NOVOGRADAC
TAX CREDIT TUESDAY
PODCAST

Summary: July 16, 2019

In this week's Tax Credit Tuesday Podcast, Michael J. Novogradac, CPA, talks about the timing of a possible tax extenders vehicle and the introduction of a bill to make the Community Development Block Grant-Disaster Recovery program permanent. After that, he has a recap of the Treasury's hearing last week on proposed opportunity zones regulations. He closes out this week's podcast with a couple of state-level tax incentive updates: one from Hawaii and the other from Rhode Island.

Summaries of each topic:

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GENERAL NEWS

Debt Ceiling and Spending Caps

- Now in last week's podcast, I talked about how the likely pathway for tax extenders in this Congress is as a rider on must-pass legislation, such as a bill to suspend the debt ceiling.
- Now many expected lawmakers to begin finalizing a deal to suspend the debt ceiling around September.
  - Previous projections indicated Treasury's ability to use "extraordinary measures" to avoid breaching the debt limit would be exhausted in late September or early October.
- Well, House Speaker Nancy Pelosi received a phone call from Treasury Secretary Steven Mnuchin last Thursday, wherein he reported that Treasury may be not be able to avoid breaching the limit before Congress returns from the August recess on September 9.
- So, Speaker Pelosi signaled that she will try to negotiate debt ceiling legislation sooner than that.
- She told reporters last week that she would work on a debt ceiling deal before the August congressional recess, this is according to the Washington Post.
- Now Speaker Pelosi wants to pair a debt limit deal with one to increase the fiscal year 2020 spending caps.
- As I noted last week in a prior podcast, if Congress does not act, defense spending will need to be cut by $71 billion and nondefense spending by $55 billion from the 2019 levels.
- Now the House has passed 10 of the 12 fiscal year 2020 spending bills assuming a substantial increase from those 2019 levels.
- Now to maintain maximum leverage, Speaker Pelosi wants to include the spending caps increase with any debt limit deal.
- However, the White House and Congressional Democrats remain far apart on the spending cap negotiations and there are only six legislative days before July 26, when the House is scheduled to depart for their August recess.
- At this point, it does not appear likely that a spending caps deal can be struck with the limited time left.
- Now I'll monitor the progress of the debt ceiling and spending caps negotiations and will report back in future podcasts.
- The likelihood of tax extenders or other tax provisions catching a ride on this must-pass legislation will be discussed in future podcasts as well.

Reforming Disaster Recovery Act of 2019

- In other notable legislative news, I'll discuss a disaster recovery bill that is receiving urgent attention, especially in light of Tropical Storm Barry's effect on the Gulf Coast.
- A bill that would authorize permanently and reform the Community Development Block Grant-Disaster Recovery program was introduced in the House last week.

- The Community Development Block Grant-Disaster Recovery program, or CDBG-DR, provides states and local communities long-term recovery resources to rebuild affordable housing and infrastructure after a disaster.
- Now the legislation would require federal disaster recovery dollars to be distributed equitably with a balance among homeowners, renters and the homeless.
- Another requirement is to replace scarce affordable housing for low-income residents by prioritizing a one-for-one replacement of damaged or destroyed public or federally subsidized rental housing.
- The bill would maintain a requirement that at least 70 percent of federal recovery funds benefit low- and moderate-income households.
- The legislation would also provide a timeframe for allocating CDBG-DR funding.
    - More specifically, HUD would need to allocate federal disaster assistance dollars within 60 days of Congress approving the funding.
- Now the lead sponsors of the Reforming Disaster Recovery Act of 2019 are Reps. Al Green, a Democrat from Texas, and Ann Wagner, a Republican from Missouri.
    - Both Reps. Green and Wagner are senior members of the House Financial Services Committee.
- Now the bill may be marked up by the committee today.
- I will provide updates in next week’s podcast.
- In the meantime, we’ve posted a copy of the bill on our website and I’ll include a link in today’s show notes.

OZ Hearing

- Now onto the topic of opportunity zones: The IRS last Tuesday held a hearing on proposed opportunity zones regulations.
    - Specifically, the hearing focused on the second tranche of the Treasury Department’s proposed opportunity zones regulations that were published May 1.
- Now you may recall that a hearing on the first tranche of proposed opportunity zones regulations was held this past Valentine’s Day.
    - Those proposed regulations were published last October.
- The Valentine’s Day hearing was in D.C. and was so popular that many attendees had to line up outside of the hearing room.
    - Some people in line never even had a chance to come in—a testament to the level of interest in opportunity zones!
- With that in mind, Treasury decided to hold last week’s hearing in a much bigger auditorium in Maryland, just outside of D.C.
- Last week’s hearing was likewise well attended.
- There were 19 scheduled speakers.
- And those speakers ranged from accountants and lawyers to developers, CDFIs, syndicators and economic development groups.
- My partner John Sciarretti testified on behalf of the Novogradac Opportunity Zones Working Group.
- He highlighted three topics and recommendations on how to encourage more investment in opportunity zones.
- The first topic he discussed was the special amount includible rule for investments in qualified opportunity fund partnerships and S corporations.

        - Now that's a mouthful: Special amount includible rule.
    - Well the includible rule provides that in the case of an inclusion event, or in 2026, the deferred gain recognition date, that the amount includible in income from the deferred gain from investments in a pass-through qualified opportunity fund ends up being the lesser of:
        - The remaining deferred gain, we kind of generally understand that rule, less statutory basis adjustments, or, and this is where it's a bit different,
        - The gain that would be recognized on a fully taxable disposition of the investment.
    - So that's what the includible rule is.
        - Either the remaining deferred gain, less statutory basis adjustments, or the gain that we recognize on a fully taxable disposition of the investment.
    - Well the rule is in place to limit or prevent taxpayers from avoiding recognizing deferred gain when the fair market value of their interests diminish due to debt-financed distributions.
    - Because the statute itself talks about fair market value, not gain recognized on a fully taxable disposition.
    - So, what's the problem?
    - Well, this special inclusion rule is adversely affecting investment in affordable housing and other high-impact community development investments.
    - Affordable housing and community development investments are taking a hit because the 10-year gain exclusion benefit is generally less valuable ad investors don't anticipate realizing as great an appreciation on their investments.
    - The statutory 2026 inclusion rule provides some downside benefit for these types of investments for losses that might be recognized between now and 2026.
    - But as a result of this special inclusion rule, some aspiring investors are turning away from affordable housing and community development investments in qualified opportunity zones.
    - So what's the solution?
    - Well, the Opportunity Zones Working Group recommends that Treasury make a proposed rule that's consistent with the mechanics of the general statutory rule, with one exception: that the definition of fair market value is modified to be the net value of the investment, excluding debt, plus prior cash distributions.
    - Our proposed change would both:
        - Prevent artificial reduction of investment value through debt-financed distributions, and
        - It would do that without adversely affecting affordable housing and community development investors.
        - The bottom line is that our proposal would enable more impactful investments in opportunity zones.
    - So, that's the first issue that John discussed.
- Now the second issue, the second topic, was the special 10-year exclusion election rule for qualified opportunity fund partnerships and S corporations.
    - Now under the proposed rule, an investor in a qualified opportunity fund pass-through entity can elect to exclude from gross income its allocable share of capital gain from disposition of an opportunity zone property by a qualified opportunity fund.

- But, of course, only after the investor has held its opportunity fund interest for at least 10 years.
- In other words, after an investor holds a qualified opportunity fund interest for at least 10 years, the investor can choose to exclude from gross income its share of capital gain from the sale by the qualified opportunity fund of opportunity zone property.
- Now I should clarify this election only applies to capital gains from the sale of a qualified opportunity zone partnership by the qualified opportunity fund or other qualified opportunity zone property.
- The election does *not* include gain from the sale of property that is ordinary income and the election also doesn't include any gains attributed to the sale of property by a qualified opportunity zone business by a pass-through entity held by the qualified opportunity fund.
- So, what's the issue with this proposed rule?
- Well, there's a discrepancy between the rule governing the sale of a qualified opportunity fund interest, which allows the exclusion of all gains attributable to the appreciation of all property—whether capital or ordinary, or whether the property is held by the qualified opportunity fund or the business.
- Now the working group's recommendation is to expand the gain exclusion rule to apply generally to *all gains* attributable to the sale of any property used in a trade or business by a qualified opportunity fund or qualified opportunity zone business.
- We do though, recommend an exception for the sale of inventory property or property otherwise held and sold in the ordinary course of operating a business.

- So, we talked about the special inclusion rule, the 2026 gain inclusion rule, and the 10-year exclusion election.
- The third topic John discussed in his testimony dealt with the grace period for qualified opportunity funds and qualified opportunity zone businesses to use property in a trade or business.
  - So let's start with what the rules are.
  - First, tangible property of a qualified opportunity fund or a qualified opportunity zone business must be *used* in a trade or business to be considered a qualified opportunity zone business asset or qualified opportunity zone business property.
  - Second, the statute also provides that new businesses must be organized for the purposes of being a qualified opportunity zone business, with the subtle and implied acknowledgement that a start-up period is anticipated.
  - Now the issue with these rules is that they do not address whether a qualified opportunity fund or qualified opportunity zone business is permitted a grace period to use tangible property in a trade or business.
  - That lack of clarity raises some questions, such as:
    - If a qualified opportunity fund invests in equipment but it takes time to put the equipment into production, is the equipment not qualified until it's used?
    - Another question: If a qualified opportunity zones business or a qualified opportunity fund constructs a building and after 31 months the building is not fully completed and therefore not leased, is the building <u>not</u> qualified until the building is placed in service?

        - Or even within qualified opportunity fund construction, the qualified opportunity fund technically doesn't qualify for the working capital exception, so does it even have 31 months for the building to be placed in service?
        - Well the working group suggests two recommendations for the startup business question.
        - It means we're asking for a grace period.
        - More specifically, the working group's first, or foundational, suggestion is for Treasury to provide that tangible property of a qualified opportunity fund or a qualified opportunity zones business not be treated as failing to satisfy the trade or business use requirements solely because the tangible property is not used in a trade or business before a reasonable start-up period based on facts and circumstances.
        - This so long as the qualified opportunity fund or business continues to develop and work to put the property into service in their trade or business.
        - Now an alternative suggestion is to provide a 12-month grace period for qualified opportunity funds and qualified opportunity zones businesses to use tangible property in a trade or business, and have that grace period begin no earlier than after a 31-month period.
- So, those were the three main topics from the opportunity zones working group issues paper that were discussed at the hearing.
    - Now the paper itself that was submitted, the comment letter, contains many more – it's over 50 pages – of comments and summaries of the proposed regulations.
- Now other topics discussed by speakers include implementing reporting requirements, providing flexibility to reinvest interim gains and more.
- Now, you may have seen, Novogradac was live streaming the hearing on our YouTube channel.
- If you missed the live stream, don't worry.
- We've posted a recording of the hearing on our YouTube channel.
- The video link is in today's show notes and I'll tweet it out as well.
- We've also posted a transcript of the hearing on our Opportunity Zones Resource Center, courtesy of Tax Analysts.
- Also, as always, if you have any feedback on the proposed opportunity zones regulations, consider joining the Novogradac Opportunity Zones Working Group.
- Contact my partner John Sciarretti for more information.
- And I'll also include to his email in today's show notes.

Other News

- In other news, I have two brief state updates for you.
- First, Hawaii now has a state historic tax credit (HTC).
    - Gov. David Ige last week signed a bill to create the credit.
    - There is a $1 million annual cap and the credit will expire at the end of 2024.
    - It's not that large, but it is a start.
- Meanwhile, Rhode Island's budget for fiscal year 2020 contains a provision that should please investors in opportunity zones.
    - A budget provision allows state taxpayers to avoid paying capital gains taxes on additional gains from opportunity zones investments after they've held the investment for seven years.
    - As you know, the federal opportunity zones incentive allows that benefit after 10 years.

RELATED RESOURCES

Affordable Housing Credit Improvement Act Blog Post

Bipartisan Group of Lawmakers Reintroduces Comprehensive Affordable Housing Legislation, Expanded with Six Significant New Provisions

Reforming Disaster Recovery Act of 2019

Reforming Disaster Recovery Act of 2019 (bill text)
Bill summary

Opportunity Zones Hearing

Transcript of July 9, 2019, Hearing, Courtesy of Tax Analysts
Video: John Sciarretti, CPA, Speaks at IRS OZ Proposed Regulations Hearing
Learn more about the Opportunity Zones Working Group by emailing John Sciarretti

Hawaii HTC

Hawaii S.B. 1394: Creating historic preservation income tax credit

Rhode Island Budget

Rhode Island fiscal year 2020 budget, containing opportunity zones benefit

NMTC Webinar

Novogradac NMTC 101: The Basics Webinar, July 18, 2019