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Adviser: EPA Letter to IRS on Opportunity Zones Merits Attention

The Tax Cuts and Jobs Act of 2017 introduced the concept of Opportunity Zones (OZs) to promote long-term investment in qualifying areas. Since the law was passed, the IRS has designated some 8,700 Qualified Opportunity Zones (QOZs) across the United States, including many in key parts of the city of Cleveland.

The OZ program has garnered significant attention in the real estate community, both locally and nationwide, as it essentially allows for a) deferral of capital gains, upon reinvestment of gains in QOZ areas, until the earlier of the sale of the asset or Dec. 31, 2026; b) a partial exclusion (up to 15%) of original capital gains deferred, based on the term of ownership of the asset through 2026; and c) a 100% exclusion of capital gains through 2047 on further appreciation of qualified assets held for at least 10 years — sometimes referred to in the industry as the "juice." The juice provides enormous potential for tax savings of appreciated property.

The Treasury Department issued initial OZ program regulations on Oct. 19, 2018. The regulations provide a variety of parameters to qualify for favored tax treatment under the law, including deadlines for reinvestment of capital gains and deployment of funds. Among other things, the regulations and accompanying revenue ruling state, in effect, that as to real estate investments, either a) the investor must "substantially improve" the real estate, which may be done by doubling the tax basis of the building only, without regard to the value of the land; or b) the "original use" of the subject property must "commence" with the applicable investment.

In the context of "substantial improvements" to property, the land value is not counted. Based on the foregoing, the cost of environmental remediation of land would likely not be taken into account and the funds applied to remediation would not qualify for special treatment under the OZ program.

The "substantial improvement test and the "original use" test have garnered much comment and attention from industry and lobbying groups, as well as from inside the administration, in order to allow investors more direction and leeway in qualifying under the program.

Of perhaps greater interest, on Dec. 18, 2018, the U.S. EPA, through its Office of Brownfields and Land Revitalization (OBLR), issued a letter to the IRS asking for clarification of the above tests, primarily in the context of brownfields remediation. The purpose of the OBLR request is to spur redevelopment of brownfield and other underutilized sites by expanding the breadth and impact of the OZ program.

Specifically, the EPA submitted the following requests:

1. Allow remediation costs to be counted toward substantial improvements. The OBLR recommended that final IRS guidance should clarify that funds applied to environmental remediation (including assessment, cleanup and other site preparation costs) should qualify under the program and should be considered when evaluating the "substantial improvement" test under the regulations.

2. Allow deployment of funds over time. The OBLR asked the IRS to take into account the extended time period necessary for remediation projects and to allow for deployment of funds during the entire period of cleanup. Specifically, the EPA suggested the “stacking” of a 30-month window for cleanup, in addition to the 30-month window for vertical construction in the existing regulations.

3. Allow carryover of gains. The OBLR asked the IRS to enable gains realized from the sale of remediated property to be carried over into other QOZ property. This would allow an investor to complete remediation, sell the remediated property to a vertical developer and reap the ongoing benefits of the OZ program.

4. Allow brownfields cleanup to constitute “original use.” The OBLR also asked that the term “original use” be defined so it automatically applies to properties that are characterized as brownfield sites under the CERCLA. This would go a long way toward simplifying the analysis for investors as to whether the OZ program applies to a project.

5. Allow reuse of vacant, underutilized or land bank property to constitute “original use.” Beyond brownfields, the OBLR also recommended that the definition of “original use” should include property that is underutilized or vacant for a period of one year or more and property foreclosed upon and held by a local government or land bank. OBLR further suggested that the underutilized test may apply to the entire property or to “a portion thereof … which is used only at irregular periods or intermittently.” This would provide flexibility as to qualified redevelopment of partially shutdown facilities.

These recommendations, if adopted, would have important implications for real estate investors. For example, an investor could qualify under the program, under the original-use test, based on “underutilization” of the asset for at least one year. Also, an investor who purchases impacted properties and performs remediation and site preparation could take advantage of the program without conducting their own vertical or other redevelopment. Rather, the investor could complete sufficient remediation activities, sell the remediated property and reinvest the proceeds in other QOZ property, with a carryover of tax advantages. In addition, a redeveloper who performs both remediation and vertical development could count the remediation costs toward satisfying the “substantial improvement” test.

At this time, the real estate community awaits further IRS guidance, which has been delayed by the partial government shutdown. Many other important issues concerning the regulations persist. The final regulations will significantly alter the financial analysis of investment in sites located within OZ areas.

Crain’s Cleveland Business

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January 19, 2019 04:00 AM

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