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Will the IRS Include Brownfields Properties in Its Opportunity Zone Regulations?

The Opportunity Zone tax incentives created by the federal Tax Cuts and Jobs Act of 2017 seemed to be a perfect opportunity to spur development of environmentally impaired properties, known as brownfields, in economically distressed communities. But the IRS draft regulations currently under consideration do not appear to allow for inclusion of brownfields in the program. That could mean, for lack of a better description, a real lost opportunity for many communities since brownfields often are in the very areas that the Opportunity Zone program is intended to benefit.

The tax law created Opportunity Zones, which now have been designated in all 50 states, the District of Columbia and five U.S. territories, to provide tax benefits to investors in the form of deferred tax on gains invested in a Qualified Opportunity Fund (QOF) until they sell or exchange the investment in the fund or December 31, 2026, whichever is earlier. Depending on how long the investment is held, up to 15 percent of deferred gain can be excluded. If held for more than 10 years, the investor will not be taxed on any gain from a sale or other disposition of the interest in the QOF. Many investors and economically distressed areas have been eager to take advantage of the program.

Not coincidentally, many Opportunity Zones have properties that could qualify for inclusion in the federal Environmental Protection Agency's (EPA) Brownfield Program, which has existed for a number of years to cleanup and reuse properties that sit idle due to environmental contamination. Although the Opportunity Zone provisions and the Brownfields program seem like a match made in investor-heaven, the EPA pointed out in comments on the IRS proposed regulations and guidance that brownfields may not fall within the definitions of property that qualifies for the incentives.

The statute requires that at least 90 percent of a QOF's assets be Qualified Opportunity Zone (QOZ) property, which ultimately requires direct or indirect ownership of "qualified opportunity zone business property." To be QOZ business property, the "original use" of the property must commence with the QOF or the QOF must make "substantial improvements" in the property within 30 months of acquisition. "Substantial improvements" generally means additions to the property's basis greater than the adjusted basis of the property at the beginning of the 30-month period.

For brownfields properties, the "original use" and the "substantial improvement" requirements are potentially problematic. A property is a brownfield in the first place because its former use(s) caused environmental contamination that render it uneconomical to redevelop without substantial remediation. Under the current "original use" test, this prior use of a former factory site requiring extensive remediation means that the "original use" cannot begin with the QOF. Further, in Rev. Rul. 2018-29, which provides guidance on the meaning of "substantial improvement," the IRS indicated that the substantial improvement rules do not apply to land. Even if the remediation qualified as "substantial improvements," they do not have much chance of completion in the 30-month window for "substantial improvement."

The EPA's comments to the IRS recommend defining "original use" to incorporate brownfields properties located in QOZ. Thus, if a brownfields remediation firm buys a contaminated property in a

QOZ with the intent to remediate the property and redevelop it for a new use, the EPA suggests that the brownfield status should qualify as the "original use." Similarly, the EPA recommended that the IRS treat the "original use" of property that has been vacant or underutilized for a year or more as commencing with the QOF, and allow foreclosed and tax-reverted properties held by local governments to be treated as "underutilized or abandoned" property. If adopted, this recommendation would allow the QOF to satisfy the 90 percent test during the remediation period.

The EPA also recommended that the IRS treat the environmental assessment, cleanup and other site preparation costs as expenses meeting the "substantial improvement" test. Rev. Rul 2018-29 appears to apply only to improvements to a building, which would leave out the critical improvements to the land necessary to make a brownfield ready for redevelopment. If adopted, this recommendation would resolve the potential ambiguity as to whether improvements to the land itself count towards the necessary investment to constitute a substantial improvement. Finally, the EPA recommended that IRS allow carryover of gains from QOF investments in brownfields properties to other QOF investments and stacking of QOF investments of brownfield properties.

The IRS held a public hearing last month after having to delay the hearing from January 2019 due to the government shutdown. The final version of the regulations are expected any time. It is, however, unclear whether the IRS will adopt any of these recommendations in its next iteration of the regulations. The IRS's clarification on this and other issues is time sensitive — the elimination of the 15 percent of capital gains invested in a QOF requires a seven-year holding period in the QOF. This means December 31, 2019, is the last day to make the investment to meet this holding period by the end of 2026, the year in which the deferred gain is recognized.

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