Opportunity Zone Regulations Favor Investor Flexibility Over Community Protection

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The Treasury Department’s latest proposed regulations on investments in opportunity zones (OZs) — low-income areas designated for special federal tax breaks — state that the program’s purpose is to “increase business activity and economic investment in qualified opportunity zones,” not to improve the economic well-being of those who live there. Indeed, the regulations make it easier for investors to take advantage of the OZ tax breaks but they don’t add any real protections for local residents.

Created as part of the 2017 tax law, the OZ program lets investors defer taxes that they would otherwise owe on capital gains (profits that they realize when selling, for example, stock), by “rolling” the amount of the gains into funds that invest in opportunity zones (OZ funds). In addition, if investors hold onto their interests in these OZ funds for a certain number of years, they can qualify for additional tax breaks — including a permanent capital gains tax exemption on all gains they realize on their OZ investments through 2047.

Previously, we warned that OZ tax benefits will flow to wealthy investors with no guarantee that the zones will help distressed communities, and we recommended that Treasury issue regulations to prevent them from becoming tax shelters. The proposed regulations do little to allay these concerns and, in fact, make it much easier for investors to claim the tax benefits even if they make only minimal new investments in the zones.

The law includes a provision to help encourage new business activity (as opposed to encouraging investors merely to shuffle their assets to secure new tax breaks), requiring a certain percentage of an OZ fund’s assets (like real estate and equipment) to be located within a zone and to be purchased in 2018 or later. Further, the fund must either use the assets for the first time in an OZ or “substantially improve” them (if the assets were already located in a zone). But the proposed regulations essentially and inexplicably eliminate this requirement for new business activity in several important circumstances:

- OZ funds can buy undeveloped land (that is, land without a building or other structure on it) without investing new capital to improve the land. They must use the land as part of a “business,” but this test is usually easy to satisfy. For example, an investor could buy unimproved land and run a parking lot business on the land as it rises in value. After ten years, the owner can sell the land to a developer tax free.

- Similarly, if an OZ fund buys a building that was vacant for at least five years, the fund doesn’t have to make any investments to rehabilitate the building. It could run a low-investment business on the property, such as leasing the building to a storage facility operator, and sell the building ten years later tax free.

- OZ funds can invest in businesses that lease property (rather than own it) and these businesses don’t need to make any improvements to the leased property. Indeed, a business that already operates in an OZ and owned its own building before the 2017 tax law could sell the building and lease it back from the buyer, and the building would help the fund qualify for tax breaks even though no new investment occurred.
In the cases described above, the OZs see minimal new business activity, but wealthy individuals and corporations that invest in them can still qualify for big tax breaks.

The proposed regulations add one rule that gives the IRS limited authority to combat abuse, but it’s vague and its enforcement is uncertain. Under this “anti-abuse” rule, the IRS may challenge any investment that it finds isn’t intended to increase investment or business activity in an OZ, which as we noted above is how the agency narrowly defines the “purpose” of the OZ program. But even for achieving this limited goal, the rule is extremely weak because it doesn’t specify the types of transactions that it will consider abusive, other than, perhaps, blatant land speculation. Further, the anti-abuse rule’s efficacy depends on a dramatically underfunded IRS to perform audits and other enforcement activities.

Treasury should reconsider its proposed regulations and use its regulatory authority to help prevent wealthy investors from using the OZ program as a massive capital gains tax shelter. Treasury, for instance, should bolster the proposed regulations’ vague anti-abuse rule by outlining specific examples of abusive transactions, which should not be limited to outright land speculation. Additionally, with few protections in the law or the proposed regulations to ensure that OZ tax breaks will benefit low-income workers and residents of the zones, Congress must exercise its oversight authority to carefully consider how the program is working, who really benefits, and how to prevent widespread tax avoidance — and it should make appropriate adjustments to the law based on the findings.