Weekly Capital Market Comments

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NORTHEAST SEQUOIA
PRIVATE CLIENT GROUP

The Wizard Of Oz

We decided to take a detour from eating crow this week, as the S&P continued to grind higher. After gaining almost 3% for the week (through Thursday), the S&P is up another 3% today, now higher by over 42% from the March 23rd lows, and is now flat for the year. Still, we reiterate our call for a "W" trajectory in the equity market, no matter how anti-consensus it may now seem. We believe there remain too many unknown unknowns, including 1) the domestic impact of a global economic shut-down, 2) the potential devastating knock-on effects of rioting in many of our major cities, 3) the possibility of higher capital gains taxes if Democrats win the White House (and possibly the Senate), 4) a resurrection of a trade war with China, and 5) the economic hang-over associated of government stimulus sunsetting in July. Also, as we pointed out last week, by-backs may be limited in 2020/21, and with today's surprise job number, many traders may no longer think the U.S. is headed for negative rates.

This week, we had the pleasure of interviewing John Grady. John is a partner with Practus, LLP, a boutique law firm focused on the asset management industry and based in Philadelphia. John dedicates much of his practice on funds, advisers, and broker-dealers on a range of issues, including capital formation, operations, M&A, and general regulatory matters. John is a long-time friend and one of the foremost experts on Opportunity Zones ("OZ"). Interestingly enough, the concept of Opportunity Zones has even found its way into a plotline on the TV show, "*Billions*."

Opportunity Zones ("OZs"), initially championed by Senator Cory Booker (D-NJ) and Senator Tim Scott (R-SC) and were enacted in 2017 as part of the Tax Cuts and Jobs Act. OZs are an economic development tool that targets economically distressed communities, through the financing of commercial and industrial real estate, housing, infrastructure as well as existing or business ventures. Under certain conditions, investors in OZs may qualify for favored tax treatment. These tax benefits are especially attractive to investors seeking to roll-over long-term capital gains following the longest bull market in history. So, with all the hoopla surrounding OZs as of late, we couldn't pass up an opportunity to interview the **Wizard of OZ**.

NEPCG: OZs seemed like an excellent investment for investors looking to mitigate and defer capital gain exposure, especially on the heels of a 10-year bull market run for equities. But with the December 31st, 2019 sunset limiting the full 15% step-up potential over a 7-year hold, how do you see sponsor demand trending today?

Grady: "In general, losing a portion of the available capital gains tax reduction (from 15% to 10%), does not seem to have driven behavior. While the IRS and Treasury have done several things to ease the impact of the pandemic on certain types of real estate-related transactions (there is new relief from the IRS that allows DST trustees to take actions to respond to the pandemic), there seems to be a consensus that the real benefit lies in the ability of persons directing their gains into OZ deals to avoid tax altogether on the gains produced by their investment."

NEPCG: How has the COVID pandemic impacted OZ developments currently underway?

Grady: As I noted, the IRS has been trying to extend otherwise applicable timing deadlines to account for difficulties caused by the pandemic. Whether it's identifying OZ projects, putting the capital to work, the IRS has, in some cases, provided additional time for those working with OZ projects to meet the many relatively-tight deadlines established by the OZ legislation and the regulations adopted thereunder. In one sense, because OZ investing starts with a desire by investors to defer capital gains taxes, the fact that the markets have recovered from their pandemic-related lows means that investors may again be looking at capturing gains in their portfolios. If they do, many of them are going to be on the lookout for OZ projects that they can invest in now to get the benefit of the deferral provisions of the OZ program.

NEPCG: If COVID wasn't enough, the country has witness rioting and property damage in many neighborhoods that are similar to where OZs are considered to provide the most socioeconomic benefit. How do you believe these recent events may impact the propensity for sponsors to pursue new OZ projects in the future?

Grady: "Even before these unfortunate events of the past several months, there were aspects of the OZ program that allowed savvy investors and their development partners to focus on neighborhoods that either bordered on the types of neighborhoods that are at the heart of the program, or that had already made strides toward economic improvement before the legislation was passed. Remember, the zones themselves were determined by the various states using somewhat older (now census data). This means that some areas designated

as OZs using that census data are not as economically disadvantaged now as they were when the 2010 census data was accumulated. As for "border" areas, some OZs designated by the various state governors are areas that border on some very affluent areas. This was not unlawful, but it has led to a renewed focus on such areas as a way of potentially mitigating some of the development risk."

NEPCG: From an investor's standpoint, are OZs still a compelling investment? What are one or two positives and negatives?

Grady: The positives are what they have been from the start; capital gains tax deferral and, potentially, reduction, and an opportunity to invest those gains tax-free for a 10- year period. The negatives are also somewhat the same as before; investors have a limited time to identify a desired OZ investment (a "qualified opportunity zone fund"), and must generally commit to a 10-year holding period to get the full benefit of the OZ legislation. There is a great deal of attention being paved to find ways allowing investors to have the benefits with a shorter holding period measured on a deal-by-deal basis. And solving that riddle might eliminate one of the negative elements referred to above.

NEPCG: John, what else are we not thinking about?

Grady: Watch this space for developments – whether it's an extension of time, relief for the capital raising/investing side, or allowing OZ projects in a fund to have less than 10-year lives without generating tax liability for investors. The Treasury and the IRS are committed to maximizing the value of the OZ legislation and may continue to find ways to remove obstacles that impeded its success.

We'd love to hear your thoughts.