PENNINGTON PARTNERS & CO.

The Continuing Case to Invest in Opportunity Zones

November 2021

Overview:

Pennington Partners & Co. (Pennington) is a leading financial services solutions-focused firm that partners with entrepreneurs, their families, and the advisors that serve them.

Our philosophy that the "sum of our parts" is greater than any one of us operating individually is central to our ethos.

One of the firm's strengths is in identifying and sponsoring unique risk-adjusted investment opportunities for our partner families. In December 2017, the Tax Cuts and Jobs Act was adopted to establish the "opportunity zone" program (OZ Program) to provide tax incentives for long-term investing in designated economically distressed communities. Opportunity zones are designated geographic areas that have been identified as low-income census tracts. These census tracts were nominated by governors and certified by the U.S. Department of the Treasury. To be eligible, the census track needed to have 1) a median family income of less than 80% of the surrounding area or 2) an average poverty rate of 20% or more. There are currently 8,700 opportunity zones in both rural and urban areas throughout the country, with OZs in every state and territory. It is estimated that over 35 million people reside in the designated OZs. In the past decade, the majority of the designated OZ's have seen sluggish economic progress and an overall decline in population.

Pennington worked expeditiously to learn about the program in order to determine whether it could be beneficial for our families. We concluded that the tax benefits and social impacts of the program were just too attractive to ignore. We partnered with a small team of experienced real estate professionals to form PTM Partners and we raised a $98M qualified opportunity zone fund (QOZF) in 2019 to build a portfolio of commercial properties on the east coast of the U.S. One of the firm's operating partner families had a sizeable capital gain, a portion of which was invested as the fund's anchor partner. In addition to co-founding PTM Partners, Pennington created three separate entities in 2019 for one of our operating partner families, one to purchase a building and two to create and fund new qualified OZ businesses.

We continue to believe that the favorable aspects of the OZ Program will provide substantial opportunities to create a social impact while generating attractive risk-adjusted, after-tax returns. We intend to maintain a thought leadership position for the benefit of our partner families and the communities that we are investing in.

Benefits of the Opportunity Zone Program

The OZ Program was established to provide tax incentives for long-term investments in designated economically distressed communities. The program's goal is to create jobs and drive economic growth in some of the country's poorest areas by incentivizing investors to redirect capital there, rewarding investors with a variety of tax benefits if certain conditions are met. Opportunity zones have the potential to spur economic growth and advance communities across the country while boosting returns for investors through unprecedented tax incentives. The key components to these incentives, which include tax deferral/abatement and tax-free post investment appreciation on certain qualifying investments, are highlighted below:

- The short- or long-term capital gain triggered from the sale of any capital asset is deferred if the capital gains are reinvested into a QOZF within a certain period
- A 10% step-up in basis for capital gains reinvested in QOZFs if invested by December 31, 2021
- A permanent exclusion from taxable income on capital gains from the sale or exchange of a QOZF investment held for at least 10 years
    - — By founding or investing in an operating business that is a C-corporation, one may be able to take advantage of section 1202 (Qualified Small Business Stock) of the tax code and may only have to hold an investment for a minimum of 5 years
- This permanent exclusion also applies to recapture of depreciation accumulated over the life of the investment for real estate investments

How Does it Work?

A business owner sells his or her company for $100mm, where he or she has a $10mm basis. The business owner invests $20mm in several Opportunity Zone Fund's in a combination of real estate investments and operating businesses. The capital gain in this example was $18mm that would be deferred until 2026. If the OZ investment is held for at least five years at the end of 2026, capital gains tax liability is for only $16.2 million (10% step up in basis). If the OZ investment is sold for $40 million, generating another $20 million gain, the new gain would be tax-free if sold after a holding period of at least 10 years. The program's eligibility is inclusive of any type of capital gain including the sale of art, collectibles, individual securities, and real estate as examples.

The following table shows the after-tax incremental returns of investing in a QOZF. The table assumes the current maximum long-term capital gains rate of 23.8%. The incremental returns of a QOZF investment will increase substantially if the Biden administration successfully implements its plan to raise Long-Term Capital Gains rates to match ordinary income rates.

Incremental Post-Tax Returns of a Sample QOZ Investment[1]

	After-tax non-OZ Investment: Real Estate	Qualified Opportunity Fund Investment: Real Estate	After-Tax non-OZ Investment: Private Equity	Qualified Opportunity Fund Investment: Private Equity
Capital gain	$10,000,000	$10,000,000	$10,000,000	$10,000,000
Initial gain tax	($2,380,000)		($2,380,000)	
Initial investment	$7,620,000	$10,000,000	$7,620,000	$10,000,000
Weighted Average Annual Income Return	7%	7%	0%	0%
Appreciation (LTCG) Return	7%	7%	20%	20%
Total IRR	14%	14%	20%	20%
Total Income Realized	$7,913,393	$10,385,030	$0	$0
Reduction in Taxable Income Due to Depreciation	-$2,819,400	-$3,700,000	$0	$0
Taxable Income	$5,093,993	$6,685,030	$0	$0
Income Tax Paid	-$1,884,777	-$2,473,461	$0	$0
Post-Tax Income	$6,028,615	$7,911,569	$0	$0
Gross proceeds at liquidation	$14,989,693	$19,671,514	$47,181,032	$61,917,364
Total investment gains	$7,369,693	$9,671,514	$37,181,032	$51,917,364
Payment of deferred and reduced capital gains in 2026		($2,142,000)	$0.00	($2,142,000)
Second capital gains tax on liquidation	($1,753,987)		($8,849,086)	
Payment of Depreciation Recapture	($1,905,000)			
Total Proceeds Post-Tax	$17,359,322	$25,441,082	$38,331,946	$59,775,364
Total Post-Tax Net Annual Return on Initial Gain (%)	6%	10%	14%	20%

[1] Modeling assumes full asset depreciation. Modeling assumes depreciation recapture tax rate is 25%. All capital assumed called at period start
Model uses the following tax rates: i) 37% ordinary income, ii) 23.8% Long-Term Capital Gains

QOZ vs 1031

The favorable regulations noted above have thus far been applied primarily to real estate investments. For certain individuals that have gains in real estate and are considering a 1031 (like-kind) exchange, an OZF investment may be more attractive. Unlike like-kind deferrals, which require the full amount of sale proceeds to be reinvested in real estate, OZ investments allow for the ability to invest only the gain (or a portion of the gain) rather than the full amount of an investment as well as a broader range of investments eligible for deferral.

The determination of which program is better will vary based on each individual investor's objective. If an investor's primary goal is to defer taxes indefinitely and never access the investment capital, the 1031 exchange may be the preferable solution; however, if an investor wishes to realize the profits on an investment at some point in their lifetime, a QOZ Fund is the better option. The following table shows a comparison of 1031 exchanges and OZ funds.

1031 Exchanges Vs. Opportunity Zone Funds

	After-tax non-OZ investment	Qualified Opportunity Fund Investment
Eligible Asset Classes	Only real assets held for productive use	Any
What needs to be invested?	All proceeds	Only capital gains
Investment timing	Within 180 days	Within 180 days
Intermediary required?	Yes	No
Tax Benefits	Can delay tax indefinitely, but capital gains are fully taxable at the time of the sale of the new property	QOZ investment receives a 10% increase in basis after 5 years, until December 31, 2026
	Standard depreciation treatments apply	Depreciation can be taken on debt financing for the property and there is no depreciation recapture at exit with fair market step-up in basis of the investor's interest in the fund1
	Heirs get step up in basis to the market value, but can eliminate tax up to the estate tax exemption	Capital gains tax are deferred until Dec 31, 2026 and no capital gains after 10 years upon sale or exchange of the investor's interest in the fund

Other QOZ Opportunities

There are numerous other potential QOZ solutions that are worth consideration.

Private Operating Businesses

The OZ program applies to operating businesses that are based in OZs or are formed within OZs. Generally, the primary hurdle to becoming a Qualified Business is the requirement that at least 50% of a company's gross income be derived from the active conduct of a business in an OZ. When the OZ program was established, it wasn't clear how companies could demonstrate this. However, the IRS has now established safe harbors that provide that this requirement will be met if either:

- The management, operations and tangible property needed to generate 50% or more of the gross income of the business are located in an OZ; or

- 50% or more of the services performed for the business by employees and independent contractors (based either on hours worked or compensation paid) are performed in an OZ

Thus, a startup that locates its headquarters in an OZ could satisfy the 50% gross income test regardless of whether its income is generated inside or outside of the OZ. Alternatively, a startup headquartered outside an OZ could meet the 50% gross income test if its employees and independent contractors spend most of their time inside the Opportunity Zone. While there are other requirements a company must meet to qualify as a Qualified Business, founders should consider the potential benefits to the company of the OZ program and consider these safe harbors in determining company headquarters or planned hires.

The OZ program can be especially attractive to invest in or start operating businesses, as companies possess a much greater potential for equity upside, which means a much larger savings on non-payment of the capital gains tax.

Single Asset Real Estate OZ Investment

Pennington has developed a pipeline of over $100mm of opportunities for single real estate assets that are situated in OZs. We believe this option could be attractive for individuals and families with realized or unrealized capital gains to consider in lieu of a multi-asset OZF because it allows individuals to evaluate the merits of the investment before making a commitment vs the blind pool nature of the typical OZF.

Multi-Asset Real Estate Fund

Pennington is a minority partner in PTM Partners Qualified Opportunity Zone Fund II. Individuals and families affiliated with Pennington that are looking for a diversified portfolio of real estate investments in an Opportunity Zone Fund will have the ability to participate in the vehicle on preferential terms.

Working with Pennington to Create Your Own OZ Fund

As noted above, Pennington has worked closely with a couple of its partner families in structuring OZ investments for both real estate and for operating businesses. An individual that starts a business in an OZ may never have to pay capital gains taxes on the sale of that business. We welcome the opportunity to discuss options with entrepreneurial individuals or families that have generated capital gains in the recent past or have significant built-in gains that they would like to realize if not for the potential tax liability.

About Us

Founded by two entrepreneurial families in 2016, Pennington Partners & Co. is an award winning multi-family office (MFO) whose mission is to elevate the lives of highly successful entrepreneurs and their families. We offer a full suite of modern investment and wealth planning solutions, including three core divisions, household management, investment advisory services, and a tax advantaged investment platform, all intentionally designed to support the complex needs of our partners.

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