

OPPORTUNITY ZONES: TAX BENEFITS, CRITICISMS, AND EARLY IRS ENFORCEMENT

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Introduction

After Congress enacted the Qualified Opportunity Zone (“QOZ”) legislation in late 2017, significant funds began flowing into projects located in low-income communities, and taxpayers making the investments are set to obtain several federal income tax benefits. In light of these realities, everybody must be pleased with the QOZ program thus far, right? Wrong. Various oversight groups and members of Congress have criticized aspects of the QOZ program and demanded action, including increased enforcement by the IRS.

This article describes the purpose of QOZs, how properties eligible for investment were selected, key terminology and concepts, three tax benefits for investors, penalties for non-compliance, filing obligations, special anti-abuse measures, administrative guidance, initial criticisms of the QOZ program, and early IRS enforcement actions.

Purpose of the legislation

Many believe that the U.S. economy functions independently, guided only by complicated market

forces. That is not the case. Congress often manipulates behavior through the legislation it enacts. For instance, Congress periodically offers tax incentives designed to encourage private investment in troubled areas.¹ One recent example was the passage of Section 1400Z-1 and Section 1400Z-2, the foundation of the QOZ program.

Why did Congress feel it appropriate to pass this law? According to legislative history, Congress introduced the QOZ program in hopes that it would help revitalize distressed communities, serve as a catalyst for growth and opportunity, attract inactive capital, stop business closures, foment entrepreneurship, and ensure that *local* needs are met by allowing state Governors to play a key role in the process.²

The IRS’s explanation for the legislation was more clinical. It stated that the idea was “to provide specified federal income tax benefits to [investors] to encourage the making of longer-term investments . . . of new capital in one or more [QOZs] and to increase the economic growth of such [QOZs].”³ One Congressman, an early advocate of QOZs, described the goal in a different manner. He indicated that the intent was a “noble enterprise in trying to get early-stage capital to hard-to-reach areas,” a recognition that about 80% of all private equity investments currently go to just three coastal

This article examines the Qualified Opportunity Zone program, including tax benefits, administrative guidance, initial criticisms of the program, and early IRS enforcement actions.

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states, and a desire to redirect money to the “flyover states.”⁴

Selecting locations for investment

A QOZ is a “low-income community” that was properly designated.⁵ Designation was a two-step process. The Chief Executive Officer of each state, which was ordinarily the Governor, first reviewed the eligible properties and *nominated* particular tracts for QOZ status. After receiving the nominations, the Treasury Secretary, with assistance from the Community Development Financial Institutions Fund, *certified* them.⁶ The deadline for designating QOZs closed in mid-2018, such that there will be no additional QOZs, absent a legislative change in the future.⁷ There are approximately 8,750 QOZs.⁸

In identifying potential tracts for QOZ status, Governors were instructed to give appropriate consideration to areas that were already the focus of mutually reinforcing state, local, and/or private economic-development initiatives, have recently experienced significant lay-

tory authority for *one round* of nominations and designations [so] there are no current or proposed plans to reopen consideration of additional census tracts to be designated as QOZs.”¹³

A peek at key terminology

As one would expect with a multi-billion-dollar government incentive program, the terms and rules are extremely complicated; several hundreds of pages of regulations prove that. There will be plenty of time to dig into the details as the IRS starts challenging QOZs in earnest. For now, it is enough to review the broader background.

The main characters in a typical, simplified scenario are the investor, Qualified Opportunity Fund (“QOF”), and Qualified Property.

- An eligible taxpayer, sometimes referred to as an investor, engages in a transaction triggering capital gains, which he then invests in a QOF within 180 days of the transaction. Investors can be certain individuals, business entities, tax-exempt organizations, trusts, or estates, but this article refers to all investors as individuals for the sake of simplicity.¹⁴
- A QOF is an investment vehicle, which is a partnership or corporation, which was established for purposes of investing in Qualified Property, and which holds at least 90% of its assets in Qualified Property.¹⁵
- Qualified Property means tangible property, acquired by cash purchase after 12/31/2017, whose original use begins with the QOF or which is substantially improved by the QOF, and substantially all of whose use takes place in the QOZ.¹⁶ A QOF can hold Qualified Property in one of two ways, directly or indirectly. Direct ownership needs no further discussion. Indirect ownership, however, requires an explanation. A QOF can own either Qualified Stock in a corporation or a Qualified Interest in a partnership, which, in turn, holds the Qualified Property.¹⁷

Tax benefits for investors

Taxpayers making a QOF investment hope to take advantage of the three tax benefits.

First benefit – tax deferral on rollover gain. A taxpayer generally can elect to defer federal income taxes on the capital gains triggered by engaging in a sale or exchange of property with an unrelated person, as long as the taxpayer invests such gains in a QOF within 180 days.¹⁸ In

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offs due to business closures or relocations, and have prior success with geographically-targeted development programs, such as Promise Zones, New Market Tax Credits, Empowerment Zones, and Renewal Communities.⁹

Limits existed on the number of QOZs, of course. Generally, the amount of QOZs could not exceed 25% of the total low-income communities in a particular state.¹⁰

Certain tracts of land that did *not* qualify as low-income communities could still become QOZs. For this to occur, the tract in question had to be contiguous to a QOZ, and the median family income in such tract could not exceed 125% of that in the neighboring QOZ.¹¹ Moreover, not more than 5% of the tracts in a state could achieve QOZ status thanks to the contiguous-property method.¹²

Some people have urged the IRS to reopen the process in order to add, remove, or modify QOZs to comport with updated census data and/or initial investment activity. The IRS has said that its hands are legislatively tied, explaining that “Section 1400Z-1 provides the statu-

other words, a taxpayer can postpone paying federal income taxes on capital gains if he properly reinvests them in a QOF (“Rollover Gains”).¹⁹

The tax deferral can theoretically last up to nine years, from 2018 (*i.e.*, the first year tax deferral was available) through 2026 (*i.e.*, the termination date set forth in the regulations). The tax deferral might end *before* 2026, though, if the taxpayer disposes of his QOF investment earlier, or if another “inclusion event” occurs.²⁰

The taxpayer’s basis in the Rollover Gains is \$0 when he reinvests them in a QOF, but the basis increases somewhat the longer the taxpayer keeps his QOF investment. The tax-reduction-via-basis-adjustments are described further below.

A taxpayer can choose to invest *all* the proceeds from a sale or exchange of property in a QOF, meaning both the return of basis and the capital gain. This produces what is called a “Mixed Fund.”²¹ However, tax deferral *only* applies to the Rollover Gain (*i.e.*, capital gain), as shown by the example below.

[I]f a taxpayer sells stock at a gain and invests the entire sales proceeds (capital and return of basis) in a [QOF], an election can be made only with respect to the capital gain amount. No election can be made with respect to the amounts attributable to a return of basis, and no special tax benefits apply to such amounts.²²

Second benefit – reduced taxes on rollover gain. If a taxpayer maintains his investment in a QOF for more than five years before disposing of it, the Rollover Gain will be subject to reduced taxes.²³ This benefit is not the result of *lowering* the tax rate, but rather it stems from

increasing the taxpayer’s basis in the Rollover Gain from \$0. Put another way, the tax rate remains the same, but the amount of gain subject to such rate drops.²⁴

Specifically, if a taxpayer holds the QOF investment for at least five years before disposing of it, his basis increases by 10% of the Rollover Gain.²⁵ The pot gets sweeter where a taxpayer holds his QOF investment for at least seven years; the basis rises to 15% of the Rollover Gain.²⁶

The character of the Rollover Gain survives the QOF investment.²⁷ This means that when tax-deferral ends and the IRS obligates taxpayers to pay taxes on the Rollover Gain, the question of whether it will face short-term or long-term capital gain rates is dictated by the character of the Rollover Gain at the time it was originally invested in the QOF years earlier. In other words, holding the Rollover Gain in a QOF for several years does *not* serve to convert it from short-term to long-term.²⁸

Third benefit – tax exclusion on fund appreciation. In cases where a taxpayer stays the course for at least 10 years, he avoids federal income taxes altogether on the appreciation of the Rollover Gain as a result of its long-standing investment in a QOF (“Fund Appreciation”).²⁹ As readers will recall, the taxpayer will have already paid federal income taxes on the Rollover Gain by or before 2026, although in a reduced amount thanks to the basis increase of 10% or 15%. The issue here focuses on exclusion of Fund Appreciation (*i.e.*, increase in value of the Rollover Gain invested in a QOF) from federal income taxes for a taxpayer who holds his QOF investment for at least 10 years.

¹ U.S. Senate, Committee on the Budget. Reconciliation Recommendations Pursuant to H. Con. Res. 71. 115th Congress, 1st Session, Report 115-20 (Dec. 2017), pg. 318; U.S. House of Representatives, Conference Report. Tax Cuts and Jobs Act. 115th Congress, 1st Session, Report 115-466 (12/15/2017), pg. 537.

² U.S. Senate, Committee on the Budget. Reconciliation Recommendations Pursuant to H. Con. Res. 71. 115th Congress, 1st Session, Report 115-20 (Dec. 2017), pg. 318.

³ Reg. 1.1400Z-2(f)-(c)(1).

⁴ U.S. House of Representatives, Committee on Ways and Means, Subcommittee on Oversight. Hearing on the Opportunity Zone Program and Who It Left Behind. 11/16/2021. Statement by Ron Kind, Representative of Wisconsin.

⁵ Section 1400Z-1(a). For these purposes, the definition of “low-income community” is the same as that used in Section 45D(e) in connection with the New Market Tax Credit. See Section 1400Z(c)(1).

⁶ Section 1400Z-1(b)(1); Section 1400Z-1(c)(2). For more information on the Community Development Financial Institutions Fund, see Congressional Research Service. Community Development Financial Institutions Fund: Programs and Policy Issues. Report R42770 (Jan. 2018).

⁷ Revenue Procedure 2018-16, section 2.06.

⁸ U.S. Joint Committee on Taxation. Qualified Opportunity Zones: An Overview (June 2019), pg. 15.

⁹ U.S. Senate, Committee on the Budget. Reconciliation Recommendations Pursuant to H. Con. Res. 71. 115th Congress, 1st Session, Report 115-20 (Dec. 2017), pg. 319; U.S. House of Representatives, Conference Report. Tax Cuts and Jobs Act. 115th Congress, 1st Session, Report 115-466 (12/15/2017), pg. 538.

¹⁰ Section 1400Z-1(d)(1). If a state had fewer than 100 low-income communities, up to 25 tracts could be QOZs. See Section 1400Z-1(d)(1).

¹¹ Section 1400Z-1(e)(1).

¹² Section 1400Z-1(e)(2).

¹³ TD 9889, Preamble, pg. 306 (emphasis added).

¹⁴ Reg. 1.1400Z2(a)-1(b)(13).

¹⁵ Section 1400Z-2(d)(1); Reg. 1.1400Z2(a)-1(b)(18); Reg. 1.1400Z2(d)-1(a).

¹⁶ Section 1400Z-2(d)(2)(A); Section 1400Z-2(d)(2)(D)(i); Reg. 1.1400Z2(a)-1(b)(32); Reg. 1.1400Z2(d)-2(a). The required use or improvements can be by the QOF itself or a “qualified opportunity zone business.”

EXHIBIT 1
Qualified Opportunity Fund Investment

Year	Value of QOF Investment	Basis Increases	Mandatory Capital Gain Recognition	Amounts Taxed If Investment Sold
2019	\$100,000	\$0	n/a	\$100,000
2020	\$107,000	\$0	n/a	\$107,000
2021	\$114,490	\$0	n/a	\$114,490
2022	\$122,504	\$0	n/a	\$122,504
2023	\$131,080	\$0	n/a	\$131,080
2024	\$140,255	\$10,000	n/a	\$130,255
2025	\$150,073	\$10,000	n/a	\$140,073
2026	\$160,578	\$15,000	\$85,000	\$60,578
2027	\$171,819	\$15,000	n/a	\$71,819
2028	\$183,846	\$15,000	n/a	\$83,846
2029	\$196,715	\$15,000	n/a	\$0

This tax exclusion, which taxpayers must elect, occurs by way of basis adjustment, as opposed to tax-rate manipulation. If the taxpayer disposes of his QOF investment after the 10-year period, his basis in the QOF investment will be equal to the fair market value of the QOF investment on the date of disposition.³⁰ The IRS assumes that the fair market value and sales price will be one and the same.³¹ The effect of increasing the basis to match the sales price is an exclusion of Fund Appreciation from federal income taxes.

A taxpayer must hold the QOF investment for at least 10 years to benefit from income exclusion, but he can maintain it much longer if he so desires. In particular, a taxpayer can keep the QOF investment and make the income-exclusion election up until 12/31/2047.³²

Summary of the three tax benefits. In summary, Section 1400Z-2 essentially offers three tax benefits for an investor: (1) deferral for up to nine years on payment of federal income taxes on Rollover Gain, which allows the investor to harness the time value of money; (2) reduction of income taxes on Rollover Gain when a taxpayer holds the QOF investment for at least five years, achieved through basis increases; and (3) exclusion of Fund Appreciation from federal income taxes when a taxpayer holds the QOF investment 10 years or more, accomplished, again, by way of basis increases.³³ Below is an illustration of how these tax benefits function together:

On 6/30/2019, Taxpayer has a basis in XYZ stock of \$40 and sells such stock for \$140, realizing a capital gain of \$100. Taxpayer reinvests the \$100 gain (but not the \$40 return of capital) in a QOF within the 180-day period. Taxpayer does not have to pay tax on the capital gain in 2019. Taxpayer's initial basis in the QOF investment is \$0. On 6/30/2024, Taxpayer has held the QOF investment at least five years, so his basis increases to \$10. On 6/30/2026, Taxpayer has held the QOF investment at least seven years, so his basis increases an additional \$5 to \$15. On 12/31/2026, Taxpayer must recognize \$85 of gain (*i.e.*, \$100 in Rollover Gain less \$15 in basis), even though he has not sold the QOF investment. On 7/1/2029, Taxpayer has held the QOF investment for at least 10 years, so he sells it for \$219 and pays no additional tax on the Fund Appreciation.³⁴

For those readers who became blurry-eyed reading the preceding examples, Exhibit 1 is a chart reflecting the concepts in a visual fashion. It assumes a 7% annual compounded rate of return on the QOF investment.³⁵

Exhibit 1 shows that a taxpayer who takes \$100,000 of Rollover Gain, invests it in a QOF, and maintains it for the long haul will postpone payment of federal income taxes on Rollover Gain from 2019 to 2026, escape taxes on \$15,000 of Rollover Gain thanks to two basis increases, and avoid taxes on Fund Appreciation of \$96,715. Viewed from another angle, when it comes to his investment worth \$196,715 in 2029, the taxpayer only had to pay taxes on \$85,000 (of approximately \$17,000) in 2026, with the remainder being tax-free.³⁶

Comparison –with and without the tax incentive. In addition to seeing the effects of the three tax benefits in isolation, it is worthwhile comparing an investment with and without the QOZ program. Assume for this illustration that a taxpayer has Rollover Gain of \$100 in 2019, the capital gains rate is 20%, and the interest rate is 2.5%.

If a taxpayer were to decide *not* to invest the \$100 of Rollover Gain in a QOF, and if the rate of return on his investment were 9%, the following would occur: (1) in 2010, the taxpayer would pay \$20 in capital gains tax on the \$100 of Rollover Gain; (2) at the 10-year mark, in 2029, the \$80 investment would have grown to \$231; (3) the taxpayer would pay \$30 in capital gains tax on the \$231 of Fund Appreciation; and (4) the taxpayer would have \$201 leftover in 2029 (*i.e.*, \$231 minus \$30).

On the other hand, if a taxpayer were to decide to invest the \$100 of Rollover Gain in a QOF, and if the rate of return on his investment were 6%, the following would occur: (1) in 2019, the taxpayer would pay \$0 in capital gains tax on the \$100 of Rollover Gain; (2) at the seven-year mark, 2026, the taxpayer would be obligated to pay \$17 in capital gains tax on the \$85 of Rollover Gain, achieved after applying the \$10 and additional \$5 basis increases; (3) at the 10-year mark, in 2029, the \$100 investment would have grown to \$219; (4) the taxpayer would pay \$0 in capital gains tax on the \$119 of Fund Appreciation; (5) the taxpayer paid \$1 in interest charges on the \$17 he borrowed from 2026 to 2029; and (6) the taxpayer would have \$201 leftover in 2029 (*i.e.*, \$219 minus \$17 minus \$1).

The preceding illustration demonstrates that a taxpayer would achieve the same after-

tax result, using the same amount of money, whether he made a non-QOF investment yielding a 9% return or a QOF investment yielding a 6% return.³⁷

Penalties for shirking standards

As explained above, in order for a partnership or corporation to be a QOF, it must have been formed for purposes of investing in Qualified Property and, in fact, must hold at least 90% of its assets in Qualified Property.³⁸ The partnership or corporation, in other words, must talk the talk *and* walk the walk. What happens if a QOF fails to maintain the investment standard? The IRS asserts sanctions, of course.

If a QOF does not continuously meet the 90% test, it must pay a penalty for each non-compliant month, calculated according to the following formula: 90% of the gross assets of the QOF, divided by the total amount of Qualified Property held by the QOF, multiplied by the applicable interest rate.³⁹ The IRS refrains from imposing this penalty, however, in situations where there is “reasonable cause” for the violation.⁴⁰

Tax and information returns

Participation in a QOF investment triggers several reporting obligations with the IRS, the most noteworthy of which are examined below.

Investors. Investors must file their annual tax return, which, in the case of individuals, is Form 1040 (U.S. Individual Income Tax Return). They must enclose various information returns with their Forms 1040. For example, investors file a Form 8949 (Sales and Other Dispositions

¹⁷ Section 1400Z-2(d)(2)(B); Section 1400Z-2(d)(2)(C); Reg. 1.1400Z2(a)-1(b)(31); Reg. 1.1400Z2(a)-1(b)(33); Reg. 1.1400Z2(d)-1(c).

¹⁸ Section 1400Z-2(a)(1)(A); Reg. 1.1400Z2(a)-1(a); Reg. 1.1400Z2(a)-1(b)(10); Reg. 1.1400Z2(a)-1(c)(5); Reg. 1.1400Z2(a)-1(d). Initial confusion existed as to whether tax deferral was open to both ordinary income and capital gains, or just the latter. This uncertainty resulted from the fact that the title of Section 1400Z-2 and legislative history expressly state “capital gains,” whereas the general rule in Section 1400Z-2(a)(1) broadly references “gain.” The position of the IRS, announced in the first set of proposed regulations, is that “based on the legislative history as well as the text and structure of the statute, Section 1400Z-2 is best interpreted as making [tax] deferral available only for capital gains.” See REG-115420-18, Preamble, 10/19/2018, pg. 6.

¹⁹ The regulations refer to these as “eligible gains,” not Rollover Gains. See Reg. 1.1400Z2(a)-1(b)(11).

²⁰ Reg. 1.1400Z2(a)-1(b)(14); Reg. 1.1400Z2(b)-1(b).

²¹ Reg. 1.1400Z2(a)-1(b)(15); Reg. 1.1400Z2(a)-1(f).

²² U.S. Joint Committee on Taxation. General Explanation of Public Law 115-97. JCS-1-18 (Dec. 2018), pgs. 319-320.

²³ Section 1400Z-2(b)(1).

²⁴ Section 1400Z-2(b)(2).

²⁵ Section 1400Z-2(b)(2)(B)(iii); Reg. 1.1400Z2(b)-1(g).

²⁶ Section 1400Z-2(b)(2)(B)(iv); Reg. 1.1400Z2(b)-1(g).

²⁷ Reg. 1.1400Z2(a)-1(c)(1); Instructions for Form 8949 (2021), pg. 11; See also IRS Publication 544 – Sales and Other Dispositions of Assets (2021), pg. 19.

²⁸ Reg. 1.1400Z2(a)-1(c)(1); Instructions for Form 8949 (2021), pg. 11; See also IRS Publication 544 – Sales and Other Dispositions of Assets (2021), pg. 19.

²⁹ Section 1400Z-2(c); Reg. 1.1400Z2(c)-1. The regulations refer to this as “post-acquisition gain,” not Fund Appreciation.

³⁰ Section 1400Z-2(a)(1)(C); Section 1400Z-2(c); Reg. 1.1400Z2(c)-1.

³¹ TD 9889, Preamble, pg. 112 (explaining that general federal income tax principles dictate that “fair market value of property will generally be equal to the actual sales price of such property when a buyer and seller are unrelated . . . therefore, in a disposition of assets of a QOF to an unrelated party where the taxpayer makes a valid [tax exclusion] election under Section 1400Z-2(c), the relevant fair market value of the assets generally would be the sale price.”

³² TD 9889, Preamble, pg. 122.

of Capital Assets) to report the capital gain they are deferring thanks to their QOF investment (*i.e.*, Rollover Gain), as well as any capital gains that they later must recognize.⁴¹ Individual investors also must file Form 8997 (Initial and Annual Statement of Qualified Opportunity Fund Investments) to notify the IRS about the Rollover Gain, the value of the QOF investment at the beginning and end of each year, any capital gains triggered by the end of tax-deferral on Rollover Gain or by disposition of the QOF investment, and more.⁴²

QOFs. QOFs have duties, too. They must file their annual tax return, namely, Form 1065 (U.S. Return of Partnership Income) or one of the many varieties of Form 1120 (U.S. Corporation Income Tax Return). Moreover, QOFs must enclose Form 8996 (Qualified Opportunity Fund) to self-certify to the IRS that they meet all standards to be considered QOFs, provide details about their direct or indirect investment in Qualified Property, and calculate the penalty if they fail to maintain the 90% investment standard.⁴³

In order for a partnership or corporation to be a QOF, it must have been formed for purposes of investing in Qualified Property and, in fact, must hold at least 90% of its assets in Qualified Property.

Anti-abuse measures

Congress broadly tasked the IRS with producing all regulations that might be necessary and appropriate to carry out Section 1400Z-1 and Section 1400Z-2 including, but not limited to, rules to prevent abuse.⁴⁴ The IRS has already introduced two “anti-abuse rules” specifically designed for the QOF context.

General anti-abuse rule. The IRS first created the “general anti-abuse rule,” which warns that the IRS plans to recharacterize any transaction or series of transactions a “significant purpose of [which] is to achieve a federal income tax result that is inconsistent with the purposes of Section 1400Z-2 and the [corresponding] regulations.”⁴⁵ The IRS further hinted that recharacterization might result in an investment not meeting the QOF standards, thereby depriving investors of the three tax benefits described above.⁴⁶

Special anti-abuse rule for partnerships. The IRS next came up with a “special anti-abuse

rule for partnerships.”⁴⁷ Under this rule, if a partnership is formed or utilized with a “significant purpose” of avoiding the requirement that a capital gain must otherwise be subject to federal income tax in order to qualify as Rollover Gain, the IRS intends to disregard such partnership, partially or entirely, to prevent the existence of a QOF investment for any partner who would not personally meet the requirements.⁴⁸

Examples of application of anti-abuse rules. The IRS formulated the following examples to show how it plans to apply the anti-abuse rules.⁴⁹

Example 1. Two nonresident alien individuals plan to sell stock at a gain of \$50, invest the resulting capital gain in a QOF, and then make a tax-deferral election under Section 1400Z-2(a). They would make this election with the intent of holding the QOF investment for 10 years and then making an election to increase the basis to fair market value. A gain on a sale of the stock by the individuals, however, would *not* be subject to federal income tax, and thus would not qualify as Rollover Gain. Therefore, instead of selling the stock personally, the individuals form a domestic partnership with a significant purpose of using such partnership to make a tax-deferral election. The individuals contribute their stock to the newly-formed partnership in exchange for partnership interests, after which the partnership sells the stock, generates \$50 in gain, and invests it in a QOF. If the partnership had not made a tax-deferral election, the individuals would not have been subject to tax on the portion of the partnership’s recognized gain on the sale of the stock allocated to them.

Based on these facts, the partnership was formed and availed of with a significant purpose of avoiding the requirement that Rollover Gain must otherwise be subject to capital gains tax. Accordingly, under the “special anti-abuse rules for partnerships,” the IRS will disregard the partnership, and the \$50 investment will not qualify for QOF treatment.⁵⁰

Example 2. Two nonresident alien individuals plan to sell stock at a gain of \$50, invest the resulting capital gain in a QOF, and then make a tax-deferral election under Section 1400Z-2(a). They would make this election with the intent of holding the QOF investment for 10 years and then making a tax-exclusion election

on the Fund Appreciation. A gain on a sale of the stock by the individuals, however, would *not* be subject to federal income tax, and thus would not qualify as Rollover Gain. Therefore, the individuals contribute their stock to an existing partnership, the sole partners of which are U.S. citizens, with a significant purpose of utilizing the partnership to make them eligible for immediate tax-deferral and later tax-exclusion. During the relevant year, the partnership sells property it owned before the individuals contributed their stock, resulting in capital gain of \$100, all of which is eligible to be invested in a QOF. The partnership also sells the stock contributed by the individuals, resulting in \$50 of capital gain. The partnership then invests the entire \$150 in a QOF and makes a tax-deferral election.

The individuals availed of the partnership with a significant purpose of avoiding the QOZ requirements. Thus, the IRS will use the “special partnership anti-abuse rule” to disregard the partnership with respect to the \$50 gain from the sale of the stock, such that the \$50 gain is not Rollover Gain. The partnership will become a Mixed Fund, with \$100 constituting a QOF investment, and \$50 not constituting a QOF investment.⁵¹

Example 3 — Part 1. Entity C is a QOF. It owns stock in Corporation C, which is Qualified Stock. Entity C also owns stock in Corporation D, which is *not* Qualified Stock, and which represents less than 10% of the total assets of Entity C. The regulations cause Entity C to be a related party with both Corporation C and Corporation D. At this point, Individual is *not* considered a related person with respect to Entity C, Corporation C, or Corporation D.

Individual sells tangible property to Corporation C for \$100 and sells other tangible property to Corporation D for \$75. Individual realized total capital gains of \$175 from the two sales, which he invested in Entity C, treated as Rollover Gain, and made a tax-deferral election.

The investment by Individual in Entity C resulted in him becoming a related party to Corporation C and Corporation D pursuant to the regulations. This related-party status rendered Individual ineligible to classify the \$175 as Rollover Gain because the relevant sale or exchange must have occurred between Individual and an unrelated party.⁵²

Example 3— Part 2. The situation is the same as in Example 3 Part 1, directly above, except that Entity C contributes the \$100 and \$75 (previously invested by Individual) to Corporation C and Corporation D, respectively, as part of a larger plan. Under the step-transaction doctrine and circular-cash-flow principles, the IRS would disregard this movement of funds as being inconsistent with the purposes of Section 1400Z-2 and its regulations. The IRS would treat the series of transactions as a contribution by Individual of tangible properties to Entity C in exchange for an interest in Entity C, followed by a contribution by Entity C of the tangible properties to Corporation C and Corporation D.⁵³

Example 4. Entity D is a QOF. It owns a majority interest in Partnership D, which constitutes a Qualified Partnership Interest. Partnership D acquires land located in a QOZ. At the time of acquisition, there was no plan or intent to develop or otherwise utilize the land in a trade or business that would substantially in-

³³ U.S. Senate, Committee on the Budget. Reconciliation Recommendations Pursuant to H. Con. Res. 71. 115th Congress, 1st Session, Report 115-20 (Dec. 2017), pgs. 319-320; U.S. House of Representatives, Conference Report. Tax Cuts and Jobs Act. 115th Congress, 1st Session, Report 115-466 (12/15/2017), pgs. 538-539; U.S. Joint Committee on Taxation. General Explanation of Public Law 115-97. JCS-1-18 (Dec. 2018), pg. 317; Congressional Research Service. Tax Incentives for Opportunity Zones. Report R45152 (4/26/2022), pgs. 3-6.

³⁴ U.S. Joint Committee on Taxation. Qualified Opportunity Zones: An Overview (June 2019), pg. 11 (modified by author to enhance readability); See also U.S. Joint Committee on Taxation. General Explanation of Public Law 115-97. JCS-1-18 (Dec. 2018), pgs. 320-321.

³⁵ Congressional Research Service. Tax Incentives for Opportunity Zones. Report R45152 (April 2022), pgs. 3-7 (modified by author to enhance readability); See also Congressional Research Service. Tax Incentives for Opportunity Zones – In Brief. Report 45152 (Nov. 2018).

³⁶ Congressional Research Service. Tax Incentives for Opportunity Zones. Report R45152 (4/26/2022), pg. 4.

³⁷ U.S. Joint Committee on Taxation. Qualified Opportunity Zones: An Overview (June 2019), pg. 12.

³⁸ Section 1400Z-2(d)(1); Reg. 1.1400Z2(a)-1(b)(18).

³⁹ Section 1400Z-2(f)(1); Reg. 1.1400Z2(f)-1(a).

⁴⁰ Section 1400Z-2(f)(3); Reg. 1.1400Z2(f)-1(a). Despite public requests, the IRS has declined to issue a non-exhaustive list of circumstances that would constitute “reasonable cause” in the QOZ context. See TD 9889, Preamble, pgs. 308-309.

⁴¹ Instructions for Form 8949 (2021), pg. 11; See also IRS Publication 544 – Sales and Other Dispositions of Assets (2021), pg. 19.

⁴² Form 8997 (Initial and Annual Statement of Qualified Opportunity Fund Investments).

⁴³ Form 8996 (Qualified Opportunity Fund); Instructions for Form 8996 (Rev. Dec. 2021).

⁴⁴ Section 1400Z-2(e)(4); Reg. 1.1400Z2(d)-1(a)(2).

⁴⁵ Reg. 1.1400Z2(f)-1(c)(1).

⁴⁶ Reg. 1.1400Z2(f)-1(c)(1).

⁴⁷ Reg. 1.1400Z2(f)-1(c)(2)(i).

⁴⁸ Reg. 1.1400Z2(f)-1(c)(2)(ii).

⁴⁹ Reg. 1.1400Z2(f)-1(c)(3). The author has modified the examples to enhance readability.

crease the economic productivity of the land. Instead, there was a plan to pave the land for use as a parking lot. Partnership D planned to install a gate to the paved parking area, a small structure that would serve as an office for a parking attendant, and two self-pay stations for use by customers. The parking lot was not reasonably expected to expand significantly, and the initial small number of employees was not reasonably expected to significantly increase. A significant purpose for the acquisition of the land was to sell it at a profit and exclude any capital gain from appreciation by making an election under the QOZ rules.

The acquisition of the land is a transaction carried out to achieve a federal income tax result that is inconsistent with the purposes of Section 1400Z-2 and the corresponding regulations. Consequently, the land is not Qualified Property and the gain from the sale of the land will not be excluded from gross income under the QOZ rules. This recharacterization is appropriate to ensure that the tax results of the

farming activity from its previous use of hog and pig farming, as well as the significant capital improvements made to the land, comprise a significant investment in the business activities on the land. Thus, Partnership D did not hold the land solely for speculative investment. Consequently, the acquisition of the land, the activities conducted on the land, the capital improvements made to the land, and the later disposition of the land for a significant profit are not inconsistent with the purposes of Section 1400Z-2 and its regulations, and the “general anti-abuse rule” does not apply.⁵⁵

Example 6. Individuals intend to sell stock, generate capital gain, and invest it in a QOF. The individuals form Entity F and file Form 8996 certifying that it is a QOF organized for purposes of investing in Qualified Property. However, the individuals have no intention of investing in Qualified Property. Instead, the individuals intend to invest in other property hoping that it will appreciate substantially. Each year, Entity F files Form 8996 and pays the applicable penalty for not meeting the 90% investment standard. After holding their interests in Entity F for 10 years, the individuals sell them to an unrelated third party for a substantial gain and make an election to exclude the Fund Appreciation.

A significant purpose of the transaction is to achieve a tax result that is inconsistent with the purposes of Section 1400Z-2 and its regulations. Therefore, the IRS will recharacterize matters, such that Entity F is not a QOF and the individuals are not eligible to make tax-deferral or tax-exclusion elections.⁵⁶

Example 7. Entity E treats itself as a QOF. It owns all the stock in a domestic corporation, Corporation E, and treats it as Qualified Stock. Corporation E uses the majority of the cash invested by Entity E to purchase gold bars from unrelated parties. The aggregate value of the gold bars is \$1,000. Corporation E rents a safe deposit box in a QOZ and hires one employee to manage the purchase and sale of gold bars. Each year, Corporation E purchases a small number of additional gold bars and sells to customers a portion of the gold bars on hand. The aggregate value of both the purchases and sales approximates half the value of the bars held at the beginning of the year. Corporation E seeks to treat the gold bars as Qualified Property. When Corporation E began the gold bar business, it did not reasonably expect that the business or number of employees would signifi-

The IRS has introduced two “anti-abuse rules” specifically designed for the QOZ context.

transaction are consistent with the purposes of Section 1400Z-2 and its regulations.⁵⁴

Example 5. Entity D is a QOF. It owns a majority interest in Partnership D, which constitutes a Qualified Partnership Interest. In year 1, Partnership D acquired a tract of land located in a QOZ, whose owner at the time was using the land for hog and pig farming. Partnership D projected that the land would significantly increase in value during the following 10-year period. At the time of acquisition, Partnership D intended to conduct sheep and goat farming activities on the land (instead of hog and pig farming), and then did so. During the 10-year period, Partnership D made significant capital improvements to the land, including improvements to existing farm structures, construction of new farm structures, and installation of a new irrigation system. As expected, the value of the land substantially increased during the following decade.

The ownership of the QOF in Partnership D was a Qualified Partnership Interest. Therefore, the gain upon the sale of its interest in Partnership D after holding it for 10 years was excluded from federal income taxes. The modification of the land to suit sheep and goat

cantly increase, but gold was reasonably expected to appreciate. After holding Entity E for more the 10 years, the investors sell their entire interests and make an election to exclude the gain.

A significant purpose of Corporation E's activities is to achieve a tax result that is inconsistent with the purposes of Section 1400Z-2 and its regulations. The gold bar business carried out by Corporation E was merely speculative in nature and was not expected to increase economic activity in the QOZ. Consequently, the gold bars are not Qualified Property. Corporation E fails to be a qualified business, unless other assets that it owns or leases are Qualified Property that satisfy all relevant requirements. If Corporation E fails to be a qualified business, Corporation E's stock fails to be Qualified Property in the hands of Entity E.⁵⁷

Doubling down on the anti-abuse rules. Importantly, despite requests from the public, the IRS has refused to (1) create a safe harbor from the anti-abuse rules in situations where a QOF attempts in "good faith" to comply with all the rules, (2) issue a list of *per se* abusive activities, or (3) allow anticipatory disclosure by a QOF of beneficial community outcomes to prevent application of the anti-abuse rules.⁵⁸

Administrative guidance thus far

The IRS has issued various items of administrative guidance since Congress enacted Section 1400Z-1 and Section 1400Z-2 in December 2017. The main ones are set forth below.

Revenue Procedure 2018-16. The IRS's first effort out of the gate was Revenue Procedure 2018-16, which offered guidance to Govern-

ors about the procedures for designating tracts as QOZs.⁵⁹ Among other things, it provided online data identifying the location and demographic statistics regarding over 41,000 tracts that were eligible for designation.⁶⁰ This included both low-income communities, which could directly qualify as QOZs, as well as contiguous tracts that were not low-income communities, which could indirectly qualify.⁶¹ Importantly, the IRS acknowledged that it used the best information available at the time, but it was somewhat outdated. In identifying potential tracts, the IRS utilized census data from 2011 through 2015, even though Governors were selecting tracts in 2018 for investments that might endure for decades.⁶²

The IRS granted considerable flexibility in terms of designations. For instance, it offered a "safe harbor," indicating that if a tract appeared in the online data, the nomination by a Governor would not fail to be certified on grounds that the tract was no longer eligible according to more recent census data.⁶³ Conversely, if a tract were eligible for QOZ status under more recent data but not according to the outdated online data, Governors could still nominate such tract on the condition that they submitted an analysis demonstrating eligibility.⁶⁴

Governors made their nominations online, using a special "nomination tool" created by the IRS for that purpose.⁶⁵

Notice 2018-48. The IRS released Notice 2018-48 a few months later. It contained a list, on a state-by-state basis, of the tracts that the Treasury Secretary had designated as QOZs.⁶⁶

Proposed regulations. The next IRS action was the issuance of two sets of proposed regulations, the first in October 2018 and the second in May

⁵⁰ Reg. 1.1400Z2(f)-1(c)(3)(i); See also TD 9889, Preamble, pgs. 24-28.

⁵¹ Reg. 1.1400Z2(f)-1(c)(3)(ii); See also TD 9889, Preamble, pgs. 24-28.

⁵² Reg. 1.1400Z2(f)-1(c)(3)(iii)(A); See also TD 9889, Preamble, pgs. 21-23; See also TD 9889, Preamble, pg. 265 (stating that "all relevant provisions of the [Internal Revenue] Code and general principles of tax law, including the step-transaction doctrine, govern the determination whether a transaction is between unrelated parties.")

⁵³ Reg. 1.1400Z2(f)-1(c)(3)(iii)(B); See also TD 9889, Preamble, pgs. 22-23 (stating that "generally applicable federal income tax principles would require this result if, under the facts and circumstances, the consideration paid by the QOF or [Qualified Business] returns to its initial source as part of the overall plan.")

⁵⁴ Reg. 1.1400Z2(f)-1(c)(3)(iv).

⁵⁵ Reg. 1.1400Z2(f)-1(c)(3)(v).

⁵⁶ Reg. 1.1400Z2(f)-1(c)(3)(vi); See also TD 9889, Preamble, pg. 274 (stating that Example 4 and Example 5 "serve to reiterate the guiding principles that land held for speculative purposes

does not further the purposes of Section 1400Z-2 and the [corresponding] regulations.")

⁵⁷ Reg. 1.1400Z2(f)-1(c)(3)(vii).

⁵⁸ TD 9889, Preamble, pgs. 275-276.

⁵⁹ Rev. Proc. 2018-16, section 1.

⁶⁰ Rev. Proc. 2018-16, section 3.01.

⁶¹ Rev. Proc. 2018-16, section 3.01.

⁶² Rev. Proc. 2018-16, section 3.01.

⁶³ Rev. Proc. 2018-16, section 3.06.

⁶⁴ Rev. Proc. 2018-16, section 3.07.

⁶⁵ Rev. Proc. 2018-16, section 5.01.

⁶⁶ Notice 2018-48 (7/9/2018).

⁶⁷ REG-115420-18, 83 Fed. Reg. 54279 (10/29/2018); REG-120186-18, 84 Fed. Reg. 186529 (5/1/2019).

⁶⁸ Notice 2019-42 (6/25/2019).

⁶⁹ TD 9889 (1/13/2020).

⁷⁰ Notice 2020-18; Notice 2020-23; Notice 2020-39; Notice 2021-10.

⁷¹ REG-121096-19 (4/12/2021).

2019.⁶⁷ These regulations, predictably, sparked hundreds of public comments and two hearings.

Notice 2019-42. Everyone thought that the Treasury Secretary had designated all QOZs the year before, but the IRS identified in Notice 2019-42 two new tracts in Puerto Rico.⁶⁸

Final regulations. The IRS, after digesting significant public input about the proposed regulations, issued the final regulations in January 2020.⁶⁹ They are hefty. Taking into account the Preamble, the final regulations consist of nearly 550 pages.

Notices necessitated by the Coronavirus. The formation of, and investment in, QOFs enjoyed considerable momentum from the start, but the Coronavirus eventually created barriers. Therefore, the IRS issued several Notices creating administrative relief to QOFs and investors affected by the pandemic, such as the postponement of various qualifying and filing deadlines.⁷⁰

Proposed regulations for foreign investors. Cognizant that not only U.S. taxpayers might be interested in making a QOF investment, the

Impropriety in QOZ designations. Some members of Congress have expressed concern that “politically connected individuals might have had an unfair or improper influence on geographic designation of certain census tracts as [QOZs].”⁷³ Reading between the proverbial lines, it appears that certain politicians are alleging that organizers of QOFs, investors, and/or others curried favor, likely with the state Governors in charge of nominating tracts, by way of lobbying, campaign contributions, etc. In addition to voicing accusations, these politicians have taken actions, including persuading the Treasury Inspector General for Tax Administration to investigate and introducing legislation that would permit removal and replacement of existing QOZs.⁷⁴

Self-certification abuzz with issues. Some groups have suggested that allowing QOFs to “self-certify” to the IRS that they meet all relevant standards is a mistake, one that might foster undetected non-compliance. Critics of the current self-certification procedure have proposed that QOF managers be required to obtain a specific license and/or to make sworn declarations about lack of prior issues with fraud, embezzlement, theft, or similar actions. Others, adhering to the theory that those who stand to financially benefit cannot be trusted, have suggested jettisoning self-certification and substituting the obligation for QOFs to obtain and submit to the IRS each year an independent, objective, third-party certification.

Still others advocate a different approach. They recommend that, when filing their first Form 8996 declaring themselves in compliance, QOFs must specify their community-development goals, such as creating quality jobs for low-income individuals, developing affordable housing, or achieving other beneficial local outcomes.⁷⁵

The IRS is sticking to its guns at this point, opining that imposing too many regulatory mandates on QOFs could backfire. The IRS also has emphasized the need to focus on the big picture, which is directing significant private investment to communities with serious financial challenges. Importantly, the IRS does not rule out the possibility of increasing scrutiny of QOFs if it detects abuse in the future. The IRS summarizes things as follows:

In developing the proposed regulations, as well as Form 8996, the Treasury Department and the IRS intended to strike a balance between providing taxpayers with a flexible and efficient process for organizing QOFs, while ensuring that investments

The IRS has issued various items of administrative guidance since Congress enacted Section 1400Z-1 and Section 1400Z-2 in 2017.

IRS published more proposed regulations in April 2021. These contemplated requirements that foreign persons and foreign-owned partnerships must meet in order to be eligible for QOZ tax benefits. They also coordinated such benefits with the international tax withholding rules.⁷¹

Announcement 2021-10. The IRS received numerous questions about whether the updated census data from 2020 would affect the boundaries of QOZs, which the Treasury Secretary designated in mid-2018 based on data from several years earlier. The IRS clarified in Announcement 2021-10 that the newest data would not have an impact because the law allows neither the designation of new QOZs beyond 2018 nor the post-designation reduction, expansion, or other modification of existing QOZs.⁷²

Initial criticisms

You cannot please everyone, and this adage applies to QOZs. Criticisms, some constructive and others political, have been aired from the outset. Below is a sample.

in such vehicles will be properly directed toward the economic development of low-income communities. The suggested recommendations, while potentially helpful for directing such investment and limiting abuse, likely would present numerous obstacles for potential QOF investors and ultimately reduce, rather than increase, the total amount of investment in low-income communities. As a result, the final regulations do not adopt the commenters' recommendations. However, the Treasury Department and the IRS will consider these comments in the event that additional guidance on QOF certification is warranted.⁷⁶

The sky is the limit. Various oversight organizations have highlighted to Congress that, unlike other tax incentives aimed at community development, Section 1400Z-2 does not impose limits on the amount of Rollover Gain that can be tax-deferred for up to nine years, Fund Appreciation that can ultimately enjoy tax exclusion, investors who can claim the tax benefits, or federal revenue that will be spent (via foregone tax revenues) on the QOZ program.⁷⁷

No inter-agency collaboration. Currently, only the IRS administers the QOZ program, and it only collects data for the limited purpose of tax administration and enforcement. No other federal agency is directly involved. This lack of supervision is unique in the area of development tax incentives.⁷⁸

In enacting Section 1400Z-1 and Section 1400Z-2, Congress did not instruct another federal agency to collaborate with the IRS in overseeing the QOZ program. Oversight organizations have suggested that the Treasury Department is well suited to fill this role, but two main impediments exist: legalities and money. Congress would first need to amend the law to authorize the Treasury Department

to play this expanded part. Congress would then need to appropriate the necessary funds.⁷⁹

Insufficient data collection. The Congressional Research Service has pointed out that QOFs are not required to issue periodic reports disclosing the location of investments or their impact on low-income communities, the data that the IRS currently obtains from Forms 8996 is insufficient, and, in all events, the IRS cannot publish much of the data that it collects because of strong confidentiality protections for taxpayers.⁸⁰

Other reports to Congress have identified several challenges facing the IRS. They explain that comprehensive data about the QOZ program is lacking because the IRS captures data from returns that QOFs and investors file electronically, but does not transcribe all data from paper-filed returns as a result of time, resource, and other limitations.⁸¹ This absence of complete data hampers the IRS's ability to identify non-compliance by way of "automated matching" of multiple returns.⁸² Moreover, the IRS reviews only "limited information" concerning QOFs and investors because its sole function is tax administration, not tax policy.⁸³

The QOZ program is costing the government billions of dollars in foregone tax revenue. The magnitude of the expenditure has caused certain members of Congress to ask whether the government is getting enough bang for its buck; that is, whether QOF investments are adequately stimulating development in low-income communities. Congress asked the Government Accountability Office to research the matter. It explained in two recent reports that it could not accurately evaluate the performance of the QOZ program because the government has not been collecting sufficient data.⁸⁴

⁷² Announcement 2021-10 (5/14/2021).

⁷³ Congressional Research Service. Tax Incentives for Opportunity Zones. Report R45152 (4/26/2022), pgs. 11-12.

⁷⁴ Congressional Research Service. Tax Incentives for Opportunity Zones. Report R45152 (4/26/2022), pgs. 11-12.

⁷⁵ TD 9889, Preamble, pgs. 126-128.

⁷⁶ TD 9889, Preamble, pg. 128.

⁷⁷ Government Accountability Office. Opportunity Zones: Improved Oversight Needed to Evaluate Tax Expenditure Performance. GAO-21-30 (Oct. 2020), pg. 10.

⁷⁸ Government Accountability Office. Opportunity Zones: Improved Oversight Needed to Evaluate Tax Expenditure Performance. GAO-21-30 (Oct. 2020), pg. 11.

⁷⁹ Government Accountability Office. Opportunity Zones: Improved Oversight Needed to Evaluate Tax Expenditure Performance. GAO-21-30 (Oct. 2020), pgs. 13 and 19.

⁸⁰ Congressional Research Service. Tax Incentives for Opportunity Zones. Report R45152 (April 26, 2022), pgs. 13-14.

⁸¹ Government Accountability Office. Opportunity Zones: Data on Investment Activity and IRS Challenges Ensuring Taxpayer Compliance. GAO-22-105526 (Nov. 2021), pg. 2; Government

Accountability Office. Opportunity Zones: Census Tract Designations, Investment Activities, and IRS Challenges Ensuring Taxpayer Compliance. GAO-22-104019 (Oct. 2021), pgs. 45-46.

⁸² Government Accountability Office. Opportunity Zones: Census Tract Designations, Investment Activities, and IRS Challenges Ensuring Taxpayer Compliance. GAO-22-104019 (Oct. 2021), pgs. 45-48.

⁸³ Government Accountability Office. Opportunity Zones: Data on Investment Activity and IRS Challenges Ensuring Taxpayer Compliance. GAO-22-105526 (Nov. 2021), pgs. 2-3.

⁸⁴ Government Accountability Office. Opportunity Zones: Improved Oversight Needed to Evaluate Tax Expenditure Performance. GAO-21-30 (Oct. 2020), pg. 10; Government Accountability Office. Opportunity Zones: Census Tract Designations, Investment Activities, and IRS Challenges Ensuring Taxpayer Compliance. GAO-22-104019 (Oct. 2021).

⁸⁵ Government Accountability Office. Opportunity Zones: Data on Investment Activity and IRS Challenges Ensuring Taxpayer Compliance. GAO-22-105526 (Nov. 2021), pg. 3, footnote 6; Congressional Research Service. Tax Incentives for Opportunity Zones. Report R45152 (4/26/2022), pg. 14.

Members of Congress, concerned about this perceived lack of data, have thus far introduced at least five bills designed to strengthen oversight, transparency, and accountability.⁸⁵

Inadequate enforcement. The IRS has taken several actions to implement the QOZ program. Among other things, it contracted with the Community Development Financial Institutions Fund to assist in reviewing QOZ nominations by state Governors, created Form 8996 and Form 8997 to gather data from QOFs and investors, implemented special return-processing codes to track Rollover Gains, and started formulating a compliance plan.⁸⁶ Positive steps, indeed, but problems persist.

Because of the current restrictions on information gathering and sharing described above, the IRS has not yet managed to implement procedures to identify inaccurate, inconsistent, and/or incomplete data from QOFs and investors. According to various governmental reports, violations of rules and procedures are commonplace. For instance, more than 6% of QOFs included improper assets in determining

ships and high-income individual taxpayers) present significant risks of tax non-compliance. Nevertheless, recent reports observe that the IRS has thus far neglected to research adequately the non-compliance issues that these groups likely will trigger in the QOZ context.⁹⁰

And so the enforcement begins

Many predicted that IRS enforcement in the QOZ arena would not begin in earnest until 2026, the year in which investors were required to pay taxes on Rollover Gain. However, the IRS, with an assist from Congress, has accelerated that timeline, beginning enforcement actions already. Readers unaware of this reality should carefully consider the items below.

Legislative proposals. As explained above, several members of Congress have recently introduced QOZ legislation aimed at fortifying oversight, transparency, and accountability.⁹¹ Others have floated bills that would permit removal and replacement of existing QOZs.⁹² All such proposed legislation is grounded in the notion that the rules need to be better crafted by Congress, and better enforced by the IRS.

House hearing. The House Committee on Ways and Means held a hearing in November 2021 on the status of the QOZ program.⁹³ The Chairman set the tone, kicking off the event with a few loaded questions, including whether the program represents “crony capitalism on steroids with the government picking the winners and the losers” and whether “the IRS even can tell if the participants in the program are complying with the rules”⁹⁴

A few of the speakers were positive and optimistic, but most were critical of the QOZ program thus far. One speaker underscored that the tax benefits offered by Section 1400Z-2 encourage QOF investments that render the highest possible post-tax returns for investors, not those with the greatest impacts on the low-income communities in which the QOZs are located. He also suggested that the timeframe is all wrong, because 10 years is not long enough to fully develop projects beneficial to low-income communities (such as small businesses, affordable housing, childcare facilities, medical centers, and schools), but too long to encourage projects other than real estate. Based on these and other criticisms, the speaker listed several things that Congress might do to improve the law, and the IRS might do to enforce it.⁹⁵

Senate investigation. Determined to prevent the House Ways and Means Committee from

Criticisms, some constructive and others political, have been aired from the outset of the QOZ program.

whether they met the 90% investment standard and, thus, whether they qualified as a QOF in the first place.⁸⁷ Investors have their shortcomings, too. The reports indicate that a “material percentage” of Forms 8997 filed by investors have “obvious and blatant inaccuracies.”⁸⁸

Another problem identified by government organizations is that the IRS has not sufficiently focused on the most relevant types of taxpayers. Nearly 90% of QOFs are large partnerships, many of which have hundreds of partners, more than \$100 million in assets, and investments in large, complex, multi-year real estate development projects.⁸⁹

Moreover, the majority of investors in QOFs are high-income individual taxpayers. This is logical considering that QOF investments, from a practical perspective, generally are feasible only for individuals who engage in a transaction that generates significant capital gains, have the financial wherewithal to allow the Rollover Gain and Fund Appreciation to sit untouched for many years, and qualify as “accredited investors” for securities law purposes.

The IRS and others have previously recognized that these two groups (*i.e.*, large partner-

grabbing the entire spotlight, the Senate Finance Committee launched an investigation of QOZs at the start of 2022.⁹⁶ It was not subtle about this, of course, sending letters to various companies that organized QOFs, making such letters accessible to the public on its website, and disseminating a press release. Leadership of the Senate Finance Committee claims that the purpose of the investigation is to gather and use data to formulate legislative solutions to problems. However, the letters directed to the companies seem designed to scandalize. They state, for instance, that (1) some members of Congress are worried that the QOZ program “permits wealthy investors another opportunity to avoid billions of dollars in taxes without meaningfully benefitting the distressed communities the program was intended to help,” (2) the current QOZ rules lack safeguards and transparency measures to protect taxpayers from “subsidizing high-end real estate investments by billionaires without demonstrating the benefit they are providing to low-income communities they claim to help,” and (3) the QOZ program is helping wealthy developers finance projects like luxury apartments, hotels, office buildings, self-storage facilities, and a super-yacht marina.⁹⁷

Involuntary decertifications. QOFs currently enjoy self-certification; they simply swear on their annual Form 8996 that they satisfy all the requirements. If they fail to meet all criteria, such as maintaining at least 90% of all assets in Qualified Property, they face a civil penalty based on the size and duration of the shortfall.

Things might become more severe, though. A government organization has recommended that the IRS develop procedures to decertify

QOFs, and presumably strip investors of their tax benefits, in cases where QOFs intentionally violate the rules.⁹⁸ Commentators have advocated for involuntary decertification under less extreme circumstances, and the IRS is pondering the matter: “[T]he Treasury Department and the IRS continue to consider the circumstances under which involuntary decertification of a QOF would be warranted, and intend to propose guidance regarding those circumstances.”⁹⁹ The IRS has already reserved a spot in its regulations for this future guidance.¹⁰⁰

Anti-abuse rules just for QOZs. As explained above, the IRS created a “general anti-abuse rule” and a “special anti-abuse rule for partnerships,” the applicability of which depends on whether the IRS believes that a transaction or series of transactions has a “significant purpose” of trying to achieve a federal income tax result that is inconsistent with “the purpose of Section 1400Z-2 and [corresponding] regulations.”¹⁰¹ Moreover, in the examples of abusive transactions, the IRS acknowledges its plan to incorporate judicial principles, such as the step-transaction and circular-cash-flow doctrines, to halt perceived abuses.¹⁰² The IRS has also declined to create exceptions to the anti-abuse rules in situations involving “good faith” violations.¹⁰³

Such regulations likely trigger concerns for QOFs and investors because (1) the applicable standard is “significant purpose,” instead of “primary purpose,” as it is in other contexts, (2) the IRS took certain liberties in deciphering the “purpose” of Section 1400Z-2 when writing the regulations and it now intends to impose its anti-abuse rules based on its own interpretation, (3) the IRS already concedes that it will resort to judicial doctrines, which it usually raises

⁸⁶ Treasury Inspector General for Tax Administration. Additional Actions Are Needed to Address Qualified Opportunity Zone Fund and Investor Noncompliance. Report 2022-40-018 (2/7/2022); See also Jonathan Curry, “IRS Lacks Plan for Keeping Opportunity Zone Investors in Line,” 2022 Tax Notes Today Federal 29-2 (2/11/2022).

⁸⁷ Treasury Inspector General for Tax Administration. Additional Actions Are Needed to Address Qualified Opportunity Zone Fund and Investor Noncompliance. Report 2022-40-018 (Feb. 2022), pgs. 5-6; See also Jonathan Curry, “IRS Lacks Plan for Keeping Opportunity Zone Investors in Line,” 2022 Tax Notes Today Federal 29-2 (2/11/2022).

⁸⁸ Treasury Inspector General for Tax Administration. Additional Actions Are Needed to Address Qualified Opportunity Zone Fund and Investor Noncompliance. Report 2022-40-018 (Feb. 2022), pg. 8; See also Jonathan Curry, “IRS Lacks Plan for Keeping Opportunity Zone Investors in Line,” 2022 Tax Notes Today Federal 29-2 (2/11/2022).

⁸⁹ Government Accountability Office. Opportunity Zones: Data on Investment Activity and IRS Challenges Ensuring Taxpayer Compliance. GAO-22-105526 (Nov. 2021), pgs. 4-5; Government Accountability Office. Opportunity Zones: Census Tract

Designations, Investment Activities, and IRS Challenges Ensuring Taxpayer Compliance. GAO-22-104019 (Oct. 2021), pgs. 48-50.

⁹⁰ Government Accountability Office. Opportunity Zones: Data on Investment Activity and IRS Challenges Ensuring Taxpayer Compliance. GAO-22-105526 (Nov. 2021), pgs. 4-5; Government Accountability Office. Opportunity Zones: Census Tract Designations, Investment Activities, and IRS Challenges Ensuring Taxpayer Compliance. GAO-22-104019 (Oct. 2021), pgs. 48-50; U.S. House of Representatives, Committee on Ways and Means, Subcommittee on Oversight. Hearing on the Opportunity Zone Program and Who It Left Behind. 11/16/2021 (Statement by Jessica Lucas-Judy, Director of Strategic Issues at the Government Accountability Office).

⁹¹ Government Accountability Office. Opportunity Zones: Data on Investment Activity and IRS Challenges Ensuring Taxpayer Compliance. GAO-22-105526 (Nov. 2021), pg. 3, footnote 6; Congressional Research Service. Tax Incentives for Opportunity Zones. Report R45152 (4/26/2022), pg. 14.

⁹² Congressional Research Service. Tax Incentives for Opportunity Zones. Report R45152 (4/26/2022), pgs. 11-12.

as a legal “Hail Mary” in situations where taxpayers complied with the letter of the law, but supposedly not the spirit, and (4) the IRS refuses to create any exceptions.

Incipient audits. The IRS seems to be easing into enforcement actions, such that widespread panic has not started yet. The IRS has already trained its Revenue Agents about the QOZ program and the related compliance issues.¹⁰⁴ Additionally, the IRS sent “education letters” to taxpayers whose initial returns were incorrect with respect to a QOF.¹⁰⁵ The IRS also started examining “random samples” of returns filed by QOFs and investors to identify non-compliance trends.¹⁰⁶

Moreover, soon after several government organizations criticized the IRS, it began sending “warning letters” to taxpayers.¹⁰⁷ QOFs that failed to enclose Forms 8996 with their tax returns, or that filed incomplete or invalid Forms 8996, received a Letter 6501 (Qualified Opportunity Fund Investment Standard). The IRS thereby instructed the QOFs to correct matters in a timely fashion or face an IRS audit.¹⁰⁸

For their part, investors with non-compliance problems, such as missing or erroneous Forms 8997, also got unwanted attention. The IRS sent them Letter 6502 (Reporting Qualified Opportunity Fund Investments) and/or

Letter 6503 (Annual Reporting of Qualified Opportunity Fund Investments), threatening them with an audit, loss of tax benefits, and penalties if they failed to timely rectify matters.¹⁰⁹

Conclusion

Congress enacts a tax incentive to influence public actions, taxpayers do precisely what Congress wants them to do pursuant to the law, regulations, and other guidance, certain parties later become upset with the outcome of the incentive and cry foul, this triggers congressional hearings, investigations, and other scrutiny, and the IRS launches an enforcement campaign to halt supposed abuses. Does this sound familiar? Well, it should, as this has occurred in several other contexts in recent years.

Are QOZs destined to suffer the same fate? Hopefully not, but given the criticisms by various oversight organizations, recent actions by Congress, broad anti-abuse rules, and burgeoning audits, QOFs and their investors would be wise to retain tax defense counsel soon to review the relevant transactions and documents, identify items that the IRS might question, and get prepared for potential challenges. ■

⁹³ U.S. House of Representatives, Committee on Ways and Means, Subcommittee on Oversight. Hearing on the Opportunity Zone Program and Who It Left Behind. 11/16/2021. Jessica Lucas-Judy, Director of Strategic Issues at the Government Accountability Office, Brett Theodos, Senior Fellow at the Urban Institute, David Wessel, Director of Fiscal and Monetary Policy at the Brookings Institution, John Persinger, Chief Executive Officer of the Erie Downtown Development Center, and various members of Congress spoke at the hearing.

⁹⁴ U.S. House of Representatives, Committee on Ways and Means, Subcommittee on Oversight. Hearing on the Opportunity Zone Program and Who It Left Behind. 11/16/2021. Comments by Bill Pascrell, Representative of New Jersey, Chairman of the Subcommittee on Oversight.

⁹⁵ U.S. House of Representatives, Committee on Ways and Means, Subcommittee on Oversight. Hearing on the Opportunity Zone Program and Who It Left Behind. 11/16/2021. Statement by Brett Theodos, Senior Fellow at the Urban Institute.

⁹⁶ Jonathan Curry, “Wyden Launches Probe of Opportunity Zone Investors,” 2022 Tax Notes Today Federal 10-1 (Jan. 14, 2022).

⁹⁷ Jonathan Curry, “Wyden Launches Probe of Opportunity Zone Investors,” 2022 Tax Notes Today Federal 10-1 (1/14/2022) (see attached letters to various companies).

⁹⁸ Treasury Inspector General for Tax Administration. Additional Actions Are Needed to Address Qualified Opportunity Zone Fund and Investor Noncompliance. Report 2022-40-018 (Feb. 2022), pg. 7; See also Jonathan Curry, “IRS Lacks Plan for Keeping Opportunity Zone Investors in Line,” 2022 Tax Notes Today Federal 29-2 (2/11/2022).

⁹⁹ TD 9889, Preamble, pg. 130.

¹⁰⁰ Reg. 1.1400Z2(d)-1(a)(4).

¹⁰¹ Reg. 1.1400Z2(f)-1(c)(1); Reg. 1.1400Z2(f)-1(c)(2).

¹⁰² Reg. 1.1400Z2(f)-1(c)(3)(iii)(B); See also TD 9889, Preamble, pgs. 22-23 (stating that “generally applicable federal income

tax principles would require this result if, under the facts and circumstances, the consideration paid by the QOF or [Qualified Business] returns to its initial source as part of the overall plan.”)

¹⁰³ TD 9889, Preamble, pgs. 275-276.

¹⁰⁴ Government Accountability Office. Opportunity Zones: Census Tract Designations, Investment Activities, and IRS Challenges Ensuring Taxpayer Compliance. GAO-22-104019 (Oct. 2021), pg. 50.

¹⁰⁵ Government Accountability Office. Opportunity Zones: Census Tract Designations, Investment Activities, and IRS Challenges Ensuring Taxpayer Compliance. GAO-22-104019 (Oct. 2021), pg. 89.

¹⁰⁶ Government Accountability Office. Opportunity Zones: Census Tract Designations, Investment Activities, and IRS Challenges Ensuring Taxpayer Compliance. GAO-22-104019 (Oct. 2021), pg. 50.

¹⁰⁷ Internal Revenue Service. IRS Letters Going Out to Taxpayers Who May Need to Take Action Related to Qualified Opportunity Funds. Information Release IR-2022-29 (4/12/2022); Jonathan Curry, “IRS Puts Questionable Opportunity Funds on Notice,” 2022 Tax Notes Today Federal 71-1 (4/13/2022).

¹⁰⁸ Internal Revenue Service. IRS Letters Going Out to Taxpayers Who May Need to Take Action Related to Qualified Opportunity Funds. Information Release IR-2022-29 (4/12/2022); Jonathan Curry, “IRS Puts Questionable Opportunity Funds on Notice,” 2022 Tax Notes Today Federal 71-1 (4/13/2022).

¹⁰⁹ Internal Revenue Service. IRS Letters Going Out to Taxpayers Who May Need to Take Action Related to Qualified Opportunity Funds. Information Release IR-2022-29 (4/12/2022); Jonathan Curry, “IRS Puts Questionable Opportunity Funds on Notice,” 2022 Tax Notes Today Federal 71-1 (4/13/2022).