

Opportunity Zones

The Tax Cuts and Jobs Act of 2017 created a new investment option for capital gains, “Qualified Opportunity Funds.” Qualified Opportunity Funds (QOFs) promote investment in the development of real estate and businesses in “Qualified Opportunity Zones.” Qualified Opportunity Zones (OZs) are census tracts of low-income and distressed communities designated by state governors and certified by the Department of Treasury. Investors who invest their capital gains in QOFs can defer and reduce their capital gains tax burdens. Given that there may be as much as \$6.1 trillion in unrealized capital gains assets in the U.S., the Opportunity Funds investment option may represent a significant chance for communities to attract new capital for the cleanup and redevelopment of brownfields located in the 8,762 designated Opportunity Zones.

As of the publication date of this document, the Department of Treasury and the Internal Revenue Service (IRS) had not published final regulations or guidance governing the Opportunity Fund investment program. However, draft guidance published by the IRS on May 1, 2019 (see 84 FR 18652) indicates that investments in the cleanup and redevelopment of brownfields located in designated Opportunity Zones will be able to make use of QOF investments, provided that the investments are part of a full economic redevelopment project that includes both the cleanup of the brownfield and an investment in a business or building located on the brownfield property.

How the Program Works

The Opportunity Zone law offers deferred taxes, then significant tax breaks, to a broad array of investors who deploy and hold their capital gains in businesses and capital improvement projects located in Qualified Opportunity Zones (QOZs). To realize preferential tax treatment, investors must place their capital gains into a Qualified Opportunity Fund. QOFs may be either a corporation or partnership established solely for the purpose of investing in QOZs, in exchange for an equity interest in that QOZ project. The program will allow investors to establish QOFs for a targeted area, or even a single-purpose project in a QOZ. These QOFs must hold at least 90 percent of their assets

in QOZ property, which includes qualifying stock, partnership interest, or business property located within a QOZ.

Each state nominated a limited number of population census tracts to be designated as QOZs. A population census tract was eligible for designation as a QOZ if it satisfied the definition of “low-income community” (LIC) (which is the same as the federal definition for New Market Tax Credits) or is contiguous with an LIC that is designated as a QOZ, and the median family income of the non-LIC tract does not exceed 125 percent of the median family income of that contiguous LIC QOZ. Opportunity Zones have now been designated in all 50 states, the District of Columbia, and five U.S. territories.

To qualify as a QOZ property, assets must either have their “original use” in a QOZ; or the QOZ property must be “substantially improved” (which generally requires making investments with a cost at least equal to the asset’s purchase price) within 30 months of the property’s acquisition. During “substantially all” of the QOZ’s holding period, substantially all use of such property must be in a QOZ. Proposed IRS guidance provides that activities on bare land, and activities to revitalize buildings that have been vacant for at least five years, will constitute “original use,” while activities to renovate buildings vacant for fewer than five years must meet the “substantially improved” tests.

There are three basic types of tax benefits that are available to QOF investors: deferral of capital gains tax initially invested, reduction of those capital gains, and exemption from taxation of new capital gains that occur after the initial investment in a QOZ project. An explanation of each benefit is provided below.

Deferral of Capital Gains Tax: A taxpayer who has an investment that has appreciated can postpone or defer 100 percent of capital gains taxes by investing a gain realized from a sale or exchange into a QOF within 180 days of the sale or exchange of stocks, mutual funds, or other investments such as sale of real estate or a business. The tax on the gain can be deferred until the earlier of the date on which the QOF investment is sold or exchanged, or December 31, 2026.

Reduction of Capital Gains Through a Step-Up in Basis:

A taxpayer who invests in a QOF by December 31, 2019, will be able to reduce the taxable portion of its capital gains on that initial investment. If the QOF investment is held for longer than five years, there is a 10 percent exclusion of the deferred gain. If held for more than seven years, the 10 percent is stepped up to 15 percent. If the QOF investment does not take place by December 31, 2019, the investor can still receive some portion of step-up benefits, depending on when the investment is made.

Permanent Gains Exclusions: If the investor holds the investment in the QOF for at least 10 years, the investor is eligible for an increase in basis of the QOF investment equal to its fair market value on the date that the QOF investment is sold or exchanged. Therefore, a taxpayer holding the investment in the QOF for at least 10 years will not have to recognize any gain (i.e., pay capital gains tax) on the post-acquisition economic appreciation in its QOF interest when it is sold or exchanged, so long as the taxpayer disposes of the investment prior to January 1, 2048. However, the taxpayer still will have to pay the deferred, reduced taxes on the initial gain.

For all of these QOZ benefits, the IRS rules clarify that proceeds from the sale or disposition of QOF assets do not impact an investor's holding period in the QOF if the proceeds are reinvested within a 12-month period; however, ordinary tax principles will be applied to interim gains as the tax benefit is linked to the duration of the taxpayer's investment in a QOF, not to the duration of a QOF's investment in any specific asset/business.

Advantages for Brownfields Site Redevelopers

Because QOZs are census tracts of low-income and distressed communities, QOZs will often include brownfields. Although final guidance governing QOFs were not yet available when this document was published, proposed guidance published by the IRS suggested that OZ incentives may be a useful tool for attracting private investment in brownfields redevelopment projects. For instance, pre-development costs for planned vertical development, including demolition, asbestos abatement, and brownfields cleanup costs are allowable QOF investments, if such costs are tied to vertical development that otherwise meets the IRS requirements for QOF properties and businesses.

Beyond the tax benefits that investors involved in brownfields projects located in QOZs may gain, the new tax provision should provide incentives for brownfields redevelopment in general. Due to the tax advantages of QOF investments, distressed communities designated as QOZs may become more attractive to investors because of the potential for better returns on development projects in QOZs.

Limitations

As specific IRS criteria must be met to take advantage of Opportunity Zone benefits, the following key issues and requirements should be considered when determining whether Opportunity Zone benefits may be applied to a brownfields project located in a QOZ:

- **Maintaining working capital plan for vertical development:** For brownfields projects, the pre-development phase could foreseeably get drawn out when the contamination or liability issues prove to be more complex than expected. It is important that the developer maintain a written working capital plan for the ultimate development project and its phases, to which the developer substantially adheres for deploying each tranche of capital raised for the project over a 31-month period from the time of investment of each tranche.
- **Original use:** The proposed IRS regulations clarify that vacant parcels of land, buildings intended for demolition, or buildings intended for renovation that have been vacant for at least five years will all satisfy "original use" and will not be subject to the substantial improvement test requiring a doubling in basis in buildings within a 30-month period from acquisition. Therefore, for brownfield properties that fit within these categories, developers will not face a timeclock for doubling the basis in buildings on the properties.
- **Substantial improvement:** If a brownfield redeveloper wishes to use QOF investments to renovate a building that has been vacant for fewer than five years, it will need to substantially improve the facility within 30 months, which may be too short a period to allow project developers and their investors to obtain entitlement and regulatory approvals and perform demolition, excavation, cleanup, and other site preparation work necessary for redevelopment of a contaminated brownfield.

SNAPSHOT – CONFLUENCE CORRIDOR, GLENWOOD SPRINGS, CO

The City of Glenwood Springs, Colorado, will leverage the federal designation of two downtown census tracts as Opportunity Zones to advance its EPA-funded Confluence Corridor Brownfields Area-Wide Plan (AWP). The AWP focuses on redeveloping vacant and contaminated properties into vibrant, mixed-use development at the confluence of the Roaring Fork River and Colorado River in the heart of downtown.

Glenwood Springs used an EPA Region 8 Targeted Brownfields Assessment to understand the environmental conditions at its long-vacant, former wastewater treatment plant that occupies a prime site for redevelopment. The area-wide plan envisions a mix of more than 400,000 square feet of commercial, retail, and housing, along with a multi-modal transit center and riverfront recreational parks and nature areas within the Opportunity Zone boundary. The City of Glenwood Springs created a Glenwood Springs Opportunity Pitchbook highlighting shovel-ready and investment-ready projects in its Opportunity Zone brownfields; hosted forums with local investors, bankers, and developers to educate the community about the incentive; issued a request for proposals from developers of the Confluence Corridor that uses the Opportunity Zone designation as a key incentive; and is reaching out directly to Opportunity Fund managers about investing in the confluence Opportunity Zone brownfields.

- **Land-banking:** Cleanup of a brownfield without plans for economic or vertical real estate development is not likely to be eligible for QOF investment, as IRS does not wish to incentivize “land-banking” or “land speculation” with Opportunity Zone rules.

ADDITIONAL INFORMATION

Over the course of 2019, the Treasury Department and the Internal Revenue Service are expected to provide further details, including additional legal guidance, on this new tax benefit. More information will be available at <https://home.treasury.gov/> and <https://www.irs.gov>, or from sources such as <https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx>.