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Pairing the Opportunity Zones Incentive and Historic Tax Credits

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The buzz about opportunity zones (OZs) is widespread and growing. Developers, investors and business owners throughout the country are working quickly to learn about the new community development tool that helps deploy capital into underserved areas.

The OZ incentive became law with the passage of the sweeping tax reform bill signed into law in December 2017. Since the inception of the OZ incentive, developers of historic properties have been contemplating ways to combine the OZ incentive with historic tax credits (HTCs) to raise additional capital for these often difficult to finance transactions. From a statutory perspective, there is nothing that precludes OZ investments to be paired with HTCs, and there are a number of structuring options that could potentially be used to combine the two incentives.

As a practical matter, there are several areas of compatibility between the OZ incentive and the HTC program that make OZ investment an attractive source of funding for historic rehabilitation developments. For one, many historic structures are located in the distressed census tracts targeted by the OZ incentive. A report published by Rutgers University found that of the $6.5 billion in HTC rehabilitation expenses in 2017, half, or $3.25 billion, occurred in low- and moderate-income census tracts and 79 percent, or $5.1 billion, occurred in economically distressed areas. Additionally, the HTC program's relatively short period of 24 months (in a non-phased rehabilitation) to incur qualified rehabilitation expenditures that exceed the adjusted basis of the building could also satisfy the OZ requirement to substantially improve a property during a 30-month period. Finally, the typical long-term holding period for real estate investments and concentrated operations within a single location make these types of investments attractive to OZ investors looking to maximize benefit while mitigating compliance risks.

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OZ Refresher

The OZ incentive provides certain tax benefits to taxpayers with capital gains by enabling them to invest the amount of the gain into qualified opportunity funds (QOFs) generally within 180 days from the date of the sale triggering such gain. The OZ investment allows taxpayers to defer paying the tax on these capital gains until the earlier of the sale of the investment in the QOF or Dec. 31, 2026. At that time, the capital gain must be recognized and the taxpayer must pay tax on the lesser of the original deferral (less basis adjustments–discussed below) or the fair market value of the investment. Investors that hold the equity interest in the QOF for seven years will realize an additional benefit in which 15 percent of the original capital gain (10 percent after a five-year hold and an additional 5 percent after a seven-year hold) may be permanently forgiven. This added incentive is accomplished through an upward basis adjustment in the investment after the five- and seven-year time periods. At the time of the initial investment, the investor's basis in the capital gain deferred investment is zero. Further, an investor may realize significant additional benefit if it holds the investment for 10 years or more whereby any gain on the sale of the investment in the QOF is permanently eliminated.

QOFs generally must hold at least 90 percent of their assets in qualified OZ property, which consists of any combination of the following:

1. Qualified OZ stock in a qualified OZ business (QOZB),
2. Qualified OZ partnership interest in a QOZB, and
3. Qualified IZ business property (QOZBP).

QOZBP is generally defined as tangible property acquired by purchase from an unrelated party after Dec. 31, 2017; has its original use in an opportunity zone by the QOF or QOZB or is substantially improved; and during substantially all of the QOF's or QOZB's holding period, substantially all of the use of such property is in an opportunity zone. Special rules apply to leased property.

Other rules exist related to the qualification of an entity as a QOZB, including that substantially all of the tangible property (70 percent) of such entity is QOZBP and at least 50 percent of the gross income of the entity is derived from the active conduct of business in the OZ. Certain trades or businesses often referred to as the "sin" businesses are also disqualified.

The OZ incentive is governed by Internal Revenue Code Section (IRC) 1400Z-2. The IRS has issued two tranches of proposed regulations. While the IRC and proposed regulations provide various rules related to the OZ incentive, many questions remain. The IRS is currently considering comments from numerous industry practitioners that may affect the final regulations. QOFs may rely on the proposed regulations before the issuance of the final regulations as long as the QOF applies the rules of the proposed regulations in their entirety.

Pairing HTC and OZ

Considering the rules described above related to a QOZB and QOZBP, it is clear to see why developers of historic properties are looking at this incentive as a potential opportunity to raise capital for their HTC projects. Traditional HTC investors are exploring the ability to receive both HTCs and OZ benefits in a single investment. Project developers are also raising outside capital separate from HTC investment equity either through their own capital gain deferrals or from outside economic investors, recognizing the synergies of the two incentives.

One point of compatibility is that the HTC requires a substantial rehabilitation of the historic property,

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which aligns well with the OZ requirement to substantially improve the property. In fact, in both cases, developers generally must spend more than the basis of the property to meet these similar (not identical) tests. In addition, rental real estate activities can generally qualify as the active conduct of a trade or business whose gross income is essentially 100 percent derived in the OZ in which the property is located. More on this point later. However, as with any tax credit or incentive, depending on the transaction structure, the OZ rules pose numerous structuring and compliance challenges when combined with HTCs. The following discussion highlights a selected few issues that arise in contemplating these combined incentives.

Basis Adjustment–HTC

In a traditional direct HTC investment, the developer or project sponsor and the investor form a partnership in which the investor member typically owns 99 percent of the partnership and the developer/project sponsor owns a 1 percent interest. An important aspect of the direct investment structure is the requirement of a reduction in basis of the building and the owners' bases in the partnership interests by the amount of HTCs claimed. As noted earlier, an investor's initial basis in its OZ investment in a QOF is zero. With the required basis adjustment of HTC property equal to the amount of HTCs, the zero basis of an OZ investment is likely to cause significant tax issues for an investor looking to use a capital gain deferral to make an HTC investment directly into a landlord entity.

QOF or QOZB?

The landlord entity in a HTC transaction could possibly qualify as a QOF or a QOZB. In addition, it may be possible for a master tenant entity in a lease pass-through structure to qualify as a QOF or QOZB. The 90 percent test for a QOF and various qualification tests for a QOZB will need to be considered in determining how best to structure an OZ investment into a HTC transaction. For example, if the master tenant is the QOF and the HTC investor owns 99 percent and elects to defer capital gain as an OZ investment (which also serves as an HTC investment), the master tenant must hold 90 percent of its assets in QOZP. An equity interest in the landlord could potentially qualify as QOZP (assuming the landlord is a QOZB), as could the purchase of certain tangible property (equipment or furniture and fixtures).

However, a prepaid lease or loan to the landlord (structures often used in a pass-through lease transaction) would generally not qualify as QOZP, and such assets are likely to cause the master tenant to fail the 90 percent test. In a similar vein, to qualify as a QOZB, the entity may not hold more than 5 percent of its assets in nonqualified financial property. Nonqualified financial property is defined in IRC Section 1397C and includes assets such as partnership interests and debt instruments. Thus, a master tenant that holds an equity interest in a landlord, makes a loan or prepays rent to a landlord is likely to hold more than five percent of its assets in nonqualified financial property, and therefore not qualify as a QOZB.

Active conduct of a trade or business

As discussed earlier, the QOZB must derive more than 50 percent of its gross income from the active conduct of a trade or business in an OZ. While these types of businesses have very little risk of deriving income outside of their physical locations, developers must still ensure that the rental of real property meets the "active conduct of a trade or business" part of the test. Proposed Treas. Reg. 1.1400Z2(d)-1(d)(5)(ii)(B)(2) explicitly states that the "ownership and operation (including leasing) of real property is the active conduct of a trade or business."

However, the provision goes on to state "merely entering into a triple-net lease with respect to real

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property… is not the active conduct of a trade or business by such taxpayer." In a traditional lease pass-through HTC structure, the landlord entity enters into a triple net master lease with a master tenant. Whether such an arrangement would constitute an entity "merely entering into a triple-net lease" is unclear. Consideration should be given to the provisions within the master lease and the level of operational activity performed by the landlord with respect to the property in determining whether the entity will qualify as a QOZB.

HTC Transition rules

The tax reform bill brought significant changes to the manner in which HTCs are claimed by investors. A detailed discussion on HTC transition rules can be found in this issue of the Novogradac Journal of Tax Credits on page 65 , but here's a summary on how the HTC transition rules raise questions for QOZBPs. In order to protect the more lucrative benefits of the prior law and meet the grandfathering provisions of the HTC rules, many developers rushed to acquire historic properties before the end of 2017. To qualify as QOZBP, tangible property must be acquired after Dec. 31, 2017. Questions remain as to whether the mere acquisition of a historic building would taint the entire rehabilitation for purposes of qualifying the subsequent qualified rehabilitation expenditures as QOZBP. Numerous comments have been submitted to the IRS with respect to this and similar issues, and the final regulations may provide additional guidance.

Other structuring considerations

Numerous additional compliance and tax issues exist when considering the pursuit of OZ and HTC. One consideration is the timing of the equity investments. Given the 180-day window for investing capital gains into QOFs, HTC investors looking to take advantage of OZ incentives may have to adjust their typical pay-in schedules in order to meet the OZ requirements. Another relates to the typical holding period of a HTC investment and whether the OZ incentives align with the anticipated holding period of the HTC investor. Longer holding periods structured to maximize OZ benefits may be costly to developers in the form of higher than expected priority and cash flow returns to be paid to HTC investors. In addition, developers question whether investors will provide a premium in equity pricing for investments that combine both incentives. Finally, in a typical HTC pass-through structure, a developer affiliate serves as the managing member of the master tenant and is responsible for managing the operations and administrative activities. The additional compliance requirements of a QOF may increase the burden to developers.

While layering the OZ incentive into a HTC transaction may be complicated, HTC developers are no strangers to complex financing structures, and the OZ incentive may offer an additional incentive to attract much needed capital into difficult projects in low-income communities. For further questions regarding the potential to use OZ investments in HTC transactions, please consult your Novogradac tax advisor. ❖

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