COMMUNITY FOUNDATION
PUBLIC AWARENESS INITIATIVE

How Community Foundations Can Use the Opportunity Zone Tax Incentive for Community Development[1]

December 2018

This white paper discusses a timely and significant opportunity for community foundations (CFs): How they can use the recently enacted federal Opportunity Zone tax incentive to benefit communities in need by leveraging their knowledge of underprivileged communities, networks of donors, and commitment to community development. The memo explores several options for CFs to take advantage of the Opportunity Zone (OZ) incentive to support their mission, including by serving as:

- **Manager of a Qualified Opportunity Fund**
- **Advisor to Qualified Opportunity Fund**
- **Co-investor with Qualified Opportunity Fund**
- **Fundraiser for Qualified Opportunity Fund**

There are two main reasons the **Community Foundation Public Awareness Initiative** felt compelled to prepare this memo.

First, it seems obvious to us that CFs should be in the discussion over how to use OZs most effectively: They know their communities better than anyone; they have engaged boards and connections with local government; and they work with donors with unrealized capital gains who may be interested in investing in these revitalization zones. It makes little sense for the funds that might ultimately benefit low-income communities in Alabama or Ohio or Missouri to be housed at a big investment bank in another state or city. *We believe the best outcome is for OZ money to stay local, raised from local donors, and invested in the same community.*

Second, we also recognize that for certain high-end donors, the OZ incentive potentially creates *competition* for CFs. Funds that might otherwise go to the CF as charitable gifts of appreciated stock might now be directed to funds being set up to support Opportunity Zones across the nation. The tax benefit to the donor of the direct charitable gift is greater, but some donors may want to make *both* a gift and an investment. **If the networks of professional advisors that work with CFs could say to select clients, *"You may want to make both a charitable gift and an Opportunity Zone investment, and you can do both of those things***

[1] This white paper has been prepared by the Community Foundation Public Awareness Initiative at Van Scoyoc Associates, but it would not have been possible without the substantial legal and technical contributions of Alex Reid at Morgan Lewis and Kevin Wilson at Novogradac & Company. Contact information for all contributors can be found on page 11.

***through the community foundation,"* this creates a new business opportunity for CFs, and a new way to service current donors.**

Background

The federal Opportunity Zone tax incentive enacted in December 2017 as part of the Tax Cuts and Jobs Act (P.L. 115-97) is designed to spur economic development and job creation in underserved communities across the United States by providing significant tax benefits to investors.[2] Through an array of incentives including tax deferral and forgiveness for capital gains, the initiative aims to create a new market and stimulate a new pool of investors in "Opportunity Zones" (OZs). By some accounts, the program is the first new federal lifeline to such impoverished communities in more than a decade. And the incentive has the potential to become the largest economic development program in recent U.S. history once it is up and running. While the program has not been immune to recent public criticism, it is likely here to stay, and CFs have a role to play to ensure capital is directed to projects with high social value.

The core idea of OZs is to connect so-called "idle capital" with distressed communities needing patient, long-term capital investment. Targeted areas must be "qualified" as Opportunity Zones. A **Qualified Opportunity Zone** (QOZ) is a low-income community, which generally is a census tract either with a poverty rate of at least 20 percent or with median income at or below 80 percent of the area median income. Under the new law, the governor of each state or territory was given authority to designate 25 percent of the state's low-income communities as OZs, so each locality could customize the selection process to meet its unique needs. (A current list of designated Opportunity Zones can be found here.) While the federal government has set the standard, the success of this initiative will depend on the active engagement of state and local leaders—including, importantly, CF leaders and their boards of directors—to maximize the effectiveness for their constituency.

To qualify for the tax incentive to defer or erase future capital gains taxes, a taxpayer must reinvest capital in a **Qualified Opportunity Fund** (QOF), which is organized as a corporation or a partnership that holds at least 90 percent of its assets in qualified OZ property. The OZ tax incentive comprises three tax benefits:

1. **Gain deferral** – Investors do not pay tax on capital gains upon sale. Taxation of the gains is deferred until December 31, 2026, or earlier sale. The initial deferral allows the investor to leverage tax savings to fund a larger investment.

2. **Partial forgiveness** – If the investor holds the investment for five or seven years before December 31, 2026, 10 and 15 percent, respectively, of the originally deferred gain is effectively forgiven.

[2] For those who are interested, we will be making a technical explanation of the Opportunity Zone tax incentive available on our website at https://www.commfoundations.com.

3. **Forgiveness of additional gains** – If the investor holds their investment in the QOF for over 10 years (assuming the incentive is extended past the 10-year expiration of several provisions in the new tax law), any additional gains will not be subject to tax.

Together, these benefits should be of great interest to key potential investors. For example, taxpayers who have recently liquidated substantial assets and are confronting a hefty tax on their capital gains, as well as taxpayers who may be contemplating selling appreciated assets to invest in socially beneficial entities but are reluctant to do because of the "toll charge" required to free up their capital, have a tremendous incentive to roll their gains into a QOF eligible for the tax benefits afforded under these new rules. **Community foundations are uniquely positioned to identify these individuals and help them direct their capital to communities in need.**

Tax Law Requirements Applicable to Community Foundations

CFs are natural partners to Qualified Opportunity Funds because of their knowledge of the community and regular contact with socially-engaged donors who may have unrealized capital gain property. However, challenges to such partnerships may exist. For one, Section 501(c)(3) of the Internal Revenue Code prohibits nonprofit organizations, including CFs, from engaging in "private inurement," meaning that the organization may not distribute its earnings and profits to any private party. This prevents CFs from having "investors," and would prevent a CF from qualifying as a QOF itself, or holding QOF assets within the charity.

In addition, Section 501(c)(3) requires nonprofit organizations to operate primarily for charitable purposes, meaning they must engage primarily in activities that directly benefit the organization's charitable class to a substantial degree. Activities that benefit private parties (including high-net-worth investors in a QOF) should be indirect and insubstantial.

These legal requirements do not, however, preclude CFs from establishing QOFs in a separate entity that the CF manages and helps attract capital to, or providing program services to other QOFs or qualified OZ businesses in the community. Even if the CF determines that a particular QOF or QOF investment is not sufficiently charitable to qualify as a substantial activity of the CF, the foundation may conduct the activity separately through an alternative investment vehicle such as a taxable corporation.

So what is "charitable" enough? As defined by Treasury regulations, the term "charitable" includes the relief of the poor and distressed, lessening the burdens of government, and the promotion of social welfare by organizations designed to lessen neighborhood tensions caused by the lack of jobs. It also encompasses activities that combat community deterioration by establishing new businesses, rehabilitating existing businesses, and eliminating conditions of blight; as well as activities to eliminate prejudice and discrimination against minorities.

Besides providing direct services to individuals, another way of conducting charitable activity is by providing services directly to for-profit businesses, provided that the ultimate good received by the public outweighs the private benefit accorded to the direct beneficiaries. **This may be the sweet spot for community foundations**.

Here is the bottom line for community foundations that want to directly attract capital and manage their own Qualified Opportunity Funds:

If the QOF itself would be investing in activities that could be construed as charitable – and the tax code and revenue rulings provide substantial leeway – then the community foundation could manage the QOF directly and attract capital for it from its donors with unrealized capital assets, its public charity status notwithstanding. However, the local investments made by the QOF may not be known ahead of time.

Therefore, to maximize its options, a CF may wish instead to form a taxable subsidiary (using its own staff and investment committee and sharing the same board of directors) to manage the QOF and attract QOF capital to the subsidiary, or provide services to a third-party manager of a QOF. In that case, the CF would be providing services to benefit the community, which is permissible, and bringing its substantial expertise to the table in the OZ process.

It also provides a way for community foundations to maintain and serve their donors, because those who want to donate appreciated stock and those who want to use the Opportunity Zones incentive may like the convenience factor of coming to the same organization to do both.

These factors generally must be present for the IRS to conclude that providing services to a for-profit company – including a QOF or a QOF's qualified Opportunity Zone business property investment – accomplishes charitable purposes, despite the potential for private benefit:

- Assistance should be targeted to aid an economically depressed or blighted area, which generally should include OZs;
- The benefit should flow to a disadvantaged group, such as minorities, the unemployed or underemployed;
- Businesses have had difficulty obtaining conventional financing because of the deteriorated nature of the area in which they were or would be located, or because of their minority composition;
- Aid is directed to a business that requires economic assistance to locate or remain in the economically depressed or blighted area; and/or provides jobs and training to the unemployed or underemployed from such area.

There is substantial legal precedent to support community development programmatic activity by tax-exempt organizations.[3] **These rulings and others support the notion that a CF can**

[3] For example, see Rev. Rul. 74-587, 1974-2 C.B. 162 (charitable organization made loans and purchased equity interests in businesses unable to obtain funds from conventional sources because of financial risks associated with their location and/or because of being owned by members of a minority or other disadvantaged group); or Rev. Rul. 76-419, 1976-2 C.B. 146 (charitable organization purchased blighted land in economically depressed community, converted land into industrial park, and induced industrial

provide QOF services to a taxable entity spun off from the foundation itself. Any activity that not only does not qualify for tax-exempt status, but also generates unrelated business taxable income ("UBTI") can be isolated in a taxable for-profit subsidiary.

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With this understanding of the opportunities and constraints, CFs will want to explore several roles they can play within the Opportunity Zone program—ranging from serving as deeply involved managers of opportunity funds to less direct forms of engagement. **Four of the most interesting approaches are explained in the following sections.**

I. Community Foundation as Qualified Opportunity Fund Manager

While a community foundation may not take on investors itself, it may establish and manage a QOF to bring in investment capital from outside investors. This QOF may be organized as a limited liability company managed by the CF and owned by the investors. Alternatively, a CF can affiliate with a third-party QOF, and provide services to the QOF.

As noted above, the choice of whether to manage a QOF directly, indirectly through a taxable subsidiary, or on a limited basis through a services contract, turns on the charitability of the QOF and its underlying investments. **Just as a private foundation can manage a program-related investment fund, so too can a CF manage a QOF devoted to charitable purposes**. Income from performing charitable activities substantially related to a CF's tax-exempt purposes is **not** subject to unrelated business income tax (UBIT), nor does it endanger the organization's tax-exempt status under the operational test. (This structure is shown in **Figure 1** in the Appendix.)

As discussed earlier, in some instances, the degree of private benefit in a QOF and its portfolio investments may be too significant for the QOF to qualify as "charitable" (i.e., the individuals and businesses that benefit from the investments are outside the charitable class.) In those cases, the CF has other options: It may form a taxable subsidiary to manage the QOF, or it can provide services to the QOF on a contractual basis.

A **taxable subsidiary** may conduct an active, unrelated trade or business and distribute the net earnings from that business by paying after-tax dividends to a tax-exempt parent. The taxable subsidiary pays tax at 21 percent on the income it earns, but it is unhampered by the constraints of Section 501(c)(3), which may enable it to generate a higher rate of return. Note that payments other than dividends made by a taxable subsidiary owned more than 50 percent by a tax-exempt organization are generally subject to tax as UBTI when received by the tax-exempt organization. This is because such payments generally reduce the taxable income of the taxable subsidiary.[4] (The taxable subsidiary structure is shown in **Figure 2** in the Appendix.)

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enterprises to locate new facilities in park through favorable lease terms that required employment and training opportunities for unemployed and underemployed residents of the area).

[4] See Section 512(b)(13).

Attracting the right investors to the right QOF is a matter of striking the right balance between an investment's economic return and its charitable impact. It is an art rather than a science, where knowledge of potential investors' objectives plays an important role. Community foundations are well positioned to add value to this equation if they know both the risk/return profile of qualified OZ property and the risk tolerance of potential community investors.

Opportunity Funds:
A Community Foundation Checklist

For community foundations interested in pursuing management of a Qualified Opportunity Fund (QOF), here are some important things to consider:

■ Within Opportunity Zones that have already been selected, the foundation will need to work with community leaders, investors/donors, and legal counsel to determine which potential QOF investments may be legally defined as "charitable" versus those that may not. Who will benefit directly and indirectly from the investment? Will private businesses or individuals who are not part of the charitable class receive substantial direct benefits? If the investment is not sufficiently charitable, then the CF should not directly manage the investment but should instead use a taxable corporate subsidiary.

■ The CF may have to think about its staffing needs going forward. For example, the foundation may need to expand the role of the finance and investment departments to address these new responsibilities. The CF may need new board approvals, amended finance committee charters, and other staff training.

■ The CF may need to establish a QOF via a limited partnership, manager-managed limited liability company, or other taxable subsidiary or a different alternative investment vehicle. A manager-managed LLC would be managed by the CF and owned by the investors, whose management rights are limited. The CF would have no ownership interest, but rather a contractual obligation to perform specified management responsibilities. Since a nonprofit can't utilize the tax benefits, the CF's economic interest lies in (1) fees paid by the QOF to the CF for investment management services, and (2) services provided to current and future donors who may become long-term supporters of the community foundation.

■ The CF can work with civic leaders and co-investors to identify investment opportunities, and performs due diligence to evaluate these potential investments.

■ The CF would work with its donors to ensure that investors in the community foundation's QOF put in their funds within 180 days of recognizing gains. The QOF would then deploy capital, either directly or indirectly, in qualified Opportunity Zone business property.

■ The CF would facilitate ongoing compliance requirements, including annual tax filings, financial statements, and other regulatory filings.

Here's an example of how this could all work in practice.

Let's assume that Main Street Community Foundation ("Main Street") serves a community designated as an Opportunity Zone. The OZ contains a dilapidated, abandoned manufacturing facility that has been unused for 20 years. A local entrepreneur plans to rehabilitate the old plant and create a new business that will use the facility to manufacture widgets.

The entrepreneur creates a new company, Widget Co., and seeks to raise capital investments of $100 million to finance the improvements to the facility. Main Street, through a rigorous due diligence process, has determined that an investment in Widget Co. will generate an after-tax internal rate of return of approximately 10 percent, inclusive of the opportunity zone tax incentive benefits, if the investor holds its investment for at least 10 years. Without the OZ tax incentives, the rate of return generated by the investment would be closer to 6 percent. The entrepreneur's traditional network of investors declined the opportunity to invest in Widget Co. because the investment would not provide them with their desired economic returns for the level of risk involved. Those same investors have a different vision: They are considering converting the site to a luxury condominium development, which will provide a greater rate of return with less risk.

The community, however, strongly supports the manufacturing facility because of the sustained community benefits the new business will provide. In response, Main Street establishes a limited liability company and certifies investments in Widget Co. as a QOF. The foundation serves as a manager of the QOF, and earns an annual management fee for services performed. As manager of the QOF, the foundation can delegate fund management responsibilities to Main Street's own investment committee. (Again, the LLC or other entity holding the QOF investments can have the same investment committee and board of directors as the community foundation that created it.) Ten individual investors, some of whom are Main Street's donors, each invest $10 million in the QOF, which in turn invests the money in Widget Co. The company uses the proceeds to improve the facility, commences manufacturing operations, and creates 100 new jobs with wages that support a dignified standard of living, full benefits and workers' rights, and safe and healthy working conditions.

If a CF does not wish to control the manager of the QOF through a taxable subsidiary, then it can provide services to the manager of the QOF. We discuss this option next.

II. Community Foundation as Advisor to Qualified Opportunity Fund

Whether or not a CF establishes and manages a QOF itself, there may be QOFs that invest in qualified OZs in or around the CF's community of focus. Large, national QOFs are likely to value the CF's insight to the unique attributes and needs of the community in the qualified opportunity zone. While the preceding section – detailing how community foundations can serve as QOF managers – is likely of greatest interest to most CFs because it allows them to serve both individual donors and the community, there are other ways a CF can engage in the Opportunity Zone space. **One example is to provide services to the QOF without actually bringing investors to the table.**

For example, a community foundation may assist a QOF manager with sourcing qualified OZ property, obtaining meetings with local owners and developers, or identifying high-net-worth individuals with an interest in investing in the region. In such situations, the CF may serve as advisors to the QOF, either pro bono or for a fee. The foundation would need to determine whether the nature of the services substantially advances its tax-exempt purposes to conclude if the compensation received is subject to UBIT. By helping to direct the OZ investments, a CF can ensure that the funds are invested in qualified OZ property that provides desired community benefits. (This service provider structure is illustrated in **Figure 3** in the Appendix.)

The advisory relationship may extend from general consulting regarding the Opportunity Zone to advice about specific portfolio investments in the area. CFs could offer technical resources to fund projects in OZs that can deliver equitable growth, development without displacement, and healthy communities of opportunity. And they can provide this resource and be paid a fee without jeopardizing their nonprofit status or creating income subject to UBIT.

Regardless of which approach a foundation might pursue, the potential pay-off serves philanthropy's "double bottom line"—delivering important economic and social benefits to communities in need, while earning a return for the QOF's investors.

III. Community Foundation as Co-Investor with Qualified Opportunity Fund

As tax-exempt organizations, community foundations do not themselves receive a tax benefit from deferral or elimination of capital gains tax on their investments. For this reason, CFs would not typically invest directly in a QOF. It is more likely that the CF would seek to attract capital to the fund from its own donors.

A community foundation may well, however, choose to invest alongside a QOF in a qualified Opportunity zone Business. Depending on the investment terms, such a co-investment may be a pure investment for capital appreciation, a mission-related investment to achieve a mix of capital appreciation and social impact, or a program-related investment to achieve a charitable purpose. (This structure is illustrated in **Figure 4** in the Appendix.)

Under these investment models, CFs may generate greater efficiency from existing impact investment programs by leveraging those resources with QOFs. For example, perhaps a CF has been engaging in negotiations to fund an impact investment loan to finance an affordable housing development in the community. The proposed development has community support and has received all necessary approvals, but there is a sizeable funding gap. The new incentive now creates as opportunity to close the gap with private capital: QOF equity can bridge the gap and provide the funding necessary to complete the proposed development.

IV. Community Foundation as Fundraiser for Qualified Opportunity Fund

One of the most valuable resources CFs possess, and among their most important long-term assets, is their list of donors. These are often high-net-worth individuals who have excess capital at their disposal and are interested in using their resources to deliver community impact. They are perfect candidates for investors in QOFs. **A CF seeking to assist a QOF in this**

manner may license its donor list to a QOF in return for a royalty, or it may market the QOF directly to its donors. While royalty income is generally exempt from UBIT, marketing fees are likely to be treated as advertising or other unrelated income and may be subject to tax. There are also federal and state securities laws and business registration considerations to be mindful of when undertaking investment marketing activity. But helping a QOF find motivated investors is another important role CFs can play to benefit the greater community they serve.

We acknowledge that many donors may use the CF structure rather than a private foundation to retain their anonymity, and a CF may be reluctant to share its donors for related privacy concerns. It may be that few CFs would take this approach and may instead wish to work directly with professional advisors, as referenced in the introduction. This royalty approach is simply an option for CFs to get involved in the OZ process.

As an example of the royalty approach, the Sierra Club pioneered licensing its donor list to create the affinity credit card business. Receiving a referral fee for helping a donor do something he or she wants to do anyway is a win-win. In the context of the OZ legislation, the CF is "selling" community development to donors interested in that topic.

Final Thoughts

As federal officials continue to iron out implementation details for the Opportunity Zone initiative, CFs will gain a better understanding of whether such investment holds benefits for them and their donors. Meantime, the effort attracted renewed attention this month with a push from the White House. President Trump announced a new White House Opportunity and Revitalization Council, bringing together 13 federal agencies and chaired by U.S. Housing and Urban Development Secretary Ben Carson. The council will help prioritize and support public investment in Opportunity Zones for infrastructure dollars, crime prevention spending, small business loans, and more. The goal – "lifting up American communities that have been left behind" – is one all community foundations can embrace.

Additional Resources

To learn more about the **Opportunity Zone** program and how your community foundation can get involved, see:

Council on Foundations: Opportunity Zones Resources

Council on Foundations' Webinar: Opportunity Zones (October 2018)

Council on Foundations' Webinar: A Primer for Funders (December 2018)

Economic Innovation Group

Enterprise Community Partners Opportunity360

Morgan Lewis Webinar: Opportunity Zone Funds (November 2018)

Morgan Lewis LawFlash: Opportunity Zone Fund Regulations (October 2018)

Mission Investors Exchange: Opportunity Zones Resources

Novogradac Opportunity Zones Resource Center

Novogradac Opportunity Zones Handbook

Novogradac Industry Alert Emails

Novogradac Opportunity Zones Working Group

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Appendix:

Four Models for Community Foundation Support of Opportunity Zones

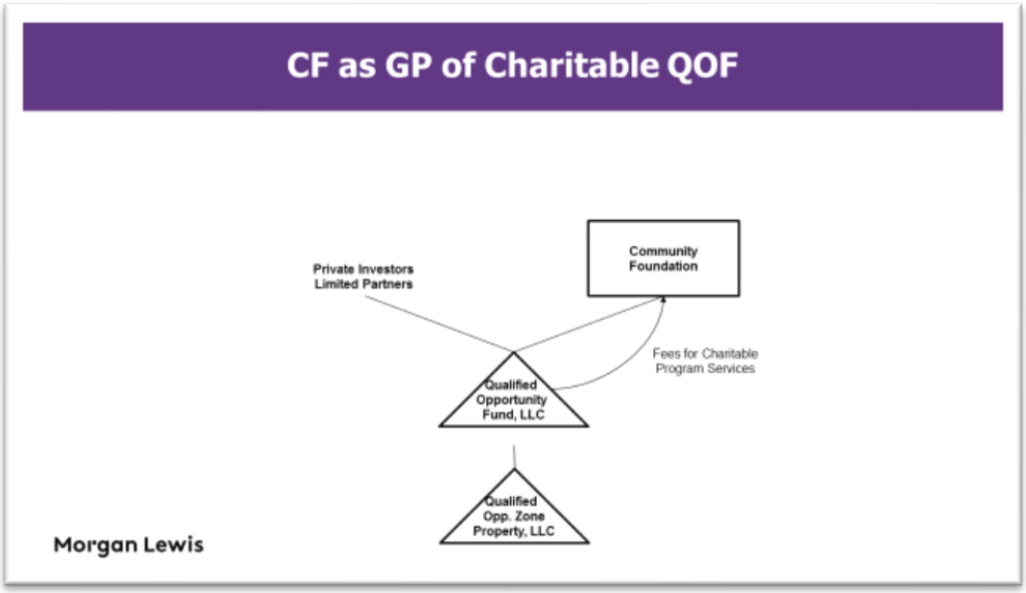

Figure 1

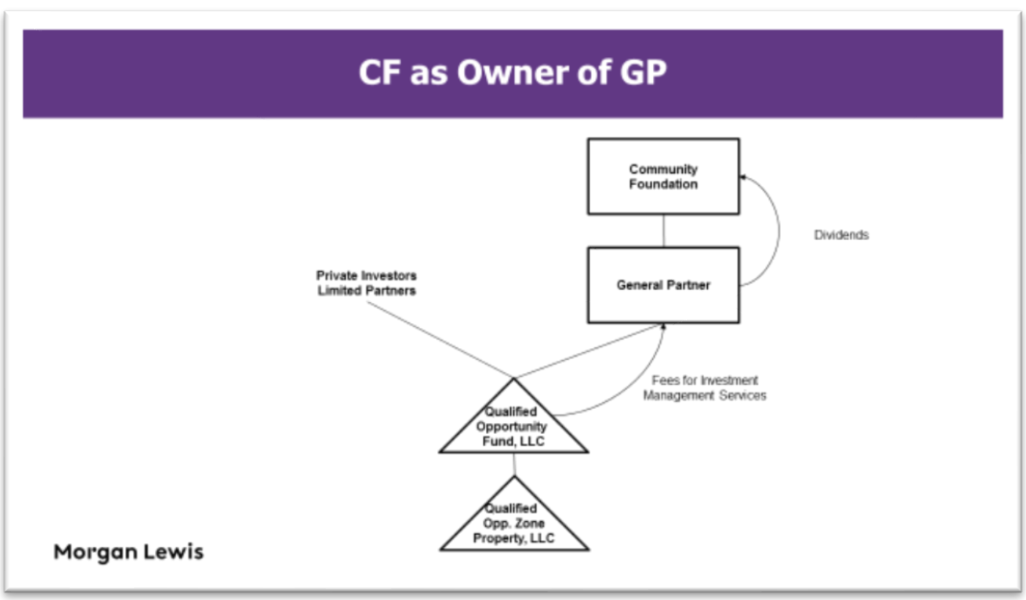

Figure 2

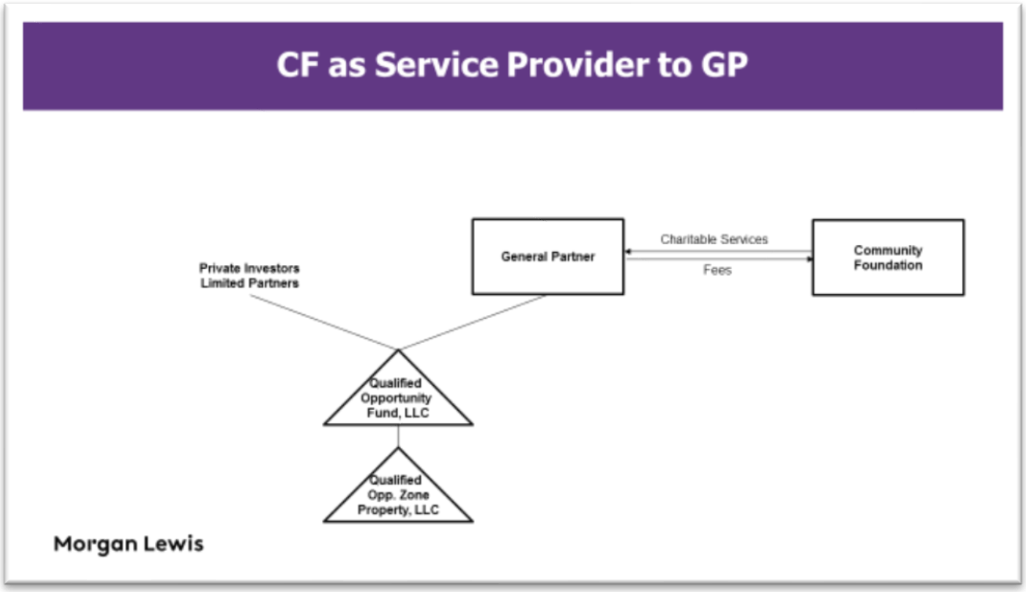

Figure 3

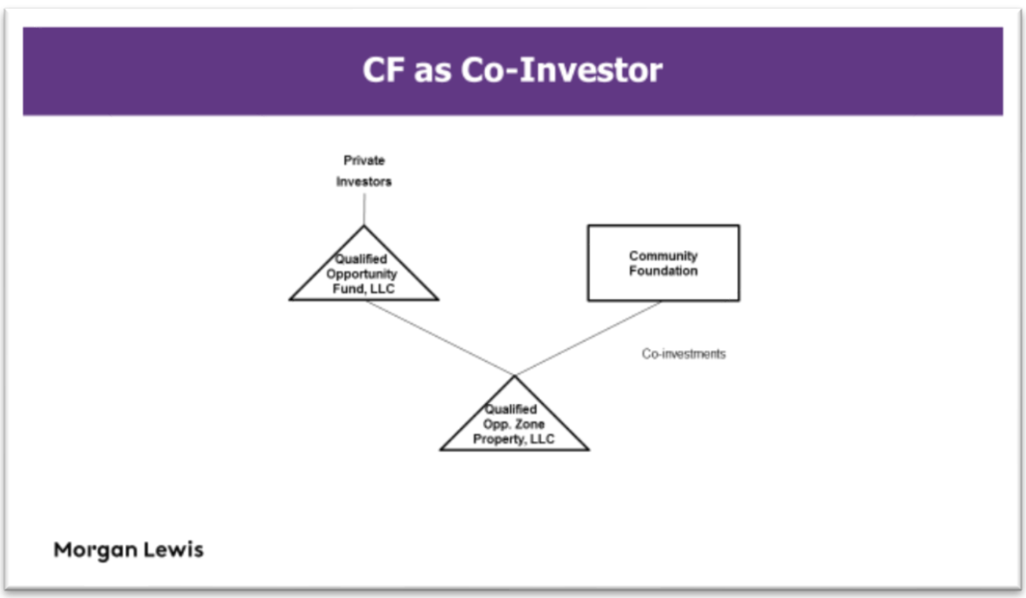

Figure 4