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White Paper:

Expressing the Tax Advantages of Qualified Opportunity Zones:

The Municipal Bond Market as a Guide

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QOZ Tax Adjustments Executive Summary

- QOZs are similar to municipal bonds:
  - <u>Tax advantages are substantial for selected investors</u>
    - Muni – Investors with High Ordinary Rates as bonds are exempt from ordinary income
    - QOZs – Investors with Realized Capital Gains
    - In most states, breaks apply to state level income and capital gain taxes
  - <u>Tax advantages are not readily apparent in pricing</u>
    - AAA Muni's trade with yields below US Treasuries
    - QOZs
      - Located in QOZs which can be riskier locations
      - Require improvement and a 10-year hold for full benefits
- Using Tax adjusted returns can greatly help comparison shopping
    - We have developed a method for demonstrating QOZ Tax adjusted returns
    - Follows the methodology of well accepted tax adjustment process in municipal bond market

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Municipal Bond Market & QOZs

Muni Bonds & U.S. Treasuries

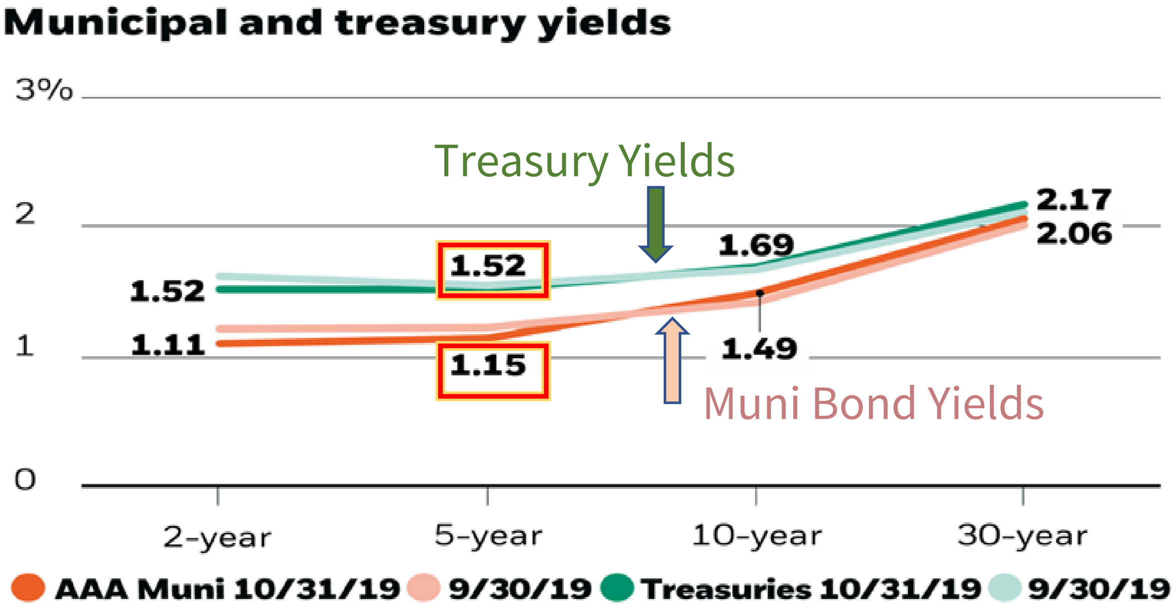
Tax Exempt Municipal Bonds:

- Liquidity concerns
  - Smaller investor pool
  - Smaller issuers
  - Higher Bid Ask spreads
- Hard to analyze – Investors look to:
  - Credit rating agencies
  - Credit Insurance

US Treasuries by contrast

- Highly liquid market
- Credit is considered as "riskless"

Yet Investors pay a premium over US Treasuries and receive lower yields:



Sources: BlackRock; Bloomberg.

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Premium for Tax Exempt Bonds

- The premium for municipal bonds arises from their tax-exempt nature

  High ordinary income tax rate buyers receive higher effective yields

	US Treasury 5 Year	AAA Muni 5 Year
Market Yield	1.52%	1.15%
After Tax Yield (30% rate)	1.06%	1.15%
After Tax Yield (39% rate)	0.93%	1.15%

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Using Tax Adjusted Yields

- The Municipal Bond Market uses Tax Adjusted Yields to help buyers make efficient comparisons to other bonds and CD type investments
- The Tax Adjustment expresses the yield as if the muni bond buyer was going to pay taxes on the bond
  - Calculation is Muni Rate/(1-ordinary tax rate)
  - Eg: 1.15%/(1-.30) = 1.64%

	US Treasury 5 Year	AAA Muni 5 Year
Market Yield	*1.52%*	*1.15%*
Tax Adjusted Yield (30% rate)	1.52%	1.64%
Tax Adjusted Yield (39% rate)	1.52%	1.89%

- The Tax Adjusted Yield shows Muni's sell at an effective discount to US Treasuries
  - Buyers of Muni's are being compensated for lower-liquidity and greater credit risk

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QOZ Tax Adjusted Metrics

Real Estate like bonds price <u>Pre-Tax</u> using:

- Equity Multiple or MOIC
  - Measures total cash generated
- IRR
  - Measures cash generation weighted by time
  - "Can't eat IRR"
- Cash on Cash Yield
  - Measures income during hold period

<u>Yet</u> QOZs offer three significant tax incentives*

- **Deferral** of Recognition of Gain until Dec 31, 2026
- **Reduction** of Recognized Gain
  - 10% if invested prior 12/31/2021
  - Additional 5% reduction if prior to 12/31/19
- **Freedom** from Capital Gains Tax on new investment
  - Must be held for 10 years
  - Cannot be held for more than 30 years
  - Includes depreciation recapture

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**Incentives apply to Federal capital gains taxes and nearly all states also honor QOZ incentives for state level capital gain taxes.*

Pricing QOZ Real Estate Projects

- **Problem**: QOZ tax incentives are at the investor level
  - Most traditional real estate tax incentives are at project level
    - TIFFs, New Market Tax Credits, property tax abatements, etc
  - QOZ incentives are not incorporated into project financials
- **Solution**: Tax adjust to *match after tax dollars* into investor pockets
  - Creates fast and efficient comparison metrics
  - Use accepted Methodology of Municipal Bond Market
- **Examples to Follow**
  - **10 Year project: Takes full advantage of all QOZ benefits**
  - **6 Year project: Takes advantage of the deferral and reduction benefits**

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Tax Adjustments to a 10 year QOZ
Example to Follow

Objective: Tax adjust QOZ metrics to allow comparison shopping using <u>standard</u> before tax metrics

Problem: Tax Adjustments must be simple, sensible, and easy to follow

Solution: Make just <u>two</u> adjustments to deliver **equal after-tax total cash** as QOZ to investor:

- **Year 0:** <u>Reduce the invested capital</u> to reflect upfront tax payment due
  - In a non QOZ case the investor must pay the capital gain tax leaving a smaller balance to invest than with a QOZ project
    - *Note: In a QOZ, the investor defers the recognition of the gain until Dec 31, 2026*
    - *The payment of the deferred (and reduced) tax is captured in the QOZ years 1-10 cash flows*
- **Years 1-10:** <u>Proportionally increase the project cash flows</u> to fund the higher tax burden for a non QOZ project
  - The rationale is one must "own" more of the project to generate the additional distributions to cover the capital gain tax due on sale in a non QOZ.
  - *Note: QOZ project is free of capital gains in year 10 on sale*

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10 Year Tax Adjusted Returns

Build to Hold Project Example

Project Metrics:

- Invest $1000 realized gain
- 12% Income Distributions at Stabilization
  - No Distributions in Years 0-2
  - 50% Stabilized in Year 3
  - Full Yield of $120 in Years 4-10 (assume no growth)
- Sale at end of Year 10
  - $2000 - Cap rate of 6% on Equity
- Total Capital returned is $2900*

Project Returns: (calcs follow)

	Project (Stated)	Tax Adjusted For Federal Taxes Only	Tax Adjusted For Federal and NY State Taxes
Equity Multiple/MOIC	2.90	3.97	4.89
IRR	13.0%	17.3%	20.3%
Cash on Cash	12.0%	16.4%	20.2%

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** In a QOZ, this project generates total net after tax cash flow of $2356* for Fed only payer and $2,242* for a Fed & NY State payer Includes payment of deferred tax on $1000 gain. (see appendix for rate assumptions)*

10 Year QOZ Tax Adjusted Metrics
(Federal Taxes only)

	Year 0 2019	1 2020	2 2021	3 2022	4 2023	5 2024	6 2025	7 2026	8 2027	9 2028	10 2029	Years 1-10 Totals	Years 0-10 IRR	Years 0-10 MOIC	Years 0-10 Total Taxes
QOZ															
QOZ Flows	**$ (1,000)**	**$ -**	**$ -**	**$ 60**	**$ 120**	**$ 120**	**$ 120**	**$ 120**	**$ 120**	**$ 120**	**$ 2,120**	**$ 2,900**	**13.0%**	**2.90**	
Taxes	$ -	$ -	$ -	$ (23)	$ (46)	$ (46)	$ (46)	$ (248)	$ (46)	$ (46)	$ (46)	$ (544)			$ (544)
After-Tax Flows	$ (1,000)	$ -	$ -	$ 37	$ 74	$ 74	$ 74	$ (128)	$ 74	$ 74	$ 2,074	$ 2,356			
Tax Adjusted Without QOZ															
Tax Adjusted Flows	**$ (762)**	**$ -**	**$ -**	**$ 63**	**$ 125**	**$ 125**	**$ 125**	**$ 125**	**$ 125**	**$ 125**	**$ 2,214**	**$ 3,029**	**17.3%**	**3.97**	
Taxes	$ (238)	$ -	$ -	$ (24)	$ (48)	$ (48)	$ (48)	$ (48)	$ (48)	$ (48)	$ (363)	$ (673)			$ (911)
After-Tax Flows	$ (1,000)	$ -	$ -	$ 39	$ 78	$ 78	$ 78	$ 78	$ 78	$ 78	$ 1,851	$ 2,356			

Step 1:
Reduce the invested capital
This model reduces by the 23.8% federal tax rate.

Step 2:
Proportionally increase the project cash flows
This model needs a 4.4% increase in cash flows to match ATAX cash.

Adjustment Check:
Ending ATAX cash balances are now equal

Conclusion:
QOZ tax-adjusted metrics

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10 Year QOZ Tax Adjusted Metrics
(New York and Federal Taxes)

	Year 0 2019	1 2020	2 2021	3 2022	4 2023	5 2024	6 2025	7 2026	8 2027	9 2028	10 2029	Years 1-10 Totals	Years 0-10 IRR	MOIC	Total Taxes
QOZ															
QOZ Flows	**$ (1,000)**	**$ -**	**$ -**	**$ 60**	**$ 120**	**$ 120**	**$ 120**	**$ 120**	**$ 120**	**$ 120**	**$ 2,120**	**$ 2,900**	**13.0 %**	**2.90**	
Taxes	$ -	$ -	$ -	$ (24)	$ (48)	$ (48)	$ (48)	$ (346)	$ (48)	$ (48)	$ (48)	$ (658)			$ (658)
After-Tax Flows	$ (1,000)	$ -	$ -	$ 36	$ 72	$ 72	$ 72	$ (226)	$ 72	$ 72	$ 2,072	$ 2,243			
Tax Adjusted Without QOZ															
Tax Adjusted Flows	**$ (650)**	**$ -**	**$ -**	**$ 66**	**$ 131**	**$ 131**	**$ 131**	**$ 131**	**$ 131**	**$ 131**	**$ 2,322**	**$ 3,176**	**20.3 %**	**4.89**	
Taxes	$ (350)	$ -	$ -	$ (26)	$ (53)	$ (53)	$ (53)	$ (53)	$ (53)	$ (53)	$ (592)	$ (933)			$ (1,283)
After-Tax Flows	$ (1,000)	$ -	$ -	$ 39	$ 79	$ 79	$ 79	$ 79	$ 79	$ 79	$ 1,730	$ 2,243			

NY State Taxes further reduce the capital available to invest.

Ending ATAX cash balances are equal.

A NY State Investor needs to find a non-QOZ deal with these tax-adjusted metrics to have the same cash in the bank at Year 10.

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Tax Adjustments to a 6 year QOZ

Example to Follow –No Tax Freedom

Objective: Show QOZ deferral and reduction benefits while easily comparing to other projects

Solution: Make similar two adjustments to deliver **equal after-tax total cash** as QOZ to investor:

- **Year 0:** Reduce the invested capital to reflect upfront tax payment due
  - In a non QOZ case the investor must pay the capital gain tax leaving a smaller balance to invest than with a QOZ project
    - *Note: In a QOZ, the investor defers the recognition of the gain until Dec 31, 2026*
    - *The payment of the deferred (and reduced) tax is captured in the QOZ years 1-10 cash flows*
- **Years 1-6:** Proportionally adjust (up or down) the project cash flows to **equalize after-tax** investment totals for a non QOZ project
  - Capital gains taxes in year 6 are likely higher for a QOZ as the deferred taxes from year 0 are now due on sale of the investment
  - May need less of the "project" to cover the likely lower year 6 tax burden

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6 Year Tax Adjusted Returns

Build, Fill, and Sell Project Example

Project Metrics:

- Invest $1000 realized gain
- 12% Income Distributions at Stabilization
  - No Distributions in Years 0-2
  - 50% Stabilized in Year 3
  - Full Yield of $120 in Years 4 – 6
- Sale at end of Year 6
  - $2182 - Cap rate of 5.5% on Equity
- Total Capital returned is $2602*

Project Returns: (calcs follow)

	Project (Stated)	Tax Adjusted For Federal Taxes Only	Tax Adjusted For Federal and NY State Taxes
Equity Multiple/MOIC	2.60	3.08	3.44
IRR	18.1%	21.6%	24.0%
Cash on Cash	12.0%	16.4%	20.2%

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** In a QOZ, this project generates total net after tax cash flow of $1918 for Fed only payer and $1663 for a Fed & NY State payer Includes payment of deferred tax on $1000 gain. (see appendix for rate assumptions)*

6 Year QOZ Tax Adjusted Metrics (Federal Taxes only)

Year	0 2019	1 2020	2 2021	3 2022	4 2023	5 2024	6 2025	Years 1-6 Totals	Years 0-6 IRR	 MOIC
QOZ										
QOZ Flows	**$ (1,000)**	$ -	$ -	$ 60	$ 120	$ 120	$ 2,302	**$ 2,602**	**18.1%**	**2.60**
Taxes	$ -	$ -	$ -	$ (23)	$ (46)	$ (46)	$ (570)	$ (684)		
After-Tax Flows	$ (1,000)	$ -	$ -	$ 37	$ 74	$ 74	$ 1,761	$ 1,918		
Tax Adjusted Without QOZ										
Tax Adjusted Flows	$ (762)	$ -	$ -	$ 54	$ 108	$ 108	$ 2,079	**$ 2,350**	**21.6%**	**3.08**
Taxes	$ (238)	$ -	$ -	$ (21)	$ (41)	$ (41)	$ (329)	$ (432)		
After-Tax Flows	$ (1,000)	$ -	$ -	$ 34	$ 67	$ 67	$ 1,750	$ 1,918		

Sale in 2025 triggers payment of the 2019 deferred capital gains taxes and since the sale occurs prior to a 10-year hold, the QOZ tax freedom on the sale is not available. Nevertheless, the QOZ is tax-advantaged.

Conclusion:
Tax-adjusted metrics show the power of Deferral and Reduction.

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6 Year QOZ Tax Adjusted Metrics (New York and Federal Taxes)

	0	1	2	3	4	5	6	Years 1-6	Years 0-6	
Year	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**Totals**	**IRR**	**MOIC**
QOZ										
QOZ Flows	**$ (1,000)**	$ -	$ -	$ 60	$ 120	$ 120	$ 2,302	**$ 2,602**	**18.1%**	**2.60**
Taxes	$ -	$ -	$ -	$ (24)	$ (48)	$ (48)	$ (819)	$ (939)		
After-Tax Flows	$ (1,000)	$ -	$ -	$ 36	$ 72	$ 72	$ 1,483	$ 1,663		
Tax Adjusted Without QOZ										
Tax Adjusted Flows	$ (650)	$ -	$ -	$ 52	$ 103	$ 103	$ 1,979	**$ 2,237**	**24.0%**	**3.44**
Taxes	$ (350)	$ -	$ -	$ (21)	$ (41)	$ (41)	$ (470)	$ (573)		
After-Tax Flows	$ (1,000)	$ -	$ -	$ 31	$ 62	$ 62	$ 1,509	$ 1,663		

NY State Taxes further reduce the capital available to invest.

A NY State Investors needs to find a non-QOZ deal with these tax-adjusted metrics to have the same cash in the bank at Year 10.

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FAQs

- **The MOIC and IRR appear reasonable for a build to hold return. However, the project is in a QOZ and does not seem that I am being compensated for it?**
  - This is what the QOZ tax adjusted return helps answer. A muni bond that yields less than a Treasury appears to not compensate the buyer. Showing a tax adjusted yield makes comparisons much easier and allows the investor to gauge if the effective higher tax adjusted return is fair compensation.
- **Why don't I pursue three 3.33-year build projects with higher IRRs rather than this 10-year build to hold QOZ with a lower IRR?**
  - Using a QOZ tax adjusted return, the investor can gauge what type of shorter-term projects one needs to string together to match the same after-tax cash in the bank at year 10.
- **Why do you suggest matching year 10 after tax cash totals rather than the 10 year after tax IRRs in your adjustment process?**
  - Banks take cash deposits not IRR deposits. You can't eat IRR.

Conclusion

- **Tax Adjusting QOZ metrics works**
  - Allows efficient comparison of QOZ projects using standard metrics
  - Follows well established muni market methodology
- **Use two step proposed methodology to match after tax cash flow**
  - Easy to follow – matches after tax cash in the bank
  - Reflects investors options in QOZ as compared to a non QOZ
    - Works with any hold period: 1-29 years
      - Tax Deferral on initial capital gain is available until Dec 31, 2026
      - Maximum QOZ hold is 29 years
    - Quantifies:
      - Deferment
      - Reduction if held for 5 years
      - Tax Freedom if held for 10 years
- **Tax Adjusted QOZ metrics can illustrate the material advantages of a QOZ**

  Across the two examples (partial and full benefits):
    - Equity Multiples improved by as much as 68%
    - IRRs improved by as as much as 53%

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Appendix
Tax Rate Assumptions

Income Type	Federal Only	Federal + New York State
Ordinary Income	38.0%	40.0%
Capital Gains	23.8%	35.0%

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