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The Wizard of OZ – (that's "Opportunity Zones") - by Dan Flanigan

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Opportunity Zones: What questions did the U.S. Treasury answer on October 19, 2018—Part 2

In Part 1, published in NYREJ on December 18th, I discussed certain important questions with respect to the Opportunity Zone (OZ) program that were answered, and answered quite favorably to taxpayers, by the U.S. Treasury in regulations and a ruling issued on October 19, 2018 (proposed regulations). In this Part 2, I discuss two more areas of initial uncertainty that the Treasury resolved in a favorable way for taxpayers but, even more importantly, in a way that also made it much more likely that the OZ program may actually achieve the policy goals behind it.1

The first area involves two related questions. Question: First, how much time will the investor have to invest capital gain proceeds after consummation of the transaction producing the gain? If the time period allowed were too short, it would potentially leave many understandably cautious investors on the sidelines or, conversely, encourage foolishly hasty investments that would only give the program a bad name.

Answer: 180 days, nearly a full six months from the date of the gain-producing transaction. But even better, if the gain is realized by a partnership, S corporation, or other pass-through entity, the entity itself has 180 days from the sale to make the investment. If the business does not do so, the individual partners, members, or sub-S shareholders have the option (severally, i.e. not requiring the joinder of others or gymnastics such as the "swap and drop" used sometimes in 1031 situations) of (i) the initial 180 days from the sale or (ii) 180 days after the end of the partnership's taxable year (December 31st for calendar year entities) in which the sale occurs to invest their respective shares of capital gain proceeds in an Qualified Opportunity Fund (QOF).

Second, once the partnership or individual investor injects its capital gain proceeds into a QOF, and the QOF invests in an opportunity zone business (OZB), those funds, which have now become "working capital," could be ineligible "nonqualified financial property," preventing the OZB from satisfying the law's requirement that no more than 5% of its property be nonqualified financial property.

Question: How long can the OZB take to fully deploy that working capital? The whole point of the program is to get capital moving into OZs, not just sitting on the sidelines, but there are prudential investment considerations and practical development and construction realities involved. The most obvious such situation is a ground-up development involving everything from purchase of the land,

to the often long and difficult process of obtaining rezoning and possibly obtaining other entitlements and incentives, and, ultimately, to construction of the improvements, all things that individually and in the aggregate can take a very long time. And of course an operating business can also take a considerable period of time to ramp up to a point that it would use all of its investors' capital contributions.

Answer: The proposed regulations establish a "safe harbor" of 31 months for an OZB to deploy the capital if there is 1.) a written plan to use the capital for the acquisition, construction, or substantial improvement of tangible property; 2.) a written schedule for spending the capital "consistent with the ordinary start-up of a trade or business" within 31 months of receipt; and 3.) the capital is actually used in a manner substantially consistent with the plan and schedule. And there is even more flexibility because the 31 months is merely a safe harbor; the actual rule is that an OZB is allowed to hold a "reasonable amount" of working capital, potentially allowing additional flexibility in appropriate circumstances.

What does "substantially all" mean? The OZ provisions were not designed solely to encourage real estate development. They were arguably primarily intended to spur the establishment of operating businesses in OZs, which could under the right circumstances produce spectacular tax-free returns for investors. Imagine, for example, using the capital gain from a sale of a property or business to establish a new start-up business in an OZ that becomes wildly successful, perhaps employing hundreds and helping to revitalize (not, we hope, merely gentrify or re-gentrify) a community and, after 10 years, the investors, through an IPO or other disposition, achieve a huge return on the original investment tax-free. However, the statute requires that "substantially all" assets of the OZB must be "qualified Opportunity Zone business property," which means, among other things, that the property must be located in the OZ itself. This requirement flows from an understandable policy goal of preventing a business from just establishing a mail-drop or tiny outpost in an OZ but locating the vital job-producing and community-enhancing assets and business outside of the OZ. But then how can such a business grow and prosper when the statute requires it to have "substantially all" of its assets penned up within the OZ?

Question: What does "substantially "all" mean in this context?2 It potentially suggests only slightly less than all, perhaps 90% or an even higher percentage. If interpreted so stringently, this could manacle the OZ business, stunting its ability to grow and thus preventing it from achieving the highest possible returns for the particular OZ community and the investors in the OZB.

Answer: The IRS made another market-friendly decision in determining that 70% would be deemed to be "substantially all," thus providing more room for the operating business to branch out and grow than a narrower interpretation would have allowed.3 While there is still much to flesh out in future regulations and revenue rulings, and it may turn out that even the fairly generous 70% rule is still too restrictive to achieve the goals of the OZ program, this aspect of the proposed regulations means, at least, that the OZ child's growth will not be unnecessarily stunted from infancy by unworkable rules.

The Treasury's resolutions of open issues discussed in this and in Part 1 were vital to keeping the OZ momentum going strong. But there are still many difficult unanswered questions. Additional

Treasury guidance is expected in January. The next column in this series will discuss some of the most important remaining questions the investment community hopes will be answered soon.

Much of this article is based on a Webinar recently presented by my colleagues in the OZ Practice Group at POLSINELLI, which can be accessed at polsinelli.com/intelligence/oz.

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As with Part 1, this article assumes readers' knowledge of the basic OZ statutory provisions; for a summary of the basic provisions, see polsinelli.com/intelligence/oz-ppt.

This is just one of many uses of the phrase "substantially all" in the statute, but this is the only instance where the Proposed Regulations ascribed a specific percentage or otherwise explicated the ambiguous phrase.

The hope is that Treasury will apply a similarly sophisticated approach in defining the concept in other contexts.