Opportunity Zone Investing

2017 Tax Cuts & Jobs Act

THE SHERBERT GROUP
INTEGRATED TAX CREDIT SOLUTIONS

MOXIE INVESTMENT FUNDS

FRAMEWORK ARCHITECTURE

TMS

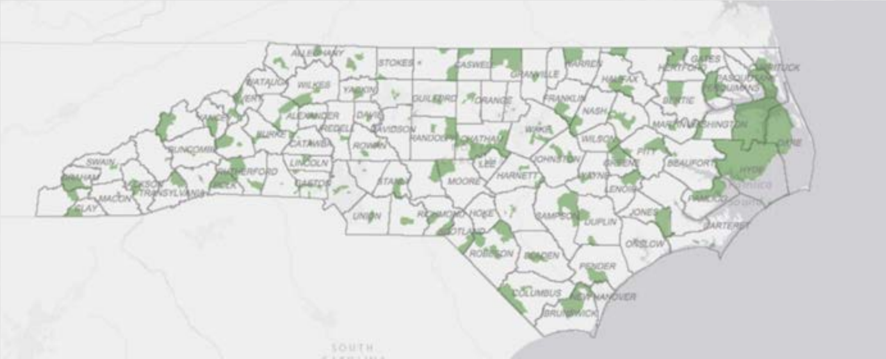
CPA

The Sherbert Group is a unique integration of companies that provide valuable tax, accounting, investment and consulting services to clients in the tax credit industry.

- Serving clients in 16 states
- Combined portfolio of $4 billion
- Member of the American Institute of CPAs Government Audit Quality Center
- Expertise & experience in a variety of state & federal tax incentives
- Specializing in real estate tax credits

Introduction

- Qualified Opportunity Zones were added to the Internal Revenue Code by the 2017 Tax Cuts and Jobs Act (The “2017 Tax Act”) by Code sections:
    - 1400Z-1 discusses designation of Opportunity Zones



- 1400Z-2 discusses how to invest capital gains into opportunity zones and receive significant tax benefits

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Who Can Benefit?

- Literally any US taxpayer with capital gains (net 1231 capital gains) can potentially benefit from this new tax incentive. This includes:
  - Individuals or corporations looking to reinvest gains from sales of property in order to defer and reduce taxes;
  - Real estate developers and start-up companies located in an Opportunity Zone who are looking for equity investment; and
  - Real estate sponsors, syndicators and/or private equity funds looking to create Qualified Opportunity Funds and then make investments in Qualified Opportunity Zone Property, including investments in corporations, partnerships or direct investments in property.

3 Major Buckets of “Opportunity”

- A taxpayer who timely reinvests gain from a sale of property into a “Qualified Opportunity Fund” (“Fund”) can enjoy the following tax benefits:
  - Bucket 1 - Deferral: Gain on a property sale that is invested in a Fund is deferred until the earlier of the date that the taxpayer sells its interest in the Fund or December 31, 2026.
  - Bucket 2 - Capital Gain Reduction: If the taxpayer invests in the Fund for at least 5 years, 10% of the original gain is excluded; if the investment lasts for at least 7 years, an additional 5% (for a total of 15%) of the original gain is excluded.
  - Bucket 3 - Appreciation Exclusion: If the taxpayer invests in the Qualified Opportunity Fund for at least 10 years, all appreciation in the new investment will be tax-free.

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Bucket 1 – Deferral of Capital Gain

- Investor Sells an Investment or Property for a Capital Gain of $100
  - Reinvests the Capital Gain in a Qualified Opportunity Fund
- Capital Gain of $100 is deferred until the earlier of:
  - Date when NEW investment is sold or exchanged, or
  - December 31, 2026
- How much Gain is Recognized?
  - Lesser of the amount of gain excluded originally or the sales proceeds or the fair market value of the investment on 12/31/2026
- What does this mean?
  - Original Gain $100
  - Reinvestment $100
  - Sale in 2020 for $90
  - In 2020 your deferred gain of $100 is recognized as $90 gain

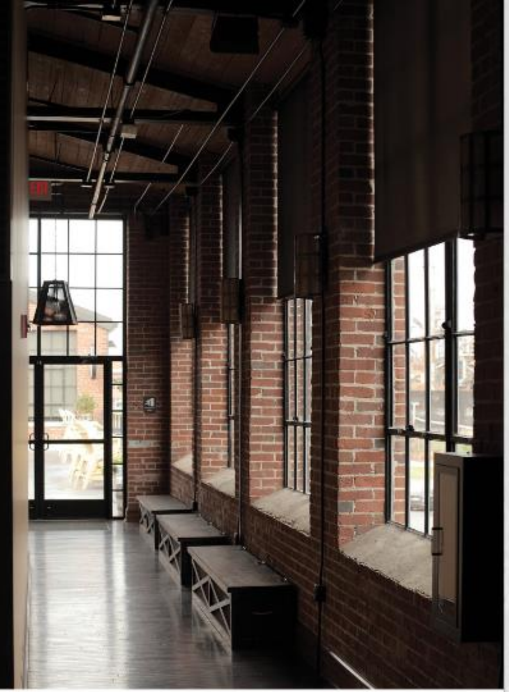
Bucket 2 – Reduction of Gain

- If New Investment is held for 5 years, the basis in the Investment is increased by 10%
- If New Investment is held for 7 years, the basis in the Investment is increased by 15%

This can result in the reduction of the original deferred gain.

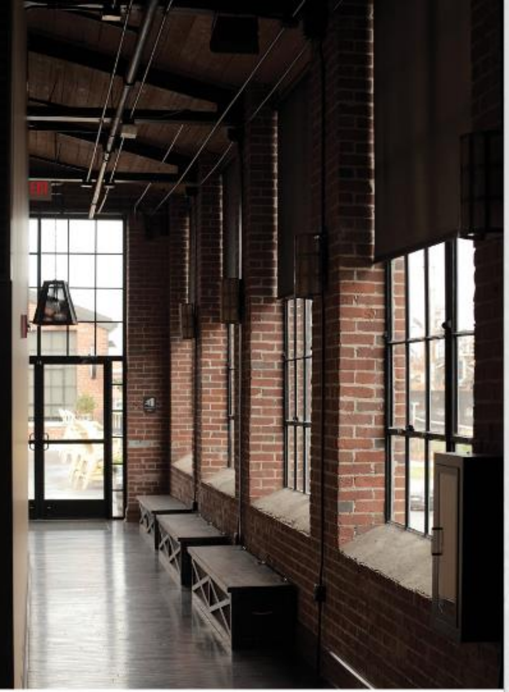
Examples:

1. Original reinvested gain of $100 (12/31/2019)
   Sell in 2022 for $90
   Gain recognized $90 (no reduction of gain since not held for 5 or 7 years)
2. Original reinvested gain of $100 (12/31/2019)
   Sell on 1/1/2025 for $90 (5 years plus 1 day)
   Basis = $0
   Increase in Basis 10% x $100 = $10
   Sales Proceeds $90 (A)
   Adjusted Basis = $10 (B)
   Resulting Gain $80 (A) – (B)



Bucket 3 – Permanent Exclusion of New Investment Acquisition Appreciation

- For Investments held by taxpayer for at least 10 years, the basis of such property = FMV at the time the investment is sold or exchanged for Qualifying Investments made between now & December 31, 2028
- Following example – <u>Investment in Fund is Held for 10 Years and Sold in 2029</u>



Example – Investment in Fund is Held for 10 Years and Sold in 2029

Opportunity Zone Investment Held for at least 10 Years		Ordinary Investment		Benefit
Bucket 2 - Reduction of Gain				
Deferred Gain (taxed in 2026)	$100.00	Gain (taxed in 2018)	$100.00	
Basis Step-up	15.00	Basis Step-up	0.00	
Taxable Gain	85.00	Taxable Gain	100.00	
Tax (at 23.8%)	$20.23	Tax (at 23.8%)	$23.80	$3.57
Bucket 1 - Present Value of Deferral of Gain (assumed 12/31/2018)				
Present value of tax @ 10% discount rate	$9.44		$20.23	$10.79
Bucket 3 - Permanent Exclusion of New Investment Appreciation				
Gain on Disposition of Investment in Fund	$100.00	Gain on Investment	$100.00	
Basis Step-Up	100.00	Basis Step-Up	0.00	
Taxable Gain on Disposition	0.00	Taxable Gain on Disposition	100.00	
Tax (at 23.8%)	$0.00	Tax (at 23.8%)	$23.80	$23.80
TOTAL BENEFITS				$38.16
BENEFITS AS A PERCENT OF ORIGINAL GAIN				38.16%

What is a Qualified Opportunity Fund?

- A Corporation or Partnership organized for the purpose of investing in "Qualified Opportunity Zone Property" that holds at least 90% of its assets in QOZP
  - 90% determination is made at 6-month and year-end measurement periods (test can be performed without taking into account investments received in preceding six months for investments held in cash or debt instruments of 18 months or less)
  - If a Opportunity Zone does not have at least 90% of its assets in QOZP, then fund assets (not invested in QOZP) are penalized at the same interest rate for underpayments of Federal Taxes under IRC Section 6621 – 6% starting in January – no penalty if failure is due to "reasonable cause", which has not been well defined.
  - Calculation = Shortfall amount x underpayment rate divided by 12
  - This is reported on Form 8996

Qualified Opportunity Fund

- Capital gains via Cash or property at lower of tax basis or FMV
- No services allowed for contribution
- Net 1231 gains at 12/31

QOF

Qualified Opportunity Zone Property
90% - Valued by GAAP Audit or Cost Average, 2 testing periods per year

- **STOCK** (QUALIFIED OPPORTUNITY ZONE BUSINESS)
- **PARTNERSHIP INTEREST** (QUALIFIED OPPORTUNITY ZONE BUSINESS)
- **QUALIFIED OPPORTUNITY ZONE BUSINESS PROPERTY**

Qualified Opportunity Zone Business (Stock or Partnership Interest)

- Purchased after December 31, 2017, via cash & qualifies for 90% of holding period as QOZB
  1. Substantially all (70%) tangible property **owned or leased** is a QOZBP
  2. 50% gross income is derived from active conduct of the trade or business in the QOZ
     A. 50% Gross Income Measured via
        1. At least 50% of hours worked were in a QOZ
        2. At least 50% of payroll dollars spent were for services performed in a QOZ
        3. Tangible property & Management Operations Functions are responsible for at least 50% of the gross income of the trade or business.
        4. If it can be demonstrated by Facts and Circumstances that at least 50% of gross income is derived from business in a QOZ.
  3. “**Substantial portion” 40% of intangible property is used** in active conduct of the trade or business in the OZ (ex. Franchise Fee)
  4. < 5% of the average of the aggregate unadjusted basis is attributable to Nonqualified Financial Property (“NQFP”) – Debt, Stock, Non –Qualifying Partnership Interest, LESS reasonable Working Capital, ordinary accounts receivable.
  5. No Sin Businesses – Golf Course, Country Club, Massage, Hot Tub/Suntan Facility, Race Track/Gambling, off premises alcohol seller.

Qualified Opportunity Zone Business (Stock or Partnership Interest)

- Working Capital safe harbor – 3 requirements:
  1. Designated in writing for acquisition, construction and/or substantial improvement of tangible property.
  2. A written schedule for the expenditure of working capital assets to be spent within 31 months. Delays due to government actions or inactions does not cause a failure of the safe harbor.
  3. Actual use of the working capital that is consistent with 1 and 2.
- Delays attributable to waiting for governmental action, the application for which is completed during 31 month period do not violate 31 month period.
- Allows for multiple 31 month-working capital safe harbors
- The written designation for planned use of working capital now includes the development of a trade or business in the qualified opportunity zone as well as acquisition, construction, and/or substantial improvement of tangible property.

QOZB Structure Diagram

Taxpayer

Investment ↓

Qualified Opportunity Fund

QOF must hold at least 90% of its assets in QOZP (i.e. QOZ stock, QOZ partnership interest or QOZBP)

Investment ↓

QOZB Partnership or Stock

Substantially all (at least 70%, per proposed regulations) of the tangible property owned or leased by the QOZB must be QOZBP.

Qualified Opportunity Zone Business Property

- Tangible property used in business
  1. Property acquired by QOF via non-related party purchase after December 31, 2017,
  2. Original use of such property in the QOZ commences with the QOF <u>or</u> the QOF Substantially Improves the property <u>AND</u>,
     a) <u>Original Use—Person or prior person first places the property in service in the QOZ for depreciation or amortization</u>
     b) <u>5 year vacancy requirement for abandoned/vacant buildings</u>
  3. During "substantially all" 90% of the QOF's holding period for such property, "substantially all" 70% of the use of such property is in a QOZ.
     - Inventory in transit does not break use test
  4. Leased property now qualified

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Leased Property Rules

Leased property for QOZBP now qualifies when:

- Acquired under a lease entered into after 12/31/2017
- Substantially all (70%) of all the use of the leased tangible property must be in a QOZ during 90% of the lease term
- No original use requirement on improvements made by a lessee
- No substantial improvement requirement
- Can be leased from related party if:
  - Market rate lease terms exist
  - No prepayment for rent exists greater than 12 months of rent
  - Leased tangible personal property only qualifies if:
    - Lessee becomes the owner of the tangible property of which has value not less than the value of the leased personal property(within 30 months)
    - Substantial overlap in zones

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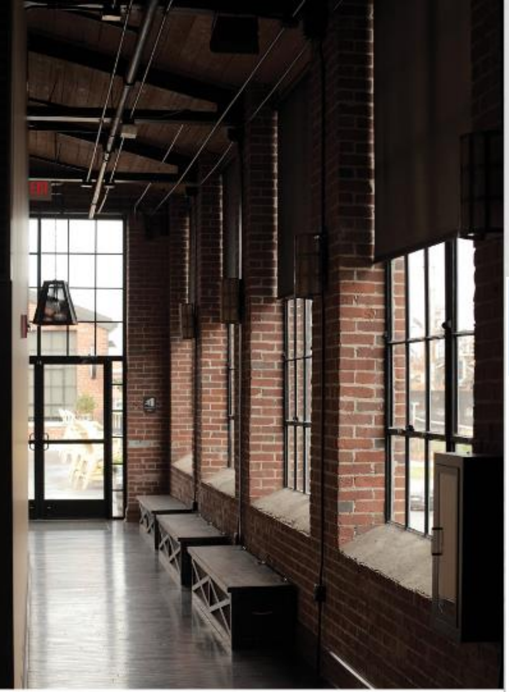
Valuation of Leased Property for 90% Test

- Financial statement method(GAAP)
- Alternative valuation method
  - Net present value of lease payments
  - Discount rate under 1274(d)(1) prescribed
    - Calculated once at the time lease is entered into

Compare QOZB with QOZBP

QOF owns an equity interest in a corporation or partnership operating a QOZB:	QOF directly own QOZBP and operates business:
70/30 test relevant to QOZBP	90/10 test (if QOF does not hold interests in subsidiaries, 90% of its assets must be QOZBP)
Working Capital Safe Harbor applies to allow unlimited amount of cash as long as entity substantially complies with a written plan of deployment for acquisition, construction and/or rehabilitation within 31 months	No working capital safe harbor; absent further guidance, all cash would be counted toward the 10% of assets that can be non-QOZBP
50% gross income from active conduct of trade or business (deemed to be met during construction/rehabilitation under working capital safe harbor)	No gross income requirement from active conduct standard



Compare QOZB with QOZBP (continued)

QOF owns an equity interest in a corporation or partnership operating a QOZB:	**QOF directly own QOZBP and operates business:**
Can own an unlimited amount of Intangible Property as long as a "substantial portion" (40%) is used in the active conduct of a trade or business (deemed to be met during construction/rehabilitation under working capital safe harbor)	All Intangible Property counts toward the 10% of assets that can be non-QOZBP (QOZBP only calls for tangible property)
No sin businesses allowed	No prohibition on sin businesses
Statute provides a 5-year grace period for characterization of property held by a QOZB as QOZBP	As currently written, this 5-year grace period does not apply to QOZBP held directly by a QOF

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Proposed Regulations Issued October 19, 2018

- Provide a safe harbor that allows an O Zone Business to hold funds for up to 31 months for the acquisition, construction, or improvement of real and other tangible property
- Calculate the substantial improvement test by reference to the basis of the building, excluding the basis of the land
- Require that an O Zone Business have only 70% of its assets invested in O Zone Business Property
- Allow gains recognized by a partnership to be invested in an O Fund by either the partnership or its partners
- Allow all of the benefits of the program to be claimed by taxpayers through December 31, 2047, despite the earlier expiration of the O Zone designations
- Allow an O Fund to specify the first year and month in which it will be classified as an O Fund
- Limit the eligible gains that can be deferred under the program to capital gains, arguably contrary to the statute

Guidance Provided in Additional Regulations

- Triggering events for income inclusion
- Distributions from a QOF
  - Are inclusion events if the investor has no basis
  - Results in acceleration of the original deferred capital gain to the extent there is no basis
- Reasonable period defined for re-investment or proceeds (12 months)
- No substantial improvement requirement for land, but the land must be used in active conduct of a trade or business (speculative land purchased to hold does not qualify) to be considered QOZBP
- Investor that holds its QOF interest for 10 years can elect to exclude QOF K-1 capital gain (from a QOZB's sale of QOZBP) from gross income

OZ Critical Dates

- QOZBP AND QOZB Must be acquired after 12/31/2017
- QOZ Investment must be made by 12/31/2019 in order to get 15% reduction in deferred gain if held until 12/31/2026
- QOZ Investment must be made by 12/31/2021 in order to get 10% reduction in deferred gain if held until 12/31/2026
- Deferred gain must be recognized no later than 12/31/2026
- Qualified Opp. Zones expire 12/31/28, no more QOZ investments can be made after this
- Sale of QOZ Investment must be made by 12/31/2047

North Carolina Legislation

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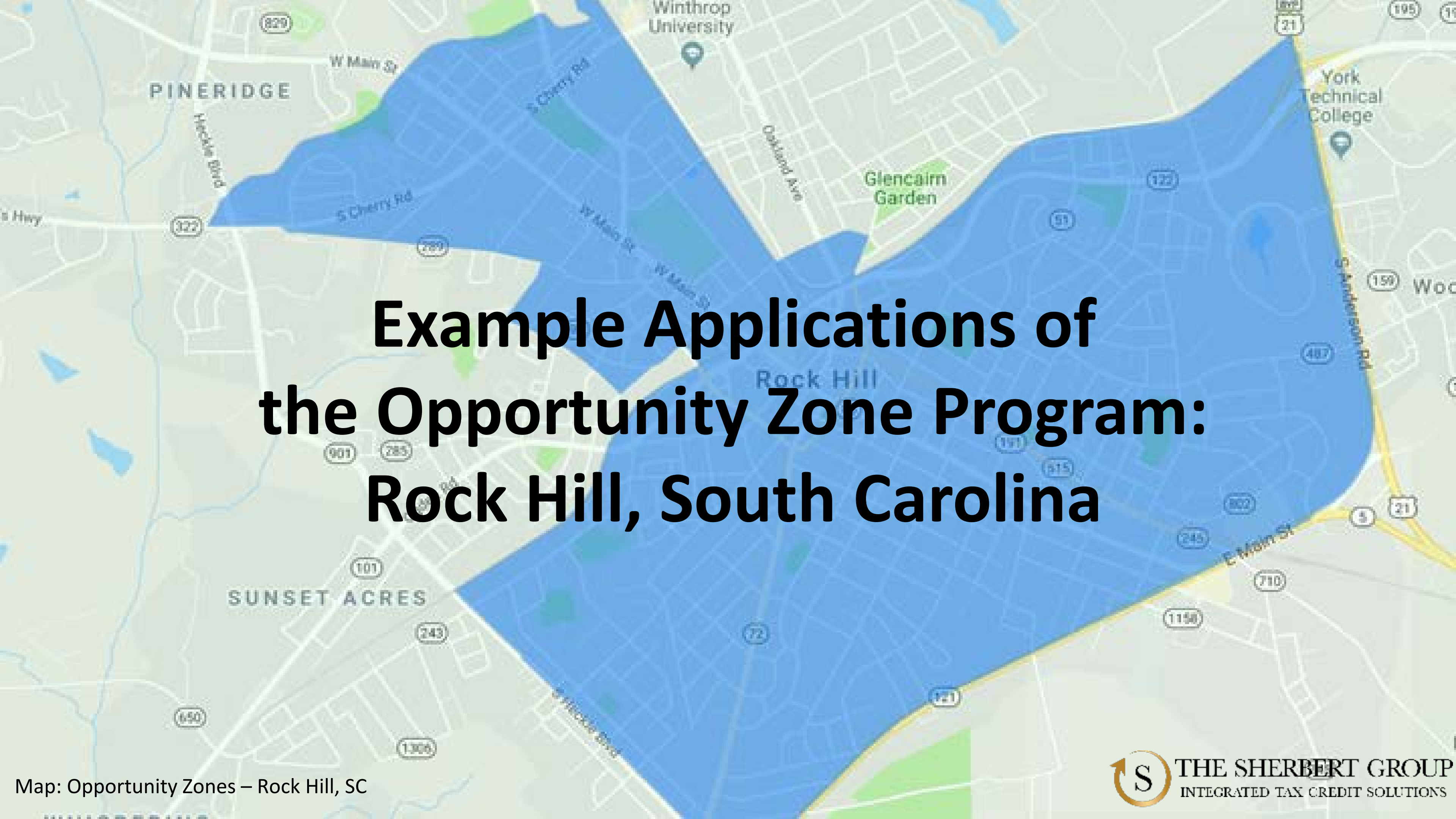
Example Applications of the Opportunity Zone Program: Rock Hill, South Carolina



Map: Opportunity Zones – Rock Hill, SC

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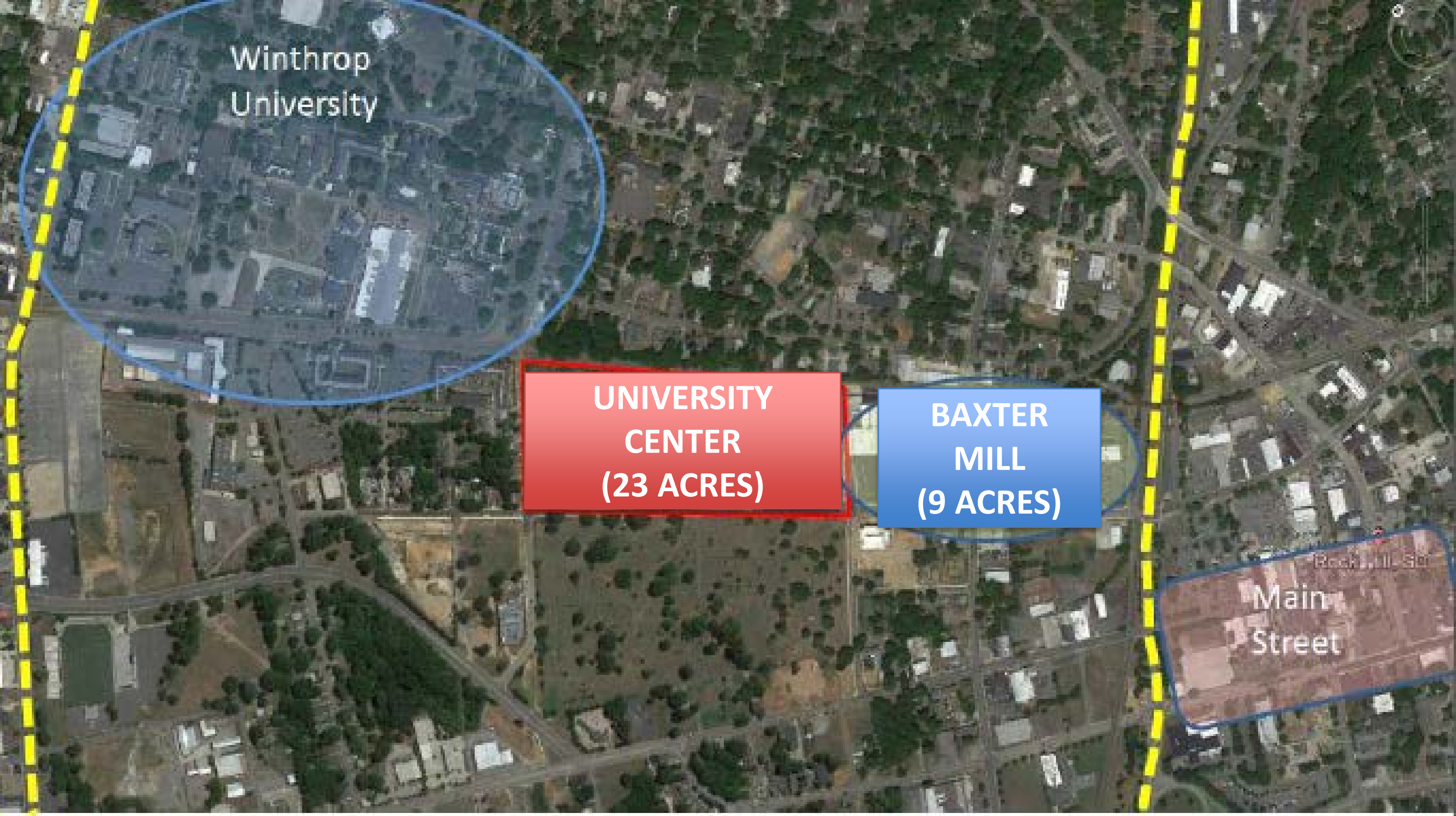
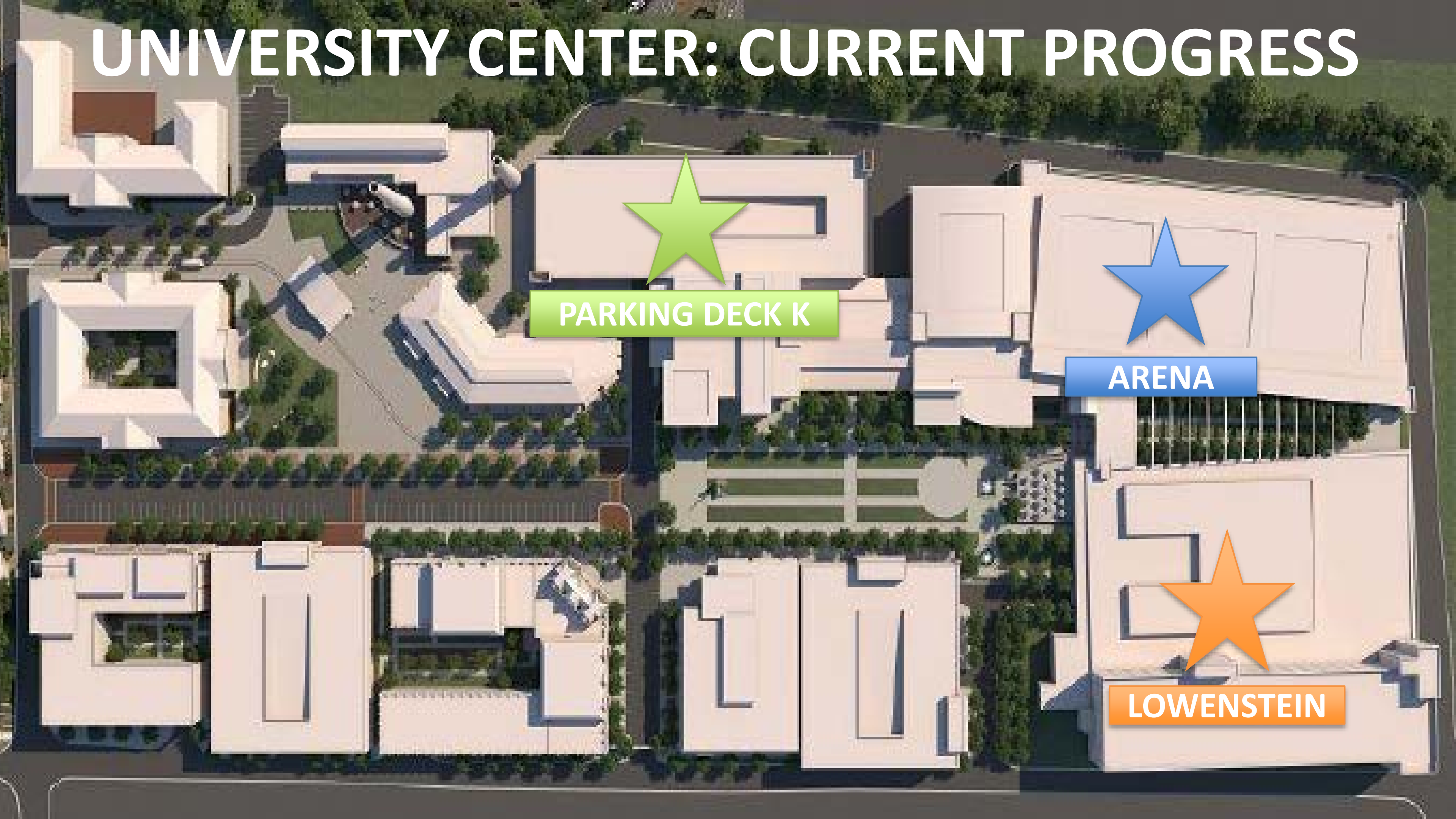

Winthrop University
UNIVERSITY CENTER (23 ACRES)
BAXTER MILL (9 ACRES)
Main Street

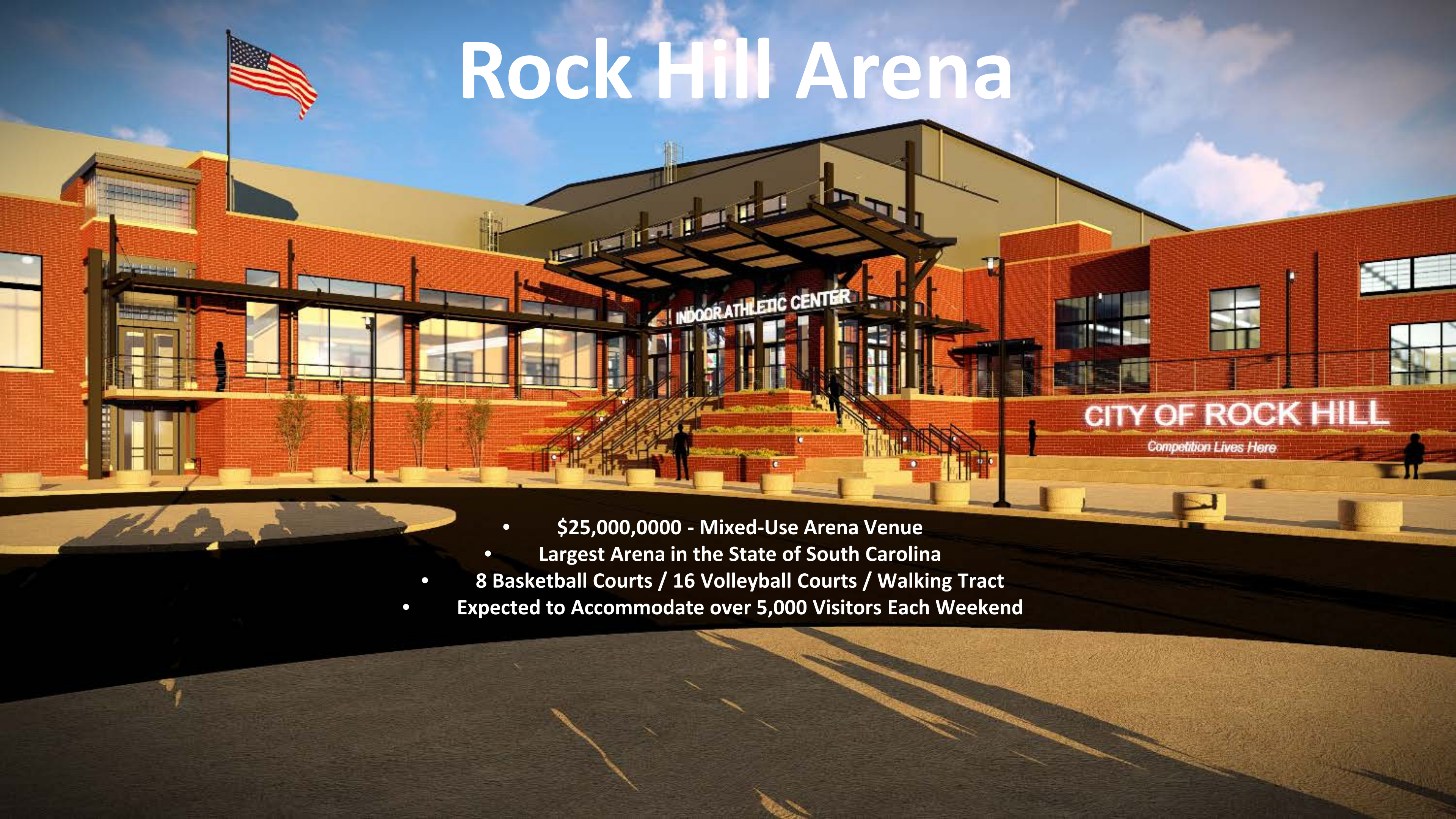
UNIVERSITY CENTER: CURRENT PROGRESS



Lowenstein Building

- $46,000,000 - 225,000 SF Class A Mixed-Use Office Building
- Currently 70% Lease by National and Local Tenants
- Expected Lease-Up by 2019

Rock Hill Arena



- $25,000,0000 - Mixed-Use Arena Venue
- Largest Arena in the State of South Carolina
- 8 Basketball Courts / 16 Volleyball Courts / Walking Tract
- Expected to Accommodate over 5,000 Visitors Each Weekend

Parking Deck K

- $10,000,000 – 5-Story Parking Deck
- 750+ Stalls Serving the University Center Site
- Second Infrastructure Phase of Four Phases

UNIVERSITY CENTER: FUTURE OPPORTUNITY ZONE EXAMPLES

Parking Deck C

- $6,500,000 – 433 Stall Parking Deck
- Construction Expected to Commence in 2019
- Phase Three of Four for Infrastructure Investment

Parking Deck C – Structuring the Deal

Capital Gain Investors

↓ Equity Investment

Qualified Opportunity Fund

↓ Equity Investment

QOZB

↑ Annual City Payment

↑ - senior housing
- student housing
- public use daily rental

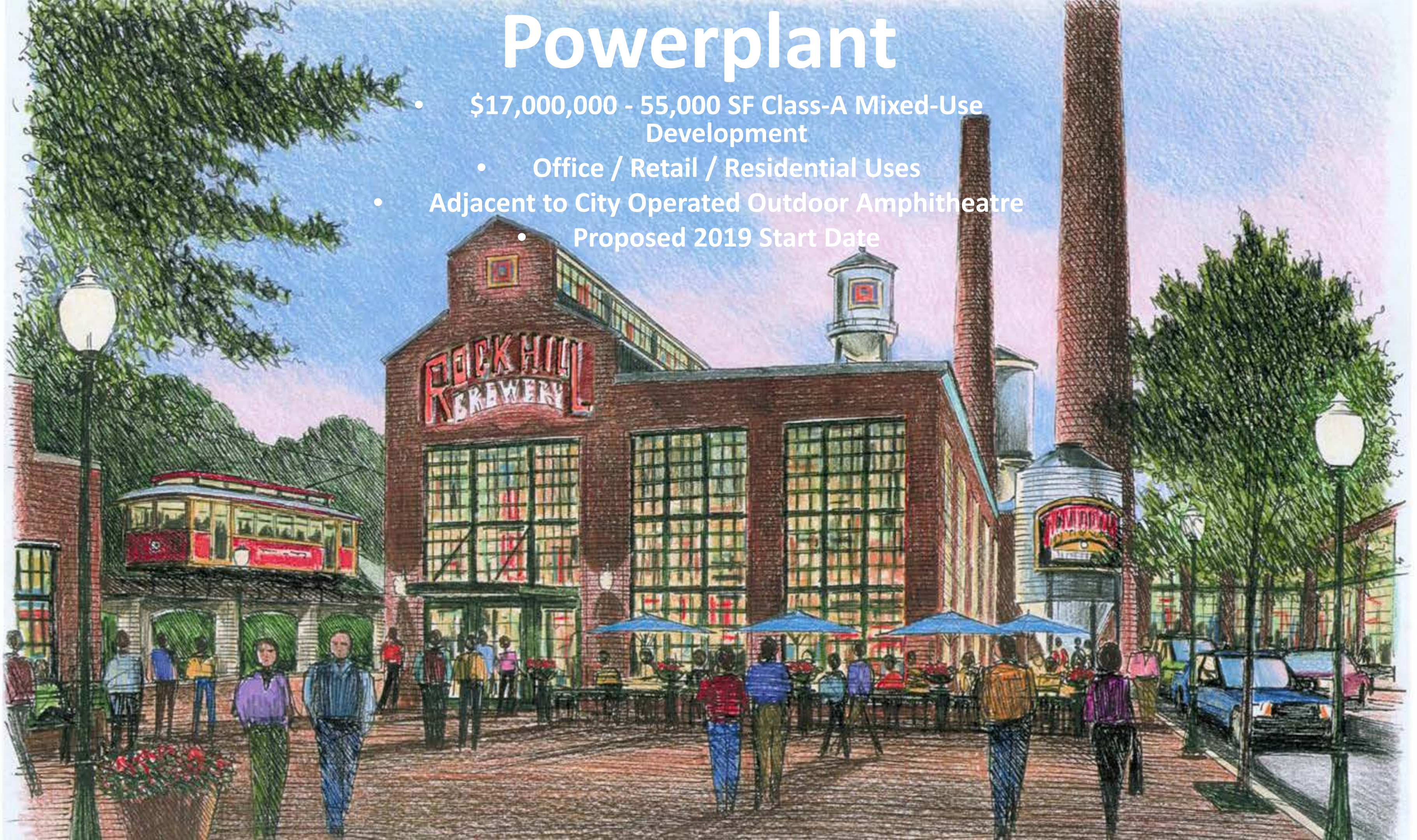
*After year 10, OZ investors are bought out at 5% IRR

University Center Hotel

- **$22,300,000 - 110 Keys**
- **Construction Period: Q2 2019 – Q2 2020**
- **Meeting & Rooftop Space**
- **Serving both Leisure & Business Travelers**
- **Up to $3,900,000 in Opportunity Zone Equity**
- **Potential Investor IRR with Full Opportunity Zone Benefit is 11-16% (Depending on How Distributions are Structured Under Finalized Regulations)**

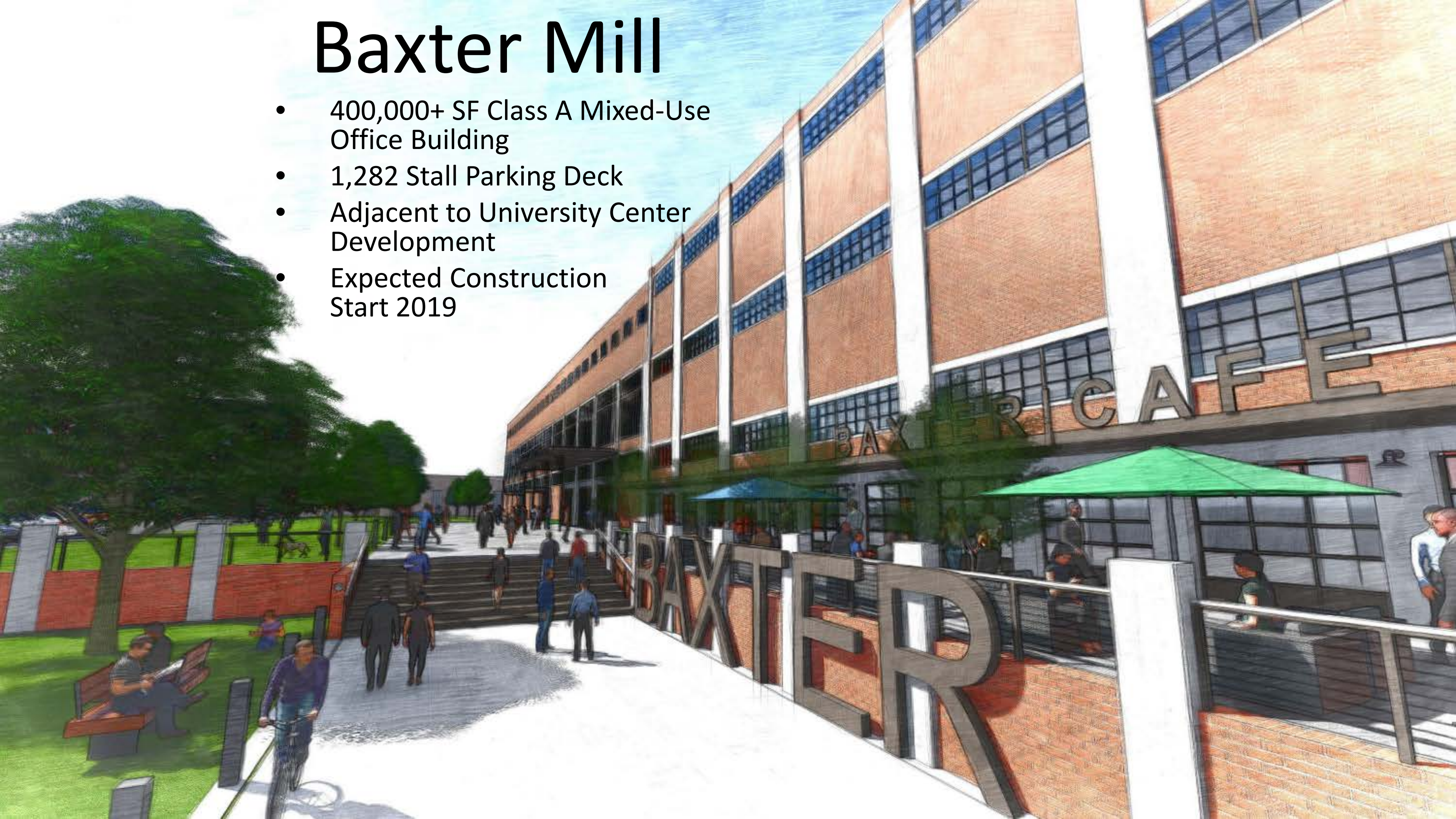
Powerplant

- $17,000,000 - 55,000 SF Class-A Mixed-Use Development
- Office / Retail / Residential Uses
- Adjacent to City Operated Outdoor Amphitheatre
- Proposed 2019 Start Date



Baxter Mill

- 400,000+ SF Class A Mixed-Use Office Building
- 1,282 Stall Parking Deck
- Adjacent to University Center Development
- Expected Construction Start 2019



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