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UNDERSTANDING THE OPPORTUNITIES IN OPPORTUNITY ZONES

Presented by

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INTRODUCTIONS

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MICHAEL WILLIAMSON

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Michael Williamson Chairs the Firm's Real Estate Practice Group. His practice includes finance, equity investments, tax credits, real estate fund formation, syndicated investments, and portfolio and syndicated credit facilities, including asset-based lending, secured and unsecured credit facilities, municipal and project finance. Michael earned his B.A. in Government and Public Policy Analysis at Pomona College and his J.D. at Loyola Law School.

JOSHUA PERTTULA

Abington Emerson

Joshua Perttula is a founding partner and principal of Abington Emerson Investments, LLC, ("Abington Emerson"), a private real estate investment company headquartered in Los Angeles, California. Mr. Perttula leads the firm's real estate, finance, and investment departments. Abington Emerson's real estate portfolio consists of assets in multi-family, office, retail, hospitality and mobile home parks across seven states and includes multiple investments in Opportunity Zone areas. The firm is currently in the process of launching its first Opportunity Zone Fund. Joshua is also an expert and active consultant on land use and real estate policy as it relates to local governments. He graduated with a B.A. in both Economics and Political Science from the University of California, Irvine and holds a J.D. from the University of California, Hastings College of the Law. Joshua is also a member of the Board of Trustees of the California State Bar and a licensed real estate broker in the State of California.

ARI BELIAK

Bank of America

Ari Beliak is a Senior Vice President at Bank of America in Community Development Banking. He is co-leading the Bank's response to Opportunity Zones, and provides debt and equity solutions for affordable housing developers based in Northern California, Nevada, and Colorado. Ari was the key driver in Bank of America Merrill Lynch's funding of the nation's largest affordable housing project, the San Francisco Rental Assistance Demonstration. He has an extensive background in affordable housing, real estate finance, and law. Prior to joining the Bank, Ari practiced law for Sidley Austin LLP, served in various real estate finance capacities for Wells Fargo Bank, including their affordable housing group, and was a management consultant for A.T. Kearney. Ari received his BA and MBA from the University of California, Berkeley and JD from University of California, Hastings College of the Law.

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The “opportunities” in Opportunity Zone investments are 3 significant federal tax benefits:

IRC Section 1400Z gives investors who invest in Opportunity Zones:

1. Deferral of federal capital gains (FCG) tax on harvested capital gains.

2. Partial cancellation of FCG on OZ invested capital.

3. Elimination of all FCG on post 10 year appreciation of investment in OZ.

Fundamental OZ Policy

- Issue: Significant pools of capital remain “trapped” in investments due to tax payers’ unwillingness to pay tax on capital gains.
- Issue: Vast areas of the US consist of low-income communities starved for capital needed to revitalize businesses, infrastructure and neighborhoods.
- Solution: Incentivize investors to “free up” appreciated capital by deferring and reducing current capital gains tax and eliminating tax on potential future appreciation on OZ investments held for the long term.

What is an Opportunity Zone?

A subset of 25% the federal census tracts in a State classified as a “low income census” tracts (other minor variations).

Governors have designated and US Treasury has certified over 9,000 OZ.

OZ designation lasts until 10th year anniversary of designation date.

Legislation proposed to extend OZ designations.

A map of all current certified OZ is at https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml

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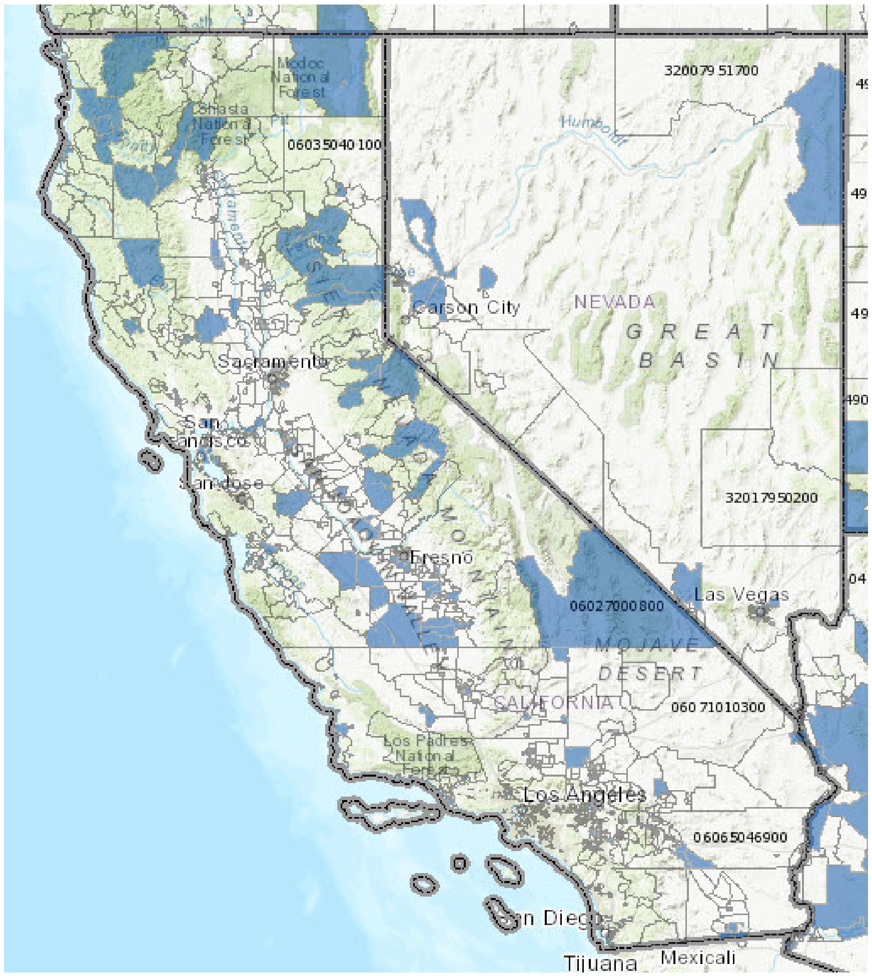
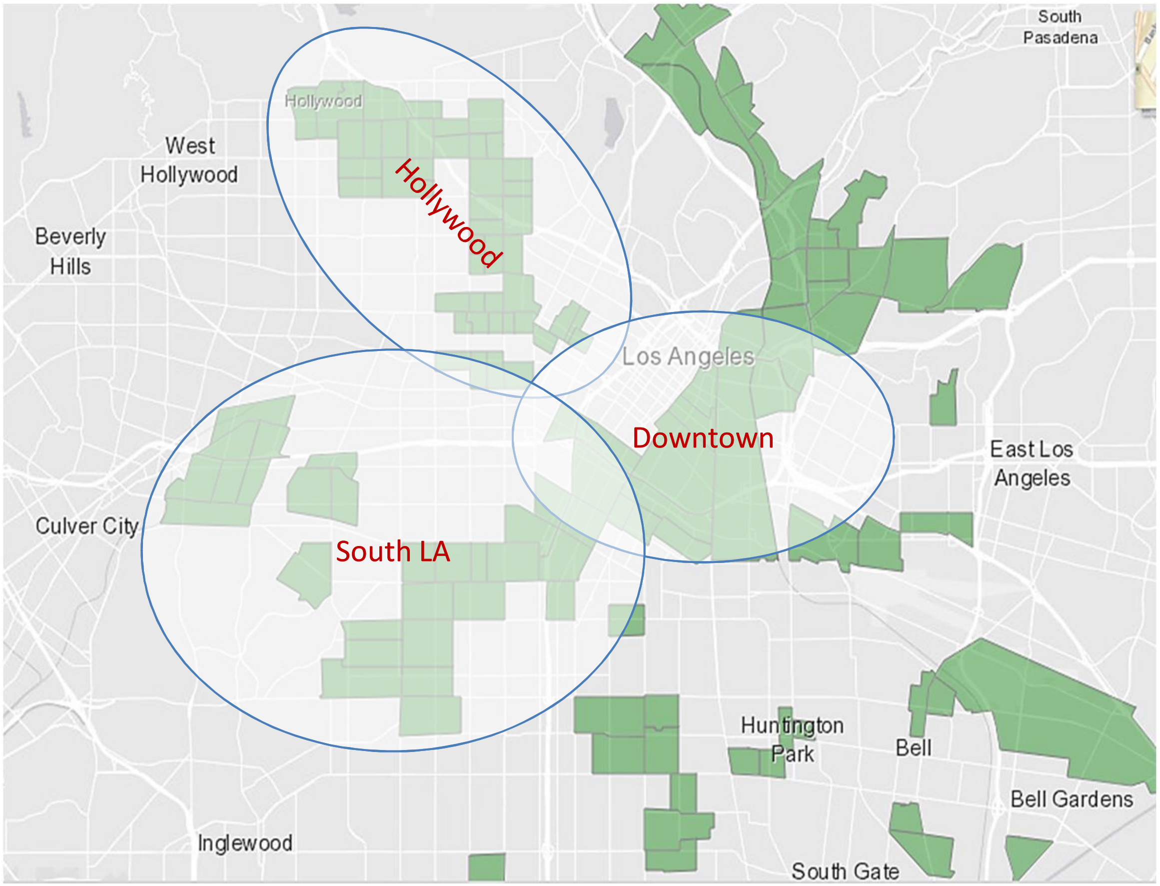
US Opportunity Zones

California Opportunity Zones



Los Angeles Opportunity Zones



Who can take advantage of the OZ benefits?

- Any taxpayer investing in a Qualified Opportunity Fund (QF) within 180 days of realizing FCG from the sale of any asset.
  - No tracing or segregation of funds like a IRC 1031
  - Any asset – no like kind requirement
- Draft IRS tax forms recently released for public comment.

How does this work in practice?

Investor sells stock 6/1/2018 realizing $1 million in FCG. Before 11/28/2018 (180 days later) Investor invests $1 million in a QF.

Investor gets:

1. Zero FCG tax on stock sale (applicable state taxes still apply i.e. CA).

2. If investment is held for

   a. 5 years, Investor's basis in QF increases 10% - eliminating FCG tax on $100,000, and

   b. 7 years, Investor's basis in QF further increased by 5% - eliminating FCG tax on a total of $150,000.

3. After 10 years, Investor's basis in QF equals the then FMV of QF interest = no FCG tax regardless of increase in value.

Deferred and reduced FCG is due December 31, 2026

FCG tax paid is due in *all events* on December 31, 2026.

However, amount due is on *lesser* of

(A) 85% of the $1 million, or

(B) FMV of QF investment

QF Investments made post 2018 have declining deferral benefit – i.e. if made in 2024 there would only be a 2 year deferral.

What is a Qualified Opportunity Fund (QF)?

An investment vehicle which satisfies a three part test:

1. Entity test – either a domestic corporation or partnership (also limited liability company)

2. Purpose test – organized to invest in OZ

3. Asset test – 90% of QF's assets are stock or partnership interests in "qualified opportunity zone business" and/or "qualified opportunity zone business property"

How is a Qualified Opportunity Fund established?

- Supposed to be easy.
- QF self certifies by filing IRS Form 8996 (drafts circulated for comment) with tax return for the year the QF is formed.
- No limits on number of QF that can be formed.
- Extent of compliance monitoring and reporting remains to be seen.

What is QOZ stock or partnership interest?

Ownership interests in a "qualified opportunity zone business" acquired by the QF for cash after 12/31/2017 consisting of

1. "qualified opportunity zone stock" = stock in a domestic corporation

2. "qualified opportunity zone partnership interest" = capital or profits interest in partnership

For "**substantially all**" of the QF's holding period the underlying QOZB has to continue to qualify under 1400Z.

Not clear what this "substantially all" means here.

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What is a QOZB?

A trade or business where “substantially all” of its tangible property is QOZB property and

1. 50+% of gross income is derived from trade or business (no non-profits)

2. No “non qualified financial property) greater than 5% of asset basis = no excess liquidity or financial instruments (no lenders)

3. No “sin” businesses (golf course, country club, massage parlor, hot tub or sun tanning facility, race track, gambling or package liquor sales). Like NMTC restrictions but farming not excluded

4. No prohibitions on using debt + equity to acquire QOZB/P – important point

Use of Debt to acquire QOZB Property

$10 million real estate development

QF capital stack:

Mortgage	$7 million
Mezz debt	$1 million
OZ equity	$2 million

2028+ property sold for $20 million

Repay mortgage and mezz debt, $2 million equity returned = remaining $10 million not subject to any FCG (any depreciation recapture likely *not* excluded from ordinary income tax) = $2 million of FCG tax eliminated (@20% tax rate).

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Use of Mixed Equity to acquire QOZB Property

$10 million real estate development

QF capital stack:

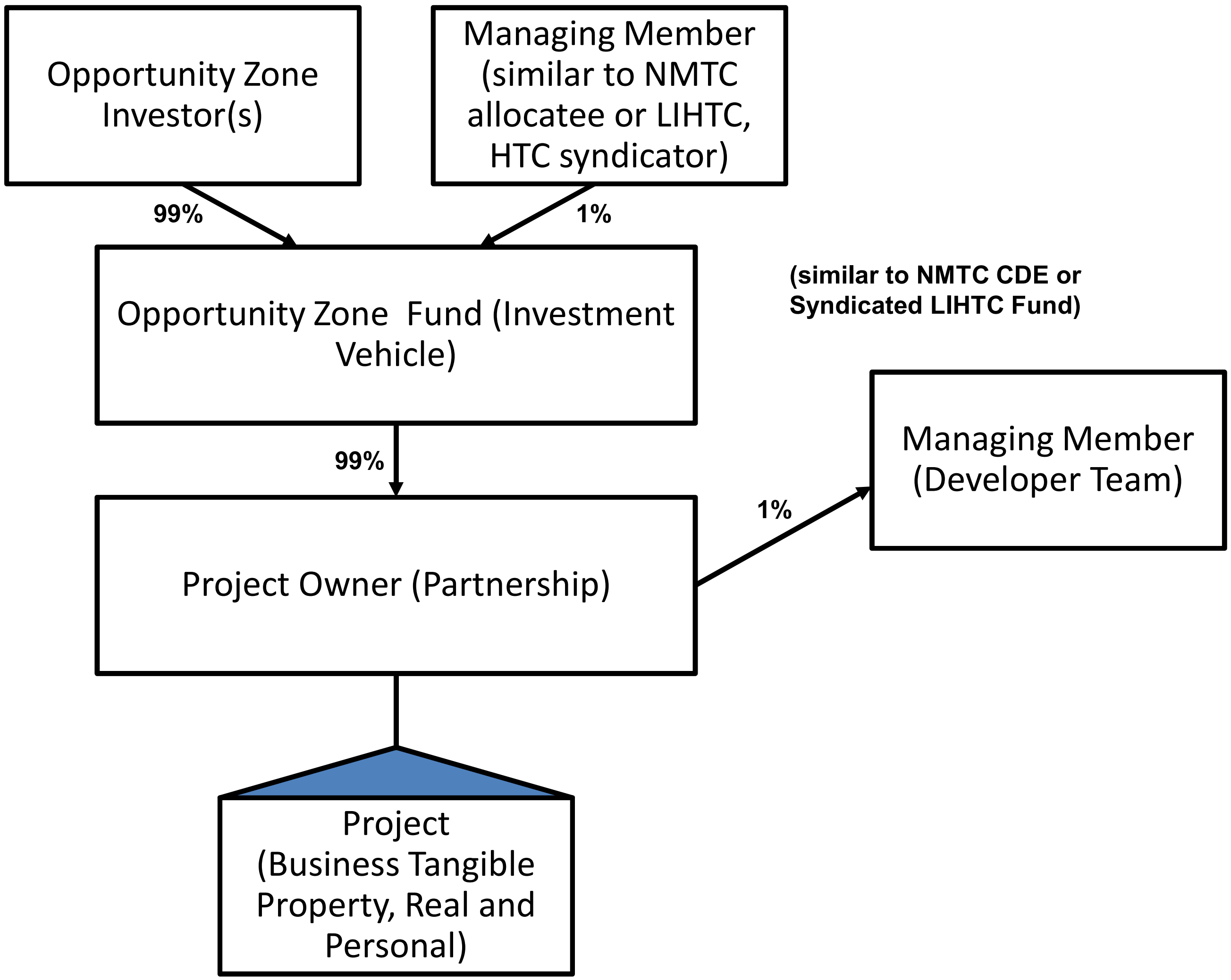
Mortgage	$7 million
Mezz debt	$1 million
OZ equity	$1 million
Non OZ equity	$1 million

2028+ property sold for $20 million

Same as before except only 50% of remaining $10 million is tax free = $1 million of FCG tax eliminated.

If $1 million equity and $1 million of additional mezz debt = $ 2 million of FCG tax eliminated.

Opportunity Zone Fund Investment - Structure 1



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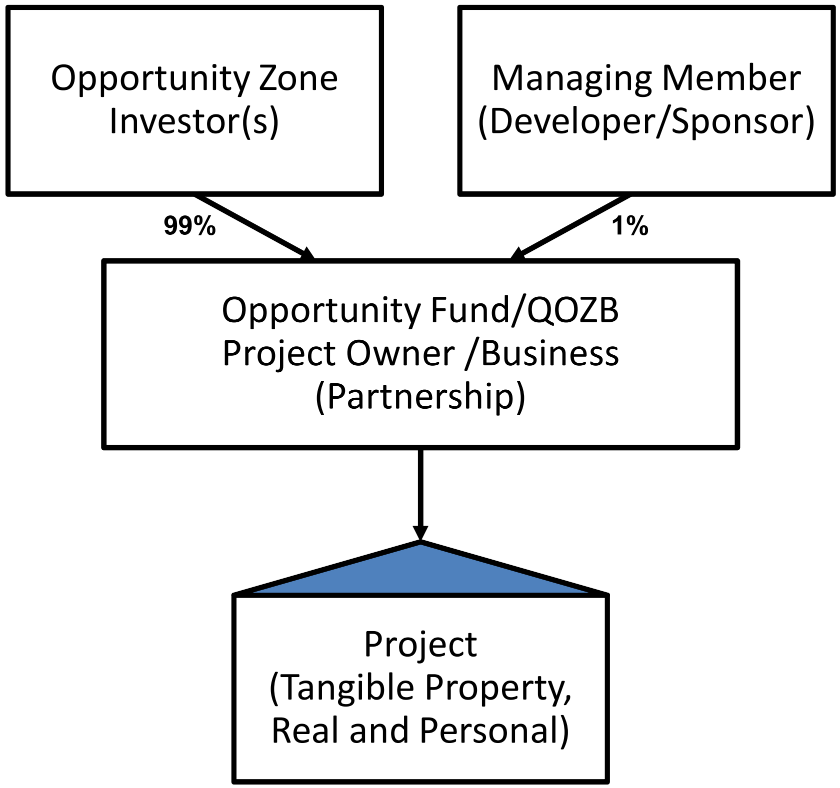
Opportunity Zone Fund Investment Structure 2



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Practical QF Fund Structure Issues - 1

1. Duration of investment:

   Maximum benefit achieved with 10 year investment – a lifetime in US real estate investing.

2. Timing of individual FCG transactions:

   Challenge of aggregating sufficient individual investors within 180 day window.

   Use equity and debt bridges to invest in QOZB and take out with OZ equity using capital call.

Practical QF Fund Structure Issues - 2

3. Ability of investor to exit transaction:

   Debt vs. equity concerns – Forced redemption as exit option may affect "equity" treatment

4. Mixed equity investor types:

   Disclosure of fund manager conflicts – sell now and lose tax benefits or hold on for tax benefits and miss cycle.

5. Redeployment/reinvestment of early QF investments:

   IRC 1400Z suggests OF can reinvest proceeds and continue to defer FCG tax. Guidance needed on timing and procedure.

QOZB Issues 1

1. Multi-branch business - Separate ownership from other branches of larger business – 50% of gross income of QOZB must come from activities in OZ.
2. No non-profits – Create taxable sub with 168h election.
3. Farming/agriculture permitted – Use to fund cannabis grow QOZB?

QOZB Issues 2

3. Is leasing residential real property permitted – Likely yes.

4. Can QOZB lease vs. purchase tangible property – Likely yes.

5. Can an existing business be a QOZB – yes to the extent of newly (post 2017) purchased or leased tangible property.

6. Requiring QOZB to maintain is QOZB status for 10 years. Control within partnership agreement, indemnities, guaranties etc.

QOF Issues

1. Timing issues for deploying OZ investor funds.

   180 days after receipt of the OZ investor funds – 90% of QF $ must be deployed in QOZB/P – tested at end of the first 6-month period of the QF's taxable year and on the end of the taxable year of the OF.

2. Who is liable for taxpayer/investor errors on tax returns and elections under consolidated partnership audit rules. Cover with disclosure/risk allocation.

3. Liability of QOF manager for noncompliance with program, reporting, reinvestment. Cover with disclosure/risk allocation.

What is a QOZB property?

Tangible property used in a trade or business so long as

(A) the property was acquired from an unrelated (no more than 20% in common) entity, and

(B) original use of the property began with the QF/QOZB, or

(C) the QOZB "**substantially improves**" the property; and

(D) during "**substantially all**" of the holding period "substantially all" of the property's use is in an OZ.

What does "substantially improve" QOZB property mean?

Spend a dollar over the acquisition basis of the property within 30 months – like the "substantial rehab" test for historic (rehabilitation) tax credits.

Unlike the "sub rehab", "sub improvement" includes cost of land or leasehold.

Buy property for $2 million, complete total development project for $10 million within 30 months.

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Penalty if QF fails to timely deploy (reinvest?) investments

Unless failure was due to "**reasonable cause,"** a monthly penalty can be levied equal to shortfall times the applicable IRC underpayment rate (4+%).

Like the NMTC program, expect a reasonable period in which to reinvest under the circumstances. I.e., if sale occurs on the last day of a measuring period, it may be impossible to timely reinvest those funds in QOZB/P.

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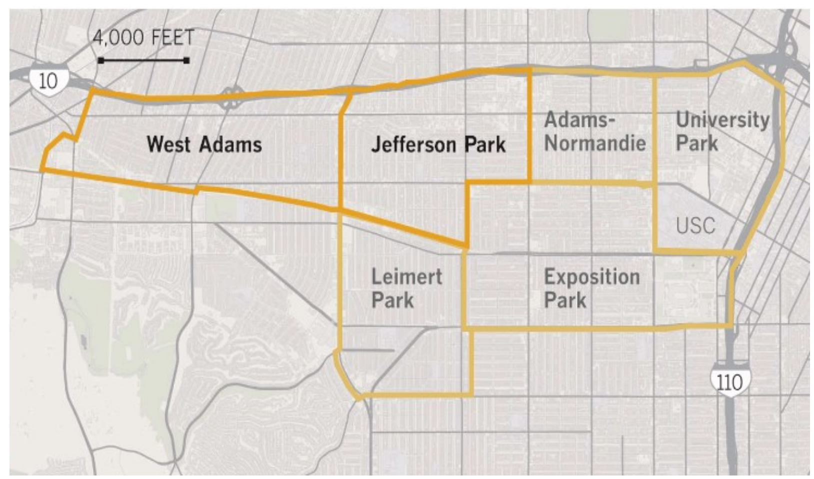
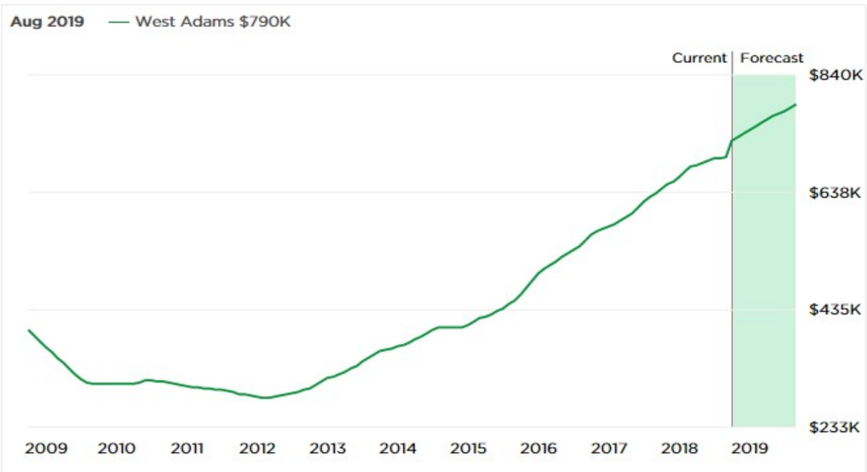
Central LA Opportunity Zone Case Study: West Adams

- **West Adams** is a historically African American and Latino neighborhood in South Los Angeles characterized by urban blight, crime and depressed property values. Today its location the 10 Freeway, Exposition Boulevard, la Cienega and Western Avenue makes it an attractive location between downtown and the Westside.
- The 2016 Expo Line light rail extension from Downtown Los Angeles to Santa Monica has spurred development and numerous OZ in the area can accelerate that.
- Proximity to light-rail or subway projects increases the influx of college-educated, higher-income households – and, also largest increases in rent and home prices, according to a recent UCLA study.
- The area is already enjoying a number of investor friendly local incentives and transit benefits in addition to the Opportunity Zone designation.
- Abington Emerson is an active investor in the area - since 2015 and intends to deploy and raise OZ funding on several active projects.

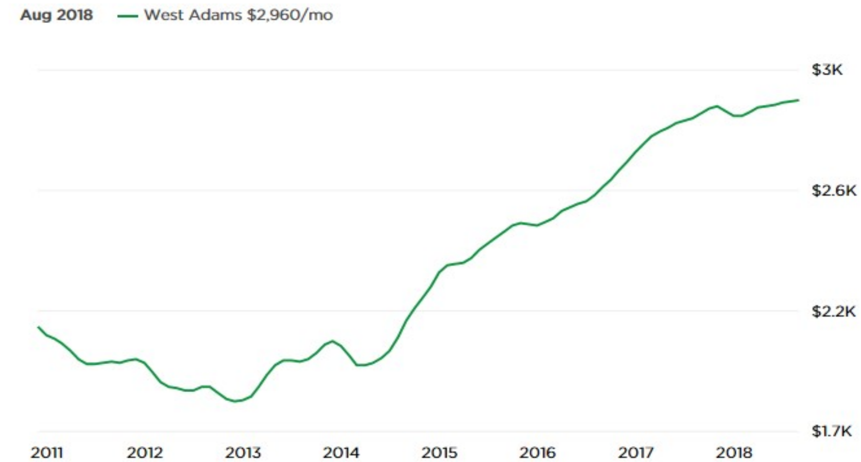


Central LA Opportunity Zone Case Study: West Adams

Home Value Index: West Adams

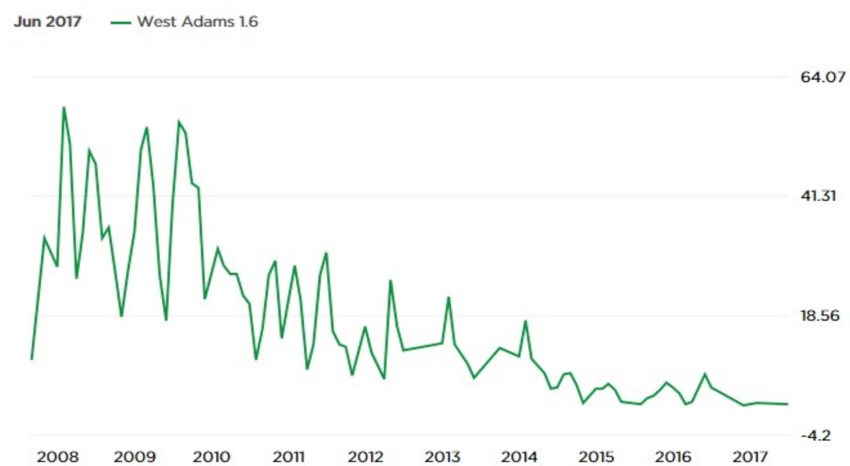


Rental Rates: West Adams



Median Price per Square Foot: West Adams

Foreclosures: West Adams



Use of OZ with other tax subsidies

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Dual purposing or leveraging OZ equity with other subsidies:

Low Income Housing Tax Credits – 10 to 15 year hold, FMV issues but negative capital account on 10+ year exit could be mitigated by FMV basis reset; pundits suggest increase in pricing

New Markets Tax Credits – 7 year duration issue and FMV issue

Rehabilitation (Historic) Tax Credits – 5+ year hold issue, commercial real estate may have higher FMV

Tax Exempt Private Activity Bonds – No issues provided QOZB/P type fundable with PAB (active trade or business)

Renewable Energy Investment Tax Credits – 5+ year hold issue; use for sponsor or private equity portion of capital stack

AUDIENCE QUESTIONS?