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Opportunity Zones will be a boost to the muni market

By

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WASHINGTON — The municipal bond market is expected to receive a boost, albeit an indirect one, from new Internal Revenue Service regulations covering investments in Opportunity Zones.

In the coming months bond lawyers expect numerous municipal governments to issue new bonds to support some of those investments or to issue private activity bonds for other qualified developments such as multifamily rental housing.

“Opportunity Zones are not, per se, a bond program,” said Michael Bailey, a partner at Foley & Lardner in Chicago. “By definition they deal with equity investments. But in many respects they do dovetail with public finance and I think there’s an important relationship to public finance.”

Most important, Opportunity Zones are located in distressed areas where municipal governments have oftentimes focused their issuance of tax-exempt bonds to develop infrastructure and boost the local economy by issuing PABs for nonprofits such as hospitals and community centers.

Opportunity Zone investment has been slow to develop since the creation of OZs as part of the Tax Cuts and Jobs Act of 2017 to encourage capital investment in economically distressed census areas.

OZs allow investors to defer and reduce capital gains and for investments held at five or seven years, and in the case of investments held at least 10 years, avert tax on any appreciation.

The U.S. Treasury allowed states and the commonwealth of Puerto Rico to designate 8,700 OZs.

The IRS guidance released April 17 is the second of what are expected to be three tranches of guidance for investors, many of whom had unanswered questions after the first tranche was released late last year.

The new guidance clarifies the “substantially all” requirements for the holding period and use of the tangible business property. For instance, for the use of the property, at least 70% must be used in a qualified Opportunity Zone, or QO. For the holding period of the property, tangible property must be qualified OZ business property for at least 90% of the QO fund’s or qualified Opportunity Zone business’s holding period. And the partnership or corporation must be a qualified Opportunity Zone business for at least 90% of the QO fund’s holding period.

Richard Chirls, a tax partner at Orrick, Herrington & Sutcliffe in New York, told The Bond Buyer he expects “a lot of the capital that has been sitting on the sidelines, waiting for these new regulations will now be willing to move forward and make investments.”

“I think that the new regulations have done a very good job of adding flexibility, addressing some of the hurdles that were identified in terms of the practical steps that have to be taken in order to bring capital into the Opportunity Zones and make the actual investments into the opportunity property or Opportunity Zone businesses,” Chirls said.

Numerous state and local governments around the country have contacted their bond attorneys and municipal advisors seeking guidance on how to take advantage of OZs to promote economic development.

Brian Teaff, a partner at Bracewell in Houston, said he’s had conversations with a number of city and county governments, with some of the larger clients putting together task forces of elected officials, real estate developers and activist groups.

“A lot of people had deals tentatively ready to go, but they were not comfortable under the prior set of proposed regulations for actually pulling the trigger,” Teaff said. “There were just too many risks. To the extent that these regs provide additional guidance and additional comfort, I would expect that we will finally start to see some action.”

Teaff said municipalities are promoting their workforce availability, education availability and any transit they have to get workers to the job site. Some cities are marketing specific projects such as mixed-use developments that include multifamily housing.

“At least the way the first tranche of regulations were written, at a minimum we know housing or real estate is a perfect asset for Opportunity Zones because we know at minimum, the income is derived within the zone,” Teaff said.

PABs have increasingly been used for multifamily housing as part of financing packages that include the 4% federal low-income housing tax credit.

Other possible PAB uses in OZs include a sewage facility or solid waste disposal facility, Deaff said.

As part of the effort to lure OZ investors, Louisville, Ky., and Stockton, Calif., have published prospectuses about their OZs.

Louisville, which has 19 OZs, announced its first OZ investment in November when a local developer committed $750,000 for the expansion of Blacksmith Iron Works, a fabrication and custom metal solutions business, according to Caitlin Bowling, a spokeswoman for Louisville Forward.

Joseph Krist, a partner at Court Street Group Research, said the new IRS guidance is helpful but won’t guarantee enough information for some investors because metrics such as the number of jobs created aren't required.

“That will be a problem going forward,” Krist said.

Corrected April 24, 2019 at 1:09PM: An earlier version gave the wrong location for Brian Teaff's office.