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The Wizard of OZ (that’s “Opportunity Zones”): Be My Valentine? - by Dan Flanigan

March 05, 2019 - Front Section

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Be My Valentine?

The Treasury hearing on the OZ Regulations, originally scheduled for January 10 but postponed due to the government shutdown, re-convened on Valentine's Day, attended by an overflow crowd, and proceeded for five hours (with a lunch break) of presentations with occasionally interesting questions and commentary by the six presiding IRS and Treasury officials 1.

Each speaker was allotted ten minutes, and almost all of them kept within that limit without having to be badgered by the unfailingly courteous bureaucrats in charge. Many speakers echoed each other in the issues they covered, but some interesting and more original points were made. Various speakers tried to focus the attention of the three G-women and three G-men at the front of the room to technical but important issues such as:

The need to specify how to value assets in a sensible way in measuring compliance with respect to the 70% and 90% tests and the “substantial improvement” requirement;
The need to remedy the awkwardness of having to sell stock or partnership interests rather than assets in order to qualify for OZ benefits; and
Bumper-car style collisions between the new OZ rules and long-standing partnership tax concepts like accelerated depreciation and complications caused by the zero-basis status of OZ investments including the timing of taking passive losses.

Active Conduct of Trade or Business “In The Zone”

But the most mentioned items were those larger policy issues covered in my previous columns. Not surprisingly, several speakers piggy-backed on the letter to Treasury discussed at length in my February 19 column from16 co-sponsors of the OZ legislation including senators Tim Scott and Cory Booker (co-sponsor letter). As in the co-sponsor letter, the issue of most urgent concern was that pesky addition by the October proposed regulation drafters of the phrase “in the zone” to the statutory direction that 50% of the gross income of a qualified OZ business must derive from the active conduct of a trade or business. More on that below.

Interim Gain

The other most frequently expressed concern was the “interim gain” issue, i.e. the need to be able to recycle investments (without an immediate recognition of gain and corresponding loss of the exemption) that are sold before the 10-year bell has rung. Several speakers effectively argued, often referring to the co-sponsor letter, that the intent of Congress was to encourage both operating businesses and multi-asset funds with a portfolio of diversified investments, which would be difficult to impossible without the ability to recycle.

Original Use, Investment Timing Grace Period For 2018 Gains

Some new (or at least not previously prominently publicized) ideas came forth. Stockton Williams of the National Council of State Housing Agencies (NCSHA) argued that “land or property” vacant for at least one year should be deemed to satisfy the original use requirement2. Jill Homan of Javelin 19 Investments reminded everyone of the confusion and uncertainty about the fundamental features of the program, confusion that did not even begin to be clarified until the October 2018 proposed regulations. Accordingly, she suggested that there should be a special grace period for individuals who realized gains during 2018, the first year of implementation of the OZ program, which would allow those investors until the end of June 2019 to invest (the same time period that partners in a partnership with a December 31, 2017 year-end now enjoy).

That 800-Pound Gentleman

Williams also called out that obese and excessively hirsute gentlemen in the room (and all the other OZ rooms everywhere). His name, starting with a “G,” is “Gentrification” (though I don’t believe that specific word was once mentioned in the entire hearing). Williams conveyed NCSHA’s wish that the Treasury require OZ Funds “whose activities result or may result in a loss of affordable housing to current lower income residents in an [OZ] [to] specify publicly the actions, they will take to try to mitigate that outcome.” But he proposed no particular penalty for failing to disclose, or inaccurately disclose, or fail to mitigate. More stringently, he also urged that the IRS regulations expressly prohibit “the intentional removal or conversion of existing affordable housing in an [OZ] unless new housing of comparable quality and affordability is provided in or near the zone with similar or basic better amenities.”

“All The Jobs Elsewhere?”

The active conduct of a trade or business “in the zone” issue produced the most interesting colloquy of the day—between Michael Novey of the Treasury Office of Tax Policy and Williams. Novey pointed out that some of the commenters on the issue “think that there should be no (emphasis added) geographic component to the 50% test, only a trade or business component.” Entire elimination of the geographic component, Novey went on to point out, would allow a company to install “its computer servers in the zone but no jobs, and if the balance of tangible property was such that it was all there in those servers but nobody was working there except perhaps an occasional repair visit…I’m talking about nothing but property in the zone and all the jobs elsewhere.”

To put it bluntly, this flummoxed the good-natured Williams who admitted that his non-response to Novey’s question “wasn’t so good.” But the cavalry came to the rescue later in the hearing in the form of Steve Glickman, the former CEO of the Economic Innovation Group, who vigorously countered any notion that there should be a geographic component to the gross income test: “The gross income test was never meant to apply to the zone in which the businesses were located. The reason for that is that the zone’s businesses are located, are by definition low-income, high-poverty, and thus for growth businesses to be successful, they would have to be able to sell all over the country and all over the world. There’s nothing in the statute that requires a tie to geography, and I believe that the additional regulatory language is a misread of congressional intent, and more importantly will sharply limit the ability to use this program to invest in high-growth business, in manufacturing, and others that were really the focus of this program from the beginning."

While Glickman and the authors of the co-sponsor letter seem to have the best of the argument on Congressional intent, there is obviously at least a rearguard within Treasury who believe, and seem to be making a fair point, that a geographical component to the gross income test is necessary to prevent abuse. Thus, we may see a version of "in the zone" disappear from the test itself but perhaps reappear in another more benign form in future anti-abuse provisions of the regulations.

Lots of Reasons to Stay Tuned…Billions of Reasons…Trillions?

Thanks to my colleague Debbie Klis of our Washington, D.C. office who agreed to stand in the long line and observe the hearing in order to provide her colleagues a "hot off the press" report.

1 As usual with these columns, this column assumes readers' knowledge of the basic OZ statutory provisions; for a summary of the basic provisions, see Polsinelli.com/intelligence/oz-ppt.

2 The IRS had asked in its October Proposed Regulations whether "some period of abandonment or under-utilization of tangible property [should] erase the property's history of prior use in the [OZ]?"

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