Ding Dong, the OZ Ground Lease (May Be) Dead!

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10.11.2021

As a practitioner who regularly advises clients on qualified opportunity zone (OZ) matters, I have spent the bulk of the past three years discussing ground lease structures. Developer clients initially cringed at the notion, but capitulated as we discussed the lack of clarity in OZ guidance and the risk of investor disqualification. A recent IRS clarification, however, may negate the need for ground leases in many, if not most, of the scenarios previously necessitating them. This should be welcome news for real estate developers transacting in the land of OZ, especially given that the 10% tax forgiveness deadline for OZ investments looms in the not-so-distant future.

Most OZ transactions utilize the ?indirect? structure, whereby a qualified opportunity fund (QOF) invests in a subsidiary entity meeting the requirements of a qualified opportunity zone business (OZB). Of the many requirements that an OZB must satisfy, typically the most challenging is that 70% of its tangible property (both real and personal) must be qualified opportunity zone business property (OZBP). OZBP must be acquired after December 31, 2017 by purchase from an unrelated party, with relatedness determined based on a threshold of 20% cross ownership between the buyer and the seller. In my experience, these OZBP requirements left many developers looking for other structuring options, and, in nearly all cases, those alternative structures involved ground leases.

The OZ rules also permit leased tangible property to qualify as OZBP so long as the lease commences after December 31, 2017. Unlike purchased OZBP, however, leased OZBP is not subject to any related-party limitations. Consequently, ground leases arose as a ?fix? for transactions with troublesome property, such as pre-2018 property, related-party property or contributed property. In a typical transaction, the property owner enters into a long-term ground lease of land to an OZB. The OZB, which may or may not be related to the landowner, constructs and owns the improvements on the property, maintaining an option to buy the underlying land for its fair market value once the improvements meet or exceed the 70% OZBP requirement.

While these ground lease transaction structures work, they are needlessly cumbersome for basic real estate projects. Developers alter their deal economics to account for ground rent payable to landowners

and struggle to get lenders to understand the transaction. When financing options become available, they often require cross collateralization of both the leased ground and the building improvements, leading to an increase in rent payable to the ground lessors to compensate them for the risk. When buyout options are finally exercisable, developers often need a fresh cash infusion for the acquisition and a third-party valuation of the land to avoid OZ issues. In my experience, the hassle of the ground lease has been enough to cause many developers to walk away from potential OZ projects.

After hearing the collective cries of developers (and their OZ tax advisors), the IRS issued a potential solution in the form of regulatory corrections, 86 FR 42716 and 86 FR 42715 (the Corrections). The Corrections operate through the working capital safe harbor applicable to OZBs. Under final regulations issued by the IRS, the safe harbor provides that an OZB?s working capital assets are excluded from the definition of ?nonqualified financial property? and treated as ?reasonable in amount? if the OZB (i) has a written plan for its deployment of the working capital assets in developing an OZ trade or business, (ii) has a written schedule to deploy such capital over a 31-month period and (iii) follows through with its plan and schedule in a ?substantially consistent? manner. Absent the Corrections, it was unclear how the IRS would treat nonqualifying OZ property during the 31-month safe harbor period, and, thus, ground leases served as a cautionary measure to avoid disqualification.

Now, however, many developers should be able to rely on the Corrections and avoid the addition of a ground lease in their OZ structures. The Corrections provide that tangible property can be treated as OZBP for purposes of the 70% test if an OZB (i) has a safe harbor plan that designates working capital to be spent in the development of tangible property and (ii) expects that tangible property to meet the OZBP requirements following the expenditure of such funds. More importantly for these purposes, though, the Corrections call for the complete suspension of the 70% OZBP asset test during the working capital safe harbor period for certain ?start-up businesses.? While the Corrections do not define ?start-up business,? it presumably should include a new OZB developing new or improved OZBP.

Applying the Corrections to a hypothetical scenario, assume a developer transacts with a landowner for the contribution of its property to a new OZB that will construct and develop property in an OZ. In exchange for its contribution, the landowner will receive a 25% ownership interest in the OZB. To fund the project, the developer intends to seek additional equity from a QOF. Prior to the issuance of the Corrections, this transaction would have been problematic for OZ purposes due to both the contribution of the land and the relatedness of the landowner and the OZB. At least initially, the nonqualifying land would have been the primary tangible asset of the OZB, potentially resulting in a noncompliant OZ project. Following the issuance of the Corrections, though, the parties should be able to proceed with the contribution and suspend the application of the 70% OZBP asset test so long as the OZB places the developed property in service and satisfies the 70% OZBP test by the end of the working capital safe harbor period.

This seemingly minor clarification is likely to have a big impact on the OZ real estate community. It should simplify transactions and make compliance reporting easier for developers and their advisors during construction. Nevertheless, while the Corrections provide a solution for many OZ challenges, there still may be those projects that require the insertion of a ground lease; namely, those where the improvement value is unlikely to meet or exceed the 70% OZBP asset threshold when placed in

service. In those (hopefully) rare cases, I and my fellow OZ practitioners can dust off our ground lease structure charts and prepare ourselves for the inevitable OZ deal frustration.

For further information on these extensions and other OZ matters, please contact us.

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