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QOZ PLANNING WHEN PENALTIES ARE A CERTAINTY

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¹ The comments contained in this paper are the individual views of the author who prepared them, and do not represent the position of the California Lawyers Association or its Taxation Section.

² Although the participants on this project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

EXECUTIVE SUMMARY

What happens when the Internal Revenue Service (“IRS”) discovers a deficiency in an audit of a Qualified Opportunity Fund? One small mistake can jeopardize all the tax benefits plus much of the profit, force the sale of the business, and lead to decertification of the Fund. With stakes this high, the government should explain how it will apply the “reasonable cause” defense for Qualified Opportunity Funds. It should also give guidance for investors, who do not enjoy this defense.

This paper attempts to explain why audits in this area will be unusually painful for taxpayers. First, the program is full of “cliffs.” It has steep penalties for noncompliance, with no room for partial credit. Second, the program is complex; it is easy to wander over one of these cliffs. Third, Congress and the Treasury Department have encouraged participation by unsophisticated people who do not appreciate the need for legal advice. Turning next to possible defenses, this paper argues that the Treasury Department’s current definition of “reasonable cause,” which mirrors usage elsewhere in the Internal Revenue Code, is a poor fit for Qualified Opportunity Zones (“QOZ”).

This paper also offers some proposals to reduce this friction. The following proposals would mitigate the “cliffs” described herein:

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; that is, 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. As long as Form 8997 shows that all the taxpayer’s investments were made within a single 180-day window, and as long as the entity made no QOZ election of its own, this requirement should be satisfied.
2. Congress should allow QO Funds with no subsidiary QOZ Businesses to hold assets in the same way that QOZ Businesses can.
3. Congress should allow QO Funds 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-fund 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 ten-year basis step up.
7. The Treasury Department (if possible) or Congress (if necessary) should provide that divorce is not an inclusion event.
 8. The IRS should amend Rev. Proc. 2021-03 § 4.02(1), to provide that it will rule on debt versus equity as to investments in QO Funds.
 9. The requirement for magic words in the organizational documents should be mentioned in applicable regulations.
 10. If the Fund forgot to include the magic words, it should be allowed to obtain a private letter ruling (“PLR”) that it is a Fund if it can show it always intended to operate as a Fund.
 11. The Treasury Department should clarify the meaning of the phrase "unadjusted cost basis" for valuing purchased property, self-constructed property, and QOZ Business interests.
 12. The Treasury Department should clarify how the 20% related test will be applied.
 13. The Treasury Department should clarify whether the cost of buying out tenants counts towards substantial improvement.
 14. The Treasury Department should clarify how it will apply the requirement to double the “adjusted basis” in cases where the property has been placed in service prior to the start of improvements.
 15. The Treasury Department should create a safe harbor where a 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 where both transfers are all-cash, and where 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.

The author also proposes some ideas on how the Treasury Department and Congress should clarify the confusion surrounding penalties described in this paper:

1. Investors should have a “reasonable cause” defense.
2. QO Funds should have a defense for positions with substantial authority, or for positions with reasonable basis if disclosed.
3. Congress should authorize the Treasury Department to issue a broader range of more graduated penalties for failures to satisfy the 90% Investment Standard. This would allow the Treasury Department to distinguish between degrees of failures, and to tailor the penalty to the severity of the failure.

4. In the preamble to the final regulations, the Treasury Department remarked that a commentor requested “a non-exhaustive list of circumstances that would constitute reasonable cause.” The Treasury Department declined. It should reconsider this decision.
5. Congress should authorize the Treasury Department to “deem” property to be QOZ Property, in appropriate cases.
6. Congress should require reporting on the benefit QO Funds provide to their communities. This proposal is already widely discussed, but mostly for statistical purposes. The author suggests that this would also help the IRS in the audit process when determining to impose penalties.

DISCUSSION

I. INTRODUCTION

The Qualified Opportunity Zone (“QOZ”) program is entering its fifth year. That means audits are coming. When that happens, the author expect the IRS will examine a large fraction of Funds and investors. It will likely see QOZs 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? QO Funds have a “reasonable cause” defense, but there is little guidance as to 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.”³

With audits approaching, this guidance can no longer wait. Noncompliance with QOZ rules is nothing like filing a late return or underreporting one’s tax liability. The decisions in question 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 decertification of the Fund. 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.

As detailed herein, the author explains why these audits will be unusually painful for taxpayers. First, the program is full of “cliffs.” It has steep penalties for noncompliance, with 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. This paper also proposes possible defenses. The author argues that Treasury’s current definition of “reasonable cause,” which mirrors usage elsewhere in the Internal Revenue Code, is a poor fit for QOZs.

Assuming these fears come true, and the IRS disallows tax benefits on a massive scale, taxpayers will not be the only ones to suffer. These penalties will be litigated, and the IRS may face political blowback. The final portion of this paper offers some proposals to reduce this friction.

A. Cliffs in the QOZ Rules

1. *Introduction to QOZs*

Everything about QOZs falls under two terms: (1) Qualifying Investment (which relates to QO Funds); and (2) the 90% Investment Standard (which relates to QO Zones).

³ Preamble to Final Regulations, *Federal Register*, Volume 85, No. 60, pages 1941-42, available at <https://www.federalregister.gov/d/2019-27846/p-650>.

First, the investor makes a Qualifying Investment. This is an equity investment in a QO Fund, 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 all this, she can defer this rolled-over gain until 12/31/2026, plus a haircut of 10% or 15% if she invested before 12/31/2021 or 12/31/2019, respectively. Also, if she holds the QO Fund for at least ten years, then when she eventually sells it her basis in the Fund gets stepped-up to fair market value (“FMV”).

Any tax partnership or corporation can become a QO Fund, 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 QO Fund 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 then to get the best total return for investors along three axes: maximizing traditional economic profit; maximizing the value of the ten-year step-up; and minimizing annual penalties.

The hard part is determining whether the Fund owes penalties. This is where we meet the 90% Investment Standard. To evaluate this, the Fund files Form 8996. This asks about two “testing dates” during the year, generally June 30 and December 31. On both dates, the Fund values the property on its balance sheet. Then it calculates the percentage of that value on both dates that is attributable to “QOZ Property.” If the average of those percentages falls below 90%, and if the Fund cannot show reasonable cause, it owes penalties.

As this implies, QOZ Property is good property. There are two kinds. First, there is “QOZ Business Property.” This is tangible property, used in the Fund’s trade or business, acquired by purchase after 12/31/17, from an “unrelated” party (20% test). For 90% of the Fund’s holding period, 70% of its use must be within the QO Zone (defined below). Its original use in the QO Zone 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).⁴

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:⁵

- i. Of tangible property, at least 70% must be QOZ Business Property.
- ii. Of intangible property, at least 40% must be used in the active conduct of the Fund’s trade or business.
- iii. Of gross income, at least 50% must be from the active conduct of a trade or business in a QO Zone.
- iv. Of total assets, no more than 5% can be cash or similar property. Under this rule, QOZ Businesses cannot own interests in other entities unless these are disregarded entities.
- v. 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

⁴ IRC § 1400Z-2(d)(2)(D); Treas. Reg. § 1.1400Z2(d)-2(b).

⁵ IRC § 1400Z-2(d)(3); Treas. Reg. § 1.1400Z2(d)-1(d)(1)(iii).

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% Investment Standard stands for the idea that the Fund must (directly or indirectly) do business in, and own property in, a QO Zone.

What is a QO Zone? 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 QO Zone. First, it had to be a “low-income community” as defined under the New Markets Tax Credit (“NMTTC”) program. This meant a poverty rate of 20% or more, or median family income at 80% of the statewide or metro area median family income. Over 41,000 population census tracts were initially eligible in this way.⁶ Second, from this set, each state selected 25% of its eligible census tracts for designation as QO Zones.⁷

2. *The Working Capital Safe Harbor*

A major challenge for Treasury is how to deal with excessive cash in a QO Fund. 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 QO Fund would periodically find itself sitting on large amounts of working capital.

As a compromise, Treasury starts with the constraints mentioned above: 90% of a Fund’s assets must be QOZ Property (so only 10% can be cash), and no more than 5% 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 where 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.

Where these terms are met, the QOZ Business will enjoy a few benefits for up to 62 months. First, the amount of working capital held by the QOZ Business will be deemed “reasonable;” thus, it will be exempt from the 5% test (relating to maximum working capital assets). Second, any income from the working capital will count towards the 50% test (relating to minimum gross income from trade or business in a QO Zone). Third, intangible property bought during that period will be treated as meeting the 40% test (relating to minimum intangibles used within a QO Zone). Fourth, the entity will be treated as meeting the 70% test (relating to minimum tangible property constituting QOZ Business Property), regardless how much non-qualifying property it also holds during that period.⁸

⁶ See Rev. Proc. 2018-16.

⁷ IRC §1400Z-1. For an interactive map of all QO Zones, visit https://www.novoco.com/sites/default/files/mapbox/opzone/gozone_map_17.html

⁸ Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v), (vi).

QO Funds enjoy some, but not all, of these benefits.⁹ 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.¹⁰ On all subsequent testing dates, that cash counts as bad property for the 90% Investment Standard.

3. *The Cliffs*

For each month in which the Fund fails the 90% Investment Standard, the IRS calculates penalties by multiplying the amount of assets the Fund must reallocate to meet that standard, times the underpayment rate under IRC § 6621(a)(2) “for such month” (*i.e.*, the short-term rate plus 3%, divided by 12).¹¹ For illustration, assume an underpayment rate of 3.5%, and a Fund with \$1MM of assets but no good property for the entire year. Then it owes a penalty for the year of $\$900,000 * 12 \text{ months} * (3.5\% / 12) = \$31,500$.

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 QOZ 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 \$1MM. The result would be the same even if only a small fraction of the investment capital had been provided by investors seeking QOZ tax benefits. Since this penalty should have been reported on Form 8996, it will also accrue interest, late-payment penalties, and accuracy-related penalties.

In addition, this regime rarely allows for partial credit. QOZs 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 drop from having 70% to 69% of its tangible property as QOZ Business Property, the entire entity interest will cease to qualify. Perceiving that this would be catastrophic, the regulations waive penalties for the first testing date after failing this test.¹² 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 prior to the date of the Fund’s election.
6. The investor failed to file Form 8997, or filed late.

⁹ Treas. Reg. § 1.1400Z2(d)-2(b)(4)(ii).

¹⁰ Treas. Reg. § 1.1400Z2(d)-1(b)(2)(i)(B).

¹¹ IRC § 1400Z-2(f); see Form 8996, Part IV.

¹² Treas. Reg. § 1.1400Z2(d)-1(d)(6).

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 pre-existing tangible assets on its balance sheet.
9. The Fund did not include the magic 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.

B. Traps for Taxpayers

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

1. Basic Errors for Unrepresented Investors

Sometimes people buy a property mistakenly believing it to be in a QO Zone. 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 QO Zones and Low-Income Communities. Many people learn from google that “QO Zones are Low Income Communities” (which is literally true), and some online maps show both.

Based on the author’s real-world experience, the public also confuses the program with like-kind exchanges. It is expected 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.¹³ Of course, it is not in the seller’s interest to explain this, since a property sells for more when it has a tenant.

Also, unrepresented investors 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

¹³ People often call this the “certificate of occupancy” test. In fact, Treasury relies on placement in service, not certificates of occupancy. Treas. Reg. § 1.1400Z2(d)-2(b)(3)(i)(D); *see also*, Preamble to Final Regulations, *Federal Register*, Volume 85, No. 60, page 1909, available at <https://www.federalregister.gov/d/2019-27846/p-368>. Placement in service can occur prior to issuance of a certificate of occupancy. *See e.g.*, PLR 8415003 (Dec. 15, 1983).

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 exactly when they receive the cash.

2. *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 pass-through incurred a gain, because passive investors may not have access to that information. So, for these investors, Treasury created a special rule: if a pass-through had a gain in, say 2021, its partners can extend their investment deadline till as late as 9/11/2022.¹⁴

However, this rule is often misunderstood. The fallacy is that Treasury created a single extra-long investment window, from the date the pass-through incurred the gain until 9/11/2022. It did not. The taxpayer must elect between one of three possible 180-day windows: commencing 1/1/2021 (or whatever date the gain was incurred at the pass-through level), 12/31/2021 (the last day of the passthrough's tax year),¹⁵ or 3/15/2022 (the due date for the K-1, without extensions).¹⁶ 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.

The author has experienced situations where an investor invests part of his gain on 1/30/2021 (during the first window), then decides to invest the rest of that gain on 5/15/2022 (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 non-Qualifying Investment. The investor would encounter the same obstacle if the gain arose in the passthrough on 7/3/2021, and he then made two investments, one on 12/30/2021 (the last day of the first period) and one the very next day, on 12/31/2021 (the first day of the middle period).

Another common mistake: the taxpayer assumes the deadline is 9/15, since this happens to be a major tax deadline. In fact, the deadline is 9/11.

3. *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-QOZ context, "favorable" means allocating extra basis to the building, since land is not depreciable. In the QOZ context, the opposite could be better; that's because, while one must generally double the basis of pre-existing tangible property, this

¹⁴ Treas. Reg. § 1.1400Z2(a)-1(c)(8)(iii).

¹⁵ What if the partner's interest is terminated during the year, say on July 1? In my opinion, we use July 1. See IRC § 706; see also Preamble to Final Regulations, *Federal Register*, Volume 85, No. 60, page 1875; Preamble to Proposed Regulations dated October 29, 2019, *Federal Register*, Volume 83, No. 209, page 54282.

¹⁶ These numbers assume a calendar-year partnership or S corporation. Trust returns would be due 3/31.

requirement does not apply in the case of 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.

In particular, there is a concern about taxpayers who rely on a favorable property tax statement—just as taxpayers who pay for a new appraisal when the property tax statement is not favorable. This opportunism is dangerous; and the concern is the IRS will judge each tax statement based on its probative value, just as it would any other appraisal.

Two variables are relevant. First, recency: in California, property is only reassessed upon 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

4. *Cost Segregation Studies and Substantial Improvement*

To substantially improve property, one must double its adjusted basis over a chosen 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 (“TCJA”), this creates a potential loophole. Previously, only new property was eligible for bonus depreciation; 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 just feels aggressive. Just as Treasury added a requirement of improving vacant land “by more than an insubstantial amount,”²² I could imagine them devising a comparable requirement for bonus depreciation.

¹⁷ Rev. Rul. 18-29.

¹⁸ See Sean Flavin, Taxing California Property. § 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 his allocation on "comparable sales of bare land ... with the improvement value representing the balance of the total value.")

¹⁹ Preamble to Final Regulations, *Federal Register*, Volume 85, No. 60, page 1913, <https://www.federalregister.gov/d/2019-27846/p-407>

²⁰ IRC § 168(k)(2)(E).

²¹ The same loophole may also be available for similar provisions which predated the TCJA. See e.g. IRC § 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); § 1397D (for Empowerment Zones, similar test to determine whether a property is “substantially renovated”). By contrast, for certain purposes, adjusted basis is defined to not include depreciation. See IRC § 42(d)(4)(D) (low income housing credit).

²² Preamble to Final Regulations, *Federal Register*, Volume 85, No. 60, page 1915, at <https://www.federalregister.gov/d/2019-27846/p-419>.

5. *Magic Words in the Operating Agreement*

As mentioned, it is easy to become a Fund. 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 QOZ property.”²⁴ Not every state lets you modify the language in an LLC’s Secretary of State 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 to not mention the first requirement anywhere in the regulations. It only appears in Form 8996. As a result, many Fund managers never learn about this requirement until they ask their tax preparer to file the form, at which point it is too late. It has been suggested to mention the requirement in the applicable 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 non-compliant taxpayers eventually learn about this question on Form 8996, they have two options. One: they can give up on the QOZ. This will require the investors to amend their previously filed personal returns, and to pay penalties and interest on the late payment of taxes. It might also lead to litigation against the Fund manager. Two: they can commit fraud (or something on that spectrum) and check the “Yes” box. To cover up their tracks they may also try to backdate an amendment to their operating agreement. The second option is undesirable, but common sense suggest that many people are not likely to choose the first.

6. *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, clients are told 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 who would not sympathize? What sort of plan would a start-up actually prepare, if it had access to a “loan” at 0% interest through 2026; it could only get these terms if it “borrowed” within a 180-day window which 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 has no prior entrepreneurial experience? We are all used to the idea that

²³ IRC § 1400Z-2(d)(1).

²⁴ Form 8996 line 3.

²⁵ Comment IRS-2019-0022-0026, available at <https://www.regulations.gov/comment/IRS-2019-0022-0026>

²⁶ Preamble to Final Regulations, *Federal Register*, Volume 85, No. 60, page 1896-7. <https://www.federalregister.gov/d/2019-27846/p-273>

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

7. *QO Funds Were not Meant to Operate Businesses*

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

QO Funds 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 QO Funds 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 QO Funds makes planners reluctant to ever 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% interests in multiple disregarded entities.

The only reason to recommend operating a business directly out of a QO Fund is when the plan is to build 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. Congress made these “sin businesses” incompatible with being a QOZ Business, but there is no similar prohibition for QO Funds. If Treasury wants to be literal, so can taxpayers.

8. *Consider One Fund Per Investor*

In designing the organizational chart, it is also common to see all Qualifying Investments made through a single common Fund. However, the most efficient arrangement is usually to give each investor the option of creating her own Fund. Each Fund then buys an interest in the QOZ Business directly. The manager/sponsor gets to focus solely on real estate decisions, and the investor gets the comfort of making most of the tax-level decisions herself. By better aligning incentives, it reduces the risk of mistakes that can lead to penalties.

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.”).

However, this only makes sense where 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.

9. *For Non-Qualifying Investments, Use Non-QO Funds*

In designing the organizational chart, many sponsors also mistakenly force all investors to make their entire investment into QO Funds—even investors who do not have enough previous gains to have 100% Qualifying Investments. In that case, the extra equity becomes a “mixed-fund investment,” and the investor becomes a mixed-funds partner. Although mixed-fund investments are technically allowed, they create unnecessary problems.

First: distributions to a mixed-funds partner cannot be allocated specifically to the non-qualifying investment; they are always pro-rata between the qualifying and non-qualifying investments.²⁸ For example, imagine a person who 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 non-qualifying investment, strictly speaking \$150,000 would be identified with the qualifying investment, triggering an inclusion event.

Second: if the Fund should incur penalties, the non-Qualifying Investments will be included in the denominator for the 90% 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-fund investments in a Fund. Instead, the sponsor should create two investment vehicles: A QO Fund for Qualifying Investments, and an ordinary tax partnership for non-Qualifying Investments. Unfortunately, many Funds do not offer this option.

10. *Mixed-Fund 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 non-qualifying equity, this dilutes the percentage of equity which is eligible for basis step-up at year ten. If the extra equity is debt, then there is no mixed-funds investment, and no dilution.

However, this will only be helpful where the substitution of debt for equity does not reduce the value of the equity. That could only happen where all the investors make the loan

²⁸ Treas. Reg. § 1.1400Z2(b)-1(c)(6)(iv)(B). Thus, a non-qualifying 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 FIFO. Treas. Reg. § 1.1400Z-2(a)(1)(c)(2). Since this regulation only discusses stock, the omission of partnership interests seems deliberate. *Cf.* Treas. Reg. § 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).

in the same proportion as their equity interests. But under the general test for debt vs. equity, which Treasury applies to QOZ investments,²⁹ a proportionate-interest loan strongly implies equity.³⁰

“Loans” are sometimes made in cases where 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 ten years later.

11. *Profits Interests and Agency Costs*

In normal investments, we incentivize the manager by throwing money at him or her. This is harder to do in QOZ investments. As mentioned, QOZ investors want management to maximize their return along three axes: maximizing traditional economic profit; maximizing the value of the ten-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 ten-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 QOZ 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, in order to maximize his own non-QOZ profits interest. In that case, the investors’ sole remedy is a claim for breach of fiduciary duty, which is hard to prove.

This is the most significant risk which could lead to a lawsuit in a QOZ deal. It is surprising that PPMs 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

²⁹ See Preamble to Final Regulations, *Federal Register*, Volume 85, No. 60, page 1874, available at <https://www.federalregister.gov/d/2019-27846/p-76> (the tax treatment hinges on “a debt-equity analysis based on a careful examination of all relevant facts and circumstances”); Nathan R. Christensen, Comment, The Case for Reviewing Debt/Equity Determinations for Abuse of Discretion, 74 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, available at <https://repub.eur.nl/pub1.14/20559/708A002Cd01.pdf>.

³³ Treas. Reg. § 1.1400Z2(b)-1(6)(iv).

on a banana peel—as though to lull the reader into a sense of complacency. Then they allude to the non-alignment of incentives in a roundabout way. Only time will tell whether investors can bring a claim on this basis.

One suggested way out of this mess is paying the manager a fee instead of a profits interest. While this technique may not be used often, it could become standard for QOZ deals—assuming the IRS cannot recharacterize the fee as equity. Here is an illustration.

Assume the QO Fund sells the building in Y10. 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 Y10, the gain and deduction are both allocated among the partners.

Next, under a special QOZ 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 Y10 as part of the election), this loss becomes an active NOL 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.

12. *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

³⁴ Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii).

³⁵ For a discussion of this technique—in which I argue that the QOZ program resembles “classic” tax shelters from the ‘70s and ‘80s, and in which I encourage every real estate QO Fund to obtain a cost segregation study to maximize this benefit—see Andrew Gradman, How Forgiving Forgiving Recapture Gain Turns QOZs Into Tax Shelters, Tax Notes Federal, November 2019.

³⁶ IRC § 1400Z-2(d); Preamble to Final Regulations, *Federal Register*, Volume 85, No. 60, page 1899. By contrast, for the NMTC, this isn’t a requirement. See IRC § 45D(d)(2)(B).

problem, but 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 a one investor (creating a disregarded entity) or as two (creating a partnership).

13. *The Problem of Divorce*

However, in a non-community-property state, creating a partnership could create problems down the road.

The general rule is that the division of assets in divorce does not trigger tax. Not so for QOZs: based on language in the Conference Report, Treasury decided that inclusion events should arise upon any “disposition.”³⁷ It interpreted this to occur when “(i) the initial eligible taxpayer had severed the direct investment interest in the 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 IRC § 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 QO Fund interests were held in only one spouse’s name. Any transmutation of QO Fund interests from community to separate property—whether by divorce or by post-nuptial agreement—would constitute a disposition, triggering an inclusion event as to exactly half the asset.

Although Treasury’s effort to be consistent are admirable, its logic is not. 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 where both the distributing and controlled corporations are QO Funds 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

³⁷ Preamble to Proposed Regulations dated May 1, 2019, *Federal Register*, Volume 84, No. 84, page 18661, available at <https://www.federalregister.gov/d/2019-08075/p-81>

³⁸ Preamble to Final Regulations, *Federal Register*, Volume 85, No. 60, page 1877. Available at <https://www.federalregister.gov/d/2019-27846/p-97>

³⁹ *Id.*

⁴⁰ Preamble to Final Regulations, *Federal Register*, Volume 85, No. 60, page 1889. Available at <https://www.federalregister.gov/d/2019-27846/p-208>;

⁴¹ Treas. Reg. § 1.1400Z2(b)-1(c)(11).

successors, then surely it could do the same as to the people who succeed to the assets of a dissolved marriage.

14. *Valuation Issues*

Wrongly valuing assets can cause penalties. This is particularly dangerous for taxpayers who want 37% of their Fund to consist of non-qualifying 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 Code.⁴³

There is a similar bug for valuing ownership interests in QOZ Businesses. At first, Treasury instructed us to use FMV. This begged 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 set forth in those subchapters do not count as “adjustments;” only IRC § 1016 makes adjustments.⁴⁶ Some clarification is needed here.

15. *The 20% “Related” Test*

Many taxpayers believe that if they previously owned land in a QO Zone, they won the lottery. In fact, to count as QOZ Business Property, tangible property cannot be bought from a “related” party. So, if someone owns land in a QO Zone, 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

⁴² See Treas. Reg. §1.1016-2(a) (improvements are an adjustment to basis).

⁴³ See IRC § 42(d)(4)(D) (in certain 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. § 1.1400Z2(d)-1(b)(4)(ii), as amended by IRS-2019-0022-0144, Par. 6, available at <https://www.regulations.gov/document/IRS-2019-0022-0144>

⁴⁵ IRC § 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 IRC § 1011(a) (basis is first “determined” under IRC § 1012 or subchapters C, K, and P, and then “adjusted” under IRC § 1016).

⁴⁷ For this purpose, “related” is in terms of IRC §§ 267(b) and 707(b)(1), using 20% for 50%. See IRC § 1400Z-2(a)(1), (e)(2).

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.” “[T]axpayers 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

16. *Can't 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 than first buying a 60% TIC interest in a property, then later buying up the remaining 40%. 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, *i.e.*, perfecting an interest in the property that one is supposed to then improve.

17. *Intangible Property—Broad, but Unworkable*

A QOZ Business must use at least 40% 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 regulations, it was unclear what this meant. It is doubtful whether this would be met where the intangible was used outside the Zone—for example, a trade secret used to manufacture products which are sold outside the Zone. Final rules may look like the “marketing intangible” rules for apportioning business income among states. A proper use of IP would be, for example, a fast-food franchise, where the IP is used to sell burgers in the community.

Surprisingly, the final rules were much less demanding than that. 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’ tangible

⁴⁸ Borden, B. T., 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, October 18, 2019.

⁵⁰ IRC § 1400Z-2(d)(2)(D)(ii).

⁵¹ IRC § 1400Z-2(d)(3)(A)(ii), incorporating IRC § 1397C(b)(4); Treas. Reg. § 1.1400Z2(d)-1(d)(3)(ii)(A).

⁵² Treas. Reg. § 1.1400Z2(d)-1(d)(3)(ii)(B).

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 QOZ deals. However, doubt exists. QOZs are best suited for businesses based around the appreciation of tangible property. A QOZ based around intangibles faces too many traps. The problem is that investors generally try to seed these businesses with their own pre-existing 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 IRC § 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 QO Fund (such as personal goodwill) do not get the basis step-up.⁵⁴

18. *No Depreciation Unless There is Basis*

Investors tend to conflate QOZ 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 a QOZ deal—as long as 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 PPM will leave it at that. But this is misleadingly incomplete. The twist is that, under the QOZ rules, Qualifying Investments do not generate outside basis from invested capital prior to 12/31/2026 (unless they invested by 12/31/2021, in which case they get the 10% or 15% free basis before 2026).⁵⁵ Thus, if the investment is made after 12/31/2021, the investor will have no pass-through deductions in 2022 through 2025 unless she has a share of the partnership’s debt. Conversely, if she did invest on or before 12/31/2021 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% or 15% tax savings she is expecting, if in the intervening years she was allocated deductions which consumed that extra basis.⁵⁶

This rarely poses a problem for the do-it-yourself investor; they tend to be allocated this debt, whether they know it or not. The challenge arises in institutional funds, where the debt is guaranteed by a GP. Many Funds and investors are likely incorrectly calculating investors’ outside basis.

⁵³ Preamble to Final Regulations, *Federal Register*, Volume 85, No. 60, page 1919, available at <https://www.federalregister.gov/d/2019-27846/p-457>

⁵⁴ See Andrew Gradman, Personal Goodwill For New QO Funds, Business Goodwill For Old Ones: IRS May Cry “Whipsaw”. *California Tax Lawyer*. Volume 31, No. 1, 2022.

⁵⁵ IRC § 1400Z-2(b)(2)(B)(i); Treas. Reg. § 1.1400Z2(b)-1(g)(4).

⁵⁶ See Treas. Reg. § 1.1400Z2(b)-1(g)(4)(ii) (the 5% and 10% basis increases are “basis for all purposes, including for purposes of suspended losses under section 704(d)”).

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.

19. *QOZs and Liquidity*

Clients need to be reminded that QOZs are illiquid, at three critical moments.

First, there 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 QO Fund, that is like buying a one-dollar deduction; you may only defer (perhaps) twenty-five 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 QOZ program. If the basis of the sold asset is low enough, there won't be enough sales proceeds to both pay the CA tax and defer all the federal gain in a QOZ 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 feature of the program deserves wider criticism. One of the stated goals of QOZs was to overcome the "lock-in effect." Lock-in is a side effect of our realization-based tax system: current 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 didn't is because 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

QOZs 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 12/31/2026,⁶⁰ 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

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

⁵⁸ See Bittker & Lokken, *Income, Estates, & 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).

⁶⁰ A partnership distribution in excess of outside basis triggers an inclusion event, Treas. Reg. § 1.1400Z2(b)-1(c)(6)(iii), and Qualifying Investments do not create outside basis until 12/31/2026.

⁶¹ See Treas. Reg. § 1.1400Z2(a)-1(c)(6)(iii)(A)(2) (no Qualifying Investment, if contribution is followed by a distribution which would be a disguised sale, disregarding that both transfers are cash-only). Even after two years, the no-sale "presumption" can be overcome where "the facts and circumstances clearly establish" a sale. QOZs meet two factors: (i) The timing and amount of the later transfer are determinable with reasonable certainty; and (v) A person loaned money to the partnership to enable the later transfer (i.e., in the sense that QOZ tax deferral is an "interest fee loan" from the Treasury). Also, in some cases, (ix) the transfer to the partner is disproportionately

it cannot be used to pay the tax. As frustrating as it is to reward people for their own mistakes, the QOZ statute is to blame for deliberately capitalizing on people's shortsightedness. Naturally, Congress is already coming under pressure to extend this deadline.⁶²

The third liquidity issue is the ten-year holding period. If you should urgently need cash before year ten, 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 ten-year basis step up.

20. Late Filing Requires a PLR

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.

However, because these forms contain regulatory elections, a late filing can only be cured 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 tax 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.

C. The Marketing of QOZs to Unsophisticated Investors

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

What makes QOZs 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. QOZs fit a convenient narrative about charity and free enterprise: they make both look easy. Before he became synonymous with QOZs, Sean Parker built Napster and Facebook. If there's one thing he understands, it's how to make something go viral. QOZs take a page from their tech industry origins: the marketing was brilliant but beware of in-app purchases.

When we think of QOZs, we tend to think of sophisticated investors and big institutional funds. However, there are also many individuals or families trying to do this themselves. QOZs have captured the imagination of the taxpaying public. There is no cap; they require no advance planning; the sooner you act, the greater the tax benefit. Anyone can Google "*find qoz investments*," request a PPM, attest to being a qualified investor, attest to having read and understood the entire memorandum, and write a check.

large compared to the partner's interest in partnership profits, and (ii) the transferor has a legally enforceable right to the later transfer. See Treas. Reg. § 1.707-3(d) (presumption); § 1.707-3(b)(2) (listing factors).

⁶² David Wessel, *Only the Rich Can Play*, PublicAffairs (October 5, 2021) page 88 (herein "Wessel").

⁶³ See, e.g., PLR 202141004.

⁶⁴ Treas. Reg. § 301.9100-3(a).

QOZs' 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 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 QOZs was both welcome and cruel. QOZs 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 QOZs. 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 QOZs, 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, similar to 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 towards more investment is also reflected in provisions which have no purpose except to impose costs on investors who wait to invest—namely, the deferral of gain, which ends at 2026 (so it loses value every year), and the 10% and 15% basis increases, which sunset after 2019 and 2021. We saw the perverse consequences of this in December 2019. For every \$1MM invested in a QO Fund, 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 on December 19. 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% basis increase.

As a matter of tax policy, these staggered 10% and 15% 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 QOZ bill was unveiled, David Wessel explains how the EIG moved to "build the case that something like OZs was needed to revitalize the American economy":

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 56, at page 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 Andrew 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, 11/02/2021. <https://www.dailyjournal.com/articles/364837>

⁶⁸ IRC § 168(k)(6).

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 states' 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 weren't already 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, QOZs go against human nature by design. Back in the 1970s and 1980s, physicians like my father and grandfather looked for passive investments to shelter their professional income. Today, physicians want to "buy a building and do a QOZ" 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.

D. 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 QO Funds, penalties can be waived for "reasonable cause."⁷⁰

This term is not defined. However, it is common in the Internal Revenue Code and regulations.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 *US v. Boyle*, 469 US 241 (1985), based on the premise that the meaning of "reasonable cause [is] the same throughout the penalty provisions of the Internal Revenue Code."⁷² In the preamble to the final QOZ regulations,

⁶⁹ Wessel, *supra* note 56, at page 92.

⁷⁰ IRC § 1400Z-2(f)(3).

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

⁷² *In re Wyly*, 552 B.R. 338, 579 (Bankr. N.D. Tex. 2016).

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 I.R.M. § 20.1.1.3.2.⁷³

This Internal Revenue Manual provision is helpful, but it leaves many unanswered questions.

1. *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 “[s]ome 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 Internal Revenue Manual does not explain how to adjust its guidance to account for these variations.

2. *Multiple Interpretations*

Second, some of these rules are ambiguous. For example, in *Boyle*, the Court purported to announce a “bright line” test: in cases with similar facts, taxpayers cannot treat reliance on an advisor 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 advisor 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 as to whether a reasonable cause defense would be available where, “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.⁷⁴

3. *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 doubt exists that this could be fairly administered. Characterizing a requirement as merely “procedural” often reflects the self-interest of the person making the characterization. If the goals of QOZs were simply to get people to invest in QO Zones, every rule would be procedural. However, Congress and Treasury viewed

⁷³ Preamble to Final Regulations, *Federal Register*, Volume 85, No. 60, page 1941-42, available at <https://www.federalregister.gov/d/2019-27846/p-650>. The IRM provision appears at https://www.irs.gov/irm/part20/irm_20-001-001r.

⁷⁴ Compare *Estate of Thouron v. US*, 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).

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 certain merely procedural faults, at what point do we admit that we have two sets of rules—the public-facing ones, and the real ones?

4. *QOZ Penalties are not About Tax Return Positions*

Fourth, 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 Internal Revenue Manual and in the regulations, makes sense in this context. By contrast, a failure to satisfy the 90% 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 which 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 QOZs, this seems like a trivial and arbitrary standard compared to the magnitude of the dispute.

For comparison, note that in the entirety of Subchapter A (containing the tax credits) and Subchapter U (Empowerment Zones, *etc.*), the phrase “reasonable cause” only appears 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.⁷⁵ None of these are comparable.

5. *Consider the Goals of the Program?*

A more reasonable way to resolve these issues would be to consider the degree to which the QOZ investment was actually benefiting the community. However, this is currently difficult because there is currently no social impact reporting.

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.”⁷⁶

⁷⁵ IRC §§ 42(l)(1), 25(f)(5), 1397E(f)(2).

⁷⁶ See Urban Institute, An Early Assessment of Opportunity Zones for Equitable Development Projects, June 2020, available at <https://www.urban.org/research/publication/early-assessment-opportunity-zones-equitable-development-projects>.

In fact, it is easy to find examples of Funds which (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 the more than 8,700 Opportunity Zone census tracts ...”⁷⁷

This behavior is not blameworthy; it is the natural response to the incentive.

6. *Unsophisticated Investors*

Another problem: According to the Internal Revenue Manual, 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.”

Where a taxpayer tried to do a QOZ without legal help, the IRS might argue that this was unreasonable. However, QOZs 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.

7. *How to Handle Future Penalties?*

Another difference is that a QO Fund’s failure to meet the 90% 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.

II. CONCLUSION

Here are some proposals to mitigate the “cliffs” described herein:

1. If a taxpayer receives a gain on a K-1, he or she should be able to choose the day on which his 180-day period begins: that is, 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. As long as Form 8997 shows that all the taxpayer’s investments were made within a single 180-day window, and as long as the entity made no QOZ election of its own, this requirement should be satisfied.

⁷⁷ Cadre, “Opportunity Zones: OZ Investing, Explained,” available at <https://cadre.com/insights/opportunity-zone-investing-2020/>

2. Congress should allow QO Funds with no subsidiary QOZ Businesses to hold assets in the same way that QOZ Businesses can.
3. Congress should allow QO Funds 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-fund 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 ten-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 § 4.02(1) to provide that it will rule on debt versus equity as to investments in QO Funds.
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 PLR that it is a Fund, if it can show it always intended to operate as a Fund.
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% related test will be applied.
13. Treasury should clarify whether the cost of buying out tenants counts towards substantial improvement.
14. Treasury should clarify how it will apply the requirement to double the "adjusted basis" in cases where the property has been placed in service prior to the start of improvements.
15. Treasury should create a safe harbor where a 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 where both transfers are all-cash, and where 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.

Finally, Treasury and Congress should clarify the confusion surrounding penalties described herein by considering the following:

1. Investors should have a “reasonable cause” defense.
2. QO Funds 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% 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 regulations, Treasury remarked that a commenter 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 QO Funds 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.