

MEMO

Subject: Opportunity Zones – Anti-Abuse Rules
From: John Lettieri, President & CEO, Economic Innovation Group
Date: September 20, 2019

Background

Section 1400Z-2, added by Public Law 115-97 (the Tax Cuts and Jobs Act), provides tax incentives for investors to make equity investments in qualified opportunity funds (QOFs) that will in turn invest in qualified opportunity zone business property (QOZ Business Property), either directly or indirectly through qualified opportunity zone businesses (QOZ Businesses) operating in qualified opportunity zones (QOZs).

Section 1400Z-2(e)(4)(C) specifically grants authority to Treasury to prescribe regulations to prevent abuse. The proposed regulations provide a broad anti-abuse rule:

“if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of section 1400Z-2, the Commissioner can recast a transaction (or series of transactions) for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 1400Z-2. Whether a tax result is inconsistent with the purposes of section 1400Z-2 must be determined based on all the facts and circumstances.”¹

The proposed regulations do not provide any safe harbors or examples of facts and circumstances showing activities that are or are not abusive. However, the preamble to the proposed regulations identifies as abusive certain uses of land:²

[T]he Treasury Department and the IRS recognize that, in certain instances, the treatment of unimproved land as qualified opportunity zone business property could lead to tax results that are inconsistent with the purposes of section 1400Z-2. For example, a QOF's acquisition of a parcel of land currently utilized entirely by a business for the production of an agricultural crop, whether active or fallow at that time, potentially could be treated as qualified opportunity zone business property *without the QOF investing any new capital investment in, or increasing any economic activity or output of, that parcel*. In such instances, the Treasury Department and the IRS have determined that the purposes of section 1400Z-2 would not be realized, and therefore the tax incentives otherwise provided under section 1400Z-2 should not be available. If a significant purpose for acquiring such unimproved land was to achieve that inappropriate tax result, the general anti-abuse rule set forth in proposed §1.1400Z2(f)-1(c) . . . would apply to treat the acquisition of the unimproved land as an acquisition of non-qualifying property for section 1400Z-2 purposes.³

¹ Prop. Treas. Reg. § 1.1400Z2(f)-1(c)(1).

² 84 Fed. Reg. 18,652, 18,655 & 18,669, *Explanation of Provisions*, §§ I.B; X (May 1, 2019).

³ 84 F.R. at 18,655 (emphasis added).

The preamble to the proposed regulations also emphasizes that land must be held in a trade or business and not for investment.⁴ In addition, the proposed regulations provide a backstop to prevent insubstantial improvements of land. Specifically, a QOF may not rely on the proposed rule excluding land from the original use or substantial improvement requirements if the land is unimproved or minimally improved and the QOF or QOZ Business purchases the land with an expectation, an intention, or a view not to improve the land by more than an insubstantial amount within 30 months after the date of purchase.⁵

The Problem: The Anti-Abuse Rule Could Have Chilling Effects on Certain “Good” Transactions While Not Sufficiently Deterring “Bad” Transactions

Strong anti-abuse rules are critical to ensuring the integrity of the emerging QOZ market and preventing bad actors from benefitting from the QOZ incentives. At the same time, the anti-abuse rules should not be so broad or onerous as to have a chilling effect on investors to engage in the economic activity and development in low-income communities that was intended by the statute. A broad, purpose-based anti-abuse rule, without any guidance on what is and is not considered to violate the purpose could have the opposite effect, with bad actors taking an overly aggressive approach and good actors taking an overly conservative one.

Overall, we support a strong anti-abuse rule that is flexible enough for the IRS to address scenarios that it has not yet considered. However, we believe there are some relatively simple ways to shut down certain abuses. In addition, we believe that clarifications in the form of examples and/or safe harbors could provide some much-needed clarity without sacrificing the flexibility of the IRS to use the anti-abuse rule against unforeseen scenarios.

Specific Recommendations to Implement the Anti-Abuse Rule

- Because the anti-abuse rule is purpose-based, we believe that a general statement of the purpose of section 1400Z-2 would be helpful in applying the anti-abuse rule.
- We believe that final regulations could adopt some targeted rules to shut down certain potential abuses.
 - First, we believe that a robust certification and reporting regime will help ensure transparency and minimize abuse (or at least provide the IRS with information to help detect abuse).
 - Form 8996 currently requires that a QOF include the following information in its organizing documents: (1) statement of its purpose of investing in QOZ Property, and (2) description of the QOZ Business(es) that the QOF expects to engage in. Requiring actual disclosure of this information on the Form 8996 would provide an additional check that the QOF is operating consistent with the purposes of section 1400Z-2.

⁴ 84 F.R. at 18,654-55.

⁵ Prop Treas. Reg. § 1.1400Z2(d)-1(f).

- Requiring a “clean hands” certification by QOF managers on Form 8996 that they have not been indicted, charged with or convicted of, or had a civil judgment rendered against them, for fraud, embezzlement, forgery, theft, or certain other offenses within the past three years, similar to the New Markets Tax Credit allocation application, would weed out bad actors.
 - Requiring the reporting of information (including information concerning the nature and location of assets, activities, income, and employees) that is relevant to determining whether the QOZ requirements are satisfied is well within Treasury’s authority, and such additional transparency would deter bad actors. We refer you to our comment letter dated May 31, 2019 in response to the Request for Information on Data Collection and Tracking for Qualified Opportunity Zones.
 - Second, there are some concerns that, with the 70-percent “substantially all” threshold, up to 30 percent of a rental real estate QOZ Business’s property could be located outside of and have no true connection with a QOZ. Adoption of an additional location requirement for real estate businesses would ensure that the economic activity of real estate businesses is located in and benefitting the QOZ.
 - We strongly support the adoption of a 70-percent “substantially all” requirement for tangible property, as it provides much-needed flexibility where certain property of the QOZ Business fails to meet one of the tests for QOZ Business Property (e.g., some property was owned before 2018) or, for legitimate business purposes, must be located outside of a QOZ.
 - However, we believe that permitting the holding of 30 percent of real property outside the QOZ is inconsistent with the purpose of section 1400Z-2. Thus, final regulations could require that a greater percentage (e.g., 90 percent) of the tangible property owned or leased by a real property QOZ Business must be either located within a QOZ or contiguous to a QOZ. This 90-percent threshold would be in addition to the 70-percent asset test, which would otherwise remain unchanged for all other purposes of section 1400Z-2(d)(3)(A)(i) (including the ability to hold small amounts of property that do not qualify as QOZ Business Property).
 - Third, final regulations should prevent circumvention of the sin business limitation by engaging in such a business at the QOF level or by leasing to such a business by providing that the use of property in an enumerated sin business prevents such property from qualifying as QOZ Business Property.
 - The de minimis use (e.g., 5 percent or less) of property in a sin business should be excluded to avoid foot-faults.
- Further clarity is needed on how much and what kinds of improvement or capital investment in land will be sufficient to not run afoul of Prop Treas. Reg. § 1.1400Z2(d)-1(f) or the general anti-abuse rule.
 - We are hearing that the anti-abuse rule coupled with the statements in the preamble have been a significant hurdle for land-related deals. For example, some have interpreted the statements in the preamble as requiring a QOZ Business that wants to make capital improvements to land (e.g., farmland, timberland, brownfields) to also own the business

that operates that land. However, that fundamentally changes the investment—the real estate business and the operating business are very different investments that attract very different investors.

- This confusion is having a chilling effect on land deals, which has a particularly negative impact on rural QOZs.
- Examples illustrating what kind of land improvements violate (e.g., simply paving the land for a parking lot) and do not violate (e.g., planting a timber farm; making capital improvements to an existing farm to build farm structures, acquire grazing animals, plant crops, and install irrigation systems; or remediating a brownfield and leasing it for productive use) the anti-abuse rule would also be helpful.
- A safe harbor threshold of expenditures to constitute more than an insubstantial amount would provide greater certainty so that land-related projects can move forward. We believe additions to basis constituting at least 25 percent of the basis of the land would be a sufficient safe harbor threshold to prevent abuse.
- Final regulations (or separate guidance) could include a safe harbor to steer QOFs towards activities that are most likely to further the purposes of section 1400Z-2.
 - Such a safe harbor could leverage existing (or future) federal, state, or local programs that ensure that the QOF's activities deliver well-defined and measured benefits to communities, such as the independent certification of nonprofit benefit corporations that currently exists in a number of states.
- Finally, although not an anti-abuse rule per se, guidance on the reasonable cause exception to the penalty for failure of a QOF to satisfy the 90-percent test would provide welcome clarity.
 - Existing guidance on the reasonable cause exception to the failure to file penalty is not helpful, as the considerations and factual scenarios are completely different.