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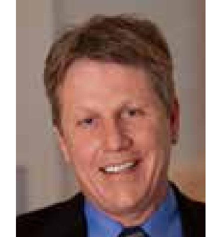
HISTORIC TAX CREDIT TOOL BOX

Opportunity Zones: A New Tool in the Box



JOHN M. TESS, HERITAGE CONSULTING

Normally, this column provides real-life examples of successful federal historic tax credit (HTC) developments. Often these are linked with other investment tools, such as low-income housing tax credits, U.S. Department of Housing and Urban Development Rental Assistant Demonstration (RAD) funding or other sources.

Today, we want to explore a new tool in the box, one that has enormous potential for investment and one that can work seamlessly with other funding sources.

Opportunity Zones

Congress passed Public Law 115-97 in late 2017, enacting the Tax Cuts and Jobs Act of 2017, substantially changing the federal income tax system. Developers of historic properties will remember the law as retaining, though modifying, the 20 percent federal HTC, but eliminating the 10 percent HTC. Another critically important provision of the law was the creation of the opportunity zones (OZ) incentive.

An OZ is an economically distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment. Localities qualify as OZs if they have been nominated for that designation by the state and that nomination has been certified by the Treasury Secretary via his delegation of authority to the Internal Revenue Service (IRS). OZs are defined by census tracts that were nominated for designation by the governor of every U.S. state and territory. Governors nominated up to 25 percent of their state's low-income community census tracts to be designated. Approximately 8,000 OZs were designated in all 50 states, the District of Columbia and five U.S. territories.

Brian Swanton, president and CEO of national developer Gorman & Co., believes opportunities

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funds will be an enormous boost to historic rehabilitation developments.

"Historic rehabilitation projects are always complicated financial deals and there is always a challenge in securing funding," Swanton said. "Gorman has been at the forefront in embracing new sources and leveraging them with historic tax credits, including new markets, EB-5 and RAD. Unlike many funding programs, opportunity funds appear to be a more traditional source of funding. Given the dollar amounts being discussed, the potential for opportunity funds to invest in historic projects is enormous."

Qualified Opportunity Funds

The OZ incentive provides a tax incentive for investors to defer taxes on their realized capital gains from prior investments if they reinvest the gains into qualified opportunity funds (QOFs) within a specified period. QOFs are set up as either a partnership or corporation specifically for investing in eligible properties in an OZ. There is no fixed cap or limit on the amount of capital from deferred capital gains that may be invested in QOFs.

Investors may benefit from three tax incentives created by the OZ incentive by investing capital gains into QOFs:

- Temporary deferral of federal income tax on capital gain through Dec. 31, 2026,
- Up to a 15 percent exclusion of capital gain for investments in QOFs held beyond seven years, and
- Forgiveness of additional capital gains for investments in QOFs held beyond 10 years (For a more detailed discussion of the tax benefits of OZ investments, see the Washington Wire column in the September 2018 Novogradac Journal of Tax Credits).

Fundamentally, QOFs are a vehicle to defer a taxpayer's federal tax liability from capital gains until 2026, as well as the opportunity for partial exclusion of gain or to avoid any tax liability on the future appreciation of the investment in the QOF, assuming the investment is held for the required number of years.

The IRS published its first set of proposed regulations for OZs Oct. 19. In general terms, the guidance is favorable to investors, giving them flexibility and certainty without requiring them to document or demonstrate the value of their tax-subsidized deals. Specifically, the IRS allows a qualified OZ business to hold funds for up to 31 months for the acquisition, construction or improvement of real property to invest in qualified OZ property, even though investors will have deferred the tax on the capital gains they invested in these funds immediately.

The IRS will also permit investors to continue to have the ability to claim the tax benefit from forgiveness of additional gains from a 10-year holding period until 2048, even though the underlying tax act sunsets in 2028. For qualifying real property investments, the law states that the qualified OZ business must spend enough to satisfy the substantial improvement definition. This means that the qualified OZ business must substantially improve the property during any 30-month period, assuming that the original use of the property was not by the qualified OZ business.

The proposed regulations contain a favorable definition of the substantial improvement test whereby the business must spend an amount to improve the property at least equal to the basis of the building over a 30-month period without regard to the basis of the land.

Although the regulatory framework is only now unfolding, there have been a number of "early adopters." Each issue of this magazine features a list of QOFs and it is anticipated that the number of funds will grow quickly as the IRS better defines the tax framework.

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Novogradac also maintains a list of funds in its Opportunity Zone Resource Center.

Historic Tax Credits and QOFs

Fundamentally, QOFs represent a new potential funding source for developers to use for historic rehabilitation developments, either as an additional non-tax-credit equity source or as a means of enhancing returns for federal and state HTC investors whose tax credit equity could be invested into properties through QOFs. The OZ incentive aligns itself well with historic rehabilitation properties because under the HTC program, qualified rehabilitation expenditures incurred over a 24-month period must exceed the basis of the building. Therefore, the HTC program's shorter period to substantially improve the property, if met, will also satisfy the OZ substantial improvement test. In addition, when comparing the typical life span of a HTC investment when combining a typical construction period plus the 60-month, post-rehab compliance period, the seven-year hold period for benefiting from the 15 percent exclusion of capital gain for investments in QOFs matches up well.

Novogradac's list of QOFs features several funds that are looking for investment opportunities nationally. Certainly, not all funds will be targeting real property development and even fewer will target historic revitalization. Nonetheless, of particular interest to tax credit investors is that the regulatory framework for QOFs appears to encourage a "holding" position, which aligns well with the five-year, post-rehabilitation ownership requirement of HTCs.

One critical criterion to capitalize on the OZ incentive is being located in a low-income census track. This is not necessarily a major threshold: According to the recently published Annual Report on the Economic Impact of the Federal Historic Tax Credit, prepared by Rutgers' University's Bloustein School of Planning and Public Policy, 2017 saw $6.5 billion in rehabilitation investment, half ($3.25 billion) of which occurred in low and moderate income census tracts and 79 percent of which ($5.1 billion) was located in economically distressed areas. Obviously, there is a lot of HTC activity in economically challenged areas.

It is important to note that this "qualifier" is often a factor in access to state HTCs. Ohio's competitive HTC process gives preference to projects in low-income census tracts. To qualify for New York's HTC, a property must be located in a low-income area. Illinois has the River Edge Historic Tax Credit program that specifically targets the economically challenged towns along the Mississippi River. Many states, such as Maryland, offer a 5 percent state HTC boost for affordable housing projects, many of which are also located in low-income census tracts.

The Bottom Line

QOFs are a new potential source of capital for HTC developments. While the regulatory framework is still evolving, the potential pool of funds is substantial and the investment parameters appear to work seamlessly with HTCs. As developers look to creative ways to fund their revitalization projects, certainly, QOFs should be in their toolbox. ❖

John M. Tess is president and founder of Heritage Consulting Group, a national firm that assists property owners seeking local, state and federal historic tax incentives for the rehabilitation of historic properties. Since 1982 Heritage Consulting Group has represented historic projects totaling more than $3 billion in rehabilitation construction. He can be reached at 503-228-0272 or jmtess@heritage-consulting.com.

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