The Social Impact Side of the Qualified Opportunity Zone Discussion: What Can Treasury Do?

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Washington, DC
Closely Held Business Committee
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TCJA Conference Report vs. Implementation
“Governors are required to provide particular consideration to areas that:

(1) are currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity;

(2) have demonstrated success in geographically targeted development programs such as promise zones, the new markets tax credit, empowerment zones, and renewal communities; and

(3) have recently experienced significant layoffs due to business closures or relocations.”
Designation of Opportunity Zones (Implementation)

- Treasury Department’s CDFI Fund reviewed and approved the state designations.

- Review was largely a mechanical exercise to ensure identified census tracts met baseline definitional requirements.

- No narrative was solicited from states to determine their processes for selecting the Zones, much less whether they attempted to address the selection criteria identified in Conference Report.
Certification of Opportunity Funds (Report Language)

Report 115-446 (page 538)

“The provision intends that the certification process for a qualified opportunity fund will be done in a manner similar to the process for allocating the new markets tax credit. The provision provides the Secretary authority to carry out the process.”
Certification of Opportunity Funds (Implementation)

• A process analogous to the *NMTC allocation process* suggests:
  
  • Opportunity Funds would be certified prior to receiving qualified investments.
  
  • Opportunity Funds would need to demonstrate a mission of serving low-income communities, and demonstrate that they are accountable to those markets (through representation on a governing board or advisory board)
  
  • Opportunity Funds would need to be able to demonstrate that they are providing investments that are benefitting the communities and their residents.

• The IRS instead determined that Opportunity Funds could self certify, and would report (as yet unidentified) information to the Treasury Department regarding their investments and outcomes.

• This was likely done to help expedite the formation of Opportunity Funds and to better facilitate the flow of investor capital to these entities.
Certification of Opportunity Funds (Implementation)

• There is currently no role for the Treasury Department to screen Opportunity Funds for bad actors, or to ensure that investment dollars are benefitting the communities.

• An alternative approach would be for the IRS to update the Form 8996 to:

  • Obtain assurances and certifications to ensure that the principal parties are not currently, nor have they recently been, party to civil or criminal judgements relating to fraud or abuse.

  • Require Opportunity Funds to identify (from a drop down menu) at least one of several community development impacts that they intend to achieve with their investments.

  • Include data collection points that demonstrate the extent to which these objectives are met over time.
• “The Secretary or the Secretary’s delegate is required to report annually to Congress on the opportunity zone incentives beginning 5 years after the date of enactment.
• The report is to include an assessment of investments held by the qualified opportunity fund nationally and at the State level.
• To the extent the information is available, the report is to include the number of qualified opportunity funds, the amount of assets held in qualified opportunity funds, the composition of qualified opportunity fund investments by asset class, and the percentage of qualified opportunity zone census tracts designated under the provision that have received qualified opportunity fund investments.
• The report is also to include an assessment of the impacts and outcomes of the investments in those areas on economic indicators including job creation, poverty reduction and new business starts, and other metrics as determined by the Secretary.”
Opportunity Fund Reporting Requirements (Implementation)

• IRS published a Request for Information seeking public comment on the following questions:

  1. What data would be useful for tracking the effectiveness of providing tax incentives for investment in O-Zones to bring economic development and job creation to distressed communities?
  2. Is there other information that can be collected on a tax form that would be helpful in measuring effectiveness of Opportunity Zone incentives?
  3. What data would be useful in measuring how much would have been invested in qualified opportunity zones in the absence of the O-Zone incentive?
  4. What data would be useful for ensuring that the investment opportunity remains an attractive option for investors?
  5. What are the costs and benefits of various methods of information collection? Who should perform this data collection?
  6. What considerations should government officials take into account when considering data to analyze the effectiveness of the qualified opportunity zone incentives to promote economic development to distressed areas? Over what time period should this analysis occur?

• Comments are due to the IRS on May 30, 2019
• Information may be used to inform redesign of Form 8996
What do Opportunity Zones look like?
Opportunity Zones are different

- Large segment of the US qualified (56% → 12% designated)
- Not an intermediary like a NMTC CDE or HFA
- Not a cap on total taxpayer subsidy
- Not a competitive application process
- Lots of possible use cases (but RE heavy)
- Not likely an even distribution of investment across Zones
- Incentive, not subsidy
- Speculative back end value, relatively shallow up front value
- How many more deals will pencil out?
Chicago/Cook County Opportunity Zones

Source: Urban Institute analysis of US Treasury Department data.
Cleveland/
Cuyahoga
County
Opportunity
Zones

Source: Urban Institute analysis of US Treasury Department data.

Cuyahoga county boundary
Cleveland city boundary
Designated Opportunity Zones
Eligible, not selected
Miami-Dade Opportunity Zones
Bay Area Opportunity Zones
DC Area Opportunity Zones

Source: Urban Institute analysis of US Treasury Department data.
Investment Score Distribution of Opportunity Zones

- Designated Opportunity Zone
- Eligible tract, nondesignated

<table>
<thead>
<tr>
<th>Score</th>
<th>Designated Opportunity Zone</th>
<th>Eligible tract, nondesignated</th>
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<tbody>
<tr>
<td>1</td>
<td>10.9%</td>
<td>9.9%</td>
</tr>
<tr>
<td>2</td>
<td>11.1%</td>
<td>9.7%</td>
</tr>
<tr>
<td>3</td>
<td>10.1% 10.0%</td>
<td>10.1% 10.0%</td>
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<tr>
<td>4</td>
<td>10.1% 9.9%</td>
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<td>6</td>
<td>9.4% 10.1%</td>
<td>9.9% 10.0%</td>
</tr>
<tr>
<td>7</td>
<td>8.6% 10.3%</td>
<td>8.6% 10.3%</td>
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</tbody>
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Less existing investment vs. More existing investment
<table>
<thead>
<tr>
<th>Zone characteristics</th>
<th></th>
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<tbody>
<tr>
<td>Median household income</td>
<td>$33,345</td>
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<tr>
<td>Poverty rate</td>
<td>31.8%</td>
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<tr>
<td>Unemployment rate</td>
<td>13.1%</td>
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<tr>
<td>Median home value</td>
<td>$145,187</td>
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<tr>
<td>Median rent/month</td>
<td>$768</td>
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<tr>
<td>Homeownership</td>
<td>44.6%</td>
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<tr>
<td>Severe rent burden</td>
<td>26.5%</td>
</tr>
<tr>
<td>Vacancy rate</td>
<td>15.8%</td>
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<tr>
<td>Zone characteristics (cont’d)</td>
<td>Value</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>-------</td>
</tr>
<tr>
<td>White alone</td>
<td>39.6%</td>
</tr>
<tr>
<td>Black alone</td>
<td>24.0%</td>
</tr>
<tr>
<td>Hispanic</td>
<td>29.9%</td>
</tr>
<tr>
<td>Asian Americans &amp; Pacific Islanders alone</td>
<td>2.9%</td>
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<tr>
<td>Age 25+ with HS degree or less</td>
<td>54.8%</td>
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<tr>
<td>Age 25+ with BA degree or higher</td>
<td>38.0%</td>
</tr>
<tr>
<td>In a metro area</td>
<td>78.2%</td>
</tr>
<tr>
<td>In a micro area</td>
<td>11.4%</td>
</tr>
<tr>
<td>Not metro or micro</td>
<td>10.5%</td>
</tr>
</tbody>
</table>
Reporting needs
Reporting needs

- **Who**: Who is making an investment? Who is receiving an investment? What are the basic industry and size attributes of the business receiving the investment?

- **What**: What is the purpose of the project?

- **When**: When was the investment made?

- **Where**: Where is the project located?

- **How much**: What is the investment amount?
Operating Businesses in Opportunity Zones: Raising Capital from Qualified Opportunity Funds

**Example:** Business with long-term prospects, either currently located in opportunity zone or considering relocating in opportunity zone. The business is looking to raise cash from investors.

Cash investment might be used for any of the following: (i) new purchases of FFE; (ii) capital improvements; (iii) reasonable working capital to cover cash shortfalls.

**Assumptions:**
- Business leases space, owns tangible property used in the business (furniture, fixtures, equipment)
- Employees work on site
- Goods and services sold on site
Investors

QOF

GP / Mgr

QOF

QOZ Business

QOZ Business Property

QOZ Business Property

Opportunity Fund Requirements (Summary)

- Capital gain from sale / exchange to unrelated party
- 180 days to invest in QOF
- >70% of tangible property must be QOZ Business Property
- Active conduct / nonqualified financial property limitations (w/ 31-month working capital safe harbor)
- No sin businesses

- >90% of assets must be QOZ Property
- Form 8996 self-certification
- QOF must acquire interest in QOZ Business for cash at original issue
- QOZ Business qualifies for >90% of QOF’s holding period
- Acquired by purchase from unrelated seller or by lease
- Original use / substantial improvement (w/ 30-month safe harbor)
- >70% use in QOZ for >90% of QOF/QOZB’s holding period

Form 8996 self-certification

QOF must acquire interest in QOZ Business for cash at original issue

QOZ Business qualifies for >90% of QOF’s holding period

Acquired by purchase from unrelated seller or by lease

Original use / substantial improvement (w/ 30-month safe harbor)

>70% use in QOZ for >90% of QOF/QOZB’s holding period
Qualified Opportunity Zone Business Property

- Property owned by qualified opportunity zone business must meet either “original use” or “substantial improvement” requirement
  - Original use begins when tangible property is placed in service in the QOZ for depreciation or amortization purposes.
    - Used tangible property satisfies the original use test if the property has not been previously used or placed in service in the QOZ.
    - Structures vacant for at least five years prior to purchase by qualified opportunity zone business will satisfy “original use.”
  - Substantial improvement requires doubling of basis within 30 months, but is determined asset-by-asset.
  - No substantial improvement requirement for unimproved land.
Qualified Opportunity Zone Business Property

• Leased Property
  • No original use requirement for leased property.
  • Improvements made by a lessee to leased property are treated as purchased by the taxpayer and satisfy the original use requirement.
    • Proposed regulations impose requirement to purchase other original use property in the case of leases of tangible personal property
  • No substantial improvement requirement for leased property.
    • Lease may be with related party if certain requirements are met.
  • Under alternative valuation method (unadjusted tax basis), for purposes of 70%/90% asset tests, the value of leased property is equal to the PV of all payments under the lease calculated at the time the QOZ business enters into the lease
    • Includes periods during which the lessee may extend the lease at a pre-defined rent
Qualified Opportunity Zone Business

• Holding Period Requirement:
  • During substantially all of the QOZ business’s holding period for the property, substantially all of the use of such property was in a QOZ
  • Proposed regulations define “substantially all” for the holding period requirement as 90%
Qualified Opportunity Zone Business/Property

• **Gross Income Test**
  - QOZ business must derive at least 50% of its gross income from the active conduct of a trade or business **in the QOZ**.
  - Three new safe harbors provide flexibility for operating businesses.
    - Services performed (based on hours) are performed in the QOZ;
    - Amount paid for services are for services performed in the QOZ; or
    - Gross income is derived from tangible property and management and operational functions located in the QOZ.

• **Working Capital Safe Harbor**
  - Safe harbor for working capital if spent according to written schedule within 31 months expanded to include “development of a trade or business” in a QOZ.
  - Fairly limited extension for delay attributable to waiting for government action on completed application.
Operating Businesses in Opportunity Zones: Compliance Hurdle

• **Scenario 1: Start-up business**
  - Can lease workspace in QOZ
  - Can purchase used tangible property if not previously used in the QOZ
  - Can lease equipment
  - Can hold cash for working capital reserves
  - Can accept cash from investors up to 31 months prior to active business operations
Operating Businesses in Opportunity Zones: Compliance Hurdle

• **Scenario 2: Business Currently Operating in QOZ**
  • May fail to satisfy 70% asset if business has significant amount of disqualified tangible property purchased or leased before December 31, 2017,
  • 70% asset test becomes less problematic as time moves on, and more likely that tangible property was purchased or leased after 2017
  • If receiving more cash than needed for reasonable amount of working capital, what qualifies as “development of a trade or business” for purposes of 31-month working capital safe harbor?
Operating Businesses in Opportunity Zones: Compliance Hurdle

**Scenario 3: Business Considering Relocating in QOZ**

- May fail to satisfy 70% asset if business has significant amount of tangible property purchased or leased before December 31, 2017
  - Becomes less problematic as time moves on past 2017 and more likely that tangible property was purchased or leased after 2017
- May fail to satisfy holding period requirement for tangible property brought into new QOZ location from prior business location
Operating Businesses in Opportunity Zones:
The Investor’s Perspective

• Flexibility in investment in QOF.
  • Contributions of property (taxable or nontaxable) and acquisitions of QOF interests qualify as QOF investment.
  • Carried interests do not qualify as QOF investment.

• Net section 1231 gains are eligible for deferral.
  • Potential trap for unwary – 180-day period begins only at end of tax year.

• Debt can be used to increase basis, unlocking ordinary tax benefits of partnerships (losses and deductions; leveraged distributions).

• 90% asset test applied at six months and end of tax year
  • Option to disregard certain working capital received within six months effectively provides 6-12 months to invest capital.
Operating Businesses in Opportunity Zones: The Investor’s Perspective

• Interim Gains
  • Proceeds from disposition treated as QOZ Property for 90% test if held in cash, cash equivalents, or short-term debt and reinvested within 12 months.
  • Does not trigger deferred gain.
  • However, gains from disposition are taxed under ordinary tax rules.
  • Interim gains could be eligible gain that itself may be invested in a QOF.

• Inclusion Events
  • Investor reduces its equity interest in the QOF investment (e.g., sale, gift, liquidation of QOF);
  • Investor receives a distribution of property that effectively “cashes out” its QOF investment (e.g., partnership distribution in excess of partner’s basis, corporate distribution treated as sale or exchange); or
  • Investor claims worthless stock deduction with respect to QOF investment.
  • Certain transactions expressly not inclusion events, such as bequests, transfers to disregarded entity, tax-free transfers to partnership.
Operating Businesses in Opportunity Zones: The Investor’s Perspective

- Permit exit by selling qualified opportunity zone property.
  - Election to exclude QOF capital gains reported on Schedule K-1.
  - Rule does not appear to apply to dispositions by QOZ business.
  - Rule does not exclude ordinary income, such as that produced by the sale of “hot assets” (including depreciation recapture), so retains bias towards single-asset funds.

- Exit by selling qualified opportunity fund interests.
  - Election to step-up basis of qualified opportunity fund assets to avoid “hot asset” income.
  - Step up basis in QOF interest to FMV “including debt” – unclear whether gross or net value.
  - Proposed regulations addressing exit after 10-year holding period do not provide for reliance.
How can Opportunity Zones be leveraged for maximum community benefit?
Principles

- Align with the requirements of the original incentive
- Incorporate community voice, goals, and needs
- Consider market conditions
- Do no harm
- Be cost effective
- Promote transparency, monitoring, learning, and evaluation
What can civic leaders do?

- **Compile** relevant information, esp. shovel-ready projects
- **Connect** buyers and investors
- **Invest in people**: human capital, transit, and infrastructure
- **Align and provide** public and philanthropic resources
What can civic leaders do? (cont’d)

- Further incentivize projects that provide community benefit with real requirements about what is produced (e.g. affordable housing, local hiring, clean energy)
  - State tax credits
  - Reduced regulatory burden (e.g. hastened permitting)
  - Potential realignment of current programs (e.g. TIF)
  - Purchase vacant/underused properties
  - Conditional zoning
  - Cross-jurisdiction incentives
What can partners do?

- Resources, grants, and guarantees
- Loss reserves, credit enhancement
- Support land banks/purchase vacant land
- Invest in nonprofits that provide needed services within Zones