Qualified Opportunity Zone Update

December 9, 2020

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Moderator: Steve Martens

Today's Agenda

1. Overview of Qualified Opportunity Zones, "Qualified Opportunity Funds" ("QOFs"), and "Qualified Opportunity Zone Businesses ("QOZBs")

2. Selected Recent Transactions

3. Qualified Opportunity Zones in the Biden Administration

4. Q&A

QOZ Overview

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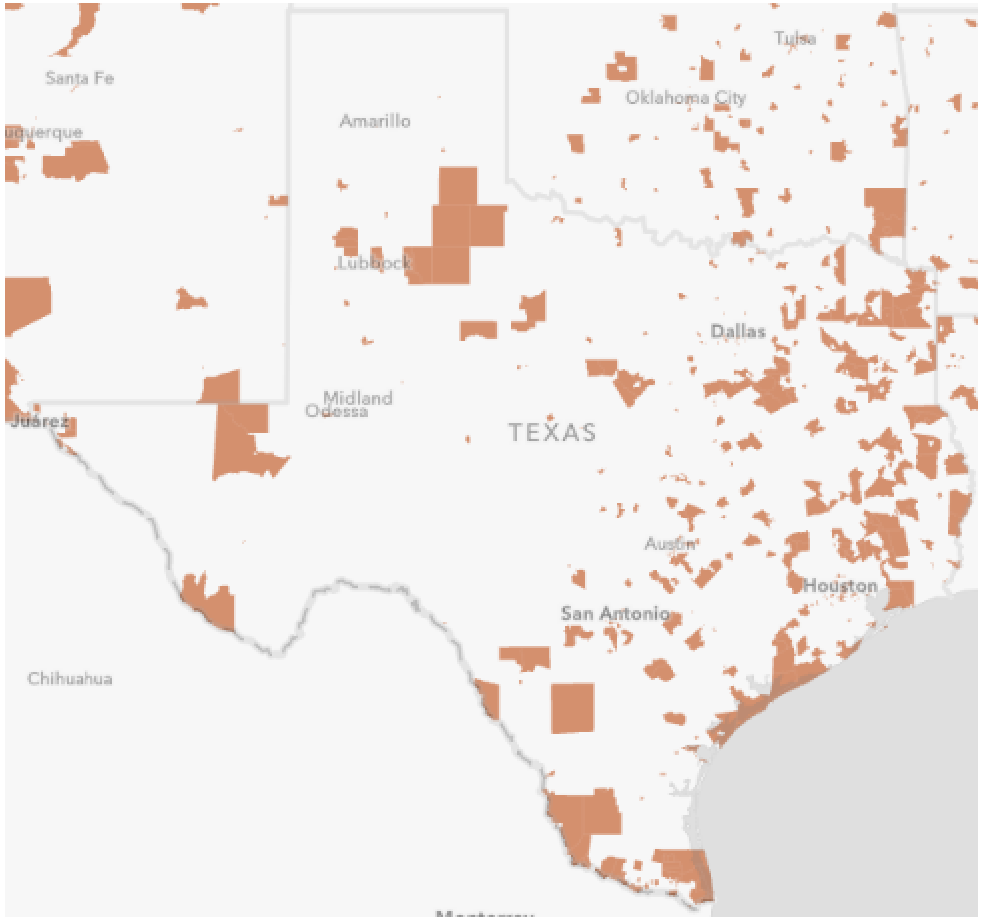
What is a "Qualified Opportunity Fund"?

- Big picture: a QOF is a corporation or partnership in which taxpayers can "roll over" capital gains and obtain special tax benefits.

- A QOF must invest in specific geographic regions, called Opportunity Zones or QOZs. Generally, these are low-income areas that the state government has nominated.

- Interactive QOZ maps are available online (just Google, e.g., "opportunity zone map")

Texas Opportunity Zone Map



Who Benefits from QOFs?

Real Estate Sellers: May benefit from a higher selling price if selling Opportunity Zone asset that is ripe for development or redevelopment to a QOF (or QOFs) that are competing for opportunities to deploy capital.

Real Estate Investors: May obtain tax benefits only if "rolling over" capital gains, and especially if prepared to hold 10 years.

Real Estate Developers/Sponsors: May obtain a lower cost of capital (or charge a higher promote) in exchange for a promise to pursue QOF tax benefits for investors (but cannot obtain tax benefits directly for carried interest / promote).

Tax Benefits for Investors

- Taxpayers can **<u>defer and potentially reduce</u>** taxes on capital gains (the "old gains") by rolling the gains over into a QOF. QOF investments in 2020 would defer the taxation of the old gains until 2026 and reduce the amount of gain reported by 10% (so 90% would be taxed at 2026 rates).

- **<u>In addition, any subsequent appreciation ("new gain") in the QOF attributable to the gain rollover is tax-free if the investment is held for 10 years.</u>**

- A QOF may accept non-capital gain rollovers, but such investment achieves **<u>neither</u>** of these benefits and would be an considered an ordinary fund investment. A QOF interest can be bifurcated for this purpose (so there may be only a partial exclusion after 10 years).

Structuring a QOF Deal

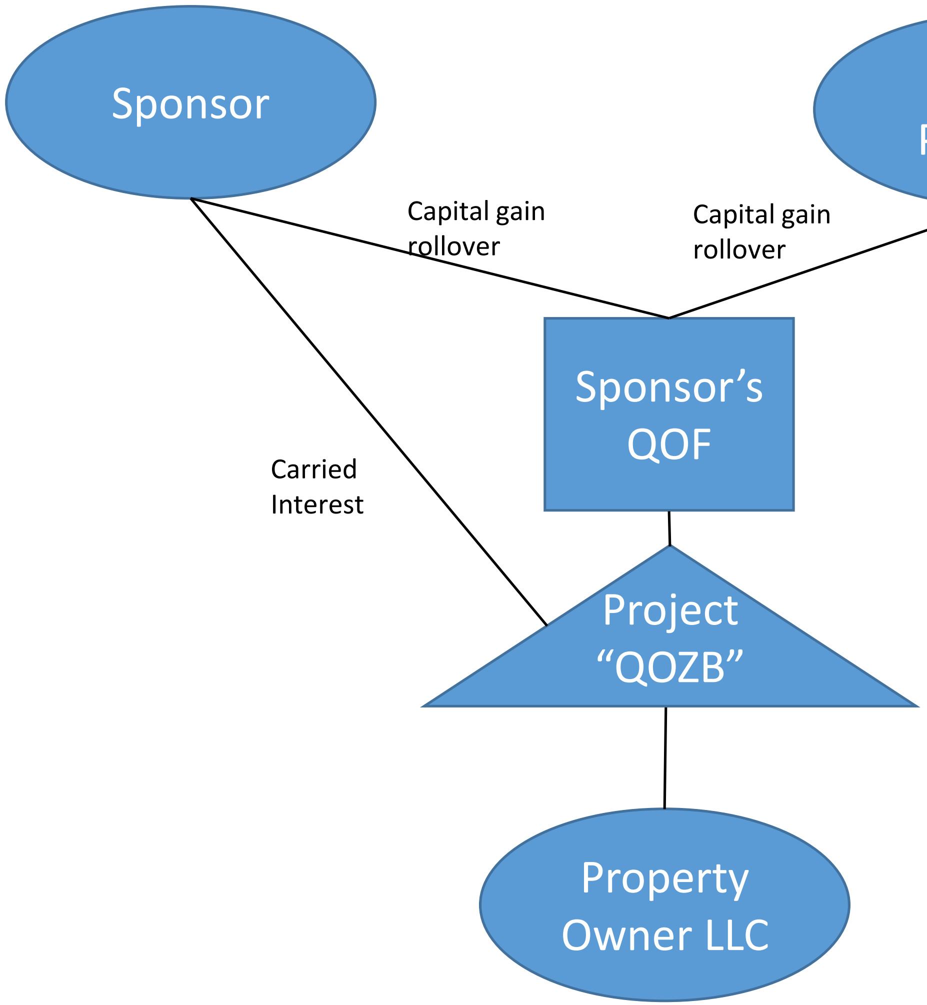
- The QOF statutory and regulatory environment makes QOF deal structuring unusually “persnickety.” There are many traps for the unwary.

- Tax counsel with a focus on QOFs must be involved from the outset in deal structuring.

Traps and Pitfalls

- The source of a capital gain rollover must not be a sale to a related person.
- “Circle of cash” and “related party” problems with trying to get existing assets into QOF/QOZB solution.
- There are strict timing requirements for when cash must be funded into a QOF and funded by a QOF into a QOZB.
- There must be exactly two tiers of tax-regarded entities (the QOF and the QOZB). QOZBs cannot own tax-regarded subs.
- Leveraged distributions can cause gain recapture unless there has been at least 2 years from the most recent equity funding.
- Leases by the QOZB that are either (1) triple-net or (2) to a “sin business” can cause problems.
- …and more!

Basic QOF Fund Structure

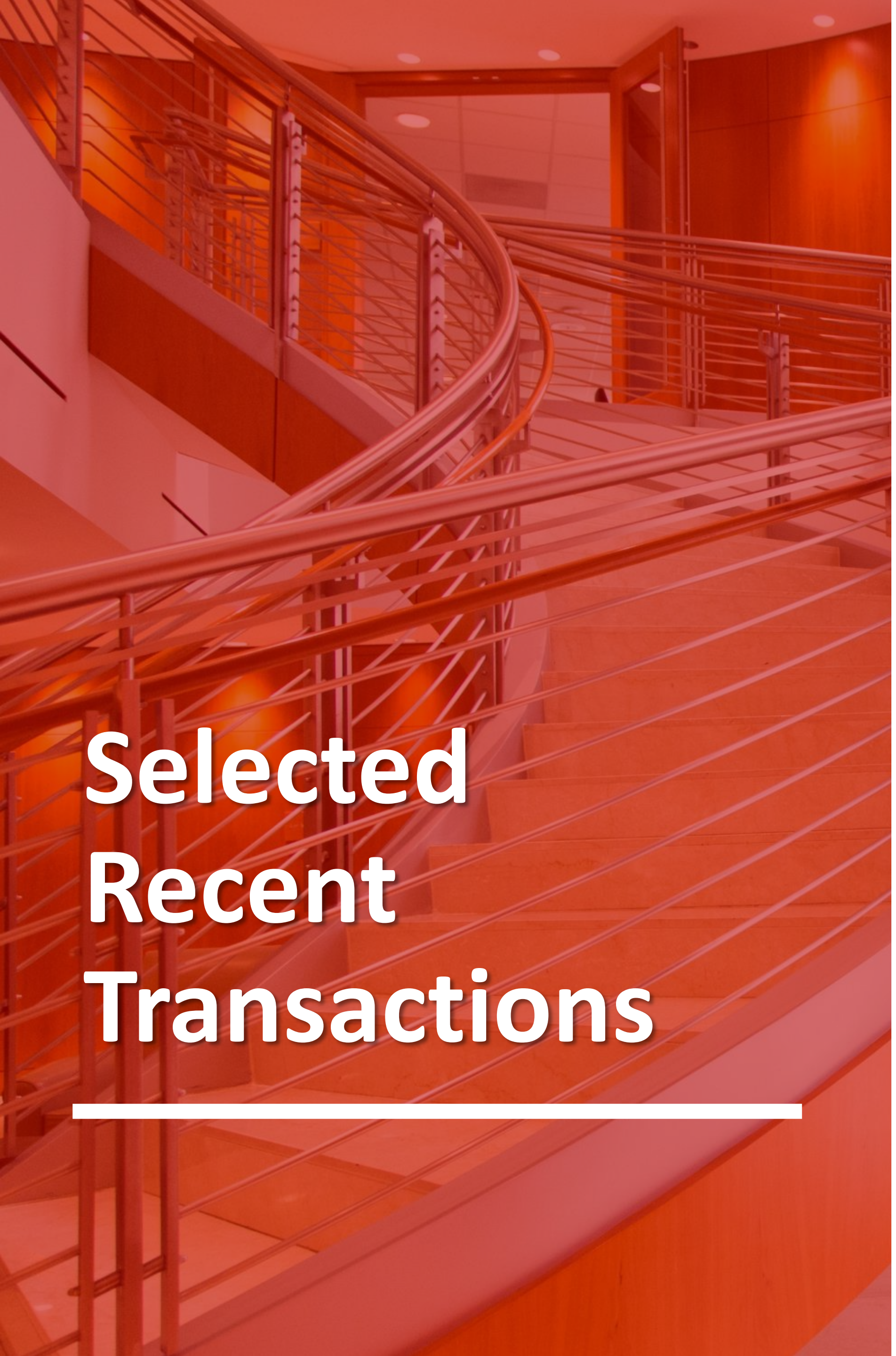


“Qualified Opportunity Zone Businesses”

- As a practical matter, even a simple real estate development by a QOF must be done through one of these tax-regarded “QOZBs.”
- Because the QOZB must be tax-regarded, there must be a second owner who does not invest through the QOF. A carried interest probably suffices.
- A QOZB must be funded in cash and must meet a 70% asset test.
- QOZBs generally must operate (at least initially) under a “working capital plan”
- A QOZB must meet a 50% active income test.
- A QOZB cannot operate, or lease more than *de minimis* property to, a “sin business.”
- A QOZB generally cannot be an IP holding company.
- The QOZB cannot own more than a *de minimis* amount of financial assets or lower-tier entity interests (implicitly disqualifying some financial businesses).

COVID-19 Update

- The COVID-19 emergency declaration, currently in effect between 4/1/2020 and 12/31/2020, has several QOF implications.
- Any 2020 asset test failures must still be reported, but are excused with automatic “reasonable cause” relief.
- Any “capital gain rollover” deadline between 4/1/2020 and 12/31/2020 is now extended to 12/31/2020.
- “Substantial improvement” deadline tolled during this time.
- Any working capital plan funded before 12/31/2020 benefits from an extra 24 months for a “working capital plan” (extending it to 55 months).
- QOFs have an extra year to hold any cash proceeds to reinvest.



Selected Recent Transactions

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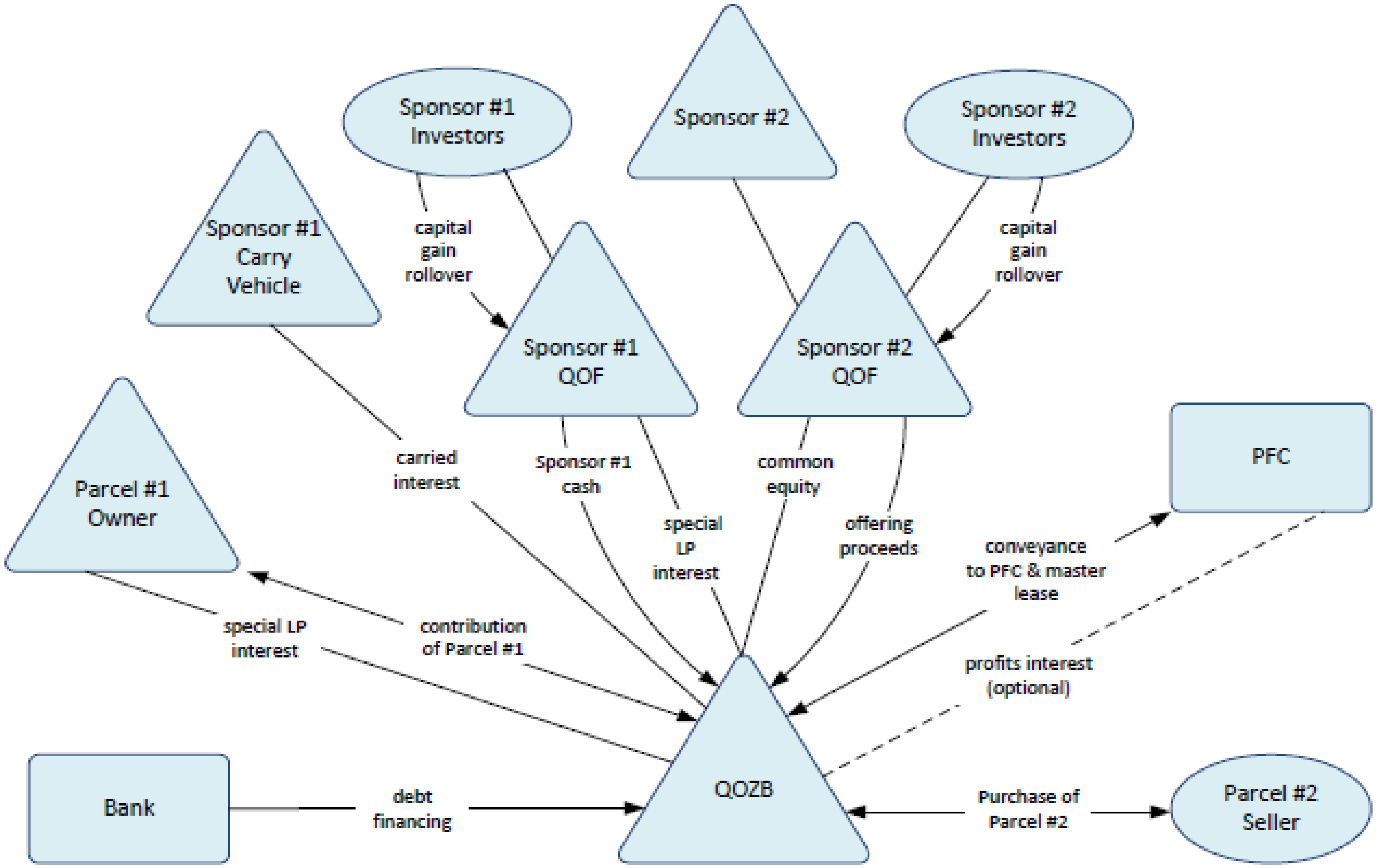
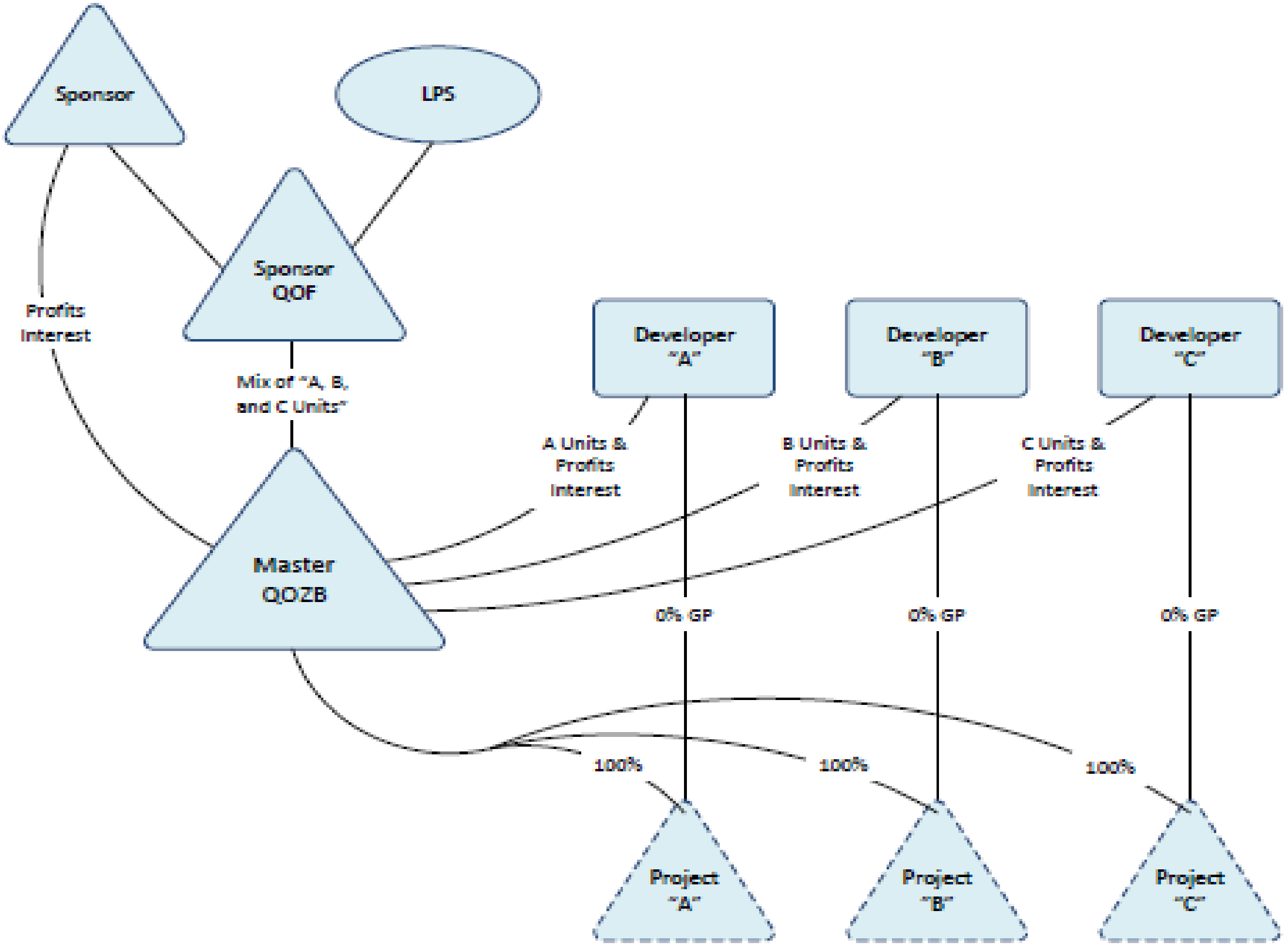
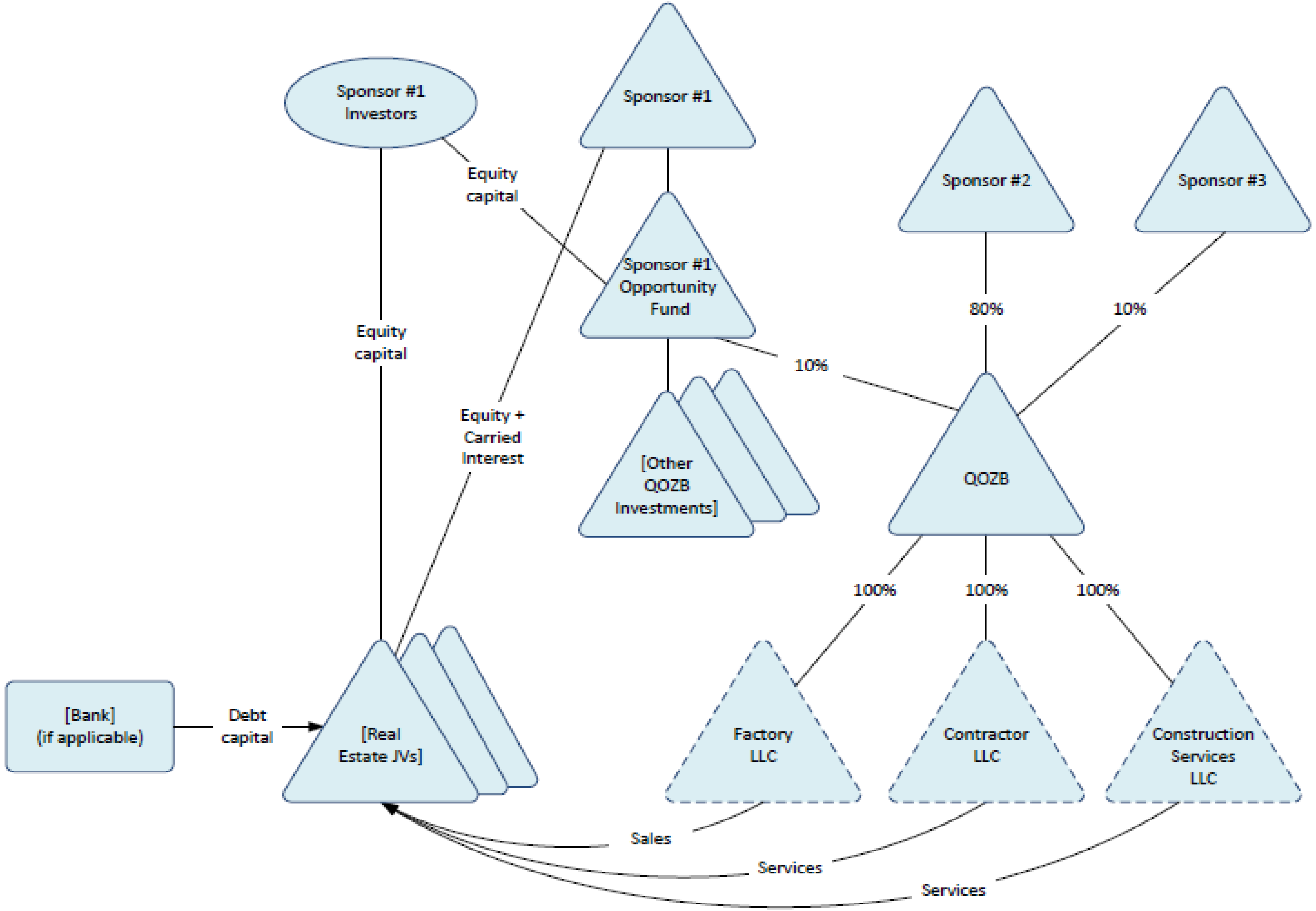
Transaction #1: Historic Hotel Renovation



Transaction #2: Multi-Stage Development



Transaction #3: Integrated Real Estate Strategy



QOZs & the Biden Administration

What President-Elect Biden is Saying about QOZs:

- Incentivizing Opportunity Funds to partner with non-profit or community-oriented organizations, and jointly produce a community-benefit plan for each investment, with a focus on creating jobs for low-income residents and otherwise providing a direct financial impact to households within the Opportunity Zones.

- Directing that Opportunity Zone benefits be reviewed by the Department of Treasury to ensure these tax benefits are only being allowed where there are clear economic, social, and environmental benefits to a community, and not just high returns – like those from luxury apartments or luxury hotels – to investors.

- Introducing transparency by requiring recipients of the Opportunity Zone tax break to provide detailed reporting and public disclosure on their Opportunity Zone investments and the impact on local residents, including poverty status, housing affordability, and job creation.

Democratic vs. Republican Senate Control

- Likely that efforts will be made in any omnibus tax bill to provide a statutory underpinning for this notion of partnering with community organizations empowered to certify QOFs.
- Likely that QOFs will be required to provide increased information reporting, regardless of whether a tax bill passes
- Hostility to “luxury” housing / hotels should give pause
- Likely, but not assured, that any legislative or administrative changes would provide some form of “grandfather” relief

What if President-Elect Biden can't pass a tax bill?

- Investors should not underestimate the power of the administrative state, especially when QOZs are concerned.
- Existing statute explicitly provides authority for Treasury to write "rules for certification" and "rules to prevent abuse."
- Treasury has taken public stance that "partnering with community organizations" not supported by text of current statute. But there is certainly a theory of executive power that would let Joe do it anyway, i.e., by executive order.
- Political cost of executive overreach / desire for "return to normalcy" and respecting agency independence could be protective of existing regulatory scheme.

Q&A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