Important Information about Qualified Opportunity Zone Funds

We have prepared this document to help you understand the common characteristics and risks associated with investing in qualified opportunity private equity funds to assist you in making a more informed decision when buying or selling these securities. This document is compiled for your information and is intended to be a conversation starter between you and your Baird Financial Advisor or other appropriate experts, such as your tax or legal advisors. Your Baird Financial Advisor is available to address your questions and discuss the features, characteristics, costs, and risks of any particular investment. Although offering tax advantages, investing in qualified opportunity zone funds can be speculative and involve significant risks. As a result, these investments may not be suitable for all clients.

Characteristics of Qualified Opportunity Zone Funds

Qualified Opportunity Funds (QOFs) are an investment vehicle designed to qualify as a "qualified opportunity fund" within the meaning of Section 1400Z-2 of the Internal Revenue Code, created as part of the 2017 tax reform known as the Tax Cuts & Jobs Act. This bill included a package of tax incentives that are intended to drive investments in areas of the country that could benefit the most from new development. These incentives include the following:

- Capital gains that are invested in the fund may be deferred from taxable income until 2026.
- 10% of the original gain can be excluded from income if the QOF investment is held for five years and another 5% can be excluded if the QOF investment is held for seven years, so long as those holding periods are met before December 31, 2026.
- In addition, provided an investor holds its interest in a QOF for at least 10 years, appreciation in the QOF beyond the investor's original investment will be tax-free when the fund is eventually sold.

QOFs make investments in start-up businesses, the development of new properties or redevelopment of existing properties – or any combinations of the three – within low-income communities known as "Qualified Opportunity Zones" (or QOZs). A QOF is organized as a corporation, limited liability company or partnership for the purpose of investing in Qualified Opportunity Zone Property, as described below. Through a QOF, investors combine or pool their capital that enables the manager of the fund to make multiple investments in one or more QOZs. QOFs are typically professionally managed by a general partner who sources and vets potential investments and has the discretion to make investments for the fund. The QOF itself can be a pre-existing entity that elects to be a QOF or a new entity established solely for the purpose of a QOZ investment, and it must certify to the IRS that it meets the requirements to be a QOF on an annual basis.

Unlike mutual funds, QOFs are generally exempt from registration as investment companies under the Investment Company Act of 1940. In addition, interests in QOFs are commonly issued in private placements rather than in public offerings to avoid registration under the Securities Act of 1933. In order to rely on such exemptions, QOFs often limit the number and type of persons that may invest in them. Most QOFs are only available to persons or entities who meet certain qualification and minimum investment requirements. Often, only high net worth persons and institutional investors are eligible to invest. Limited partner or other equity interests in a QOF are not listed on an exchange or otherwise transferable. In limited circumstances, some QOFs will repurchase interests from investors, but an investment in a QOF should be regarded as illiquid.

Qualified Opportunity Zones

There are approximately 8,700 QOZs around the country, spread around every state and US territories. QOZs are geographic areas that have been certified by the US Treasury as meeting various qualifications such as areas with high poverty rates or where family incomes are well below averages for the broader geographic area. Governors submitted recommendations for areas to be designated as QOZs, and the US Department of the Treasury made the final determinations as to the areas that qualify. Once an area has been designated a QOZ, that designation remains in place for at least 10 years, but no later than December 31, 2047.

777 East Wisconsin Avenue
Milwaukee, Wisconsin 53202

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To encourage these investments, QOFs offer a unique triple-play of tax benefits – the ability to defer the tax on capital gains that are rolled into the QOF, a partial exclusion of that gain after a period of time, and tax-free growth for long-term investors in the QOF. Like all investment opportunities, however, QOFs present risks, so investors need to avoid being blinded by the tax benefits and instead evaluate these on their overall investment merits.

Qualified Opportunity Zone Fund Requirements

The primary requirement to be a QOF is that at least 90% of the QOF's assets must be invested in Qualified Opportunity Zone Property (QOZP), which includes "qualified opportunity zone business property and equity interests in underlying domestic business entities that are engaged in a "qualified opportunity zone business." Only new investments in QOZP are allowed – any property owned by the QOF before the date it certifies to be a QOF doesn't count toward the 90% requirement. Investments in QOZP include direct ownership in QOZP or indirect ownership in QOZP through an investment in an underlying business entity that invests in QOZP. QOZP essentially consists of QOZ business property and QOZ business stock or capital or profits interests in a domestic corporation or partnership that is a QOZ business.

In order to qualify as direct ownership in QOZP, the property must be tangible property, such as buildings, equipment, machinery, etc., that is used in a trade or business. If the property is existing property in the QOZ it must be substantially improved by the QOF within 30 months of acquisition. If the property is new property, its first use by the QOF must be inside the QOZ, such as new construction or purchasing and relocating existing machinery into the QOZ from a different location.

In order to qualify as indirect ownership of QOZP, the underlying business entity must be a QOZ business and meet additional requirements. Those include a requirement that at least 70% of the underlying business's assets must be direct ownership of QOZP and at least 50% of the underlying business's income must be generated inside the QOZ. Moreover, the business cannot be a golf course, country club, massage parlor, hot tub or suntan facility, liquor store, or racetrack or other gambling facility.

Specific Requirements and Potential Tax Benefits

Before an investor can take advantage of the potential tax incentives or benefits of investing in a QOF, the investor must first realize a capital gain and then reinvest all or a portion of that gain into a QOF. An investment in a QOF can come from the sale of any asset that results in a capital gain. All types of investors can invest in a QOF, including individuals, corporations and pass-through entities. The gain to be invested in a QOF can be a short-term or a long-term capital gain, but it must be taxable gain and must not be classified as ordinary income. The gain cannot be the result of a sale to a related party, such as a parent, child, or sibling.

The primary tax incentives of investing in a QOF are the following:

- **Gain Deferral.** The gain invested in a QOF is not included in taxable income in the year in which it is realized. Rather, the gain is not taxable until the earlier of the sale of the investor's interest in the QOF or December 31, 2026. Because the gain invested in the QOF is not considered taxable income, the investor's initial cost basis in the QOF defaults to $0. The gain that must be recognized and becomes taxable is equal to the lesser of the original deferred gain or the current market value of the investment, minus any cost basis adjustments made under the Basis Adjustment rules described below. Thus, a decline in the value of the QOF after the original investment will reduce the amount of gain to recognize. This gain must be recognized even if the investor continues to hold the QOF investment on December 31, 2026. The recognized gain maintains the same tax treatment it had at the time it was originally realized. If the investor continues to hold the QOF beyond December 31, 2026, the investor's basis in the investment is increased by any gain recognized on that date.

- **Basis Adjustment.** When the investor has held the QOF investment for five years, his/her cost basis is increased by 10% of the amount of the original gain that was deferred. For example, if the original gain invested in a QOF was $100,000, then after QOF investment was held for five years, 10% of that $100,000 gain (or $10,000) is added to the investor's cost basis, which then lowers the original deferred capital gain that must be recognized. If the QOF investment is held for another two years after that, the basis is increased by another 5% of the deferred gain. Thus, up to 15% of the gain can be completely excluded from income through these basis adjustments. However, in order to receive the basis increases described above, the investor would need to meet the five and seven-year holding requirement before December 31, 2026.

As a result, any QOF investment made after December 31, 2021, would not be eligible for either the 10% or 5% basis adjustment, although the initial investment will still qualify for the original gain deferral until the end of 2026.

- **Tax-Free Growth.** If the investor holds the QOF for at least 10 years, any gain realized upon the sale of the investment is exempt from tax. This applies to the appreciation on the QOF investment beyond the investor's cost basis. Thus, after the deferred gain is recognized, any additional gains from the sale of the QOF investment are not subject to tax if the QOF investment is held for 10 years or more before it is sold. However, an investor must sell 100% of his/her QOF investment no later than December 31, 2047, to receive this gain exclusion.

Understanding the Risks

Risk is inherent in any investment product or strategy. Certain of the common risks and other important considerations associated with investment in Qualified Opportunity Zone Funds are highlighted below. You are strongly encouraged to review the prospectuses or other disclosure documents associated with any product for a more fulsome discussion of additional risks and other important considerations before making any invest decision. More information about investment risks generally and other important considerations is available at www.bairdwealth.com/retailinvestor.

While the tax advantages available to QOF investments can be very attractive to those investors looking to defer the tax on a realized capital gain, there are a variety of non-tax considerations and other risks that should be addressed.

- The investments made within the QOF (the QOZP) must meet a variety of very strict requirements. In many cases these will often be real estate-oriented investments – hotels, apartment buildings, parking garages, storage units, etc. Investors should consider whether those types of investments fit well within their portfolio. Remember that the QOF isn't the investment, but rather is the vehicle for investing in the underlying QOZP, just like a mutual fund is basically a vehicle for investing in stocks or bonds.

- Because of the complexity of the QOF structure, sponsors are likely to require relatively high minimum investments to participate. Many of the early offerings start at $100,000, but others have minimums as high as $1 million or more.

- In order to maximize the tax benefits, investors should plan on holding their QOF investment for at least 10 years. Investments in these funds should not be considered a place to hold money while waiting for another investment opportunity.

- Along those lines, many QOFs impose lock-up periods on their investors. The QOF will need time to collect investments, identify the right QOZP and then complete the redevelopment of the property or establishment of the new business. Lock-up periods of several years are not uncommon.

- As with all investments, the expenses associated with the QOF must be considered. Each QOF will assess some type of overlying management fee, just like any other investment. In many QOF structures, there may also be a preferred return, incentive allocation or performance fee paid to the general partners before earnings are shared with other investors. These expenses may be justified by the quality of the team running the QOF, and the tax advantages can help offset these costs as well, but like any investment those expenses will reduce the total return earned by investors.

Other Risks to Consider

An investment in a QOF is similar in many ways to an investment in a private equity fund but with more of a real estate focus. More information about investing in a private equity fund and related risks is available at www.bairdwealth.com/retailinvestor under "Important Information About Private Equity Funds."

In connection with an investment in a QOF, potential investors receive a Private Placement Memorandum ("PPM"). The PPM discloses material information about the offering such as strategy, terms and risks to allow investors to make an informed decision. If the investor decides to become a limited partner, the investor will be responsible for completing and signing a subscription booklet, which assists the manager of the fund in determining whether the investor is eligible to invest in the fund. The investor will also be required to sign the fund's partnership or LLC operating agreement. The partnership or operating agreement sets forth the terms of the investment, the fees charged and the rights and requirements of the limited partners, among other provisions.

An investment in a QOF is regarded as speculative and involves significant risks. Some of the common risks associated with investing in a QOF are those described below. The specific risks associated with a particular QOF are described in its PPM.

- **No Assurance of Return of Capital.** There can be no assurance that the QOF will be able to select, make or realize good investments or to implement its strategy or achieve its investment objective. As a result, there can be no assurance that the QOF will be able to generate returns for its investors.

- **Lack of Operating History.** QOFs are newly organized entities with no prior operating history and track record.

- **Limited Number of Assets; Lack of Diversification.** A QOF may participate in a limited number of assets and as a result the return of the fund may be substantially and adversely affected by the unfavorable performance of even a single asset.

- **Highly Competitive Market.** The activity of identifying, acquiring, owning, developing and operating QOZ investments is highly competitive and involves a high degree of risk and uncertainty.

- **Substantial Commitment Requirements.** Most QOFs require a significant commitment which can be drawn at the general partner's discretion as provided in the limited partnership agreement. Investors should therefore be prepared to have sufficient funds available to meet those capital calls, which can be significant in size and frequency during the early years of the fund.

- **Lack of Liquidity.** Investments in QOFs should be regarded as illiquid. They are not listed on an exchange, traded in the secondary market and are generally not transferable. In addition, QOFs frequently impose lock-up periods during which investors are not able to sell their QOF investments. Although QOFs may offer investors the right to redeem all or part of their QOF investments on a quarterly basis with advance written notice, the right to redeem will be subject to various conditions and limitations.

- **Fees.** There are potentially significant fees that investors in QOFs bear and that have not been negotiated at arm's length and are paid to the general partner or its affiliates. These fees include start-up or organizational costs, placement fees, management fees, administrative service fees, transaction fees, and the general partner's carried interest, performance allocation or incentive fee.

- **No Control Over Investments or Governance.** QOFs are regarded as blind pools. Investors may understand the types of companies and investments that a QOF proposes to make but do not know the specific investments it will make. In addition, investors in QOFs are passive and rely on the general partner to make investments and exit those investments. Investors do not have a say in what investments are made and when they are sold. Typically, the governance rights for limited partners in QOFs are minimal, making it very difficult to replace the general partner.

- **Real Estate Investment Risks.** A QOF is subject to the risks inherent in the ownership, development and operation of real estate and real estate-related businesses and assets. Deterioration of real estate fundamentals in the U.S. generally may negative impact the performance of a QOF. These risks include the burden of ownership of real property, general and local economic conditions, the supply and demand for properties and real estate values, environmental and zoning laws, casualty losses, regulatory limitations on rents, decreasing in property values, changes in the appeal of neighborhoods as well as particularly properties to tenants and potential purchases, property tax rates, energy and supply shortages, development and construction costs and delays, the availability and cost of debt financing, environmental and contingent liabilities, increased operating expenses, and difficulties in turning around distressed or under-performing assets or businesses. Also, given that a QOF's investments and assets will be in QOZs, which have high poverty rates and are regarded as depressed areas, a QOF is subject to the risk that conditions in those QOZs will continue to deteriorate and that the QOF will lose money.

- **Leverage.** A QOF may use a substantial amount of leverage in connection with its assets and investments. This leverage may subject the assets to restrictive financial and operating covenants, impairing the ability for such assets to finance their future operations and capital needs and limit their flexibility to respond to changing business and economic conditions. While leverage presents opportunities for increasing a QOF's return, it may potentially increase losses, and the ability of the fund to achieve its targeted returns may be linked to the fund's ability to locate and obtain leverage at appropriate levels and costs.

- **Dependence on Key Personnel.** The success of a QOF is highly dependent on the skill and expertise of the general partner and its management team. The loss of one or more key individuals may have a material adverse effect on the performance of the fund.

- **Conflicts of Interest.** There may be conflicts of interest between the general partner and investors. The general partner may make riskier investments than would otherwise be appropriate in order to generate high returns and earn its performance fee or incentive allocation. The general partner or its affiliates may have other funds that compete for similar investments as the QOF and may create other such funds. Allocations of investment opportunities between the QOF and other funds managed by the general partner, or its affiliates are made in the sole discretion of the general partner and its affiliates. Managing multiple funds may make it difficult for the general partner to devote its full time and attention to managing the QOF. Additionally, the general partner or its affiliates may make co-investments or side-by-side investments with the QOF. The general partner may also cause the QOF to invest in a business in which the general partner or its affiliates may have an investment or cause a portfolio company to enter into a transaction with another company in which the general partner or its affiliates may have an investment.

- **Limited Information.** QOFs often do not provide much information about their assets and investments and the performance, other than annual or semi-annual financial statements, an annual Schedule K-1, and possibly quarterly reports.

- **Compliance with QOZ and QOF Requirements.** An investment in a QOF is subject to the risk that the fund may violate or not comply with applicable statutory and regulatory requirements.

- **Lack of Regulation.** A QOF is not registered as an investment company under the Investment Company Act of 1940 and the general partner may not be registered as an investment adviser under the Investment Advisers Act of 1940. Moreover, an offering of interests in a QOF is not registered under the Securities Act of 1933. Accordingly, QOFs are generally not subject to much regulation and investors may not have the protections afforded by such laws.

- **Tax Considerations.** QOFs are usually taxed as partnerships and investors will receive an annual Schedule K-1 showing their pro rata share of the fund's gains, losses, income, credits and distributions. An investment in a QOF will complicate an investor's tax return and increase tax preparation costs. Please consult your tax advisor before investing in a private equity fund.

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More Information

For more information on Qualified Opportunity Zone Funds, please consult your Baird Financial Advisor.

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