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THE TWINNING OPPORTUNITIES IN QUALIFIED OPPORTUNITY ZONES

This article describes some of the opportunities that our firm sees to combine the newly created tax incentives for investments in Qualified Opportunity Zones ("QOZs") with the Low-Income Housing Tax Credit ("LIHTC"), the New Markets Tax Credit ("NMTC") and the Historic Tax Credit ("HTC").[i] For a brief description of QOZs, please see our March 15, 2018 Client Alert located HERE. For a detailed analysis of the QOZ program, see our March 15, 2018 article located HERE.

Qualified Opportunity Zones ("QOZs") are a new tax incentive for people and businesses that sell something and have a taxable gain that could be invested into certain low-income areas. The purpose of the QOZ program is to incentivize investment and increase the economic growth in such low-income areas. There are very few restrictions on the type of investment and qualifying investments that can qualify for deferral of existing gains and permanent exclusion of some gains.

QOZs were created as part of the Tax Reform law that was enacted on December 22, 2017, Public Law No: 115-97. The QOZ provisions are contained in Internal Revenue Code Sections 1400Z-1 (Designation of Qualified Opportunity Zones) and 1400Z-2 (Special Rule for Capital Gains Invested in Opportunity Zones).

It is expected that guidance will be issued by U.S. Department of Treasury ("Treasury") or by the Internal Revenue Service ("IRS"). There are many open issues about which guidance is hoped to be obtained. This memo addresses opportunities for twinning and identifies some areas where guidance from the IRS will be needed. The conclusions in this memo are our initial conclusions and are subject to change as guidance is released.

I. Quick Summary of Qualified Opportunity Zones

No Competition and No Limits - In contrast to Low-Income Housing Tax Credits ("LIHTC") or New Markets Tax Credits ("NMTC") there is no cap on the amount of benefits and no competition--any investment in almost any kind of business that is located in a QOZ can get the tax benefits if the appropriate rules are followed. In this regard, QOZs are similar to Historic Tax Credits ("HTC") in that a HTC building gets the credits automatically if the various HTC and National Park Service rules are followed.

No Restriction Against Housing – Unlike the NMTC, there is no prohibition on investments in residential rental housing. Thus twinning QOZ and LIHTC is possible.

Basic Overview - Taxpayers who have a gain from a sale or exchange of property ("Existing Gain") can get 3 Types of Tax Benefits if they invest the amount of gain in a Qualified Opportunity Zone Fund ("QOZ Fund"):

a) Deferral of Tax on the Existing Gain – Existing Gains from the sale or exchange of property that are invested in a QOZ Fund within 180 days of such sale or exchange will have the tax due as a result of the Existing Gain deferred until the earlier of (i) December 31, 2026 or (ii) when the investment in the QOZ Fund is sold or exchanged. On such a date Deferred Gain will be recognized equal to (A) the lesser of (1) the deferred gain, or (2) the fair market value of the QOZ Fund investment, over (B) the basis in the QOZ Fund which is initially set at zero (but see (b) below).

b) Permanent Reduction in Tax on the Existing Gain – effectively a reduction of the deferred Existing Gain by 10% or 15% is available for investments in a QOZ Fund held for 5 or 7 years, respectively. This is technically implemented by increasing the basis in the QOZ Fund by such amounts.

c) Permanent Avoidance on New Gain – tax on gain generated from the investment in the QOZ Fund (new gain, as opposed to Existing Gain) is avoided entirely if the investment is held for 10 years when the basis in the QOZ Fund can be stepped up to fair market value.

II. Thoughts on Twinning with LIHTC and HTC

a) **LIHTC Twinning Looks Promising** - We think twinning with LIHTC appears to be a very effective form of investment. The 10-year credit delivery period for LIHTC investments combines very well with the 10-year period to achieve maximum benefits for QOZ investments.

b) **HTC Twinning Can Also Work** - Twinning with HTC could also be possible, although having a 10-year investment horizon would be substantially longer than normal HTC investments. The deferral of Existing Gain, however, requires no minimum hold. Further, the 10% reduction in Existing Gain is available for investments held for 5 years and a 15% reduction in Existing Gain takes only 7 years. Given the time involved in rehabilitation of a historic building, the 7-year QOZ period and the 5-year HTC recapture period and credit delivery period may be close to the same.

c) **Deferral and Partial Avoidance of Exit Taxes on LIHTC Year 15 Projects** – Many LIHTC investors are now exiting transactions and generating significant exit taxes due to the Investor having a negative capital account. Because much of the exit taxes would be mostly capital gain, this tax due on the exit could be deferred if the investor invested in a new QOZ Fund. That Existing Gain would be deferred until the earlier of when the investment was sold or December 31, 2026. Further, that Existing Gain would be reduced by 10% or 15%, if the investment were maintained for 5 or 7 years, respectively. Finally, if the fair market value of the QOZ Fund has gone down, then gain would only be recognized up to the amount of such fair market value. For some LIHTC investments, the value of the investment drops as the LIHTC is delivered. Thus it would be possible that the gain triggered on December 31, 2026 could be less than the Deferred Gain.

d) **Avoidance of Exit Taxes on New LIHTC Projects** – For projects located in QOZs that anticipate having exit taxes due in 15 years, investment in such a project through a QOZ Fund could avoid or reduce such exit taxes. When the Project completes the end of the 15-year LIHTC Compliance Period and the investor exits the QOZ Fund by a sale or exchange, the Investor's basis in the QOZ Fund is stepped up to fair market value. The exact mechanics of the step-up in basis are not yet clear due to the Investor already having additional basis due to underlying debt, but the step-up should help, and with favorable guidance could help very significantly.

e) **Due to Pay-In Timing Requirements, LIHTC and HTC Investors with Year 15 Exit Taxes or with Frequent Gains Have an Advantage** – In order to get the QOZ benefits, a taxpayer must invest its gain in a QOZ Fund within 180 days of the sale or exchange that generated the gain. The 180-day window creates significant pressure to find an investment and quickly fund that investment. However, LIHTC and HTC transactions generally backload equity to increase investor yield and to manage risk. LIHTC and HTC investors who regularly generate gains, for example through a trading desk, would have an advantage because by generating gains throughout the period from Initial Closing→Construction Completion→Receipt of 8609, they would create gains available for investment in a QOZ Fund within 180 days of the project's required capital contributions. In addition, LIHTC investors that have old transactions generating capital gain exit taxes could defer the tax on such gains by investing the amount of gain into a new LIHTC transaction that is in a QOZ by making sure the fund they invest in is a QOZ Fund.

f) **Alternative Structures to Address Timing of Subsequent Gains**– There are other possible ways to address situations where LIHTC projects need investments prior to an investor generating matching gains to invest. In such a situation, the investor could make a loan to a QOZ Fund. Then if the Investor had gain later, the Investor could make a QOZ investment into the QOZ Fund that would then be used to repay the loan. This way the Investor could make required capital contributions (via a loan) needed by the Project from the non-gain investment, but still meet the 180-day timing requirements of the QOZ program by replacing the capital at a later time. It might also be possible to modify the foregoing and have the investor make a non-QOZ investment into a QOZ fund when a capital a contribution is needed. At the time when the investor has a gain, they could make a QOZ investment into the Fund and use those funds to repay the non-QOZ investment. Both of these structures allow projects in the low income QOZs to get investment when they need it and then have gain funds invested at a later time and repay the prior loan/investment. Guidance would be needed to confirm these structures.

g) **<u>LIHTC and HTC Quick Return from Credits Creates an Edge for Twinning</u>** - A twinned LIHTC transaction allows the investor to start receiving back substantial benefits as soon as LIHTC delivery begins in the First Year of the LIHTC Credit Period. In LIHTC transactions, receipt of the LIHTC and associated losses during the 15-year compliance period "effectively" provides both a return of the amount invested as well as a return on that investment. Therefore, the value of the Project at the end of the 15-year Compliance Period is not critical because by that time the investor has already received a sufficient return. The same is true for HTC transactions, although they tend to have at least some cash return. But the LIHTC and HTC transactions contrast well with a non-twinned deal where it would be much more critical for the investment to maintain its value and even appreciate. This is because operational profits that we assume could be distributed during the 10 year QOZ holding period are unlikely to be a sufficient return; therefore maintenance of the investment's value, and even appreciation, would be an important component of value for QOZ investors. In summary, QOZ-LIHTC/HTC transactions return value quicker and reduce risk by not requiring maintenance of value or appreciation in value.

h) **<u>Low Debt LIHTC Transactions Would Not Be Favored</u>** - Because the basis in the QOZ Fund is initially set at $0, an investor in a QOZ Fund would only be able to take losses from a QOZ Fund investment in an LIHTC Project if the Project had debt that would give the Investor basis in the QOZ Fund. Thus 9% LIHTC transactions with low debt would not deliver as much return.

   Note - there would be an increase in basis in Year 5, Year 7 and on 12/31/2026, so there could be some back-weighted losses that would be available at those times.

i) **<u>Light LIHTC Rehabilitations Would Likely Not Work</u>** – The QOZ rules effectively require that one spend more on the rehabilitation than the cost of acquiring the Project. This is similar to the HTC rule, but a much heavier burden than the lower requirement for LIHTC projects (20% of acquisition basis or $6,000/unit plus inflation). Thus, light rehabilitations would generally not work.

j) **<u>What is the Preferred LIHTC-QOZ Investment?</u> –** A cash flow positive 4% LIHTC transaction with a very substantial rehabilitation that exceeds acquisition costs might be the ideal twinning candidate. By their nature 4% transactions generally have substantial debt. Because investments in QOZ Funds initially have a zero basis, Investors could be unable to deduct losses flowing up through the QOZ Fund due to a lack of outside basis. Tax-exempt bond transactions have substantial debt that would give the QOZ Investor outside basis allowing the Investor to take losses. Then as the 5-year, 7-year and 12/31/26 basis increases occur, the Investor's basis would step up and thus reduce or eliminate tax that would otherwise have been due at a disposition where losses were taken based on project debt. Finally, the step up to fair market value after 10 years could help ameliorate or avoid exit taxes.

III. Thoughts on Twinning with NMTC

a) **Holding Period**. The NMTC 7-year investment period works will with the QOZ 7-year deferral. To also achieve the basis step-up to fair market value would require an additional 3-year investment.

b) **Possible Twinned Structure** – A qualified community development entity or its subsidiary ("CDE") that also attains status as a QOZ Fund could accept qualified equity investments ("QEIs") that generate NMTC along with the QOZ benefits to the investor. QOZ legislation treats investments of gain separately from other sources, meaning that QOZ benefits would only be generated on the portion of the investment sourced from equity rather than a leverage loan. Unlike NMTC, which are generated on investments sourced from equity and debt, QOZ benefits are limited to investments of gain. Even so, the added QOZ benefit to the NMTC investor would facilitate competitive market advantages, higher yields, or some combination of the two.

c) **Investment Timing** – Unlike twinned LIHTC and HTC transactions, NMTC investments and QEI fundings occur upfront, precluding the need to coordinate gain generation with capital calls. Moreover, the funding of a QEI may precede a QOZ Fund's closing on a lower tier investment through a pre-fund, providing flexibility in the event the 180-day deadline arrives prior to readiness to close. The deadline for a QOZ Fund's 90% investment in Qualified Opportunity Zone Property ("QOZP") or a QOZ Business is less flexible than the NMTC measure of the "substantially all" test and falls at the midpoint and end of the QOZ Fund's tax year. Thought would need to be given to coordinating the NMTC closing with the QOZ deadlines.

d) **Lower Tier Considerations –** Lower tier QOZ investments differ from qualified low-income community investments ("QLICIs") and recipient eligibility is both wider and more restrictive than a qualified low-income community business ("QALICB"). The most obvious difference is that while a QLICI may be either debt or equity, a QOZ Fund's investment must be in stock or partnership interests of an eligible business. A QOZ Fund may also use QOZ funds to purchase tangible property for use in its own business or directly in assets that will be used in a trade or business. The overlapping investment that would satisfy both NMTC and QOZ requirements is an equity QLICI that doubles as QOZ partnership interest. Depending on the capitalization of the business recipient, this could result in loss of the NMTC reasonable expectations test and also increase the risk of a redeemed QEI. However, the significantly higher yield from an investment that includes both QOZ and NMTC benefits could be enough to overcome the loss of the reasonable expectations safe harbor for QALICBs which look very sound. Also, while a QOZ business eligible to receive a QOZ Fund's investment shares many characteristics with a QALICB, there are possible differences. For instance, guidance is expected to be requested on whether the "active conduct" of a business by a QOZ business would be as expansive as the NMTC concept, which simply requires the generation of revenues or furtherance of a nonprofit purpose.

e) **Unwind Incentives** – As a result of the NMTC basis reduction, investors in leveraged deals commonly face an exit tax, a tax that could conceivably be affected by the basis adjustments under the QOZ program. For deals with compliance periods ending prior to December 31, 2026 (with QEIs made prior to 2020), there may be a slight incentive to continue to defer recognition of Existing Gain built into their equity investment until that date. For later deals, the 2026 recognition event would have likely neutralized that distortion. A slightly larger incentive may be to hold a QEI for 10 years, where the basis in the equity portion of the QEI would step up to fair market value of the investment, which could offset some or all of the NMTC basis reduction and reduce or eliminate exit taxes.

f) **Basis Needs**- The reduction of basis in a QEI in the amount of the NMTC would be problematic when coupled with the deemed $0 basis because there would be no basis to reduce (can't have negative basis). This could be cured by using debt to generate basis. To be able to absorb the NMTC basis reduction, the debt would need to be equal to at least 39% of the amount of the Exiting Gain that would be deferred. The debt could be at the QALICB level and, in light of the equity QLICI, flow back up to the Investor and result in basis which could be reduced as required for NMTC. Alternatively, the Investor could borrow funds in excess of the gain it wishes to defer and invest those in the QOZ Fund. The "mixed funds" provision of the QOZ legislation makes clear that investments in QOZ Funds made from sources other than eligible gain are not eligible for the benefits, nor subject to the requirements and limitations, of the QOZ program. If leveraged debt was used and was not treated as a QOZ investment, then the investor's basis in the QEI attributable to the leverage loan should not be deemed to be $0.

g) **Leveraging Investments**– In the right set of facts, leveraging of equity could be helpful in a NMTC transaction. The necessary situation would be where the NMTC Investor has gain it wishes to defer (say $1,000,000) but chooses to invest that gain partly through cash ($300,000) and partly through money it borrows ($700,000). Those funds would then be contributed to a CDE that was also certified as a QOZ Fund. The contribution would be both a $1,000,000 QEI and $1,000,000 of qualifying QOZ Investment. However, due to the NMTC required basis reduction, to allow this to work the QOZ Fund would need to invest in a business that has debt that results in basis to the Investor at least equal to the NMTC generated, $390,000. For example, the CDE/QOZ Fund could contribute capital to a QALICB Partnership in exchange for a capital and profits interest in the partnership. Those partnership interests would qualify as be QOZ Partnership Interests ("QOZPI"). If the QALICB also borrowed funds as part of the project financing, the debt would create basis that would flow up through the QALICB, then through the CDE/QOZ Fund and then up to the Investor. The

Investor would then have the basis necessary to withstand the required NMTC basis reduction. Thus it becomes possible to adapt a leveraged NMTC structure for a QOZ investment, as long as the Investor had enough gain and the QALICB borrowed funds to create the necessary basis.

For more information, please contact Glenn Graff, Ben Swartzendruber or any of your contacts at Applegate & Thorne-Thomsen.

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