White Paper:

How Opportunity Zones Can Aid in the Remediation of Brownfields Properties

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Terms such as "Opportunity Zones" and "Brownfields" do not easily roll off the tongue, but they are our "terms of art" for programs with enormous potential: allowing real estate development and investment professionals to turn challenging building projects into very successful accomplishments.

There is some misunderstanding of what both terms mean, so allow me to start with the basics and then look at how developers and investors can effectively strategize and implement these programs to their highest and best use.

"Opportunity Zones" ("OZ") are described in greater detail below, but in general they encompass U.S. census tracts which largely correspond with HUD-designated New Markets Tax Credit ("NMTC") eligible census tracts. The NMTC census tracts tend to be located in urban neighborhoods and rural communities that lack access to the patient capital needed to support and grow businesses, create jobs, and sustain healthy local economies. These areas are traditionally located in some of the most distressed communities in the nation — where the individual poverty rate is at least 20 percent, or where median family income does not exceed 80 percent of the area median[1].

With origins in the field of urban planning, the phrase "Brownfield Land" is defined as any previously developed land that is not currently in use and which may be contaminated. The term often is used to describe land previously used for industrial or

[1] As per the New Markets Tax Credit Coalition.

commercial purposes with known or suspected pollution — including soil contamination due to hazardous waste.[2]

Both OZs and Brownfield Land provide opportunities for developers to take advantage of Federal or State programs, incentives, or grants ("credits" or "incentives") to reduce their taxes (or the taxes of a passive investor who has purchased the credits from the developer). Those credits often provide the stimulus that can make a project financially feasible. Generally, these credit and incentive programs have been thought to be independent from each other. But they do not need to be, and there exists a lucrative potential for OZ benefits and Brownfield credits to be part of the same project — providing significant returns to the developer, investor, and even the community.

With the introduction of OZs in 2017, I have watched a scenario unfold where significant synergies may be achieved when these programs are able to be used together. This White Paper explains how it can work.

Opportunity Zones

Within the Tax Cuts and Jobs Act of 2017[3] (the "Tax Reform Legislation") was a provision which initially did not generate much interest and excitement — but it may be one of the most significant tax reform codifications we have seen in decades.

To spur revitalization projects in areas of the nation where developer interest was generally lacking, the Tax Reform Legislation established what it called "Opportunity Zones" by way of a provision of the Internal Revenue Code, that being Section 140OZ-2 (the "OZ Rules")[4].

The U.S. Treasury Department then directed the individual states to designate certain census tracts as Opportunity Zones. These zones were to be areas that traditionally had been economically disadvantaged areas and had not experienced the growth that had benefited other parts of the U.S. economy since the end of the 2008 recession.

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[2] Wikipedia.

[3] H.R.1 – An Act to provide for reconciliation pursuant to Titles II and V of the concurrent resolution on the budget for fiscal year 2018. 115th Congress (2017-2018).

[4] 26 U.S. Code § 1400Z–2. Special rules for capital gains invested in opportunity zones.

The hope in creating these Opportunity Zones was that they would lure capital into those areas: helping to facilitate economic revival. The way the OZ Rules were to achieve this goal was to allow investors who have generated eligible gains from a capital event ("capital gains") to defer and possibly offset taxes on those capital gains by investing their gains into Opportunity Zones[5].

As mentioned above, the first step in the procedure was to ask the individual states to designate which census tracts they consider to be Opportunity Zones; a procedure completed during the first half of 2018. The Treasury Department approved those nominated census tracts as Opportunity Zones, giving developers the reassurance that Brownfields sites they are now evaluating as Opportunity Zone investments will remain as such. On October 19, 2018, Treasury issued its first round of Regulations regarding Investing in Qualified Opportunity Funds[6] (a Qualified Opportunity Zone Fund is hereinafter referred to as a "QOF"). On April 23, 2019, the Treasury issued its second round of Regulations regarding Investing in QOFs[7], and on December 19, 2019 Treasury issued its final round of Regulations regarding Investing in QOFs[8] (the "Proposed Final Regulations").

Following the publication of the Proposed Final Regulations, we now had a framework within which to work. Many firms — including mine — formed QOFs to make an easier path for clients to take advantage of the OZ legislation.

Generally, it would work in this way:

Assume that a taxpayer has a long-term capital gain, subject to the current 20% rate, plus the 3.8% add-on for the Affordable Care Act, for a total of 23.8%. To benefit from the OZ Rules, the capital gain would need to be invested into Opportunity Zone Property (i.e. real estate or a business - hereinafter referred to as "OZ Property") within 180 days of realizing the capital gain. OZ Property must be (i) tangible property that is

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[5] The gains that the OZ Rules apply to are "eligible gains" that are treated as capital for tax purposes (prior to January 1. 2027), and that are not generated from sale or exchange with a "related" party, i.e. a 20% direct or indirect relationship between the parties (either before or after the sale/exchange).

[6] 26 CFR Part I, REG-115420-18.

[7] 26 CFR Part I, REG-120186-18, RIN 1545-BP04.

[8] 26 CFR Part 1 TD 9889 RIN 1545-BP04.

used in a "trade or business"; (b) property that was purchased from an unrelated[9] party after December 31, 2017; and (c) that the original use of the property must begin with the QOF or the underlying OZ Business (the "original use requirement"), unless the QOF or underlying OZ Business "substantially improves" the OZ Property, which means that the QOF must invest at least 100% of the adjusted tax basis of the OZ Property into the OZ Property within 30-months of the acquisition of the OZ Property[10].

If the capital gain is invested into a QOF within 180 days, the QOF would then have an *additional* 180 days to invest into an OZ Property. A QOF can be an entity such as, but not limited to, a corporation, LLC, partnership, or limited partnership. If a partnership or an S Corporation realizes gain but elects not to defer that gain, instead allocating the gain to its owners, then the owners (partners, shareholders, or limited partners) can choose when to begin the 180-day reinvestment period. The Proposed Final Regulations allow the owners of a pass-through entity to begin the 180-day period on the last day of the entity's tax year, rather than on the date of the sale of the asset.

The QOF is able to self-certify on IRS Form 8996 when filing its first-year tax return. Once the initial election is made, the taxpayer may elect the deferral on IRS Form 8949 in order to elect to increase the basis of the investment to the fair market value of the investment on the date that the investment is sold or exchanged.[11]

The QOF needs to have 90% of its assets invested in OZ Property, calculated as either the value or the cost of assets (the "90% test"). This 90% test, which is performed via a certification on Form 8996, measures the average of the QOF's holdings in OZ Property on the last day of the first 6-month period of the QOF's tax year and the last day of the QOF's tax year (the "test period"). The QOF is required to invest 90% of its assets in OZ Property during the test period. In terms of how you

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[9] Owners of 20% or less of QOF/QOZB (including capital and promotes) or 30% or less of the total asset mix.

[10] The substantial improvement requirement is applicable to building improvements and not the land itself. Also, the QOF can meet the substantial improvement test by purchasing other property that satisfies the original use test if the new property improves the functionality of the property being improved.

[11] The taxpayer's basis in the QOF investment is initially zero. Once the taxpayer has held the QOF investment for 5-years, the basis of the QOF investment is increased to 10%, thereby allowing for the taxpayer to disregard 10% of the original capital gain. If the taxpayer holds the QOF investment for at least 10-years, the basis of the QOF investment is increased to 100% of the fair market value of the QOF interest, i.e. its sale price. This results in there being no tax due on the gain attributable to the QOF investment. The taxpayer must defer the capital gain using Form 8949 and then elect to increase the basis upon sale of the QOF interest using the same form.

determine the value of an asset, it is either its value as reported on the QOF's financial statement or the cost of the asset to the QOF. In terms of tax credits, we use the cost of the tax credits to the QOF for purposes of the 90% test.

If a QOF invests in a business within an Opportunity Zone or operates a business through a subsidiary, the test for determining whether the business qualifies as OZ Property is that it needs to have "substantially all" of its assets within an Opportunity Zone. The Regulations state that "substantially all" of its assets means 70% or more.[12]

A QOF can make either a direct investment (QOF owns the OZ Property) or an indirect investment (QOF owns stock or a partnership interest in an entity that owns the OZ Property) into OZ Property. For an indirect investment the OZ Property must actively generate income, i.e. > 50% of income must be generated within the Opportunity Zone. Note that triple-net-leases are not considered active income generators.

Accordingly, assume that the capital gain is invested into a QOF, and the QOF then invests in OZ Property, so that the "substantially all" test is met. The taxpayer will elect to defer the capital gain and pay no taxes on said gain. The taxpayer would have to pay 90% of the capital gains taxes by 12/31/2026.

There is a substantial additional benefit, as well, in that if the taxpayer holds the OZ Property for 10 years, i.e. until 12/31/2030, all appreciation on the asset will be tax-free. Assume that a $1.0 million invested in the QOF was valued at $1.4 million when sold in 12/31/2028, then the $400,000 in appreciation would be tax-free.

In addition to the above there are several additional points to note:

(a) The taxes are only deferred until 12/31/2026, regardless of whether the OZ Property is sold. By way of example, in order to get the tax-free appreciation, an investment

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[12] The subsidiary or OZ Business must meet the definition of an Opportunity Zone Business and then must satisfy a "70% test", an "income and assets test", and a "qualifying business" test. The "70% test" is satisfied if 70% of the tangible property owned by the OZ Business is OZ Property. The "income and assets test" requires that (a) 50% of the gross income of the OZ Business be derived from active conduct of trade or business in the OZ, which is achieved by: [(i) 50% or more of hours spent by employees be within OZ (ii) 50% or more of payments to employees are for services within the OZ, or (iii) 50% of the management/operation of the OZ property is within the OZ, AND a substantial portion of the intangible property is used in the active conduct of trade or business in the OZ], and (b) less than 5% of the assets are non-qualified financial property (debt (with a term of more than 18 months), stock, partnership interests, options, futures, forward contracts, warrants, notional principal contracts, annuities). The disqualified business test is that the OZ Business cannot own a sin business, i.e. a golf course, Country Club, massage parlor, hot tub or suntan facility, racetrack or other gambling facility, or an alcoholic beverage store.

made in 2020 must be held until 12/31/2030, but taxes are due at 12/31/2026, so the taxpayer needs to ensure he/she has sufficient additional capital to pay the taxes at that time;

(b) The regulations correct an apparent timing issue, in that (i) the Opportunity Zone designation per statute will expire on 12/31/2028; (ii) a taxpayer must hold the OZ Property for 10 years from the date the investment is made to achieve the 100% basis step-up; and (iii) the taxes are deferred only until 12/31/2026. The regulations correct this imbalance as follows:

> Because the latest date for which a taxpayer may generate a capital gain is 12/31/2026, and a taxpayer would then have 180 days to invest that gain in a QOF, i.e. by June 30, 2027, and the QOF would then have 180 days to invest the funds into OZ property, i.e. December 31, 2027 — the 10-year hold would then run until 12/31/2037, and the Regulations allow another 10 years to dispose of the investment. Therefore, the taxpayer would have until 12/31/2047 to make the step-up basis election;

(c) One of the more interesting clarifications in the proposed final regulations is the use of the term "treated as capital gain" because this allows for a gain from the sale of a Sec. 1231 asset — which by definition is not a capital asset — to qualify as a capital gain. A 1231 gain is a gain from the sale/exchange of real or depreciable property used in a trade or business and held for over one (1) year. 1231 assets include buildings, machinery, land, timber, and other natural resources, unharvested crops, cattle, livestock, and leaseholds.

(d) The other important takeaway from the regulations is one that was of particular interest to me — having been involved in acquisitions of tax credits for commercial solar energy installations. A regulatory clarification deals with the exclusion from gain on the sale of a QOF interest held longer than 10 years. This exclusion is the most important provision of the OZ Rules in that, as more fully explained below if the investment in the QOF is retained for at least 10 years, there will be no gain recognized upon a sale of the QOF interest. The Proposed Final Regulations expand the scope of that exclusion to sales of assets by the QOF *and* a Qualified Opportunity Zone Business ("QOZB"). This means that ordinary income (such as depreciation recapture) from the sale of an asset will be protected under the exclusion.

Finally, that there are two important distinctions for Opportunity Zone investments versus 1031 like-kind exchanges, i.e.:

(1) The capital gains can be invested in OZ "property" which does not have to be of a like-kind to the asset sold; and

2) The original basis of the asset does not have to be invested in the OZ Property (as it does in a 1031 like-kind exchange); and the taxpayer can invest up to the whole capital gain, but does not have to invest the entire gain.

Brownfields

Tax credit programs to encourage the remediation of contaminated land have been around for many years now. These lands, known as Brownfields, are described simply and precisely by the EPA to be properties that may have hazardous substances, pollutants or contaminants present.

Frequently Brownfield sites were previously used for industrial purposes. Most people assume that a Brownfields site looks like what they picture a Superfund to resemble, but the majority of Brownfields sites are more likely to simply be former industrial properties — some of which are vacant and some of which are still active, such as gas stations.

Traditionally, a Brownfields site which presents a good redevelopment possibility is a former industrial (manufacturing, office, storage) property that can be re-purposed to a new, valuable use. It may currently contain underground storage tanks that need to be removed, and if those tanks have leaked, a full remediation will require soil removal and replacement.

In Massachusetts and several other states, the laws requiring environmental remediation is a strict liability statute: meaning that a current owner/lessee of contaminated property becomes legally obligated to remediate the contaminated property regardless of whether that person or entity caused the contamination or not. States will then offer certain relief to those not at fault for the contamination who were forced to remediate the property. This relief is usually given as loan or grant funding to cover testing or certain remediation activities; environmental insurance which would then allow a taxpayer to obtain financing to fund a remediation effort; Covenants not to Sue; and Tax Credits. Our focus in this White Paper is solely on the tax credits.

Chapter 206 of the Legislative Acts of 1998 established the Massachusetts Brownfields Tax Credit ("BTC") program. The BTC's enabling statute added G.L. c. 62, § 6(j) and G.L. c. 63, § 38Q to the Massachusetts General Laws, which allows

individuals and business entities a credit against their Massachusetts personal income tax or corporate excise liability for a percentage of the costs incurred for an environmental response action that results in either a permanent solution or remedy operation status in compliance with 21E. Furthermore, the BTC provisions were amended by chapter 123 of the Acts of 2006 to authorize the transfer, sale or assignment of the BTC to another taxpayer with a liability under c. 62 or c. 63 or to a nonprofit organization.

By way of background: the BTC is available to certain taxpayers with projects located in Economically Distressed Areas ("EDA"). The BTC covers all types of releases subject to the Massachusetts Contingency Plan ("MCP"). The BTC in relevant part enables a taxpayer that uses an Activity and Use Limitation ("AUL") to obtain a tax credit of 25% of the net "response costs" as that term is defined in MGL c. 21E ("21E"). If an AUL is not used, the tax credit is 50%.

Brightfields

According to the U.S. Department of Energy (DOE), a Brightfield is an abandoned or contaminated property that is redeveloped through the incorporation of solar energy — which can be many different types of solar applications, including photovoltaic arrays. We take the definition of "abandoned or contaminated property" to mean the Brownfields sites that we referred to earlier. As you may already realize, a solar project that requires the remediation of a contaminated property can indeed be eligible for two classifications of tax credits: one for the clean-up of the land; the other for the installation of a solar array that generates clean energy.

Tying the Programs Together

As a tax credit consultant, I am excited about the possibility that two tax credit programs can be combined into one. This could allow even more projects for "the public good" to be contemplated; projects that clean our lands or to help rebuild distressed communities. Now, these worthy initiatives may be financially feasible for developers and investors.

In 2013, my firm hosted a seminar that focused on Brownfields and Brightfields programs. Our panel explored the Massachusetts Brownfields and Federal Renewable

Energy programs from both a government and private sector perspective; and focused on the intersection of these programs. Specifically, we examined a tax credit model gaining popularity: where Brownfields sites are outfitted with Renewable Energy infrastructure (either in addition to other improvement or as a stand-alone facility), effectively turning them "from Brownfields into Brightfields".

With the advent of the Opportunity Zone regulations, we now add a very powerful incentive to our tax planning toolkit — which should greatly incentivize the marketplace to remediate Brownfields properties and turn them into productive, safe, and income-producing properties. For example, Cherrytree's *QOF* wraps tax credits around an OZ Property so that the taxpayer investing capital gains in the QOF can achieve superior returns.

Our financial modeling has shown that the addition of tax credits to an OZ Property results in a 2.51% increase in IRR, a 40% increase in ROI, and almost a half-point increase in the investment's multiple.

One of the more substantial benefits of this strategy is that, as described earlier, the OZ Rules allow the deferral of capital gains taxes invested into an OZ Property — but *only* until December 31, 2026, at which time the taxes (albeit with a 10% discount[13]) must be paid. As the taxpayer will inevitably desire to hold the investment in the OZ Property or QOF for at least 10 years in order to achieve the benefit of tax-free appreciation on any gain of the value of the investment, the taxpayer will need to have separate funds to pay those capital gains taxes…or rely on the QOF to make a distribution for the sole purpose of paying the taxes.

When tax credits are wrapped into an OZ investment, the taxpayer can accrue the tax credits for the purpose of paying the taxes in 2026. This causes the taxes to be *offset* rather than *deferred*, which is a significant added benefit that supercharges investment return.

Another way in which the OZ rules and a Brownfields remediation, when combined, could be beneficial involves the Brownfield Tax Credit. As described earlier, the Brownfields credits are issued for either 50% or 25% of the eligible remediation expenses (depending on whether the remediation achieved a cleanup to residential standards [50%] or industrial standards [25%]). The tax credit can then be used by the taxpayer who earned the credit, or it can be transferred to another taxpayer —

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[13] As detailed above, after the taxpayer holds the investment in the OZ Property or QOF for 5 years there is a 10% basis increase which results in a 10% reduction in the capital gains taxes that are due on December 31, 2026.

traditionally the preferred route, as this allows the taxpayer to recover part of the expenses incurred to remediate the property.

However, the Federal Government and the states treat the proceeds which the taxpayer receives from the transfer of the tax credit as taxable proceeds. In many of our transactions, taxpayers seek assistance in structuring the flow of proceeds in order to minimize the tax obligations they incur when transferring these tax credits. Given that a Brownfields tax credit transfer is a capital gain event, the OZ Rules now provide us with the ability to offer taxpayers who have transferred their tax credits the option to re-invest the proceeds from such transfer into OZ property or a QOF — thereby deferring or offsetting those capital gains taxes.

This is an effective strategy that could foster an increase in remediation activity of Brownfields sites — and a corresponding increase in the conversion of Brownfields lands to Brightfields. In the end, effective use of these programs will increase the supply of available renewable energy and decrease the size of our carbon footprint.

And that's good for everyone.

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