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Answers to the Questions from the NDC Webinar on Opportunity Zone Implementation July 27, 2018

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Predictions-

Q. Does EIG have a current estimate of the uptake given its understanding of the light regulatory environment and current capital market? Do you have predictions on the use for financing real estate assets vs non-real estate?

EIG has not made any predictions on either the scale of capital that will move or its distribution across asset classes. Using Federal Reserve data we have estimated that U.S. households were sitting on $3.8 trillion and U.S. corporations a further $2.3 trillion in unrealized capital gains at the end of December 2017 in stocks and funds alone, however. Suffice it to say that a small fraction of that moving into Opportunity Funds would quickly be a community development game-changer. Interest is high across the full spectrum of potential investors, so we are cautiously optimistic. With respect to real estate versus non –real estate investments, it will depend on three things: 1) Some critical interpretations of the statute coming out of Treasury; 2) the pipeline of deals; and 3) innovations within and around the Opportunity Zone/Fund market that creates financial products that are attractive to entrepreneurs.

Q. Do you feel investors will have any desire to work with CDFI's (Community Development Financial Institutions) to invest in projects or are they going to be more prone to really large projects?

This depends on both the investor goal and the scope of work of the CDFI. We think there will be investors that would want to collaborate with a local entity. However, the smaller the investment the more of a challenge it would be to find an investor that is not a local person.

CDFIs hold a really valuable commodity: information. They know their communities, know the investment opportunities, and have relationships with the entrepreneurs and business owners. That commodity is about to become very hot, so CDFIs should figure out how they are best positioned to play. Some may want to create their own Opportunity Fund vehicle, others may want to co-invest, and others may find alternative ways to constructively partner (co-locating workforce development activities, for example, or offering traditional debt financing to business that move into O-Fund financed developments). Many local communities already have relationships with CDFIs and those partnerships will be invaluable.

Q. What percentage of equity share can we expect from Opportunity Funds in affordable housing projects?

This depends on the project. If investor yields are lower than debt costs, then you might see more equity than a typical capital structure. Lower-income rent levels will limit equity since it will limit the ability to repay the investor at the end. You could, however, imagine 100% equity investments for housing projects in markets that have some limited appreciation. Of course, that could also trigger concerns with gentrification in these areas due to the need to see increased values to return investor cash. Public sector and philanthropy could ease those concerns depending on how they might be involved.

Qualified Opportunity Funds-

Q. Can investors only utilize the Opportunity Fund approach? Can they just acquire business investment property? Farmlands, forest lands? All investments seeking to benefit from the tax advantages of investing in Opportunity Zones <u>must</u> be made through a qualified Opportunity Fund.

Treasury still needs to make final determination of how land factors into the substantial improvement requirements investors face for acquiring property. Any tangible property though needs to be used in the active conduct of a business, so a "buy and hold" model is not permissible.

Q. If I am a private investor and want to invest in a fund, how can I do so? Related question: as a private equity investor, I'm interested in taking a more active role in an OZ fund - championing and perhaps leading an investment project. Are there funds open to this?

I think this depends on where and what you want to do. This program is so new that funds are just now forming. Investors may find funds that are comfortable collaborating or joining forces.

A few things to keep in mind: anyone can start a fund, and funds can be closely held and have a single investor. They must only be separately organized corporations or partnerships formed with the specific purpose of investing in qualified Opportunity Zone property. They must hold at least 90% of their assets in such property. Beyond that, though, there are no prohibitions on the model (beyond standard related party and anti-abuse regulations). So a savvy investor can set up his or her own fund. Other funds will have multiple investors, and many of these will need fund managers to curate and maintain an investment portfolio. As a private equity investor, you may be well-suited to filling this need, and I suggest networking with potential fund creators and investors in your community.

Q. Do we expect to see an accredited investor restriction?

The statute doesn't create new securities rules so existing State and Federal regulations remain in place. Some funds may choose to place their own restrictions, however.

Q. Someone mentioned that Opportunity Funds require a separate legal entity. Can you give some more details, please? I'm with a nonprofit CDFI and wondering how we should begin to establish an O-Fund.

You would likely need to create a separate Fund or separate partnerships for OZ capital to create a tax paying investment entity, clarify partnership requirements, and facilitate investment without putting the nonprofit entity at risk.

Q. How will funds provide cash-out events to cover investor tax bills?

Funds will need to sort out exit strategies from the initiation of the Fund or investors are unlikely to join. Many are assuming and will need to show the plausibility of a refinancing action to return investor capital.

Q. Can you talk about the reporting requirements for funds to IRS/Investors, how rigorous, what does it compare to?

As of right now there are no reporting requirements beyond the basic information IRS will have to acquire in order to confirm the eligibility of the Fund's investment portfolio. That should be known to funds and investors in late

2018. The original legislation, the Investing in Opportunity Act, did call for robust and transparent reporting requirements to be available to the public, but this content was stripped from the final bill due to a procedural quirk stemming from how Congress ultimately passed the tax reform package. It remains to be seen whether IRS and Treasury put some reporting requirements back in through the rule-writing process.

Q. How is everyone finding Opportunity Funds? There was one mentioned with a $10,000 minimum limit. How can local agencies locate these organizations?
Right now, there is no central marketplace or clearinghouse. NDC participates in several coalition efforts designed to work toward implementation of the law in a manner most beneficial to the communities in need. We are happy to help local governments and others find potential partners. While there are likely to be significant market advantages to moving early, many funds will not form until IRS and Treasury provide more regulatory clarity later this year and into next.

Qualified Opportunity Zones-

Q. Does the designated Opportunity Zone have to be applied for through the state?
Yes. The legislation required that Governors designate zones and the IRS did the final approval. Zones have already been designated and are in effect until 2028.

Q. When will be the next time a state can designate a census tract as an Opportunity Zone?
2028, unless the provision gets reauthorized by a future Congress before then.

Q. Similar to New Market Tax Credits, are census tracts that are adjacent to Opportunity Zones eligible for any benefits?
No – only the designated zones are eligible.

Q. Is there a place you can find more information on the data on socioeconomic change/lack of change? If not, can you expand on how the number was researched?
The data that EIG cites comes from Brett Theodos and colleagues at the Urban Institute. You can explore their analysis and download the national database here: https://www.urban.org/policy-centers/metropolitan-housing-and-communities-policy-center/projects/opportunity-zones-maximizing-return-public-investment

Q. Can a zone get kicked out of the program?
No, eligibility is now locked in for 10 years.

Investments-

Q. Will there be any provisions that allow working lands in rural areas (i.e. agriculture, timber, etc.) without the "substantial improvement" requirement? How will raw land in general be treated?
This determination really depends on the IRS' final determinations on how land is treated and what constitutes substantial improvements. The legislation wanted to see new capital investment generated as opposed to recycling capital.

Q. Please expand on the original use test.
The statue defines "qualified Opportunity Zone business property" as tangible property used in a trade or business if the *original use* of such property in the zone commences with the fund (or the business in which the fund is

investing) or the fund (or business) substantially improves it. That may seem clear, but Treasury does still need to clarify a few things: for example, if a property has been vacant for over a year, can new use qualify as "original"?

Q. Are O-Funds only allowed to make equity investments? Can it make loans?
Only equity.

Q. If an Opportunity Fund invests in a startup, what is the implication of the startup potentially relocating outside of the Opportunity Zone during the period of the investment?
Depends on final rules around the percent of assets required to remain in the OZ tract. The statute does have a relatively generous 5-year "off-ramp" period for the fund to complete its divestment in the case of a company growing out of a qualifying footprint, since Congress wanted to be sure not to penalize success.

Q. If an O-Fund invests in a business in an O-Zone, is there a limit to how much of their income is from customers located in the O-Zone?
No. So long as substantially all of the business' real estate assets and capital equipment are located in the OZ tract there are no requirements as to where their customers come from.

Q. Is the reduction of capital gains in the fund if one holds the property for 10 years or if the invested funds are in the fund for 10 years though it may be that they bought and sold two to three properties, for example for gains within the fund and within the zone?
Treasury will have to clarify how Qualified Opportunity Funds deal with the potential sale of businesses or properties and the subsequent reinvestment of proceeds within the zone. The most conservative interpretation is that investments must remain in the original business or property for the full 10 years, but the framers of the law intended that funds that stayed in the zone would be continuously eligible to hold the deferral. Expect clarity to come late 2018 or early 2019.

Q. Can you invest post-taxed cash into an Opportunity Fund to take advantage of the 10-year appreciation benefit alone? i.e. - they don't have a capital gain they need to defer to 2026, they just have cash that they want to invest.
No. So far the legislation was clear in providing the preferred tax benefit solely to capital gains proceeds.

Q. What is the risk of recapture if an investment fund invests in a business that subsequently moves out of a zone?
This will depend on final rules requiring a certain percent of assets to remain in the OZ tract. Investors in general have five years to divest from a company that moves out (see answer above). If a Fund fails to maintain an eligible portfolio without reasonable cause, the statute outlines a modest penalty at the IRS's standard underpayment rate. It's also important to keep in mind that the worst-case scenario in all situations (the fund dissolves for any reason, for example) is normal tax treatment.

Q. What flexibility or limitations are expected for using OZ funds to develop housing?
The only real limitation is the investor's return requirements and the exit strategy to return capital.

Q. Regarding brownfields, beyond sufficient cleanup how substantial must the improvements be to qualify?

The improvements must be made over a 30-month period (it is not yet clear when that clock starts, however; stay tuned for IRS guidance) and exceed the investor's adjusted tax basis in that property. So it is a relatively steep 100% improvement test.

Q. Regarding Property Purchases: wasn't it said they can purchase property in which they are actively involved? Please clarify

Yes, property must be actively used in a trade or business (either of the Fund itself (Funds can directly own real estate or capital goods) or of a business in which the Fund invests). Funds cannot acquire property and *not* put it to commercial use.

Q. Can O-Zone investments be used for mining or timber, and other natural resource extractive industries?

There are no explicit restrictions on these industries in the statute, but the business model will probably depend on forthcoming guidance from There are no explicit restrictions on these industries in the statue, but the economics of the business IRS/Treasury.

Q. What kind of housing can be invested in? Does it have income restrictions? Can it be home ownership and/or rental?

There are no restrictions, but some models will be more attractive to investors than others depending on forthcoming rules and regulations from IRS/Treasury. The affordable housing community certainly sees real potential here.

Q. Is there an online resource that provides some examples of the various types of investments (e.g. into property, into a business, etc.)? Does it give examples of the types of legal agreements necessary?

Not yet, but a number of organizations are coming up with models in real time. Regularly check back on EIG's Opportunity Zones Resources page for the latest. https://eig.org/opportunityzones/resources

Community Engagement and Equity-

Q. How can we build wealth in these communities? Job creation and even redevelopment will not give residents an equity stake.

This depends on local efforts. Local government and philanthropy can work together to solicit investment capital and direct it to more impactful investments. Capital is just one piece of a very complicated puzzle. If it works, Opportunity Zones will help many of the other pieces fall into place alongside, provided local and civic partners take advantage of the opportunity.

Q. What is going to keep the wealthy from owning even more of the wealth in the country because of this? How can we assume local stakeholders will be included?

This depends on investor requirements and the investment. You could imagine shared equity initiatives in home mortgages or "rent-to-own" investments in real estate that could allow a business to move towards ownership as part of the investor exit strategy. Also, public and philanthropy funds could be used in conjunction with OZ investment capital to help facilitate permanent community equity.

Q. Is there any way that this program can get debt finance to Main Street businesses in the O Zones? This is primarily an equity program but most small, and very small businesses need debt not equity. A fund won't want to take an equity position in a small restaurant or seamstress operation. Can we create 3rd party entities that lend?

A network of CDFI have been advocating for the IRS to allow an investment in a CDFI to be an eligible investment so they can use capital to lend. Not sure this will survive in final regulations. Best to focus on ways to invest equity. Depending on the cost and structure of equity, it could be a better match for Main Street businesses. Having the flexibility to repayments based on business success rather than the impact of fixed debt to help many businesses. The key is whether we can create equity vehicles to minimize business disruption and could be more cost effective than debt. NDC has a small business lending program designed to lend to businesses in the communities where we are providing technical assistance. NDC has a Small Business Administration 7(a) license that allows us to provide a 75% federal guarantee for small business loans and also provides smaller loans in selected communities through our Community Impact Loan Fund. Many other CDFIs have small business lending programs as well.

Q. What are current roles/needs for organizations that would support "OZ plus" that goes beyond geography as a collapsed targeting criteria for race/class/investment needs to achieve greater social impact?

It would be up to local efforts and funding support to help investments go beyond the geographic eligibility. There may be investors or collaborators with foundations that want to invest in activities that benefit the local community based on race and class. Local officials are uniquely poised to bring other economic development incentives and programs into a project that meets the community's needs. Local leaders can create micro development plans for the Opportunity Zones now that the boundaries are set.

Q. Are there any places thinking of adding existing or new subsidy, density (real estate), or other benefits to put up those handrails for the marketplace?

I have not yet heard of specific local efforts related to OZ investments. We are seeing some State and Local governments realign existing program criteria to favor OZ investments and some have moved to align a similar tax benefit (like a State capital gains tax or historic preservation) and align in tandem with OZ requirements. In theory and design OZs are intrinsically complementary to initiatives around transit-oriented development, placemaking, and much more.

Community Facilities-

Q. If a local government has a public facility project, how do they access the Opportunity Fund capital? Can an O-Fund invest in public facilities? How?

NDC does a lot of development projects on behalf of government facilities. So a separate partnership could be used with a local government for a lease-lease-back structure with the private party doing the development and using OZ sourced capital to lower costs to the government agency. The key is determining how to monetize the tax benefits (like depreciation) that governments don't benefit from and using those benefits to offset cash return requirements.

Q. How can public facilities be an eligible investment in OZs? Not clear to me, given the equity stake requirement--unless facilities are privatized.

Since funds are provided as equity, a local government would need to be comfortable with some type of public-private project through a likely Lease/lease-back structure. The public could receive the monetized benefit from tax treatment of the real estate that the government does not benefit from (i.e. tax losses from depreciation). OZ Equity could reduce debt to the project saving public funds during the 10-year investment period.