Opportunity Zone Investments:

A New Source of Capital for New and Existing EB-5 Projects

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EB-5 capital raising has slowed due to visa backlogs, increasing the need for additional sources of capital for EB-5 projects.

Until the need for additional EB-5 Visa capacity is addressed, raising large amounts of EB-5 capital quickly will be a challenge. The growth in investor flow from countries other than China has been impressive, but there is a long way to go to make up for the slow-down in the Chinese market.

China reached the EB-5 visa capacity limit for the first time back in 2015 and has been in retrogression ever since. Chinese investor subscriptions dropped dramatically when the USCIS Ombudsman published its annual report in mid-2017, in which it stated that Chinese retrogression could result in waiting times that would exceed 10 years. This caused many EB-5 projects to fall short of their intended fund-raising levels.

Despite these challenges, the pending legislative reform originally scheduled for late March 2018 provided some reasons to be optimistic. The drafts of EB-5 reform legislation all included an increase in the EB-5 investment amount (which, other things being equal, would allow for fewer investors to achieve the desired EB-5 project raise), and some even proposed increased visa capacity. However, it now appears that legislation or regulations are not likely to provide any visa capacity-related relief for EB-5 project funding shortfalls in the near term. This reality has depressed Chinese investor inflows even further. While other countries are showing impressive growth, they aren't yet able to come close to making up the funding shortfall.

The net result is a significant decrease in EB-5 funding velocity across all projects. Competition for investors is intense, and the business development process to develop channels to source investors in emerging markets is complex and time-consuming. Meanwhile, the project funding demands of EB-5 projects already underway continue. So, where can EB-5 projects look for help to close their funding shortfall?

Opportunity Zone financing may provide a new and substantial source of capital to meet EB-5 project funding shortfalls.

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The Investing in Opportunity Act was signed into law on December 22, 2017 as part of the larger package of tax reform legislation. Under this new legislation, codified as sections 1400Z-1, and 1400Z-2 of the Internal Revenue Code, taxpayers with taxable gains on any form of investment (stock, property, etc.) who invest those gains within 180 days into a qualified Opportunity Zone Fund (sometimes referred to as an OZ Fund) have the opportunity to receive three significant federal tax benefits:

First, the investors receive a deferral of taxation on 100% of their taxable gains invested in an Opportunity Zone business until the earlier of the date that their investment in the OZ Fund is sold or December 31, 2026, at which time they are required to include their original deferred gain in their income;

Second, investors are also eligible to receive a 10% reduction of the taxable gains invested in the OZ Fund if their investment in the OZ Fund is held for at least 5 years, which increases to a 15% reduction if it is held for at least 7 years; and

Third, investors are not taxed on any capital gains realized upon the sale of their investment, which is due to the appreciation of their interest in the OZ Fund, if their investment in the qualified Opportunity Zone Fund is held for at least 10 years.

Here is an illustration of how these three tax benefits work in tandem:

The potential tax savings to taxpayers could be substantial, which could ignite demand for new investments in the Opportunity Zones. For EB-5 project sponsors, the benefit is that Opportunity Zone investors will expect to receive a portion of their financial return from tax savings and may therefore be willing to accept lower cash distributions than other non-tax advantaged investors. This could lower the cost of capital to EB-5 project sponsors. Many EB-5 projects could be prime candidates for Opportunity Zone financing, which could fill the funding gap of these EB-5 projects caused by the downturn in the EB-5 financing market.

Opportunity Zone financing offers some advantages to EB-5 financing that are intended to result in rapid, large scale adoption of this new financing option.

The Opportunity Zone areas have already been designated and approved, and will remain qualified for 10 years, so it is easy to determine immediately whether an EB-5 project will qualify for Opportunity Zone financing. Investments can be made in an OZ Fund that:

Is structured as either a partnership (or presumably an LLC taxed as a partnership) or corporation;

Is formed for the purpose of investing in qualified Opportunity Zone property;

Holds at least 90% of its assets in qualified Opportunity Zone property; and

Invests directly in a qualified Opportunity Zone business property or indirectly through another partnership or corporation (which itself is not an OZ Fund).

Unlike EB-5 financing, Opportunity Zone investments do not need pre-approval by any government agency, so the cost and time needed to set up OZ Funds should be lower than EB-5 financing. Also, unlike EB-5 financing and other community development incentive programs, there is no cap on the number of investors who can invest in Opportunity Zones and receive the tax benefits of these investments, there is no cap on the amount of Opportunity Zone tax benefits that investors, either individually or collectively, may obtain, and there is no limit on the amount of capital that can be invested. According to an analysis done by Economic Innovation Group, a D.C.-based think tank, there are more than $6 trillion dollars in unrealized capital gains currently held by U.S. households and corporations, so even a relatively small portion of the total potential pool of investors could lead to investment amounts that are many orders of magnitude larger than EB-5 financing.

There are still a number of unanswered questions regarding Opportunity Zones that are anticipated to be answered in several sets of regulations, the first of which is expected to be issued by the Internal Revenue Service by the end of 2018.

Among other questions are the following:

Can limited liability companies (LLCs) be used as well as partnerships and corporations, on the grounds that a multiple member LLC is always taxed as either a corporation or a partnership?

Can an Opportunity Zone business or business property be sold prior to the end of the required time periods if the capital is reinvested in another Opportunity Zone business or business property?

Can the Opportunity Zone business property be refinanced and the proceeds in excess of the taxpayers' basis be distributed to investors before the end of the required time periods?

These questions have all been posed to the IRS, and

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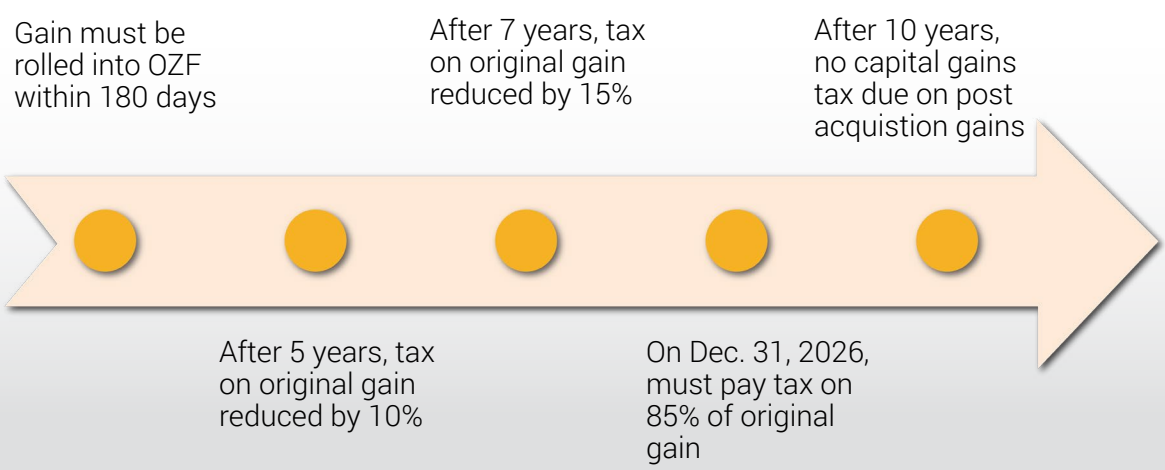

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it is anticipated that the IRS regulations will address these issues. In the meantime, EB-5 project sponsors should analyze their existing and proposed projects now to determine if their projects will meet the basic requirements for OZ Funds, and if so consider how best to take advantage of this new market opportunity to finance these projects.

How EB-5 project sponsors can decide if Opportunity Zone financing can be used for their EB-5 projects.

First, is the EB-5 project located in an Opportunity Zone? State Governors were given the responsibility of identifying the low-income areas in their states to be designated as Opportunity Zones. Initial submissions were provided in March and by the end of June 2018, the IRS published a list of 8,700 approved Opportunity Zones, which are designated by census tracts. The entire list of approved Opportunity Zones can be found at: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

Almost all EB-5 projects are located in a Targeted Employment Area ("TEA"), based on unemployment rates at the census tract level, with most projects requiring a combination of census tracts to meet the necessary unemployment rate requirements. It is possible that an EB-5 project location in a TEA could also be in an Opportunity Zone. However, there is no mathematical aggregation that can be done with Opportunity Zones, such as can be done for TEAs. Opportunity Zones are much more transparent than TEAs as the Opportunity Zone designation is valid for 10 years (no need to obtain a renewal each year like with EB-5 TEAs), and no aggregation or combining is allowed. In short, Opportunity Zones are set for 10 years and there is no wiggle room or creativity that can be employed such as with TEAs – either your project falls within an Opportunity Zone or it doesn't.

Second, does the EB-5 project meet the requirements of a "Qualified Opportunity Zone Business Property"? To be eligible, the EB-5 project has to consist of tangible property used in a trade or business of the OZ Fund which: (i) was acquired by purchase after December 31, 2017, (ii) is not put into use until after the EB-5 project owner's purchase of the property or the property is "substantially improved" by the EB-5 project owner, which requires that the costs of constructing, renovating or expanding the property during any 30-month period beginning after the date of the acquisition of the property must exceed the adjusted basis of the property at the start of the 30-month period. This requirement is analogous to the EB-5 program requirement that funds be invested in a business that will create new jobs, either because it will be newly-built or it will be constructed, renovated or expanded. For existing EB-5 projects that acquired their property before December 31, 2017, there may be a possibility of transferring a portion of the property to a new entity to be funded with OZ Fund investments as a means of meeting this requirement. Thus, many EB-5 projects, including some existing EB-5 projects, could potentially be eligible as "Qualified Opportunity Zone Business Property." The key is that the EB-5 project (or at least that portion of the property that is financed with Opportunity Zone investments) must be purchased after December 31, 2017 and the OZ Funds must invest in the EB-5 project before it is constructed, renovated or expanded or put into service.

Third, is the EB-5 project intended to be held for at least five years, and possibly over 7 years? This is important because Opportunity Zone investors are required to retain their investment for at least 5 years to obtain any reduction in the taxable gain deferred through their original investment in the OZ Fund, and they are required to pay the tax owed on the amount of the deferred gain when their interest in the OZ Fund is sold. It is possible that future IRS regulations will allow an OZ Fund to sell one or more of its original OZ properties before the 5- and 7-year dates and reinvest the proceeds by acquiring other OZ properties, but we do not yet know if that will be approved in the IRS regulations. The basic rule for Opportunity Zone investors is that if they hold their interest a qualifying OZ Fund for at least 5 years, the investor gets a 10% reduction in taxable gain originally invested in the OZ Fund, and if the investment is held for at least 7 years, the investor gets a 15% reduction in taxable gain originally invested in the OZ Fund. Further, these 5- and 7-year holding periods must occur prior to December 31, 2026, the date on which the deferred gain is recognized and becomes taxable gain. As discussed previously, this is one of the three key benefits investors will be hoping to achieve by making their investment in a qualified Opportunity Zone Fund.

Fourth, is there a possibility that the EB-5 project could be held for at least 10 years and realize significant capital appreciation during that time period? If so, this could qualify eligible investors for the third tax benefit under the Opportunity Zone program, which is the ability to exclude 100% of the capital appreciation on the Opportunity Zone investment when they sell their interests in the OZ Fund. This benefit is available only if the investor holds a qualified OZ investment for the entire 10 years – there is no partial or pro-rated tax reduction on the gain from the Opportunity Zone investment for holding the investment less than 10 years. It is possible that future IRS regulations will allow an OZ Fund to sell one or more of its original OZ business or business properties before the 10-year date and reinvest the proceeds by acquiring other OZ businesses or business properties, without affecting the investor's qualification for this tax benefit, but we do not yet know if that will be approved in the IRS regulations.

How EB-5 project sponsors can position their projects to attract Opportunity Zone investment capital.

First, is there a possibility of adding Opportunity Zone capital to an existing EB-5 project to fill an EB-5 funding shortfall? If the EB-5 project meets the four criteria described above, the project owner/Fund could create a new class of limited partnership interests (or membership interests if the IRS concludes that investments may be held through LLCs, which we anticipate will be the case), to be sold to Opportunity Zone investors. Even if the EB-5 project property was acquired by the EB-5 project owner on or before December 31, 2017, it may be possible to sell a portion of the project to a new project owner in order to utilize new OZ Fund investments after that date for the EB-5 project, so long as the new project owner agrees to construct its portion of the EB-5 project in accordance with the existing EB-5 business plan. The new class of investment established for purchase by OZ Funds would have a different rate of return than offered to other equity investors, and possibly reinvestment requirements to retain the eligibility of this class of investors for their tax benefits. Given the compelling tax benefits for OZ Fund investors and the economic benefits for the EB-5 project, it's worth navigating these rules to attract and facilitate investments from this potentially huge new market.

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Adding OZ Fund investors could benefit both EB-5 project sponsors and EB-5 investors by funding a capital shortfall with equity capital that is designed for a long-term holding period. This is especially helpful to EB-5 investors who are caught in the EB-5 visa backlog, because they also are expected to have a long-term holding period in order to qualify for their visa. In addition, the OZ Fund investors are not required to meet any job creation requirements in order to claim their tax benefits, so the EB-5 investors could retain all of the jobs for the project, while the OZ Fund investors could retain all of their tax benefits.

Second, is there a possibility that new projects could be funded using Opportunity Zone capital? EB-5 project sponsors working on new projects could design their ownership structure to be qualified to meet Opportunity Zone requirements, as well as EB-5 investment requirements, so that the project can attract both types of investors simultaneously. This would allow EB-5 project sponsors to tap both US and non-US investment markets. The Opportunity Zone portion of the financing would be required to be equity financing, but the EB-5 financing could still be either debt or equity.

Third, consider how best to market Opportunity Zone investments soon to eligible investors. Investors interested in the Opportunity Zone investment tax benefits are required to invest in an OZ Fund within 180 days of realizing their taxable gains. This means they will need to act quickly, and they will be looking for the best quality investments that meet the Opportunity Zone criteria and that will have the best chance for long-term capital appreciation over their anticipated 10 year holding period. EB-5 projects that qualify will have the benefit of already having market studies, EB-5 offering documents (that will require modification but can be repurposed to save time and cost), and possibly even other sources of existing financing. These advantages will help EB-5 project sponsors to move quickly into the market for these new investors.

Fourth, consult qualified securities and tax counsel and expert third parties to structure and market your Opportunity Zone eligible investments.

Opportunity Zone financing is in its start-up phase, which means there are substantial risks and rewards for moving quickly into this new capital market. EB-5 project sponsors may be some of the best positioned new entrants into this new market, and they should act soon to determine the eligibility of their projects for Opportunity Zone investment. Those who do qualify should engage expert advisers to structure the Opportunity Zone investment for compliance with IRC sections 1400Z-1 and -2, and to commence marketing the availability of their projects to eligible investors.

The potential for new investors seeking qualified Opportunity Zone investments is substantial, and those EB-5 project sponsors with projects located in one of the designated Opportunity Zones will be well positioned to attract this new capital to their projects. This new capital may fill the shortfall in EB-5 financing caused by thte visa delays affecting the EB-5 investment market in China. EB-5 project sponsors should act soon to determine if their projects will meet the criteria for this new capital market and take the steps necessary to add Opportunity Zone financing to their projects.