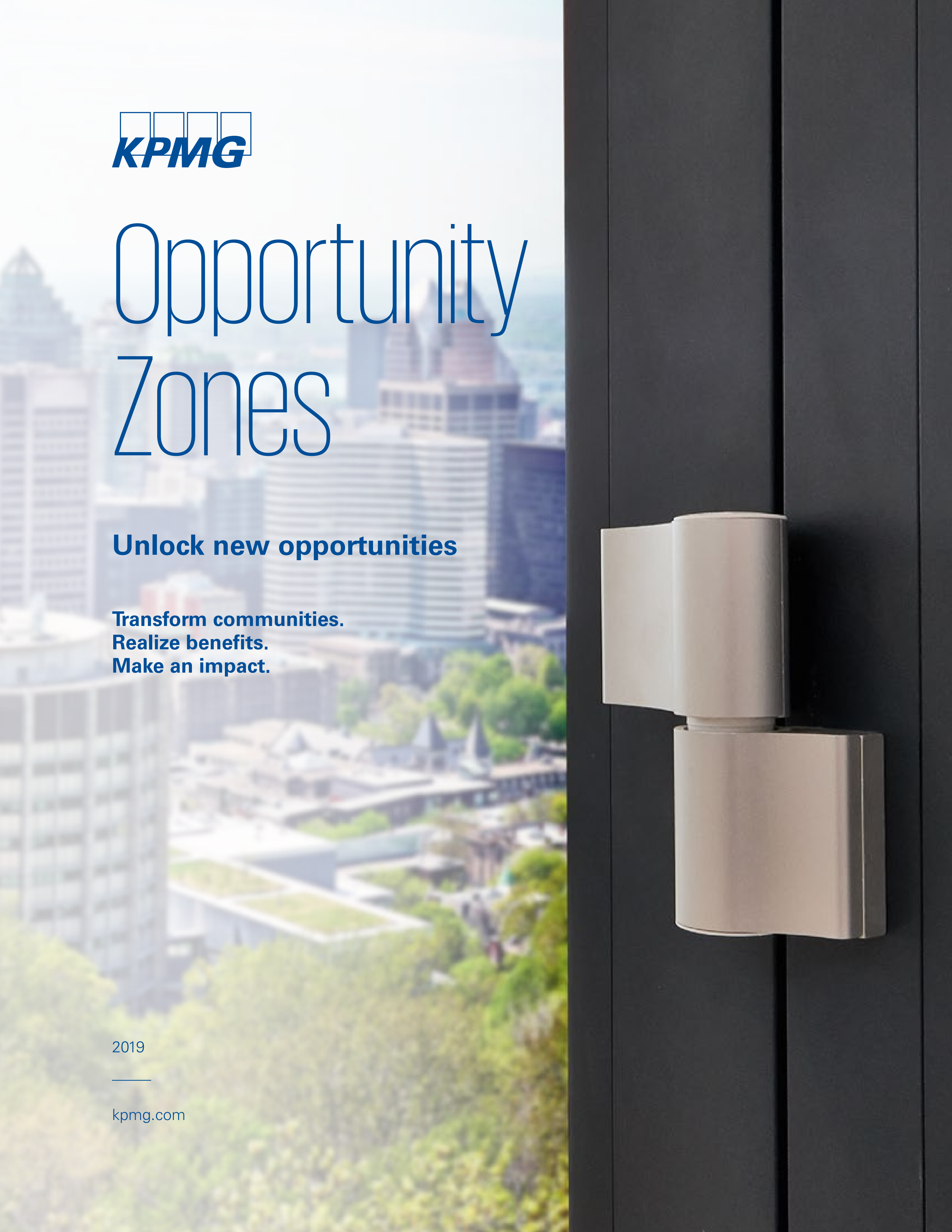

KPMG

Opportunity Zones

Unlock new opportunities

Transform communities.
Realize benefits.
Make an impact.

2019

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Contents

Executive summary

Since their introduction, Opportunity Zones have developed interest at an extraordinary pace. The program has swiftly mobilized investors, advisers, developers, and communities excited by its potential to access a vast reservoir of untapped capital to help revitalize underserved neighborhoods. The program provides an outlet for investors with capital gains to unlock substantial tax incentives, with the potential to generate additional investment yields. Doing well by doing good.

Enacted as part of the 2017 Tax Cuts and Jobs Act,[1] the Opportunity Zones program was established to encourage social advancement and private investment in economically distressed census tracts to aid job creation and new business formation. The program incentivizes investment by allowing for the deferral of capital gains (rollover gains), reducing tax obligations on a portion of those gains, and most notably, allowing Qualified Opportunity Zone (QOZ) investments to grow tax free.

Key points of the program

- More than 8,700 low-income census tracts have been designated by the Treasury
- Self-certification of Qualified Opportunity Funds (QOF)
- Eligible capital gains can be from nearly any source
- Eligible capital gain must be invested in QOF within 180 days
- QOF must invest in QOZ property, which includes both QOZ business property or interest in QOZ business.
- There is a 31-month safe harbor for working capital held by a QOZ business
- Substantial improvements to non-original use QOZ business property within 30 months (improvements must exceed the cost of the property, excluding land)
- QOF must have at least 90 percent of its assets in QOZ property (including interests in QOZ businesses)
- At least seventy percent of the tangible property owned or leased by a QOZ business must qualify

[1] Section 1400Z, H. R. 1-115th Congress (2017–2018)

Potential tax benefits of investing in a QOF (DRE benefits)

D	**Deferral Benefit (time value of money)** Capital gain rolled over into a QOF may not be included in income until December 31, 2026.
R	**Reduction Benefit (basis step-up)** Taxpayers can receive a basis step-up of 10 percent or 15 percent of the rollover gain, thereby reducing the rollover gain included in income if they invest in QOF for five or seven years, respectively, before December 31, 2026.
E	**Exclusion Benefit (appreciation exclusion)** If QOF investment is held for 10 years or more, the taxpayer generally will not pay tax on the appreciation when the investment is sold or exchanged.

On May 1, 2019, new proposed regulations[2] were published, addressing many critical uncertainties that had kept substantial capital sidelined, and providing welcomed flexibility to investors and businesses that are seeking to take advantage of the Opportunity Zones incentives.

Key points on 2nd set of regulations

- Multiasset funds may be accomplished.
- Debt financed distributions are allowed if you have basis and it is not a disguised sale.
- Asset recycling can be accomplished—A QOF will have 12 months to reinvest sale or disposition proceeds. However, gain is taxable unless a like kind exchange completed.
- A building that has been vacant for five or more years may be considered original use.
- QOZ business property may be acquired under a market rate lease (including from related parties), subject to certain additional requirements.
- Working capital safe harbor—ability to extend beyond 31 months if delay is caused by waiting for government action.
- Carried/profits interests for services generally are not eligible for benefits in a QOF.
- Business income safe harbors include 50 percent of services (hours or compensation) performed in a QOZ or gross income generated from tangible property and management within a QOZ. Source of gross income is not based upon where customers are located.

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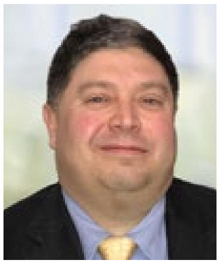
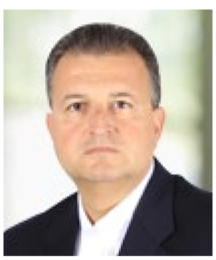
[2] Proposed regulations under section 1400Z-2 of the Code that would amend the Income Tax Regulations (26 CFR Part 1). Section 13823 of the Tax Cuts and Jobs Act, Pub. L. No. 115-97,131 Stat. 2054, 2184 (2017) (TCJA) and Rev. Rul. 2018-29 (released October 19, 2018)

About the authors



Joe Scalio
Senior Lead Partner, Tax
Qualified Opportunity Zone Business Lead

As one of the KPMG's national leaders in the Qualified Opportunity Zone ("QOZ") practice, Joe actively engages with industry leaders, government officials, and investors to provide insights that help resolve tax and regulatory issues regarding QOZ investments. He is also active in helping taxpayers to maximize QOZ tax incentives and structure Qualified Opportunity Funds ("QOFs") and Qualified Opportunity Zone Businesses ("QOZBs"). Joe has provided tax advisory, tax structuring, tax modeling, and tax reporting services to various asset management entities including real estate investment trusts, real estate funds, private equity funds, and business development companies.



Phil Marra
National Audit Leader, U.S. Building, Construction & Real Estate
National Real Estate Funds Leader

Phil is an audit partner based in New York with more than 30 years in the real estate sector. Phil has a wide range of experience in providing audit, accounting, due diligence, and advisory services to real estate, finance, parking, construction, and hospitality clients. He has lectured extensively on qualified opportunity zones. He is also a member of KPMG's U.S. Asset Management Leadership team.

Richard Blumenreich
Principal in Charge, TCEAS, Washington National Tax

Richard Blumenreich is principal-in-charge of the Washington National Tax Credit and Energy Advisory Services ("TCEAS") Group. Previously, he was a principal in the Washington National Tax Passthroughs Group and IRS Chief Counsel Assistant Branch Chief and Attorney with responsibility over tax credits, depreciation, and partnerships. He focuses primarily on tax issues relating to tax credits, partnerships, depreciation, amortization of intangibles, leasing, and qualified opportunity funds.

Ruth Tang
Partner, Audit

Ruth is an audit partner in KPMG's Alternative Investments practice in New York and specializes in serving real estate clients. She has 18 years of experience auditing a broad range of significant real estate developers, construction contractors, and private equity. Ruth regularly provides insight on technical accounting matters that arise during transactions and implementation of new accounting standards. As part of her role, she also leads KPMG's northeast Qualified Opportunity Zone team and has assisted companies in developing their opportunity zone and social impact strategy.

Demetri Yatrakis
Principal, Tax

Demetri is a tax principal in KPMG's New York Financial Tax practice. He has over 15 years of diversified tax and financial consulting experience with real estate and private equity clients. Prior to joining an accounting firm, Demetri was an attorney-adviser in Washington, DC at the IRS Office of Chief Counsel (Passthroughs and Special Industries). Demetri specializes in providing tax and advisory services to various real estate, construction, hospitality, and infrastructure clients and is a team lead in KPMG's New York QOZ practice.

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Do well, do good

The Opportunity Zone program offers substantial tax incentives in the form of gain deferral and exclusion for investing those gains in distressed communities across the nation, known as QOZs. The brainchild of Senators Tim Scott (R-SC), Cory Booker (D-NJ) and the Economic Innovation Group (EIG), a Washington, DC-based public policy organization, the program encourages investors, in EIG founder Sean Parker's words, "to put money into places where they wouldn't normally invest."[3]

In fact, Treasury Secretary Steven Mnuchin went on record during late 2018 indicating his expectation that QOZs may see more than $100 billion in capital.[4]

It's the logical progression of mission and impact investing, where both social and economic opportunities are clear and compelling. According to EIG, between U.S. households and corporations there were more than $6 trillion in unrealized capital gains at the end of 2017,[5] all conceivably eligible for this program. If even a fraction of that total comes into the program, the community development benefits and tax relief could be staggering. Corporations may be particularly interested in this program to address environmental, social, and governance (ESG) objectives.

Consider this report an overview of the Opportunity Zones program for a business purpose. It is designed to provide investors, both corporate and individual, as well as real estate developers and business owners with an understanding of the motivation behind and functional details around this new, tax-advantaged asset class, which Senator Booker has called a "domestic emerging market."[6]

> The Opportunity Zones program is a substantial improvement over many existing programs that the federal and state governments have put into place. It is one of the most effective innovations we've seen to incentivize equity to come into these census tracts. Government often structures debt-type vehicles to help with investment in these areas. This is the first time they are trying to seriously incentivize equity. In that way, it's not just about real estate, it's about business.
>
> **Phil Marra**
> **National Audit Leader—U.S. Building, Construction & Real Estate**
> **National Real Estate Funds Leader**
> **KPMG LLP**

[3] Forbes, "An unlikely group of billionaires and politicians has created the most unbelievable tax break ever," July 18, 2018.

[4] The Hill, "Mnuchin predicts $100B in cap investment from new opportunity zones," September 28, 2018.

[5] Economic Innovation Group, "Opportunity Zones: Tapping into a $6 trillion market," July 21, 2018.

[6] Forbes, "An unlikely group of billionaires and politicians has created the most unbelievable tax break ever," July 18, 2018.

What is a Qualified Opportunity Zone?

The heads of every U.S. state, territory, and Washington, DC were asked to identify 25 percent of their low-income population census tracts to be nominated as QOZs for purposes of applying a federal tax incentive. On June 14, 2018, more than 8,700 census tracts were certified by Treasury Secretary Mnuchin.

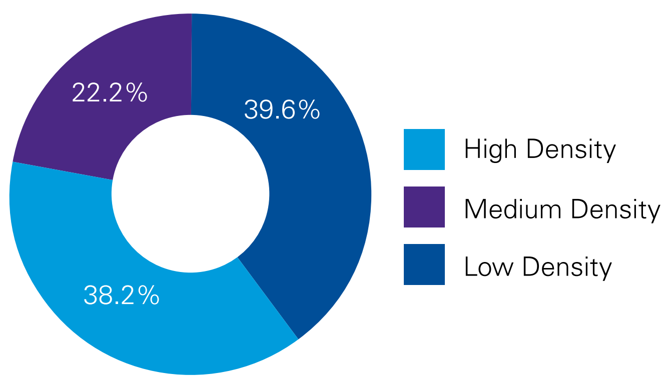
The selected tracts encompass areas in clear need of intervention, as well as locations with the capacity to incentivize private capital and absorb new investment. In general, the intent was to improve struggling communities, spur investment in new business, and create job growth in the near term. Many governors, however, had a unique developmental focus for their opportunity zones, covering such themes as:

- Revitalization of blighted areas
- Affordable housing
- Research facilities and tech incubators
- Hospitals and medical facilities
- Manufacturing and logistics
- University growth and student housing
- Military base restoration
- Education and social infrastructure
- Maximization of opportunities near existing transit hubs
- Specific job opportunities

Demographics

Of the certified QOZs, nearly 40 percent are in rural areas, approximately 38 percent are more urban, and approximately 22 percent are suburban, as measured by population density.[7]

Nearly 70 percent of the residents in QOZs live in "severely distressed" census tracts, which is defined by the Treasury Department's Community Development Financial Institutions Fund as areas with poverty rates of at least 30 percent.



Source: Economic Innovation Group, 2018

A complete list of designated QOZs and maps can be found on the Opportunity Zones Resources page on the **U.S. Department of Treasury CDFI Fund website**.

[7] National Geographic: Population density refers to the number of individuals occupying an area in relation to the size of that area.

Potential federal income tax benefits (DRE benefits)

Investors with taxable gains from the sale or exchange of virtually any type of property (e.g., stocks, real estate, art) or capital gain allocations from K-1s or 1099s (eligible gains), may potentially defer those gains by reinvesting the gain amounts (rollover gains) into a QOF within 180 days of the sale or exchange. Initially, the tax basis of the QOF investment is zero.

Incrementally, the Opportunity Zones program provides a step-up in basis for rollover gains and permanent exclusion of additional gains generated by the QOF if the investment is held for the required holding period.

The Opportunity Zones program offers investors three key federal tax benefits of Deferral, Reduction, and Exclusion DRE benefits that can be realized over the course of a QOF investment period.

Federal Benefits		
D **Deferral Benefit** (Time Value of Money)	Temporary deferral of rollover gains by investing in a QOF until the earlier of the disposition of the investment or December 31, 2026.[8]	
R **Reduction Benefit** (Basis Step-Up)	Step-up in investment of the rollover gains. Ten percent of the gain may be excluded permanently if the investment is held for five years. An incremental 5 percent (total of 15 percent) may be excluded if held for seven years. Both holding periods are through December 31, 2026.	
E **Exclusion Benefit** (Appreciation Exclusion)	The entire gain from sale of the "interest in" the QOF may be permanently excluded if the investment is held for at least 10 years. The exclusion of this gain relates only to the value increase in the investment in the QOF.	
State and Local Benefits **Tax & Non-Tax Incentives**	Various state and local Governments have conformed to the federal rules. Additionally, project incentives and support may provide added value that could offset as much as 10 to 15 percent of project costs.	

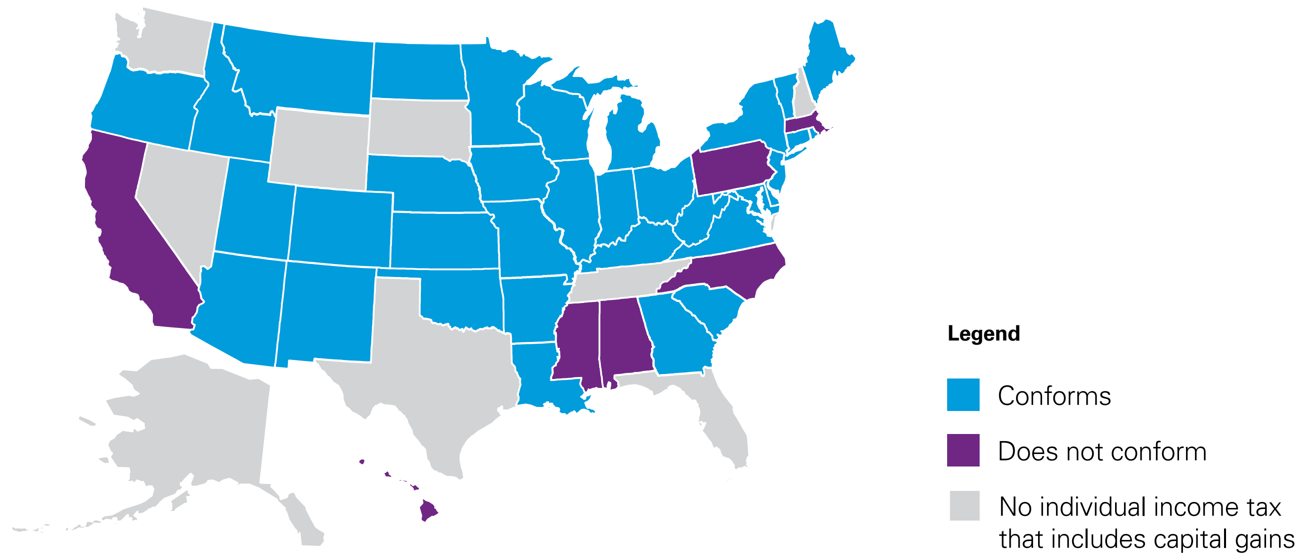
[8] The deferred gain recognized may be reduced to the extent the fair market value of the investment is less than the deferred gain.

State and local benefit enhancement

Approximately 30 states have conformed to the federal income tax rules for individuals, with others partially conforming. Thus, the same federal tax benefits for a QOZ investment will apply at the state level for conforming states.

State QOZ conformity—individual income tax

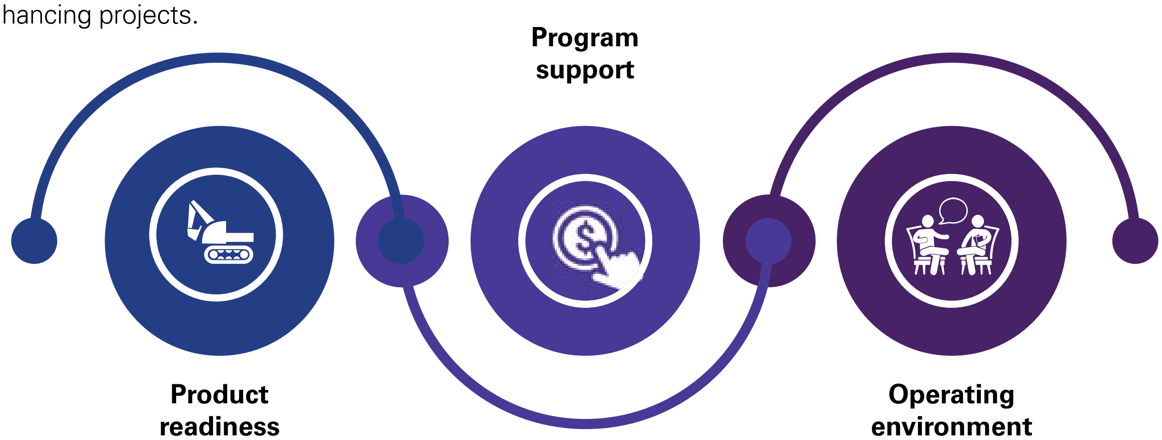
The below maps depict states which have conformed to individual federal tax rules for individuals.



Updated as of August 22, 2019.

Public sector role

QOZ investments have the potential to deliver both financial and social returns on investments. This possibility is giving rise to a new market, a new class of investors, new financing instruments, and new community development institutions. The public sector has a critical role to play in developing Opportunity Zones programs and products that will attract private capital to community-enhancing projects.



Business incentives come in a variety of forms

States and many local communities rely on business incentives to stimulate investment and economic development. These benefits may be combined with the QOZ benefits to attract investment and job growth in their local region, including statutory and thematic incentives. Frequently, incentive agreements result in a "win-win" situation for both companies and the jurisdictions involved. Incentives often have a significant impact on a company's bottom line when they are realizable and recognizable. Typically, incentives can offset between 10 percent and 15 percent of project costs.

Statutory tax credits

Established by jurisdictional statutes and are available "as of right" if qualifications are met.

Tax incentives

- Property tax abatements
- Sales & use tax exemptions or refunds
- Corporate income & franchise tax credits

Other tax incentives

— Tax increment financing
— Enterprise zone & foreign trade zone benefits
— Sustainability incentives
— New market tax credits
— Low-income housing tax credits

Discretionary & negotiated incentives

Jurisdictions distribute incentives to approved projects. Skilled negotiations with granting jurisdictions can result in increased incentives.

Nontax incentives

- Cash grants
- Free/subsidized land
- Utility discounts & cost offsets

Cost avoidance

— Expedited permitting
— Designated project manager
— Infrastructure incentives
— Employee training
— Transportation cost offsets
— Security assistance
— Technology assistance

Keys to success

1. Involve the local community early and often
2. Minimize friction in planning, zoning, licensing, etc.
3. Prioritize transformational projects over transactional projects
4. Make philanthropy and anchor institutions part of the solution
5. Incentivize or mandate impact measurement and transparency
6. Do the groundwork to uncover local gems and hidden assets

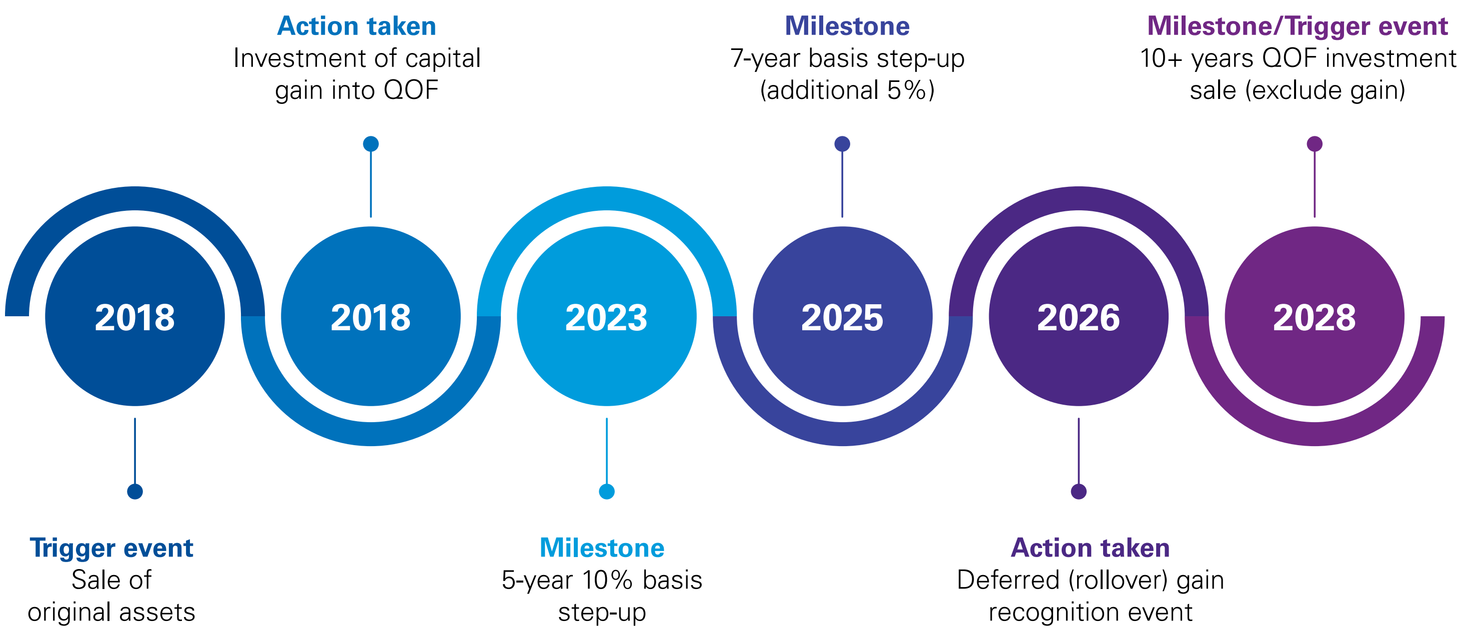
Bringing the tax benefits to life

Let's look at a hypothetical example.

In 2006 an individual invests $10 million in Company A, an internet start-up. In 2018, the individual sells their interest in Company A for $110 million. Under the Opportunity Zones program, the individual defers their $100 million capital gain (rollover gain) and invests in QOF X, and then QOF X invests in a QOZ property.

The individual keeps the rollover gain invested in QOF X through the tax year 2026. For the tax year 2026, the individual will only be taxed on 85 percent of the rollover gain from the Company A investment (achieving a 10 percent tax savings at the five-year mark and an additional 5 percent tax savings at the seven-year mark).*

After holding the investment for at least 10 years, the individual sells its investment in QOF X for $220 million. Under the Opportunity Zones program, the individual pays no federal tax on the gain of $120 million from the sale of QOF X.



* Taxpayers who invest in QOFs by the end of 2019 would achieve the same tax result.

Benefit	Time-Value of Money	Federal Tax Benefit	State Tax Benefit	Benefit Calculation
D **Deferral Benefit** (Time value of money)	$6.10 M	–	–	Rollover Gain ($100M) discounted at an Estimated Rate of Return of 7%
R **Reduction Benefit** (Basis step-up)	–	$2.10 M	$0.70 M	Rollover Gain ($100M) x Basis Step-Up (10%) x Federal and State Tax Rates (estimated at 21% and 7%)
	–	$1.05 M	$0.35 M	Rollover Gain ($100M) x Additional Basis Step-Up (5%) x Federal and State Tax Rates (estimated at 21% and 7%)
E **Exclusion Benefit** (Appreciation exclusion)	–	$25.20 M	$8.40 M	Appreciation Gain ($120M) x Basis Step-Up (100%) x Federal and State Tax Rates (estimated at 21% and 7%)
Total Benefit	$6.10 M	$28.35 M	$9.45 M	
			$43.9 M	

One important detail to keep in mind in relation to QOZ investing: the tax incentives depend on timing. To achieve the maximum potential tax benefit, investments of capital gains into a QOF must be made by December 31, 2019.

While the deferral and reduction benefits dissipate over time, the exclusion benefit is available for investments made between 2018 and 2026 for investments held for at least 10 years, through 2047.

“

In very efficient markets, like prime neighborhoods in most of the major metropolitan areas across the country, pricing is so accurate that it’s hard to find good deals. The places where there are opportunities to do well are in the communities where the institutional money simply has not gone. And that tends to be these qualified opportunity zones. In this instance, you can take these opportunities and turn them into investments that make very healthy returns and contribute to the community. For that reason, the Opportunity Zones program is a very important piece of federal policy. It is going to create a lot of interest in neighborhoods that, at least in the past, capital has overlooked.

—Prominent real estate developer in New York

”

Navigating QOF requirements

Qualification

A QOF may be organized as a corporation or partnership. Investments of eligible gains in a QOF are required to be made within a specified 180 day period.

An investment vehicle can become a QOF through a self-certification process that requires completing Form 8996. No approval or action is required by the IRS, but compliance with the various requirements is critical and begins with an understanding of the key provisions and terminology of the Opportunity Zones program.

Generally, a QOF must invest and hold at least 90 percent of its assets in qualified opportunity zone property (QOZ Property) determined by the average of the percentage of QOZ Property held in the QOF as measured: (i) on the last day of the first 6-month period of the tax year; and, (ii) on the last day of the QOF's tax year. The last day of a tax year is the only testing date if the tax year is less than six months.

The regulations provide an election for a QOF to exclude amounts contributed within six months of a testing date (if held in certain short-term investments or cash) from its 90 percent asset test on that subsequent testing date.

Eligible gains

Gain is eligible for deferral (referred to herein as "related gains") if it is from the sale or exchange of property with an unrelated party (not more than 20 percent) and the gain is treated as a capital gain for federal income tax purposes, including:

- Gross short-term and gross long-term capital gains
- Net gain on section 1256 contracts for a taxable year
- Net section 1231 gains for a taxable year
- Unrecaptured section 1250 gains (subject to section 291).

Investments in QOFs may consist of both eligible gains and other cash. Only the portion of the QOF investment that is made up of eligible gains is eligible for the tax benefits associated with the Opportunity Zones program, but all capital invested by the QOF are subject to applicable rules such as substantial improvement requirements.

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Eligible taxpayers

The first day of the 180-day period to reinvest gains into a QOF generally is the date on which the gain would be recognized for federal income tax purposes.

Special rule for partners

To the extent that a partnership does not elect to defer all or a part of its eligible gain, its partners may make their own gain deferral election with respect to their distributive share of such eligible gain provided the partner is not related to the buyer of the propery. The partners' 180-day period generally begins on the last day of the partnership's taxable year; although, partners may choose to begin their 180-day period on the same date as the start of the partnership's period.

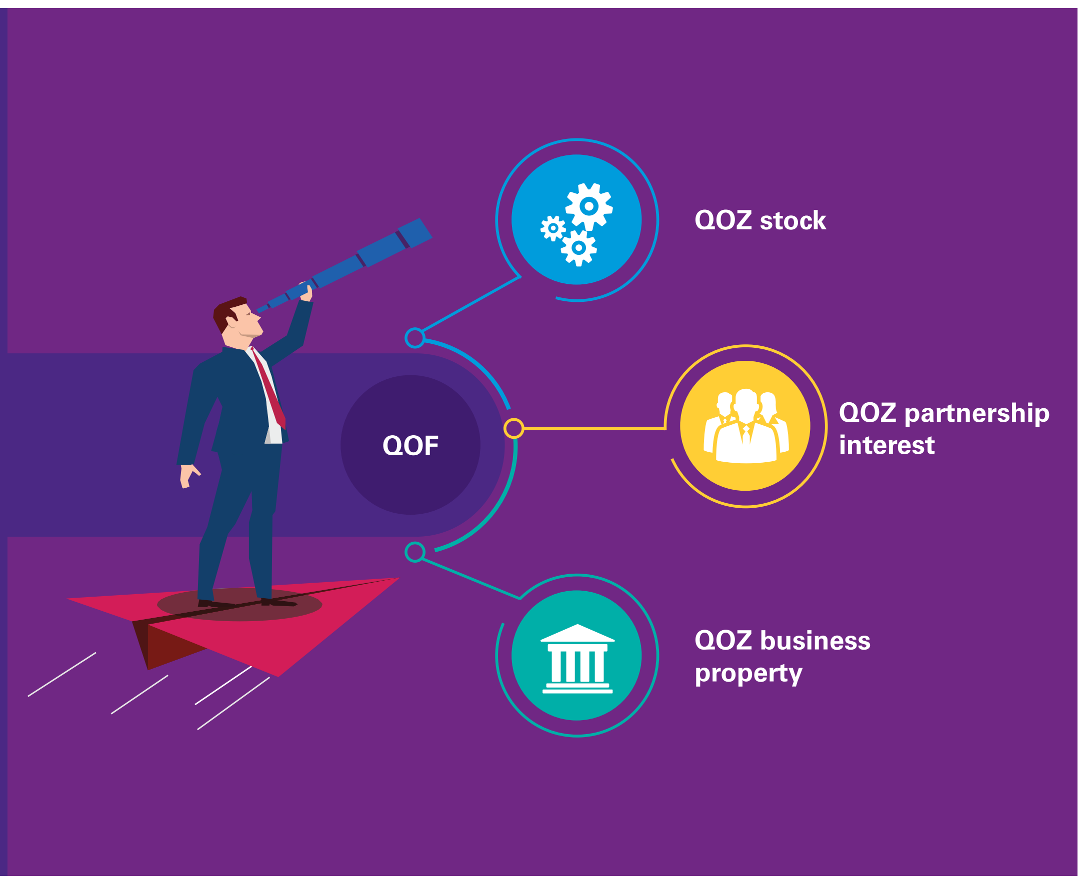
In instances where an eligible gain is realized by a partnership and a deferral election is made by its partners, the 180-day period is effectively extended. Given the optionality relating to the deferral, proper consideration should be given to which level the election should be made. For example, if a partner is related to the buyer of the property that generated the partnership's eligible gain, then the partner may not be able to make an election even though the partnership could.

Similar rules generally apply to S corporations, trusts, and estates.

The proposed regulations provide that **tax payers eligible** to elect gain deferral include:

- **Individuals**
- **C corporations** (including regulated investment companies (RICs) and real estate investment trusts (REITs))
- **Partnerships**
- **S corps, estates, and certain trusts**

QOZ property
QOF must have substantially all (90%) of its assets in QOZ property. QOZ property includes QOZ stock, partnership interests, and business property acquired or leased after 2017. QOZ business property does not included property acquired from related party, if such related party has more than a 20 percent overlapping ownership. QOZ business property can either be original use or require substantial improvement. The concept of original use and substantial improvement are explained below.



Original use

— For tangible property, original use generally begins when property is first placed in service for depreciation or amortization purposes in the QOZ (original use property).

— Newly purchased but previously used property qualifies as original use property if it has not been previously used in the QOZ (if it has been used in the QOZ, it must be substantially improved).

— Tangible property in a QOZ that has been unused or vacant for five years.

— Tenant improvements to leased property.

Substantial improvement

— For property that is not original use property, generally a QOF or QOZ Business must make investments that more than double the basis of such property within 30 months of acquisition.

— In an acquisition of land and other property, the land does not need to be substantially improved.

— The substantial improvement requirement does not apply to leased property (although there is an antiabuse rule that is meant to prevent circumvention of the purpose of the substantial improvement rules through the use of leases).

If you acquire both land and building in a transaction, the amount of substantial improvement must exceed the building's purchase price for this purpose and the QOF is not separately required to substantially improve the land. There are special rules relating to land and building components that are critical to understand, as illustrated below:

Land

— Land in a QOZ acquired after 2017 generally qualifies as QOZ business property (and can be excluded from a taxpayer's required substantial improvement calculation).

— Unimproved land that is acquired without a view or intention to improve the land by a "more than insubstantial amount" within 30 months does not qualify as QOZ Business Property.

— Land in a QOZ that is leased pursuant to a FMV lease entered into after 2017 generally qualifies as QOZ Business Property.

Buildings

— For buildings in a QOZ, the original use of the building must commence with the QOF or QOZB, or the QOF or QOZ Business must substantially improve the building for it to qualify as QOZ Business Property.

— The regulations require that, if an acquired building needs to be substantially improved to qualify, the improvements must be made to that building (as opposed to measuring aggregate improvements to a larger unit of property).

— Leased buildings generally qualify as QOZ Business Property (with no substantial improvement required) provided certain other requirements are met.

Leased property can be QOZ business property if certain requirements are met, as outlined below:

Leased property

— The lease is entered into after 2017

— The terms of the lease are market rate at the time the lease was entered into

— In the case of a related-party lease:

  – The lease cannot contain a prepayment of more than 12 months

  – If the original use of tangible personal property under the lease does not commence with the lessee, the lessee must acquire additional QOZ business property at least equal to the value of the leased tangible personal property.

QOZ business

Initially, much of the activity in Opportunity Zones had been centered on real estate, largely because the rules for investors and developers of real estate were better defined. With the clarifications on business investment set forth in the new regulations, the Opportunity Zone program is expected to generate significant investment in new or relocated businesses and start-ups, facilitating economic development, business growth, and job creation.

A QOZ business (QOZB) is a trade or business:

01

Substantially all (70 percent) of the tangible property owned or leased by the business is QOZ Business Property

02

At least 50 percent of the business's total gross income (subject to certain safe harbors) is from the active conduct of the trade or business in the opportunity zone

03

A substantial portion (40 percent) of the business's intangible property is used in the active conduct of the trade or business in the opportunity zone

04

Less than 5 percent of the average of the aggregate unadjusted bases of the business's property is attributable to nonqualified financial property (e.g., debt, stock, partnership interests), with exception for reasonable amounts of working capital

05

Is not a "Sin Business"

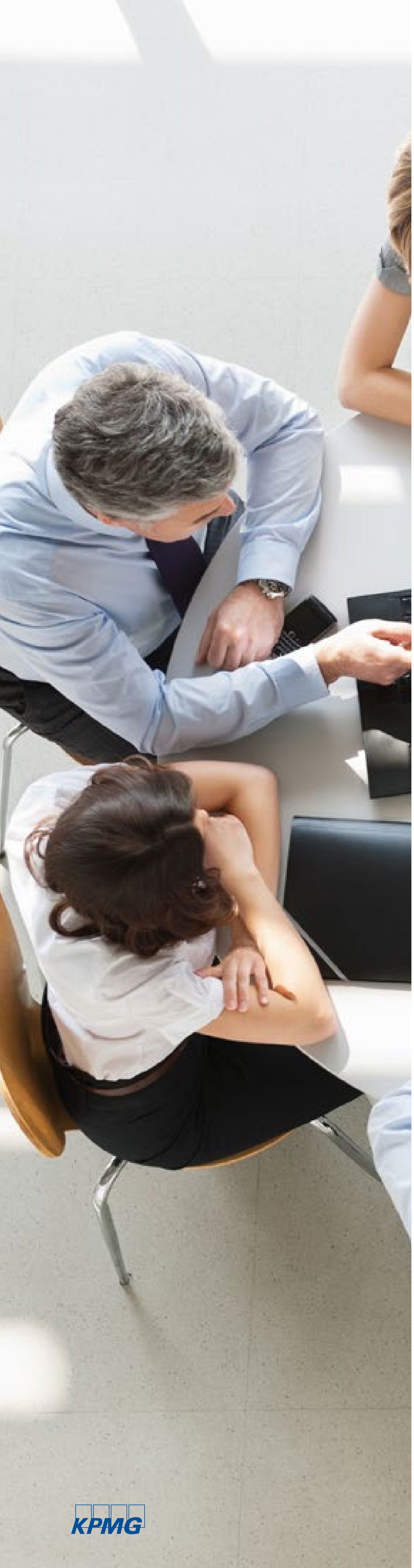
- Private or commercial golf course
- Country club
- Massage parlor
- Hot tub facility
- Suntan facility
- Racetrack or other facility used for gambling
- Any store the principal business of which is the sale of alcoholic beverages for consumption off premises

50 percent gross income test safe harbors

Satisfying the 50 percent gross income test may be accomplished by the following three safe harbors:

- **Hours:** At least 50 percent of the services performed by the QOZB's employees and independent contractors are performed within QOZs (based on the hours of all employees and independent contractors).
- **Compensation:** At least 50 percent of the amounts paid by the QOZB to employees and independent contractors is paid for work performed within QOZs (based on all compensation paid to employees and independent contractors).
- **Hybrid:** The combination of the QOZB's tangible property located in QOZs and the management and operational functions performed within QOZs are necessary to generate at least 50 percent of the QOZB's gross income.

Absent qualification for one of these safe harbors, a QOZB can still satisfy the 50 percent gross income test based on an "all facts and circumstances" test.



Working capital safe harbor

The proposed regulations include a reasonable working capital safe harbor for a QOZB that is developing a trade or business in a QOZ, including when appropriate, the acquisition, construction, and/or substantial improvement of tangible property in such a zone. The working capital safe harbor applies at the QOZB level and is intended to provide additional lead time for investment or project and start up enterprises to develop its trade or business in a QOZ and be able to satisfy the QOZB asset tests. Such development plans must be maintained in writing.

A QOZB may treat all working capital (cash, cash equivalents, and debt instruments not exceeding 18 months) as reasonable for a period of up to 31 months, if:

- There is a plan that identifies the working capital as property intended to be used in a trade or business in the QOZ
- There is a schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital; and to be under that schedule the working capital must be spent within 31 months of receipt of the working capital
- The working capital is actually used in a manner that is substantially consistent with the schedule.

The 31-month period may be paused if a QOZB is waiting on governmental action for which the application is complete. Further, a QOZB may apply multiple overlapping or sequential working capital safe harbors, which can be useful for phased developments or in situations where a QOF may have later rounds of investments.

In addition, if the working capital safe harbor is satisfied, the QOZB may:

- Treat gross income from such working capital as qualifying gross income for the 50 percent gross income test
- Treat the use requirement for intangible property as satisfied during the period the working capital safe harbor is in effect
- Treat the property to which the working capital will be expended as not failing the requirements to be QOZB property during the expenditure period.

Noncash contributions to a QOF

An investor can acquire a QOF interest in exchange for noncash property.

If an investor contributes appreciated property to a QOF, the amount of the qualifying investment is equal to the investor's adjusted basis in the property and the investor will have a nonqualifying investment equal to the amount of the unrealized appreciation in the property.

An investor who acquires a QOF interest for both qualifying capital (i.e., rolled over eligible gains) and nonqualifying capital (e.g., services, appreciated property) is considered to own two separate interests in the QOF (this is called a "mixed-fund" investment).

Debt-financed distribution

The proposed regulations generally allow a debt-financed distribution (subject to certain disguised sale rules) provided that the amount distributed does not exceed the partner's basis in its partnership interest.

Step up to FMV on exit after 10 years

The proposed regulations provide that the step up to FMV on exit is to the gross FMV of the interest. In addition, the basis of the QOF partnership assets is also adjusted, with such adjustments calculated as if the transferor partner had purchased the interest for FMV.

QOZ interest as collateral

Under the proposed regulations, status as an eligible interest is not impaired by a taxpayer's use of the interest as collateral for a loan. QOFs can receive initial equity contributions and employ debt to fund the remaining portion of the construction and other costs. Additional equity contributions of eligible gains over time could be used to repay all or a portion of that debt, provided the other QOF requirements are met.

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Three things set this program apart: First, unlike other government programs, Opportunity Zones don't have any job requirements. That allows real estate, which generally doesn't have many employees, to be able to utilize this program. Next, the self-certification process makes it easy to set up a QOF. It can be a captive fund where you roll over your own gains—it doesn't have to be for third-party investors. Finally, in addition to the federal incentives, we're now seeing many states starting to add to these benefits, whether it's conformity with all of the exclusions and benefits or even the state of Ohio saying they will be issuing tax credits for investments in QOFs.

Joe Scalio
Senior Lead Partner, Tax
KPMG LLP

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The extent of the tax benefits from Qualified Opportunity Zones can be significant. Some of the modeling we have completed has shown that investors can get between a 300 to 500 percent basis point improvement on their internal rate of return as a result of investing in these opportunity funds.

Richard Blumenreich
Principal in Charge, TCEAS
Washington National Tax, KPMG LLP

Carried interest for services

A QOF interest acquired in exchange for services is not a qualifying investment (i.e., QOF benefits are not available for carried interest for services).

Secondary acquisition of a QOF interest

Acquisition of an existing QOF interest with rollover gains is allowable under the proposed regulations. This means that one could purchase an interest in a pre-existing QOF and still reap the tax benefits of the QOF.

That is, taxpayers can acquire a qualifying investment in a QOF by purchasing QOF interests from existing QOF owners (secondary purchase), if the acquisition is made within the relevant 180-day period of an eligible gain. The QOF interest will be a qualifying investment in the hands of the secondary purchaser even if it was not a qualifying investment in the hands of the seller.

Depreciation recapture

Depreciation recapture that is treated as a capital gain but taxed at a higher rate (i.e., unrecaptured section 1250 gain), is an eligible gain that may be invested in a QOF. The exclusion benefit on a sale of a QOF interest includes any depreciation recapture that would have resulted on a sale of the QOF interest, if all of the requirements are met.

QOFs compared to like-kind exchanges

The like-kind exchange provisions of section 1031 of the tax code have offered opportunities to defer taxation of gains on the sale or exchange of real estate. The Opportunity Zones program provides new options for tax planning which, in many respects, is less restrictive than like-kind exchanges and offers potentially more beneficial tax incentives.

Gains from deferred like-kind exchange	QOZ deferred gains
All proceeds from the original sale must be reinvested within 180 days of the sale.	Any gains elected to be deferred must be reinvested in a QOF within 180 days of the sale or exchange of the asset.
Deferred gain is recognized upon taxable sale of the new property.	The deferred gain is recognized upon the earlier of the sale or exchange of QOF interest or December 31, 2026. (Deferred gain may be reduced to the extent that fair market value of the investment is less than the deferred gain).
Basis in the new property is equal to the basis in the original property exchanged (assuming no additional amounts beyond sale proceeds).	Initial basis in the QOF investment is zero.
Future like-kind exchanges may be applied.	No future gain deferrals are allowed after the first deferred election.
Like-kind exchange property may be located anywhere in the U.S.	QOZ property must be located in a designated QOZ.
There is no basis step-up or gain reduction as a result of holding the new property for a period of time.	A basis step-up of 10 percent occurs if the interest in the QOF is held for at least five years and another 5 percent if the interest in the QOF is held for at least seven years. (Holding periods are through December 31, 2026.) After 10 years, the basis in the QOF is equal to the FMV when sold exchanged.
Generally, exchanges may occur between related parties (subject to antiabuse rules).	Only the gain on the sale or exchange with an unrelated person is a qualifying gain.
Under the Tax Act, section 1031 only applies to real property exchanges.	Qualified gains are from any property held by the taxpayer.

QOF structuring

From an investment perspective, the Opportunity Zones program is inherently versatile, but has numerous requirements. The second round of proposed regulations addressed numerous open questions that had previously stalled capital raising.

Investors can arrange a single-tier structure, in which a QOF holds QOZ business property directly. Alternatively, a two-tier structure can be employed, in which a QOF holds an interest in a partnership or corporation (a QOZB). The QOZB holds the QOZ Business Property as part of a QOZ business. Either of these structures can be single or multiasset ventures.

Structuring versatility

The regulations contain numerous provisions that improve structuring versatility and are similar to typical structures currently used in the real estate industry. Rules such as the working capital safe harbor, distribution provisions and timing requirements have been put in place to facilitate active investment through 2026. Some limitations include that a QOF cannot hold an investment in another QOF. However, other investors can invest in multiple QOFs or a QOZB. As such, investment managers or developers may invest in either a QOF or QOZB. However, if they earn a carried interest for services, such amounts do not get the tax benefits associated with a QOZ investment.

Multiasset partnership or S corporation QOFs

The initial regulations were unclear on how multiasset funds could comply. The new regulations make way for multiasset QOFs by allowing the allocation of capital gains arising from the disposition a property by QOF to be allocated to an investor. However, this election is not available for property sold by a QOZB.

Sales of QOZ Property during the 10-year holding period

The new regulations provide for a 12-month period for a QOF to reinvest the proceeds from a sale or disposition of QOZ Property into other QOZ Property without the proceeds being treated as non-QOZ property, provided the proceeds are held as short-term investments.

However, the regulations do not defer the recognition of income or loss by a QOF on the disposition of the QOZ Property. It may be possible for the investor in the QOF to defer the recognition of the gain from the QOF by investing in another QOF or by the QOF completing a section 1031 like-kind exchange.

Aggregator structures

The new proposed regulations permit QOF interest holders to contribute their interests to another partnership without triggering an inclusion event, provided it does not cause a termination of the QOF partnership. Because of this rule, persons owning multiple QOF interests (e.g., interests in multi-asset fund consisting of parallel QOFs) have considered whether it may be beneficial to aggregate their interests in this new partnership (aggregator partnership or, altogether, the aggregator structure). Although there are some unclear issues surrounding such a contribution, this structure may provide a way forward to providing the diversification and other benefits of a multi-asset QOF fund while simplifying reporting for the ultimate owner. Note that the ordering of the transfers is critical. The QOF interest holders must be considered to have held their interests in the multiple QOFs for tax purposes prior to contributing their interests to the aggregator partnership.

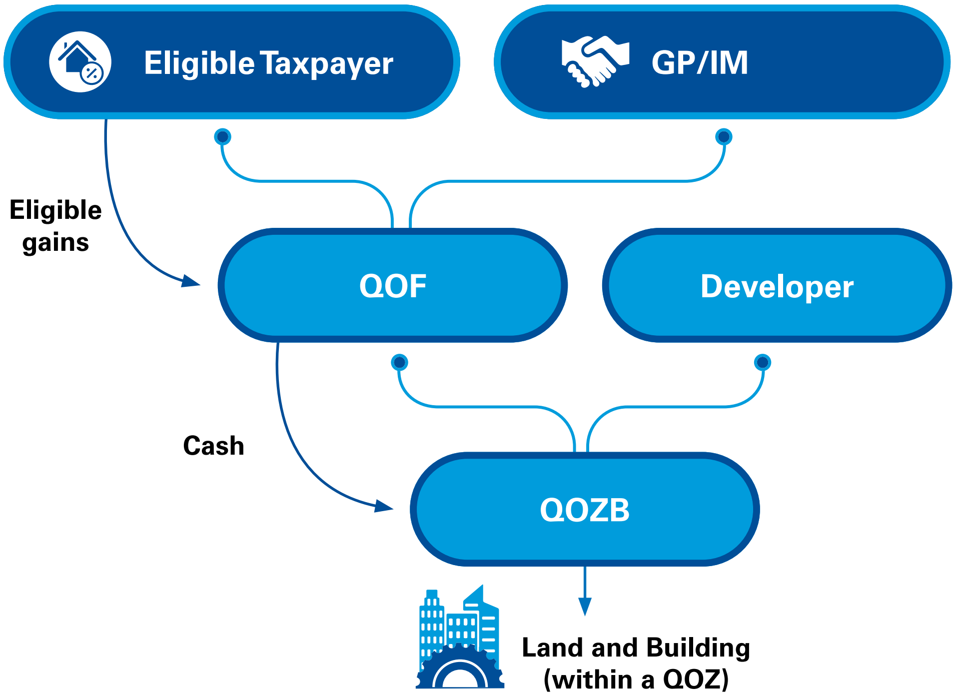
Emerging structure options

Two options that have emerged for structuring a real estate related QOF are using (1) flow-through entities such as partnerships or LLCs and (2) real estate investment trusts (REITs). The most common reason cited for selecting among these is the way in which information is reported to investors. Using a flow-through structure, investors receive K-1s, whereas dividends paid to REIT owners are reported on Form 1099-DIV.

There are tax, legal, and business advantages and disadvantages of using these two vehicles, and a detailed analysis of investors, investment types, and exit plan need to be considered before a selection is made.

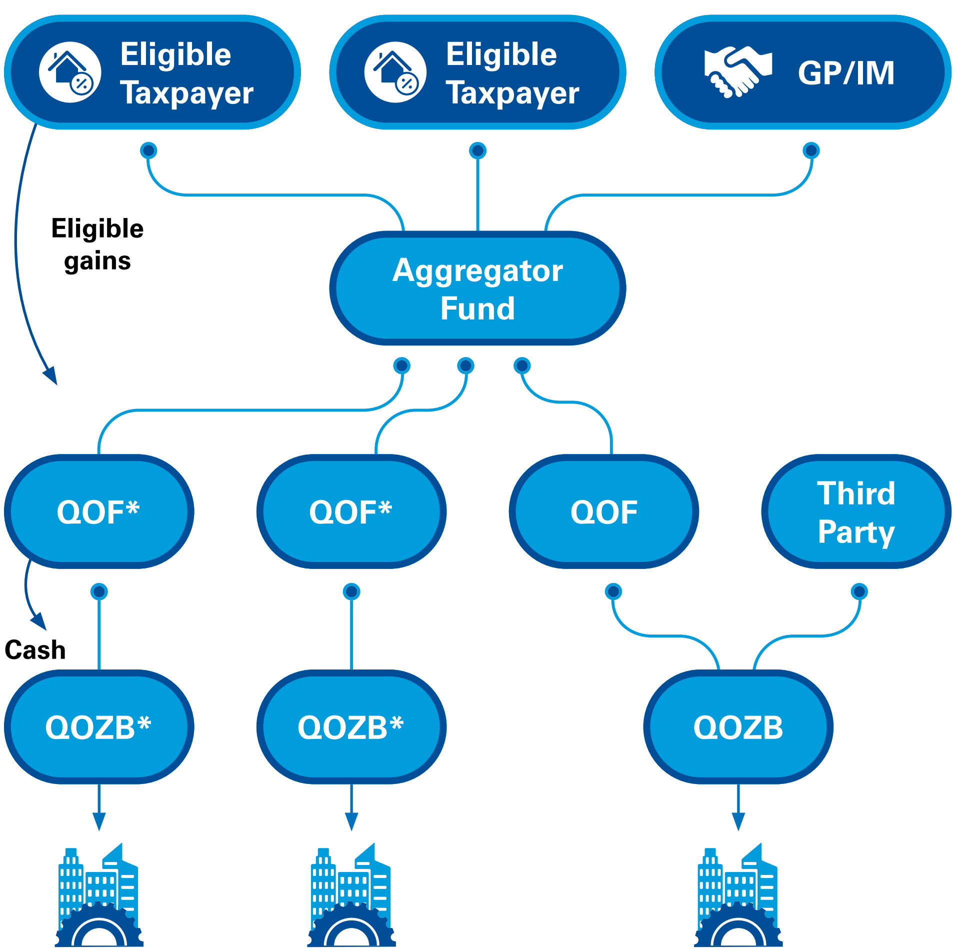
Illustrative QOF organizational structures

Two-tier structure for a single development project



- An eligible taxpayer contributes rollover gains to a QOF.
- The QOF contributes cash to a QOZB, which purchases or leases and develops a project.
- The QOZB may rely on the "working capital safe harbor."
- An investment manager or developer may invest at the QOF or QOZB level with nonrollover dollars.
- The investment is held for at least 10 years.

Multiasset fund structure with aggregator entity



- An eligible taxpayer contributes rollover gains to a QOF.
- The QOF contributes cash to a QOZB, which purchases or leases and develops a project.
- The QOZB may rely on the "working capital safe harbor."
- An investment manager or developer may invest at the QOF or QOZB level with nonrollover dollars.
- The QOF interests are subsequently contributed to an aggregator entity.
- The investments are held for at least 10 years.
- If desired, multiple QOFs may be formed, and exit after 10 years may be by sale or exchange of individual QOF interests.

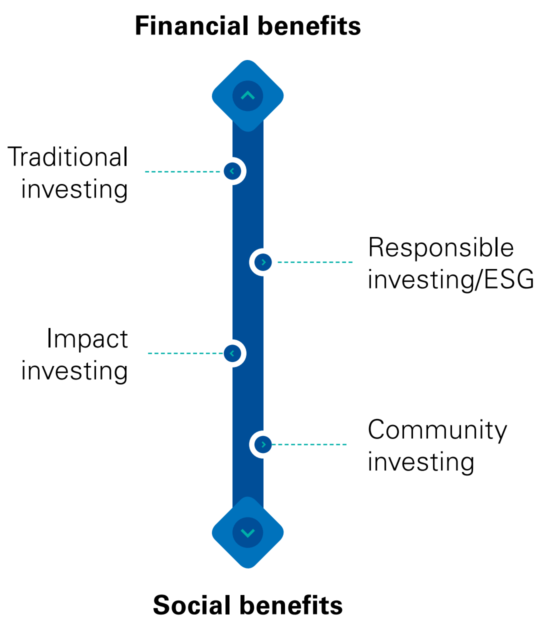
*QOZBs and QOFs must be tax recognized entities with at least two partners

Impact investing

The objective of the Opportunity Zones program is to facilitate investment and job creation in low-income census tracks. The tax benefits of QOZ investing are compelling, as is the potential to create wealth and economic mobility for the country's most disadvantaged people and places. The success of the legislation—and prospects for its renewal—depends on its ability to generate financial and social returns on the QOZ investment.

The QOZ investor continuum

The QOZ continuum includes a broad set of stakeholders with differing priorities from traditional investors to those investors willing to make a financial trade-off for achieving social, economic, or environmental impact.



Investing for impact

Amid the buzz, it is easy to lose sight of the legislative quid pro quo—the concession of tax revenue in exchange for sustainable economic development. Regardless of whether impact measurement is mandated by law, the principles and methodologies of impact investing provide a useful framework for analyzing whether, and how, communities have been impacted by QOZ investments.

QOZ snapshot[9]

- QOZs are home to 31 million people, 56 percent of whom are minorities.
- The average QOZ has a poverty rate nearly double the national average.
- The median income of families living in QOZs is 40 percent below the national average.
- More adults living in QOZs lack a high school diploma than have a college degree.
- Prime age worklessness in QOZs in nearly 10 points higher than the U.S. as a whole.
- Life expectancy for zone residents is four years shorter than it is for nonzone residents.
- Seventy-one percent of QOZs meet the U.S. Treasury Department's definition of "severely distressed."
- More than 96 percent of QOZs do not show readily observable signs of gentrification.

Applying an impact lens to QOZ investing may also be considered good business. QOZs are a market-driven proposition, and data and transparency are essential to any well-functioning market. Access to data during market formation can break down barriers to capital/deal flow. Community engagement is essential for building trust and preventing costly speed bumps. Impact measurement can also manage headline risk and assist in creating a firewall to guard against unintended consequences.

[9] Source: Economic Innovation Group, "The State of Socioeconomic Need and Community change in Opportunity Zones," December 2018.

Measuring the social impact

In order to be able to measure the social impact, senators Tim Scott (R-SC), Cory Booker (D-NJ), Todd Young (R-IN), and Maggie Hassan (D-NH) have introduced legislation, S. 1344, that would impose reporting requirements on QOFs to provide Treasury with information to measure the social impact of QOZ investments.

The proposal would provide Treasury with information about the following:

— The number of QOFs that have been formed

— The amount of assets held in QOFs

— The composition of QOFs by asset class

— The percentage of designated Opportunity Zones that have received investments

— The impacts and outcomes of QOF investments on Opportunity Zones, including job creation, poverty reduction, new business starts, and other metrics the Secretary may require.

More specifically, the proposal requires QOFs to report the following information:

— The total amount of an investment by a QOF and the date on which the investment was made

— The type of investment, such as a new business, the expansion of an existing business, or a real property development

— The location of the business or real property

— The type of activity supported by the investment, including single or multi-family residential, commercial real estate, manufacturing or retail

— The economic sectors in which a business operates

— In the case of a business, the approximate number of full-time employees

— In the case of real property, the total square footage and number of residential units, as applicable.

This information would be aggregated and presented to show the impact the Opportunity Zone program had on the respective census tracts.

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Our team has been focused on finding ways to invest in underserved neighborhoods since 2001. Following the creation of QOZs, we’ve seen heightened interest from investors and developers who are actively seeking quality projects in QOZs. Given the Opportunity Zones program is not capped, unlike LIHTCs and tax-exempt bonds, it has the potential to reach more areas and support more projects. As long-term investors in these neighborhoods, we are excited to see how this potential and subsequent increase in interest can lead to wider-spread, deeper impacts that chip away at long-standing challenges through appropriately risk-managed investments.

Michael Lohr
Vice President
Urban Investment Group
Goldman Sachs

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How KPMG can help

Capturing potential QOZ benefits involves a cross-functional approach requiring experienced personnel who can help you seize such benefits and unlock available opportunities. We are confident that our experience and knowledge can help you successfully address today's challenges and help you prepare for tomorrow's opportunities.

Zone qualification & feasibility

- Determine the applicability and economic/tax benefits of a QOZ investment
- Assemble a business incentive feasibility study
- Prepare a project profile for economic development representatives
- Assist in responding to inquiries from economic development representatives

Implementation & compliance

- Assistance with organizational and tax structuring of the QOF and QOZBs
- Review of QOF formation documents for partnerships and corporations
- Review of contribution and partnership agreements for federal and state tax implications
- Preparation of QOF annual tax compliance and tax return services
- Monitoring of QOFs for continuing compliance under the QOZ requirements, including asset and income tests
- Tax modeling of QOF structures
- Audit of QOFs and QOZBs

Impact investing

- Defining your impact strategy
- Designing impact measurement framework, including specific metrics and data sources
- Qualify investments against financial and social return objectives
- Deploy tools and methodologies for data collection, analysis, and reporting of social, economic, and environmental impact
- Advising on mechanisms for community stakeholders for involvement in QOZ benefits
- Verify impact measurements and alignment with impact principles and strategy

Other services

- Accounting Advisory
- State and local tax incentives
- Due diligence of assets/businesses to be acquired
- Valuation and financial modeling
- Purchase price allocation
- Construction advisory services
- Contract compliance
- Know your customer (KYC) Compliance

Contact us

Joe Scalio
Senior Lead Partner, Tax
Qualified Opportunity Zone Business Lead
T: 267-256-2778
E: jscalio@kpmg.com

Phil Marra
National Real Estate Funds Leader
T: 212-954-7864
E: pmarra@kpmg.com

Demetri Yatrakis
Principal, Tax
T: 212-872-5829
E: dyatrakis@kpmg.com

Ruth Tang
Partner, Audit
T: 212-909-5083
E: ruthtang@kpmg.com

Contributing authors

Charlie Lanza
Senior Manager, Audit
T: 212-954-8462
E: clanza@kpmg.com

Richard Blumenreich
Principal in Charge, TCEAS
Washington National Tax
T: 202-533-3032
E: rblumenreich@kpmg.com

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