The Big Opportunity:
Does an Opportunity Zone Fund Work for You?

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Opportunity Zones (OZs) present immediate tax and investment opportunities for investors and entrepreneurs.

Any investor who has, or will, earn a sizeable capital gain from investments or a business sale should understand how this new tax regime can save substantial tax dollars and accelerate their financial goals. OZs also bring new economic prospects to America's underinvested areas. It's a classic win-win.

BENEFITS

The benefits for investors can be amazing.

- ***Defer*** payment of capital gains taxes owed
- ***Reduce*** capital gains tax owed on that original asset by 15%
- ***Never pay*** capital gains taxes on the Opportunity Zone asset

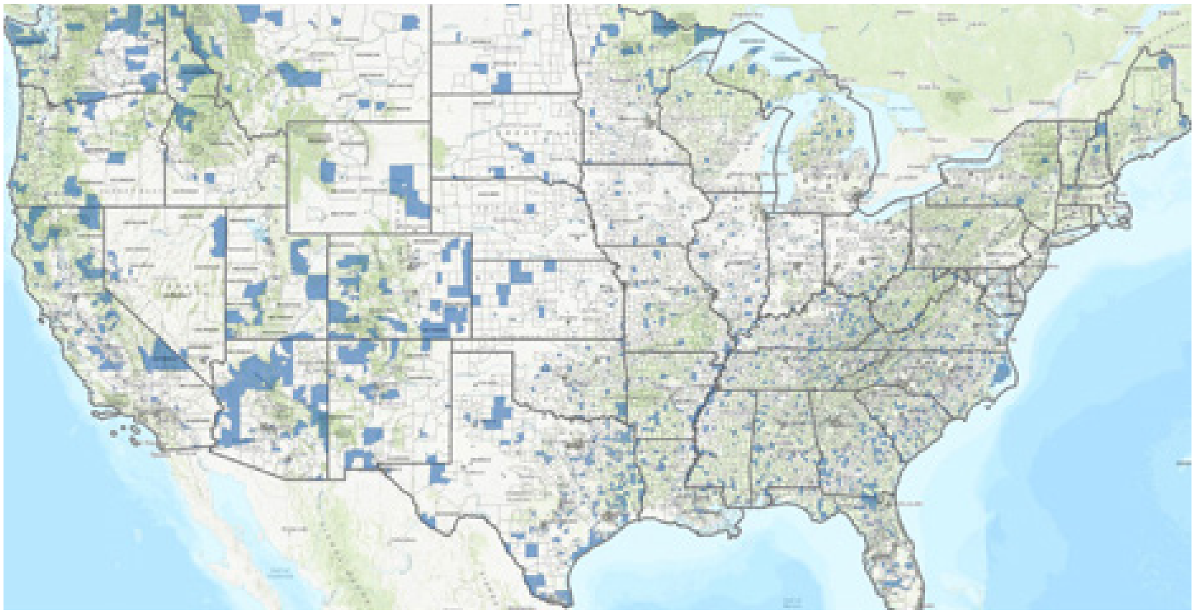
An Investor's Process:

Is an OZ Fund right for you? To help you decide, we'll cover five key components:

- **Program Overview:** What are the basic mechanics of the program and timelines?
- **Fund Requirements:** Understanding this will help you understand why certain investment strategies won't be available.
- **Your Situation:** See if you have the 5 key characteristics of a successful Opportunity Zone investor.
- **Fund Selection:** We'll offer a decision framework to help you and your advisory team make the best choices from the universe of funds available.
- **Due Diligence:** Because these funds will generally be long term and illiquid, a solid due diligence process is vital.

Program Overview

Created by the Tax Cuts and Jobs Act, over 8,700 tracts of land across the county have been designated as “Opportunity Zones,” providing new and compelling tax incentives for rethinking where and how to do business.



Opportunity Zones were designed to incentivize the reinvestment of an estimated $6 trillion in private, unrealized capital gains into designated areas that have failed to recover from the Great Recession. These designated areas cover the entire country and they vary widely in their economic and geographic characteristics. While some areas are what we consider “low income,” many are not. Anyone who has strolled the East End in Manhattan may be surprised that it is an Opportunity Zone census tract!

Tax Benefits and Deadlines that Impact You

Normally, a profit resulting from the sale of an asset is taxed at a maximum capital gains rate of 20%. Many states have chosen to mirror the Federal level of OZ tax treatment as well.

Defer the Original Capital Gain Tax

Now, Congress gives taxpayers the option of deferring payment of that tax until year-end 2026 by reinvesting that profit into an Opportunity Zone Fund (“Fund”). The Fund then reinvests the proceeds into eligible Opportunity Zone property (“OZ Property”).

Reduce the Original Capital Gain Tax

If invested for five years, investors will have their original capital gains tax liability reduced by 10%.

If invested for seven years, the investor receives another 5% tax break on the original amount deferred, for a total 15% tax-break. The amount of tax deferred becomes due and payable by year-end 2026, so investors *must invest by year-end 2019* to achieve the full 15% reduction provided by the seven-year investment timeline. The 10% reduction phases out two years later (year-end 2021), and temporary deferral of the original tax liability is gone by year-end 2026.

Eliminate Capital Gain Tax on Fund

If the OZ Fund investment is held for at least ten years, then the Fund's sale of its OZ Property will be treated by the IRS as 100% tax-free. All OZs are scheduled to expire by year-end 2028, but investments made prior to this expiration date will continue to accrue tax-free gains until 2047.

A TEN YEAR TIMELINE

YEAR 1
2019
Invest capital gains from prior investment into a Qualified Opportunity Fund and begin deferring tax

YEAR 5
2024
Tax basis increased from $0 to 10% of the invested capital gains, reducing future tax liability

YEAR 7
2026
Tax basis increases by additional 5%, for a 15% total increase, durther decreasing future tax liability

YEAR 8
2027
Pay taxes on original capital gain (less 15% reduction)

YEAR 10+
2029+
Pay no federal capital gains taxes on the appreciation of the QOF Investment once sold

How it Works: An Example:

Consider the following hypothetical that highlights the basic timing rules and tax mechanics. On July 1, 2019, Audrey sells her business and several stocks for a $1 million profit. Assuming 20% long-term capital gains rate, Medicare surtax of 3.8%, and State taxes of 5%, Audrey's tax liability is $288,000.

Rather than pay this tax to the IRS on her 2019 return, Audrey invests the $1m in a Fund within 180 days of her sale.

Audrey's Timeline:

- July 1, 2019: Audrey realizes her capital gain.
- December 27, 2019: Audrey's deadline to invest in a Fund (180 days later)
- July 1, 2024: Audrey receives a 10% step-up in basis on her $1 million investment because she has held the investment for five years.
- July 1, 2026: Audrey receives an additional 5% step-up in original basis because she has held the investment for seven years.
- December 31, 2026: Audrey's original assets' deferred capital gains tax becomes due and payable. She now has reduced her deferred capital gain from $1 million to $850,000, and her capital gain tax liability goes down from $288,000 to $244,800
- 2029: On the 10th anniversary of her Fund investment she is eligible for a tax-free exit of the Fund.

If Audrey's Fund appreciates 6% per year and she sells the Fund for $1.79 million, she can then elect to step up her basis in the Fund to an amount equal to the sale price, resulting in *no tax* on the sale. Having paid her $244,800 capital gains tax bill in 2026, Audrey's total after-tax profit during the ten-year investment period is $546,048.

Had Audrey not invested in a Fund and instead paid the original capital gains taxes and invested the remaining $712,000 in a similar non-OZ Fund asset, she would have netted a total after tax profit of only $112,915.

By investing in a Fund, Audrey benefited by $433k!

HYPOTHETICAL AFTER-TAX VALUE

	Non-Qualified Opportunity Fund	Qualified Opportunity Fund
Original Capital Gain *from sale of prior investment*	$1,000,000	$1,000,000
Tax Rate	28.8%	28.8%
Tax on original capital gain	($288,000)	Deferred
Investable amount *after tax*	$712,000	$1,000,000
Compounded annual return	6%	6%
Appreciation *over 10 years*	$563,084	$790,848
Tax on appreciation *after 10 years*	($162,168)	$0
Long term capital gains taxes paid in 2027 *on original capital gain*	$0	($244,800) *30% of 850k basis stepped up to 15%*
Total growth above original capital gain *after 10 years net of taxes paid*	**$112,915**	**$546,048**

In this simplified example, Audrey has maximized the Opportunity Zone tax benefits and received $433,000 in additional benefits.

OZ Fund Requirements

While the program is fairly straightforward for the Fund investor, the IRS requires investment properties to meet more criteria than merely being located in an Opportunity Zone. Thus, it is critical that Funds comply with these regulations in order to provide the taxpayer-investor the intended tax-preferred treatment.

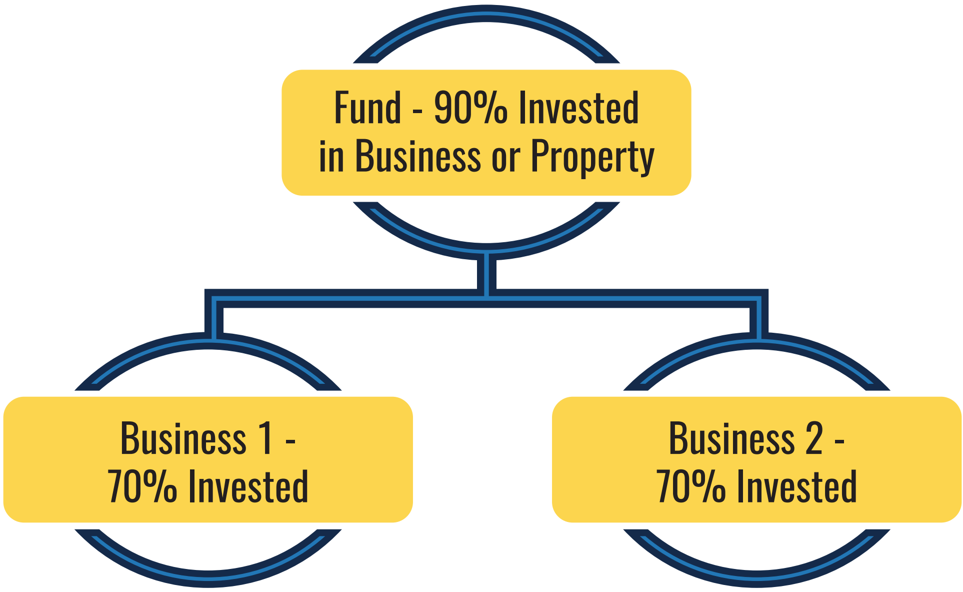
Qualifications for a Fund:

OZ Property

A Fund must hold at least 90 percent of its assets in "OZ Property," which generally means qualified business property ("OZ Business Property"), or a qualified company ("OZ Business").

OZ Business Property

If the investment is made into tangible business property, merely being located in an OZ is not enough. The property must be "QOZ Business Property," which means that it must be (1) purchased from an unrelated party, and (2) at least 70% of the property's use must be located in the Opportunity Zone.



“Substantial Improvement” Requirement

For already-existing business property that has been placed in service, such as an apartment building, the property must be substantially improved after the investment, meaning the cost of renovations must at least equal the cost of purchase, minus the land.

An already-existing property that has not been depreciated or amortized — such as a new commercial build or a homeowner’s primary residence — would qualify as OZ Business Property under an “original use” exception.

OZ Businesses

If the investment is made into a company, then the company must be an “OZ Business,” which is a business entity organized for that specific purpose, and treated as a corporation or partnership for tax purposes. After formation, the company must satisfy four elements:

- At least 70% of the tangible property owned or leased by the company must be QOZ Business Property (as defined above);
- At least 50% of the company’s total gross income, services performed, or amounts paid for services must occur within a QOZ;
- At least 40% of its intangible property must be used in the active conduct of such business; and
- The company must have a written schedule to spend working capital to the extent that more than 5% of its property is attributable to non-qualified financial property, such as long-term debt.

One of the most important things for any OZ investor to understand is that the Fund’s problems could become your problems if they fail to meet any of the requirements. You could be hit with not only your original tax liability but penalties and interest by the IRS. This is why due diligence, which we discuss in detail below, is so very important.

Failure to satisfy one or more of these elements may result in a penalty or ineligibility to receive the investor’s intended tax-preferred treatment.

Your Situation

To determine if this is a good program for you, you'll need to consider the following:

Eligible Capital Gains

Congress has dictated that all capital gains are eligible. For all capital gains, the investor has 180 days from the point of realizing the gain to make an investment in the Fund. If the investor is a pass through entity (i.e. S Corp or LLC electing partnership tax status), the entity could reinvest for 180 days after, or, when those gains drop down to the individual taxpayer on December 31 of that year, that starts the 180-day clock.

While a determination of what constitutes eligible gains depends on the taxpayer's individual facts and circumstances, a CPA who specializes in the Opportunity Zone rules and their effect on corporate and pass-through taxation can mitigate the risks of making a non-qualifying investment, as well as triggering an inclusion event that would terminate deferral.

Business Owner Alert

Section 1231 gains, which relate to the sale of property of businesses, must wait until 12/31 of that year due to the IRS's position that they must be netted with any Section 1231 losses.

Size of Investment

Investing in a Fund will require tax and investing analysis. In Audrey's case, the benefits greatly outweighed the cost of analyzing and dealing with the requirements, but that may not be true in all cases. It would be similarly important to weigh the costs and benefits of conducting this initial OZ analysis.

Rule of Thumb

If your capital gains are less than $50,000 it likely does not make sense to pursue this.

Your Tax Rates

Currently, capital gains are taxed at a rate specified by your income.

LONG-TERM CAPITAL GAINS					
Rate	Single	Married Filing Jointly	Married Filing Separately	Head of Household	Trusts & Estates
0%	$0-$39,375	$0-$78,750	$0-$39,375	$0-$52,750	$0-$2,650
15%	$39,375-$434,550	$78,750-$488,850	$39,375-$244,425	$52,750-$461,700	$2,650-$12,950
20%	$434,550+	$488,850+	$244,425+	$461,700+	$12,950+

MEDICARE CONTRIBUTION TAX					
Rate	Single[1]	Married Filing Jointly[1]	Married Filing Separately[1]	Head of Household	Trusts & Estates[2]
3.80%	$200,000+	$250,000+	$125,000+	$200,000+	$12,750+

If you believe your income, and therefore capital gains rates, will increase substantially by the time the deferred capital gains taxes are due in 2026, this could move you away from a Fund investment depending upon how substantial the advantage of the tax-free exit is to you.

Your Team

The strength of your advisory team is vital in determining if an OZ Fund is right for you. As this is a new program, misinformation abounds and a strong advisory team will set you up for success.

- **CPA:** Your CPA will be your MVP on your advisory team. Your CPA will guide you through determining the type of gain you have and the date it is eligible. In addition, your CPA should guide you through requirements pertinent to your individual tax situation, as well as required tax filings. Your CPA should be notified immediately after you have sold an asset, and before if possible, especially for business sales.

  While many CPAs are just now getting up to speed due to the IRS's last language being released in April, 2019, most of the CPAs with whom we have relationships are quickly gaining the knowledge required.

- **Financial Advisor:** A financial advisor will help guide your financial planning, including liquidity needs. In addition, they will be helpful in balancing the investment's lack of liquidity with your personal financial plan. Keep in mind you will need to pay your original capital gain in 2026, and this must be considered.

  Your advisor's ability to assist with analysis on individual Funds that are available likely will depend upon whether their financial institution has any on their platform. Most of these products will be too new to be on many financial advisors' platforms. Therefore, the advisor won't receive compensation for the work and this could potentially disallow them from assisting you. Your advisors' offerings should not dictate whether this program makes sense for you. A few may file this under the "too hard" category and dismiss it out of hand.

- **Attorney:** The tax code contains statutory formation requirements for OZ Funds and OZ Businesses. Whether you form your own OZ Fund or subscribe to a third-party OZ Fund, it would be wise to enlist an attorney who specializes in Opportunity Zones to identify liability risks to your intended income tax treatment. An attorney could also advise you on non-OZ matters, such as governance, control, voting, and information rights.

Ability to Hold Illiquid Assets

To receive the full OZ tax benefits, investments will need to be held for at least 10 years. Unlike investments in a stock or mutual fund, you will want to analyze it as though you will be in for the full period. In addition, most Funds in this space will not provide much liquidity until year 10.

The underlying real estate or businesses that the Fund will invest in are, by their nature, long-term holds with limited liquidity. You'll need to make sure that you do not need this capital for living expenses. You will also want to plan for your capital gain payment occurring in 2026.

Finding the Right Fund

If you have gone through the 5-step process to determine if an OZ Fund investment is right for you, now you must choose the type of OZ Fund to begin to narrow your search before applying due diligence on individual Funds. The easiest way to begin this process is to review the risk and return of the different types of underlying assets. This may differ for different investors, as someone who has invested in Venture Capital in the past may have more of a comfort level with Venture Funds rather than Real Estate.

There will be three types of basic investments:

Real Estate

Private Equity

Investment in funds that directly invest in mature private companies

Venture Capital

Investment in funds that directly invest in early stage or rapidly expanding businesses.

If you were to choose Real Estate, it's helpful to categorize by the different levels of risk to determine your best fit. Think of this like a balancing act where you may have an aggressive *Strategy/Action*, but you can tamp down the risk by investing in a more conservative *Asset Type*.

When determining the appropriate Real Estate vehicle, we consider the following factors:

Strategy

- **Core**: This is the most conservative strategy with generally the lowest expected returns. It is a purchase of a performing asset with no real renovations or tenant lease up required. Generally just purchased for income needs.
- **Core Plus:** Purchase and light renovations with some minor tenant lease-ups.
- **Value Add:** Purchase and either major renovations or changes in management with significant lease-ups required.
- **Opportunistic:** Complicated projects requiring major capital investment and complete tenant turnover or lease-up required.

A Word on Risk

Due to the "substantial improvement" test requiring the QOZB to invest a significant amount into the asset; these Funds will almost all *be classified in the riskiest real estate strategy:*

Opportunistic

Asset Type

This is the type(s) of Real Estate we will be investing in. Will it have relatively stable rents and a diverse set of tenants that don't require significant capital needs when tenants turn over, such as with single-family homes? Or, will it require significant buildouts at tenant turnover and is economically sensitive, such as with new office buildings?

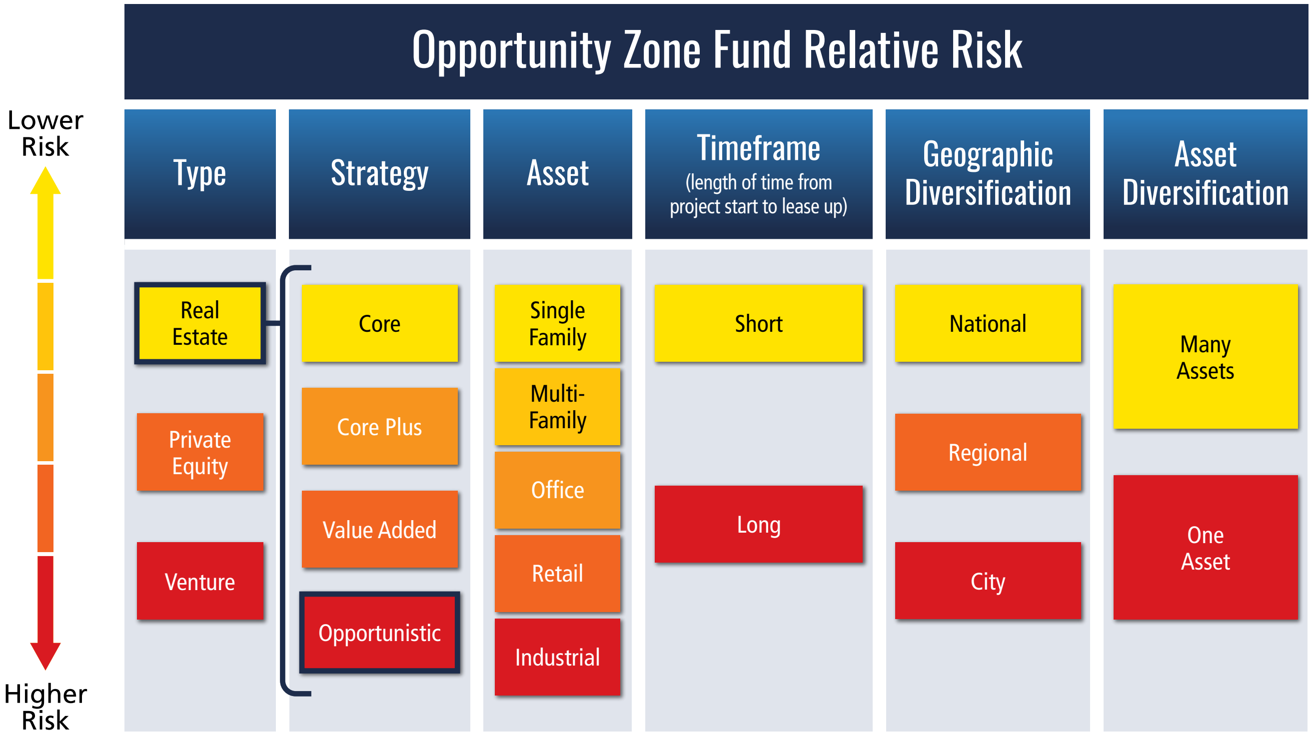
Timeframe to Lease-Up

If there is a shorter conversion period from the purchase of an asset to when a tenant is placed it is inherently less risky. By way of example, buying raw unentitled land to develop will likely take years to develop and sell or place tenants in it. By that time, our economy may look different, or it may become an uneconomic strategy.

Diversification

The greater the geographic diversification and the number of assets, the more conservative an investment becomes.

Due to the "Significant Improvement" requirement, almost all OZ Funds focusing on Real Estate will be "Opportunistic." Should an investor want to be more conservative, they would likely want to offset that risk by choosing more conservative *Asset Types, Timeframe* to *Lease-Up*, and *Diversification*.

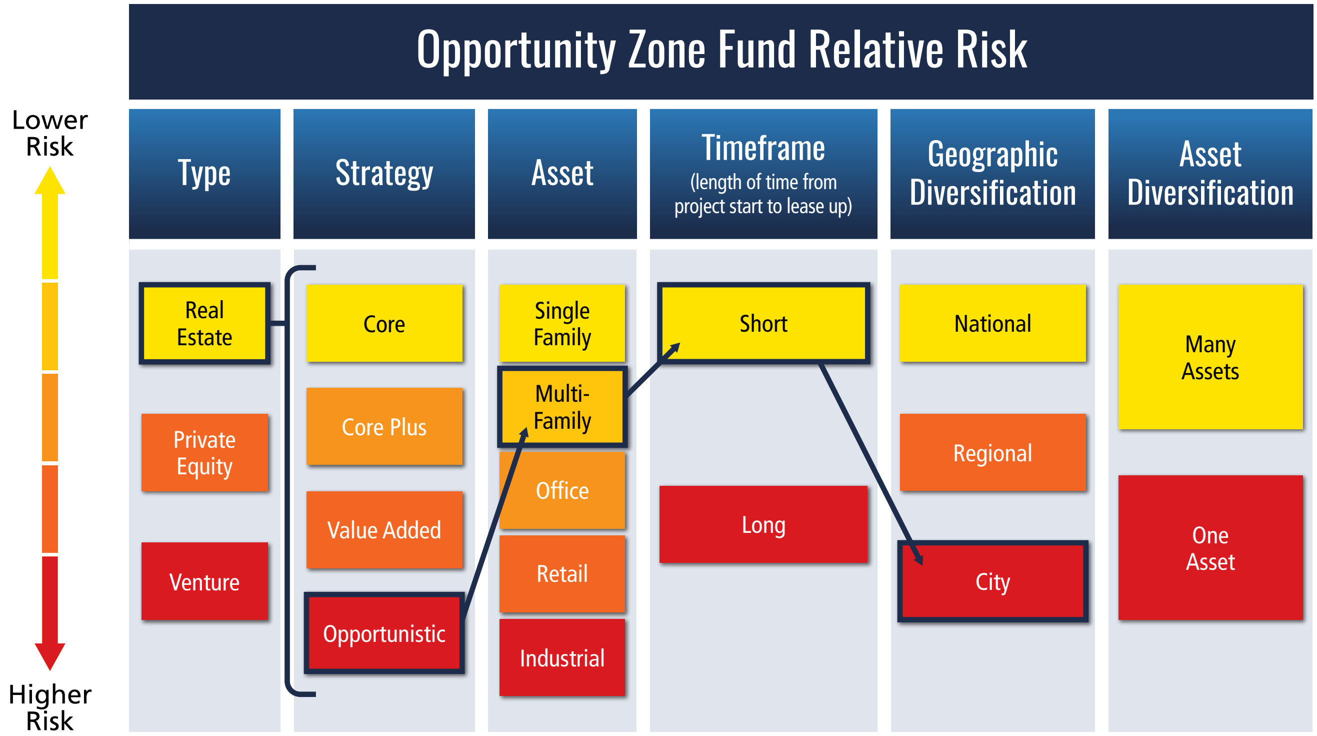


These are not hard-and-fast rules of risk/return. For example, a highly-leveraged risky multifamily apartment complex may be riskier than an office building with no leverage.

So, if you'd prefer to keep a relatively lower risk profile due to the lack of liquidity and long term hold, you may want to choose a Fund dictated below that is involved with smaller multifamily apartment complexes.

Or, if you would like to be aggressive, you may want to choose Funds whose strategy is buying undeveloped land and developing it. The expected returns should be commiserate with the risk of the total strategy.

In Audrey's example from earlier, below is what her risk/return looked like. In short, while an opportunistic strategy was employed, she tamped down her risk by investing in a relatively lower asset: multifamily apartments.



Due Diligence

Now that you've reduced the pool to a select type of Fund, you can begin due diligence on the different Funds available to you. We recommend an initial due diligence process that mirrors that process you would undertake for any private placement. Due to the detailed nature of a good due diligence process, this is only intended to be a broad overview to give you an idea of the components of a process.

If an OZ Fund is raising outside capital, they are required under securities laws to have various securities filings to exempt them from certain public registration and filing requirements. As such, you have fewer protections and a "buyer beware" thought process must be employed. If you have not reviewed any of these in the past, you would be well advised to seek professional help.

Once requested, the OZ Fund will supply you with a Private Placement Memorandum, Subscription Agreement, and sometimes a Business Plan.

- **Private Placement Memorandum (PPM):** A legal document providing prospective investors a description of the company, terms of the offering, risks, and fees. These are also referred to as "Offering Memorandum" or "Offering Document".
- **Subscription Agreement:** This will be the legal document that effectuates the sale of the OZ Fund to you.
- **Business Plan:** This may also be embedded in the PPM that will provide details on the assumed investment strategy and assets.

Additional Items We Request

Generally, most investors stop at a scan of the PPM, so this list of requests may seem unusual to the OZ Fund. We recommend conducting initial due diligence yourself prior to requesting it in order to winnow down your potential Funds. Then provide the OZ Fund with some of your due diligence so they know they're sending information to a serious potential investor.

- **Operating Agreement:** This is the legal document that will govern the rights and responsibilities of the different parties.
- **Models:** The PPM and business plan will likely have a cash flow model that is based on various assumptions. Reviewing those assumptions and "shocking" them up and down can give you an idea of the levers of risk and return. There is no government entity assuring that their assumptions, and therefore the "target rate of return" that will be shown, is reasonable. It is up to you and your advisors. Your financial advisor should be able to help you with the modeling.

General Due Diligence:

Exclusion Process

- **Minimum Required Investment:** Greater than the investment you wish to place
- **Analysis of the Parties:** If competence and character of the parties give you pause, move on.

- **Compliance with Securities Laws:** If you are not provided with the relevant legal documents, and the OZ Fund is raising capital and doesn't tell you which securities exemption, the costs of lack of compliance will ultimately be borne by the Fund (and its investors). In addition, this omission demonstrates a lack of competence (and perhaps character) that likely exists in other areas.

Detailed Due Diligence on Remaining Funds

- **Entity Structure Sketch:** Many Funds will be structured to have a holding company, a Fund entity, and one or multiple "Joint Venture" entities. There are many variations on the optimal structure and we always sketch out the various entities' ownership structure and cash flows.

- **Waterfall Analysis:** After you've sketched out the ownership structure, be aware of how the cash flows and profits are allocated. Importantly, many times the cash flows/profit structure will change depending on the performance of the Fund.

- **Fee Analysis:** Determine whether the level of fees is reasonable for the activity being performed. In the case of real estate investments, keep in mind that the fees are really what is required to run an operating business. Generally, there will be an overall asset management fee levied as an annual charge as a percentage of the value of the fund, a "carry" or profit sharing, and development fees. Play close attention to the full fee structure and any fees to affiliates. For the "carry", you should analyze whether the profit is shared on each asset, a "deal by deal" carry or if it's a "fund level carry". A fund level carry will net out all the gains and losses and then share profit, which is more advantageous to the investor.

  While you can buy a mutual fund that purchases publicly traded stocks that has fees of only .5% of the assets per year, these Opportunity Zone funds will be inherently more work from an operating perspective. Do not rely solely on the PPM "term sheet" or summaries of the fees. It is vital to dig down into the underlying Affiliate and Related Party Transactions to get a full extent of the fees.

- **Legal Rights:** You will have very limited ability to control the management of the Fund. However, you need to understand these limitations.

- **Transparency:** This is more art than science. There are ways to either bury negative disclosures and ways to have a candid conversation about the drawbacks to a strategy. In the example in the box to the right, in touting how low their fees were while they were compensated by affiliated transactions (which isn't necessarily a bad thing), they failed the test of transparency.

Don't Rely Solely on the Term Sheet

In reviewing an OZ Fund recently, the Term Sheet touted an "industry low" .5% management fee and 5% profit allocation; yet when reviewing their affiliates, it was obvious that they owned their "affiliates", who were paid quite handsomely for the development and management of the assets.

- **3rd Party Due Diligence Reports (if available):** While only the largest Funds will afford the costs to employ a 3rd party due diligence team, it's helpful to see if they're available. This will only be provided upon request and if you're serious in their view, as the 3rd Party providers generally charge for each investor to review them. "Mick Reports" are the most well known in the industry.

- **Securities Compliance:** The securities laws generally require offers and sales of investment contracts to be either registered with the SEC or state securities division, or exempt from registration. Securities regulators impose hefty fines for noncompliance, and thus, investors should obtain adequate assurances of compliance with federal and state securities laws.

- **Liquidity/Distribution Rights:** As a long term investment, there will likely be limited rights of liquidity and distributions on the timing of your choice. Be sure to delineate between what is a "right" you have and when/if they are able to rescind that right.
- P**referred Distribution:** Some Funds may have a "Preferred Distribution" between 3%-5% per year. This "Pref" will impact the waterfall of cash flows, but does not likely give you the right to get the 3-5% per year; only that you will receive that "Pref" before any profit sharing allocation occurs.
- **Quarterly/Annual Liquidity:** Some Funds may set an amount that the Fund is able to redeem on a regular timeframe. Perhaps as much as 5% per quarter is allowed to be withdrawn across the Fund, of which you would be able to take your pro-rata amount out. Many of these liquidity rights are able to be rescinded by the management team if they believe this will hurt the Fund. With illiquid assets, this is not necessarily a bad thing, but not understanding it is.
- **Exit Strategy:** This is vital for the OZ Fund industry, however it will be difficult for them to plan what will be the most economical exit strategy in 10 years. However, the important thing is that there is a general thought process that is occurring.

OZ-Specific Due Diligence

This will be difficult for an investor without significant understanding of the different OZ requirements to adequately review. Most sophisticated investors, however, can likely get an idea of the competence of the counter party in hearing the responses and if they're open to sharing any of their compliance processes. We have seen many smaller Funds that are claiming OZ eligibility that obviously don't qualify and pass the various tests.

- Corporate compliance for QOZ rules
  - OZ Property scrub
  - Substantial improvement scrub
  - Asset test compliance and written working capital requirements
- QOZ business complexities
  - Incoming investor assets matched with capital needs
- Ability to raise required capital for the asset(s) they are purchasing
  - If a Fund is raising a certain amount of capital for a certain asset and they don't hit their minimum capital needs, they will likely need to return the capital to you.
  - You will likely be out of your 180 day window, will likely miss the opportunity and, as a result, pay your original capital gains tax with penalties and interest!

Social Impact

This program is in place so we can help those communities that have been underinvested. If a fund checks your investing boxes, put your money where your heart tells you your money will do good!

For the right investor, the benefits of the new OZ tax regime are compelling. Pairing the right investment with the right investor optimally results in an opportunity to do well and also to do some good.

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Clint Edgington leads Beacon Hill Investment Advisory's investment team. Beacon Hill provides advisory and family office services to business owners to simplify their financial lives; including their businesses, their retirement plans, and their public and private investment holdings.

Beacon Hill works with business owners' teams of tax, M&A, and legal professionals to evaluate and invest, in a tax efficient manner, in private and direct investments; primarily focused on private debt, direct real estate, and small to middle market buyout and equity investments.

Clint has created, and is the manager of, his family's private Opportunity Zone Fund.

Find more information on Clint at

www.beaconhilladvisory.com/clint-edgington

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Andrew Doup advises taxpayer-investors, fund managers, developers, and entrepreneurs on tax-preferred qualified opportunity zone transactions.

Andrew and Kegler Brown's team of corporate, tax, real estate, and securities attorneys were among the first to structure real estate and venture capital Opportunity Zone funds in Ohio, and have since been recognized as national experts in this area. Kegler Brown informs state and local public policy decisions through their growing network of private and public economic development leaders.

Andrew serves as a trusted advisor, creating additional value for clients by helping manage their risk of liability throughout the business lifecycle. He counsels on choice of entity, corporate structuring, finance, management, acquisitions, and dispositions. A combat veteran, Andrew approaches problems with a combination of creativity and attention-to-detail that enables his clients to make business decisions with confidence.

Find more information on Andrew at

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