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September 26, 2019

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Opportunity Zones:
The Red Hot Commercial
Real Estate Topic of 2019 & 2020!

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**OPPORTUNITY ZONES:
CONSIDERATIONS FROM AN OZ
INVESTOR'S PERSPECTIVE (AS OF Q4 2019)**

**MYLESTITLE ADVISORY COUNSEL BREAKFAST
SEMINAR – HAYFIELDS COUNTRY CLUB**

Steve Sharkey, Tax Partner

September 26, 2019

I. OZS ARE TAX-ADVANTAGED INVESTMENTS

1. Opportunity Zone Tax Benefits only **enhance** returns. Don't forget investment fundamentals.
2. A BAD INVESTMENT WITH OZ TAX BENEFITS IS STILL A BAD INVESTMENT.
3. OZ Investors need to do their fundamental investment due diligence/underwriting.

I. OZS ARE TAX-ADVANTAGED INVESTMENTS (cont.)

OZ BENEFITS ON ROLLED OVER (DEFERRED) CAPITAL GAIN	
1. DEFERRAL	Capital Gains that are re-invested in a QOF are <u>deferred</u> until earlier of 12/31/2026 or sale of investment in QOF
2. PARTIAL REDUCTION	Capital Gains that are re-invested in an QOF are <u>reduced</u> by (i) 15% if investment is made by 12/31/19 and held for 7 years and (ii) by 10% if investment is made by 12/31/21 and held for 5 years
OZ BENEFITS ON NEW INVESTMENT	
3. GAIN ELIMINATION	Gain on sale of investment in QOF is <u>not subject to Federal income tax</u> if held for at least 10 years

I. OZS ARE TAX-ADVANTAGED INVESTMENTS (cont.)

EXCEPTION – Pure Tax Reduction Play

Although 10-year gain elimination is “holy grail” of OZ, a short-term OZ investment can buy down CG tax rate

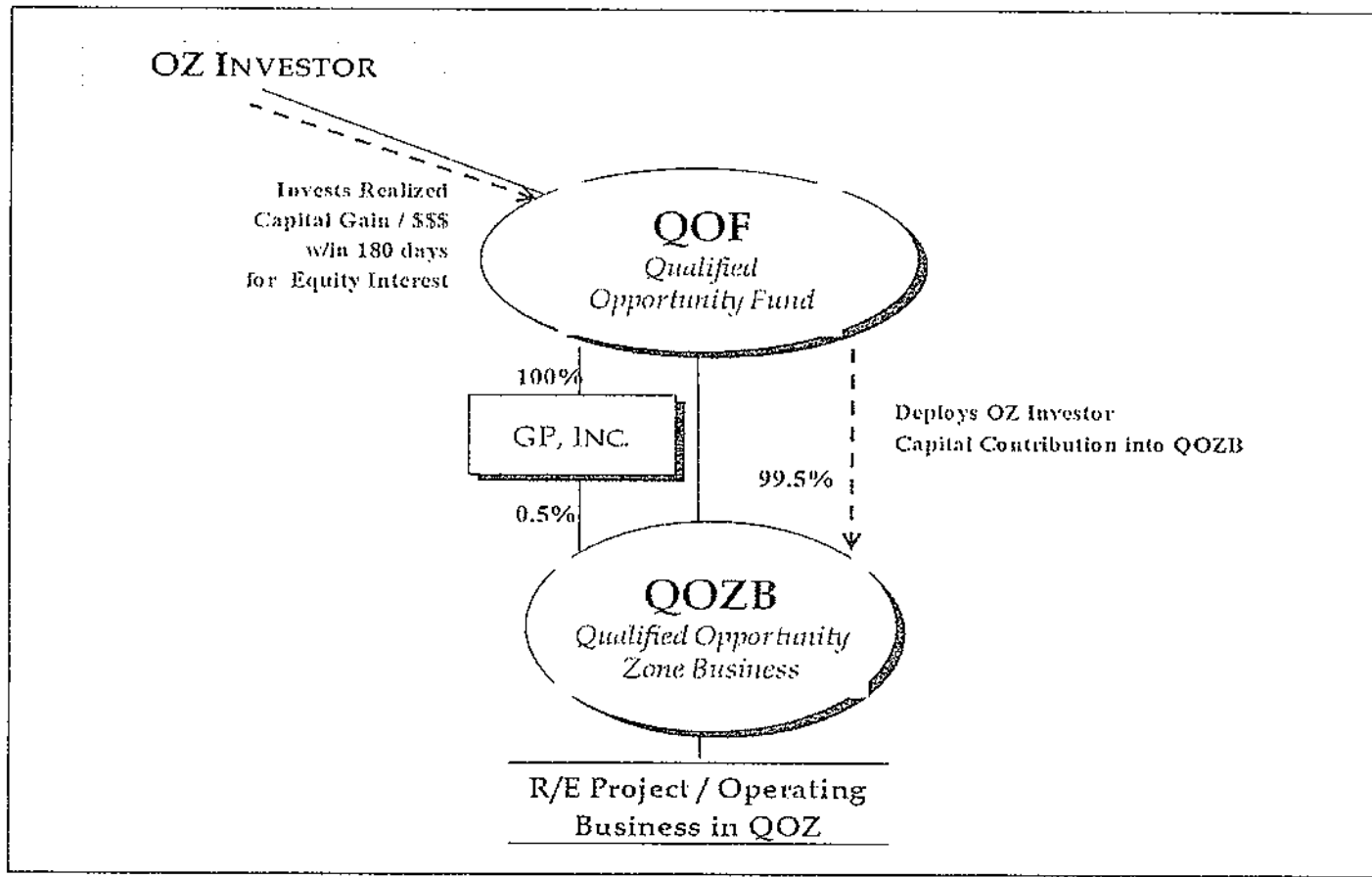
Benefit of Deferral + Partial Reduction of Rolled Over Capital Gain					
Assumptions					
2026 Tax Rat	30.0%	assumes 20% Federal + 3.8% NII + 6% State			
NPV Discount	8.0%				
Investment Year	O-Zone Gain Reduction	Gain Recog%	Effective CG Tax Rate	NPV of Effective CG Tax Rate @2026	Combined Reduction in Effective Tax Rate
2019	15.0%	85.0%	25.50%	14.88%	15.12%
2020	10.0%	90.0%	27.00%	17.01%	12.99%
2021	10.0%	90.0%	27.00%	18.38%	11.62%
2022	0.0%	100.0%	30.00%	22.05%	7.95%
2023	0.0%	100.0%	30.00%	23.81%	6.19%
2024	0.0%	100.0%	30.00%	25.72%	4.28%
2025	0.0%	100.0%	30.00%	27.78%	2.22%
2026	0.0%	100.0%	30.00%	30.00%	0.00%

II. OZS ARE COMPLICATED

1. Involve 2 types of gains:
 - a) Capital Gains rolled over into QOF Investment
 - b) Gain on sale/disposition of QOF Investment
2. 180-day reinvestment period has odd exceptions
 - a) Special rule for gain recognized through partnership and S corporation
 - b) Special rule for Section 1231 gains (including commercial real estate)

II. OZS ARE COMPLICATED (cont.)

3. By design, OZ Investment almost always involves 2 levels of entities – QOF and QOZB.



II. OZS ARE COMPLICATED (cont.)

4. Involve MANY deadlines/timelines:

OZ Investor Reinvestment Period	180-day from sale producing capital gain/from end of year for pass-thru or 1231 gain
QOF Deployment Period	6 months+ from when capital contribution is received
10% Gain Reduction on Rolled Over Capital Gain	5 years from when Investment in QOF is made (no later than 12/31/2021)
15% Gain Reduction on Rolled Over Capital Gain	7 years from when Investment in QOF is made (no later than 12/31/2021)
Day of Reconning -- Deferral of Rolled over Gain Ends	December 31, 2026
10 Year Hold Period for Gain Elimination on OZ Investment	10 years from when Investment in QOF is made (no later than 12/31/2021)

II. OZS ARE COMPLICATED (cont.)

5. Some Other Complications:

- Related Party Rules can be thorny
- Complex rules for leased tangible property
- Glitch regarding gain elimination on 10-year exit in multi-asset QOF
- Property contributed to QOF/QOZB without recognition of tax can create OZ problems
- Restrictions on Nonqualified Financial Property restricts common “corporate” ownership structures

TAKE-AWAY: OZ Tax Benefits come at the **cost** of complexity.

III. OZS ARE NOT FRIENDLY TO ESTATE PLANNING.

1. BACKGROUND: OZ Investor's Deferred Gain is must be taken into income on 12/31/2026, or earlier if OZ Investor disposes of Investment in QOF.
2. DEATH OF OZ INVESTOR BEFORE 12/31/2026:
 - a) Deferred Gain is not accelerated by death
 - b) BUT Deferred Gain is taxable on 12/31/2026 to Estate or Beneficiary who receives/holds OZ Investment
3. DEFERRED GAIN TRIGGERED BY MANY/MOST ESTATE PLANNING TRANSFERS BEFORE 12/31/2026:
 - a) Under April 2019 Proposed OZ Regulations, no-consideration estate transfers would accelerate recognition of Deferred Gain.
 - b) Exception for transfer to Grantor Trust or tax-free contribution to entity taxed as partnership.

IV. OZS ARE NOT JUST FOR REAL ESTATE INVESTMENTS

1. OZ Provisions were not intended to primarily benefit investment in real estate. Designed to include Operating Businesses in Opportunity Zones.
2. Basic requirements for Operating Business as QOZB:
 - a) Substantially all (at least 70%) of its tangible property must be located in Opportunity Zone and satisfy other tests of QOZ Business Property
 - b) Under Proposed Treasury Regulations issued in April 2019, at least 50% of employees/workers perform their services in Opportunity Zone (measured by hours or by payroll).

IV. OZS ARE NOT JUST FOR INVESTING IN REAL ESTATE

3. These rules would tend to favor technology startup companies with relatively low amounts of tangible property / equipment.
 - a) e.g., Google or Expedia, rather than Tesla.
4. QUERY: We have NOT SEEN rush to structure tech startups and new Venture Capital funds as Opportunity Zone investments.

Why?

V. OZ REAL ESTATE INVESTMENTS ARE DEVELOPMENT PROJECTS

1. OZ Investments in real estate are necessarily development projects. Either:
 - a) New Construction, with no minimum spend (other than to avoid “land banking”/hot dog stand concern).
 - b) Redevelopment, that requires additional capital investment in real estate equal to acquisition cost – excluding land value
2. Stabilized properties and land investment are **not good** OZ Investments.
3. BUT NOTE THAT April 2019 Proposed OZ Regulations confirm new construction project can qualify if purchased prior to completion/placed in service.

VI. OZS ARE GENERALLY FORMED AS TWO-TIER PARTNERSHIP ARRANGEMENT

1. By design, OZ Investment almost always involves 2 levels of entities – QOF and QOZB.
2. As a starting point, both QOF and QOZB will usually be taxed as partnerships. Maintains traditional income tax benefits of partnership treatment:
 - a) no income tax at entity level
 - b) flow-through of taxable losses to owners
 - c) ability to accommodate tax-free contributions and distributions of property
 - d) flexibility in capital structure

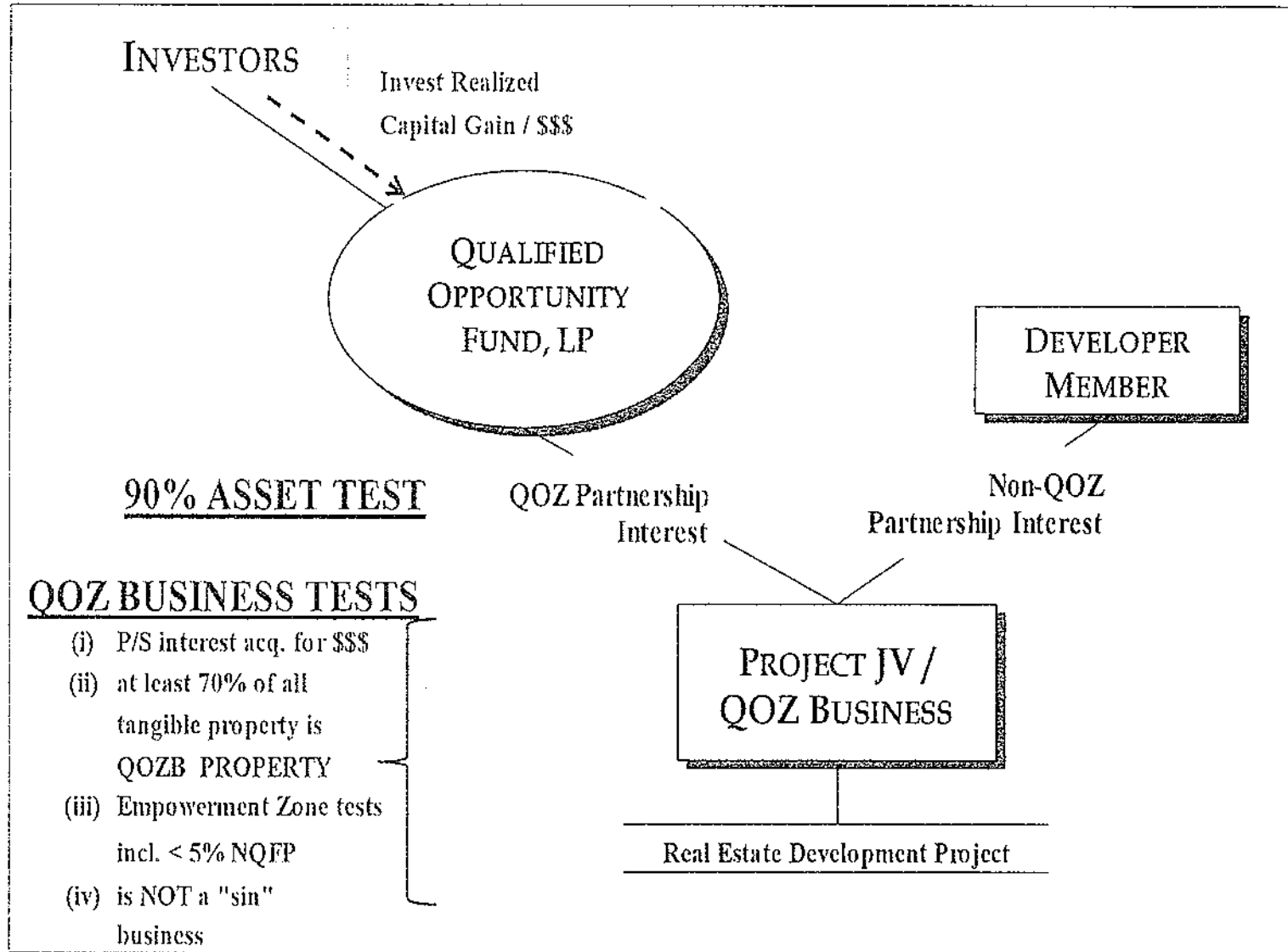
VI. OZS ARE GENERALLY FORMED AS
TWO-TIER PARTNERSHIP ARRANGEMENT (cont.)

3. Tax treatment as partnership permits tax-free distributions of nonrecourse financing proceeds.
 - a) April 2019 Proposed OZ Regulations confirm that distribution of financing proceeds to partners does not conflict with OZ rules provided that
 - Partner has sufficient (debt) basis in partnership interest to receive distribution
 - Distribution occurs 2 years or more after OZ Investor makes rollover investment in QOF
 - b) OZ Investor yields enhanced by QOF borrowing and making debt-financed distributions. Should be no recapture at 10-year disposition.

VII. MANY / MOST OZ INVESTMENTS ARE MADE THROUGH JV ARRANGEMENTS.

- a. By their nature, QOFs are money sources.
- b. By their nature, QOZ investments are development projects (capital investment in new property).
- c. Leads to natural marriage of (i) QOF with (ii) project/business developers who have assets under control and who are have proven development capabilities.
- d. “Hot Spots” for JV Arrangements:
 - Two layers of promotes.
 - QOF will need significant reporting and control of JV to ensure continued qualification as QOZB

VII. MANY / MOST OZ INVESTMENTS ARE MADE THROUGH JV ARRANGEMENTS (cont.)



VIII. OZ INVESTMENTS CAN BE IN A “DO IT YOURSELF” QOF OR SYNDICATED QOF

DIY QOF.

1. The term “Fund” (in “Qualified Opportunity Fund”) can be misleading. Relatively easy for a taxpayer to set up a “captive” (wholly owned) QOF.
 - a) All that is required is for taxpayer to form an entity taxed as a partnership that has a limited purpose of investing in Opportunity Zones.
 - b) Taxpayer’s QOF then invests in real estate project or operating business that satisfies (and will continue to satisfy) requirements for QOZB
2. Broadest use of OZ Investments to date has been Real Estate Developers reinvesting gains into new projects

CONSIDERATIONS FOR SYNDICATED OZ INVESTMENTS

A. SINGLE ASSET QOF VS. DIVERSIFIED PORTFOLIO/FUND.

	<i>Single Asset QOF</i>	<i>Diversified Portfolio QOF</i>
<i>Capital Contributions</i>	more predictable/defined	called when/as needed by QOF
<i>10-year Hold Period</i>	more predictable/defined	10 years from last eligible investment
<i>10-year Exit Issue</i>	manageable	currently uncertain
<i>Ability to Fund Long-term capital requirements</i>	limited	spread over portfolio
<i>Risk of Loss</i>	concentrated	spread over portfolio
<i>Failure to Invest</i>	single QOZ investment is specified so low risk	if pipeline of investments have not been secured, at risk for Sponsor closing QOZ investments

CONSIDERATIONS FOR SYNDICATED OZ INVESTMENTS

B. CAPITAL COMMITMENT VS. SINGLE CONTRIBUTION. Do OZ Investors make one-time investment of rollover gain OR have ongoing capital contribution obligation?

<i>Capital Raise Approach</i>	<i>QOF Issues</i>
<u>Capital Calls:</u> QOZ Investors sign up for Capital Calls under Capital Commitment	May not align well with when QOZ Investors sell assets and realize capital gain
<u>Single Contribution:</u> QOZ Investors make single \$\$\$ contribution when they sell assets and realize capital gains	May not align well with when QOF needs \$\$\$ to invest in QOZ Property. Presents problems with 90% Asset Test

CONSIDERATIONS FOR SYNDICATED OZ INVESTMENTS

C. QOF OFFERING PERIOD. How long will Sponsor offer interests in QOF to OZ Investors?

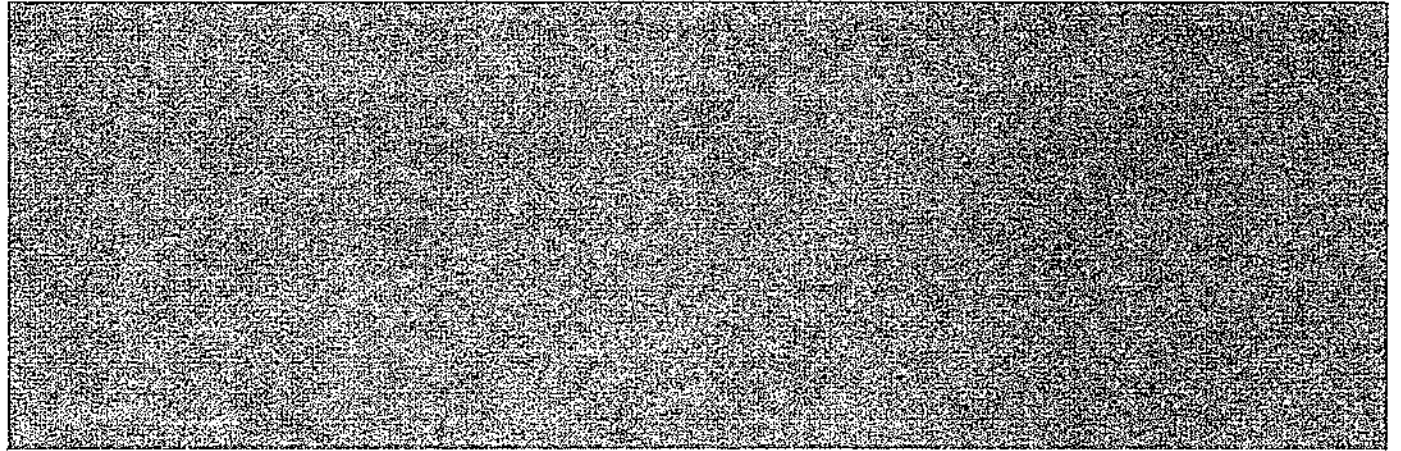
- Longer offering period pushes out the date when OZ Investors can get the benefit of tax-free appreciation on 10-year hold.

D. BLIND POOL VS. SPECIFIED DEVELOPMENT PROJECTS.

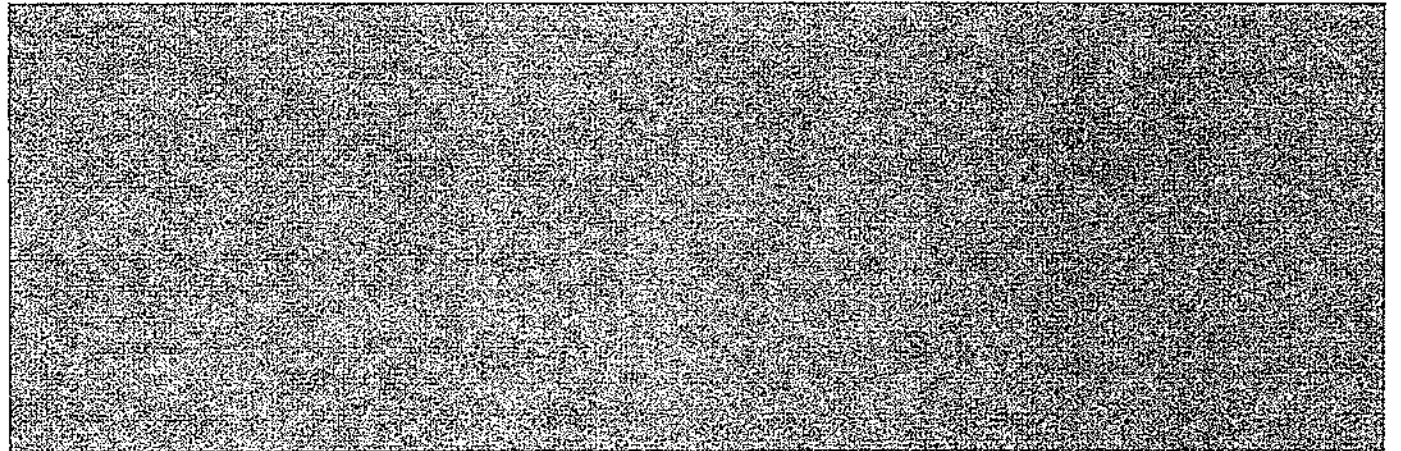
- One year into the QOZ program, the race is on to tie up/control high quality Real Estate investments. Less competition currently with operating & start-up companies.
- Want to select a Sponsor that has proven ability to source OZ investments.

CONSIDERATIONS FOR SYNDICATED OZ INVESTMENTS

- E. VERTICALLY INTEGRATED VS. JV ARRANGEMENTS. Is Sponsor able (with affiliates) to manage acquisition, development and operation independently (vertically integrated) or will Sponsor need to structure QOZ investments as JV arrangements with Developer Partners.
- F. LONG-TERM SOURCES OF CAPITAL. 10-year hold period is a long time. What sources of liquidity will be available to capitalize QOF investments / projects / companies over the long haul?



Q&A





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CREATIVE PLANNING WITH QUALIFIED OPPORTUNITY ZONES

Maximizing Economic Outcomes for Investors, Developers
and Business Owners





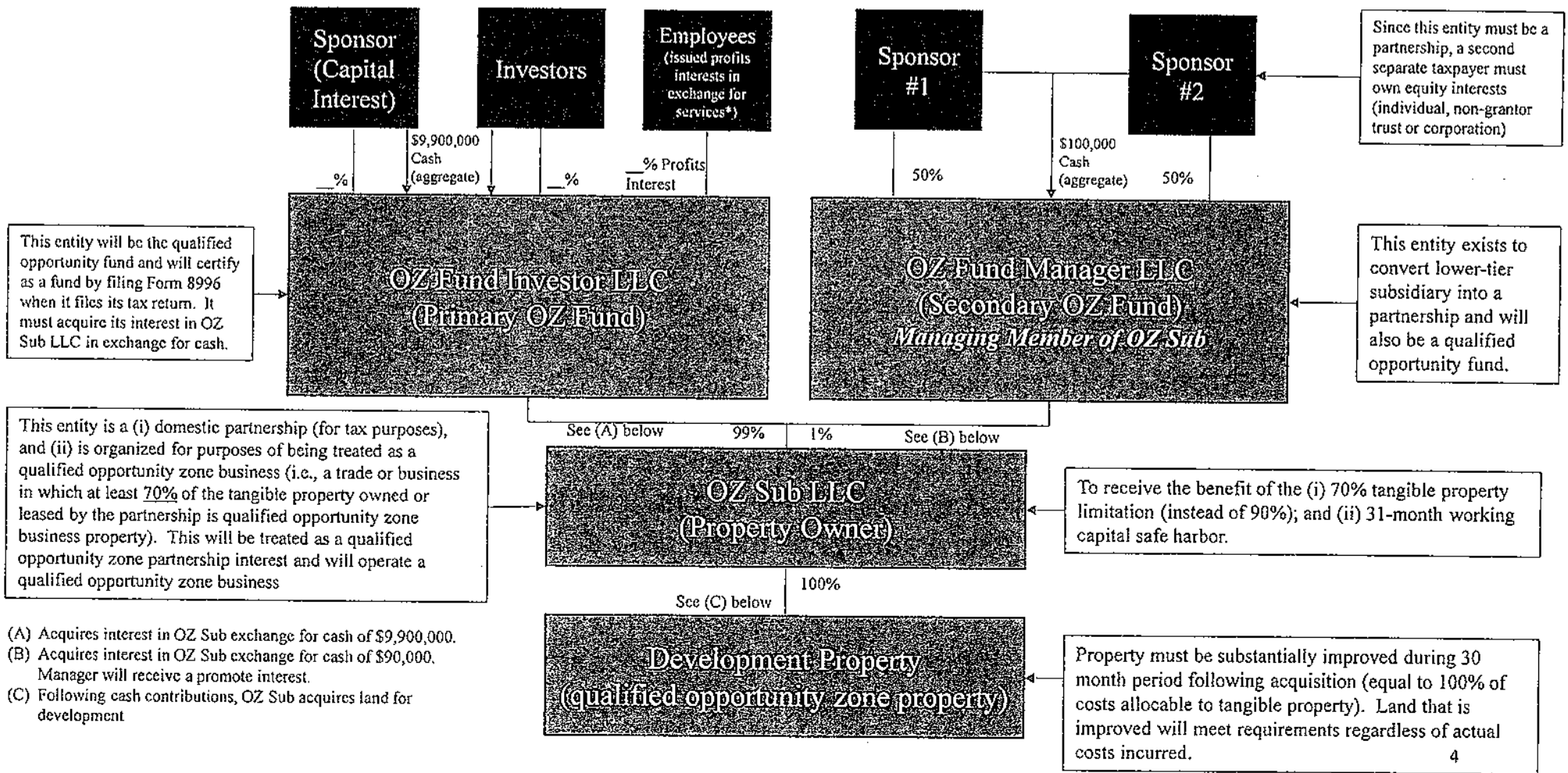
**OVERVIEW OF
QUALIFIED
OPPORTUNITY
ZONES**

QUALIFIED OPPORTUNITY ZONE TAX BENEFITS

A TAXPAYER THAT **REINVESTS CAPITAL GAINS** WITHIN 180 DAYS IN A **QUALIFIED OPPORTUNITY FUND (“QOF”)** IS ENTITLED TO THE FOLLOWING TAX BENEFITS:

1. **CAPITAL GAIN DEFERRAL**. The taxpayer will defer the reinvested capital gains until the earlier of the date of an *inclusion event* or December 31, 2026. In most cases, gains will be deferred until 2026 with the tax liability due in April 2027.
2. **CAPITAL GAIN REDUCTION**. If the taxpayer holds its investment for 5 years prior to the date deferred gains are recognized, 10% of the original capital gain is eliminated. If the taxpayer holds its investment for 7 years prior to the date deferred gains are recognized, an additional 5% of the original capital gain is eliminated.
3. **TAX-FREE APPRECIATION**. If the taxpayer holds its investment for at least 10 years, 100% of the gains at disposition will be **tax-free (including, for real estate, the elimination of depreciation recapture in most cases)**.

EXAMPLE OF QUALIFIED OPPORTUNITY FUND STRUCTURE



CONVERTING QOZ TAX BENEFITS TO INCREASED INVESTMENT RETURNS

Comparison of Internal Rate of Return
Real-Life Institutional Investment

Comparison #1: Tax Rates Remain Unchanged

	<u>IRR</u>	<u>Increase in IRR vs. Baseline</u>
Baseline Scenario (No OZ Tax Benefits)	6.99%	0.00%
Scenario #1 (Deferral Reinvested @ IRR)	10.89%	55.76%
Scenario #2 (Deferral Reinvested at Conservative Rate)	10.26%	46.68%

Comparison #2: Tax Rates Increase by 25%

	<u>IRR</u>	<u>Increase in IRR vs. Baseline</u>
Baseline Scenario (No OZ Tax Benefits)	6.99%	0.00%
Scenario #1 (Deferral Reinvested @ IRR)	11.08%	58.45%
Scenario #2 (Deferral Reinvested at Conservative Rate)	10.29%	47.07%



QOZ PLANNING FOR INVESTORS - OVERVIEW

An investor qualifies for QOZ benefits by:

Causing an **eligible taxpayer** to reinvest **capital gains** (from an **unrelated person**) within **180 days** in exchange for an **eligible interest** in a QOF and making an **election** to defer such gains.

TAX PLANNING OPPORTUNITIES FOR INVESTORS

TIP #1: NO ELIGIBLE GAINS

IF AN INVESTOR DOES NOT HAVE CAPITAL GAINS (YET) BUT WANTS TO INVEST IN A QUALIFIED OPPORTUNITY FUND, THE INVESTOR MAY ACHIEVE IDENTICAL RESULTS BY USING CONVERTIBLE DEBT.

AN INVESTOR MAY USE CONVERTIBLE DEBT THAT IS CONVERTED TO EQUITY AFTER CAPITAL GAINS ARE RECOGNIZED (STRUCTURED WITH IDENTICAL ECONOMICS TO PREFERRED EQUITY)

TAX PLANNING OPPORTUNITIES FOR INVESTORS (CONT.)

TIP #2: STATE TAX PLANNING

INVESTOR INTENDS TO MOVE TO A LOWER TAX STATE IN THE FUTURE. THE INVESTOR MAY BENEFIT BY CHOOSING TO DEFER CAPITAL GAINS NOW THAT ARE NOT SUBJECT TO STATE TAXATION AND RECOGNIZE THE GAINS AFTER MOVING TO A LOWER TAX JURISDICTION. ***NOTE: WATCH OUT FOR STATE LEVEL GAINS FROM PASS-THROUGH ENTITIES THAT WILL REMAIN SUBJECT TO STATE TAX.***

TAX PLANNING OPPORTUNITIES FOR INVESTORS (CONT.)

TIP #3: GRANTOR TRUST PLANNING

IF AN INVESTOR INVESTS IN A QOF BY USING A GRANTOR TRUST (WHICH MAY BE USED AS THE INITIAL INVESTOR OR BY TRANSFERRING AN INTEREST IN A QOF TO A GRANTOR TRUST), THE INVESTOR WILL EFFECTIVELY CAUSE THE GRANTOR TRUST (AT THE DISPOSITION OF THE QOF INTEREST) TO OBTAIN A TAX-FREE STEP UP EVEN IF THE TRUST IS NOT INCLUDED IN THE INVESTOR'S ESTATE FOR ESTATE AND GIFT TAX PURPOSES.

TAX PLANNING OPPORTUNITIES FOR INVESTORS (CONT.)

TIP #4: USING VALUATION DISCOUNTS TO REDUCE GAINS

THE AMOUNT OF GAIN RECOGNIZED AS OF ANY INCLUSION EVENT OR DECEMBER 31, 2026 IS BASED ON THE FAIR MARKET VALUE OF THE INVESTMENT. SINCE FAIR MARKET VALUE IS BASED ON NORMAL VALUATION PRINCIPLES, CLOSELY HELD INTERESTS IN A QUOF WILL BE SUBJECT TO SUBSTANTIAL DISCOUNTS FOR LACK OF CONTROL AND LACK OF MARKETABILITY, AND POTENTIALLY REDUCING THE GAIN RECOGNIZED ON DECEMBER 31, 2026.



**QOZ PLANNING
FOR
*DEVELOPERS***

QOZ PLANNING FOR INVESTORS - OVERVIEW

A real estate developer will form (or collaborate with a fund manager to form) a qualified opportunity fund (“QOF”) that will meet the following requirements and self-certify as a QOF:

1. Organized as a partnership or corporation
2. The QOF must be formed for the purpose of investing in qualified opportunity zone property
3. Hold at least 90% of its assets as qualified opportunity zone property (which is satisfied by holding interests in a qualified opportunity zone business).

TAX PLANNING OPPORTUNITIES FOR DEVELOPERS

TIP #1: USING PROPERTY ACQUIRED PRIOR TO 2018

ALTHOUGH PROPERTY MUST BE ACQUIRED BY THE QOF AFTER DECEMBER 31, 2017, A PROPERTY OWNER MAY **GROUND LEASE** PROPERTY TO A QOF (EVEN IF IT IS A RELATED PARTY) AND THE PROPERTY WILL BE ELIGIBLE FOR QOZ TAX BENEFITS (NOTE THAT USING A GROUND LEASE CAUSES CHALLENGES FOR FINANCING PURPOSES)

TAX PLANNING OPPORTUNITIES FOR DEVELOPERS

TIP #2: USING UPPER TIER PROFITS INTERESTS

A PROFITS INTERESTS THAT IS ISSUED TO AN INVESTOR WILL NOT GENERALLY QUALIFY FOR QOZ TAX BENEFITS. HOWEVER, IF A PARTNERSHIP INVESTS IN A QOF (SUCH THAT THE PARTNERSHIP IS THE INVESTOR), A PROFITS INTERESTS ISSUED BY SUCH ENTITY SHOULD RECEIVE ITS SHARE OF TAX FREE GAINS SINCE THE ELECTIONS WILL BE MADE AT THE PARTNERSHIP LEVEL.

TAX PLANNING OPPORTUNITIES FOR DEVELOPERS

TIP #3: MEETING SUBSTANTIAL IMPROVEMENT TEST

SINCE THE SUBSTANTIAL IMPROVEMENT TEST (REQUIRING IMPROVEMENTS EQUAL TO 100% OF THE ORIGINAL BASIS) IS BASED SOLELY ON THE ALLOCABLE PORTION OF THE BUILDING (LAND IS EXCLUDED FROM THE CALCULATION). BY OBTAINING AN APPRAISAL FOR A RENOVATION PROJECT, A PROPERTY MAY BE ABLE TO MEET TO MEET QOF QUALIFICATIONS BASED ON IMPROVEMENTS THAT EQUAL OR EXCEED THE VALUE OF THE BUILDING.



QOZ PLANNING
FOR *BUSINESS*
OWNERS
(INCLUDING REAL
ESTATE
BUSINESSES)

TAX PLANNING OPPORTUNITIES FOR BUSINESS OWNERS

TIP #1: USING A QOZB

IN MOST CASES, THE USE OF A QUALIFIED OPPORTUNITY ZONE BUSINESS (THAT IS OWNED BY THE QOF) IS PREFERABLE SINCE A QOZB (1) MAY USE THE 31-MONTH WORKING CAPITAL SAFE HARBOR; AND (2) IS ONLY REQUIRED TO HOLD 70% OF ITS ASSETS AS QUALIFIED OPPORTUNITY ZONE PROPERTY (WHICH EFFECTIVELY REDUCES THE AGGGREGATE QOZP REQUIREMENT TO 63% OF THE QOF'S ASSETS).

TAX PLANNING OPPORTUNITIES FOR BUSINESS OWNERS

TIP #2: QUALIFYING AS A TRADE OR BUSINESS

MERELY HOLDING REAL ESTATE SUBJECT TO A TRIPLE NET LEASE MAY NOT BE CONSIDERED A TRADE OR BUSINESS, WHICH IS REQUIRED FOR A QOZB. STRUCTURING LEASE ARRANGEMENTS OR HAVING ADDITIONAL BUSINESS ACTIVITIES WILL MITIGATE THIS RISK.

Thank You

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