The Power and Possibility of Opportunity Zones

Jane Campbell and Timothy Lee
The Path to Passage

- The Tax Cuts and Jobs Act (H.R. 1) was signed into law by President Trump on December 22, 2017.
- The sweeping tax overhaul legislation included provisions from S. 293, the Investing in Opportunity Act
- Original Opportunity Zones legislation sponsored by Sen. Tim Scott (R-SC); originally co-sponsored by Sen. Cory Booker (D-NJ)
- House of Representatives counterpart, H.R. 828, sponsored by Reps. Pat Tiberi (R-WI) and Ron Kind (D-WI)
- Bipartisan support
  - 14 Senate co-sponsors
  - 81 House co-sponsors
Opportunity Zones Tax Incentives

Opportunity Zones offer investors three incentives for putting their capital to work in economically distressed communities:

A **temporary deferral**: An investor can defer capital gains taxes until the end of 2026 by rolling their gains directly over into an Opportunity Fund.

A **tax liability reduction**: The deferred capital gains liability is effectively reduced by 10% if the investment in the Opportunity Fund is held for 5 years and another 5% if held for 7 years.

A **tax exemption**: Any capital gains on subsequent investments made through an Opportunity Fund accrue tax-free as long as the investor stays invested in the fund for at least 10 years.

Graphics courtesy of Economic Innovation Group
Mechanics of Opportunity Zone Investments

Individual Taxpayers → Opportunity Fund → Qualified OZ Business Property

Opportunity Fund → Qualified OZ Partnership Interest

Opportunity Fund → Qualified OZ Stock
Opportunity Zones In Practice

There are three major components to Opportunity Zones:

**Investments:**
Opportunity Funds make equity investments in businesses and business property in Opportunity Zones.

**Funds:**
Opportunity Funds are investment vehicles organized as corporations or partnerships for the specific purpose of investing in qualified Opportunity Zones.

**Zones:**
States and territories nominated 25% of their eligible low-income census tracts as Opportunity Zones. Treasury approved final map.
There are three types of property eligible for Opportunity Zone investment:

- **Stock** of a qualified Opportunity Zone corporation
- **Partnership interest** in a qualified Opportunity Zone partnership
- **Business property** used in qualified Opportunity Zones

- A qualified Opportunity Zone business must use “substantially all” of its tangible property within a zone and meet a few additional basic tests. *Treasury just released draft regulations setting the “substantially all” test at 70% of the basis of the building itself excluding the cost of land*
- Investments that **do not** qualify include funds of funds, “sin” businesses (e.g. golf courses, package stores, casinos), and financial institutions
- A **substantial improvement** test applies unless the business property is original use
The early movers are seeking to shape the future of Opportunity Zone investing, and with it the character of neighborhood and community development in the U.S. for at least the next decade.

-Dennis Pierce, ImpactAlpha, “Early Movers are Getting a Jump on Opportunity Zones – and the Future of Community Investing”

- Deferral of capital gains taxation affords Opportunity Zone investors larger investments upfront
- Basis step-up explicitly reduces deferred taxation of invested capital gains, rewarding long-term commitment to Opportunity Zone communities
- Capital gains tax on investment returns eliminated entirely for 10-year investors
**Opportunity Zone Investment: A Simplified Example (1)**

**December 2018**

**Investor:** Buys 10 shares of technology stock at 100; sells at 200. Realizes capital gain of $1,000. Two options: Pay federal income tax today, or invest in Opportunity Zone.

**Opportunity Zone:** Offers deferral of federal tax on realized capital gains, plus elimination of taxes on returns to OZ investments held for 10 years.

**Capital Gains Tax:** Federal law provides for up to 23.8% tax on long-term capital gains. Many states levy additional capital gains taxes.
**Investor:** Contributes $1,000 in realized capital gains, otherwise taxable, into a qualified Opportunity Fund.

**Fund Manager:** Pools contributed funds from multiple investors and invests in equity, real estate, and equipment in businesses and housing located in Opportunity Zones.
Investor: Has held Opportunity Fund investment for 10 years.

- Completely exempt from capital gains tax on appreciation of Opportunity Zone holding
- Entitled to 15% basis step-up on deferred capital gains tax of original investment; tax liability deferred until end of 2026
Opportunity Zone Investment: A Simplified Example (4)

Non-Opportunity Zone Investment of Realized Capital Gains

- Original Capital Gains Investment: $238.00
- Investor’s Net Asset Appreciation: $561.57
- Federal Capital Gains Taxes: $175.40

- December 2018: $238.00
- December 2028: $764.85

Opportunity Zone Investment of Realized Capital Gains

- Original Capital Gains Investment: $1,000.00
- Investor’s Net Asset Appreciation: $1,000.00
- Federal Capital Gains Taxes: $202.30

- December 2018: $1,000.00
- December 2028: $1,764.85

Graphics not to scale.

<table>
<thead>
<tr>
<th>Capital Gains</th>
<th>Basis Step-Up</th>
<th>Initial Tax Load</th>
<th>Net Invested Funds</th>
<th>Gross Value of Investment at End of Holding Period, 7.0% Annual Return</th>
<th>Gross Return on Invested Funds</th>
<th>Tax Load on Gross Return, End of Holding Period</th>
<th>Deferred Tax Load on Original Invested Funds</th>
<th>Cumulative Tax Load</th>
<th>Net Return on Invested Funds</th>
<th>Net Investment Value after Holding Period</th>
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Cumulative Difference in Net Investment Returns $96.81

Cumulative Difference in Net Investment Returns $145.56

Cumulative Difference in Net Investment Returns $441.28

Land and Buildings

- Land does not require substantial improvement, but buildings do
- “Substantial improvement” is investment that meets or exceeds the cost basis of the buildings (excluding the land)
‘Substantially All’ Threshold

• 90% of the assets of any Opportunity Fund must be situated in Opportunity Zones or invested in Opportunity Zone businesses.
• Qualified Opportunity Zone businesses must have “substantially all” of their tangible property located within an opportunity zone.
• According to the new guidance, “substantially all” is defined as “at least 70%” for determining whether substantially all of the tangible property owned or lease by a taxpayer is qualified opportunity zone business property (as defined under section 1400Z-2(d)(3)(A)(i)).
Opportunity Funds will self-certify their compliance with applicable requirements using IRS Form 8996.
Opportunity Fund Organizational Structure

- Qualified Opportunity Funds can be:
  - LLCs
  - Partnerships
  - Corporations.

- Taxpayers eligible to elect deferral under section 1400Z-2 (“gain deferral election”) are those that recognize capital gain for federal income tax purposes. These taxpayers include:
  - Individuals
  - C corporations (including Regulated Investment Companies and Real Estate Investment Trusts)
  - Partnerships, and
  - Certain other pass-through entities.
The safe harbor allows qualified opportunity zone businesses to apply the definition of working capital provided in section 1397C(e)(1) to property held by the business for a period of up to 31 months, if three requirements are met:

1. There is a written plan that identifies the working capital assets as property held for the acquisition, construction, or substantial improvement of tangible property in the opportunity zone.
2. There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets, and under that schedule, the working capital assets are spent within 31 months of the receipt by the business of the financial property.
3. The working capital assets are actually used in a manner that is substantially consistent with the schedule.
Key Features of Opportunity Zones

✓ **Flexibility:** Low income communities come in many different shapes and sizes. All have different needs. This tool is capable of supporting a variety of mutually reinforcing activities within the same community.

✓ **Scalability:** There is no statutory cap on the amount of capital that can flow into Opportunity Zones in any given year. As such, this tool has the potential to help fuel economic renewal on a national scale.

✓ **Simplicity:** Opportunity funds do not compete for fixed allocations of public-sector financing, and as a result do not require pre-approval of their investments. This should lower the cost, time and risk to business transactions, and encourage broad participation.
Opportunity Zones Across The United States

- Of the 74,134 census tracts in the US and its territories, 8,762 (11.8%) have been designated as Opportunity Zones.
- Opportunity Zones are now designated for 10 years.
- Opportunity Zones (indicated in dark blue) are both urban and rural.
  - Urban areas are less visible on the map, but very much part of the QOZ initiative.
  - For example, the city of Chicago alone has 133 QOZs.
- The Treasury Department’s CDFI Fund has published a complete list of Opportunity Zones at [https://www.cdfifund.gov/pages/opportunity-zones.aspx](https://www.cdfifund.gov/pages/opportunity-zones.aspx)
Profile of America’s Opportunity Zones

¾ of Opportunity Zones lie within metro areas

31.3 million residents
(35.0 million including Puerto Rico and other US territories)

1.6 million businesses

24 million jobs

A strong foundation of businesses and jobs on which to expand

10 percent of the nation’s population resides within an Opportunity Zone

Metropolitan
Non-Metropolitan

24%
76%
Opportunity Zones Across The United States

Map provided by US Department of the Treasury.
Opportunity Zones Investment Strategy for Distressed Communities

This is the moment for local leadership. The map is set. It is time to mobilize in the Opportunity Zones.

- State and local governments can lead by:
  - Convening stakeholders and key constituencies, including anchor institutions
  - Engage the local community to determine its needs and develop an investment plan for the zone
  - Promoting inclusive and equitable economic growth for existing residents and businesses by aligning existing incentives and infrastructure investments in support of expanding access to opportunity
  - Implementing protections that prevent displacement
  - Incentivizing investments geared toward high social benefit
# Community Development Policy Tools

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<thead>
<tr>
<th>Tax Credits</th>
<th>Debt Financing</th>
<th>Community Targeting</th>
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| • Low Income Housing  
• New Markets  | • Tax Exempt Capital Markets  
• Federal Credit Programs: HUD, USDA  | • Opportunity Zones  
• HUBZones  
• Disaster Areas  
• Other Criteria  |
Complementary Roles: Debt and Equity

- Opportunity Zones can be part of an integrated, holistic approach to boot-strapping community development investment
- Opportunity Zone boost to equity investment complements existing incentives on the debt side, including federal credit programs (e.g. HUD, USDA) and tax-exempt capital markets
- Guidance specifically states Opportunity Zones should complement, not replace, other initiatives
Key Tools for Local Governments

✓ **Land use:** Address land use zoning as a means to protect/preserve affordable “commercial workspaces and locations”

✓ **Planning:** Local governments’ proactive participation in negotiating redevelopment plans designed to prevent displacement of micro- and/or small businesses

✓ **Knowledge:** Conduct economic impact assessments that measure the value of business services to a city’s resident base

✓ **Social Impact:** Small businesses are often more than service providers: they are social supports, particularly for lower-income communities

✓ **Incentives and Community Investment:** Economic incentives from Tax Increment Financing, Community Development Block Grant investment, infrastructure development, workforce training, and others contribute to creating stronger communities
How Are Things Likely To Proceed From Here?

2018
✓ Opportunity Zones certified and final map in place
✓ Q3-Q4: Early mover funds form and capitalize
✓ Q4: IRS/Treasury release further guidance
  • Q4: IRS released Opportunity Fund self-certification form

2019
• Bulk of funds form and capitalize
• Investment starts to flow

2020 and 2021
• Funds begin to invest at scale
• Funds reach 90 percent thresholds
• Investors continue to pile on in advance of the 2021 deadline to get the 5-year step-up by 2026
• First real picture of impact takes shape
A Holistic Approach to Success

Community Members and NGOs

Local Institutions

Institutional Investors

States and Localities

Federal Government

Housing

Small Businesses

Large Businesses

Education

Infrastructure
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