OPPORTUNITY ZONES DEMYSTIFIED:

OPPORTUNITIES AND CHALLENGES FOR FUND SPONSORS

May 14, 2019

DISCLAIMER

- This presentation is provided solely for the purpose of enhancing knowledge on tax matters. It does not provide tax advice to any taxpayer because it does not take into account any specific taxpayer’s facts and circumstances.
- These slides are for educational purposes only and are not intended, and should not be relied upon, as tax, accounting or legal advice.

OPPORTUNITY ZONE TAX CREDIT

- Enacted as part of 2017 Tax Reform
- Initial Proposed IRS Regulations issued October 19, 2018
- Additional IRS Proposed Regulations issued April 17, 2019
- Over 8700 designated zones, covering 11% of the US
  - Massachusetts has 138 tracts in 79 communities classified as Opportunity Zones
- Does not preclude other Federal, State and Local Tax Credits
- Over 76 Funds are going to market trying to raise $24 Billion to invest in Qualified Opportunity Zones
- Estimates have over $6 Trillion in unrecognized capital gains

HOW DO TAXPAYERS BENEFIT?

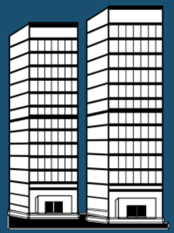
Taxpayers can *defer*
and potentially *reduce*
taxation on capital gains

by making timely
investments in

A Qualified Opportunity
Fund (“QOF”)

which invests in

Opportunity Zone
Property
(Businesses / Real
Estate)



GENERAL OVERVIEW OF TAX BENEFITS

1. Deferral of capital gain
   - Invest Capital Gain in a QOF within 180 days after gain realized.
   - Recognize gain earlier of when sold or 12/31/2026.

2. Exclusion of a percentage of the deferred capital gain
   - Hold investment for 5 years, exclude 10% of gain permanently (through step-up in basis)
   - Hold investment for 7 years, exclude 15% of gain permanently (through step-up in basis)

3. Exclusion of appreciation from taxation
   - If investment in QOF held for at least 10 years, exclude all appreciation from taxation.
   - Investment has to be disposed of by 12/31/2047 to get full step-up in basis

TAX BENEFIT EXAMPLE (PRIVATE EQUITY)

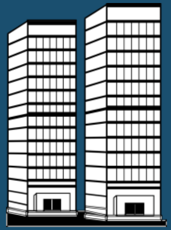
Taxpayers sells IBM Stock on April 15, 2019 for a $500,000 gain ($119,000 potential tax)

Which is invested in the QOF on 9/1/19 (within 180 days of gain recognition)

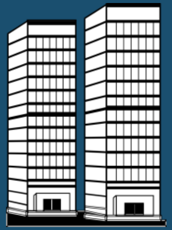
She forms a QOF with another partner, elects to defer gain, and elects QOF treatment

QOF

She finds a business in an OZ to invest in



QOF buys the interests in the business



<u>Sept 2024</u>
10% Exclusion ($50,000 cap gain excluded)

<u>Sept 2026</u>
5% Exclusion ($25,000 cap gain excluded)

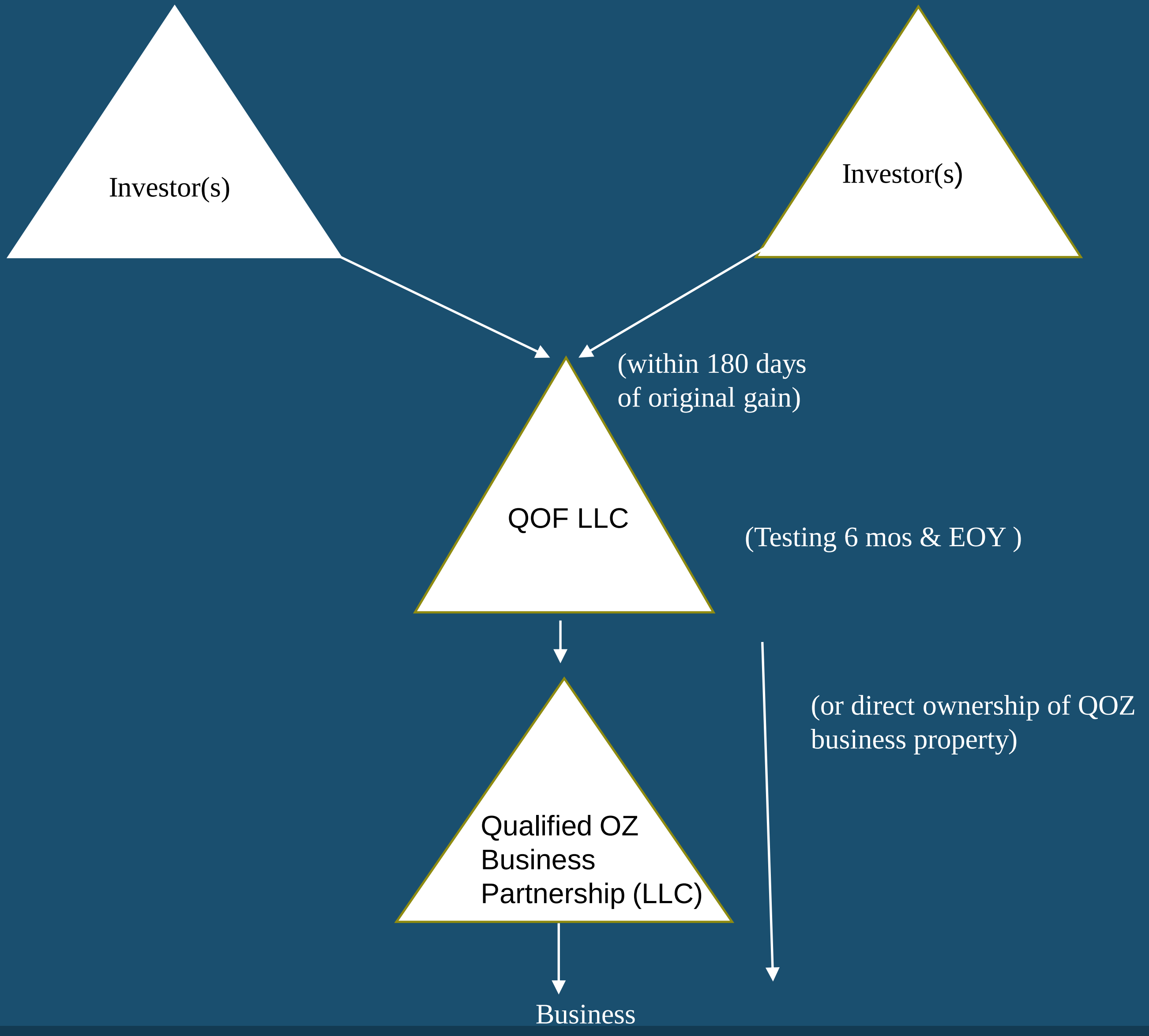
<u>Sells interests after 9/1/2029 for $800,000</u>
Appreciation tax-free (total of $375,000 cap gain excluded from income)

<u>12/31/2026</u>
Tax on $425,000 of remaining deferred gain

BENEFIT – TAX SUMMARY

- Rolled over $500,000 of potential capital gain
- Sold for $800,000 cash in 2029
- Total of all taxes paid from the investment is only $101,150 in taxes in 2026 (assuming tax rate is the same)
- Received $375,000 completely tax free
- Only 12.6% effective tax rate
- Must create QOF and invest by end of 2019 to be eligible for full tax benefits

BASIC “PE / VC” QOF STRUCTURE



GENERAL REQUIREMENTS

- Capital gains have to be re-invested directly in a QOF
- QOF has to hold at least 90% of its assets in "qualified opportunity zone property"
- Only 3 types of Qualified Opportunity Zone Property
  - Qualified opportunity zone business property
  - Qualified opportunity zone stock
  - Qualified opportunity zone partnership interest
- Special rules for cash. Depending on where the cash sits it could be a bad asset for testing purposes.

QUALIFIED OPPORTUNITY ZONE BUSINESSES / PARTNERSHIP
GENERAL REQUIREMENTS

- 70% assets are Qualified Opportunity Zone Business Property
- At least 50% of the gross income is derived from an “Active Trade or Business” in an Opportunity Zone
  - April 2019 Proposed Regulations included 3 Safe Harbors
- A substantial portion of the intangible property of the company is used in the active conduct of the business
- Limitations on nonqualified financial property.
- Stock / interests in QOZB are acquired after 12/31/2017
- Not an excluded business

QUALIFIED OPPORTUNITY ZONE BUSINESS PROPERTY

- Tangible property used in a trade or business of a QOF if:

1. Acquired by purchase or lease by the QOF after 12/31/17
    - Recent Proposed Regulations provided additional guidance on leases
2. Original use commences with the QOF
   or QOF substantially improves the property, and
3. Substantially all of the use of the property is in a QOZ

- Substantial Improvement
  - Over a 30 month period improvements to tangible property (building & equipment)
    - building = cost of building (not counting land)

ONGOING QOF COMPLIANCE

- QOF / QOZB asset testing / asset valuation
- Lease valuation / analysis
- Distribution testing – determine whether inclusion event occurs
- Basis calculations
- Tax Reporting - Initial QOF registration, ongoing tax reporting

RISKS AND UNCERTAINTIES: WHAT TO THINK ABOUT

- Investment Risk
- Tax Rate Risk – what if the capital gains tax rate goes up?
- Regulations are just in proposed form, not finalized
- These are long-term investments – if a QOF sells assets before 10 years creates taxable income / gain
- Capital Call timing issues (both for investors and fund sponsors)
- Depreciation / Debt Financed Distributions

PRIVATE EQUITY CONSIDERATIONS

- Subsequent Closings – be careful not to create an “inclusion event”
- Exit Strategy – asset sale v. interest sale or interest redemption
- Tax Distributions (particularly on December 31, 2026)

OPPORTUNITIES FOR BUSINESSES

- Anyone starting a business in an Opportunity Zone (e.g., a restaurant) should seriously consider structuring ownership through a QOF
  - Enhanced capital market availability –more funds looking to invest in zones
  - Enhanced Exit strategy – QOFs may be looking to purchase eligible businesses

PS&H OPPORTUNITY ZONE LEGAL SERVICES

- Qualified Opportunity Fund formations

  Representation of both Sponsors and Investors
- Full-service Commercial Real Estate, Leasing and Financing Counsel
- Full-service Business Law Group
- Structuring Advice
- Tax Advice

KLR OPPORTUNITY ZONE SERVICES

- Transaction services, including structuring to help ensure that it is both tax compliant and consistent with client’s business objectives and assistance with complex financial modeling and projections
- Comprehensive compliance services, including testing, reporting and certification
- Audit, attest and tax services, including federal, state and local preparation
- Other specialized services including Opportunity Zone Fund investment and business valuations, research and development credit studies, cost segregation studies, investment impact analysis and applications for state tax incentives.

QUESTIONS?

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