Power Couples: Twinning Opportunity Zones with Other Economic Development Tax Incentives

*Sierra R. M. Williams**

You never change things by fighting the existing reality. To change something, build a new model that makes the existing model obsolete.
—R. Buckminster Fuller (1982)

I. Introduction

Since this country's inception, federal economic development programs have been fundamental and innovative tools to incentivize both public and private sector investment in distressed areas. In particular, economic development programs offer the prospect of maximized profits (or the prospect of *some* profit in the case of less-profitable/riskier investments) for wealthy and entity investors, as most allow tax credits that reduce the current-year tax base dollar-for-dollar, tax deferral (resulting in less current-year tax owed), or additional sources of funding.

Each economic development program is implemented for different reasons, using unique methodologies to target different segments of the market. For example, the Low-Income Housing Tax Credit program was adopted as a means to tackle the affordable housing crisis, while the Energy Tax Credit program was adopted to incentivize companies to shift to renewable green energy. Meanwhile, within the Opportunity Zones Incentive (OZ Incentive)[1]—the newest economic development innovation found within the Tax Cuts and Jobs Act (TCJA)[2]—the federal government has established a broader program that incentivizes place-based economic development, allowing investments in a far wider range of businesses, property, and joint ventures than other programs in years past. This less restrictive structure of the OZ Incentive provides overlap with many other programs' market coverage, giving investors a unique opportunity to engage innovative tax planning techniques: entering into complex ventures

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*Associate Attorney at Dinsmore & Shohl LLP. Georgetown University Law Center, LL.M. (*with distinction*), Taxation, Graduate Tax Scholar. West Virginia University College of Law, J.D., M.B.A., 2020. I wish to thank both Professor Michael I. Sanders and Mike Novogradac for their brilliance, advice, and expertise throughout my research on this topic. For being my best friend and daily inspiration, I also wish to thank my father, Stephen D. Williams.

1. *See generally* I.R.C. §§ 1400Z-1, 1400Z-2 (2021).
2. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

to take advantage of the benefits of more than one program. I refer to this coupling process as "twinning."

The OZ Incentive and other programs found within the tax code have varying levels of synergy and can twin, but oftentimes imperfectly, since the objectives of each program—while in similar "economic development" veins—can vary depending on the particular investment and program requirements. While the increased cost and compliance in dealing with multiple tax-credit programs at once can be off-putting to some investors, the lucrativeness of twinning could still win the day. Particularly if the cost of administration is compared to the alternative heightened tax burden, a figure that can only increase with the Biden administration's proposed capital gains rate increases this fall.[3] Within this article, I discuss possible OZ twinning structures, their pitfalls when twinned with other programs, and policy changes that could make the twinning process more streamlined.

This article proceeds in six parts. Part II discusses the history and objectives of the OZ Incentive and provides a general overview of the program, highlighting relevant provisions for purposes of this article. Part III discusses the objectives of the Low-Income Housing Tax Credit program in general, subsequently giving a brief overview of its structure and discussing possible twinning structures with the OZ Incentive. Part IV discusses the objectives of the New Markets Tax Credit program, subsequently giving a brief overview its structure and similarly discussing possible twinning structures with the OZ Incentive, as in Part III. Part V briefly highlights the potential for tripling and quadrupling of OZs with various other incentives, although that cannot be addressed at length in this article. Finally, Part VI concludes with a brief discussion of balancing the risks and benefits associated with the innovative twinning process.

II. Opportunity Zones

A. History and Objectives

"Enterprise zone" economic development programs have been found within the United States tax code for decades. In 1980, Rep. Jack Kemp (R-NY) sponsored a bill that would create federal enterprise zones, eliminating taxes and regulations that would allow businesses to be more profitable in the designated areas.[4] Ronald Regan made this bill the center of his

3. On September 13, 2021, the House Ways and Means Committee released its recommended budget reconciliation measures, proposing a new wave of tax code changes that could affect every investor. *See* House Ways & Means Committee, Committee Print Consisting of Subtitles F, G, H, and J, Budget Reconciliation Legislative Recommendations Relating to Infrastructure Financing, Green Energy, Social Safety Net, and Prescription Drug Pricing (Sept. 13, 2021) [hereinafter Reconciliation Proposal].

Of note, the reconciliation measure proposes an increased capital gains rate of twenty-five percent.

4. Dina Schlossberg, The Empowerment Zones/Enterprise Communities: New Cure for Distressed Urban Communities or the Same Old Band-Aid, 2 Hybrid 33, 42 (1994).

campaign for President,[5] although it never garnered enough support from Congress at the time. President George H. W. Bush subsequently included enterprise zones in his 1993 fiscal budget but vetoed the Democrat-majority legislation because it increased government spending and "he feared being attacked for breaking his pledge of no new taxes."[6] Despite the initial setbacks, enterprise zones began to garner widespread public support, eventually being codified as *temporary* remedies to encourage economic revitalization of urban communities (including the District of Columbia),[7]

5. "Those who view poverty and unemployment as permanent afflictions of our cities fail to understand how rapidly the poor can move up the ladder of success . . . . But to move up the ladder, they must first get on. And this is the concept behind the enterprise zones." William Yardley, *Peter Hall, Who Devised the Enterprise Zone, Dies at 82*, N.Y. Times (Aug. 6, 2014), https://www.nytimes.com/2014/08/07/business/peter-hall-city-planner-who-devised-the-enterprise-zone-dies-at-82.html.

6. Nicholas Lehmann, *The Myth of Community Development*, N.Y. Times, Jan. 9, 1994, § 6 (Magazine), at 27, 30 (inner quotations omitted).

7. The Omnibus Budget Reconciliation Act of 1993 established nine "Empowerment Zones" and ninety-five "Enterprise Communities," each zone receiving $20 million of funding for two years. I.R.C. § 1396 (2021). The designated area must have been one of "pervasive poverty, unemployment, and general distress." I.R.C. § 1392 (a)(2) (2021). The EZ/EC program was innovative in its own right, allowing tracts with no population and tracts with populations of less than 2000 (if seventy-five percent of the tract was zoned for commercial/industrial use) to be treated as meeting the poverty rate requirements. *Id.* § 1392(b)(1). Businesses within these zones were given wage credits of twenty percent of the wages paid or incurred during the calendar year from qualified zone employees who lived and worked in the empowerment zone (taking only the first $15,000 per employee into account for this percentage) (I.R.C. § 1396(a) (2021)), additional Section 179 expensing privileges, and tax-exempt financing. *See* I.R.C. §§ 1396–1397D (2021). Similar to the OZ incentive discussed *infra*, taxpayers did not recognize gain on rollover investments in these zones. *See generally id.* § 1397B (2021). Gain from any sale of a "qualified empowerment zone asset"—qualified stock, partnership interests, and business property from taxpayers conducting a trade or business within the empowerment zone or enterprise community—held for more than one year was permitted to be exempt from taxable income to the extent this gain was used to purchase a replacement of the sold asset. *Id.* §§ 1397B(b)(1), 1397B(a). These designations expired on December 31, 2009, but President Obama signed the Tax Relief, Unemployment Insurance, Reauthorization, and Job Creation Act of 2010 to allow for further Empowerment Zone designations (including the DC EZ). After 2011, President Obama signed the American Taxpayer Relief Act (ATRA) on January 2, 2013, to extend the Empowerment Zone designations *solely for tax credit purposes* until December 31, 2013. *Empowerment Zones and Enterprise Communities*, ArcGIS Hub (Mar. 1, 2018), https://hub.arcgis.com/datasets/1101a6c1e2364302b70485ca99fc7e69_0; *see also* ATRA, § 327(c), Pub. L. 112-240 126 Stat. 2313 (Jan. 2, 2013). This legislation was followed by another tax credit extension through the President's signing of the Tax Increase Prevention Act of 2014 (TIPA 2014). *Id.* Similar to the EZ/EC program, the Taxpayer Relief Act of 1997 established a new Enterprise Zone in the District of Columbia, which was to be treated as an additional Empowerment Zone under Section 1391. I.R.C. § 1400(a) (2021). The most significant benefit provided to the DCEZ (for purposes of this article) was the zero percent capital gains rate of Section 1400B. If

the tackling of poverty and unemployment,[8] and redevelopment after national disasters.[9]

Despite Congress's clear willingness to become an innovative bipartisan machine when it comes to economic development efforts, the concept of permanent OZs did not originate in either chamber. The idea for the concept of a forgotten America among the more rural areas of the nation—an America seeming to fall behind or stagnate while metropolitan areas experienced economic booms[10]—is instead accredited to the Economic

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taxpayers held DCEZ assets for more than five years, the qualified capital gain from any sale or exchange of such property was not included in the taxpayer's gross income. I.R.C. § 1400B(a) (2021). The DCEZ, similar to the original Empowerment Zones, also considered "substantially improved" buildings—buildings where additions to basis were $5,000 or greater than at the start of the period—as being DCEZ business property. *Id.* § 1400B(b)(4)(ii) (2021). This designation expired on December 31, 2011. Vaughn Hromiko, *Washington DC Empowerment Zone Is No More*, WOTC Blog (Mar. 26, 2013), https://wotcblog.com/category/federal-zones-and-areas/federal-empowerment-zones. Neither the ATRA nor the TIPA 2014, *infra*, extended the designation of the DC Enterprise Zone.

8. Renewal Communities and their package of tax benefits were enacted with the third round of Empowerment Zone designations under the Community Renewal Tax Relief Act of 2000. Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000). The selection process for RCs differed from that of EZs/ECs, with designations being based on communities' poverty, unemployment, income statistics, crime rate, and outmigration. *See* I.R.C. § 1400E (2021). This legislation was also the first economic development incentive promulgation that consisted primarily of tax benefits. I.R.C. § 1400F(a) (2021). Renewal community qualified capital gain was excluded from gross income if the qualified community asset was held for more than five years. *Id.* Additionally, RCs were given employment credits of fifteen percent of incurred wages of qualified zone employees (taking only the first $10,000 per employee into account). I.R.C. § 1400H(a), (b) (2021). Finally, taxpayers were authorized to an increased Section179 deduction and a commercial revitalization deduction (should they elect to take either). *See generally* I.R.C. § 1400I (2021). This program's benefits lapsed on December 31, 2014. I.R.C. § 1400F(c)(2) (2021).

9. The New York Liberty Zone was designated after September 11, 2001, to alleviate business costs in the damaged area. It allowed employees working within it during either 2002 or 2003 a working opportunity tax credit (limited to forty percent of the first $6,000), while allowing businesses increased depreciation deductions under Section 167 for qualified property, tax-exempt bond financing, and an increase in expensing under Section 179. *See generally* I.R.C. § 1400L (2021). Similarly, the Gulf Opportunity Zone was established after Hurricane Katrina in 2005. Taxpayers within the GOZ received a higher ceiling for Low-Income Housing Tax Credits, higher 167(a) trade or business property depreciation deductions for the first year property was placed into service, an increase in Section 179 expensing, fifty percent expensing for certain demolition and clean-up costs after Katrina, expensing for environmental remediation costs, a permissible five-year net operating loss for timber and farming losses, allowance of Katrina casualty losses to be included in Section 1231 losses for the taxable year, and much more. *See generally* I.R.C. § 1400N (2021).

10. Twenty counties in the United States generated half of the country's new business establishments in 2014: only seventeen percent of the U.S. population was responsible. *See* Econ. Innovation Group, The New Map of Economic Growth and Recovery 9

Innovation Group (EIG), a bipartisan public policy organization committed to developing innovative economic development strategies.[11] EIG's premier study in this area, *Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas*,[12] was the basis for the bipartisan *Investing in Opportunity Act* that eventually became part of the TCJA. It was discovered that a geographical disparity existed, with "large swaths of the country facing chronic rates of long-term unemployment and historically low levels of new investment,"[13] which in turn could have detrimental social effects and send the area into a downward economic spiral.[14] John Lettieri, CEO, remarked: "For us, this problem began in the data . . . the top 20 percent of the country [began to create] more net new jobs, businesses, and growth than the other 80 percent combined[;] . . . 75 percent of venture capital goes to New York, Massachusetts, and California."[15]

EIG found the success of long-term investment vehicles (as opposed to temporary designations) like the New Market Tax Credit[16] to be more appealing to investors and considered it a better avenue to encourage economic growth, noting that businesses did not take advantage of all possible benefits in the past due to a more cumbersome tax code, lack of clear knowledge, or "inability to qualify for all requirements."[17] In particular, EIG thought that the overly restrictive definitions and scope of the laws within previous tax reforms severely limited the taxpayers that could take advantage of them.[18] EIG determined that the best course of action, in lieu of public sector investment, was *private* sector investment; incentives should be given to private sector investors to encourage them to "invest in

(2016) [hereinafter New Map]. From 2010 to 2014, only seventy-three counties accounted for half of the job growth after the Great Recession in 2008. *Id.* at 17.

11. *See About Us*, Economic Innovation Group, https://eig.org/about-us (last visited Apr. 19, 2021).

12. Jared Bernstein & Kevin Hassett, Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas, Economic Innovation Group (2015) [hereinafter Distressed Areas].

13. *Id*. at 2.

14. *Id.* at 4. This is a better reflection of the reality of such areas, and shows a need for true reform, for while "economic theory might predict that individuals should move away from the city or neighborhood[,] many choose not to." *Id.*

15. John Lettieri, Opening Remarks at the IPED Opportunity Zones Conference (Mar. 5, 2019) (alteration added).

16. *See* I.R.C. § 45D (2021). See Part IV, *infra*.

17. *Id.* at 12 (*citing* U.S. Gov. Accountability Office, Empowerment Zone and Enterprise Community Program: Improvements Occurred in Communities, but the Effect of the Program Is Unclear, GAO (2006)).

18. Distressed Areas, *supra* note 12, at 13. "Restrictions on the size of the investment that can qualify discourages large well-capitalized investors from participating . . . if only small investments qualify, then complex coordination is an essential element of success." *Id.* at 14. This may be too weak to convince businesses and quality investors to "make the first move." *Id.*

higher risk ventures in economically depressed communities."[19] EIG suggested a reform that would entice people to redeploy unrecognized capital to places of economic need,[20] while harnessing the raw power of venture capitalists and community leaders, private equity, banks mutual funds, and hedge funds in addition to small businesses.[21] A new economic development investment "pooling" structure was also suggested to alleviate cost and labor of the federal government and allow it to partake in a more supervisory federal role.[22]

EIG's study was evidence that something needed to be changed and became the strongest foundation for the OZ incentive.[23] Shortly thereafter, the United States Senate introduced the Investing in Opportunity Act in 2017[24] with the intent to encourage investment in low-income areas. Led by Senator Tim Scott (R-SC) and supported by fourteen cosponsors, the bill—and the future of enterprise zones—found its home within the bipartisan TCJA.[25]

B. *Overview of the Incentive*

The OZ Incentive is the latest tax program aimed at encouraging competitive business practices in designated areas.[26] An Opportunity Zone (OZ) is

19. *Id.* at 16.

20. *Id.* Another analysis by EIG "estimated that the amount of unrealized capital gains held by U.S. investors stood at roughly $2.26 trillion" at the end of 2014. *Id.*

21. *Id.* at 17. This would be considerably different from past economic incentives, which tended to focus only on small businesses. *See* I.R.C. § 1400L(a)(2)(C)(ii) (2021).

22. This was taken to heart in the Opportunity Zone code. Opportunity funds were created to allow investor pooling. *See id.* § 1400Z-2(d)(1).

23. Many opposed the initiative before enactment, oftentimes citing the failures of previous tax credit provisions. *See, e.g.*, Bowdeya Tweh, *Empowerment Zone Shows Underwhelming Results*, NWI Times (Apr. 25, 2011), https://www.nwitimes.com/niche/inbusiness/government/empowerment-zone-shows-underwhelming-results/article_257676ec-d3cf-5fe4-90b0-8442665045d5.html (noting that "fewer than half the businesses that received low-interest loans from the [Gary-East Chicago-Hammond] zone still are active, and about $2.7 million in low-interest loans is delinquent or tied up in bankruptcy or other legal proceedings."); Marlon G. Boarneta & William T. Bogart, *Enterprise Zones and Employment: Evidence from New Jersey*, 40 J. Urb Econ. 198 (1996) (noting that urban programs did not have a significant impact on unemployment rate in the designated zone areas).

24. Investing in Opportunity Act, S. 293, 115th Cong. (2017), https://www.congress.gov/115/bills/s293/
BILLS-115s293is.pdf.

25. *See* H.R. Rep. No. 155-466, at 539–540 (Dec. 15, 2017) (Conf. Rep.). *See generally* I.R.C. §§ 1400Z-1, 1400Z-2 (2021).

26. Businesses are less likely to move jobs overseas and are more likely to invest in American workers, while allowing smaller businesses to "immediately expense capital investments." Senator Shelly Moore Capito, *Afterward to the West Virginia Law Review Appalachian Justice Symposium*, 120 W. Va. L. Rev. 1163, 1164 (2018).

a population census tract that is a low-income community (as defined in Section 45D(e)[27]) that has been designated as an OZ.[28]

1. Taxpayer Benefits

Taxpayers are eligible for unique benefits if they choose to invest capital gains[29] in OZs, allowing them to defer capital gains and have a nonrecognition of appreciation on an investment if the investment is held for a certain length of time.[30] If a taxpayer recognizes capital gains from a sale[31] or exchange with an unrelated person[32] of any property held, the taxpayer may elect to invest all or a portion of the gain in a qualified opportunity fund (QOF)[33] within 180 days from the sale or exchange.[34] If a taxpayer chooses to invest, they may elect to exclude the gains from gross income

27. Any population census tract in which the poverty rate is at least twenty percent, the median family income does not exceed eighty percent of statewide median income (if rural), or the median family income does not exceed eighty percent of the greater of statewide median income or the metropolitan area median income (if the tract is located within a metropolitan area). I.R.C. § 45D(e)(1) (2021); *see id.* § 1400Z-1(c)(1).

28. Up to twenty-five percent of the qualified census tracts in a state were permitted to be nominated by governors as Opportunity Zones. *Id.* § 1400Z-1(d)(1). While enterprise zone designations were consistent with *only* low-income communities, the Opportunity Zone program allowed population census tracts that were *not* considered low-income to be designated as Opportunity Zones if the tract was adjacent to a low-income community that was designated as an Opportunity Zone and the median family income of the tract did not exceed 125 percent of the median income of the adjacent low-income community census tract. *Id.* § 1400Z-1(e)(1) (2021). However no more than 5 percent of the designated Opportunity Zones could be adjacent tracts. *Id.* § 1400Z-1(e). This allowed disparities between areas close to each other to be minimized and more prosperous areas with greater investment potential to be designated. When deciding which tracts to nominate, governors were obliged to take into particular account low-income communities that (1) were currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity; (2) had demonstrated success in geographically targeted development programs such as promise zones, the new markets tax credit, empowerment zones, and renewal communities; and (3) had recently experienced significant layoffs due to business closures or relocations. H.R. Rep. No. 115-466, at 538 (Dec. 15, 2017) (Conf. Rep.) (citations omitted). After the selections were made, Opportunity Zones were designated after approval and certification by the Secretary. I.R.C. § 1400Z-1(b)(1) (2021).

29. Long-term or short-term gains from the sale or exchange of a capital asset.

30. Under the regulations, eligible taxpayers include individuals, C corporations, real estate investment trusts, partnerships, S corporations, trusts, and estates. 26 C.F.R. § 1.1400Z2(a)-1(b)(13) (2021).

31. It must be noted as well that this tax incentive applies to *gains*, not *proceeds*. Because of this restriction, none of Section 1031 applies. Taxpayers are able to sell one kind of asset and invest it in something completely different.

32. An "unrelated person" is a person other than a related person as defined in Section 954(d)(3). I.R.C. § 971(f) (2021).

33. For the definition of a "qualified opportunity fund," see Part II.B.2, *infra*.

34. I.R.C. § 1400Z-2(a)(1)(A) (2021).

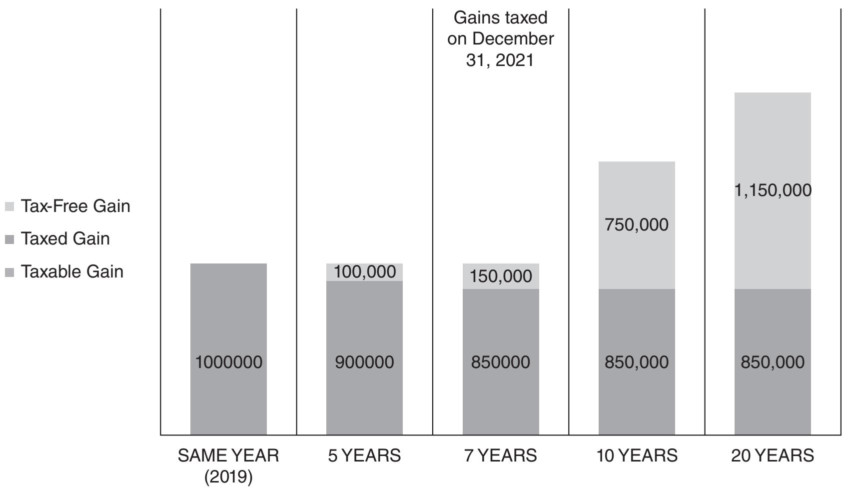
for that taxable year, deferring recognition of the gains until the earlier of either the date on which the investment is sold/exchanged or December 31, 2026.[35]

The amount of gain recognized upon either sale or December 31, 2026, is the excess of the greater of the amount of the gain invested or fair market value of the investment (if the investment is worth less than the original amount invested) over the taxpayer's basis in the investment.[36] Similarly, the taxpayer's basis depends entirely upon how long the investment has been held. A taxpayer's initial basis in an Opportunity Zone investment is zero—meaning if the investment was immediately sold, all of the gain would be taxable—to encourage taxpayers to hold their investments for longer periods of time.[37] If the taxpayer has held onto the investment for five years before sale or December 31, 2026, the basis of the investment will be increased by an amount equal to ten percent of the amount of deferred gain.[38] Subsequently, if the taxpayer has held onto the investment for seven years before sale or December 31, 2026, the basis of the investment will be increased by another five percent of the total amount of deferred gain.[39] Basis can be increased by up to fifteen percent before the taxation date of December 31, 2026. After this date, however, if a taxpayer continues to hold onto the investment for at least ten years, the basis of the property will be equal to the fair market value of the investment on the date it is sold or exchanged.[40]

An example of this process makes it easier to comprehend. If a taxpayer chose to invest $1 million of capital gain in a QOF in 2019 and holds the investment until December 31, 2026, the gain will not be taxed until that date. Of import, the gain will be taxed on December 31, 2026, regardless of whether or not the taxpayer sells the investment; the rub is how much, as investments in OZs all begin with a basis of zero (an amount that fluctuates depending on the length of time the investment is held before sale). If, at the time of taxation, the investment was held for five years, his basis in the investment would be $100,000, or ten percent, meaning he would only have to pay taxes on $900,000 of the initial deferred gains ($1 million minus $100,000). If the investment was held for seven years, his basis would be fifteen percent of the initial deferred gains: $150,000, meaning, the taxpayer would only have to pay taxes on $850,000 of the initial deferred gains. If the taxpayer decides, however, after the taxation date of December 31, 2026, to hold the investment for a total of ten years before selling it, upon sale, his basis is equal to the fair market value of the investment. If his investment was now worth $1.5 million (and he sold it for $1.5 million), his basis in the investment is also $1.5 million at sale. With no excess between

35. *Id.* § 1400Z-2(b)(1).
36. *Id.* § 1400Z-2(b)(2)(A).
37. *Id.* § 1400Z-2(b)(2)(B)(i).
38. *Id.* § 1400Z-2(b)(2)(B)(iii).
39. *Id.* § 1400Z-2(b)(2)(B)(iv).
40. *Id.* § 1400Z-2(c).

the fair market value and the basis in the investment at the time of sale, the amount of gain recognized for tax purposes—after December 31, 2026—is zero. Overall, out of the $1.5 million gain, the taxpayer will have only been taxed (on a deferred basis) on $850,000 of the original $1.0 million gain while receiving an additional $500,000 in gain completely tax-free, making this an immensely profitable OZ investment. The potential for profit is multiplied if, say, the taxpayer chooses to hold the investment for twenty years (and assuming the fair market value has increased to $2.0 million). No matter how much the gain appreciates after ten years, the result is the same: tax-free capital gains after the payment of taxes on December 31, 2026, and a ten-year holding period.



2. Qualified Opportunity Fund Creation

QOFs, which can either be organized as a corporation or partnership,[41] are investment vehicles that are created for the sole purpose of investing in qualified OZ property or businesses and can *only* invest in those businesses with qualified capital gains.[42] It is not necessary that the corporation or partnership be a new entity, but that entity must be self-certified through Form 8996[43] and meet the QOF investing requirements.

41. LLCs choosing to be taxed as corporations or partnerships are able to use this incentive as well. Single-member LLCs that are not taxed as a corporation or partnership do not apply. *See Opportunity Zones Frequently Asked Questions*, Internal Rev. Serv., https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions (last visited Apr. 19, 2021).

42. I.R.C. § 1400Z-2(d)(1) (2021).

43. This form is used both for initial self-certification and ongoing annual reporting of compliance with the ninety percent test. Internal Rev. Serv., *Form 8896: Qualified Opportunity Fund* (Jan. 2021), https://www.irs.gov/pub/irs-access/f8996_accessible.pdf.

QOFs have two options when it comes to investing in OZs: direct and indirect. If an opportunity fund chooses to invest *directly* in opportunity zone business property, the fund must hold at least ninety percent of its assets in qualified OZ property, determined semi-annually, in order to continue to defer the taxation of the capital gain.[44] However, if an opportunity fund chooses to invest *indirectly*—through a 100 percent partnership interest or stock of an opportunity zone business—each subsidiary business must have "substantially all"—seventy percent— of its leased or owned property be qualified opportunity zone property.[45] The structure of the OZ Incentive allows QOFs to either invest strictly in OZ assets with a higher percentage "substantially all" test, or to invest in OZ businesses that own such assets with a lesser percentage needed to meet the "substantially all" test. However, the seventy percent threshold is much lower than the nninety percent threshold that is needed for QOFs to invest directly in qualified OZ property. This regulation creates an incentive for QOFs to invest in Opportunity Zone businesses *instead* of direct investing in qualified OZ property.

C. *Qualified Opportunity Zone Property and Businesses*

For investment purposes, Qualified Opportunity Zone Property (QOZP) is property that is either (1) qualified OZ stock, (2) a qualified OZ partnership interest, or (3) qualified opportunity zone business property (QOZBP).[46] Qualified OZ stock or partnership interest is a domestic corporation's stock or partnership interest if it is acquired by the fund after December 31, 2017 (at its original issue, through an underwriter or directly, if a stock), from a Qualified Opportunity Zone Business (QOZB) in exchange for cash, in which the corporation or partnership is a QOZB during substantially all of the qualified opportunity fund's holding period for the stock or partnership interest.[47]

A QOZB is a trade or business in which (1) seventy percent of the tangible property owned or leased by the taxpayer is QOZBP, (2) at least fifty percent of the total gross income is derived from the active conduct of such business,[48] (3) forty percent of the intangible property held is used in the active conduct of such business,[49] (4) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to "nonqualified financial property" (debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, and annuities[50]),[51]

44. I.R.C. § 1400Z-2(d)(1) (2021).

45. 26 C.F.R. § 1.1400Z2(d)-2(d)(2)(i).

46. I.R.C. § 1400Z-2(d)(2)(A) (2021).

47. *Id.* § 1400Z-2(d)(2)(B), (C).

48. 26 C.F.R. § 1.1400Z2(d)-1(d)(3)(i) (2021).

49. *Id.* § 1.1400Z2(d)-1(d)(3)(ii). Intangible property is used in an active conduct of a business if its use is normal or customary in the conduct of the business and it is used in an activity of the business that contributes to the generation of income. *Id.*

50. I.R.C. § 1397C(e) (2021).

51. 26 C.F.R. § 1.1400Z2(d)-1(d)(3)(iv) (2021).

and (5) the business is not "any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principle business of which is the sale of alcoholic beverages for consumption off premises."[52] In practice, these businesses can be new businesses that are formed in OZs, existing businesses that are expanding into OZs, and existing businesses moving into OZs.

For both direct investment *and* the seventy percent tangible property standard required for QOZBs, QOZBP is tangible property used in a trade or business of the qualified opportunity fund if the property was acquired by the fund by purchase[53] after December 31, 2017, the original use of such property commences with the QOF or the QOF "substantially improves" the property,[54] substantially all use of the property was in a qualified OZ during substantially all of the QOF's holding period of the property.[55] Property is considered "substantially improved" by the opportunity fund if additions to basis in the hands of the fund exceed an amount equal to the adjusted basis of the property at the beginning of the thirty-month period beginning after the date of acquisition of the property.[56] For example, if a fund purchases an already existing building for $100,000, it must improve the property by an additional $100,000 before the tax on the gains can be deferred. Of particular import, this substantial improvement is measured by additions to the basis of the building, not the land on which it is located.[57] Purchased unimproved land has *no* substantial improvement requirement.

To facilitate the ease of investment into both QOZP and QOZBs, the Regulations implemented several safe harbors. First, taxpayers have a 180-day investment window to reinvest qualified capital gains into a QOF, starting from the date of sale.[58] This investment can be done as a lump sum or in separate payments. After the 180-day window has passed, however, so too does the ability to defer taxation on any remaining uninvested capital gains. Second, the Regulations created a "working capital" safe harbor for reasonable amounts of nonqualified financial property held by QOZBs if (1) the amounts are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in an OZ, (2) there is a written schedule for the expenditure of the working capital assets, in which the assets must be spent within thirty-one months of receipt, and (3) the assets are actually used in a manner that is consistent with the

52. I.R.C. § 144(c)(6)(B) (2021) (as referenced in I.R.C. § 1400Z-2(d)(3)(A) (2021)).

53. Defined in Section 179(d)(2), a purchase allows an investor to take a Section 179 deduction the year the property is placed in service.

54. For property, the original use of which did not begin with the taxpayer, the OZ investment benefits will not apply unless the QOF substantially improves the building. Rev. Rul. 2018-29.

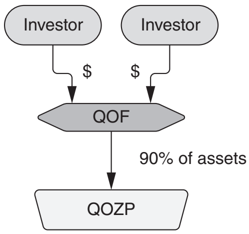
55. I.R.C. § 1400Z-2(d)(2)(D)(i) (2021).

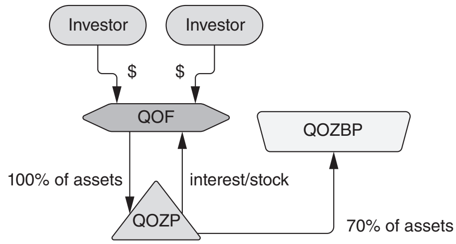
56. *Id.* § 1400Z-2(d)(2)(D)(ii).

57. 26 C.F.R. § 1.1400Z2(d)-2(b)(4)(iv) (2021)

58. I.R.C. § 1400Z-2(a)(1)(A).

writing and the schedule.[59] This flexibility allows QOFs a reasonable period of time to invest gains in either QOZP or QOZBs, depending on the structure of the venture. In practice, this program has the potential to provide a large source of equity to finance the start-up, expansion, or acquisition of a business located within an OZ.





The preceding regulations can complicate taxpayers understanding of the OZ Incentive, but simple OZ Incentive ventures often result in two dominant structures[60]:

In the above diagrams, while direct investment (*above*) may look more simplified, the use of a QOZB (the stock or partnership interest of which qualifies as QOZBP) through the indirect method (*right*) alleviates stricter property holding requirements of ninety percent at the QOF level to allow for the less stringent test of seventy percent at the QOZB level to apply. These structures become exceedingly more complicated when twinning the OZ Incentive with other economic development programs.

III. Twinning with the Low-Income Housing Tax Credit

A. Low-Income Housing Tax Credits

1. Objectives

The Low-Income Housing Tax Credit (LIHTC) program was created by the Tax Reform Act of 1986[61] as an indirect means of federal funding to finance the acquisition, construction, and rehabilitation of affordable, low-income rental housing. It was Congress's hope that this program would become a robust incentive to provide more low-income housing in a time when it is in high demand, since most low-income housing is viewed as less-than-profitable when considering costs. The LIHTC program provides a

59. 26 C.F.R. § 1.1400Z2(d)-1(d)(3)(v) (2021). Due to the COVID-19 pandemic, this working capital safe harbor can be extended an additional twenty-four months. IRS Notice 2021-10 (2021), https://www.irs.gov/pub/irs-drop/n-21-10.pdf. Additionally, on April 14, 2021, due to the COVID-19 pandemic and its related difficulties, the IRS released a Notice of Proposed Rulemaking that intends to modify the working capital safe harbor twenty-four-month extension to clarify that the writing and schedule may be amended as necessary. 86 Fed. Reg. ¶ 19585 (Apr. 14, 2021).

60. All figures within this article were created by the author using the Lucidchart program.

61. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986)

dollar-for-dollar reduction in federal tax liability for qualified projects over a ten-year period, which in turn provides a means for some of the united to rent at below-market rates.[62] In practice, due to the need for upfront financing to complete projects (in lieu of taking on debt and receiving other means of funding), developers *sell* the ten-year tax credit stream to outside investors in exchange for equity, making it financially feasible to charge lower rents and expand available affordable housing.[63]

2. Overview

Under the LIHTC program, there are two types of credits currently available: the competitive "9%" and the noncompetitive "4%" credits, the amount of each credit being the applicable percentage of the qualified basis of each qualified low-income building.[64] Qualified basis is defined as "eligible basis"[65] multiplied by the "applicable fraction."[66] The "applicable fraction" is either (1) the number of low-income units/total number of rental units available or (2) the total floor space of the low income units/ total floor space in all units.[67] In simple terms, only the percentage of the basis that is allocated to the low-income units is available for the LIHTC credit each year. The applicable percentage is the total amount of that qualified basis either seventy percent for a new building that is not federally subsidized (the competitive 9% credit) or thirty percent for any other building (the noncompetitive 4% credit). Additionally, for the 9% credit, LIHTC projects could qualify for an additional thirty percent of eligible basis (that would increase the amount of credits available) if the LIHTC project is (1) located in a "qualified census tract," (2) located in a "difficult to develop area," or (3) deserving of such increase by HCAs.[68]

62. *See generally* I.R.C. § 42 (2021).

63. Cong. Rsch. Serv., An Introduction to the Low-Income Housing Tax Credit (Jan. 26, 2021), https://crsreports.congress.gov/product/pdf/RS/RS22389 [hereinafter LIHTC Introduction].

64. I.R.C. § 42(a) (2021). A qualified low-income building means any building which is part of a qualified low-income housing project at all times during the period. *Id.* § 42(c)(2).

65. Eligible basis of a new building is its adjusted basis as of the close of the first taxable year of the credit period (i.e., cost basis under I.R.C. § 1012). I.R.C. § 42(d)(1). For existing buildings, the eligible basis is also its adjusted basis at the close of the first taxable year of the credit period (i.e. cost if the building was purchased during that taxable year) and zero in any other case (i.e., if the building has not been purchased when the credit was approved). *Id.* § 42(d)(2).

66. *Id.* § 42(c) (2021).

67. *Id.* § 42(c)(1)(B).

68. A "qualified census tract" is any census tract designated by the Secretary of Housing and Urban Development and either (1) fifty percent or more of households have an income less than sixty percent of the area median gross income for the year or (2) has a poverty rate of at least twenty-five percent. *Id.* § 42(d)(5)(B)(2). A "difficult development area" is any area designated as an area which has high construction, land, and utility cost relative to area median gross income. *Id.* § 42(d)(5)(B)(iii). However, the special designation by HCAs provision is only available for 9% credit projects. *Id.*

Due to these complicated rules, most ventures typically involve one-hundred percent low-income housing instead of mixed rentals to take maximum advantage of the credit. For each credit, the federal government allocates a percentage not more than either maximum percentage (9% or 4%) that can be taken each year—the percentage varying depending on the month the project began—totaling seventy percent or thirty percent at the end of the ten-year period. For purposes of this article's length, only the mechanics of the 9% LIHTCs will be discussed (though it must be noted that tax-exempt bond financing and other federal programs—like Community Development Block Grants—can also be used in the OZ/LIHTC twining structures seen *infra* in lieu of the 9% credits to generate returns through the 4% LIHTCs).

For the competitive 9% LIHTCs, each state's Housing Credit Agency (HCA) receives an annual LIHTC allocation from the Internal Revenue Service (IRS), the amount available for that state each year being the state's "credit ceiling,"[69] a number that is only expected to increase under the Biden administration's newest proposals.[70] For 2021, for example, the maximum amount of LIHTCs that can be allocated to LIHTC projects is the greater of (1) $2.8125 multiplied by the state population or (2) $3,245,625.[71] The credit ceiling limitation seen with the competitive 9% LIHTCs does not apply to the non-competitive 4% LIHTCs, as they are automatically granted by meeting certain requirements with tax-exempt bond projects.[72]

After allocation, each HCA must develop a Qualified Allocation Plan (QAP) that identifies (1) the selection criteria that will be used for determining housing priorities (including project location, special needs, public housing waitlists, tenant populations, etc.) and (2) gives preference to projects serving the lowest-income tenants for the longest periods of time that are located in low-income census tracts.[73] Credits are allocated to developers that submit LIHTC plans that most closely reflect those priorities, the

§ 42(d)(5)(B)(v). Of note, recent bipartisan efforts have been made in both chambers of Congress to modify these "130% basis boost" provisions to make it easier to receive the increases through the Affordable Housing Credit Improvement Act. Affordable Housing Tax Credit Coalition, *AHTCC Applauds Reintroduction of Bipartisan Affordable Housing Credit Improvement Act* (Apr. 15, 2021), https://www.taxcreditcoalition.org/ahtcc-applauds-reintroduction-of-bipartisan-ahcia.

69. I.R.C. § 42(h)(3)(C)(ii) (2021).

70. As the House Ways and Means Committee's reconciliation proposals currently stand the 9% credit allocations by fifty percent, phasing this increase over five years (adjusted for inflation from 2026 to 2028), including the 12.5% expansion in the 9% housing credit passed in 2018. If passed, this provision would come into effect after December 31, 2021. Reconciliation Proposal, *supra* note 3, § 135502.

71. Internal Revenue Service, Revenue Procedure 2020-45.

72. Steven Maguire & Joseph S. Hughes, CRS Report RL31457, Private Activity Bonds: An Introduction (last accessed Apr. 25, 2021).

73. *See* I.R.C. § 42(m)(1) (2021).

credits being documented on IRS Form 8609.[74] After the HCA completes its portion of the form, taxpayers are required to complete a certification for the first year of the credit period on that same form.[75] Typically, an allocation means the credits are merely set aside for the developer; generally, a developer has two years to complete its project, and the credits cannot be claimed until a property has been completed.[76] Once the credits become available, they are then "sold" to investors in exchange for equity, the sale occurring within a partnership agreement that legally binds both parties and gives the investors an ownership interest in the LIHTC project.

Throughout the ten-year credit period (and the fifteen-year low-income housing provision period agreed to by the developers[77]), HCAs are responsible for monitoring each LIHTC project to ensure continuous compliance with the LIHTC provisions. Pursuant to the Regulations, the HCA must conduct on-site inspections at least once every three years and inspect at least twenty percent of the project's low-income units (and the rent records of the tenants residing there).[78] These agencies are required to submit annual reports to the IRS, identifying annual credits allocated to each building by submitting IRS Form 8610.[79] There is a danger—should any project fail to meet the criteria for the period—of noncompliance, which could result in credit recapture or credit reduction (depending on the severity of the issue).[80]

With the preceding requirements in mind, most ventures utilize either a "direct investment" or "syndicated investment" structure for investors to receive maximum credits from developers. Clear preference for the syndicated method is preferred, however. Of the $15 billion total equity invested in 2017, twenty-seven percent was through direct investment, and seventy-three percent was syndicated.[81]

74. Typically, qualified projects include multifamily rental housing, single-family homes, duplexes, and townhouses, and can include more than one building. However, owners and developers must meet an income test for tenants and a gross rent test to become LIHTC projects. *See id*.

75. *Id.* § 42(l)(1) (2021).

76. LIHTC Introduction, *supra* note 63.

77. This is called the "extended use agreement" pursuant to I.R.C. § 42(h)(6). (2021). A building is only eligible for credit if there is a minimum long-term commitment to the provision of low-income housing. *Id.* § 42(h)(6)(A). This period can be no less than fifteen years. *Id.* § 42(h)(6)(D).

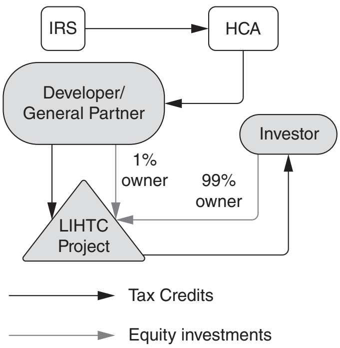
78. 26 U.S.C. § 1.42-5 (2021).

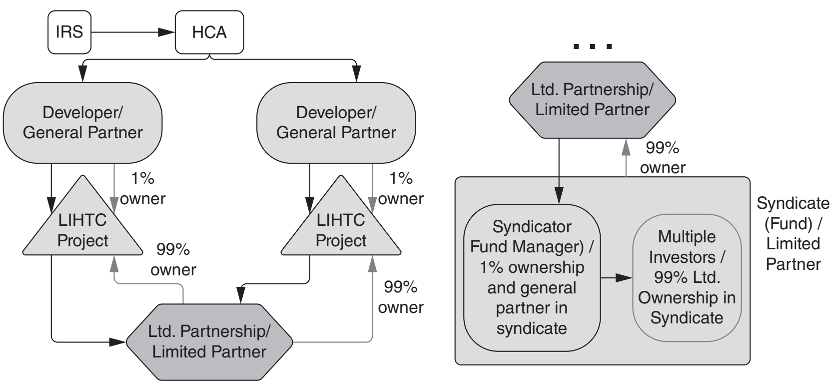
79. I.R.C. § 42(l)(3) (2021).

80. *Id.* § 42(j).

81. CohnReznick LLP, Housing Tax Credit Investments: Investment and Operational Performance (Apr. 2018), https://www.cohnreznick.com/-/media/resources/tcis/cr_lihtc_march2018_interactive.pdf.

Through the direct investment model (*left*), investors directly own a ninety-nine percent limited partnership interest in the LIHTC project. A developer or affiliate (*many times* this entity being a nonprofit entity or a nonprofit subsidiary of a for-profit entity) assumes the general partner role with a one percent general partnership interest, and it is responsible for applying to the HCAs for the LIHTC credits, passing them through to the investors, and managing the compliance of the project. This model is typically only feasible for investors that have enough internal resources to manage the acquisition, underwriting and asset management aspects of the deal. It is highly popular with large institutional investors, such as banks or corporations.

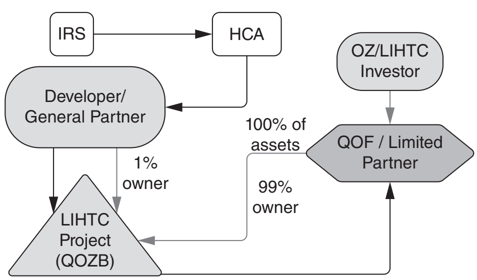




Conversely, for investors looking to pool funds without institutional resources (as is the case with individual investors and smaller organizations)—or looking to invest in multiple LIHTC projects—the syndicated investment method is utilized (*above*). Syndicates (or funds) are typically structured as limited partnerships and are responsible for organizing and managing investments by holding a limited partnership interest in a LIHTC partnership. This arrangement allows the developers/affiliates to still operate as general partners, passing the credits through the LIHTC partnership to the syndicate above. While this adds complexity, it accesses a larger stream of capital for LIHTC projects, simplifies investments and credit allocations for investors, and maintains a secondary level of limited liability to protect the assets of the investors at the syndicate level.

B. Possible OZ/LIHTC Structures[82]

Twinning LIHTCs with OZs is one of the most attractive uses of the OZ Incentive, as most designated OZs have troubled residential housing markets; OZs experience a housing vacancy of thirteen percent, rent-burdened renting households as high at fifty-three percent, median home-ownership rates of fifty-two percent (compared to sixty-seven perecent nationwide), and average median home values of $170,000 (compared to $218,000 nationwide).[83] The programs blend well, particularly in light of the rigidness of the "substantial improvement" requirement under the OZ Incentive. It is far easier to purchase undeveloped land to build new buildings, the same new buildings that can qualify for the competitive 9% tax credit under the LIHTC program. Additionally, LIHTC projects located within OZs can easily qualify as an QOZB, provided they meet the seventy percent tangible property test and the various capital holding requirements.

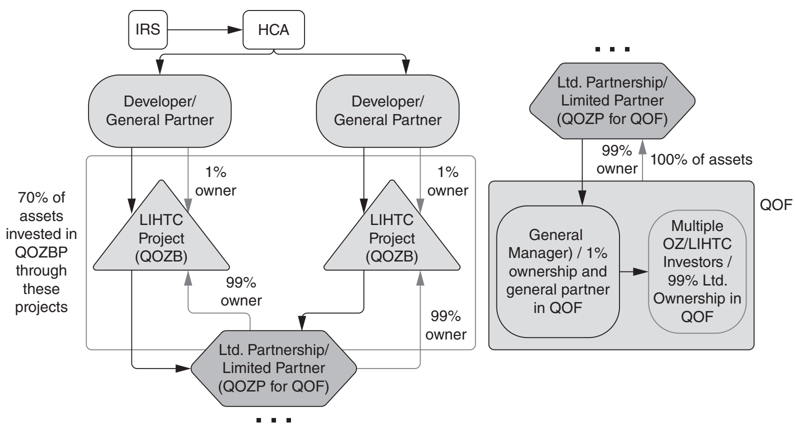


82. The following section draws on previously articulated provisions in the tax code, and careful consideration has been given to how these structures align with the statutory framework. *See* discussion *supra* Parts II.B, III.A.2 for specific provisions.

83. Econ. Innovation Grp., Opportunity Zones, https://eig.org/opportunityzones/facts-and-figures (last accessed Apr. 26, 2021).

When twinning the OZ and LIHTC programs, the direct method and a slightly modified syndicate method can be utilized.[84] However, it instead focuses on how many LIHTC projects the QOF wants to invest in. Each comes with its own set of varying requirements and is ultimately dependent on timing.

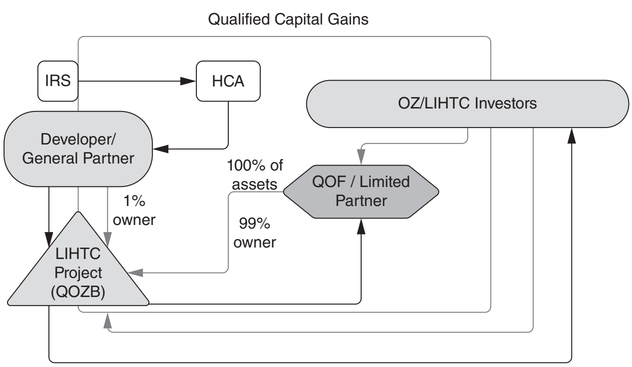
The direct investment structure (*left*) becomes a more attractive and more lucrative venture for investors under OZ/LIHTC twinning considerations. Qualified capital gains are pooled into the QOF, who then invests one hundred percent of those assets into the LIHTC project, a QOZB. This is similar to the typical *indirect* investment structure seen when using the OZ Incentive alone, as it eliminates the ninety percent QOZP standard used at the QOF level. A developer/affiliate comes in as a one-percent owning general partner, funneling the credits back through the QOF for the investors. This structure can also be utilized when multiple developers/affiliates want to receive credits for the same projects. Each involved developer/affiliate entity would have around a one percent interest (or whatever percentage deemed appropriate), each able to pass the credits through to investors. At the QOF level, these credits would be lumped together and allocated based on the amount of basis currently in the LIHTC project itself (as opposed to each developer/affiliate entity being able to "stack" credits on top of one another).



84. Under the OZ requirements, a partnership (i.e., syndicated fund) can only invest *partnership* capital gains through a QOF. 26 C.F.R. § 1.1400Z2(a)-1(b)(13) (2021). Thus, if individuals want to pool together to invest individually earned capital gains, they would have to form a QOF operating as a partnership (in lieu of a two-tiered partnership/syndicate structure).

On the other hand, the modified syndicate structure (*above*) is a more streamlined way to invest in multiple LIHTC projects at once (although single-asset funds are currently preferred for their simplicity). The QOF invests one hundred percent of assets into an operational limited partnership as a limited partner, the partnership interest qualifying as QOZP for purposes of the ninety-percent asset test required at the QOF level. The operational partnership and its subsidiary LIHTC projects simultaneously qualify as an active trade or business within an OZ—in other words, a QOZB. As with the regular syndicate method, developers/affiliates are one-percent owning general partners, responsible for applying for and allocating the LIHTCs to the projects, all of them flowing up through the operational partnership and into the QOF for the investors.

However, for the modified syndicate structure, there is a wrinkle. To make use of the modified syndicate method—and for the operational partnership to satisfy the seventy-percent tangible asset test under the OZ Incentive for its LIHTC projects—the operational partnership must own or lease the actual property being put to use in the LIHTC projects (in lieu of the developer). Indirect investment into the LIHTC project without actual ownership *could* be construed as a passive investment, rendering the operational partnership ineligible for QOF investment.



Finally, as an alternative third structure if greater amounts of equity are needed, investors have a third "sidecar" option. Investors have the ability to take advantage of *both* the direct or modified syndicate method by investing qualified capital gains in a QOF *and* simultaneously directly investing further into LIHTC projects through the direct method. This allows a greater combined amount of incentives to be taken per investor: some taken through the LIHTC program and others taken through investment in the OZ program. The direct method sidecar is modeled (*left*). This example would be favored with institutional investors that do not have consistent capital gains proceeds but have the resources to manage and fund larger projects—or for QOFs that simply do not have enough equity for projects with the current amount of qualified capital gains available.

C. The Pitfalls of OZ/LIHTC Ventures

Many of the OZ Incentive's requirements complicate matters, particularly when twinning with the LIHTC program. The trouble begins with it being built on the back of capital gains alone. Historically, commercial banking institutions have been the largest LIHTC investment providers.[85] However, with the limitation of the program that investors must only invest capital gains, the ability of commercial banking institutions to qualify for the program is severely limited.[86] Most banks have unpredictable and unreliable supplies of capital gains, presenting a likelihood that the capital gains the banks *do* have will be spent on far more profitable projects than affordable housing. This arrangement causes a downward pressure on non-bank investors to provide the bulk of OZ capital, which requires more coordination in pooling their funds together in a QOF.

The capital gains limitation again limits non-bank investor involvement at the individual level as well, particularly when it comes to LIHTCs. Many funds often require investment minimums or "accredited" investors."[87] This requirement operates to cut out less-wealthy investors and smaller businesses. Which begs another question: *why* capital gains at all? EIG intended the OZ Incentive to reinvigorate distressed communities, likely with community funding, but the program often operates in practice to benefit wealthy investors that either (1) already intended to invest in the OZ in the first place or (2) generated a cash windfall through the sale of capital assets and want to shelter current-year capital gains. It would have been far more reasonable to allow *personal* income taxation deferral if individuals invested current-year ordinary income—taxed at ordinary income rates—into QOFs.[88]

85. Dirk Wallace & Michael Novogradac, Novogradac, Treasury Should Revise Opportunity Zones Guidance to Encourage Affordable Rental Housing (Sept. 20, 2019), https://www.novoco.com/notes-from-novogradac/treasury-should-revise-opportunity-zones-guidance-encourage-affordable-rental-housing.

86. Not even considering the fact the a QOF cannot be a subsidiary member of a consolidated group under the regulations. Banks often operate by creating single corporate subsidiaries that are community development corporations (CDCs), allowing them to invest in public welfare projects. Meanwhile, capital gains come from other subsidiaries, preventing the bank from using this public welfare arm to invest those gains.

87. Essentially, under the SEC regulations, an accredited investor must have a net worth of at least $1 million (excluding primary residence) or annual income of $200,000 ($300,000 in joint income with a spouse) for the past two consecutive years with an expectation of the same in the current year. 17 C.F.R. § 230.501(a) (2021).

88. This decision also operates to inadvertently discriminate against people of color, the notion of which deserves far better than a footnote. On average, white families hold $100,000 median value in privately held business equity and $30,000 median value in publicly traded stocks, compared to Black families who own $27,700 and $7,500 and Hispanic families who own $30,000 and $11,000, respectively. Tax Policy Center, Racial Disparities and the Income Tax System: Capital Gains, Dividends, and Interest (Jan. 30, 2020), https://apps.urban.org/features/race-and-taxes/#capital-gains-and-dividends. But I digress.

For the LIHTC program specifically, risks are associated with the required investment holding periods differing by a few years. To take advantage of the step-up in basis on appreciated gain, QOF investors have to hold their investment for ten years, whereas investors entering into LIHTC agreements have to agree to be bound by the LIHTC program requirements for at least fifteen years (the credit being spanned over ten of those years). It is foreseeable that certain investors will deem the risk of holding their OZ investment for fifteen years too great, particularly if the LIHTC project fell out of compliance with the LIHTC program and the credits earned were recaptured by the IRS within the fifteen-year period. To some investors, ten years is already a lengthy enough holding period in a riskier distressed area where profit—in addition to the money already invested—is less than guaranteed, particularly with the expectation of paying the tax on the deferred gains on December 31, 2026.[89] Exiting a transaction after fifteen years may not be worth the trouble.

Additionally, questions abound about the initial basis of capital gain investments and how they interplay with the LIHTC rules. As a rule, capital gains invested in QOFs begin with a basis with zero (meaning all will be taxable on December 31, 2026), only increasing to bases of ten percent and an additional fifteen percent after the investments have been held for five and seven years. This schedule means that for the first five years of a LIHTC project, OZ investors' "eligible basis"—the adjusted basis at the close of the first taxable year—will be zero, rendering them unable to take the credit for the first few years. In that event, the sidecar situation—investing in a LIHTC through a QOF and investing further capital through the regular LIHTC structure—would be more beneficial if taxpayers were incentivized by both the credit *and* stepped-up appreciated gain.

Finally, the future of the OZ program itself is naturally called into question under the Biden administration. Of the proposals released in mid-September, there was no mention of the OZ program at all.[90] If the OZ program is truly going to fall into disuse, it only increases the pressure on individuals to act now to secure the benefits the OZ program has to offer.

That being said, despite the few incongruencies of the two programs, twinning them maximizes profit potential and makes less-profitable projects more attractive to investors. This allows more diversity and flexibility with investing, particularly since the program is innovative. The OZ program has the potential to change how the affordable housing markets operate, particularly if institutions begin to view the OZ Incentive as a value in

89. Although it must be noted that this 2026 tax recognition event is limited by the fair market value of the LIHTC investment, meaning if a low-valued LIHTC project had been entered into, much of the gain may still avoid taxes permanently. Glenn A. Graff, *Issues and Opportunities When Combining Opportunity Zones and LIHTC*, Novogradac J. Tax Credits (Apr. 2019), https://www.att-law.com/wp-content/uploads/BLOG/Issues-and-Opportunities-When-Combining-Opportunity-Zones-and-LIHTC-article.pdf.

90. *See generally* Reconciliation Proposal, *supra* note 3.

addition to the LIHTCs. Finally, with the right deal structure, OZ/LIHTC twinning can also generate greater amounts of equity, bringing together many investors with different motivations.

IV. Twinning with the New Market Tax Credit

A. New Market Tax Credits

1. Objectives

The New Market Tax Credit (NMTC) program was authorized under the Community Renewal and Tax Relief Act of 2000[91] and has been reauthorized and refunded every few years, most recently with $5 billion in 2020,[92] with a permanent extension on the horizon if the Biden administration's Build Back Better Act is passed.[93] Found in Section 45D of the Internal Revenue Code, the purpose of the program is to encourage investment in low-income communities (LICs)[94] and their businesses, while subsequently reducing the borrowing and financing costs associated with those investments. Overall, the NMTC program provides a dollar-for-dollar federal tax credit to investors through Community Development Entities (CDEs) on a competitive basis, the CDEs in turn loaning and/or investing the equity into operating businesses within LICs with below-market rates, more favorable loan terms, and more flexibility.

2. Overview

Authority to allocate NMTCs is jointly administered by the IRS and the Community Development Financial Institutions Fund (CDFI Fund). Allocation of the NMTCs granted on a competitive basis granted to CDEs, which are domestic corporations or partnerships where the entity (1) primarily services or provides investment capital to LICs or low-income persons, (2) maintains accountability to residents of LICs through representation on its governing or advisory boards, and (3) is certified as a CDE through the CDFI.[95]

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91. Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

92. I.R.C. § 45D(f)(1)(H) (2021).

93. *See* Reconciliation Proposal, *supra* note 3, § 135201. While making the NMTC program permanent, it also provides an additional allocation of $2 billion and $1 billion for 2022 and 2023 allocation rounds, respectively, while setting the allocation amounts at $5 billion for 2024 and all years thereafter (adjusted for inflation beginning in 2024).

94. A low-income community is any population census tract in which the poverty rate is at least twenty percent, the median family income does not exceed eighty percent of statewide median income (if rural), or the median family income does not exceed eighty percent of the greater of statewide median income or the metropolitan area median income (if the tract is located within a metropolitan area). *Id.* § 45D(e)(1) (2021).

95. *Id.* § 45D(c); *see also* CDFI Fund, NMTC Program: 2020 Allocation Application, https://www.cdfifund.gov/sites/cdfi/files/2021-04/Updated_CY_2020_NMTC_Allocation_Application_FINAL_21OCT2020.pdf (last accessed Apr. 24, 2021).

For CDEs, the application covers (1) the CDE's business strategy to invest in LICs, (2) capitalization strategy to raise equity, (3) management capacity, and (4) the expected impact on economic growth.[96] Once NMTCs are granted, the CDE "sells" them to investors in a similar manner as the LIHTCs. Through the allocation application process, the CDFI Fund must give priority to any CDE (1) with a record of having successfully provided capital or technical assistance to disadvantaged businesses or communities or (2) that intends to make QLICIs in one or more businesses in which persons unrelated to the entity hold a majority stake.[97] However, the CDFI Fund then ranks applications and awards NMTCs to the projects that will be expected to have the greatest community development and impact. The competitive process thus gives the CDEs ability to use local expertise to decide what businesses to invest in or lend money to with the funds that it raises, as well as an incentive to perform *and* perform well enough to bring benefit both to the LICs that it services and the investors that it attracts.

As for the credit itself, the NMTC is taken over a seven-year period and equals thirty-nine percent of the original amount invested in the CDE: five percent of the original amount each year for the first three years and six percent of the original amount each year for the remaining four years.[98] This credit is first available to be taken the year the investment was initially made, and ends six years afterwards.[99] To be eligible for the credit, taxpayers must make a "qualified equity investment" (QEI) in a CDE in return for stock or partnership interests in the CDE. If (1) the equity investment in the CDE is acquired by the taxpayer (directly or through and underwriter) in exchange for cash, (2) eighty-five percent of the aggregate gross assets is used by the CDE to make qualified low-income community investments (QLICIs), and (3) such investment is designated for purposes of the NMTC program by the CDE, the equity investment is considered a QEI and is eligible for the credit.[100] Notably, returns of equity, capital, or principal from the investment must be reinvested within twelve months to continue to qualify as a QEI.

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96. Cong. Rsch. Serv., New Markets Tax Credit: An Introduction (June 27, 2019), https://fas.org/sgp/crs/misc/RL34402.pdf.

97. I.R.C. § 45D(f)(2) (2021).

98. *Id.* § 45D(a)(2). The CDFI Fund also awards a proportional amount of tax credits for investing in rural LICs. To qualify for a "rural CDE" designation, an organization must (1) have a track record of at least three years of direct financing experience, (2) have dedicated at least fifty percent of direct financing activities in the last five years to rural LICs, and (3) commit that at least fifty percent of QLICIs will be directed to rural LICs. CDFI Fund, Introduction to the New Markets Tax Credit Program (Sept. 15, 2020), https://www.cdfifund.gov/sites/cdfi/files/documents/2020-introduction-to-the-nmtc-program_-final.pdf.

99. *Id.* § 45D(a)(3).

100. *Id.* § 45D(b)(1). This amount does not include equity investments with CDEs more than five years after the date that the entity receives an allocation of NMTCs. *Id.*

The CDEs must make QLICIs to qualified active low-income community businesses (QUALICBs) in order to stay in compliance with the NMTC program.[101] QLICIs can be direct in the form of equity investments or loans, but many other activities qualify as QLICIs: (1) purchasing QLICIs made by other CDEs to QUALICBs, (2) providing financial counseling, business plan development, or nonprofit operating assistance to businesses located in and the residents of LICs, and (3) investing or loaning to any other CDE that is in compliance.[102] QUALICBs are any corporation (including a nonprofit corporation), partnership, or sole proprietorship in which (1) at least fifty percent of the total gross income is derived from the active conduct of a qualified business[103] within any LIC, (2) a substantial portion of the use of the entity's tangible property (owned or leased) is within any LIC, (3) a substantial portion of the services performed by employees are performed in any LIC, and (4) less than five percent of the average aggregate unadjusted bases of the property is attributable to nonqualified financial property.[104]

In practice, these complicated requirements make the danger of NMTC recapture very real. For example, such a danger includes any of the following: if at any time during the seven-year holding period a CDE falls out of compliance with its requirements, QLICIs are not invested properly, or a CDE redeems its QLICI, a recapture event occurs.[105] The amount of the tax credit will be increased in the recapture year by *all prior year credit allowance amounts* plus interest.[106] Thus, it is imperative that the requirements are consistently followed.

Because of the uniqueness and flexibility of the NMTC program—the ability to fund projects using both equity *and* debt—and the varied definitional requirements listed above, the structures under this credit are more complex.

The unleveraged structure (*left*) involves investors directly investing QEIs in the CDEs. These are equity investments that cover one hundred percent of the total QLICI to be made by the CDE. This QEI guarantees the investors will receive the tax credits and returns on their investment, provided all other requirements are met. After the QEI investments have been

101. *Id*. § 45D(d)(1).

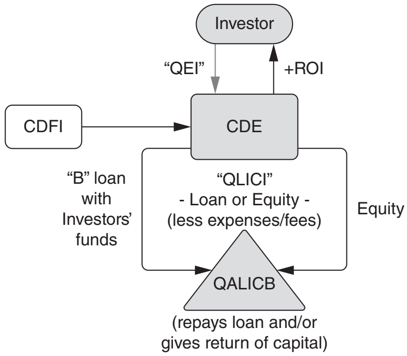
102. *Id*. Investment may be made through multiple layers of CDEs, with the last CDE in the chain demonstrating that it invested in or made loans to QUALICBs or provided financial services to businesses or residents of LICs. Introduction to the New Markets Tax Credit, *supra* note 98.

103. A "qualified business" means any trade or business operating within a LIC not involved in "sin" businesses, renting residential property or consisting predominantly of holding intangibles for sale or license. I.R.C. §§ 45D(d)(3), 1397C(d). Commercial rental property *is* permitted to be a qualified business if there are substantial improvements of such property. *Id*. § 45D(d)(3)(A).

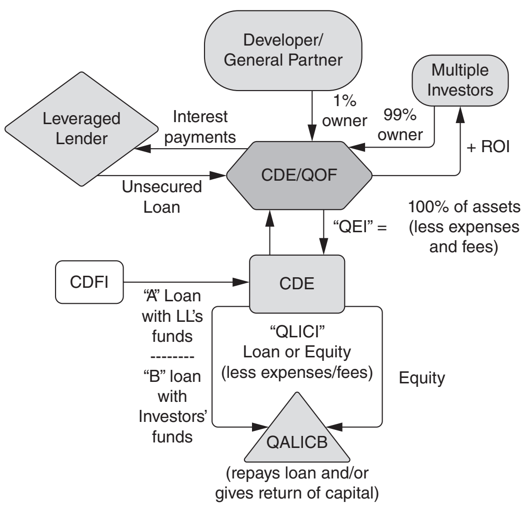
104. *Id*. § 45D(d)(2).

105. *Id*. § 45D(g). Notably, this does not include bankruptcy.

106. Id.



received, the CDE then makes QLICIs through either below-market-rate, seven-year loans with investors' funds (called "B" loans) or equity investments (and is allowed to deduct from the QLICI transaction expenses and administrative fees). However, the CDE does not have to choose; it can do both at the same time, depending entirely on the nature of the QUALICB at issue. The transaction here becomes entirely varied, depending on the transaction documents. The QUALICB could be asked to repay the loan in installments at the end of the loan period, pay interest payments throughout the entirety of the seven-year period, give periodic return of capital to the CDE throughout the holding period, refinance the loans at the end of the seven-year period or (in some cases), the "loan" could be cancelled in its entirety once the investor exits the project. If structured correctly, this transaction benefits all players: the investor will receive tax credits and a return of equity, the CDE will earn fees from the management of the investments, and the QUALICB will receive a favorable loan or equity.



The IRS authorized a different type of NMTC investment structure in Revenue Ruling 2003-20: the leveraged structure (*left*). Similar to the syndicate structure seen in the LIHTC program, this structure has the ability to pool equity from multiple investors into one cohesively managed investment fund (IF), which then directly makes a QEI investment with one-hundred percent of the assets (minus administrative fees and expenses) into a CDE below. However, this structure creates an opportunity for even more capital: the ability to use unsecured loans[107] from leveraged lenders, the proceeds of which can be used for the total QEI investment. However, negotiations ensue; such an unsecured loan from the leveraged lender typically comes with market rates and standard terms.

The interplay of debt makes a huge difference for the investors. While the leveraged lender receives economic benefits of the loan (i.e., interest payments) that are pushed up through the structure, the NMTC investor now receives NMTCs on his cash investment *plus* the amount of the QEI that was financed by the debt. If an investor invests $100,000 of equity, he would only receive $39,000 in NMTCs. With the leveraged structure, if an investor invests $100,000 of equity and a leveraged lender loans $100,000 to the IF, the investor now receives $78,000 in NMTCs ($39,000 x 2).

At the CDE level, there is a new complication. In addition to the equity and "B" loan QLICIs that can be made to QUALICBs with investor funds, CDEs now have the ability to make "A" loans with leveraged lender funds. The terms of "A" loans typically mirror the terms of the loans made to the IF by the leveraged lenders, with market interest rates if conventional loans, which takes a degree of flexibility from the QUALICB's choices of repayment. Usually, it results in the QUALICB pushing interest payments on the loan back up through the structure to the leveraged lender throughout the first seven years, only then making traditional loan payments after the seven-year period has ended. However, for projects that require that amount of capital, the lack of flexibility with "A" loans is worth the sacrifice and profit potential.

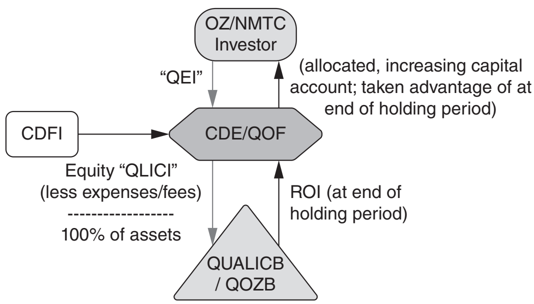
While this structure is exceedingly more complex, all parties benefit again, often with greater results. The leveraged lender receives a standard rate of return plus interest, the IF and CDE receive administrative fees and expense payments, the QUALICB receives heightened capital and mixed loans to fund even the most elaborate community development projects, and the investor receives heightened NMTC amounts and some return of equity.

107. Unsecured loans are important here. They are non-recourse (meaning they do not contain a conversion or ability to participate upon default feature) and are secured only by the IF's QEI interest in the CDE. Revenue Ruling 2003-20.

B. Possible OZ/NMTC Structures[108]

Aside from the afforable housing issues detailed under the LIHTC program, the twinning of the NMTC program and OZ Incentive makes for a valuable deal, particularly since both the have the flexibility to invest in a wide variety of commercial and industrial sectors. However, there is one key difference: debt. That aspect is what makes NMTC programs attractive, and what must be innovated to twin with the OZ Incentive in the most practical way.

The unleveraged structure (*left*) is relatively the same with OZ/NMTC twinning. However, instead of meeting *just* the complex QOF requirements, the QOF must also meet the CDE requirements to be designated as a CDE that can receive NMTCs. This must be done because the QEI—the act of the investors exchanging equity for stock or partnership interests—is the mechanism that allows the investors to receive NMTCs on the basis of that investment. This example diagrams a partnership interest.



To meet the QOF requirements, the CDE/QOF must invest at least ninety percent of its assets in QOZP (QOZBP or partnership interests/stock of a QOZB). However, with the overlay of the NMTC requirements, the CDE/QOF cannot directly invest in QOZBP because a CDE must make QLICIs to QUALICBs, limiting the CDE/QOF's investment options to investing ninety percent of its assets in partnership interests or stock of QUALICB/QOZBs. Since the "substantially all" language of the OZ Incentive definition for the QOF investment test does not discuss the possibility of excluding administrative fees and expenses from that requirement, the CDE/QOF (if it chooses to take those expenses under the provisions of the NMTC program) should only take a very minimal amount.

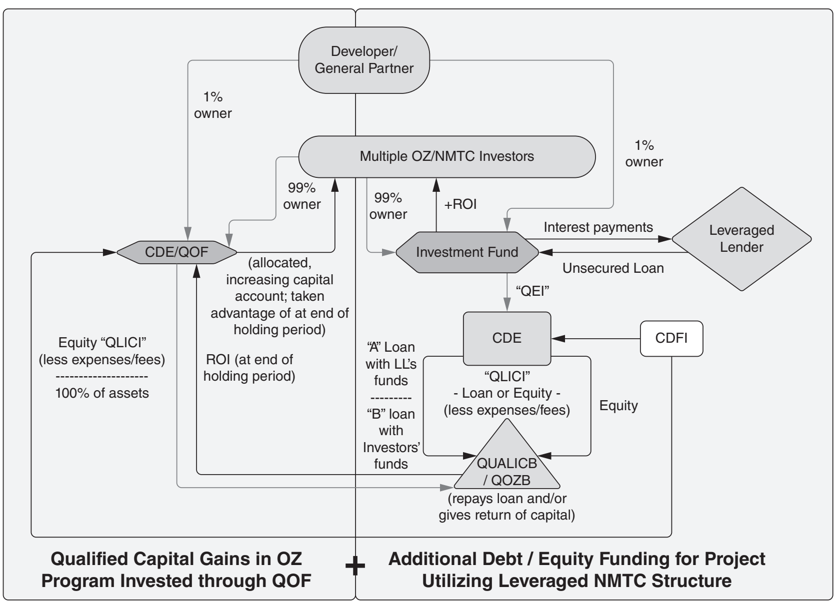
Another limitation is then imposed at the CDE/QOF level regarding QLICIs. The CDE/QOF can only directly invest equity received by investors

108. The following section draws on previously articulated provisions in the tax code, and careful consideration has been given to how these structures align with the statutory framework. *See* discussion *supra* Sections II.B, IV.A.2 (specific provisions).

in QUALICBs; QOFs are not allowed to issue loans of any kind, meaning the "B" loan flexibility is absent. Fortunately, the QUALICB and QOZB standards are similar here after the QLICI has been made, the QUALICB requirements being the less restrictive of the two (fifty percent of tangible assets vs. seventy percent of tangible assets). If the QOZB requirements are met—*and* the business does not deal in residental rental property, licenses, or "sin" businesses—the QUALICB requirements are much easier to meet.

After the transaction has been completed, the NMTCs are pumped back through to the investors by the CDE/QOF, who (in a partnership structure) can possibly add the allocated credits to the partnership account, recouping them upon the sale of their interest after the ten-year holding period for OZ investments.

If, instead, investors wanted to attempt a leveraged structure, that requires all the more of an innovative solution. QOFs cannot give loans of any sort and cannot receive anything other than qualified capital gains as means for investing in QUALICB/QOZBs. However, that limitation does not have to be the endgame. Instead, the sidecar mechanism (exhibited *above* with the sidecar hybrid LIHTC structure) will have to be put to use. The leveraged OZ sidecar (*below*) involves two separate investments made by investors in two separate CDEs. One utilizes the unleveraged structure to take advantage of both the NMTC and the OZ Incentive gain deferral and step-up in basis for qualified capital gains—again, by having a CDE/QOF hybrid as the central piece. The other investment utilizes the traditional leveraged structure used in NMTC investments with a traditional CDE (which could be a nonprofit or for-profit entity).



While many find the above structure to be immensely complicated and *maybe* unnecessary, the leveraged OZ sidecar created here maximizes the benefits for all parties involved, more so than either program alone. First, the investors receive NMTCs from their capital gains investments *and* their double-dipped NMTCs from their equity investments in the IF (receiving additional credit for amount loaned to the IF from the leveraged lender), while also receiving the traditional OZ capital gain tax deferral and stepped-up appreciated gains upon the sale of the investment after the ten-year OZ investment holding period. Second, both the CDE and the CDE/QOF receive expenses and fees while having the ability to direct funding to any business with its local expertise and knowledge of their communities, targeting those businesses that will reap the greatest rewards. Third, IF receives administrative fees and expenses while negotiating favorable terms with the leveraged lender. Fourth, the QUALICB/QOZB receives massive amounts of equity and debt funding from two different CDEs, rendering it able to spare no expense in its projects. Finally, the LIC as a whole benefits from the increase in productivity, job creation, economic reinvigoration, and community resources that such an intricate project creates and maintains.

C. The Pitfalls of OZ/NMTC Ventures

Aside from the general pitfall mentioned above—the limitation of the OZ Incentive to being only capital gains—other issues can arise with OZ/NMTC twinning. In comparison to the OZ/LIHTC twin, which had too *long* of a holding period, an OZ/NMTC twin has too *short* of a holding period. NMTC investors are only required to hold their investments for seven years to receive the maximum benefit of their investment, whereas OZ investors must hold their investment for ten years. This timing may work to investors' advantages for a few reasons, however. First, after seven years, there is no risk of recapture of the credits, unlike in the OZ/LIHTC twin; the risk of losing any benefit of the initial investment decreases greatly for the last three required years needed to maximize the OZ investment. Second, with the leveraged OZ sidecar option, investors may be able to leverage the remaining risk by exiting their traditional leveraged structure investment, leaving them with enough returns to offset any would-be loss in the three years while waiting to exit the OZ investment.

Additionally, it is entirely unclear—as with the OZ/LIHTC twin—whether taxpayers have the ability to receive the NMTCs for years in which their OZ basis is zero, which would be for five out of the seven years that the NMTC is available. However, two things can make a difference. First, if a taxpayer elects not to defer all of the taxation of the qualified capital gains on the date of sale (before reinvesting them into a QOF), and instead paid *some* of the tax in the current year without electing deferral, it would render sufficient basis to take against the credit each year that it was available. Maximizing the ability to take the credit would involve paying capital gains tax owed on at least twenty-seven percent of the capital gains being used in the QOF (giving you basis for the first five years while waiting for basis to increase in Year 5 after holding the investment as required by the OZ Incentive). Second, if utilizing the leveraged OZ sidecar, a taxpayer's basis in that leveraged structure QEI may be able to be reduced by NMTCs received from the OZ investment.

V. Tripling and Quadrupling?!

The structures discussed here do not reflect the vast reality of innovative transactions that the OZ Incentive opens up to investors willing to risk for reward. Many other twinning structures can be utilized, particularly with the Historic Tax Credit (HTC) and the Renewable Energy Tax Credit programs (RETC). However—and perhaps an even more terrifying thought for some—*tripling* credits is possible as well. OZ/HTC/LIHTC ventures can be born through operational partnerships buying up severely dilapidated historic buildings in dire need of a "substantial improvement" and turning them into low-income rental housing. OZ/HTC/NMTC ventures can thrive through a QUALICB purchasing severely dilapidated historic buildings in dire need of a "substantial improvement" and turning them into business meccas.

Quadrupling is even possible. OZ/HTC/RETC/NMTC ventures could abound through the purchase of a severely dilapidated, historic building and turning it into a renewable energy facility (providing jobs to the community and preserving the building's historic features).OZ/HTC/RETC/LIHTC ventures could follow in the same vein, but instead providing low-income rental housing and an on-site renewable energy facility. While these structures have not been discussed in any sort of depth or complexity, innovating with twinning, tripling, and quadrupling has the potential to take our economy and productivity to places it has never been.

VI. Conclusion

In summary, when contemplating a tax credit twinning venture, it is necessary to evaluate all risks and benefits associated with such a venture. The transactions possible with the Opportunity Zones Incentive are still being explored, with new guidance and regulations being released constantly. However, to make existing structures obsolete with each new development, to create new methods of venture capital, to incentivize both economic development *and* profit for the betterment of all, some risk may be necessary. The reward is there—the golden fleece draped over the tree. All it takes is the right project and an innovative, strategic, and daring mind.