Opportunity Zones Program: Qualified Funds and Related Tax Incentives

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The Opportunity Zones Program was created as part of the 2017 tax reform package (Tax Cuts and Jobs Act). Its goal is to drive long-term capital to distressed communities by providing tax benefits on investments in Opportunity Funds. The program will allow U.S. investors to receive a temporary tax deferral and other tax benefits when they reinvest unrealized capital gains into Opportunity Funds for a minimum of five years.

Definitions:
<u>Opportunity Zone</u>: A census tract which has been designated by the governor of its state as eligible to receive private investments through Opportunity Funds.
<u>Opportunity Fund</u>: A private investment vehicle, certified by the U.S. Department of the Treasury (the "Treasury"), to aggregate and deploy capital in Opportunity Zones for eligible uses defined as 'Opportunity Zone Property.'
<u>Opportunity Zone Property</u>: Asset types eligible for investment under the Opportunity Zones Program. These include: stock in a domestic corporation; capital or profits interest in a domestic Partnership; and tangible property used in a trade or business of the Opportunity Fund that substantially improves the property.

Opportunity Zone Certification (IRC §1400Z–1)

The Opportunity Zone Program uses low-income community census tracts as the basis for determining areas eligible for an Opportunity Zone designation. Per state or territory, up to 25% of the total number of census tracts that meet the eligibility requirements can be designated as an Opportunity Zone (i.e., if a state has 136 low-income census tracts, up to 34 may be designated as Opportunity Zones). States or territories with less than 100 low-income communities may designate up to 25 Opportunity Zones. Additionally, up to 5% of a state's Opportunity Zones may be census tracts that are continuous to a low-income tract (subject to the median family income of the contiguous tract not exceeding 125% of the median family income of the low-income tract).

Opportunity Zones are designated by the governors of states and territories. Governors had 90 days from the enactment date of the program (which was December 22, 2017) to submit a list of designated census tracts for approval (the "Determination Period"). The Treasury must approve or provide feedback within 30 days of the governor's submission (the "Consideration Period"). Both the Determination Period and Consideration Period can be extended for a period of 30 days. Opportunity Zone designations last for a period of 10 years (the "Designation Period"), at which point the certification process will take place again.

Governors had until March 21, 2018 to submit their recommendations for Opportunity Zone designations, unless the state requested a 30-day extension (to April 20, 2018). If a Governor failed to submit Zone nominations, that Governor would effectively be opting out of the program, rendering the state ineligible to receive private investment encouraged through Opportunity Zones tax benefits over the next decade. On April 9, 2018, the Treasury designated Opportunity Zones in 15 states and 3 territories – issuing approvals for all states and territories that submitted Opportunity Zone nominations by the March 21 deadline. On April 19, 2018, five additional states and one territory had their nominations approved. An additional 25 states, Washington, D.C., and Guam had their nominations confirmed on May 18, 2018. Every eligible state and territory nominated census tracts for Opportunity Zones designation, and as of June 18, 2018, the final four states' submissions were approved.

Opportunity Funds (IRC §1400Z–2)

Opportunity Funds are a new class of investment vehicles (organized as a corporation or a partnership) that specialize in aggregating private investment and deploying that capital in Opportunity Zones to support Opportunity Zone Property. Opportunity Funds can be a partnership, corporation, or limited liability company. Investors receive either stock or an interest in the Opportunity Fund. The statute does not limit the number of funds that can be created, nor does it provide instruction on the nature of investments (i.e., risk/return profile).

Qualified Opportunity Funds are required to hold at least 90% of assets in qualified Opportunity Zone Property. The percentage of assets is measured twice yearly, "on the last day of the first 6-month period of the taxable year of the fund, and on the last day of the taxable year of the fund" (i.e., if a fund uses the calendar year as its taxable year, the dates of measurement will be June 30 and December 31). Funds that fail to meet the 90% standard are subject to penalties for each month in which they fail to meet the 90% standard. The penalty is "the amount equal to 90 percent of its aggregate assets, over (ii) the aggregate amount of qualified opportunity zone property held by the fund, multiplied by the underpayment rate established under [Code] section 6621(a)(2)" for each month a fund fails to meet the required threshold.

To become a Qualified Opportunity Fund, an eligible taxpayer self-certifies. Thus, no approval or action by the IRS is required. To self-certify, a taxpayer completes a form (which will be released in the summer of 2018) and attaches that form to the taxpayer's federal income tax return for the taxable year. (The return must be filed timely, taking extensions into account.) Given the straightforward nature of statute requirements, it is unclear whether additional qualifications will be considered. The timeline for the availability of additional guidance is not yet known.

Tax Incentives (IRC §1400Z–2)

If an investor realizes a gain from the sale or exchange of a capital asset to an unrelated party, the investor must invest in an Opportunity Fund within 180 days after the sale or exchange to be eligible for the program's tax incentives. No upfront subsidy is provided to investors; all tax incentives are linked to the duration of the qualified investment. The provision has two main incentives:

- Temporary deferral of inclusion in gross income for capital gains that are reinvested into Opportunity Funds. Investors are free to invest cash in Opportunity Fund investments in any amount; however, the portion an Opportunity Fund investment that is invested in excess of the capital gain amount is not eligible for the tax exemption.

-Investors can roll existing capital gains into Opportunity Funds with no up-front tax bill.

-If investors hold their Opportunity Fund investments for five years, the basis of their original investment is increased by 10% of the amount of deferred capital gains (meaning they will only owe taxes on 90% of the remaining basis outside of rolled-over capital gains). If investors hold for seven years, the basis increases by a further 5% of the amount of deferred capital gains.

-Investors can defer their original tax bill until December 31, 2026 at the latest, or until they sell their Opportunity Fund investments, if earlier.

• Exclusion from taxable income of capital gains on Opportunity Fund investments held for at least 10 years. If an investor holds its investment in an Opportunity Fund for 10 years, the investor can elect to have the basis of the investment equal the fair market value of the investment as of the date of sale or exchange. In other words, after settling their original tax bill, investors in Opportunity Funds who maintain their investments for 10 years will face no capital gains taxes on their Opportunity Zone investments. As a final note, losses associated with investments in Opportunity Funds should be recognized as under pre-Tax Cuts and Jobs Act law.

As an illustration of an Opportunity Zone investment and the financial benefits associated making such an investment, we have outlined a sample ten year holding period making the following assumptions regarding the investment:

Purchase Price:	$50,000,000
Load:	12.0%
Investment Cost:	$56,000,000
Financing:	$25,000,000 (4.4% Interest; 30 Year Amortization)
Rolled Over Investment	$31,000,000
Deferred Capital Gain	$15,500,000
Initial Investment Tax Basis	$40,500,000

A summary of the cash flows generated by our sample investment over a ten year period are as follows:

For the Years Ending	2018 Year 1	2019 Year 2	2020 Year 3	2021 Year 4	2022 Year 5
Annual Income					
NOI	$2,750,000	$2,818,750	$2,889,219	$2,961,449	$3,035,485
Financing	$1,502,283	$1,502,283	$1,502,283	$1,502,283	$1,502,283
Cash Flow	$1,247,717	$1,316,467	$1,386,936	$1,459,166	$1,533,203
Cash-on-Cash Return	4.02%	4.25%	4.47%	4.71%	4.95%
After Tax Cash Flow					
Depreciation	$1,454,545	$1,454,545	$1,454,545	$1,454,545	$1,454,545
Interest Expense	$1,375,000	$1,375,000	$1,375,000	$1,375,000	$1,375,000
After Tax Income	-$79,545	-$10,795	$59,673	$131,904	$205,940

Income Taxes Due	$0	$0	$20,886	$46,166	$72,079
After Tax Cash Flow	$1,247,717	$1,316,467	$1,366,050	$1,413,000	$1,461,124
Cash-on-Cash Return	4.02%	4.25%	4.41%	4.56%	4.71%

For the Years Ending	2023 Year 6	2024 Year 7	2025 Year 8	2026 Year 9	2027 Year 10
Annual Income					
NOI	$3,111,373	$3,189,157	$3,268,886	$3,350,608	$3,434,373
Financing	$1,502,283	$1,502,283	$1,502,283	$1,502,283	$1,502,283
Cash Flow	$1,609,090	$1,686,874	$1,766,603	$1,848,325	$1,932,090
Cash-on-Cash Return	5.19%	5.44%	5.70%	5.96%	6.23%
After Tax Cash Flow					
Depreciation	$1,454,545	$1,454,545	$1,454,545	$1,454,545	$1,454,545
Interest Expense	$1,375,000	$1,375,000	$1,375,000	$1,375,000	$1,375,000
After Tax Income	$281,827	$359,611	$439,340	$521,063	$604,828
Income Taxes Due	$98,639	$125,864	$153,769	$182,372	$211,690
After Tax Cash Flow	$1,510,450	$1,561,010	$1,612,834	$1,665,953	$1,720,401
Cash-on-Cash Return	4.87%	5.04%	5.20%	5.37%	5.55%

Given the uneven cash flows associated with the tax benefits of an Opportunity Zone investment, we believe the most appropriate return metric is an internal rate of return (IRR) calculation. Below is a summary of the applicable after-tax cash flows if investing into the same investment both **WITHIN** an Opportunity Fund and **OUTSIDE** an Opportunity Fund:

For the Years Ending	2018 Year 1	2019 Year 2	2020 Year 3	2021 Year 4	2022 Year 5
Outside an OZ					
Cash Flows	$1,247,717	$1,316,467	$1,366,050	$1,413,000	$29,504,339
After Tax IRR (5 Year Sale)	2.57%				
Cash Flows	$1,247,717	$1,316,467	$1,366,050	$1,413,000	$1,461,124
IRR (10 Year Sale)	5.76%				

For the Years Ending	2023 Year 6	2024 Year 7	2025 Year 8	2026 Year 9	2027 Year 10
Outside an OZ					
Cash Flows					
After Tax IRR (5 Year Sale)					
Cash Flows	$1,510,450	$1,561,010	$1,612,834	$1,665,953	$36,907,696
IRR (10 Year Sale)					

As is indicated above, the IRR if investing under the parameters outlined above into a property which is **OUTSIDE** an Opportunity Fund would be 2.57% over a five-year period or 5.76% over a ten-year period.

For the Years Ending	2018 Year 1	2019 Year 2	2020 Year 3	2021 Year 4	2022 Year 5
Within an OZ					
Cash Flows	$1,247,717	$1,316,467	$1,366,050	$1,413,000	$29,814,339
IRR (5 Year Sale)	2.76%				
Cash Flows	$1,247,717	$1,316,467	$1,366,050	$1,413,000	$1,461,124
IRR (10 Year Sale)	6.76%				

For the Years Ending	2023 Year 6	2024 Year 7	2025 Year 8	2026 Year 9	2027 Year 10
Within an OZ					
Cash Flows					
IRR (5 Year Sale)					
Cash Flows	$1,510,450	$1,561,010	$1,612,834	-$969,047	$44,205,416
IRR (10 Year Sale)					

The IRR if investing under the parameters outlined above into a property which is **WITHIN** an Opportunity Fund would be 2.76% over a five-year period or 6.76% over a ten-year period.

Conclusion

Using our hypothetical investment as outlined above, over a five year holding period, an investment in an Opportunity Fund-held property has an IRR that is 19 basis points higher than if the same property were held outside of an Opportunity Fund (2.76% IRR versus 2.57% IRR). Looking at the same hypothetical investment with a ten year holding period, the IRR spread between the two investment scenarios increases to 100 basis points (6.76% IRR for an Opportunity Fund investment, 5.76% IRR for a non-Opportunity Fund investment).