

Real Estate Update

Waxman among packed crowd at IRS hearing on Opportunity Zone Regulations

February 22, 2019

Last week, **David Waxman** (Cleveland) was among 200 attendees in the standing-room-only crowd for the IRS's hearing regarding its initial set of proposed Qualified Opportunity Zone (QOZ) regulations in Washington, DC. IRS received more than 150 written comments to the Proposed Regulations prior to the hearing, and 22 interested parties provided oral testimony. As of 2/21, the next set of Opportunity Zone guidance may be submitted to the Office of Management and Budget (OMB) within the next week.

Below is a list of the more salient issues addressed. Keep reading for a full text explanation of each.

- » Need for longer period for Qualified Opportunity Funds (QOFs) to deploy initial capital raised for QOZ projects
- » Need for ability to extend 30-month substantial improvement period in event of unforeseen circumstances beyond reasonable control of Qualified Opportunity Zone Business (QOZB)
- » Extension of 180-day period to invest capital gain in QOF for first year of program
- » Correcting the penal nature of disqualifying owners of real estate purchased prior to 2017 from being able to avail themselves of the program's tax benefits
- » Revisions to requirement that at least 50% of a QOZB's gross income be from the active conduct of a trade or business "in" the QOZ
- » Need to permit vacant or underutilized property to be treated as "original use" in the hands of the QOF or QOZB
- » Permitting QOF investors to avail themselves of the step-up election when the QOF sells assets
- » Permitting QOFs to reinvest interim gains without incurring penalties or triggering a taxable event
- » Permitting QOFs/QOZBs to refinance and distribute proceeds to investors without investors losing the tax benefits
- » Reasonable reporting requirements

Need for longer period for Qualified Opportunity Funds (QOFs) to deploy initial capital raised for QOZ projects

The Proposed Regulations provide QOFs only 6 months to deploy 90% of the initial cash it receives (the 90% Asset Test). The concern raised was that the period is simply not enough time for a QOF to deploy the capital, especially with respect to the formation of multi-asset QOFs. One suggested solution was to afford QOFs a "start-up" period after the QOF's formation date (e.g., 12–18 months), during which the QOF will be deemed to have met the 90% Asset Test, avoiding the possibility of penalties. If IRS does not revise the Proposed Regulations to satisfactorily address this, it will be difficult to entice investment in multi-asset QOFs.

Need for ability to extend 30-month substantial improvement period in event of unforeseen circumstances beyond reasonable control of Qualified Opportunity Zone Business (QOZB)

The Proposed Regulations require that “tangible property is treated as substantially improved by a QOF only if, during any 30-month period beginning after the date of acquisition of the property, additions to the basis of the property in the hands of the QOF exceed an amount equal to the adjusted basis of the property at the beginning of the 30-month period....” However, as with any real estate development/re-development, unforeseen challenges and delays are certain to occur. It is likely IRS will address this by providing a grace period in the event that unforeseen circumstances arise during the 30-month substantial improvement period, provided the QOF or QOZB has made, and continues to make, good faith efforts to comply with the time requirement.

Extension of 180-day period to invest capital gain in QOF for first year of program

An essential requirement for an investor to be eligible for the QOZ program is that it invest its capital gains into a QOF within 180 days after the sale or exchange that generated the gain. Because the Proposed Regulations were not released until mid-October of 2018, a significant number of taxpayers were prevented from investing in QOFs that year. The suggestion was made that Treasury provide relief to those investors by permitting them to invest those otherwise non-qualifying gains in a QOF as long as the investment is made by the end of 2019. Given the timing of the Proposed Regulations, as well as the delay caused by the government shutdown, hopefully Treasury will provide some relief.

Correcting the penal nature of disqualifying owners of real estate purchased prior to 2017 from being able to avail themselves of the program’s tax benefits

A chief concern is that, under the Proposed Regulations, those who owned real estate within a QOZ prior to 2018 cannot avail themselves of the QOZ program’s tax benefits, while those acquiring the same real estate after 2017 may do so. Because the Congressional intent of the QOZ program is to promote and encourage new investment in tangible property and investments in QOZs, some urged Treasury to correct the inequity in its final regulations.

Revisions to requirement that at least 50% of a QOZB’s gross income be from the active conduct of a trade or business "in" the QOZ

Another particular concern to operating QOZBs is that the Regulation requires that a QOZB derive 50% of its gross income from the active conduct of a trade or business “in” the QOZ. Because many operating businesses will derive income from sale and services outside of QOZ, the requirement would significantly limit the ability for QOZs to attract operating businesses, and QOFs to attract investors to QOFs owning operating QOZBs. Nearly all of those commenting on behalf of the investment, development, and business communities suggested removal of the locational requirement.

Need to permit vacant or under-utilized property to be treated as “original use” in the hands of the QOF or QOZB

Treasury, in the Proposed Regulations, requested comments on whether tangible property that had been abandoned or under-utilized for some period of time should be able to qualify as “original use” and thereby qualify as qualified opportunity zone business property (QOZBP). These properties will never be considered to have been originally used in the hands of a QOF or a QOZB and, therefore, would have to be substantially improved (i.e., doubling the cost of the building). Given the nature of QOZs, a significant portion of its real estate will be abandoned or under-utilized. Some of these buildings will not require significant enough renovation to meet the substantial improvement test and, therefore, will be passed-over for

redevelopment, leaving them vacant or significantly under-utilized. Permitting these properties to qualify as “original use” in the hands of a QOF or QOZB will address the core goal of the QOZ program – to spur economic development and job creation in distressed communities. One commenter proposed a regulation providing that the definition of “building” be limited to a completed structure that has received a certificate of occupancy, without which the structure will not have had a previous use. Thus, for structures without a certificate of occupancy, “original use” in the hands of the QOF or QOZB will begin upon the QOF’s or QOZB’s receipt of a certificate of occupancy.

Permitting QOF investors to avail themselves of the step-up election when the QOF sells assets

The Proposed Regulations suggest that the investor may only avail itself of the basis step-up when it sells its interest in the QOF. However, a critical goal of the Opportunity Zone program is to incentivize the investor’s long-term investment in QOFs, not the QOF’s stake in a portfolio of investments. This is the reason Congress specifically directed Treasury to provide adequate time for QOFs to reinvest capital returned to it from an underlying portfolio investment. Again, many of those commenting on behalf of the investment, development, and business communities stressed that this type of QOF-level activity should not disallow the tax benefits to the QOF’s investors, as long as they do not take distributions from the QOF or sell their QOF interest before meeting the 10-year holding period.

Permitting QOFs to reinvest interim gains without incurring penalties or triggering a taxable event

This is especially important for QOFs with diversified portfolios of assets. As aptly stated by Stefan Pryor, Rhode Island Secretary of Commerce, “Rules should allow funds to reinvest interim gains in a timely manner without incurring a penalty or triggering a taxable event. . . . Investors would be reluctant to commit to holding a stake in a single company for 10 years given all the forces that could intervene during that period. Investors should be able to divest from less-than-successful companies if they keep their capital at work in Opportunity Zones.”

Permitting QOFs/QOZBs to refinance and distribute proceeds to investors without investors losing the tax benefits

Commonly in real estate investments, after construction has been completed and the property stabilized, permanent financing is obtained and some portion of investor capital returned to investors. The Proposed Regulations are not clear how these distributions would be treated under the QOZ program. Current tax law exempts debt-financed returns of capital to the degree that a distribution does not exceed the investor’s basis in the entity. Commenters suggested that the final regulations recognize this and clarify that the same rule will apply with debt-financed returns of capital under the QOZ program.

Reasonable reporting requirements

All of those commenting on the QOZ program’s reporting requirement acknowledged its importance. Thus, the issue is not whether QOFs have the obligation to report, rather the scope of the obligation. The important focus in this regard should be reasonableness. In a January 2019 letter from 16 of the Congressional co-sponsors of the QOZ program, Treasury was urged to include reasonable reporting requirements in the final regulations, including QOF- and transaction-level information, so as to prevent waste, fraud, and abuse, and to ensure that the QOZ program’s incentives are delivering impact for communities. The letter also pointed out that making data publicly available will act to move capital off the sidelines, by connecting investors to QOFs and allowing community stakeholders to align local strategies and additional investments with QOF capital.

What's next?

At the Hearing, Scott Dinwiddie, IRS Associate Chief Counsel for Income Tax & Accounting, announced that IRS intends to release its second set of proposed regulations within the next month or so.

However, at a roundtable Waxman attended Thursday (2/21), Ohio Senator Rob Portman announced that the next set of IRS Opportunity Zone guidance is scheduled to be submitted to the OMB within the next week or so.

Hopefully, final regulations will follow shortly after. Stay tuned.

.....

For more information, please contact the author or any member of McGlinchey Stafford's [Real Estate Team](#).



David Waxman

(216) 378-4970

dwxman@mcglinchey.com

© 2019 McGlinchey Stafford PLLC. This alert is published by the law firm McGlinchey Stafford. It is not intended to provide legal advice or opinion. Such advice may only be given when related to specific fact situations that McGlinchey Stafford has accepted an engagement as counsel to address. Attorney advertising. No representation is made that the quality of legal services to be performed is greater than the quality of legal services performed by other attorneys.