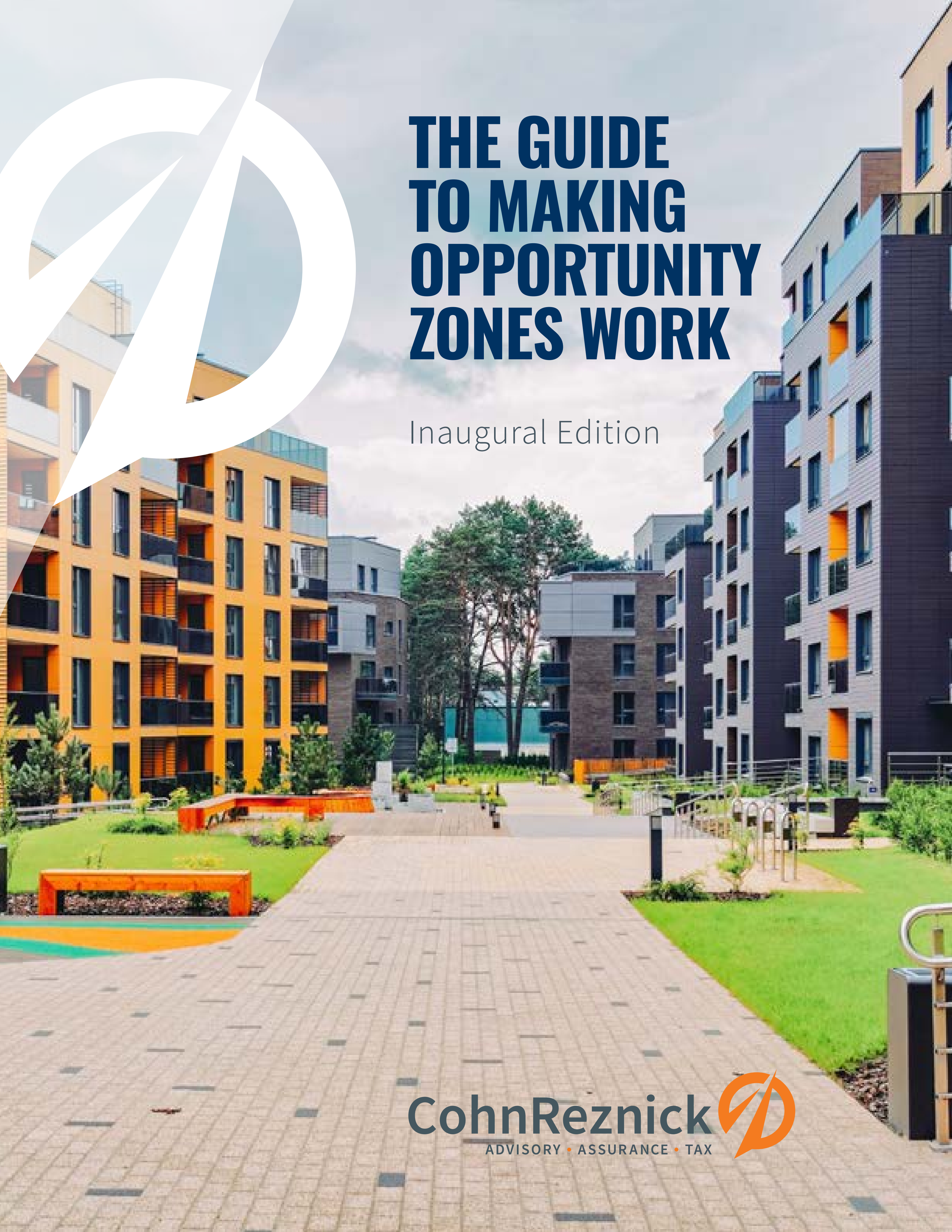
THE GUIDE TO MAKING OPPORTUNITY ZONES WORK

Inaugural Edition



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PROLOGUE

> "Opportunity Zones convey tax advantages to investors who take the proceeds of a capital gain, like the sale of a stock or a business, and invest them through a fund into a qualifying project in a designated zone. They were a largely overlooked provision of President Trump's tax law when Congress was debating it in 2017, but in the two years since the law's signing, the zones have stirred interest from investors on Wall Street, along with philanthropists and city leaders looking to revitalize distressed areas."[1]
>
> –*The New York Times*, **Treasury completes rules for Opportunity Zone tax breaks**, Dec. 20, 2019

Nearly three years after the passage of the 2017 *Tax Cuts and Jobs Act* (TCJA) brought to life the first new community development tax incentive in decades, we are still in the early stages of understanding how Opportunity Zones (OZs) can and should be implemented.

There's far more that we don't know than what we do know about this new industry, given the complex rules that were released by the IRS in three tranches over the course of 2018 and 2019 and now number in the hundreds of pages. As this new marketplace begins to take shape, we wanted to share what we have learned to help interested parties – from the investor to the resident and everyone in between – avoid many of the missteps and confusion we've witnessed, and to help you better understand how to navigate this evolving environment.

We hope you think of this guide as your comprehensive, plain-English tutorial to the nuts and bolts of OZ investing, whether you invest cash or intellectual capital in creating more equitable and sustainable low-income communities. We will go beyond technical nuances to provide practical tips that can help create and support a healthier OZ ecosystem for everyone involved.

What you can expect from this guide

This guide is not intended to be an authoritative, technical treatise. For that reason you will not find extensive citations to the law or the regulations themselves. (For those who want to dive into the weeds, you can find links to those resources in **Appendix B**.)

What you will see throughout this guide are references to ways in which the rules were designed to advance the overall **policy intent of Opportunity Zones: Encouraging new economic activity in left-behind places**. We created this guide to show how this principle can be upheld when the various stakeholders in this broad marketplace work together to help shift economic activity to communities that need it most.

We wanted to create a resource that would both inform existing investors, fund managers, developers, entrepreneurs, and community leaders in this space, and serve as a primer for those who are new to OZs. While this guide is not meant to address every issue or explore every possible use case (and there are hundreds), we set out to provide a helpful overview of the emerging industry and address the most common scenarios we encounter.

At the core, you should read this book because OZ investing will be a significant component of community development initiatives, business plans, tax strategies, investment portfolios, and estate plans for the next decade and beyond. In fact, both President Donald Trump and former Vice President Joe Biden embraced OZs as centerpieces in their 2020 election campaigns, and you can't say that about too many other economic policy issues.

1. **Treasury completes rules for Opportunity Zone tax breaks**, *The New York Times*, Dec. 20, 2019.

Opportunity Zones have not been without their share of controversy. Incentivizing private investment in low-income communities stimulates the broader philosophical debate around the most appropriate roles of the national government, state and local government, philanthropy, and the private sector. Where some predict a rising tide that will lift all boats, others fear the pressures of gentrification that can lead to displacement, and still others wonder whether there will be any impact at all. There are without question disconnects that arise between investor and community priorities. At the same time, government has fewer and fewer tools at its disposal to provide subsidy and encourage alignment. This dynamic reflects the serious issues that require acknowledgement and discussion in order for OZs – and communities – to be successful.

What's undoubtedly true, though, is that we have seen profound growth in inequality within and among communities, and OZs are generating an enormously important conversation about the best way that all stakeholders can address the vast divides we are seeing in economic, education, and health outcomes. While OZs won't solve these long-standing and serious issues on their own – this is not a silver bullet that can holistically address racism, underinvestment, and community leadership – OZs are an important new experiment that we believe merits serious consideration and engagement from all corners of civil society.

The Urban Institute, a D.C.-based economic and social policy think tank, stated in a recent report that "OZs are helping spur the evolution of a new community development ecosystem, engaging both project developers and investors who have limited historical engagement in community development work."[2] They also point out a need to be sensitive to how "mission-oriented" projects may struggle to compete with higher-return projects for attention and capital. It is this engagement and dialogue that is particularly exciting for all of us who believe in the urgency of developing better place-based solutions to address inequality in America.

Who should use this guide

At the end of the day, we want this guide to serve as a step toward creating a more informed dialogue and better understanding among all stakeholders, including:

- **Investors** who have capital gains to redeploy into worthy businesses, real estate, and infrastructure projects, whether they are small "retail" investors with modest stock market gains, high-net-worth individuals who have sold high-growth companies and large real estate portfolios, or large institutions and corporations following an M&A transaction;
- **Fund managers** who are seeking OZ capital and investment opportunities via strategies that focus on the opportunities and challenges of long-term investing in economically distressed communities;
- **Project/real estate developers** who are looking for new sources of capital that will flesh out the financing needed to complete local projects that in the past haven't been able to get the attention of private investment markets;
- **Businesses/entrepreneurs** who have resisted the urge to move – or been unable to move – to the handful of super-performing cities that attract so much of the country's private equity and growth capital; and
- **Community leaders and their constituents** who have a vision to turn around their central business districts, neighborhood corridors, brownfield sites, and abandoned malls, looking to find better and more sustainable ways to support planned growth by partnering with the private sector, in their towns and cities and far beyond.

As we planned this guide, the variety of audiences who have a stake in the success of Opportunity Zones posed an interesting challenge. On the one hand, each player has unique considerations and nuances that lend themselves to discrete chapters. On the other, the success of OZ projects depends on all participants having a holistic understanding of how these investments work, and how all players' working together can ultimately support their intended outcomes.

We have organized and written this guide in a way that is intended to give readers a better understanding of the larger ecosystem, as well as an appreciation for how they can fit in. Since there are so many different approaches to fund management, capital accumulation, and asset identification.

2. **An Early Assessment of Opportunity Zones for Equitable Development Projects**, The Urban Institute, June-July 2020.

The following terms are either unique or crucial to the Opportunity Zone compliance regime. As a quick orientation, you'll find below a brief description of each, as well as the locations where you'll find the most thorough definitions, explanations, and discussion of the context of these terms.

Qualified Opportunity Zone (QOZ)

A census tract that generally meets the federal definition of a low-income community, has been nominated for the QOZ designation by its state or territory, and has had that nomination certified by the CDFI Fund (supporting the IRS). *Start learning more about QOZs in* ***Chapter 1****. Note that you will see both "OZ" and "QOZ" used as acronyms throughout this guide. We have used "OZ" when referring to the initiative in general, and "QOZ" to refer to a specific area that has been certified an Opportunity Zone.*

Qualified Opportunity Fund (QOF)

A special investment vehicle organized for the specific purpose of investing in OZ assets and projects. OZ investors can form their own "captive" QOFs or invest through third-party ones. 90% of a QOF's assets must be invested in either QOZ businesses or QOZ business property, depending on how the fund is structured.

For a ***high-level overview****, see* ***page 16****; for full detail and guidance* ***for QOF managers****, see* ***Chapter 3****; for considerations* ***for OZ investors****, see* ***page 32****.*

90% investment standard

The bedrock of the OZ compliance regime, this test requires that the value of a QOF's holdings of QOZ property – QOZ business property, stock, and/or partnership interests, depending on how the fund is structured – make up at least 90% of the value of all the assets held by the QOF. ***Fund managers****, see* ***page 39****.*

INTRODUCTION: HOW WE GOT HERE

The insidious growth of geographic inequality in America is creating an urgency we have not seen since the 1930s to re-evaluate economic policy strategies. As we are witnessing the COVID-19 pandemic generating the second global economic crisis in just over a decade, places that are still reeling from the Great Recession of 2008-09 are especially vulnerable to further declines in growth, businesses, jobs, and the social infrastructure that is critical to the health and well-being of low-income communities.

Existing federal and state relief measures won't be sufficient to spread economic opportunity beyond the pockets of prosperity that have characterized the uneven recovery over the past several years. Undoubtedly, private investment on a large scale is needed to complement these public dollars, and the Opportunity Zones program can be a key part of that equation.

OZs were designed to be powerful and flexible enough to unlock patient and scalable capital that has the potential to change the trajectory of left-behind communities by catalyzing positive returns for the people who live, work, and invest in those places.

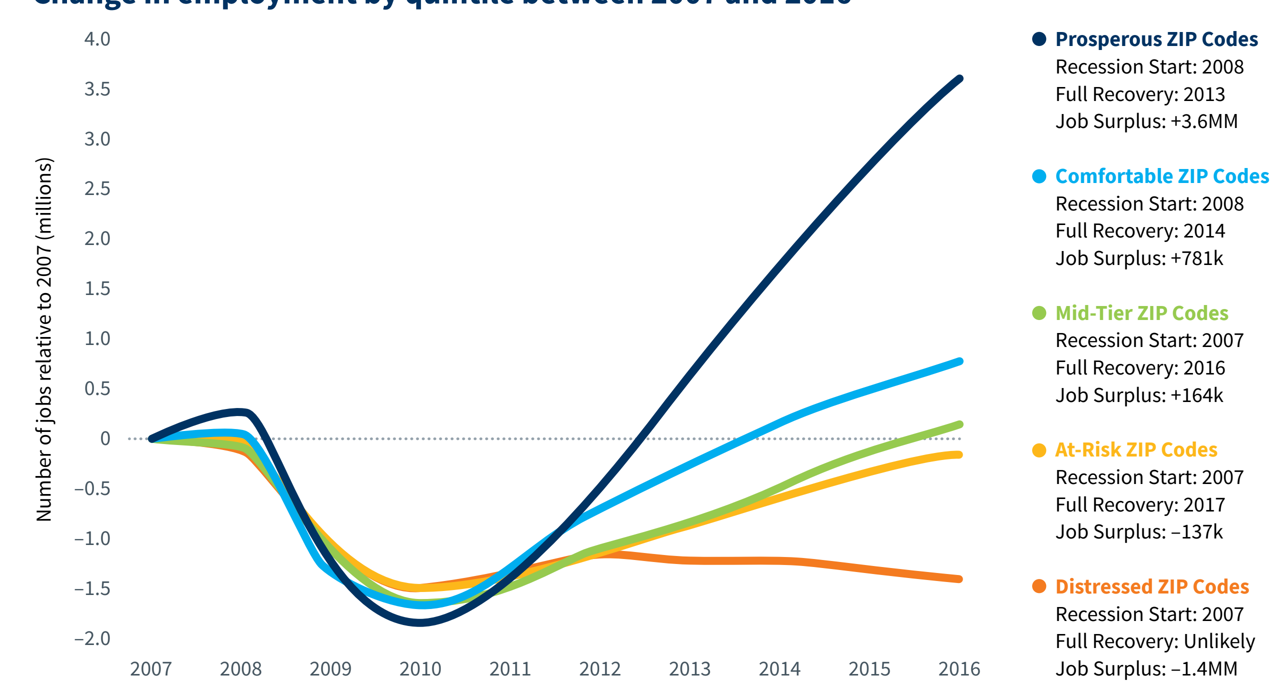
The uneven economic recovery

While prosperity is no longer limited exclusively to "superstar cities," too many communities still struggle with levels of disinvestment and blight that lead to long-term unemployment, widening health and education outcomes, and less hope and opportunity for over 50 million Americans.[1]

"Despite the record-setting national economic growth of the past few years, the country has made little progress in raising the floor of economic well-being for its most vulnerable communities," the Economic Innovation Group (EIG) writes in the 2020 edition of their Distressed Communities Index (DCI), which compares economic well-being in ZIP codes throughout the country.

1. 2018 Distressed Communities Index and 2020 Distressed Communities Index, Economic Innovation Group (EIG), October 2018 and October 2020.

Change in employment by quintile between 2007 and 2016



Source: 2018 EIG Distressed Communities Index

CHAPTER 4

FOR OPPORTUNITY ZONE DEVELOPERS

Real estate is the bedrock of place-based economic development, and so it is not surprising that the bulk of Qualified Opportunity Zone (QOZ) activity has occurred in real estate projects.

To understand the mechanics of this incentive, developers have to keep in mind that QOZs were added to the Tax Code in order to spur new, long-term investment in these areas. To achieve this policy intent, OZs come with a complex set of rules and regulations, and not all projects will qualify. Projects that do qualify may require significant new investment, and that investment must be deployed within a certain time window. Oftentimes, these projects come with additional community, political, and media scrutiny, because they offer such powerful tax incentives to investors.

All that said, Opportunity Zones can be a powerful way to align interests among stakeholders; streamline entitlements, permitting, and zoning requirements on the local level; access federal grants for infrastructure, transportation, and economic development; incentivize debt financing from banks and other financial institutions; engage local and national philanthropic support; and engage with community residents and advocacy organizations around priorities. This new method to mobilize equity capital into development projects can be particularly useful in cities and communities that have been cut off from capital markets or are generally off the radar screen of investors, but possess fundamental economic potential.

In this chapter, we cover many of the legal and technical concepts that developers need to know, including:

- **How raw land, vacant property, and brownfield sites are treated**
- **How the purchase of land that has a building on it is treated**
- **What constitutes substantial improvement**
- **How a QOZ business is defined, and how the working capital safe harbor works**
- **Rules for what is considered a "trade or business"**
- **What types of leased real property do and do not work**

What types of projects qualify?

In short, Qualified Opportunity Funds (QOFs), which are the source of equity capital for QOZ projects, must invest in businesses, in partnerships, or directly in tangible property. To be considered "good" QOZ business property, that tangible property must meet each of the following tests:

- It was acquired by purchase (production, construction, and manufacturing all meet this test) after Dec. 31, 2017;
- The original use of the property in the QOZ commenced with the QOF, or the property was substantially improved by the QOF;
- During substantially all of the time the QOF held the property, substantially all of the use of the property was in a QOZ (generally not an issue for real estate projects); and
- The property is used in a trade or business.

> **Related party rules**
>
> **It is not unusual for real estate developers to acquire land prior to beginning a development project. In many instances, the land is acquired directly by the developer and contributed into the joint venture (JV) partnership in exchange for a capital interest in the project. In general, if the developer sells the property to the QOF or the QOZ business, the developer can own no more than 20% of the project without running afoul of the related party rules, which if violated make the acquired asset "bad" for purposes of the 90% portfolio test and QOZ business property tests described in Chapter 3.**

Purchase of raw land and "original use"

Let's start the conversation from the ground up, which is how most Opportunity Zone deals begin their lifespan.

Remember that the QOZ provision was intended to spur new economic development. Unimproved or minimally improved land ("raw land") cannot qualify for QOZ benefits unless it is substantially improved during a 30-month period. Activities such as renting raw land to a third party or converting the land to a parking lot do not meet the standards to qualify as a trade or business for QOZ purposes. However, raw land acquired with a plan or intent to improve it by "more than an insubstantial amount" for use by an eligible entity in a QOZ business (QOZB) can qualify.

Land can be either purchased by or contributed to the QOF, and in either case, any building on the land would qualify as "good" QOZ business property. If land is contributed to a development (instead of purchased), the land itself is not good QOZ business property, but any new buildings on the land are because their "original use" begins in the QOZ.

The IRS regulations define "original use" more broadly than simply building a brand-new building. The IRS says that "original use of tangible property occurs when the property is first placed in service in a manner that would start depreciation or amortization if the property were being used in a trade or business."[1] This generally means in practice that entirely constructed buildings can be purchased as original use if they have not yet been leased out or rented.

Vacant property and brownfield sites

Original use can also include placing back into service property that was taken out of service ("vacant property").[2] Remember, the focus of this incentive is to drive new investment into these zones, not just to create new transactions to qualify existing investments for tax breaks. To counteract the possibility for abuse, the QOZ rules include mandatory minimum periods of vacancy before the property's placement back into service would qualify as original use.

The final regulations provide that the required minimum period of vacancy is three years before a sale to a new owner, instead of the five years required under the proposed regulations. The shortening of the time frame was a taxpayer-friendly rule in the final regulations that should help more properties qualify as QOZ property. The rules also allow an exception for property that was vacant when its location was designated a QOZ, in which case the minimum vacancy period is one year before a sale to a new owner.

1. Opportunity Zones Frequently Asked Questions, IRS, updated Sept. 19, 2020.
2. Real property, including land and buildings, is considered vacant property if it is "significantly unused," which in a land and building scenario means that more than 80% of the property's square footage of usable space is not currently being used when the property is purchased for QOZ purposes.

CONCLUSION

WHERE WE GO FROM HERE

> **"In America's winner-take-all economy, what's true for individuals and companies is also true of cities – the superstars are walking away with it all. A handful of metropolitan areas now attract most of the investment capital, create most of the jobs, generate most of the new companies, and account for most of the economic growth. Instead of growing together, as was once the case, we are growing apart.**
>
> **"...Any successful strategy must leverage the region's strengths – infrastructure, businesses, institutions, and know-how – to create globally competitive industry clusters, while also developing an entrepreneurial ecosystem that can generate and nurture innovative new companies. … It requires significant financial investment from federal and state governments in the form of tax-free Opportunity Zones, research funding, low-cost loans, seed capital for new businesses, worker training, and infrastructure. Alongside that public investment, there must be significant investment by local companies, universities, banks, and pension funds."**
>
> –*Washington Post* columnist **Steven Pearlstein**, **Forget Seattle and L.A. We should bet big on St. Louis and Baltimore**. March 5, 2020

Opportunity Zones are a bit of a blank canvas. In contrast to the layers of bureaucracy of more established community development programs that require applicants to compete for limited government funds – thereby ensuring a limited investment ecosystem – the OZ tax benefits are available to anyone with some capital gain dollars to invest.

Because OZs are designed to work the way the market works, they have the potential to create a massive market that empowers all sorts of stakeholders, from athletes and high-net-worth investors who seek to make a difference in places they care about, to fund managers targeting a turnaround strategy for distressed areas, to real estate developers who need that last piece in the capital stack to get the wheels turning on an overlooked urban core project, to entrepreneurs willing to grow their venture-backed technology company within a community that needs that shot of job-creating adrenaline. The incentive can give businesses a reason to settle and hire in communities that are outside of the handful of entrepreneurial hubs. And it can be a powerful tool that communities can add to their existing economic development toolbox.

Signs indicate that this market is coming to fruition. The White House Council of Economic Advisers estimated that Qualified Opportunity Funds raised $75 billion in funds in the first two years of the program,[1] and CBRE found that the cities disproportionately benefiting from that investment are not Portland, Seattle, and Miami, but Birmingham, Baltimore, and Detroit.[2]

In 2020, the world has changed more than we could ever have imagined. The public health, social, and economic impacts of COVID-19 have exacerbated problems such as socioeconomic inequality and the risks of living in dense areas, and accentuated the importance of getting private equity capital into places struggling with long-term disinvestment. Our society is grappling anew with racial injustice and inequity and how to create real, lasting change, including addressing some of the structural inequalities that disproportionately impact communities of color, some of which are OZs. These matters are only becoming more pressing. While navigating the technical intricacies of OZs and striving toward projects' business and investment aims, we can't lose sight of how important it is that stakeholders align around community development, and how – with the right emphasis – we

1. The impact of Opportunity Zones: An initial assessment, White House Council of Economic Advisers, August 2020.
2. Multifamily developers seize opportunity, CBRE, Nov. 10, 2019.

can chip away at obstacles and help build progress. As the Editorial Board of the *New York Times* wrote in an op-ed on how to reduce inequality in cities, "The beauty and peril of cities is that we all are bound together."[3]

For those with the resources to do so, now is the time to invest. As was the case in the wake of the 2008-09 recession, investors look at the start of a new economic cycle as an ideal time to invest in distressed assets that represent significant upside potential during the recovery. This requires patient capital, and the 10-plus-year investment horizon for OZ projects makes OZ funding a unique solution for places that might otherwise be left behind.

Looking forward, Opportunity Zones will continue to be an important part of the political and policy landscape no matter who sits in the White House. President Donald Trump has signaled his strong support, including issuing an August 2020 Executive Order encouraging federal agencies to prioritize OZs when considering where to locate their offices. In his "Build Back Better" plan, former Vice President Joe Biden highlighted OZ enhancements as an important prong of his approach to address racial inequality. Legislators at both the federal and state levels continue to piggyback on OZs by layering in additional incentives.

It doesn't hurt that mayors generally believe Opportunity Zones are targeting areas of true economic need, and they are confident in their ability to capitalize on the program. In June 2020, the U.S. Conference of Mayors adopted a resolution expressing their support for this "tool to attract new investments in low-income communities" and calling on legislators to enhance the statute to facilitate recovery efforts in the wake of the COVID-19 pandemic.[4]

The mayors also called for more transparency around the impact of these funds. While reporting requirements, which were included in the original *Investing in Opportunity Act*, were stripped out of the *Tax Cuts* and *Jobs Act* for reasons that have to do with the way the legislation was passed, the need for a reporting framework is something that has always enjoyed bipartisan support. A number of bills have been introduced that would reinstate and expand on the original reporting requirements., most notably the *IMPACT Act*, by one of the original co-sponsors of the OZ legislation, Sen. Tim Scott (R-S.C.).[5]

3. The cities we need, *New York Times* Editorial Board, May 11, 2020.
4. Opportunity Zones, U.S. Conference of Mayors, June 2020. Also see the 2019 Menino Survey of Mayors, Boston University Initiative on Cities, January 2020.
5. The Improving and Reinstating the Monitoring, Prevention, Accountability, Certification, and Transparency Provisions of Opportunity Zones (IMPACT) Act would create annual reporting requirements for Qualified Opportunity Funds (QOFs) and taxpayers investing in such funds. The bill also requires the Department of the Treasury to make publicly available annual reports on QOFs.

Artwork created for the project, some used, some not.

HEAR ON THE STREET

HEARD ON THE STREET