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Federal Opportunity Zones and the Potential for Increased Real Estate Transactions in 2019

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Key Take-Aways for Developer/Owners

- Are OZs good for all Deals? - OZ equity and structure do NOT make a bad deal good BUT it may make a good deal better
- Cheaper Equity - In certain geographic locations for certain product types (e.g., office, multi-family and grocery anchored retail), there is 5% (annual return) equity available for 7 years – NOW! Much cheaper than normal 9% equity
- Geography - OZ deals can be done in ALL 50 states and Puerto Rico (almost the entire island is an OZ)
- Capital Gains – the key for optimizing the use of the program is to have CAPITAL GAINS to invest – other money can be invested but it does NOT get the benefit
- Product Types – all product types (e.g., office, residential, retail, hotel, industrial, etc.) are eligible other than “sin business”
- Properties – one can find properties in an OZ in 58 seconds with an I-phone and a little bit of knowledge – type in the state, opportunity zone and go to economic development site, look for interactive map – easy to find

Key Take-Aways and ?s for Developer/Owners

- Timing – when was the property or business acquired – after 1/1/18?
- Timing – do I need to sell my property to reap the benefits of QOZ if I already own in the OZ? For the most part YES!
- Bruce Springsteen Issue – Badlands – if I own land pre-1-1-18 and do not want to sell it, what can I do with it to unlock value? Will a ground lease to another entity work for QOZB purposes – YES!
- Cannabis – is it a “prohibited” activity and therefore, cannot be done in a QOZ or as a QOZB?
- Ground Leases – can a JV be formed to take advantage of the QOZ and QOZB? Can the JV ground lease from an owner in a OZ?
- “Original Use” Property – what is it and is this nirvana for OZ investors?

Hurdles to Overcome:

- Having the right Sponsor/Developer - The ability to raise capital will be a chore but will be easy compared to find the right sponsor/developer who can effectively and efficiently deploy capital within the 30 month and 31 month windows permitted under the statute and proposed regulations
- Limited Track Record of Fund Raisers and People they will look to in order to deploy the capital raised
- Lack of approvals to build and lack of financing to build – relatively easy to spend \$1 M, \$10 M, however, it is not so easy to spend \$50 M and \$100 M in 30 months if you don't have approvals and plans that are done! Finding and intermediating those that have real projects will be the key
- Blind Pool Funds – let's raise \$500 M plus in a vehicle intended to deploy on the west coast in 5 cap or below self storage assets...great idea; with no identified assets or sponsors and no real permits that are identified or timing, will investors trust that the fund raiser has the wherewithal to find deals in the 180 days and 30/31 month windows?

Hurdles/?s to Consider

- Lack of an Exit Mechanism:
 - Who gets to trigger a sale/redemption and when? Inside of 2026....ouch?
 - What happens if one of the partners in an QOF does not get along with the others...shot gun buy sell of the property which is a traditional means of settling problems may have a bit of a ramification....how else to solve???
- Access to Capital Now:
 - OZ equity investors out there NOW looking for 5% annual returns, not the typical 9% real estate returns!
 - developers having deals and needing ready to use \$\$\$
 - Capital having money and not being able to find deals now
 - Lack of an online or sourcing mechanism to intermediate sources and needs – will be solved but at the moment it is word of mouth
 - Developer must have the knowledge, wherewithal and ability to “substantially improve” at least to the amount of the QOF investment within the given 30/31 month window – they must be able to show the investors and lenders that they can do this or why waste time with them

Developer/Sponsor Issues:

- Who has permits, approvals and control of sites – not bull crap, but real deals, with site control?
- Who has the knowledge and reputation and capital they are willing to deploy quickly to match funds with and/or get debt to match QOF dollars with market ready projects in OZs?
- Better get your butt moving because if you don't during 2019, then you will have lost the benefit of the 15% reduction in capital gains – huh, what??? 7 years from 2026 is **2019**, thus if not moving to execute in 2019, this piece of the puzzle will be **LOST!**
- What are partners/investors willing to do by way of timing on:
 - Buy/Sell rights – after/before 12/31/2026
 - Kick out for malfeasance and impact on capital gains treatment?
 - Ability to refinance before 12/31/2026?
 - Hold period – required until 12/31/2026? Longer?
 - Required redemption after 5 years? 12/31/2026? Longer?

Investors - Key Questions and Take Aways

- Debt vs Equity Issue – IRS Treatment
- Put of Investor Equity – can they force the sponsor to buy them out and at what price – Par + unpaid preferred return or FMV
- Exit – when – 2026 or after 10 years with appreciation?
- Is the investor a QOZ investor who only wants shelter, deferral and CG reduction or a RE investor who wants return and cash flow NOI or both?
- What fee is the investor willing to pay to the Fund Manager – 100 bps, 150 bps, 200 bps? Assets under management or total value of the asset?
- Track record of the fund manager (note – what track record?) or track record of the sponsor?
- What is the exit mechanism for a dispute before 12/31/2026? Buy/Sell – impact on OZ return?
- Who pays for capital call and cap ex at the property? Is this an investor responsibility?

Brokers - Key Take Aways

- Tenants who are your clients who move into zones, establish businesses with capital gains and stay in the OZ for 10 years +, can thereafter sell their business capital gains tax free so long as not a sin business
- Owners who own property in the OZ may not be aware of it – add value by telling them and showing them how they can use this to potentially attract tenants – attraction and retention vehicle
- Market to tenants who are in the zone that if structured appropriately after 1-2018, appreciation in their business if they stay in the zone for 10+ years, may be tax free federally on a sale before 12-31-2047
- Include information about OZs in your marketing materials if your properties are located in the Opportunity Zone – show you know what you are talking about and can add value.

Miscellaneous

- Universities – we do NOT pay capital gains so this does not apply to us right? Does a university raise funds from donors; are those donors potentially looking to defer and reduce capital gains; are universities building buildings in OZs?
- Hospitals - we do NOT pay capital gains so this does not apply to us right? Does a hospital receive funds from donors; are those donors potentially looking to defer and reduce capital gains; are hospitals building buildings in OZs?
- Infrastructure – can one build infrastructure using a P-3 in combination with an OZ Fund and use the benefits? Interesting ? Given that you need a taxpayer with capital gains to be able to benefit from the benefits but if those taxpayers invest in the Fund, and the infrastructure (e.g., a port building, a road within a zone, etc.) can be structured to utilize the program

Benefit Overview – OZone Investments made during 2018 or 2019

Original Investment



Sale of Assets

- Sell assets for \$200M with a basis of \$120M during 2018/2019
- Realize \$80M of capital gain

5 Year Basis Step-Up

- 5 Year Deferral
- 10% Basis Step-Up
- Capital gain reduced to \$72M

7 Year Basis Step-Up

- 7 Year Deferral
- 5% Basis Step-Up
- Capital gain reduced to \$68M

Deferred Gain Recognized

- No later than December 31, 2026 - Gain Recognized on original capital investment of \$80M (up to \$12M may be excluded)



New OZone Investment



OZone Investment

- Invest \$80M in certified QFund, which invests in OZone property
- Realized capital gain of \$80M is deferred.



OZone Investment Sale

- 10 Year Exclusion
- Sell OZone investment property for \$300M
- \$220M capital gain excluded

Example Savings – Investment made during 2018/2019 and Sale of Assets after 10 years

Original Investment

Estimated 5 Year Benefit (\$1.6M) = Capital Gain (\$80M) x Basis Step-Up (10%) x Capital Gain Tax Rate (20%)

Estimated 7 Year Benefit (\$2.4M) = Capital Gain (\$80M) x Basis Step-Up (15%) x Capital Gain Tax Rate (20%)

New OZone Investment

Estimated 10 Year Benefit (\$44M) = Capital Gain (\$220M) x Basis Step-Up (100%) x Capital Gain Tax Rate (20%)

Benefit Overview – OZone Investments made during 2020 or 2021

Original Investment



Sale of Assets

- Sell assets for \$200M with a basis of \$120M during 2020/2021
- Realize \$80M of capital gain

5 Year Basis Step-Up

- 5 Year Deferral
- 10% Basis Step-Up
- Capital gain reduced to \$72M

Deferred Gain Recognized

No later than December 31, 2026 - Gain Recognized on original capital investment of \$80M (up to \$8M may be excluded)



New OZone Investment



OZone Investment

- Invest \$80M in certified QFund, which invests in OZone property
- Realized capital gain of \$80M is deferred.



OZone Investment Sale

10 Year Exclusion

- Sell OZone investment property for \$300M
- \$220M capital gain excluded

Example Savings – Investment made during 2020/2021 and Sale of Assets after 10 years

Original Investment

Estimated 5 Year Benefit **(\$1.6M)** = Capital Gain **(\$80M)** x Basis Step-Up **(10%)** x Capital Gain Tax Rate **(20%)**

*There is no potential basis step-up available for the 7 year holding period for investments made after the year 2019.

New OZone Investment

Estimated 10 Year Benefit **(\$44M)** = Capital Gain **(\$220M)** x Basis Step-Up **(100%)** x Capital Gain Tax Rate **(20%)**

Benefit Overview – OZone Investments made during 2022 – 2026

Original Investment



Sale of Assets

- Sell assets for \$200M with a basis of \$120M during 2022 through 2026
- Realize \$80M of capital gain

Deferred Gain Recognized

No later than December 31, 2026 - Gain Recognized on original capital investment of \$80M



New OZone Investment



OZone Investment

- Invest \$80M in certified QFund, which invests in OZone property
- Realized capital gain of \$80M is deferred.



OZone Investment Sale

- 10 Year Exclusion
- Sell OZone investment property for \$300M
- \$220M capital gain excluded

Example Savings – Investment made during 2022-2026 and Sale of Assets after 10 years

Original Investment

*There is no potential basis step-up available for either the 5 or 7 year holding periods for investments made after the year 2021.

New OZone Investment

Estimated 10 Year Benefit **(\$44M)** = Capital Gain **(\$220M)** x Basis Step-Up **(100%)** x Capital Gain Tax Rate **(20%)**

Designated Opportunity Zones

8,762

census tracts designated

1,858

rural census tracts designated

31%

average poverty
rate

14.4%

average unemployment
rate

60%

average family income in OZ
census tracts relative to
area median income (AMI)

24 million

current jobs in designated
tracts

1.6 million

businesses in designated
tracts

Economic Development Examples

1 Business infrastructure real estate funds:

- *Industrial*
- *Retail*
- *Mixed use*
- *TOD*

2 Venture capital funds:

- *Seed stage investments*
- *Series A investments*

3 Operating business private equity:

- *Equity recapitalizations*
- *Growth capital investments*

4 Enhancement for other federal tax credit transactions:

- *NMTCs*
- *Historic Tax Credits*

IRC §1031 Exchange vs. OZone Investment

IRC § 1031 Like-Kind Exchange (“LKE”)

- All proceeds from the original sale must be reinvested within 180 days of the exchange
- Deferred gain is recognized upon taxable sale of the new property
- Basis in the new property is equal to the basis in the original property exchanged
- Future LKEs may be applied
- No limitation on location of LKE property
- There is no basis step-up or gain reduction as a result of holding the new property for a period of time
- Generally, exchanges can occur between related parties
- Under Tax Reform, section 1031 only applies to real property exchanges

IRC § 1400Z-2 OZone Investment

- Only the realized gain portion of the original sale must be reinvested within 180 days of the sale to defer gains
- Deferred gain is recognized upon the earlier of the sale of the property or December 31, 2026
- Basis in the OZone property is zero (assuming only the gain is reinvested) until the deferred gain is recognized
- No future deferrals are allowed after the first election
- Location limited to designated OZones
- There is a basis step-up in the new property if held for 5 years and 7 years of 10% and 5% of the deferred gain, respectively. After 10 years, the basis is equal to the FMV of the investment when sold
- The original sale or exchange of the property must be to an unrelated person
- Investment in new property can be any property if it meets the definitions of qualified opportunity zone property

Where are we seeing focus and attention?

- What classes of Real Estate are likely to attract attention from investors:
 - Grocery anchored retail
 - Warehouse and industrial
 - Skilled nursing and medical office
 - Affordable Housing
- Will Investors pay more for LIHTC credits knowing they might be able to also get capital gains shelter?
- What is Deferral, Reduction and potential non-payment of gain worth for a project – maybe 500 bps to 800 bps

Steps Toward Implementation



Key Points

Investors

- Tax incentive is most valuable for 10 year investments in appreciating assets
- Six months to invest after realizing a capital gain
- Another six months to deploy 90% of capital in Zones
- Capital is required to be an equity investment – loans from investors are not eligible for the tax incentive

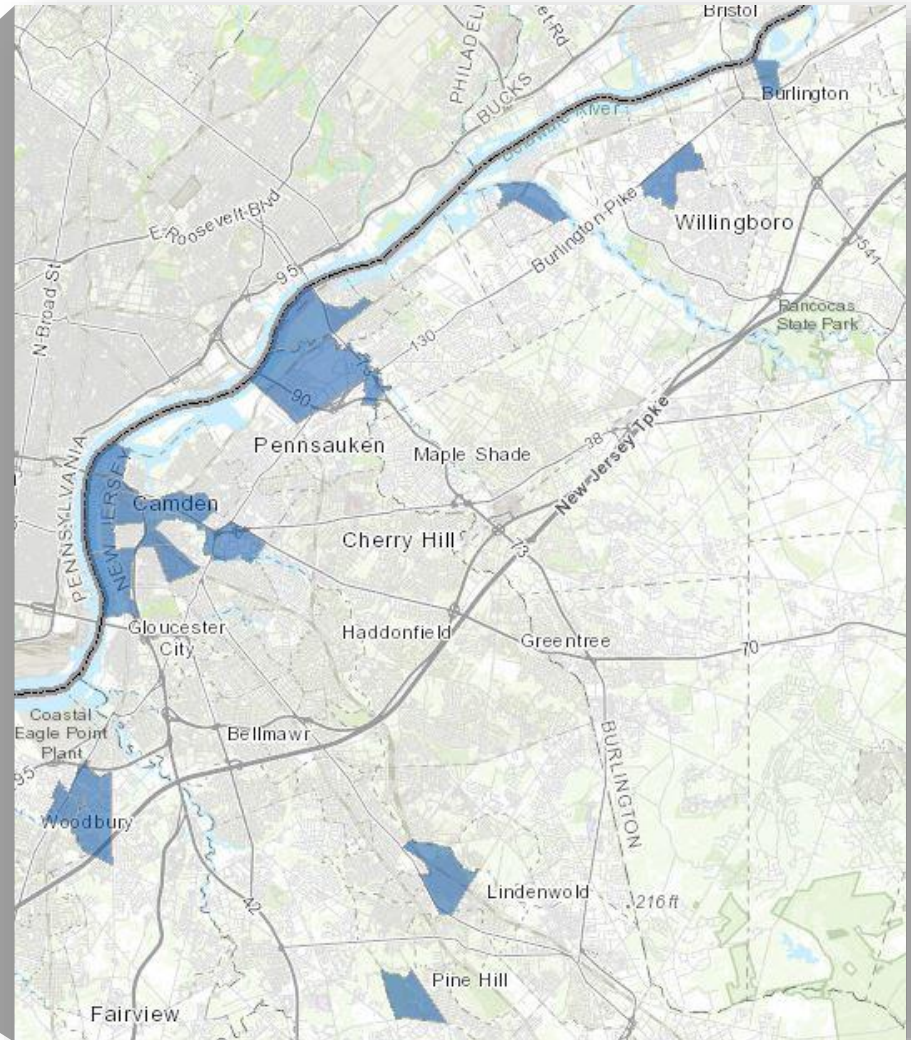
Funds

- All capital must flow through an Opportunity Fund to be eligible for the tax incentive
- Funds are self-certified via an IRS tax form
- Fund must be established for the purpose of investing in Opportunity Zones
- 90% of fund assets must be invested in Zones to maximize the tax incentive

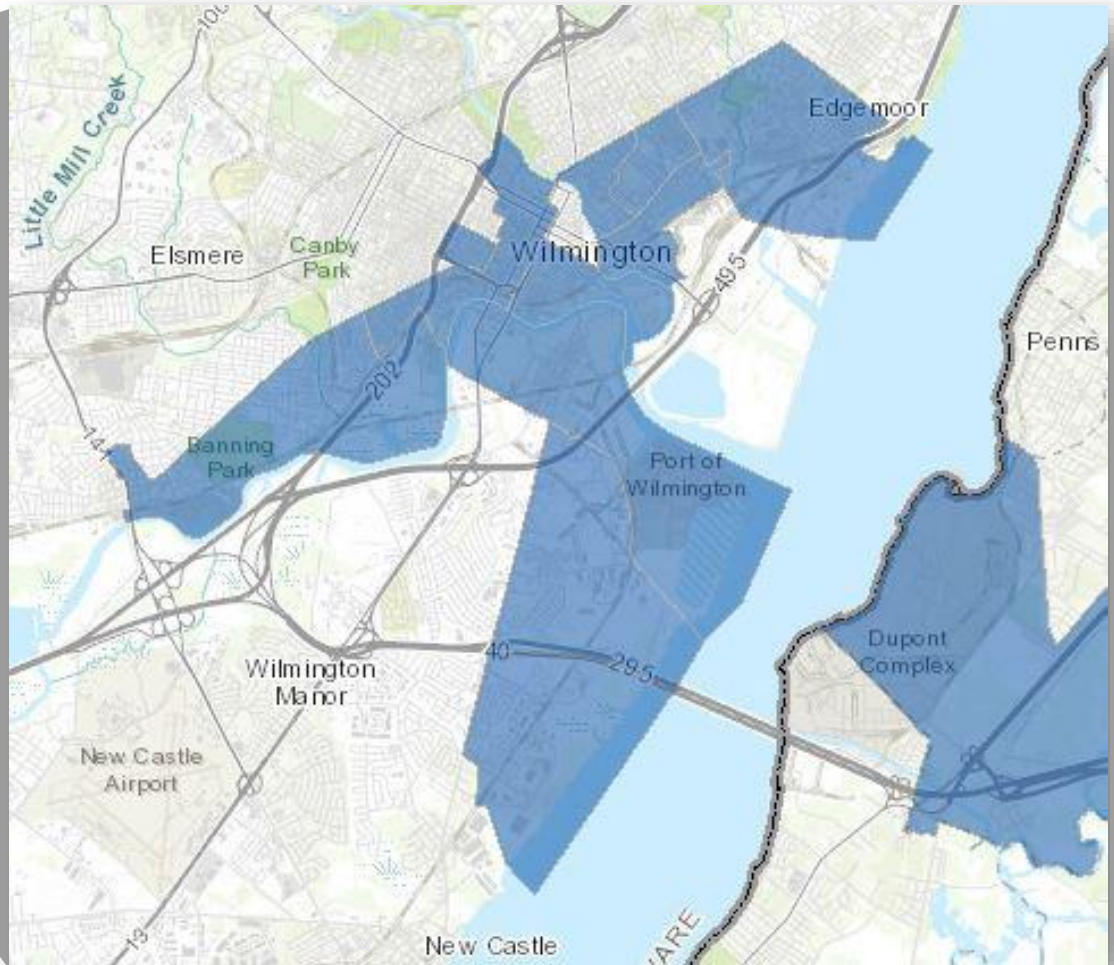
Eligible Investments

- Must be equity investments
- Real estate investments must include substantial rehabilitation – doubling basis within 30 months
- “Sin businesses” are not eligible
- Other requirements include property use in “active conduct of business” and limits on assets held in cash

Camden, New Jersey



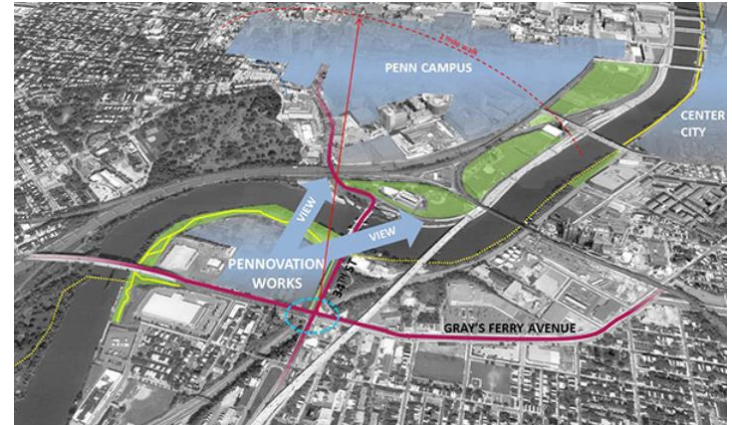
Wilmington, Delaware



Regional Site Examples



The Arsenal in Frankford



The Pennovation Center in Grays Ferry



Camden, NJ



Chester Waterfront

Deals we are Doing Now:

\$40M into a QOF and \$175M mixed use project with a school

\$20M into a QOF and a substantial improvement for a warehouse of \$42M

\$12M, 40 units of mixed use construction in Philadelphia; \$8M of equity investment from a QOF at 5% annual pay, 7 years; \$2M construction loan

\$13M apartment original use property in southern US by limited partner investor

\$83M office and lab building in Pennsylvania in the OZ; \$30M of OZ equity to be raised and invested

\$60M OZ equity fund in a Reg D private placement among accredited investor friends and family for an industrial and mixed use residential project of \$123M

\$75M assisted living and independent living construction project adjacent to a hospital on a ground lease in southern US in an OZ

Deals we are Doing Now

350 acre winery in Southern CA in an OZ

12 acre OZ in an urban environment zoned to allow for 2.3 M feet of mixed use development across for a Metro stop

18 acre site in urban center, CDC looking to create performance space and artist loft space for affordable housing

Tax Credit Fund Creator looking to create 3 separate funds, one for market rate housing, one for renewables and one for affordable housing, each for \$250M to \$300M of capital to invest in transactions within the OZ

12 sites in OZ adjacent to soccer stadium being reviewed for college retail and residential development

Resources:

Opportunity Zones Resources:

The authority to implement IRC 1400Z-1 and 1400Z-2 has been delegated to the IRS. The CDFI Fund is supporting the IRS with the Opportunity Zone nomination and designation process under IRC 1400Z-1 only.

The IRS has posted a list of [Frequently Asked Questions about Opportunity Zones](#) and is currently working on guidance on how the Qualified Opportunity Zone benefit under IRC 1400Z-2 (including the certification of Qualified Opportunity Funds and eligible investments in Qualified Opportunity Zones) will be administered. IRS and Treasury are giving this guidance high priority for rapid issuance over the next few months. Please send any comments or questions to CC.ITA.Section.1400@irsounsel.treas.gov.

Resources (continued)

Opportunity Zones:

[List of designated Qualified Opportunity Zones \(QOZs\)](#): This spreadsheet was updated June 14, 2018, to reflect the final QOZ designations for all States. (See [IRS Notice 2018-48, 2018–28 Internal Revenue Bulletin 9](#), July 9, 2018, for the official list of all population census tracts designated as QOZs for purposes of Internal Revenue Code §§ 1400Z-1 and 1400Z-2.)

For a map of all designated QOZs, [click here](#).

- To view all designated QOZs, click on the “Layers” tab on the menu on the right hand side of the screen. Select “Opportunity Zone Tract” and unselect “2011-2015 LIC Census Tract,” and zoom in to a specific area on the map. Designated QOZs will appear in blue.
- To view a specific census tract, enter the tract number in the search bar, select “2011-2015 Census Tract” by clicking on the mailbox symbol on the left of the search bar, click search, and select the census tract number that appears in the results below.

Resources (continued)

Additional Resources:

IRS Revenue Procedure: Provides information on the eligibility criteria for census tract designation as a Qualified Opportunity Zone and the nomination and designation process.

Opportunity Zones Information Resource, with sortable lists by State of all census tracts originally eligible for designation as a QOZ.

Opportunity Zones Shapefile: This Zip file contains a Geographic Information System (GIS) shapefile of all population census tracts designated as QOZs as well as all population census tracts originally eligible for designation as a QOZ. See Readme text document for additional detail.

Resources (continued)

For all questions on IRC 1400Z-2 related to Opportunity Funds and Opportunity Zone Investments:

Phone: (414) 231-2240

E-mail: CC.ITA.Section.1400@irsounsel.treas.gov

Resources and Tools

opportunityzones.newmarkets.org

Visit [NMSC's Opportunity Zones](#) pages for:

A [mapping tool](#) of designated census tracts

Federal and state [government resources](#) and updates

[LISC and partner resources](#), including presentations and webinar recordings

Opportunity Zones and Opportunity Funds [FAQ](#)

A sign-up form for our Opportunity Zones [email updates](#)

Resources and Tools (continued)

Other Opportunity Zones resources:

The [Investing in Opportunity Act](#)

Community Development Financial Institutions [\(CDFI\) Fund Opportunity Zones updates](#) and resources

Economic Innovation Group [\(EIG\) Opportunity Zones pages](#) for related news, background information, and a list of bipartisan supporters

Thank You



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