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Opportunity Zones: The Good, The Bad And The Ugly

By **Kelly Frey** (January 29, 2019, 5:59 PM EST)

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Never have so many written so much about so little. The law of opportunity zones consists of (1) Section 13823 of the Tax Cuts and Jobs Act that enabled (2) a new section of the Internal Revenue Code — Section 1400Z — for which the Internal Revenue Servicecreated:

- A FAQ website;
- Less than 100 pages of proposed regulations — public hearings on the proposed regulations having been delayed from their original Jan. 10, 2019, date due to the government shutdown; and
- Some nominal guidance in regard to a couple of revenue rulings.

Despite this meager primary source material, thousands of pages of legal commentary on opportunity zones have been written.

Why?

The initial reason may simply be a "gold rush" mentality among money managers, accounting and consulting companies, and law firms. Opportunity zones were designed to tap a new pile of money: huge amounts of unrealized capital gains — the “gold,” which is estimated to be in the billions or trillions of dollars, depending upon the commentator — that can be invested in more than 8,700 census tracts — opportunity zones — that are spread across all 50 states over a limited time period in order to delay and/or avoid taxation on such gains.

But equally as likely is the fact that with little primary source-law available, numerous questions must be answered before the unrealized capital gains — and associated fund-management and legal fees — will begin to flow.

The Good: Opportunity Zone Advantages

Opportunity zones create tax relief opportunities for investors while providing revitalization to lower-income areas.

Using the opportunity zone structure, an investor can defer taxation on both initial capital gains invested in opportunity zones for five years and completely avoid any taxation on the gain from appreciated opportunity zone property into which the capital gains are invested. Additionally, if investors hold their opportunity zone investment long enough, they can eliminate taxation on 15 percent of the capital gain invested, with a minimum five-year holding period. There is no limit on the amount of capital gains that can be invested in opportunity zones, and there is an unlimited amount of capital appreciation in an opportunity zone investment that could be realized without any taxation on such gains/appreciation.

Opportunity zones are also ubiquitous. They make up over 12 percent of the poorer, less developed, higher unemployment census tracts in the United States, in which more than 35 million people live. The immediate effect of the opportunity zone legislation was to make properties in these specific census tracks more valuable/costly. And with the tax savings associated with opportunity zone investments, funding for improvement projects in these areas will have a competitive, economic advantage over funding comparable projects outside of opportunity zone that do not qualify for such tax savings. This encourages development in opportunity zone compared to non-opportunity zone projects, if all other variables are equal.

Additionally, many of the opportunity zones designated by the federal government or the governors of each state are adjacent to urban areas already involved in revitalization or infrastructure improvements, making the integration of these “poorer tracts” into their adjacent “wealthy” communities more likely.

The result should be, per the intent of the legislation, to incentivize private sources of capital to invest in improvements in geographic areas that have not yet participated in the post-2008 financial crisis revival — in other words, improving opportunity zone “main streets” that have yet to benefit from the economic boost enjoyed by Wall Street via injection of trillions of dollars into the economy by the Federal Reserve.

The Bad: Opportunity Zone Uncertainties

Investors like certainty, and with opportunity zones there is currently a high degree of uncertainty due to the lack of primary source materials, especially Internal Revenue Service guidance.

Specifically, while investors are interested in opportunity zones, we are left with what Captain Barbossa in "Pirates of the Caribbean: The Curse of the Black Pearl" referred to as “more what you’d call ‘guidelines’ than actual rules.”[1] Given that, one commentator has suggested only two options: “Fill in the missing gaps with educated guesses,” or “Wait for more guidance.”[2]

Pending such guidance, and accountants and lawyers being loath to “guess” in their opinions on specific deal structures, a host of comments on the proposed regulations issued by the IRS have requested clarification on the specifics of taxation with respect to opportunity zones and opportunity zone investments.

On Jan. 10, 2019, the American Bar Association Section of Taxation remitted 45 pages of such requests for clarification to the IRS, including such basic questions as:

- The type of gains that are eligible for favorable tax treatment under Section 1400Z;
- The end date of the step-up election under Section 1400Z-2(c);

- The determination of asset value for purposes of the 90 percent asset test;
- Safe harbors for working capital; and
- “Leased” versus “owned” property qualifications.[3]

Others have echoed such need for guidance, especially with respect to the actual businesses in opportunity zones, as opposed to the opportunity zone funds incentivized to finance these businesses.

Pending further guidance, the highest levels of certainty relate to investments in real estate and real estate redevelopment. So, for example, there is a high level of certainty that a simple multi-family residential or mixed-use commercial project located in an opportunity zone — where the opportunity zone business/fund purchases raw land, builds out improvements exclusively in the respective opportunity zone and obtains all of its income from the lease payments from such residential project — can be currently structured to claim the tax benefits of the new Section 1400Z. So perhaps these are the first types of opportunity zone projects, funds and businesses we will see.

In addition to the uncertainty related to Section 1400Z treatment, a clock is ticking that may mitigate against opportunity zone maximum utilization. Specifically, current guidance suggests that investors have only 180 days to reinvest capital gains into opportunity zone funds and/or businesses under Section 1400Z.

That short time window may have made sense during the longest bull market in U.S. history, where investors experienced an almost daily increase in the asset value of their equity — and resultant unrealized capital gains. However, December 2018 was one of the worst months in equity market history, during which some stock indices were down more than 20 percent, wiping out billions of dollars in the very unrealized capital gains targeted by the opportunity zone legislation. As more time passes, if prior unrecognized capital gains further erode due to market conditions, the 180-day rule will mitigate against the same volume of projects as originally anticipated during legislation enacted while the equity market was booming.

In parallel, deterioration of the “wealth effect” felt by many during the stock market run-up over the last 10 years seems to have cast a pall over the initial exuberance associated with opportunity zones.

Given this status, only opportunity zone projects that make solid economic sense may proceed — which from an economically rational perspective is as it should be, initial exuberance notwithstanding.

The Ugly: Opportunity Zone Problems

Any new legislation may create unintended consequences, which is certainly the case with opportunity zones — at least until further guidance or revision occurs. With respect to opportunity zone, the legislation and guidance created an opportunity for significant abuse by non-U.S. investors.

Specifically, taxes on capital gains recognizable to foreign investors are often reserved through withholding requirements — under Sections 1445 and 1446. However, if this gain is invested in an opportunity zone fund, the foreign investor could legally require a refund of any of the amount withheld — pending recognition only upon the sale of the investment in the opportunity zone fund or business, or the 2026 final recognition deadline — at which time, if structured properly, no withholding of the opportunity zone fund liquidation is required.

Similarly, if the foreign investor is a member of a partnership and the partnership converts what would be a taxable gain into anopportunity zone investment, neither the partnership, nor the foreign investor via any distribution of the partnership, will recognize that gain until the sale of the opportunity zone investment or the 2026 final recognition deadline, at which time, if structured properly, no withholding or tax would occur.

On a more practical level, without further guidance, some of the very types of businesses that would most benefit lower-income communities may be reluctant to move forward with opportunity zone activities. Specifically, opportunity zone regulations severely limit "working capital" reserves and have been focused on somewhat draconian requirements with respect to substantially all of an opportunity zone business' assets — the 90 percent or 70 percent rule, respectively, for opportunity zone funds versus opportunity zone businesses — and business activity being in the opportunity zone.

While regulations provide sufficient guidance with respect to the acquisition or rehabilitation of real estate, they currently make it very difficult if not impossible to structure the next generation businesses most localities covet: An opportunity zone start-up technology business, funded by venture capital (that mandates large cash reserves until ultimate deployment in salaries, etc.), whose primary assets are intangible intellectual property (not currently dealt with adequately in guidance), that may generate income from international licensing, rather than direct sales/income from within the opportunity zone and require relatively meager tangible personal or real property (the type of assets for which the clearest guidance exists).

Similarly, current opportunity zone regulations define qualifying opportunity zone property as "acquired … by purchase." As pointed out in the ABA tax section letter to the IRS, (a) "many businesses may be more efficiently formed with property leased …[than through property in which the business has] outright ownership" and (b) leased property must be rationally valued for the purposes of qualifying an opportunity zone business.[4]

The proper extension of the opportunity zone treatment to what are typically leased retail storefronts would more accurately reflect current business practices and provide the proper incentive for the migration into opportunity zone of retail establishments comparable to those that exist in more prosperous census tracts.

Lastly, opportunity zone development is plagued by the same social engineering issues as other geographically-based tax incentives. Regarding opportunity zone incentives, low-value property can be repurposed and improved to revitalize blighted areas, increasing the value and tax base for the larger community. But the associated gentrification of low-income areas subject to such geographical incentives can substantially displace lower-income residents, without creating viable economic alternatives.

This is a practical dilemma on the local level that is not addressed by the federal tax incentive, as there is no requirement in the opportunity zone legislation to generate any "social benefits" to those that live in the effected opportunity zone that is improved.[5]

Additionally, opportunity zone legislation does not address the needs for infrastructure attendant to any rapid improvement of opportunity zone tracts, leaving it up to local mandates to improve roads, utilities, etc. to keep pace with the private development that is incentivized.

Summary

The law of opportunity zones created an exceptional framework incentivizing the redeployment of untapped and untaxed paper gains from private investors to economically improve lower income census tracts. However, the lack of certainty with respect to how such capital must be deployed in order to qualify, coupled with significant penalties in the legislation for failure to qualify, resulted in a lag between the enabling legislation and any actual projects enabled by such legislation. That lag, when combined with deteriorating equity market conditions, threatens to dampen the beneficial effects of the legislation.

Pending further guidance, accounting and legal professionals are left to speculate as to the proper structure of deals other than real estate development projects — and local governments are left with managing the gentrification of opportunity zones and integration of these lower-income census tracts into the larger local economies.

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[1]

> First, your return to shore was not part of our negotiations nor our agreement so I must do nothing. And secondly, you must be a pirate for the pirate's code to apply and you're not. And thirdly, the code is more what you'd call 'guidelines' than actual rules. Welcome aboard the Black Pearl, Miss Turner!

[2] Forrest David Milder, “INSIGHT: A Dozen Things You Should Know About Setting Up an Opportunity Fund”, first published in Daily Tax Report, November 29, 2018.

[3] Jan. 10, 2019 letter of Eric Soloman, Chair ABA Section of Taxation to the Hon. Charles P. Rettig, Commissioner, Internal Revenue Service.

[4] Id, Section IV(A)(3).

[5] See generally, Ronald Fieldstone, Opportunity Zones: Whose 'Opportunity' Is It Really?, Law360, Jan. 3, 2019.