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Opportunity Zone Planning When Penalties Are a Certainty

by Andrew Gradman

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Opportunity Zone Planning When Penalties Are a Certainty

by Andrew Gradman

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In this article, Gradman argues that Treasury should clarify how it will impose penalties on qualified opportunity funds because of the number of challenges that the program presents for taxpayers. He then offers suggestions for specific changes to remedy these issues.

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What happens when the IRS discovers a deficiency in an audit of a qualified opportunity fund? One small mistake can jeopardize the tax benefits plus much of the profit, force the sale of the business, and lead to fund decertification. With stakes this high, Treasury should explain how it will apply the "reasonable cause" defense for QOFs. It should also give guidance for investors, who do not enjoy this defense.

Parts I through III of this article explain why these audits will be unusually painful for taxpayers. First, the program is full of "cliffs," with steep penalties for noncompliance and no room for partial credit. Second, the program is complex — it is easy to wander over one of these cliffs. Third, Congress and Treasury deliberately encouraged participation by unsophisticated people who do not appreciate the need for legal advice. Turning next to possible defenses, Part IV argues that Treasury's definition of reasonable cause, which mirrors usage elsewhere in the IRC, is a poor fit for Opportunity Zones (OZs). Part V offers proposals to reduce this friction.

Introduction

The OZ program is entering its fifth year. That means audits are coming. When that happens, I expect the IRS will examine a large fraction of funds and investors. It must see OZs as low-hanging fruit: The penalties are steep, the rules are complex, and a lot of people are proceeding without professional advice. But what happens when the IRS finds an error? QOFs have a reasonable cause defense, but there is little guidance on how this will be applied. Treasury says it will defer to existing definitions of that term and "will consider" whether to provide more guidance "in the future."[1]

With audits approaching, this guidance can wait no longer. Noncompliance with OZ rules is nothing like filing a late return or underreporting one's tax liability. The decisions relate to the management of a complex, long-term business venture. One small mistake can jeopardize all the tax benefits plus much of the profit, force the sale of the business, and lead to fund decertification. With stakes this high, Treasury should explain how it will apply the reasonable cause defense. It should also give guidance for investors, who do not enjoy this defense.

[1] Preamble to Final Regulations, *Federal Register*, Vol. 85, No. 60, at 1941-1942.

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Discussion

I. Cliffs in the OZ Rules

A. Introduction to OZs

Everything about OZs falls under two terms: qualifying investment, which relates to QOFs, and the 90 percent investment standard, which relates to qualified OZs. First, the investor makes a qualifying investment. This is an equity investment in a QOF, made within 180 days after she incurs (or is deemed to incur) at least that much capital gain. She then files forms 8949 and 8997. Having done this, she can defer this rolled-over gain until December 31, 2026, plus a haircut of 10 percent or 15 percent if she invested before December 31, 2021, or December 31, 2019, respectively. Also, if she holds the QOF for at least 10 years, then when she sells it, her basis in the fund gets stepped-up to fair market value.

Any tax partnership or corporation can become a QOF simply by adding a little boilerplate into its formation documents, then completing Form 8996. This may seem suspiciously easy; it is much harder to become a 501(c). The reason for the difference is that becoming a fund creates no direct benefits for the entity, only costs. An entity will be willing to become a QOF if it is investor-controlled, or if there is enough investor demand for qualifying investments to permit the entity to increase its management fee at least enough to cover these extra costs. Going forward, management's job is to get the best total return for investors along three axes: maximizing traditional economic profit, maximizing the value of the 10-year step-up, and minimizing annual penalties.

The hard part is determining whether the fund owes penalties. This is where we meet the 90 percent investment standard. To evaluate this, the fund files Form 8996. This asks about two yearly testing dates, generally June 30 and December 31. On both dates, the fund values the property on its balance sheet and then calculates the percentage of that value that is attributable to QOZ property. If the average of those percentages falls below 90 percent, and if the fund cannot show reasonable cause, it owes penalties.

As this implies, QOZ property is good property, of which there are two kinds. First, there is QOZ business property — tangible property, used in the fund's trade or business, acquired by purchase after December 31, 2017, from an "unrelated" party (20 percent test). For 90 percent of the fund's holding period, 70 percent of its use must be within the QOZ (defined below). Its original use in the QOZ must commence with the fund, or the fund must substantially improve it (i.e., in any 30-month period, additions to basis must exceed initial adjusted basis).[2]

Second, the fund can own interests in subsidiary entities. These are QOZ partnership interests and QOZ stock, and the entities themselves are QOZ businesses. For a subsidiary entity to qualify it must meet the following requirements[3]:

- Of tangible property, at least 70 percent must be QOZ business property.
- Of intangible property, at least 40 percent must be used in the active conduct of the entity's trade or business.
- Of gross income, at least 50 percent must be from the active conduct of a trade or business in a QOZ.
- Of total assets, no more than 5 percent can be cash or similar property. Under this rule, QOZ businesses cannot own meaningful interests in other entities unless these are disregarded entities.
- No designated "sin" businesses. These are a private or commercial golf course; a country club; a massage parlor; a hot tub facility; a suntan facility; a racetrack or other facility used for gambling; or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

In short, the 90 percent investment standard stands for the idea that the fund must (directly or indirectly) do business in, and own property in, a QOZ.

What is a QOZ? The 2010 census divided the nation into 74,134 census tracts. Under the statute, a tract had to go through two steps to become a QOZ. First, it had to be a low-income community as defined under the new markets tax credit program. This meant a poverty rate of 20 percent or more, or median family income at 80 percent of

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[2] Section 1400Z-2(d)(2)(D); Treas. reg. section 1.1400Z2(d)-2(b).

[3] Section 1400Z-2(d)(3); Treas. reg. section 1.1400Z2(d)-1(d)(1)(iii).

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the statewide or metro area median family income. Over 41,000 population census tracts were initially eligible in this way.[4] Second, from this set, each state selected 25 percent of its eligible census tracts for designation as QOZs.[5]

B. The Working Capital Safe Harbor

A major challenge for Treasury is how to deal with excessive cash in a QOF. Since the program is trying to get investors to make investments they would not otherwise make, there is a concern the fund will contrive to keep its cash on the sidelines. At the same time, there are many legitimate reasons why a QOF would periodically find itself sitting on large amounts of working capital.

As a compromise, Treasury starts with the constraints mentioned above: 90 percent of a fund's assets must be QOZ property (so only 10 percent can be cash), and no more than 5 percent of a QOZ business's assets can be cash. However, since the statute allows QOZ businesses to hold a reasonable amount of working capital, Treasury came up with the "working capital safe harbor." This applies when the QOZ business prepares a written schedule for spending the cash within 31 months of receipt by the business, consistent with the ordinary start-up of a new business, and then spends the funds in accordance with that schedule.

When these terms are met, the QOZ business will enjoy benefits for up to 62 months. First, the amount of working capital held by the QOZ business will be deemed reasonable and thus exempt from the 5 percent test relating to maximum working capital assets. Second, any income from the working capital will count toward the 50 percent test relating to minimum gross income from trade or business in a QOZ.[6] Third, intangible property bought during that period will be treated as meeting the 40 percent test relating to minimum intangibles used within a QOZ. Fourth, the entity will be treated as meeting the 70 percent test relating to minimum tangible property constituting QOZ business property, regardless of how much nonqualifying property it also holds during that period.[7]

QOFs enjoy some, but not all, of these benefits.[8] Most importantly, they have a less-favorable version of the working capital safe harbor: Funds can ignore newly invested cash for the first testing date after it is received.[9] On all later testing dates, that cash counts as bad property for the 90 percent investment standard.

C. The Cliffs

For each month in which a fund fails the 90 percent investment standard, the IRS calculates penalties by multiplying the amount of assets a fund must reallocate to meet that standard, times the underpayment rate under section 6621(a)(2) "for such month" (i.e. the short-term rate plus 3 percent, divided by 12).[10] For example, assume an underpayment rate of 3.5 percent and a fund with $1 million of assets but no good property for the entire year. Then it owes a penalty for the year of $900,000 * 12 months * (3.5 percent/12) = $31,500.

These penalties can get big fast. That's because, while we usually apply the underpayment rate against an amount of credit or tax, in the OZ context we apply it to the full dollar value of assets held by the fund. If a fund has no good property, as in this example, and if the IRS does not discover the error for six years, the penalty alone will equal $189,000, or nearly a fifth of the initial value of $1 million. The result would be the same even if only a small fraction of the investment capital had been provided by investors seeking OZ tax benefits. Since this penalty should have been reported on Form 8996, it will also accrue interest, late payment penalties, and accuracy-related penalties.

Also, this regime rarely allows for partial credit. OZs are full of sheer cliffs. For example, to substantially improve an existing building, the fund must double the building's adjusted basis. In theory, falling short by a dollar will fail this test. If a mistake of this kind causes a QOZ business to

[4] *See* Rev. Proc. 2018-16.

[5] Section 1400Z-1. For an interactive map of all QOZs, visit https://www.novoco.com/sites/default/files/mapbox/opzone/gozone_map_17.html.

[6] However, this protection does not apply to other income earned by the QOZ business. *See* Dan Kowalski, Jill Homan, and Joseph B. Darby III, "Working Capital Safe Harbor: The Rules Are Clearer — But Still Complicated," 13(4) *Novogradac J. Tax Credits* (Apr. 5, 2022).

[7] Treas. reg. section 1.1400Z2(d)-1(d)(3)(v), (vi).

[8] Treas. reg. section 1.1400Z2(d)-2(b)(4)(ii).

[9] Treas. reg. section 1.1400Z2(d)-1(b)(2)(i)(B).

[10] Section 1400Z-2(f); *see* Form 8996, Part IV.

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drop from having 70 percent to 69 percent of its tangible property as QOZ business property, the entire entity interest will cease to qualify. Since Treasury perceived that this would be catastrophic, the regulations waive penalties for the first testing date after failing this test.[11] But if the error is not discovered until an audit years later, the fund will still owe penalties for the remaining interval.

Here are some other catastrophic errors an auditor can look for:

1. The investor's investment was not transferred into the fund's legal custody.
2. The investment is viewed as debt, not equity.
3. The investor had a gain, but not a capital gain.
4. The investor had a capital gain and invested in a fund, but after (or before) the 180-day window.
5. The investor invested before the date of the fund's election.
6. The investor failed to file Form 8997 or filed late.
7. The fund distributed (or is deemed to have distributed) assets to the investor, triggering an inclusion event.
8. The fund was an old entity, with preexisting tangible assets on its balance sheet.
9. The fund did not include the correct language in its formation documents in its first year.
10. The fund failed to file Form 8996 or filed late.
11. The fund or QOZ business held cash for longer than allowed.
12. The fund acquired intangible assets.
13. The QOZ business lacked a written plan or did not comply with that plan.
14. Tangible property was bought from a related party.
15. The investor contributed tangible property, which the fund did not immediately sell.

[11]Treas. reg. section 1.1400Z2(d)-1(d)(6).

II. Traps for Taxpayers

It is easy to stumble over one of these cliffs. Here are some examples. Some of these mistakes would be made only by a taxpayer who didn't get tax advice. Others are sophisticated techniques that are widely accepted by tax lawyers — but that still could be rejected by the IRS.

A. Basic Errors for Unrepresented Investors

Sometimes people buy a property, mistakenly believing it to be in a QOZ. Although Form 8996 asks for a census tract number, some people still don't realize their mistake at this point. For example, it is easy to confuse QOZs and low-income communities. Many people learn from Google that the two are the same — which is literally true — and some online maps show both.

Based on calls I get, I think the public also confuses the program with the like-kind exchange. I expect that many people have leased their property on triple-net terms (which is not allowed) or may even have simply bought a property without substantially improving it. Another common mistake for unrepresented investors: The seller's broker loves to point out that his client's new construction can count as original use to the buyer's fund. That's true, but only if it was not placed in service at the time of purchase.[12] Of course, it is not in the seller's interest to explain this, since a property sells for more when it has a tenant.

Unrepresented investors also often botch the 180-day rule. As December approaches, they assume they can defer gains from the entire year. Or they get casual: It is a nuisance to have to study bank records and reconstruct the exact dates, amounts, and character of one's gains, all without the help of a 1099. Or they don't understand the meaning of constructive receipt, and since they don't yet have a 1099, they wrongly assume that their 180-day clock begins when they receive the cash.

[12]People often call this the "certificate of occupancy" test. In fact, Treasury relies on placement in service, not certificates of occupancy. Treas. reg. section 1.1400Z2(d)-2(b)(3)(i)(D); *see also* Preamble to Final Regulations, *supra* note 1, at 1909. Placement in service can occur before issuance of a certificate of occupancy. *See, e.g.*, LTR 8415003 (Dec. 15, 1983).

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B. 180-Day Rule: Special Rule for K-1s

A more subtle mistake arises when the gains appear on a K-1. Treasury appreciated that it could be unfair to start the 180-day period from the date the underlying passthrough incurred a gain because passive investors may not have access to that information. So, for these investors, Treasury created a special rule: If a passthrough had a gain in, for example, 2021, its partners can extend their investment deadline until as late as September 11, 2022.[13]

However, this rule is often misunderstood. The fallacy is that Treasury created a single extra-long investment window, from the date the passthrough incurred the gain until September 11, 2022. It did not. The taxpayer must elect one of three possible 180-day windows: commencing January 1, 2021 (or whatever date the gain was incurred at the passthrough level); December 31, 2021 (the last day of the passthrough's tax year);[14] or March 15, 2022 (the due date for the K-1, without extensions).[15] The goal was never to create a windfall for K-1 recipients; it was to align the 180-day investment window with the date the taxpayer actually learned about the gain.[16]

I have seen cases in which an investor invests part of his gain on January 30, 2021 (during the first window), then decides to invest the rest of that gain on May 15, 2022 (during the third window). These two investments are mutually exclusive; when this taxpayer files his 2021 return, he will be forced to identify one of these as a nonqualifying investment. The investor would encounter the same obstacle if the gain arose in the passthrough on July 3, 2021, and he then made two investments, one on December 30, 2021 (the last day of the first period), and one the next day, on December 31, 2021 (the first day of the middle period).

Another common mistake is that the taxpayer assumes the deadline is September 15, since this is a major tax deadline. In fact, the deadline is September 11.

C. Allocating Purchase Price to Land

Whenever one buys a building, one must allocate the basis between the building and the underlying land according to their respective values. This makes it tempting to shop for a favorable appraisal. In the non-OZ context, "favorable" means allocating extra basis to the building, since land is not depreciable. In the OZ context, the opposite could be better because, while one must generally double the basis of preexisting tangible property, this requirement does not apply for land.[17] Thus, ideally one would want to allocate precisely the amount of basis to the land needed to meet one's substantial improvement plans — no more.

However, one should not blindly accept a favorable appraisal. Appraisals are not binding on the IRS. They are merely evidence. The IRS can always rebut this evidence with other evidence. I worry about taxpayers who rely on a favorable property tax statement — just as I worry about taxpayers who pay for a new appraisal when the property tax statement is not favorable. This opportunism is dangerous; I think the IRS will judge each tax statement based on its probative value, just as it would any other appraisal.

Two variables are relevant. First, recentness: In California, property is reassessed only on change of ownership or new construction. After that, the appraisal grows stale with time. And second, use of comparables: An allocation to land in a property tax statement is more reliable if the client can point to similar allocations for comparable properties.[18]

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[13] Treas. reg. section 1.1400Z2(a)-1(c)(8)(iii).

[14] What if the partner's interest is terminated during the year, say on July 1? In my opinion, we use July 1. *See* section 706; *see also* Preamble to Final Regulations, *supra* note 1, at 1875; Preamble to Proposed Regulations dated Oct. 29, 2019, *Federal Register*, Vol. 83, No. 209, at 54282.

[15] These numbers assume a calendar-year partnership or S corporation. Trust returns would be due March 31.

[16] It is reported in Lisa M. Starczewski, Jonathan Talansky, and Lisa M. Zarlenga, "Investments in Qualified Opportunity Zones," 598 T.M. (2020), that a representative of the IRS Office of Chief Counsel "thought the use of more than one 180-day period for portions of a partner's allocable share of an eligible gain would be acceptable even though a strict interpretation of the statutory language would suggest otherwise." On the other hand, I have spoken with a staff member of the Joint Committee on Taxation who reads the rule literally. In any event, not all tax professionals feel comfortable relying on secondary sources and nonbinding statements of government officials when planning.

[17] Rev. Rul. 18-29.

[18] *See* Sean Flavin, *Taxing California Property*, section 17:7 (while in some cases the appraiser's allocation between land and building can be "more or less arbitrary," in other cases the appraiser will base the allocation on "comparable sales of bare land . . . with the improvement value representing the balance of the total value").

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D. Cost Segregation Studies and Substantial Improvement

To substantially improve property, one must double its adjusted basis over a period. The term "adjusted basis" includes depreciation, and in the preamble, Treasury affirmed this point.[19] Thanks to another provision in the Tax Cuts and Jobs Act, this creates a potential loophole. Previously, only new property was eligible for bonus depreciation, but under the TCJA, used property also became eligible.[20] Taken literally, this implies that if you buy property, place it into service, and then obtain a cost segregation study, you can zero out some of the basis immediately. This makes it easier to double the adjusted basis.[21] Still, exploiting this with a cost segregation study feels aggressive. Just as Treasury added a requirement of improving vacant land "by more than an insubstantial amount,"[22] I could imagine their devising a comparable requirement for bonus depreciation.

E. Magic Words in the Operating Agreement

As mentioned, becoming a fund is easy. A fund is simply a tax partnership or tax corporation "which is organized . . . for the purpose of investing in qualified opportunity zone property."[23] To show this, the entity takes two steps. First, by the end of its first year, its "organizing documents include a statement of the entity's purpose of investing in OZ property."[24] Not every state lets you modify the language in a limited liability company's filings, so this is probably satisfied by language in the operating agreement. Second, it self-certifies that it is a QOF by filing Form 8996 with its return the following year.

Perceiving that this is too easy, Treasury decided not to mention the first requirement anywhere in the regulations. It appears only in Form 8996. Thus, many fund managers do not learn about this requirement until they ask their tax preparers to file the form, at which point it is too late. In a comment, I suggested mentioning the requirement in the regulations.[25] Treasury declined, offering this non sequitur explanation: It "likely would present numerous obstacles for potential QOF investors and ultimately reduce, rather than increase, the total amount of investment in low-income communities."[26]

When noncompliant taxpayers eventually learn about this question on Form 8996, they have two options. First, they can give up on the QOF. This will require the investors to amend their previously filed personal returns and pay penalties and interest on the late payment of taxes. It might also lead to litigation against the fund manager. Or they can commit fraud — or something on that spectrum — and check the "Yes" box. To cover their tracks, they may also try to backdate an amendment to their operating agreement. As a lawyer, I do not recommend the second option. But I doubt many people are choosing the first.

F. Working Capital Safe Harbor

Some taxpayers find the working capital safe harbor to be confusing. Treasury wants the written schedule to be "consistent with the ordinary start-up of a trade or business." Since this is not defined, I urge clients to imagine that the source of this funding was a bank loan and that the lender would not make the loan without seeing a competent plan for spending the funds.

My non-institutional clients often chafe at this requirement, and I sympathize. What sort of plan would a start-up prepare if it had access to a "loan" at 0 percent interest through 2026, it could only get these terms if it "borrowed" within a 180-day window that had no bearing on whether it had a plan to spend the money, the "lender" did not ask to see the plan, and the investor had no prior entrepreneurial experience? We are all used to the idea that a transaction must have economic

[19] Preamble to Final Regulations, *supra* note 1, at 1913.

[20] Section 168(k)(2)(E).

[21] The same loophole may be available for similar provisions that predated the TCJA. *See, e.g.*, section 47(c)(1)(B) (for the rehabilitation credit, a property is "substantially rehabilitated" when qualified rehabilitation expenditures in any 24-month period exceed adjusted basis on the first day of that period); section 1397D (for Empowerment Zones, similar test to determine whether a property is "substantially renovated"). By contrast, for some purposes, adjusted basis is defined to not include depreciation. *See* section 42(d)(4)(D) (low-income housing credit).

[22] Preamble to Final Regulations, *supra* note 1, at 1915.

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

[24] Form 8996, line 3.

[25] Comment IRS-2019-0022-0026.

[26] Preamble to Final Regulations, *supra* note 1, at 1896-1897.

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substance. But it is hard to know how the IRS will test a requirement that a taxpayer must *pretend* the transaction has economic substance.

G. QO Funds Were Not Meant to Operate Businesses

Many first-time fund sponsors want to keep things simple: The QOF issues interests to investors, then buys and rehabilitates a building. However, when it comes to OZs, having a simple organizational chart can create serious complications.

QOFs were not intended to operate businesses themselves. Their purpose was to aggregate and allocate cash into a portfolio of investments, like a mutual fund.[27] This is reflected in the statute: While QOFs can hold tangible property, they cannot hold reasonable amounts of working capital like QOZ businesses can. When Treasury designed the working capital safe harbor, it took this distinction literally.

The lack of a serious working capital safe harbor for QOFs makes planners reluctant to operate a business in these entities. Why limit one's options before even getting started? As a result, unless the fund manager has a remarkably finely tuned plan, it is usually better to create a subsidiary QOZ business and to have all business operations run through that entity. The added flexibility is worth the cost of one more tax return and one more state filing fee. The fund can hold interests in multiple QOZ businesses, and the QOZ businesses can own 100 percent interests in multiple disregarded entities.

The only times I recommend operating a business directly out of a QOF are when the plan is to build a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. Congress made these "sin businesses" incompatible with being a QOZ business, but there is no similar prohibition for QOFs. If Treasury wants to be literal, so can we.

H. Consider One Fund Per Investor

In designing the org chart, it is common to see all qualifying investments made through a single common fund. However, in my opinion the most efficient arrangement is to give each investor the option of creating her own fund. Each fund then buys an interest in the QOZ business directly. The manager or sponsor gets to focus solely on real estate decisions, and the investor gets the comfort of making most of the tax-level decisions herself. Better aligning incentives reduces the risk of mistakes that can lead to penalties.

However, this makes sense only when the investor is comfortable getting her own independent advice on how to manage her private fund. Also, the sponsor may be reluctant to offer this choice: If an investor manages her own fund, she will expect a discount, which may be visible to the other investors.

I. For Nonqualifying Investments, Use Non-QOFs

In designing the org chart, many sponsors also mistakenly force all investors to make their entire investment into QOFs — even investors who do not have enough previous gains to have 100 percent qualifying investments. In that case, the extra equity becomes a mixed-funds investment, and the investor becomes a mixed-funds partner. Although mixed-funds investments are technically allowed, they create unnecessary problems.

First: Distributions to a mixed-funds partner cannot be allocated specifically to the nonqualifying investment — they are always pro rata between the qualifying and nonqualifying investments.[28] For example, imagine a person who

[27] *See* Jared Bernstein and Kevin A. Hassett, "Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas," Economic Innovation Group (Apr. 2015) ("Consider, as an alternative, a structure analogous to that of a venture capital firm or mutual fund company, but specialized in development investments in businesses in predetermined locales. These specialized investment vehicles, which could raise capital from a mix of individual and institutional investors, would operate in targeted locales, and special tax provisions that are established for them would apply so long as the investments stayed within qualified geographic areas. One key advantage is that they are structured so as to allow partners to pool their resources and invest in numerous projects at any given time in a highly nimble fashion.").

[28] Treas. reg. section 1.1400Z2(b)-1(c)(6)(iv)(B). Thus, a nonqualifying investment cannot be redeemed without also redeeming a pro rata amount of qualifying investment, triggering an inclusion event. By contrast, for corporate stock, the regulations allow for specific identification or first-in, first-out. Treas. reg. section 1.1400Z-2(a)(1)(c)(2). Since this regulation only discusses stock, the omission of partnership interests seems deliberate. *Cf.* Treas. reg. section 1.704-1(b)(2)(iv)(b) (a partner's interests in a partnership have a single capital account, regardless of the class of interest or the time or manner acquired).

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had $600,000 in eligible gain, invested $800,000 in a fund, and later had $200,000 of his interests redeemed by the fund at their original values. While he would prefer to surrender the nonqualifying investment, strictly speaking $150,000 would be identified with the qualifying investment, triggering an inclusion event.

Second: If the fund incurs penalties, the nonqualifying investments will be included in the denominator for the 90 percent investment standard. Potential penalties will multiply needlessly. If the investors perceive this, and if they are well represented, they will want to decide in advance who should bear this potential burden. But there is no right answer to that question.

To avoid these problems, the sponsor should never permit any mixed-funds investments in a fund. Instead, the sponsor should create two investment vehicles: a QOF for qualifying investments and an ordinary tax partnership for nonqualifying investments. Unfortunately, many funds do not offer this option.

J. Mixed-Funds Investments and the Debt-Equity Distinction

Some investors try to avoid these difficulties using a different method: They characterize the extra "investment" as debt. If this worked, it would solve a further problem: Whenever an investor owns nonqualifying equity, this dilutes the percentage of equity that is eligible for basis step-up at year 10. If the extra equity is debt, then there is no mixed-funds investment, and no dilution.

However, this will be helpful only when the substitution of debt for equity does not reduce the value of the equity. That could happen only when all the investors make the loan in the same proportion as their equity interests. But under the general test for debt versus equity, which Treasury applies to OZ investments,[29] a proportionate-interest loan strongly implies equity.[30]

I have also seen "loans" made in cases in which the investor wants to make a qualifying investment immediately but has not yet incurred a capital gain. The loan is merely temporary — it is followed by an equity investment, and prepayment of the note, as soon as the capital gain arises. However, if the fund was undercapitalized when the "loan" was made, the IRS will have more reason to be skeptical.

To make things worse, the IRS will ordinarily not rule on whether an ownership interest is equity or debt, since this is a "matter in which the determination requested is primarily one of fact."[31] Thus, a taxpayer will not learn whether her debt will be respected until it is repaid, or perhaps until she seeks to sell her equity and claims the basis step-up 10 years later.

K. Profits Interests and Agency Costs

In normal investments, we encourage the manager by throwing money at him. This is harder to do in OZ investments. OZ investors want management to maximize their return along three axes: maximizing traditional economic profit, maximizing the value of the 10-year step-up (e.g., there could be tax advantages to turning down a good offer in year 9 in favor of a lower offer in year 10), and minimizing annual penalties. While the risk of penalties can be shifted via contract,[32] it is harder to strike the right balance between economic return and the 10-year hold.

The obvious solution would be to give the manager a qualifying investment with the same tax features as the other investors. However, under the OZ rules, profits interest (which are earned in exchange for services) do not count as qualifying investments.[33] Another solution would be to give the investors a veto over the decision to sell, but they don't always have this kind of clout. As a result, the manager may be tempted to accept a favorable offer to sell before 2026 or 10 years to maximize his own non-OZ profits interest. In that

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[29] *See* Preamble to Final Regulations, *supra* note 1, at 1874 (the tax treatment hinges on "a debt-equity analysis based on a careful examination of all relevant facts and circumstances"); Nathan R. Christensen, "The Case for Reviewing Debt/Equity Determinations for Abuse of Discretion," 74(4) *U. Chi. L. Rev.* 1309, 1313 (2007) (listing factors).

[30] BNA Portfolio 702, "Capitalizing a Business Entity: Debt vs. Equity" (text at footnote 1812).

[31] Rev. Proc. 2021-03, section 4.02(1).

[32] Arguably, since the manager is the least-cost avoider, from an efficiency standpoint he should bear these costs; the question for negotiation should be how much he is compensated for doing so. For an overview of this principle, see Roberto Pardolesi and Bruno Tassone, "Guido Calabresi on Torts: Italian Courts and the Cheapest Cost Avoider," 1(4) *Erasmus L. Rev.* (2008).

[33] Treas. reg. section 1.1400Z2(b)-1(6)(iv).

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case, the investors' sole remedy is a claim for breach of fiduciary duty, which is hard to prove.

In my opinion, this is the most significant risk, which could lead to a lawsuit in an OZ deal. What surprises me is that offering materials often fail to mention it. These documents are so meticulous in every other way — they disclose the risk of foreign embargoes, of changing interest rates, of a principal slipping on a banana peel — as though to lull the reader into a sense of complacency. Then they allude to the nonalignment of incentives in a roundabout way. Only time will tell whether investors can bring a claim on this basis.

Recently, I have begun suggesting a way out of this mess: paying the manager a fee instead of a profits interest. While I have not yet seen this technique used, I believe it could become standard for OZ deals — assuming the IRS cannot recharacterize the fee as equity. Here is an illustration.

Assume the QOF sells the building in year 10. This creates a gain at the partnership level. Concurrently, the fund pays the manager a fee. This creates a deduction at the partnership level. At the end of year 10, the gain and deduction are both allocated among the partners.

Next, under a special OZ rule for partnerships, the partners with qualifying investments can elect to exclude this gain, and the partnership is deemed to liquidate and reconstitute.[34] On their final K-1, the partners are allocated no gain. But they are still allocated a loss (deduction) equal to the fee.

Before the partnership terminates, this loss may have been passive. However, when the partnership terminates (automatically in year 10 as part of the election), this loss becomes an active net operating loss in the hands of the partners. Thus, the investors can apply the loss against ordinary, high-tax income in future years.[35] In this way, the extra tax borne by the manager (fee as ordinary income) is roughly offset by an equal deduction in the hands of the investors.

From the manager's perspective, receiving fees is inferior to receiving a profits interest. However, since the partnership interest becomes worth more in the hands of the partners than it would have been in the hands of the manager — since it can now count as a qualifying investment — this makes it possible to gross up the manager with enough extra fees to make it worth his while to cooperate with this arrangement, while the partners still come out ahead. Or the partners can give even more of this surplus to the manager, thus solving the problem of agency costs.

L. The Need for a Taxable Entity

QOFs and the QOZ businesses must be distinct taxable entities — that is, either corporations or partnerships. They cannot be disregarded LLCs.[36] This requirement has proven surprisingly challenging. Many real estate professionals are accustomed to working through single-member LLCs and learn this requirement too late. Others simply do not want to invest with partners. An S corporation would solve this problem, but it has other disadvantages (for example, investors are not allocated basis from company debt).

If the solo investor is married, one trick is to use Rev. Rul. 2002-69. This states that when spouses in community property states invest together in an LLC, they may choose whether to be treated as one investor (creating a disregarded entity) or as two (creating a partnership).

M. The Problem of Divorce

However, in a non-community-property state, creating a partnership could generate problems down the road. The general rule is that the division of assets in divorce does not trigger tax — not so for OZs. Based on conference report language, Treasury decided that inclusion events should arise on any disposition.[37] It interpreted this to occur when "(i) the initial eligible taxpayer had severed the direct investment interest in the

[34] Treas. reg. section 1.1400Z2(c)-1(b)(2)(ii).

[35] For a discussion of this technique — in which I argue that the OZ program resembles "classic" tax shelters from the '70s and '80s, and in which I encourage every real estate QOF to obtain a cost segregation study to maximize this benefit — see Andrew Gradman, "How Forgiving Recapture Gain Turns QOZs Into Tax Shelters," *Tax Notes Federal*, Nov. 25, 2019, p. 1295.

[36] Section 1400Z-2(d); Preamble to Final Regulations, *supra* note 1, at 1899. By contrast, for the new markets tax credit, this isn't a requirement. *See* section 45D(d)(2)(B).

[37] Preamble to Proposed Regulations dated May 1, 2019, *Federal Register*, Vol. 84, No. 84, at 18661.

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QOF and (ii) the transferee taxpayer was not treated for Federal income tax purposes either as the same taxpayer as the initial eligible taxpayer or as a successor taxpayer."[38] In Treasury's view, that does not include death,[39] but it includes divorce.[40]

Suppose spouse X (in a non-community property state) wants to create a fund alone, using X's own property. However, because a taxable entity is needed, X is instead advised to hold the LLC in partnership with spouse Y. Now suppose X and Y get divorced. In that case, for X to walk away with the fund interest, Y must have an inclusion event. Since family lawyers tend to only know the general rule in section 1041, their clients may not learn they've triggered an inclusion event until after the settlement is signed.

In community property states, the problem is not the partnership — it's the marriage. Taking Treasury's rule to its logical conclusion, it should not matter whether the QOF interests were held in only one spouse's name. Any transmutation of QOF interests from community to separate property — whether by divorce or by postnuptial agreement — would constitute a disposition, triggering an inclusion event as to exactly half the asset.

Although I admire Treasury's effort to be consistent, I disagree with its logic. By its own rule, transfers to "successor taxpayers" are not dispositions. Treasury applies this term to — among other things — the shareholders in a 355 transaction in which both the distributing and controlled corporations are QOFs immediately after the final distribution.[41] If Treasury has the authority to treat the shareholders in a non-pro-rata corporate "divorce" of this kind as successors, then surely it could do the same for the people who succeed to the assets of a dissolved marriage.

N. Valuation Issues

Wrongly valuing assets can cause penalties. This is particularly dangerous for taxpayers who want 37 percent of their fund to consist of nonqualifying property, the theoretical limit.

Unfortunately, these rules are still buggy. For example, for purchased or self-constructed property, we are supposed to use the "unadjusted cost basis." If taken literally, this means we do not count improvements.[42] That makes no sense; the basis of self-constructed property consists of nothing but improvements. They probably meant adjusted basis without regard to depreciation, as is done elsewhere in the IRC.[43]

There is a similar bug for valuing ownership interests in QOZ businesses. At first, Treasury instructed us to use FMV. This raised the question whether we could apply minority discounts. Later, Treasury amended this; it eliminated the FMV rule and clarified that, "solely for purposes of this paragraph (b)(4)(ii)(A), the acquisition by a QOF of qualified opportunity zone stock or a qualified opportunity zone partnership interest is treated as a purchase of such interest by the QOF." In turn, "the value of each property owned by an eligible entity that is acquired by purchase for fair market value . . . is the eligible entity's unadjusted cost basis of the asset under section 1012 or section 1013."[44]

What is Treasury getting at here? When one buys stock or a partnership interest, it has a cost basis. But when one contributes property to that entity, its basis is determined under subchapter C or K. This is not a cost basis.[45] Moreover, the modifications to basis in those subchapters do not count as adjustments; only section 1016 makes adjustment.[46] Some clarification is needed.

O. The 20 Percent 'Related' Test

Many taxpayers believe that if they previously owned land in a QOZ, they won the lottery. In fact, to count as QOZ business property, tangible

[38]Preamble to Final Regulations, *supra* note 1, at 1877.

[39]*Id.*

[40]Preamble to Final Regulations, *supra* note 1, at 1889.

[41]Treas. reg. section 1.1400Z2(b)-1(c)(11).

[42]*See* Treas. reg. section 1.1016-2(a) (improvements are an adjustment to basis).

[43]*See* section 42(d)(4)(D) (in some contexts for the low-income housing tax credit, "the adjusted basis of any building shall be determined without regard to paragraphs (2) and (3) of section 1016(a)").

[44]Treas. reg. section 1.1400Z2(d)-1(b)(4)(ii), as amended by IRS-2019-0022-0144, para. 6.

[45]Section 1012(a) (setting forth general rule that "the basis of property shall be the cost of such property," and contrasting this to basis as determined in subchapters C, K, and P).

[46]Section 1011(a) (basis is first "determined" under section 1012 or subchapters C, K, and P, and then "adjusted" under section 1016).

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property cannot be bought from a related party. So if someone owns land in a QOZ, he can't transfer this to a fund unless (i) the fund has the capacity to hold it as non-QOZ business property, or (ii) he owns a small enough interest in the fund that he won't be related, or (iii) the fund promptly sells it.[47]

What happens when the partner contributing the property is the manager, the manager will earn a profits interest, and that profits interest grows as a function of profit? How should we determine whether he is related? As Bradley Borden has pointed out, there is "no definitive guidance governing the measurement of partners' profits interests and capital interests," and "taxpayers and their advisors are left to guess which approach the IRS or courts might apply if the issue is contested." He concludes that "the need for certainty in areas such as investments in qualified opportunity zones . . . suggests the IRS should consider providing guidance regarding the measurement of interests in profits."[48]

P. Cannot Apply Costs of Buying Out Tenants

To meet the "substantial improvement" requirement, many funds include the costs of buying tenants out of their leases.[49] The idea is understandable because those costs are capitalized into the basis of the building.

Still, it is unclear whether the IRS will accept it. Arguably, buying a rented-up building and then buying out the tenants is no different from first buying a 60 percent tenants-in-common interest in a property, then later buying up the remaining 40 percent. The problem is that the second purchase is not made "after the date of acquisition of such property," as required by the statute.[50] It is itself the purchase of the property — perfecting an interest in the property that one is supposed to then improve.

Q. Intangible Property — Broad, but Unworkable

A QOZ business must use at least 40 percent of its intangible property "in the active conduct of a trade or business in the qualified opportunity zone."[51] Until this was clarified in the final regs, it was unclear what this meant. At the time, I doubted whether this would be met so that the intangible was used outside the zone — for example, a trade secret used to manufacture products that are sold outside the zone. I expected the final rules to look like the "marketing intangible" rules for apportioning business income among states. I imagined that a proper use of intangible property would be, for example, a fast-food franchise, through which the intangible property is used to sell burgers in the community.

To my surprise, the final rules were much less demanding. Intangible property meets the statutory requirement if (1) its use is "normal, usual, or customary in the conduct of the trade or business" and (2) it "is used in the qualified opportunity zone in the performance of an activity of the trade or business that contributes to the generation of gross income for the trade or business."[52] Note that Treasury considered, but rejected, using other factors, such as "(i) where a business provides services or has customers, (ii) where the business's tangible assets are located, (iii) how and where the business is marketed, and (iv) the geographic scope of the legal rights to use the intangible property."[53]

Some planners saw this as a green light to doing non-real-estate OZ deals. However, I'm not so sure. I still believe OZs are best suited for businesses based around the appreciation of tangible property. A QOF based around intangibles faces too many traps. The problem is that investors generally try to seed these businesses with their own preexisting intangible assets, such as client lists. While this does not technically violate any related-party rules (there is no such rule for intangibles), these assets will cause other problems. "Selling" them to the fund implicates

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[47] For this purpose, "related" is in terms of sections 267(b) and 707(b)(1), using 20 percent for 50 percent. *See* section 1400Z-2(a)(1), (e)(2).

[48] Bradley T. Borden, "Partnership-Related Relatedness: Measuring Partners' Capital Interests and Profits Interests," 33(4) *Prac. Tax Law.* 3 (2019).

[49] *See, e.g.*, Phil Jelsma, "Treatment of Lease Termination Costs for Opportunity Zones," *Los Angeles Daily Journal*, Oct. 18, 2019.

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

[51] Section 1400Z-2(d)(3)(A)(ii), incorporating IRC section 1397C(b)(4); Treas. reg. section 1.1400Z2(d)-1(d)(3)(ii)(A).

[52] Treas. reg. section 1.1400Z2(d)-1(d)(3)(ii)(B).

[53] Preamble to Final Regulations, *supra* note 1, at 1919.

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section 482 and the circular cash flow doctrine; contributing them would create a mixed-funds investment and dilute the basis step-up at year 10; and not contributing them is not tax-favored, since assets held outside the QOF, such as personal goodwill, do not get the basis step-up.[54]

R. No Depreciation Unless There Is Basis

Investors tend to conflate OZ deals with normal real estate deals. As a result, they expect that if deductions exceed operating income, they will be able to shelter their own passive income. This will be true — even in an OZ deal — if the partner has sufficient outside basis. For this purpose, outside basis is traceable to the partner's share of invested capital and partnership debt.

Often the offering materials will leave it at that. But this is misleadingly incomplete. The twist is that, under the OZ rules, qualifying investments do not generate outside basis from invested capital before December 31, 2026 (unless they invested by December 31, 2021, in which case they get the 10 percent or 15 percent free basis before 2026).[55] Thus, if the investment is made after December 31, 2021, the investor will have no passthrough deductions in 2022 through 2025 unless she has a share of the partnership's debt. Conversely, if she did invest on or before December 31, 2021, and got this extra basis, but if she has no other basis from partnership debt, then in 2026 she may not get the full 10 percent or 15 percent tax savings she is expecting, if in the intervening years she was allocated deductions that consumed that extra basis.[56]

This rarely poses a problem for the do-it-yourself investors; they tend to be allocated this debt, whether they know it or not. Also, the issue can be drafted around where the debt is nonrecourse, as defined in Treas. reg 1.752-1(a)(2). The challenge arises when the debt is guaranteed by one, but not all, of the parties. I suspect that many investors in these funds are incorrectly calculating investors' outside basis.

To solve this problem, some attorneys create two classes of units, depending on whether the investor wants to personally guarantee the debt, or they let the investor toggle on his guarantee at some later date. Of course, being personally liable for a mortgage debt is a big decision, so investors should not make this decision lightly.

S. OZs and Liquidity

Clients need to be reminded that OZs are illiquid at three critical moments. First is the year of the investment. If you pay a dollar as tax, that's like buying a dollar's worth of tax credit. But if you invest that dollar in a QOF, that is like buying a $1 deduction; you may defer (perhaps) only 25 cents of tax. Buying a credit (or paying the tax) is like buying a gift certificate; spending the same amount of money on a deductible transaction is like clipping a coupon.

This liquidity problem is compounded because California does not conform to the OZ program. If the basis of the sold asset is low enough, there won't be enough sales proceeds to both pay the state tax and defer all the federal gain in an OZ investment. To pay the tax, the investor may be tempted to withdraw money from her own fund, triggering an inclusion event.

Next, there will be a cash crunch in 2026, when the deferred tax comes due. In my opinion, this program feature deserves wider criticism. One of the stated goals of OZs was to overcome the "lock-in effect." This is a side effect of our realization-based tax system in which appreciation is not taxed until sale.[57] The more appreciation deferred in this manner, the more painful it is to eventually sell.[58] As a country, we could have avoided lock-in by switching to mark-to-market. One reason we did not is that this creates phantom gains. When tax is not imposed at moments of liquidity, taxpayers may lack cash to pay, and the government will have a harder time collecting.[59]

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[54] *See* Gradman, "Personal Goodwill for New QO Funds, Business Goodwill for Old Ones: IRS May Cry 'Whipsaw,'" 31(1) *Cal. Tax Law.* 53 (2022).

[55] Section 1400Z-2(b)(2)(B)(i); Treas. reg. section 1.1400Z2(b)-1(g)(4).

[56] *See* Treas. reg. section 1.1400Z2(b)-1(g)(4)(ii) (the 5 percent and 10 percent basis increases are "basis for all purposes, including for purposes of suspended losses under section 704(d)").

[57] *See* David M. Schizer, "Realization as Subsidy," 73 *N.Y.U. L. Rev.* 1549 (1998).

[58] *See* Boris Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts*, Chapter 1 ("Any tax on capital gains thus has a lock-in effect . . . Since the taxpayer can reinvest only the after-tax proceeds received for the old asset, the new asset must promise a higher rate of return to justify the switch.").

[59] Ari Glogower, "Taxing Capital Appreciation," 70 *Tax L. Rev.* 111 (2016).

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OZs overcome lock-in at the cost of creating a phantom gain. How will investors pay? Their best bet is to refinance and take a distribution. But the fund manager may not be willing or able to cooperate. Or the distribution could trigger an inclusion event. This could happen if the distribution occurred before December 31, 2026,[60] or if the contribution-and-distribution resembled a disguised sale.[61] Or the investor might lock up the money in some other illiquid investment, where it cannot be used to pay the tax. As frustrating as it is to reward people for their own mistakes, I blame the OZ statute for deliberately capitalizing on people's shortsightedness. Naturally, Congress is already coming under pressure to extend this deadline.[62] I suspect it will have no choice.

The third liquidity issue is the 10-year holding period. If you should urgently need cash before year 10, it may be impossible to sell or redeem your fund interest. And even if you do succeed in selling, you'll kick yourself for doing so because you'll lose the 10-year basis step-up.

T. Late Filing Requires a Private Letter Ruling

A fund must file Form 8996 with its partnership return by the September extension. An individual investor must file Form 8997 by the October extension. If either deadline is missed, many taxpayers assume they can simply amend or file late.

[60]A partnership distribution over outside basis triggers an inclusion event, Treas. reg. section 1.1400Z2(b)-1(c)(6)(iii), and qualifying investments do not create outside basis until December 31, 2026.

[61]*See* Treas. reg. section 1.1400Z2(a)-1(c)(6)(iii)(A)(*2*) (no qualifying investment, if contribution is followed by a distribution that would be a disguised sale, disregarding that both transfers are cash-only). Even after two years, the no-sale "presumption" can be overcome when "the facts and circumstances clearly establish" a sale. Investments in QOFs meet two factors: (i) The timing and amount of the later transfer are determinable with reasonable certainty; and (v) a person lent money to the partnership to enable the later transfer (i.e., in the sense that OZ tax deferral is an "interest fee loan" from the treasury). Also, in some cases, (ix) the transfer to the partner is disproportionately large compared with the partner's interest in partnership profits, and (ii) the transferor has a legally enforceable right to the later transfer. *See* Treas. Reg. section 1.707-3(d) (presumption); section 1.707-3(b)(2) (listing factors).

[62]David Wessel, *Only the Rich Can Play: How Washington Works in the New Gilded Age* 88 (2021).

However, because these forms contain regulatory elections, a late filing can be cured only by private letter ruling,[63] an expensive process. Moreover, relief will be granted only if the taxpayer "acted reasonably and in good faith."[64] This means something like the return preparer forgot to include the form. It does not include changing one's mind with the benefit of hindsight. And if the entity failed to include the magic language in its operating documents as required by Form 8996, it is unclear when the IRS would forgive such a lapse.

III. The Marketing of OZs to Unsophisticated Investors

In addition to the many cliffs and traps for the unwary described in parts I and II, a third factor contributes to this perfect storm for audits: The OZ program was deliberately designed to attract investors who are unprepared to comply with all these rules.

In my opinion, what makes OZs unique is not that they are complex — that is true of most tax law. They are unique because, despite being complex, they also have low barriers to entry. OZs fit a convenient narrative about charity and free enterprise: They make both look easy. Before he became synonymous with OZs, Sean Parker built Napster and Facebook. If there's one thing he understands, it's how to make something go viral. OZs take a page from their tech industry origins: The marketing was brilliant, but beware of in-app purchases.

When we think of OZs, we tend to think of sophisticated investors and big institutional funds. However, there are also many individuals or families trying to do this themselves. At least, that's the impression I get based on the calls I have received these last four years. OZs have captured the imagination of the taxpaying public. There is no cap, they require no advance planning, and the sooner you act, the greater the tax benefit. Anyone can Google "find qoz investments," request offering materials, attest to being a qualified investor, attest to having read and understood the entire memorandum, and write a check.

[63]*See, e.g.*, LTR 202141004.

[64]Treas. Reg. section 301.9100-3(a).

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OZs' popularity begins with how they insinuate themselves into conversations between tax planners and clients. In the old days, if a client incurred a gain, there wouldn't be much to talk about. Business credits are often unsuitable for individuals,[65] and deductions come at a cost. So in these situations, the tax professional would explain the thing about death and taxes.

Like the news of an experimental cure for an incurable disease, the arrival of OZs was both welcome and cruel. OZs finally gave the preparer something encouraging to say. In fact, to not mention them might be malpractice. So whenever a client had a large gain, any competent preparer would at least mention OZs. In this way, a lot of taxpayers learned about the program from people who didn't fully understand it. They saw in them what they wanted to see.

The think tank behind OZs, the Economic Innovation Group (EIG), deliberately engineered them to maximize investment. At one point, economist Gene Sperling suggested putting a cap on total dollars invested per year, like other credits. The EIG team "refused, insisting there be no cap on the amount of tax breaks OZ investors could claim. Consistent with their Silicon Valley roots, they wanted scale."[66] This bias toward more investment is reflected in provisions that have no purpose except to impose costs on investors who wait to invest — namely, the deferral of gain, which ends in 2026 (so it loses value every year), and the 10 percent and 15 percent basis increases, which sunset after 2019 and 2021. We saw the perverse consequences of this in December 2019. For every $1 million invested in a QOF, one could save roughly $12,500 seven years later if one invested in December rather than January. Many investors would have been better served by more due diligence, or by studying the final regulations, which were released December 19, 2019. And those who rushed may not have benefited anyhow, as managers may have increased their fees in response to the demand. Something similar happened in December 2021, with the expiration of the 10 percent basis increase.

As a matter of tax policy, these staggered 10 percent and 15 percent basis increases are extraordinary. Usually, we create an incentive and let people choose whether to pursue it on its merits. Instead, by tapering the tax benefit over time, Congress created an artificial sense of scarcity. It sent a message to investors that money sitting on the sidelines is money wasted; it is purely designed to encourage early adoption. This differs from legislative sunsets in that we at least pretend to be unhappy about sunsets.[67] This tapering of tax benefits is also extremely rare; bonus depreciation is another example,[68] but this is a poor comparison because we have encouraged taxpayers to buy depreciable assets for decades.

This push for more investment causes individuals to make bad decisions. When the first OZ bill was unveiled, David Wessel explained how the EIG moved to "build the case that something like OZs was needed to revitalize the American economy":

> It commissioned a poll of 1,200 millennials that found them less inclined to be entrepreneurs than older generations. It published an "Index of State Dynamism" that combined seven metrics to create a gauge of stats' economic vitality going back to 1972. "Americans are less likely to start a business, move to another region of the country, or switch jobs now than at any time in recent memory," EIG said.[69]

Encouraging Americans to start new businesses sounds smart, but there is a good reason people were not doing that. People are naturally risk-averse — they lack the time or ability to manage their investments. In that sense, by drawing people out of blue-chip investments and into high-risk businesses, OZs go against

[65] They are subject to the passive activity limitations; some credits are subject to a national cap; and the full value of some credits can only be unlocked by banks, under the Community Reinvestment Act.

[66] Wessel, *supra* note 62, at 67.

[67] *See* Manoj Viswanathan, "Sunset Provisions in the Tax Code: A Critical Evaluation and Prescriptions for the Future," 82 *N.Y.U. L. Rev.* 656 (2007). For my criticism of sunset provisions in the estate and gift tax, see Gradman, "If You Squander This Once-in-a-Lifetime Chance to Make Tax-Free Gifts, You're Not a Bad Person," *Los Angeles Daily Journal*, Nov. 2, 2021.

[68] Section 168(k)(6).

[69] Wessel, *supra* note 62, at 92.

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human nature by design. Back in the 1970s and '80s, physicians like my father and grandfather looked for passive investments to shelter their professional income. Today, I get calls from physicians who want to "buy a building and do a QOZ deal" by themselves. A policy that encourages doctors to moonlight as real estate developers, instead of caring for patients, sounds like a bad policy. Often, these taxpayers seek professional help only after making significant, irreversible mistakes. We may never know how much money taxpayers have wasted in this way.

IV. Penalties

With confusing rules, no partial credit, and unsophisticated investors, the question becomes: How will taxpayers defend themselves on audit? Investors have no special defenses. However, for QOFs, penalties can be waived for reasonable cause.[70] This term is not defined, but it is common in the IRC and regs.[71] In similar situations, courts have looked to these existing definitions. For example, for a failure to file Form 3520, courts have adopted the definition in *United States v. Boyle*,[72] based on the premise that the meaning of "reasonable cause [is] the same throughout the penalty provisions of the" IRC.[73] In the preamble to the final OZ regulations, Treasury suggested a similar approach. It indicated that, for the time being, the IRS should apply "the general standards" set out in the so-called Penalty Handbook in Internal Revenue Manual section 20.1.1.3.2.[74] This IRM provision is helpful, but it leaves many unanswered questions.

A. Multiple Conflicting Rules

First, it does not provide a single coherent rule. Rather, it contains a quilt of phrases from disparate cases and regulations. As the provision acknowledges, these are not entirely consistent. For example, it notes that "some IRC penalty sections also require evidence that the taxpayer acted in good faith or that the taxpayer's failure to comply with the law was not due to willful neglect." The IRM does not explain how to adjust its guidance to account for these variations.

B. Multiple Interpretations

Second, some of these rules are ambiguous. In *Boyle*, the Court purported to announce a bright-line test: In cases with similar facts, taxpayers cannot treat reliance on an adviser as reasonable cause. However, what constitutes similar facts? In *Boyle*, the Court emphasized that this was not a case "in which a taxpayer has relied on the erroneous advice of counsel concerning a question of law . . . such as whether a liability exists." Rather, the taxpayer was seeking to rely on the adviser for knowing whether "tax returns have fixed filing dates and that taxes must be paid when they are due," which, if read literally, makes the case trivial. *Boyle* expressly took no position on whether a reasonable cause defense would be available when, "in reliance on the advice of his accountant or attorney, the taxpayer files a return after the actual due date but within the time the adviser erroneously told him was available." Courts disagree on this question.[75]

C. Merely Procedural Rules?

Another problem: In considering whether to waive penalties against a fund, should the IRS consider whether the penalty was merely procedural in nature? Many taxpayers hope the answer will be yes, but I don't think this could be fairly administered. Characterizing a requirement

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[70] Section 1400Z-2(f)(3).

[71] The following sections refer to reasonable cause: section 6651(a)(1) (failure to file tax return or pay tax); section 6652(a)(2) (failure to file information returns and registration statements); section 6654(e)(3)(B)(ii) (failure of a newly retired or disabled taxpayer to pay estimated income tax); section 6656(a) (underpayment of required tax deposits); section 6657 (payment of taxes with bad check); section 6664(c) (underpayment of tax); section 6675(a) (excessive claim for use of fuel); section 6677(d) (failure to file information regarding foreign trusts); section 6679(a) (failure to file return regarding foreign corporation or partnership); section 6684 (tax infractions regarding some tax-exempt organizations). The following regulations refer to reasonable cause: section 1.6695-1(a)(1), (b)(3), (c)(1), (d)(1) (failure to perform acts regarding the preparation of income tax returns for other persons); section 301.6651-1(c)(1), (2) (failure to file a return or to pay a tax); section 301.6679-1(a)(3) (failure to file returns regarding foreign corporations and foreign partnerships); section 301.6688-1(c) (failure to file information required to be furnished regarding U.S. possessions); section 301.6724-1(m) (failure relating to an information reporting requirement). This list is from *Federal Procedure, Lawyers Edition*, section 48:838. Reasonable cause for failure to pay tax.

[72] 469 U.S. 241 (1985).

[73] *In re Wyly*, 552 B.R. 338, 579 (Bankr. N.D. Tex. 2016).

[74] Preamble to Final Regulations, *supra* note 1, at 1941-1942. The IRM provision appears at IRS, "20.1.1 Introduction and Penalty Relief," last updated Oct. 19, 2020.

[75] *Compare Estate of Thouron v. United States*, 752 F.3d 311, 314 (3d Cir. 2014) (holding that *Boyle* denies reasonable cause only in cases of clerical oversight) *with Knappe v. United States*, 713 F.3d 1164 (9th Cir. 2013) (holding that *Boyle* extends to any missed deadline that doesn't involve reliance on a professional for a "substantive" tax question).

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as merely procedural often reflects the self-interest of the person making the characterization. If the goals of OZs were simply to get people to invest in QOZs, every rule would be procedural. However, Congress and Treasury viewed each of these rules as substantive: They were intended to ensure that the spending would also benefit the surrounding communities.

In any event, if the IRS makes a practice of routinely forgiving some merely procedural faults, at what point do we admit that we have two sets of rules — the public-facing ones, and the real ones?

D. OZ Penalties Are Not About Tax Return Positions

Third, many of the above-mentioned penalties relate to tax return positions. This is a ministerial function. Thus, the phrase "ordinary business care and prudence," which features in the IRM and in the regulations, makes sense in this context. By contrast, a failure to satisfy the 90 percent investment standard represents a deficiency in a massive business undertaking, many years and millions of dollars in the making.

Imagine, for example, cases in which a building was not substantially improved because the taxpayers obtained an appraisal that wrongly allocated too much basis to the land component. For any other definition of reasonable cause, we might emphasize whether the fund should have known the appraisal was too good to be true. But when it comes to OZs, this seems like a trivial and arbitrary standard compared with the magnitude of the dispute.

For comparison, note that in the entirety of subchapter A (containing the tax credits) and subchapter U (Empowerment Zones, and so forth), the phrase "reasonable cause" appears only three times: relating to failure to obtain certification of a qualified low-income building, in the credit for holders of qualified mortgage credit certificates, and as part of the credit to holders of qualified zone academy bonds, which was repealed by the TCJA.[76] None of these is comparable.

[76] Sections 42(l)(1); 25(f)(5); 1397E(f)(2).

E. Consider the Goals of the Program?

A more reasonable way to resolve these issues would be to consider the degree to which the OZ investment was benefiting the community. However, this is difficult because there is currently no social impact reporting.[77] Even if some form of impact reporting were created, it is unclear how many funds could pass the test. In a June 2020 report, the Urban Institute concluded that "the structure of the incentive appears to be least workable for the projects that could have the highest impact." It continues: "Instead of rewarding impact investors who are willing to support projects with large social impacts, the capital gains exemption on OZ projects is structured to provide the largest financial benefits to the projects that provide the highest returns. Luxury housing in appreciating neighborhoods therefore may receive much larger public support than, say, affordable housing projects."[78]

In fact, it is easy to find examples of funds that (euphemistically) advertise that they will try to invest only in areas that are *not* underprivileged. The following marketing material is typical:

> Opportunity Zones are, by definition, communities with below average incomes and higher poverty rates, and census tracts designated as Opportunity Zones tend to have relatively high unemployment and low home values. That said, we have found that it is, in fact, possible to identify individual OZ locations that have surprisingly strong growth potential. One way of doing this is by leveraging predictive demographic data, using variables that can be forecasted with reasonable accuracy — examples include income and population growth data, key drivers of long-term real estate demand that have historically been projected with reasonably high accuracy. . . . We then rank

[77] *See* Gradman, "What Good Is OZ Reporting if We Don't Agree on the Goals?" 38 *Tax Mgmt. Real Est. J.* 3 (Mar. 16, 2022); Gradman, "Incremental OZ Reform Could Be a Step Backward," *Tax Notes Federal*, May 9, 2022, p. 923.

[78] *See* Brett Theodos et al., "An Early Assessment of Opportunity Zones for Equitable Development Projects," Urban Institute (June 17, 2020).

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the more than 8,700 Opportunity Zone census tracts.[79]

This behavior is not blameworthy; it is the natural response to the incentive. As a result, it is hard to even know what we mean when we ask whether a QOF is meeting the purposes of the OZ program.

F. Unsophisticated Investors

Another problem: According to the IRM, one factor in determining reasonable cause is whether the taxpayer was ignorant of the law and "could not reasonably be expected to know of the requirement." When a taxpayer tried to do an OZ deal without legal help, the IRS might argue that this was unreasonable. However, I have argued that OZs are unique in that they are designed to attract unsophisticated investors. Since the barriers to entry were so low, arguably the bar for what is reasonable should be lowered for these investors.

G. How to Handle Future Penalties?

Another difference is that a QOF's failure to meet the 90 percent investment standard will continue year after year. Even if the IRS decides to waive prior-year penalties, it must also deal with future penalties.

However, the regulations do not empower the IRS to deem a property to be substantially improved for future testing dates. Nor do they permit the IRS to prescribe flexible or graduated penalties, which would turn the steep cliffs described in this article into a "staircase." Instead, the fund will generally continue to incur full penalties until it sells the property.

V. Conclusion: Some Suggestions

Here are proposals to mitigate the "cliffs" described in Part II:

1. If a taxpayer receives a gain on a K-1, he should be able to choose the day on which his 180-day period begins — any day between the underlying sale and the due date for the K-1. There should be no need to declare this date in advance. If Form 8997 shows that all his investments were made within a single 180-day window, and as long as the entity made no OZ election of its own, this requirement should be satisfied.
2. Congress should allow QOFs with no subsidiary QOZ businesses to hold assets in the same way that QOZ businesses can.
3. Congress should allow QOFs and QOZ businesses to be disregarded entities.
4. Congress should allow QOZ businesses to hold interests in other QOZ businesses.
5. Congress should recalibrate the penalty calculation so it does not take into account mixed-funds investments.
6. Congress could create an election, whereby a taxpayer can defer the gain otherwise due in 2026 for one or more years (no later than the sale of the qualifying investment), in exchange for giving up some appropriate portion of the 10-year basis step-up.
7. Treasury (if possible) or Congress (if necessary) should provide that divorce is not an inclusion event.
8. The IRS should amend Rev. Proc. 2021-03, section 4.02(1), to provide that it will rule on debt vs. equity as to investments in QOFs.
9. The requirement for magic words in the organizational documents should be mentioned in the regulations.
10. If the fund forgot to include the magic words, it should be allowed to obtain a private letter ruling that it is a fund, if it can show it always intended to operate as such.
11. Treasury should clarify the meaning of the phrase "unadjusted cost basis" for valuing purchased property, self-constructed property, and QOZ business interests.
12. Treasury should clarify how the 20 percent related test will be applied.
13. Treasury should clarify whether the cost of buying out tenants counts toward substantial improvement.
14. Treasury should clarify how it will apply the requirement to double the

[79] Cadre, "Opportunity Zones: OZ Investing, Explained," Oct. 16, 2020.

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adjusted basis in cases in which the property has been placed in service before the start of improvements.

15. Treasury should create a safe harbor in which qualifying investment will be respected, even if the contribution is followed by a debt-financed distribution resembling a disguised sale. For example, this could apply when both transfers are all-cash and when the distribution is made in 2026 or 2027.
16. Treasury should create a less formal process for making late elections on forms 8996 and 8997.

And here are some thoughts on how Treasury and Congress should clarify the confusion surrounding penalties described in Part IV:

1. Investors should have a reasonable cause defense.
2. QOFs should have a defense for positions with substantial authority, or for positions with reasonable basis if disclosed.
3. Congress should authorize Treasury to issue a broader range of more graduated penalties for failures to satisfy the 90 percent investment standard. This would allow Treasury to distinguish between degrees of failures, and to tailor the penalty to the severity of the failure.
4. In the preamble to the final regs, Treasury remarked that a commentator requested "a non-exhaustive list of circumstances that would constitute reasonable cause." Treasury declined. It should reconsider this decision.
5. Congress should authorize Treasury to deem property to be QOZ property in appropriate cases.
6. Congress should require reporting on the benefit QOFs provide their communities. This proposal is already widely discussed, but mostly for statistical purposes. I am suggesting that this would also help the IRS in the audit process in determining whether to impose penalties.

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