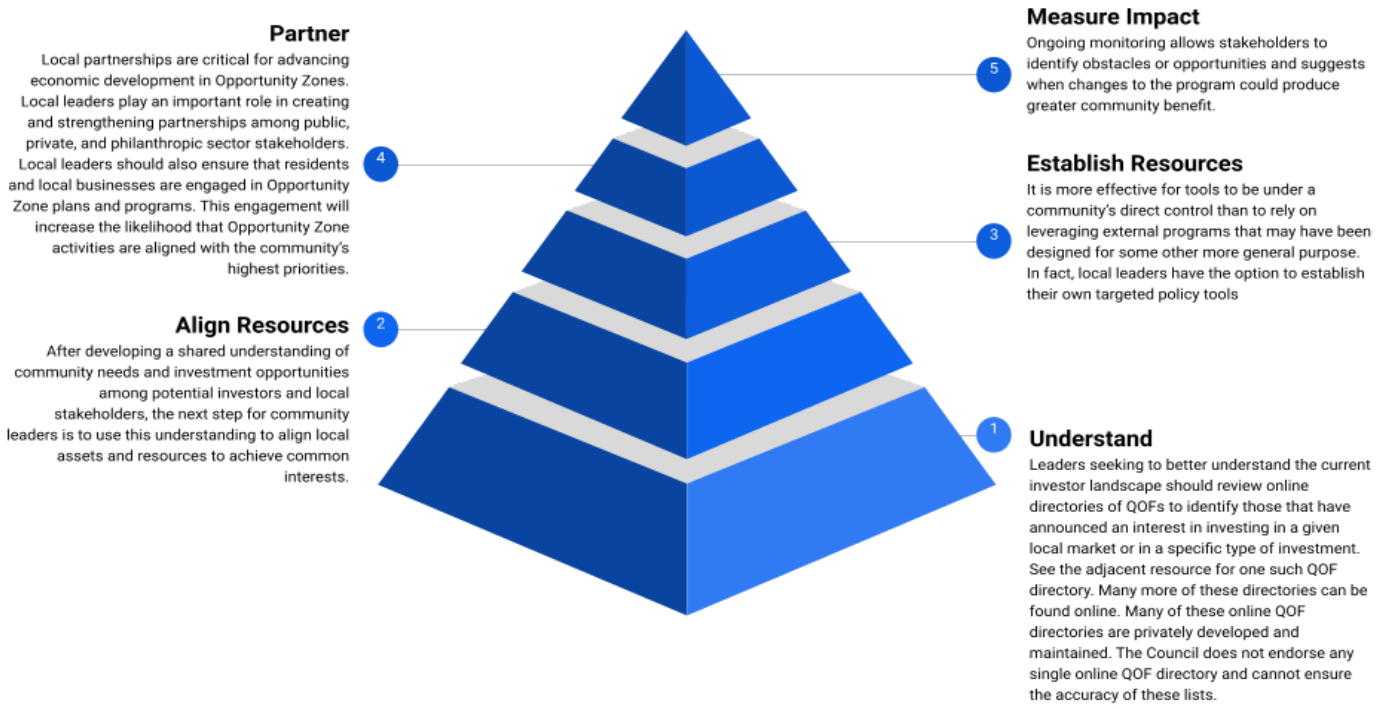
Leaders also need to be prepared to engage with both real estate investors and equity market investors. It is important to recognize that these groups may have different views about what makes the most sense as an investment. Understanding the interests of different types of investors will allow local leaders to ensure that the investments being made are in line with their community’s highest priorities for community and economic development.

Understand the Current Environment

Most Opportunity Zone communities face systemic challenges, including poverty, unemployment, public safety, and overall economic decline. These are the barriers to business formation and investment that the Opportunity Zones incentive is designed to overcome. Success will require mutual understanding by all stakeholders of the unique challenges, assets, and opportunities present in their community.

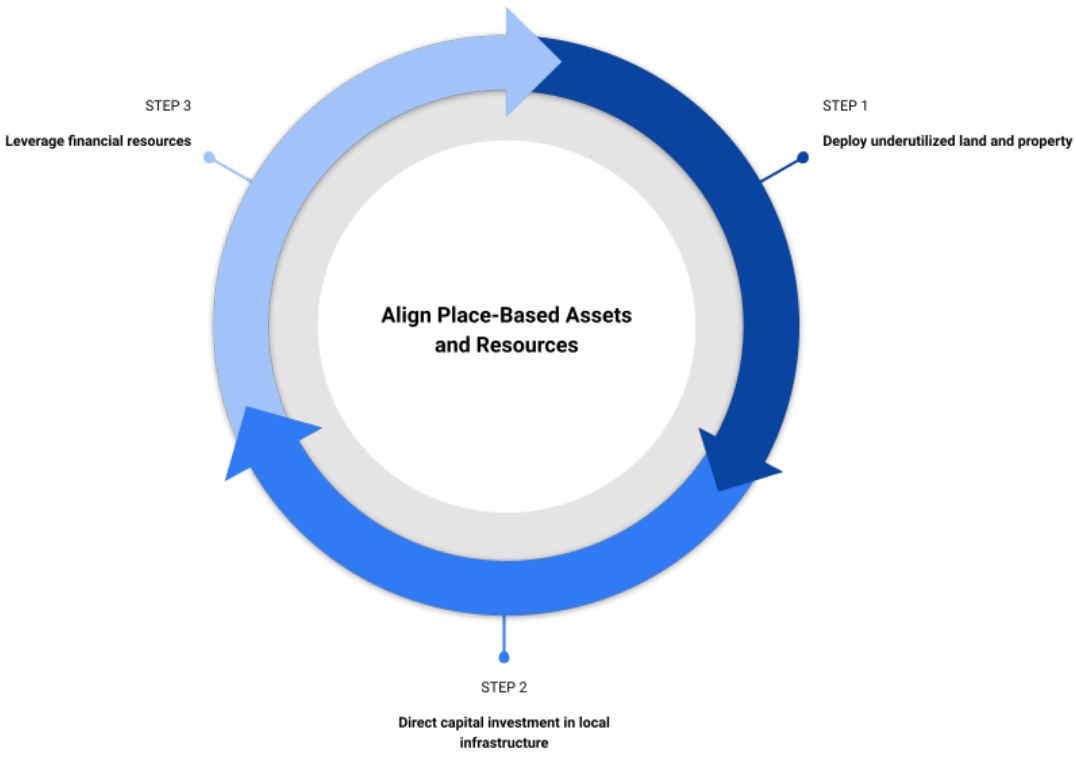
Without the Opportunity Zones incentive, some investors might shy away from these communities. With the incentive, investors will scrutinize every opportunity carefully and pose a series of hard-edged business questions: Is this community a place where reinvested capital can be preserved safely during the required holding period? Is it a place with the opportunity to achieve additional capital gains that can be sheltered from future taxation?

A clear understanding of a community’s needs and assets will allow local leaders to highlight promising investment opportunities and ensure that the investments made align with the community’s highest priorities. The following elements are vital for communities to consider and understand when developing effective, comprehensive plans for revitalization and ongoing economic growth in their Opportunity Zones.



Align Resources

After developing a shared understanding of community needs and investment opportunities among potential investors and local stakeholders, the next step for community leaders is to use this understanding to align local assets and resources to achieve common interests.



Deploy Underutilized Land And Property

Inexpensive or underutilized land and property can be critical tools for catalyzing development in Opportunity Zones. In places where local actors can donate public or private vacant or underutilized land or sell it at a discount, the economics of a given project may change dramatically. With no-cost or low-cost land or property, investments that otherwise would not be financially feasible can become possible. This is a key leverage point for local leaders to be able to support development that meets the needs of their community.

Many Opportunity Zones already include retail centers, business corridors, and residential or industrial zones that may contain underutilized properties that can be adapted and reused. Local leaders should create an inventory of such properties, identify who owns them and work with the owners to put these assets to use toward community development goals. If the properties can be made available at reduced cost or with less regulatory delay, investors who have been shown their potential for redevelopment can leverage newly aligned Federal and State programs to move projects forward.

This kind of alignment depends on the cooperation of many types of landowners, including Federal, State, and local governmental entities; nonprofits; anchor institutions; community development organizations; and current private owners.

Direct Capital Investments In Local Infrastructure

In economically distressed communities, inadequate infrastructure is a result of historic disinvestment and can stand in the way of attracting renewed investment. To support Opportunity Zone projects, local leaders should align their capital improvement plans with the infrastructure improvements that are needed most by the industry sectors expected to drive demand for space in the region.

In some cases, Federal support may be available for infrastructure improvements. In other instances, QOF investors may commit voluntarily to community-benefit agreements that provide for privately financed infrastructure improvements. In other cases, it may be necessary to employ such funding mechanisms as a Tax Increment Financing district, which allows improvements to be paid for out of increased future tax revenues from what will then be a higher value use of the property.

Leverage Financial Resources

For many communities with Opportunity Zone designations, several potential sources of financial support exist to facilitate QOF projects, as well as parallel efforts in community revitalization and wealth building. In many cases, one source of financial support can reinforce another. Local leaders should be on the lookout for funding that can both support a QOF project and improve the environment for follow-on investments. The following are some categories of financial resources that are being leveraged, separately or in combination, starting with Federal supports that flow through State and local economic ecosystems.

Federal Resources

More than 270 Federal grants and programs have aligned with the Opportunity Zones initiative. In many instances, proposals or grant applications affecting areas that have been designated as Opportunity Zones will be given funding preference by Federal agencies. Local leaders should

seize this advantage to improve the likelihood of securing Federal funding to support local development and complement QOF investments in their Opportunity Zones. Grants are available from numerous agencies and departments across the Federal government.

Such grants may be used to decrease project costs, make urgently needed investments in infrastructure, or ensure that Opportunity Zone investments result in continuing community revitalization. Localities that may not have a specific grant development office yet should work with their State government experts for technical assistance.

Because many Federal and State programs have been aligned to offer additional benefits for Opportunity Zones, it may become easier to obtain planning grants that will enable communities to plan for and obtain investments that will be made only later in the revitalization cycle.

State Funding and Incentives for Economic and Job Development

State governments offer many incentives for developers and businesses, including income tax credits based on job creation or research and development (R&D), property tax abatements to reward new investment, and even cash incentive grants for business expansion or relocation. In many instances, these incentives have become part of the tool set used by QOF managers to attract new, high-quality employers to an Opportunity Zone.

Good sources of information on State incentives include local and regional economic development associations, trade magazines that cover the business of selecting industrial sites, and national level policy monitors at the National Governors Association and the National Conference of State Legislatures. Examples of existing State incentives that can be leveraged to encourage the growth and development of businesses that choose to locate or expand in Opportunity Zones include the following:

- Tax credits for job creation are offered by most States, although some target especially “quality” jobs in defined categories and/or in certain “tiers” of counties that are suffering economic distress.
- Discretionary cash incentive grants for business expansion are available from “deal-closing” funds, such as the Texas Enterprise Fund, the Arkansas Quick Action Closing Fund, and several others.
- More than 30 States currently offer tax credits modeled roughly on the Federal Research and Experimentation Tax Credit (Internal Revenue Code Section 41), which rewards increased investment in R&D over time by new and existing businesses.
- Many States also offer tax credits to “angel investors” who back what typically are called “qualified” emerging technology businesses. The term “angel investor” refers to wealthy individuals investing their own money, rather than managing institutional money through a formal venture capital fund.

Like the Federal government, many States and localities have modified existing programs, such as those listed above, or created new incentives or grants designed to work in concert with the

Opportunity Zones incentive. Some also have adjusted their tax codes to match Federal treatment of capital gains invested in QOFs. These incentives serve to make investments in Opportunity Zones even more attractive, multiplying the impact of the initiative.

Community Workforce Development Resources

Many local governments have experience leveraging public and philanthropic resources to support community and workforce development. These valuable resources can help support comprehensive redevelopment in Opportunity Zones, because many offer funding streams that fill financing gaps, reduce risk in a way that allows a challenging project to move forward, or complement a QOF investment and empower a community to leverage it further. Examples of local community development resources and incentives include the following:

Local tax credits and exemptions

• State or local grants for workforce development and training

• Support from a local Affordable Housing Trust to fill gaps on residential projects

• Foundation funding for capacity building in community development corporations

• Loan guarantees, loss reserves, or other forms of credit enhancement, ranging from Small Business Administration (SBA)–guaranteed loans to loan collateral that may be pledged by local philanthropies

• Pro bono legal or business advice as brokered by the SBA's Small Business Development Centers, (which provide small businesses with management and technical assistance) or other advisory entities

Philanthropic and Nonprofit Resources

Philanthropic foundations are natural supporters of positive outcomes in Opportunity Zone communities. Foundations can support Opportunity Zones through grantmaking to support specific projects, as well as through how they invest their endowment assets. Many foundations across the country already have been active investors in QOFs alongside private investors. In addition, foundations have been supportive of Opportunity Zones in other ways, such as by helping create investment prospectuses and build economic development ecosystems.

At the national level, both the Kresge Foundation and the Rockefeller Foundation have made grants to selected cities to hire managers committed to responsible stewardship in Opportunity Zones, and they have committed endowment funds as guarantees for loss that encourage selected QOFs to take higher risks.

Even relatively small communities should be able to engage the philanthropic community. Regional private foundations (sometimes called "family foundations") have grant-making

capacity and may offer program-related investments in low-rate loans or loan guarantees, either as formal partners in a QOF or by making parallel investments on their own.

Foundations of all sizes generally are seen as thought leaders in impact investing, and many investors in the private sector look to them for models of socially responsible investing. Working with foundations can ensure that the benefits of QOF and follow-on investments yield the desired benefits for residents of the designated Opportunity Zones.

Regional community foundations, which are supported by broad-based donations rather than by an individual family, can be another valuable resource that local leaders can work with for financial support. Engaging community foundations and their donors may identify individuals who are willing to form their own QOFs for direct investment locally or regionally.

Communities are sometimes able to involve operating nonprofits in engaging their own funders.

Private Investors

Local leaders should try to align private investor interests with available assets and the resources described above to advance the community's highest priority projects and promote broader economic growth. By aligning these resources, community leaders can improve the financial feasibility of key projects, making the prospect of investing in the community more attractive. Aligning resources with investor interests also can reduce investors' perceptions of potential risk.

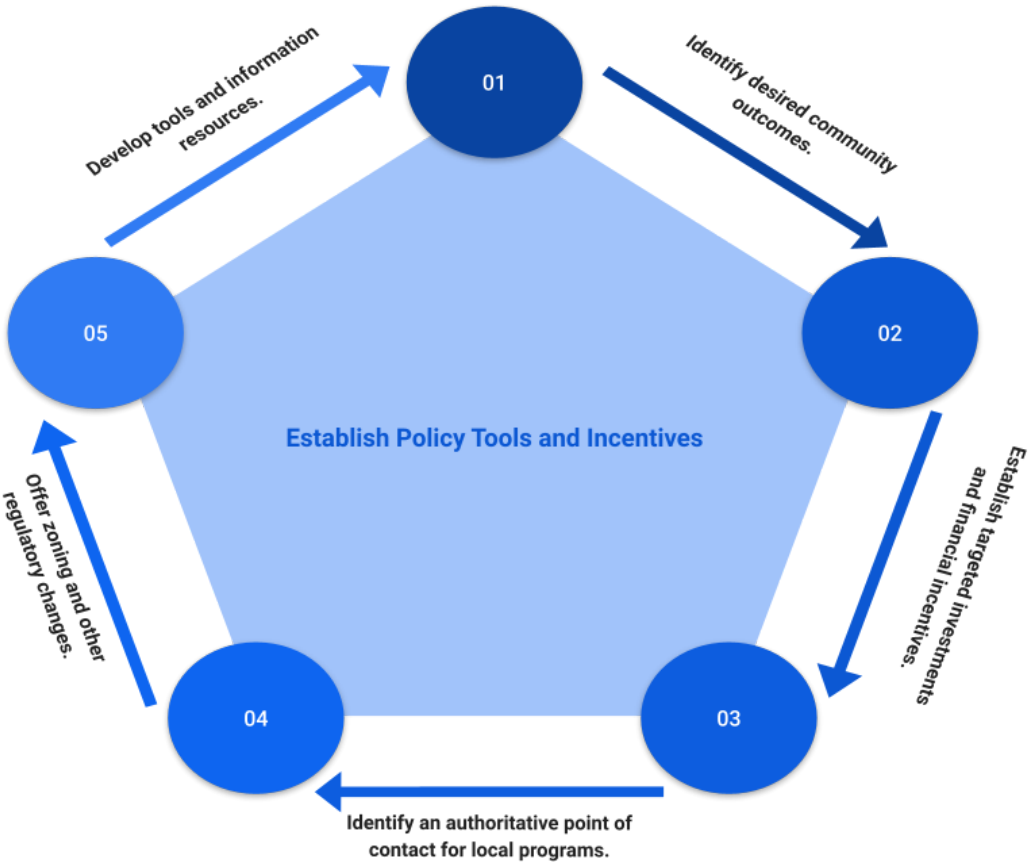
Local leaders should clearly articulate the benefits that local resources can offer to investors and highlight the strongest investment opportunities. For example, local leaders should consider introducing QOF managers to potential investments connected with existing entrepreneurship programs, such as regionally supported business incubators and accelerators, which reduce the risk of early-stage ventures and demonstrate their profit potential.

Similarly, local workforce development programs that support the economic mobility of residents can assure investors of a ready source of human capital to advance their goals. Investments in physical infrastructure and public safety also can be mutually beneficial for the community and potential investors.

Promoting this alignment between investor interests and existing assets and resources serves to increase the likelihood of private investment, and also to ensure that the investments being made are those most likely to advance the community's highest priorities. The alignment of existing assets and resources within Opportunity Zones will position communities for the next step: establishing new tools and incentives to achieve desired outcomes.

Establish Policy Tools and Incentives

The process of developing local policy instruments must begin with identifying the desired community outcomes. Examples of possible outcomes include growth in specifically targeted industries or sectors; promotion of entrepreneurship among community residents; equity and inclusion in local hiring; blight reduction; Brownfield activation; low-income housing development; and prevention of displacement. These outcomes are not mutually exclusive, but the priorities of a given community will shape the development of the most effective local policy interventions. Some of the needs identified in the "Understand" action step will serve to pinpoint the highest-priority outcomes for QOF investments. In other cases, communities should work backward from assessment tools.



States and local governments should leverage existing tools and programs or create new ones to facilitate or better leverage QOF investments. Provided that the desired outcomes for an Opportunity Zone have been identified and agreed upon, the designation offers the opportunity to layer additional, highly targeted incentives at the local level, leveraging the more general support available from other levels of government and from the private sector, while preserving local government as the government closest to the community.

Some targeted programs may be modeled after examples from the State level of government; others may come from the traditional municipal toolset, as authorized by State law. Local governments should explore any of the following:

• Use of local financial incentives, such as tax credits and abatements, which can be structured to be contingent on specific community outcomes, such as new job creation or local hiring

• Creation of tax increment financing districts, which can allow improvements within the district to be financed by increased future tax revenues resulting from economic growth

• Reduction of fees for municipal services, which can reduce overall project costs, to promote projects that meet specific local priorities

• Support for local nonprofit job-training programs, which can improve attractiveness for investors as well as opportunities for residents

• Support for local business incubation, which can promote a strong economic ecosystem while also creating opportunities for local entrepreneurs

• Elimination of harmful regulatory barriers that stifle entrepreneurship and innovation

Although generic incentives and services already may exist as part of a locality's economic development apparatus, in the fast-moving and highly competitive environment opened up by the Opportunity Zones initiative, QOF managers and their investors will appreciate knowing that local leaders have fine-tuned these offerings to meet the needs of investors in Opportunity Zones.

Potential investors want to know who has quick and accurate answers to their questions about what kinds of leveraging support are available and who is responsible for delivering those supports. Many cities have created Chief Opportunity Zone Officers as the primary points of contact for the local community, QOFs, and other developers and stakeholders. Whatever title is used, local leaders should designate a specific and authoritative point of contact for such information. In some instances, these positions are funded through foundation support.

In addition to financial incentives, other functions under local control can affect which projects become easier and more attractive for investors to support and for developers to execute, either as part of a QOF-financed project or as a follow-on investment in community renewal. Examples of regulatory policy changes that localities should explore include the following:

• Up-zoning, which allows more bulk or density than was previously permitted in an area without obtaining special approval, thereby making certain projects more financially attractive than they would be otherwise

• Targeted zoning changes, which enable uses that might not otherwise be permitted in a neighborhood without going through the process of requesting a zoning variance

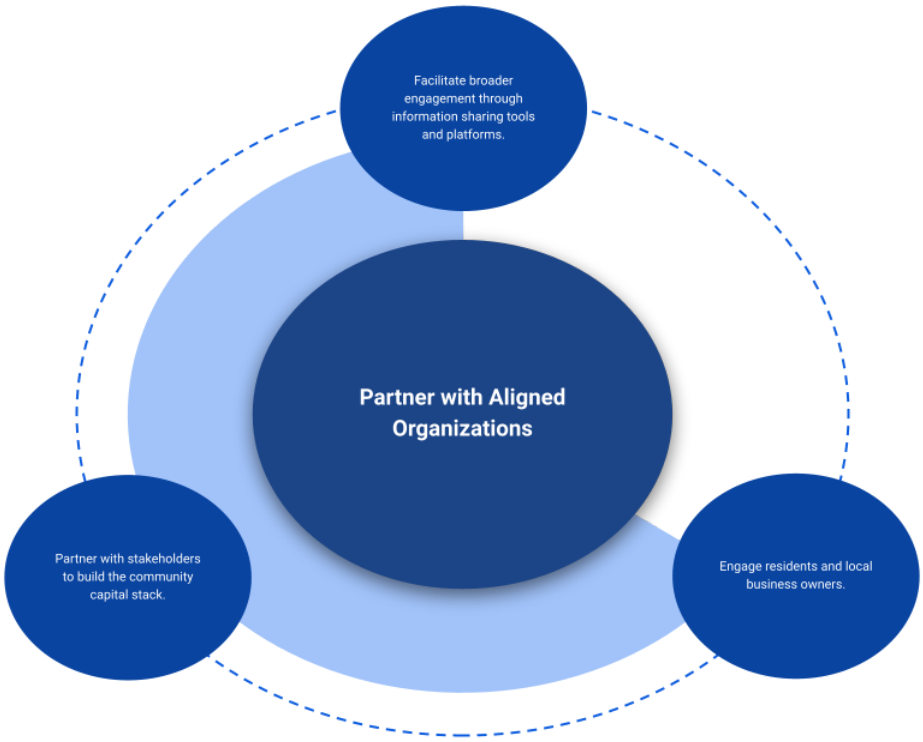
• Expedited permitting and reviews, which reduce the time and, ultimately, the overall cost of property redevelopment

Local leaders should develop information resources that provide investors with information on high-priority, development ready projects. Many localities have already created investment prospectuses. See the resource below for a comprehensive description of the contents of the typical prospectus. Other cities have created or participated in online platforms to share information on promising development opportunities in or around Opportunity Zones.

Some localities also engage in direct matchmaking between QOFs and owners of property with high potential for adaptive reuse. Establishing local tools and incentives in alignment with State, Federal, and private resources prepares local leaders for the critical implementation stage: partnering for local impact.

Partner with Aligned Organizations

Local partnerships are critical for advancing economic development in Opportunity Zones. Local leaders play an important role in creating and strengthening partnerships among public, private, and philanthropic sector stakeholders. Local leaders should also ensure that residents and local businesses are engaged in Opportunity Zone plans and programs. This engagement will increase the likelihood that Opportunity Zone activities are aligned with the community's highest priorities.



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Community-Based Organizations

Community-based organizations (CBOs) in neighborhoods generally focus on providing services to residents, building housing, and advocating for jobs development. These CBOs may or may not have strong relationships with economic development directors at any level of government. Local leaders should work hard to build strong relationships between CBOs and government economic development offices, because partnerships built on mutual trust will empower communities to choose and support activities that best advance equitable and inclusive growth within an Opportunity Zone.

Good communication will unlock government financial resources that can be leveraged, as well as skilled advice from government managers with experience in economic development, workforce training, K–12 education, housing and community development, and public infrastructure investment. Participation by the full range of experts helps align all available resources with the needs of employers and residents within an Opportunity Zone.

Nonprofits and Philanthropic Organizations

In areas where robust partnership among sectors does not yet exist, nonprofits and philanthropies can play an important convening role, consolidating and sharing best practices and working together to develop strategies that best fit their designated Opportunity Zones. Regional or statewide nonprofits can bring to bear Chapters learned in Opportunity Zones outside of the immediate region, elsewhere in the region, or across the State. Leveraging the convening power of nonprofits could be particularly useful for smaller counties, towns, and rural areas that may not have the internal capacity or expertise to maximize the Opportunity Zones incentive.

Anchor Institutions

Anchor institutions — such as colleges, universities, and medical centers — located in or near an Opportunity Zone can undertake many of the following activities:

• Targeting their purchasing operations to support locally based small and medium-sized businesses;

• Offering career ladders to residents who want to retrain and add to their skills;

• Supporting the housing needs and choices of employees at all levels who choose to live in or near an Opportunity Zone;

• Engaging in research on Opportunity Zones, with the side benefit of providing data collection and analytical capability to the local community; and

• Transferring scientific and technical knowledge via formation of startups that can drive vibrant occupancy in a designated Opportunity Zone.

• Finally, educational institutions that teach entrepreneurship to their students can make this same instruction available to community residents who want to build or expand a business within an Opportunity Zone.

Industry

Local leaders are making special efforts to engage industry in the community capital stack. Business leaders should be drawn proactively into dialogue about community development. The focus should extend well beyond such financial institutions as banks to include operating businesses in Opportunity Zones, as well as the larger businesses that comprise a citywide or regional chamber of commerce or business partnership.

The Opportunity Zones initiative seeks to influence future investments in underserved areas, not just by the specific tenants targeted by a property developer, but by the regional business

community as a whole. The more regional industry leaders know about positive developments in an Opportunity Zone, the more likely they are to consider future investments in it.

Engage Residents and Local Business Owners

During the course of the Opportunity Zones initiative, community wide partnerships will be important to the success of neighborhood revitalization efforts that build on Opportunity Zone designations and benefits. Understanding complex systems and making investments constructively requires many different perspectives and players in addition to residents and local business owners.

Working in coalitions can align the vested interests of individual organizations by uniting action and broadening legitimacy through effective community engagement. Local leaders should build formal partnerships that create synergy and enable community support for rapid change and development.

Facilitate broader engagement through information- sharing tools and platforms.

Community partnerships that draw on all elements of the capital stack can ensure that the best and most sustainable projects can be financed and brought to successful completion. To make this process work, communication is key. It is important that community partners and investment stakeholders convene regularly to discuss priority projects. Effective engagement requires articulation of a shared vision and demonstrated respect for the time and contributions of all participants.

Local leaders in many communities have been taking this approach to proactively share information and build trust. To ensure that local programs and collaborative efforts have the desired outcomes, local leaders should think proactively about how they will measure the impact of Opportunity Zone investments and related programs, as discussed in the following step.

Measure the Impact

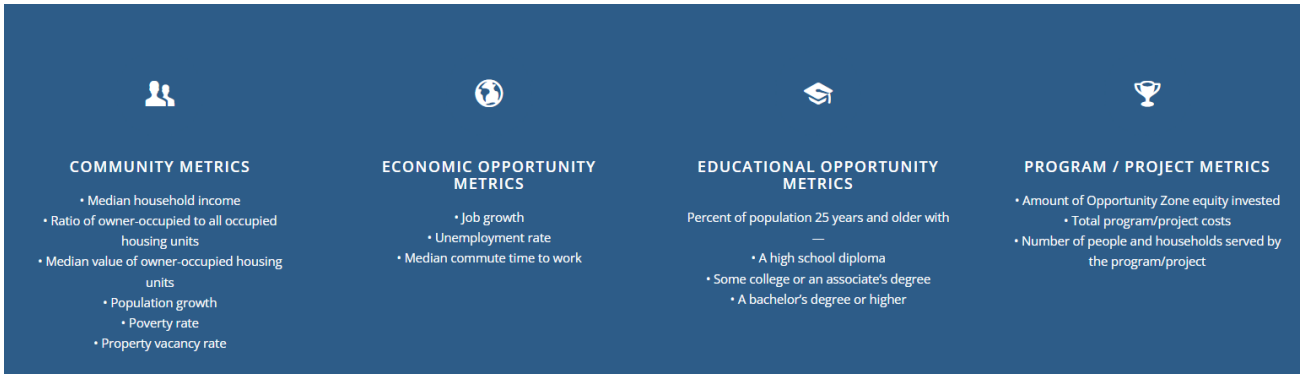
Depending on the nature of the partnerships struck between Opportunity Zone residents and other components of the community capital stack, it may be important to track different measures of success. Guided by the specific outcomes agreed to at the local level, leaders should plan to measure not just the number and value of QOF-financed investments, but also their direct impacts on employment opportunities and housing stock, along with the indirect results of community improvements that are stimulated by newly mobilized government resources or by new private investments. Ongoing monitoring allows stakeholders to identify obstacles or opportunities and suggests when changes to the program could produce greater community benefit.

Identify key indicators and metrics

When identifying the most useful metrics to track based on locally agreed-upon goals, leaders should be guided by several broad principles. Ensure objectivity. To ensure objectivity in measuring and assessing impact, local leaders should explore opportunities to partner with external entities that are not involved in managing the initiative and do not stand to benefit.

Colleges, universities, think tanks, and other research organizations may prove reliable, objective, and credible partners for this purpose. Involving an objective partner at the earliest stage will help ensure that reasonable metrics are tracked. Isolate program impact. The measurement methodology used should go beyond the traditional measurement of change in the value of baseline socio economic indicators. A valid measurement must distinguish the impact of the projects from changes in socioeconomic variables that would have occurred in the community even if it had not received benefits from the Opportunity Zones initiative. The net impact of the initiative on the target community may be measured by employing one of the following techniques:

1. comparing the outcomes of the initiative to the outcomes that likely would have occurred had the initiative not been implemented, or
2. comparing the outcomes of the initiative with those of a community that does not have designated Opportunity Zones.



Collect Information On Impact Over Time

To be useful, an evaluation regime must collect data on a project's impact over time. Local leaders should be aware that Federal agencies are working hard to make data that are useful in this process available. IRS Form 8996 — Census data provides rich information on a broad range of outcomes of interest. Yet this information has its greatest value if matched to data on QOF investments. IRS Form 8996, used by QOFs to report their activities, promises increasingly useful information over time. In December 2019, the IRS released a revised Form 8996 that now requires QOFs to report on the location, amount, type, and date of their investments.

One of the five work streams of the White House Opportunity and Revitalization Council is the Measurement work stream, which is led by the Council of Economic Advisers. Federal agencies engaged in this work stream are continually evaluating their own metrics that assess the effectiveness of their actions taken to benefit Opportunity Zones. Localities should stay informed about the work and publications of the Council, which will guide them in evaluating the impacts of the Opportunity Zones initiative on their communities.

Chapter 11: The J-Curve Effect

Definition: In private equity, the J curve is used to illustrate the historical tendency of private equity funds to deliver negative returns in early years and investment gains in the outlying years as the portfolios of companies mature. The steeper the positive part of the J curve, the quicker cash is returned to investors.

Private equity funds may take early losses because investment costs and management fees initially absorb money.

Understanding the J-Curve Effect

It sounds like the name of a spy thriller, but the J-curve effect is a phenomenon that happens during the early years of an investment in traditional private equity. During the investment period, fees are charged, and returns can be slow to come in, because of the way these investments are structured. When a private equity fund launches, investors commit a certain amount of money, which gets drawn down as investment opportunities are identified. That process may take up to three to five years, but investors typically pay management fees on the full amount of capital they committed, starting on day one.

For example, if an investor commits $100,000 to a fund that charges a 2% annual management fee, the investor will pay that fee on the full $100,000 in the first year. That is true even if the fund only invests a portion of the amount in the first year. To further illustrate this hypothetical example, let us assume that only $20,000 is invested in the first year, the investor would pay $2,000, effectively resulting in a 10% management fee on invested capital that first year.

Another factor is that if a private equity fund invests in distressed businesses—the kind that require a turnaround—it would generally lead to even higher upfront costs. And in some cases, funds boost their initial investments in businesses by borrowing money from third parties. If the investments begin to pay off, that senior debt typically gets paid off first before equity investors begin to see returns.

These factors can lead to a net outflow of cash during the early years of a typical private equity investment. When returns are plotted on a graph, it looks like the letter "J." (Some in the industry refer to this as the "valley of tears.")

Three Ways to Smooth the Curve However, there are three ways to smooth out the J-curve, potentially reducing and/or shortening this period for investors:

- Invest in a company that charges fees on invested capital, rather than committed capital.
- Invest in a company that seeks to acquire durable and growing businesses, rather than those in distress.
- Invest through a combination of private equity and debt (also known as private capital) with the goal of generating both income and growth.

The first such strategy is to invest in a company that is established and charges fees when capital is invested. In this way, an investor's capital is not charged management fees until it is put to work.

The second strategy for smoothing the J-curve is to avoid acquiring businesses that need turnarounds. These can be strong performers over the long haul, but they carry higher risk and often need repeated infusions of working capital early on, meaning a longer period of negative cash flow for investors before the investment may generate a return. Instead, invest in a company that focuses primarily on strong, healthy businesses that need capital in order to grow (rather than recover).

Third, invest in a strategy that often owns both the controlling equity positions alongside debt positions (also referred to here as private capital), rather than equity alone. The addition of private debt is appealing as the interest payments may generate income. When distributed, that income can further flatten the J-curve.

To be clear, private capital is a complex investment strategy, and it is not right for everyone. It requires that suitability standards be met, and it requires a long-term time horizon and a greater tolerance for risks and fees compared to traditional investments. That said, a private capital investment may help investors access some of the upside using a private equity strategy while potentially reducing some of the drawbacks, including the J-curve.

J Curve in Private Equity

In private equity, the J Curve represents the tendency of private equity funds to post negative returns in the initial years and then post increasing returns in later years when the investments mature that requires the fund to pay down its debt with some or all of the excess cash flow.

Frequently, financial analysts say that IRS Opportunity Zone Tax breaks cannot turn a bad investment into a good one. It is important to understand that the Opportunity Zone program has a built in downside protection on additional or subsequent investment into a Qualified Opportunity Zone Fund.

This downside protection was originally built into 1400-Z(2)(b)(2)(A)(i). It clearly shows that the amount of gain that is included in GROSS INCOME is the LESSER of the amount of the original capital gains and the fair market value of QOF investment. The purpose of this LESSER amount of the original capital gains is the catalyst of possible downside risk for the investment.

Here is a clear example of what we are talking about.

Let's say a $100,000 is placed in an QOF by an investor in 2019 tax year, which would in turn reduce their basis for deferred capital gains due by 2026 by $15,000 (15% of $100,000). You will also need to assume that the investor has a 30% combined federal, state and local capital gains tax rate.

If the investor did not have the Opportunity Zone tax rate provision and reduction, that investor would have to pay $30,000 in 2019 at a 30% rate on $100,000. In 2026, with the Opportunity Zone tax incentives, that same investor would only have to pay a MAXIMUM $25,500 in tax, in their best case scenario. The math is the following $100,000-$15,000 = $85,000 x 30% = $25,500. At the minimum, their savings is at least $4,500. Why do we highlight the MAXIMUM Taxes to be paid. Because the LESSER clause on fair market value comes into play. Let's discuss two possible scenarios in fair market value.

1) In the case where the fair market value of QOF investment increases, the investor would owe the exact same amount of $25,000 as in our example. Let's say the investment increases by 50% over a seven year time frame, the LESSER of the original capital gains ($100,000) and the fair market value of the QOF (i.e. $150,00) stays at the $100,000 original capital gain. The $25,000 tax is applied to the above LESSER of original capital gains $100,000, resulting in a $4,500 tax savings, increasing the investors effective rate of return from 50% to 54.5% after taking that savings into account. That $4,500 tax savings will hold true if the fair market value stays the same or increases during the period.

2. In the case where the fair market value of the QOF decreases, the effective taxes in 2026 will be less than the projected $25,500. Let's assume the QOF investment value decreases by a 50% of the seven years, the LESSER of the original capital gain ($100,000) and the market value of the QOF would be $50,000. This would result in taxes of $10,500, which is ($50,000-$15,000) = $35,00 x 30% = $10,500. This results in a $19,500 tax reduction. With this scenario, a 50% loss turns into a 30.5% loss after taking into consideration a $19,500 tax reduction.

It is important to understand that this is applicable even if the QOF investment is not sold by the investor. The QOF usually provides the market value to the investor, which enables them to see if the LESSER rule is applicable.

This can show that when you analyze QOF investments that follow a J-Curve, many will deliver the highest after-tax returns to their investors. J-Curve market patterns occur when the QOF investment decreases in value in the early years of the investment and grows at a fast pace in later years. The Opportunity Zone IRS tax rules were designed to incentivize capital investment in OZone cities and businesses where there is usually initial risk yet in the long run provide long term benefits to their local economic communities and economy.

Reducing Downside Risk

A common saying among financial advisers is, “the opportunity zone tax incentives cannot make a bad investment good.” However, the design of the reduced capital gains on the original investment provides some downside protection on the subsequent investment into a Qualified Opportunity Fund (QOF). That design feature is found in section 1400-Z(2)(b)(2)(A)(i) and states that the amount of gain included in gross income is the LESSER of the amount of original capital gains and the fair market value of the QOF investment. This LESSER clause results in the potential for reducing the downside risk in a QOF investment.

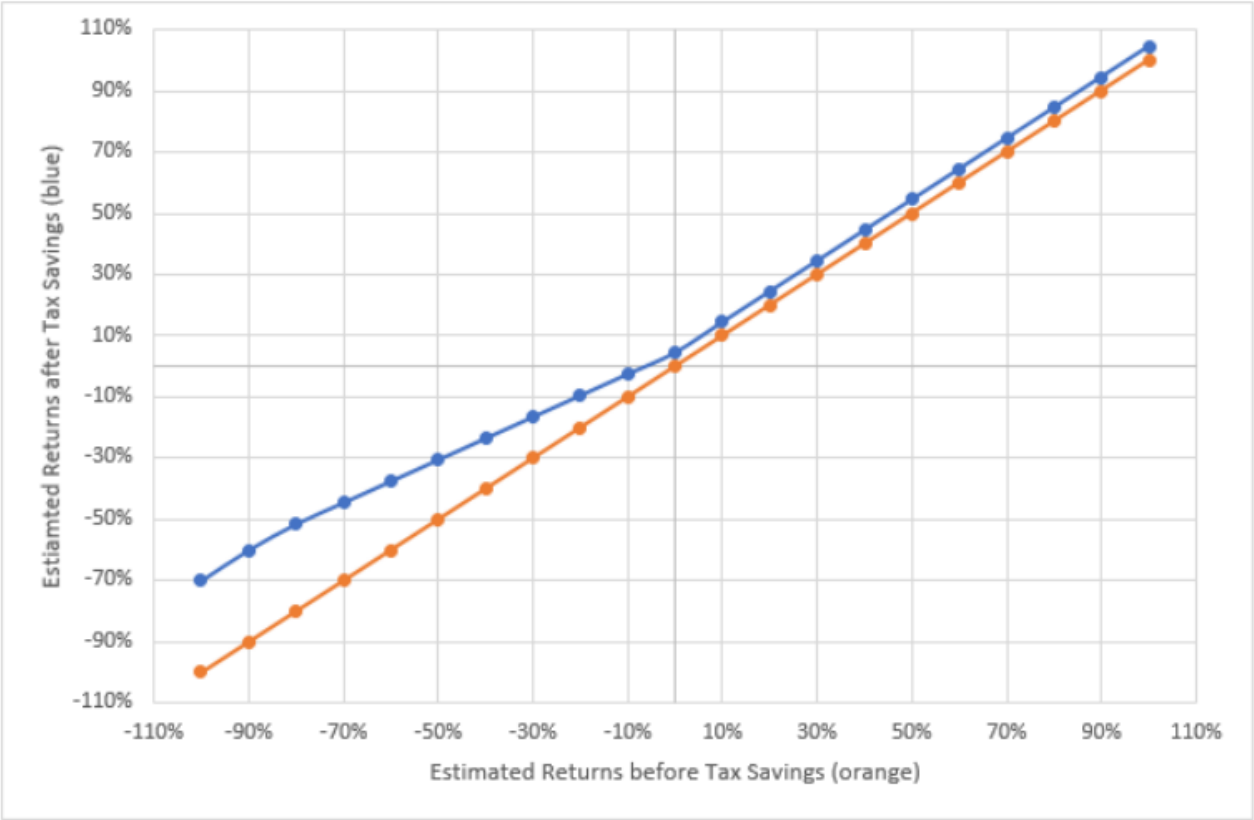
Let’s work through an example.

Suppose the investor puts $100,000 in capital gains into a QOF in 2019, reducing the basis for the deferred capital gains due at the end of 2026 by $15,000, which is 15% of $100,000. We will also assume that the investor has (and will have) a 30% combined federal, state and local capital gains tax rate. Without the opportunity zone (OZ) tax reduction, the investor would have owed $30,000 in taxes in 2019 (30% of $100,000). In 2026, with the OZ tax reduction, the investor will pay AT MOST $25,500 in taxes, which calculates as 30% of ($100,000 - $15,000) or 30% of $85,000. Therefore the investor’s tax savings are locked in at least $4,500.

Why the emphasis on AT MOST? Because the LESSER clause on fair market value comes into effect. Let’s consider two cases for the change in fair market value, up and down:

1. If the fair market value of the QOF investment goes up, the investor will owe the same $25,500 as above. For example, if the fair market value of the QOF investment goes up by 50% over the seven years, the LESSER of the original capital gains (i.e. $100,000) and the fair market value of the QOF (i.e. $150,000) remains at the $100,000 original capital gains. So, the taxes payable are $25,500 as calculated as above. In effect, the investor's return increases from 50% to 54.5% after considering the $4,500 in tax savings. The same $4,500 result holds whenever the fair market value stays the same or increases.

2. If the fair market value of the QOF investment goes down, the taxes paid in 2026 will be less than the $25,500 above. For example, if the market value of the QOF investment goes down by 50% over the seven years, the LESSER of the original capital gains (i.e.$100,000) and the market value of the QOF (i.e. $50,000) becomes $50,000. So the taxes payable become $10,500, calculated a 30% of ($50,000 - $15,000) of 30% of $35,000. In this case, the tax savings are $19,500. In our example here, the 50% loss becomes a 30.5% loss after considering the $19,500 in tax savings. The common financial advice should be reworded as “the opportunity zone tax incentives can make a bad investment, not as bad.”



We note that this applies even if the investor does not sell the QOF investment. The QOF will typically provide the investor with a market value of their investment in order to see if the lesser rule applies. In fact, a QOF investment that follows a J-curve in market value may provide the highest after-tax returns.

A J-curve pattern is one where the market value of the QOF investment falls in the early years but grows rapidly in the subsequent years. We believe that this was an intention of the opportunity zone legislation as it encourages capital into communities and businesses that may initially have more risk but will provide long-term economic benefits

Chapter 12: State and Local Incentives

Federal tax reform enacted in 2017 resulted in a program called qualified opportunity zones (QOZs) which enables tax savings through investment in distressed areas. But did you know that projects and businesses receiving opportunity zone fund investment aren't precluded from seeking other credits and incentives?

In fact, state and local economic development agencies may be more likely to direct public dollars toward QOZ projects or businesses in the form of income tax incentives, hiring incentives, non-tax incentives, or property tax reductions.

Here are a few state, local, and federal tax credits and incentives businesses should consider when investing in QOZs.

1. **New market tax credits (NMTC).** Similar to QOZs, the NMTC program offers incentives for investment in marginalized areas. Areas that qualify for QOZ credits frequently qualify for NMTC also. The NMTC offers third-party, interest-only forgivable loans to projects in severely distressed census tracts across the U.S. This incentive is designed to encourage investments that create significant community benefits such as job creation, access to healthy foods, or medical care. The NMTC loan is added to the capital stack, reducing a project's overall investment needs. After seven years, the loan is forgiven, resulting in a significant back-end benefit to a project. Funds can be used for real estate and construction, machinery, and equipment, and even operating costs. It is available to for-profit and not-for-profit businesses.

2. **Tax increment financing (TIF).** Municipalities use TIF to incentivize property development in distressed areas – areas that frequently overlap QOZs. TIF allows municipalities to pledge a portion of the property tax increment, resulting from project investment, to reimburse the developer for certain eligible costs. The combination of TIFs and QOZs may be particularly attractive to real estate investment trusts (REITs) and real estate developers as a way to reduce project development costs.

3. **State job and investment credits**. State job credits incentivize companies that create or retain jobs. State investment credits incentivize capital investment. States frequently offer enhancements to these credits for projects in distressed areas – again, often overlapping with QOZs.

4. **Work opportunity tax credit (WOTC)**. WOTC is a federal job-creation credit designed to incentivize businesses that hire disadvantaged employees. For-profit companies that frequently hire from lower-income or other disadvantaged groups may benefit from using WOTC for QOZ projects to further improve a project's return on investment.

5. **In-kind contributions.** States and municipalities can contribute land or infrastructure improvements to projects in order to encourage project development. These contributions are likely to occur in QOZ areas. These in-kind contributions can benefit a wide range of clients and can result in improved project viability.

Opportunity zones are an important addition to the economic development toolbox, but they should not be viewed in a vacuum. Consider the ways state and local incentives can increase the total benefits to QOZ projects, increasing project feasibility and improving return on investment.

What Is the State Tax Treatment of Opportunity Zone investments?

How each state treats the federal deferral of gain on opportunity zone investments generally depends on a state's:

- IRC conformity tie-in date; and
- starting point for computing income tax liability.

Most state conformity tie-in dates adopt the federal treatment of opportunity zones. In some instances, states have specifically adopted the federal opportunity zone provisions even if they do not adopt all federal tax provisions.

The computation of corporate income tax liability in most states begins with federal taxable income.

To calculate individual state income tax, most states start with:

- federal adjusted gross income (AGI); or
- federal gross income.

So, state income taxpayers can generally defer gain on opportunity zone investments for the same period as provided under IRC Code Sec. 1400Z-2.

What are some state-specific limitations?

A few states limit tax deferral on the gain to in-state qualified opportunity zone designations or include other restrictions.

Restrictions include:

- limiting tax deferral on the gain to in-state qualified opportunity zone designations;
- limiting tax benefits available under the opportunity zones program to certain tax years;
- enacting minimum wage requirements;
- prohibiting specified types of entities from participation; and
- requiring certain application and reporting requirements.

Arkansas allows tax deferral on the gain for state income tax purposes if the qualified opportunity zone is located in the state. Hawaii limits the scope of the tax benefits to opportunity zones designated by its governor.

Maryland enacted legislation limiting tax benefits to certain tax years and applying minimum wage requirements. Further, Maryland legislation created additional application and reporting requirements for lead-based paint affected properties in qualified opportunity zones.

What other incentives do states provide?

Additional tax incentives designed to guide investors to in-state low-income areas are used by a handful of states.

Ohio allows an income tax credit for investments in Ohio-designated opportunity zones for individuals, trusts, estates, and pass-through entities.

West Virginia allows taxpayers to take a deduction for certain income from business activity in West Virginia opportunity zones on top of the federal exclusion. This generally eliminates state income taxes for West Virginia qualified opportunity zone businesses for up to ten years.

In addition to the federal deferral of gain, Wisconsin allows a subtraction from income for individual taxpayers for an investment in a Wisconsin qualified opportunity fund that invests in an in-state qualified opportunity zone. An additional capital gain exclusion or basis adjustment is allowed for Wisconsin corporate taxpayers for investments in a Wisconsin qualified opportunity fund. Both of these tax provisions are applicable to taxable years beginning after 2019.

Chapter 13: IRS & SEC Compliance

What are the risks of investing in Opportunity Zones?

While investors are right to be intrigued about Opportunity Zones, we want to highlight three potential risks that investors should be aware of as they explore this new market.

Navigating Regulatory Uncertainty

Given that regulatory guidance for Opportunity Zones is fairly set at this point, we believe investors should favor QOF investment strategies with minimal regulatory uncertainty. For example, potential investors should consider Opportunity Zone Funds that plan to invest in real estate, as this sub-sector of the market is well understood. In contrast, market players are still waiting for further clarification on rules about investing in operating businesses located within Opportunity Zones.

Sizing Risk

An increasing number of Opportunity Zone Funds are entering the market. According to OZFunds.com there are now more than 800 funds in the market seeking a total of $150 billion in capital, with several funds targeting $500 million or more. When navigating this market, potential investors should be careful to invest with Opportunity Zone Funds that are appropriately sized to the market opportunity, keeping in mind that Opportunity Zone Funds have a limited amount of time to deploy investor capital. For example, an excessive influx of capital has the potential to increase competition for deals and distort prices. To preserve flexibility, investors should consider Opportunity Zone Funds that are large enough to be diversified across geographies and small enough to be nimble and price disciplined.

Conflicts of Interest

For Opportunity Zone Funds, there is always the potential for a conflict of interest because the tax benefits only accrue to the investor, not the Fund's GP. To illustrate this challenge, consider the requirement that Opportunity Zone Funds must invest 90% of their assets in designated Opportunity Zones for at least 10 years. But if the Fund receives an attractive offer and decides to sell an asset before the 10-year holding period is up, thereby dipping below the 90% threshold, the GP will receive a performance fee, but the LP would forfeit their tax incentive. In talking to a number of Opportunity Zone Funds, we have yet to find one that has adopted legally binding language that would obligate them to protect the investor's tax benefit.

Local State and Federal Compliance

Most states recognize the federal deferral of gain on qualified opportunity zone investments. A few states limit tax deferral on the gain to in-state qualified opportunity zone designations or include other restrictions. Others provide additional incentives for investments made in low-income communities in the state.

These incentives designed to further encourage taxpayers to invest in opportunity zones in the state include:

- income tax deductions;
- additional capital gain exclusions or basis adjustments; and
- tax credits.

Penalties for Non-Compliance

New Regulations for Compliance:

2. EXTENSION OF 90% TEST FOR QOF: Under the OZ regulations, a QOF in required to invest90% of its assets into qualifying opportunity zone property within 6 months and at the end of the taxable year (i.e., December 31st for a calendar year QOF). If the 90% test is not met, then the QOF is subject to penalties on a portion of the funds in the QOF.

3. EXTENSION OF 30 MONTH SUBSTANTIAL IMPROVEMENT TEST: Under the final OZ regulations, one of the way tangible properties qualifies as qualified opportunity zone business property is to meet the "substantially improved" test within 30 months of acquisition. The new relief provides for a tolling of the 30-month period beginning April 1st, 2020 and ending December 31st, 2020. In other words, properties that are acquired during or that have previously been acquired within an opportunity zone after 1-1-18 and which are under construction will be provided with an additional 9 months to satisfy the substantial improvement test.

Even if a business fails this test, there are two fallback provisions:

● If a business fails to be qualified as of a test date, the business gets a one-time 6-month cure period (until the next test date). *Note the cure only provides relief for the failure to meet the 90% holding period test
● If the cure period has already been used, a fund may still be able to
avoid the typical penalty for investing in non-qualified OZ businesses if
it can show "reasonable cause" as to why it could not keep the business in compliance or shed the investment.

If the qualified OZ business fails to meet the requirements, the QOF will own 0% qualified OZ property and will be subject to a monthly penalty of $22,500 ($9 million x 3% ÷ 12). Failure for an entire year would result in a penalty of $270,000 Generally, should a QOF fail to satisfy the 90% test, the QOF must pay a penalty for each month of the failure. This penalty is equal to the amount by which the QOF's actual QOZ property falls short of the required 90% multiplied with the underpayment of tax rate for that month. This rate is the short-term AFR plus 3%.

SEC and OZ Funds

The adoption of the Tax Cuts and Jobs Act in December 2017 established the "opportunity zone" program to provide tax incentives for long-term investing in designated economically distressed communities. The program allows taxpayers to defer and reduce taxes on capital gains by reinvesting gains in "qualified opportunity funds" that are required to have at least 90

percent of their assets in designated low-income zones.

Interests in a qualified opportunity fund offered and sold to investors will typically constitute securities within the meaning of federal and state laws except in limited circumstances. As a result, such qualified opportunity funds must comply with all applicable regulations of the SEC and the securities regulators in the states where they are doing business, in addition to other applicable regulations, such as those of the Internal Revenue Service and Treasury Department.

Are Interests in Qualified Opportunity Funds "Securities"?

QOFs are statutorily defined as "any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property." Under federal and state laws, securities are defined broadly to include shares of stock, limited partnership interests, membership interests in an LLC, notes, bonds, and investment contracts. Interests in a QOF offered and sold to investors will typically constitute securities within the meaning of federal and state laws except in limited circumstances (such as a QOF established and operated as a general partnership where each partner has a substantial role in its management).

As a result, QOFs must comply with all applicable regulations of the SEC and the securities regulators in the states where they are doing business, in addition to other applicable regulations, such as those of the Internal Revenue Service (IRS) and Treasury Department. This includes being aware of, and complying with, applicable provisions such as the registration and anti-fraud provisions of federal and state securities laws.

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Are QOF Offerings Required to be Registered with the SEC and the States or Are Exemptions from Registration Available?

Under the federal Securities Act of 1933 (Securities Act), all offers, and sales of securities must be either (1) registered with the SEC or (2) conducted in compliance with an exemption from registration. State securities laws also require registration or an exemption from registration before securities may be offered or sold in the state. Even if an exemption from registration applies, the offer and sale of the securities are subject to the anti-fraud provisions of the federal and state securities laws enforced by the SEC and state securities regulators (private investors also may have standing to bring claims).

Securities regulators interpret broadly the meaning of the term "offer." For example, advertising a business opportunity could be considered an offer; therefore, it is prudent to assume that efforts to attract investors to a QOF are offers of a security and subject to federal and state securities laws.

Offerings of QOF interests may not need to be registered with the SEC or state securities regulators if an exemption from registration is available. Federal and state securities laws contain several exemptions from registration. For example, some frequently used exemptions from registration that may be available to QOF issuers include:

- Rule 506(b) of Regulation D, which provides an exemption from registration for a private offering to accredited investors and up to 35 sophisticated investors; and
- Rule 506(c) of Regulation D, which provides an exemption from registration for an offering that may be conducted publicly so long as the QOF issuer takes reasonable steps to verify the accredited investor status of each purchaser.

Are there Any Broker Registration Requirements for Those Selling Interests in QOFs?

A person who solicits or refers potential investors to an offering of securities by a QOF or assists in structuring a QOF issuer should carefully consider the broker registration requirements under the federal and state securities laws.

A "broker" is a person engaged in the business of effecting securities transactions for the account of others. Generally, it is unlawful for an unregistered broker (or dealer) to effect any transactions in, or to induce or attempt to induce the purchase or sale of, a security. As a result, absent an available exception or exemption, a person engaged in the business of effecting transactions in securities for the account of others would be required to register with the SEC as a broker. Similarly, state securities laws require registration with the state securities regulator when transacting business as a broker-dealer or agent in a given state, absent the availability of applicable exemptions.

The question of whether a person is a broker turns on the facts and circumstances of the transaction. Over the years, the courts and the Commission have identified certain activities as indicators of broker status. These include, among other things:

- Marketing securities to investors;
- Soliciting investors to purchase or sell a security;
- Assisting an issuer to identify potential purchasers of securities;
- Screening potential purchasers of securities;
- Negotiating between the issuer and the investor;
- Handling customer funds and securities; and
- Making valuations as to the merits of an investment or giving investment advice.

In evaluating whether a person has acted as a broker, no one factor is determinative; all facts and circumstances must be considered, and not all factors need to be present to establish that a person has acted as a broker.

The significance of these activities is heightened where there also is compensation that depends on the outcome or size of the securities transaction — in other words, transaction-based compensation. Securities regulators have long viewed receipt of transaction-based compensation as a strong indication that someone is engaged "in the business" of being a broker. Thus, a person receiving transaction-based compensation for engaging in these activities should consider whether it needs to register as a broker, absent an exception or an exemption.

The sponsor of a QOF may employ persons to market and solicit the QOF to potential investors. While Exchange Act Rule 3a4-1 provides a non-exclusive safe harbor from broker registration for certain associated persons of an issuer, this exemption is contingent, among other things, on the person having substantial duties "otherwise than in connection with transactions in securities," participating in no more than one offering every twelve months, and not receiving compensation that is based either directly or indirectly on transactions in securities. If, however, a fund sponsor were to choose to market the fund interests through its employees, paying them a sales commission, then in those situations, the employees, as well as potentially the employer, may be acting as brokers.

Similarly, a sponsor of a QOF may wish to work with an intermediary that refers potential investors to the fund. An intermediary that is paid compensation for making such referrals or performing the activities indicative of broker status, as discussed above, may be required to register as a broker. As a result, broker registration requirements can apply to a wide range of persons including, among others, solicitors, consultants, finders, promoters, or service professionals (e.g., lawyers, accountants, and others who place investors into a QOF investment in return for a fee dependent on the completion of a successful securities transaction).

Is the QOF Required to Register as an "Investment Company"?

QOFs can also implicate the registration provisions of the Investment Company Act of 1940 (Investment Company Act) and, potentially, the Investment Advisers Act of 1940 (Advisers Act) or related provisions of state securities laws.

The Investment Company Act generally defines an "investment company" as an issuer which:

- Is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
- Is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or,
- Is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire "investment

securities" having a value exceeding 40 percent of the value of its total assets (exclusive of government securities and cash items) on an unconsolidated basis.

Absent an exclusion from this definition or an exemption from requirements to register, entities meeting this definition are generally subject to the registration provisions of the Investment Company Act. As noted above, QOFs typically are pooled investment vehicles through which investors contribute funds to invest in qualified opportunity zones. Depending on the facts and circumstances, these investment vehicles may have to register as investment companies under the Investment Company Act.

Are there Exclusions from the Definition of an Investment Company that Might Apply?

Below are some high-level summaries of exclusions from the definition of "investment company" under the Investment Company Act that might apply:

Private Fund Exclusions - Section 3(c)(1) and Section 3(c)(7)

Section 3(c)(1) of the Investment Company Act states, in part, that an issuer is not an investment company if its outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons or, in the case of a qualifying venture capital fund, 250 persons, and which is not making and does not presently propose to make a public offering of its securities. Section 3(c)(7) of the Investment Company Act states, in part, that an issuer will not be an investment company if its outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers" and it is not making and does not at that time propose to make a public offering of its securities. For purposes of this provision, the term "qualified purchaser" is defined by Section 2(a)(51) of the Investment Company Act.

Mortgage-Related Pools Exclusion - Section 3(c)(5)(C)

Under Section 3(c)(5)(C), an issuer generally will not be considered an investment company if it is not engaged in the business of issuing redeemable securities and if, in part, it is primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. QOFs that primarily invest in qualifying investments may be eligible for the exemption under Section 3(c)(5)(C). However, with some exceptions, the Commission has taken the position that an issuer that is primarily engaged in the business of holding interests in a pooled investment vehicle that invests in real estate generally may not rely on Section 3(c)(5)(C).

Is the Adviser to a QOF Subject to the Advisers Act or Comparable Regulation under the State Securities Laws?

The Advisers Act defines an investment adviser, in part, as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities…" State securities laws generally follow this definition. Absent an exclusion from this definition or an exemption from the requirement to register, entities meeting this definition that have a certain level of assets under management, or who advise a registered investment company, are subject to Commission registration under the Advisers Act. Generally, the level of assets under management triggering Commission registration is $100 million, although in some cases, those advisers with between $25 million and $100 million in assets under management are subject to Commission registration. Otherwise, advisers falling below the $100 million threshold generally are required to register with the appropriate state securities regulator.

Depending on the facts and circumstances, to the extent that an entity involved in opportunity zone investments engages in the activities enumerated in the definition of "investment adviser," it may have to register as such with the SEC under the Advisers Act, or in some cases, the appropriate state securities authorities. Persons and entities that might need to register include (but are not limited to) general and managing partners of partnerships, managing members of limited liability companies, or individuals or entities performing functions of an investment advisory nature.

Common Exclusions from "Investment Adviser" Definition and Exemptions from Registration

Below is a non-exhaustive list of commonly relied upon exclusions from the Advisers Act definition of "investment adviser" and exemptions from registration:

- Professional Exclusion. Section 202(a)(11)(B) excludes from the term "investment adviser" any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of their profession.
- Broker Exclusion. Section 202(a)(11)(C) excludes from the term "investment adviser" any broker or dealer whose performance of such services is solely incidental to the conduct of their business as a broker or dealer and who also receives no special compensation for such services.
- Private Fund Adviser Registration Exemption. In summary, Advisers Act Rule 203(m)-1 provides that an investment adviser that serves as an adviser solely to private funds and has assets under management of less than $150 million is exempt from registering as such with the SEC. However, an investment adviser relying on this exemption must still comply with certain SEC reporting requirements.

Most Opportunity Funds are 506(c) in structure.

SEC Rule 506 Regulation D

Rule 506 of Regulation D provides two distinct exemptions from registration for companies when they offer and sell securities. Companies relying on the Rule 506 exemptions can raise an unlimited amount of money.

Under Rule 506(b), a “safe harbor” under Section 4(a)(2) of the Securities Act, a company can be assured it is within the Section 4(a)(2) exemption by satisfying certain requirements, including the following:

- The company cannot use general solicitation or advertising to market the securities.
- The company may sell its securities to an unlimited number of "accredited investors" and up to 35 other purchasers. All non-accredited investors, either alone or with a purchaser representative, must be sophisticated—that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.
- Companies must decide what information to give to accredited investors, so long as it does not violate the antifraud prohibitions of the federal securities laws. This means that any information a company provides to investors must be free from false or misleading statements. Similarly, a company should not exclude any information if the omission makes what is provided to investors false or misleading. Companies must give non-accredited investors disclosure documents that are generally the same as those used in Regulation A or registered offerings, including financial statements, which in some cases may need to be certified or audited by an accountant. If a company provides information to accredited investors, it must make this information available to non-accredited investors as well.
- The company must be available to answer questions by prospective purchasers.

Under Rule 506(c), a company can broadly solicit and generally advertise the offering and still be deemed to be in compliance with the exemption’s requirements if:

- The investors in the offering are all accredited investors; and
- The company takes reasonable steps to verify that the investors are accredited investors, which could include reviewing documentation, such as W-2s, tax returns, bank and brokerage statements, credit reports and the like.

Purchasers of securities offered pursuant to Rule 506 receive "restricted" securities, meaning that the securities cannot be sold for at least six months or a year without registering them. Companies that comply with the requirements of Rule 506(b) or (c) do not have to register their offering of securities with the SEC, but they must file what is known as a "Form D" electronically with the SEC after they first sell their securities. Form D is a brief notice that includes the names and addresses of the company’s promoters, executive officers and directors, and some details

about the offering, but contains little other information about the company. You can access the SEC's EDGAR database to determine whether the company has filed a Form D.

What Are Blue Sky Laws?

Blue sky laws are state regulations established as safeguards for investors against securities fraud. The laws, which may vary by state, typically require sellers of new issues to register their offerings and provide financial details of the deal and the entities involved. As a result, investors have a wealth of verifiable information on which to base their judgment and investment decisions.

Blue sky laws, which serve as an additional regulatory layer to federal securities regulations usually mandate licenses for brokerage firms, investment advisors, and individual brokers offering securities in their states. These laws require that private investment funds register not only in their home state but in every state where they wish to do business.

Issuers of securities must reveal the terms of the offering, including disclosures of material information that may affect the security. The state-based nature of these laws means each jurisdiction can include different filing requirements for registering offerings. The process usually includes a merit review by state agents who determine whether the offering is balanced and fair for the buyer.

While blue sky laws vary by state, they all aim to protect individuals from fraudulent or overly speculative investments.

The laws' provisions also create liability for any fraudulent statements or failure to disclose information, allowing lawsuits and other legal actions to be brought against issuers. The intent of such laws is to deter sellers from taking advantage of investors who lack experience or knowledge and to ensure that investors are presented with offers for new issues that have already been vetted by their state administrators for fairness and equitability.

There are certain exceptions regarding the types of offerings that must be registered. These exemptions include securities listed on national stock exchanges (part of an effort by federal regulators to streamline the oversight process where possible). Offerings that fall under Rule 506 of Regulation D of the securities act of 1933, for example, qualify as "covered securities "and are also exempt.

Background on Blue Sky Laws:

History of Blue-Sky Laws

The term "blue sky law" is said to have originated in the early 1900s, gaining widespread use when a Kansas Supreme Court justice declared his desire to protect investors from speculative ventures that had "no more basic than so many feet of 'blue sky.'"

In the years leading up to the 1929 stock market crash, such speculative ventures were rife. Many companies issued stock, promoted real estate, and other investment deals while making lofty, unsubstantiated promises of greater profits to come. There was no SEC securities and exchange commission and little regulatory oversight of the investment and financial industry. Securities were sold without corroborating material evidence to support these claims. In some cases, details were fraudulently hidden to attract more investors. Such activities contributed to the hyper-speculative environment of the 1920s that led to inflation of the stock market before its inevitable collapse.

Although blue sky laws did exist during that time period—Kansas enacted the earliest one, in 1911—they tended to be weakly worded and enforced, and the unscrupulous could easily avoid them by doing business in another state. After the stock market crash and the onset of the great depression, Congress enacted several Securities Acts to regulate the stock market and the financial industry on a federal level and to establish the SEC.

In 1956 the uniform securities act was passed, a model law providing a framework that guides states in the crafting of their own securities legislation. It forms the foundation for 40 out of 50 state laws today, and itself is often nicknamed the Blue-Sky Law. Subsequent legislation, such as the National Securities Markets Improvement Act of 1996, preempts blue sky laws where they duplicate federal law.

Chapter 14: Tax Stacking Opportunity Zones

Most commonly used tax credits stacked with the opportunity zone program.

In this Chapter we are going to break down some of the most commonly "stacked" tax programs that overlay with the Opportunity Zone program. Tax "stacking" is a way of using various or multiple tax programs at the same time to create a stronger return on the investment. With Opportunity Zones the idea is to still use those various tax programs at the QOZB and QOZBP level and then pass those "juiced" returns to the QOF which then passes those to the QOF investor.

Low Income Housing Tax Credit

Overview

The low-income housing tax credit (LIHTC) program, which was created by the Tax Reform Act of 1986 (P.L. 99-514), is the federal government's primary policy tool for the development of affordable rental housing. LIHTCs are awarded to developers to offset the cost of constructing rental housing in exchange for agreeing to reserve a fraction of rent-restricted units for lower income households.

Though a federal tax incentive, the program is primarily administered by state housing finance agencies (HFAs) that award tax credits to developers. Developers may claim the tax credits in equal amounts over 10 years once a property is "placed in service," which means it is completed and available to be rented. Due to the need for upfront financing to complete construction, developers typically sell the 10-year stream of tax credits to outside investors (e.g., corporations, financial institutions) in exchange for equity financing. The equity that is raised reduces the amount of debt and other funding that would otherwise be required.

With lower financing costs, it becomes financially feasible for tax credit properties to charge lower rents, and thus, potentially expand the supply of affordable rental housing. The LIHTC program is estimated to cost the government an average of $10.9 billion annually.

Types of Credits

There are two types of LIHTCs available to developers.

- The so-called 9% credit is generally reserved for new construction and is intended to deliver up to a 70% subsidy.
- The so-called 4% credit is typically used for rehabilitation projects utilizing at least 50% in federally tax-exempt bond financing and is designed to deliver up to a 30% subsidy.

This report will also refer to the 4% credit as the "rehabilitation tax credit" and the 9% credit as the "new construction tax credit"to facilitate the discussion.

The 30% and 70% subsidy levels are computed as the present value of the 10-year stream of tax credits divided by the development's qualified basis (roughly the cost of construction excluding land). The subsidy levels (30% or 70%) are explicitly specified in the

Internal Revenue Code (IRC).

The U.S. Department of the Treasury uses a formula to determine the credit rates that will produce the 30% and 70% subsidies each month. The formula depends on three factors: the credit period length, the desired subsidy level, and the current interest rate. The credit period length and the subsidy levels are fixed in the formula by law, while the interest rate changes over time according to market conditions. Given the current interest rate, the Treasury's formula determines the two different LIHTC rates that deliver the two desired subsidy levels (30% and 70%).

In addition, for certain projects, the resulting credit rates may not be below a minimum (or "floor") of 4% or 9% (depending on the subsidy level), discussed in more detail below. Once the credit rate has been determined, it is multiplied by the development's qualified basis to obtain the amount of LIHTCs a project will receive each year for 10 years. The credit rate stays constant throughout the 10-year period for a given development, but varies across LIHTC developments depending on when construction occurred and the prevailing interest rate at that
time.

Minimum Credit Rates

The rehabilitation and new construction tax credits have ordinarily not been 4% and 9%. The Tax Reform Act of 1986 (P.L. 99-514) specified that buildings placed in service in 1987 were to receive exactly a 4% or 9% credit rate. Buildings placed in service after 1987 were to receive the credit rate that delivered the 30% and 70% subsidies as determined by Treasury's formula. The

rehabilitation credit rate has been below 4% every month since January 1988 the Taxpayer Certainty and Disaster Tax Relief Act of 2020, enacted as Division EE of the Consolidated Appropriations Act, 2021 (P.L. 116-260), sets a minimum credit (or "floor") of 4% for the housing tax credit typically used for the rehabilitation of affordable housing. In other words, the effective rehabilitation credit rate cannot fall below 4%. This change applies to buildings placed in service starting in 2021 and is permanent.

The effects of the minimum credits depend on how far the tax credit rates determined by Treasury are from 4% and 9%. The minimum credits have no effect if the credit rates produced by Treasury's formula are at least 4% and 9%; the credit rates will be determined by Treasury's formula and generate subsidies of up to 30% and 70%, respectively. If, however, the credit rates determined by Treasury are below the floors, then the credit rates are set equal to either 4% or 9%. When this happens, new construction projects can potentially receive a subsidy above 70%, with the subsidy increasing the farther the credit rate determined by Treasury's formula is below 9%.

Similarly, rehabilitation projects can potentially receive a subsidy above 30%. The current interest rate is the key factor determining whether the floors take effect. Treasury's formula produces low credit rates when interest rates are low and higher credit rates when interest rates are high. In December 1990, when Treasury's formula last determined a credit rate above 9% (9.06%), the 10-year Treasury constant maturity rate was 8.08%. In January 2021, the rate was around 1%. Thus, interest rates would need to increase significantly from current levels for the floor to no longer have an effect.

An Example

A simplified example may help in understanding how the LIHTC program is intended to support affordable housing development. Consider a new apartment complex with a qualified basis of $1 million. Since the project involves new construction, it will qualify for the 9% credit and, assuming for the purposes of this example that the credit rate is exactly 9%, will generate a stream of tax credits equal to $90,000 (9% × $1 million) per year for 10 years, or $900,000 in total. Under the appropriate interest rate the present value of the $900,000 stream of tax credits should be equal to $700,000, resulting in a 70% subsidy. Because the subsidy reduces the debt needed to construct the property, the rent levels required to make the property financially viable are lower than they otherwise would be.

Thus, the subsidy is intended to incentivize the development of housing at lower rent levels—and thus affordable to lower-income families—that otherwise may not be financially feasible or attractive relative to alternative investments. The situation would be similar if the project involved rehabilitated construction except the developer would be entitled to a stream of tax credits equal to $40,000 (4% × $1 million) per year for 10 years, or $400,000 in total. The

present value of the $400,000 stream of tax credits should be equal to $300,000, resulting in a 30% subsidy.

The Allocation Process

The process of allocating, awarding, and then claiming the LIHTC is complex and lengthy. The process begins at the federal level with each state receiving an annual LIHTC allocation in accordance with federal law. The administration of the tax credit program is typically carried out by each state's housing finance agency (HFA). State HFAs allocate credits to developers of rental housing according to federally required, but state-created, allocation plans. The process typically ends with developers selling awarded credits to outside investors in exchange for equity. Federal Allocation to States LIHTCs are first allocated to each state according to its population. In 2021, states will receive LIHTC allocation authority equal to $2.8125 per person, with a minimum small population state allocation of $3,245,625.

These figures reflect a temporary increase in the amount of credits each state received as a result of the 2018 Consolidated Appropriations Act (P.L. 115-141). The increase is equal to 12.5% above what states would have received absent P.L. 115-141 and is in effect through 2021. The state allocation limits do not apply to the 4% credits, which are automatically packaged with tax-exempt bond financed projects.

State Allocation to Developers

State HFAs allocate credits to developers of eligible rental housing according to federally required, but state-created, qualified allocation plans (QAPs). Federal law requires that a QAP give priority to projects that serve the lowest-income households and that remain affordable for the longest period of time. States have flexibility in developing their QAPs to set their own allocation priorities (e.g., assisting certain subpopulations or geographic areas), and to place additional requirements on awardees (e.g., longer affordability periods, deeper income targeting). QAPs are developed and revised via a public process, allowing for input from the general public and local communities, as well as LIHTC stakeholders. Many states have two allocation periods per year. Developers apply for the credits by proposing plans to state agencies.

An allocation to a developer does not imply that all allocated tax credits will be claimed. An allocation simply means tax credits are set aside for a developer. Once a developer receives an allocation it generally has two years to complete its project. 15 Credits may not be claimed until a property is placed in service.

Tax credits that are not allocated by states after two years are added to a national pool and then redistributed to states that apply for the excess credits. To be eligible for an excess credit

allocation, a state must have allocated its entire previous allotment of tax credits. This use-or-lose feature gives states an incentive to allocate all of their tax credits to developers.

To be eligible for an LIHTC allocation, properties are required to meet certain tests that restrict both the amount of rent that may be charged and the income of eligible tenants. Historically, the "income test" for a qualified low-income housing project has required project owners to irrevocably elect one of two income-level tests, either a 20-50 test or a 40-60 test.

To satisfy the first test, at least 20% of the units must be occupied by individuals with income of 50% or less of the area's median gross income (AMI), adjusted for family size. To satisfy the second test, at least 40% of the units must be occupied by individuals with income of 60% or less of AMI, adjusted for family size.

The 2018 Consolidated Appropriations Act (P.L. 115-141) added a third income test option that allows owners to average the income of tenants. Specifically, under the income averaging option, the income test is satisfied if at least 40% of the units are occupied by tenants with an average income of no greater than 60% of AMI, and no individual tenant has an income exceeding 80% of AMI. Thus, for example, renting to someone with an income equal to 80% of AMI would also require renting to someone with an income no greater than 40% of AMI, so the tenants would have an average income equal to 60% of AMI.

In addition to the income test, a qualified low-income housing project must also meet the "gross rents test" by ensuring rents (adjusted for bedroom size) do not exceed 30% of the 50% or 60% of AMI, depending on which income test option the project elected.

The types of projects eligible for the LIHTC include rental housing located in multifamily buildings, single-family dwellings, duplexes, and townhouses. Projects may include more than one building. Tax credit project types also vary by the type of tenants served; for example,

LIHTC properties may be designated as housing persons who are elderly or have disabilities. Properties located in difficult development areas (DDAs), or qualified census tracts (QCTs) are eligible to receive a "basis boost" as an incentive for developers to invest in more distressed areas. In these areas, the LIHTC can be claimed for 130% (instead of the normal 100%) of the project's eligible basis.

This also means that available credits can be increased by up to 30%. HERA (P.L. 110-289) enacted changes that allow an HFA to classify any LIHTC project that is not financed with tax-exempt bonds as difficult to develop, and hence, eligible for a basis boost.\

Renewable Energy Tax Credit

Developers and Investors

Upon receipt of an LIHTC award, developers typically exchange or "sell" the tax credits for equity investment in the real estate project. The "sale" of credits occurs within a partnership that legally binds the two parties to satisfy federal tax requirements that the tax credit claimant have an ownership interest in the underlying property. This makes the trading of tax credits different from the trading of corporate stock, which occurs between two unrelated parties on an exchange. The partnership form also allows income (or losses), deductions, and other tax items to be allocated directly to the individual partners.

The sale is usually structured using a limited partnership between the developer and the investor, and sometimes administered by syndicators. As the general partner, the developer has a relatively small ownership percentage but maintains the authority to build and run the project on a day-to-today basis. The investor, as a limited partner, has a large ownership percentage with an otherwise passive role. Syndicators charge a fee for overseeing the investment transactions.

Typically, investors do not expect their equity investment in a project to produce income. Instead, investors look to the credits, which will be used to offset their income tax liabilities, as their return on investment. The return investors receive is determined in part by the market price of the tax credits. The market price of tax credits fluctuates, but in normal economic conditions the price typically ranges from the mid-$0.80s to low-$0.90s per $1.00 tax credit. The larger the difference between the market price of the credits and their face value ($1.00), the larger the return to investors. Investors also often receive tax benefits related to any tax losses generated through the project's operating costs, interest on its debt, and deductions such as depreciation.

The right to claim tax benefits in addition to the tax credits will affect the price investors are willing to pay. The vast majority of investors are corporations, either investing directly or through private partnerships. Financial firms are large investors in LIHTC. Partly this is due to the Community Reinvestment Act (CRA), which considers LIHTC investments favorably. Other investors include real estate, insurance, utility, and manufacturing firms, which are seeking a return in the form of reduced taxes from investing in the tax credits.

The LIHTC finances part of the total cost of many projects rather than the full cost and, as a result, must be combined with other resources. The financial resources that may be used in conjunction with the LIHTC include conventional mortgage loans provided by private lenders and alternative financing and grants from public or private sources. Individual states provide financing as well, some of which may be in the form of state tax credits modeled after the

federal provision. Additionally, some LIHTC projects may have tenants who receive other government subsidies such as housing vouchers.

Recent Legislative Developments

Most recently, the Taxpayer Certainty and Disaster Tax Relief Act of 2020, enacted as Division EE of the Consolidated Appropriations Act, 2021 (P.L. 116-260), sets a minimum credit (or "floor") of 4% for the housing tax credit typically used for the rehabilitation of affordable housing. The Joint Committee on Taxation estimates this change will reduce federal revenues by $5.8 billion between FY2021 and FY2030. This change is permanent.

Division EE of P.L. 116-260 also increased, for calendar years 2021 and 2022, the credit allocation authority for buildings located in any qualified disaster zone, defined as that portion of any qualified disaster area which was determined by the President during the period beginning on January 1, 2020, and ending on the date which is 60 days from enactment of P.L. 116-260. For 2021 the increase is equal to the lesser of $3.50 multiplied by the population residing in a qualified disaster zone, and 65% of the state's overall credit allocation authority for calendar year 2020.

For 2022, the increase is equal to any unused increased credit allocation authority from 2021 (i.e., 2021 increased credit allocation authority may be carried over to 2022). Buildings impacted by this provision will also be granted a one-year extension of the placed in-service deadline and the so-called 10% test. The JCT estimates these changes will reduce federal revenues by $887 million between FY2021 and FY2030.

New Market Tax Credits

The New Markets Tax Credit (NMTC) is a nonrefundable tax credit intended to encourage private capital investment in eligible, impoverished, low-income communities. NMTCs are allocated by the Community Development Financial Institutions Fund (CDFI), a bureau within the U.S. Department of the Treasury, under a competitive application process. Investors who make qualified equity investments reduce their federal income tax liability by claiming the credit.

Overview

The New Markets Tax Credit (NMTC) was enacted by the Community Renewal Tax Relief Act of 2000 (P.L. 106-554) to provide an incentive to stimulate investment in low-income communities (LIC). The original allocation authority eligible for the NMTC program was $15 billion from 2001

to 2007. Congress, subsequently, has increased the total allocation authority to $61 billion and extended the program through 2019.

Qualified investment groups apply to the U.S.

Department of the Treasury's Community Development Financial Institutions Fund (CDFI) for an allocation of the New Markets Tax Credit. The investment group, known as a Community Development Entity (CDE), seeks taxpayers to make qualifying equity investments in the CDE.

The CDE then makes equity investments in low-income communities and low-income community businesses, all of which must be qualified. After the CDE is awarded a tax credit allocation, the CDE is authorized to offer the tax credits to private equity investors in the CDE.

The tax credit value is 39% of the cost of the qualified equity investment and is claimed over a seven-year credit allowance period.

In each of the first three years of the investment, the investor receives a credit equal to 5% of the total amount paid for the stock or capital interest at the time of purchase. For the final four years, the value of the credit is 6% annually. Investors must retain their interest in a qualified equity investment throughout the seven-year period. The 114th Congress extended the NMTC program authorization with the Protecting Americans from Tax Hikes (PATH) Act (Division Q of P.L. 114-113), which extended the NMTC authorization through 2019 at $3.5 billion per year.

Program Components

The process by which the NMTC affects eligible low-income communities involves multiple agents and steps. Figure 1 illustrates the key agents in the NMTC process.

The multiple steps and agents are designed to ensure that the tax credit achieves its primary goal: encouraging investment in low-income communities. For example, the Treasury Department's CDFI reviews NMTC applicants submitted by CDEs, issues tax credit authority to those CDEs deemed most qualified and plays a significant role in program compliance.

Community Development Entities (CDE)

A CDE is a domestic corporation or partnership that is an intermediary vehicle for the provision of loans, investment funding, or financial counseling in low-income communities (LICs). To become certified as a CDE, an organization must submit an application to the CDFI that demonstrates that it meets three criteria:

- (1) it is a domestic corporation or partnership duly organized under the laws of the jurisdiction in which it is incorporated,
- (2) it has a primary mission of serving low-income communities, and
- (3) it maintains accountability to residents of these low-income communities. A CDE may demonstrate meeting the third criterion by filling at least 20% of either its advisory or its governing board positions with representatives of low-income communities.

Only CDEs may apply for the NMTC. Upon receipt of NMTC allocation, CDEs attract investors using the credits. While both for-profit and nonprofit CDEs may apply for the NMTC, only for-profit CDEs may pass the NMTC on to investors. To ensure that projects are selected on economic merit, nonprofit CDEs awarded NMTCs must transfer their allocations to for-profit subsidiaries prior to offering NMTCs to investors.

CDEs play a critical role in a properly functioning NMTC process. CDEs are the intermediaries between the potential low-income community investments and the CDFI during the application process. CDEs also present investors with investment opportunities and provide the CDFI the majority of its compliance data.

Qualifying Low-Income Communities

Under the tax code's NMTC provisions, only eligible investments in qualifying low-income communities are eligible for the NMTC. Qualifying low-income communities include census tracts that have at least one of the following criteria:

- (1) has a poverty rate of at least 20%;
- (2) is located in a metropolitan area and has a median family income below 80% of the greater of the statewide or metropolitan area median family income; or
- (3) is located outside a metropolitan area and has a median family income below 80% of the median statewide family income.

As defined by the criterion above, about 39% of the nation's census tracts covering nearly 36% of the U.S. population are eligible for the NMTC. Additionally, designated targeted populations may be treated as low-income communities. Further, the definition of a low-income community includes census tracts with low populations and census tracts within high migration rural counties. As a result of the definition of qualified low-income communities, virtually all of the country's census tracts are potentially eligible for the NMTC.

Qualified Investors and Investments

All taxable investors are eligible to receive the NMTC. As noted above, investors receiving the credit can claim the NMTC over a seven-year period, starting on the date of the investment and

on each anniversary, at a rate of 5% for each of the first three years and a rate of 6% for each of the next four years, for a total of 39%. Once the investor begins claiming the NMTC, the credit can be recaptured if the CDE:

- (1) ceases to be a CDE,
- (2) fails to use substantially all of the proceeds for eligible purposes, or
- (3) redeems the investment principal.

Almost all qualified equity investments (QEI) in low-income communities or serving low-income populations could be eligible to receive the NMTC. These eligible investments are referred to as qualified low-income community investments (QLICIs). QLICIs are categorized in four ways:

- (1) loans or investments to qualified active low-income community businesses (QALICB),
- (2) the provision of financial counseling,
- (3) loans or investments in other CDEs, and
- (4) the purchase of loans from other CDEs. All QLICIs, including QALICBs, are explicitly prohibited from investing in residential rental property and certain types of businesses, such as golf courses and casinos.

NMTC Allocation Process and Compliance

To receive an allocation, a CDE must submit an application to the CDFI, which asks a series of standardized questions about the track record of the CDE, the amount of NMTC allocation authority being requested, and the CDE's plans for any allocation authority granted.

The application covers four areas:

- (1) the CDE's business strategy to invest in low-income communities,
- (2) capitalization strategy to raise equity from investors,
- (3) management capacity, and
- (4) expected impact on jobs and economic growth in low-income communities where investments are to be made.

In addition, priority points are available for addressing the statutory priorities of investing in unrelated entities and having demonstrated a track record of serving disadvantaged businesses or communities. The application is reviewed and scored to identify those applicants most likely to have the greatest community development impact and ranked in descending order of aggregate score.

Tax credit allocations are then awarded based upon the aggregate ranking, until all of the allocation authority is exhausted. In each of the completed NMTC rounds, significantly more CDEs applied for allocations than were able to receive allocations.

Prior to receiving the authority to offer tax credits to investors, every CDE allocate must sign an allocation agreement. The allocation agreement clarifies the terms and conditions of the allocation
authority, such as the total tax credit authority, service areas, authorized uses of the allocation, and CDE reporting requirements. Failing to meet the terms of the allocation agreement subjects the CDE to the potential revocation of allocation authority.

Additionally, the Internal Revenue Service (IRS) monitors compliance with the tax consequences of NMTC allocations, focusing on the "substantially all" requirement. As specified in the IRS regulations, CDE allocatees must issue tax credits to investors within five years of signing their allocation agreements and invest the QEIs in QLICIs within 12 months of signing their allocation agreements. If these requirements are not satisfied, the CDE loses the authority to allocate the unused NMTC. In addition, CDEs that receive principal payments from their QLICIs have 12 months to reinvest those funds in QLICIs to avoid recapture.

NMTC Investment Activity

Once an allocator signs its allocation agreement and receives its NMTC allocation authority, it may begin soliciting capital from investors. Column 2 of Table 1 lists the total allocation awarded to date by the NMTC, by funding round. Investors receive the right to claim NMTCs on a portion of their investment, by acquiring stock or a capital interest in a CDE with an allocation. The CDE, in turn, must invest the proceeds in qualified low-income community investments. Investors have, to date, invested roughly $51.9 billion in CDEs. Columns 3 and 4 list the remaining available NMTC allocation, in dollars and as a percentage that have not yet been allocated to an investor, by round.

NMTC activity has occurred in all 50 states, the District of Columbia, and Puerto Rico. However, the distribution of NMTC activity appears concentrated in a few states—with the 10 states with the highest activity accounting for just over 50% of all NMTC projects and activity. In contrast, the 25 states with the least NMTC activity account for less than 13% of all NMTC activity. The current distribution of activity is not likely to reflect the distribution of low-income populations and may raise questions concerning the equity of the NMTC.

Finally, the NMTC is one of several programs designed to improve conditions in low-income communities.

Historical Tax Credits

The 20% federal HTC is a financial incentive that supports investment in historic buildings. It encourages private property owners to rehabilitate historic properties for an income-producing

use, such as rental housing, office, retail, manufacturing, and entertainment space. It is an important tool for the redevelopment of historic Main Streets and can be a catalyst for neighborhood and downtown revitalization. It can also be an effective tool to create affordable housing, including mixed-use developments that have commercial space on the first floor and residences on the upper floors.

Through HUD's Rental Assistance Demonstration (RAD) program, Public Housing Authorities can partner with private investors interested in the HTC to rehabilitate historic public housing developments. Projects receiving Low-Income Housing Tax Credits (LIHTC) may raise additional equity if they also qualify for the HTC.

The HTC rewards owners for making an investment that extends the economic life of older buildings and helps to revitalize communities, and it becomes a source of project equity when syndicated to outside investors. A project can claim HTC equal to 20% of qualified expenses. The tax credit directly reduces income taxes owed. Each dollar of tax credit offsets one dollar of taxes due. A project with $1 million of qualified expenses will generate $200,000 of HTC to offset $200,000 of federal income taxes.

Historic tax credits benefit a wide range of building types and communities throughout the United States – urban centers, small towns, rural areas. They include high-style architect-designed masterpieces as well as simple functional buildings. HTC projects can be catalytic for community revitalization. Many communities have a "white elephant" building that may qualify for the program. Vacant school buildings, for instance, are frequently converted to affordable housing.

While large, high-dollar rehab projects attract a lot of attention, buildings of all sizes can take advantage of the HTC.

Roughly 50% of all HTC projects cost less than $1 million
Roughly 25% of all HTC projects cost less than $250,000

Since the HTC program was established in 1976, the program has impacted communities throughout the country. The statistics for the program are impressive:

- 42,293 projects completed 1977-2016
- Projects in all 50 states
- $84.15 billion of private investment
- Over $7 billion investment in 2016 alone
- 2.44 million jobs created
- 153,255 low- and moderate-income housing units created/rehabilitated

Basic Criteria

Historic Tax Credits (HTC) are available through a non-competitive, open application process. If you meet the program requirements, you can claim the credit. The project must involve an "income producing" "certified historic structure." The scope of work must meet the requirements of a "certified historic rehabilitation" and must make a "substantial investment" in the property, specifically in items that are considered Qualified Rehabilitation Expenditures (QRE). There is no cap on the amount of credits an individual project can claim nor on the amount of credits available for the program in any given fiscal year.

Definitions:

Income-producing Properties include all buildings that generate income for their owners. Office buildings, retail stores, hotels, restaurants, and rental apartments are the most common uses. Buildings owned by a for-profit owner but leased to a non-profit institution may also qualify but check with your tax advisor. Owner-occupied dwellings are not eligible for the HTC, and buildings must remain income-producing for 5 years after rehab is complete.

Certified Historic Structures are buildings listed in the National Register of Historic Places either individually or as contributing resources to a historic district. Buildings determined to be non-contributing to a historic district (because of age or alterations) are not able to use the HTC. While other types of resources (bridges, structures, objects, landscapes, etc.) can be listed in the National Register, they do not meet the Internal Revenue Service (IRS) definition of a "building" that is required to use the HTC. A building can apply for National Register designation while applying for the HTC.

A certified historic rehabilitation meets the Secretary of the Interior's Standards for Rehabilitation (Secretary's Standards). The State Historic Preservation Office (SHPO) and the National Park Service (NPS) review photographs of the building, architectural plans, and a written scope of work to ensure that the project preserves the character-defining features of the historic building, site, and environment.

QRE include depreciable construction costs as well as allocated soft costs. All permanent changes to the exterior and the interior of the building are QRE. A simple way to visualize QRE is to imagine turning the building upside down. Anything that falls out is NOT QRE. A general list of non-QRE expenses includes:

Acquisition

Enlargement of the building footprint or mass (although additions may be allowed if they meet the design guidelines). This includes structures and equipment required for new circulation

towers, if those elements are outside the historic building footprint Site improvements, including hardscaping and landscaping Personal property, such as furniture, appliances, and signage Marketing and lease-up

Substantial Investment is defined by the IRS as QRE exceeding the greater of $5000 or the "adjusted basis" of the building. If the building is newly acquired the formula is:

Purchase Price
-Value of land
=Adjusted Basis

If you previously made improvements to the building those need to be added to the equation, and any earned depreciation can be subtracted.

Purchase Price
- Value of land
+ Value of prior capital improvements
- Depreciation
=Adjusted Basis

Upside Down House

A simple way to visualize QRE is to imagine turning the building upside down. Anything that falls out is NOT QRE.

QRE must meet the substantial investment test in a 24-month period. The applicant has some flexibility in defining that window, but if needed the project can be phased to extend the 24-month window to 60 months (5 years). The application must present the phases, in both a narrative description and architectural plans, at the start of the project, although the phasing plan can be amended later in the project. Because the extended rehabilitation period may require recalculation of the adjusted basis for the later phases of work, check with your tax advisor if you are considering a phased project.

National Register of Historic Places

Projects that use the HTC must involve a building listed in the National Register of Historic Places. The National Register of Historic Places is the nation's list of historic buildings, structures, sites, and objects that merit preservation. The National Register was created by the

National Historic Preservation Act of 1966, and it is administered by the National Park Service with input from the State Historic Preservation Offices (SHPOs).

Typically, resources must be at least 50 years old to qualify for National Register designation. There are exceptions for newer resources that can demonstrate exceptional significance. As mentioned above, only designated buildings are eligible for historic tax credits. To find out if a property is on the National Register contact your SHPO or visit the National Park Service (NPS) website.

In addition to its age, a National Register property must demonstrate that it has significance at the national, state, or local level in at least one of four areas. These include association with historical events or patterns of history, association with important persons, and architectural or artistic distinction. The fourth criterion, the ability to yield information about history or prehistory, mainly applies to archaeological sites. A property that is on the National Register as part of a historic district can have less individual significance as long as it supports the significance of the larger whole.

Finally, the appearance of a property must be able to communicate its period of construction and its historic significance, a quality referred to as architectural integrity. Resources that have integrity appear much as they did when they were built or achieved historic significance. The National Register program defines seven types of integrity – location, setting, design, materials, workmanship, feeling, and association. Changes to a building that remove historic material or add new elements can weaken integrity in one or more areas. When alterations compromise integrity to the point that the building would not be recognizable to the people who knew it during its period of significance, it is no longer eligible for National Register listing.

One persistent myth about the National Register is that designation limits how a building can be changed or used and will impact future sale of the building. Listing in the National Register does not inherently impact how an owner uses a building or changes a building unless the owner chooses to use a federal incentive (such as historic tax credits or a federally funded grant program) or if the property is subject to a federal permit or other action (such as licensing for a cell tower). Similarly, National Register listing offers a layer of protection to properties that may fall within the path of a federal undertaking, such as a highway construction project.

Some states and localities do require a review when changes are proposed to historic buildings to ensure that the changes are compatible with the property's character. This review is often triggered by a building permit and usually focuses on the exterior facades. Check with your SHPO or local planning department to see if this type of review applies in your area.

Secretary of the Interior's Standards for Rehabilitation

The preservation guidelines that apply to HTC projects are the Secretary of the Interior's Standards for Rehabilitation [36 CFR 67.7]. Rehabilitation encourages the retention of surviving

historic material and features, but also accommodates modifications that enable a building to be adapted for a new function and that allow it to remain economically viable. An HTC project must meet all 10 standards as they apply to both the building's exterior, interior, and site.

The 10 Standards for Rehabilitation can be summarized as:

- Retain and repair historic materials, features and spaces;
- Retain historic character, even if use changes; and
- Design compatible, reversible additions, or alterations

NPS Guidelines for Rehabilitation provide general advice in a recommended/not-recommended format. Each building is viewed as unique in its architecture, history, current conditions, and context for redevelopment. Reviewers consider the individual building history and circumstances to determine appropriateness of proposed treatments.

HTC Application Process

HTC applications are reviewed first by SHPO and next by NPS. The application has three parts.

The National Register (NR) status of your building at the start of the project determines where you enter the application process. If your property is not listed on the NR, you would start by preparing a draft nomination and filing this with your part 1 application. If your property is already contributing to a historic district, you file the part 1 to confirm that status. If your property is individually listed, you can go directly to part 2. The process for part 2 and part 3 is the same for all projects.

Typical HTC Application Process Flowchart

For buildings that are not already on the NR, the Part 1 provides detailed information about the building's physical appearance, architectural integrity, history, and significance. The Part 1 documentation should be equivalent to a draft NR so that the reviewers can determine if the building is NR eligible. While the Part 1 approval is a preliminary determination, it provides developers, investors, and lenders with a level of comfort before the project moves forward.

After the Part 1 is approved, the owner can apply for official National Register designation. This is a separate process from the HTC review and takes 6-9 months to complete. Rehabilitation can begin before the building has NR status, but the building must be officially listed on the NR within 30 months after the rehabilitation is completed. Tax credits can be claimed while the nomination is in progress, at the owner's risk.

A critical piece of the Part 1 application is documentation of the building's appearance before rehabilitation starts. "Before" photographs showing existing conditions on the exterior and interior are required to illustrate the configuration and relationship of spaces; the types and conditions of building materials; and the character-defining features and finishes that communicate the historic style, function, and significance of the property.

The Part 2 application includes a detailed description of proposed treatments, including materials and techniques to be used, and presents architectural plans and pertinent construction specifications. Architectural plans should be sufficiently developed to show how historic features will be treated and/or altered and how new elements will be added. Additional photos documenting in detail the existing ("before") conditions are submitted with the Part 2.

If SHPO or NPS feels that an element of the scope does not meet the Standards, they will place a condition on the approval. As long as the completed rehabilitation addresses this condition, the Part 3 application will be approved at the end of the project. The reviewers prefer to issue a "clean" approval with as few conditions as possible (preferably none) and will help applicants figure out how to revise the scope of work to meet the Standards.

Applicants can file an amendment to officially revise the scope of work to address any conditions. Approval of the amendment assures the applicant that NPS will approve the revised approach when the Part 3 is submitted. An amendment can also be filed if new information becomes available or if the scope of work evolves during construction.

Construction can start before NPS approves the Part 2 application, but at increased risk. If at the end of construction any element of the scope does not meet the Standards, the credits cannot be claimed.

Part 1 confirms that the building is a certified historic structure eligible for historic tax credits. In other words, it must be contributing to a National Register historic district or determined eligible for NR listing. Part 1 is not required for individually listed buildings unless the nomination includes more than one resource. In this case, as with a district, a Part 1 must be submitted to indicate which building(s) are contributing or non-contributing.

Part 2 presents the scope of work for the rehabilitation and is reviewed to verify it will meet the Secretary's Standards for Rehabilitation. Many investors and lenders require an approved Part 2 application before they will close on project financing.

Part 3 certifies that the completed rehabilitation meets the Secretary's Standards. The submittal includes "after" photos documenting the exterior and interior of the completed rehabilitation, estimated QRE and total project costs, and ownership information (for assignment of credits). The date of Part 3 approval must be attached to IRS documents in order to claim the credits. If a project is phased, the amendment certifying completion of that phase may be used as evidence of pending approval.

The NPS charges a fee to review the Part 2 and Part 3 applications. The fee has a sliding scale based on the project cost. The applicant pays half of the fee when NPS receives the Part 2 application and half when NPS receives the Part 3 application.

How do I use the HTC?

The owner of the historic property may claim the HTC after rehabilitation is complete and certified as meeting the Secretary's Standards (Part 3 approval). The owner must be a for-profit taxpaying entity, but that can take several forms.

A fee simple property owner of the property may be an individual, partnership or corporation.

A limited partnership can distribute the benefit to its members. In this scenario, an equity partner can invest in the project in exchange for rights to the credit. The investment helps finance rehabilitation. Historic projects typically sell for varying amounts, but in 2017, a typical project attracts a net investment of $.70/$1 HTC that will be allocated. IRS Safe Harbor rules issued in 2015 require that the investor be a real partner with potential for both upside (gains) and downside (losses) in the deal.

Under some circumstances the lessee of a newly rehabilitated building can claim the credit if the lease term exceeds 80 percent of the depreciation period (39 years for non-residential property and 27.5 years for residential rental property). After a project is certified to receive the HTC (Part 3 approved), the owner can use the credit to offset income tax liability dollar-for-dollar, beginning the year the building is placed in service (rehab is complete). It can be carried back one year and forward for up to 20 years. Always check with a tax advisor before starting a project to understand how the HTC will apply to your specific circumstances.

Claiming the credit is very straightforward. The taxpayer submits IRS Form 3648 along with the NPS project number with their annual tax documents. The amount of the credit calculated on Form 3648 is factored into final calculations and deducted from the bottom line of taxes owed. If your project has not yet received Part 3 approval you must complete that step within 30 months after the placed in-service date.

If a project has multiple phases, partial credit may be claimed when one or more phases of work are ready to be placed into service and the substantial investment test is met. The partial credit drawdown will be subject to recapture if the project does not receive Part 3 certification.

HTC are also subject to recapture if the building ownership changes, or non-compliant changes are made within 60 months after NPS certifies the rehabilitation (Part 3 approved). Recapture is prorated based on the amount of time passed since issuance of credits.

Combining the HTC & Other Incentives

The HTC can be coupled with other local, state, and federal incentives. State historic tax credits are currently available in 34 states, and nearly half of all federal HTC projects are twinned with this incentive. Many state HTCs can be directly transferred (i.e., sold) to other businesses or individuals who want to offset their state tax obligation. If your project is in a state that also has a state HTC, check with your tax advisor to see if these are transferable and by what means.

The two most common federal incentives used with the HTC are the Low-Income Housing Tax Credit (LIHTC) and New Markets Tax Credits (NMTC). Other federal, state, and local Incentives that developers often use to finance rehabilitation include HOME Investments Partnership Program (HOME) and (Community Development Block Grant) CDBG funds, United States Department of Agriculture (USDA) rural loan programs, Brownfields grants, tax abatement, and tax increment financing (TIF). Investment in an HTC project can also count toward Community Reinvestment Act (CRA) requirements for banks. Be aware that a federal grant may affect the amount of HTC a project receives. If your project is using additional sources of federal funds, be sure to consult with your tax advisor to understand how these funds may affect your project.

HTC & LIHTC:

HTC projects have rehabilitated over 150,000 units of affordable housing since 1976. Some of these projects were originally developed as affordable housing, while others adaptively reuse buildings constructed for other purposes. The HTC and LIHTC program guidelines are generally compatible, although there are some notable differences in how the credits are calculated, which costs are QRE, and when the credits are awarded. The HTC will reduce the eligible basis for the LIHTC, although the LIHTC does not affect the amount of HTC a project earns. Combining the HTC with the LIHTC is very attractive to affordable housing developers because it attracts additional equity to a project.

Five Secrets for a Successful HTC Project

1) Assemble a team of experienced, knowledgeable professionals to make your project run smoothly. These might include a preservation consultant who understands the application process, procedures, and Standards; an architect and structural and Mechanical, Electrical, and Plumbing (MEP) engineers who are experienced with historic buildings; and a real estate attorney and tax accountant who are familiar with the tax rules related to the HTC. Team members should have a track record of recent success on HTC projects similar to yours. Ask for references. Have they worked on projects similar to yours (e.g., conversion of a historic school to affordable housing)? Find out what kinds of obstacles they encountered on other projects and how they overcome those obstacles.

2) Initiate contact with SHPO staff early in the process and maintain regular communication. SHPO staff are often able to visit the project site during the planning stage. They can help identify key historic elements that will be critical to retain during the project and can suggest appropriate rehabilitation strategies. If the situation is particularly complicated, SHPO can bring NPS into the conversation. Their wealth of experience can provide creative solutions and ideas.

3) Allow ample time for the review process. At minimum, the review period is 60 days (30 at SHPO + 30 at NPS). Once you build in administrative time to transmit and log application packages, it is not unusual for the review period to run 90 days, particularly at peak periods in the construction cycle. While these timeframes can sound daunting, they usually mesh well with the general development process if you anticipate them from the outset. A set of plans shared with contractors for pricing may be sufficiently developed to submit for Part 2 review. You will sleep better knowing the Part 2 has been approved before major expenditures have occurred and the hammers start swinging.

4) Rehabilitation plans may evolve during construction. An unexpected condition might be discovered in the field, budgets can modulate, new tenants may make specific requests. If plans change, do not assume that the revisions will meet the Standards. Submit an amendment for SHPO and NPS to review.

5) Throughout the process, address issues proactively before they become problems. Engage SHPO in addressing these situations whether they occur before, during or after construction.