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Primer on Qualified Opportunity Zones

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By

ADAM S. WALLWORK

LINDA B. SCHAKEL

Adam S. Wallwork and Linda B. Schakel are attorneys in the tax and public finance groups at Ballard Spahr LLP.

In this report, Wallwork and Schakel describe the nomination and designation process for qualified opportunity zones (QOZs) and how investors can profit from investments held in QOZ businesses held by qualified opportunity funds. They also discuss the mechanics of gain exclusion under the QOZ provisions.

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I. Introduction

A new community revitalization program added by the Tax Cuts and Jobs Act (P.L. 115-97) has drawn attention from large companies, banks, community development authorities, governors, and mayors across America.[1] The new tax law allows states, the District of Columbia, U.S. possessions, and Puerto Rico (collectively "states") to designate qualified opportunity zones (QOZs) to encourage new capital investment in low-income census tracts by allowing taxpayers to temporarily defer the inclusion of eligible gain in gross income.[2] To encourage long-term investments in opportunity zones, investors in self-certified opportunity zone funds may partially exclude from gross income a portion of their gains reinvested in the fund after holding the investment for at least five years, and they may permanently exclude post-acquisition appreciation in the investment after 10 years.[3] Through their "CEOs" (governors, or mayor in the case of the District of Columbia), states may nominate a limited number of low-income communities (LICs) and non-LIC contiguous tracts for designation as QOZs.[4]

The states' sole formal role is in the nomination process.[5] The initial nomination deadline was March 21; however, states could request and receive a 30-day extension, through April 20.[6] From the time it received a state's nomination, Treasury has 30 days in which to designate the nominated tracts as QOZs, unless the state requests and receives a 30-day extension of Treasury's designation period.[7] Each QOZ exists from the date it is designated by Treasury until the December 31 on or after the 10th anniversary of its designation.[8] Because all QOZs that have not already been designated must be designated no later than June 18, they must terminate no later than December 31, 2028.

As many as 8,762 opportunity zones may be designated under new section 1400Z-1 and, as of April 18, more than 55 percent of the maximum number of QOZs nationwide (4,831 total census tracts) had been designated by Treasury in accordance with nominations by 20 states, the Virgin Islands, American Samoa, the Northern Mariana Islands, and Puerto Rico.[9] These include 4,732 LIC census tracts and 99 non-LIC contiguous tracts.[10]

The QOZ tax incentives are designed to encourage investors to redirect gain from prior investments into investments in low-income census tracts. Under the program, taxpayers can defer — and in some cases permanently exclude — qualified gains by reinvesting them in a qualified opportunity (QO) fund that directly invests in QOZs.[11] To qualify, a taxpayer must reinvest gain from an asset's pre-2027 sale or exchange into a QO fund within 180 days of the date of that sale or exchange.[12]

Taxpayers must make an election under section 1400Z-2(a)(1)(A) for the tax year in which the asset was sold or exchanged to exclude the gain from gross income in that year. Although Treasury has not yet provided guidance on how to make that deferral election, taxpayers who sell assets less than 180 days before the due date of their tax returns under section 6072 (generally March 15 for partnerships and S corporations and April 15 for individuals and C corporations) may need to elect deferral before reinvesting their cash in a QO fund.[13]

A QO fund is any entity treated for federal income tax purposes as a corporation or a partnership[14] that (1) is organized to invest in QOZ property, (2) holds at least 90 percent of its assets in that property, and (3) has been certified as a QO fund.[15]

Sen. Tim Scott, R-S.C., a lead sponsor of the opportunity zone program, conceived of QO funds as a new way for groups of investors across America to pool resources and risks by investing collectively in QOZ property.[16] The QO fund must invest at least 90 percent of its assets in QOZ property.[17] QOZ property consists of any QOZ stock, QOZ partnership interest, or QOZ business property.[18]

To encourage new investment in the QOZ, the stock or partnership interest acquired by the QO fund must be newly issued by, and acquired solely for cash from, a domestic partnership or corporation after 2017.[19] Further, when the QO fund acquires its partnership interest or stock, the partnership or corporation must be operating a trade or business in the QOZ (or, for a newly formed entity, must be organized to be a QOZ business) and must operate as a QOZ business for substantially all of the QO fund's holding period for the partnership interest or stock.

Similarly, QOZ business property is newly constructed or substantially improved tangible business property acquired by the QO fund after 2017 and used by the QO fund in a business operating in the zone for substantially all the time the QO fund holds the property. For this purpose, property is substantially improved only if capital expenditures on the property within 30 months of its acquisition equal or exceed the property's purchase price.[20] That 30-month period for substantially improving used QOZ business property is six months longer than the comparable period for improving District of Columbia enterprise zone (D.C. zone) and renewal community assets.[21] Also, unlike D.C. enterprise zone and renewal community assets, substantial improvement of QOZ business property does not require a minimum $5,000 expenditure on the property, which makes it easier for equipment to be QOZ property than D.C. zone assets or qualified community assets.[22] These concepts are discussed in more detail later.

The QOZ program offers three incentives for taxpayers who timely roll over their capital gain from a sale or exchange of property into an investment in a QO fund. Although nothing in section 1400Z limits benefits to taxpayers who roll over capital gains of non-zone assets, that limitation does appear in the Joint Committee on Taxation's description of the proposal, so for this report, we assume conservatively that only those taxpayers will be allowed to realize benefits under section 1400Z-2.[23]

Section 1400Z-2(a)(1)(A) defers taxation of an electing investor's qualifying gain until the earlier of (1) the date on which the taxpayer disposes of the investment in the QO fund or (2) December 31, 2026. Taxpayers who roll over 2017 gains (within 180 days) into a QO fund could defer taxation for more than eight years under this provision.

Under the second incentive, taxpayers receive two basis increases — on the fifth and seventh anniversaries of their investment in the QO fund.[24] Those provisions authorize long-term investors in a

QO fund to permanently exclude from gross income as much as 15 percent of their originally deferred gain that is rolled over into that fund.

As the third incentive, taxpayers who hold their QO fund investments for at least 10 years before selling them may exclude any gain attributable to appreciation in the fund's investments.[25]

Congress has drafted a uniquely confusing timeline under sections 1400Z-1 and 1400Z-2 that makes no attempt to harmonize holding periods with various deadlines set by statute. Opportunity zone designations are scheduled to expire after December 31, 2028, but the temporary deferral period ends two years earlier, on December 31, 2026. Also, after December 31, 2026, no property sold or exchanged by a taxpayer will be eligible for deferral or exclusion from gross income under section 1400Z-2.[26]

In February 2017 Scott introduced the bipartisan Investing in Opportunity Act (S. 293), on which sections 1400Z-1 and 1400Z-2 are based. The bill had a deemed sale feature, which provided that "any qualified opportunity zone property that has not been sold or exchanged on or before December 31, 2026, shall be treated as sold on December 31, 2026."[27] The mechanism of a deemed sale generally requires taxpayers to recognize all appreciation in the asset sold on the date of sale. In the version that was debated and passed by Congress, there is no deemed sale on December 31, 2026, although the amount of gain rolled over by the taxpayer into the QO fund is recognized on that date. Section 1400Z-2(c)'s 10-year holding period for permanent exclusion is described in the TCJA conference report as applying to the taxpayer's "post-acquisition" gains,[28] so that taxpayers would only recognize gain rolled over into the QO fund on December 31, 2026, and could avoid taxation on additional appreciation in the investment after holding it for 10 years. However, the statute is ambiguous and must be clarified.

We have assumed, based on the legislative history of section 1400Z-2, that taxpayers who hold an investment in a QO fund for 10 years will be able to permanently exclude post-acquisition gains in their investments for holding periods that extend beyond 2026, because otherwise, what the conference report describes as "the second main tax incentive in the bill" makes no sense. In more carefully constructed capital gain relief programs for the D.C. enterprise zone and renewal communities (each of which required a five-year holding period), Congress expressly provided that the termination of the designation of D.C. zones and renewal communities would not prevent taxpayers from satisfying the five-year holding period that allowed a tax-free disposition of qualifying assets.[29] Although such a provision is not included in section 1400Z-2, we believe Congress intended for taxpayers to benefit from permanent exclusion of post-acquisition gains for investments in QO funds held for 10 years, even if that 10-year holding period extends beyond December 31, 2028. Otherwise, this incentive would be unavailable for any taxpayer who invests in a QO fund after 2018.

We recognize, however, that this interpretation renders the QOZ designation period largely meaningless, because it ignores the termination of the zone for this purpose and is inconsistent with

language requiring that QOZ business property held by a QO fund be "in the qualified opportunity zone" at a time that zone does not exist.[30] We anticipate that although the statute is ambiguous, IRS guidance will clarify that an electing investor who rolls over investment gains into a QO fund on January 1, 2019, for instance, and holds that investment for 10 years ending on January 1, 2029, will still be eligible to exclude from gross income gains from a later sale of that investment even though the termination of the QOZ designation period might be read to terminate the QO fund. However, guidance is necessary to clarify that this benefit is available to taxpayers who invest in QO funds after 2018.

Based on the foregoing, we expect that if a taxpayer realizes a $1 million capital gain from the sale of common shares in a public company, PublicCo, on January 1, 2018, and properly elects to defer that gain by purchasing a $1 million interest in a QO fund by June 29, 2018, a sale of the taxpayer's fund investment for $2 million on June 29, 2028, should yield the following results (making reasonable assumptions to make each incentive work):

- only $850,000 of the taxpayer's $1 million of rollover gain is recognized on December 31, 2026 (the last day of the temporary deferral period), because the taxpayer's basis in the QO fund investment increased to $100,000 after five years and to $150,000 after seven years;
- the taxpayer's basis in the investment increased to $1 million after December 31, 2026 (equal to the $850,000 of gain recognized plus $150,000 of increased basis after a seven-year holding period); and
- the taxpayer would recognize no capital gain from the $2 million sale of the QO fund interest on June 29, 2028, because the taxpayer held the investment for 10 years after acquiring it, so the $1 million of post-acquisition appreciation exceeding the taxpayer's $1 million after December 31, 2026, is excluded from gross income.

Thus, the taxpayer's capital gain is reduced by 42.5 percent to $850,000 from $2 million and is not taxed until 2026, which is eight years after the taxpayer would have otherwise recognized a $1 million gain from the sale of PublicCo stock. On a present-value basis, assuming a 20 percent capital gains tax and a 5 percent interest rate compounded semiannually, the true economic cost of the taxpayer's $170,000 capital gains tax in 2026 (20 percent of $850,000) is 42.7 percent below the $200,000 tax levied in 2018, exclusive of any additional appreciation in the investment that may be avoided altogether after a 10-year holding period.[31]

The QOZ tax incentives build on incentives provided under the new markets tax credit (NMTC) program and prior capital gains exclusion programs for investments in federally designated enterprise zones, empowerment zones, and renewal communities. Unlike the NMTC program, however, there is no national limitation on the amount of gain that can be deferred or excluded under the QOZ program. Many of the specifics regarding the investments and the guidelines for tax relief need to be clarified by the IRS, which has been delegated the authority to implement the QOZ program.

The QOZ program's incentives for investment could stimulate economic growth in areas still trying to recover from the global economic crisis that began in 2007. While there is no real limit on these incentives beyond taxpayers' appetite for tax-advantaged investments in QOZs, the JCT has estimated that investors in QOZs will receive an average of $1.55 billion in tax benefits per year over the program's first eight years for an aggregate tax stimulus of $12.4 billion.[32] That represents a federal tax subsidy two times the size of all community development tax incentives provided to empowerment zones and renewal and enterprise communities under the Community Renewal Tax Relief Act of 2000 (P.L. 106-554), which established the NMTC.[33]

Scott has indicated that the three incentives offered for investing in QOZs will allow "trillions of dollars in private capital to be used to encourage small business, support entrepreneurs, and to develop dilapidated properties in zip codes most in need of a resurgence."[34] What effect tax reform's most important stimulus for low-income areas might have during the statute's 10-year horizon will depend on local governments' effective use of the program to target areas ripe for redevelopment and on investors' ability to understand the QOZ provisions that may help them overcome reluctance to take risks associated with investments in high-poverty LICs.

Some of the statute's most basic features remain ambiguous, including what gains qualify for deferral and nonrecognition under section 1400Z-2(a)(1)(A) and (b)(2)(B) and when investors must invest in qualified zone funds to maximize their benefits under the program. And as the clock ticks, the 180-day window closes on more and more investment gains that taxpayers might otherwise deploy in QOZs if they better understood this program.

This report describes the nomination and designation process for QOZs, the mechanics of the gain deferral and relief available to investors in QO funds, and how investors can profit from this program in ways that simply were impossible under prior tax incentive programs for community redevelopment. It also details the mechanics of the gain exclusion under the QOZ provisions. First, however, we consider the historical context and bipartisan origins of the QOZ program. We identify ambiguities as we try to address investors' questions about the statutory timeline for recognizing various benefits under new section 1400Z-2 and the mechanics of gain deferral and exclusion available to investors in QO funds.

II. Tax Incentives for Economically Depressed Areas

A. Tax Stimulus for Federally Designated Areas

The idea of using "free enterprise zones" to rebuild urban areas was first proposed by Prime Minister Margaret Thatcher's chancellor of the exchequer, Lord Geoffrey Howe, in his 1980 budget statement as a program for industrial and commercial renewal of blighted areas. Howe's budget established seven enterprise zones in Newcastle, Liverpool, Belfast, and East London, in which businesses would qualify for increased depreciation allowances and complete relief from development land taxes.[35] Also,

developers in enterprise zones were exempt from various environmental, building, customs duties, and industrial development certificate procedures.[36]

Free marketers in the United States, led by Republican Rep. Jack Kemp, championed legislation in the 1980s to provide tax incentives in U.S. enterprise zones but restricted their proposals to tax benefits, without granting exemptions to environmental, commercial, and industrial regulations as in the British model. In 1993 Congress finally established the first generation of American empowerment zones and enterprise communities, with a limited package of tax benefits to businesses in those areas. Since 1993 Congress has provided tax credits, increased expensing deductions, capital gains relief, and tax-exempt financing to spur business development in economically distressed areas.[37] But most of those programs have expired, and the NMTC program, which has been extended several times, is scheduled to expire December 31, 2019.[38] The NMTC program has been a boon for low-income census tracts since 2001; by the time it ends, it will have delivered $23.4 billion in tax credits for investments in those areas.

After 2019 the QOZ program will replace the NMTC as the primary tax stimulus targeted to federally designated low-income census tracts. Many of the QOZ program's features were used in the NMTC program, and capital gains relief provisions have been used for enterprise communities, empowerment zones, and renewal communities. But the QOZ incentives are unique in ways that make some of the program's ambiguous features difficult to determine before IRS guidance is released.

Senate Majority Leader Mitch McConnell, R-Ky., has described the special tax incentives under the opportunity zone program as a creative new solution to the problem of creating jobs in rural areas, small cities, and suburbs, which have been largely left behind in the city-centered economic recovery since 2008.[39] Indeed, as discussed later, low-population states like North Dakota, Vermont, and Wyoming benefit from a 25-census-tract minimum number of QOZs for jurisdictions with fewer than 100 LICs, which allows those states to designate more than 50 percent of their LIC census tracts as QOZs.[40]

Moreover, non-LIC contiguous tracts that are ineligible for tax subsidies under the NMTC may still qualify for designation as QOZs. Surprisingly, all of Georgetown — the toniest area in the District of Columbia — is eligible for opportunity zone tax benefits because the tract that includes Georgetown University has a 77.5 percent "poverty rate" (presumably because students live there) and the rest of Georgetown is contiguous with that tract.[41] Because no more than 5 percent of a state's QOZs may be non-LIC contiguous tracts, the District of Columbia, along with Guam and 12 states, cannot nominate more than two non-LIC contiguous tracts as QOZs. For more populous states, like California and New Jersey, however, it may be especially appealing to nominate non-LIC contiguous tracts in metropolitan areas that may be ripe for development and have median family incomes equal to the median family income in the Los Angeles, New York, and San Francisco metropolitan areas.

Local political pressures may confine QOZs in some states to areas genuinely in need of economic stimulus. For instance, Connecticut and Massachusetts prioritize for QOZ status areas that have a high poverty rate and higher-than-average unemployment, and that have lost jobs because of company closings in recent years.[42] Georgia, Texas, and Wisconsin have already submitted QOZ nominees consisting entirely of LIC tracts.

On the other hand, QOZ nominations thus far submitted by populous states like New Jersey and California indicate that strategic and competitive needs may play an outsized role in the selection process. For instance, New Jersey's QOZ nominees include Hackensack and Jersey City tracts — areas that are across the Hudson River from Manhattan and in which real estate markets are booming, with housing prices that exceed those in most of Brooklyn and Queens. Another tract nominated by California is half a mile from Los Angeles's financial center and has a median family income of $103,750.[43]

Although Hackensack and downtown Los Angeles are by no means impoverished communities, Congress and Treasury have given states more than 42,000 eligible census tracts from which to choose their QOZs, many of which are in affluent metropolitan areas where the median family income is twice the national average. It is not surprising that some state CEOs would choose to diversify their QOZ portfolios by making some of their best business districts even better rather than building new metropolises from scratch.

The NMTC, capital gains exclusions for qualified community assets, D.C. zone assets, and enterprise zone qualified business entity stock; and nonrecognition from the sale of qualified empowerment zone assets each provides investment incentives intended to connect private capital to businesses in low-income census tracts.[44] QOZ tax incentives are different, but they share some characteristics with those other programs. It's helpful to briefly consider the evolution of those antecedents to better understand the origins of QOZs.

B. Tax Incentives for Distressed Communities

Tax incentives have been available for some economically depressed census tracts for 25 years.[45] The first of those incentives was made available to businesses in enterprise communities and empowerment zones under the Omnibus Budget Reconciliation Act of 1993,[46] passed by a Democratic Congress (without Republican support) and signed into law by President Clinton. OBRA 1993 authorized the secretaries of Housing and Urban Development and of Agriculture to designate no more than 95 high-poverty, noncontiguous population census tracts nominated by state and local governments as enterprise communities, and no more than nine nominated areas as empowerment zones.[47] The HUD secretary implemented the enterprise community and empowerment zone programs for urban areas, and the USDA secretary implemented the programs in rural areas.[48] Businesses in enterprise zones received a $20,000 increase in the expensing deduction under section 179 for qualified zone property placed in service during the tax year under section 1397A, and

enterprise and empowerment zone businesses could benefit from up to $20 million in tax-exempt bonds authorized to be issued under section 1394 to finance a wide variety of commercial and manufacturing facilities.[49]

Since 1993 Congress has created special tax incentives for 16 types of economically distressed area, including renewal communities under section 1400F and D.C. zones under section 1400B. Those areas qualified for an array of tax incentives, such as rollover gain nonrecognition for empowerment zone assets held for at least one year, and a 0 percent capital gains rate for D.C. zone assets held for at least five years.[50] Those deferrals and exclusions from gross income for qualified capital gains are no longer available.

1. Capital gain exclusions.

Congress created many of its capital gains exclusion programs under the Community Renewal Tax Relief Act, enacted December 21, 2000.[51] The act added section 1400F to the code to exclude from taxable income qualified capital gain from the sale of specified qualified renewal community assets held for more than five years.[52] It also added section 1397B to provide for the nonrecognition of gain for any sale of a qualified empowerment zone asset held by the taxpayer for more than one year and rolled over into another empowerment zone asset within 60 days,[53] and an exclusion for gain from the sale or exchange of enterprise zone qualified business entity stock under section 1202(a)(2).[54] Further, the act added an NMTC for low-income census tracts under section 45D[55] and amended section 1400B, originally added by the Taxpayer Relief Act of 1997,[56] to offer taxpayers a 0 percent capital gains rate from the sale of qualified D.C. zone business assets in any census tract in the District of Columbia with a poverty rate of at least 10 percent if the asset was held for more than five years before it was sold.[57] The renewal community capital gains relief provisions under section 1400F derive from the D.C. zone capital gain exclusion under section 1400B.

Section 1400F gave the HUD secretary authority to designate up to 40 renewal community census tracts nationwide with pervasive poverty, unemployment, and general distress, from among tracts nominated by state and local governments.[58] Renewal community designations terminated at the end of 2009.[59] However, by statute, taxpayers remained eligible for the renewal community capital gain exclusion under section 1400F for gains attributable to the period from January 1, 2002, to December 31, 2014.[60] To qualify for that exclusion under section 1400F(a), the taxpayer had to acquire one of three types of qualified community assets between those dates and realize gain from the sale of those assets within the 2002-through-2014 period.[61] Qualified community assets purchased after 2009 or sold after 2014 did not qualify for the exclusion.

Because Congress did not tie tax benefits from the sale of D.C. zone and qualified community assets to the zone or community's designation period, investors had clear statutory guidelines about when they had to acquire and sell those assets to qualify for a 0 percent capital gains rate. Unlike for D.C. zone and qualified community assets, however, Congress did not establish an additional period after the

end of a QOZ designation for QOZ property to qualify for favorable tax treatment. Moreover, Congress requires taxpayers investing in a QO fund to hold their interest in that fund twice as long (10 years) as the corresponding five-year holding periods for D.C. zone and qualified community assets to realize all potential tax benefits under section 1400Z-2.

What this means in practice is that taxpayers who invest in a QO fund after 2018 do not know whether they will be entitled to the full range of tax benefits offered to QOZ investors under section 1400Z-2. Resolving fundamental ambiguities about when investors must make investments in QO funds to realize tax benefits should be a top priority for Treasury because any ongoing uncertainty on this issue could dampen the effect of the opportunity zone program in federally designated QOZs.

a. Qualified assets.

The following describes the renewal community capital gains incentive regarding qualified community assets for the renewal community capital gains exclusion: qualified community stock, qualified community partnership interests, and qualified community business property.[62]

i. Qualified businesses.

Qualified community stock and qualified community partnership interests consist of equity interests in a U.S. corporation, limited liability company, or limited or general partnership if (1) the taxpayer acquires — solely in exchange for cash — stock at its original issuance (directly or through an underwriter) or a capital or profits interest in the partnership from the partnership; (2) the corporation or partnership was a renewal community business (or, for a new corporation or partnership, was being organized to be such a business) when that stock or partnership interest was acquired; and (3) the corporation or partnership qualified as a renewal community business during substantially all of the taxpayer's holding period for the stock or partnership interest.[63]

To be a renewal community business, the entity must be a "qualified business," meaning that:

- it is engaged in the active conduct of a trade or business within a federally designated renewal community;
- it derives at least 50 percent of its total gross income from that active trade or business;
- it uses a substantial portion of its tangible and intangible property in the active trade or business;
- it performs a substantial portion of its services in a renewal community;
- at least 35 percent of its employees are residents in a renewal community;
- less than 5 percent of the aggregate unadjusted bases of the its property is attributable to collectibles other than collectibles held primarily for sale to customers in the ordinary course of the business; and

- less than 5 percent of the aggregate unadjusted bases of its property is attributable to "nonqualified financial property."[64]

Nonqualified financial property generally means debt instruments, stock, partnership interests, annuities, and derivative financial instruments (including options, futures, forward contracts, and notional principal contracts) other than (1) reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of no more than 18 months; and (2) accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of inventory property.[65]

Any trade or business is a qualified business unless it falls into one of five excluded categories listed below. The following trades or businesses are generally excluded from benefits provided to empowerment zones and enterprise and renewal communities:

- residential rental property businesses;[66]
- nonresidential rental businesses (treated as qualified businesses only if at least 50 percent of the gross rental income from the property is from an enterprise zone business);[67]
- personal property rental businesses (treated as qualified businesses only if at least 50 percent of the rental of that property is by enterprise zone businesses or by residents of an empowerment zone);[68]
- businesses that hold or develop intangibles for sale or license;[69]
- entertainment businesses ("sin businesses") that engage in activities prohibited by section 144(c)(6)(B) (including businesses that operate a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, facility used for gambling, or any store whose principal business is the sale of alcoholic beverages for consumption off premises);[70] and
- farming.[71]

QO funds are apparently only restricted from investing in entertainment businesses engaged in activities prohibited by section 144(c)(6)(B), and therefore should be able to reduce investor risks through a more diversified portfolio of investments in qualified zone businesses (including intangibles licensing and residential rental property businesses) than had previously been available for investors under the enterprise and renewal community and empowerment zone programs.[72]

On top of meeting the requirements for a qualifying business, if a taxpayer (presumably the investor in the QO fund[73]) purchases a C corporation's stock, the stock must satisfy several additional conditions to be a qualifying community asset. First, the corporation that issued the stock to the taxpayer must not directly or indirectly purchase any of its own stock from the shareholder or a person related to the taxpayer (within the meaning of section 267(b) or 707(b)) at any time during the four-year period beginning on the date two years before the stock is issued to the taxpayer.[74] Also, the corporation's stock will not be considered a qualifying asset if at any time during the two-year period beginning on the date one year before the corporation issues stock to the taxpayer, the corporation makes one or

more purchases of its own stock with an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all the corporation's stock at the beginning of that two-year period.[75]

Congress copied its redemption rules for QOZ stock, without modification, from capital gain provisions applicable to D.C. Zone business stock[76] and qualified community stock[77] that cross-reference the redemption rules for qualified small business stock under section 1202(c)(3).[78] However, section 1202(c)(3)'s rules for qualified small business stock, like D.C. zone and qualified community assets, apply to stock acquired directly by investors rather than through a fund.[79] In the context of a QO fund, which purchases qualified zone assets on behalf of at least one investor who in turn receives capital gains tax relief, it would appear that the investor rather than the fund itself is the taxpayer referred to in the cross-reference, but guidance is needed to clarify the issue.[80]

Under the redemption rules for both the four-year period and the two-year period extending before and after the corporation's original issuance of stock to the taxpayer, any transaction treated under section 304(a) as a distribution in redemption of a corporation's stock is treated as a purchase by that corporation of an amount of its stock equal to the amount treated as a section 304(a) distribution.[81]

In general, section 304 deems a sale by an owner of one corporation's stock to a second corporation as a distribution in redemption of the second corporation's stock if the owner holds shares in each corporation equal to at least 50 percent of the corporation's voting stock or at least 50 percent of the value of all classes of the corporation's stock.[82] Assuming that under the QOZ stock redemption rules, the taxpayer includes the investor and any person related to the investor within the meaning of section 267(b) or section 707(b), that investor's (or related person's) sale of stock from one controlled corporation to a second corporation controlled by the investor could disqualify the QO fund's acquisition of stock in the second corporation from being QOZ stock under section 1400Z-2(d)(2)(B)(ii).

A fund's ability to track the section 304 transaction history of any one taxpayer and persons related to that taxpayer is challenging in the best of circumstances. However, QO fund managers cannot be expected to keep track of multiple taxpayers' intercompany stock transfers over a two-year period, as well as intercompany stock transactions engaged in by persons related to multiple taxpayers within the broad categories of relatedness defined in sections 267(b) and 707(b). Even relying on representations by investors may be insufficient in this context because investors may not want to take the risk that another fund investor's intentional or unintentional misrepresentation could doom their tax benefits from investing in a QOZ or cause penalties to be incurred by the fund for failing to maintain 90 percent of its assets in QOZ property. For this reason, the QOZ stock redemption rules may effectively limit the number of investors in a QO fund to one or two investors, although that may undercut Scott's theory of these funds being a means of pooling resources from multiple investors to develop businesses in QOZs.[83]

The redemption rules for qualified D.C. zone partnership interests, qualified community partnership interests, and empowerment zone partnership interests (collectively, qualified partnership interests) all follow the three redemption rules for qualified small business stock in section 1202(c)(3), but those rules do not apply to QOZ partnership interests.[84] Under the D.C. zone, renewal community, and empowerment zone programs, some redemptions of partnership interests acquired by a taxpayer may cause those interests to lose the tax benefits associated with qualified zone or community assets, including 0 percent capital gains rates on sales of D.C. zone and renewal community property, and tax-free rollovers of empowerment zone assets.[85] Thus, a D.C. zone, qualified community, or empowerment zone partnership interest does not include any interest acquired by the QO fund if:

1. at any time during the four-year period beginning on the date two years before the issuance of the interest, the partnership issuing the interest directly or indirectly purchased any partnership interest from the investor or from a person related to the taxpayer within the meaning of section 267(b) or 707(b); or
2. during the two-year period beginning on the date one year before the issuance of the interest, the partnership made one or more purchases of its interests with an aggregate value, as of the time of the respective purchases, exceeding 5 percent of the aggregate value of all its interests as of the beginning of that two-year period (with redemptions under section 304, as modified for partnerships, applicable to each rule).[86]

There is no apparent policy reason why Congress would exempt QOZ partnership interests from the above redemption rules while requiring all other qualified partnership interests under related incentive programs to satisfy them. However, Treasury's Office of Tax Policy will need to determine whether Congress's failure to include a redemption rule for QOZ partnerships was indeed an oversight and, if so, whether it can be resolved without a legislative fix.

ii. Qualified tangible business property.

Tangible property is qualified community business property if (1) the taxpayer acquired it by purchase (within the meaning of section 179(d)(2)); (2) the property's original use in the renewal community begins with the taxpayer; and (3) during substantially all of the taxpayer's holding period for the property, substantially all of its use was in a renewal community business of the taxpayer.[87] Section 179(d)(2) provides that a taxpayer can acquire property by purchase only if the taxpayer's relationship to the seller would not result in the disallowance of losses under section 267 or 707(b), except that only an individual's spouse, ancestors, and lineal descendants (but not whole or half-blood siblings) are included among the familial relationships that disqualify losses or are treated as constructively owned by the taxpayer.[88] Also, qualified community business property may not be acquired by a corporate taxpayer from another component member of the taxpayer's 50-percent-controlled group (within the meaning of 1563(a), with more than 50 percent ownership substituted for 80 percent ownership by vote or value for parent-subsidiary, brother-sister, and combined groups).[89] Finally, to be a qualified community asset for the renewal community gain exclusion, the property in the hands of the taxpayer

must not be determined in whole or in part by reference to the property's adjusted basis in the hands of the transferor or be determined under the rules in section 1014(a) for property acquired from a decedent (generally its fair market value).[90]

b. Qualifying capital gain.

Qualified capital gain from the sale or exchange of a qualified community asset held for more than five years is excluded from gross income. To qualify for the exclusion, the gain must be recognized on the sale or exchange of (1) a capital asset or (2) property used in a trade or business (as defined in section 1231(b)).[91] However, qualified capital gain for the renewal community capital gain exclusion and the capital gain exclusion for D.C. zone assets excludes any gain from the sale of depreciable property that would be treated as ordinary income under section 1245 or taxed at a higher 25 percent rate under section 1250 than the otherwise applicable 20 percent maximum tax rate on gains from the sale of property.[92]

As discussed earlier, the QOZ program provides temporary deferral of some realized gains reinvested in a QO fund, partial nonrecognition of the deferred gain for taxpayers who hold their investments in a QO fund for at least five years, and permanent exclusion of gains from the sale or exchange of an investment in a QO fund held for at least 10 years.[93] The QO fund must use the taxpayer's capital to purchase QOZ property, including QOZ stock, QOZ partnership interests, and QOZ business property. Like the renewal community and D.C. zone asset capital gains exclusion, the QOZ deferral and exclusion provisions draw to some extent on rules under section 1397C, and they adopt redemption rules for QOZ stock like those described above. But the structure of investments qualifying for temporary deferral and permanent exclusion is different: Rather than investing directly in a low-income or high-poverty area, taxpayers invest in a QO fund, which then reinvests their capital in QOZ property.

2. Low-income communities under the new markets tax credit.

To understand which communities are intended beneficiaries of the QOZ program, it is necessary to look to the concept of an LIC under section 45D(e), which defines an LIC for purposes of the NMTC. Section 1400Z-1(c)(1) provides that a QOZ is a tract "designated as a qualified opportunity zone" that is an LIC within the meaning of section 45D(e). The NMTC's structure for indirect investing in LICs through certified entities is also adopted under the QOZ provisions.

The NMTC program was established to encourage investing in LICs through so-called community development entities (CDEs). Section 45D(e) defines an LIC as any population census tract that meets one of the following poverty or low-income thresholds:

1. the poverty rate for the tract is at least 20 percent;

2. for a tract not located in a metropolitan area, the median family income for the tract does not exceed 80 percent of the statewide median family income;
3. for a census tract in a metropolitan area, the median family income for the tract does not exceed 80 percent of greater of (a) the statewide median family income or (b) the metropolitan area median family income;[94]
4. the tract (a) has a population of less than 2,000, (b) is in an empowerment zone, and (c) is contiguous with an LIC that has a poverty rate of at least 20 percent or a median family income at least 20 percent below the statewide median (or, if relevant, the metropolitan area median family income);[95] or
5. the tract (a) is in a high-migration rural county with a net outward migration of at least 10 percent of the county's population during a 20-year period ending with the year in which the most recent census was conducted, and (b) the median family income for the tract does not exceed 85 percent of the statewide median family income.[96]

To stimulate investment in LICs,[97] section 45D offers some equity investors in qualified CDEs a 39 percent credit over seven years.[98] A U.S. corporation or partnership is a CDE if (1) its primary mission is serving, or providing investment capital for, LICs or low-income persons; (2) it maintains accountability to residents of LICs through their representation on any governing board of the entity or on any advisory board to the entity; and (3) it has been certified as a CDE.[99] The CDFI Fund awards allocations to CDEs on a competitive basis, and CDEs that receive an allocation can provide tax credits to investors; however, the investors' aggregate investments in the CDE may not exceed the aggregate allocation award to the CDE.

A taxpayer's NMTC is earned over seven years in an aggregate amount of 39 percent of the taxpayer's investment.[100] Congress has given the CDFI Fund authority to allocate $3.5 billion in awards to CDEs each year through 2019, which translates to $1.365 billion in credits per year. As noted earlier, the NMTC program is scheduled to expire after 2019.

A qualified equity investment, which must exist for a section 45D NMTC to be claimed, is an equity investment in a CDE much like the indirect investment structure adopted under new section 1400Z-2.[101] Under the NMTC, the taxpayer's investment in the CDE must be acquired by the taxpayer at its original issue, directly or through an underwriter, solely in exchange for cash.[102] Also, substantially all (85 percent for NMTCs) of the cash received by the CDE must be used by the qualified entity to make qualified LIC investments.[103]

III. Opportunity Zone Incentives

The TCJA allows the governor of each state (the mayor for the District of Columbia) to designate QOZs to encourage new capital investment in low-income census tracts. Taxpayers may defer eligible gain by investing in QOZs, which exist for at least 10 years. QOZs begin on the date they are designated by Treasury, and they end on December 31 of the calendar year that begins on or after the 10th

anniversary of the designation date. No QOZs can be designated after June 18, 2018, so no QOZ designation can last beyond December 31, 2028. As discussed later, because QOZs in Puerto Rico are deemed certified and designated as of the TCJA's enactment date of December 22, 2017, it would appear that the designation period for Puerto Rico's QOZs ends December 31, 2027.

Electing taxpayers will be able to defer, and in some cases permanently exclude, some gains realized between December 22, 2017, and December 31, 2026, by investing in a QO fund. To be eligible, within 180 days of a sale or exchange of a non-zone asset, the taxpayer must roll over the gain into a QO fund that must hold at least 90 percent of its assets in QOZ property, including direct and indirect interests in zone businesses, as detailed later.

A. Overview of QOZ Designation Process

Rev. Proc. 2018-16, published February 8, clarifies key procedural aspects of the designation process and indicates that Treasury has developed an online nomination tool. Additional information on the nomination process, including how to access the online tool and how to request an extension of the determination period, was sent to each state.[104]

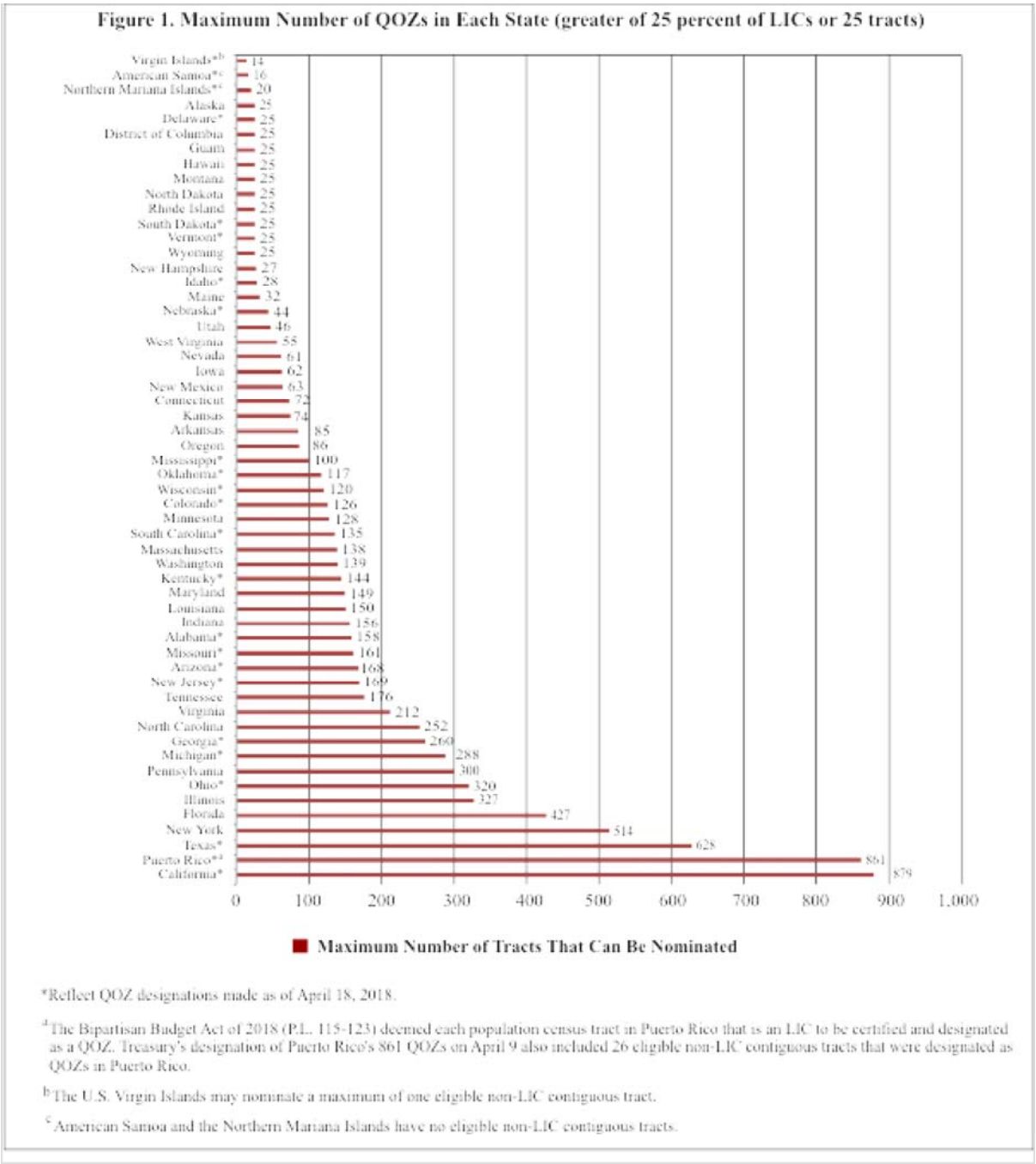
Each state CEO had until March 21 to nominate a limited number of population census tracts to be designated as QOZs, and an extended deadline of April 20 applied for CEOs who requested and received a 30-day extension from Treasury.[105]

1. Maximum number of QOZs.

The maximum number of tracts that a state can nominate as QOZs is generally equal to the greater of (1) 25 percent of the number of all LICs in the state or (2) 25 tracts. At least 95 percent of the nominated tracts must be LIC census tracts, meaning that up to 5 percent may be non-LIC contiguous tracts, as discussed below.[106]

a. Eligible tracts.

The definition of an LIC under the quantitative



limits on QOZs and non-LIC contiguous tracts is similar to the definition under section 45D(e)(1) for NMTCs: any population census tract if (1) the poverty rate of the tract is at least 20 percent or (2) the median family income for the tract does not exceed 80 percent of statewide median income, or, for a metropolitan census tract, 80 percent of the metropolitan area median family income if greater than the statewide median.[107] A non-LIC tract may be designated if it is contiguous to an LIC that has been nominated as a QOZ by a state (including a different state), and if median family income for the tract does not exceed 125 percent of the median family income for the contiguous LIC tract.[108] However, no more than 5 percent of a state's QOZ designations can be allocated to non-LIC tracts.

The CDFI Fund has developed an online information resource, which state CEOs may rely on under a safe harbor established by Rev. Proc. 2018-16, to determine:

- the total number of LIC tracts in each state;
- the maximum number of census tracts that each state may nominate as QOZs;
- the maximum number of eligible non-LIC contiguous tracts that each state can include in its QOZ nominations; and
- whether a census tract within a state is either (1) an eligible LIC that may be nominated as a QOZ or (2) an eligible non-LIC contiguous tract that may be included in the nomination of one or more LIC tracts on whose QOZ designation the non-LIC tract's eligibility depends.

Under the safe harbor of Rev. Proc. 2018-16, if the CDFI Fund's information resource identifies a census tract as being eligible for nomination as a QOZ, a state CEO's nomination of that tract will not fail to be certified because the tract is no longer eligible under more recent census data. If a CEO chooses not to use the CDFI Fund's information resource, the state must provide an analysis demonstrating the tract's eligibility, including more recent Census Bureau data.[109] Figure 1 shows the maximum number of census tracts that may be designated as QOZs in each state, with actual QOZ designations as of April 18, marked with an asterisk (*).

The information resource lists 42,160 population census tracts eligible for designation as QOZs: 31,848 LICs and 10,312 non-LIC contiguous tracts. Based on the information resource, 42 states (including Puerto Rico) will be eligible to nominate more than 25 census tracts as QOZs, and 14 states (including four U.S. possessions and the District of Columbia) will be limited to 25 nominations.[110]

A total of 8,762 QOZs are eligible to be designated nationally if every local government nominates the maximum number of tracts. Moreover, the program is truly national in scope. Although California, Florida, New York, and Texas account for one-third (33.25 percent) of the U.S. population, only 28 percent of QOZs nationwide will go to those states. By contrast, Puerto Rico, which has less than 1 percent of the U.S. population, has been designated 10 percent of all QOZs nationwide (all 861 of its eligible tracts). Because the maximum number of QOZs is generally a function of the number of LICs, several states, including Mississippi and Louisiana, will receive a substantially larger portion of QOZs than their relative share of the U.S. population.

b. Cross-state nominations.

The LIC tract on which a non-LIC continuous tract's eligibility is based need not be in the same state.[111] State CEOs involved in such nominations of non-LIC tracts need to coordinate with the adjoining state's CEO to confirm that the contiguous LIC tract has been nominated.

Example 1. Maryland has an LIC with a median family income of $100,000. (The Maryland tract satisfies the definition of an LIC based on a 20 percent poverty rate.) A population census tract in

Delaware borders the Maryland LIC tract, but the Delaware tract is not itself an LIC. If Delaware's tract has a median family income not exceeding $125,000 and Maryland confirms that it has nominated its LIC tract for designation as a QOZ, the Delaware tract may be nominated by Delaware for designation as a QOZ if no more than 5 percent of Delaware's aggregate number of QOZs consists of non-LIC contiguous tracts.

c. Rounding rule.

Rev. Proc. 2018-16 provides that (1) the total number of tracts that may be nominated by a state is rounded up to the next whole number if the number of LICs in the state is not evenly divisible by 4, and (2) the number of non-LIC contiguous tracts is rounded up to the next whole number if the number of designated QOZs in the state is not evenly divisible by 20.[112]

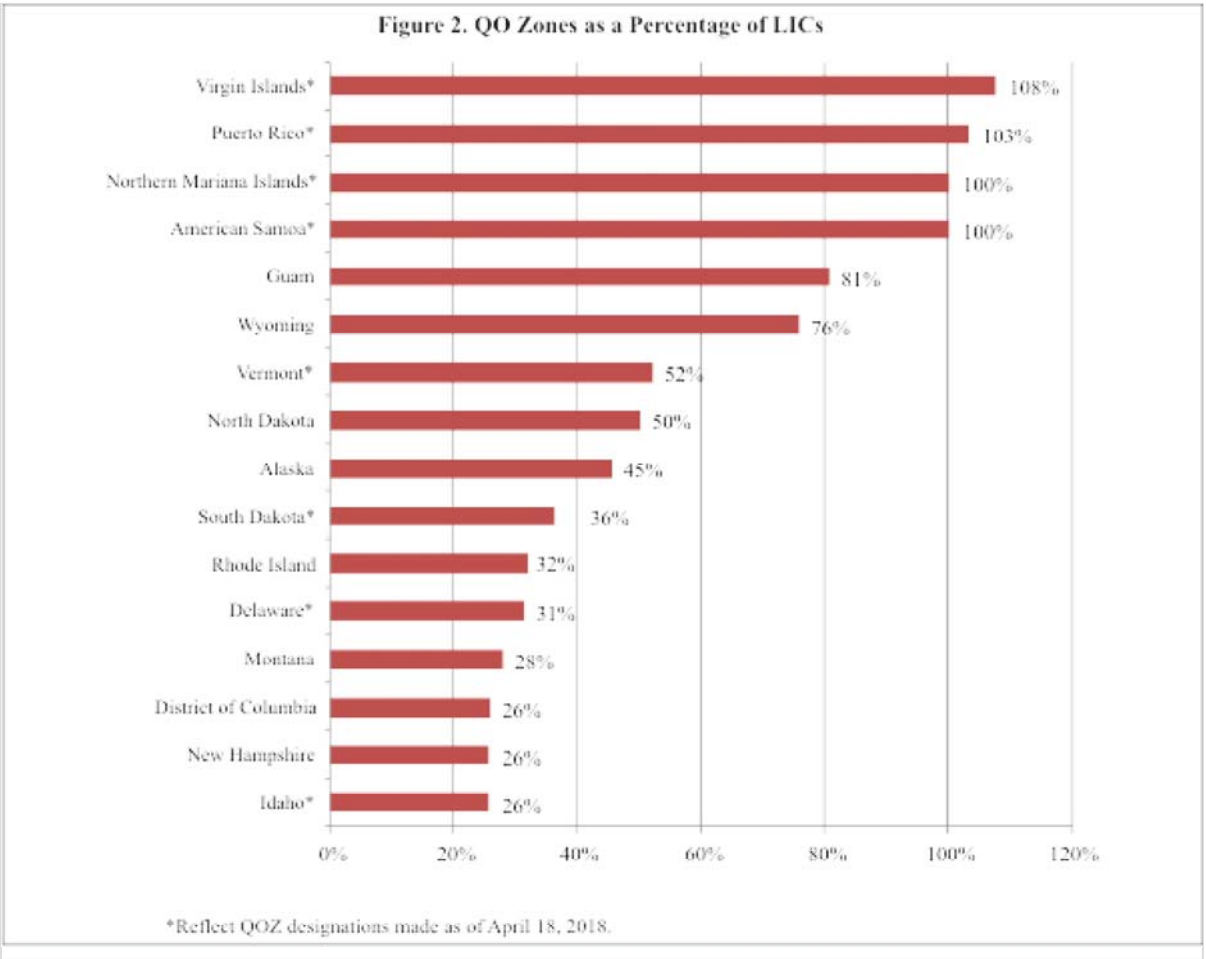
Example 2. State X has 198 LICs. The maximum number of QOZ designations by the state is 50, even though 25 percent of 198 is 49.5. If State X nominates all 50 of the QOZs allowed, three nominated tracts may be non-LIC contiguous tracts (5 percent of 50, or 2.5, rounded up to 3). State X could nominate 50 QOZs (25.3 percent of statewide LICs), including 47 QOZs that are LICs (94 percent of statewide QOZs), with three non-LIC contiguous tracts (6 percent of statewide QOZs) without running afoul of either the 25 percent limit on the number of QOZs or the 5 percent limit on non-LIC contiguous tracts.

d. U.S. possessions and Puerto Rico.

States with fewer than 100 LICs generally receive a substantially larger number of LICs in proportion to their population than other states. For instance, each U.S. possession's share of QOZs exceeds its relative share of U.S. population by a ratio of at least 2 to 1. Moreover, the minimum 25 tracts authorized for designation as QOZs for each possession exceeds the total number of LICs in the U.S. Virgin Islands (13), American Samoa (16), and the Northern Mariana Islands (20).[113] This does not appear to be something that Congress anticipated.

Although section 1400Z-1(a) defines a QOZ as "a population census tract that is a low-income community that is designated as a qualified opportunity zone" and describes the 25-tract minimum as "a total of 25 of such [LIC] tracts,"[114] the rounding rule under Rev. Proc. 2018-16 allows at least one QOZ in each possession to be an eligible non-LIC contiguous tract.[115] The CDFI Fund's information resource initially authorized 25 tracts to be nominated by every possession, but a February 27 update reflecting a technical correction limited those jurisdictions to all LIC tracts plus one additional non-LIC tract (under the 5 percent limitation) if the possession has any such tracts. As a result, 14 QOZs have been designated in the U.S. Virgin Islands (13 LICs plus one non-LIC contiguous tract), which is more than 100 percent of the possession's LICs.[116] However, because neither American Samoa nor the Northern Mariana Islands has any eligible non-LIC contiguous tracts, only 16 QOZs have been designated in American Samoa, and only 20 have been designated in the Northern Mariana Islands.[117]

Further, under a special rule that applies only to Puerto Rico, each population census tract in the territory that was an LIC as of December 22, 2017 (the enactment date of the TCJA) is automatically deemed certified and designated as a QOZ as of that date.[118] Although not expressly authorized by statute,[119] Treasury has allowed Puerto Rico to designate 26 non-LIC contiguous tracts along with its 835 automatically designated LICs as QOZs eligible for benefits under the opportunity zone program.[120]



Congress's ambiguous statute has thus expanded the opportunity zone program to more than 100 percent of the LICs in both the U.S. Virgin Islands (108 percent) and Puerto Rico (103 percent). Figure 2 illustrates how beneficial the QOZ program's 25-tract minimum and special rule for Puerto Rico are for jurisdictions with comparatively small populations. It lists each state's maximum number of QOZs as a percentage of its LICs, with QOZ designations as of April 18 marked with an asterisk (*).

As noted, although Congress's de jure designation of Puerto Rico's LIC census tracts as QOZs effective as of December 22, 2017, eliminated the need for the governor of Puerto Rico to nominate tracts for designation, it may also mean that the designation period for Puerto Rico's QOZs may end one year sooner than those of all other states.

Under section 1400Z-1(b)(3), the designation period for QOZs in Puerto Rico would end December 31, 2027, which is the close of the 10th calendar year beginning on or after their designation date. Because

all the census tracts for all other states will be certified and designated in 2018, their designation period will last until December 31, 2028. It is unclear whether Congress intended this anomaly.

2. Nomination and designation deadlines.

A state CEO's timely notice of nominations through Treasury's online nomination tool started the 30-day clock for Treasury to designate the tracts as QOZs (although states could request a 30-day extension). For states that notified Treasury of their QOZ nominations by the March 21 statutory deadline, Treasury had until April 19 to designate the QOZs, unless that deadline was extended to May 11 at the state's option. For states that notified Treasury of their QOZ nominations on the extended nomination deadline of April 20, Treasury will have until May 21 (the first business day after May 19) to make the designations, unless states extend that deadline for another 30 days, to June 18. June 18 is thus the last possible date for a QOZ designation to be made by Treasury.

As noted earlier, QOZ status begins on the date of designation and continues through the close of the 10th calendar year beginning on or after the designation date, which in all cases (except Puerto Rico) will be December 31, 2028.

B. Tax Incentives for Investing in QOZs

As noted earlier, the QOZ tax incentives are designed to encourage investors to redirect gain from prior investments into investments in QOZs. Taxpayers who make an election under section 1400Z-2(a)(1)(A) will be able to defer, and in some cases permanently exclude, some gains by investing in a QO fund. To be eligible, the taxpayer must roll over gain into a QO fund within 180 days of the sale or exchange of property. The QO fund must use that money to purchase QOZ property (including QOZ business property, QOZ stock, and QOZ partnership interests).[121]

A QO fund is a corporation, LLC, or partnership organized to invest in QOZ property that holds at least 90 percent of its assets in that property.[122] QO funds must be certified and FAQs released April 24 indicated that certification by eligible entities will be made simply by filing a form (to be released this summer) with a timely-filed federal income tax return for the tax year.

1. Temporary deferral.

A taxpayer may elect to defer gain from a sale or exchange to an unrelated person of any property (including stock, partnership interests, real estate, or personal property) (eligible gain). To defer eligible gain, the taxpayer must reinvest all or part of that gain in a QO fund within 180 days of the sale of the gain-producing property and elect to defer gain that is rolled over. The method for making that election is unclear and will require guidance. Any eligible gain that the taxpayer does not invest in a QO fund must be recognized, and unlike in like-kind exchanges, only the amount of the eligible gain must

be reinvested in the QO fund rather than all the proceeds from the sale of the gain-producing property.

If the taxpayer timely invests in a QO fund, her eligible gain may be deferred until the earlier of her disposition of the QO fund investment or December 31, 2026 (the deferral period). At the end of the deferral period, the taxpayer must include in income the excess of (1) the lesser of (a) the eligible gain the taxpayer rolled over or (b) the FMV of the taxpayer's QO fund investment as of the end of the deferral period over (2) the taxpayer's basis for the QO fund investment (the deferred amount).

Example 3. If a taxpayer sells property with a tax basis of $50 in exchange for $100, only the $50 realized gain (not all $100 received by the taxpayer) must be reinvested in a QO fund within 180 days of the sale for all gain on the transaction to be eligible for deferral.

Although section 1400Z-2(a)(1)(A) provides that gains from the sale or exchange of "any property" may be temporarily deferred and, in some cases, excluded from gross income, the committee report on section 1400Z refers exclusively to "capital gains."[123] Moreover, section 1400Z-2 is titled, "Special rules for capital gains invested in opportunity zones," and the Investing in Opportunity Act, on which sections 1400Z-1 and 1400Z-2 are based, was introduced in the Senate in February 2017 as a bill to amend the 1986 code "to provide for the deferral of inclusion in gross income for *capital gains* reinvested in opportunity zones." (Emphasis added.)

We anticipate that, for this purpose, capital gain includes gain from the sale or exchange of real estate used in a trade or business that is held for more than one year (section 1231 property) but does not include gain subject to recapture of depreciation and amortization deductions, which is treated as ordinary income of the taxpayer to the extent thereof under section 1245 or section 1250.[124] However, while D.C. zones and renewal communities have a concept of "qualified capital gains," which excludes gains on section 1245 property and section 1250 property, those gains are not excluded from the QOZ tax benefits under section 1400Z-2.[125] Therefore, we must wait for guidance from Treasury and the IRS on both these issues.

Given the ambiguity between the statute's text and its legislative history, and in the absence of IRS guidance, it is difficult for taxpayers to effectively plan their investments in QO funds, which, for reasons discussed below, are potentially required before the end of 2018 for all tax benefits under the QOZ program to accrue.

Example 4. After claiming $10,000 of depreciation on a machine, a taxpayer sells it on December 22, 2017, at a $10,000 gain. That gain is subject to recapture under section 1245 and is treated as ordinary income. Assuming a marginal income tax rate of 37 percent, the $10,000 of depreciation recapture generates $3,700 of federal income tax, which is $1,700 or 17 percent higher than the 20 percent tax rate on long-term capital gains.[126] On June 19, 2018, the taxpayer reinvests the $10,000 in a QO fund.

Further guidance is needed before the taxpayer can be sure that an election under section 1400Z-2(a)(1)(A) will allow him to defer and partially exclude ordinary income from the machine's sale by timely reinvesting the $10,000 of section 1245 gain in a QO fund, or to know whether gain deferral and relief applies to section 1250 depreciation recapture income, taxed at a 25 percent rate.

Because of the statute's ambiguity, it would be risky for taxpayers to take a position, without further guidance from Treasury, that gains other than gain recognized from the sale or exchange of a capital asset or property used in a taxpayer's trade or business (as defined by section 1231(b)) are eligible for deferral and partial nonrecognition under section 1400Z-2(a) and (b). Because gains realized now are eligible for rollover into a QO fund, it is urgent for the success of the program that taxpayers receive further guidance on whether they may roll over gain from depreciation recapture into a QO fund and partially avoid taxation at ordinary income rates. For purposes of this report, we assume, conservatively, that only capital gains are eligible for relief provided to investors in QOZs under the three incentives in section 1400Z-2.

2. Partial nonrecognition of rollover gain.

Section 1400Z-2(b)(2) gives taxpayers who make an initial election to temporarily defer inclusion of capital gains in gross income two basis step-ups — after five- and seven-year holding periods in the QO fund — which may permanently exclude 10 or 15 percent, respectively, of the originally deferred gain. To qualify, taxpayers must timely roll over eligible gain and hold the QO fund investment for the applicable holding period before the investment's sale or exchange. The taxpayer's basis in the QO fund investment is zero for investments of less than five years.

a. QO fund investments held for at least five years.

If the taxpayer holds her QO fund investment for at least five years, 10 percent of the eligible gain that she rolled over is added to her basis for the QO fund investment. Thus, if the QO fund investment is held by the taxpayer for at least five years, 10 percent of her deferred eligible gain is permanently excluded.

b. QO fund investments held for at least seven years.

If the taxpayer holds her QO fund investment for at least seven years, 15 percent of the eligible gain that she rolled over is added to her basis for the QO fund investment. Thus, if the QO fund investment is held by the taxpayer for at least seven years, 15 percent of the deferred eligible gain is permanently excluded.

Table 1. Base Case (Example 5A)

Source of Gain	QO Fund Stock	FMV	Initial Basis	Five-Year Basis Step-Up	Seven-Year Basis Step-Up	10-Year Basis Step-Up	Tax Basis	Sale Price	Capital Gain	Pe
Rollover	100 sh	$100	$0/sh	—	—	N/A	$100	$100	$100	$
Appreciation	—	$100	$0	N/A	N/A	—	—	$100	$100	$
Total		$200					$100	$200	$200	$

Table 2. Five-Year Holding Period (Example 5B)

Rollover Gain (June 19, 2018)	QO Fund Stock	Purchase Price	Original Adjusted Basis	Five-Year Basis Increase	Capital Gain	20 Percent Tax
$100	$100	$100	$0	$10	$190	$38

Federal Capital Gains Tax

Type of Gain	Gain	Basis	Taxable Gain	Tax Rate	Tax	Effective Tax Rate
Rollover	$100	$10	$90	20%	$18	18%
Appreciation	$100	$0	$100	20%	$20	20%
Total	$200	$10	$190	20%	($38)	19%

Example 5. Investor realizes a $100 gain from a sale of property on December 22, 2017. On June 19, 2018, Investor rolls all $100 over into a purchase of 100 shares of stock in a QO fund and elects to temporarily defer his gain from the 2017 sale under section 1400Z-2(a)(1)(A). The electing taxpayer takes an initial basis of $0 in each of the QO fund's 100 shares, which each has an FMV of $1 per share and an aggregate FMV of $100, on June 19, 2018. In each of the following scenarios, we have assumed that Investor sells the shares of stock in the QO fund when each share has doubled in value from $1 to $2.

Example 5A. On June 19, 2018, Investor's basis in the QO fund investment is $0 and its FMV is $100. Between June 19, 2018, and June 18, 2023, Investor's basis will remain $0, so a sale of the investment would result in a capital gains tax on $100 of 2017 gain and $100 of appreciation attributable to the tax year in which the investment is sold. If Investor receives $200 in exchange for the 100 shares of stock, the tax on the gain will be $40.

Example 5B. If Investor sells the QO fund investment on June 19, 2023, because he has held the investment for at least five years, 10 percent of his rollover gain will be permanently excluded, and only $90 of gain will be recognized. If the investment in the fund has appreciated to $200 by June 19, 2023, Investor will recognize $90 of gain deferred in 2018 and an additional $100 of appreciation in the value of the investment, which is not entitled to a permanent exclusion election because Investor has not held the investment for 10 years. Investor will recognize an aggregate gain of $190 for the tax year that includes June 19, 2023. Table 2 summarizes the results of the sale on June 19, 2023.

After holding the investment for five years, Investor has excluded 10 percent of the $100 originally deferred gain ($10) and recognized 90 percent of the rollover gain ($90) for a total tax liability of $18 on the amount originally deferred. However, the $100 of appreciation in Investor's stock is fully taxable at a 20 percent capital gains rate for a total tax liability of $38 ($20 plus $18) and an effective rate of 19 percent on the investment held for five years.

Table 3. 50-50 Bifurcation of $100 Investment Sold for $200 After Five Years (Example 5C)

	(I)	(II)	(III)	(IV)	(V)		
Source of Funds	**QO Fund Stock**	**Purchase Price (June 19, 2018)**	**Original Adjusted Basis**	**Basis Adjustment**	**Final Basis**	**Sale Price (June 19, 2023)**	**Gain Recognized**
Eligible gain	$50	$50	$0	$5	$55	$200	$145
Ineligible cash	$50	$50	$50	N/A	$50	$100	$50
Total	$100	$100	$50	$5	$155	$200	$195

Table 4. Comparison of Tax Consequences in Examples 5B and 5C

	Taxable Income	Tax Rate	Tax	Effective Tax Rate
Example 5B (five-year investment)	$190	20%	($38)	19%
Example 5C (bifurcated)	$195	20%	($39)	19.5%
Difference	+$5	—	+$1	+0.5%

Example 5C. If Investor had instead realized $50 gain from the sale of property on December 22, 2017, rather than $100, and had realized no other gains attributable to gain from a sale or exchange of property within 180 days of the investment's purchase, he is not subject to any of the special rules for QO fund investments, including tax deferral, relief, and basis adjustments. If he invested $100 in the QO fund on June 19, 2018, in exchange for 100 shares of stock ($1 per share), and $50 of the investment had been derived from savings held in a bank account since December 21, 2017, Investor's $100 investment would be bifurcated[127]: $50 of Investor's gain would be eligible for a deferral election and for exclusion of 10 or 15 percent of the originally deferred gain after five- and seven-year holding periods, respectively. The other $50 would be ineligible for deferral and partial exclusion and could not give rise to permanent exclusion of gains upon Investor's sale of the QO fund's stock. Bifurcation of qualified and non-qualified investments in a QO fund is expressly authorized by the elective nature of the QOZ program and can be used to commit some, but not all, of a taxpayer's gain to investments in qualified zone property. Assuming the statute's bifurcation concept makes sense, Investor should be treated in this situation as having purchased 50 shares of stock eligible for deferral and 50 shares of stock that are ineligible. On June 19, 2023, Investor becomes eligible for a 10 percent increase in basis for 50 eligible shares, from $50 to $55, and sells 100 shares of the QO fund's stock for $200 (at $2 per share).

Table 3 summarizes the tax consequences of the expected bifurcation of Investor's 100 shares of the QO fund stock into 50 eligible shares and 50 ineligible shares.

Table 4 compares Investor's result from the bifurcation with the result from the five-year investment in Example 5B, assuming a 20 percent capital gains rate applies.

Under the special bifurcation rule in section 1400Z-2(e), Investor's $100 investment in the QO fund is divided into two $50 investments. The 50 shares of QO fund stock purchased by Investor with $50 not attributable to gain from a sale or exchange of property within 180 days of the investment's purchase is not subject to any of the special rules for QO fund investments. Neither deferral nor basis adjustments nor exclusion will apply to that $50 purchase of 50 shares. However, temporary deferral will apply at the election of Investor to his 2017 gain of $50 reinvested within 180 days in the QO fund, and partial exclusion will be available after the applicable holding periods are met. Although further guidance is necessary, it would be logical to bifurcate the Investor's $100 investment for purposes of

the permanent exclusion available after he has held the investment for 10 years. Because Investor purchased 50 of the 100 shares of stock with proceeds of eligible gain, 50 percent of the appreciation in the investment after 10 years should be eligible to be permanently excluded, and 50 percent should not.

c. QO fund investments held for at least 10 years.

If the taxpayer holds her QO fund investment for at least 10 years, all the gain attributed to appreciation in the value of her investment in the QO fund is permanently excluded. This benefit is available only if the taxpayer elected to defer gain. Because (1) the QOZs will expire after 2028, and (2) to be eligible for this benefit, a QO fund must invest in property in a QOZ, IRS guidance is needed to determine how this benefit might apply to an investment made in 2019 or later.

Taxpayers cannot recognize the benefit of permanent exclusion of post-acquisition appreciation in the QO fund until at least 2028, even if they invest this year. Meanwhile, all the deferred gain will have been recognized by December 31, 2026, resulting in an increase in basis. Those two provisions are expected to ensure that only the taxpayer's post-acquisition appreciation in the QO fund, other than gain built in at the outset from the rollover gain and zero-dollar basis, will be eligible for permanent exclusion under a separate election, which we expect to be made when the QO fund investment is sold or exchanged. However, further guidance is expected.

For that reason, taxpayers must make two separate elections. The first election under section 1400Z-2(a)(1)(A) authorizes the deferral of the taxpayer's initial gain and the basis increases, which results in 10 to 15 percent nonrecognition of taxpayer's deferred gain after a holding period of five to seven years. The second election, under section 1400Z-2(c), is available only in 2028 or later and would be made after the taxpayer sold or exchanged the investment in the QO fund.

Any eligible gain that has not been recognized before December 31, 2026, is recognized on that date, and the investor's corresponding basis in the QO fund investment increases after 2026 to the full amount of gain originally invested in the QO fund on a tax-deferred basis. As a result, under the permanent exclusion election, only appreciation in the taxpayer's QO fund investment since she acquired the investment will remain after 2026. That is because all rollover gain (not excluded by increased basis) must be recognized in 2026, and only post-acquisition appreciation in the investment will remain when a taxpayer sells or exchanges an investment eligible for nonrecognition after a holding period of 10 years.

Example 6. On July 1, 2018, Taxpayer sells for $150 an investment in XYZ Tech Co. with a tax basis of $50, realizing a $100 gain. She rolls over $100 into an investment in a QO fund on August 15, 2018. Assume the asset sold for an FMV of $200 at the end of the holding periods described below.

Table 5. Example 6

Holding Period	Adjusted Basis	Fair Market Value	Gain Recognized
Four years	$0	$200	$200
Five years	$10	$200	$190
Seven years	$15	$200	$185
December 31, 2026 (temporary deferral ends)	$15	$200	$85
10 years (dnding August 15, 2028)	$200	$200	$85 in 2026 $0 in 2028

Table 5 shows that Taxpayer has realized a total gain of $200 from the two investments — $100 of gain realized on the sale of the investment in XYZ Tech Co. in 2018 and $100 on the sale of the investment in the QO fund in 2028. When Taxpayer initially invested $100 of gains in the QO fund, her basis in the investment was $0, which preserved the $100 gain that was excluded from her 2018 income. On the fifth anniversary of Taxpayer's investment in the QO fund (August 15, 2023), her basis increased by 10 percent of the deferred gain, to $10, and on the seventh anniversary (August 15, 2025), her basis increased by another 5 percent of the deferred gain, to $15. On December 31, 2026, Taxpayer's temporary deferral period for the $100 rollover gain ended, at which time her basis in the investment was $15. Taxpayer therefore recognizes $85 of gain in the 2026 tax year and pays a $17 federal capital gains tax (20 percent of $85). Taxpayer sells the investment on August 15, 2028, after holding it for 10 years. This results in no additional gain to Taxpayer, so only $17 in total tax has been imposed on the $200 gain she realized on investments in XYZ Tech Company and the QO fund — an effective tax rate of 8.5 percent. Whether Taxpayer's investments in a QO fund are eligible for any benefits after QOZ designations terminate is an open question and will need to be resolved by Treasury or Congress.

Example 6A. If Taxpayer had held the investment until January 1, 2029, before selling it, the QO fund's QOZ business property would no longer be property used "in the qualified opportunity zone" for purposes of section 1400Z-2(d)(2)(D)(i)(III) because that zone would have ceased to exist. The special five-year extension on QOZ business property's qualification under 1400Z-2(d)(3)(B) directly applies only to a QOZ business other than the QO fund (that is, tangible property used by an issuer of QOZ stock, or a partnership interest). But if the QO fund had started and continued using its tangible business property in the QOZ for some time before January 1, 2029, it appears that Taxpayer's investment would not necessarily cease to be an investment in a QO fund immediately after the close of 2028. However, we will have to wait for further guidance.

C. Status of QO Funds After 2028

Because all QOZs must be designated in 2018, their designations will terminate after December 31, 2028. Recall that the code defines a QO fund as a corporation or partnership, at least 90 percent of the assets of which are QOZ property. Also recall that QOZ property must be either tangible property used by the QO fund in a business in a QOZ or stock or a partnership interest in a QOZ business, substantially all of whose assets are used by the business in the QOZ.[128] If all QOZs terminate after 2028, it is unclear how QO funds could own qualifying businesses operating in, or qualifying business property acquired for use in, a QOZ after 2028. And if QO funds cannot exist after the designation period ends, it is unclear how a taxpayer who has not held a QO fund investment for at least 10 years by December 31, 2028, can continue to hold a QO fund after that date to qualify for permanent exclusion of post-acquisition gains. Therefore, if a taxpayer acquires a QO fund investment after 2018, there is a risk under the current language of the provision that permanent exclusion of appreciation in the investment after its acquisition would no longer be available. We need guidance from the IRS on this issue.

Example 7. If Taxpayer timely rolls over a $50 gain realized on July 5, 2018, into a QO fund investment on December 31, 2018, that $50 rollover gain must be recognized no later than December 31, 2026, even if Taxpayer holds the QO fund investment until December 31, 2028. On December 31, 2023, Taxpayer's basis in the QO fund increases from $0 to $5 (10 percent of the $50 deferred gain) because of the five-year basis step-up, and on December 31, 2025, Taxpayer's basis in the QO fund investment increases from $5 to $7.50 (an additional 5 percent of the $50 deferred gain). If Taxpayer holds the investment through 2027, $42.50 of gain is still recognized at the end of the temporary deferral period on December 31, 2026. Taxpayer's gain increases the basis in the QO fund investment from $7.50 to $42.50. If Taxpayer holds the QO fund investment until December 31, 2028, and then sells it for $100, which is the investment's FMV on that date, she will realize an additional $50 of gain. But if she makes an election under section 1400Z-2(c) at the time of the sale, none of the $50 gain will be recognized. The gain attributable to post-acquisition appreciation in the value of the QO fund will instead be permanently excluded from gross income after a holding period of 10 years.

Example 7A. The facts are the same as in Example 7, except that Taxpayer's $50 gain was realized on July 6, 2018, and the timely rollover into a QO fund investment occurs on January 1, 2019. Under those circumstances, Taxpayer's basis increases from $0 to $5 on January 1, 2019, and from $5 to $7.50 on January 1, 2026. On December 31, 2026, Taxpayer will recognize the same $42.50 of remaining deferred gain ($50 deferred gain less $7.50 basis), which will increase her cumulative basis in the QO fund investment to $50. On January 1, 2029, Taxpayer will have owned the QO fund investment for at least 10 years. But on that date no QOZs will exist. It is therefore unclear whether Taxpayer's interest in the former QO fund, which apparently owns no QOZ property (as such), is still an interest in a QO fund and thus qualifies for permanent exclusion of the appreciation in the investment's value from $50 to $100 as of January 1, 2029. The answer will be critical for investors looking to realize tax benefits from

an investment in a QO fund any time after December 31, 2018, which is 10 years before the last day on which any QOZ will be designated as such under current law.[129]

1. Taxpayer investments in a QO fund.

Temporary deferral of inclusion in gross income for some realized gains is available under section 1400Z-2(a)(1)(A) only to the extent that corresponding amounts are timely invested in a QO fund. A QO fund is defined as a corporation or partnership organized as an investment vehicle to invest in QOZ property (other than another QO fund).[130] A QO fund must be certified by the CDFI Fund.

a. Certification.

The JCT and conference reports refer to a "certification process" for QO funds by the CDFI Fund "in a manner similar to the process for allocating the new markets tax credit."[131] This will need clarification. Under the NMTC program, an entity can be certified as a CDE if it meets two statutory requirements related to the entity's primary mission and to the CDE's accountability to LICs.[132] Those criteria are different from what is required of a QO fund. Unlike NMTCs, there are no credits being allocated to certified entities subject to a statutory limit, so it is unclear whether and at what point an entity must be certified as a QO fund to make the elections required to take advantage of capital gains provisions.

b. 90 percent assets threshold and penalty.

A QO fund must hold at least 90 percent of its assets in QOZ property, and it must pay a penalty for each month it fails to meet that holding threshold,[133] unless there is reasonable cause for the failure.[134] The 90 percent threshold is determined by the average of the percentage of QOZ property held in the QO fund as measured on the last day of the first six-month period of the QO fund's tax year and on the last day of the fund's tax year. June 30 and December 31 would be the relevant testing dates for a calendar-year taxpayer.[135]

The monthly penalty for failure to meet the 90 percent threshold is essentially equal to the shortfall multiplied by the underpayment rate established under section 6621(a)(2). The underpayment rate equals the sum of the federal short-term rate for each month (announced by the IRS in quarterly revenue rulings) plus 3 percent per year (or 5 percent per year for any tax underpayment by a C corporation exceeding $100,000). For partnerships, the penalty is determined proportionately as part of each partner's distributive share of the partnership.

Example 8. Investor realized a $100 gain from a sale of property on December 22, 2017, and rolled it over into a $100 purchase of 100 shares of a QO fund's stock on June 19, 2018. At all relevant times, the underpayment rate under section 6621(a)(2) is 5 percent. The QO fund is a fund certified by Treasury that uses a calendar-year method for federal income tax purposes. The fund's only assets on and after June 19, 2018, consisted of $100 cash, as well as the following assets acquired with that $100, which

always have an aggregate FMV of $100: On June 19, 2018, the QO fund spent $100 to acquire new QOZ business property used by the fund in its trade or business in the zone; then on July 1, 2019, the QO fund sold 20 percent of the QOZ business property for $20 cash and immediately used that cash to purchase T-bills; and from July 1 to December 31, 2019, the QO fund held QOZ business property with a tax basis and FMV of $80, and $20 in T-bills with a tax basis and FMV of $20. We have intentionally simplified the example by assuming the QO fund's assets have the same basis and FMV because the statute does not indicate whether 90 percent of the average of the percentages of the fund's assets that must be held as QOZ property during each of the relevant testing periods is measured by the basis or FMV of the QO fund's assets. Guidance is expected from Treasury to clarify this issue.

Throughout 2018 and the first-six month measuring period in 2019, the QO fund held all its assets in QOZ property, consisting of $100 in QOZ business property, so the fund owes no penalties for those periods. However, on July 1, 2019, and throughout the second six-month measuring period, the average of the percentages of the QO fund's holdings that consisted of QOZ property fell to 80 percent. Since the QO fund fell 10 percent below the 90 percent minimum allowable percentage of QOZ property, it must pay a monthly penalty for the last six months of 2019. That penalty's base amount is $10, equal to the difference between 90 percent of the aggregate of QOZ property ($80) and T-bills ($20) held by the fund ($90) and the aggregate amount of QOZ property ($80). That $10 difference is multiplied by the 5 percent underpayment rate under section 6621(a)(2) to reach the monthly penalty amount of 50 cents. The QO fund's 50-cent penalty is assessed over six months of 2019 for an aggregate penalty of $3 that year.

Example 8A. The facts are the same as in Example 8, except that, as in Example 5C, Investor purchased 100 shares of stock in a QO fund for $100 on June 19, 2018, of which only $50 of the purchase price derived from the taxpayer's sale of property on or after December 22, 2017 (that is, within the 180-day period required for a deferral election under section 1400Z-2(a)). The other $50 investment derived from the taxpayer's cash reserves and did not qualify for any of special provisions related to deferral, investment basis, or permanent exclusion under the bifurcation rule in section 1400Z-2(e)(B). However, this rule does not on its face apply to the QO fund asset threshold under section 1400Z-2(d), so the same penalty described in Example 8 would apply.

Interestingly, while section 1400Z-2(e) precludes the taxpayer from realizing tax benefits from the nonqualified portion of an investment in the QO fund, nothing in the statute exempts the QO fund from burdensome investment requirements for that portion of the taxpayer's investment, or precludes the taxpayer from committing short-term funds to help the QO Fund meet its 90 percent minimum allowable percentage of QOZ property. Congress has carefully limited the bifurcation rule to the provisions affecting a taxpayer's benefits from investing in a QO fund, without any implication that QO funds can use bifurcation as a shield to avoid investing 90 percent of all their assets, including cash, in QOZ property. Three subsections of 1400Z-2 concern a taxpayer's benefits, and two concern investment thresholds and penalties applicable to the QO fund. The bifurcation rule refers to all three of the tax benefit subsections and none of those applicable to QO fund's asset thresholds.

2. Qualified zone investments by a fund.

a. QOZ property.

The QO fund qualifies by making investments in QOZ property. Recall that QOZ property is defined to include:

- Stock in a U.S. corporation that is a QOZ business. The stock must be acquired at original issuance (directly or indirectly through an underwriter) solely for cash after December 31, 2017. Also, the corporation must have been a QOZ business when the stock was issued (or, for a new corporation, was being organized to be a QOZ business). Further, the corporation must qualify as a QOZ business during substantially all of the QO fund's holding period for the stock.
- Capital or profits interests in a U.S. partnership that is a QOZ business. The interest must be acquired from the partnership solely for cash after 2017. Also, the partnership must have been a QOZ business when the interest was acquired (or, for a new partnership, was being organized to be a QOZ business). Further, the partnership must qualify as a QOZ business during substantially all of the QO fund's holding period for the interest.
- Tangible property used in the trade or business of a QOZ business. The property must be acquired by purchase after 2017. The original use of the property in the QOZ must begin with the QO fund, or the QO fund must substantially improve the property. Further, substantially all the property must be in a QOZ during substantially all of the QO fund's holding period for the property. Under these requirements, property is treated as substantially improved only if capital expenditures on the property in the 30 months after the QO fund acquires it exceed the property's adjusted basis on the date of acquisition by the QO fund.

Taxpayers cannot acquire QOZ business property from a related person (including, for this purpose, some 20-percent-affiliated entities and controlled groups). Moreover, the rule under section 179(d)(2) applicable in other federal tax incentive programs operated in enterprise and renewal communities and empowerment zones would appear to be applied as if 20 percent rather than 50 percent relatedness between individuals and entities and between entities and entities disqualified a purchase.[136] This is unlike prior programs and will need to be further explained by Treasury and the IRS in future guidance under sections 1400Z-1 and 1400Z-2.

b. QOZ businesses.

A QOZ business is any trade or business that meets the following requirements:

- Substantially all the tangible property owned or leased by the business must be purchased by it after 2017. The QOZ business must be the first person to use the property in the QOZ, or it must substantially improve the property (capital expenditures on the property in the 30 months after the QO business acquires it must equal or exceed the property's adjusted basis at the beginning of that 30-month period). The property must be used in the QOZ during substantially all of the

QOZ business's holding period. Finally, the property must not be acquired from a related person or a member of a 20-percent-controlled group of which the taxpayer is a member.

- At least 50 percent of the total gross income of the entity is derived from the active conduct of business in the QOZ.
- A substantial portion of the business's intangible property is used in the active conduct of business in the QOZ.
- Less than 5 percent of the average of the aggregate adjusted bases of the property of the business is attributable to nonqualified financial property, which means debt instruments, stock, partnership interests, annuities, and derivative financial instruments (including options, futures, forward contracts, and notional principal contracts), other than (1) reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of no more than 18 months, and (2) accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of inventory property.
- The business cannot be a country club, massage parlor, hot tub facility, racetrack, health club, or store whose principal business is the sale of alcoholic beverages for consumption off premises.

IV. Conclusion

In the wake of the financial crisis, community development advocates have generally faulted the complex and detailed requirements that states and local governments have often been required to satisfy to qualify low-income, high-poverty census tracts for federal tax incentives.[137] The programs established for empowerment zones and enterprise and renewal communities were viewed as less successful than anticipated because many of the limitations, restrictions, and exclusions made them unavailable to the nation's largest companies in several industries. National and multinational companies were excluded as a practical matter from tax benefits under rules that limited benefits in empowerment zones, enterprise communities, and renewal communities to businesses with 35 percent of their workforce in the applicable zone or community,[138] and many businesses large and small in the software, music, publishing, farming, and residential rental industries were excluded by fiat.

The QOZ program avoids these earlier pitfalls by opening its benefits to the vast majority of businesses nationwide and expanding its incentives to cover gains realized outside the zone and reinvested in it. Because the empowerment zone asset rollover and exclusions for capital gains realized on the sale of D.C. zone and renewal community assets depended on an increase in value of the assets in the zone rather than the economic status quo ex ante, they cut against market forces rather than relying on them. The new program's stated policy reflects a welcome paradigm shift from rewarding zone businesses (as such) to rewarding capital retained or reinvested in the zone.

The old approach rewards a business for its accidental location in a zone, while the new approach reflected in the legislative history of the QOZ program has the potential to truly increase the aggregate amount of capital in a federally designated area for the program's life. This would be true even if zone

businesses were essentially rewarded for selling one zone asset and buying others, because the program's incentives encourage long-term retention of the newly acquired zone asset, which could at any time be relocated outside the zones, where profits were greater. Although economic distortions are inevitable in programs designed to encourage a reallocation of capital, it is important that those distortions serve the program's needs. The policy behind the QOZ program is thus appropriately directed.

Whether the program serves that policy objective, however, will be up to Treasury as it drafts rules to interpret an ambiguous statute that cannot properly function as written. Investors need to know how long they must hold assets in a zone to determine whether reallocating capital there is worthwhile. Without further guidance from Treasury, that determination cannot be reasonably made.

Absent guidance on the interplay between the termination of QOZ designations and QO fund holding periods that would, as a practical matter, go beyond the statutory termination date of QOZs, we offer the following tentative conclusions:

- Eligible gain is deferred until the earlier of December 31, 2026, or the year the taxpayer disposes of its interest in the QO fund.
- No tax benefits are available unless the eligible gain is realized from a sale or exchange no later than December 31, 2026, and is rolled over into a QO fund investment within 180 days from the date of the sale or exchange.
- The latest date on which eligible gains can be reinvested in a QO fund is June 28, 2027 (which is the last day of the 180-day period beginning December 31, 2026).
- If the taxpayer reinvests eligible gain after 2019 but before 2022, because he cannot hold his interest in the QO fund for at least seven years before December 31, 2026, the taxpayer's tax on his eligible gain will be deferred and may be excluded in an amount that does not exceed 10 percent of the eligible gain. However, the maximum potential exclusion of 15 percent of the eligible gain will not be available.
- If the taxpayer reinvests eligible gain after 2021, because he cannot hold his interest in the QO fund for at least five years before December 31, 2026, the taxpayer's tax on his eligible gain will be deferred, but no exclusion will be available.
- If the taxpayer holds a QO fund investment after 2026, he will recognize all remaining eligible gain (less amounts excluded from basis increases) in the tax year that includes December 31, 2026, and his basis in the investment after 2026 will at least equal the amount of the eligible gain originally rolled over into the investment.
- For taxpayers who hold a QO fund investment after 2026 and for at least 10 years after the investment was acquired, only gains accrued from appreciation in the investment since the taxpayer acquired an interest in the QO fund will not be recognized and eligible for permanent exclusion on a later sale or exchange of the investment by the taxpayer.

- For this important program to have its intended effect, however, taxpayers need clearer guidance from Congress and the IRS about whether their investments after the close of 2018 will qualify for the full range of tax benefits under section 1400Z-2.

FOOTNOTES

[1] *See* Jim Tankersley, "Tucked Into the Tax Bill, a Plan to Help Distressed America," *The New York Times*, Jan. 30, 2018, at B1.

[2] Congress originally excluded Puerto Rico from designating QOZs under section 13823(a) of the TCJA. However, section 41115 of the Bipartisan Budget Act of 2018, P.L. 115-123 (Feb. 9, 2018), added section 1400Z-1(b)(3) to the code, which established a new opportunity zone rule for Puerto Rico. *See infra* Section III.A.1.d.

[3] Section 1400Z-2(b)(2)(B)(iii) and (iv); and section 1400Z-2(c).

[4] Section 1400Z-1(c)(1). As discussed later, the QOZ provisions adopt the definition of LIC under section 45D for the new market tax credit (NMTC).

[5] Section 1400Z-1(b)(1)(A) and (c)(2)(B).

[6] Section 1400Z-1(b)(2).

[7] Section 1400Z-1(b)(1)(B), (b)(2), and (c)(2)(A).

[8] Section 1400Z-2(a)(1)(A) and (d)(1).

[9] *See* Treasury Community Development Financial Institutions Fund, "List of Designated Qualified Opportunity Zones" (updated Apr. 18, 2018) (CDFI list).

[10] Because Treasury has not yet published an official list of QOZ designations in the *Internal Revenue Bulletin*, this report relies on the CDFI list, *id.*, which, although unofficial, is regularly updated as new designations are made. *See* Rev. Proc. 2018-16, 2018-9 IRB 383, sections 3.04 through 3.06 (establishing the CDFI Fund's database of LICs and eligible non-LIC contiguous tracts as a safe harbor for QOZ designations). *See also* CDFI Fund, "Opportunity Zones Information Resource" (updated Feb. 27, 2018) (CDFI information resource), which contains sortable lists by state of all census tracts eligible for designation as a QOZ.

[11] Section 1400Z-2(a)(1)(A) and (f).

[12] Section 1400Z-2(a)(1)(A).

[13] *Compare* section 1400Z-2(a)(1)(A) (requiring funds to be reinvested within 180 days), *with* section 6072(a) (requiring individual tax returns to be filed by April 15 and corporate tax returns to be filed by the 15th day of the fourth month after the close of the fiscal year); *and* section 6072(b) (requiring S corporations and partnerships to file tax returns by the 15th day of the third month after the close of the fiscal year).

[14] We assume that for this purpose, a QO fund may be structured as any foreign or domestic entity that is either a corporation within the meaning of section 7701(a)(3) (including a C corporation, an S corporation, a joint stock company, an association, or an insurance company) or a partnership within the meaning of section 7701(a)(2) (including a limited liability company, limited liability partnership, limited liability limited partnership, joint venture, or any other passthrough business entity that is not a trust, estate, corporation, or disregarded entity as defined in section 7701 and its regulations). Thus, it appears that a QO fund cannot be a foreign or domestic trust.

[15] As discussed later, recent guidance from the IRS indicates that eligible entities will be allowed to become QO funds simply by filing a form with the IRS. *See infra* Section III.B.

[16] Scott release, "Scott's Bipartisan Investing in Opportunity Act Passes Out of Finance Committee" (Nov. 17, 2017).

[17] QO funds that establish reasonable cause for their failure to meet the 90 percent requirement are not subject to penalty. Section 1400Z-2(f)(3).

[18] Section 1400Z-2(d)(2).

[19] Stock in a U.S. corporation that is a QOZ business may be acquired at original issuance directly or through an underwriter.

[20] Section 1400Z-2(d)(D)(ii).

[21] *Compare* section 1400Z-2(d)(D)(ii), *with* section 1400F(b)(4)(B), which cross-references section 1400B (b)(4)(B)(ii)(I).

[22] *Compare* section 1400Z-2(d)(D)(ii), *with* section 1400F(b)(4)(B), which cross-references section 1400B (b)(4)(B)(ii)(II).

[23] Before the Senate's markup, the JCT wrote that "only taxpayers who rollover capital gains of non-zone assets before December 31, 2026, will be able to take advantage of the special treatment of capital gains for non-zone and zone realizations under the proposal." *See* JCT, "Description of the Chairman's Modification to the Chairman's Mark of the 'Tax Cuts and Jobs Act,'" JCX-56-17, at 53-54 (Nov. 14, 2017).

[24] Section 1400Z-2(b)(2)(B)(iii) and (iv).

[25] Section 1400Z-2(c).

[26] Census tracts designated as QOZs retain their designation until the close of the 10th calendar year beginning on or after the tract's designation, which, for tracts designated in 2018, is December 31, 2028. Section 1400Z-1(f).

[27] S. 293, proposed section 1400Z-1(a)(2)(C).

[28] H.R. Rep. No. 115-466, at 539 (Dec. 15, 2017) (Conf. Rep.).

[29] Section 1400F(d) (cross-referencing section 1400B(b)(5)).

[30] Section 1400Z-2(d)(2)(D)(i)(III).

[31] Present value of deferred tax in 2026 = -20 percent of $850,000 x $(1 + 0.025)^{-16}$ = -$114,516.24. That is, 42.74 percent below the $200,000 cost of 2018 tax that would otherwise be due on $1 million of capital gain assessed at a 20 percent rate in 2018.

[32] JCT, "Estimated Budget Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act,'" JCX-67-17 (Dec. 18, 2017).

[33] JCT, "Estimated Revenue Effects of H.R. 4923, the 'Community Renewal and New Markets Act of 2000,'" JCX-86-00 (July 25, 2000).

[34] Scott release, *supra* note 16.

[35] Don Hirasuna and Joel Michael, "Enterprise Zones: A Review of the Economic Theory and Empirical Evidence," at 8-9 (Jan. 2005).

[36] Margaret Thatcher Foundation, 1980 Budget (Howe 2) (Mar. 26, 1980).

[37] *See* the Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, section 13301(a).

[38] *Id*.

[39] McConnell remarks, 164 *Cong. Rec.* S617, S618 (Feb. 6, 2018).

[40] Section 1400Z-1(d)(2); *see* CDFI information resource, *supra* note 10 (listing 76 percent of Wyoming's, 52 percent of Vermont's, and 50 percent of North Dakota's total number of LICs as eligible for QOZ designation).

[41] CDFI Fund, "Opportunity Zone Resources: Map" (listing tract 11001000201, which includes Georgetown University, as an NMTC-qualified LIC tract, and listing all of Georgetown (including census tracts 11001000802, 11001000300, 11001000100, and 11001000400) as "Opportunity Zone Eligible Contiguous Tracts").

[42] Massachusetts Executive Office of Housing and Economic Development, Massachusetts Opportunity Zone Application, at 1.

[43] *See* California Department of Finance, "Opportunity Zones in California: List of Nominated Tracts" (including Los Angeles census tract 2060.31, which is in the Little Tokyo Historic District); release from New Jersey Gov. Phil Murphy (D), "Governor Murphy Submits Recommended Opportunity Zones to U.S. Treasury," at *2 (Mar. 22, 2018).

[44] *See* section 45D(e)(1) (defining LIC for NMTCs); and section 1392(a)(4) (establishing poverty rate criteria for areas eligible for designation as enterprise zones and empowerment zones).

[45] Omnibus Budget Reconciliation Act 1993, sections 13301(a) and 13311.

[46] *Id*. at sections 13301 through 13303.

[47] Section 1391(b)(1) (authorizing designation of enterprise communities); and section 1391(b)(2) (authorizing designation of empowerment zones).

[48] Section 1393(a)(1).

[49] OBRA 1993, section 13301(a).

[50] *See* section 1400B(a).

[51] P.L. 106-554, section 121(a).

[52] *Id*. at section 101(a); code section 1400F(a).

[53] P.L. 106-554, section 116(a); code section 1397B(a)(1).

[54] P.L. 106-554, section 117(a); code section 1202(a).

[55] P.L. 106-554, section 121(a).

[56] *Id*. at section 701(a).

[57] Section 1400B(a).

[58] Section 1400E(a)(1) and (2).

[59] Section 1400E(b)(1)(A).

[60] Section 1400F(c)(2).

[61] Section 1400F(b)(4) (providing the time frame for eligible property to be acquired); and section 1400F (c)(2) (setting time limits for the eligible property to be sold).

[62] Section 1400F(b)(1).

[63] Section 1400F(b)(2).

[64] Section 1400G (cross-referencing section 1397C(b) and (e)).

[65] Section 1397C(e)(1) and (2).

[66] Section 1397C(d)(2)(A).

[67] Section 1397C(d)(2)(B).

[68] Section 1397C(d)(3).

[69] Section 1397C(d)(4).

[70] Section 1397C(d)(5)(A); and section 144(c)(6)(B).

[71] Section 1397C(d)(5)(B).

[72] Section 1400Z-2(d)(3)(A)(ii).

[73] Section 1400Z-2(a)(1) (referring to the investor in the QO Fund as "the taxpayer").

[74] *See* section 1400F(b)(2)(B) (cross-referencing section 1202(c)(3)) and section 1202(c)(3)(A).

[75] Section 1400F(b)(2)(B) (cross-referencing section 1202(c)(3)) and section 1202(c)(3)(B).

[76] Section 1400B(b)(3).

[77] *Id.*

[78] Section 1400Z-2(d)(2)(C).

[79] Section 1202(c)(3)(A).

[80] *Compare* section 1400Z-2(d)(2)(C), *with* section 1400F(b)(3), section 1400B(b)(3), *and* section 1202(c)(3)(A).

[81] Section 1400F(b)(2)(B) (cross-referencing section 1202(c)(3)); and section 1202(c)(3)(C).

[82] Section 304(c)(1).

[83] Scott release, "Senator Scott Introduces the Bipartisan Investing in Opportunity Act," at 1 (Feb. 2, 2017).

[84] Section 1397B(b)(1)(A); section 1400B(b)(2)(B); and section 1400F(b)(2)(B).

[85] Section 1400F(b)(3).

[86] Section 1400B(b)(3) (flush language); section 1400F(b)(3); and section 1397B(b)(1)(A).

[87] Section 1400F(b)(4).

[88] *See* section 179(d)(2) (referring to relationships described in sections 267 and 707(a)); section 267(b) and (c); and section 707(b)(1) and (b)(3).

[89] Section 179(d)(2)(B) and (d)(7).

[90] Section 179(d)(2)(C)(i) and (ii); and section 1014(a).

[91] Section 1400F(c).

[92] Section 1400F(c)(3); and section 1400B(e)(3).

[93] Section 1400Z-2(a)(1)(A), (b)(2)(B), and (c).

[94] Section 45D(e)(1).

[95] Section 45D(e)(4).

[96] Section 1400Z-1(c)(1) defines an LIC according to the definition under section 45D(e)(2) for the NMTC. That definition includes a "targeted population" of "individuals, or an identifiable group of individuals . . . who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments." *See* reg. section 1.45D-1(d)(9)(i)(A)(1) (defining low-income person for the NMTC). Although section 1400Z-1(c)(1), by cross-reference to section 45D(e)(2), seems to include the reference

to targeted populations, the IRS has effectively excluded those populations from QOZ designation by providing a safe harbor that includes only low-income census tracts, with no obvious way to designate low-income individuals or other targeted populations. *See* Rev. Proc. 2018-16, section 3.06.

[97] Section 45D(e)(5)(A) and (B).

[98] Section 45D(a)(2).

[99] Section 45D(c)(1). The IRS delegated certification to the CDFI Fund.

[100] Section 45D(a)(2).

[101] Section 45D(b)(1); and reg. section 1.45D-1(c).

[102] Section 45D(b)(1)(A); and reg. section 1.45D-1(c)(1)(i).

[103] Section 45D(b)(1)(B); and reg. section 1.45D-1(c)(1)(ii).

[104] Rev. Proc. 2018-16, section 3.01.

[105] Rev. Proc. 2018-16, section 2.06.

[106] Section 1400Z-1(d)(1) and (2).

[107] Section 1400Z-1(c)(1) (defining LIC by cross-reference to section 45D(e)).

[108] Section 1400Z-1(e).

[109] The CDFI Fund's complete list of eligible tracts is available at Rev. Proc. 2018-16, sections 3.04 through 3.06. *See also* CDFI information resource, *supra* note 10.

[110] Treasury has designated all the Virgin Islands' 13 LIC tracts and one of its non-LIC contiguous tract as QOZs under the rounding rule discussed below. Neither the Northern Mariana Islands nor American Samoa — which have 20 and 16 LICs, respectively — has any eligible non-LIC contiguous tracts, so only 20 population census tracts in the Northern Mariana Islands and only 16 in American Samoa have been designated as QOZs.

[111] Rev. Proc. 2018-16, section 2.09(3).

[112] *Id*. at sections 2.09(1) and (3).

[113] *See* CFDI list, *supra* note 9.

[114] Section 1400Z-1(d)(2).

[115] Rev. Proc. 2018-16, section 2.09(3).

[116] CDFI list, *supra* note 9.

[117] *Id.*

[118] CDFI list, *supra* note 9.

[119] *See* section 1400Z-1(b)(3).

[120] CDFI list, *supra* note 9 (listing as designated LICs Puerto Rico's 835 LICs, plus 26 non-LIC contiguous tracts).

[121] Section 1400Z-2(d)(1)-(2) (requiring 90 percent of the fund's assets to be held as QOZ property).

[122] Section 1400Z-2(d)(1) and (f).

[123] H.R. Rep. No. 115-466, at 537-538. *See also* JCX-56-17, *supra* note 23, at 53-54.

[124] Reg. sections 1.1245-6(a) and 1.1250-1(c)(1).

[125] Section 1400B(e)(3); and section 1400F(c)(3) (cross-referencing section 1400B(e)(3)).

[126] Section 1(h)(1)(D).

[127] Section 1400Z-2(e)(1).

[128] *See* section 1400Z-2(d)(2)(D)(i)(II) and (III); and section 1400Z-2(d)(3)(A)(i).

[129] *See* section 1400Z-1(f).

[130] Section 1400Z-2(d)(1).

[131] *See* JCX-56-17, *supra* note 23, at 53; and H.R. Rep. No. 115-466, at 538.

[132] *See* section 45D(c)(1)(A) through (C).

[133] Section 14002-2(f)(1).

[134] Section 14002-2(f)(3).

[135] *See* section 1400Z-2(f)(1) through (3).

[136] The relatedness rules under sections 267(b) and 707(a) apply, as modified, to QOZ business property and QOZ businesses, using a 20 percent rather than a 50 percent relatedness standard.

[137] Roger A. Clay Jr. and Susan R. Jones, *Building Healthy Communities: A Guide to Community Economic Development for Advocates, Lawyers and Policymakers* 126 (2009).

[138] Section 1397C(b)(6).

END FOOTNOTES

DOCUMENT ATTRIBUTES

CODE SECTIONS	SEC. 1400Z-1 DESIGNATION SEC. 1400Z-2 SPECIAL RULES FOR CAPITAL GAINS INVESTED IN OPPORTUNITY ZONES.
JURISDICTIONS	UNITED STATES
SUBJECT AREAS / TAX TOPICS	REAL ESTATE TAXATION TAX CUTS AND JOBS ACT
MAGAZINE CITATION	STATE TAX NOTES, MAY 14, 2018, P. 683 88 STATE TAX NOTES 683 (MAY 14, 2018)
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TAX ANALYSTS ELECTRONIC CITATION	2018 STT 105-10