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Withholding and QOZs: Treasury Withholds Relief, and Non-U.S. Investors Withhold Capital

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INTRODUCTION

Not infrequently, we are asked why there hasn't been greater uptake of the Qualified Opportunity Zone (QOZ) program by non-U.S. taxpayers. Although data is lacking, we note anecdotally that, at least in our tax practice, we encounter far fewer non-U.S. taxpayers investing in qualified opportunity funds than we do in the other funds we advise. We posit that the reasons for this poor uptake are structural in nature, as many non-U.S. taxpayers' primary exposure to U.S. real estate assets is through U.S. blocker structures set up by pooled investment vehicles, which generally don't give rise to eligible gains because by design such structures ''block'' effectively connected income (ECI). Although non-U.S. taxpayers could seek to restructure U.S. blocker structures to recognize eligible gains, withholding taxes apply to such transactions under the current regulations and are a significant deterrent to potential non-U.S. taxpayers. For these reasons we, like prior commenters, would welcome new guidance providing relief from withholding taxes on eligible gains. At worst, such relief would harmonize QOZ policy in respect of non-U.S. taxpayers; at best it could help catalyze this important source of capital investment into distressed communities.

In this article we examine the following:

- Intent of the QOZ Program;
- Rules for non-U.S. taxpayers considering investments in QOZs;
- Non-U.S. taxpayers' real estate investments as a share of potential QOZ capital;
- Potential issues with withholding on such non-U.S. investors' eligible gains as a general matter;
- Structural issues associated with common structures for non-U.S. taxpayers' investments in U.S. real estate (i.e., the use of U.S. blocker corporations) and alternative exits that could be used to address these structural issues;
- The mechanics of withholding on such alternative exits;
- Additional areas of uncertainty related to tax return filing requirements and reporting on inclusion events; and
- Potential solutions.

INTENT OF THE QOZ PROGRAM

The QOZ program had bipartisan origins and became law as part of the 2017 Tax Cuts and Jobs Act (TCJA).[1] The goal of the program is to ''attract an influx of capital to designated low income communi-

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The information in this article is not intended to be ''written advice concerning one or more Federal tax matters'' subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.

[1] Pub. L. No. 115-97, 131 Stat. 2054 (2017). Congress enacted the legislation colloquially referred to as the TCJA as ''An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.''

ties''[2] by providing tax benefits to investors who invest certain eligible capital gains into qualified opportunity funds (QOFs) within a designated rollover period (generally 180 days). The tax benefits intended to attract this capital include deferral of taxation on an invested gains until December 31, 2026 (or an earlier ''inclusion event''); a basis adjustment resulting in a permanent reduction of 10% of the gain if the investor's interest in the QOF is retained for at least five years; and a permanent gain exclusion with respect to any appreciation in a QOF provided such interest is retained by the investor for at least 10 years.

The QOZ component of the TCJA was scored on the premise that investors would, absent the QOZ tax incentives, continue to hold their existing investments. Although the overall score was negative, more revenue was projected by lawmakers to be raised by §1400Z[3] in tax year 2026 than lost in each of the prior deferral years 2018-2025 based on the expectation that taxpayers would sell gain assets they would have retained but for the QOZ tax incentives.[4]

The current program, however, does not provide clear guidance to non-U.S. taxpayers on the consequences of selling their assets in order to invest in a QOF, such as the withholding and reporting consequences of such a sale.

QOZ RULES FOR NON-U.S. TAXPAYERS

Although neither the statute nor the proposed QOZ regulations[5] contained any restrictions on non-U.S. taxpayers investing in QOFs, prior to publication of the final QOZ regulations,[6] certain practitioners were hesitant to advise non-U.S. taxpayers that they could avail themselves of QOZ tax benefits.[7] Additionally, commenters raised concerns about the practicality of non-U.S. taxpayers' participation in the program in light of the absence of relief from withholding on non-U.S. taxpayers' eligible gains.[8] The final QOZ regulations clarified that non-U.S. taxpayers may participate in the QOZ program, but only to the extent they reinvest capital gains that are ''effectively connected'' with a U.S. trade or business (i.e., subject to tax in the U.S.). However, the final QOZ regulations left open the question of relief from withholding on

[2] October Proposed Regulations, 83 Fed. Reg. 54,279, 54,283 (Oct. 29, 2018) (citing H.R. Rep. No. 115-466 at 537).

[3] All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[4] *See* Joint Committee on Taxation, Estimated Budget Effects of the Conference Agreement for H.R. 1, The ''Tax Cuts and Jobs Act'': Fiscal Years 2018-2027, JCX-67-17 (Dec. 18, 2017). Additionally, it has been estimated that $52 billion would not have been invested into QOZs to date without the incentive. *See* The Council of Economic Advisers, The Impact of Opportunity Zones: An Initial Assessment (Aug. 2020).

[5] October Proposed Regulations, 83 Fed. Reg. 54,279 (Oct. 29, 2018), May Proposed Regulations, 84 Fed. Reg. 18,652 (May 1, 2019).

[6] T.D. 9889, 85 Fed. Reg. 1866 (Jan. 13, 2020).

[7] Certain practitioners noted the lack of any prohibition and general policy behind the statute to endorse that non-U.S. taxpayers could invest capital gains. As the American Bar Association (ABA) noted, ''there is no indication in either the legislative history to Pub. L. No. 115-97 or the 2018 Blue Book that QOZ investment benefits should only be available to U.S. persons.'' ABA, Section of Taxation, Comments on Proposed Regulations Regarding Investments in Qualified Opportunity Funds Under Section 1400Z-2, at 18, fn. 43 (July 1, 2019) (hereinafter ABA Comment Letter). The New York State Bar Association (NYSBA), agreeing that non-U.S. taxpayers should be able to participate since they ''do not see a statutory or policy reason why [non-U.S. investors] should be wholly barred from obtaining tax benefits for qualifying investments in QOFs,'' went on to conjecture that ''the benefits of the QOZ regime should not be extended to non-U.S. investors . . . for capital gains that are not ECI.'' NYSBA, Tax Section, Report No. 1418 — Report on Proposed Qualified Opportunity Zone Regulations under Section 1400Z-2 at 9 (July 1, 2019) [hereinafter NYSBA Comment Letter]. As noted in the preamble to the final regulations:

> The Treasury Department and the IRS received comments regarding the scope of the term ''eligible gain'' with respect to gains realized by persons that generally are not subject to Federal income tax with respect to those gains, such as persons that are not United States persons under section 7701(a)(30) or that are entities generally exempt from tax under the Code. Some commenters suggested that an eligible gain should include all realized capital gains, including gains that are not subject to Federal income tax. However, other commenters stated that permitting deferral elections with respect to gains that are not subject to Federal income tax would be inappropriate because section 1400Z-2 is premised on the assumption that a person could make qualified investments in a QOF only with respect to amounts of capital gains for which taxation is deferred.
> T.D. 9889, 85 Fed. Reg. 1866 at 1871 (Jan. 13, 2020).

[8] The ABA voiced concern that the ''withholding obligation could create a cash flow constraint that adversely affects the non-U.S. person's ability to [timely] reinvest otherwise eligible capital gains in a QOF . . .'' ABA Comment Letter, at 17. The Florida Bar Association agreed with the concern: ''Given that the [non-U.S.] taxpayers do not have access to the funds being held by the withholding agent until the IRS issues the FIRPTA withholding certificate . . .'' The Florida Bar, Tax Section, Comments on the Proposed Regulations under Section 1400Z-2 (Qualified Opportunity Zones) at 4 (Nov. 16, 2018).

The NYSBA further underlined this point explaining that ''unless [the non-U.S. investor] has other available cash on hand,'' the FIRPTA regime ''may discourage non-U.S. investors from making investments in QOFs.'' NYSBA Comment Letter at 73. In a later comment letter, The Florida Bar Association again requested ''a method to obtain a reduced FIRPTA withholding certificates for [non-U.S.] taxpayers who intend to invest gains into opportunity zones.'' The Florida Bar, Tax Section, Comments on the Proposed Regulations under Section 1400Z-2 (Qualified Opportunity Zones) at 7 (June 28, 2019).

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non-U.S. taxpayer's eligible gains, noting that ''[t]he Treasury Department and the IRS continue to consider . . . other matters related to the mechanics of applying §1400Z-2 in the context of a sale subject to withholding tax.''[9]

As background, a gain deferral election may only be made under §1400Z-2(a) by an eligible taxpayer with respect to an eligible gain. The final regulations changed the definition of eligible taxpayer from ''a person that **may recognize gains** for purposes of federal income tax accounting'' to ''a person that is required to report the recognition of gains during the taxable year under federal income tax accounting principles,''[10] and added the following language to the relevant component of the eligible gains definition — ''would be recognized for Federal income tax purposes and subject to tax under subtitle A of the Code before January 1, 2027 (subject to Federal income tax), if section 1400Z-2(a)(1) did not apply to defer recognition of the gain.''[11] The final regulations also added rules for determining whether gain is subject to U.S. federal income tax for this purpose, which effectively remove treaty exempt gains from the definition of eligible gain (whether exempt in the initial year of recognition or when included at the end of 2026 or upon an inclusion event), and a special partnership anti-abuse rule disregarding partnerships ''formed or availed of with a significant purpose of avoiding the requirements of [§]1.1400Z2(a)-1(b)(11)(i)(B) that a gain be subject to Federal income tax in order to be an eligible gain.''[12] In making these changes (which, as described further below, considerably limit the ability of non-U.S. taxpayers to participate in the program), the preamble to the final QOZ regulations indicated that the new limitations on the definition of eligible gains were imposed due to concerns that (1) the IRS be able to confirm deferred gains were capital gains, and (2) U.S. and non-U.S. taxpayers investing in QOFs be treated similarly.[13] The final QOZ regulations did not, however, address commenters' concerns regarding the mechanics of withholding and reporting on deferred gains of non-U.S. taxpayers.

NON-U.S. TAXPAYER INVESTMENT IN U.S. REAL ESTATE AS A SOURCE OF POTENTIAL QOF CAPITAL

Non-U.S. taxpayers own up to 20% of U.S. stocks and bonds.[14] Gains from the sale of personal property, which these securities are characterized as under the I.R.C., are generally sourced to the jurisdiction of the taxpayer (i.e., in this case, non-U.S. source)[15] and not subject to U.S. federal income tax unless this treatment is overridden by another provision in the I.R.C. The changes in the final QOZ regulations, outlined above, shrunk the pool of available QOF capital considerably by making gains from the sale of these securities ineligible for reinvestment into QOFs.

After stocks and bonds, commercial real estate represents the largest investable asset class, comprising up to 20% of total U.S. investable assets.[16] Non-U.S. taxpayers accounted for approximately 12% of the total U.S. commercial real estate investment volume in 2019.[17] Such non-U.S. investors have historically gravitated toward real estate investment trusts (REITs) and large private equity format investments.[18] Gains from non-U.S. taxpayers' sale of public REIT shares

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[9] T.D. 9889, 85 Fed. Reg. 1866 at 1880.

[10] Reg. §1.1400Z2(a)-1(b)(13).

[11] Reg. §1.1400Z2(a)-1(b)(11)(i)(B).

[12] 85 Fed. Reg. 1866, at 1991-92. The special partnership anti-abuse rule, and two examples, were presumably included in the final regulations because partnerships were added to the definition of eligible taxpayer. The significant purpose requirement presumably permits pre-existing partnerships with a non-U.S. partner(s) to be eligible taxpayers, notwithstanding whether the only partners of the partnership are non-U.S. taxpayers. Non-U.S. partnerships are not generally required to file a federal tax return unless they have gross income that is ECI or U.S.-sourced. See Reg. §1.6012-1(b), §1.6012-2(g), §1.6031(a)-1(b) requiring non-U.S. individuals, corporations and partnerships, respectively, to file federal tax returns when they have ECI at any time during a taxable year.

[13] See T.D. 9889, which states:

> The Treasury Department and the IRS have determined that eligible taxpayers generally should be able to make an election under section 1400Z-2(a)(1) and the section 1400Z-2 regulations only for capital gains that would be subject to tax under subtitle A before January 1, 2027 (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. Section 1400Z-2 defers the time when eligible gains are included in income, and there would not be any taxable income to defer for a gain that is not subject to federal income tax. This approach ensures that both United States persons and non-U.S. persons may be eligible for the federal income tax benefits of section 1400Z-2 under the same conditions. Moreover, particularly with respect to non-U.S. persons, the lack of any requirement that a gain be subject to Federal income tax would make it difficult for the IRS to verify the extent to which the amount being invested in a QOF was, in fact, with respect to a capital gain.

85 Fed. Reg. 1866 at 1871.

[14] U.S. Dep't of the Treasury et al., Foreign Portfolio Holdings of U.S. Securities as of June 28, 2019 (Apr. 2020).

[15] *See* §865.

[16] SIFMA, Capital Markets Fact Book 2019; NAREIT, Estimating the Size of the Commercial Real Estate Market (July 2019).

[17] Real Capital Analytics, US Cross-Border Investment Compendium, Q3 2020.

[18] Eversheds Sutherland, Unlocking US Real Estate: A Guide for International Investment (2017).

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are generally, like gains from the sale of other stocks and bonds, ineligible gains for the QOZ program.[19]

Unlike stocks and bonds, non-U.S. taxpayers' gains from the sale of U.S. real estate assets are generally eligible gains for the QOZ program. Real estate may be an investment asset, an asset used in a trade or business, or inventory, depending on the intent of the holder and various other facts and circumstances.[20] As early as the second set of proposed regulations under §1400Z, the IRS and Treasury clearly established that gains from the sale of real estate used in a trade or business (which are not capital gains in the first instance but rather recharacterized under §1231 as capital gains) were eligible gains for purposes of the QOZ program, leaving out only real estate held as inventory or dealer property.[21] And, because real estate capital gains of non-U.S. taxpayers from the sale of investment property or §1231 property gains are deemed to be effectively connected to a U.S. trade or business under the Foreign Investment in Real Property Tax Act (FIRPTA), they will generally be eligible gains for the purpose of the QOZ program.

Gains from the sale by non-U.S. taxpayers of U.S. real estate assets therefore represent a much more significant share of the available pool of non-U.S. taxpayer QOF equity than they might otherwise.

WITHHOLDING ISSUES IN GENERAL

A notable feature of the QOZ program is that only the taxpayer's net gain from its disposition of an investment must be reinvested in order to defer tax on the taxpayer's transaction. For example, if property with a basis of 20 is sold for 50, only 30 (and not the full 50, as would be the case with a like-kind exchange under §1031) must be reinvested in order to achieve tax deferral and the other QOZ tax benefits.[22] For this reason, withholding tax of up to the amount of return of basis might not be considered punitive (i.e., up to 20 in this example could be withheld before a non-U.S. taxpayer would be ''penalized'').[23] Stated differently, the gain as a percent of proceeds from a transaction would need to exceed the withholding percentage to have the effect of reducing a non-U.S. taxpayer's ability to invest in a QOF. For example, if property sold for $100, had a basis of $10 and withholding of $15,[24] it would effectively mean that the taxpayer would only have available cash of $85 to invest into a QOF instead of its $90 of eligible gain. Similarly, if cash of $100 were distributed by a partnership to a non-U.S. partner in respect of a transaction in which $85 of gain was recognized, the $17 of ECI withholding in the case of a corporation or $31.45 of ECI withholding in the case of a non-corporation would reduce the non-U.S. taxpayer's ability to invest into a QOF.[25]

Although we might therefore say that only ''low basis'' transactions are affected by the cashflow issues associated with an absence of withholding relief, these are precisely the types of transactions the QOZ program was designed to incent (i.e., the ''locked-in'' gain transactions that might not otherwise happen because the potential tax was too ''punitive''). Moreover, these issues become even more challenging when examined in the context of how non-U.S. taxpayers invest into U.S. commercial real estate.

STRUCTURAL ISSUES WITH NON-U.S. TAXPAYERS' INVESTMENTS IN U.S. REAL ESTATE AND OTHER ECI ASSETS

Given that the QOZ program requires the taxpayer who recognizes the eligible gain to directly invest into the QOF,[26] the mechanics of how most non-U.S. taxpayers invest into U.S. assets are important.

Gain from the disposition of a direct investment in U.S. real estate or an indirect investment through a U.S. operating business structured as a partnership, as

[19] Section 897(c)(3) and §897(k)(1)(A) provide that stock of a publicly traded REIT is only USRPI to a non-U.S. taxpayer to the extent it holds more than 10%.

[20] Real estate may be a capital asset under §1221 unless it is §1231 property used in the taxpayer's trade or business or it is inventory held primarily for sale to customers generating ordinary income or loss under §64. Whether a taxpayer is an investor or a dealer with respect to its real estate assets is a question of facts and circumstances subject to interpretation by the IRS and the courts.

[21] May Proposed Regulations 84 Fed. Reg. 18,652 (May 1, 2019).

[22] It is also possible in the QOZ context to reinvest (and make a QOF gain deferral election with respect to) less than the amount of the full gain and achieve a partial deferral.

[23] On the other hand, the like-kind exchange permits deferral of an unlimited duration and may be more valuable as an estate planning tool.

[24] See §1445(a) requiring FIRPTA withholding of 15% of the amount realized on the disposition.

[25] See §1446(b)(2) requiring ECI withholding at the highest rate of tax specified in §1 in the case of a non-U.S. non-corporate partner or in §11(b) in the case of a non-U.S. corporate partner.

[26] Reg. §1.1400Z2(a)-1(a)(1) states that ''an eligible taxpayer may elect to defer recognition of some or all of one or more eligible gains that otherwise would be recognized by the eligible taxpayer in the taxable year to the extent that the eligible taxpayer timely acquires a qualifying investment in a qualified opportunity fund (QOF) within the meaning of section 1400Z-2(d)(1) and [Reg.] 1.1400Z2(d)-1.''

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well as most or all of the income from such an investment, is subject to U.S. federal income tax and required to be reported by a non-U.S. taxpayer on a U.S. federal income tax return. This remains the case regardless of the non-U.S. investor's investment intent or how long the investment has been held. Such income and gains are taxable under the U.S. federal income tax rules relating to income that is "effectively connected" with a U.S. trade or business ECI, including in the case of sales of U.S. real estate under FIRPTA.

U.S. blocker corporations are frequently used by non-U.S. investors in order to reduce the administrative burden associated with U.S. tax return filing requirements, as compared to a direct investment into U.S. real estate or investment through one or more disregarded entities or partnerships.[27] Shareholder debt is frequently added to a U.S. blocker corporation in order to reduce the U.S. tax cost of the real estate investment via interest deductions that offset taxable income and gain. In general, the U.S. blocker corporation files a U.S. tax return annually for each year of the investment, and the non-U.S. investors who directly or through one or more partnerships invest in the U.S. blocker corporation do not file U.S. tax returns. After the investment is sold, the U.S. blocker corporation is liquidated in order to return proceeds from the sale of real estate to the non-U.S. investors. If a U.S. blocker corporation disposes of its interests in U.S. real estate prior to liquidating it may make liquidating distributions that are not subject to U.S. withholding taxes (that is, they are neither dividends attracting withholding taxes under §1442 as "fixed determinable annual and periodic" income or subject to taxes under §1445 or §1446 as FIRPTA gain or ECI).

Non-U.S. investors who participate in U.S. investments, whether in real estate assets or operating businesses, via a U.S. blocker corporation will not generally recognize eligible gains that may be invested into a QOF. Although liquidation proceeds from a U.S. blocker corporation are capital gains, they are unlikely to be "eligible gains" per the restrictive definition in the final regulations — they are not ECI because the blocker either is not, or would not be at the time of liquidation, a U.S. real property holding company (USRPHC). Although a U.S. blocker corporation is itself an eligible taxpayer and could elect to defer gains by investing into a QOF, many U.S. blocker corporations are formed to pool investments from multiple unrelated non-U.S. and U.S. tax-exempt investors, who are unlikely to share a common intention to invest into a particular QOF, or even a QOF in general.[28]

Although it may be possible to restructure an investment in a U.S. blocker corporation to give rise to eligible gain, several hurdles exist. Consider for example, an investment into a U.S. operating partnership via a U.S. blocker corporation. Assuming that such an restructuring transaction were commercially feasible, if a non-U.S. taxpayer has identified a potential QOF investment it wishes to reinvest gains into it may be too late to restructure the blocked investment; a transaction to liquidate or sell the U.S. blocker corporation would only give rise to ineligible gains and little to no incremental ECI gain may be left to recognize on the sale of the partnership that follows. If, on the other hand, the non-U.S. taxpayer proactively restructures its blocked investment before any appreciation occurs, the non-U.S. taxpayer faces the following challenges: (1) the administrative burden of filing U.S. tax returns in respect of the investment for several years, (2) the risk that the investment may not be sold in time to reinvest before the end of 2026 into a QOF, (3) incrementally higher tax on its income and gain to the extent the U.S. blocker corporation were leveraged,[29] and (4) gain from the ultimate sale of

[27] To the extent real estate is held in U.S. trade or business, which would generally be the case where used in a rental real estate business or where FIRPTA would treat gains from the sale of real estate as effectively connected with a U.S. trade or business, the non-U.S. investor is required to file a U.S. federal income tax return. Outside of the context of QOZ investing and the need to generate eligible gains, this is generally viewed as undesirable to the extent the use of a leveraged U.S. blocker corporation would reduce the U.S. federal income taxes otherwise due.

[28] We observe that this effective restriction on non-U.S. taxpayers from reinvesting gains recognized by a U.S. blocker corporation was likely unintentional, resulting from the new restricted definition of eligible gains taken together with the general rule that a taxpayer must directly invest eligible gains into a QOF. The IRS and Treasury could presumably provide through guidance a special rule allowing non-U.S. investors to reinvest gains recognized via a U.S. blocker corporation. Such a rule would be consistent with the stated purpose behind the eligible gains definition noted in the preamble to the final regulations to ensure the IRS could confirm the reinvested gains were capital gains (the IRS would have access to the U.S. blocker corporation's tax return) and parity between U.S. and non-U.S. taxpayers (presumably the notion here was not to allow non-U.S. taxpayers to reinvest untaxed gains, not gains taxed by virtue of legal entity structuring by another entity).

[29] For example, gain on sale of the operating partnership that was subject to an effective tax rate lower than 21% when recognized/paid by a U.S. blocker corporation, even if deferred via an investment into a QOF, would be recognized in 2026 at the then applicable rate to the taxpayer (as of today either 21% in the hands of a corporate taxpayer, and 37% in the hands of an individual); a 10% reduction of the non-U.S. taxpayer's eligible gain under §1400Z-2(b)(2)(B)(iii) would generally only be available if the investment into a QOF was made before the end of 2021 (which in this example would seem unlikely given a typical holding period for the investment and the assumption that the investment is not currently appreciated).

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partnership interests would be subject to withholding under §1446(f).[30]

It may be more feasible to restructure an investment in real property held via a U.S. blocker corporation to give rise to eligible gain. As FIRPTA will generally cause gains from the sale or liquidation of a U.S. blocker corporation that is a USRPHC to be ECI, any gain recognized on restructuring would be eligible gain.[31] However, such strategies will, unless a U.S. blocker corporation is controlled by the non-U.S. taxpayer, require participation from a sponsor and will generally be subject to withholding. In this context, commenters' concerns about withholding on eligible gains come to life.

WITHHOLDING ON ELIGIBLE GAIN IN CONNECTION WITH ALTERNATIVE EXITS

As noted above, commenters have identified FIRPTA and ECI withholding as an issue for non-U.S. taxpayers looking to invest in QOFs,[32] and the IRS and Treasury continue to consider these issues. In light of the structural issues with non-U.S. taxpayers' investments in U.S. real estate through U.S. blocker corporations discussed above, a non-U.S. taxpayer may consider restructuring transactions or alternative exit strategies, in either case designed to give rise to eligible gains and therefore subject to withholding.

For example, a non-U.S. taxpayer investor in a U.S. real estate fund, rather than waiting for the fund sponsor to sell U.S. real estate assets and return capital to the non-U.S. taxpayer in the form of ineligible gains, seeks to recognize gains from its U.S. real estate investments in late 2021 in order to invest into a QOF in early 2022 (within the required 180-day rollover period). The investor identifies a willing buyer for an interest in the partnership owning a U.S. blocker corporation, which is a U.S. real property interest (USRPI), and obtains consent from the sponsor to provide information to the purchaser for the purposes of due diligence surrounding the transaction, and for the transfer itself (each of which takes time).[33] FIRPTA generally requires a buyer to withhold 15% on the gross proceeds paid in connection with its purchase of a USRPI from a non-U.S. seller unless an exception applies. None of the exceptions from withholding at closing (which generally require a seller to provide documentation establishing its non-foreign status or the non-USRPI status of the interest disposed) can be expected to apply.

Although certain exceptions to withholding at closing are available for non-recognition transactions, Reg. §1.1445-2(d)(2) is unlikely to apply given that (i) Reg. §1.1400Z2(a)-1(e) specifically provides that §1400Z-2 is not a non-recognition provision for purposes of Reg. §1.897-6T,[34] and even were §1400Z-2 considered a non-recognition transaction for this purpose; (ii) §1400Z-2 only excludes a portion of the gain (and partial nonrecognition transactions are not eligible for the exception per Reg. §1.1445-2(d)(2)(ii)(A)); and (iii) Reg. §1.1445-2(d)(iv) specifically excludes from the withholding exemption at closing deferred like-kind exchanges ''where the transferee cannot determine that the exchange has been completed and all the conditions for nonrecognition have been satisfied at the time it is otherwise required to pay the section 1445 withholding tax and file the withholding tax return (Form 8288, ''U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests'').'' For all these reasons, the IRS and Treasury would need to provide affirmative relief for purchasers to feel comfortable relying on a non-recognition notice from a non-U.S. seller.

If no exception from FIRPTA withholding applies at closing and the seller's maximum tax liability is less than 15%, a non-U.S. seller may apply for a withholding certificate.[35] If the non-U.S. taxpayer intends to reinvest 100% of its gain into a QOF within 180 days and make a gain deferral election, its maximum liability should be zero. However, because such application only delays reporting and payment of the tax by the purchaser until after the disposition of the ap-

[30] Although not discussed at length in this article, there is currently no relief from withholding of this type, which applies both to a potential purchaser and the partnership itself as a backstop.

[31] To the extent a blocker corporation is held by non-U.S. investors indirectly through a protective non-U.S. blocker corporation (e.g., a Cayman blocker corporation formed to block FIRPTA gains on a potential distribution in excess of earnings and profits, and basis — a relatively common structure for non-U.S. taxpayers other than §892 investors), it will generally not be possible to sell the blocker corporation to recognize eligible gains.

[32] *See, e.g.,* NYSBA Comment Letter. *See also* The Real Estate Round Table, Guidance Regarding Opportunity Zones (Dec. 19, 2018) (hereinafter RER Comment Letter).

[33] In general, §1445(a) withholding would apply to any disposition of a USRPI (whether a U.S. blocker corporation that is a USRPHC is sold directly, a partnership that is a 50/90 partnership within the meaning of Reg. §1.1445-11T(d) is sold, or the non-U.S. investor is redeemed by such 50/90 partnership); if a U.S. blocker corporation that is a USRPHC redeems a non-U.S. investors FIRPTA withholding applies under §1445(e)(3).

[34] In other words, the final regulations make clear that, currently, a non-U.S. seller of a USRPI cannot notify the purchaser that no withholding should be required because the seller intends to defer the gain through an eligible investment in a QOF.

[35] See procedures under Reg. §1.1445-3(b), which require a statement of law and facts in support of a reduction in withholding.

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plication by the IRS (i.e., the buyer does not remit the tax to the IRS, but neither does the buyer remit the cash to the seller),[36] unless the sale is a related-party transaction, a cashflow issue will be present. Commenters have noted that the 90-day review period for the early refund could be a significant commercial constraint on investing into a QOF given the strict 180-day rollover period in §1400Z.[37] Of greater significance, when taking into account the restrictions imposed by the IRS and Treasury on like-kind exchanges as a form of non-recognition transaction exempting a sale from withholding at closing, it is unclear that the IRS would be compelled to issue a withholding certificate. In the QOF context this would potentially leave the non-U.S. taxpayer waiting for its refund until after the tax return on which it makes its gain deferral election for its investment into a QOF is filed.

To complicate matters, the relevant return on which a refund would be requested might not be filed until a subsequent tax year. For example, in the case of a 2022 gain event and a reinvestment into a QOF in 2023, the refund might not be granted until 2024 (two full taxable years after the QOF investment is made).[38] Unless relief is provided by the IRS and Treasury, the non-U.S. seller could, at best, expect an early refund to be granted after it made its investment into a QOF.[39]

Similar withholding issues would arise were a non-U.S. taxpayer to restructure its investment in a U.S. blocker corporation to ensure that gains allocated to the non-U.S. taxpayer when the fund sponsor exits from the real estate assets in the future are eligible gains. For example, if the relevant U.S. blocker corporation is held via a 50/90 partnership formed by a fund sponsor,[40] a redemption transaction would likely give rise to 15% FIRPTA withholding.[41] As described above there is currently no relief from such withholding; we posit this would be a significant deterrent to restructuring an investment in property the sale of which would otherwise give rise to eligible gains via U.S. blocker corporations.

Additionally, the ultimate gains from the sale of such restructured real estate investment remitted to the non-U.S. taxpayer in a non-liquidating distribution would give rise to ECI withholding by the fund sponsor under §1446(a) (unless an exception applies).[42] Applicable regulations provide that a non-U.S. taxpayer partner's allocable share of partnership ECI does not include income or gain exempt from U.S. tax.[43] However, if §1400Z is not a non-recognition provision it is unclear whether a partners' intent to make a gain deferral election under §1400Z-2 would qualify its allocated ECI as ''exempt'' from taxation for purposes of §1446 withholding.

TAX RETURN FILING REQUIREMENTS AND REPORTING ON INCLUSION EVENTS

Underlying the IRS and Treasury's failure to provide relief on withholding taxes may be a concern that non-U.S. taxpayers may not pay taxes when deferred gains are included in 2026.[44] There is currently no requirement in the I.R.C. or regulations for a QOF to report inclusion events or gains and no withholding regime appears to apply to included gains (that is, in-

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[36] Reg. §1.1445-1(c)(2) allows for delayed reporting and payment of FIRPTA withholding in cases where a withholding certificate has been applied for as of the date of a transaction.

[37] The ABA noted that although withholding certificates may be obtained by the non-U.S. taxpayer, ''the application process for withholding certificates issued by the Service could also create cash flow constraints given the 90-day review period . . . [which could] delay a transaction and limit the non-U.S. person's ability to reinvest in a QOF within the applicable 180-day period,'' and that because FIRPTA withholding is applied on gross proceeds this ''could have a materially adverse effect on investment of any gain from the disposition . . . [which could be] contrary to the purpose of section 1400Z-2, which was intended to encourage economic investment in economically distressed areas.'' ABA Comment Letter at 17-18.

[38] For a normal refund, a non-U.S. taxpayer requests a refund with its annual U.S. tax return.

[39] The early refund process allows a non-U.S. transferor to receive a refund (without interest) of the excess withholding prior to the un-extended due date of the transferor's tax return. No particular form is required for the early refund request but the regulations require specific documentation including (1) a copy of the Form 8288-A showing the amount that was already transmitted to the IRS and (2) either a copy of the withholding certificate previously issued by the IRS or the application for the withholding certificate if combining such application with the early refund application. *See* Rev. Proc 2000-35; Reg. §1.1445-3(g).

[40] With respect to partnerships, the §1445 withholding regime applies to certain partnerships owning USRPIs if (a) 50% or more of the value of the partnership's gross assets consist of a USRPI, and (b) the combined value of the partnership's USRPI and its cash and cash equivalents equal or exceed 90% of the value of the partnership's gross assets. *See* Reg. §1.897T-1(a), §1.1445-11T(d).

[41] Were the blocker ''above the fund,'' withholding would likely apply under §1445(e)(3).

[42] Although commenters have been less focused on ECI withholding under §1446 (which applies to allocations of ECI from U.S. partnerships) similar issues arise in that context. *See, e.g.,* NYSBA Comment Letter.

[43] *See* Reg. §1.1446-2(b)(2)(iii).

[44] Currently, the IRS Large Business and International division has multiple active campaigns concerning non-U.S. taxpayer compliance including the ''Form 1120-F Non-Filer Campaign'' and the ''FIRPTA Reporting Compliance for NRAs.'' Large Business and International Active Campaigns, IRS. https://www.irs.gov/businesses/corporations/lbi-active-campaigns#form-1120-non-filer.

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clusion events appear to arise solely at the investor level).[45]

Commenters have expressed concern as to how inclusion events should be reported by non-U.S. taxpayer investors in QOFs and how any taxes would be collected, recommending that non-U.S. taxpayers investing in QOFs be required to file U.S. federal income tax returns over each year of their holding period for a QOF and certain commenters going so far as to recommend special rules disallowing year 10 benefits unless non-U.S. taxpayers could affirmatively confirm payment of taxes on inclusion events and/or as of December 31, 2026.[46]

Another comment letter recommended that in order to relieve withholding on a non-U.S. taxpayer seller of a USRPI, guidance could be promulgated requiring the seller to file a gain recognition agreement (GRA) with its timely filed U.S. federal income tax return for the taxable year of disposition. In that scenario, gain would presumably be included by the non-U.S. taxpayer in 2026 or upon any earlier inclusion event under the rules of §1400Z and withholding could accordingly be relieved on the non-U.S. taxpayer's eligible gain by providing a buyer with documentation at closing certifying the seller's intent to file the GRA.[47] The same commenter further recommended that the non-U.S. taxpayer seller file an annual statement detailing the prior disposition, the current ownership of the QOF investment and any inclusion event(s) with its U.S. federal income tax return and file a form similar to the Form 8828, *Consent to Extend the Time to Assess Tax Under section 367 — Gain Recognition Agreement,* agreeing to extend the period of limitations on assessment of tax with respect to the amount of deferred gain.[48] Another commenter consistent with the general rule that attributes attach to a deferred gain when subsequently recognized, suggested that the IRS consider that the withholding would arise at the time of a subsequent inclusion event and/or December 31, 2026.[49]

There is no reporting of inclusion events at the QOF level, for example on Form 8996.[50] Instead, inclusion events are self-reported by the QOF investor on Forms 8949 — *Sales and Other Dispositions of Capital Assets,*[51] and 8997 — *Initial and Annual Statement of QOF Investments.* Presumably non-U.S. taxpayers not otherwise required to file U.S. federal income tax returns would generally not file Form 8949. It is unclear whether non-U.S. taxpayers not otherwise required to file U.S. tax returns would be required to file solely for the purpose of remitting Form 8997, and Form 8997 only appears to be required to be filed in a year in which a QOF interest is held (not, for example, in the year a gain deferral election is made, if earlier). Although the instructions to Form 8997 are currently silent on this point, presumably the IRS would have an interest in collecting the information on such form to track payment of tax on inclusion events.

Now that the IRS and Treasury have limited the universe of non-U.S. taxpayers' eligible gains to ECI, there is relatively more clarity that a gain deferral election would be filed on a non-U.S. taxpayer's Form 8949. This form is generally filed with such taxpayer's U.S. federal income tax return for the year of the investment into a QOF, with a ''negative gain'' recorded on the form. There is relatively less clarity on the mechanics of effecting the gain deferral election if the gain is invested across a straddle period and where the non-U.S. taxpayer is not otherwise required to file a tax return in the year of investment (for example if the eligible ECI gain is recognized in a prior taxable year, and the QOF investment itself is not considered to give rise to a filing obligation). Although it would be helpful to clarify whether a U.S. federal income tax return should be filed by the non-U.S. taxpayer solely for the purpose of remitting the Form 8949 to make a gain deferral election in this circumstance, even less clear is whether non-U.S. taxpayers are, under current law, required to file U.S. federal income tax returns for each year of their holding period in a QOF.

The regulations provide that when previously deferred gain is included by the QOF investor, such gain ''has the same attributes in the taxable year of inclusion that the gain would have had if recognition of the

[45] Except to the extent withholding would arise outside the QOZ context, for example, if the inclusion event were due to a sale of the QOF or a distribution in excess of basis.

[46] NYSBA recommended that ''to ensure that non-U.S. investors have paid tax on their deferred ECI . . . consideration should be given to providing that non-U.S. taxpayers are not entitled to tax benefits under [s]ection 1400Z-2(c) after a ten-year holding period unless they establish that they have properly paid tax on their deferred ECI.'' NYSBA Comment Letter at 9. Additionally, multiple commenters including NYSBA and ABA recommended that non-U.S. taxpayers be affirmatively required to file U.S. tax returns with respect to the non-U.S. taxpayer's deferred gains.

[47] *See* ABA Comment Letter.

[48] *See* ABA Comment Letter.

[49] *See* RER Comment Letter.

[50] Although, for example, a partner that disposes of an indirect interest in a QOF is required by Reg. §1.1400Z2(b)-1 to notify the direct partner so that it can recognize its proportionate inclusion event, no notice must be provided to the QOF. We therefore disagree with the recommendations of prior commenters that asked for clarification that a non-U.S. investor's ''deferred gain is subject to withholding . . . when included in income on December 31, 2026 and not at the time the sale took place.'' RER Comment Letter, at 11.

[51] Form 8949 is filed with Schedule D to an individual return of tax (Form 1040) or corporate return of tax (Form 1120).

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gain had not been deferred'' and that ''[t]hese attributes include those taken into account by sections 1(h), 1222, 1231(b), 1256, and any other applicable provisions of the Code.''[52] Because deferred gains retain their original character when included by a QOF investor, and non-U.S. taxpayers may only invest ECI gains, at a minimum the non-U.S. investor taxpayer would be required to file a U.S. federal income tax return (presumably including Form 8949 as well as Form 8997), in the year of any inclusion event and/or in 2026.

Additionally, QOF partnerships investing in qualified opportunity zone business (QOZB) partnerships will have a U.S. trade or business by definition,[53] and therefore all non-U.S. taxpayer partners should expect to file U.S. tax returns each year they are partners in the QOF under pre-existing law because they will be partners in a partnership that is engaged in a U.S. trade or business (regardless of whether or not they are allocated ECI for a particular taxable year).[54] However, certain safe harbors may permit QOZBs developing property to qualify provided they expect to have a trade or business as of the end of the safe harbor period[55] and it would be helpful for the IRS and Treasury to clarify whether non-U.S. taxpayer partners in a QOF partnership that has only an anticipatory trade or business are required to file U.S. federal income tax returns.

POTENTIAL SOLUTIONS

Were the IRS to affirmatively require non-U.S. taxpayers to file Forms 8997 (even in tax years they might not otherwise be required to), this would appear to put non-U.S. investor taxpayers on even footing with U.S. investors. Given that parity between U.S. and non-U.S. taxpayers was a concern noted in the preamble to the final regulations by the IRS and Treasury, and one of their reasons for limiting eligible gains of non-U.S. taxpayers, this feels like the right balance. Were the Form 8997 required to be filed beginning in the year the gain deferral election were made (even if a QOF investment were made in a subsequent tax year), it should provide the IRS with sufficient information to track whether the QOF investment is ultimately perfected and if not whether gain is included. Making these relatively simple changes would moot several of the more esoteric tax return filing questions discussed above and provide the IRS with a mechanism to track the payment of taxes on deferred gains in 2026 as well as on any potential inclusion events.

To the extent a non-U.S. taxpayer was required to file U.S. tax returns for each year of its holding period, we believe it would be appropriate for the IRS and Treasury to afford flat relief on withholding provided a taxpayer certified its intent to invest into a QOF within 180 days. Were such investment not in fact made, the taxpayer would generally remit tax on its gain with its return for the year of its eligible gain.[56] Presumably the IRS and Treasury could similarly provide a mechanism for a non-U.S. taxpayer partner to certify its intent to reinvest gain in a QOF and obtain a reduction in withholding under §1446(a).[57]

Relief may not be needed in situations where a non-U.S. taxpayer makes an investment directly in U.S. assets and therefore has a greater ability to control the structure of its investment. For example, a non-U.S. taxpayer that is a corporation could liquidate its U.S. blocker corporation in a nontaxable transaction under §332 and retain control of a U.S. real estate or flow through investment, so that when it exits it recognizes eligible gain. Similarly, a non-U.S. taxpayer invested in pooled U.S. investment vehicles through its own

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[52] Reg. §1.1400Z2(a)-1(c)(1)(i).

[53] Reg. §1.1400Z2(d)-2(d) requires a QOF to be engaged in a trade or business within the meaning of §162.

[54] Reg. §1.6012-1(b), §1.6012-2(g), §1.6031(a)-1(b) requires non-U.S. individuals, corporations and partnerships, respectively, to file federal tax returns when they have ECI at any time during a taxable year. Although in certain situations, QOZBs may not in fact be engaged in a U.S. trade or business.

[55] The determination as to when the trade or business of a taxpayer begins is based on facts and circumstances. If the anticipatory trade or business of a QOF partnership is leasing rental real estate, the trade or business generally begins when the property is available for rent and generating revenue. The standard may be met as early as when the certificate of occupancy has been obtained. It could, therefore, be possible that in the case of a QOF developing a future rental real estate property, a non-U.S. taxpayer investor would not be required to file a tax return in the initial development year(s) of such QOF. *See Aboussie v. United States*, 779 F.2d 424 (8th Cir. 1985). The final regulations provide that during the working capital safe harbor period tangible assets that are acquired, constructed, or leased using working capital qualify as good QOZB property for purposes of the 70% asset testing standard. *See* Reg. §1.1400Z2(d)-1(d)(3)(viii).

[56] This may require an amendment of the prior year return in certain situations.

[57] Currently a partner can provide a Form 8804-C, *Certificate of Partner-Level Items to Reduce Section 1446 Withholding* to its withholding partnership to reduce or eliminate its ECI withholding (without waiting for IRS approval). The existing Form 8804-C has fields for the non-U.S. partner to certify to the withholding agent that it has allowable deductions, losses, or NOLs to reduce its ECI withholding. We would suggest that the IRS expand the Form 8804-C instructions to include a place where a non-U.S. partner can certify to its withholding agent that it intends to timely invest the applicable ECI gains into a QOZ thereby eliminating any withholding. A domestic partnership that receives a Form 8804-C is currently required to attach it to the Form 8813 that it files with the IRS, thereby allowing the IRS to track eligible ECI gains that are reinvested into QOZs by non-U.S. persons. *See* Instructions, Form 8804-C.

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U.S. partnership would have significantly greater flexibility to generate eligible gains for reinvestment into a QOF on account of its controlled U.S. partnership (1) not being a non-U.S. seller for purposes of FIRPTA withholding; (2) being an eligible taxpayer to make a gain deferral election;[58] (3) having a potentially longer 180-day period to invest;[59] and (4) having control over ECI withholding and therefore potentially being able to take its planned gain deferral election into account in calculating its withholding liability.[60]

However, for other non-U.S. taxpayer investors whose exposure to U.S. effectively connected assets is primarily through pooled investment vehicles, the structural issues noted above will generally prevent them from recognizing eligible gains and, absent relief, the withholding issues noted above will be significant disincentive to the alternative exit transactions they might otherwise undertake in order to give rise to eligible gains.

CONCLUSION

Through the multiple rounds of regulations, participation by non-U.S. taxpayers in the QOZ program raised an interesting set of eligibility, withholding, and reporting questions, and these question in turn generated a number of comment letters. Although the final regulations addressed the eligibility question, questions about withholding and reporting remain unanswered. While we contemplate above several potential solutions providing paths forward in the areas of withholding and reporting, the fact is that the final QOZ regulations did not provide non-U.S. taxpayers the same level of certainty as U.S. investors. As a result, this significant source of capital is likely left to sit on the sidelines.

As the QOZ program approaches its third birthday, we hope to soon see more uptake of the QOZ program by non-U.S. taxpayers. But if the IRS and Treasury continue to withhold relief, due to lingering uncertainty, we expect that non-U.S. investors will continue to withhold QOZ investment dollars.

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[58] Note flat ability of partnerships to elect gain deferral with respect to all capital gains; presumably even from a sale of Microsoft shares if the special partnership anti-abuse rule does not apply. The special partnership anti-abuse rule in the final regulations would not appear to apply to the formation of a partnership specifically for this purpose, provided the gain to be recognized by the partnership would be an ''eligible gain'' in either case. *See* Reg. §1.1400Z2(f)-1(c)(2)(ii).

[59] This may also allow for additional time as the 180-day period generally begins on the last day of the partnership's tax year in which the partner's distributive share of the partnership's eligible gain is considered under §706(a). *See* Reg. §1.1400Z2(a)-1(c)(8)(iii).

[60] Using either the installment method or an annualization method may allow for additional planning when calculating and remitting withholding liability. See Reg. §1.1446-3(b)(2)(ii) for available annualization methods.

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