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Testimony of

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Committee on Small Business and Entrepreneurship

Hearing on
Liberty City Rising: Achieving Upward Mobility through Small Business and Community Partnerships

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Chairman Rubio,

Thank you for the opportunity to testify at today's hearing about Opportunity Zones. My name is Mary Burke Baker, and I am a government affairs counselor in the Washington, D.C. office of the international law firm K&L Gates LLP, where I lead the firm's Tax Policy Practice and co-lead the firm's cross-disciplinary Opportunity Zone initiative ("OZ Team"). Prior to joining K&L Gates, I spent six years working on tax issues on the Senate Committee on Finance and before that I served at the Internal Revenue Service ("IRS") for over 25 years in a variety of technical and senior management roles.

I am participating in this hearing today on my own behalf and my comments are my own and do not necessarily reflect the views of K&L Gates LLP, my colleagues or any firm clients.

This field hearing is particularly timely as investors, developers and entrepreneurs are making decisions about when and where to utilize Opportunity Zone ("OZ") incentives for projects and businesses that will provide affordable housing, employment and long-term economic stability in disadvantaged communities. The hearing demonstrates the strong commitment of Chairman Rubio and other Members of the Committee on both sides of the aisle to facilitate and accomplish these fundamental objectives in our nation's low-income urban and rural areas. It is important that city officials, local economic development authorities, and business and community leaders understand the potential of the program, how it works, and what they can be doing in order to maximize OZ benefits for Liberty City, its businesses and its citizens. Accordingly, my testimony includes discussion about the OZ program generally and ways that the program can help Liberty City specifically to build up the local economy, create jobs and improve the quality of life for its residents. My comments are based on the terms of the incentive as described in the OZ legislation included as part of the 2017 Tax Cuts and Jobs Act ("TCJA"), proposed regulations issued in October, 2018, and the Joint Committee on Taxation's ("JCT") Blue Book explanation of the TCJA. Additional proposed regulations and guidance are expected from the U.S. Department of Treasury ("Treasury") and the Internal Revenue Service ("IRS") further clarifying the mechanics and implementation of the OZ incentive.

Since enactment of the OZ incentive, I have seen first-hand the tremendous interest in the program across the country. In response to this enthusiasm about OZs, K&L Gates has established a cross-practice, multi-office OZ Team to assist clients with the procedural, legal and regulatory requirements and questions stemming from the program. Our OZ Team includes lawyers from the tax, policy, investment management, private equity, real estate, renewable energy, and tax-exempt organizations/nonprofit institutions practices, and is designed to help clients understand and engage in the program.

How Can Opportunity Zones Help Liberty City?

Liberty City is located in an OZ. Since nominations for OZs were limited by law to only 25 percent of qualifying low-income census tracts in a state, Florida Governor Rick Scott's nomination and Treasury Secretary Stephen Mnuchin's approval of Liberty City as an OZ is significant.

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The OZ program can help attract investment dollars to Liberty City that can be deployed in a variety of ways to improve the quality of life for residents, bolster the economy and create well-paying jobs. Rehabilitation of existing buildings or new construction can provide affordable housing for residents. Commercial real estate development can provide accessible and modern space for new enterprises. New and expanding businesses — including manufacturing, assembly, warehousing, distribution, retail, day care centers, restaurants, start-ups, incubators, research facilities, and medical and other services — can provide the base for long-term economic sustainability by offering permanent, well-paying jobs within practical commuting distances of current residents. Further, the ripple effects of stable housing and new businesses and jobs could support additional investment in the city, particularly from related suppliers and service providers.

How Does the Opportunity Zone Incentive Work?

To maximize the potential of OZs, it is necessary to understand the incentive and how it works. While additional regulations are expected in the near future that will provide more specifics on how to maximize OZ benefits, the statute and the initial round of proposed regulations provide a solid foundation into the basics of OZ.

Policy

OZs were created to incentivize long-term investments to spur economic activity and create jobs in low-income areas by offering tax benefits to investors and potentially reducing the cost of capital for business owners, developers, innovators and entrepreneurs. Consistent with the policy of the incentive, OZ generally requires an investment in new or substantially improved property, and OZ assets and businesses are required to be substantially located and used within the OZ. Businesses must be active trades or businesses; passive investment activity is outside the scope of the policy and is severely curtailed.

Overview

Individuals, corporations and many pass-through entities can delay paying federal income tax on capital gains until as late as their tax year including December 31, 2026 if those gains are invested in Opportunity Funds ("OF") that hold at least 90 percent of their assets in businesses or tangible property located in low-income areas designated as OZs. Further, the capital gains on an investment in an OF can be federal income tax-free if the investment is held for at least ten years. The tax benefits could reduce the cost of capital for these projects, making them more viable, especially when paired with other development incentives such as the New Markets Tax Credit. Unlike many federal, state and local development incentives, there are no caps or allocations limiting the extent of investment in OZs. Congress intended that the OZ program operate with minimal restrictions in order to maximize investor participation and thus economic activity and job creation.

What are the Requirements to Qualify as an Opportunity Zone?

The threshold requirement to be an OZ is a population census tract with at least a 20 percent poverty rate or median income that does not exceed 80 percent of the larger of the average median income in the state or applicable metropolitan area. Twenty-five percent of qualifying tracts in each state, including Florida, have been named as qualified OZs upon nomination by state governors and designation by the Secretary of the Treasury. The designation of all OZs has been completed and this information is available on the Treasury website. Because OZs were identified at the local and not the federal level, states (and possessions, and the District of Columbia) have more control over the development of underserved communities.

Opportunity Funds

A qualified OF is any investment vehicle organized as a corporation or a partnership (including a multi-member LLC) for the purpose of investing in and holding at least 90 percent of its assets in qualified OZ property. An OF may invest in directly in tangible property used in a trade or business of the fund, or hold an equity interest in a corporation or partnership (including a multi-member LLC) operating a qualifying business in an OZ. An OF may invest in property and businesses in only one OZ or in multiple OZs. Funds will be required to self-certify annually to the IRS whether they comply with the 90 percent test, measured on an annual basis based on the averages of investments held at the six-month marks of the OF's taxable year.

Investor Incentives

Any individual or corporation, and most pass-through entities, including partnerships and trusts, with taxable capital gains arising from the sale or exchange with an unrelated person of business or nonbusiness property, including stock, real estate, personal property, or an enterprise, may invest the capital gains in an OF within 180 days of the transaction (counting the day of the transaction) and enjoy tax deferral on the gains. This can include foreign investors with a U.S. capital gains tax obligation. Taxes on the capital gains invested in the OFs are delayed until the earlier of the disposition of the investment in the OF or December 31, 2026, with 10 percent and 5 percent increases in basis at the five- and seven-year holding periods, respectively (a total of up to 15 percent). In addition, capital gains on OF investments (but not the deferred capital gains) held for at least 10 years will not be subject to federal income tax. Proposed regulations state the investments can be held as late as 2047. In total there are three benefits to investors: the tax deferral and the increase in basis on the original capital gains invested, and the tax-free treatment of capital gains on the investment in the OF if held at least 10 years. To achieve the maximum OZ benefit, investments in an OF must be made by December 31, 2019. Investments in an OF must be made no later than December 31, 2026.

Qualified OZ Property

Qualified OZ property includes any qualified OZ stock, any qualified OZ partnership interest, and any qualified OZ business property acquired by an OF by purchase after December 31, 2017. Property must be held by an OF to be qualifying property. As discussed below, qualified stocks and qualified partnership interests must be in domestic corporations and domestic partnerships that are qualified OZ businesses.

Qualified OZ Business Property

Qualified OZ business property is tangible property owned by the OF directly or by an OZ business owned by the OF and substantially used within the OZ. Qualifying tangible property must be acquired by purchase after December 31, 2017. The original use of the property must be in the OZ or the OF must "substantially improve" the property. Original use is not defined in the statute, but the JCT's explanation of the term defines it to mean new property. There is speculation that forthcoming Treasury regulations may allow property that has been abandoned or in disuse for a certain period of time to be deemed original use. To meet the substantially improved requirement, the OF must invest an amount equal to or greater than the adjusted basis of the building within any 30-month period after the date of acquisition. Proposed regulations clarify that the value of the land on which the building is sitting is not taken into account for purposes of the substantial improvements test. The beginning of the 30-month period is unclear. The JCT's Blue Book indicates that it begins on the date of acquisition of the property, but the term "any" in the statute suggests it could begin on a date later than the date of acquisition. Anticipated proposed regulations are expected to clarify many of these important questions.

Qualified OZ Business

A qualified OZ business is an active trade or business located in an OZ. Per proposed regulations, at least 70 percent of the tangible property used in the business must be qualified OZ business property. At least 50 percent of the total gross income of the business must be from the active conduct of the business. It is unclear whether this means that at least 50 percent of the gross income must arise from within the OZ, or that 50 percent of the income must arise from operating the business within the OZ but that sales can occur anywhere within or without the OZ. Forthcoming proposed regulations are expected to answer this important question and will have a significant impact on the types, sizes and numbers of businesses that can qualify to be OZ businesses. A substantial portion of the entity's intangible property must be used in the active conduct of the business. Certain types of businesses, including golf courses, racetracks, gaming facilities, and establishments selling alcohol for off-premise use do not qualify.

Less than 5 percent of the business' aggregate unadjusted bases in assets may be in nonqualified financial property, including stock, partnership interests, long-term debt, options, and certain other financial products. Proposed regulations provide a safe harbor for working capital held by the business. Funds that the business holds but is not ready to invest toward the acquisition, construction or substantial improvement of tangible property will be excluded from nonqualified financial property if the business has a written plan showing that the funds will be spent within 31 months on qualifying property, a timeline demonstrating the expenditure of the funds, and the business substantially adheres to the plan and the timeline. Funds accounted for in the written plan will be treated as qualifying property for purposes of the 90 percent test that OFs must meet to avoid penalties. At this time, the safe harbor is available only to OZ businesses and not to OFs that directly hold their tangible assets. The safe harbor helps resolve potential bottlenecks that can arise when investors must invest in OFs within 180 days of the capital gains transaction and the OF must invest at least 90 percent of its assets in qualifying OZ property, yet the OZ business is not yet ready to spend the funds because it is waiting for building or zoning permits or experiencing other delays.

The 70 percent threshold and the working capital safe harbor represent advantages of an OF holding an equity interest in a qualifying OZ business compared to an OF having direct ownership of tangible property.

Examples of Opportunity Zones in Action

While the statutory terms and conditions of OZ may seem confusing and complex, the program is intended to be user-friendly in order to facilitate participation and maximize the potential for economic growth and job creation. The following examples demonstrate how OZ can be implemented as well as the flexibility of the program to accommodate a wide array of projects in order to achieve these policy goals. Note that these are simple examples for illustrative purposes and additional details would apply for actual transactions.

- **Affordable housing.** An abandoned warehouse is located in an OZ near schools, public transportation and a grocery store. A developer sees the potential to convert the building into affordable housing. The developer sets up an OF in January 2018 to accept capital gains from investors that the OF will use to purchase the warehouse and convert the warehouse into housing. In February 2018, investors invest $1 million of capital gains into the OF within 180 days of their realizing the gains. Later in February 2018, the OF acquires the warehouse property for $1 million. $600,000 of the cost is allocated to land and $400,000 to the warehouse building. Over the course of the next 30 months, the OF spends $400,001 to substantially improve the property, funded by a series of capital calls of additional capital gains being invested within 180 days from when they arise. At all times, the OF holds at least 90 percent of the capital gains invested in the OF in the warehouse property and the ongoing improvements. The rehabilitation is completed in August, 2020. Investors hold their investment in the OF until 2031.

  In tax year 2026, investors pay tax on deferred capital gains, including $850,000 on the first tranche ($1 million less a 15 percent increase in basis), and on each capital call tranche invested thereafter, calculated based on the holding period of each additional investment and the applicable percentage increase in basis. In tax year 2031, investors dispose of their investments in the OF at a capital gain of $7 million. The entire $7 million capital gain is not subject to federal capital gains tax. This project meets all of the timing, location and investment requirements of the OZ incentive.

  Manufacturing. An entrepreneur invents a product and wants to manufacture the product in an OZ. Entrepreneur forms a domestic corporation in 2018 that will build, own and operate the manufacturing facility. The entrepreneur locates a fund sponsor who sets up an OF for the purpose of investing in the new manufacturing corporation. Later in 2018, the OF sponsor lines up investors with $5 million in capital gains to invest in the OF within 180 days of the transactions giving rise to their capital gains. The OF buys newly issued stock in the manufacturing entity for $4.8 million, meeting the 90 percent test. The corporation has a written plan and spending timeline demonstrating how it will spend the $4.8 million within 31 months to build the structure and install production equipment. The business adheres to the written plan and the timeline. The manufacturing facility is located within an OZ, including plant and equipment, and all manufacturing is performed in the OZ. At least 50 percent of the sales are within the

OZ. The corporation's income is from the active trade or business of manufacturing, patents held by the corporation are used in the trade or business, and the company holds minimal passive financial assets.

Investors retain their investment in the OF for at least 10 years. In tax year 2026, investors pay tax on deferred capital gains of $4,250,000 ($5 million less 15 percent increase in basis). In 2029, investors sell their interest in the OF at a gain of $5 million, which is not subject to federal capital gains tax. This project meets all of the timing, location and investment requirements of the OZ program.

Retail. A local grocery store chain with a robust corporate responsibility initiative identifies the need for a full service grocery store in an OZ. In 2018, the chain forms a new partnership for purposes of constructing and operating a store in the OZ. The grocery chain's bank has set up an OF for the purpose of investing in OZ projects and the OF will invest to build the new store. The bank locates investors who invest $3 million in capital gains into the OF within 180 days of the applicable transactions giving rise to the capital gains and the OF invests $2.9 million in the new grocery store partnership. The partnership has a written plan demonstrating how it will spend the $2.9 million within 31 months to construct the building, acquire fixtures and purchase delivery vehicles and other tangible assets necessary to operate the store. The business adheres to the written plan and the timeline. Upon completion of construction, the store is an active business with at least 50% of its income arising from sales within the OZ.

In 2026, investors pay tax on deferred capital gains of $2.55 million ($3 million less 15 percent increase in basis) and when they dispose of their investment in the fund in 2030 for $8 million, the entire capital gain from the investment is not subject to federal capital gains taxes. This project meets all of the timing, location and investment requirements of the OZ program.

How Liberty City Can Compete Successfully for OZ Investments

The impact of OZ on any particular area, including Liberty City, is largely dependent on the OZ's ability to attract investment. There are no statutory caps or allocations limiting the use of or investments in OZs. However, there is competition for investor dollars and projects among OZs as awareness about the program spreads among investors, developers, entrepreneurs and communities throughout the United States. To compete, economic development authorities, government agencies, business associations and community leaders in urban and rural areas throughout the country are taking steps to proactively encourage investment in their communities by publicizing the program and community needs, and coordinating with stakeholders to facilitate the use of OZs. These steps include:

- Understanding the policy goals of OZ and the requirements and mechanics of the program to be able to maximize the use and benefits of the program
- Identifying the types of businesses and services needed in the community that could be provided using the OZ program
- Working with local financial institutions to set up OFs to facilitate investments and projects in the community

- Working with local business and community leaders, entrepreneurs and innovators to encourage their participation in the program by sponsoring funds, locating investors and starting businesses
- Coordinating the OZ program with the Community Reinvestment Act and other federal, state and local development initiatives and programs
- Coordinating zoning and permitting guidelines and requirements to cut red tape, promote businesses and developments that will serve existing residents of OZs and prevent undue gentrification
- Developing messaging to address potential investor and entrepreneur questions and concerns about risk, return on investment and why Liberty City is a good place to invest
- Marketing the OZ program through websites, roundtables, panels, public meetings and informational materials

The Future of OZ

This is an opportune time to determine how OZ can benefit Liberty City and for the city to launch aggressive efforts to attract investors and projects. Now that Treasury has released an initial round of proposed regulations, many investors and project developers who were waiting for guidance are ready to take action on OZ. Entrepreneurs are eagerly anticipating additional regulations more focused on businesses and will be ready to act when those regulations are released. Additional legislation to facilitate use of the incentive also may be on the horizon, including adaptations of OZ for disaster recovery or infrastructure.

However, this window of time is not open-ended. Certain time parameters in the legislation limit how long investors can wait. To benefit from the 10 percent step-up in basis, investments in OFs must be made no later than December 31, 2021, and to benefit from the total 15 percent step-up investments must be made by December 31, 2019. Investors must invest no later than December 31, 2026 to qualify for tax-free treatment of capital gains on a 10-year or longer OF investment. In addition, investors face a strict 180-day limit in which to invest realized capital gains in an OF and qualify for beneficial tax treatment. Project planning and permitting lead times, the 30-month time frame to meet the substantially improved requirement, and the 31-month working capital safe harbor present additional time constraints and pressures.

Opportunity Zones are aptly named and offer tremendous opportunities to disadvantaged communities like Liberty City to stimulate economic growth and job creation and to improve the quality of life for residents on a long-term basis. OZ tax incentives for investments in low-income areas can reduce the cost of capital for development projects and attract investments that might otherwise be directed elsewhere. It is vitally important that communities like Liberty City understand the program and act promptly in order to maximize their ability to attract long-term investments and ensure they receive their fair share of OZ investments and projects.

Enclosure: OZ Flow Chart

THE MECHANICS OF OZ