# Bond Case Briefs

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## P3 Investors: Are You In The Zone?

Last December we told you about favorable IRS guidance letting P3 contractors and investors keep full tax deductions for interest on debt.[1] The IRS kept a P3-friendly approach in last week's proposed regulations on "qualified opportunity zones" – which, like the interest limitations in our December post, come from the 2017 Tax Cuts and Jobs Act ("TCJA").[2] The qualified opportunity zone legislation promotes a broad range of real estate and business development in distressed areas, and these proposed regulations are particularly helpful to private parties contracting for and investing in P3s in these areas – for example, to build a city hall, school, courthouse, or convention center.

A qualified opportunity zone ("QOZ") is an economically-depressed census tract, ripe for revitalization, recommended by state governors and designated by the Treasury Department.[3] Revitalization occurs through a "qualified opportunity fund" ("QOF") whose assets must consist at least 90% (the "90% test") of real estate and other tangible property used in a trade or business and located in a QOZ that the QOF owns (1) directly such as an apartment, office, commercial, or industrial building ("direct-owned assets") and/or (2) indirectly as a shareholder, partner, or LLC member in an "active" trade or business such as a hotel, restaurant, factory, or technology start-up ('indirect-owned assets").

The TCJA encourages investment in a QOF (and, by extension, revitalization of the underlying QOZ) by letting a taxpayer roll gain from the sale of most investments into a QOF within 180 days after sale. The taxpayer must recognize the deferred gain from the original sale effective at the close of 2026, but up to 15% of the original gain escapes tax depending on how long the taxpayer held the QOF interest. Plus, if the taxpayer holds the QOF interest for more than 10 years, any appreciation in that interest above the gain rolled over from the original investment completely escapes tax. These tax benefits make it easier for a developer to attract private investors if a P3 project is inside a QOZ and a developer forms a QOF to build and operate it: Investors may forego higher returns in exchange for the tax benefits, and P3 developers' (and by extension governments') costs fall accordingly.

Congress left it to the IRS to build the infrastructure for how a developer operates a QOF and a taxpayer obtains benefits from investing in one. The IRS issued proposed regulations in mid-October 2018,[4] and a second round last week.[5] This second round benefits P3s as follows:

- Taking our city hall, school, courthouse, or convention center as an example, the tax-exempt government agency in the P3 typically owns the real estate and improvements – e., what would otherwise be a QOF's direct-owned assets. The real value of the QOF would be in the P3 private business counter-party that performs labor, owns or leases equipment, and purchases supplies – and for these indirect-owned assets to count toward the 90% test that business must be "active" within the QOZ even though throughout the project labor might be performed and equipment and supplies move in and out of the QOZ. The proposed regulations follow a common-sense approach by providing that substantial services may be performed and equipment located outside the QOZ from time to time (and establishing safe harbors in this regard); providing that supplies and inventory may be held temporarily outside the QOZ so long as they are destined for incorporation

in the project inside the QOZ; and providing lenient treatment for equipment that the developer leases as opposed to owns (though the rules are more stringent for property leased from related parties).
- P3 projects must undergo months of bidding, permit, and preparatory work before the first shovel hits the ground; but a QOF in the meantime must gather and hold multiple tranches of investments as taxpayers try to roll over their gains into the QOF within the 180-day deadline. Working capital and other reserves are not direct- or indirect-owned assets and therefore could cause the QOF to violate the 90% test. The first round of proposed regulations had a "working capital" safe harbor to prevent this result, but commentators said this relief was inadequate. The more recent proposed regulations significantly expand these safe harbors; expand other circumstances under which a QOF need not consider a recent capital raise in applying the 90% test; and – perhaps most important – provide that a QOF will not be penalized for permitting and other governmental delays.

A developer and potential investor can rely on these proposed regulations if they apply the rules consistently and across-the-board. The IRS does not anticipate issuing more proposed regulations, but the last two rounds should give developers enough comfort to form QOFs and attract investors for qualified opportunity zone P3s.

[1] See "P3 Industry Gets an Early Holiday Present in IRS Guidance on Interest Deduction" (Dec. 11, 2018).

[2] The text of the TCJA, and accompanying Congressional reports, can be viewed here. The specific qualified opportunity zone statutes (Internal Revenue Code sections 1400Z-1 and -2) can be viewed here.

[3] To identify qualified opportunity zones, go to the Treasury Community Development Financial Institutions Fund web site and follow the instructions — you can view qualified opportunity zones as a list of census tracts, or as a map overlay.

[4] These proposed regulations (and detailed preamble explanation) can be viewed here. Along with the proposed regulations, the IRS issued an interpretive revenue ruling and a draft Form 8996 QOF certification with instructions.

[5] The proposed regulations (and detailed preamble explanation) can be viewed here. Along with the proposed regulations the IRS issued a 7-page request for information to monitor economic activity in QOZs.

By Douglas Schwartz on May 6, 2019

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