<u>HOW WILL QOZs BE USED WITH LIHTC</u>

Forrest Milder, Nixon Peabody, LLP, Boston, MA

Glenn Graff, Applegate & Thorne-Thomsen, Chicago, IL

Charlie Rhuda, Novogradac, Boston, MA

NH&RA, Martha's Vineyard, July 20, 2018

I. Overview

A. QOZs can be a nice fit with LIHTC. However, some types of projects will work with QOZs and some of the QOZ requirements create economic issues for LIHTC Projects. But when it works, the benefits of combining the programs are significant.

B. QOZs can also work well with Historic Tax Credits.

C. We think QOZs will work with NMTC, but there are additional issues related to combining them.

D. For all of the above, additional guidance from the IRS will be critical in determining how to structure transactions and how well they will combine.

II. LIHTC

A. Quick Return for LIHTC/QOZ – for QOZ benefits, one has to not sell or exchange the interests in the QO Funds. This limits the ability to monetize the investment for 10 years. But in an LIHTC transaction, one effectively monetizes 10% of the investment every year by getting the LIHTC.

B. Adopting Typical Syndication Structure – Having a syndication fund be a QO Fund is viable. The fund could be a single property fund or could be a multiple property fund.

1. Single Asset Funds? There are issues with how the basis step-up works after 10 (or 15) years if properties are disposed of. Absent guidance from the IRS, single asset funds may have an advantage. Guidance from the IRS may make this easier for multiple asset funds.

2. Feeder Partnerships – It is unclear if a taxpayer with a gain can invest that in a partnership and have that partnership invest in various QO Funds within 180 days of the gain. This question has been posed to the IRS and Treasury. If it works, it will make investments much easier.

C. Exit Taxes as Pipeline for Investment for Investors – Many LIHTC Investors don't have much capital gain. But investors who have exit taxes from Year 15 Projects could use that exit tax gain as the basis for an investment in a QO Fund. Note that it isn't clear if depreciation recapture would qualify for investment, so a portion of the exit tax gain may not quality as a QOZ gain investment.

1. Deferral of Exit Taxes - By Investing in a QO Fund, the Investor would at a minimum be able to defer the exit taxes to December 31, 2026.

2. Avoidance of Some Exit Taxes - 15% or 10% of the exit taxes could be avoided by holding for 7 or 5 years.

3. Possible Avoidance of More Exit Taxes - If the FMV of the property has decreased by December 31, 2026 due to a significant portion of the tax credits being used, then the tax due on 12/31/26 could be significantly reduced.

D. New Construction – Seems like it should work, subject to some of the interim construction issues discussed earlier. E.g., does the property qualify as Opportunity Zone Business Property while it is under construction.

E. Rehabilitations Must Be Very Significant – Similar to the HTC rules, the cost of the improvements has to exceed the acquisition costs. For properties with a significant as-is value, a light or moderate rehabilitation will likely not be significant.

F. Low Debt Projects Disadvantaged – because the Investor has a zero basis in the QO Fund initially, it would have difficulty being able to use the depreciation losses that LIHTC projects generate. To be able to use the losses, the ownership entity would need to have debt that would then be allocated up to investors and allow them to utilize the losses.

1. 9% Low Debt Projects – not as attractive

2. 4% Projects with debt – more attractive

G. Cash Flow Issues –

1. Investor Driven Timing Issues - The 180-day window to invest gains 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. Thus meeting the QOZ timing requirements would negatively impact yield.

a) Advantages Investors - LIHTC and HTC investors who regularly generate gains, for example through a trading desk or insurance companies with gains, 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.

2. Project Driven Timing Issues – Projects need equity at certain times in order to expeditiously construct a project. However, the LIHTC/QOZ Investor may not have control of the timing of the gain and thus may not be able to timely invest gain in a QO Fund when the Project needs the money.

a) Investor Bridge Funding – Could Investors loan money in and then replace the loan with equity when a gain is triggered? IRS guidance is needed.

b) Other Bridge Funding – loans from other sources could be used until the equity is available.

H. Step-Up at Year 15 Seems Like It Can Reduce or Avoid Exit Taxes – it isn't completely clear yet, but there is a compelling argument that stepping up to Fair Market Value in Year 15 (which is after the Year 10 minimum hold time) means one can at least step up to the amount of debt. This would eliminate exit taxes.