



Issues and Opportunities When Combining Opportunity Zones and LIHTC

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The opportunity zones (OZ) incentive and the low-income housing tax credit (LIHTC) both have significant potential to create benefits.

This article provides a brief overview of some of the issues and opportunities when combining newly created OZ incentive with the LIHTC. Some familiarity with the OZ incentive is assumed.

Quick OZ Recap

If a taxpayer (investor) (a) generates unrelated capital gains (eligible gain), (b) invests up to such amount in a qualified opportunity fund (QOF) within 180 days, (c) elects to defer taxation on the gain, and (d) the QOF properly invests its funds into qualifying property or partnerships, then the following OZ incentives are generally available:

- a. avoidance of 10 percent or 15 percent of the tax on capital gains if the QOF investment is held for a five- or seven-year period ending before Dec. 31, 2026,

- b. deferral of tax on remaining capital gain until the earlier of Dec. 31, 2026, or when the QOF investment is sold, and
- c. if the QOF investment is held for 10 years or more, then when the QOF investment is sold, the investor can elect to step up its basis in the QOF up to the fair market value of such investment and avoid tax on the sale. Technically, when the QOF investment is made the investor will have a zero basis in the QOF investment. Such basis will increase by the 10 percent or 15 percent of tax avoided and by any gain recognized on Dec. 31, 2026.

QOZ-LIHTC Structure

The organizational structure of an OZ-LIHTC transaction is similar to a LIHTC-only transaction. The OZ-LIHTC investor would invest in a corporate or partnership fund that qualifies as a QOF. That

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QOF would be the LIHTC limited partner in a partnership (operating partnership) that meets certain requirements to be a qualified OZ business and owns a LIHTC building that meets certain OZ requirements. Note that under OZ rules, funds or partnerships cannot be members of the QOF; the actual entities deferring the capital gains must be members of the QOF and those entities will receive both the LIHTCs and OZ benefits.

Top OZ-LIHTC Issues and Opportunities

1. Pick the right LIHTC developments—new construction or very substantial rehabilitations, with significant debt.

OZ rules require the unrelated purchase of either new property, or existing property that is improved by an amount at least equal to the adjusted basis of the property. As a result, light rehabilitations will likely not qualify for OZ investment. Also, land or buildings must generally be acquired from unrelated parties, measured by a relatedness standard that is 20 percent rather than the 50 percent that applies for LIHTC purposes. Deals with significant nonrecourse debt, such as 4 percent tax-exempt bond transactions, facilitate compliance with special OZ basis rules discussed below.

2. Treatment of significant related party fees is unclear.

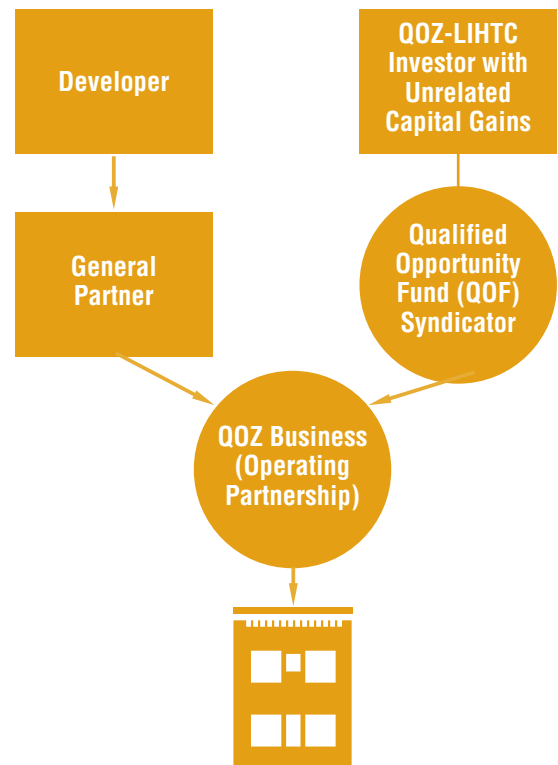
The OZ rules require that at least 70 percent of tangible property be purchased from an unrelated party. When constructing or rehabilitating a building, it is unclear how to analyze capitalized fees paid to related parties, e.g. developer fees or general contractor fees. Such related party fees could be aggregated and viewed as a separate asset, so perhaps it is OK as long as they are less than 30 percent of the total tangible property. Or should the standard be 20 percent, the general OZ related party test? Or should fees be ignored since they are for services and not the acquisition of property?

3. Investors may benefit even without expected future appreciation

LIHTC developments commonly lose value by the end of the 15-year compliance period given ongoing

affordability restrictions and prior receipt of LIHTCs, neutralizing the benefit of a 10-year basis step-up. While a lack of upside may reduce the value of the OZ incentive, gain deferral and 10 percent/15 percent tax avoidance remain. Two additional benefits may also exist:

- A. Possible permanent reduction of 2026 gain recognition: The mandatory 2026 recognition of previously deferred capital gain is limited by the fair market value of the QOF investment. A LIHTC development that is well into its credit delivery by 2026 may have lost significant value thus reducing mandatory gain recognition. This reduction in 2026 tax may be limited by the application of Internal Revenue Code (IRC) Section 7701(g), which would provide that the market value of the QOF investment would not be less than the investor’s share of nonrecourse debt of the QOF or operating partnership. The significance of Section 7701(g)’s impact varies significantly, sometimes even having no impact at all. Note also that avoidance of gain



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would also result in the investor having a lower basis in the QOF, which sometimes may limit the investor's ability to deduct future losses.

B. Reduced exit taxes: LIHTC investors often owe tax upon exit because they have been allocated losses in excess of their equity contributions. If the QOF investment has lost value, IRC Section 7701(g) can apply allowing the investor to step up its Year 15 QOF basis to at least the amount of the nonrecourse debt. While there are possible issues relating to the treatment of depreciation recapture and hot assets for purpose of IRC Section 751, the step-up to at least the amount of debt should allow the OZ-LIHTC investor to avoid some or all of the exit taxes that would otherwise be due.

4. Investors need capital gains or exit taxes to get any OZ benefits.

The OZ capital gain deferral, 10 percent and 15 percent avoidance of gain and 10-year basis step-up are only available if an election to defer capital gain has been made. Typical LIHTC investors such as banks often lack significant capital gains, limiting their access to OZ benefits. However, the capital gains portion of exit taxes from prior LIHTC or historic tax credit transactions should generally qualify as long as the gain is not from a sale to a related party. In addition, some non-traditional LIHTC investors may have capital gains from their businesses.

5. Single asset funds are currently preferred.

The 10-year basis step-up is only available if the OZ-LIHTC investor sells its investment. A plain reading of the language leads one to conclude the term investment means the investor's interest in the QOF. Thus, if the QOF instead sells its interest in the operating partnership, no step-up is available. Unfortunately, the sale of an interest in a QOF holding multiple operating partnerships will complicate and likely reduce valuation of such partnerships. Future IRS regulations may facilitate QOFs owning multiple

operating partnerships perhaps by concluding the term investment includes the investors indirect investment in the operating partnership. In the absence of such rules, most QOFs are structured to own only one operating partnership.

6. Developers can also benefit from OZ investments.

A LIHTC developer that timely defers capital gains can organize its general partner entity as a QOF and invest funds in its QOF to then be contributed into the operating partnership. The developer could later avoid tax by selling its interest in its QOF after the 15-year LIHTC compliance period.

7. Invest in transactions with debt to take advantage of tax losses.

As QOF partners, investors can generally deduct their share of losses, but only to the extent of their basis in the QOF interest. The OZ rules provide that investors initially get no basis for equity invested in QOFs, although this basis can step up by 10 percent and 15 percent of gain deferred after five and seven years, and also stepped up for gain recognized Dec. 31, 2026. As a result, investors would initially be unable to deduct losses allocated up through the operating partnership and QOF. However, investors' basis also includes their share of debt flowing through the partnerships. Therefore, if the operating partnership has unrelated debt, such debt can be allocated to the QOF and OZ-LIHTC investor to allow deductions of tax losses up to its share of the debt.

8. Capital contribution timing issues.

LIHTC investors typically delay significant portions of their capital until completion of construction and other requirements are met. As a result, the majority of a LIHTC investor's capital may not be invested until 18 to 36 months from the initial equity investment. However, OZ investors are required to make their investments into QOFs within 180 days of the date of the unrelated capital gain. This can create three types of issues:

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- A. Capital gain too early: OZ-LIHTC investors may have substantial capital gains currently and need to invest those gains within 180 days, but a LIHTC transaction's normal timing may not require such capital to be contributed for many more months. This can reduce the OZ-LIHTC investor's yield. However, OZ benefits may provide additional yield that can overcome the impact of the earlier capital contribution, especially if the QOF may lose value by Dec. 31, 2026, and reduce gain recognition as discussed above.
- B. Late capital gain problems: OZ-LIHTC investors may not have the necessary capital gain to defer when an operating partnership needs funds. These difficult issues might be able to be addressed if the operating partnership or QOF borrows funds, and later the OZ-LIHTC investor invests cash that used to repay the debt. However, such additional loans may create non-tax issues that need to be evaluated.
- C. Insufficient capital gains: OZ-LIHTC investors may wish to invest funds that exceed available capital gain. OZ mixed funds rules allow investments with capital gains deferral elections to be treated as separate investments eligible for OZ benefits while non-gain investments do not receive any OZ benefits.

9. Monitor the QOF 90 percent test.

QOFs are required to have 90 percent of their assets invested in qualifying operating partnerships/corporations or qualifying tangible property. If the QOF pays for other capitalized items, those cannot exceed 10 percent. Cash held by the QOF, as well as capitalized fees paid by the QOF in some cases could exceed 10 percent. In addition, if the QOF has generally accepted accounting principles (GAAP) financial statements, then the 90 percent test is based on the GAAP amounts. Otherwise, cost is used. Use of GAAP financials is very problematic and it is hoped that future rules will make that optional.

Conclusion

The OZ incentive has potential to be used with LIHTCs and make a more desirable investment. Not every LIHTC investor will be interested and not every LIHTC project will qualify. But for the right project with the right investor, the OZ incentive can create a more desirable investment and help in the redevelopment of distressed communities. ❖

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