Opportunity Zones

A Review of Treasury Guidance

By Michael Thomas

Fashioned as a revitalization tool for economically distressed communities around the country, Opportunity Zones are designed as a throughway for previously unused capital. But there are questions.

Since October 2018, the U.S. Treasury Department has released two sets of guidelines clarifying how Opportunity Zones (OZ), an economic development policy signed into law through the Tax Cuts and Jobs Act of 2017, will work for investors, businesses, policy practitioners, and those who stand to benefit. Fashioned as a revitalization tool for economically distressed communities around the country, Opportunity Zones are designed as a throughway for previously unused capital. Although this new policy was met with excitement, it was marred by trepidation from those who had questions over the finer details of the initiative.

The goal of the governing policy is to inject untapped resources into areas that are in need of economic growth; this is to be achieved by attracting unrealized gains from the capital markets. The idea is to attract capital through tax incentives — a method the federal government has used before in attempting to funnel resources to regions that are in need of economic opportunity.

The federal government established Enterprise Zones in regions of the United States in the 1980s, followed by Empowerment Zones in the 1990s, and more recently, the Obama administration's Promise Zones. All of them were supposed to encourage economic activity in specific areas and can be considered "special economic zones." They all create incentives for investment by offering some kind of support from the federal government. Whether that support comes in the form of tax abatement, assistance with applying for federal grants, workforce training, or a combination of federally backed incentives, they all funnel new investment into certain geographic areas.

OPPORTUNITY ZONES: A SUMMARY

Like all broad stroke initiatives, OZs require a thorough look at the details to ensure an understanding of how those initiatives impact stakeholders at all levels, and if those impacts are in line with the initiative's legislative intent. OZs work by offering discounts on taxes owed when an investment sustains a capital gain. Unrealized gains are the difference in the cost-basis for an asset or investment and its current price after appreciation. Taxes are owed on the appreciation realized once the investment is sold for a profit, or a gain.

OZs allow investors to move unrealized gains into Qualified Opportunity Zone (QOZ) funds and receive a discount on those taxes owed based on how long the unrealized gains remain in the QOZ. There's an estimated $4 trillion in unrealized gains in the U.S. financial markets, so proponents of the policy contend that huge amounts of potential resources are available for new investments in OZs. Which areas qualify as OZs are based on a combination of Census data and selections made by the governors of the states the OZs are in. The U.S. Treasury has certified 8,700 opportunity zones in the United States and Puerto Rico.

If the unrealized gains invested are held in the QOZ for fewer than 5 years, the taxes owed on capital gains are deferred until the interest held in the QOZ funds are sold or exchanged. If the unrealized gains are held in the QOZ for 5 to 7 years, investors get a tax deferral and a reduction of 10 percent on the capital gain taxes they owed. If the unrealized gains are held for 7 to 10 years, investors get a tax deferral until the end of 2026 and a reduction of 15 percent on the capital gain taxes they owe. If the gains are held for 10 years or more, investors get reduction of 15 percent on the capital gain taxes they owe, and they won't owe capital gains tax on profits sustained from the sale of QOZ fund interests.

The original legislation allowed for many questions and uncertainties that have had interested parties wondering what might be the best way to take advantage of the possible benefits. As the guiding administrative authority for the implementation of OZs, the Treasury Department has issued two sets of guidance since October 2018 to clarify parameters and answer questions. Not all the potential unanswered issues and questions can be addressed here, but this article will cover a few main issues that received significant attention.

ORIGINAL USE

Real estate developers have shown great interest in using OZs to their advantage. Originally, tangible assets such as real estate would need to double in value within 30 months of acquisition to be eligible as a QOZ business property. This regulation begged the question: Is real estate that is purchased with existing buildings/development treated differently than undeveloped land? The proposed regulations have answered this query.

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There is a qualifying rule for real estate that already has buildings/development, but not for undeveloped land that is acquired through QOZ funds. In the cases that do require the improvement of buildings on real estate acquired through QOZ funds, evaluations of improvements and appreciation will exclude land, meaning that testing for substantial improvement will be performed on an asset-by-asset basis. For properties on acquired real estate that has been unused or vacant for 5 consecutive years before they were acquired, there is no obligation to increase the value of the real estate through improvement.

The potential upsides and downsides of this clarification depend on one's perspective. Ensuring that undeveloped land has no improvement requirement could encourage more activity from investors, increasing the overall scale of investment into lands within OZs. However, the proposed rule could create the potential for abuse. Investors could intentionally or unintentionally use tax-advantaged policy for "land banking" (the practice of acquiring contiguous, undeveloped parcels of land until the properties increase in value sufficiently to encourage the sale of the parcel). This practice might seem innocuous, but holding land within OZs in the hopes of future appreciation could squeeze out other potential investors who intended to develop the land immediately, spurring economic development more quickly. Land banking could undermine the legislative intent behind OZs.

The Internal Revenue Service (IRS) has general "anti-abuse" rules to police OZ policy, but those provisions state clearly that decisions to refashion benefits and qualifications will be based on the facts and context of each individual transaction. While this doesn't mean that the IRS cannot or will not effectively police OZ activity, it does mean that anti-abuse recourse will likely be based on the judgements of regulatory decision makers in control when oversight is being exacted.

"SUBSTANTIALLY ALL," ASSET TESTS, AND USE OF CAPITAL

The original authorizing policy didn't specify how to distinguish what kinds of businesses, and their inherent activities, are eligible to be QOZ businesses. This makes sense, since it can be assumed that attracting the greatest number of businesses possible to invest in OZs is an implicit goal of the policy. But because the legislative intent is to encourage economic productivity in specific regions, where a business's income is going to end up bears discussion. One goal of OZs is to channel profits that result in new jobs, wages, and tax revenue for the locations QOZ businesses operate. To offer clarification on this, issued guidance dictates that 50 percent of gross income must be conducted within the OZ where the business resides. The following safe harbors apply to the 50 percent rule:

- At least 50 percent of the services performed for such business by its employees and independent contractors are performed within the QOZ, measured in terms of hours.
- At least 50 percent of the services performed for the business by its employee's independent contractors are performed in the QOZ, based on the amount paid for services.
- The physical property of the business that is in a QOZ and the management or operational functions performed for the business in the QOZ are each necessary to generate 50 percent of the gross income of the business activity.

Although the IRS has not outlined what does or doesn't qualify as active trade or business activity, it has determined that owning and operating property does qualify under OZ rules.

The term "substantially all" is used a number of times in the authorizing legislation, with different meanings for specific entities and transactions. Most pressing is how the term applies to assets that are eligible to be held inside QOZ funds. How much of the capital inside a QOZ fund is applied toward eligible property depends on whether the tangible property is held through a QOZ business or if it is held directly through a QOZ fund. If a QOZ fund holds property directly, 90 percent must be QOZ business property. If a QOZ fund owns property through a QOZ business, the requirement is lowered to 70 percent. In these instances, a QOZ fund would hold interest in an eligible partnership (or other eligible entities) that purchased and held QOZ business property as an eligible business activity. Through this qualification, a QOZ fund could actually invest just 63 percent of its assets in qualified opportunity zone business property if 90 percent of the assets held are in eligible partnerships or interests and 70 percent of the assets of those entities is qualified property. In the second set of proposed guidance, the IRS offered further clarification for the asset tests:

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- A QOZ fund asset test does not take into account investments received in the preceding six months, so long as those new assets are cash, cash equivalents, or debt tools with terms of 18 months or less.
- Proceeds received by a QOZ fund from the sale of QOZ business property and other eligible interests are treated as QOZ property for the 90 percent investment requirement, so long as the QOZ fund reinvests the proceeds during the 12-month period beginning on the date of such sale.

Several timelines are built into OZ policy, one of which is how long a QOZ fund can keep its unused assets in the form of cash, cash equivalents, and certain debt instruments. Investors have been eager to understand what guidelines must be followed while capital from a QOZ is being deployed. The first set of proposed guidelines laid out a 31-month safe harbor period for working capital to "…investment(s) in qualified opportunity zone businesses that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property." The second round of guidance offered further clarification:

- The working capital safe harbor now includes the development of a trade or business in the QOZ as well as acquisition, construction, and/or substantial improvement of tangible property, thus extending it to operating businesses.
- Exceeding the 31-month period does not violate the safe harbor if the delay is due to waiting for government action (such as pursuing needed permits), if the application for that action is completed during the 31-month period.
- Detailing acquisitions, constructions, improvements, etc. must be detailed in writing for the safe harbor provision to be applied.
- A QOZ business may benefit from overlapping or sequential applications of the working capital safe harbor to different injections of capital.

The IRS also issued clarifications about leasing property as part of the business activity of a QOZ business:

- There is no original use requirement or substantial improvement requirement for leased property. This could simply be because of the way leased properties are typically used for business purposes, but it does leave room for interpretation.
- Leased property does not need to be from an individual or other entity that is unrelated to the lessor, but certain requirements need to be met for this to be a valid option under the QOF rules.
- When considering guidelines for leasing, businesses should take care in understanding how the term "substantially all" is interpreted. "Substantially all" (70 percent in this case) of a leased QOZ business's use must be in a QOZ during "substantially all" (90 percent) of the time that the businesses leases the property.

SECONDARY MARKETS

The IRS issued guidelines over the sale of QOZ fund interest that could act as a powerful expansion tool for attracting even more investment than the original tax benefits offered. The IRS will allow investors to purchase interest in QOZ funds from individuals and entities in their possession while retaining the tax benefits. Additionally, the IRS will allow for the inheritance of interest in QOZ funds to retain the original tax benefits.

Opening up a secondary market could result in an expansion of access to OZ investment, theoretically allowing for a greater pool of resources for OZs to use. However, this expansion leads to more questions over a variety of issues. Can secondary market investors purchase QOZ fund interests with debt? Should there be limitations on what, where, and how QOZ fund interests end up in terms of markets and potential investors? These could be non-issues, but it can be unproductive to issue guidance that only creates more questions.

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WHAT'S NEXT?

None of the guidelines proposed by the Treasury Department and the IRS are finalized, and there will be further discussion. The IRS has stated that investors should feel confident in following the proposed guidelines now, but the agency hasn't clarified what might happen if an action that currently follows proposed guidelines becomes more complicated through the finalized rules. The tax incentives available are valuable and can be a truly powerful tool in marshalling new resources, but there is a possibility that the benefits will predominantly go to investors and do little for the roughly 35 million Americans living inside OZs. Local municipalities will be happy for an increase in economic activity and tax revenue, however it comes, but the government of an economically distressed town might find itself up against well-funded investors while attempting to ensure the best thing for their constituents.

The emphasis has been on getting the capital in the right location first and letting the rest sort itself out — an understandable position to take when addressing impoverished areas. But providing better opportunity and economic growth for people in need is at the core of this initiative. There is little information about how OZs will affect the cities and towns within them, and the original reporting requirements were taken out of the version of the Tax Cut and Jobs Act that was signed into law.

The Treasury Department did request detailed suggestions about what metrics should be tracked and the best way to account for them, and in May 2019, bipartisan legislation was introduced that requires the Treasury to track OZ data. Daniel Kowalski, Counselor to the Secretary of Treasury, has said that a third tranche of guidance for OZs may or may not be coming, which could leave future questions for Congress and the White House to hash out.

It's difficult to say whether OZs will draw more attention in the near future. The upcoming presidential election features Senator Cory Booker (D-NJ), one of the original legislators behind OZs. His campaign run could draw attention to the initiative, good or bad. There is as much uncertainty as there is hope for the future success of Opportunity Zones.

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