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How Substantial Is My Substantial Improvement?

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The creation of the "opportunity zone provisions"—i.e., IRC §1400Z, through the passage of the Tax Cuts and Jobs Act of 2017, was widely received by industry pundits, professionals and even most laymen as being the biggest thing in real estate since the passage of the so-called "1031 transaction" rules. In a nutshell, the Opportunity Zone provisions serve as an incentive for taxpayer investment in low-income neighborhoods designated as "qualified opportunity zones" (QOZ) by combining the benefits of both tax deferral and permanent tax elimination. However, as most industry professionals quickly learned, the QOZ rules were difficult to understand and raised a number of hair-raising issues and questions.

To address these concerns, the U.S. Treasury has released two separate sets of proposed regulations over the last 12 months to address certain threshold issues associated with acquisitions of real property located in a QOZ (the "proposed regulations"). To be sure, the proposed regulations have done a good job addressing many of the statute's significant concerns. However, there remain numerous potential traps for the unwary.

In this article we focus on one of the principal requirements of the opportunity zone provisions—namely, that previously used tangible assets must be *substantially improved* and that, in order to do so, the property owner must double its initial cost basis in such property.

While this "double your basis" requirement seems simple in concept at first glance, as discussed in more

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detail below, the rule raises a number of interpretive questions in its practical application.

Overview of QOF

By way of background, under the opportunity zone provisions, taxpayers investing capital gains in a "qualified opportunity fund" (the "QOF") have the opportunity to enjoy three tax benefits: tax deferral on the capital gain invested in the QOF, partial reduction of that tax, and elimination of the tax on any appreciation in the QOF investment. To receive these benefits, the QOF must be a corporation or partnership organized for the purpose of investing in "qualified opportunity zone property" ("qualified property") and at least 90 percent of the QOF's assets must be qualified property.

Qualified property means either certain tangible property held directly by the QOF, "qualified opportunity zone stock" or "qualified opportunity zone partnership interest." The stock or interest must be acquired by the QOF after Dec. 31, 2017, at original issue and solely in exchange for cash. At the time the stock or interest is issued, the entity must be a "qualified opportunity zone business" ("qualified business"). The entity must remain a qualified business for substantially all of the time the QOF holds the stock or interest.

In order to be a qualified business, at least 70 percent of an entity's tangible property must be (1) purchased by the entity after Dec. 31, 2017, (2) the original use of the property in a "qualified opportunity zone" starts with the entity, or the entity substantially improves the property, and (3) substantially all of the use of the property was in a "qualified opportunity zone" during substantially all of the time the entity holds the property.

Substantial Improvement

Qualified property will be treated as substantially improved by a qualified business only if during any 30-month period beginning after the date of the property's acquisition its basis is increased by an amount exceeding its initial cost basis. Although the rules seems simple enough to understand, there are a number of interpretive questions that must be carefully analyzed to apply the rule practically in the real world.

> Qualified opportunity funds and qualified businesses must be mindful of the cost basis analysis applicable to any property they intend to substantially improve under the opportunity zone provisions.

At the outset, the property owner must determine what property is subject to the requirement of substantial improvement. In this regard, the U.S. Treasury has provided guidance clarifying that the price paid for land is excluded for purposes of determining whether substantial improvement occurs with respect to real property. Thus, by way of example, if a qualified business acquires a parcel of real estate, which includes land with a value of $60,000 and a building with a value of $40,000, to substantially improve this property, the taxpayer would be required to make $40,000 of improvement to the building.

But how does one bifurcate between the basis of the land and the building in the practical world? The reality of most real estate transactions is that there is no purchase price allocation between land and real estate improvements. As a result, because there is no specific guidance on how to allocate basis, a property owner must utilize a consistent and reasonable approach to determine its basis for purposes of the substantial improvement test.

A further complexity arises because, under the current proposed regulations, the determination of substantial improvement is made on an asset-by-asset basis. Thus, it is important to specifically identify the various assets acquired as part of a transaction and allocate basis across such assets reasonably. In a complex acquisition in the world of today's complex real estate transactions in cities such as New York, this may require breaking down basis between land, building, personal property, air rights, and various other forms of tangible property.

What is the actual initial cost basis of the property? Separately, the property owner must determine the aggregate initial cost basis of the property to be substantially improved. This step is critical because each dollar of initial basis represents an additional dollar of capital expenditure necessary to substantially improve the property. For example, which closing costs are required to be included in the cost basis of the property and which are not? It goes without saying that a qualified business would be wise to minimize its initial cost basis to the extent possible; but when and where such liberties can be taken may not always be so clear.

Generally speaking, expenses such as appraisal fees, title insurance premiums, legal fees and similar closing costs are capitalized into the initial cost basis of real property. On the other hand, debt related expenses incurred in connection with the acquisition of a property could be excludable under certain circumstances.

What expenses count towards substantial improvement? Under the Tax Code, certain expenses, such as acquisition, production, and improvement expenses, must be capitalized, while other expenses, such as property taxes and interest, may be immediately deductible (and therefore would not be included in the property's basis). However, taxpayers are allowed to elect on an annual basis to capitalize various carrying costs that would otherwise be currently deductible. These costs include real estate taxes, interest charged on debt incurred to acquire or improve property, insurance premiums, and many other traditional "soft costs." Somewhat counter-intuitively, because of the "double your basis requirement," a qualified business may actually be incentivized to capitalize expenditures that would otherwise be currently deductible so that such expenditures can count for purposes of satisfying the rule. In other cases, a qualified business may feel compelled to capitalize expenditures because it doesn't have enough information at the relevant time to determine whether it will have other expenditures available to capitalize during the 30-month period during which the "double your basis" rule must be satisfied.

But even where a taxpayer is certain about whether or not it seeks to capitalize a particular cost, the determination of which soft costs are included, and which are not, is often somewhat of a judgment call. For example, can tenant improvements that are made for the benefit of a tenant under a lease be capital expenses of the property owner? Because the test for substantial improvement is focused solely on comparing the basis of the property in the qualified business's *hands* to the initial cost basis, as opposed to focusing on the person who incurs the expenditure, expenditures that come in the form of tenant improvements may in some cases be eligible and, in other cases, not.

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An additional complexity arises because a qualified business must be able to determine that each applicable capital expense is reasonably related to the applicable asset it is improving since, as stated above, the substantial improvement test is performed on an asset-by-asset basis. For example, a taxpayer could add a fountain installation to the front driveway area of a building. This fountain could be viewed as a unique asset or alternatively as an improvement to the building. Thus, taxpayers must consider the each improvement separately to ensure that the substantial improvement requirement can be met with respect to such improvement.

Conclusion

QOFs and qualified businesses must be mindful of the cost basis analysis applicable to any property they intend to substantially improve under the opportunity zone provisions. Indeed, while the ability to capitalize otherwise deductible expenses may lessen the burden of substantial improvement and may ultimately lead to a trade-off that comes at the cost of current deductions, the analysis of determining how and whether an asset has been substantially improved is not as simple as meets the eye and requires careful consideration.