THINK BIG THOUGHTS! IT'S NOT TOO LATE TO TAKE ADVANTAGE OF THE QUALIFIED OPPORTUNITY ZONE TAX INCENTIVE

Presented by:

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Jonathan W. Cox

MEMBER

Jon serves a broad range of clients in the public finance sector as bond counsel to school districts, counties, cities, boroughs, townships, municipal authorities, industrial development authorities, as well as nonprofit corporations, such as continuing care retirement communities, colleges, hospitals, fire companies, and other community and economic development organizations.

In addition, Jon serves as bank counsel to regional and community banks, documenting or reviewing commercial real estate, construction, equipment and working capital loans, as well as taxable and tax-exempt loans to governmental entities and nonprofits.

Since the passage of the Tax Cuts and Jobs Act of 2017, Jon has dedicated himself to understanding the Qualified Opportunity Zone tax incentive and working closely with colleagues in the firm's interdisciplinary Opportunity Zone Practice Group to assist individuals, partnerships, and economic development organizations in attracting, structuring, and establishing Qualified Opportunity Funds and Qualified Opportunity Zone Businesses.

Prior to entering the practice of law, Jon obtained a variety of academic, government, and business experience teaching geology, consulting with the U.S. Geological Survey, and then planning and engineering fiber optic networks for an international telecommunications company.

Jon is a native of Central Pennsylvania. He attended Dickinson College and later, the Dickinson School of Law, where he was a Dean's Scholar. Jon and his wife, Karen, reside in Carlisle, Pennsylvania, along with their two teenage children.

REPRESENTATIVE MATTERS

- Served as special counsel and bond counsel to Franklin & Marshall College and the Lancaster Higher Education Authority in connection with the issuance of the $25 million College Revenue Bonds, Series A and B of 2018 (Franklin & Marshall College Project) for a new visual arts center for the College.
- Served as bond counsel to East Stroudsburg Area School District in connection with the issuance of the $70.1 million General Obligation Bonds, Series A and AA of 2017 for a refunding project of the School District.

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PRACTICE AREAS:

Public Finance

Municipal Law & Governance

Opportunity Zones

Financial Transactions

STATE ADMISSIONS:

Pennsylvania

EDUCATION:

J.D., cum laude, The Dickinson School of Law of the Pennsylvania State University, 2006; Woolsack Honor Society

B.S., magna cum laude, Dickinson College, 1997

- Served as tax increment financing counsel and bond counsel to the Cumberland County Industrial Development Authority in connection with the issuance of the $7.9 million Limited Guaranteed Tax Increment Revenue Note, Series of 2017 (Carlisle Auto Industries, Inc. Tax Increment Financing District) for the purpose of funding public infrastructure improvements within an a redevelopment area of the borough.
- Served as bond counsel and bank counsel in connection with the private placement with M&T Bank of the $14.2 million Revenue Note, Series of 2017 (SpiriTrust Lutheran – The Village at Luther Ridge Project) of The Franklin County Industrial Development Authority for the purpose of funding a new skilled nursing facility.
- Served as special counsel and bond counsel to Harrisburg Area Community College and the Lancaster Higher Education Authority in connection with the issuance of the $31.6 million College Revenue Bonds, Series and Series A of 2016 (Harrisburg Area Community College Project) for improvements to the College's York Campus and for refunding prior debt.
- Served as bond counsel to the Waynesboro Borough Authority in connection with the private placement of the $8.77 million Sewer Revenue Note, Series of 2017 for refunding purposes.
- Served as bond counsel to Fulton County in connection with the issuance of the $6 million General Obligation Notes, Series A, B, and C of 2017 for a refunding project of the County.
- Served as bond and bank counsel in connection with the private placement of the $5 million Revenue Note, Series of 2016 (Franklin County Library System Project) for the purpose of funding improvements to a public library.

PROFESSIONAL AFFILIATIONS

- Pennsylvania Association of Bond Lawyers
- National Association of Bond Lawyers

COMMUNITY INVOLVEMENT

- Carlisle Family YMCA, Board Member and Finance Committee Chair
- Cumberland Area Economic Development Corporation, Board Member and Vice Chair
- Real Estate Collaborative, LLC, Management Committee Member and Secretary
- Friends of Michaux State Forest, Board Member
- Cumberland Youth Cycling Development, Board Member, Corporate Secretary, and Coach
- Murata Business Center Advisory, Board Member
- Pennsylvania Association of Bond Lawyers, Board Member and Treasurer

AWARDS AND RECOGNITION

- Carlisle Family YMCA 2018 Adult Service Award
- Central Penn Business Journal Forty Under 40
- Dickinson Law
    - Dean's Scholar
    - Frank A. and Dorothy J. Sinon Scholarship for Excellence in the Study of Tax Law
    - Irving Yaverbaum Accounting Prize
- Dickinson College, William Vernon Prize for Excellence in Geology

NEWS AND INSIGHTS

MEDIA COVERAGE

- "Local governments urged to team up to meet water mandates," *Gettysburg Times*, September 2018.

2019 Update: LEGAL PRIMER

Think Big Thoughts! It’s Not Too Late to Take Advantage of the Qualified Opportunity Zone Tax Incentive

Presented by:

Jonathan W. Cox, Esq.

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August 8, 2019

Introduction to QOZs

- A federal tax incentive designed to induce investment in designated low income census tracts in each state.
- A source of low cost, patient capital for business creation and expansion
- The QOZ incentive has three parts:
  - DEFER capital gains tax through 12/31/2026 on property sold to make investments in a QOZ (can be any capital gain property, not just real estate)
  - REDUCE deferred gains by 10 to 15% if held 5 to 7 years, respectively
  - EXCLUDE capital gains on all appreciation if held > 10 yrs

Think Big Thoughts - Potential for Significant Reallocation of Capital

Estimated $6.1 Trillion in Unrealized Capital Gains in the Stock Market Alone

Long Bull Market – Investors Looking for Efficient Ways Take Gains

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Think Big Thoughts - Potential to Turn the Capital Stack Upside Down

Reduce absorption and stabilization risk with more equity and less debt…

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Think Big Thoughts – Representative Client Applications

- Venture capital – R&D, tech, biotech
- Real estate developers / syndicators
- Construction
- Hospitality
- Franchisors / franchisees
- Private equity funds
- Public and private banks
- Economic development
- P3s
- Nonprofit - For Profit Joint Ventures

Think Big Thoughts – Where Are the QOZs?

For an interactive map of the designated QOZs, see http://www.cdfifund.gov

There Is Still Time – Delayed Guidance

- 12/22/2017 – Tax Cuts and Jobs Act introduced the QOZ incentive
- 6/14/2018 – Treasury certifies designation of all QOZs
- 10/19/2018 – Treasury issued proposed regulations
- 2/14/2019 – Treasury held public hearing on proposed regulations
- 3/12/2019 – 2nd round of proposed regulations sent to the Office of Information and Regulatory Review
- 4/17/2019 – Release date for 2nd round of proposed regulations

There Is Still Time - Important Dates

- 12/31/2019 – Deadline to invest in QOFs for 15% deferral
- 12/31/2021 – Deadline to invest in QOFs for 10% deferral
- 6/29/2027 – Last opportunity to invest in QOFs
- 12/31/2047 – Deadline to elect step – up in basis

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QOZ Basic Terms - QOF

- *What Is a Qualified Opportunity Fund (QOF)?*

An investment vehicle organized as a corporation or a partnership for the purpose of investing in **qualified opportunity zone property** (other than another qualified opportunity fund) and that holds at least 90% of its assets in qualified opportunity zone property, measured semi-annually.

QOZ Basic Terms - QOZP

- *What Is Qualified Opportunity Zone Property?*

Either stock or a partnership interest in a **qualified opportunity zone business** (see below) or direct investment in **qualified opportunity zone business property** (see below)

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QOZ Basic Terms - QOZB

- *What Is a Qualified Opportunity Zone Business?*

A trade or business in which:

(1) substantially all of the tangible property owned or leased by the business is **qualified opportunity zone business property**;
(2) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business;
(3) a substantial portion of the intangible property of such entity is used in the active conduct of any such business;
(4) less than 5% of the average aggregate unadjusted bases of the such entity is attributable to nonqualified financial property (e.g., marketable securities); and
(5) is not a "sin business," i.e. a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

QOZ Basic Terms - QOZBP

- *What Is Qualified Opportunity Zone Business Property*?

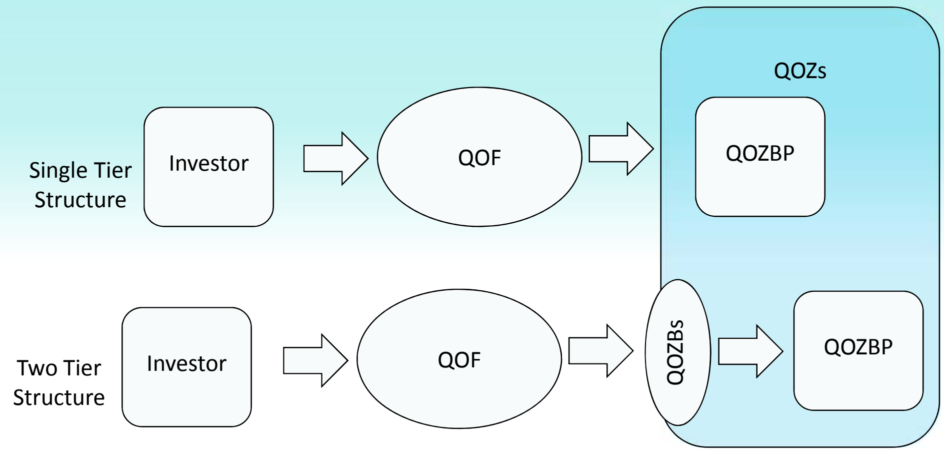
Tangible property used in a trade or business within a qualified opportunity zone fund or business if:

(1) acquired or substantially improved after Dec. 31, 2017 for cash;
(2) the original use of the tangible property in the zone commences with the creation of the qualified opportunity fund or business or the qualified opportunity fund or business substantially improves the property; and
(3) during substantially all of the qualified opportunity fund or business' holding period for such property, substantially all of the use of such property was in a qualified opportunity zone.

The term "substantial improvement" means at least doubling the basis in the improvements on the property within 30 months of acquisition of the property.

Qualified Opportunity Fund Investment

Single Tier vs. Two-Tier Structures



Two Tier Structure
QOZB Pros and Cons

- QOF invests in QOZB which acquires QOZBP
- Only 70% of assets must be qualified assets compared to 90% for a QOF
- 50% gross revenue from “active conduct of a trade or business in the zone”
  - Can be measured by hours worked or payroll expenses in the zone, not where customers are located
  - Facts and circumstances test whether leasing constitutes a trade or business under Section 162 (continuous and regular involvement)
- 31 month working capital safe harbor (for development of the business or acquisition of tangible assets)
- No “sin businesses”

Single Tier Structure
QOF Pros and Cons

- QOF acquires QOZBP directly
- No working capital safe harbor (funds must be 90% deployed w/in 180 days)
- No "active conduct" requirement, but still must be trade or business
- No prohibition against sin businesses

QOZ Proposed Regs - Part 1

- Quick highlights from QOZ Regs Part 1 (released 10/17/2018):
  - Substantial improvement of property means doubling the basis in the improvements on the land (not the basis in the land) within 30 months
  - Created 31 month working capital safe harbor for QOZBs to turn cash into tangible assets pursuant to written plan
  - Defined substantially all as 70% for purposes of the tangible asset requirement for QOZBs
  - Promulgated self certification form for QOFs and instructions for investors to report deferral election
  - Confirmed that QOZ benefits can be leveraged with debt (but did not address debt financed distributions)
  - Reserved guidance on "active conduct" standard
  - Suggested that working capital safe harbor only applicable to acquisition of tangible assets (subsequently expanded in second round of regs to include development of a QOZB generally)
  - Created question whether 50% of revenue must come from sales of services / goods to customers located within the zone (clarified in second round that 50% can be measured by hours worked or payroll expenses incurred in the zone)

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QOZ Proposed Regs - Part 2

- Quick highlights from QOZ Regs Part 2 (released 4/17/2019):
  - No "original use in the zone" or "substantial improvement" requirement for leases entered into after 12/31/2017, even between related parties, if lease is market rate and there are no prepayments of rent (great news for pre-existing property owners / businesses who want to use QOZ capital to expand operations / start new business units, etc.)
  - 31 month working capital safe harbor applies to the development of the trade or business, not just the acquisition of tangible assets (great news for non-real estate plays)
  - 50% gross revenue test can be measured by hours worked or payroll expenses incurred in the zone (alleviating concerns that 50% of the revenue must come from sales to customers located within the zone—again, great news for non-real estate plays)
  - Ownership of real property (including leasing) in a trade or business within a zone constitutes active conduct (still need to meet Section 162 definition of trade or business—"merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business by such taxpayer")
  - Exit strategy—sale of QOF asset tax-free to QOF investors after 10 years w/ supporting K-1; liquidation of fund after ten years also allows step-up in basis (not just sale of fund interest)
  - Debt financed distributions are non-taxable events so long as distributions do not exceed basis
  - QOF has 12 months to reinvest proceeds of disposition of QOZP
  - QOF interests passing by will or trust retain QOZ benefits (and obligations)

Questions?

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FACT SHEET - QUALIFIED OPPORTUNITY ZONES

TAX-ADVANTAGED EQUITY INVESTMENTS IN LOW INCOME COMMUNITIES

QOZs in a Nutshell.

Incentivizes equity investment in low-income communities by allowing the deferral of capital gains taxes through the end of 2026 on all capital invested from the disposition of capital gain property, providing up to a 15% reduction in such capital gains taxes when paid at the end of 2026, and further providing for a step-up in basis to the fair market value of the investment if the investment is held for at least ten years.

STATUTORY BASICS

Zones Designated.

Each State and U.S. Territory were permitted to designate certain census tracts as QOZs in a total amount not to exceed 25% of the total low income census tracts in the State or Territory, of which 95% had to be low income tracts under the 2010 Census, with the discretion to designate another 5% of QOZs on the basis that they were contiguous with such low income tracts. The designation process has concluded. See https://www.cims.cdfifund.gov for a map of designated QOZs.

What Is a Qualified Opportunity Fund?

An investment vehicle organized as a corporation or a partnership for the purpose of investing in **qualified opportunity zone property** (other than another qualified opportunity fund) and that holds at least 90% of its assets in qualified opportunity zone property, measured semi-annually.

What Is Qualified Opportunity Zone Property?

Either stock or a partnership interest in a **qualified opportunity zone business** (see below) or direct investment in **qualified opportunity zone business property** (see below)

What Is a Qualified Opportunity Zone Business?

A trade or business in which: (1) substantially all of the tangible property owned or leased by the business is **qualified opportunity zone business property**; (2) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (3) a substantial portion of the intangible property of such entity is used in the active conduct of any such business; (4) less than 5% of the average aggregate unadjusted bases of the such entity is attributable to nonqualified financial propety (e.g., marketable securities); and (5) is not a "sin business," i.e. a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

What Is Qualified Opportunity Zone Business Property?

Tangible property used in a trade or business within a qualified opportunity zone fund or business if: (1) acquired or substantially improved after Dec. 31, 2017 for cash; (2) the original use of the tangible property in the zone commences with the creation of the qualified opportunity fund or business or the qualified opportunity fund or business substantially improves the property; and (3) during substantially all of the qualified opportunity fund or business' holding period for such property, substantially all of the use of such property was in a qualified opportunity zone. The term "substantial improvement" means at least doubling the basis in the improvements on the property within 30 months of acquisition of the property.

20% Related Party Limit.

The owner of a property may not sell its property to a qualified opportunity fund or business if such owner holds more than a 20% equity interest in such qualified opportunity fund or business.

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CLARIFICATIONS UNDER THE PROPOSED REGULATIONS

Substantial Improvement

Investors must double their basis in the improvements only, not the land and improvements. A building located on land within a QOZ is treated as substantially improved if, during any 30-month period beginning after the date of acquisition of the building, additions to the taxpayer's basis in the building exceed an amount equal to the taxpayer's adjusted basis of the building at the beginning of such 30-month period.

Substantially All

Substantially all of a QOZB's tangible property must be qualified opportunity zone business property. Substantially all for this purpose means 70%.

31 Month Working Capital Safe Harbor for QOZBs

QOZBs may not hold more than 5% of their assets as non-qualified financial property. The regulations provide a working capital safe harbor to this rule for 31 months if there is a written plan that identifies how the capital will be used to develop the business or to acquire, construction or improve tangible property in the opportunity zone, there is a written schedule consistent with the ordinary business operations of the business that the working capital will be used within 31-months, and the business substantially complies with the schedule.

Active Conduct Standard

50% of gross revenue of a qualified opportunity zone trade or business within the zone can be measured by payroll or other expenses used to produce revenue, not location of customers; ownership (and leasing) of trade or business within the zone deemed to be active conduct (trade or business still defined by Section 162, however, so leases need to be carefully drafted to ensure contiguous and regular involvement of landlord in management of the property)

Leases

Leases are not subject to the original use or substantial improvement requirement, even for related parties, so long as the lease is FMV and there are no prepayments of rent.

Allocation of Debt

Although a QOZ investors' basis in its QOZ capital initially is zero, the proposed regulations make it clear that debt incurred by a QOF or a QOZB increases the basis of the qualified opportunity investor. For qualified opportunity investors that invest both capital gains and non-capital gains, the debt increases the basis of the respective investments *pro rata*, confirming that the benefits of a qualified opportunity zone investment can be leveraged.

Debt Financed Distributions

Permitted so long as distributions do not exceed basis in the fund (including 752(a) basis).

Exit Strategy

Liquidation and wind-up of QOF deemed to be a sale to the holder and an inclusion event for which the 10 year step up election may be made (prior guidance / statute suggested step up only available upon sale of the QOF interest); sale of an asset of a fund / QOZB also tax-free to QOF investor if QOF investment held at least 10 years (as demonstrated by appropriate K-1(s)).

QOF Interests Passing by Will or Trust

Does not create inclusion event for deferred gain. Decedent's holding period tacks with the heir / beneficiary's holding period for purposes of 5 / 7 / 10 year holding periods.

One Year to Reinvest QOF Funds

A QOF has one year to redeploy proceeds from the disposition of any QOZ property.