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Introduction to

Opportunity Zones

Executive Summary

- Opportunity Zones are an exciting bi-partisan newly enacted part of the US tax code to encourage the redeployment of capital gains into selected low income US census tracts
  - Investments can be in real estate or operating businesses
    - Improvements generally required for real estate – double basis in building
    - Business investments must put cash into the operating entity
- Primary benefits of an OpZone investment using capital gains
  - Defers recognition of the invested gain
    - Up to the earlier of seven years or Dec 31, 2026
  - Reduction of the capital gain
    - by 10% if held 5 years
    - by 15% if held for seven years
    - by any loss on OpZone investment as measured by a FMV appraisal at year 7
  - <u>No capital gains</u> on the OZ investment if held for more than 10 years

Illustrated Economics

OpZone vs Conventional Investment

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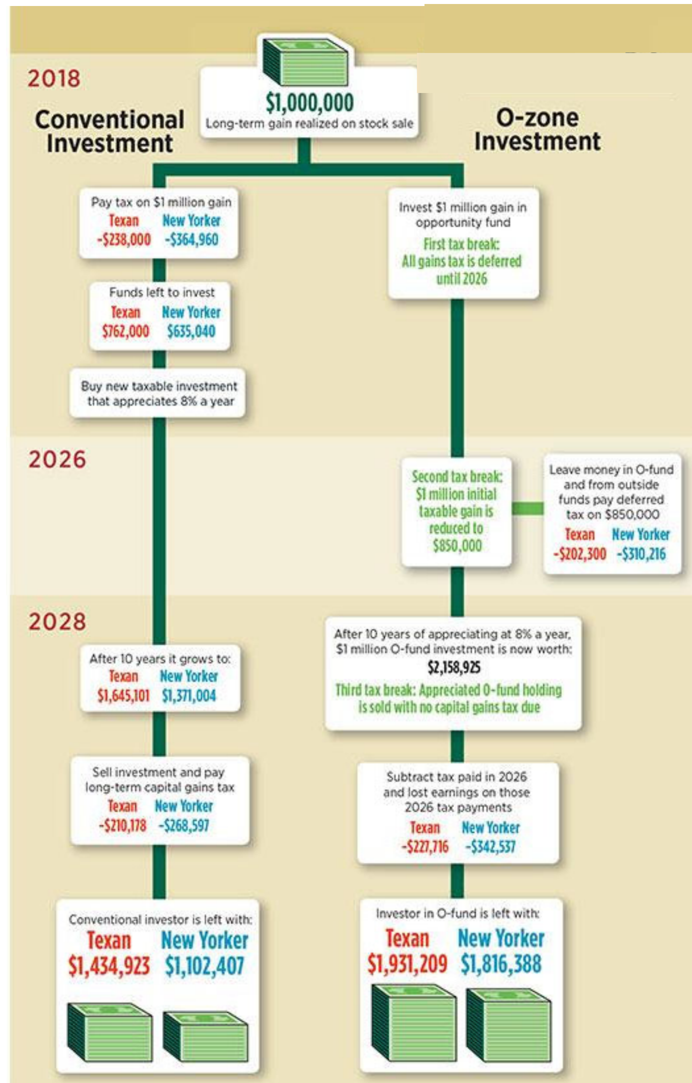

Graphic Source: Forbes

Economic Motivation to Transact

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	1031 Flows or Hold Strategy			OpZone Strategy		
Date	Investment	Taxes	Total	Investment	Taxes	Total
1/1/2019	$ (1,000,000)	$ -	$ (1,000,000)	$ (1,000,000)	$ -	$ (1,000,000)
1/1/2020	$ -	$ -	$ -	$ -	$ -	$ -
1/1/2021	$ -	$ -	$ -	$ -	$ -	$ -
1/1/2022	$ -	$ -	$ -	$ -	$ -	$ -
1/1/2023	$ -	$ -	$ -	$ -	$ -	$ -
1/1/2024	$ -	$ -	$ -	$ -	$ -	$ -
1/1/2025	$ -	$ -	$ -	$ -	$ -	$ -
1/1/2026	$ -	$ -	$ -	$ -	$ (202,300)	$ (202,300)
1/1/2027	$ -	$ -	$ -	$ -	$ -	$ -
1/1/2028	$ -	$ -	$ -	$ -	$ -	$ -
1/2/2029	$ 2,158,925	$ (513,824)	$ 1,645,101	$ 2,158,925	$ -	$ 2,158,925
Net After Tax Profit			**$ 645,101**			**$ 956,625**
IRR			**5.10%**			**6.70%**
OpZone increase in IRR						**1.31 X**

Assumes 8% pretax equity appreciation and 23.8% capital gains rate - Similar numbers for lower and greater appreciation levels

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Opportunity Zones

Overview

Legislative History

- Estimated $5 trillion of capital gains currently being deferred
- Act is designed to incentivize recognition of capital gains and subsequent redeployment into poorer areas
- Principle Supporters
  - Sen Scott (Rep) of South Carolina (rural voice)
  - Cory Booker (Dem) of New Jersey (urban voice)
  - Shaun Phillips – New Tech fortune derived from Napster and Facebook
- Act was incorporated into the 2018 Trump Tax Act
  - Act had a shortage of mechanics - left room for speculation
- Governors designated the Opportunity Zones

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Designated Zones

- Governors designated the Opportunity Zones
  - Picked 25% of the zones meeting the income test
  - Selection completed by Summer of 2018
  - States are now vested in the program
  - Just over 10 % of total tracts - 8,762 tracts out of US and PR's total of 75,000
- Opportunity Zones are low income census tracks
  - Income test only - No other indicators of blight were used such as
    - crime rates
    - high percentage of single parent families
    - School lunch program participants
  - Generally 80% or below of medium state/metro household income
    - Limited number per state can be 125% of medium income if located next to a low income tract
  - 2010 Census Data
    - Some zones have had considerable development in the meantime
      - Brooklyn Waterfront
      - Downtown San Antonio
  - Other anomalies include
    - College towns with University Students – College Station
    - Downtowns with few middle class residents – Houston
- Current Act does not contemplating rezoning

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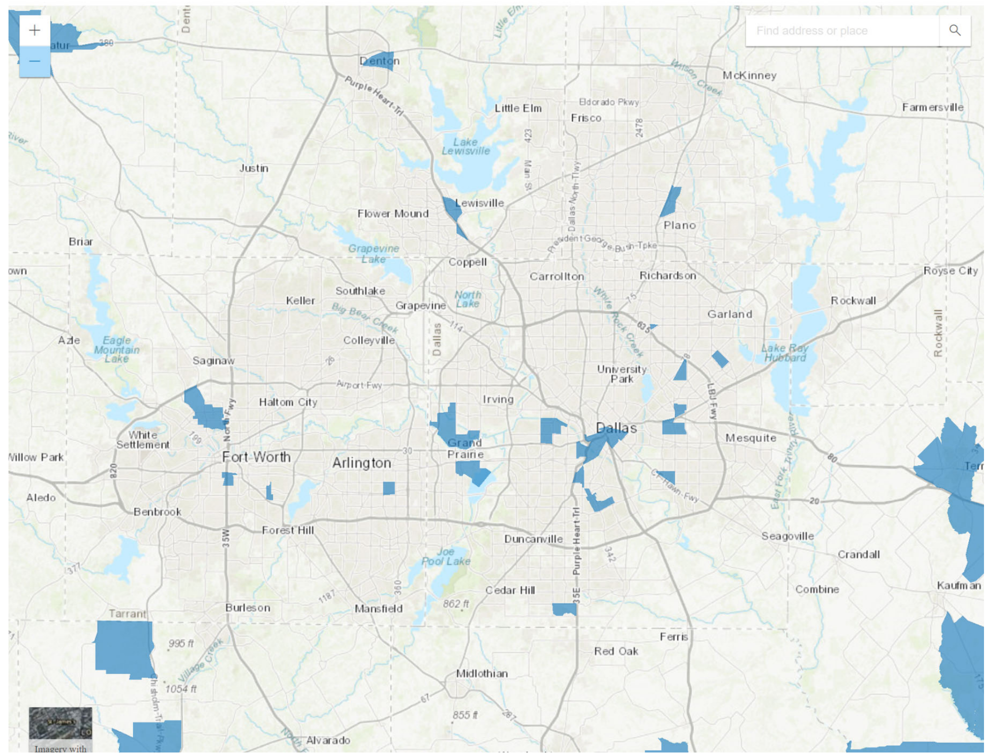
Metroplex Zones



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Regulatory Status – Very Friendly

- First set of regulations released Oct 18, 2018 by the IRS
  - Appears that IRS was told to make these regulations workable
    - No attempts to rein in a nice sounding idea
  - Enforcement is by audit of tax returns
    - No government applications required
  - Regulations ask for comments
- <u>Current regulations can be relied upon</u>
- Another set of regulations dealing with mechanics expected by end of year
- States have indicated a willingness to fast track OpZone Projects

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Capital Gains Required for OpZone Tax Benefits

- To get the favorable tax benefits, the OZ investment must be made from capital gains
- Nearly every type of capital gain qualifies
  - Short Term
  - Long Term
  - Net Commodity trading contracts
  - Gains from transactions with <u>related parties are not eligible</u>
- OZ Investment must be made within 180 days of "recognition" of gain
- Recognition Date for a pass through entity has flexibility
  - Date of Sale
  - Year End
  - Partners don't have to use the same date
- Must invest through a "fund"
  - Can be a simple partnership

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Eligible Investments – Very Broad

- Located in an Opportunity Zone
  - Boundaries are not open for appeal
  - Operating Business must pass asset and income locality tests
- Must be involved in trade or business
  - No primary residence
  - Triple Net Lease might not qualify
- Can be a start up
- If an existing business – substantial improvement required
- Cannot be a Sin Business or golf course
- Purchase must be from an unrelated party
- Purchase must be made after December 31, 2017

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Early Disposition

If an investor sells early:

- IRS guidance says tax deferral can continue if reinvested within 180 days in OpZone
- Likely reinvestment will restart the 10 year hold requirement for no capital gains on sale

Cash out refinance may blow the tax treatment

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Opportunity Zones

Technical Requirements of Properties

Real Estate is a clear opportunity

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Two ways that Real Estate Qualifies

- Purchased after Dec 31, 2017 and the Original Use commences with the Opportunity Zone Business
  - Original Use is not yet defined. The feeling is that a building purchased prior to its Occupancy Certificate would qualify
- The OZ Fund doubles the basis in the building
  - The code explicitly allows for 31 months to improve the basis if the following conditions are met
    - Must be a written plan identifying schedule and expenditures
    - Expenditures must be substantially consistent with the plan
    - Cash for improvement must be held in short term instruments

Example transaction with a building rehab

- Fund has $1 million gain to invest
- Buys existing building in an OpZone for $2 million
  - Borrows $1.5 million - $1 Million for purchase and $500K for rehab
  - FMV appraisal allocated the purchase price as follows
    - Land : $1.5 million
    - Building $0.5 million
  - Fund creates plan to rehab building with remaining $500K still in cash
  - Fund rehabs building in 31 months and doubles the building basis
- 7 Years Hence, Fund investors get FMV appraisal on property
  - Pay the reduced and deferred taxes on $1,000,000 gain ($202k)
  - Reg allow one to use the OpZone Fund as collateral for borrowing
  - (If FMV of the equity is less than $1 million, then gain is reduced)
- 10 years hence, building sells for $5 million
- Fund/Investors pay no capital gains taxes
  - Investors might not have to recapture depreciation

Fund Testing

- 90% of a fund assets at test date must be in some combination of
  - Qualified property
  - Qualified business
- Fund testing is every six months
- Initial test date
  - Last day six months from formation
  - Last day of the year
- Can creates a period of almost a year from Jan 1 gain date
  - 180 days to put into Fund
  - Initial Test date is 6 months
- Modest penalty for failure
  - IRS long term rate * shortfall
  - IE Cost of carry to the IRS

Qualified Business Property

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Can be owned by the Fund directly (1 tier structure)

- Acquired from an unrelated party
  - 20% maximum ownership overlap
- Original use in the zone commences with acquisition for use in the zone
- EG buying a building before the CO is issued

Qualified Business

Fund owns Qualified Business (2 tier structure) and business generally speaking has

- 70% of the tangible assets (owned or leased) must be in the Opzone and be qualified property
  - Property not acquired for Original Use must be substantially improved
  - Working Capital safe harbor for improvement
  - For real estate the improvement test is doubling the basis in the building
  - Test is tied to financial accounting or basis
- 50% of the gross income must be derived from active business in the OpZone
- Substantial portion of Intangible property must by used in the active business in the Opzone
- No more than 5 percent of the average unadjusted basis of its assets may consist of "non-qualified financial property,"
  - Can't make assets of a holding company work

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Strongside Opportunity Funds

Opportunity Zone Funds

Strongside Financial Group is an experienced team that offers expertise in selecting and managing investments in Opportunity Zones.

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