Citi Community Capital

A Brief Overview | June 19, 2018

Deering Groves - 281 Units
Developed by: AHS Residential
Miami, FL

Opportunity Zones

Lisa Brill
Partner

Jeffrey Jaeger
Principal

John Heppolette
Citi Community Capital
Co-Head

Michael Novogradac
Partner

Welcome

- To ask a question
  - email AskCitiCommunityCapital@citi.com
  - Follow instructions from the Operator - Press *1 for the operator to open your line. This will enter you into the queue to ask a question
- The recording will available within the next 24 hours at http://www.citibank.com/icg/sa/citicommunitycapital/resource_center.jsp
- Resources
  - Novogradac Opportunity Zones Resource Center - https://www.novoco.com/resource-centers/opportunity-zones-resource-center
  - Sherman & Sterling - https://www.shearman.com/perspectives/2018/05/opportunity-zones-a-preliminary-examination
- Poll Results

Agenda

- Introduction of Panelists
- Background and current status of Opportunity Zones (OZs)
- Panelist Discussion
- Audience Question and Answer

Your Webinar Panelists

John Heppolette
Citi Community Capital
Co-Head
citi

Lisa Brill
Partner
Shearman
SHEARMAN & STERLING

Jeffrey Jaeger
Principal
STANDARD

Michael Novogradac
Partner
NOVOGRADAC & COMPANY LLP
CERTIFIED PUBLIC ACCOUNTANTS

Opportunity Zone Definitions

Established under the Tax Cuts and Jobs Act of 2017, Opportunity Zones are intended to spur private investment in low income communities by providing tax benefits to investors.

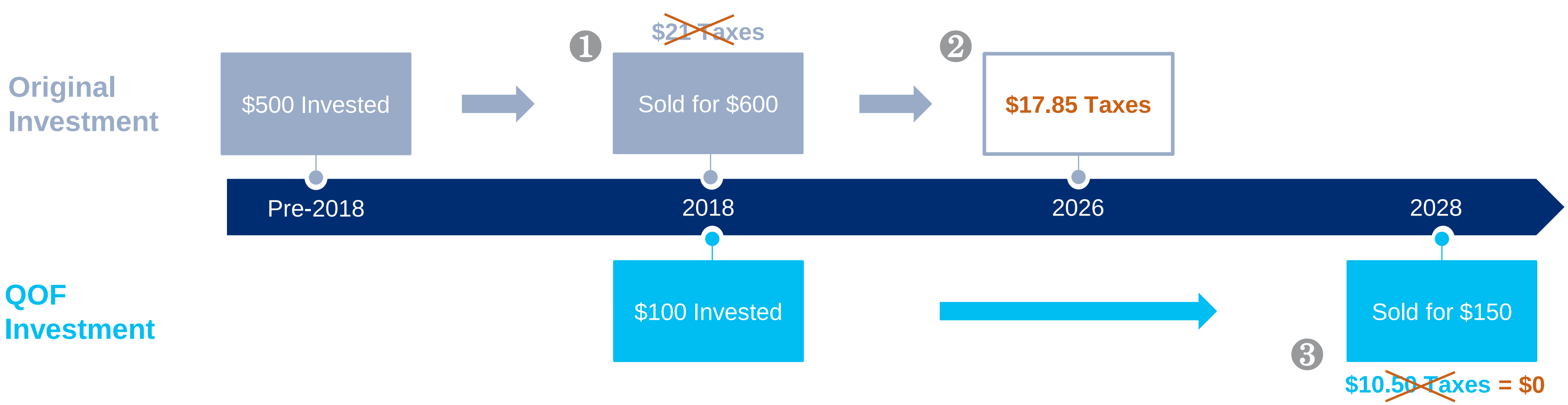
- All **Qualified Opportunity Zone** ("QOZ") nominations have been certified by Treasury, and designated as "QOZs".
- State Governors were able to nominate a census tract as a **Qualified Opportunity Zone** ("QOZ") if:
  - it is a "low-income community" under Section 45D(e) for New Markets Tax Credits, or
  - it is contiguous with a designated low-income community and the median family income does not exceed 125% of the median family income of the contiguous designated low-income community (such QOZs could be no more than 5% of the QOZs in a State)
- Generally, the number of QOZs was limited to 25% of the number of low-income community census tracts in a State
- A list of QOZs can be found here: https://www.cdfifund.gov/pages/opportunity-zones.aspx
- A **Qualified Opportunity Fund** ("QOF") is an investment vehicle that designates itself as a QOF and holds at least 90 percent of its assets in Qualified Opportunity Zone Property ("QOZP")
- **Qualified Opportunity Zone Property** includes Qualified Opportunity Zone Business Property ("QOZBP"), or stock or partnership interests in a Qualified Opportunity Zone Business ("QOZB") in which substantially all of the tangible property is QOZBP.
  - At least 50% of a QOZB's gross income must be derived from active business
  - "Non-qualified financial property" must be less than 5% of the basis of QOZB
  - As long as a QOF has been organized with a purpose to acquire QOZP, nothing appears to prohibit a QOF from acquiring such property with seed money or debt prior to receiving contributions from investors
  - The Act does not prohibit the acquisition of QOZP with mortgage, mezzanine or fund-level financing
  - For real estate, QOZBP must generally be new construction or "substantially improved", effectively meaning that rehab costs over 30 months must exceed acquisition cost

Note: Governors nominated tracts, Treasury certified the nominations, and designated the tracts.

Qualified Opportunity Fund Benefits

Any individual, corporation, or trust can defer capital gains from the sale or exchange of property to an unrelated person by investing such gains in a Qualified Opportunity Fund within 180 days of such gain.

1. **Deferral of taxes on original gain** - Taxation on original gains is deferred until the earlier of disposition of QOF interest or December 31, 2026
   - E.g., a corporation originally invested $500, sold that asset in 2018 for $600, and reinvested the $100 gain in a QOF
   - The investor does not pay $21 of taxes on the $100 gain in 2018
2. **Reduction of taxes on original gain** – The deferred taxes are reduced by 10% if held for 5 years, or 15% if held for 7 years
   - The investor would only pay $18.90 of taxes if QOF is disposed of in December 2023, or $17.85 if disposed of in December 2025
   - If the QOF is not sold before 2026, $17.85 is owed in 2026
3. **Elimination of taxes on gain from QOF -** If a QOF is held for 10 or more years, no taxes are due upon sale on additional gain
   - The investor would pay $0 in tax if the QOF is disposed of for $150 in 2028



Application to Affordable Multifamily Housing

Affordable housing developers planning a new project in a Qualified Opportunity Zone may find it beneficial to own the project through a Qualified Opportunity Fund.

GP Interest Benefits

- If a sponsor owns their GP interest through a QOF (or designates the lower-tier partnership as a QOF) with an initial investment of gains from another investment, and sells that QOF interest in year 15, there is generally no taxation on the gain from the QOF.
  - While there may be minimal benefit from the **deferral** and **reduction** of the taxation on the prior gain rolled into the QOF, there could be significant benefit from the **elimination** of taxes upon exit in year 15.
  - This may obviate the need/desire to pursue a 1031 exchange at exit.

LP Interest Benefits

- In addition to the benefits of **deferral** and **reduction** of taxation on the original gain invested in an LP interest, there could be an **elimination** of taxation on the gain on exit from “high loss” deals in year 16.

Considerations and Unknowns

Investors have started to think through the benefits and how to structure these investments, but there is limited guidance from the Department of Treasury and the IRS on the details. More information is expected soon.

- Elimination of taxation on the gain requires the initial investor to sell their interest in the QOF. It is unknown whether IRS/Treasury will provide clarity regarding treatment for sale of the underlying property or investment rather than the QOF itself.
- Until IRS/Treasury issues guidance, it is unclear for how long a QOF can hold cash from the disposition of an asset before the cash needs to be reinvested in QOZP.
- It is unknown whether a QOF that is a partnership may effectively realize gains on behalf of investors and reinvest such gains in new QOZP to allow investors to defer and/or eliminate taxation of such gains. If IRS/Treasury does not issue such guidance, investors may require restrictions on the QOF’s ability to sell assets until certain criteria are met.
- The treatment of land as qualified property remains unknown
  - Typically treated for tax purposes as an asset separate from any buildings constructed on the land
  - Amounts spent on construction or improvements of buildings may arguably not cause the land to be treated as substantially improved, in which case the land would not be considered qualified property for purposes of the 90% test
  - Expected that IRS/Treasury will allow land to be combined with the building for substantial improvement test, but no official guidance yet
- Interests in a QOF could be considered securities. No guidance on potential SEC implications

Panelist Discussion

- **Panelist Questions**
- I heard a rumor that Treasury does not intend to issue further guidance. What do you know?
- I have a project tied up that is in a Qualified Opportunity Zone. How soon could a Qualified Opportunity Fund be set up, and what will it cost?
- I have a property that is partially in an opportunity zone, do you think there is a chance I can get it to qualify as opportunity zone property?
- Taking entitlement risk on investment opportunities. What happens if the entitlement process takes much longer than expected in a development and how would it impact opportunity zone investments?
- Questions about gains:
  - Is the QOF Investment limited to previously realized gain?
  - Does all of the QOF Investment have to be all of the gain?
  - Can gains be mixed or pooled?
  - How do I manage fresh cash in opportunity zone investments?
- How do you see bank and investor interest on the institutional level? CRA has fueled huge growth in the LIHTC and new market space, and LIHTC equity receives special considerations for bank equity investments. Will this become a factor at all in opportunity zone investing, and will there be CRA-driven investor/lender involvement in a substantial way?
- Can you “Land Bank” in an Opportunity Zone?
- Some states are expected to follow the federal exclusion and some are not. How does this change rates of returns in different states, and levels of interest from investors.
- **Additional Questions, Time Permitting**
- Are there other key unanswered questions related to combining low-income housing tax credits with Opportunity Zones?
- Do you think a future Congress will extend the requirement that deferred gain be recognized no later than December 31, 2026?
- Can the opportunity zone incentive be combined with new markets tax credits and/or historic tax credits?
- For sellers of rental real estate, how does opportunity zone investing compare to using 1031 like-kind exchanges?

Audience Question and Answer

- To ask a question
  - email AskCitiCommunityCapital@citi.com
  - Follow instructions from the Operator - Press *1 for the operator to open your line. This will enter you into the queue to ask a question

Citi believes that sustainability is good business practice. We work closely with our clients, peer financial institutions, NGOs and other partners to finance solutions to climate change, develop industry standards, reduce our own environmental footprint, and engage with stakeholders to advance shared learning and solutions. Citi's Sustainable Progress strategy focuses on sustainability performance across three pillars: Environmental Finance; Environmental and Social Risk Management; and Operations and Supply Chain. Our cornerstone initiative is our $100 Billion Environmental Finance Goal – to lend, invest and facilitate $100 billion over 10 years to activities focused on environmental and climate solutions.