Opportunity Zones and Tax Credits: A Match Made In…?

Catalina Vielma looks at the potential for a new program to work with the long-established housing credit.

By Catalina Vielma, Affordable Housing Finance, August 1, 2018

Opportunity Zones have officially become the industry's buzz phrase for 2018. Since the passage of the Tax Cuts and Jobs Act, we have watched governors designate which census tracts they want to favor and listened as the states forecast the potential impact on their local economy. As I visit developers and housing finance agencies across the country, I continually hear this question: "It sounds great, but how do Opportunity Zones work with housing tax credits?"

First, it is important to know that Opportunity Zone investors are unlikely to be the same investors that provide most of the capital for the low-income housing tax credit (LIHTC) program. LIHTC investors are primarily major institutional banks, and they invest in the housing credit program for myriad reasons, including economic benefit and the need to meet their Community Reinvestment Act (CRA) obligations. Opportunity Zone investors are more likely to be high-net-worth individuals, managed investment funds, life insurance companies, and mutual funds that regularly realize significant capital gains.

The vast majority of institutional banks do not generate capital gains because they are not permitted to own equity investments. As a result, while there will be some exceptions, we expect that the Opportunity Zone tax incentives will be unavailable to most banks. To be clear, banks are not prohibited from investing in LIHTC projects located in Opportunity Zones, but they will do so without generating the additional Opportunity Zone tax benefit.

As developers explore the potential of Opportunity Zones, knowing who their potential investors are and why they're involved matters. While tax credit equity pricing is impacted by a property's relative "CRA value," the investor appetite for developments located in Opportunity Zones is more likely to be driven by their relative risk and reward profile. As previously noted, most Opportunity Zone investors will not be institutional banks and therefore are not motivated by CRA.

The type of tax credit developments that will benefit from Opportunity Zone equity extend beyond developments utilizing the LIHTC. Opportunity Zone developments that are "twinned" with historic and/or New Markets tax credits will likely generate premium yields. Looking beyond tax credits, Opportunity Zone investors can place their capital in myriad Opportunity Zone businesses—from hotels, market-rate housing, community centers, and more. Market-rate developments are the most likely to attract significant investor appetite due to the tax-free treatment of any long-term appreciation in the underlying asset. As Opportunity Zone investors compare affordable housing with myriad Opportunity Zone businesses, developers must ask themselves how they can maximize the attractiveness of their developments.

Although we have received limited guidance to date, the Opportunity Zone statute requires that the original use of the Opportunity Zone property must commence with the opportunity fund or, in the case of an existing property, that the Opportunity Zone business undertake a “substantially improvement” of the property. For this purpose, a property is substantially improved if the improvement costs incurred within 30 months after acquisition exceed the adjusted basis of the property at the time of acquisition. As a practical matter, this means that the majority of acquisition/rehab LIHTC projects will not qualify for Opportunity Zone tax benefits.

Maximizing benefit can extend to a developer’s capital gains, too. Developers accustomed to deferring capital gain taxation through Sec. 1031 tax-free exchanges will find the Opportunity Zone provisions to be a superior alternative, principally due to the treatment of long-term appreciation. Developers must keep in mind that there can only be a common interest of 20% between the entity that sells the property and the corporation/partnership that owns the Opportunity Zone business.

To date there has been very little guidance from the IRS on how the Opportunity Zone provisions are supposed to work. The IRS has announced a self-certification process for establishing Opportunity Zone Funds, under which each will simply attach a self-certification form to the fund’s first-year tax return. By the end of the summer we hope to see technical guidance from the IRS covering a variety of topics including the treatment of debt and whether investment partnerships will be allowed to space the pay-in of their capital to match the development process for LIHTC equity and other real estate development projects.

As we develop strategies for attracting Opportunity Zone Fund equity to LIHTC developments, I’m looking forward to the potential expansion of the capital market for the LIHTC. Based on preliminary modeling, we expect Opportunity Zone equity to fund 2% to 4% of the total equity investment, depending on the transaction profile and investor appetite. Housing finance agencies may want to consider incorporating the recognition of Opportunity Zone status in their qualified allocation plans, and developers should focus on land acquisition prospects in Opportunity Zones. Policy makers, at local and federal levels, must consider anti-displacement strategies that protect existing residents from gentrification that investor equity, for market-rate and affordable developments, may accelerate.

While Opportunity Zone Fund equity will not fully mitigate the lost value of the credit from the corporate tax rate deduction, it provides an intelligent way of adding equity to tax credit developments in underserved communities and, potentially, could attract a new cohort of investors to the tax credit equity market. That’s an opportunity I’m excited about.