Impact Investing in the San Joaquin Valley

Opportunity Zones 101

Kevin Wilson
Novogradac & Company LLP
52 million Americans (1 in 6) live in economically distressed communities.
Job and business growth fails to reach most distressed zip codes.

More than half of the country’s distressed zip codes contained fewer jobs and places of business in 2015 than they had in 2000.

Average 2011-2015 Growth Rates

<table>
<thead>
<tr>
<th></th>
<th>Employment</th>
<th>Establishments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prosperous Zip Codes</td>
<td>24.5%</td>
<td>12.6%</td>
</tr>
<tr>
<td>United States</td>
<td>9.4%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Distressed Zip Codes</td>
<td>-6.0%</td>
<td>-6.3%</td>
</tr>
</tbody>
</table>

Source: EIG’s Distressed Communities Index; U.S. Census Bureau
The slow winding down of the economy’s dynamism is producing more geographically unequal outcomes.

- In the 1990s, half or more of all counties grew at the national rate. Now only one quarter do.
- National figures are becoming less reflective of local realities.

Source: U.S. Census Bureau’s County Business Patterns
How do we start to address these problems? Plugging the capital gap through Opportunity Zones.

• The **U.S. is a capital rich country**, and investors are sitting on historic gains from a record breaking stock market. The pot of potential capital eligible for reinvestment in Opportunity Zones totals **$6.1 trillion**.* Yet, we have a tremendous gap faced by the communities who need it most.

• Opportunity Zones will **connect investors with low-income communities** by creating a new national network of deal opportunities in much the same way that we systematically invest in foreign emerging markets now.

• We believe this will ultimately lead to the creation of a **new industry of community-based investments - a new asset class**. This could change the way investors look at opportunities outside of their bubble and how communities think about how they attract private sector investment and create jobs.

---

*Source: EIG analysis of the Federal Reserve’s Survey of Consumer Finances and Financial Accounts of the United States found that U.S. households were sitting on an estimated $3.8 trillion in unrealized capital gains in stocks and mutual funds alone at the end of 2017 and U.S. corporations held another $2.3 trillion.*
The Opportunity Zones provision was conceived as an innovative, bipartisan solution to expand the geography of economic growth.
Opportunity Zones can help catalyze growth and opportunity in communities around the country.

- The Opportunity Zones provision is designed to spur long-term private sector investments in low-income communities nationwide.
- This new economic development program offers a frictionless way for investors to reinvest unrealized capital gains into distressed communities through Opportunity Funds, in exchange for a graduated series of incentives tied to long-term holdings.
- It is the first new national community investment program in over 15 years, and has the potential to scale into the largest economic development program in the U.S.
- It is specifically designed to channel more equity capital into overlooked markets.
Opportunity Zones were selected collaboratively and transparently.

- States consulted heavily with their municipalities, counties, and local and regional economic development organizations to assemble their portfolios of Opportunity Zones.
- The high degree of engagement nationwide is an early milestone of success for this fledgling effort.

- California OZ website: 
  [https://opzones.ca.gov/](https://opzones.ca.gov/)
Tax Benefits of the Opportunity Zone Incentive
Taxpayers can get capital gains tax deferral (& more)

Qualified Opportunity Funds (QOFs)

for making timely investments in

which invest in

Qualified Opportunity Zone Property

October 3, 2018 www.novoco.com
3 Tax Incentive Benefits

1. Gain Deferral
2. Partial forgiveness
3. Forgiveness of additional gains
Period of Deferral

The period of capital gain tax deferral ends upon the earlier of:

- 2018 2019 2020 2021 2023 2024 2025 2026 2027 2028
- Dec. 31, 2026,
- or...
- EARLIER SALE

October 3, 2018
Amount Recognized

THE LESSER OF:

1. Amount of gain deferred
   or

2. The fair market value of investment in QOF interest

MINUS:

Taxpayer’s basis in the QOF interest

Note: The taxpayer’s outside basis in the Opportunity Fund is initially deemed to be zero.
Jan. 2, 2018
Taxpayer enters into a sale that generates $1M of capital gain

June 30, 2018
(Within 180 days), Taxpayer contributes entire $1M of capital gain to a Qualified Opportunity Fund

- Taxpayer is deemed to have a $0 basis in its QOF investment
- QOF Invests the $1MM in Qualified Opportunity Zone Property
June 30, 2023
(After 5 years), Taxpayer’s basis in investment in QOF increases from $0 to $100k

June 30, 2025
(After 7 years), Taxpayer’s basis in investment in QOF increases from $100k to $150k

Dec. 31, 2026
$850K of the 1MM of deferred capital gains are taxed and the basis in QOF investment increases to $1MM.

June 30, 2028
(after 10 years), Taxpayer sells its investment for $2.0MM. Basis in the investment is deemed to be FMV. The effect is no tax on appreciation in investment.
Opportunity Zone Incremental Benefit

- **Standard After Tax IRR**
- **Total IRR**

<table>
<thead>
<tr>
<th>23.8% Tax Rate</th>
<th>4 Year</th>
<th>5 Year</th>
<th>7 Year</th>
<th>12/31/2026</th>
<th>10 Year</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Standard After Tax IRR</strong></td>
<td>6.00%</td>
<td>6.00%</td>
<td>6.00%</td>
<td>6.00%</td>
<td>6.00%</td>
</tr>
<tr>
<td><strong>Incremental OZ Benefit</strong></td>
<td>1.44%</td>
<td>2.08%</td>
<td>1.95%</td>
<td>1.71%</td>
<td>3.08%</td>
</tr>
<tr>
<td><strong>OZ Investment IRR</strong></td>
<td>7.44%</td>
<td>8.08%</td>
<td>7.95%</td>
<td>7.71%</td>
<td>9.08%</td>
</tr>
<tr>
<td><strong>Percentage Increase</strong></td>
<td>35%</td>
<td>32%</td>
<td>29%</td>
<td>51%</td>
<td></td>
</tr>
</tbody>
</table>
Perishability of Incentives

Year of QOF Initial Investment

Incremental IRR

- 3.08% in 2018
- 2.96% in 2019
- 2.74% in 2020
- 2.61% in 2021
- 2.25% in 2022
- 2.09% in 2023
- 1.91% in 2024
- 1.74% in 2025
State Tax Implications

- Opportunity Zone benefits increase if states conform to the Federal Law
- Some states piggy-back off of the current Federal Law but could decouple from OZs
  - New York decided not to decouple
  - Hawaii decided to decouple
  - North Carolina released a draft bill that would decouple
- Some states do not conform to Federal Law but could add OZs at the state level
  - Colorado is considering a bill to add the OZ benefit at the state level
- Some states do not have a state income tax (e.g. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming).
- State Tax Implications of an single OZ transaction may include multiple states
  - State where original gain was realized
  - State(s) where the opportunity fund has nexus
- Some states are tying other State incentives to opportunity zones
  - Missouri proposed increased cap for state historic credits for properties in OZs
  - California introduced a bill to exempt projects in OZs from the CA Environmental Quality Act
State Tax Code Conformity - Corporate Income

A state's conformity with the federal opportunity zones provisions is an important factor investors should consider. Investors in states that do conform with the federal opportunity zones provisions may receive state tax incentives similar to those available at the federal level. Conversely, investors in nonconforming states may be unable to defer and reduce state taxation on the initial gains invested in opportunity zones. Investors in these nonconforming states may also be required to recognize gains for state tax purposes on their eventual sale of the opportunity fund investment.

Legend:
- Conforming - Rolling: The state automatically conforms to the current IRC as it is amended.
- Conforming - Fixed Date: The state conforms to the IRC as of a specific date that is after the enactment of the Opportunity Zones legislation.
- No Capital Gains: The state has no state income tax or does not tax capital gains.
- Nonconforming: The state conforms to the IRC as of a specific date prior to the enactment of the Opportunity Zones legislation or the state has specifically decoupled from the Opportunity Zones legislation.
Qualified Opportunity Fund

An investment vehicle organized as a corporation or a partnership for the purpose of investing in Qualified Opportunity Zone Property (QOZP).

Must hold at least 90% of its assets in qualified opportunity zone property.
Certification Process

- An eligible taxpayer self-certifies to become a certified qualified opportunity fund.
- No approval or action by the IRS is required.
- A taxpayer merely completes a form (which will be released in the summer of 2018) and attaches that form to the taxpayer’s federal income tax return for the taxable year.
- The return must be filed timely, taking extensions into account.
Readily Identifiable Investment Types in Opportunity Zones

- Commercial Real Estate Development and Renovation in Opportunity Zones
- Opening New Businesses in Opportunity Zones
- Expansion of Existing Businesses into Opportunity Zones
- Large Expansions of Businesses already within Opportunity Zones
QOZB: Excluded Businesses

Can’t be a “Sin Business”

A private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.
## Comparison of Requirements by Direct and Indirect Investment by Opportunity Fund

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Direct Investment</th>
<th>Indirect Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of O Fund’s assets that must be invested in qualified opportunity zone business property</td>
<td>90%</td>
<td>N/A</td>
</tr>
<tr>
<td>Percentage of O Fund’s assets that must be invested in stock or partnership interests</td>
<td>N/A</td>
<td>90%</td>
</tr>
<tr>
<td>Percentage of O Fund’s assets that may be held in cash or other liquid investments</td>
<td>10% (together with intangible property)</td>
<td>5% plus reasonable working capital</td>
</tr>
<tr>
<td>Percentage of O Fund’s assets that may be held in intangible property</td>
<td>10% (together with cash)</td>
<td>Unlimited, but intangible property must be used in trade or business</td>
</tr>
<tr>
<td>Percentage of O Fund’s assets that must be invested in tangible property</td>
<td>90%</td>
<td>No minimum</td>
</tr>
<tr>
<td>Percentage of gross income that must be derived from O Zone</td>
<td>None</td>
<td>50%</td>
</tr>
<tr>
<td>Ineligible Businesses</td>
<td>None</td>
<td>Sin Businesses</td>
</tr>
</tbody>
</table>
Combining with Other Tax Incentives
Combining Opportunity Zones with Low Income Housing Credits

- Investment holding periods line-up nicely
- Basis limitations may suspend loss benefits unless debt basis
- Appreciation not likely, but there may be an opportunity for forgiveness of exit tax on excess loss benefits.
- Substantial rehabilitation rules don’t line-up
  - LIHTC - $6,000+/Unit per Section 42, state regulations may have larger rehab requirement
  - OZ - expenditures in excess of beginning basis over 30 months
- Tax deferral payment likely less due to diminished FMV.
Pending Interpretative Issues

- Does congressional intent mandate demonstration of community benefit?
- What does “substantially all” mean? (70%? 90%?)
- What gains are eligible for deferral? (ordinary? depreciation recapture?)
- Is residential rental property eligible?
- How are operating leases treated in “substantially all” test?
- Can land satisfy original use test?
- Can vacant building satisfy original use test?
- How much time does business have to become OZB?
- Are cash reserves QOZBP?
- Is debt basis treated as a separate investment?

NOTE: OMB RECEIVED REGULATORY GUIDANCE FOR REVIEW FROM IRS ON SEPTEMBER 12. PROPOSED RULE IS EXPECTED TO CLARIFY SEVERAL ISSUES. MANDATORY REVIEW OF AT LEAST 10 DAYS ENDS TODAY.
Opportunity Zones
for the National Trust

Kevin Wilson
Novogradac & Company LLP