VOLUME 25 SUMMER 2020

ILLINOIS BUSINESS LAW JOURNAL

IS OPPORTUNITY ZONE INVESTING ATTRACTIVE TO WEALTHY INVESTORS?

❖ ARTICLE ❖

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ABSTRACT

In the media, in state capitals, and even in Congress, the super-rich are frequently cited as the biggest economic winners from the opportunity zone laws passed as part of the 2017 Tax Cuts and Jobs Act. Although high net worth investors can access the tax benefits more easily than others can, a closer look at the law and regulations reveal that the wealthiest taxpayers are usually less incentivized than other wealthy investors to participate in Qualified Opportunity Zone (QOZ) investing. The QOZ tax benefits are significant, promising capital gains tax exclusion on new QOZ investments. But high net worth investors have more access than others to indefinite deferral mechanisms, making capital gains exclusion less valuable. QOZ investments requires capital gains realization and, by tax year 2026, capital gains recognition, presenting current costs in exchange for future tax benefits mostly available ten years after the investment is made. Even though the QOZ laws are designed to provide tax benefits to any investor with capital gains, the investors best-positioned to benefit are those with realized gains who lack access to indefinite capital gains deferral. And in the current low tax and low interest rate environment, even those investors may not find QOZ investing attractive.

INTRODUCTION

When the Joint Committee on Taxation (JCT) of the U.S. Congress presented revenue estimates for the 2017 Tax Cuts and Jobs Act, it limited its report to a 10-year projection window,[1] as required by the budget process.[2] One of the many line items it evaluated was the creation of the new Qualified Opportunity Zone (QOZ) program, codified in Internal Revenue Code Sections 1400Z-1 and 1400Z-2. But the QOZ law, created to encourage the investment of new capital in low-income communities,[3] promises most of its tax incentives after an investor's qualifying investment is held for at least ten years, beyond the horizon of the JCT's report. Further compounding the opacity of the law is the lack of robust reporting requirements by investors and the somewhat technical nature of the regulations. Because the law's benefits and budgetary impact are difficult to project, there continues to be significant speculation surrounding the extent to which the law will make a mark on low income communities and on the federal budget. A frequent criticism of the QOZ laws is that the law helps wealthy taxpayers without providing sufficient benefit to the public in return.[4]

While certain media outlets,[5] members of congress,[6] and state lawmakers[7] have objected to the structure of the opportunity zones law, the Treasury regulations advance a clear purpose "to provide specified tax benefits to owners of QOFs [Qualified Opportunity Funds] to encourage the making of longer-term investments of new capital, through QOFs and qualified opportunity zone businesses, into one or more QOZs [Qualified Opportunity Zones] and to increase the economic growth therein."[8] To the extent that this mission is achieved, wealthy investors are meant to benefit financially. The QOF owners mentioned in the statement of purpose are almost certain to be wealthy taxpayers because in order to access the QOZ tax benefits, investors must realize capital gains within the 180 days preceding the QOF investment.[9] Thus, investors interested in reaping the tax benefits must have access to capital

1. *Estimated Budget Effects of the Conference Agreement for H.R. 1, The "Tax Cuts and Jobs Act"*, Joint Committee on Taxation, December 18, 2017 JCX-67-17, https://www.jct.gov/publications.html?func=startdown&id=5053

2. "The current budget process also requires the Joint Committee staff to generate revenue estimates of tax legislative proposals over a 10-year period, often referred to as the "budget window."" Joint Committee Revenue Estimation Process, The Joint Committee On Taxation, https://www.jct.gov/about-us/revenue-estimating.html

3. 85 FR 1941

4. This is a concern expressed with regard to countless other tax expenditures as well. For a useful framework for assessing the different kinds of tax expenditures and who they benefit, see David M. Schizer, Limiting Tax Expenditures (2015), Tax Law Review.

5. The New York Times has focused on the windfall received by a select few billionaires. See e.g., *Opportunity Zones — for Billionaires* (Nov. 16, 2019) https://www.nytimes.com/2019/11/16/opinion/trump-tax-opportunity-zones.html

6. "Opportunity Zones were supposed to help uplift low-income communities and those living in poverty, but instead we are seeing them benefit billionaires and their luxury projects." *Congresswoman Rashida Tlaib Introduces Bill to Repeal Controversial Opportunity Zones* (November 22, 2019) https://tlaib.house.gov/media/press-releases/congresswoman-rashida-tlaib-introduces-bill-repeal-controversial-opportunity

7. *See, for example*, HB 4010 A, a bill proposed in the Oregon House of Representatives and recommended by committee but adjourned because of a failure to reach quorum after a Republican walkout. Although Oregon income tax generally uses federal income tax as a starting point for calculation, the bill seeks to reduce the extent of the QOZ capital gains exclusion for Oregon tax purposes.

8. 85 FR 1907. Internal Revenue Code § 1400Z-1 governed the process by which state governors decided which census tracts would receive the QOZ designation. By summer 2018, the Treasury Department had effectively finished the QOZ certification process. See *Treasury, IRS Announce Final Round of Opportunity Zone Designations* (June 14, 2018) U.S. Department of the Treasury https://home.treasury.gov/news/press-releases/sm0414

9. For example, an investor interested in making a qualifying $15 purchase in a Qualified Opportunity Fund will need to realize $15 in capital gains 180—or fewer—days before purchasing the QOF interest. This might occur if the investor sold $40 in

and capital gains, two resources unlikely to be held by the lower to middle percentiles of American households.[10] Moreover, because the wealthiest Americans tend to have the most capital and capital gains, they are positioned to receive the richest tax benefits.[11]

But although the wealthiest investors might have the most capital and capital gains available to benefit most under this uncapped program,[12] the opportunity zone incentive structure may not actually incentivize participation by the wealthiest taxpayers in the United States. Relative to the average investor, wealthy taxpayers are less likely to trigger capital gains realization, a necessary condition for opportunity zone benefit eligibility. Furthermore, wealthy investors have more access to indefinite gains deferral mechanisms than the average investor. Corporate reorganizations, partnership property distributions, and like-kind exchanges are just a few examples of how wealthy investors can dispose of property without triggering a taxable event.

This paper will evaluate the opportunity zone benefits within the framework of wealthy investor decision making and will argue that QOZ investing is not beneficial to most high net worth investors despite the widespread sentiment to the contrary. Part I will include a review of the opportunity zone incentives. Part II will contain a discussion of indefinite capital gains deferral and some of the ways wealthy investors can access this benefit. Part III will argue that even wealthy investors without access to indefinite deferral may not be incentivized to make QOZ investments. Although the tax benefits are attractive to these investors, the current low tax, low interest rate environment makes the tax-deferred, long-term, opportunity zone investments less beneficial to most investors.

I. THE QUALIFIED OPPORTUNITY ZONE LAWS ARE STRUCTURED TO INCENTIVIZE INVESTORS TO BRING NEW CAPITAL INTO DESIGNATED AREAS

The opportunity zone laws provide tax benefits to investors making equity investments into Qualified Opportunity Funds (QOFs), entities which must maintain substantially all of their assets invested in Qualified Opportunity Zone (QOZ) property. Whether the QOF held assets directly ("qualified opportunity zone business property") or through another entity ("qualified opportunity zone stock or qualified opportunity zone partnership interest"), substantially all of the assets owned by the qualifying entities must be located in QOZs, designated census tracts located in every U.S. state, the District of Columbia, and five U.S. territories. Investments are only eligible for tax benefits if they are made within 180 days of a

assets with a $25 basis, an investment representing a $15 gain.

10. "Approximately 33 percent of U.S. households own taxable investment accounts, 29 percent own only retirement accounts, and 38 percent do not own any investment accounts. Households that own taxable investment accounts are more affluent and financially knowledgeable than households with only retirement accounts, which are in turn more affluent and financially knowledgeable than the households without investment accounts." Gary Mottola, *A Snapshot of Investor Households in America* (September 2015), FINRA Investor Education Foundation https://www.sec.gov/spotlight/fixed-income-advisory-committee/finra-investor-education-foundation-investor-households-fimsa-040918.pdf

11. Wealthy investors also have access to the investment and legal advice necessary to evaluate the risks and rewards of QOZ investments as compared to other options.

12. One example of a capped program is the New Markets Tax Credit. Through 2018, the Department of the Treasury's Community Development Financial Institutions (CDFI) Fund awarded approximately $50 billion in allocations. This amount, which translated to a potential reduction in investor tax liability of approximately $20 billion. The QOZ program, as designed, could cost many times that number without any special authorization or allocation.

capital gains realization event.[13] Thus, the law is designed to unlock gains held on investors' balance sheets and to incentivize investors to direct those funds into investments in these QOZs. Investors making qualifying investments can elect to defer the gains from the capital gains realization until tax year 2026 unless any action triggers gains recognition before that point.[14] The QOZ investment itself, once held for at least ten years, can qualify for a step up in basis to fair market value at the time of disposition. This benefit, an exclusion of capital gains, offers an enormous potential benefit to investors.[15] An investor with a 40% marginal tax rate and a $100 million capital gain from the QOZ investment, would save $40 million in federal income tax.[16]

Tangible property purchased as part of a qualifying opportunity zone investment falls into one of two categories: first use property or substantially improved property. The former is property that has never been used before being put into service in the QOZ, such as brand new machinery. The latter is property that was previously used inside or outside of a QOZ but has substantial funds invested into improving the asset. Under the regulations, property can qualify as substantially improved if one dollar in improvements was invested for each dollar spent on purchasing the asset.[17] In the case of real property, one of the main exceptions to the general rule is that assets can qualify as substantially improved as long as one dollar of improvements was invested for each dollar allocated to the purchase price of the building, a subset of the total purchase price of the property which includes land.[18] The regulations anticipate investments in operating businesses, real estate,[19] and other assets, yet certain types of investments are better suited for the benefits—the large and simple investments that can absorb large amounts of qualifying equity with limited risk and a limited compliance burden.

A. Investments involving large and simple asset purchases or improvements are best-suited to the QOZ rules

The QOZ regulations are flexible in terms of the type of capital investment that qualifies for tax benefits. Investments can be made in businesses and in real estate, in purchased

13. There are some exceptions to this 180 day rule. For example, partners in a partnership that sells assets and allocates gain can enjoy an 180 day period starting from the end of the tax year rather than from the asset sale date. See §1.1400Z2(a)-1(c)(8)(iii)(A).

14. In addition to this deferral benefit, certain investors can receive some capital gains exclusion on the initial gain: 10% if held for at least five years by year end 20206 and 15% if held for at least seven years by that time. See §1400Z-2(b)(2)(B). Events which trigger earlier gains recognition include liquidation of a QOF, certain distributions to QOF partners, and the transfer of a qualifying investment by gift. See §1.1400Z2(b)-1(c).

15. Significantly, this benefit depends on the investment growing significantly in value, a state of affairs that cannot be taken for granted.

16. It should be emphasized here that the QOZ program is only a deferral and exclusion of federal income taxes. Although some states have parallel laws that create a similar effect for state income taxes, the laws and regulations created by Congress and the Treasury Department relate only to federal income taxes.

17. *See* §1400Z-2(d)(2)(D)(ii) and §1.1400Z2(d)-2(b)(4).

18. IRS Revenue Ruling 2018-29. Thus, an $80 property allocated $55 to the building and $25 to the land needs to receive only $55—and not $80—in qualifying improvements in order to constitute eligible property under the law.

19. The final regulations even allow certain non-capital purchases to be counted towards the substantial improvement investment requirement. "For example, suppose a QOF purchases a nonoriginal use building in a QOZ for $1 million, makes $950,000 in improvements to the building that bring that building into good condition for that local market, and purchases $50,001 of furniture or equipment for use within the building. This building would not meet the substantial improvement test under the proposed regulations but it would meet it under the final regulations." 85 FR 1945.

property or leased property, on owned land or leased land, through simple QOF entities or through more sophisticated and potentially more liquid entities like qualifying REITs, and with plenty of room for activity outside of opportunity zones as well.[20] The laws also require very little reporting by the QOFs about their investments. The recently-updated QOZ reporting form, IRS Form 8996, requires QOFs to report the census tracts in which QOZ tangible property is located, the value of investments held in each census tract, and the EIN numbers of QOZ businesses located in each census tract.[21]

Property eligible under the QOZ laws must be used in a trade or business, a requirement meant to prevent QOZs from becoming tax-advantaged warehouses for valuable tangible and intangible property.[22] Although start-ups receive special benefits in the final QOZ regulations,[23] real estate or operating businesses requiring large capital investments are best suited for the QOZ benefits because they are easy and quick to execute relative to developing a brand new business in a QOZ. Execution speed is important because capital must be invested in QOFs by mid-2027 in order to be tax advantaged upon QOZ project disposition. Investors may also want to invest funds in the QOF before the QOF invests the funds in the business, a possibility subject to generous but limited time periods before the unspent capital disqualifies the investment's eligibility under the law.[24] Examples of QOZ investments announced to date include alternative energy projects such as solar panel farms, new real estate development projects, and manufacturing plants such as a $50 million feed mill for a poultry producer.[25]

And there is another critical reason for execution to happen quickly. Penalties accrue to QOFs that do not have an adequate percentage of qualifying property as a percentage of their assets.[26] Testing periods occur every six months but QOF investments can qualify for a thirty one month working capital safe harbor during which a business entity ("qualified opportunity zone business") can be treated as if it qualified under the relevant asset testing standards, even if a small percentage of its assets were invested in opportunity zones at the time.[27] This safe harbor exists because businesses or real estate development projects take time to be built and developed. Certain projects may need a longer period of time to develop and some entities can be eligible for a second safe harbor, but that safe harbor requires another round of eligible capital in order to receive tax benefits from all invested equity. Excessive cash or cash equivalents on hand can result in triggering penalties because neither constitute qualifying property.[28] Although the regulations provide for the possibility of safe harbor tolling in certain cases of government delays—like in a complex real estate development—the

20. Subject to specific definitions for amounts of property and amounts of time, most a QOF's qualifying property must be located in a QOZ most of the time, facilitating significant activity outside of QOZs. Indeed, all customers and most employees can be located outside of a QOZ with the owner-QOF still qualifying for benefits.

21. *See* Part VI of IRS Form 8996. No information about specific addresses, jobs created, or engagement with the community is required.

22. For example, laboraties developing innovative drugs to be patented and licensed for commercialization over the long term.

23. See discussion at 85 FR 1923.

24. See §1.1400Z2(d)-1(d)(3)(v) for the requirements of the working capital safe harbor and the related discussion below.

25. *Filing frenzy shows companies lining up for opportunity zones* (Dec. 12, 2019) Bloomberg, https://www.pionline.com/investing/filing-frenzy-shows-companies-lining-opportunity-zones

26. *See* §1400Z-2(f).

27. *See* §1.1400Z2(d)-1(d)(3)(v).

28. *See* §1.1400Z2(d)-1(d)(3)(iv) for the general limitations on cash and cash equivalents held by QOZ businesses.

applicable cases are quite limited.[29] Therefore, while startups benefit from a longer safe harbor window provided in the final regulations,[30] the limited timeframe to deploy capital in order to comply with QOZ rules poses a risk to investors hoping to enjoy the tax benefits and avoid penalties. Large, simple projects can facilitate the most tax-advantaged capital investment by investors with the least amount of risk.

B. *Some investors will enjoy a windfall by receiving QOZ incentives in projects that do not advance the purpose of the laws*

As with many tax incentive programs, some QOZ taxpayers will enjoy a windfall for receiving a tax benefit for investments they would have made anyway, a circumstance that does not advance the purpose of the law. For example, two redeveloped properties in the Hackensack, New Jersey downtown area were completed in 2019 after years of planning and construction. 210 and 214 Main St were then put on the market[31] before any leasing or operations commenced at the property so that a QOZ investor could ensure that the assets would be qualifying property.[32] This "first use" designation is just one example of a tax benefit which did not stimulate any new investment. This type of investment is also attractive to investors because the timeliness issues of QOF capital investment are hardly relevant.[33] Although the initial investors could not enjoy tax benefits for the project because eligible property could not be purchased before 2018, the project may have enjoyed a higher exit price because it could be sold to investors interested in a QOZ-compliant project.[34] This kind of project is attractive to QOZ investors because development budgets, construction delays, and other compliance complexities existing in QOZ developments would not be a part of the business plan for any newly developed property being purchased.[35]

Although there are other examples of windfalls generated by the QOZ laws,[36] Congress

29. "In general, the final regulations make clear that, if a governmental permitting delay has caused the delay of a project covered by the 31-month working capital safe harbor, and no other action could be taken to improve the tangible property or complete the project during the permitting process, then the 31-month working capital safe harbor will be tolled for a duration equal to the permitting delay." 85 FR 1926.

30. A 62-month safe harbor was introduced in the final regulations for start-up businesses. See Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v).

31. Joshua Burd, *C&W: Buyer wanted for 126-unit rental project at historic Hackensack site* (June 3, 2019), Real Estate NJ, https://re-nj.com/cw-buyer-wanted-for-126-unit-rental-project-at-historic-hackensack-site.

32. The final regulations provide an example illustrating this allowance and makes clear that this kind of investment is consistent with the law's purpose: "The construction of new buildings in economically disadvantaged communities, which are acquired for the purpose of introducing new businesses into such communities, clearly achieves the policy goals underlying section 1400Z-2 and should be encouraged," 85 FR 1909. "[T]he original use of tangible property in a qualified opportunity zone commences on the date any person first places the property in service in the qualified opportunity zone for purposes of depreciation or amortization, or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner." Treas. Reg. § 1.1400Z2(d)-2(b)(3)(i)(A)

33. All or most of the investor's equity investment would constitute qualifying property from day one with no execution or compliance risk required in the coming months or years.

34. A higher price would require an investor for whom the qualifying investment status was valuable. This will be discussed at length below.

35. The QOF should be able to purchase the building, whether directly or through other entities, and enjoy simple reporting and guaranteed compliance with all of the QOZ laws. In addition, because the law allows for a certain percentage of non qualifying property to be held by the compliant QOF, investors can overfund the QOF making the purchase by a certain degree and enjoy the tax benefits (tax deferral and partial exclusion) for those additional funds as well.

36. For example, the designation of certain wealthy and economically vibrant areas, like parts of Manhattan, as QOZs, a fact pattern critics say represents the failure of the laws. In these areas, development was likely feasible or even planned without the

directed the Secretary of the Treasury to prescribe anti-abuse rules in order to prevent efforts to game the system.[37] This powerful tool, combined with a long-term horizon for the QOZ tax incentives makes for a strong deterrent against investments that are designed to satisfy the technical rules but do not at all increase economic growth in QOZs. One example of how such a scenario could play out involves land banking. Investors might purchase land in a QOZ that they believe will appreciate in value in the coming decades, put minimal investment such as asphalt and parking booths in order to develop a parking business, and thus satisfy the substantial improvement rules because of the lack of required investment corresponding to the land value.[38] In the final regulations, the Treasury Department declined to include anti-speculation rules "because [when] a significant purpose for the acquisition of the land is to hold the land for speculative investment, the anti-abuse rule functions to recharacterize the transaction so that the taxpayer may not receive the benefits of section 1400Z-2."[39] The prospect that the anti-abuse tools might be utilized in a broad set of circumstances will certainly chill many kinds of business behavior and limit many investors from enjoying tax benefits without making the kind of investments anticipated by Congress and the Treasury Department.

II. BUT BECAUSE MANY WEALTHY INVESTORS BENEFIT FROM THE ABILITY TO INDEFINITELY DEFER CAPITAL GAINS, QUALIFYING OPPORTUNITY ZONE INVESTMENTS ARE USUALLY NOT ATTRACTIVE

All investing involves taking risks and making assumptions about the future. Investors consider investments by assessing their own risk tolerance and investor profile but also by comparing the costs and benefits of various options. To investors who have made the decision to realize gains, investing in a QOF offers the benefits of tax deferral and exclusion to investors willing to invest for at least ten years and pay the capital gains tax by 2026. But high net worth investors may not need to realize gains and thus may face a different calculus. These investors must decide whether to realize gains, which will lead to the payment of taxes by 2026, for the opportunity to invest in an often-riskier asset promising tax benefits. As discussed below, some high net worth investors do not stand to benefit from these tax benefits because they foresee alternative avenues to capital gains tax avoidance. And even those high net worth investors who can appreciate the QOZ tax benefits still face the question of whether to trigger the required gains needed in order to make a qualifying investment.[40]

QOZ incentives and investors or developers likely enjoyed a windfall, much like in the way benefits are enjoyed from a favorable change to zoning codes. The party capturing the upside differs based on the specific situation. Parties that might benefit include the existing owners of the property, new investors purchasing the property, and the developer planning to manage a QOZ improvement or construction project. Of course, as discussed below, most property owners in QOZs will not enjoy any increase in values from the QOZ program.

37. *See* §1400Z-2(e)(4).

38. "[T]he Treasury Department and the IRS note that land does not need to meet the original use requirement or the substantial improvement requirement to be treated as qualified opportunity zone business property," 85 FR 1915.

39. 85 FR 1933

40. The law allows for investors without gains to make investments in QOFs as well but those investments would not qualify for the tax benefits. See §1400Z-2(e).

A. Opportunity zone investing involves a variety of risks and an uninviting threshold decision for investors who do not have to realize capital gains

The opportunity zone incentives were created in order to encourage long-term investments in areas not generally attractive to investment. Despite the promise of tax deferral and tax exclusion, opportunity zone investments feature many risks that wealthy investors do not otherwise face in their portfolios. Firstly, geographic and demographic concerns are meaningful for many QOZ investments. Many QOZs feature communities with low household incomes, low rates of educational attainment, and high crime rates. Many QOZs are also located far away from commercial centers and do not have robust economic drivers of their own.

Second, because QOZ investments must be held for ten years in order to receive most of the program's promised tax benefits, investors must take extra care in weighing the program's costs and benefits as compared to their alternative investment options. Moreover, the ten years will likely serve only as a minimum investment term because the tax benefits are beneficial to the extent that fair market value is higher than the project's basis. If the QOZ property is not well-positioned for disposition at the ten year mark, or if the broader market environment is not favorable at the time, it might take many years before the QOF decides to exit the investment and elect to make the step up in basis allowed by § 1400Z-2(c).[41] This situation contrasts starkly with most other investments which tend to be more liquid.[42]

Finally, the opportunity zone law is new and thus, despite robust regulations, represents uncertainty. The new law presents compliance risks such as the possibility that a lack of proper asset tracking or regulatory compliance results in a denial of tax benefits when investors are ready to dispose of the investment after ten or twenty years. Even if the long term tax benefits are received, reporting errors could result in penalties which reduce the overall investment return.[43] The risks can stay with the investors even while investment operators or developers impose compliance costs. Fund operators have reportedly charged QOZ investors additional fees to defray the compliance and reporting costs involved in QOZ investments while refusing to take responsibility—in the form of a contractual duty—for a compliant outcome.

But there is a more significant barrier to investment in QOFs than the QOZ-specific risks featured in the investments. Wealthy investors interested in QOZ investing have a threshold requirement to make that is not attractive: capital gains realization.[44] One of the most

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41. The final regulations anticipate that some investors may not exit for decades and that there might need to be a provision for a step-up in basis absent disposition before a certain date: "The Treasury Department and the IRS will continue to consider... how best to value investments in QOFs absent a sale or exchange between unrelated persons by December 31, 2047." 85 FR 1895.

42. To the extent that a secondary market will develop for QOF interests, QOZ investments might also be quite liquid. However, a transaction taking advantage of this liquidity will require the loss of the tax benefits if executed within ten years (unless the funds are reinvested in another qualifying QOF investment, see 85 FR 1866.). Moreover, given the relatively small pool of QOF investors and the discount generally applicable to private equity fund interests, investors will probably have to provide a meaningful discount to value in order to sell their QOF interests quickly. (The final regulations estimate QOZ activity to involve between 5,500 and 12,000 QOFs. See 85 FR 1943.)

43. *See* e.g., §1400Z-2(e).

44. "[T]he final regulations clarify that deferral of a gain under section 1400Z-2(a)(1) and the section 1400Z-2 regulations generally is available only for capital gain that would be subject to Federal income tax but for the making of a valid deferral election under section 1400Z-2(a)(1) and the section 1400Z-2 regulations." 85 FR 1872.

important ways wealthy investors grow their wealth is by avoiding the need to realize gains, allowing gains to continue to compound over the long term. While investors with smaller portfolios might need to sell assets in order to pay for emergency expenses, finance major lifecycle events, or to take advantage of new investment opportunities, wealthy investors can more easily hold onto their assets and enjoy the luxury of inaction. By not facing the liquidity pressures that many other investors face, high net worth investors can focus on the longer-term estate planning implications of their actions.[45]

Selling assets involves several costs including research costs involved in choosing a new investment, as well as the transaction costs involved in the sale of one investment and the purchase of another. Perhaps most significantly, capital gains realization can trigger a tax event that might have never come up. Because Internal Revenue Code Section 1014 allows for a step-up of basis for appreciated assets passed by a deceased investor to inheritors, the deferred tax bill can be completely avoided as long as no gains recognition occurs before that time. And when gains need to be realized, wealthy investors often have ways to avoid gain recognition, deferring taxation further into the future with the hope that, at passing, the tax can be avoided forever with a step-up in basis.

B. Many wealthy investors have several avenues for preserving indefinite capital gains deferral, making the QOZ investment decision less attractive

Internal Revenue Code section 1001 triggers capital gains recognition—and the resulting taxation—upon the sale or other disposition of property. Unrealized "paper" gains held by investors for years or decades may finally be taxable when appreciated stocks, real estate, or other assets are sold. The decision might be made by an investor who is no longer interested in owning a particular asset or asset class, or by the general partner of a project who is able to trigger a sale over the objections of the limited partnership investor.

But several avenues for deferral are available to many wealthy investors.[46] First, partnerships can serve as vehicles for investors to effectively exchange appreciated assets for others without facing tax recognition.[47] Likewise, corporate reorganizations transactions allow for investors to parlay an appreciated asset into a different asset without gains recognition. Finally, as discussed below, real estate investors have a special tool available to them for indefinite capital gains deferral: section 1031 like-kind exchanges. These tools and others involve a range of expertise and cost but the wealthiest investors tend to have the benefit of sophisticated advisors who can recommend and execute a variety of transactions and warn against potential pitfalls. As well, the large sums of money involved in wealthy investors' transactions can justify the advisory fees that expensive transactions require and would not be worthwhile for investors with fewer assets.[48]

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45. Financial advisors are often compensated when transactions occur, a conflict of interest with investors interested in tax-advantaged inaction. This state of affairs makes many high net worth individuals suspicious of making costly changes to their portfolio.

46. Strategic trust structuring including strategies for fragmenting ownership and ways to enjoy valuation discounts is one of many ways that investors can reduce their tax liability.

47. Investors would wait seven years before distributing contributed appreciated property, consistent with § 704(c)(1)(B). Partnership tax anti-abuse rules and the requirements of § 737 would also serve to limit maneuverability.

48. Simple like-kind exchanges are often accomplished for a few hundred dollars in fees paid to a Qualified Intermediary

Because wealthy investors have a special ability to indefinitely defer capital gains with regard to their real estate holdings, property owners are particularly disincentivized to participate in QOZ investing. This is not consistent with the state of affairs expressed in the media, which cite landlords as major beneficiaries of the QOZ laws. Most property owners in opportunity zones have not received any benefits and never will.[49] There have certainly been high-profile exceptions to this generalization, such as the prime development sites that wound up in designated opportunity zones.[50] Nevertheless, most real estate investments do not qualify under the QOZ laws because they do not involve the necessary value-add strategy. Even though an early revenue ruling by the IRS clarified that real estate investments require less value-add investment than other asset classes,[51] even this level of investment is very rare in real estate investments. A property worth $100 with a building worth $60 might return $8 in profit each year, after considering repair and maintenance costs on the building. And while a major purchase like a roof or boiler replacement might need to happen every fifteen years or so, it is unlikely that the price tag will rise above the amount received in one year's profits. In contrast, a qualifying real estate investment would involve $60 in upgrades, making the QOZ investments most relevant for ground-up construction and gut-rehab projects for which the upgrade portion of the developer's budget can easily exceed the required threshold.

Property owners are also unlikely to opt for QOZ investments when they realize capital gains as part of a sale of property. This is because Internal Revenue Code section 1031 offers indefinite deferral to property owners who enter into qualifying like-kind exchanges of property. Although the 2017 Tax Cuts and Jobs Act eliminated like-kind exchanges for several types of property, one asset class—real estate—remains as a beneficiary under the law. The 1031 exchange has several time-sensitive rules by which investors can use a Qualified Intermediary (QI) to facilitate a qualifying exchange. Even though virtually all like-kind exchange buyers and sellers are not entering into a bilateral exchange agreement, a QI can allow for a seller of property to select from an almost endless assortment of replacement properties and acquire new property without recognizing gains on the relinquished property.[52] And indefinite deferral, as mentioned above, often has I.R.C. section 1014 as the ultimate goal, a tax benefit which is triggered when the real estate investor passes away.

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that facilitates the transaction (in addition to transaction fees for the sale and purchase transactions). However, there are layers of sophistication that can be involved in these transactions which can provide additional flexibility or benefit to investors such as negotiating acquisition or disposition terms to improve like-kind exchange flexibility, reverse exchanges, and construction 1031 exchanges.

49. QOZ property is only more valuable as a result of the new laws to the extent that investors will enjoy tax benefits by investing in that property. Those benefits are only available if certain rules are met including (1) that the investor realized gains within the 180 days before making the qualifying investment in a QOF, (2) that the investment involves the purchase of new property or the substantial improvement of existing property, and (3) all of the structuring and compliance rules are met. These conditions make the overwhelming majority of properties irrelevant to the law because they are either existing, stabilized properties—with little room for large investment—or too small to justify the administrative requirements of the law.

50. For example, the select few billionaires whose large development sites in Florida, Nevada, Michigan, and elsewhere, became even more valuable when they were included in QOZs.

51. IRS Revenue Ruling 2018-29 created a lower investment threshold for substantially improving real estate than the general rule presented in §1400Z-2(d)(2)(D)(ii). A $80 property with value allocated $55 to the building and $25 to the land needs to receive only $55—and not $80—in qualifying improvements in order to constitute eligible property under the law.

52. A large office building can be exchanged for two small strip malls; five small apartment buildings can be exchanged for two large warehouses; etc.

The particular requirements of the QOZ program can also present challenges to investors, including those in the real estate industry.[53] First, the short-term deferral offered by QOZ investments can also present problems to investors, especially those in the real estate industry. The tax year 2026 capital gains recognition creates a "phantom tax," which comes due without any corresponding cash distribution from the investment. Many landlords cannot easily access the funds required to satisfy this tax liability because their net worth is tied up in illiquid real estate holdings.[54] As well, the long-term investment horizon of the QOZ program contrasts sharply with the flexibility of like-kind exchanges which are not limited to QOZ geographies nor to the types of projects that can qualify under the QOZ regulations. The investments purchased in like-kind exchange transactions are often "triple net" properties which feature long-term tenants like national retailers with leases requiring the tenant to pay for all of the property's expenses. However, triple net properties will rarely qualify under the QOZ substantial improvement or new property requirements because they generally do not involve substantial improvement to the property. A fund could however develop a new location for a triple net tenant but the QOZ regulations have made clear that creating and managing triple net properties does not constitute an active conduct of a trade or business, a requirement under the QOZ laws.[55] Even though the regulations allow for a portion of qualifying property to be tenanted by a triple net tenant, the ease and flexibility of QOZ investments are still dramatically lower than those made consistently with section 1031.[56]

Because wealthy investors tend to have a portion of their portfolio in real estate, the like-kind exchange is an example of an indefinite deferral tool available to a broad range of wealthy investors. According to 2017 IRS estate tax data, taxpayers with an estate larger than $20 million in value had an average of around 15% of that estate in real estate while taxpayers with estates smaller than $20 million tended to have between 20% and 25% of the estate in real estate.[57] And like-kind exchanges are valuable for these investors even when properties do not appreciate in value. Depreciation deductions taken to reduce taxable income, an important benefit available to real estate investors, reduce taxable basis resulting in depreciation recapture taxes triggered by a realization event. Like-kind exchanges results in a basis carryover to a new investment and tax deferral for the investors.

In a world that can seem full of uncertainty, capital gains deferral offers wealthy investors

53. As discussed above, QOZ tax benefits relate to the equity invested in QOFs and not to the projects themselves. Thus, there are real estate and operating business investments in QOZs, including opportunities that could satisfy the QOZ rules, that investors and operators decide not to organize as QOF investments in order to remain free of the QOZ requirements. Taking this appraoch is especially feasible when the investors involved do not stand to gain much more from the QOZ tack, such as a project that can be purchased in a like-kind exchange and might involve a slower renovation schedule than required in a QOZ context depending on the health of the local economy.

54. Real estate transactions are expensive, involving legal fees, inspection fees, financing fees, and transfer taxes, among other costs. This fact, and the due diligence most investors require before purchasing property (each building with its unique geography, condition, features), makes it difficult to sell property quickly for its full value.

55. "Merely entering into a triple-net-lease with respect to real property owned by a taxpayer does not constitute the active conduct of a trade or business by such taxpayer." Treas. Reg. § 1.1400Z2(d)-1(d)(3)(iii)(B).

56. In addition to the capital gains tax exclusion, another benefit offered by QOZ investments over like-kind exchanges is the more modest investment requirement. While the amount of a QOZ investment corresponds to the amount capital gain generated from the sale of an appreciated asset, the amount that must be invested in a qualifying like-kind exchange is the entire sales amount, a sum that can far exceed the gain.

57. *Estate Tax Returns Filed for Wealthy Decedents, Filing Years 2008–2017*, Publication 5332 (Rev. 12–2018), Internal Revenue Service, https://www.irs.gov/pub/irs-pdf/p5332.pdf

comfortable familiarity. Instead of getting involved in a new kind of tax-advantaged investment, however promising, the investor can opt for inaction, a strategy that may have worked for the investor for decades (and possibly for friends and family members for even longer). And when some event prompts a realization event, there are avenues for continuing the deferral of gains recognition which do not necessitate a large tax payment in the near term. QOZ investing might benefit a wealthy investor who plans to trigger recognition at some point in the coming decades—paying some tax now to obtain tax-free recognition in ten or twenty years is a great move, all other conditions remaining the same. But most investors take a longer view, hoping for a step-up in basis at the end of their life, making capital gains avoidance permanent.[58]

III. AND EVEN THE BENEFITS FOR INVESTORS WHO CANNOT EASILY ACCESS INDEFINITE DEFERRAL HAVE BECOME LESS ATTRACTIVE

Although investors with the ability to defer capital gains indefinitely are less likely to make QOZ investments, investors unable to defer their capital gains recognition now have an attractive way to invest. By investing in a QOF within 180 days of capital gains realization, investors can enjoy several years of capital gains deferral and longer-term tax benefits from the new investment.[59] Investors with smaller portfolios are most likely to benefit since they are more likely to increase their liquidity probably through selling appreciated assets. As mentioned above, such investors may also have fewer avenues for indefinite capital gains deferral as compared to high net worth individuals. The fact that the final regulations assume "that a QOF will on average have [ten] investors"[60] may also signal the wealth profile of most QOF investors. If the QOFs created before the December 2019 promulgation of the final regulations were generally funded by high net worth individuals, it is likely that fewer investors would have been involved. A smaller number of investors would have probably sought to fund the tax-advantaged equity on their own.

The best candidates for QOZ investing are probably those investors who planned for deferral but did not successfully consummate the requirements for such a transaction. Faced with unexpected tax recognition, those investors might scramble to invest in a QOF for the near or long term. For example, real estate investors planning for a like-kind exchange have strict due dates for identifying replacement properties that they might acquire as part of the exchange. But paperwork issues, contract issues, and due diligence, among others, could result in a failed exchange. These investors may still be within the 180 day investment window for QOZ investing and might be interested in some measure of deferral and the prospect of the long-term tax exclusion.

However, even those investors might think twice before making a QOZ investment given

58. The final regulations do not provide for a double benefit to investors who pass qualifying QOF investments to their inheritors at passing: "Because a taxpayer's basis in its qualifying investment is zero except as otherwise provided in section 1400Z-2(b)(2)(B) and section 1400Z-2(c) (which concerns qualifying investments held for at least 10 years), the Treasury Department and the IRS have determined that section 1014 does not apply to adjust the basis of an inherited qualifying investment to its fair market value as of the deceased owner's death." 85 FR 1891.

59. QOZ investments held for ten years can qualify for capital gains exclusion. I.R.C. §1400Z-2(c) provides for the basis of qualifying investments held for ten years or more to be stepped up to fair market value on the date of sale or exchange.

60. 85 FR 1943.

the current low tax and low interest rate environment. Compounding the risks and uncertainties that come along with QOZ investing, the broader investing environment presents current investors with fewer expected benefits from the QOZ laws. And with those reduced benefits to investors comes a higher cost of capital and less benefit to fund operators and developers who had expected high demand from QOZ investors at a low cost of capital.

A. In the current low income tax, low interest rate environment, QOZ investing is less valuable.

In the current low income tax environment, deferral benefits might be offset in whole or in part by increased taxes in the future. "The final regulations clarify that gain recognized pursuant to section 1400Z-2(b)(1) and the section 1400Z-2 regulations is subject to taxation at the applicable Federal income tax rates for the year of inclusion, not of the year of deferral."[61] To the extent that upcoming federal elections could result in changed tax rates, the consensus is that those rates will rise to support a ballooning national debt and an expensive welfare state. Investors may prefer to forgo the potential long-term tax benefits in order to save on taxes in the short term.

Another headwind to QOZ investing is the low interest rate environment. To the extent that rates get closer to zero, investors receive less benefit from the QOZ tax deferral offered until tax year 2026. There may still be benefits[62] including increased financial flexibility[63] and the ability to invest funds that would otherwise be used to pay the tax, but the funds available to taxpayers until the tax year 2026 due date will earn lower returns on average and the deferral will therefore be less valuable to investors. But even more importantly than the short-term returns available to investors are the long-term returns. Investment return is a function of price and high asset prices translate to lower expected returns. The current low interest rates fuel inexpensive borrowing, putting upward pressure on prices. This results in lower expectations for the asset price growth which fuels QOZ tax benefits. A QOF investment that has not grown much in value over the course of a ten or twenty year holding period will not have much tax benefit to investors.[64]

B. And to the extent that QOZ investing is less valuable for investors, fund operators and developers face a higher cost of capital overall and benefit less

When new capital is brought into QOZs in a way that stimulates economic growth, the QOZ law has fulfilled its purpose as understood by the Department of the Treasury "to provide specified tax benefits to owners of QOFs to encourage the making of longer-term investments of new capital, through QOFs and qualified opportunity zone businesses, into

61. 85 FR 1891.

62. For a discussion of the benefits of deferral, and especially indefinite deferral, in a low-interest environment, see Thomas J. Brennan and Alvin C. Warren Jr, *Realization and Lock-In When Interest Rates Are Low* (August 22, 2016), Tax Notes.

63. For example, providing more time to the taxpayer to ensure enough liquidity to pay the tax without borrowing funds at high interest rates or selling assets at an inopportune time. This is especially relevant in cases like the QOZ tax year 2026 recognition requirement, when taxpayers face "phantom" taxes due in tax years without corresponding income generated by the investment.

64. See §1400Z-2(c). Operating income from QOF investments is taxes like any non QOF investment.

one or more QOZs and to increase the economic growth therein."[65] And even though the incentives were developed for investors, fund operators and developers stood to gain as well to the extent that QOF investments were demanded by investors. More competition for QOF interests translates into a lower negotiated return structure for investors and more returns (representing less risk) for operators.

But the incentive structure described above is not attractive to many kinds of wealthy investors, especially those with access to the most resources required for participation in QOZ investing. It may be no surprise then that the "the Treasury Department and the IRS project that between... 55,000 to 120,000 investors in QOFs will eventually be affected by the final regulations"[66] a number which represents a small minority of high net worth households in the United States.[67] And to the extent that these investors do not see great opportunity in QOZ investing as compared to other investment opportunities, the cost of capital for QOZ developers and operating partners will track that of similarly situated projects, reducing the benefits that they enjoy from the QOZ laws.[68]

CONCLUSION

The wealthiest investors in the United States have access to the capital, capital gains, and advice necessary to invest heavily in QOZ investments. If they were to do so, many billions of dollars in capital could be brought into QOZs, representing new and renewed buildings, new machinery and equipment, and new businesses. Upon disposition, excluded gains would represent billions of dollars in tax savings for these investors. But these investors are generally inclined towards inaction with regard to their investment portfolio in order to avoid any costly realization or recognition of gains before their assets transfer to their estate. By reducing the transaction costs and taxes involved in changing their portfolios, such investors enjoy compound gains on a larger nest egg each year.

Even when these investors want to dispose of assets, they have strategies that can allow for continued gains recognition deferral. For example, certain corporate reorganization rules and like-kind exchanges can allow for the exchange of certain assets for others without costly gains recognition. For wealthy investors who can benefit from these transactions, the benefits of QOZ investing are somewhat reduced because the temporary gains deferral available is even less attractive than the indefinite deferral available through other avenues. But more importantly, the threshold costs of QOZ investing—required gains recognition by 2026—are charges that do not need to be incurred by these investors. While other investors face gains recognition in the year of gains realization, these investors have ways to avoid recognition.

65. 85 FR at 1907

66. 85 FR at 1943

67. According to New York University economist Edward Wolff, in 2016 there were 635,800 households with a net worth equal to or exceeding $10 million in 1995 dollars. See Table 3 in Edward N. Wolff, *Household Wealth Trends in the United States, 1962 to 2016: Has Middle Class Wealth Recovered?* Working Paper 24085 (November 2017), National Bureau of Economic Research, https://www.nber.org/papers/w24085.pdf

68. Real estate developers and private equity professionals are often cited as key beneficiaries from the QOZ laws. Even though the QOZ laws are structured to benefit investors and not the developers and operators implementing business plans with investor funds, those professionals would benefit greatly from a lower cost of capital available from QOZ investors eager to advance QOF projects. However, to the extent that QOZ investments are not very attractive to investors, the cost of capital is unlikely to be significantly affected by the laws, removing most of the benefits available to real estate development and private equity firms.

And even investors who can either pay capital gains taxes or invest in QOZ investments may opt to pay the tax. In the current low tax environment, deferring capital gains recognition until tax year 2026 might result in significantly higher taxes for those taxpayers. As well, the low interest rate environment makes deferral less valuable in terms of the returns that could be generated during the deferral period. Even further, the risk profile of QOZ investments, the compliance burden, and the liquidity requirements all serve as a costly backdrop which discourage investors from making opportunity zone investments. And to the extent that investor appetite is diminished, the benefits received by fund operators and developers able to facilitate qualifying QOF are reduced.

Investors facing capital gains recognition who are comfortable enough with QOZ investment risks stand to benefit from the generous tax benefits available at disposition. It is true that many QOZ projects lack current profitability and operate in areas with high rates of crime and high unemployment rates, but many financially successful projects outside of QOZs also feature these characteristics. For these investors, the QOZ incentives will tip the scale in favor of investing. And while the required long-term investment horizon and the requirement to have capital gains available makes the QOZ investments accessible only to wealthier Americans, the wealthiest are unlikely to participate in force.