**Feb. 27, 2020, Opportunity Zones Forum: Final Regulations and Next Steps**

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# How We Got Here: An Overview of Opportunity Zones and Funds

# What is an Opportunity Zone?

An Opportunity Zone is a lower-income Census tract that has been designated as an Opportunity Zone by the US. Department of the Treasury.

- Opportunity Zones were created in the 2017 tax overhaul.
- In early 2018, governors got to nominate 25% of the tracts in their states that met the low-income criteria for Opportunity Zones; Treasury approved the tracts.
- Those who invest capital gains in long-term investments in Opportunity Zones can qualify for significant tax benefits.

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# Opportunity Zone Criteria

To qualify for Opportunity Zone status, most tracts had to have either:

- a 20+ percent poverty rate, or
- a median family income of no more than 80% of the state or metro area’s median, whichever was higher.

Up to 5% of a state’s Opportunity Zones could be slightly better off if they were adjacent to a qualifying tract that also was nominated. These are called contiguous tracts. NOTE: Contiguous tracts could make up 5% of the total, not an extra 5%.

Treasury’s preferred data for qualification were from the 2011-2015 American Community Survey. 2012-2016 ACS data also were acceptable.

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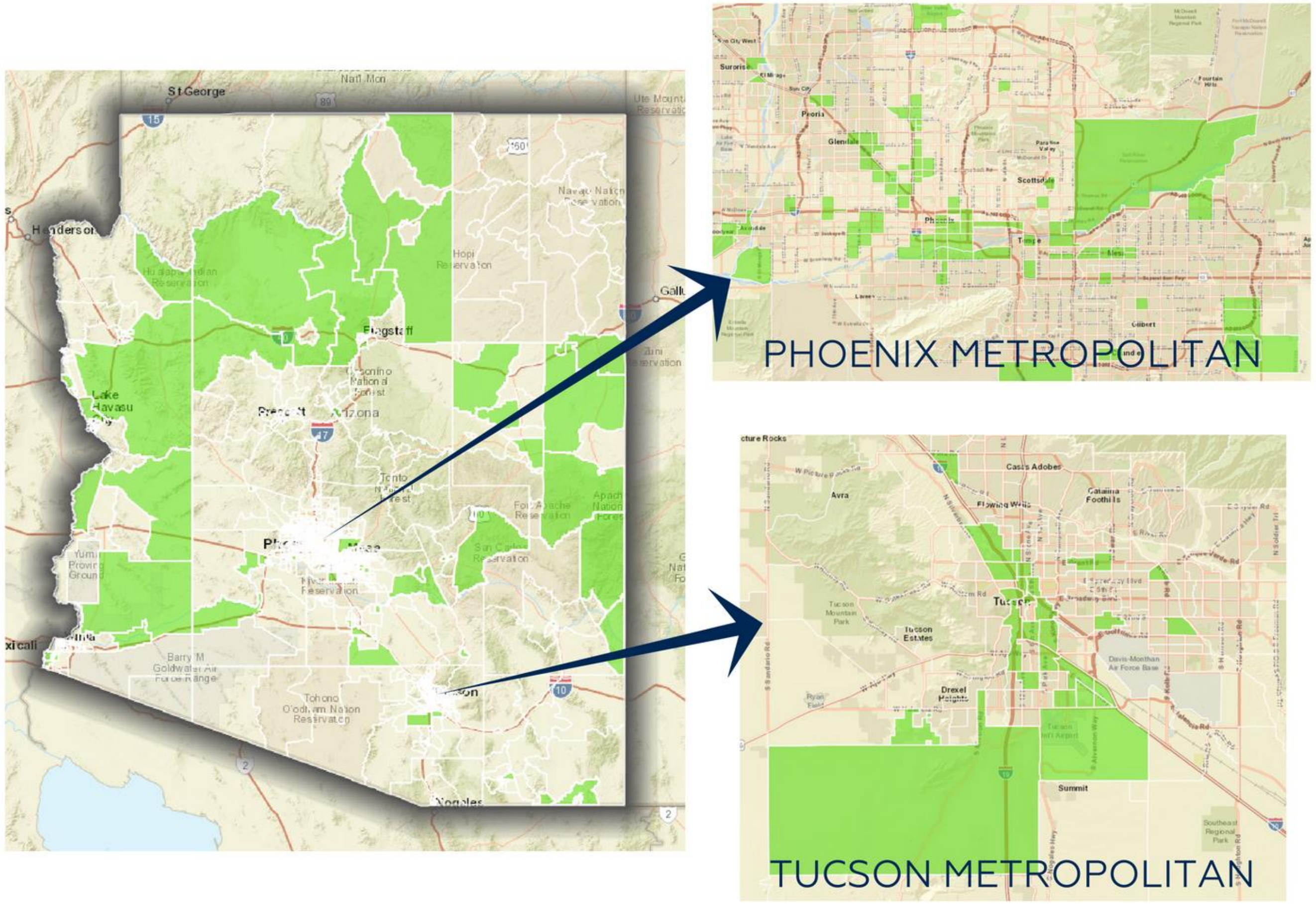
# What is a Census Tract?

"Census tracts are small, relatively permanent statistical subdivisions of a county."
–The Census Bureau

- A Census tract has about 4,000 inhabitants, on average.
  - Minimum: 1,200
  - Maximum: 8,000
- Census tracts do not cross county or state lines, but they do wash over city and tribal boundaries.
- Residential density affects the size and shape of tracts.
  - Urban tracts tend to be small and square or rectangular.
  - Rural tracts tend to be large and irregularly shaped.

# Arizona’s Opportunity Zones




[*View Arizona’s Opportunity Zones.*]

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# The Big OZ Picture

**1,526**
TOTAL ARIZONA CENSUS TRACTS

**671**
ARIZONA CENSUS TRACTS MEET CRITERIA*

**168**
CENSUS TRACTS NOMINATED & APPROVED

**REMARKABLE DEVELOPMENT OPPORTUNITIES ACROSS ARIZONA**

**CRITERIA BASED ON THE 2011-2015 AMERICAN COMMUNITY SURVEY DATA*

# Arizona’s Opportunity Zones

- Arizona has urban, suburban and rural Opportunity Zones, as well as tribal Opportunity Zones. We have a zone for every project, and a community in need of meaningful investment in every zone.
- Every county has at least one Opportunity Zone.
- Arizona was permitted to have up to 9 contiguous tracts; the state opted to nominate 8. All 8 of those, plus the 160 qualifying tracts, were approved by Treasury.
- Arizona’s OZs are on both their own map and on the Arizona Assets Map.

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# Selecting Arizona’s Opportunity Zones

**Dec. 2017**

Tax Cuts and Jobs Act signed into law. Allows governors to nominate Opportunity Zones.

Gov. Ducey asks Sandra Watson to have the ACA solicit input and recommend tracts for OZ status.

Sandra Watson decides ACA will reach out to jurisdictions across the state and strive for proportionality and inclusion in allotting OZs.

**Feb. 2018**

ACA sends individualized letters to jurisdictions seeking tract recommendations for OZ status in early Feb. Input is due Feb. 23.

In Maricopa and Pima Counties, incorporated communities with 10,000+ residents are asked to make recommendations. Elsewhere in those counties and in other counties, the county makes recommendations. Tribes also make recommendations.

**Mar. 2018**

ACA staff reviews the input and makes recommendations to Sandra Watson. Once recommendations are finalized Sandra Watspm presents them to Gov. Ducey, who approves them. They are submitted to Treasury on Mar. 21.

Arizona submits its maximum 168 tracts for OZ status, including 160 qualifying tracts and 8 contiguous tracts. ACA had to trim back the recommendations slightly to get to the max, but jurisdictions’ input was honored throughout the process.

**April 2018+**

Treasury approved Arizona’s tracts as Opportunity Zones on April 9. We are one of the first states to have our tracts approved. All states’ and territories’ tracts have since been approved. Together, they total more than 8,700.

With our tracts approved, ACA shifts to helping communities maximize the impact of Opportunity Zones in Arizona.

# How Opportunity Zones Work

U.S. tax code provides capital gains benefits to encourage investors to:

- Sell passively held investments.
- Reinvest resulting capital gains in long-term investments in property or businesses in Opportunity Zones.
  - Requires use of an intermediary vehicle, an Opportunity Fund. Investors may place their money in someone else's Opportunity Fund or start their own.

The idea of Opportunity Zones had floated around for a while with bipartisan support, notably from Sens. Cory Booker (D-New Jersey) and Tim Scott (R-South Carolina). The idea originated with Sean Parker, formerly of Napster and Facebook.

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# Federal Tax Benefits

1

## DEFERRAL

REALIZE A CAPITAL GAIN, REINVEST IT IN AN OPPORTUNITY FUND. TAXATION ON THAT GAIN DEFERED UNTIL 12/31/2026.

2

## 10% REDUCTION

IF OPPORTUNITY FUND INVESTMENT HELD FOR 5 YEARS BY 12/31/26, TAX ON PREVIOUS DEFERRED GAIN REDUCED 10 PERCENT.

3

## 15% REDUCTION

IF OPPORTUNITY FUND INVESTMENT HELD FOR 7 YEARS, BY 12/31/2026, TAX ON PREVIOUS DEFERRED GAIN REDUCED 15 PERCENT.

4

## ELIMINATION

IF OPPORTUNITY FUND INVESTMENT IS HELD FOR 10+ YEARS, NO CAPITAL GAINS TAX ASSESSED ON THAT (SECOND) INVESTMENT.

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# State tax benefits…

… depend on the state.

- Most states, including Arizona, conform to the federal tax code.
- Investing in a non-conforming state can create tax hassles and higher costs, as can living in a non-conforming state and making Opportunity Zone investments anywhere.
- Some states are considering extra incentives or giving an advantage to OZ projects when awarding grants. Arizona incentives apply statewide, including in all Arizona Opportunity Zones.

# Opportunity Fund Overview

- Must be organized as a corporation or partnership to invest in Opportunity Zones. LLCs are acceptable.
- May be organized to make a single investment/do a single project or to do multiple projects/investments.
- Must be certified by Treasury.
  - A fund "self certifies" by filling out form 8996 and submitting it with its federal tax return.
- Must have 90% of assets in qualified Opportunity Zone property.
  - Judged twice yearly, at mid- and end-point of tax year.
  - Penalty if failure to meet; may be waived if "due to a reasonable cause."
    - Penalty is an amount equal to the excess of 90% of its aggregate assets over the aggregate amount of Opportunity Zone property held by the Opportunity Fund multiplied by the IRS's underpayment rate.

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# OZ Investments: 3 Options

Opportunity Funds may invest in:

OZ BUSINESS STOCK

OZ BUSINESS PARTNERSHIP INTEREST

BUSINESS PROPERTY

Purchases must be made for cash. Stock must be original issue. Opportunity Funds may not invest in “sin businesses.”

# 1031 VS. Opportunity Fund

| 1031 Exchange | Opportunity Fund Investment |
|---|---|
| Investor must reinvest principal AND capital gain within 180 days of sale. | Investor may reinvest capital gain ONLY within 180 days of sale (generally) to get tax advantages. May roll all or part of gain. However, only the reinvested portion gets tax benefit. |
| Only real estate qualifies. | Capital gains from real estate or other investments may be invested in an Opportunity Fund. |
| “Designed for single asset swaps.” | Can be used for “a pooled fund that invests in multiple assets.” |
| “Capital gains tax payments for the initial investment may be deferred indefinitely.” Only reduction is via “a step up in basis upon death.” | Capital gains tax on the initial investment may be deferred until Dec. 31, 2026. Basis step up of 10 or 15 points applies if Opportunity Fund investment made by 2019 (15) or 2021 (10). |
| Capital gains tax owed on final asset sale. | If Opportunity Fund investment held for 10+ years, basis = fair market value, so no capital gains tax due on appreciation upon sale. In AZ and most other states, state tax law conforms. |

*Adapted from Fundrise site. Refers to federal tax policy only.*

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# Opportunity Zone and Fund Context

Opportunity Zones and Funds are tax provisions. They are not programs in the way people think of programs.

- Dollars invested are not capped, but they must be capital gains to get the tax benefits and be invested within a limited time period (by end of 2026).
  - These are not government dollars, except to the extent of the tax reduction/elimination.
- No government application or pre-investment review for an Opportunity Zone project.
- No government review, rating or licensure of Opportunity Funds beyond self certification.
- No statutory requirement that investments in Opportunity Zones be aligned with community desires/needs or that investors engage communities in the development process.
- No *public* reporting requirements have been set, but IRS form 8996 has been revised to have some reporting requirements on a fund's investments.

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# OZ Statute: Short but Complex

The OZ portion of the tax overhaul is just a few pages, but that leaves a lot to be sorted out in the regulatory process.

- Not atypical for it to take years to sort out this type of thing, but with OZ statute’s time’s limits, that has been challenging.
- Treasury has to digest the entire tax law through its regulatory process, not just OZ provisions.

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# Substantial Treasury Guidance (1)

- October 2018
  - Provided guidance on setting up funds and how investors should let IRS know they were deferring tax payment.
  - Clarified that only capital gains (long- or short-term) would receive the Opportunity Fund-related tax benefits.
  - Established a working capital safe harbor for companies developing projects with Opportunity Fund support, making multi-year projects feasible. (This has gotten expanded and clarified in subsequent guidance.)
  - Made rehab projects more desirable, if still somewhat challenging.
  - Made investing in businesses that are largely, but not wholly, in Opportunity Zones feasible.

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# Substantial Treasury Guidance (2)

- April 2019
  - Delved into how to invest in operating businesses, including clarifying guidance from October 2018.
  - Explained how to invest Opportunity Funds on rented property. (This is touched in the final guidance, too.)
  - Discussed tax implications of interim gains and rules for reinvestment, which comes up when a fund holds an investment for less than 10 years.

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# Substantial Treasury Guidance (3)

A third and final round of Treasury guidance was released in mid-December, 2019. It will take effect in mid-March, 2020.

This round of guidance will be covered extensively in the next panel, so stay tuned!

# Qualified Opportunity Zone Stock or Partnership Interest

- Must be obtained at original issue for cash.
- Business must be a qualified Opportunity Zone business when stock was issued or partnership interest acquired—or be organized to be one.
- During “substantially all” of the fund’s holding period for the stock or partnership interest, the business must qualify as an Opportunity Zone business.

# Qualified OZ business criteria

- A trade or business in which:
  - “substantially all of the tangible property owned or leased by the taxpayer is qualified Opportunity Zone property,” and
  - 50+ percent of total gross income is derived from active conduct of such business, and
  - “a substantial portion of the intangible property of such entity is used in the active conduct of any such business,” and
  - less than 5% of its assets are invested in nonqualified financial property.
- Cannot be a golf course, country club, massage parlor, hot tub facility, sun tan facility, liquor store, racetrack or “other facility used for gambling.”
  - Final guidance made a slight exception to this.

# Guidance on OZ business criteria (1)

- A trade or business in which:
  - "substantially all of the tangible property owned or leased by the taxpayer is qualified Opportunity Zone property…"
    - Treasury's October 2018 guidance defines "substantially all" for this purpose only as 70%.
      - This means that an Opportunity Fund that has to have 90% of its investment capital in qualified Opportunity Zone assets can actually have just 63% of its money in such assets if it invests in businesses rather than directly in other holdings (e.g. land, equipment).
      - The 70% ruling makes it easier (though still not easy) to invest in an existing business that has been around a while. And there are questions about the impact of final guidance on this matter.

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# Guidance on OZ business criteria (2)

- A trade or business in which:
  - 50+ percent of total gross income is derived from active conduct of such business…
    - Treasury's October 2018 guidance noted that the 50+ percent of total gross income must be derived from active conduct IN THE ZONE.
      - That addition concerned a lot of people who were not sure if/how it could be met.
    - Treasury's April 2019 guidance gave a range of ways to comply with the 50% gross income test:
      - Share of service hours performed in the zone, OR
      - Share of cost of services provided in the zone, OR
      - Tangible property and management/operations in the OZ are needed to generate 50+% of the business' gross income, OR
      - Facts and circumstances test.

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# Guidance on OZ business criteria (3)

- A trade or business in which:
  - "a substantial portion of the intangible property of such entity is used in the active conduct of any such business"…
    - Treasury's April 2019 guidance set "substantial" for this purpose at 40% but did not say how to define 40% of something intangible. This topic also was addressed in the third round of guidance.

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# Qualified OZ Business Property

- Acquired by the qualified Opportunity Fund by purchase after Dec. 31, 2017.
- Original use starts with the Opportunity Fund or the fund “substantially improves the property.”
  - “Property is substantially improved if during any 30-month period following acquisition of such property there are additions to basis that equal the adjusted basis as of the beginning of such 30-month period.”
- “During substantially all of the Opportunity Fund’s holding period, substantially all of the use of the property was in a qualified Opportunity Zone.” (This was defined as 70% in October 2018 guidance.)

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# What Is “Substantial Improvement”?

“Property is substantially improved if during any 30-month period following acquisition of such property there are additions to basis that equal the adjusted basis as of the beginning of such 30-month period.”

- In short, an Opportunity Fund generally has to spend as much money fixing up a property that was not in original use as the Fund spent acquiring it. This rule, if interpreted in just that way, would make rehab projects very unlikely.
- October 2018 guidance: The Opportunity Fund may distinguish between what it paid for the STRUCTURES on the land and what it paid for the LAND. The fund must spend only the equivalent of the value of the buildings on substantial improvement.

# What Is “Original Use” for OZ Property?

The term is used, but not defined, in statute.

- October 2018: Land can never have original use.
- April 2019 guidance: Original use for tangible property (including land) begins when the property is placed in service for purposes of depreciation or amortization.
- Also, buildings that have been vacant for several years may be repurposed under original use rules, not substantial improvement rules.
  - There’s was some disagreement about whether 5 years—as proposed in the second round of guidance—was too little, too much or just right. Treasury shortened the time period to 3 years in the final guidance.

# What about Undeveloped Land?

- Undeveloped land does not need to be substantially improved, but April 2019 guidance warns against buying with intent “not to improve the land by more than an insubstantial amount within 30 months of purchase.”
  - Also, the land must be used in a trade/business. IRS is explicitly interested in preventing land banking and has asked for comments on how to deploy anti-abuse provisions to prevent that practice.

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# Time crunch

Investors generally have just 180 days from when they realize capital gains to invest them in Opportunity Funds.

Opportunity Funds must have 90 percent of their money in acceptable Opportunity Zone assets. Funds are assessed every six months and penalized if the rule is not met.

These time pressures made investment, project development and planning very difficult. This is where guidance comes in…

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# Safe Harbor

## To facilitate a reasonable time period for projects:

- October 2018: Guidance provided a 31-month safe harbor for capital used for an Opportunity Zone business to acquire, construct and/or improve tangible property. This cash is considered reasonable working capital for the Opportunity Zone business test. Must have:
  - A written plan for developing the property
  - A written development schedule
  - Adherence to the plan and schedule
- April 2019: Guidance expanded coverage of the safe harbor to expenditures related to development of a trade/business, including payroll, inventory and rent.
- April 2019: The 31-month safe harbor may be extended for delays beyond the OZ business' control, such as government permitting delays.
- April 2019: Multiple, overlapping 31-month safe harbors are permitted for the same overall project (e.g. one for underground work, one for above-ground work).
  - Potential anti-abuse question: How many would be too many?
- Dec. 2019: Final round of guidance addresses and clarifies some of these issues.

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# Investment Timing

- Opportunity Funds are meant to invest quickly, and the statute calls for funds to be assessed at the mid- and end-points of their tax years to verify that 90% of their assets are qualified OZ property or business interests.
- The April 2019 guidance specifies that the testing should exclude investments received in the prior 6 months. Those assets must be held in cash, cash equivalent or debt instruments of 18 months or less.
- The October 2018 guidance specifies that to determine the value of an asset, the Opportunity Fund should use the value on its financial statement. If it doesn't have one, it should use the cost to the Fund to acquire the asset.

# Leased Property (1)

- The proposed regulations in the April 2019 guidance make it clear that Opportunity Funds may invest in businesses operating on leased land or invest in leased tangible property.
  - Leased tangible property may count as qualified OZ business property for purposes of the 90% asset test at the fund level and 70% asset test at the business level.
    - Lease must start after Dec. 31, 2017.
    - Lease must be market rate.
      - This was addressed in the final guidance (with regard to leases by state, local and tribal entities) and will be covered during the panel.
    - Substantially all the leased property is in an OZ during substantially all the lease period (more of an issue for equipment).

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# Leased Property (2)

- Per the April 2019 guidance:
  - There is no original use requirement for leased tangible property.
  - There is no substantial improvement requirement for it, either.
  - Lessor can be related to the Opportunity Fund or the OZ business, but there are restrictions that generate pros and cons.
  - Leased tangible property may be valued in accordance with GAAP or on a calculation of the “present value” of the lease payments.
    - Opportunity Funds must use same approach for all leased property.

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# Real Estate

## OTHER APRIL 2019 GUIDANCE:

- Owning and managing rental real estate qualifies as operating a trade/business for qualified OZ business purposes. Triple-net leases generally do not, as there is no active business conduct involved. If there is active conduct, beyond the lease, it might work, per the final guidance.
- If a piece of property straddles an Opportunity Zone It is possible to treat the whole property as OZ property. This was addressed in the April guidance and again in the December final guidance.

# Interim Gains

The April 2019 guidance clarified that:

- Opportunity Funds have 12 months to reinvest interim gains without the proceeds counted as a bad asset under the 90% test.
- The Fund’s gain gets allocated to the investors (if the Fund is not a corporation) and is taxable as income for investors. If the fund is a corporation, the corporation pays the tax.

# Miscellaneous Guidance

- October 2018:
  - Taxpayers use from 8949 to let Treasury know they are investing in an Opportunity Fund and deferring payment of capital gains taxes on that money.
  - Opportunity Funds use form 8996 to set up funds and report annually. The form is filed with the fund's taxes. It has since been revised.
- April 2019:
  - Investments in Opportunity Funds cannot be services.
  - IRC Section 1231 gains: 180-day Opportunity Fund investment clock begins on the last day of the taxable year.
    - Final guidance gave the option of starting the clock earlier, at the gain date.
  - Giving your OF shares to someone will create a tax event (inclusion of deferred gain.) Passing along your shares upon death through your estate will not.
    - Final guidance addresses the impact of transferring OF funds upon divorce.

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# Some thoughts…

- Interim gains are taxable. This seems to push funds toward investing in land-based projects, which will not move in less than 10 years, over operating businesses, though interest in operating businesses grows among some investors.
- It's unclear what investors should do with potential Opportunity Zone business property (e.g. equipment) that does not need "substantial improvement" that costs as much as the guidance says it should.
- Investors reap their most significant tax benefits when assets (or shares) or sold after 10 years. That means Funds have to invest in assets that will be sold later, not ones they will hold forever.
  - Hence, it's easier to invest in an office or industrial park than to build an HQ for a company that wants to own it in perpetuity.
  - That said, Funds can invest in new-build projects or new-property expansions/subsidiaries and get bought out by at an agreed-upon future time.

# OPEN FOR OPPORTUNITY

## ARIZONA OPPORTUNITY ZONES NETWORK

New, interactive tool designed to help further connect the Opportunity Zones community.

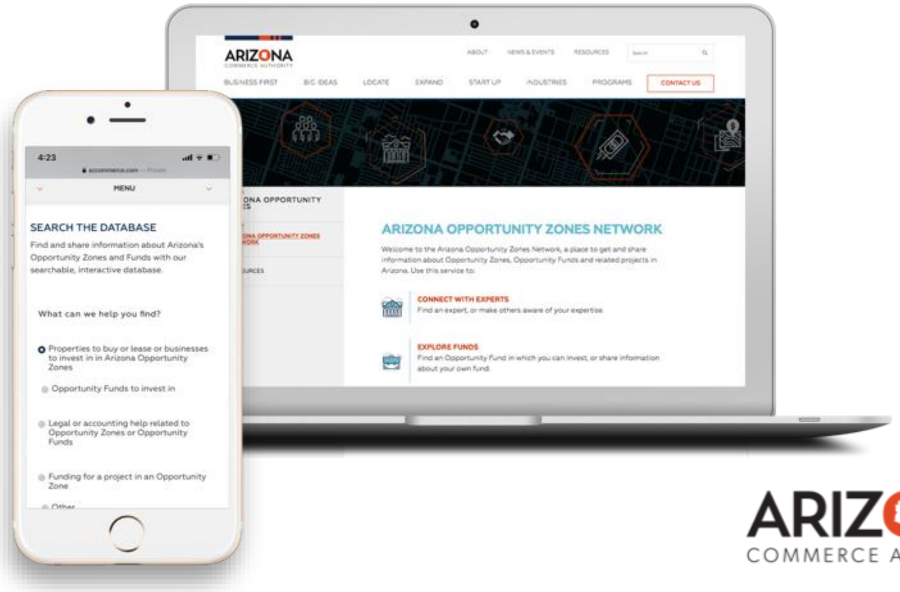
The searchable database allows users to:

- Connect with experts, investors or projects
- Find project, fund or investment opportunities
- Locate available properties
- List projects, investment opportunities or expertise

Visit the Arizona Opportunity Zones Network and add your information.

**+100** INVESTMENT OPPORTUNITIES ACROSS THE STATE

**DOZENS OF EXPERT AND FUND PROFILES**

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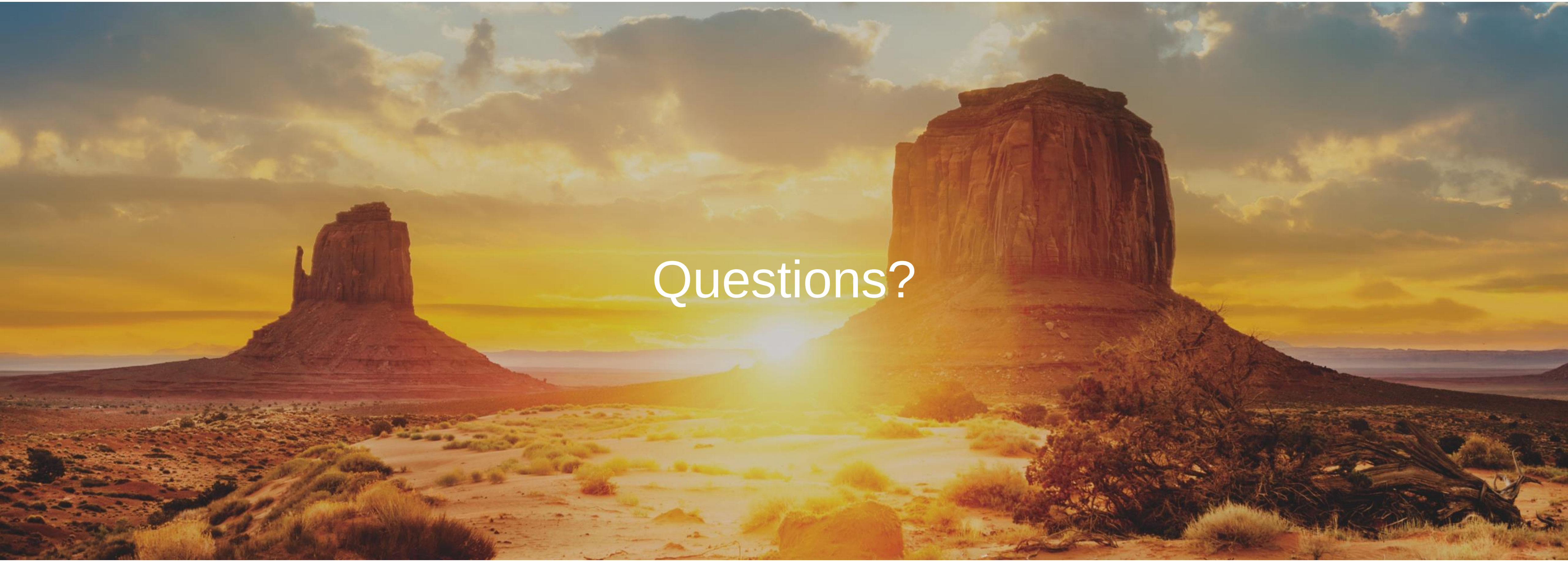

# Questions?

# WE'RE HERE TO HELP!

ADDITIONAL QUESTIONS?

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THANK YOU