*September 12, 2018*

## Opportunity Zone Overview

The Tax Cuts and Jobs Act established new Internal Revenue Code Sections 1400Z-1 and 1400Z-2, providing special tax benefits for "Opportunity Zones." These sections are intended to spur private investment in distressed communities by providing tax benefits to investors. An Opportunity Zone ("OZ") is a "low-income community" ("LIC") that is nominated by the State Governor and designated by Treasury where new investments, under certain conditions, may be eligible for preferential tax treatment.

Designated Opportunity Zones can be found here: https://www.cdfifund.gov/pages/opportunity-zones.aspx

In general, a Qualified Opportunity Fund ("QOF") is a corporation or partnership that self certifies as a QOF and holds at least 90 percent of its assets in Qualified Opportunity Zone Property ("QOZP").

QOZP includes Qualified Opportunity Zone Business Property ("OZ Business Property"), or stock or partnership interests in a Qualified Opportunity Zone Business ("OZ Business"), an active trade or business in which substantially all of the tangible property is OZ Business Property. Tangible property used in a trade or business in an OZ is OZ Business Property if the property was purchased after December 31, 2017 from sellers who are at least 80 percent unrelated to the buyer, and either (a) the original use of such property commences with the QOF or (b) the QOF "substantially improves" the property. A property is deemed "substantially improved" if, during any 30-month period beginning after the property is acquired, additions to basis with respect to the property are greater than 100% of the adjusted basis of such property at the beginning of such 30-month period. For a rehab project, the substantial improvement criteria means that renovation costs must be greater than the acquisition price.

## Qualified Opportunity Fund Benefits

To incentivize long term investment in distressed communities nationwide, any individual, corporation, or trust can defer gains from the sale or exchange of property by investing an amount equal to such gains in a QOF within 180 days of such gain. Potential benefits include:

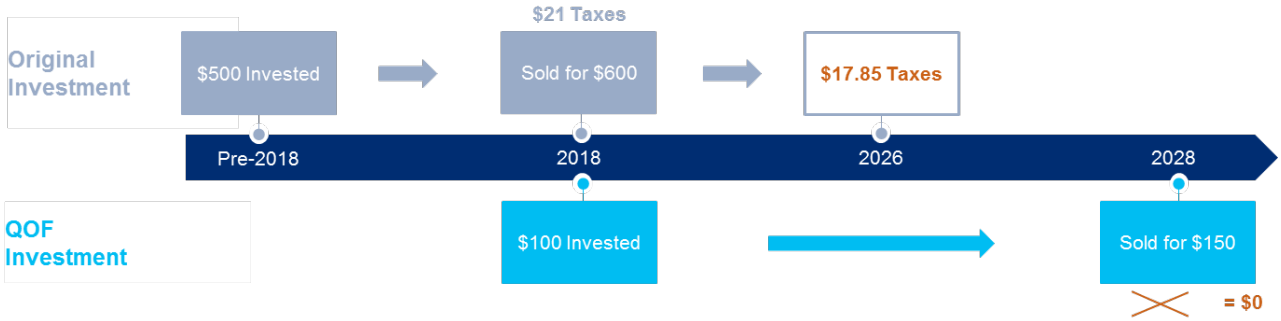
1. Taxation on the original gain is deferred until the earlier of disposition of the QOF interest or December 31, 2026
2. Reduction of those deferred taxes by 10% if property is held for 5 years and by 15% if property is held for 7 years, or possibly further reduced under a fair market value calculation in 2026
3. No taxes due on any additional gain generated by the QOF upon sale or exchange of the investment if a QOF is held for 10 or more years

## Theoretical Investment Scenario

A corporation originally invested $500 in an asset, sold that asset in 2018 for $600, and then invested $100 (the gain is $600 of proceeds less $500 of basis) in a QOF within 180 days. In this scenario the corporation does not need to pay the $21 ($100 x 21%) of taxes on the $100 gain in 2018 and it can defer the tax until as late as 2026.

If the corporation holds its QOF investment for 5 years and disposes of its investment in 2023, it only pays $18.90 in taxes ($21 x 90%), and if it holds for 7 years and disposes of it in 2025, would only owe $17.85 in taxes ($21 x 85%). If it holds the QOF Investment beyond 2026, it will still have to pay $17.85 in taxes at the end of 2026.

The corporation would pay no further tax on any additional gain if the QOF is disposed of in 2028 or later. For example, if the investment is sold in 2028 for $150, no further tax will be due on the appreciation from $100 to $150.




## Application to Affordable Multifamily Housing / Potential Benefits to Affordable Housing Developers

Many affordable housing developments are located in Qualified Opportunity Zones. There is the potential for QOFs to benefit sponsors directly through their General Partnership ("GP") interest, and indirectly through enhanced value for the Limited Partnership ("LP") low income housing tax credit ("LIHTC") investor. In addition to the benefits of deferral and reduction of taxation on the original gain invested in an LP interest, there could be an elimination of taxation on the gain from disposing of an interest in a high loss deal after 10 years. For example, if an investor has a negative capital account at the end of year 15 and it then disposes of its interest, it appears that the tax liability normally associated with this transaction may be eliminated.

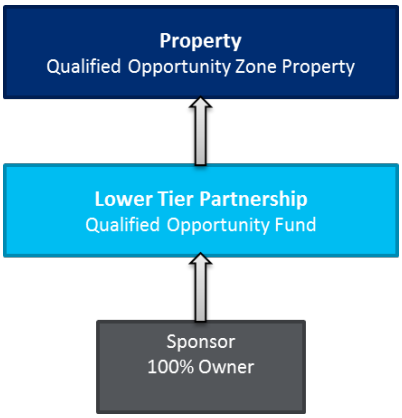
Affordable housing developers have the opportunity to hold their GP interest through a QOF, or to structure the lower-tier property partnership as a QOF, with an initial investment of gains from another investment. While there may be minimal benefit from the deferral and reduction of the taxation on the previous gain, there may be significant benefit from the elimination of taxes upon exit of the QOF in year 15 and that benefit could obviate the need to pursue a 1031 exchange.

## Potential Affordable Housing – Opportunity Zone Structure

There is a notable parallel between the holding period of an investment in a Qualified Opportunity Fund and the holding period of a LIHTC Investor in a LIHTC Partnership. Should a developer have a property they plan on constructing or significantly rehabilitating in a Qualified Opportunity Zone, the LIHTC Partnership could self-certify as a QOF and reap the potential long term tax benefits.

A General Partner and Limited Partner would enter into a traditional LIHTC Partnership structure where the LIHTC Limited Partner takes 99% of the ownership and the GP invests a nominal amount (e.g. $50,000) for 1% ownership.


At the end of the LIHTC compliance period, the General Partner would have the option to acquire the Limited Partnership interest at fair market value and become the 100% owner of the Qualified Opportunity Fund.




Once the General Partner disposes of the partnership, the traditional tax liability on the capital gain due to the appreciation of the property value since acquisition would be eliminated.

## Observations and Outstanding Questions

While investors have started to think through the benefits and how to structure these investments, there is limited guidance from the Department of Treasury and the IRS on the specific implementation of QOF's and their application for affordable housing. More guidance from the IRS and Treasury Department will be critical for QOFs to gain market acceptance. Some of the primary observations and questions are described below.

- The QOF/LIHTC investment can still be structured as a partnership investment that allocates tax credits and losses to the investor.
- The elimination of taxation on the gain requires the initial investor to sell ***their interest in the QOF***. It is currently unknown whether the IRS/Department of Treasury will provide clarity regarding tax treatment involving the sale of the underlying property or investment rather than the QOF itself.
- The treatment of land as a qualifying investment remains unknown. For tax purposes, land is typically treated as an asset separate from any buildings constructed on the land. In addition, amounts spent on construction or improvements of buildings may arguably not cause the land to be treated as substantially improved, in which case the land would not be considered qualified property for purposes of the 90% test. It is anticipated that the IRS will allow land to be combined with the building for the substantial improvement test, but no official guidance has been released yet.
- Borrowing can play a very significant role in these investments. If an investor has a "phantom gain," from disposing of a prior investment (i.e., no cash, or insufficient cash to pay taxes), this will not prevent it from using other money, even borrowed funds, to make a new QOF investment and deferring the tax bill on the prior disposition. Similarly, ***it may be that*** the new project can borrow money and combine it with the capital contributions to build the project and the exception from tax on the disposition of an interest after 10 years may still apply to the entire investment. At this time, it is not known whether the IRS will treat this entity-level borrowing as independent of the OZ rules or (based on a technical reading of the partnership tax rules) as additional cash contributed by the investor that is not necessarily derived from capital gains, and therefore ineligible for the 10-year no-additional-tax benefit.
- The 10-year no-additional-tax benefit ***only*** applies to the extent the investment is attributable to recent capital gains. If the investor invests more than that amount, the excess must be separately tracked, and it is not eligible for the favorable tax treatment.
- Note that the liability for the deferred gain will come due in 2026 (if the interest is held until that date), and the investor should be prepared to pay the tax, whether or not the new investment makes any distributions to the investor to help it pay this tax.

- To receive the preferential tax treatment, it is necessary to invest in a QOF within 180 days of realizing a gain, but a LIHTC investment is typically funded over the entire construction period. Therefore, the timing of the LIHTC investor's gains and future capital contributions may impact their OZ benefits. A commitment to invest will likely not meet the 180-day test, or and it is unclear how escrowed cash will be treated for the 90% test if LIHTC investors are willing to fully release their commitment upfront.
- There are several other timing constraints that must be clarified by the IRS. In particular, the IRS is expected to provide guidance as to what must happen, and when, in order for a QOF to qualify as an active trade or business while new construction or redevelopment of an existing project is taking place.
- The requirement that the OZ business be acquired by purchase from an 80 percent unrelated person is a tougher standard than the current 50 percent standard that applies to LIHTC transactions generally, imposing a harsher requirement on developers wanting to redevelop or resyndicate projects in which they already have a significant ownership interest.
- The requirement that more than the amount of acquisition basis be spent with respect to the development of a used facility is a higher hurdle than the 20 percent/$6,000 per unit requirement that otherwise applies to the LIHTC. This will also affect redevelopment and resyndication of existing projects wanting to qualify for OZ treatment.
- It is unclear if the income a GP would receive at the disposition of a LIHTC property in year 15 would be treated as gain, and thus eligible for an elimination of taxes, or operating income and subject to the applicable tax rate.

Frequently Asked Questions answered by the IRS can be found here:

https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions

## Conclusions for the Affordable Housing Industry

While LP investors are unlikely to pay a higher price for LIHTC until further guidance is issued by the IRS and tax counsel can provide a "should level" opinion, there is currently enough information available that some affordable housing sponsors are structuring new partnerships with a GP interest of 1% (or even less) to self-certify as a QOF in 2018. It is likely that the details of the initial certification and tax filing during new construction will be straightforward for a QOF GP interest, although the tax treatment of future income and distributions, consequences of the fair market value limit in 2026, and the ultimate disposition of the QOF or the property itself currently have meaningful unknowns as described herein.

Please reach out to CCC's Structured Lending and Investing group if you have any questions at 212-723-4205.

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