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Opportunity Zone Investors Get Creative to Beat Tax Perk Deadline

By Lydia O'Neal Jul 24, 2019

- • Opportunity zone investors must more than double value of property in 30 months
- • Land doesn’t need to be ‘substantially improved’

Opportunity zone investors are struggling with a requirement many say is bordering on outlandish—that they more than double the value of the building in which they invest in two and a half years.

One solution that plenty are considering, and suggesting to their advisers, is to find ways to lower that starting value on paper.

And while the advisers stress that unethical fudging of property valuations is an easy way to lose out on the tax breaks and possibly face some penalties in the process, others acknowledge that it isn’t hard to get a fully legal smorgasbord of appraisal values from which investors can take their pick.

“There’s this joke—you can talk to a valuation person and you say, ‘How much is it?’ and they say, ‘How much do you want it to be?’” said Glenn Dance, a former IRS official and now a tax partner at Holthouse Carlin & Van Trigt LLP in Orange County, Calif. “It’s this cottage industry—every firm’s got them.”

Investors in opportunity zones—8,766 mostly low-income U.S. census tracts reserved for capital gains tax breaks under tax code Section 1400Z-2—created by the 2017 tax law are considering shifting the value of the overall property to the land rather than the buildings. Proposed rules the IRS issued in October (REG-115420-18) state that they don’t have to “substantially improve” the land.

They do, however, have to “substantially improve” the building, or buildings, by investing an amount greater than the purchase price into the structure’s upgrade within a span of 30 months—which tax professionals refer to as more than doubling the property’s basis. Some see skewing the value toward the land as a way to make that deadline a little more viable.

“It’s a very high bar, to be sure,” Michael Novogradac, managing partner of Novogradac & Co. LLP, said of the deadline.

He said his firm is urging clients to be conservative, given the steep consequences of a misstep.

“You could be marching along for 10 years thinking you have this benefit, and then you don’t. Am I falling off the cliff or not? There’s no in-between,” he said.

The law granted investors who plug their profits from stocks and other assets into developments in the zones a tax deferral on those profits until the end of 2026, and they can shield some of the gains from tax if they hold the investment for at least five years. If an investor holds it for a decade, any appreciation of the underlying project is tax-free.

Audit Risk

Historically, the Internal Revenue Service has policed the reverse—real estate investors trying to bump up the value of the building to reap greater depreciation deductions, in which businesses write off the cost of assets

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they buy over a number of years. And the agency hasn't exactly cracked down on the practice, tax professionals said.

"They haven't seemed willing to put a stake in the ground for traditional depreciable assets and depreciation manipulation, so I don't see why they'd do the same with opportunity zones," said Troy Merkel, a partner and real estate senior analyst at RSM US LLP in Boston. "I very rarely see it come up as the impetus for an IRS audit. It may come up as something that's uncovered during a traditional audit, but I haven't seen it be a priority for the IRS in the past."

Property appraisers have their own ethical strictures, but unless the investors are getting a bank loan for the purchase or are unfamiliar with the area, astute buyers typically won't get an appraisal, said William Wilson, a member of the American Society of Appraisers who owns a Knoxville, Tenn.-based appraisal company. Firms specializing in real estate also tend to have in-house appraisers.

"Bookkeeping-wise, I think they can basically do whatever they want to," he said, cautioning that ethical appraisers must report facts, however unpopular those facts may be to their clients.

'Low-Hanging Fruit'

Some point to the IRS's focus on abuses of tax-advantaged land preservation deals—known as syndicated conservation easements, for which multiple individuals claim a charitable deduction under Section 170(h)—as a signal that the agency might crack down on land valuation gaming. The Senate is investigating conservation easements as well.

Steve Glickman, one of the creators of the opportunity zone incentives and who now runs Develop LLC, an advisory firm for investors leveraging the tax breaks, said the IRS's familiarity with traditional land valuation abuses heightens the risk that bad actors will raise red flags to IRS auditors.

"If you're doing that, you're running a really risky strategy," he said. "I think it's really low-hanging fruit to get caught in an audit."

He and others conceded, however, that the agency has for years faced steep cuts to its resources. Its number of full-time employees dropped by more than a quarter over the past two decades, and its budget has fallen by more than $2 billion since 2010.

Firms can get a range of valuations based on accepted methodologies, but what is reasonable when it comes to property valuations is subjective, tax professionals said. The new tax incentives have also attracted a multifarious crowd of investors, some of whom aren't wholly familiar with tax law and the workings of the IRS.

"I do have some concern that there may be entrants in this program who are not going to take the level of care that is necessary," said Dan Cullen, a partner at Baker McKenzie LLP in Chicago, adding that this serves as all the more reason for the IRS to steer clear of overly complex rulemaking. "I'm hopeful that the qualified opportunity zone industry will not go down a path that will produce regrettable enforcement consequences," Cullen said.

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