American Bar Association Forum on Affordable Housing and Community Development Law

Using Opportunity Zone Incentives in LIHTC Transactions: NQFP and Gain/Step-Up Related Issues

May 23, 2019

Glenn A. Graff
Applegate & Thorne-Thomsen, P.C.
ggraff@att-law.com
5% Cap on Non-Qualified Financial Property - Less than 5% of the aggregate unadjusted basis of property owned by the QOZB can be Nonqualified Financial Property (“NQFP”).

- **NQFP Definition** - includes cash, cash equivalents, debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities and other similar property.

- **Reasonable Working Capital Excluded from NQFP** - NQFP does not include reasonable amounts of working capital held as cash, cash equivalents, debt instruments with a term of 18 months or less or accounts receivable generated in the ordinary course of business.
Reasonable Amounts of Working Capital

- What about Reserves in a LIHTC Project?
  - Reserves can’t exceed what is projected to be released over the next 12 Months?
  - Replacement Reserves - are typical replacement reserves ok?
  - Reserves Required by 3rd Party Lenders - probably ok
  - Reserves Required by LIHTC Investor and within Industry Norms?
  - What about Section 8 Overhang Reserves?
Reasonable Amounts of Working Capital
31-Month Safe Harbor

Requirements for Reasonable Working Capital - Working capital will be considered reasonable if three requirements are met:

1. **Designated in Writing** - Amounts are designated in writing for the development of a trade or business in a QOZ, including when appropriate the acquisition, construction, and/or substantial improvement of tangible property in such a zone.
   - This will come from the list of Project sources.

2. **Reasonable Written Schedule** - A written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets. Under the schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets, and
   - This will come from the Project’s flow of funds schedule.

3. **Property Consumption Consistent** - the actual use of the working capital is substantially consistent with (1) and (2) above.
Reasonable Amounts of Working Capital
31-Month Safe Harbor

- **Review All Sources of Working Capital** - working capital can come from any source. Whether from capital contributions, loans, grants or other sources, the 5% NQFP limitation needs to be kept in mind.

- **Treatment of Working Capital** - tangible property that will be created with the designated working capital can be treated as QOZBP for the 90% and 70% tests even though the working capital has not yet been fully expended.

- **Practice Points**
  - Include as Part of LPA - Recommended that Written Designation and Written Schedule be included as attachments to the partnership agreement.
  - The written schedule will primarily be drawn from the Project’s flow of funds document.
2026 Gain Recognition

- **General Rule for Investments in QOFs That Are Not Partnerships or S-Corps** - On December 31, 2026, gain is recognized equal to
  i. the lesser of
    A. the Amount of Deferred Gain, and
    B. Fair Market Value ("FMV") of the QOF Interest; over
  ii. the 10% or 15% basis step-ups for holding the interest for 5 or 7 years, if applicable

- **Generous Rule** - Congress decided that if the QOF investment has lost value on December 31, 2026 (or at an earlier Inclusion Event), then the amount amount of gain recognized can be reduced.

- **Possible OZ-LIHTC Projects Benefit** - Because FMV of LIHTC Partnerships generally decreases as Credits are used up, the deferred income recognition in 2026 in some projects can be reduced resulting in permanent avoidance of some tax.
  - But see the special rule on the next slide which limits the benefit.
2026 Gain Recognition Rule - Partnerships

- **Special Rule for QOF Partnerships and S-Corps**: On December 31, 2026, gain is recognized equal to
  - Deferred Gain less 10% or 15% step-ups, or
  - The gain that would be recognized on a fully taxable disposition of the qualifying investment.

**Impact** - Gain recognized can be higher than just the fair market value of the QOF investment if there is debt involved at the QOF/QOZB level and depreciation has been taken against that debt. Can reduce or eliminate benefit from loss in FMV.

*Note there are special percentage rules that would apply to pre-December 31, 2026 partial dispositions of a QOF interest.*
2026 Example 1 – 9% LIHTC with Strong Value

Gross FMV Drops 16% and Exceeds Debt

- Investor contributes $27M to QOF on 1/1/19
- QOF borrows $3M. (interest only for 10 years)
- QOF buys $30M of property that depreciates over 30 years ($1M/year)
- 15% basis increase for 7 year hold = $4.050M
- Depreciable Adjusted Basis on 12/31/26 = $3M (debt) + $4.050M (7-year hold) - $7.050M ($8M for 8 years of depreciation, but capped at the $7.050M basis) = $0 adjusted basis as of 12/31/26
- Assume 12/31/26 Gross FMV of $25M
- Gain Computation = lesser of
  1) $27M deferred gain - $4.050M basis = $22.95M
  2) $25M (sales price in taxable transaction = Gross FMV) - $0 basis = $25M
- **Avoided Taxes** - No reduction in Deferred Gain.
- **Deferral of Losses Impacts Yield** - Because only $3M of basis from debt plus eventual $2.7M and $1.35M basis increases, losses in early years reduced by $950k. But can catch up in 2026 to extent of $22.95 gain recognized.
2026 Example 2 - 9% LIHTC with Weak Value

- Same as Example 1, but Gross FMV = $8.1M (30% of LIHTC Equity)

- Gain Computation = lesser of
  1) $27M deferred gain - $4.050M basis = $22.95M, or
  2) $8.1M (sales price in taxable transaction is amount of debt relieved from paying) less $0 basis = $8.1M

- Avoided Taxes - Taxable gain recognized reduced $14.85M. Permanently saves $3.12M in taxes.

- Deferral of Losses Impacts Yield - As in Example 1, early year losses reduced. But $8.1M basis increase from gain can allows catchup on losses.
2026 Example 3 - 4% LIHTC with Strong Value

Gross FMV Drops 16% and Exceeds Debt
- Investor contributes $9M to QOF on 1/1/19
- QOF borrows $21M. (interest only for 10 years)
- QOF buys $30M of property that depreciates over 30 years ($1M/year)
- 15% basis increase for 7 year hold = $1.350M
- Depreciable Adjusted Basis on 12/31/26 = $21M (debt) + $1.350M (7-year hold) - $8M (8 years of depreciation) = $14.350M adjusted basis as of 12/31/26
- Assume 12/31/26 Gross FMV of $25M
- Gain Computation = lesser of
  1) $9M deferred gain - $1.350M basis = $7.65M, or
  2) $25M (sales price in taxable transaction = Gross FMV) - $14.350M basis = $10.65
- Avoided Taxes - No reduction in Deferred Gain.
2026 Example 4 - 4% LIHTC with Weak Value

- **Gross FMV Drops to 30% of LIHTC Equity and Is Less than Debt**
  - Same as Example 3, but Gross FMV = $2.7M

- **Gain Computation = lesser of**
  1) $9M deferred gain - $1.35M basis = $7.65M, or
  2) $21M (sales price in taxable transaction is amount of debt relieved from paying) less 14.35M basis (adjusted basis = debt basis - depreciation + 1400Z-2 basis increases) = $6.65

- **Avoided Taxes - Gain reduced $1M. Permanently saves $210,000 in taxes**
Year 15 Exit

- General Rule - Sale of QOF Interest Tax Free

- If QOF interest is held for 10 years (likely 15 years for LIHTC Partnerships), then the taxpayer elect to step the basis of the interest up to FMV and sell the interest tax free.

  - If QOF FMV ↑ - make election, no tax owed on profit

  - IF QOF < Basis - do not elect to step up basis

  - But see special rules for QOF Partnerships
Year 15 Exit - Special Rule for QOF Partnerships

- Special Rule - Election increases basis of QOF Partnership interest to the fair market value of the interest, including debt.
  - What does “including debt” mean?
    - Gross Value Before Debt? - If it means that the basis is FMV without reducing debt, then exit will be tax free even if there is a negative capital account.
      - Solves Exit Taxes - Substantial benefit for 4% deals with negative capital accounts.
    - Net Value After Debt? - If it means the amount someone would pay for the QOF Interest, that amount would be reduced by debt of the QOF or QOZB.
      - No Exit Tax Solve - Benefit for projects with negative capital accounts is eliminated.
    - FMV No Less than Nonrecourse Debt? - IRC Section 7701(g) says that when property is sold, its FMV is no less than nonrecourse debt.
      - Partial Exit Tax Relief