OPPORTUNITY ZONE EXPO

What's Going On

Understanding your investment, rollover gains, return profiles, self-certification, investment diversification, pass-through entities, additional investment, impact of depreciation.

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(Track 1: 12:10 - 1:00pm)

Overview of Key Elements & Tax Benefits

- The Qualified Opportunity Zone program was enacted as part of *Tax Cuts & Jobs Act of 2017* to stimulate investment in low-income communities by providing tax incentives to investors.

- Tax incentives are relevant to any person that has taxable capital gain from any source.

- Related Programs:
  - New markets tax credits investments are usually structured as debt, while the qualified opportunity zone program is restricted to equity investments.

  - Executive Order establishing the White House Opportunity and Vitalization Program (December 12, 2018).

Overview of Key Elements & Tax Benefits

Key Elements

- Capital gain recognized on sale or disposition of property;

- Investment of such gain in a qualified opportunity fund within 180 days;

- Qualified opportunity fund invests in qualified opportunity zone property

Key Tax Benefits:

1. Tax on capital gain deferred until December 31, 2026;

2. capital gain reduced by 15% (if invested before December 31, 2019) and by 10% (if invested between January 1, 2020 and December 31, 2021); and

3. Investment in the qualified opportunity fund held for at least 10 years not subject to tax on appreciation.

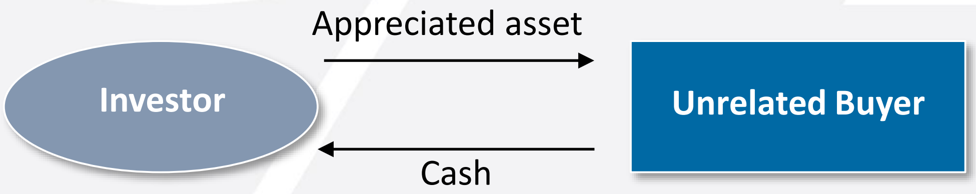
Steps in the Life of a Qualified Opportunity Fund
Step 1: Investor Recognizes Capital Gain

- The Proposed Regulations state that only capital gain is eligible gain. Note that the text of the opportunity zone statute does not limit eligible gains to capital gains (despite the heading of the statute). Conservative approach to use capital gains.

- Capital gain must be from a transaction with an unrelated party (20% ownership)

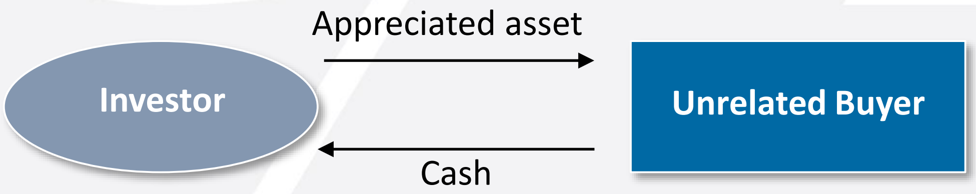
- Capital gain must be recognized on or before December 31, 2026

- Investor subject to tax on capital gain (not necessarily limited to U.S. persons)



Eligible Gain

- What are Capital Gains that Qualify?
  - Capital assets such as securities and other investment assets
  - Long-term and short-term capital gains qualify
  - Section 1231 gains - Trade or business property held for more than one year
    - Must 1231 gains and losses first be netted? When does 180-day period start?
    - Can partnerships rollover 1231 gains?
  - Ordinary gain such as inventory gain is excluded
  - Section 1245 and 1250 recapture excluded
  - Section 751 “Hot Assets”
  - Unrecaptured Section 1250 gain
  - Section 1256 contracts



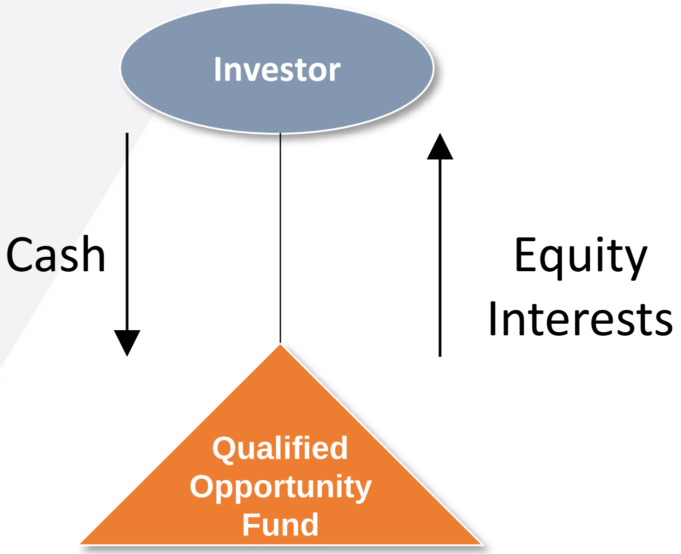
Step 2: Investor Invests Gain In A Qualified Opportunity Fund

- Investor's gain needs to be invested in a "Qualified Opportunity Fund"
  - Actual cash can come from any source
  - Sales proceeds vs. gain amount
    - *Compare to:* Sec. 1031 / Like-Kind Exchanges
  - Can be full or partial re-investment of gain
  - Investment exceeding available gain treated as a "normal" investment (i.e. no special OZ tax benefits)

- Must be an equity investment, not debt (though preferred interests OK)
  - OK to borrow against interest in the fund

- Gain dollars must be invested within 180 days (although the actual period varies based on your facts….see next slide)

- Exercise caution in confirming valid status of the fund as a "Qualified Opportunity Fund" <u>prior</u> to moving cash



Measuring the 180-Day Deadline

- **GENERAL RULE: 180 DAYS TO RE-INVEST CAPITAL GAINS**

- **Start date depends on source of gain:**
  - Gain from direct sale (stocks, real estate, etc.): date of sale
  - Gain received from a partnership (via a Form K-1):
    - Last day of partnership tax year (e.g. 12/31)
      - OR, Partner can elect to have start date = date partnership sold the asset(s)
    - **Confirm with partnership that the gain is OZ eligible!**
  - Capital gain dividend received from a REIT/RIC (via a Form 1099-DIV): date the dividend was paid
  - Undistributed capital gain from a REIT/RIC (via Form 2439): last day of REIT/RIC tax year (e.g. 12/31)
  - **Takeaway: the "true" clock could be much longer than 180 days**

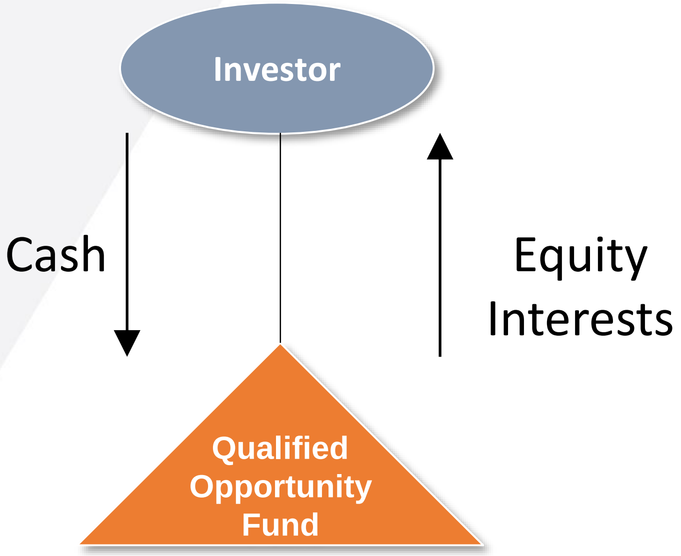
- The fund must be able to certify as a "Qualified Opportunity Fund" **on or before** the gain is invested in order for the investor to receive tax benefits
  - Inquire about fund certification status with fund manager/financial adviser prior to investing

Mixed Funds

- Taxpayers may invest amounts in a qualified opportunity fund that do not represent an investment of eligible capital gain
  - Treated as a separate investment in the fund that is not eligible for the deferral and gain exclusion benefits

- Proposed regulations clarify that deemed capital contributions under Section 752 resulting from an increase in a partner's share of liabilities do not result in the creation of a separate interest in a mixed fund that is ineligible for the qualified opportunity fund tax benefits

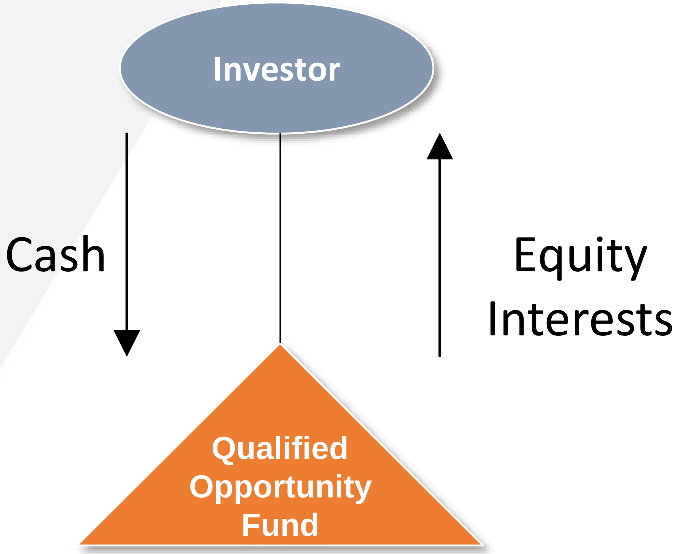
- If a taxpayer acquired interests in a fund with identical economic rights – some which are eligible for tax benefits and some which are not – ordering rules apply to determine which interests are sold in a partial sale of fund interests: FIFO for interests acquired on different days, otherwise pro rata portion of fund interests treated as sold



Commitment Period, Accepting New Investors and Capital Calls

- Potential challenges to accepting commitments over time and from subsequent closing investors
  - Subsequent acquired interest starts new 10-year holding period for later acquired interests
  - Multiple draws from same investor group during commitment period – investors may not have additional eligible gain to invest (create mixed fund investment)
  - What if capital from new investors is distributed to existing investors (as in many typical private fund structures)? potential to cause gain recognition and loss of qualified opportunity fund tax benefits

- Potential solutions
  - Single drawdown from each investor on known date
  - Financing to bridge capital calls



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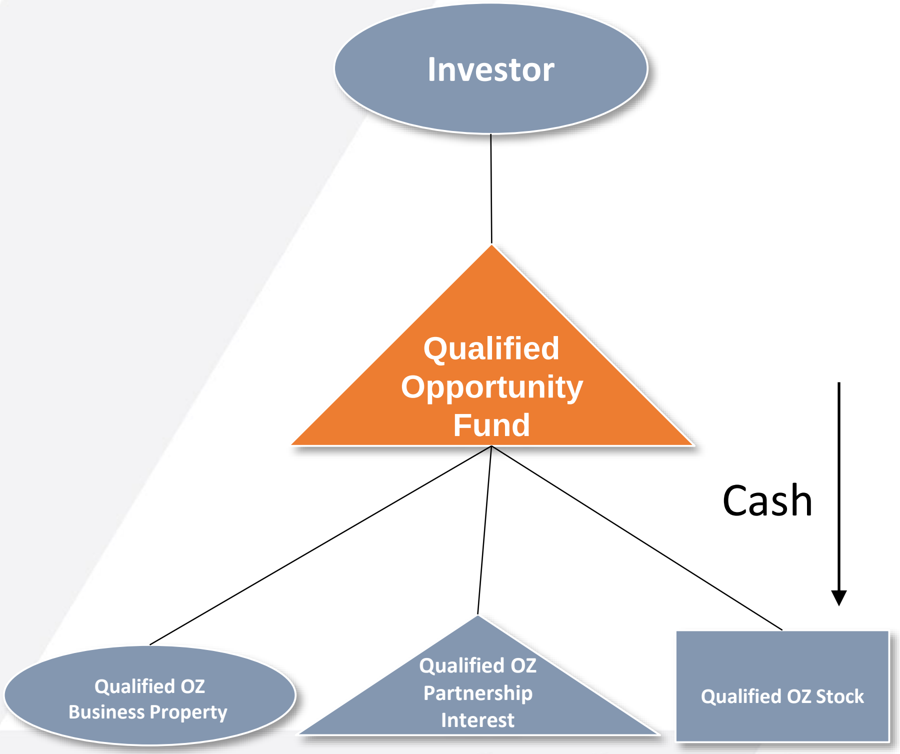
Step 3: Fund Invests in Qualified Opportunity Zone Property

- Fund must close on acquisition of "qualified opportunity zone property" before the first "testing date".
  - The first testing date is 6 months after the investment, or December 31 if earlier.

- On each testing date, at least 90% of Fund assets must be "qualified opportunity zone property".
  - First testing date is the end 6-month of the first 6 months of the taxable year (except for the first year, June 30)
  - Second is at the end of Fund's taxable year (December 31).

- If Fund fails the 90% test, monthly penalty imposed.

- On the due date for its tax returns, the Fund needs to self-certify on Form 8996 that by the end of the Fund's first taxable year, its organizing documents include a statement of the Fund's purpose of investing in qualified opportunity zone property and the description of the qualified opportunity zone business.



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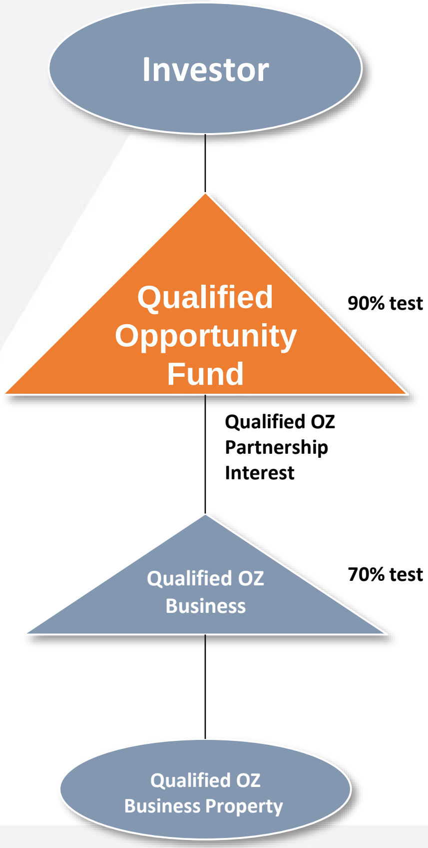
Optional Step 4: Two Tier Fund Structure

- Qualified opportunity zone property also includes investments in qualified opportunity zone partnership interests (i.e., partnership interests in a "qualified opportunity zone business").

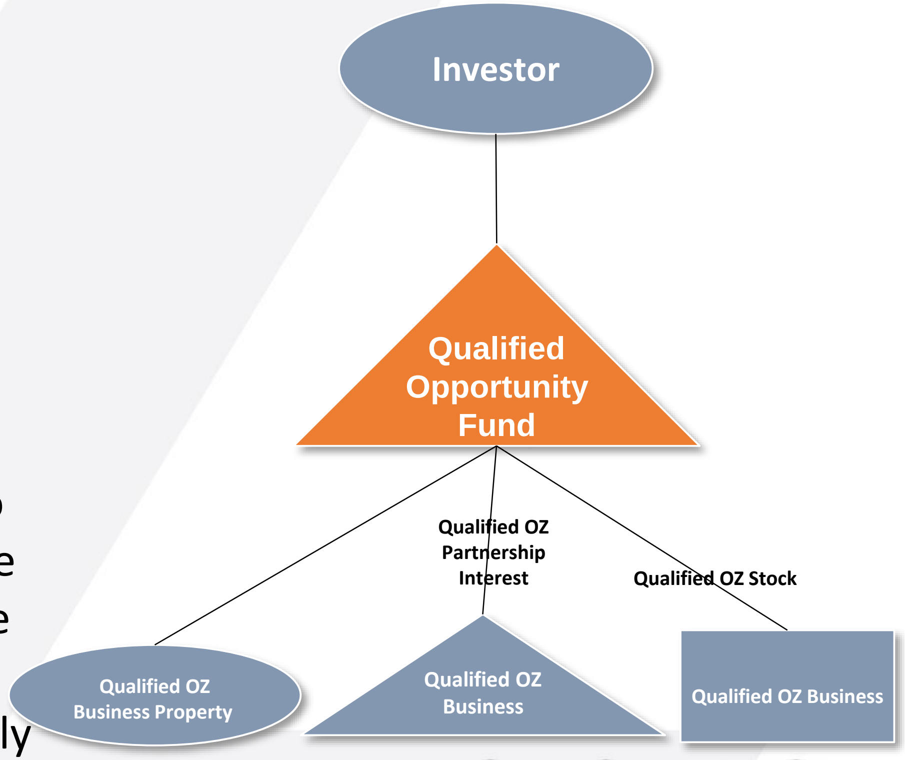
- Many Funds will have a two-tier structure for reasons that will be explained in the next panel.
    - Investors in those funds will therefore be two tiers removed from the underlying property.



Step 5: Tax Due on December 31, 2026

- Investor subject to tax on the deferred gain on December 31, 2026. This creates "phantom income":
  - In our example: In 2019, Investor sold XYZ, Inc. stock for a gain of $400,000. The tax on this gain (less the 15% discount) is due on the first estimated tax payment date after December 31, 2026 (tax on $340,000).

  - However, at that time all the $400,000 is still tied up in the Fund.
    - Investors therefore need to find alternative sources of capital to pay the tax, or have the Fund refinance the properties and make debt financed distributions with which the investors can pay the tax.
    - Whether debt financed distributions are permitted is not entirely clear (will discuss this later in the presentation).

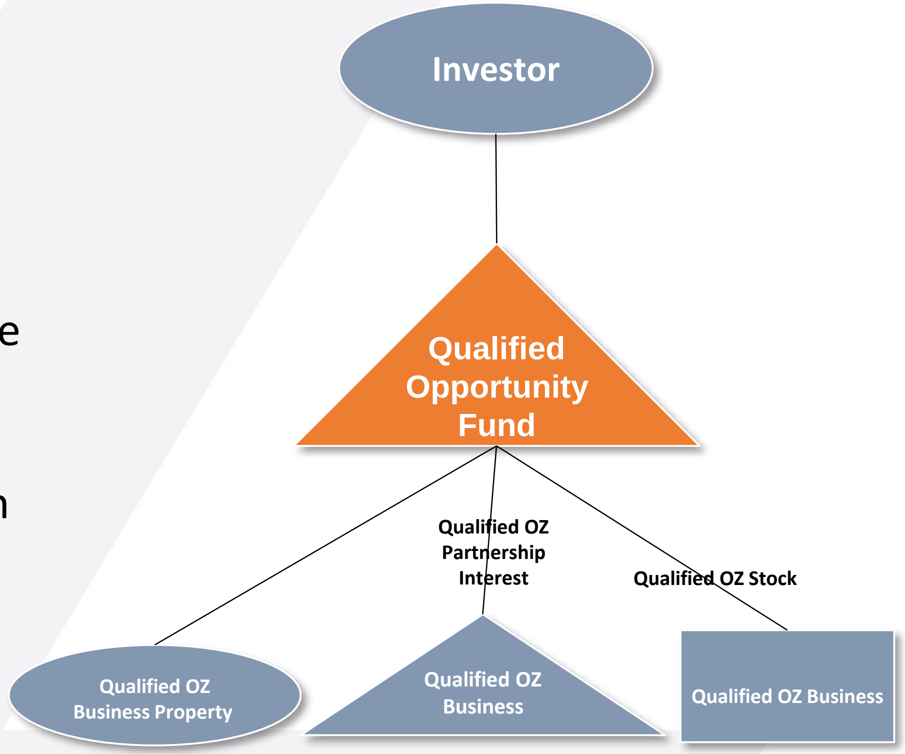


Character of Gain Recognized on December 31, 2026

- The deferred gain is recognized on the earlier of:
  - The date when the taxpayer's investment is sold or exchanged
  - December 31, 2026.

- Under the proposed regulations, the gain retains its character.
  - For example, if it were long term capital gain when deferred, it will be treated as long term capital gain when recognized.

- The Regulations are not entirely clear which tax rate should be used when the gain is recognized – the tax rate at the time of the investment in the QOF, or at the time that the gain is eventually recognized (e.g. December 31, 2026).
  - The better view is that you use the new tax rates in effect when the gain is eventually recognized (December 31, 2026).
  - Investors are therefore taking the risk that tax rates will increase.



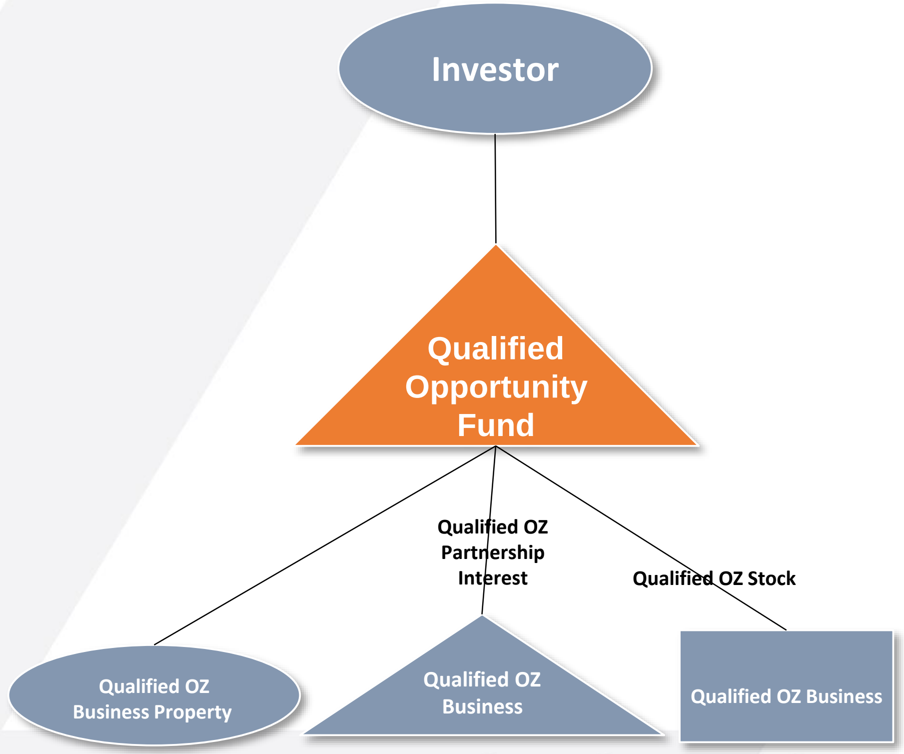
Acceleration of Gain Recognition

- The deferred gain is recognized on the earlier of:
  - The date when the taxpayer's investment is sold or exchanged
  - December 31, 2026.

- It is not entirely clear whether tax-free sales or exchanges would trigger the gain. Examples of such transactions include:
  - Transfer of interests in a QOF to another partnership/fund/S-Corporation.
  - Transfers of interests in a QOF to certain trusts.

- Are debt financed distributions treated as a "sale or exchange"?
  - Better view is that they should not as long as they do not exceed the amount of the debt allocated to the taxpayer.
  - Blue Book states that:

    "In the case of a fund organized as a pass-through entity, investors recognize gains and losses associated with both deferred-gain and non-deferred gain investments in the fund, under the rules generally applicable to pass-through entities. Thus, for example, investor- partners in a fund organized as a partnership would recognize income and increase their basis with respect to their distributive share of the fund's taxable income. "
  - Refinancing after stabilization therefore likely ok.
    - Debt financed distributions the moment after the taxpayer makes an investment in the fund – problematic.

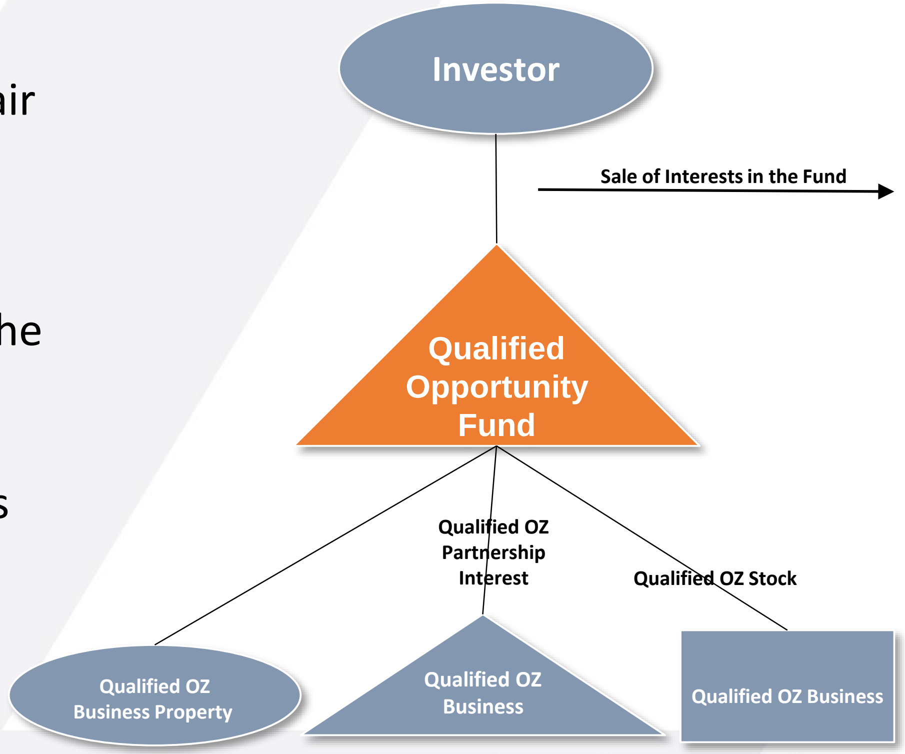


Step 6: Exiting Fund After 10 Years

- If the Investor sells its interests in the Fund after 10 year at a gain, the Investor can elect to step-up its basis in its interests in the Fund to their fair market value – resulting in no taxable gain being recognized.

- Absent guidance to the contrary, the tax benefits are only available if the Investor sells its <u>equity interests</u> in the Fund. No benefits are available if the Fund (or the qualified OZ Business) sells its assets.

- It is not entirely clear how debt taken at the Fund or qualified OZ business levels affect the determination of the fair market value.
    - When partnership interests are sold, the amount realized for tax purposes includes the amount of such debt.
    - IRS has therefore been asked to clarify that "fair market value" includes the amount of such debt, otherwise a significant amount of the gain might be subject to tax.



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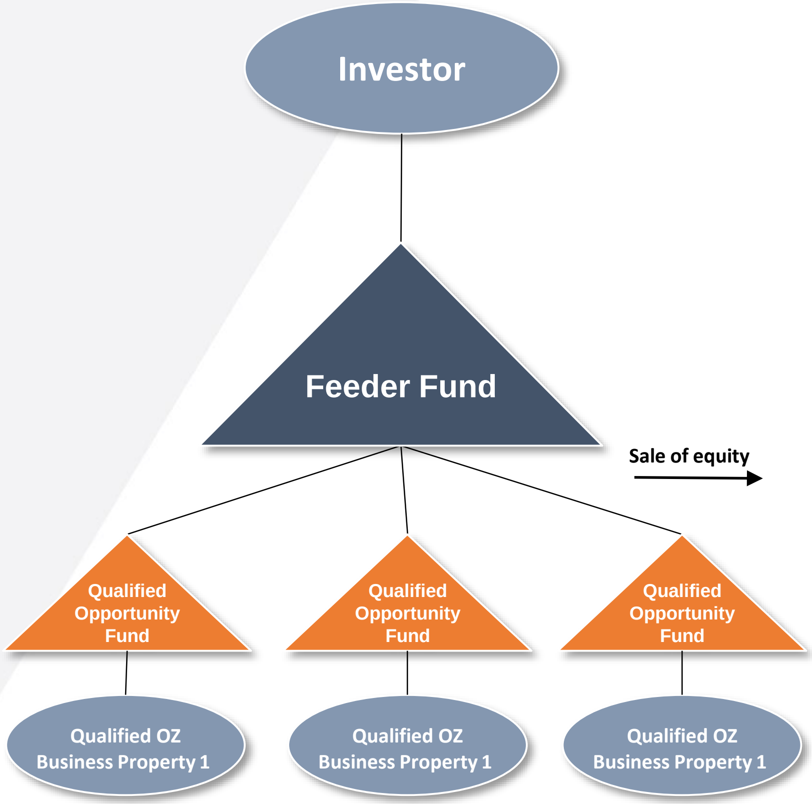
Investment Diversification

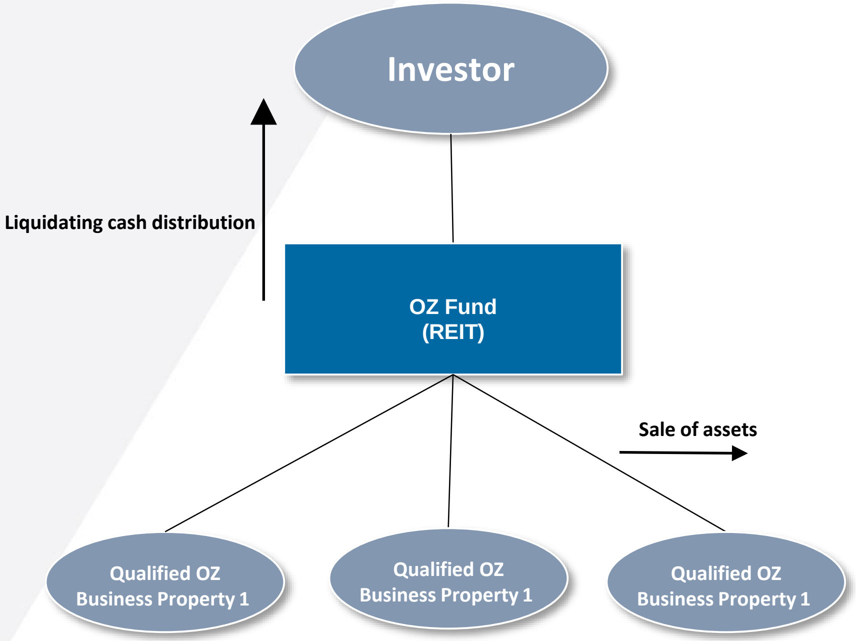
- Because the tax benefits are only available on the sale of the equity interest in the Fund, because it is difficult to find a single buyer for a portfolio of assets, many funds have been organized to own only a single project.

- One strategy for diversification would depend on favorable guidance from the IRS that would permit taxpayers to indirectly invest in several qualified opportunity funds through a single feeder partnership.
  - Right now, it is unclear whether the IRS would provide such guidance.
  - Proposed Regulations already permit a partnership to invest in a qualified opportunity fund any gain that it recognized.



Investment Diversification

- An alternative strategy, which does not depend on new guidance involves the use of a REIT.
- The REIT can then sell its assets to different buyers as part of its liquidation with the liquidating distributions treated by the Investors as the sale of the REIT's shares.
  - REITs are subject to a dividend paid deduction – meaning that Investments in REITs that distribute all of their income on an annual basis are generally subject to a single level of tax (at the shareholder's level).
  - Liquidating distributions are also eligible for a dividend paid deduction if the REIT completely liquidates within 24 months after the adoption of the plan of liquidation.
  - A REIT with an Opco as its qualified opportunity zone business may be restricted from owning any joint venture because of the 5% non-qualified financial property test.



Return Profiles

	Without OZ Program	With OZ Program	
Cash from initial sale	10,000,000	10,000,000	-
Gain from initial sale	6,689,018	6,689,018	-
Taxes immediately due on 20% capital gains*	(1,993,327)	-	1,993,327
Cash available to re-invest into new OZ deal	8,006,673	10,000,000	1,993,327
Amount to invest into OZ	6,689,018	6,689,018	-
Excess available for "other" investment	1,317,655	3,310,982	1,993,327
Cash from OZ investment and "other" investments	28,060,802	31,237,653	3,176,850
Tax on 29.6% ordinary earnings*	(3,903,502)	(5,155,182)	(1,251,679)
Tax on 20% capital gains*	(4,186,497)	-	4,186,497
Tax on special 25% capital gains*	(1,416,588)	-	1,416,588
Reduced taxes due on deferred 20% capital gains at end of year 10*	-	(1,694,328)	(1,694,328)
Total amounts invested	(8,006,673)	(10,000,000)	(1,993,327)
Total taxes paid	(11,499,915)	(6,849,510)	4,650,405
Total cash returned	29,378,457	34,548,635	5,170,178
Net cash earned from sale and reinvestment	9,871,869	17,699,125	7,827,256
10-year estimated IRR	11.57%	17.48%	5.91%

**Taxes include consideration of the 3.8% NII tax and 6.00% state tax*

Facts:

- $10M sale today
- $6.7M gain (all re-invested)
- Difference invested in securities

Other items to consider:

- Depreciation
- Suspended losses/basis
- Current income
- Depreciation recapture/751 hot assets
- Distributions (e.g. re-financing)

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