DUVAL & STACHENFELD LLP

Opportunity Zones & the Government Shutdown

D&S Opportunity Zone Practice Group

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The government shutdown which began on December 22, 2018 is now the longest shutdown ever. Aside from essential employees, both the Treasury Department ("Treasury") and the IRS were closed as a result of the shutdown. The IRS has since announced that it will recall a significant portion of its workforce to process tax returns during the filing season, but Treasury remains mostly closed. One of the numerous effects of the shutdown is the delay of critical guidance on the Opportunity Zone program.

1. Effect of the Shutdown on Opportunity Zone Guidance

We will not wade into the political morass; however, for those of us keeping close tabs on the progress of guidance on the federal Opportunity Zone[1] program, the shutdown is having two significant effects:

First, a public hearing had been scheduled for January 10, 2019 to discuss the first round of proposed regulations which were issued on October 19, 2018 (the "October Proposed Regulations"). The regulatory process for new regulations involves the issuance by Treasury of regulations in proposed form (which happened back in October), with an invitation to submit written comments and to speak at a public hearing regarding the new guidance (which was supposed to happen last week on January 10th). Treasury then considers those comments before finalizing the regulations. As a result of the shutdown, the January 10th hearing was cancelled. A new hearing to discuss the October Proposed Regulations will not occur for at least two weeks after the government reopens.

Second, Treasury had been working on a second set of proposed regulations (the "Round 2 Proposed Regulations"), which were originally expected before the end of 2018, but by mid-December Treasury said the Round 2 Proposed Regulations would not be released until January 2019. Any progress on the Round 2 Proposed Regulations stopped abruptly on December 22, 2018 when the government shutdown began. Even once the government reopens and Treasury finishes drafting the Round 2 Proposed Regulations, Treasury will need to send the Round 2 Proposed Regulations to the Office of Information and Regulatory Affairs ("OIRA") for review. The October Proposed Regulations spent 36 days under review at OIRA before they were released, so do not expect a speedy issuance of the Round 2 Proposed Regulations even once the gridlock breaks in Washington DC.

While we wait out the shutdown, here are the D&S insights on Opportunity Zone guidance once the government reopens.

[1] For additional background on the Opportunity Zone program, our earlier white papers can be found here.

2. October Proposed Regulations

The October Proposed Regulations were eagerly awaited by the tax community and the real estate industry. Overall those regulations were taxpayer friendly, and they were helpful in clarifying many gating issues for investors interested in investing in a qualified opportunity fund ("QOF"). (Our October 2018 white paper about the October Proposed Regulations can be found here.) As to be expected though, the October Proposed Regulations raised a number of questions needing clarification, many of which were addressed in comment letters sent to Treasury. As of last week, Treasury had received 145 comment letters about the October Proposed Regulations. D&S attorneys contributed to comment letters submitted by the ABA Section of Taxation and the New York State Bar Association Tax Section.

Here are two of the big-ticket topics raised in many of the comment letters on the October Proposed Regulations:

a) The 31-Month Working Capital Safe Harbor

Many of the comment letters honed in on the seemingly arbitrary designation of 31 months as the permitted time period to spend cash contributed by a QOF and requested extensions for unforeseen delays or staged contributions. If Treasury truly wants to encourage participation in Opportunity Zone investments, they will hopefully find a way to weave in provisions that pick up the realities of a commercial real estate transaction.

b) Ramp Up Periods

The October Proposed Regulations (somewhat inexplicably) tied the qualification of an in-process development as good opportunity zone property to compliance with the 31-month working capital safe harbor, implying that projects need to be complete and operational within 31 months. This raises a significant problem for any project needing predevelopment, zoning changes, environmental clean-up, etc.

There was a fairly consistent response in the comment letters asking Treasury to delink these concepts or asking for a separate timetable to measure compliance with the requirement that opportunity zone property be actively used in a trade or business. This is perhaps the most critical issue of the October Proposed Regulations which needs clarification by Treasury, and without it, many of the large scale projects that could be done in Opportunity Zones are likely to be passed by simply because of timing considerations.

3. Round 2 Proposed Regulations

Treasury acknowledged that the October Proposed Regulations did not cover all of the open issues, and they promised that certain topics would be addressed in future guidance. In fact, after the Round 2 Proposed Regulations, a third set of regulations will supposedly be in the works as well.

Many of the comment letters submitted to Treasury touched on topics that were not expressly covered in the October Proposed Regulations. Treasury actually explicitly asked for input on such topics, so hopefully the Round 2 Proposed Regulations will be drafted with the benefit of taxpayer input. These are the areas where we expect additional guidance:

a) Structuring the Exit

The biggest tax benefit of the Opportunity Zone program is the 10-Year Rule, which permits investors to pay no tax on the appreciation in their QOF investment. However, the Internal Revenue Code (the "Code") requires that investors sell their equity in the QOF to claim the benefit of the 10-Year Rule. This has created significant structuring hurdles for anyone wanting to form a multi-asset commingled fund, since a sale of a single asset would be a taxable event for the QOF investors and an entity sale of a multi-asset QOF would require a buyer to purchase the entire portfolio by acquiring the QOF equity. (There is an exception for QOFs structured as REITs where asset sales are permitted under certain circumstances, but those nuances are beyond the scope of this update.)

If Treasury is going to be able to loosen up the entity sale requirement, they will have to find a way to interpret the language in the Code in a manner that is within their regulatory authority, so this is likely the trickiest area to navigate.

b) How to Treat Land

Treasury has yet to clarify how land will be treated under the QOF asset tests. This is a threshold issue for anyone doing a phased project, since vacant land on one part of a property has the potential to cause a QOF to flunk its tests even if the QOF is actively developing another part of the property. Treasury may come out with some sort of percentage test, requiring that a specific portion of land be developed. It is doubtful they will permit a tiny development on a huge area of land to satisfy the asset test (imagine a hot dog stand on a multi-acre site), so assume there will be some measurable guideline to address the treatment of land.

c) Refinancings

The distribution of refinancing proceeds has been a popular question, and it has generated a great number of comments. This issue is tied into the technical basis adjustments under the Opportunity Zone rules in the Code, which are too nuanced to go into here, but Treasury is going to need to clarify how the Opportunity Zone rules interact with many of the existing partnership tax rules (for purposes of sorting out the treatment of refinancing distributions, and many other issues). Partnership tax experts are taking different views on how to incorporate the Opportunity Zone rules into longstanding partnership tax law, so this is one to watch.

d) Original Use

A QOF has to meet either the original use test or the substantial improvement test in order for its property to qualify as a good asset. The October Proposed Regulations included some helpful clarity on the application of the substantial improvement test, but original use remains entirely undefined so far in QOF guidance. In the real estate context, many people have been asking whether original use has to be ground up development or whether other sorts of projects may qualify. This is a topic expected to be covered in the Round 2 Proposed Regulations.

e) And more…

Other issues sorely in need of clarification include (i) how the QOF rules will apply to operating businesses outside the real estate industry, (ii) the treatment of leases, (iii) how promotes and carried interest will be treated, (iv) whether the rules will be harmonized between single-tier QOF structures and two-tier structures where a QOF invests through a lower-tier partnership, (v) how a QOF can lose its certification as a QOF, (vi) whether the substantial improvement test can be applied on an aggregate basis to multiple assets, (vii) the reporting requirements for QOF investors, and more.

If you have specific questions on the Opportunity Zone program, especially for topics that we did not cover here, please reach out to us for additional information.

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The D&S Opportunity Zone Practice Group brings together a 50-person team, including lawyers, paralegals, and our business professionals providing a unique value add for clients. The OZ team is led by:

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