The Shifting Sands of Economic Development:
Welcome to the “O” Zone

League of California Cities: 2019 Mayors & Council Members Executive Forum
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None of the information contained or provided herein constitute a recommendation nor is to be construed as tax or legal advice. Please consult a qualified tax accountant or legal advisor regarding any potential investment in Opportunity Funds.
1. **Background: OZ Program Basics**

2. **Recent Key Changes** *from a Transaction Perspective*

3. **The State Takes Action** *to Encourage OZ Investment*

4. **What’s Next? How Cities & Investors are Preparing**
What is the Opportunity Zone program, and what does it mean for California?
“Opportunity Zones have the potential to be the largest infusion of private capital into disadvantaged communities in decades.”

— Lenny Mendonca
recently appointed Director of the Office of Business and Economic Development

“We also want to pair EIFDs with the Opportunity Zones. This is the Big Idea.”

— Gov. Newsom
January 10th, 2019
2019-2020 State Budget Release

Governor on OZ legislation: “I’m still trying to get my arms around it....My original thought was let’s focus with a sense of urgency on the two values that define this moment: issues of affordability and housing and on the issue of climate change.”

— Gov. Newsom
Opportunity Zones Investor Summit
Stanford University, March 18, 2019
## OPPORTUNITY ZONES
### BASICS AND COMMUNITY BENEFITS

### OZ BASICS
- **Incentivizes** individuals to take capital gains and invest in certain low-income areas through tax deferrals and reductions.
- **Timing** is critical to maximize investments
- **Competition** will be high for OZ investment

### OZ COMMUNITY BENEFITS
1. Opportunity Zones can be used as part of an economic development strategy, creating jobs, stimulating economic activity, and jump-starting projects within a community.
2. Opportunity Zones can stimulate housing development, paving the way for cities to meet legislative housing mandates.
3. Opportunity Zones can be used to augment other tax incentives and economic development strategies, and can enhance the economic viability of a proposed project by mixing with EIFDs, NMTC, other Fed Tax Credits).
The Tax Cuts and Jobs Act of 2017 created Opportunity Zones to unlock unrealized capital gains by incentivizing private sector investment and development in low income census tracts.

3,516 low-income census tracts in California; 25% eligible for nomination.

Tract screening criteria: poverty level, sufficient business activity, geographic diversity.

879 O-Zones approved in California.

8,700 census tracts approved in the United States.

879 Census tracts approved in the State of California in April 2018.
## Opportunity Zones in 57 CA Counties

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OPPORTUNITY ZONES
WIDE VARIETY OF POTENTIAL INVESTMENTS

Housing & real estate development; infrastructure & energy projects; tech & service businesses

- Rural Areas with sluggish economies
- Blighted industrial / commercial areas with adjoining residential areas
- Deteriorating neighborhoods adjoining older industrial areas
- Declining commercial corridors

OZ Investments spur economic growth
OPPORTUNITY ZONES
THE BASICS

Federal Tax Incentive Program

• Incentivizes individuals to realize capital gains and invest in low-income areas
• Most significant tax advantage incentivizes a 10-year hold
• Capital must flow through a Qualified Opportunity Fund, which is subject to administrative and compliance requirements

Timing is Critical

• Investors have 180 days from gain reporting date to invest capital gain in OZ
• Property in OZ must be substantially improved in 31 months (with some additional flexibility for delays related to government agency actions); New 31-month “Working Capital Safe Harbor”
• To maximize tax advantage, investment should occur by 12/31/19 to achieve the 7-year 15% basis increase
QUALIFIED OPPORTUNITY FUND REQUIREMENTS*

REAL PROPERTY
Property acquired by an Opportunity Fund after 12/31/17 (unrelated party rules apply):

- Substantial Improvements: Basis attributable to building must be doubled over any 30-month period
- Land Excluded from substantial improvement test
- Purchase may be by a Joint Venture (JV entity) or QOF (direct purchase)

BUSINESS INVESTMENT
Tangible property acquired by the Opportunity Fund after 12/31/17 (unrelated party rules apply):

- 70% of Tangible Property must be qualified OZ Business Property
- ≥50% of Total Gross Income derived from active conduct of the business
- Original Use commences with purchase
- Limitations on Business Type – no sin businesses (racetracks, gaming, massage, liquor store, other)

*Consult additional clarifications in recent federal regulations/guidance, released May 2019.
INVESTOR BENEFIT BASICS

- **Project must be in a qualified Opportunity Zone census tract**
- **Tax advantages incentivize a 10-year hold**
  - **Deferral** of current capital gains taxes until earlier of 2026 or upon exit
  - **Reduction** of tax on current capital gains via step up in basis:
    - 5 year hold – Basis increased 10%
    - 7 year hold – Basis increased cumulative 15%
- **Exemption** from tax on gain on sale of QOF interest at 10 years or upon sale of assets
- **Timing requirements are critical**
  - Capital gains must be invested in the Opportunity Fund within 180 days of realization
  - 6 months for Opportunity Fund to establish Qualified Opportunity Zone Business entity
  - 31-month Working Capital Safe-Harbor for QOZ Business to develop qualified property per plan & schedule (with some flexibility for delays related to government agency actions)
OPPORTUNITY ZONES
INVESTMENT TIMETABLE

- **2019**: Investment made into Opportunity Fund
- **2020**: Basis increased by 10%
- **2021**: Basis increased another 5% for a total of 15%
- **2022**: Federal tax on deferred capital gains due by 12/31/26
- **2023**: Basis is adjusted to equal Fair Market Value. No tax on investment appreciation.
- **2024**: Basis is adjusted to equal Fair Market Value. No tax on investment appreciation.
- **2025**: Basis is adjusted to equal Fair Market Value. No tax on investment appreciation.
- **2026**: Basis is adjusted to equal Fair Market Value. No tax on investment appreciation.
- **2027**: Basis is adjusted to equal Fair Market Value. No tax on investment appreciation.
- **2028**: Basis is adjusted to equal Fair Market Value. No tax on investment appreciation.
- **2029**: Basis is adjusted to equal Fair Market Value. No tax on investment appreciation.
MECHANICS OF OZ COMPLIANCE:
OZ GATING TIMELINE

**Phase I**
- QOF Fund Funding Period
- Sale Date
- 179 day Post-Gain
- 6 Months (generally)
- 31 Months (generally)
- 100% of desired gain deferral

**Phase II**
- QOF Fund Investment into QOZ Property Period
- 179 days
- +179 Days
- OZ fund must hold average 90% QOZ Property

**Phase III**
- Investment into QOZ Property
- 70% of average assets in Corp/ Partnership/ other QOZ Property must be QOZ Property

**Phase IV**
- Testing Every 6 Months
- June 30 & Year-end

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**Action occurs at:**
- QOF Fund Level
- QOZ Business Level
- Percentage Requirements

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**Notes:**
1. The 180-day period starting date may be delayed until the end of a flow-thru entity’s (e.g. Partnership/ S Corp/ Trust/ REIT) year-end (generally December 31st).
2. 1st measurement period is 6 months after QOF Fund self-certification date.
3. Assumes investment relates to the improvement of QOZ Property and working capital is supported by business plan and actual spending pattern.
4. Failure to meet the 90% QOZ Property test will result in a monthly penalty for the dollar amount under 90% of the value. Penalty is based on section 6621(a)(2) underpayment rate which is currently 6%.
OPPORTUNITY ZONES
THE ESSENTIALS – OPPORTUNITY FUNDS

INVESTMENT BASICS

- **Two investment options:**
  - Qualified Opportunity Zone Property
  - Qualified Opportunity Zone Business

- Investment transaction must occur after December 31, 2017*

- **Property must be substantially improved** during any 30-month period; some flexibility for delays caused by government agency actions

- **Minimal requirements on project type:** could include residential, commercial, hospitality, office, industrial, or an operating business.

- **Cannot include “sin” businesses:** golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or gambling, or store which sells alcoholic beverages for consumption off premises

* Guidance from U.S. Dept. of Treasury ongoing
OTHER FUNDING SOURCES FOR OZ INVESTMENTS

- Most Opportunity Zones are also eligible for **New Market Tax Credits (NMTC)**
- Enhanced Infrastructure Financing Districts (EIFDs) lack front end capital. **OZ Projects** can fill that gap & reap the benefits of tax-exempt infrastructure financing.
- Many Opportunity Zones are **SB535** eligible (disadvantaged census tract areas).
- EIFDs improve eligibility for Federal and State **grant and loan monies**.
1. **Background:** *OZ Program Basics*

2. **Recent Key Changes from a Transaction Perspective**

3. **The State Takes Action** to *Encourage OZ Investment*

4. **What’s Next?** *How Cities & Investors are Preparing*
OPPORTUNITY ZONES
GOVERNMENT DELAYS DURING SAFE HARBOR PERIOD

Will California Projects Get Some CEQA/Permitting Relief?

- Fed. regulatory revisions will likely help California projects meet OZ timing requirements despite delays caused by government agency actions (such as CEQA review or permitting processes)

- The new regulations add some flexibility to the 31-month working capital safe harbor period for delays caused by waiting for government agency actions, such as permitting

- The application for government action must be submitted during the 31-month period
OPPORTUNITY ZONES
OPERATING BUSINESS INVESTMENT

OZ Business Investment Expected to Accelerate Due to Clarifications

- **Leased Property as OZ Business Property**
  - Leased property now qualifies as Qualified Opportunity Zone Business Property. In general, leased property does not need to satisfy the “original use” requirement, and it is not required to be “substantially improved” by the OZ Fund or OZ Business.

- **Location Requirements Eased with New Tests**
  - Clarification/flexibility was provided for numerous tests used to establish the activity that occurs within the Opportunity Zone, including new safe harbors and a facts-and-circumstances test to determine whether at least 50% of the QOZ Business’s gross income is derived from a trade or business in a QOZ.

- **Working Capital Safe Harbor Extended to OZ Business Investment**
  - The 31-month working capital safe harbor now applies to QOZ businesses as well as improvement of tangible property, giving businesses time for the “development of a trade or business” without violating the 70% test.
Key Improvements for Property Investment

- **Vacant Buildings**
  - If a building has been vacant for at least five continuous years before being bought by an OZ Fund or OZ Business, then the building will not require substantial improvements to satisfy the original use requirement.

- **Raw Land**
  - Unimproved land does not need to be “substantially improved,” though the property will not be eligible for OZ Property treatment if the OZ Fund does not intend to improve the land (and is merely being held for investment).
  - Exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action the application for which is completed during the 31-month period.
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879 low-income Census tracts approved as California OZs:
>10% of the national market

California is typically a strong investor market:
• Climate
• Labor Force
• Diversification
• Port Activity
• Quality of Life

California has some OZ challenges:
• OZ Competition in 49 States
• Slow/Costly Entitlement Process & Local Government Approvals
• CEQA Timing and Litigation Exposure
• State Tax Conformance with OZs
“WE ALSO WANT TO PAIR EIFDS WITH THE OPPORTUNITY ZONES. THIS IS THE BIG IDEA.”

— Gov. Newsom
January 10th, 2019
2019-2020 State Budget Release
SB25: Streamlining CEQA for OZ Projects  (Senator Caballero)

- **Challenge**: CEQA process can exceed the 30-month timeline for OZ investment; investors hesitant to take on timing risks
- **Solution**: Fast-tracks CEQA procedures for OZ Projects: 270-day timeline; only appeal analysis
- *Revised working capital safe-harbor in Federal regs likely helps address this challenge*

SB128: Eliminate EIFD 55% Voter Threshold for Debt (Senator Beall)

- Authorizes EIFD public financing authority to issue bonds without submitting a proposal to the voters, improving EIFD interaction with OZs

SB635: OZ Income Tax Alignment with Feds (Senator Hueso)

- **Challenge**: CA not aligned with Fed. OZ tax policy, limiting investor benefit of CA projects; most other states conform *(or do not have income tax)*, limiting CA competitiveness
- **Solution**: Conforms CA personal income tax and corporation tax law to federal OZ tax treatment.
May Revised Budget & ongoing budget negotiations use OZ program to catalyze housing development in California:

- **Infill Infrastructure Grant Program**
  - $500m for infrastructure gap funding, to support higher-density affordable/mixed-income housing.
  - Focus on infill areas in OZs to guide investment toward housing.

- **Partial CA Tax Conformance**
  - Proposes personal income tax & corporate tax law alignment with federal OZ capital gains provisions for state priorities: green technology & affordable housing.
  - Criteria allows incentives to be layered with Infill Infrastructure Grants to incentivize housing development.
The California OZ Marketplace Is Now Open

Learn more and post your projects
State of California OZ Marketplace

www.Oppsites.com
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OZ FUNDS SEEKING INVESTMENT OPPORTUNITIES

Opportunity Zone Funds are Forming Across the County
- Over 130 OZ funds (over $25 billion) already formed
- 58 funds (over $15 billion) have a nationwide or California focus

Diverse Preferences for Investment Types
- Urban & Suburban
- Real Estate & Business Operations
- Residential & Commercial Development
- Existing & Emerging Businesses
- Community-based Investing

OZ Funds Preparing & Searching for Opportunities
- More funds are expected to form, along with private OZ investors
- Many funds developing investor prospectuses
- All funds are seeking investable projects
| **Educate** | city council, staff, and the community on Opportunity Zones |
| **Identify** | key projects, property owners, and stakeholders in OZ areas |
| **Develop** | an OZ investment strategy: OZ Businesses, OZ Properties, or both |
| **Update** | economic development plans and zoning to align with targets |
| **Streamline** | local project approval processes and align with CEQA |
| **Create** | OZ Prospectus to market target projects to OZ investors |
1. Education on Opportunity Zones & Benefits – City Council & Staff
   - Community support and engagement needed for future success

2. Review/Update Economic Development Plans within each District
   - When were they last updated? Are housing and transit priorities considered?
   - Do they conform with current priorities/needs?
   - Assess current/future infrastructure needs, as aligned with proposed changes.

3. Review Existing Specific Plans
   - In alignment with econ. dev., housing, mobility, and sustainability goals?
   - Existing CEQA documents to tier off - important in streamlining approval processes for Opportunity Zone projects.
4. For each district, identify the best fit for Opportunity Funds:
   - Opportunity Zone Business or Opportunity Zone Property or Both
   - Includes a review of parcels: size, current zoning

5. Identify property & business owners in Opportunity Zones

6. Evaluate local project approval processes
   - What can be streamlined?
   - What current impediments need to be addressed?
   - Identify desired community benefits
   - Community outreach – Is community ready and on board?

7. Prepare Opportunity Zone Prospectus
CITIES DEVELOP OZ PROSPECTUS TO ATTRACT OPPORTUNITY ZONE INVESTORS

**OZ Prospectus**: emphasize strategy, stability, and structural advantages of your city to highlight market opportunities for OZ Funds.

**Prospectus Components**
- Top-level Storytelling
- City/Regional Momentum
- Economic Development Planning & Zoning Updates
- Streamlined Local Processes
- Other Funding Sources
- Target Areas
- Target Projects/Sites

With over 8,000 approved Opportunity Zones across the country, competition for Opportunity Fund investment is high.
QUESTIONS?

THE SHIFTING SANDS OF ECONOMIC DEVELOPMENT: WELCOME TO THE ‘O’ ZONE

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