ARIZONA COMMERCE AUTHORITY

May 15, 2019

ARIZONA OPPORTUNITY ZONES GUIDANCE REVIEW

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Origin of Opportunity Zones

- Created through the Tax Cuts and Jobs Act in Dec. 2017.
- Provides capital gains benefits to encourage investors to:
  - Sell passively held investments.
  - Reinvest capital gains from those investments in property or businesses in select lower-income communities called Opportunity Zones.
    - Requires use of an intermediary vehicle, an Opportunity Fund.
- Governors nominated 25 percent of each state's qualifying low-income Census tracts for Opportunity Zone status. The U.S. Department of the Treasury certified zones.
  - Arizona submitted Governor Ducey's nominations on March 21, 2018.
  - All 168 Arizona tracts were certified by Treasury on April 9, 2018.
    - Tracts are urban, suburban, rural and tribal—each county has at least 1.

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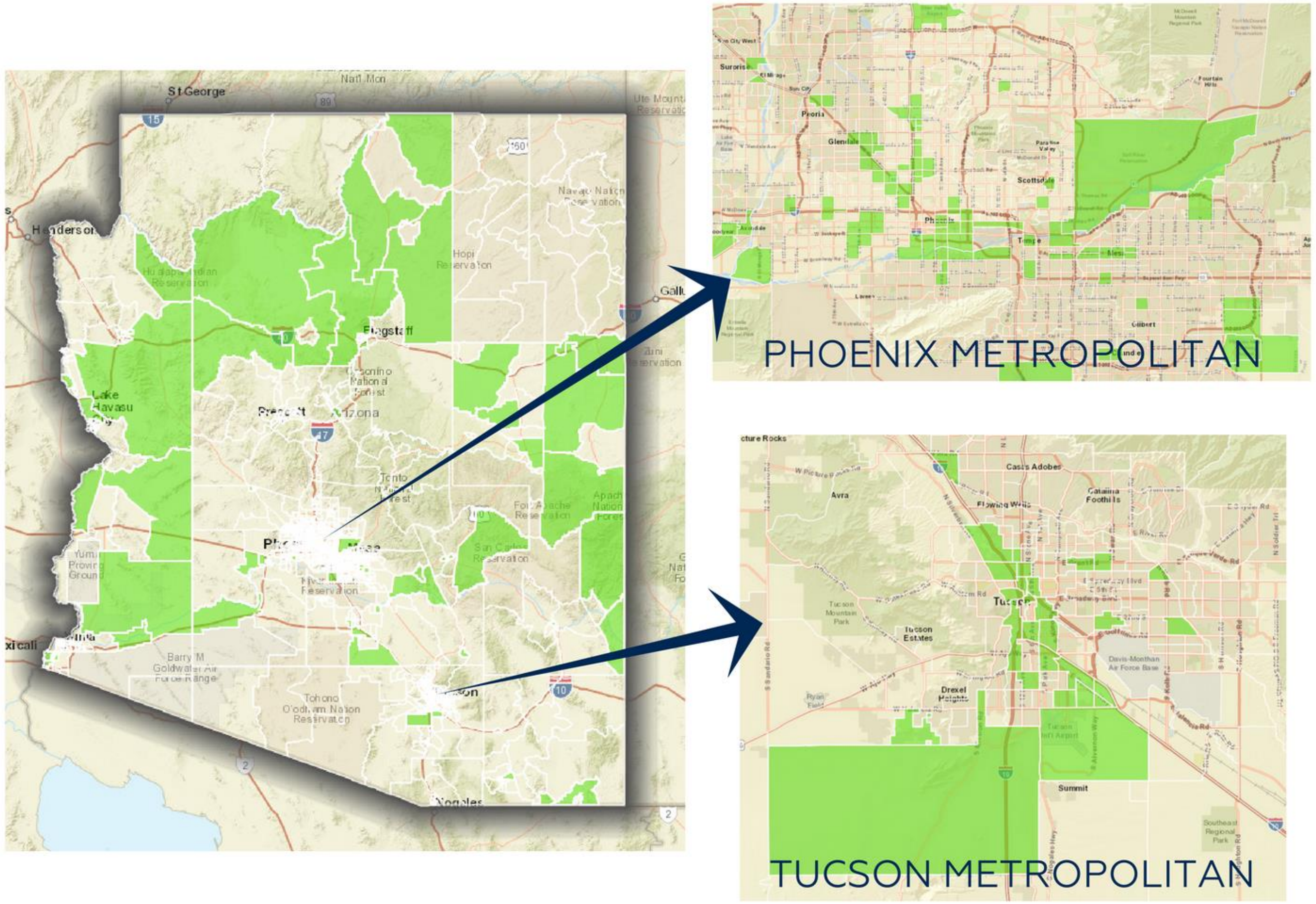
Arizona's Opportunity Zones



[View Arizona's Opportunity Zones.]

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Federal Tax Benefits

1

DEFERRAL

REALIZE A CAPITAL GAIN, REINVEST IT IN AN OPPORTUNITY FUND. TAXATION ON THAT GAIN DEFERED UNTIL DEC. 2026.

2

10% REDUCTION

IF OPPORTUNITY FUND INVESTMENT HELD FOR 5 YEARS BY 12/31/26, TAX ON PREVIOUS DEFERRED GAIN REDUCED 10 PERCENT.

3

15% REDUCTION

IF OPPORTUNITY FUND INVESTMENT HELD FOR 7 YEARS, BY 12/31/2026, TAX ON PREVIOUS DEFERRED GAIN REDUCED 15 PERCENT.

4

ELMINATION

IF OPPORTUNITY FUND INVESTMENT IS HELD FOR 10+ YEARS, NO CAPITAL GAINS TAX ASSESSED ON <u>THAT</u> (SECOND) INVESTMENT.

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ARIZONA'S OPPORTUNITY ZONES

Advancing the Opportunity

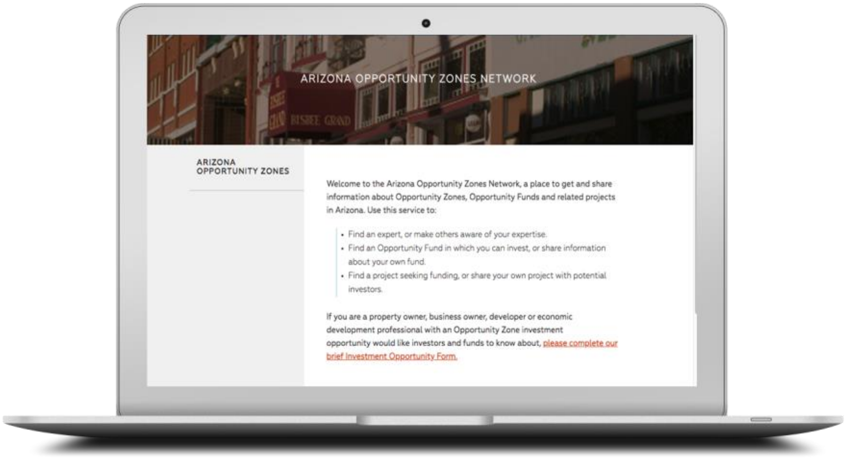
ARIZONA OPPORTUNITY ZONES NETWORK

The ACA has built a new digital tool to further connect Arizona's Opportunity Zones community.

The publicly searchable Arizona Opportunity Zones Network (AOZN) platform enables stakeholders to:

- Connect with experts or offer their own expertise
- Explore Opportunity Funds to invest in or share information about their own funds
- Find a project seeking funding or property for sale or lease—or share information about their own projects or properties with potential investors.

Visit the Arizona Opportunity Zones Network today.



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Opportunity Zone Guidance

OZ legislation is short but complicated. Treasury guidance is critical to deploying Opportunity Funds into Opportunity Zones.

- First tranche (released Oct. 19, 2018; hearing Feb. 14, 2019), provided guidance that:
  - Allows Opportunity Funds to form.
  - Makes multi-year projects feasible.
  - Makes rehab projects more desirable.
  - Makes investing in businesses that are largely, but not wholly, in Opportunity Zones feasible.

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Second Tranche of Guidance

The second set of proposed Opportunity Zone and Opportunity Fund regulations was released April 17. That guidance, among other things:

- Clarifies how several key provisions and rules apply to investments in operating businesses.
- Addresses how to invest in projects on leased land.
- Discusses tax implications of interim gains and rules for reinvestment.

Hearing scheduled for July 9, 2019.

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Today’s Panel

OPPORTUNITY FUND SPONSORS

Chris Loeffler & Brion Crum Caliber

Quinn Palomino & Bret Maidman, Virtua Partners

TRIBAL ECONOMIC DEVELOPER

Quannah Dallas, Salt River Pima-Maricopa Indian Community

ATTORNEYS

Marc Schultz, Snell & Wilmer

Daniel Gauthier, Rose Law Group

PHILANTHROPIC LEADERS

Terry Bennelli, LISC Phoenix

Suzanne Pfister, Vitalyst Health Foundation

MODERATOR

Shawn Neidorf, Arizona Commerce Authority

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Agenda

1-2:30 p.m.	Moderator will review guidance and lead discussion with panelists
2:30-3 p.m.	Audience questions

How to submit a question:

1. Look for the “Q&A” icon at the bottom of your screen.
2. Click on the icon to open the Q&A window.
3. Type your question into the Q&A box.
4. Click send.

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Operating Businesses

50% GROSS INCOME TEST

- First tranche of guidance said at least 50% of the gross income of a qualified OZ business must be derived from active conduct of trade/business **in the Opportunity Zone**.
- Second tranche covers options for how to comply:
  - Share of service hours performed in the zone, OR
  - Share of cost of services provided in the zone, OR
  - Tangible property and management/operations in the OZ are needed to generate 50% of the business' gross income, OR
  - Facts and circumstances test.

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Operating Businesses

REASONABLE WORKING CAPITAL/INVENTORY IN TRANSIT

- First tranche of guidance provided a 31-month safe harbor for capital used for an Opportunity Zone Business to acquire, construct and/or improve tangible property. This cash is considered reasonable working capital for the OZB test.
- Second tranche expanded the coverage of the safe harbor to expenditures related to development of a trade/business, including payroll, inventory and rent.
- Second tranche also clarifies that inventory in transit—raw materials coming in and finished goods going out—doesn't fail to qualify as being used in the OZ just because it must move from a vendor to the OZ and from the OZ to a customer/client.

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Operating Businesses

INTANGIBLE PROPERTY

- The statute requires that a “substantial portion” of intangible property of a qualified business entity has to be used in active conduct of a trade/business in the qualified OZ.
- The second tranche of guidance defines “substantial” as 40%, but doesn’t specify how to measure it.

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Leased Property

BASIC RULES

- The proposed regulations in the second tranche of guidance make it clear that Opportunity Funds may invest in businesses operating on leased land or invest in leased tangible property.
  - Leased tangible property may count as qualified OZ business property for purposes of the 90% asset test at the fund level and 70% asset test at the business level.
    - Lease must start after Dec. 31, 2017.
    - Lease must be market rate.
    - Substantially all the leased property is in an OZ during substantially all the lease period (more of an issue for equipment).

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Leased Property

DETAILS

- Per the second round of guidance:
  - There is no original use requirement for leased tangible property.
  - There is no substantial improvement requirement for it, either.
  - Lessor can be related to the Opportunity Fund or the OZ business, but there are restrictions that generate pros and cons.
  - Leased tangible property may be valued in accordance with GAAP or on a calculation of the "present value" of the lease payments.
    - Opportunity Funds must use same approach for all leased property.

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Real Estate

ORIGINAL USE

- Per the second round of guidance, “original use” for tangible property begins when the property is placed in service for purposes of depreciation or amortization.

- Buildings that have been vacant for 5 years may be repurposed under original use rules, not substantial improvement rules.

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Real Estate

SUBSTANTIAL IMPROVEMENT

- Undeveloped land does not need to be substantially improved, but guidance warns against buying with intent "not to improve the land by more than an insubstantial amount within 30 months of purchase."
  - It does need to be used in a trade/business. IRS is explicitly interested in preventing land banking and has asked for comments on how to use anti-abuse provisions to prevent it.
- A 31-month safe harbor for development may be extended for delays beyond the OZ business' control, such as government permitting delays.
- Multiple, overlapping 31-month safe harbors are permitted for the same overall project. (For example, one harbor may cover the underground work for a project, while another covers the above-ground work.)

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Real Estate

OTHER

- Owning and managing rental real estate qualifies as an operating a trade/business for qualified OZ business purposes. Triple-net leases do not, as there is no active business involved.
- If a piece of property straddles an Opportunity Zone such that at least as much of the property is within the zone as outside of it (by square footage), and the property outside is contiguous with the zone, then all the property is deemed to be within an OZ.

Rules for Investors

- Investments in Opportunity Funds cannot be services.
- IRC Section 1231 gains: 180-day Opportunity Fund investment clock begins on the last day of the taxable year.
- Giving your OF shares to someone will create a tax event (inclusion of deferred gain.) Passing along your shares upon death through your estate will not.

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Opportunity Funds

INVESTMENT DEADLINES

- Opportunity Funds are meant to invest quickly, and the statute calls for funds to be assessed at the mid- and end-points of their tax years to verify that 90 percent of their assets are qualified OZ property or business interests.

- The second tranche of guidance specifies that the testing should exclude investments received in the prior six months. Those assets must be held in cash, cash equivalent or debt instruments of 18 months or less.

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Opportunity Funds

DEFINING “SUBSTANTIALLY ALL”

- Use of tangible property within the zone to be qualified OZ property: 70%.
- Tangible property owned or leased that must be qualified OZ property for the business to be a qualified OZ business: 70%.
- Opportunity Fund’s holding period for tangible property a qualified OZ business property/interest in an OZ partnership or stock: 90%.
- Holding period of a qualified OZ business of tangible property as qualified OZ business property: 90%.

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Interim Gains

How to treat interim gains remains a vexing issue. The second tranche of guidance:

- Clarified that Opportunity Funds have 12 months to reinvest interim gains without the proceeds counted as a bad asset under the 90% test.
- The Fund’s gain gets allocated to the investors (if the Fund is not a corporation) and is taxable as income for investors. If the fund is a corporation, the corporation pays the tax.
  - Treasury says it does not think it has the authority to treat these gains differently.

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Interim gains

HYPOTHETICAL ANALYSIS

Background:

- Maria realizes $100 of capital gain in 2019 and invests it in a multi-asset Opportunity Fund (structured as a partnership) within her 180-day window.
- The fund, in turn, invests $10 of Maria's money, along with other people's money from their fund, into original-issue stock in Company X, a qualified Opportunity Zone business.
  - The Opportunity Fund takes a minority position in the company.
  - This investment is made in 2019.

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Interim gains

SCENARIO 1

- In 2022, Company X is sold to a third party, and the Fund sells its stock to the buyer, earning a return of 3X on its investment.
  - What is Maria’s tax liability as result of the sale of Company X?
  - What happens if the Fund reinvests all of the gains into qualified Opportunity Zone businesses within 12 months?
  - What happens if the Fund allocates this gain to her (and others)?
  - Does it matter whether she reinvests the gain into another Opportunity Fund?
  - How do these various decisions affect Maria’s 5-, 7- and 10-year clocks?

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Interim gains

SCENARIO 2

- Everything is the same, only the sale of Company X takes place in **2028** instead of 2022?
  - Can the Fund still reinvest that interim gain?
  - If the fund allocates her gain on Company X in 2028 to Maria, can Maria roll her gain into a new Opportunity Fund investment?
  - How do these various outcomes affect Maria’s 5-, 7- and 10-year clocks?

Still to come in a third+ tranche

- Rules for interim gains at the Fund level, specifically whether funds should be subject to tax.
- Reporting requirements—what information Treasury should collect on Opportunity Funds and their investments.
  - Expect changes to the Opportunity Fund tax form.
  - Treasury is seeking input on reporting.
  - NOTE: Sens. Booker & Scott have introduced a bill regarding reporting
- Anti-abuse rules.

For More Information…

- This summary draws heavily on:
  - *Clarity Provided by Second Tranche of Treasury Regulations to Incent More Investment in Opportunity Zones Businesses (Part I)*
    by Michael Novogradac, and
  - *IRS Publishes Second Round of Proposed OZ Guidance*
    by the Economic Innovation Group.

Other sources:
- Arizona Commerce Authority's Opportunity Zones Page
- Treasury's second tranche press release
- The text of the second tranche of Treasury guidance
- Treasury's Request for Information regarding Opportunity Fund reporting
- A list of actions federal agencies are taking to support Opportunity Zones

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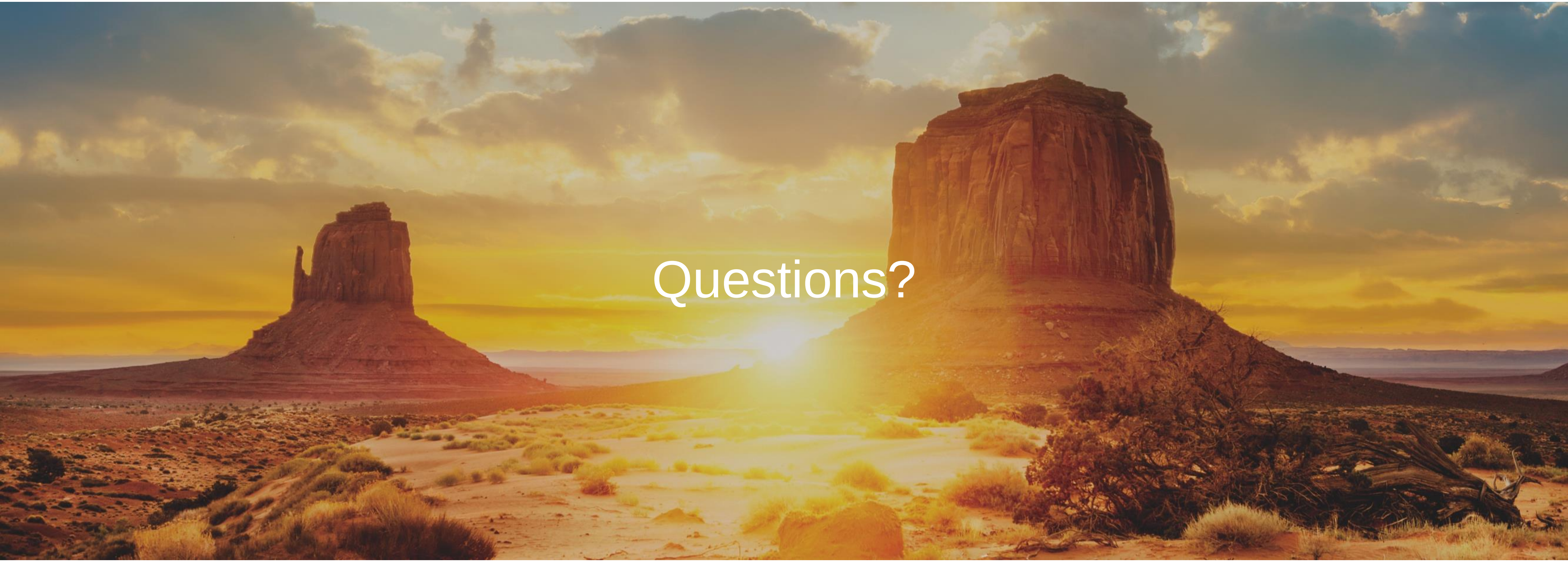
Questions?