The Puerto Rico Chamber of Commerce, Birling Capital Advisors, LLC
and El Nuevo Día present

3rd PROMESA Conference

Reinventing Puerto Rico: A Look at CDBG-DR Funding and Opportunity Zones

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PANEL II

Reinventing Puerto Rico: A Look at CDBG-DR Funding and Opportunity Zones

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Panel ll: Reinventing Puerto Rico: A Look at CDBG-DR Funding and Opportunity Zones

Moderator: Enrique Kike Cruz, NotiUno Analyst

Panelists:

I. Fernando Gil Ensenat (Housing Secretary)

II. Eng. Dennis G. Gonzalez Ramos (Disaster Recovery Deputy Secretary of CDBG-DR Program, Housing Department)

III. Eng. Francisco Diaz Masso, President & CEO, Bermudez, Longo, Diaz – Masso, LLC

IV. Mr. Michael Williams, Founder & CEO, Kinetic International

V. Jeanelle Alemar-Escabí, CPA, CGMA, JD, LL.M. & Member of Kinetic International

KINETIC Summary CDBG-DR

I. Community Development Block Grant – Disaster Recovery (CDBG – DR)

Program: Assure decent affordable housing opportunities, provision of services, assistance to the most vulnerable in our communities, the expansion and conservation of jobs.

1. Funds come from Disaster Recovery Program for community development of the United States Department of Housing and Urban Development (HUB) to grant support disaster recovery activities, including housing redevelopment and rebuilding.
2. Puerto Rico Housing Department: entity designated for administering the subsidy program:
   a) long – term recovery, restoration of housing and economic infrastructure, and revitalization
3. Funds will be divided in 4 categories
   a) Housing
   b) Planning
   c) Economic Development
   d) Infrastructure

KINETIC Summary CDBG-DR

II. Recent events:

1. First allocation of $1.5 Billion
    a) Funds approved by Congress on February 1, 2018
    b) Action Plan was approved on July 29, 2018
    c) September 20, 2018: grant agreement executed by Rosselló and Carson (HUD Secretary)
2. Second allocation of $18.5B
    a) Approved by Congress on April 10, 2018
    b) August 14, 2018 HUD announced rules for $8.2B
        i. November 18, 2018: Submitted Substantial Amendment to the Action Plan for final HUD approval ($1.5B + $8.2 B)
            1. 19 initial programs, with some changes to the programs and budgets, 8 new programs
    c) Future expected:
        i. $1.98 for power grid
        ii. $8.3B in mitigation funds
3. TOTAL: $19.9B – never before seen amounts

KINETIC Summary CDBG-DR

III. Programs:

1. Planning (Total $485M)
    a) Whole Community Resilience Planning (Vivienda & Foundation)
    b) Agency Planning Initiatives (Vivienda, Junta Planificación & Fideicomiso)
    c) Economic Recovery Planning (Vivienda & DDEC)
    d) Home Resilience Innovation Program (Vivienda & UPR)

2. Housing ($3.8B)
    a) Single Family Repair, Reconstruction and Relocation (Vivienda)
    b) Title Clearance Program (Vivienda)
    c) Rental Assistance (Vivienda)
    d) Mortgage Catch-Up (Vivienda y AFV)
    e) Social Interest Housing (Vivienda y NGO)
    f) Housing Counseling (Vivienda y NGO)
    g) CDBG – DR Gap to Low – Income Housing Tax Credit (LIHTC) (Vivienda y AFV)
    h) Community Energy & Water Resilience installations (Vivienda)
    i) Multifamily Reconstruction, Repair and Resilience Program (Vivienda)
    j) Homebuyer Assistance Program (Vivienda)

KINETIC Summary CDBG-DR

3. Economy ($1.52B)
    a) Small Business Financing (Vivienda, DDEC & Banco Desarrollo Económico)
    b) Small Business Incubators Accelerators (Vivienda & DDEC)
    c) Workforce Training Program (Vivienda & DDEC)
    d) Construction and Commercial Revolving Loans (Vivienda, DDEC & Banco Desarrollo Económico)
    e) Tourism and Business Marketing Program (Vivienda & DDEC)
    f) Strategic Projects and Commercial Redevelopment (Vivienda & DDEC)
    g) Economic Development Investment Portfolio for Growth (Vivienda & P3)
    h) Re – Grow PR – Urban Rural Agriculture (Vivienda, Agricultura & DDEC)

4. Infrastructure ($1.475B)
    a) FEMA Coordination Program (Vivienda y COR3)
    b) Critical Infrastructure Resilience Program (Vivienda)
    c) Community Resilience Center (Vivienda y NGO)

5. Multi- Sector Programs ($1.9B)
    a) City Revitalization Program (Vivienda)
    b) Puerto Rico by Design (Vivienda)

KINETIC Qualified Opportunity Zones

I. Federal Legislation

1. Enacted in December 20, 2017 as part of 2017 tax reform legislation (Tax Cuts and Jobs Act) – Sections 100Z-1 and 1400Z-2 of the United States Internal Revenue Code of 1986, as amended)
   a) First new federal community development tax program since the Clinton administration.
   b) Promote long-term investment in low-income communities, by moving long-term capital to underserved communities
   c) How do we get there? By providing tax incentive to investors that reinvest their gains into funds that invest in Qualified Opportunity Zones

ii. What is a Qualified Opportunity Zone?
1. Selected by US Department of Treasury after nomination by governors
2. Defined as "a population census tract that is a low-income community that is designated as a qualified opportunity zone." IRS has provided a list and there is also a map.
3. Almost all of PR is considered an opportunity zone. 3,500 square miles of opportunities.

KINETIC Qualified Opportunity Zones

iii. What is a Qualified Opportunity Fund?
   1. Investment vehicles that
      a. hold at least 90% of their assets in Qualified Opportunity Zone Property (stock, partnership interest or business property), and
      b. deploy capital in Qualified Opportunity Zones.
   2. To become a Qualified Opportunity Fund, an eligible *corporation* or *partnership* self-certifies by filing Form 8996, Qualified Opportunity Fund, with its federal income tax return.
      a. IRS has clarified that an LLC that chooses to be treated as a partnership or corporation for federal tax purposes can organized as a Qualified Opportunity Fund.

iv. Qualified Opportunity Zone Partnership Interests and Stock
   1. Qualified opportunity zone partnership interest/stock: capital or profits interest in a domestic partnership/corporation
      a. Tiered structure:
         i. Qualified Opportunity Zone Fund will acquire interest/stock in another partnership/corporation engaged in the qualified opportunity zone business.
            1. Interest/stock must be acquired solely in cash after December 31, 2017.
            2. When acquired, lower partnership/corporation must have been a qualified opportunity zone business, or a newly formed partnership/corporation for purposes of being engaged in a qualified opportunity zone business.
            3. Lower partnership/corporation must be engaged in a qualified opportunity zone business during the fund's holding period.
         ii. Qualified Opportunity Zone Fund cannot invest in another Qualified Opportunity Zone Fund.

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v. Qualified Opportunity Zone Business Property
   1. Tangible property used in the trade or business of the Qualified Opportunity Fund
      a. Must be acquired from unrelated parties
      b. In a transaction that is not a carryover transaction
      c. After December 31, 2017
   2. The original use of the property must commence with the OZFund or the OZFund must substantially improve the property
      a. Original use is not defined in the statute, but regulations and case law provide guidance: the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer
      b. Substantial improvement: occurs only if, during 30 months after acquisition, additions to the basis with respect to such property in the hands of the OZFund exceed an amount equal to the adjusted basis at the beginning of the 30-month period (DOUBLE THE VALUE)
         i. Use this rule for buying used real estate: you don't need to build new property, just buy used and double the value
         ii. Proposed regulations: measured based only on the basis of the building, not of the underlying land .IRS has requested comments as to whether vacant real property that is productively utilized after some period of abandonment could qualify as zone business property.

IRS notice of proposed regulations: https://www.irs.gov/newsroom/treasury-irs-issue-proposed-regulations-on-new-opportunity-zone-tax-incentive

Proposed regulations: https://www.irs.gov/pub/irs-drop/reg-115420-18.pdf

Underlying land revenue ruling: https://www.irs.gov/pub/irs-drop/rr-18-29.pdf

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vi. Qualified Opportunity Zone Business (underlying business)

1. Partnership interests or stock acquired by a OZFund must be a state in a partnership or corporation (underlying business) that meets 3 sets of requirements.
    a. First, substantially all of the tangible property owned or leased by the taxpayer that owns the business must meet QOZ Business Property rules (new property or substantial improvement)
        i. Proposed regulations: substantially all = at least 70%. If a zone entity satisfies this test, then the entire value of the opportunity fund's zone stock or zone partnership interest is treated as zone property for purposes of the requirement that at least 90 percent of an opportunity fund's assets consist of zone property (the 90 percent test). This means that an opportunity fund could hold as little as 63 percent of its assets within an opportunity zone (i.e., 70 percent of 90 percent) and provide the tax benefits to investors.
    b. Second, active trade or business test
        i. At least 50% of the total gross income derived from *active conduct* of business
            1. OJO: no definition of active, many options in IRC
        ii. Substantial portion of any *intangible* property used in the active conduct of the business
        iii. Less than 5% of the average adjusted bases of the business' property is attributable to nonqualified financial property, other than a reasonable amount of working capital
            1. Proposed regulations:
    c. Third, the business cannot be a so-called "sin business"
        i. Examples: golf courses, country clubs, tanning facilities, takeout liquor, massage parlors, and hot tub facilities.
2. OJO: rules do NOT require QOZ Business Property to be used in a QOZ Business. So, a QO Fund may invest directly in QOZ Business Property, rather than in stock or partnership interest, the investment avoids the requirements above.
3. Safe Harbor (*does not apply* to an opportunity fund that directly holds working capital or constructs property.):
    a. zone entity that acquires, constructs, and/or substantially rehabilitates tangible business property may treat cash, cash equivalents and debt instruments with a term of 18 months of less as a reasonable amount of working capital for a period of up to 31 months if certain conditions are satisfied
    b. tangible property that is being acquired, constructed and/or substantially improved with the working capital and that is expected to qualify as zone property after the expenditure of the working capital will be treated as being used in the active conduct of a trade or business during the construction and improvement period

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vii. Tax Incentives
   1. Deferral of Gain
      a. Reinvest realized gains into a OZFund in exchange for temporary tax deferral.
      b. What you need:
         i. Gain from a sale
            1. not total proceeds
            2. does not specify if short-term, long-term, ordinary, Section 1231 (business property), but IRS may later say only for capital gains
         ii. To an unrelated person
         iii. Invested in a OZFund
            1. Proposed Regulations: only equity (including preferred stock and partnership interests with special allocations) in an opportunity fund entitles the taxpayer to deferral of tax on gain with respect to the original property. NO deferral for investing in a debt instrument issued by a OZFund.
         iv. Within 180 days of the sale of the property
      c. What you get:
         i. Excluded from gross income in the year you realized the gain
         ii. Until earlier of: date investment in OZFund is sold or Dec. 31, 2026
      d. Example: Individual taxpayer, purchased asset for $200 (basis) in 2015. In 2018, sells for $300. Within 180 days, invests $100 gain in a OZFund. OZFund invests those $100 in QOZ Property in 2018.
         i. No tax for the gain is owed in 2018.
         ii. Deferral continues until earlier of: taxpayer selling or December 31, 2026.
         iii. Proposed Regulations clarify that only gain that would be capital gain (short-term or long-term) is eligible for deferral and a basis step-up.

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2. Partial Forgiveness of Tax Due with Respect to Gain
   a. OZFund investment held for:
      i. 5 years, basis deemed increased by 10% of the deferred gain,
      ii. 7 years, basis deemed increased by another 5%: 15% total
   b. Let's go back to our example:
      i. 5 years, she now has a basis of $210 ($200 original basis + ($100 gain x 10%))
      ii. 7 years, she now has a basis of $215($200 original basis + ($100 gain x 15%))
      iii. On December 31, 2026: new basis for calculating her gain would be calculated using that increased basis: remaining $85 gain
   c. These 5 and 7 years need to take place before December 31, 2026, so the maximum benefit is only available for gains realized before December 31, 2019 (plus 7 years is 2026)
3. Partial Basis Step-up with Respect to the Taxpayer's Interest in the Qualified Opportunity Zone
   a. Fifth and Seventh year: basis in the partnership interest/stock of the OZFund is increased by 10 and 5 percent, respectively
   b. Example:
      i. After 7 years, her basis in her interest in the OZFund is $15
         1. Please note initial basis shall be $0, as established in the IRC (Section 1400Z-2(b)(2)(B)(i))
      ii. Then on December 31, 2026, basis is $100 ($85 gain + $15 basis increase)

4. Basis Step-up after 10 years
   a. After 10 years, basis in partnership interest/stock is equal to FMV when sold (step-up)
   b. Completely avoids federal income tax on disposition of QOZ investment.
      i. Proposed regulations: ability to make the 10-year basis step up election is available until Dec. 31, 2047. Only consequence of the expiration of the opportunity zone designation is that new investments made after Dec. 31, 2028 will not be considered zone business property. The IRS has requested comments on this rule.

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viii. Local Legislation
   1. Typical commercial activities, such as leases, will be subject to regular tax rates
   2. House Bill 1887 was introduced at the end of 2018
      a. Creates a committee that will evaluate projects
         i. Members: Chief Financial Officer, Chief Investment Officer and AAFAF Executive Director
      b. Business activities that are eligible for incentives of Act 20-2012 (Export Services Act), Act 73-2008 (Economic Incentives Act for the Development of Puerto Rico), Act 74-2010 (Tourism Development Act), Act 83-2010 (Green Energy Incentives Act) and Act 27-2011 (Puerto Rico Film Industry Economic Incentives Act), are not eligible
      c. Opportunity zone funds operating in Puerto Rico shall have the following tax benefits:
         i. 15 year tax decree, taxpayer may choose years to be covered (postpone for 2 years after commencement of operations), may even interrupt exemption period
         ii. a preferential tax rate of 20%
            1. royalties paid to non-resident: also 20%
         iii. exemption of dividend taxation
         iv. 50% exemption on personal and real property taxes (90% exemption for low-income residential projects)
            1. Real property under construction shall be totally exempt during the construction period approved in the tax grant
         v. 50% exemption on municipal license tax (90% exemption for low-income residential projects)
         vi. 100% exemption on construction excise tax
         vii. Maximum 15% investment credit, distributed to investors, investor may later sell or transfer to other taxpayers (ok to use broker or underwriter)
            1. Tax credits under this law will have priority over credits under other existing laws
            2. Credit percentage and approval shall be determined by the committee
         viii. Similar capital gains deferral rules
            1. Only for capital? Yes, new section to be added to the Puerto Rico Internal Revenue Code specify so.
         ix. Exemption on interest earned on loans to exempt businesses
         x. Faster permits process – their process will follow this new law, not other existing permits regulations

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   d. Legislation has the effect of extending benefits to local investors pursuant to amendments to the PRIRC.
      i. Act 22-2012 is also amended to allow to defer the taxation of the capital gains earned from securities that are attributable to the period of non-residency in Puerto Rico

3. Historic moment: After the hurricane, which came to aggravate a crisis that has been ongoing for more than 10 years, Puerto Rico needs funds to rebuild its infrastructure.
   a. On January 3, 2019, Governor Rosselló signed Execute Order OE-2019-001 activating the provisions of Act 76-2000, which provides accelerated processing for emergency situations or events that require the execution of works, projects, or programs to safeguard life, health and safety.
   b. Infrastructure emergency was declared in 2017 by another executive order OE-2017-003 and Hurricane María's emergency has been extended in several occasions.
   c. Executive order recognizes emigration, economic depression, and lack of financing options for the government, which has paralyzed investment in infrastructure.
   d. Infrastructure with visible signs of deterioration: electric power grid, aqueducts and sewers, ground transportation system: roads and bridges, maritime ports, schools, hospitals, public facilities, emergency systems, telecommunications and broadband system.
   e. Declares emergency regarding the following infrastructure projects:
      i. Energy: sustainable renewable energy such as wind energy, solar energy, and alternative energy sources, such as natural gas or the conversion of solid waste, among others
      ii. Aqueduct and sewerage projects: improvements to the system, including, but not limited to, reservoirs and treatment plants
      iii. Transportation or ports projects: construction and improvements in air transportation and ground transportation systems, including roads, bridges and public transportation methods, improvement or construction of ports, docks and maritime transport, among others
      iv. Solid waste management projects: recovery systems for recyclable materials, research and development centers, compost facilities, energy conversion facilities or solid waste treatment and disposal facilities
      v. Any infrastructure work of the government of Puerto Rico that is directly related or addresses the effects caused by Hurricanes Irma and Maria or provides a solution to damages caused by these atmospheric events
      vi. Other deteriorating infrastructure projects that affect the economic development of Puerto Rico and services to the population: construction or improvements to schools, public facilities, hospitals, abandoned structures and sectors, revitalization of urban centers, housing projects, systems to address security or public health emergencies, and telecommunications facilities

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f. If your project is related to these, your permits should be expedited.

g. Establishes an Interagency Subcommittee to analyze environmental documents submitted for these projects. Members shall include representatives from the following: Planning Board, Department of Natural and Environmental Resources, Permits Management Office, Department of Economic Development and Commerce.

Thank you

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