Understanding the O-Zone:
Potential Opportunity Zone Benefits and Threats
2019 Housing California Conference

Diana Downton
Community Economics

Kevin Wilson
Novogradac & Company LLP

Sarah Brundage
Enterprise Community Partners

Matt Horton
Milken Institute

Joshua Simon
East Bay Asian Local Development Corp.
Housing California

Understanding the O-Zone –
Potential Opportunity Zone Benefits and Threats

Kevin Wilson, CPA
Novogradac & Company LLP
www.novoco.com/OZMap
Tax Benefits of the Opportunity Zone Incentive
Taxpayers can get capital gains tax deferral (& more) for making timely investments in Qualified Opportunity Funds (QOFs) which invest in Qualified Opportunity Zone Property.
Three OZ Incentive Tax Benefits

1. **Capital Gain Deferral**
   - Investment and deferral of Capital Gain (up to 180 days after event triggering the gain)
   - 10% Step up in basis of deferred gain

2. **Partial forgiveness**
   - Additional 5% Step up in basis of deferred gain
   - Taxes paid on deferred gain

3. **Forgiveness of additional gains**
   - Permanent Exclusion of gains accrued in the Opportunity Fund

April 16, 2019

www.OpportunityZonesResourceCenter.com
Opportunity Zone Incremental Benefit

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April 16, 2019  www.novoco.com
Perishability of Incentives

Year of QOF Initial Investment

Incremental IRR

2018 2019 2020 2021 2022 2023 2024 2025

3.08% 2.96% 2.74% 2.61% 2.25% 2.09% 1.91% 1.74%
Combining with Other Tax Incentives

- LIHTC
- 1031
- 1202
- NMTC
- HTC
- RETC

Opportunity Zone

April 16, 2019 www.novoco.com
# Marrying LIHTC & Opportunity Zones

## Pros

- Maximizing Opportunity Zones Incentives = at least 10 years
  - LIHTC investments = 15 year TCCP
- Housing credit projects in low to median income communities
  - Estimate >500 housing credit properties will be developed in qualified opportunity zones this year
- A negative tax capital account and federal capital gains taxation?
- Reduced investor FMV at 12/31/26
- GP back-end gain elimination?

## Cons

- 80-85% of the $16B LIHTC equity market comes from commercial banks
  - Capital gains
- Acquisition and rehabilitation of existing properties and “substantial improvement” test
- Timing of equity contributions
- GAAP impact on public companies
**Example LIHTC Project Without OZ Benefit**

**Opportunity Zone Fund**
**Benefit Schedule for Investor**
**4% New Construction (City, CA)**
**October 2018 - December 2035**

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Standard Investment Annual After Tax Internal Rate of Return: 3.06%
## Example LIHTC Project Without OZ Benefit

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Standard Investment Annual After Tax Internal Rate of Return: 5.06%
Same LIHTC Project With OZ Benefit

### Opportunity Zone Fund

**Benefit Schedule for Investor**

- **4% New Construction (City, CA)**
- **October 2018 - December 2035**
- **Assuming FMV at 12/31/2026 = 50% of original investment**

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**Qualified OZ Fund Annual After Tax Internal Rate of Return:** 10.54%
## Same LIHTC Project With OZ Benefit

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(4,402,715) 924,570 4,634,437 1,569,804 134,063 (462,285) -

Qualified OZ Fund Annual After Tax Internal Rate of Return: 10.54%

April 16, 2019 www.novoco.com
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Qualified OZ Fund Annual After Tax Internal Rate of Return: 10.54%
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 residing 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 gain for state tax purposes on their eventual sale of the opportunity fund investment.
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
California Pairing of OZ and LIHTC / RETC

• Per Page 94 of Gavin Newsom’s 2019-20 Budget Summary: CA will conform to Federal OZ incentive for “green technology [and] affordable housing.”

• CA highest tax rates are 13.3% for individual / married filing jointly taxpayers and 8.84% for corporate taxpaying entities.

• AB 10 (Chiu) Expanding the California Low-Income Housing Tax Credit Program, including expanded benefits for individual taxpayers.
State, Local Governments Work to Steer Opportunity Zones Investment

Opportunity zones (OZs) are a federal tax incentive that has generated unprecedented levels of interest among investors and has enormous potential local and regional impact. States and local governments have wide discretion to set the tax incentive and make it clear that certain zones will attract investment and create new jobs. Many states and local governments have already established OZs, and more are expected to follow.

The most significant benefit of OZs is that they provide a tax break to investors who contribute to the zone. The tax break is achieved through a variety of means, including a tax credit, deductions, or even full exemption from taxes on capital gains. This allows investors to recoup their investment while also benefiting the local community.

The tax break is available to investors who contribute to the zone through the purchase of new or improved real estate. The tax break is available for up to 10 years, with a maximum of 30% of the investment.

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Unanswered Questions

See article “20 issues to track in the Second Tranche of OZ Guidance,” including, but not limited to . . .

- Active conduct of trade or business
- Leased property
- Timing - Grace period
- Substantial improvements separate from acquisition cost
- Debt financed distributions
- Treatment of interim gains
- Treatment of vacant land
- Timing for 70% substantially all test
- Timing for substantial improvement
- Residential rental property qualified OZ business
- Multiple 31-month period for working capital safe harbor
- Reasonable working capital at QOF
Additional Opportunity Zone Resources

- California Opportunity Zone website
  - opzones.ca.gov/
- Opportunity Zone Investment Prospectus Guide
  - www.acceleratorforamerica.com/OZGuide
- Opportunity Zone Resource Center
  - www.opportunityzonesresourcecenter.com
- Affordable Housing Resource Center
  - www.taxcredithousing.com
- Industry Alert emails
  - www.novoco.com/subscription-center
- Opportunity Zones Working Group
- LIHTC Working Group
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Ensuring Equitable Investments through Opportunity Zones

SARAH BRUNDAGE
SENIOR DIRECTOR, PUBLIC POLICY

APRIL 2018
OUR VISION:
One day every person will have an affordable home in a vibrant community, filled with promise and the opportunity for a good life.

OUR MISSION:
To create opportunity for low- and moderate-income people through affordable housing in diverse, thriving communities.
FULLFILLING THE PROMISE
OPPORTUNITY ZONES

Ensuring equitable, inclusive growth in communities

- The potential to transform communities, grow small businesses and expand opportunity pathways
- Technical guidance and advocacy for transparency and accountability
- Opportunity Funds to support and complement ongoing work to achieve broad community benefits
Our Opportunity Fund Approach

- Diversified portfolio of investments that foster community and economic development strategies in underserved areas, consistent with Enterprise’s overall mission to connect residents with opportunity

- National Fund with particular focus on Enterprise’s markets; focus on community credibility and knowledge

- Impact-Oriented Approach

- Projects: multifamily, mixed-income housing (60-120% AMI); commercial/mixed-use; new construction or significant rehab
Establishing Reporting Requirements


- This provision was not ultimately included in the Tax Cuts and Jobs Act.

- Enterprise urges Congress and the Administration to commit to reporting public data on investments in Opportunity Zones as a critical step toward enabling Congress and the public to evaluate the efficacy of the tax incentive.
In the Original Opportunity Zones Legislation:

- (c) REPORT TO CONGRESS.—The Secretary of the Treasury, or the Secretary’s delegate, shall submit a report to Congress on the opportunity zone incentives enacted by this section beginning 5 years after the date of enactment of this Act and annually thereafter. The report shall include an assessment of investments held by qualified opportunity funds nationally and at the State level. To the extent such information is available, the report shall include the number of qualified opportunity funds, the amount of assets held in qualified opportunity funds, the composition of qualified opportunity fund investments by asset class, the percentage of qualified opportunity zone census tracts designated under subchapter Z of the Internal Revenue Code of 1986 (as added by this section) that have received qualified opportunity fund investments. The report shall also include an assessment of the impacts and outcomes of the investments in those areas on economic indicators including job creation, poverty reduction, and new business starts, and other metrics as determined by the Secretary.
Additional Data that Could be Federally Collected

- The date and total amount of investment
- The type of investment
- The location of investment
- The type of activity being supported by the investment
- Approximate number of residential units, and affordability
A Shared Approach for Opportunity Fund Managers

- Opportunity Zones Impact Accountability Framework (the U.S. Impact Investing Alliance, the Beeck Center at Georgetown University, and the New York Federal Reserve)

- Guiding Principles to effective and equitable OZ investment and implementation

- Impact Framework including a set of core criteria, while maintaining flexibility

- Shared Goal of Measured Outcomes as a pathway to achieve the outcomes sought by the OZ policy
Guiding Principles

• Fund managers integrate the needs of local communities into the formation & implementation of the funds, reaching low-income and underinvested communities with attention to diversity

• Investments seek to generate equitable community benefits

• Investors should be transparent and hold themselves accountability, with fair and clear processes/practices

• Investors should voluntarily monitor, measure, and track progress against specific impact objectives, and Opportunity Fund metrics should track real change
Impact Reporting & Framework

- **Investment Intention & Community Engagement.** Opportunity Fund managers should proactively report information that will encourage effective market formation and enable community engagement before and during investments.

- What are you trying to achieve with this investment? What problem are you looking to solve?

- How are you ensuring community engagement and that the investment is serving community needs?
Impact Reporting & Framework

• **Impact Measurement & Reporting.** Real Estate could include:
  
  • Net number of affordable units
  
  • % of units that are affordable
  
  • Number of affordable units renovated
  
  • Number of net additional individuals housed based on development
Impact Reporting & Framework

- Lasting Community Impact

- **Exit Strategy:** Do you have an exit strategy that points to long-term impact, beyond your hold period? Do you have a way of ensuring that this becomes a true community asset or mechanism for building community wealth?
Enterprise’s Approach for our Opportunity Fund

- It is our responsibility to investors, sponsors, legislative and community partners to assess the impact of our investments.

- We believe there is a market drive desire for credible impact measurement. Investors not only want deep financial data, but also social and impact data.

- We know from practice what are reasonable reporting requirements and metrics. Programs such as NMTC collect information about impact and require minimal extra effort – we should be able to create a similarly efficient system for OZs.

- Since there is no one-size-fits-all approach for all investment types, Enterprise plans to define unique impact measurements with each project we do, guided by the OZ framework (Beek Center) and using our Opportunity360 tool.
OUR PROPRIETARY METHODOLOGY

OPPORTUNITY FRAMEWORK

- A unique approach to identifying and strengthening opportunity pathways in communities
- Five dimensions of opportunity correlated with positive long-term outcomes for families
- A methodology that promotes and facilitates cross-sector collaboration in communities
How You Can Take Action

- Join us in urging Congress and the Administration to establish reporting requirements to ensure transparency and accountability
- Consider adopting state-level reporting requirements
- Watch for 2nd tranche of IRS regulations and/or bipartisan legislation
- Communicate these principles to Opportunity Fund managers and/or investors
Sarah Brundage
Senior Director, Public Policy
Enterprise Community Partners
sbrundage@enterprisecommunity.org
IMPACT FRAMEWORK (SAMPLE)

REPORTING FRAMEWORK (SAMPLE)

Mission statement: Key target impact of investments.

Investment Thesis: What are the sectors or industries in which the fund seeks to invest and why?

Fund information
- Size of the fund
- Location of capital deployment (census tracts)
- Type of qualifying property or business
- GP demographics (race and gender composition)

Intended Impact: Defined for each fund and investment.
- Intended impact, e.g.
  - Education – high school graduation rates, school retention rates, job retained
  - Affordable housing – number of affordable units created as % of development
  - Jobs – number of jobs retained within community, % of salary increase for lowest paid employees
  - Entrepreneurship – number of new businesses started, number of female and minority owned businesses created
  - Access to healthy food
  - Environment impact

Community Engagement
- Method of community engagement
- Type of feedback incorporated
- Partnerships with local organizations and type of partnership
- Community needs assessment or alignment with established community priorities
- How investment is aligned with local/regional economic development strategies

Post-Exit Evaluation
- Community impact beyond hold period
- Variation from original intention
Opportunity Zones and Asset Based Economic Development

Matt Horton
Associate Director, Center for Regional Economics and California Center

(310) 570 4617
mhorton@milkeninstitute.org
www.milkeninstitute.org
The Opportunity Zone Players

**Government**
- Easing local regulatory barriers
- Develop incentives to attract and build OZ projects
- Ensure project pipeline is fully fledged out
- Key Players: US Department of Treasury, HUD, State Governors, State Governments, Local Governments

**Banks**
- Providing complimentary debt financing in Opportunity Zones
- Key Players: JP Morgan Chase, Wells Fargo, Citi, Bank of America, Morgan Stanley, Credit Suisse, Goldman Sachs

**Private Capital**
- Investing equity capital through received capital gains
- Developers investing in low income areas, with the benefit of a tax incentive
- Key Players: High Net Worth investors, Family Offices, Developers, Corporates

**Non-Profits/Philanthropy**
- Enable community engagement to stabilize and sustain struggling neighborhoods
- Address community specific needs by supporting efforts at the local level
- Partner with public and private entities
- Seed initiatives that encourage and leverage private capital investment
- Key Players: Milken Institute, Economic Innovation Group, Cal FWD, LISC, Enterprise Community Partners, Kresge Foundation, Rockefeller Foundation, Governance Project, Accelerator for America, EJF Philanthropies, Parker Foundation
Community Investment pipeline

Stimulating Jobs and Economic Growth -

- **Housing** - Attracting new sources of capital to affordable housing in one of the world's most dynamic economies—could finance more than 30,000 affordable units a year.

- **Infrastructure** - In the next decade, California needs to spend nearly $900 billion or 3.05% of the state’s GDP per year in order to make up the past 10 years' of shortfall in infrastructure investments

Opportunity Zones as a Tool for Economic Development

- Infrastructure, housing, jobs, education, health
- Project Pipeline & Deal Flow
- Housing, commercial, retail
- Barriers
- Economic Development in Opportunity Zones (infrastructure, housing, jobs, education, health)
- State/Local Regulatory
- Coordination
- Community finance, tax credits
- Capital Toolbox
- Public
- Time
- Private
- State Taxes
- QOF, CRA, Social Impact Funds
- Debt, Equity

Source: Milken Institute Center for Regional Economics and Center for Financial Markets
California’s Opportunity Zones

The state of California designated a total of 879 census tracts as Opportunity Zones, all of which were certified by the US Dept. of Treasury.

The following criteria were used in the selection process:

- Focus on Poverty
- Areas with Business Activity
- Geographic Diversity

Source: State of California Department of Finance
Designing a State and Local Tool Kit to Attract Opportunity Fund Capital

1. What standards will the State require for projects to unlock incentives?

2. What incentives should the State consider in seeking to enhance its priority projects?

3. What is the path forward to launching this “tool kit” in a way that aligns with the timing requirements of the Federal incentives?
What standards will the State require for projects to unlock incentives?

- Specific Sectors/Industries
- Job Creation
- Climate/Environmental Impact
- Energy Resilience (Social Infrastructure)

- Affordable Housing
- Greenhouse Gas Reduction Funds/Co-Investment
- Community-Scale Infrastructure
- Workforce Development
- Business Formation
- Networked Philanthropy
California’s Early O-Zone Actions

• Designated 879 Qualified Opportunity Zone Tracts

• Launched State Web Portal to Highlight and Market California OZs (OpZones.Ca.Gov)
  • Beta release of California’s Marketplace for Investing in Communities

• California OZ Investor Summit: March 2019

• Encouraging locals to get ready by building a pipeline of investable projects (Local Get Ready Guide)

• Partnering with cities, NGOs, intermediaries, investors, foundations (Community Roundtables, California Opportunity Zone Partnership)

• Engaging investors groups and OZ Funds, encouraging co-investment alongside local community sustainability

• Coordinate a Multi-State Approach for Commenting on US Treasury rules

*Non-synchronized capital gains tax
What incentives should the State consider in seeking to enhance its priority projects?

**Potential Action Steps**

- **State-Level Tax Credits or Incentives**
- **Expedited Approvals on Permitting, Zoning, etc.**
- **Project Preparation Funding or Risk Mitigation Tools (e.g., guarantees)** – Pipeline Development Push Through 2018 (Accelerator for America’s Local Learning Cohort)
- **Technical Assistance to Local Government** – State Web Portal Adds Marketplace Functions
- **Other** – Ongoing Community Roundtables and Partnerships
- **Momentum Builders:**
  - More Developer Outreach (*Council of In-fill Developers, Impact Investors*)
  - Encourage Local Leaders to Carry the Ball on Local Implementation Agenda
  - SB 635 Responsibilities/Revised Responsibilities
What is the path forward to launching this “tool kit” in a way that aligns with the timing requirements of the Federal incentives?

**Key Questions for State Policy Leaders**

- How can the State integrate current state spending across the program silos that touch OZs (discuss possible options to increase spending leverage)?

- What can be done to educate the legislature about existing place-based programs and finance authorities that can support economically-distressed communities (change current programmatic metrics first before creating new programs and boxes)?
What is the path forward to launching this “tool kit” in a way that aligns with the timing requirements of the Federal incentives?

**Key Questions for State Policy Leaders**

- Is the State willing to fast-track decision-making in selecting high value standards and committing to key incentives in 2019?

- How can the State wisely partner with major stakeholders (universities, military, health systems, pension funds)?

- How does the State intend to establish a system for tracking, evaluating, and reporting impact objectives at the local level?
MI State Approach Framework

Establish a Community Finance/OZ Reporting Framework
Defining standards and tangible metrics of community benefits alongside a system of data collection, analysis, evaluation, and reporting to assess the effectiveness of OZs in meeting community development goals.

Provide Technical Assistance
Provide local jurisdictions with needed capacity: (1) Coordinate with state/local community partners and investors in forming OZ prospectuses, (2) Measure local assets, (3) Prepare potential projects in reaching shovel-ready status, (4) Provide information on state/local resources.

Identify State and Local (Regulatory) OZ Project Inhibitors
What are we willing to compromise on (i.e., local labor, land use, tax, environmental regulations) in order to direct private capital investments in realizing returns in tangible community benefits (i.e., affordable housing, jobs/business formation, social infrastructure and resiliency)?

Insulate Local Deal Flow
How do we retain community benefit once the OZ timeline expires (i.e., mitigate risk and insulate local/state regulations)?

Align Financial Toolkit and Incentives to Accelerate Community Development and OZ Project Pipeline
How do OZs fit with other community finance tools (i.e., value capture models, public private partnerships, etc.)?

Support a Regional Call for Projects
TA-style “Race to the Top” prepositioned with state standards and incentives, as well as strictly defined guidelines for local compliance (e.g., “if you have ABC and X amount of jobs, you will get priority”).
In 2016, the City of Santa Rosa implemented a Housing Action Plan to facilitate the construction of “Housing for All” to meet the needs of all household income groups.

The plan is organized around three priorities:

- **Priority One**: Take action on pending entitled development projects with constraints that can be removed by administrative action or discretion.
- **Priority Two**: Evaluate and where possible unlock projects that are pending (entitled but not moving forward).
- **Priority Three**: Ongoing Housing Action Plan Program Action implementation.
Housing Case Study – Vermont/Santa Monica

- 100% affordable housing development atop the Vermont/Santa Monica Red Line station in East Hollywood
- Project would hold 160 residential units available to people making 30 to 60 percent of the area median income
- At street level, 21,000 square feet of commercial space