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2019 SEATTLE INVESTMENT MANAGEMENT CONFERENCE

Investments in Opportunity Zones

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OUR AGENDA

- *Why* you need to know about Opportunity Zones
- *What* you need to know about Opportunity Zones after two rounds of regulations
  - Policy
  - Definitions
  - Mechanics
- What kinds of *deals* are we seeing? Structuring considerations.
- What *questions* remain about Opportunity Zones?
  - Treasury requests for comments
  - Legislation
  - Procedures and information reporting

WHY YOU NEED TO KNOW ABOUT OZ

- Significant tax benefits for investors with capital gains
  - Defer tax until 2026 on capital gains invested in Opportunity Funds
  - 10% increase in basis if investment held 5 years
  - Additional 5% increase in basis if investment held 7 years (this benefit sunsets this year)
  - Capital gain on investments held at least 10 years completely free from federal income tax (state treatments vary)
- Can decrease cost of capital for entrepreneurs and developers
- Incentivizes investment in areas that might otherwise be overlooked
- Applies to investments in active trades and businesses, real estate, many types of project financing, and more
- A mechanism for impact investing
- Can be used in conjunction with a large amount of other federal, state, and local Economic Incentives

THE POLICY

- The Opportunity Zone ("OZ") incentive was enacted as part of the tax reform bill in December 2017
- Goal is to spur long-term investment, economic growth and job creation in low income communities
- A descendent of Empowerment/Enterprise Zones, and New Markets Tax Credit

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QUALIFYING ACTIVITIES AND BUSINESSES

- Must be a “trade or business”
  - Depending on structure, must be “active”
- Real estate (residential, commercial)
- Manufacturing
- Distribution/warehouse
- Retail & hospitality
- Medical clinics, day care facilities
- Energy generation, storage, transmission
- Farming
- Transportation and infrastructure
- Research
- Start-ups & incubators

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THE PLAYERS

- Investors with capital gains, including businesses, family offices, and impact investors
- Developers, entrepreneurs, farmers, innovators, businesses, universities and other public sector entities who partner with private investors
  - Even tax-exempts should understand the OZ incentive, especially the market impact
- Urban and rural economic development authorities
- Fund sponsors and managers
- Communities, local government and business leaders, faith community in Opportunity Zones
- "People with money, people who need money, and people who can manage money"

THE MECHANICS

CAPITAL GAINS

Individuals and businesses invest unrecognized capital gains in Opportunity Funds

Tax on capital gains deferred as late as 12/31/2026

OPPORTUNITY FUNDS

Opportunity Funds hold at least 90% of assets into Opportunity Zone Property

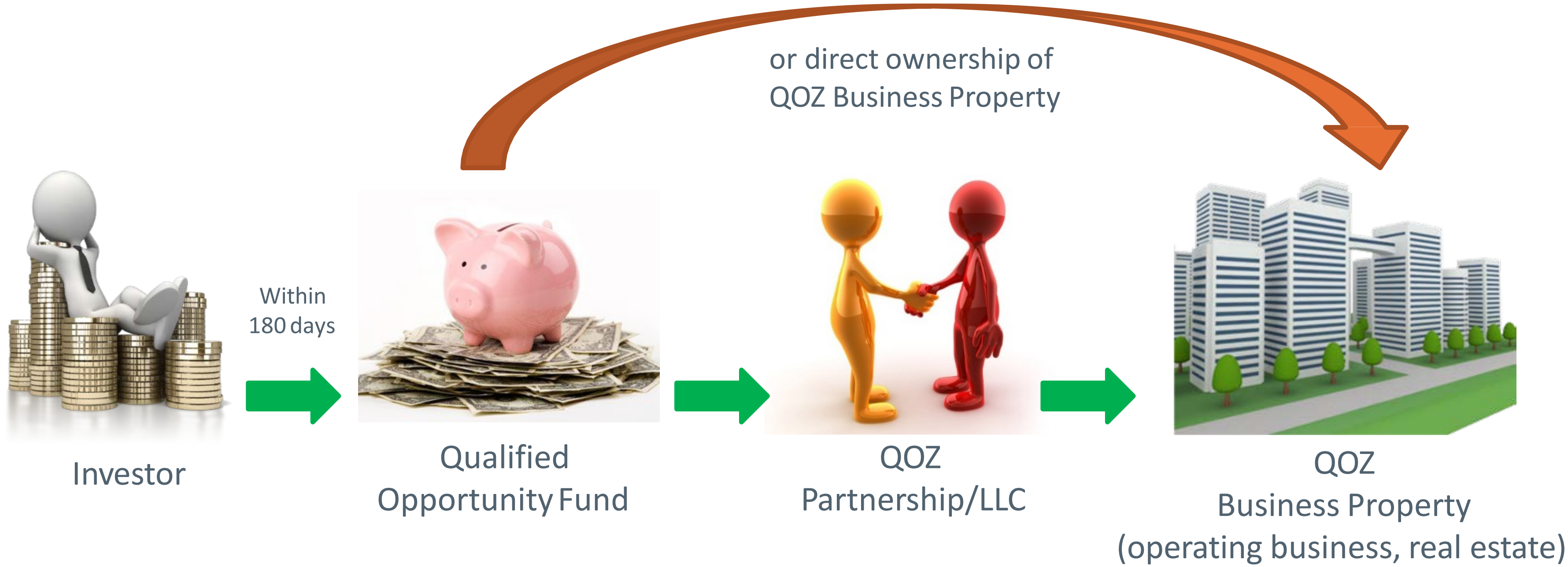
10% increase in basis after investment held 5 years; 15% total increase in basis if held 7 years

OPPORTUNITY ZONE PROPERTY

Opportunity Zone property is stock, partnership interest or Opportunity Zone business property

Gains on OF investments held at least 10 years are tax free

EXAMPLE OF A BASIC OZ MODEL



QUALIFIED OPPORTUNITY ZONE INCENTIVE TIMELINE EXAMPLE

2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028 2029

Oct. 30, 2018
Taxpayer enters into a sale that generates $1M of capital gain

On or before April 27, 2019
Taxpayer contributes the $1M of capital gain to a QOF

QOF makes a timely investment of the $1M in Qualified Opportunity Zone Property

On April 27, 2024 (5 years)
Taxpayer's basis in investment in QOF increases by 10% of investment ($100k)

On or before April 27, 2026 (7 years) Taxpayer's basis in investment in QOF increases by another 5% of investment ($50k)

December 31, 2026
$850k of the $1M of initial capital gains are taxed and the basis in QOF investment increases to $1M

April 27, 2029 (10 years)
Taxpayer sells its investment for $3M and elects to increase its basis to the FMV. No additional tax is owed on the $2M of appreciation.

NOTE: For this example, the Taxpayer's initial basis is $0 in the QOF investment and that the Taxpayer's basis in its QOF interest is not adjusted for any reason other than as a result of the steps shown above. Please note that a Taxpayer's basis in its QOF interest may be increased or decreased for other reasons under generally applicable rules of U.S. federal income tax law.

TAX ANALYSIS

- How the 5, 7 and 10 year tax benefits work if $500,000 of capital gains are invested in an OZ Fund

No investment in OZ

- $500,000 capital gains
  * 23.8% (20% capital gains + 3.8% NIIT)
  $119,000 tax owed year 1

5 year investment in OZ Fund

$500,000 capital gains tax deferred
* 90% (10% of gain excluded)
$450,000 of deferred gain recognized
* 23.8%
$107,100 tax owed year 5

(Any increase in value of OZ Fund interest subject to 23.8% tax rate)

7 year investment in OZ Fund

$500,000 capital gains tax deferred
* 85% (15% of gain excluded)
$425,000 of deferred gain recognized
* 23.8%
$101,150 tax owed year 7

(Any increase in value of OZ Fund interest subject to 23.8% tax rate)

10 year investment in OZ Fund

-December 31, 2026:
85% of deferred gain recognized.
$101,150 of tax owed, basis increases to $500,000.

-Disposition of Interest:
Basis stepped up to fair market value of investment at time of sale or exchange; disposition is federal income tax free.

THE DEFINITIONS

- Qualified Opportunity Fund (QOF):
  - Any investment vehicle organized as a corporation or partnership (which can include LLCs) for the purpose of investing in Qualified Opportunity Zone Property
  - Funds can be a mix of capital gains and non-capital gains (but only capital gains share qualifies for special tax treatment)
  - Funds self-certify annually to Treasury whether they meet requirements to comply with the OZ program (Form 8996)

THE DEFINITIONS

- Qualified Opportunity Zone Property (QOZP):
  1. OZ stock in an OZ business
  2. OZ partnership interest (capital or profits) in an OZ business (includes LLCs)
  3. OZ business property (QOZBP)
     - Tangible property used in a trade or business of the QOF
     - Acquired by purchase or lease after 12/31/2017
     - Original use in the OZ begins with the QOF or substantially improved property (improvements at least double basis). Land not considered.
     - Substantially all the use is in an OZ (70% threshold)

THE DEFINITIONS

- Qualified Opportunity Zone Business (QOZB):
  - Substantially all the tangible property owned or leased is OZ business property. 70% threshold applies
  - At least 50% of gross income derived from *active* trade/business. 3 safe harbors & facts & circumstances.
  - Substantial amount of any intangible property is used in the *active* trade or business (40% threshold)
  - Limits on financial property (deter passive investment)
    - 31 month safe harbor for working capital
    - May maintain assets in cash or equivalents
  - No “sin” businesses

DIRECT INVESTMENT OR EQUITY INTEREST?

- Three primary reasons why equity interest may be preferable
  - 70% "substantial" test for tangible assets
  - 31-month safe harbor for working capital
  - Additional buffer for cash-on-hand

OTHER TERMS AND CONDITIONS

- Must invest in QOF within 180 days after recognizing capital gain (day 1 is date of transaction)
  - For pass-through gain, 180 days can begin on last day of entity's taxable year
  - For 1231 net gains, 180 days begins on last day of taxable year
- Stock/partnership interest and tangible property must be acquired post 12/31/2017
- Related party rules apply (20% threshold)
- Can invest until 2026 (but may not qualify for all the benefits by waiting) and hold until 2047
- Failure of QOF to meet 90% test may result in penalties
  - Can disregard new investments within prior 6 months
  - 1 year to reinvest gains

OTHER TERMS AND CONDITIONS

- Investors can invest in a QOF located anywhere
- QOF can invest in QOZBP located anywhere
- May “twin” with New Markets Tax Credit and other federal, state, and local incentives
- States vary in conforming with Federal rules

FIRST ROUND OF PROPOSED REGULATIONS

- Substantial improvements do NOT include land costs
  - More projects will qualify
- “Substantially all” threshold for tangible property held by a QOZB is 70% (compared to 90% for direct investment in tangible property by a QOF)
  - Some property could be outside the OZ or acquired prior to 12/31/17
- For QOZB, 31 month safe harbor for working capital if used for acquisition, construction, or substantial improvement of tangible property (now extended to business start-ups)
  - Must have a written plan
  - More liberal treatment of “dead” cash will help avoid penalties

FIRST ROUND OF PROPOSED REGULATIONS

- LLCs OK (except single member)
- Only capital gains qualify for OZ benefits
- Pass-throughs can invest in QOF
- 180 day investment period extended in some cases – more time for investors
- Can hold investments until 2047 – fosters long-term commitment
- An “eligible entity” can delay QOF status
- QOF use Form 8996 to self-certify
- Investors use Form 8949 to elect OZ treatment

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SECOND ROUND OF REGULATIONS

- "Original use" means first depreciated or "reboot" after 5 years
- Leases qualify as an acquisition. Related party, original use and substantial improvement tests don't apply, but special rules for related parties and valuation purposes
- Vacant land: Original use and substantial improvement tests don't apply, but must be used in an active trade or business. No land banking.
- Aggregation: Parcels cannot be aggregated for purposes of the substantial improvement test
- Property straddling QOZ and non-QOZ may count toward meeting some QOZB tests if value in QOZ exceeds value outside QOZ

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SECOND ROUND OF REGULATIONS, CONT.

- 50% test:Does not require that 50% of sales arise within the QOZ. Facts & circumstances and 3 safe harbors:
  - 50% of compensation paid
  - 50% of hours worked
  - Combination of management/control and tangible property to earn 50% of revenue
- Working capital safe harbor extended to development of operating businesses

SECOND ROUND OF REGULATIONS, CONT.

- Substantially all thresholds:
  - At least 90% of the time the QOF holds property, at least 70% of the use of the property must be in the QOZ
  - A QOZB must be a QOZB at least 90% of the time the QOF holds an equity interest in the business
  - 40% of intangibles must be used in the QOZB
- These round out other thresholds established in statute and first round regulations:
  - At least 70% of QOZB tangible property must be qualified OZ business property (first regs)
  - At least 50% of gross receipts must be from active conduct of business in the OZ (statute)
  - Less than 5% of basis in QOZB assets may be nonqualified financial property (statute)

SECOND ROUND OF REGULATIONS, CONT.

- 1231 gains not determinable until 12/31; 180 day period begins then
- 10-year QOF investors can elect to exclude capital gains on sales by the QOF of QOZP (tangible property, equity interest).
- Deemed sale rules apply if distributions within first two years
- Taxpayer can qualify for OZ incentive by purchasing QOF interest from third party
- Carried interest does not qualify for OZ benefits
- Property may be contributed to a QOF, not just cash (up to amount of qualified capital gains)

SECOND ROUND OF REGULATIONS, CONT.

- Default rule (with exceptions): transfers in ownership/changes in structure trigger recognition of deferred capital gain
  - Transfers upon death or to grantor trust don't trigger recognition
  - Gifts and charitable contributions do trigger recognition
  - Changes in partnership structure may trigger recognition
  - Greater than 25% change in S corporation ownership triggers recognition
  - *Can* contribute partnership QOF interests to another partnership without triggering gain
    - *But* taxable distributions from a partnership QOF generally accelerate gain recognition, dilute benefit of OZ investment

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SECOND ROUND OF REGULATIONS, CONT.

- QOFs have one year to reinvest sale proceeds back into tangible property or a QOZB without triggering the 90% penalty
- Investments into QOFs within the previous 6 months do not have to be included in the 90% test
- Inventory in transit counts toward 90% test
- "Know it when you see it" – general anti-abuse rule (GAAR)

TREASURY STILL CONSIDERING

- Reporting on impact of OZ investments to communities
- "Substantially all" definitions
- Original use definitions
- Treatment of land
- "Substantial improvement" definitions
- Treatment of inventory
- Leased property rules and valuations
- Whether straddled property rules can be applied more broadly
- 50% test
- Trade or business definitions

TREASURY STILL CONSIDERING, CONT.

- Whether 1397C (50% income, 40% intangibles, <5% NQFP) should be extended to QOF
- Treatment of 1231 gains
- Whether to extend 12 month reinvestment rule to QOZBs
- Burdens to reset QOF holding period if capital gains reinvested
- Amount of deferral with contributed property – basis v. FMV
- Inclusion events
- Timing of basis adjustments
- Inside/outside basis and potential for abuse
- Accounting for mixed funds

TREASURY STILL CONSIDERING, CONT.

- Ownership changes in S corporations
- Disparate results from sale of property
  - Sale of QOF interest in tangible property or QOZB
  - Sale by QOF of QOZBP
  - Sale by QOZB of property
- Whether to extend 10 year exclusion election to QOZBs
- Treatment of boot in an exclusion event
- Treatment of certain corporate distributions
- Treatment of QOF stock as not stock for consolidated rules
- GAAR
- Burden on small business

OTHER PENDING QUESTIONS ABOUT OZ

- Legislative proposals
  - Technical Corrections
  - Disaster OZ
  - Infrastructure OZ
  - Accountability and milestones
    - Concerns about gentrification
    - Affordable and workforce housing
    - Number of jobs created
    - Quality of life

AFTER REGS, HERE COMES THE IRS

- OZ guidance doesn’t end with final regulations
- IRS will need to develop procedures and processes to administer and enforce OZ
  - Will the IRS have a dedicated OZ audit or oversight program?
  - What could trigger an IRS determination that a fund is not a qualifying fund?
    - What constitutes “reasonable cause” for a QOF failing to meet the 90% test?
    - How long will the QOF have to come into compliance?
    - What will be the penalty process?
    - Will the IRS contact partners directly?
  - What information reporting will the IRS require?
  - What substantiation will the IRS require, e.g., to establish “substantially all” thresholds are met?
  - What information will the IRS require in a written plan?
  - Will the IRS have a system to track reporting in 2026 and ultimate disposition of QOF investments?

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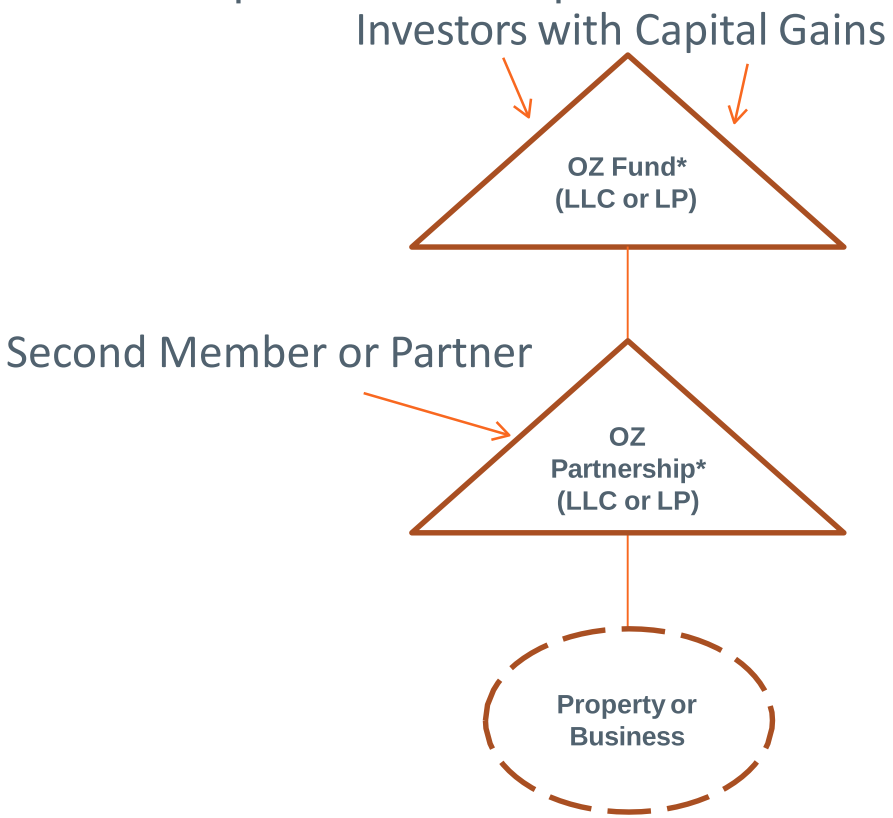
BASIC OZ FUND STRUCTURE

- Single asset, or multiple assets using mirrored structure
- Asset specific or blind pool



Benefits

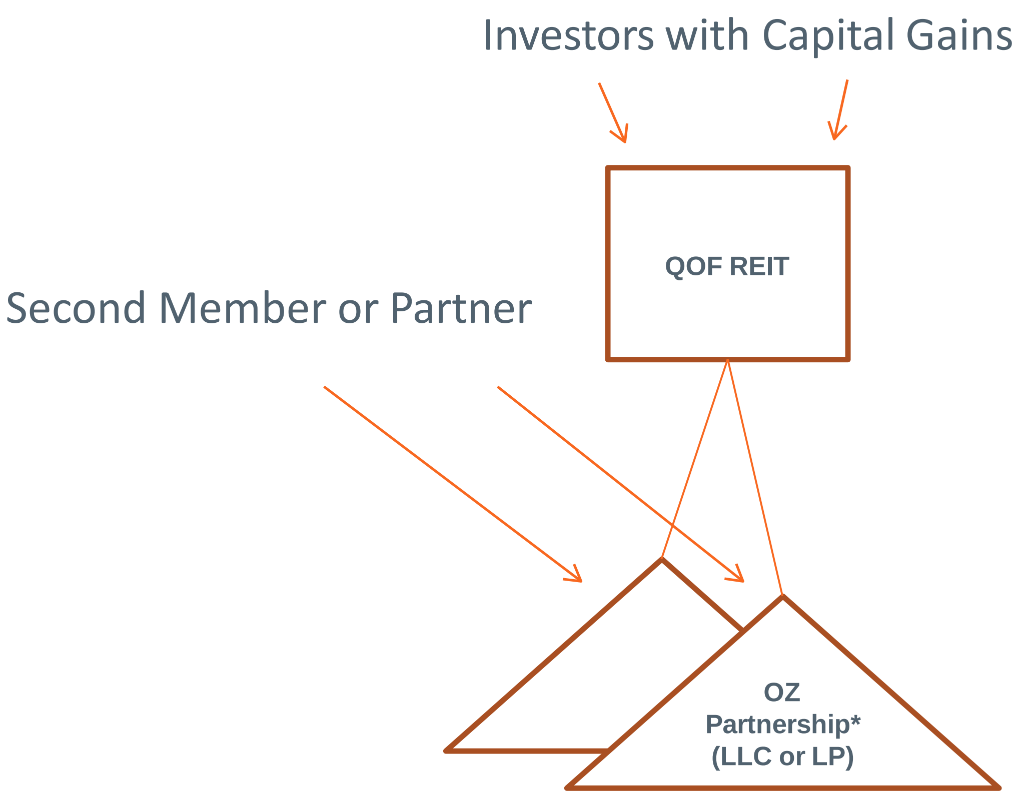
- Provides for exit event flexibility
- Offering can be pursuant to a subscription program and allow for multiple projects under mirrored structures
- Tiered structure provides for better OZ qualification flexibility

Limitations

- K-1s at both OZ Fund and OZ Partnership levels
- If long offering period with multiple projects, managing capital calls and rebalancing could be challenging

REIT STRUCTURE

- Co-mingled real estate asset fund



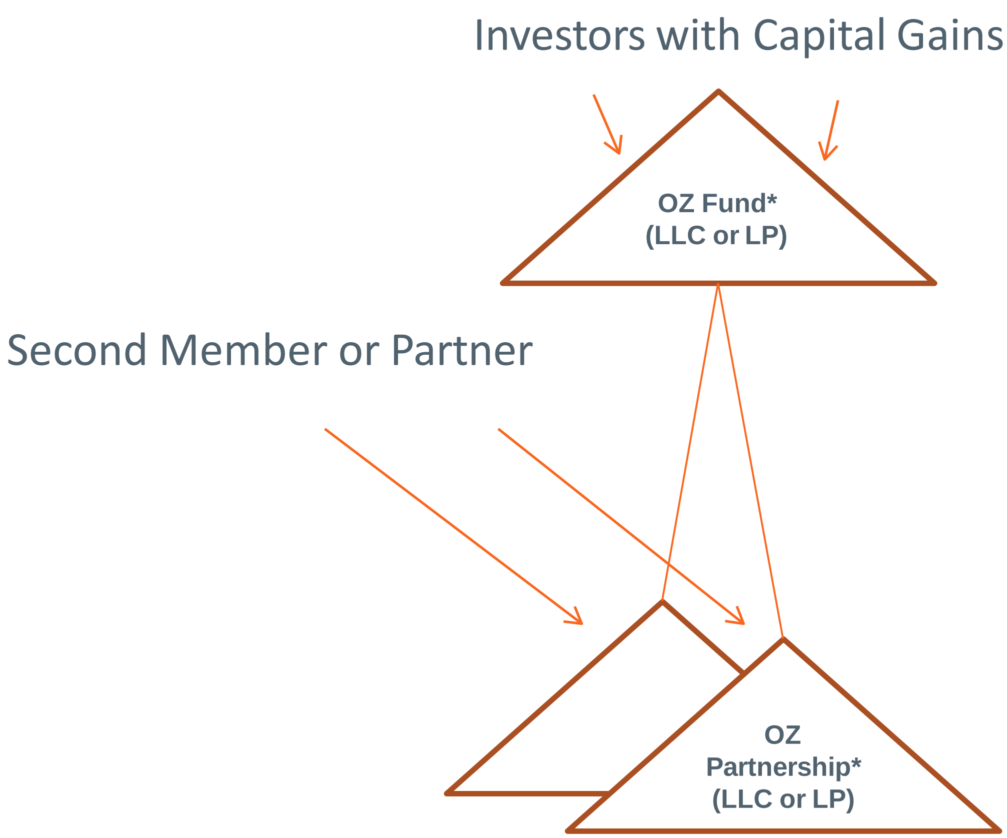
Benefits

- No separate state tax filings for investors
- Diversification
- Comingled assets
- Simplicity in tax reporting (investors receive 1099s, not K-1s)
- If exit is an IPO, ability for investors to have independent exit dates
- 199A potential (20% QBI deduction)

Limitations

- REIT compliance/qualification
- Potentially less exit event flexibility
- Only works for real estate focused strategy

COMINGLED OZ FUND STRUCTURE



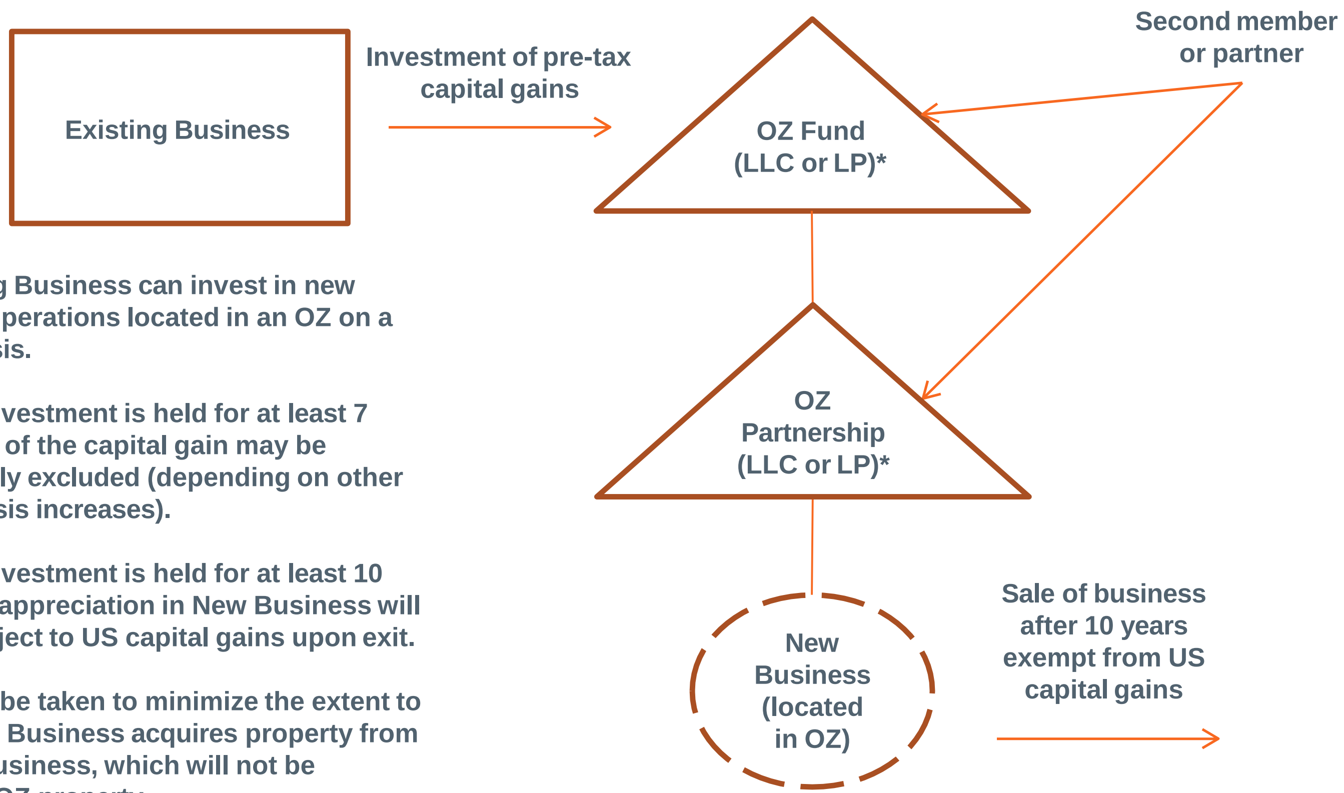
<u>Benefits</u>

- Traditional fund structure
- Easier to manage offering/commitment process
- Less administrative burden
- Diversification

<u>Limitations</u>

- Potential exit issues

EXPANDING EXISTING BUSINESS WITH PRE-TAX DOLLARS



1) An Existing Business can invest in new business operations located in an OZ on a pre-tax basis.

2) If the OZ investment is held for at least 7 years, 15% of the capital gain may be permanently excluded (depending on other uses of basis increases).

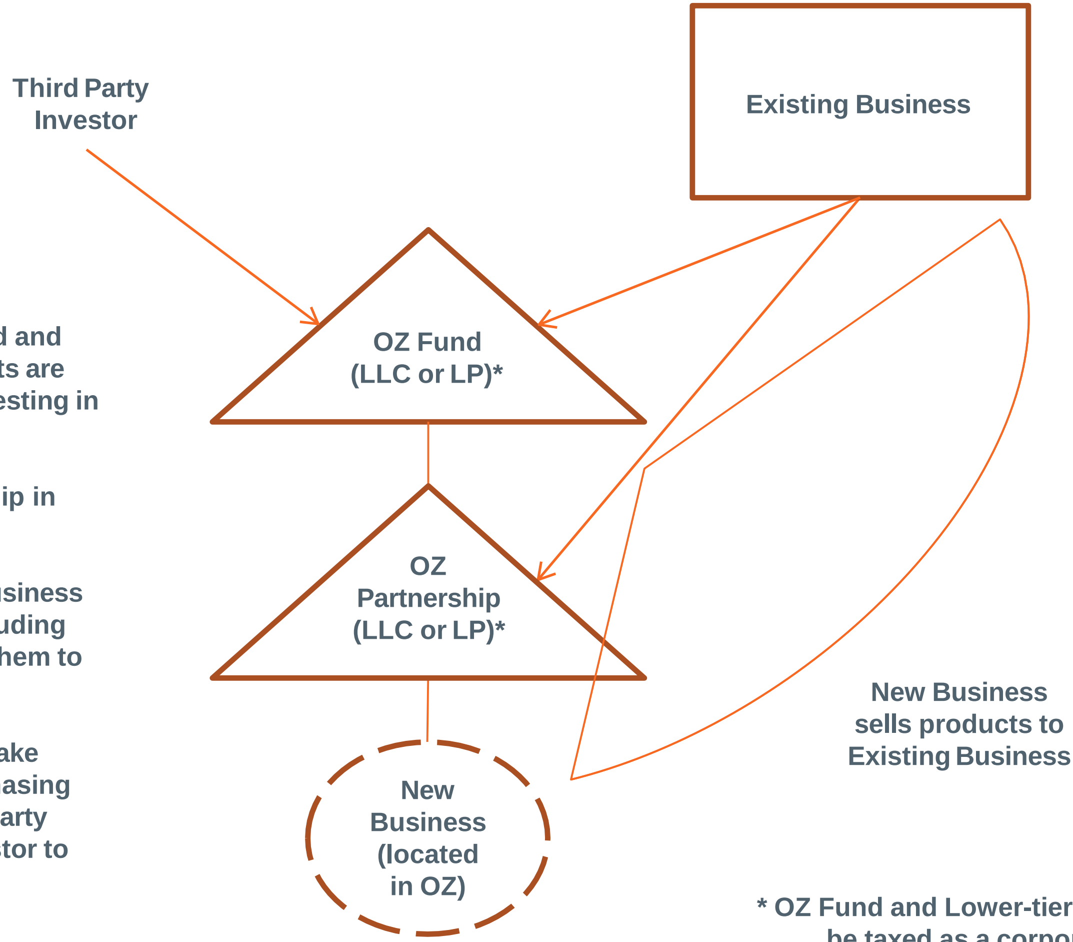
3) If the OZ investment is held for at least 10 years, any appreciation in New Business will not be subject to US capital gains upon exit.

4) Care must be taken to minimize the extent to which New Business acquires property from Existing Business, which will not be qualifying OZ property.

5) Business operations must be monitored to ensure compliance with regulations.

* OZ Fund and Lower-tier vehicle may be taxed as a corporations.

EXPAND EXISTING BUSINESS WITH THIRD-PARTY MONEY



1) Third Party Investor invests in OZ Fund and (provided that applicable requirements are satisfied) receives tax benefits of investing in OZ Fund.

2) OZ Fund invests through OZ Partnership in New Business.

3) New Business can act as part of the business operations of Existing Business, including manufacturing products and selling them to Existing Business.

4) After 10 years, Existing Business can take ownership of New Business by purchasing the interests in OZ Fund from Third Party Investor or allowing Third Party Investor to withdraw for consideration.

* OZ Fund and Lower-tier vehicle may be taxed as a corporations.

TYPES OF ECONOMIC INCENTIVES

We have received significant cash grants and other very large economic incentives for new establishments, expansions, new projects or relocations ranging from $1 million to $100 million.

Types of incentives that may be available include:

- Cash grants
- Tax abatements
- Infrastructure improvements
- Tax Credits
- Land/space
- Cost write-downs
- Utility rate incentives
- Infrastructure
- Training assistance

These incentives can also be blended with New Market Tax Credits and tax-exempt and taxable bonds, and Opportunity Funds, as well as other creative low-cost sources of finance.

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EXAMPLES OF ECONOMIC INCENTIVES OFFERED

Offer Amount	Project
$100+ million	Large bio refinery - Japanese company inbound to the southern U.S.
$60 million	Research, technology and consulting firm headquarters building (Largest-ever incentive package in Washington, DC)
$50+ million	Petrochemical plant - U.K. company inbound to U.S.
$40 million	Bio refinery - Inbound from the UK to the southern U.S.
$31 million	Technology equipment manufacturing facility in NY
$27 million	Food Preparation company in Tennessee
$25 million	Nonprofit community Investment organization in Washington, DC
$22 million	Large nonprofit headquarters building located in Washington, DC
$17 million	Popular radio and television broadcast company in Maryland
$15 million	Nationally recognized multimedia financial-services company in Virginia
$15 million	Enterprise Zone incentives for nonprofit headquarters
$10 million	Advisory services and technology solutions provider
$5 million	Internationally known nonprofit NGO for a headquarters building in Washington, DC
$3.1 million	Fresh food preparation and distribution facility in Texas
$2.5 million	Large data center in Virginia
$1.2 million	Manufacturing facility for chemical products used in gold mining in Nevada
$1+ million	Nonprofit headquarters in Washington, DC
$1 million	Large facility for a bakery in Maryland

WHAT YOU SHOULD BE DOING NOW

- Understand the mechanics, the math, and the potential of the program and how it can work for you and clients.
- Identify potential OZ projects and enterprises, potential investors to invest in QOFs.
- Evaluate impact of OZ on the market where you want to invest, regardless of whether you seek OZ investment.
- Consider terms, fund structure, complementary incentives, financing, liquidation and exit strategies, and other factors - build in resiliency for future regulations and guidance.
- Many funds and projects are proceeding.
- This is not a do-it-yourself project; mistakes can be costly and irrevocable.

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ADDITIONAL RESOURCES

To access our alert library please visit: http://www.klgates.com/opportunity-zones-ozs-practices/

03 May 2019

Practice Group(s):
Opportunity Zones (OZs)
Investment Management
Real Estate
Tax
Public Policy and Law

Worth the Wait: Second Round of Opportunity Zone Proposed Regulations Clears the Way for Many OZ Investments

Delayed regulations favorably address key concerns; could lead to a surge in OZ operating business investments and OZ real estate projects

By Mary Burke Baker, Adam J. Tejeda, Elizabeth C. Crouse, Edward Dartley, Olivia S. Byrne and John D. Price

Opportunity Zones (OZs)

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OVERVIEW | PEOPLE | RELATED CONTENT

The Tax Cuts and Jobs Act includes a new program called Opportunity Zones (each, an "OZ") that offers significant tax incentives for investors to help to attract funding for projects and businesses in low-income areas.

Under the incentive, individuals and other entities can delay paying federal income tax on capital gains until as late as December 31, 2026 if those gains are invested in "Opportunity Funds" that invest at least 90% of their assets in businesses or tangible property located in low-income areas designated as OZs. Further, the gains on investments in the Opportunity Funds can be federal income tax-free if the investment is held for at least 10 years. The tax benefits could reduce the cost of capital for these projects, making them more viable, especially when paired with other development incentives like the New Markets Tax Credit. Congress intended that the OZ incentive operate with minimal restrictions in order to maximize investor participation and thus economic activity and job creation. The K&L Gates OZ Team provides a full spectrum of cross-practice services to help fund sponsors, developers, innovators, and investors understand and implement this new incentive in order to unlock its full investment potential.

QUESTIONS? PLEASE CONTACT:

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