Bloomberg Tax

Tax Management
Real Estate Journal™

IRS Needs to Clarify Synergies Between Opportunity Zones and Brownfields

By Tom DeLawrence, Esq. and Lee Johnsey, Esq.[*]

INTRODUCTION

Tax benefits available under the opportunity zone program create an enticing incentive for investors interested in developing properties located in economically-depressed communities. This incentivized development, in turn, has the potential to revitalize communities that have long experienced economic stagnation. But as good as the opportunity zone program is, the language of the Tax Cuts and Jobs Act of 2017 (TCJA)that created it leaves a critical question unanswered: Can opportunity zone tax incentives apply to the environmental assessment and cleanup of brownfield sites? If so, the objectives of both national initiatives would be substantially furthered. The language of the TCJA that created the opportunity zone program is broad enough to suggest its tax incentives may be applicable to investments aimed at redeveloping brownfield sites situated within opportunity zones. However, clearer guidance from the Internal Revenue Service on this issue is necessary to facilitate investor confidence.

WHAT IS AN OPPORTUNITY ZONE?

Created under the TCJA, the opportunity zone program consists of a variety of tax benefits designed to incentivize investment in low-income communities. The program works as follows: Low-income communities in need of outside investment are nominated by states and certified as qualified opportunity zones by the Treasury Department. Taxpayers realizing capital gains can defer their tax obligations on those gains if they invest them within 180 days into a qualified opportunity fund (QOF)—a corporation or partnership that either directly does business in an opportunity zone or owns a qualifying interest in another corporation or partnership that does such business. If an investment is left in the QOF for five years, the taxpayer can exclude 10% of the original deferred gain. After another two years, the taxpayer can exclude an additional 5% of the original deferred gain. Finally, if the taxpayer keeps its investment in the QOF for a total of 10 years, it may sell the investment and exclude any gain resulting from the sale. The original gains can remain deferred until 2026 at the latest. This suite of tax benefits powerfully incentivizes investment in economically-depressed communities.

WHAT IS A BROWNFIELD?

A brownfield is any piece of real property where the expansion, redevelopment, or reuse of it may be complicated by the presence or potential presence of a hazardous substance, pollutant, or contaminant. Investors have traditionally been hesitant to invest in the redevelopment of brownfields because of the complicated regulatory schemes that govern them, unknown cleanup costs, and unquantifiable potential liabilities. As a result, brownfields often remain undeveloped for decades, contributing to public health concerns, blight, and economic stagnation. In recognition of these problems, Congress has made the redevelopment of brownfields a national priority and has authorized a variety of federal grants that can be used by investors to assess, clean up, and redevelop such properties.

Why Should Opportunity Zone Tax Incentives Apply to Brownfield Redevelopment?

The goals of the opportunity zone and brownfield programs overlap substantially. Brownfields exist dis-

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[*] Tom DeLawrence and Lee Johnsey are partners at Balch & Bingham LLP in Birmingham, Ala.

ISSN 8755-0628

proportionately in economically-depressed and low-income areas, including many communities that have been designated as qualified opportunity zones. Redevelopment of brownfields can thus be an important step in revitalizing opportunity zone communities. If the opportunity zone tax benefits can be realized by investors who assess and clean up potentially contaminated sites, the environmental goals of the brownfield program would be promoted as well. The enormous synergistic potential between these two programs underlies the need for greater clarity from the IRS as to whether opportunity zone tax incentives can be utilized in assessing and cleaning up brownfields. But despite the Environmental Protection Agency's urging in written comments to the IRS's proposed opportunity zone regulations, the tax agency has remained opaque on this issue.

WHAT IS THE LEGAL QUESTION?

The crux of the question comes down to the TCJA's definition of the term ''Qualified Opportunity Zone Business Property'' (QOZBP). The TCJA states that the opportunity zone tax incentives apply when a QOF owns or invests in a QOZBP, which is defined as any tangible property used in a trade or business if: (1) it was purchased by the QOF after Dec. 31, 2017; (2) the ''original use'' of the property commences with the QOF or the QOF ''substantially improves'' the property; and (3) substantially all of the use of the property is within the opportunity zone during the time the QOF holds it (IRC §1400Z-2(d)(2)(D)(i)). The upshot of this language is that the TCJA's valuable tax incentives can only apply to brownfield assessment and cleanup activities if those activities qualify as either the ''original use'' of the brownfield property or a ''substantial improvement'' thereto.

It is the IRS's current opinion that the ''original use'' of real property cannot commence with a QOF due to the permanence of land. However, a plain reading of the TCJA seems to suggest that a brownfield assessment or cleanup may qualify as a ''substantial improvement'' to the property. The TCJA states that ''substantial improvement'' has occurred if ''during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property . . . exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period.'' It would therefore seem that the ''substantial improvement'' requirement would be satisfied if, within a 30-month period, a QOF spends at least as much money assessing and/or cleaning up an opportunity zone brownfield site as it spent to purchase that site. Nevertheless, it will be difficult for investors to have confidence in this interpretation unless the IRS provides clarification.

CONCLUSION

The tax incentives created under the opportunity zone program already represent an ambitious and important step toward the revitalization of communities experiencing chronic economic stagnation. If these tax benefits can apply to the environmental assessment and cleanup of brownfield sites situated in economically-depressed areas, the goals of both the opportunity zone program and the brownfield program will be significantly furthered. Cooperative harmony between these two programs is a distinct possibility under the language of the TCJA. But greater clarity from the IRS is necessary to encourage confident investment.

ISSN 8755-0628