MEMO

Subject: **Reasonable Time for Making Qualified Opportunity Fund Investments**
From: **John Lettieri, Economic Innovation Group**
Date: **October 3, 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 invest in qualified opportunity zone property (QOZ Property), either by directly investing in qualified opportunity zone business property (QOZ Business Property) or by investing in qualified opportunity zone businesses (QOZ Businesses) operating in qualified opportunity zones (QOZs).

In general, a QOF is subject to monetary penalties unless it holds at least 90 percent of its assets in QOZ Property (the "90 percent asset test").[1] The statute provides that the 90 percent asset test is to be measured by taking the average of the QOF's percentage of QOZ Property on the last day of the first six months of the tax year and the last day of the tax year. The statute provides that no penalty will be imposed if a QOF's failure to meet the 90 percent asset test is due to reasonable cause.[2] In addition, the statute provides that Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") has broad regulatory authority to craft "such regulations as may be necessary or appropriate to carry out the purposes of [section 1400Z-2]," including "rules to ensure that a qualified opportunity fund has a reasonable period of time to reinvest" cash returns.[3]

The Problem: A QOF Raising Funds to Make Investments in a Portfolio of Operating Businesses Needs Additional Time to Deploy Capital

If, consistent with congressional intent, a QOF desires to raise funds to make investments in a portfolio of multiple businesses operating in the QOZ, it will typically take a minimum of 18 to 30 months to raise funds from investors and deploy those funds prudently into the portfolio of QOZ Businesses. Prior to the second set of proposed regulations, the 90 percent asset test could be read as allowing the QOF at most six months (and potentially only days) to invest funds in portfolio companies from the time it receives cash to when it must meet the 90 percent asset test.

[1] Section 1400Z-2(f).
[2] Section 1400Z-2(f)(3).
[3] Section 1400Z-2(e)(4).

Recognizing this issue, in the second set of proposed regulations, Treasury and the Service provided that for purposes of meeting the 90 percent asset test on a testing date, a QOF may exclude from both the numerator and denominator of the computation any investments received within the last six months that are held in cash, cash equivalents, or short-term debt instruments.[4] As a result, a QOF effectively has between 6 and 12 months to deploy capital it receives, so long as it holds this capital in cash, cash equivalents, or short-term debt instruments in the interim between receipt and deployment.

We appreciate that some leeway has been granted in providing QOFs time to invest newly received capital. But a period as short as six months is insufficient for QOFs to be able to raise and deploy at least 90 percent of their funds into qualifying investments. Thoughtful investment takes time, as does expending capital into a portfolio of QOZ Businesses and projects.[5]

Compounding the issue of deploying capital is raising it—investors only have 180 days from the date they recognize a gain to make a QOF investment, making it so that QOFs are unable to control the timing of when they accept capital from investors. In the usual case, investors often sign commitments to provide cash as the fund manager requests it to make investments, often over the course of approximately three years, but this cannot be the case with a QOF. If the final regulations do not provide additional timing flexibility, a manager of a QOF may be forced to choose between upsetting the expectations of investors because their eligible gains will expire before a capital call can be made or calling capital that a QOF is not yet prepared to deploy and risking penalties for failing to meet the 90 percent asset test.

Treasury and the Service Have Broad Authority to Provide Additional Relief

We believe Treasury and the Service have broad authority to provide additional timing relief. Congress granted broad regulatory authority to craft "such regulations as may be necessary or appropriate to carry out the purposes of [section 1400Z-2]," including "rules to ensure that a qualified opportunity fund has a reasonable period of time to reinvest" cash returns.[6] In addition, if a QOF fails to meet the 90 percent asset test, the consequence is a penalty; however, no penalty shall be imposed if the failure is due to "reasonable cause."[7] Treasury and the Service thus have the authority to provide a reasonable start-up period for QOFs to invest cash.

---

[4] Prop. Treas. Reg. § 1.1400Z2(d)-1(b)(4).
[5] Because this process of thoughtfully identifying QOZ Businesses and projects for investment occurs prior to contributing capital into a QOZ Business, the working capital safe harbor does not solve this problem.
[6] Section 1400Z-2(e)(4)(B).
[7] Section 1400Z-2(f)(3).

Indeed, Treasury and the Service have permitted some flexibility in start-up periods in other contexts. For example, for purposes of the New Markets Tax Credit, the statute requires that the credit allowance date be tested *immediately* and every 12 months thereafter, but the regulations permit an initial investment period of 12 months.[8] In addition, for purposes of the diversification requirements for variable annuity, endowment, and life insurance contracts, the regulations provide a one-year start-up period for non-real estate segregated asset accounts and a five-year start-up period for real estate segregated accounts, notwithstanding that the statute contains no such time periods.[9] Further, for purposes of the minimum distribution requirements for private foundations, the statute provides for a reasonable cause exception, and the regulations adopt a reduced distribution requirement for a four-year start-up period.[10]

Tax code provisions often contain specific effective dates, time frames, or threshold tests that are specified in absolute terms in the statutory text, but later guidance interprets the provision to provide needed additional flexibility. This flexibility may be provided for a variety of reasons, including: the need for more time to implement the intended statutory change, either for taxpayers to make changes in governing documents, policies, or accounting systems or for the Service to make changes in forms; a desire to reduce administrative burden on taxpayers and/or the Service; a desire to avoid unintended consequences or to ensure that Congress's intended goals are not frustrated in practice by details not addressed in a broad statutory provision.

The Proposed Rule Also Requires a Technical Fix

We also note that the mechanism for implementing the six-month minimum investment period – excluding the investments from both the numerator and denominator of the 90 percent asset test – can lead to some anomalous results. For example, if all the QOF owns is recently contributed cash, the computation for the 90 percent asset test would be indeterminate because both the numerator and the denominator would be zero.

Policy Options

There are a number of approaches Treasury and the Service could use to provide QOFs with the needed flexibility to invest in a portfolio of operating businesses that are clearly within Treasury and the Service's regulatory authority and also help facilitate the statute's goals of creating significant new economic development in the Opportunity Zones.

---

[8] Section 45D(a)(3); Treas. Reg. § 1.45D-1(c)(5)(iv).
[9] Treas. Reg. § 1.817-5(c)(2).
[10] Section 4942(g)(2)(C); Treas. Reg. § 53.4942(a)-3(b)(4)(i).

- Treasury and the Service need not alter the regular, semi-annual testing dates, but could instead extend the scope of Prop. Treas. Reg. § 1.1400Z2(d)-1(b)(4) so that it applies to capital received not more than 12 months before the relevant testing date, rather than to capital received not more than six months before the relevant testing date. This would allow a QOF a minimum of 12 months to deploy the capital that it receives, consistent with the rule adopted under the New Markets Tax Credit. At a minimum, final regulations could provide a full 12-month initial start-up period for the QOF, and retain the current six-month elective cash exclusion thereafter.

- Alternatively, Treasury and the Service could rely on the authority provided in the statute to refrain from imposing penalties on a QOF if a failure to meet the 90 percent asset test is due to "reasonable cause." Final regulations could provide that the failure of a QOF to meet the test during the first 12 months of its existence is due to reasonable cause, to the extent the failure is due to holding excess cash and provided that it is using reasonable efforts to invest such cash in QOZ Businesses or QOZ Business Property. At a minimum, the failure of a QOF to meet the 90 percent asset test should be considered due to reasonable cause to the extent the failure is because cash is not invested within one-year of receipt from the investor.

In addition to providing this added flexibility, Treasury and the Service could fix the technical issue identified above by treating cash, cash equivalents, and short-term debt received within the last 12 months as QOZ Property for purposes of the 90 percent asset test, rather than excluding such amounts from both the numerator and the denominator. At a minimum, to prevent anomalous or indeterminate results, Treasury should provide that if substantially all of the property of the QOF would be excluded from both the numerator and the denominator of the test, then the QOF will be deemed to satisfy the 90 percent asset test.