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## OPPORTUNITY ZONES AND OTHER PLACE-BASED TAX INCENTIVES

FINANCING AFFORDABLE HOUSING IN OPPORTUNITY ZONES

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# OPPORTUNITY ZONES AND OTHER PLACE-BASED TAX INCENTIVES

FINANCING AFFORDABLE HOUSING IN OPPORTUNITY ZONES

*Michelle D. Layser*\*

## INTRODUCTION

Two significant—and related—challenges faced by the Biden administration include an increased need for affordable housing caused by the COVID-19 pandemic, and rising income inequality that is exacerbating long-standing racial disparities in income and wealth.<sup>1</sup> Some observers have pointed to a Trump-era tax incentive known as Opportunity Zones as a tool that might be leveraged to address these social challenges.<sup>2</sup> The Opportunity Zones incentive provides tax relief to certain taxpayers who invest in low-income communities through special-purpose entities called “Opportunity Funds.”<sup>3</sup> For example, I have argued elsewhere that, with reforms, Opportunity Zones could be used to help increase affordable housing supply and promote prosocial investment in distressed communities.<sup>4</sup> This Article

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<sup>1</sup> Michelle D. Layser et al., *Mitigating Housing Instability During a Pandemic*, 99 OR. L. REV. 445, 451–55 (2021) [hereinafter Layser et al., *Housing Instability*]; Michelle D. Layser, *An Opportunity for Reform: Taxation, Inequality, and Opportunity Zones*, 2021 U. ILL. L. REV. ONLINE 20, 20, <https://www.illinoislawreview.org/symposium/first-100-days-biden/an-opportunity-for-reform/> [hereinafter Layser, *An Opportunity for Reform*].

<sup>2</sup> See Layser et al., *Housing Instability*, *supra* note 1, at 512–14; Layser, *An Opportunity for Reform*, *supra* note 1, at 20.

<sup>3</sup> See I.R.C. §§ 1400Z-1, -2.

<sup>4</sup> Layser et al., *Housing Instability*, *supra* note 1, at 512–14.

revisits that recommendation by taking a closer look at the barriers to financing affordable housing in Opportunity Zones.

The viability of the Opportunity Zones incentive to promote affordable housing partially turns on whether the law promotes mission-driven investment.<sup>5</sup> In its current form, it does not.<sup>6</sup> Instead, features of the Opportunity Zones law present barriers to mission-driven investment.<sup>7</sup> As a result, relatively few Opportunity Funds have been used to finance projects that directly benefit residents of low-income communities.<sup>8</sup> Nevertheless, the law continues to enjoy bipartisan support, with progressive leaders generally advocating for statutory reform rather than outright repeal.<sup>9</sup>

Proponents of Opportunity Zones frequently highlight the potential for the incentive to promote development of affordable housing.<sup>10</sup> On this view, Opportunity Zones stand to supplement another incentive for affordable housing development, the Low-Income Housing Tax Credit (LIHTC), helping to address the nation's affordable housing needs.<sup>11</sup> In fact, the

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<sup>5</sup> Michelle D. Laysner, *Nonprofit Participation in Tax-Driven Urban Development Projects*, 48 FORDHAM URB. L.J. (forthcoming 2021). See generally Brett Theodos et al., *An Early Assessment of Opportunity Zones for Equitable Development Projects*, URB. INST. (July 28, 2020), <https://www.urban.org/research/publication/early-assessment-opportunity-zones-equitable-development-projects> (describing challenges faced by mission-driven Opportunity Funds in the early years of the program).

<sup>6</sup> Laysner, *supra* note 5, at 3, 5–6.

<sup>7</sup> *Id.* at 3.

<sup>8</sup> See Tracy A. Kaye, *Ogden Commons Case Study: A Comparative Look at the Low-Income Housing Tax Credit and Opportunity Zone Tax Incentive Programs*, 48 FORDHAM URB. L.J. (forthcoming 2021) (noting that “community engagement and community benefit only arise when a project’s other funding sources require it or when anchor institutions, particularly nonprofit organizations, are involved in the project” and instead “OZ investment gravitates toward commercial real estate investments in the least risky neighborhoods”).

<sup>9</sup> See, e.g., *Three Bills Introduced to Better Target Opportunity Zones, A Fourth Proposes Eliminating Them*, NAT’L LOW INCOME HOUS. COAL. (Nov. 25, 2019), <https://nlihc.org/resource/three-bills-introduced-better-target-opportunity-zones-fourth-proposes-eliminating-them>.

<sup>10</sup> See, e.g., *Combatting Inequality: The Tax Code and Racial, Ethnic, and Gender Disparities: Hearing Before the S. Comm. on Fin.*, 117th Cong. 1–4 (2021) (testimony of Shay Hawkins, President, Opportunity Funds Ass’n).

<sup>11</sup> I.R.C. § 42; Kathie Soroka & Forrest Milder, *Top 5 Ways to Use Opportunity Zone Funds in LIHTC Deals*, AFFORDABLE HOUS. FIN. (Feb. 7, 2019), [https://www.housingfinance.com/news/top-5-ways-to-use-opportunity-zone-funds-in-lihtc-deals\\_o](https://www.housingfinance.com/news/top-5-ways-to-use-opportunity-zone-funds-in-lihtc-deals_o) (explaining that the Opportunity Zones incentive has the potential to reach affordable housing investors beyond those typically involved in LIHTC deals).

Opportunity Zones law can be combined with LIHTC incentives through a strategy called LIHTC-OZ “twinning.”<sup>12</sup> For this reason, proponents point to Opportunity Zones’ potential to expand the pool of investors beyond the financial institutions that currently participate in affordable housing deals.<sup>13</sup> Some early observers even predicted that the incentive could help increase the value of the LIHTC in affordable housing deals, thereby reducing waste to the government.<sup>14</sup>

Nevertheless, the amount of affordable housing developed through Opportunity Funds has remained modest.<sup>15</sup> This Article identifies several legal and practical barriers to the use of Opportunity Funds to finance affordable housing development, including through twinning with the LIHTC. These barriers include: substantial improvement rules that present barriers to affordable housing rehabilitation; basis rules that present barriers to new construction deals with low debt-to-equity ratios; strict timing rules that may not align with the realities of affordable housing construction; limits on nonqualified financial property holdings that may foreclose common affordable housing development structures; and differences in the identity and motivations of the investors who typically participate in Opportunity Zones deals versus LIHTC deals.

Many—but not all—of these barriers could be reduced through statutory amendments. As detailed below, the “substantial improvement” threshold could be reduced as applied to affordable housing. Similarly, the basis rules could be relaxed, subject to claw backs, for Opportunity Funds that develop affordable housing. Relief could be made available for affordable housing developers that violate timing rules due to common delays, such as permitting delays. And the nonqualified financial property threshold could be raised in the context of affordable housing deals. In addition to reforms like these, which would make it easier for affordable housing developers to

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<sup>12</sup> See *infra* Part I.B.2.

<sup>13</sup> Soroka & Milder, *supra* note 11.

<sup>14</sup> Bendix Anderson, *Time Is Running Out for Affordable Housing in Opportunity Zones*, AFFORDABLE HOUS. FIN. (May 28, 2020), [https://www.housingfinance.com/Finance/time-is-running-out-for-affordable-housing-in-opportunity-zones\\_o](https://www.housingfinance.com/Finance/time-is-running-out-for-affordable-housing-in-opportunity-zones_o).

<sup>15</sup> Kaye, *supra* note 8.

employ LIHTC-OZ twinning strategies, Congress could amend the statute to require residential real estate projects to include affordable units.

But *should* Congress adopt these reforms? As this Article will explain, the answer is not obvious: even if these reforms would constitute good—or at least better—social policy, they may nevertheless reflect bad tax policy. Specifically, tax incentives that subsidize activities that taxpayers would engage in without a subsidy are bad policy.<sup>16</sup> To the extent that affordable housing development is being driven by the LIHTC—and to the extent that LIHTC deals would move forward without engaging Opportunity Funds—the practice of LIHTC-OZ twinning may be an inefficient waste of government subsidies. Since it is unclear whether the potentially larger pool of Opportunity Zones investors will increase the affordable housing supply under such circumstances, policymakers should carefully consider whether reforms to increase LIHTC-OZ twinning represent good policy.

This Article proceeds as follows. Part I analyzes the potential for affordable housing development through Opportunity Funds, including through LIHTC-OZ twinning strategies. Part II identifies legal and practical barriers to LIHTC-OZ twinning transactions. Part III sets forth various reforms that could help reduce these barriers, making LIHTC-OZ twinning a more viable affordable housing development strategy, and it evaluates whether Congress should adopt such amendments.

## I. POTENTIAL FOR AFFORDABLE HOUSING DEVELOPMENT THROUGH OPPORTUNITY FUNDS

### *A. Opportunity Zones Do Not Create Incentives for Affordable Housing Development*

#### 1. Overview of the Opportunity Zones Incentive

The Opportunity Zones tax incentive was created by the Tax Cuts and Jobs Act in 2017 in order to promote equity investment in distressed neighborhoods.<sup>17</sup> Under the law, state governors were authorized to nominate

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<sup>16</sup> See David M. Schizer, *Limiting Tax Expenditures*, 68 TAX L. REV. 275, 295 (2015).

<sup>17</sup> Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13823, 131 Stat. 2053, 2183–88 (2017) (codified at I.R.C. §§ 1400Z-1, -2).

certain low-income census tracts within their jurisdictions to be formally designated as Opportunity Zones.<sup>18</sup> By June 14, 2018, 8,764 census tracts had been designated as Opportunity Zones nationwide.<sup>19</sup> These census tracts are eligible for tax-preferred investment through specialized investment entities called Opportunity Funds.<sup>20</sup>

Specifically, the Opportunity Zones law provides for three unique tax preferences. First, it provides for the deferral of capital gains realized from the sale of an asset (“Pre-Investment Gains”), provided that the gain proceeds are reinvested in an Opportunity Fund within 180 days.<sup>21</sup> Second, it provides for the partial exclusion of Pre-Investment Gains if the taxpayer remains invested for at least five years.<sup>22</sup> (All Pre-Investment Gains not excluded must be recognized no later than 2026.)<sup>23</sup> Third, it provides for the complete exclusion of all postinvestment capital gains, provided that the taxpayer holds its Opportunity Fund interest for at least ten years.<sup>24</sup>

Normally, when a taxpayer sells appreciated property, the taxpayer recognizes capital gain to the extent that the sale price exceeds the taxpayer’s basis in the property (most often, the amount the taxpayer paid to purchase the asset).<sup>25</sup> That capital gain is subject to income taxation at a special capital gains tax rate.<sup>26</sup> Currently, the capital gains tax rate is generally between zero and twenty percent, depending on the taxpayer’s tax bracket.<sup>27</sup> As a practical matter, most capital gains tax is paid by high-income taxpayers who are

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<sup>18</sup> See I.R.C. § 1400Z-1(b)(1)(A).

<sup>19</sup> *Opportunity Zones*, IRS (Aug. 2020), <https://www.irs.gov/newsroom/opportunity-zones>; Press Release, U.S. Dep’t of Treasury, Treasury, IRS Announce Final Round of Opportunity Zone Designations (June 14, 2018), <https://home.treasury.gov/news/press-releases/sm0414>.

<sup>20</sup> See I.R.C. § 1400Z-2.

<sup>21</sup> See *id.* § 1400Z-2(a)(1).

<sup>22</sup> See *id.* § 1400Z-2(b)(2)(B)(iii).

<sup>23</sup> See *id.* § 1400Z-2(b)(1).

<sup>24</sup> See *id.* § 1400Z-2(c).

<sup>25</sup> See *id.* §§ 1001, 1012 (explaining gain recognition and cost basis rules, respectively).

<sup>26</sup> See *id.* § 1(h).

<sup>27</sup> See *id.* § 1(h)(1)(B), (C), (D).

subject to the twenty percent tax rate. Moreover, President Biden has proposed increasing the capital gains tax rate to 39.6% for taxpayers with income over \$1 million.<sup>28</sup> The Opportunity Zones incentive works by providing tax relief to taxpayers who would otherwise be subject to the capital gains tax.

Assume a taxpayer has sold appreciated property—stock, for example, or real estate—for a gain of \$100,000. As long as the taxpayer invests that \$100,000 in an Opportunity Fund within 180 days of the sale, the taxpayer will not owe any capital gains tax at all until 2026 (as long as the taxpayer does not sell the Opportunity Fund interest before then). To prevent abuse, the statute specifies that the taxpayer’s initial basis in the Opportunity Fund must be set to zero.<sup>29</sup> However, if the taxpayer remains invested in the Opportunity Fund for at least five years, the taxpayer can increase its basis by ten percent of its Pre-Investment Gains.<sup>30</sup> In this case, the taxpayer could increase its basis from zero to \$10,000 after five years.

The effect of this basis step-up is to permanently exclude up to ten percent of Pre-Investment Gain. Continuing the example, assume that the taxpayer holds its Opportunity Fund interest for at least five years and receives the \$10,000 basis step-up. Further assume that the taxpayer’s Opportunity Fund interest neither increased nor decreased in value since day

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<sup>28</sup> Greg Iacurci, *Biden’s Top Tax Rate on Capital Gains, Dividends Would Be Among Highest in Developed World*, CNBC (June 21, 2021, 1:35 PM), <https://www.cnbc.com/2021/06/21/biden-tax-plan-raises-top-capital-gains-dividend-tax-rate-to-among-highest-in-world.html>.

<sup>29</sup> I.R.C. § 1400Z-2(b)(2)(B)(i). Normally, a taxpayer who invests in a partnership or corporation will receive a basis in their interest in the entity equal to the amount of cash contributed. For example, absent special rules, the taxpayer in the example would receive a basis of \$100,000 in its Opportunity Fund interest, reflecting the amount of the cash contribution. *See id.* §§ 358, 722. If the taxpayer were to immediately turn around and sell the Opportunity Fund interest for \$100,000, the taxpayer would recognize zero gain on the sale (\$100,000 amount realized – \$100,000 basis = zero capital gain) and could permanently avoid paying tax on the Pre-Investment Gain. However, the Opportunity Zones law is not intended to provide full, permanent exclusion of Pre-Investment Gain. *See id.* § 1400Z-2. For this reason, the statute requires the taxpayer’s basis to be set at zero. *Id.* § 1400Z-2(b)(2)(B)(i). As a result, if the taxpayer were to immediately sell its Opportunity Fund interest, that sale would trigger recognition of the full gain amount (\$100,000 amount realized – \$0 basis = \$100,000 capital gain).

<sup>30</sup> *Id.* § 1400Z-2(b)(2)(B)(iii). Note that the statute provided for an additional basis step-up for taxpayers who held their Opportunity Fund interest for at least seven years. *Id.* § 1400Z-2(b)(2)(B)(iv). However, since all taxpayers are required to include in income all non-exempt capital gain in 2026, that benefit was only available to taxpayers who invested in Opportunity Funds by the end of 2019. *Id.* § 1400Z-2(b)(1)(B).

one. If the taxpayer sells the Opportunity Fund interest for \$100,000 (the Pre-Investment Gain amount), it will recognize only \$90,000 of capital gain (\$100,000 amount realized – \$10,000 basis = \$90,000 capital gain), as compared to the \$100,000 gain realized on the initial asset sale. In other words, the taxpayer has permanently avoided the capital gains tax on ten percent of the Pre-Investment Gain.

At the end of 2026, all Opportunity Fund investors must pay capital gains taxes on their Pre-Investment Gains that have not yet been recognized or permanently excluded.<sup>31</sup> (In the example above, the taxpayer would be required to report \$90,000 of capital gain in 2026, even if the taxpayer remains invested in the Opportunity Fund). But that is not the end of the Opportunity Zone tax preference: if the taxpayer remains invested for ten years, another—potentially large—benefit will become available. Namely, the taxpayer will receive a complete exclusion of all postcontribution capital gains.<sup>32</sup> Returning to our example, assume the taxpayer’s Opportunity Fund interest has grown from \$100,000 fair market value to \$250,000 in the ten years since the initial investment. If the taxpayer now, after ten years, sells the Opportunity Fund interest for its appreciated value, it will not be taxed on any of the \$150,000 postcontribution capital gain.<sup>33</sup>

Together, these three tax preferences for Opportunity Fund investment—the deferral and partial exclusion of Pre-Investment Gain and the exclusion of postcontribution gain—create several incentives that may affect taxpayer behavior. The next section will describe the incentives created by these tax preferences.

## 2. Incentives Created by the Opportunity Zones Tax Preference

The Opportunity Zones tax preference creates at least three major incentives: an incentive to sell appreciated property and realize capital gains that might otherwise remain unrealized (the realization incentive); an incentive to invest in specific places designated as Opportunity Zones (the

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<sup>31</sup> See *id.* § 1400Z-2(b)(1).

<sup>32</sup> See *id.* § 1400Z-2(c).

<sup>33</sup> Normally, this taxpayer would recognize a \$150,000 capital gain on the transaction (\$250,000 amount realized – \$100,000 basis = \$150,000 capital gain). *Id.* § 1001. Instead, the taxpayer will be treated as having a fair market value basis (\$250,000) in the Opportunity Fund interest. See *id.* § 1400Z-2(c). As a result, the taxpayer recognizes zero postcontribution gain (\$250,000 amount realized – \$250,000 basis = zero capital gain).



location incentive); and an incentive to use Opportunity Funds for investments that are likely to generate significant investment returns (the profit incentive). None of these incentives specifically encourage investment in affordable housing.

The realization incentive, which encourages taxpayers to sell appreciated property, is created by reducing the lock-in effect of capital gains taxation by providing deferral and partial exclusion of certain Pre-Investment Gains. The lock-in effect has been defined as “an investor’s reluctance to incur a tax on realization of gains.”<sup>34</sup> The lock-in effect exists because tax law requires capital gains to be recognized when realized, but not at death.<sup>35</sup> As long as a taxpayer holds an asset until he or she dies, the asset’s basis will step up to fair market value at the time of death, effectively eliminating any built-in capital gains and completely avoiding income taxation.<sup>36</sup> This rule creates a powerful incentive for taxpayers to avoid realization events that would trigger a tax—and the consequence is that taxpayers may refuse to sell appreciated assets, thereby reducing liquidity in the marketplace.<sup>37</sup>

The lock-in effect arguably creates market inefficiencies, as it “impedes the flow of capital to its most productive uses.”<sup>38</sup> For this reason, some experts have advocated in favor of low capital gains tax rates or a complete exclusion of capital gains.<sup>39</sup> The Opportunity Zones incentive is a step in that direction, as it lowers the effective rate of tax on capital gains. In doing so, the incentive reduces the lock-in effect and encourages taxpayers to realize gains, increasing liquidity in the marketplace and freeing capital for more productive use—as long as that use is in an Opportunity Zone.

In theory, the newly freed capital could be used for affordable housing investment. However, the realization incentive alone does not provide an

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<sup>34</sup> Noel B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 344 (1993).

<sup>35</sup> *Id.*

<sup>36</sup> I.R.C. § 1014(a)(1).

<sup>37</sup> Cunningham & Schenk, *supra* note 34, at 348–50.

<sup>38</sup> *Id.* at 344–45.

<sup>39</sup> *See id.* at 321 (arguing that “as a second-best response to lock-in—the incentive created by the tax law to retain assets, preferably until death—a capital gains preference may be acceptable”).

incentive to use the realized gains for affordable housing—or for any other specific purpose. In fact, the law contains few restrictions on the use of capital apart from the requirement that a substantial amount be used to invest in property in an Opportunity Zone.<sup>40</sup> This requirement creates a location incentive, whereby taxpayers are encouraged to invest realized gains in qualified Opportunity Zones instead of other locations that they may have otherwise preferred. Location incentives have been criticized for shifting economic activity to places where it may be less productive,<sup>41</sup> but in some cases, location incentives may be justified if they help reduce geographic inequality caused by distance from jobs, disinvestment in the built environment, or weak community infrastructure.<sup>42</sup>

However, to reduce deprivation in Opportunity Zones, the incentive would need to promote types of investment that are likely to benefit low-income residents.<sup>43</sup> Instead, Opportunity Funds are permitted to hold a broad range of investments and may invest in a wide variety of business types, provided that the location conditions are met.<sup>44</sup> In other words, like the realization incentive, the location incentive alone does not create an incentive to invest in affordable housing—or any other type of community-oriented investment. As a result, many observers have voiced concern that Opportunity Fund investment may merely fuel gentrification of previously distressed neighborhoods.<sup>45</sup>

One reason for this concern is that the Opportunity Zones law creates a profit incentive—or an incentive to use Opportunity Funds for projects that

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<sup>40</sup> See, e.g., Kaye, *supra* note 8, at 6.

<sup>41</sup> Ellen P. Aprill, *Caution: Enterprise Zones*, 66 S. CAL. L. REV. 1341, 1348 (1993) (observing that one region's gains may be another region's loss); Tami Gurley-Calvez et al., *Do Tax Incentives Affect Investment?: An Analysis of the New Markets Tax Credit*, 37 PUB. FIN. REV. 371, 393 (2009) (noting that in the context of the NMTC, "[M]ost corporate investors . . . are large financial institutions that already invest in lower income areas because of CRA requirements, and might simply be shifting investments from one [low-income] community to another. . .").

<sup>42</sup> Michelle D. Laysner, *How Place-Based Tax Incentives Can Reduce Geographic Inequality*, 74 TAX L. REV. (forthcoming) (manuscript at 3, 16, 22–23, 30), <https://papers.ssrn.com/abstract=3516469>.

<sup>43</sup> *Id.* at 2.

<sup>44</sup> *Id.* at 2, 62.

<sup>45</sup> See, e.g., Melody Carter, *Federal Opportunity Zones: The Newest Gentrification Tool?* (Ga. Tech Sch. of City & Reg'l Plan. Applied Rsch. Paper 2019), <https://smartech.gatech.edu/handle/1853/61326>.

are likely to generate significant investment returns—through the complete exclusion of postinvestment gains after ten years. The value of this benefit is directly tied to the success of the underlying project in the sense that, the more a project appreciates in value, the more capital gain tax will be avoided. At minimum, this incentive makes Opportunity Zones most attractive to profit-driven investors, who have the most to gain from Opportunity Fund investment. And in fact, early evidence suggests that the majority of Opportunity Fund investors are highly motivated by profit potential.<sup>46</sup> Mission-driven investment, including affordable housing development, is not highly profitable, and as a result, the Opportunity Zones incentive is less powerful in this context.<sup>47</sup>

In sum, none of the incentives created by the Opportunity Zones law are likely to encourage investment in affordable housing. Instead, as the next section will argue, the most powerful incentives to use Opportunity Zones for affordable housing development—and the most promising path forward—are created by another tax law: the Low-Income Housing Tax Credit.<sup>48</sup> The next section introduces the LIHTC and explains how that tax incentive can be combined with the Opportunity Zones incentive to finance affordable housing development.

### *B. The LIHTC Creates an Incentive to Invest Opportunity Fund Capital in Affordable Housing*

#### 1. Brief Overview of LIHTC Monetization

So far, this Article has shown that the Opportunity Zones law creates no meaningful incentive to invest in affordable housing beyond what exists in the unsubsidized market. Yet, affordable housing is underproduced by unsubsidized markets because rent restrictions make such projects less

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<sup>46</sup> See Laysner, *supra* note 5, at 28.

<sup>47</sup> Kaye, *supra* note 8, at 26.

<sup>48</sup> I.R.C. § 42; see also Tracy A. Kaye, *Sheltering Social Policy in the Tax Code: The Low-Income Housing Credit*, 38 VILL. L. REV. 871 (1993) (describing how the LIHTC successfully promotes investment in affordable housing).

profitable than market-rent alternatives.<sup>49</sup> In other words, investors do not invest in affordable housing because it does not generate enough economic profit—and there is no reason why Opportunity Fund investors would behave any differently. To create a strong incentive to invest in affordable housing, a law must make affordable housing investment at least as profitable as market-rent development. The Opportunity Zones law generally cannot do this,<sup>50</sup> but another tax law can: the Low-Income Housing Tax Credit.<sup>51</sup>

The LIHTC provides a tax credit equal to a percentage of the qualified basis of qualified low-income buildings.<sup>52</sup> The tax credit is earned over a ten-year “credit period” that begins when an affordable housing project is placed in service.<sup>53</sup> This design creates a timing mismatch to the extent that affordable housing developers typically need capital to fund construction or rehabilitation—well before the project will be placed in service. To solve this problem, developers employ a strategy called tax credit monetization.<sup>54</sup>

Specifically, LIHTCs are monetized when developers (which receive LIHTC awards from the local public housing authority) sell partnership interests that give their investors the right to the future stream of tax credits.<sup>55</sup> Investors effectively “purchase” the tax credits at a discount, whereby the tax credits are priced to generate an acceptable rate of return on the investment.<sup>56</sup> In other words, profits are generated by investment in tax credits themselves,

<sup>49</sup> See Jeff Head, *Can Tax Credits and Opportunity Zones Be Combined? Yes, But . . .*, NAT'L APARTMENT ASS'N (Dec. 2019), <https://www.nahq.org/news-publications/units/december-2019/article/can-tax-credits-and-opportunity-zones-be-combined-yes->.

<sup>50</sup> The Opportunity Zones law has the potential to eliminate tax on capital gains from a profitable Opportunity Zones investment, thereby increasing the after-tax profits from a successful investment. However, nothing about the Opportunity Zones law can create profits from an otherwise unprofitable investment—and affordable housing typically generates very little economic profit.

<sup>51</sup> I.R.C. § 42.

<sup>52</sup> *Id.* § 42(a).

<sup>53</sup> *Id.* § 42(f)(1).

<sup>54</sup> See generally Thomas W. Giegerich, *The Monetization of Business Tax Credits*, 12 FLA. TAX REV. 629 (2012) (describing tax credit monetization strategies used in a variety of development contexts).

<sup>55</sup> See Kaye, *supra* note 8, at 21–22.

<sup>56</sup> See generally *Frequently Asked Questions of Investors in the Low Income Housing Tax Credit*, AFFORDABLE HOUS. INVS. COUNCIL, [https://ahicorg.starchapter.com/images/downloads/investor\\_faq\\_final.pdf](https://ahicorg.starchapter.com/images/downloads/investor_faq_final.pdf) (last visited Sept. 1, 2021) (describing LIHTC investment and pricing).

without reference to the underlying affordable housing project, thereby making the investment profitable despite otherwise low economic returns.<sup>57</sup> In fact, most LIHTC investors do not even require the return of their initial capital investment.<sup>58</sup> They simply remain in the deal during the ten-year credit period and claim the tax credits as they are earned.<sup>59</sup> Once the credit period ends, they exit the transaction and transfer their equity to the developer.<sup>60</sup>

Because tax credit monetization transforms an otherwise risky, low-profit investment into a relatively low-risk, sufficiently profitable investment, the LIHTC provides a powerful incentive to invest in affordable housing. This is particularly true in the case of financial institutions, which are subject to regulatory requirements under the Community Reinvestment Act (CRA).<sup>61</sup> The CRA requires commercial banks to invest in low-income communities within their service area, and LIHTC investment is one way that they can satisfy these requirements.<sup>62</sup> As a result, commercial banks comprise the largest share of LIHTC investors.<sup>63</sup>

In contrast, the Opportunity Zones incentive is not subject to monetization and cannot be structured to derive an investment yield from the tax preference itself.<sup>64</sup> In other words, the capital gains deferrals have value to investors seeking to reduce capital gains tax liability, but they cannot generate a profit for affordable housing investors.<sup>65</sup> Therefore, they do not

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<sup>57</sup> MARK P. KEIGHTLEY, CONG. RSCH. SERV., RS22389, AN INTRODUCTION TO THE LOW-INCOME HOUSING TAX CREDIT 6 (2021).

<sup>58</sup> *See id.*

<sup>59</sup> OFF. OF THE COMPTROLLER OF THE CURRENCY, LOW-INCOME HOUSING TAX CREDITS: AFFORDABLE HOUSING INVESTMENT OPPORTUNITIES FOR BANKS 12–13 (2014), <https://www.occ.gov/publications-and-resources/publications/community-affairs/community-developments-insights/ca-insights-mar-2014.html> [hereinafter OCC].

<sup>60</sup> *Id.* at 14.

<sup>61</sup> Cassandra Jones Havard, *The Community Reinvestment Act, Banks, and the Low Income Housing Tax Credit Investment*, 26 J. AFFORDABLE HOUS. & CMTY. DEV. L. 415, 424 (2017).

<sup>62</sup> 12 U.S.C. §§ 2901–2908.

<sup>63</sup> Havard, *supra* note 61, at 424.

<sup>64</sup> Laysner, *supra* note 5, at 25–26.

<sup>65</sup> *Id.* at 21–24.

create any meaningful incentive to invest in affordable housing. As a result, the Opportunity Fund investors most likely to participate in affordable housing deals are those who are motivated by the LIHTC. The next section explains how Opportunity Funds can participate in LIHTC deals through a strategy called “twinning.”

## 2. Twinning OZs with LIHTC

Affordable housing developers can combine both LIHTC and Opportunity Zones incentives through twinning strategies.<sup>66</sup> The most straightforward way to twin the Opportunity Zones and LIHTC incentives is for an affordable housing developer to create a tax credit investment fund (used for monetization) that also qualifies as an Opportunity Fund.<sup>67</sup> As explained below, for the tax equity fund to qualify as an Opportunity Fund, it must invest substantially all of its capital in qualified Opportunity Zone property within the timeframes specified by the statute, and it must self-certify to the Internal Revenue Service (IRS) that it is an Opportunity Fund.<sup>68</sup> Figure 1 shows the tax monetization structure in a traditional LIHTC deal, and figure 2 shows the same transaction with LIHTC-OZ twinning. Note that in the latter structure, the Opportunity Fund investor is also the tax equity investor.

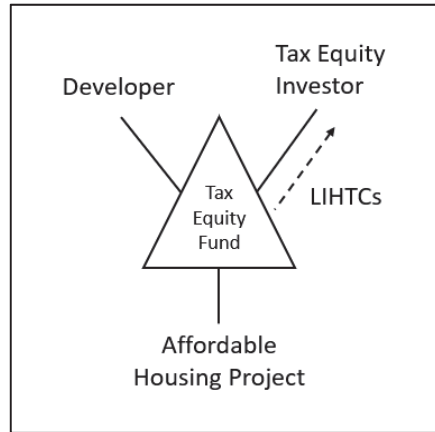
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<sup>66</sup> See generally Glenn Graff & Ben Swartzendruber, *The Twinning Opportunities in Qualified Opportunity Zones*, APPLGATE & THORNE-THOMSEN (May 10, 2018), [http://att-law.com/wp-content/uploads/BLOG/Qualified\\_Opportunity\\_Zone\\_Article\\_-\\_Twinning\\_Discussion.pdf](http://att-law.com/wp-content/uploads/BLOG/Qualified_Opportunity_Zone_Article_-_Twinning_Discussion.pdf) (explaining twinning in the LIHTC-OZ context).

<sup>67</sup> See Soroka & Milder, *supra* note 11; Anderson, *supra* note 14.

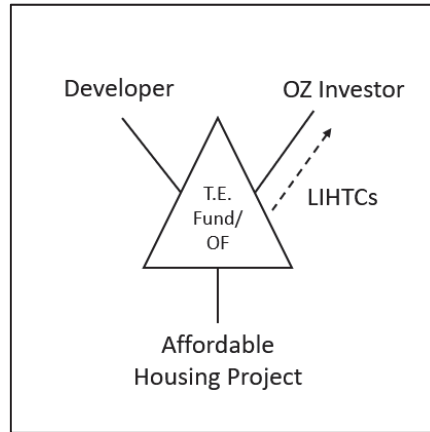
<sup>68</sup> See *infra* Part II.A.

Figure 1



LIHTC Only

Figure 2



LIHTC-OZ Twinning

Ideally, the additional tax benefits provided under the Opportunity Zones law would help increase the amount the investor is willing to pay for the tax credits.<sup>69</sup> This could increase the efficiency of the LIHTC incentive by ensuring that more of the tax credit value flows to the project itself, rather than being directed to the investor in the form of investment returns. Twinning appears to have had this effect on LIHTC pricing in at least some deals.<sup>70</sup> In addition, some early observers predicted that the Opportunity Zones incentive would help expand the pool of LIHTC investors beyond the commercial banks that currently participate.<sup>71</sup> Though the pool of LIHTC investors is sufficient to monetize the available LIHTCs in most economies, the pool sometimes shrinks during economic downturns when fewer investors anticipate sufficient tax liability to absorb the credits.<sup>72</sup> For this

<sup>69</sup> See Anderson, *supra* note 14.

<sup>70</sup> See, e.g., ECON. INNOVATION GRP., OPPORTUNITY ZONE DEVELOPMENT PROFILE: PARRAMORE OAKS 2 (2019), <https://www.ncsha.org/wp-content/uploads/Case-Study-Parramore.pdf> (noting that “[t]he location of Parramore Oaks in a designated Opportunity Zone resulted in very strong Housing Credit equity pricing of \$0.985 per \$1.00 of Housing Credit allocated”).

<sup>71</sup> Catalina Vielma, *Opportunity Zones and Tax Credits: A Match Made In . . . ?*, AFFORDABLE HOUS. FIN. (Aug. 1, 2018), [https://www.housingfinance.com/Finance/opportunity-zones-and-tax-credits-a-match-made-in\\_o](https://www.housingfinance.com/Finance/opportunity-zones-and-tax-credits-a-match-made-in_o).

<sup>72</sup> Laysner et al., *Housing Instability*, *supra* note 1, at 445–522.

reason, maintaining a large pool of LIHTC investors is important to ensure that affordable housing development continues during recession periods. Thus, LIHTC-OZ twinning has the potential to strengthen the LIHTC market in at least two important ways.

However, despite these optimistic predictions and potential benefits, early models predicted that Opportunity Funds would only provide two to four percent of tax equity investment in the LIHTC market.<sup>73</sup> Though examples exist, “[o]nly a handful of affordable housing developers have managed to attract more investors and better tax credit pricing for projects in designated Opportunity Zones.”<sup>74</sup> Among the reasons for the anemic use of Opportunity Funds for affordable housing development are legal and practical barriers presented by the design of the Opportunity Zones law. The next Part identifies such barriers.

## II. BARRIERS TO LIHTC-OZ TWINNING

### *A. Substantial Improvement Rules Present Barriers to Affordable Housing Rehabilitation*

Opportunity Funds are required to invest capital, either directly or indirectly, in qualified opportunity zone business property.<sup>75</sup> In addition to other requirements, the “original use” of such property must commence with the Opportunity Fund, or else the Opportunity Fund must “substantially improve” the property.<sup>76</sup> Property is treated as being “substantially improved” if, during any thirty month period after the date that the Opportunity Fund acquires the property, the amount of improvements exceeds the adjusted basis of the property.<sup>77</sup> This requirement presents a significant barrier to using Opportunity Fund capital for affordable housing rehabilitation.

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<sup>73</sup> *Id.*

<sup>74</sup> Anderson, *supra* note 14.

<sup>75</sup> I.R.C. § 1400Z-2(d)(1).

<sup>76</sup> *Id.* § 1400Z-2(d)(2)(D).

<sup>77</sup> *Id.* § 1400Z-2(d)(2)(D)(ii); Treas. Reg. § 1.1400Z2(d)-2(b)(4)(i)–(ii) (2020).



If a property can be rehabilitated for less than its adjusted basis, an investor may be reluctant to spend unnecessary amounts on the property solely to qualify for opportunity zone benefits. In fact, most affordable housing rehabilitation does not require nearly so much investment, and “[t]he rare exception would be an extremely distressed property, or one which is selling well under market value and needs significant re-construction in order to be livable.”<sup>78</sup> For these reasons, the substantial improvement standard effectively forecloses the use of Opportunity Funds for light rehabilitation projects.<sup>79</sup>

On the other hand, the LIHTC statute permits light rehabilitation as long as expenditures made over a twenty-four month period are at least the greater of: (1) “20 percent of the adjusted basis of the building” or (2) \$6,000 per unit, adjusted for inflation.<sup>80</sup> As a result, potential rehabilitation property located in an opportunity zone may pass the substantial improvement standard under the LIHTC statute while failing the test under the Opportunity Zones law.<sup>81</sup> These rehabilitation projects may move forward under the LIHTC law, but they cannot raise tax equity through an Opportunity Fund.<sup>82</sup>

It is worth noting that the Final Regulation alleviated some concerns about the substantial improvement rules insofar as Opportunity Funds are now permitted to aggregate certain properties for the purposes of applying the substantial improvement test.<sup>83</sup> The Final Regulations allow eligible entities to apply the substantial improvement requirements to certain buildings within the same qualified Opportunity Zone, or a single series of

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<sup>78</sup> *Low Income Housing Tax Credits and the Opportunity Zones Program*, JANOVER VENTURES (June 11, 2019), <https://www.opportunityzones.help/opportunity-zones-faqs/low-income-housing-tax-credits-and-the-opportunity-zones-program>.

<sup>79</sup> Vielma, *supra* note 71.

<sup>80</sup> I.R.C. § 42(e)(3)(ii).

<sup>81</sup> Letter from Michael J. Novogradac, Managing Partner & John S. Sciarretti, Partner, Novogradac, to Erika C. Reigle & Kyle C. Griffin, Off. of Assoc. Chief Couns. (Income Tax and Acct.), Internal Revenue Serv. (Sept. 18, 2019), [https://www.novoco.com/system/files/group/Opportunity%20Zones%20Working%20Group/novogradac\\_oz\\_wg\\_challenges\\_facing\\_affordable\\_housing\\_091819.pdf](https://www.novoco.com/system/files/group/Opportunity%20Zones%20Working%20Group/novogradac_oz_wg_challenges_facing_affordable_housing_091819.pdf) [hereinafter Novogradac Letter].

<sup>82</sup> *Id.*

<sup>83</sup> Investing in Qualified Opportunity Funds, 85 Fed. Reg. 1866, 1912 (Jan. 13, 2020) (to be codified at 26 C.F.R. pt. 1).

contiguous Opportunity Zones, on an aggregate basis.<sup>84</sup> However, the scope of the relief is not nearly as large as the affordable housing industry had hoped.<sup>85</sup>

### *B. Zero-Basis Rules Present Barriers to New Construction*

Unlike rehabilitation projects, which are largely foreclosed by the substantial improvement rules, new construction of affordable housing would seem to be clearly permissible as “original use” property. However, here too, features of the Opportunity Zones law limit the desirability of financing new affordable housing construction through Opportunity Funds. One of these features is the zero-basis rule.<sup>86</sup>

To understand why, some background in partnership tax rules is helpful. Most Opportunity Funds are formed as flow-through entities subject to the rules of Subchapter K, which governs the taxation of partnerships.<sup>87</sup> Under the partnership tax rules, the partners—not the partnership—are subject to immediate taxation as the partnership earns income, and they are eligible to claim losses and other deductions as they are generated by the partnership.<sup>88</sup> When tax equity investors enter a LIHTC deal, they not only anticipate tax

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<sup>84</sup> Treas. Reg. § 1.1400Z2(d)-2(b)(4)(v)(A) (2020). Buildings comprising an eligible building group may be treated as a single property if acquired by a single deed and may be aggregated for purposes of applying the substantial improvement test. *Id.* § 1.1400Z2(d)-2(b)(4)(v)(B). “Buildings comprising an eligible building group” that are not acquired by a single deed, but are located within the borders of contiguous parcels of land, “may be treated as a single property” and aggregated for purposes of applying the substantial improvement test if the buildings: (1) are each operated as part of one or more trades or businesses exclusively by an eligible entity, (2) share facilities or have “significant centralized business elements”; and (3) “operat[e] in coordination with, or [in] reliance upon . . . the trades or businesses.” *Id.* § 1.1400Z2(d)-2(b)(4)(v)(C).

<sup>85</sup> Dawna Steelman & Jerome A. Breed, *New OZ Regs: Substantially Improving the Substantial Improvement Test, Part I*, NOVogradac (Mar. 5, 2020), <https://www.novoco.com/periodicals/articles/new-oz-regs-substantially-improving-substantial-improvement-test-part-i>; Letter from J.P. Delmore, Assistant Vice President, Gov’t Affs., Nat’l Ass’n of Home Builders, to Internal Revenue Serv. (June 27, 2019), <https://www.nahb.org/-/media/NAHB/advocacy/docs/industry-issues/opportunity-zones/opportunity-zone-investment-regulations-nahb-comments-20190627.pdf>; Amanda H. Nussbaum et al., *Final Regulations on Opportunity Zones*, PROSKAUER (Jan. 22, 2020), <https://www.proskauertaxtalks.com/2020/01/final-regulations-on-opportunity-zones/>.

<sup>86</sup> For an introduction to the zero basis rules, see *supra* note 29 and accompanying text.

<sup>87</sup> I.R.C. §§ 701–777.

<sup>88</sup> *Id.* § 701.

credits, which are allocated to them under the partnership agreement, but also depreciation and loss deductions.<sup>89</sup>

However, partners' ability to claim loss deductions is limited to their basis in their partnership interest (often referred to as their "outside basis").<sup>90</sup> As explained in Part I.A.1 above, Opportunity Fund investors' outside basis in an Opportunity Fund is initially set to zero—meaning all tax losses are initially disallowed.<sup>91</sup> Investors can "create" outside basis, increasing their capacity to claim deductions, by causing the partnership to borrow capital.<sup>92</sup> Therefore, although new construction projects with low debt-to-equity ratios will generally be poor candidates for Opportunity Fund financing, projects with higher debt-to-equity ratios may be viable candidates for LIHTC-OZ twinning.<sup>93</sup>

In fact, many LIHTC deals do incorporate a significant amount of debt financing through tax-exempt bonds.<sup>94</sup> At first blush, these deals would seem to be particularly strong candidates for LIHTC-OZ twinning.<sup>95</sup> Unlike most affordable housing projects, which must be awarded LIHTCs through a competitive application process, projects that are at least fifty percent funded by tax-exempt bonds are exempt from the competitive process (regardless of whether the project is new construction or rehabilitation).<sup>96</sup> These projects automatically receive LIHTCs; however, the so-called "automatic 4 percent tax credit[s]" are smaller than the nine percent credits available through the

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<sup>89</sup> See OCC, *supra* note 59, at 2 n.4.

<sup>90</sup> I.R.C. § 704(d).

<sup>91</sup> See *supra* Part I.A.1.

<sup>92</sup> I.R.C. §§ 752(a) (treating an increase in partnership-level liabilities as a contribution to the extent of each partners' allocation of partnership liabilities), 722 (partners' outside basis is increased by the amount of money contributed).

<sup>93</sup> Graff & Swartzendruber, *supra* note 66, at 4.

<sup>94</sup> See *id.*

<sup>95</sup> *Id.* (describing four percent rehabilitation deals with substantial debt as potential candidates for LIHTC-OZ twinning).

<sup>96</sup> I.R.C. § 42(h)(4)(B).

competitive process.<sup>97</sup> As a result, they are most frequently used for rehabilitation projects (and not new construction)<sup>98</sup>—making them subject to the “substantial improvement” standards discussed in Part II.A above. For this reason, many of these deals may be less viable candidates for LIHTC twinning than they first appear.

### *C. Practical Barriers to Affordable Housing Development*

In addition to the rules discussed above, several other features of the Opportunity Zones law may present challenges to certain affordable housing deals. These include timing and asset holding rules that may not align with the practical realities of affordable housing transactions, and differences between the types of taxpayers who are likely to be motivated by Opportunity Zones versus LIHTC incentives. In most cases, these rules do not present absolute barriers to development projects, but they may increase the risk associated with the deals and make it more difficult to attract Opportunity Zone funding.

#### 1. Timing Rules May Not Align with Development Schedules

In some respects, the Opportunity Zones and LIHTC statutes have compatible timelines. For example, the LIHTC’s ten-year credit period matches the ten-year holding period requirements for postcontribution capital gain exclusion under the Opportunity Zones statute.<sup>99</sup> However, investors in Opportunity Zones are required to invest their capital gains within 180 days after an unrelated asset sale—and Opportunity Funds generally must satisfy their property holding requirements within six months of formation.<sup>100</sup> As a result, there are at least two timing issues that may arise: (1) investors may need to invest capital gains before the fund needs them for the project or

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<sup>97</sup> See *About the LIHTC*, NOVogradac, <https://www.novoco.com/resource-centers/affordable-housing-tax-credits/lihtc-basics/about-lihtc> (last visited Aug. 14, 2021) (describing the different types of LIHTCs).

<sup>98</sup> KEIGHTLEY, *supra* note 57, at 1.

<sup>99</sup> Graff & Swartzendruber, *supra* note 66, at 2 (noting that “[t]he 10-year credit delivery period for LIHTC investments combines very well with the 10-year period to achieve maximum benefits for QOZ investments”).

<sup>100</sup> I.R.C. §§ 1400Z-2(a)(1)(A), -2(d)(1).

(2) the fund may need the funding before the capital gains proceeds are available.<sup>101</sup> This section will analyze both of these timing mismatches in turn.

First, investors may need to invest capital gains before the fund needs them for the project.<sup>102</sup> Affordable housing investors “typically delay significant portions of their capital until completion of construction and other requirements are met,” as late as “18 to 36 months from the initial equity investment.”<sup>103</sup> As a result, the Opportunity Zones rules may require taxpayers to invest their capital gains more quickly than the typical funding timeline for affordable housing. This may create challenges for affordable housing developers hoping to attract Opportunity Zones funding, because Opportunity Zones investors may not be willing to risk their investment being disqualified.

Second—and conversely—some affordable housing developers may need funding *before* the capital gains proceeds are available to invest in an Opportunity Fund.<sup>104</sup> In this case, some advisors have suggested that an investor who anticipates forthcoming capital gains may choose to loan money to the Opportunity Fund when the developer needs it.<sup>105</sup> Then, when the gains are available, the investor can invest them in the Opportunity Fund, at which point the fund can use the extra cash to repay the loan.<sup>106</sup> These steps could help solve the timing mismatch.

However, it is unclear how many investors would be willing to participate in this structure given the risks involved. To receive LIHTCs, an

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<sup>101</sup> Glenn A. Graff, *Issues and Opportunities When Combining Opportunity Zones and LIHTC*, 10 NOVogradac J. Tax Credits 1, 3–4 (2019), <https://www.att-law.com/post/issues-and-opportunities-when-combining-opportunity-zones-and-lihtc/>.

<sup>102</sup> *Id.*

<sup>103</sup> *Id.* at 3.

<sup>104</sup> Graff, *supra* note 101, at 4 (noting that “OZ-LIHTC investors may not have the necessary capital gain to defer when an operating partnership needs funds”).

<sup>105</sup> Graff & Swartzendruber, *supra* note 66, at 3–4.

<sup>106</sup> *Id.*

investor *must* be an equity holder in the Opportunity Fund—not a creditor.<sup>107</sup> As such, the taxpayer must be highly confident that the capital gains will, in fact, materialize before the project starts generating tax credits. The taxpayer will also need to be able to predict the amount of those capital gains with reasonable certainty in order to size the investment.<sup>108</sup> In short, the strategy may be viable, but as a practical matter it seems unlikely that many affordable housing developers will be able to attract funding before investors' capital gains are available.

## 2. Common Deal Structures May Be Disqualifying

Another practical challenge faced by some affordable housing developers hoping to use LIHTC-OZ twinning is that some common deal structures may violate asset holding rules in the Opportunity Zones statute. Specifically, the Opportunity Zone statute restricts the amount of nonqualified financial property that can be held by a qualified opportunity zone business. In general, “nonqualified financial property” is defined as “debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property specified in regulations.”<sup>109</sup>

As discussed above, an Opportunity Fund is required to invest substantially all its capital in qualified opportunity zone business property or in an entity—such as a partnership—that qualifies as a “qualified opportunity zone business.” Among the requirements imposed on qualified opportunity zone businesses is that “less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.”<sup>110</sup> As a result, when an Opportunity Fund invests substantially all its capital in an entity, such as a partnership that qualifies as a qualified opportunity zones business, that entity must restrict the amount of nonqualified financial property it owns.

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<sup>107</sup> Section 42 Carryover and Stacking Rule Amendments, 69 Fed. Reg. 502, 502 (Dec. 24, 2003) (to be codified at 26 C.F.R. pt. 1) (“In general, the credit is allowable only if the *owner* of a qualified low-income building receives a housing credit allocation . . .” (emphasis added)).

<sup>108</sup> See *supra* Part I.B.1 for a discussion of tax credit monetization strategies.

<sup>109</sup> I.R.C. § 1397C(e).

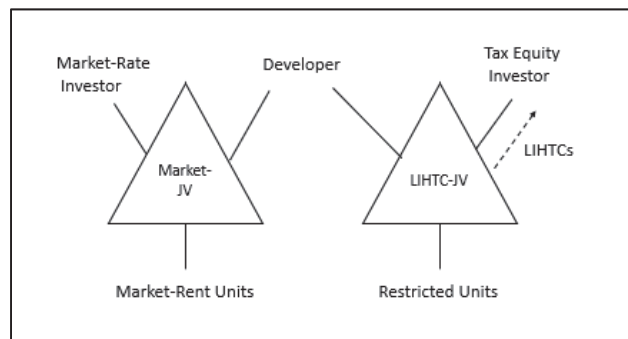
<sup>110</sup> *Id.* §§ 1400Z-2(d)(3)(A)(i)–(ii), 1397C(b)(8).

These rules inadvertently conflict with a common affiliated entity structure used in affordable housing deals. Many LIHTC properties involve both market-rent and restricted-rent components, and the ownership of these components is often split into separate partnerships.<sup>111</sup> Specifically:

the market rate units are usually owned by a partnership having the developer and the market rate investor as its partners (the “Market JV”), while the affordable units are owned by a partnership that is primarily owned by the tax credit investor (the “LIHTC JV”) and which is managed by the developer.<sup>112</sup>

Figure 3 shows the structure in diagram form.

**Figure 3**



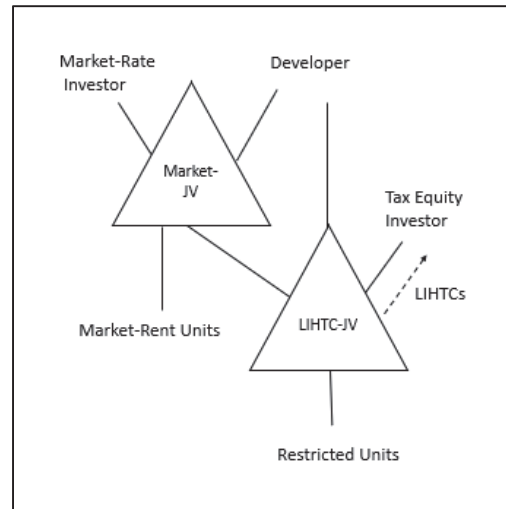
By itself, this structure would not raise any issues under the nonqualified financial property rules. However, the Market-JV is often required under state law to support the LIHTC-JV under certain circumstances, such as when the LIHTC-JV “has insufficient cash flow to pay for its share of building expenses or service its debt.”<sup>113</sup> This support is often “provided by the Market JV in the form of . . . [an] equity investment in the LIHTC JV.”<sup>114</sup> As a result, the Market-JV often owns partnership interests in the LIHTC-JV. Figure 4 shows this structure.

<sup>111</sup> Novogradac Letter, *supra* note 81, at 6.

<sup>112</sup> *Id.*

<sup>113</sup> *Id.* at 7.

<sup>114</sup> *Id.*

**Figure 4**

As one expert explains, “The concern with these structures is that the Market JV may not qualify as a [qualified opportunity zones business] because it holds partnership interests in the LIHTC JV which constitute nonqualified financial property.”<sup>115</sup> To see why, assume that a developer is hoping to attract Opportunity Fund capital to help finance the market-rate component of the project. The prospective Opportunity Fund would invest in Market-JV, a partnership that needs to be a qualified opportunity zone business. If more than five percent of Market-JV’s assets are partnership interests in LIHTC-JV, then the nonqualified financial property rules will disqualify the entity and cause the Opportunity Fund to fail.

Commentators raised this concern with the IRS during the notice and comment period prior to promulgation of the final regulations.<sup>116</sup> However, the IRS declined to exempt affordable housing developers from the nonqualified financial property rules, noting that “sections 1400Z-2(d)(3)(A)(ii) and 1397C(b)(8) provide a clear statutory definition of NQFP and an equally clear limitation on the percentage of [nonqualified financial

<sup>115</sup> *Id.*

<sup>116</sup> *Id.* at 7–8.



property] that a qualified opportunity zone business may own.”<sup>117</sup> Therefore, these rules continue to present a barrier to using Opportunity Funds to finance mixed projects featuring both market-rate and affordable units.

### 3. Opportunity Zones Investors May Not Be Motivated By the LIHTC

Finally, the identity and motivations of investors that typically participate in LIHTC deals differ from those who participate in OZ deals. LIHTC investors are typically commercial banks that invest in affordable housing to help satisfy regulatory requirements under the Community Reinvestment Act.<sup>118</sup> As previously noted, the CRA requires commercial banks to extend credit and invest in low-income communities within their assessment areas, and most LIHTC deals are intended to satisfy these obligations.<sup>119</sup>

In fact, some years banks have been so strongly motivated by the CRA that they “have been willing to purchase LIHTCs at a premium—paying more than a dollar for each dollar of anticipated tax credits.”<sup>120</sup> As a result, so-called “market investors” who demand a positive return on their investment may even be driven out of the LIHTC market in years when yields are particularly low.<sup>121</sup> However, “commercial banks typically have a limited and unreliable supply of capital gains,” “mak[ing] it highly unlikely that commercial banking institutions will be the primary source of additional OZ

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<sup>117</sup> Investing in Qualified Opportunity Funds, 85 Fed. Reg. 1866, 1920 (Jan. 13, 2020) (to be codified at 26 C.F.R. pt. 1).

<sup>118</sup> Soroka & Milder, *supra* note 11.

<sup>119</sup> Havard, *supra* note 61, at 418–19.

<sup>120</sup> Layser, *supra* note 5, at 23 (emphasis omitted).

<sup>121</sup> Nancy R. Amstadt, *The Community Reinvestment Act's Impact on Low Income Housing Tax Credit Investment*, 26 J. AFFORDABLE HOUS. & CMTY. DEV. L. 399, 399–400 (2017) (noting that the participation of economic investors ebbs and flows with price changes).

capital.”<sup>122</sup> The reason is that commercial banks are generally prohibited from making equity investments.<sup>123</sup>

In contrast, “Opportunity Zones 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.”<sup>124</sup> Unlike the commercial banks, these market investors are motivated primarily by profit, and they are less comfortable with risky investments.<sup>125</sup> Particularly given the range of possible Opportunity Fund investments, attracting this group of investors to affordable housing is a challenge.<sup>126</sup> In addition, mission-driven investors such as nonprofits, which play a significant role in many LIHTC transactions, are relatively rare in the Opportunity Zones space.<sup>127</sup>

Nevertheless, as discussed above, LIHTC-OZ twinning may be a viable path for attracting profit-driven Opportunity Fund investors since tax credit investment can be lucrative. The next Part identifies statutory amendments that could help mitigate the barriers discussed above, and it considers whether policymakers should adopt such reforms.

### III. REFORM RECOMMENDATIONS

#### *A. Industry-Specific Exceptions to General Rules*

One approach to Opportunity Zones reform would be to carve out exceptions from the general rules to better accommodate the needs of the

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<sup>122</sup> Dirk Wallace & Michael Novogradac, *Treasury Should Revise Opportunity Zones Guidance to Encourage Affordable Rental Housing*, NOVogradac (Sept. 30, 2019, 12:00 AM), <https://www.novoco.com/notes-from-novogradac/treasury-should-revise-opportunity-zones-guidance-encourage-affordable-rental-housing>.

<sup>123</sup> Vielma, *supra* note 71. A notable exception being tax equity investment in affordable housing and other community development projects, which may generate capital gains. Graff, *supra* note 101, at 3 (noting that capital gains from prior LIHTC deals would qualify).

<sup>124</sup> Vielma, *supra* note 71.

<sup>125</sup> *See id.*

<sup>126</sup> *See id.*

<sup>127</sup> Laysner, *supra* note 5, at 20.

affordable housing industry, and to remove barriers to LIHTC-OZ twinning. That said, as referenced above, Treasury has expressly declined to create industry-specific exceptions where the statute has set forth specific, generally applicable rules.<sup>128</sup> For this reason, statutory amendments would be needed. Accordingly, legislators may consider amending the Opportunity Zones statute to:

- Reduce the threshold for substantial improvement as applied to affordable housing;
- Provide affordable housing investors with a basis in excess of zero, subject to a claw back if the investor exits the transaction before ten years;
- Provide presumptive timing relief to affordable housing developers that face certain development delays, such as permitting delays; and
- Exempt investment in LIHTC-JVs from the definition of nonqualified financial property.

#### 1. Reduce Substantial Improvement Threshold

As explained in Part II.A above, the Opportunity Zones statute requires developers to double the adjusted basis of property purchased for rehabilitation within thirty months after the purchase. This rule presents a significant barrier to affordable housing rehabilitation projects, most of which would not qualify under the statute. To reduce this barrier, legislators could amend the Opportunity Zones statute to bring it into alignment with the LIHTC rules, solely for the purpose of affordable housing rehabilitation. The LIHTC permits rehabilitation projects when the amount of rehabilitation expenditures during any twenty-four-month period is at least twenty percent of the building's adjusted basis.<sup>129</sup> By amending the Opportunity Zones statute to match the LIHTC requirements, Congress could clear the way for Opportunity Funds to pursue affordable housing rehabilitation.

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<sup>128</sup> Investing in Qualified Opportunity Funds, 85 Fed. Reg. 1866, 1906 (Jan. 13, 2020) (to be codified at 26 C.F.R. pt. 1).

<sup>129</sup> I.R.C. § 42(e)(3)(A)(ii)(I).

## 2. Provide Affordable Housing Investors with Positive Basis

As explained in Part II.B above, the Opportunity Zones law departs from the normal partnership basis rules by requiring investors to take an initial basis of zero in their Opportunity Fund interest. This is an antiabuse rule that makes sense in most contexts, but it presents an additional barrier to LIHTC-OZ twinning insofar as tax equity investors are partially motivated by loss deductions. Since partners are not permitted to claim losses in excess of their outside basis, the zero-basis rules may limit their access to tax losses. As a result, LIHTC investors are likely to prefer deals that are not financed through Opportunity Funds.

Legislators could remove this barrier by creating an exception for affordable housing investment, whereby investors in Opportunity Funds committed to developing a targeted percentage of affordable units would receive basis equal to their contribution in the partnership. If this change were implemented, the inclusion in 2026 (or the date of sale, if earlier) should be calculated *as if* the investors had an initial basis of zero and all other Opportunity Zones rules (including the stepped-up basis after year five) applied. In effect, the taxpayer would be required to track two basis measurements.<sup>130</sup>

Given that most of these deals would probably involve LIHTC-OZ twinning, the risk of the investors exiting the deal early is low, as most investors would remain in the deal until the end of the ten-year credit period under the LIHTC statute. Nevertheless, the rule should be subject to a claw-back provision whereby a taxpayer who exits the deal prior to 2026 would be required to include in income an amount equal to the deductions claimed in prior years of the Opportunity Fund. This would help prevent abuse of the exception.

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<sup>130</sup> This proposal would increase the complexity of the Opportunity Zones law in the context of affordable housing. However, this increased complexity would not be insurmountable. First, participants in LIHTC deals are sophisticated taxpayers who work with teams of lawyers and consultants. Second, there is precedent in the tax code for special contexts in which taxpayers may be required to track different bases for the same property. *See, e.g.*, Treas. Reg. § 1.312-15(d) (as amended in 2019) (requiring corporate taxpayers to separately track earnings & profits bases for the purpose of calculating dividend payments). For example, experts have noted that partners in a publicly traded partnership “must continually track three bases for their PTP interests: tax basis, at-risk basis, and alternative minimum tax basis.” Dawn Drnevich & Thomas Sternburg, *Publicly Traded Partnerships: Tax Treatment of Investors*, TAX ADVISOR (Apr. 1, 2019), <https://www.thetaxadviser.com/issues/2019/apr/publicly-traded-partnerships-tax-treatment-investors.html>.

### 3. Timing Relief

The investment timing rules in the Opportunity Fund statute create the possibility that taxpayers may need to invest in an Opportunity Fund before an affordable housing developer needs the capital. One reason for this timing mismatch is that the financing schedule may be delayed due to permitting and construction delays. Legislators can provide statutory relief to affordable housing developers that face common delays like these. For example, an Opportunity Fund that would otherwise lose its qualification due to failure to meet investment deadlines could be permitted to request relief from the Secretary of Treasury by providing documentation of construction delays. Such relief would help minimize investors' risk exposure and increase their willingness to invest in affordable housing.

### 4. Amend Definition of Nonqualified Financial Property

As explained in Part II.C.2 above, some common LIHTC structures may be unavailable to Opportunity Fund investors due to restrictions on the amount of nonqualified financial property that can be held by a qualified opportunity zones business. The definition of nonqualified financial property, which is provided in Code § 1397C, includes debt and partnership interests. This general definition is broad enough to include legally mandated investment by a Market-JV in an LIHTC-JV, with the consequence of disqualifying some transactions that bifurcate market-rent and restricted-rate components into separate partnerships.

One way to accommodate such structures would be to amend the Opportunity Zones statute to include a narrow exception to the general definition. Specifically, the amended language could specify that for the purpose of the Opportunity Zones statute, the definition of nonqualified financial property does not include investment in a LIHTC investment fund. This change would remove the barrier to using Opportunity Funds to finance projects with both market-rate and affordable unit components.

#### *B. Affordability Requirements*

In addition to amending the Opportunity Zones statute to reduce barriers to LIHTC-OZ twinning, lawmakers might consider adding affordability requirements to the statute. At least one bill, proposed by Oregon Senator

Ron Wyden, adopted this approach.<sup>131</sup> Specifically, the Wyden proposal would have excluded “disqualified residential rental property” from the definition of qualified Opportunity Zone business property.<sup>132</sup> The phrase “disqualified residential rental property” would have included “any residential rental property unless 50 percent or more of the residential units of such property are both rent-restricted . . . and occupied by individuals whose income is 50 percent or less of area median income.”<sup>133</sup>

The threshold proposed by Wyden is notably higher than that set by the LIHTC statute. The LIHTC statute sets forth three tests for affordable housing, whereby the residential rental property must satisfy the 20-50 test, the 40-60 test, or the average-income test.<sup>134</sup> Under the 20-50 test, at least twenty percent of units must be rent-restricted and occupied by tenants “whose income is 50 percent or less of area median gross income.”<sup>135</sup> Under the 40-60 test, at least forty percent of units must be rent-restricted and occupied by tenants “whose income is 60 percent or less of area median gross income.”<sup>136</sup> Under the average-income test, at least forty percent of units must be rent-restricted and occupied by tenants who, on average, have incomes sixty percent or less of “area median gross income.”<sup>137</sup>

In short, none of the LIHTC affordability tests require fifty percent of units to be rent-restricted—and to the extent that the LIHTC statute requires affordability for tenants with income fifty percent or less of the area median income, it requires only twenty percent of units be set aside. Because the Wyden proposal would set higher affordability thresholds for OZ deals than LIHTC deals, it is possible that some developers would avoid the LIHTC-OZ twinning structure to avoid the stricter standards. Meanwhile, it is unclear how often Opportunity Funds would choose to produce rent-restricted residential housing without the LIHTC subsidy.

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<sup>131</sup> See Opportunity Zone Reporting and Reform Act, S. 2787, 116th Cong. § 6(c) (2019).

<sup>132</sup> *Id.*

<sup>133</sup> *Id.*

<sup>134</sup> I.R.C. § 42(g)(1)(A)–(C).

<sup>135</sup> *Id.* § 42(g)(1)(A).

<sup>136</sup> *Id.* § 42(g)(1)(B).

<sup>137</sup> *Id.* § 42(g)(1)(C).

As explained in Part I.A, affordable housing development typically requires subsidies to induce profit-motivated investors, such as Opportunity Fund investors, to participate in the market. For this reason, it is possible that statutorily mandated rent restrictions would simply chill Opportunity Fund investment in all residential housing—an outcome that may be undesirable in cities facing housing shortages. A better approach for legislators seeking to impose rent restrictions on residential property developed through Opportunity Funds would be to impose affordability thresholds similar to those in the LIHTC statute. This would increase opportunities for LIHTC-OZ twinning, helping to promote continued residential housing development through Opportunity Funds.

### *C. Policy Considerations*

This section has identified several possible reforms that could help promote affordable housing development with Opportunity Fund capital. Many—if not all—of these reforms ultimately rely on LIHTC-OZ twinning strategies. However, lawmakers should consider whether LIHTC-OZ twinning is likely to result in more affordable housing than what would be produced using LIHTC alone. As a general rule, tax incentives that subsidize activities that taxpayers would engage in without a subsidy are bad policy.<sup>138</sup> To the extent that the Opportunity Zones incentive is used to sweeten LIHTC deals that would happen without the additional incentive, the use of Opportunity Funds in this context may be wasteful.

In fact, some developers already acknowledge that they use the Opportunity Zones incentive only “to sweeten the terms of deal[s]” that have already been discussed and negotiated.<sup>139</sup> One expert commentary promises to provide “a quick cheat sheet on . . . how to structure your transaction to take advantage of OZs.”<sup>140</sup> It is unsurprising that the Opportunity Zones incentive is generally viewed as a subsidy—but not an incentive—in affordable housing deals. First, as discussed in Part I.A, the Opportunity Zones law simply does not create specific incentives to develop affordable

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<sup>138</sup> Schizer, *supra* note 16, at 295.

<sup>139</sup> See Theodos et al., *supra* note 5, at 29; see also Kaye, *supra* note 8 (describing examples of affordable housing deals that incorporated Opportunity Zone funding but would have proceeded without it).

<sup>140</sup> Soroka & Milder, *supra* note 11.

housing. Second, the LIHTC investment market is well established and, in most economies, capable of monetizing the tax credits that have been awarded—even without the participation of Opportunity Funds. It is unclear whether a potentially larger pool of investors created by the Opportunity Zones law would actually increase the affordable housing supply.

As such, policymakers should carefully consider whether reforms to increase LIHTC-OZ twinning represent good policy. It may be that the answer is yes, particularly if a larger pool of LIHTC investors would result in more efficient tax credit pricing. More likely, the answer is no—and affordable housing reformers should instead seek to repeal the Opportunity Zones law and reallocate its resources toward the expansion of traditional affordable housing tools, such as the LIHTC and Housing Choice Vouchers.<sup>141</sup>

#### CONCLUSION

The new Opportunity Zones incentive has been cited as a tool that could be leveraged to help meet the country's growing affordable housing needs. However, early research indicates that Opportunity Funds are most often used to finance market-rate real estate investment that is unlikely to serve a low-income population. This Article has analyzed the potential for affordable housing development through Opportunity Funds under existing law. In doing so, it identified multiple barriers to affordable housing development through Opportunity Funds.

For example, the statute's substantial improvement requirements make affordable housing rehabilitation all but impossible. Special basis rules inadvertently reduce the value of LIHTC investment for some taxpayers by disallowing tax losses. The timing rules introduce new risks to affordable housing transactions, and the nonqualified financial property rules make some common structures disqualifying. Many of these barriers can be reduced through statutory reform.

This Article has described several amendments that could help remove these barriers and promote the use of Opportunity Funds for affordable housing development. They include amendments that would reduce the

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<sup>141</sup> See Brandon M. Weiss, *Opportunity Zones, 1031 Exchanges, and Universal Housing Vouchers*, 110 CALIF. L. REV. (forthcoming 2022).



substantial improvement threshold in affordable housing deals, preserve basis for affordable housing developers, provide for timing relief to accommodate common delays, and amendments to the definition of nonqualified financial property to provide an industry-specific exception. In addition, the statute could be amended to affirmatively require restrictive units in any residential property developed through an Opportunity Fund.

However, even with such reforms, it is likely that most affordable housing development through Opportunity Funds will take the form of LIHTC-OZ twinning transactions, raising important questions as to whether such reforms are a good use of limited government funds. There are reasons to predict that LIHTC-OZ twinning would not meaningfully increase the supply of affordable housing, suggesting that a better approach would be to repeal the Opportunity Zones law and reallocate its resources toward the expansion of traditional affordable housing tools, such as LIHTC and Housing Choice Vouchers.