

For Richer or Poorer: Incentivizing Meaningful Investments in Qualified Opportunity Zones

*Monica L. Keo**

“Unlike some other kinds of legislation, tax laws are not enacted for the ages, but for the special exigencies of a particular time and discrete circumstances. Change in the tax laws is a way of life.”¹

ABSTRACT

The wealth disparity in the United States is nothing new. Many have proposed wealth taxes and higher tax rates for large corporations to address income inequality; however, these proposals have been criticized as tax programs that are difficult to administer. Congress passed the Tax Cut and Jobs Act (TCJA) in 2017 and created a new investment vehicle known as the Qualified Opportunity Zone (QOZ). The QOZ program incentivizes private investors to invest their capital gains in exchange for a reduction in capital gains tax. The underlying idea of the QOZ program is to utilize a new tool designed to spur economic development and job creation in economically depressed areas. However, there appears to be a disproportionate number of investments in non-low-income QOZs than low-income QOZs, which is not in line with Congress’s intent for this program. Part I of this Comment will provide a background on QOZs; it will investigate choosing QOZs as an investment vehicle and compare the QOZ program to another preferred method of deferring capital gains. Part II will examine a disparity between the purpose of the QOZ program and the current effect on investments, as well as uncover how this disparity has occurred. Part III will provide a solution to resolve the disparity through statutory amendments.

* J.D. Candidate, 2021, Seattle University School of Law; MSAL, Seattle University. I would like to thank Madi Uekawa, my law review mentor, for her thoughtful and valuable feedback; Sallie Lin, Partner at Stoen Rives LLP, for the inspiration behind this Comment; and all of the Seattle University Law Review editors who have contributed to the publication of this Comment. Also, a special thank you to my law school friends, family, and spouse, Grant, for all the support and encouragement.

1. Feldman v. Comm’r, 791 F.2d 781, 784 (9th Cir. 1986).

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INTRODUCTION

The wealth disparity in the United States is nothing new. Over the last thirty years, the top 10% of families in the United States have increased their wealth by ten percentage points.² Metropolitan cities have experienced great opportunity and growth,³ while other rural and urban areas are overwhelmed with blight and poverty.⁴ Although higher income households typically pay a larger share of their income to federal taxes than lower income households, the federal tax system has not made a dent in addressing income inequality.⁵ Many politicians have proposed wealth

2. Tommy Beer, *Top 1% of U.S. Households Hold 15 Times More Wealth Than Bottom 50% Combined*, FORBES (Oct. 8, 2020, 5:15 PM), <https://www.forbes.com/sites/tommybeer/2020/10/08/top-1-of-us-households-hold-15-times-more-wealth-than-bottom-50-combined/?sh=505aee6d5179> [<https://perma.cc/5L5V-U4L2>].

3. Richard Florida, *The Fastest-Growing U.S. Cities Aren't What You Think*, BLOOMBERG CITYLAB (Aug. 21, 2019, 10:00 AM), <https://www.bloomberg.com/news/articles/2019-08-21/america-s-fastest-and-slowest-growing-cities> [<https://perma.cc/9AGS-QFTR>].

4. *Human Resources Subcommittee Hearing on the Geography of Poverty: Hearing Before the Subcomm. on Hum. Res. of the Comm. on Ways and Means*, 115th Cong. 11–12 (2017) (statement of Elizabeth Kneebone, Fellow, The Brookings Institution Metropolitan Policy Program).

5. TAX POL'Y CTR., BRIEFING BOOK 99 (2020).

taxes⁶ and higher tax rates for large corporations⁷ to address income inequality; however, these proposals have been criticized as tax programs that are difficult to administer.⁸ A different solution to address income inequality and jump-start growth within urban and rural communities is through the Qualified Opportunity Zone (QOZ) program.

The United States tax system is a complex set of statutes and regulations that govern the methods of taxation collection.⁹ Congress passed the Tax Cut and Jobs Act (TCJA) in 2017¹⁰ and created a new investment vehicle known as the QOZ.¹¹ The QOZ program is intended to create benefits for the public and investors.¹² Congress's goal for the program is to get as much cash as possible into an area of need by unlocking unrealized gains.¹³ The underlying idea of QOZs is to utilize a new tool designed to spur economic development and job creation in economically depressed areas.¹⁴ The QOZ program is flexible and scalable; investors can fund a number of projects, and there is no cap on the investment amount that investors can channel toward these projects.¹⁵

6. See generally Press Release, Sen. Elizabeth Warren, Warren, Jayapal, Boyle Introduce Ultra-Millionaire Tax on Fortunes Over \$50 Million (Mar. 1, 2021), <https://www.warren.senate.gov/newsroom/press-releases/warren-jayapal-boyle-introduce-ultra-millionaire-tax-on-fortunes-over-50-million> [<https://perma.cc/K6ZC-H3T4>]; Ultra-Millionaire Tax Act of 2021, S. 510, 117th Cong. (2021).

7. See generally Nancy Cook & Laura Davison, *Biden Eyes First Major Tax Hike Since 1993 in Next Economic Plan*, BLOOMBERG (Mar. 15, 2021, 9:22 AM), <https://www.bloomberg.com/news/articles/2021-03-15/biden-eyes-first-major-tax-hike-since-1993-in-next-economic-plan> [<https://perma.cc/U8RV-TABC>].

8. See Ike Brannon, *A Wealth Tax Is Not a Solution for Income Inequality*, FORBES (Sept. 29, 2020, 12:38 AM), <https://www.forbes.com/sites/ikebrannon/2020/09/29/a-wealth-tax-is-not-a-solution-for-income-inequality/?sh=26cc2b7c7f5b> [<https://perma.cc/ZFV4-S2KF>].

9. See generally I.R.C.

10. Michael Hirschfeld & Philip R. Hirschfeld, *Qualified Opportunity Zone Funds: A Tax Investment Worth Considering*, PROB. & PROP. MAG., May–June 2019, at 12, 12.

11. Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

12. *Opportunity Zones Frequently Asked Questions*, IRS (Oct. 22, 2019), <https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions> [<https://perma.cc/2964-E6D9>].

13. *Id.*; see also Reid S. Vardell, Note, *The Land of Opportunity Zones: Deferring Taxable Capital Gains Through Investments in Low-Income Communities*, 84 MO. L. REV. 915, 926 (2019) (commenting that “the driving purpose behind the Opportunity Zone Program: helping people get back on their feet by bringing jobs back to their communities” is important to keep in mind when assessing the program).

14. *Opportunity Zones Frequently Asked Questions*, *supra* note 12; see also *What Are Opportunity Zones and How Do They Work?*, FUNDRISE, <https://fundrise.com/education/blog-posts/what-are-opportunity-zones-and-how-do-they-work> [<https://perma.cc/BT6T-PJDX>] (explaining that the QOZ program was designed to “revitalize economically distressed communities using private investments rather than taxpayer dollars”).

15. *The Promise of Opportunity Zones: Hearing Before the Joint Econ. Comm.*, 115th Cong. 39 (2018) (statement of John W. Lettieri, Co-Founder and President, Economic Innovation Group). Low-income communities do not have all the same needs; thus, the flexibility of the incentive is important in addressing the wide variety of needs of these communities. The flexibility allows investors to

QOZs provide tax benefits to investors through qualified investments in predesignated, low-income areas.¹⁶ Thus, the QOZ program, as enacted in 2017, was supposed to be a tool to revitalize lower income areas.¹⁷

Since the enactment of the TCJA, investment in the program has been steadily growing. During December 2018, fifty-three legal entities across the country had certified as Qualified Opportunity Funds¹⁸ (QOFs) with total capitalization of nearly \$15 billion.¹⁹ Novogradac, a national accounting firm, reported at the beginning of December 2019 that 184 QOFs raised nearly \$4.5 billion.²⁰ Early January 2020 showed that investment in QOFs increased 50% since December 2019 as Novogradac reported more than \$6.7 billion was raised in QOFs.²¹ As of December 2020, there were at least 223 total funds in existence and \$46.9 billion of total anticipated investment estimated.²² Most recently, as of April 12, 2021, there were a total of 230 QOFs with \$47.1 billion total anticipated investment.²³ This upward trend in the number of QOFs registered²⁴ and amount of raised investment money shows that investors are looking to QOZs for tax benefits, but this trend is not enough to support low-income communities.

The QOZ program does not address all of the needs of the low-income community as there are still communities in need of private

strategically invest in what is needed for each community to assist that community's particular issue. "Flexibility and scalability are essential ingredients because they unlock the vast creativity and problem-solving potential of communities and the marketplace in ways that would not be possible under a more prescriptive policy framework." *Id.* at 40.

16. I.R.C. § 1400Z-1; see *Investing in Qualified Opportunity Funds*, 83 Fed. Reg. 54,279, 54,296 (Oct. 29, 2018) (to be codified at 26 C.F.R. pt. 1).

17. *Opportunity Zones Frequently Asked Questions*, *supra* note 12. By incentivizing investors to invest their capital gains they would ordinarily try to defer through other means, the QOZ program was intended to use the quid pro quo to revitalize areas of need.

18. For an explanation of QOFs, see *infra* Part I.

19. ALAN SAGE, MIKE LANGEN & ALEX VAN DE MINNE, WHERE IS THE OPPORTUNITY IN OPPORTUNITY ZONES? EARLY INDICATORS OF THE OPPORTUNITY ZONE PROGRAM'S IMPACT ON COMMERCIAL PROPERTY PRICES 6 (2021).

20. Michael Novogradac, *Opportunity Funds Report Raising Nearly \$4.5 Billion as First Deadline Nears*, NOVogradac (Dec. 9, 2019, 12:00 AM), <https://www.novoco.com/notes-from-novogradac/opportunity-funds-report-raising-nearly-45-billion-first-deadline-nears> [<https://perma.cc/3UWC-34TY>].

21. Michael Novogradac, *Opportunity Funds Listing Shows Strong Increase in Investment*, NOVogradac (Jan. 8, 2020, 12:00 AM), <https://www.novoco.com/notes-from-novogradac/opportunity-funds-listing-shows-strong-increase-investment> [<https://perma.cc/4JS3-AQSD>].

22. *Opportunity Zone Fund Directory*, NCSHA (Dec. 17, 2020), <https://www.ncsha.org/resource/opportunity-zone-fund-directory/> [<https://perma.cc/4E9G-FWRB>].

23. *Opportunity Zone Fund Directory*, NCSHA (Apr. 12, 2021), <https://www.ncsha.org/resource/opportunity-zone-fund-directory/> [<https://perma.cc/FBK2-4SMQ>].

24. The statistics above do not fully capture the total number of QOFs registered in the country. NCSHA only captures publicly announced funds and multi-project funds.

investment. Subchapter Z of the Internal Revenue Code (the Code) permits a limited number of non-low-income communities that can be designated for QOZ status, and there appears to be a disproportionate number of investments in these non-low income QOZs compared to low-income QOZs.²⁵ Further, while identifying census tracts to nominate for QOZ status, state governors had to balance identifying areas that were in need with areas that were attractive to investors and could handle an influx in cash.²⁶ Because of this balancing act, the QOZs may not be as representative of communities that are in need of investment that the program aims to serve. Despite the current discrepancies, the program can achieve its goals of spurring economic growth and financial stability through incentivizing QOZ investments.

This Comment will address the QOZ program and how it can be used to support low-income communities. Part I will provide a background on QOZs; it will investigate choosing QOZs as an investment vehicle and compare the QOZ program to another preferred method of deferring capital gains. Part II will investigate a disparity between the purpose of the QOZ program and the current effect on investments as well as uncover how this disparity has occurred. Part III provides a solution to resolve the disparity through statutory amendments.

I. BACKGROUND ON QUALIFIED OPPORTUNITY ZONES

While the statutory text of the Code relating to Opportunity Zones is scarce, the QOZ program has many layers that require unpacking. In December 2019, the Internal Revenue Service (IRS) and the United States Department of the Treasury issued final regulations regarding QOZs.²⁷ The QOZ program is a tax incentive that allows private investment to be poured into designated zones of an investor's choosing.²⁸ These investments take the form of deferred capital gains, which are the "gain[s] from the sale or exchange of a capital asset."²⁹ A capital asset is loosely defined as "property held by the taxpayer" and is subject to a number of limitations;³⁰ however, "[a]lmost everything you own and use for personal

25. See generally Jesse Drucker & Eric Lipton, *How a Trump Tax Break to Help Poor Communities Became a Windfall for the Rich*, N.Y. TIMES (Aug. 31, 2019), <https://www.nytimes.com/2019/08/31/business/tax-opportunity-zones.html> [<https://perma.cc/J4XS-YMHX>] (noting that some of the zones are not low income as a few of the zones or areas within a zone are located amongst affluent areas).

26. See *Opportunity Zones: The Map Comes into Focus*, ECON. INNOVATION GRP. (June 15, 2018), <https://eig.org/news/opportunity-zones-map-comes-focus> [<https://perma.cc/67UT-N7HK>].

27. Treas. Reg. § 1.1400Z2 (2020).

28. See I.R.C. § 1400Z-2.

29. I.R.C. § 1222(3).

30. See I.R.C. § 1221.

or investment purposes is a capital asset.”³¹ Thus, after an investor sells their property (that qualifies as a capital asset), the investor will take the gain obtained on the sale and defer paying capital gain tax on that gain by investing their cash into the QOZ program or any other tax deferral method.³²

To participate in the QOZ program, an investor must first invest their capital gains into a QOF within 180 days from the date of sale or exchange.³³ Then, the taxpayer must make an election on their tax return to defer the tax under § 1400Z-2 on the amount of gain invested in a QOF.³⁴ A QOF is an investment vehicle for investors that takes the form of a corporation or partnership.³⁵ The purpose of a QOF is to invest in a QOZ property that holds at least 90% of its assets in a QOZ property.³⁶ A QOZ property does not necessarily mean real property, as defined in the Code.³⁷ Instead, a QOZ property could be QOZ stock, QOZ partnership interest, or QOZ business property.³⁸

In general, the rules regarding the qualifications of QOZ property require the QOF to (1) acquire the stock or partnership interest after December 31, 2017, in exchange for cash, (2) be qualified or be in the process of becoming a QOZ business, and (3) be a QOZ business during a substantial portion of the holding period in the QOZ property.³⁹ The requirements for a QOZ business property are incorporated into the definition of a QOZ business.⁴⁰ A tangible property used in a trade or business can be a QOZ business property if (1) the property was acquired and purchased by the QOF after December 31, 2017; (2) the original use of the property either starts with the usage of QOF or the QOF substantially improves the property; and (3) substantially all of the use of the property was within a QOZ during a substantial portion of the holding period in the QOZ property.⁴¹ A QOF is not restricted to investments that are only derived from capital gains; investors may include other capital

31. *Topic No. 409 Capital Gains and Losses*, IRS (Feb. 11, 2020), <https://www.irs.gov/taxtopics/tc409> [<https://perma.cc/9QNX-DUHP>].

32. *See infra* Part II.

33. I.R.C. § 1400Z-2(a)(1)(A). However, for taxpayers involved with passthrough entities and trust beneficiaries, there is a special 180-day period that may start on the due date of the entity’s tax return, not including extensions, to account for the timing of when the taxpayers may receive information regarding their share of any gains or distributions and the characteristics of the income. Treas. Reg. § 1.1400Z2(a)-1(b)(2)(iii) (2020).

34. I.R.C. § 1400Z-2.

35. § 1400Z-2(d).

36. *Id.*

37. *See* § 1400Z-2(d)(2).

38. *Id.*

39. § 1400Z-2(d).

40. *See* § 1400Z-2 (d)(3).

41. *Id.*

into a QOF. However, the mixed funds will be treated as two separate investments for the purpose of the tax benefit.⁴² Once a QOF has been established, the investors within the fund will be able to choose and designate which QOZ the investments should go to. A QOF may split its investments amongst a variety of QOZs so long as it holds at least 90% of its assets in a QOZ property.⁴³

Section 1400Z-1 of the Code allows the Chief Executive Officer of each state (mainly, the governor) to nominate a limited amount of population census tracts to be designated as QOZs.⁴⁴ Each state may designate up to 25% of its low-income communities as a QOZ⁴⁵ and the states cannot designate more than 5% of the population census tracts as a non-low-income community QOZ.⁴⁶ The definition of low-income community under §1400Z is the same definition of low-income community under §45D(e).⁴⁷ Section 45D(e) states that in general, a low-income community means any population census tract that: (a) has a poverty rate of at least 20%, (b) does not exceed 80% of the statewide median family income if such tract is not located within a metropolitan area, or (c) does not exceed 80% of the greater of the statewide median family income or the metropolitan area median family income if a tract is located within a metropolitan area.⁴⁸ For the nominated QOZs that are not low-income communities, the tract must be contiguous with a low-income community that is designated as a QOZ, and the median family income must not exceed 125% of the median family income of the neighboring low-income community.⁴⁹ Because the number of QOZ designations are limited, the choice of which tracts to designate is key to the potential growth in an area.

Twelve percent of U.S. census tracts are designated as opportunity zones⁵⁰ and the vast majority of these opportunity zones are areas with low

42. § 1400Z-2(e).

43. § 1400Z-2(d)(1).

44. § 1400Z-1(b)(1)(A).

45. § 1400Z-1(d).

46. § 1400Z-1(e)(2).

47. See § 1400z-1(c); Rev. Proc. 2018-16, 2018-9 I.R.B. 383. See also Bob Ibanez, *Opportunity Zones: An Opportunity to Apply Lessons Learned from the New Markets Tax Credit Program*, NOVOGRADAC (Sept. 26, 2018, 12:00 AM), <https://www.novoco.com/notes-from-novogradac/opportunity-zones-opportunity-apply-lessons-learned-new-markets-tax-credit-program> [<https://perma.cc/Y4AL-42JV>].

48. I.R.C. § 45D(e).

49. I.R.C. § 1400Z-1(e).

50. *Briefing Book: Key Elements of the U.S. Tax System*, TAX POL'Y CTR., <https://www.taxpolicycenter.org/briefing-book/what-are-opportunity-zones-and-how-do-they-work>. [<https://perma.cc/ED87-87GL>] [hereinafter *Briefing Book*].

average income.⁵¹ In 2018, on average, designated census tracts exhibited higher poverty rates and lower median family income than eligible census tracts.⁵² Further, about 71% of the QOZs meet the U.S. Treasury Department's definition of "severely distressed."⁵³ These statistics indicate the QOZs are placed in areas of need and that the states have taken great consideration in designating which tracts should qualify. In determining which census tracts to qualify, some states ranked their census tracts based on socioeconomic factors, while others made designations based on recommendations from relevant stakeholders, like housing agencies.⁵⁴ Governors were encouraged to obtain feedback from government officials in their state to ensure the proposed QOZs would serve the community and benefit the individuals.⁵⁵ All of the QOZ designations are intended to provide the communities with well-needed funding and assistance to jumpstart the economy of the area, but this jumpstart only happens once investors decide to invest.

A. Choosing Qualified Opportunity Zones as an Investment Vehicle

The QOZ program is designed to produce better tax benefits to investors the longer they leave their investments in a QOZ.⁵⁶ The QOZ program provides more freedom for investors as to what types of assets to invest: stocks, real estate, partnership interests, and cash.⁵⁷ Further, investors can be individuals, corporations, partnerships, and other types of domestic taxpayers.⁵⁸

QOZs have two main tax incentives: (1) deferral of inclusion in gross income for certain gains—capital gains—that are invested into a QOF⁵⁹ and (2) exclusion from gross income any post-acquisition gains on

51. KENAN FIKRI & JOHN LETTIERI, ECON. INNOVATION GRP., THE STATE OF SOCIOECONOMIC NEED AND COMMUNITY CHANGE IN OPPORTUNITY ZONES 5 (2018), <https://eig.org/wp-content/uploads/2018/12/OZ-Whitepaper-FINAL.pdf> [<https://perma.cc/AST5-QXDA>].

52. See BRETT THEODOS, BRADY MEIXELL & CARL HEDMAN, URB. INST., DID STATES MAXIMIZE THEIR OPPORTUNITY ZONE SELECTIONS?: ANALYSIS OF THE OPPORTUNITY ZONE DESIGNATIONS 8 (2018), https://www.urban.org/sites/default/files/publication/98445/did_states_maximize_their_opportunity_zone_selections_7.pdf [<https://perma.cc/VQW4-338J>].

53. FIKRI & LETTIERI, *supra* note 51, at 6. "Severely distressed" means an area with a poverty rate of 30% or a median family income that is less than 60% of the area's median income.

54. SAGE, LANGEN & VAN DE MINNE, *supra* note 19, at 5.

55. ECON. INNOVATION GRP., OPPORTUNITY ZONES: A NEW ECONOMIC DEVELOPMENT TOOL FOR LOW INCOME COMMUNITIES: GUIDANCE FOR GOVERNORS 2 (2018), <https://eig.org/wp-content/uploads/2018/02/Guidance-for-Governors-FINAL.pdf> [<https://perma.cc/VBH5-QH9B>].

56. See Meg E. Dodge, *Opportunity Zone Tax Incentives: Do Good While Investing Well*, 46 EST. PLAN. 42, 43 (2019).

57. See SAGE, LANGEN & VAN DE MINNE, *supra* note 19, at 6.

58. Prop. Treas. Reg. § 1.1400Z2(a)-1(a)(1), 83 Fed. Reg. 54279, 54280 (Oct. 29, 2018).

59. I.R.C. § 1400Z-2(b).

investments in a QOZ that are held for at least ten years.⁶⁰ Thus, once an investor has a realization event (a sale or other disposition of property),⁶¹ if they place their money into a QOF within 180 days of the event and elect to defer the gains under § 1400Z-2 on their tax return, the investor has completed the initial steps to taking advantage of the tax benefits of the program. While the tax benefits are highly enticing, the deferral of tax on the gains do not last forever. The deferred gain will be taxed on whichever date comes first: either the date the investment in the QOF is sold or on December 31, 2026, when the QOZ program to defer taxes ends.⁶² Based on the way the TCJA is currently written, on December 31, 2026, all investors who deferred their gains are required to pay taxes on that gain. However, an investor may not have to pay taxes on all of their deferred gain.

The program contains incremental tax benefits that reduce the amount of tax owed by increasing the basis⁶³ of the investment. If the investment is held in a QOZ for five years, the basis of such investment shall be increased by an amount equal to 10% of the amount of gain deferred.⁶⁴ If the investment is held for seven years, investors will receive a total of a 15% increase in basis from the original deferred capital gains.⁶⁵ To be clear, upon the seventh year, if investors have already calculated the step-up in basis from the five-year mark, they may only take an additional 5% step-up in basis from the original amount of gain deferred. If the investment is held for ten years or longer, the investor will receive a permanent exclusion from taxable income on the new capital gains.⁶⁶ Additionally, the recent Treasury Regulations expanded the savings to also allow investors to exclude all gain on the sale of QOF interest or assets, not including gain from ordinary course of sales of inventory.⁶⁷ The incremental step-up in basis incentivizes investors to keep their gains within the QOZs while also incentivizing investors to create high earning investments in the QOZ. Any future gain on the QOZ will be included in the basis of the property if held for ten years or more,⁶⁸ thus providing an opportunity for savings and returns on investment. To better explain the

60. § 1400Z-2(c).

61. I.R.C. § 1001.

62. § 1400Z-2(b); see also Christopher Karachale, *Qualified Opportunity Funds: Deferral and Exclusion Possibilities for Investors*, 102 PRAC. TAX STRATEGIES 1, 4 (2019).

63. The basis of a property is generally the cost of such property at the time of acquisition. However, the basis may be adjusted due to improvements and tax benefits. See I.R.C. § 1012.

64. § 1400Z-2(b)(2)(B)(iii); see *Briefing Book*, supra note 50.

65. § 1400Z-2(b)(2)(B)(iv); see *Briefing Book*, supra note 50.

66. § 1400Z-2(c); see *Briefing Book*, supra note 50.

67. Treas. Reg. § 1.1400Z2(c)-1 (2020).

68. § 1400Z-2(c).

incentives of QOZs, this next section will introduce a different gain deferral method and compare and contrast it to the QOZ program.

B. Comparing Methods of Gain Deferral

A highly preferred method of deferring capital gains is through § 1031 of the Code.⁶⁹ Under this section, in relevant part, a taxpayer may defer recognition of capital gains, in a non-recognition transaction,⁷⁰ when the taxpayer exchanges certain property with another taxpayer.⁷¹ This transaction is colloquially known as a § 1031 or “like-kind” exchange. A § 1031 exchange occurs when taxpayers arrange to exchange assets that have been held for trade or business or for investment purposes.⁷² To be eligible for a § 1031 exchange, both the property to be exchanged and the replacement property must be of like-kind, i.e., real property for real property, and may not be held primarily for sale.⁷³ When like-kind properties are exchanged under this section, the basis of property given up becomes the basis of the property received.⁷⁴ Thus, when a § 1031 exchange occurs, a taxpayer does not recognize any gain or loss that would stem from the new property, thereby allowing taxpayers to exchange property and acquire new assets without ever recognizing a capital gain.

However, the § 1031 exchange program limits the deferral of capital gains to investments into real estate.⁷⁵ The TCJA made a few adjustments to § 1031. For example, it discontinued § 1031 exchanges for collectables and precious metals,⁷⁶ limiting the type of assets to be used for this deferral method. Moreover, investments are limited because the investment of capital gains has to be in real estate that is of “like-kind” to the property that was sold.⁷⁷ This requirement limits the type of real estate that can be

69. Sidney Kess & Michael Kelley, *How Collectors Can Utilize the Opportunity Zone Program: Investors See a Potential Replacement for Like-Kind Exchanges*, CPA J., Mar. 2019, at 64, 64.

70. A nonrecognition transaction is a transaction where a party does not immediately report gain or loss to the IRS. 33A AM. JUR. 2D *Federal Taxation* §10000 (2021).

71. I.R.C. § 1031.

72. For example, *A* holds land for investment purposes that has a fair market value of \$100,000. *B* holds an office building and the land underneath for business purposes that have a total fair market value \$100,000. Instead of selling each property to each other and incurring the costs associated with selling as well as having to recognize a gain or loss, *A* and *B* can make a §1031 exchange. Under the §1031 exchange program, if *A* and *B* exchange their respective properties, neither *A* nor *B* have a transaction that requires the recognition of a gain or loss.

73. § 1031.

74. § 1031(d). Thus, if the original owners of the assets made depreciation deductions and therefore reduced their basis in their original property, *A* would maintain the basis of *A* property in the newly acquired *B* property, and *B* would maintain the same basis of *B* property in the newly acquired *A* property.

75. § 1031.

76. Kess & Kelley, *supra* note 69.

77. § 1031.

used to affect a § 1031 exchange. Further, § 1031 states that investors have forty-five days to nominate potential replacement properties and 180 days to acquire the replacement property in order to defer capital gains taxes from the sale of like-kind property.⁷⁸ This sequencing of timing limits investors to finding a suitable replacement in order to take advantage of the tax benefits. However, investors have been taking advantage of a loophole that essentially allows the capital gain to be wiped off the slate: Investors hold onto their investment until death and their heirs, who will inherit the property, simply receive a step-up in basis, eliminating the potential the government would receive in taxes on the underlying capital gains.⁷⁹

While the § 1031 loophole is enticing, QOZs are more versatile in terms of the type of assets that can be invested, and the funds can focus on a single city or support a project located anywhere in the country.⁸⁰ A single QOF can be invested in the renovation of an apartment building located in Washington and can be used in a development project in Hawaii; the opportunities for investment are extensive. QOFs can be invested in a diverse array of assets without breaking the QOZ program's rules; however, the program is best suited for certain long-term investments such as real estate.⁸¹ Because investors gain better tax benefits the longer they hold the QOZ, investments that hold well over time, such as real estate, are generally better suited for this program.

Currently, the top investment focus is in the residential sector.⁸² Real estate will qualify as a Qualified Opportunity Zone Business Property (QOZBP) when it is “substantially improved” through construction, renovation, or rehabilitation.⁸³ Therefore, an investor will not be able to purchase land with their QOF and assume that it qualifies for the QOZ program without additional effort expended on the property. Thus, when investing in real estate, investors must also keep in mind that the investment comes with a few added requirements.⁸⁴

The QOZ program uses tax deferrals to incentivize investors to participate in the program. The concept of tax deferral has received some criticism as reduced rates on capital gains together with long-term capital

78. *Id.*

79. *See id.*; *see also* Kess & Kelley, *supra* note 69.

80. Dodge, *supra* note 56.

81. Matthew R. Joyce, *In the (O)Zone: New Tax Program Guides Investor Capital to Areas of Need*, 68 R.I. B.J. 9, 12 (2019).

82. Novogradac, *supra* note 20.

83. I.R.C. § 1400Z-2(d)(2)(D).

84. *See* PRICEWATERHOUSE COOPERS LLP, QUALIFIED OPPORTUNITY FUNDS PROVIDE NEW TAX INCENTIVES FOR INVESTORS 4 (2018), <https://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-qualified-opportunity-funds-tax-incentives-for-investors.pdf> [<https://perma.cc/GN3M-NCJF>].

gain deferral periods have the effect of reducing overall tax revenue for the government⁸⁵ and allow individuals and corporations to keep funds that should be paid to the government. By allowing investors to defer taxes on capital gains, the federal government is unable to collect these taxes immediately and instead are giving the investors the time value of money.⁸⁶ Thus, tax deferrals hinder the federal government's ability to obtain the greatest amount of taxes if they do not collect the tax in the year the taxable event occurs. Further, tax deferrals could hinder the government's ability to collect even the entirety of a tax as programs like § 1031 exchanges, which potentially eliminate the ability to collect capital gains tax with a step-up basis upon death. However, while the QOZ program is a tax deferral program, it is able to address some of the concerns against capital gains deferral as the sunset clause⁸⁷ in 2026 requires payment on the previously deferred capital gains. While investors are able to capitalize on the time value of money of the deferred tax, the federal government is also able to ensure collection of the capital gains tax.

The QOZ program, while still in its infancy, provides investors with another option to invest their capital gains for preferential tax treatment. This investment vehicle allows investors to defer any capital gains tax until 2026, which means the investors receive an additional benefit of the time value of money on the amount of their deferred taxes.⁸⁸ The amount of tax deferral that remains in the investors' pockets will have a greater economic impact and allow investors to invest more upfront, which could generate more profits over time.⁸⁹ Additionally, the program incentivizes continued investment because the more investors spend on capital improvements, the greater the potential for appreciation in value of the QOZ that may result in a significant step-up in basis upon the disposition of the property. At the same time, this program benefits more than just the taxpayer as the communities within the QOZ are flushed with cash, capital improvements,

85. See e.g., Phyllis C. Taite, *Saving the Farm or Giving Away the Farm: A Critical Analysis of the Capital Gains Tax Preferences*, 53 SAN DIEGO L. REV. 1017, 1021 (2016). See generally THOMAS L. HUNGERFORD, CONG. RSCH. SERV., R40411, THE ECONOMIC EFFECTS OF CAPITAL GAINS TAXATION (2010).

86. The time value of money principle explains that a dollar today is worth more than a dollar tomorrow as the dollar today will increase its value due to interest. Lawrence Lokken, *The Time Value of Money*, 42 TAX L. REV. 1, 11 (1986).

87. "Sunset clause" is a term to describe a law that has a predetermined end date. Manoj Viswanathan, *Sunset Provisions in the Tax Code: A Critical Evaluation and Prescriptions for the Future*, FED. BAR ASSN'S SECTION TAX'N REP. Winter 2009, at 14, 14.

88. See generally Michael R. Laisné, *The Benefits of Tax Deferral Or: How I Learned to Stop Worrying and Love Deferral*, 40 OHIO N.U. L. REV. 559 (2014) (explaining that tax deferrals are an important tool for incentivizing investment and allowing private investors to capitalize on the benefits of the time value of money in making further investments).

89. See Drucker & Lipton, *supra* note 25.

and job opportunities. Thus, QOZs provide a better investment vehicle for both investors and the community than a §1031 exchange.

II. DISPARITY BETWEEN THE QOZ PROGRAM'S INTENT AND REALITY

The QOZ program has gained attention in a variety of industries as the new tax incentive still has grey areas that the IRS has yet to clarify.⁹⁰ While uncertainty regarding certain aspects of the program remains, in early April 2019, Kevin Hassett, a chairman on former President Trump's Council of Economic Advisers, stated: "We've got lots of early evidence that the opportunity zones are working just the way we expected."⁹¹ This hopefulness from officials may indicate the program is working as they intended. But notwithstanding this early evidence of the program's success, there are disparities between what QOZs were intended to do when the program was created and the realities of the investors' investments. This Comment will specifically address the disparity between what the QOZ program was created to do—incentivize investors to invest in low-income communities through the deferral of capital gains tax—and the effects of the program that are counter to its purpose—the disproportionate number of QOFs investing in non-low-income QOZs.⁹² Further, this Comment will provide a solution to close the disparity in order for the QOZ program to benefit those as Congress intended. This section will dive into the discrepancies between Congress's intent behind the QOZ program and the reality of how the program is perceived and implemented and identify how the discrepancies occurred.

A. Criticisms of the QOZ Program's Reality

The QOZ program relies on the cooperation between the states and private investors, as governors are responsible for identifying the areas of greatest need within their jurisdictions, and private investors are responsible for creating QOFs that will provide capital to the designated

90. See Lisa M. Starczewski, *The Eagerly Awaited Opportunity Zone Regulations: What Do They Tell Us and What Do We Still Need to Figure Out?*, 34 TAX MGMT. REAL EST. J. 214, 214 (2018); see also Nickolas Gianou, Vered Rabia, Sean Shimamoto & Diana M. Lopo, *Opportunity Zone Funds Offer New Tax Incentive for Long-Term Investment in Low-Income Communities*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (Aug. 1, 2018), <https://www.skadden.com/insights/publications/2018/08/opportunity-zone-funds-offer-new-tax-incentive> [https://perma.cc/S2Q3-ULNS].

91. Richard Rubin, *Trump Administration Offers New Flexibility in Opportunity Zones: Latest Treasury Regulations for Investing in Low-Income Areas Aimed at Removing Uncertainty*, WALL ST. J. (Apr. 17, 2019, 3:07 PM), <https://www.wsj.com/articles/trump-administration-offers-new-flexibility-in-opportunity-zones-1155520402> [https://perma.cc/24B4-MPGZ].

92. Drucker & Lipton, *supra* note 25.

areas.⁹³ Congress targeted capital gains as the funding source for the QOZ program by providing incentives for this form of capital. The *New York Times* reports that according to the IRS, 7% of Americans report taxable capital gains, and of that 7%, about two-thirds have a total annual income of at least \$1 million.⁹⁴ While this statistic could imply a number of things about the status of taxpayers among the United States, this statistic could also show that 7% of Americans could be investors with the necessary capital to foster the relationship needed for the success of the QOZ program.

Another source of funding for the QOZ program is unrealized capital gains. In 2015, U.S. households had almost \$2.3 trillion in unrealized capital gains; this number increased to \$3.8 trillion in 2017.⁹⁵ Another estimate by the Economic Innovation Group estimated a total of \$2.3 trillion in unrealized capital gains held by businesses.⁹⁶ The unrealized capital gains imply there is a pool of money that has been either deferred or stepped-up, thereby revealing a possibility of the money that can be used toward the QOZ program. As mentioned earlier, not all of the designated census tracts are required to be low-income communities so long as the tracts meet the requirements of § 1400Z-1(e). While no more than 5% of a state's census tracts may be designated as non-low-income communities, the investments into these tracts are unrestricted. Meg Dodge criticizes the QOZ program, noting that instead of taking on challenging projects in the outskirts and suburbs, investors tend to invest in projects that have sound proposals and established deals, such as real estate in major metropolitan areas.⁹⁷ Further, QOZs are more likely to host commercial and business activity than non-QOZs.⁹⁸ This tendency to invest in the projects within the metropolitan areas may be the reason why investments in the non-low-income communities have increased as they appear to be a safer investment than a QOZ in a low-income community.

Further, according to the *New York Times*, many investors are flocking to these safer “luxury” investments because they are easier to

93. Marilyn Young & John Gonas, *Qualified Opportunity Zones Funds—Factors to Consider Before Investing*, PRAC. TAX STRATEGIES, Sept. 2019, at 3, 4.

94. Drucker & Lipton, *supra* note 25.

95. *Opportunity Zones: Tapping into a \$6 Trillion Market*, ECON. INNOVATION GRP. (Mar. 21, 2018), <https://eig.org/news/opportunity-zones-tapping-6-trillion-market> [<https://perma.cc/4QAC-WB9E>].

96. JARED BERNSTEIN & KEVIN A. HASSETT, UNLOCKING PRIVATE CAPITAL TO FACILITATE ECONOMIC GROWTH IN DISTRESSED AREAS 16 (2015), <https://eig.org/wp-content/uploads/2015/04/Unlocking-Private-Capital-to-Facilitate-Growth.pdf> [<https://perma.cc/Q35U-MZQF>].

97. Dodge, *supra* note 56, at 44.

98. *Opportunity Zones: Facts & Figures*, ECON. INNOVATION GRP., <https://eig.org/opportunityzones/facts-and-figures> [<https://perma.cc/H6PW-GWEH>].

finance.⁹⁹ By investing in the QOZ that requires less maintenance, the article explains how investors will be able to inject more capital into their project with less risk on their return on investment.¹⁰⁰ The article additionally states that “[f]inancial institutions are boasting about the tax savings that await those who invest in real estate in affluent neighborhoods.”¹⁰¹ The savings mentioned are perhaps due to the amount investors may save once they have held onto the QOZ for at least ten years and will be eligible to receive the step-up in basis upon disposition. By investing into communities that are better off, investors avoid having to invest in as much maintenance and repair costs, and consequently, investors can inject their investment into capital improvements. The QOZ program is more likely to attract large corporations and high-net-worth individuals because there is no limitation on the amount of money to invest and tax benefits to receive.¹⁰² This hypothesis follows Dodge’s criticism as the QOZs within the metropolitan area are more likely to be “luxurious,” and it is less likely that in a metropolitan area, the value of the asset will decrease significantly. Thus, investors may flock to the non-low-income QOZs in order to make the most out of their investment.

Although investors may not always have Congress’s intent for the QOZ program in mind when investing, QOZs still provide benefits to not only the investors but to the communities receiving the investments. Markeze Bryant, a portfolio manager at Acumen America, recognizes QOZs “are extractive because investors with wealth from across the country are investing in low-income places and expect to generate a return on their investment.”¹⁰³ But he also recognizes that QOZs are “additive because entrepreneurs can open businesses and develop real estate.”¹⁰⁴ While Bryant recognizes that not all investors are participating in the QOZ program to make an impact, there are positives that stem from the investments in areas of need.¹⁰⁵ However, Bryant discusses how investments in self-storage centers and luxury condos in QOZs have low multiplier effects.¹⁰⁶ The people who benefit from luxury investments are

99. Drucker & Lipton, *supra* note 25.

100. *See id.*

101. *Id.*

102. John Sciarretti, Michael Novogradac & Peter Lawrence, *New Opportunity Zones Could Be Used to Finance Rental Housing*, NOVogradac (Feb. 23, 2018, 12:00 AM), <https://www.novoco.com/notes-from-novogradac/new-opportunity-zones-could-be-used-finance-rental-housing> [https://perma.cc/423F-YUYM].

103. Morgan Simon, *What You Need to Know About Opportunity Zones*, FORBES (Mar. 30, 2019, 4:03 PM), <https://www.forbes.com/sites/morgansimon/2019/03/30/what-you-need-to-know-about-opportunity-zones/#5d5986166ae2> [https://perma.cc/8K7L-FB3Y].

104. *Id.*

105. *Id.*

106. *Id.*

not the people in need, and Bryant does not “see a need for condos that are going to be priced three, four, five times what the average person can afford to pay there. It’s just a low, unproductive use of capital.”¹⁰⁷ While the luxury investments are a safe option for investors, those investments are not in the spirit of the QOZ program and do not have a significant impact in the communities needing assistance.

The luxury hypothesis is limited in a way as a Qualified Opportunity Zone Business (QOZB) cannot be a “private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store” that intends to sell “alcoholic beverages for consumption off premises”¹⁰⁸—most are businesses or amenities that one would relate to luxury or a place to spend discretionary income.

B. Identifying How the Disparities May Have Occurred

The inclusion of affluent areas within and surrounding QOZs was not by mistake. This program is said to best deliver in underperforming areas¹⁰⁹ that only require a minor boost in capital to expand investment, not areas in extreme distress where there is a limited source for market interest.¹¹⁰ The ability of the QOZs to absorb capital expenditures could be another reason why investors are targeting the more affluent areas; their investments have a better chance to unlock greater reward. The Economic Innovation Group, the main lobbyists for the QOZ project, published in June 2018 that the QOZ’s demographics show the average poverty rate amongst the zones is almost 31%,¹¹¹ which is more than double the national poverty rate.¹¹² The poverty rate indicates there are communities in need of being served; however, there are also “plenty of affluent areas inside those poor census tracts.”¹¹³ The combination of including affluent areas with low-income areas is most likely due to the balancing act—identifying tracts with a clear need, but also identifying tracts that are

107. *Id.*

108. I.R.C. § 1400Z-2(d)(3)(A)(iii) (referencing I.R.C. § 144(c)(6)(B)). See generally Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(6), 84 Fed. Reg. 18,652 (May 1, 2019) (providing proposed regulations regarding the treatment of QOZBs).

109. Underperforming areas are defined as any of the following: a census tract with a poverty rate of at least 20%; a rural census tract with a median family income that does not exceed 80% of the state median family income; or a census tract in a metropolitan area with a median family income that does not exceed the state or city median family income. I.R.C. § 1400Z-1(c)(1); I.R.C. § 45D(e).

110. FIKRI & LETTIERI, *supra* note 51, at 13.

111. *Opportunity Zones: The Map Comes into Focus*, *supra* note 26.

112. *What Is the Current Poverty Rate in the United States?*, UNIV. OF CAL., DAVIS, CTR. FOR POVERTY RSCH. (Oct. 15, 2018), <https://poverty.ucdavis.edu/faq/what-current-poverty-rate-united-states> [<https://perma.cc/5JH4-ZGHR>].

113. Drucker & Lipton, *supra* note 25.

attractive to investors and able to absorb cash¹¹⁴—that governors had to weigh when designating their QOZs. Thus, the QOZs are areas that could potentially enforce state, local, or private economic development initiatives to attract investment and startup activity.¹¹⁵

Further, it appears the non-low-income community investments are targeting QOZB incentives to qualify for the tax deferral under the fifty percent gross income test.¹¹⁶ There are some questions regarding what qualifies for the fifty percent test, but this test does appear to be an easy threshold to cross to maintain good standing in the QOZ program.¹¹⁷ There are three safe harbors that a QOZB could meet in order to satisfy the fifty percent gross income test¹¹⁸: (1) at least 50% of the hours of service that a business receives and uses are performed within the QOZ;¹¹⁹ (2) at least 50% of the total amount paid to employees, independent contractors, and employees of independent contractors for services must be for services performed within the opportunity zone;¹²⁰ or (3) at least 50% of the gross income of the trade or business are generated from the tangible property of the trade or business located in a QOZ and the management or operational functions are performed in the QOZ and are each necessary for the generation of the income.¹²¹ There is also a separate safe harbor that provides gross income derived from property that is treated as a reasonable amount of working capital under the working capital safe harbor is counted toward satisfaction of the fifty percent gross income test.¹²²

The QOZB must meet only one of these safe harbors to satisfy the fifty percent test;¹²³ therefore, this type of investment is more lucrative than the others. In other words, a QOZB can qualify for tax deferral if at least 50% of its employees' hours or wages are within the QOZ, if the property and managers needed to produce at least 50% of revenue are in the zone, or if at least 50% of revenue is generated in the zone.¹²⁴ The second safe harbor looks at a proportion of the amount that the trade or

114. *Opportunity Zones: The Map Comes into Focus*, *supra* note 26.

115. See STAFF OF J. COMM. ON TAX'N, 115th CONG., DESCRIPTION OF THE CHAIRMAN'S MARK OF THE "TAX CUTS AND JOBS ACT" (J. Comm. Print 2017).

116. Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(i), 84 Fed. Reg. 18,652, 18,658 (May 1, 2019).

117. Rubin, *supra* note 91.

118. Lisa M. Starczewski, *The Second Set of Proposed Opportunity Zone Regulations: Where Are We Now?*, 60 TAX MGMT. MEMORANDUM 1, 15 (2019).

119. *Opportunity Zones Frequently Asked Questions*, *supra* note 12.

120. Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(i)(B), 84 Fed. Reg. 18,652, 18,658 (May 1, 2018).

121. Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(i)(C), 84 Fed. Reg. at 18,659.

122. Prop. Treas. Reg. § 1.1400Z2(c)-1(d)(3)(vi)(B), 85 Fed. Reg. 19,082, 19,083–84 (Apr. 6, 2020).

123. Investing in Qualified Opportunity Funds, 84 Fed. Reg. 18,652, 18,658 (May 1, 2018).

124. See Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5) 84 Fed. Reg. at 18,690; see also Rubin, *supra* note 91.

business pays for services within the QOZ compared to amounts paid for services outside the zone.¹²⁵ As long as the majority of services are located at the business location, the second safe harbor will likely be met. For investors, the fifty percent test could be simple to meet if their investment is a brick-and-mortar business located within the QOZ as the assets, management, and revenue requirements would be well above fifty percent.

Due to the low entry barrier to meet the fifty percent test, investing in a QOZB appears to be the most logical method for investors starting a new project since operating a business may be the closest guarantee to maintaining compliance with the QOZ program. A QOZB permits the investors to invest and create businesses that will most likely satisfy the fifty percent test and may also generate income for the investors in addition to the savings from the tax deferrals. This “double” incentive potentially incentivizes other investors to follow this route, creating opportunities for additional gains that other methods—such as QOZBPs—may not offer. Investors are nervous about investing in land as a QOZBP that has buildings as it is possible that the investment may not meet the “original use” requirement by §1400Z-2(d)(D).¹²⁶ Thus, starting anew with a QOZB or investing in an existing QOZB is the more risk adverse option. The lower-risk investment and opportunity for additional gains attract investments; thus, non-low-income QOZs are gaining investment attention, detracting from the areas of most need—the low-income QOZs and impoverished areas within.

Further, nothing in Subsection Z requires QOF managers to disclose information about which QOZs are receiving investment and whether the incentive is working. The lack of disclosure enhances the disparity between low-income and non-low-income QOZs as QOFs are not held to a standard to show whether an investment is actually working toward the goal of the QOZ program by investing in an area of need or spurring jobs for those in need in the non-low-income areas.

III. CLOSING THE DISPARITY

In order to close the gap between the investments in non-low-income QOZs and those in low-income QOZs, there should be an amendment to update the Code that addresses: (1) a proportionate investment into low-income QOZs to an investment into a non-low-income QOZ and (2) a reclassification process based upon the 2020 census.

125. *Portfolio 597-2nd: Tax Incentives for Economically Distressed Areas; Qualified Opportunity Zones, B. Qualified Opportunity Zone Property*, BLOOMBERG L. (on file with Seattle University Law Review).

126. See, e.g., Riley Coy, *Good Enough: How Minimal IRS Guidance Is Sufficient to Navigate 1400Z Opportunity Zones*, 3 BUS. ENTREPRENEURSHIP & TAX L. REV. 1, 15 (2019).

A. Proportionate Investments into Low-Income QOZs

Because the TCJA introduced the QOZ program into the Code, an appropriate response to resolve the issues identified would be to amend the Code to find ways to better fund low-income QOZs. A proposed amendment to the Code would require an investment in a low-income QOZ proportionate to an investment to a non-low-income QOZ. Testimony by Terri Ludwig acknowledges that “the Department of Treasury issue regulations to prevent abuse not only to ensure that tax benefits inure to investments consistent with good public policy, but also lead to a direct and sustained benefit for the residents and local businesses in the census tract.”¹²⁷ This amendment to the Code would address the disparity by requiring more thoughtful investment into QOZs. Thus, for every investment by a QOF into a non-low-income QOZ, the same QOF must invest a percentage of Congress’s choosing of the investment amount into a low-income QOZ. For example, if a QOF invests \$100 into a non-low-income QOZ, the QOF will be required to invest an additional 7% of the \$100 invested—an additional \$7—into a low-income QOZ. As a result, investors invest in the spirit of the QOZ program, to stimulate jobs and growth in lower-income areas.

A 7% requirement is an approximation of an amount where investors can invest into a low-income QOZ and have a potential for a margin of return. Imagine a simple model where \$100 of capital gain is invested into a QOF and the QOF invests the \$100 into a non-low-income QOZ. If the investment is held for at least five years, the investor will not have to pay capital gains tax on the full \$100. The investor will save 10% and only pay tax on \$90; thus, saving \$10 on their investment. Therefore, requiring investors to invest an additional \$7 toward a low-income QOZ may still provide the investor with a margin of gain on their investment when comparing how much an investor will save to how much an investor is required to invest.

B. Reclassification of the QOZ Tracts

Another proposed amendment would be to create a reclassification process for QOZs based upon the 2020 census and to require any new designations to be based off of the 2020 census data. Currently, Subchapter

127. Terri Ludwig, Chief Exec. Officer, Enter. Cmty. Partners, Testimony Before the Joint Economic Committee: The Promise of Opportunity Zones (May 17, 2018), https://www.jec.senate.gov/public/_cache/files/7e775795-e97a-42d8-a8e3-916236ec13e1/terri-ludwig-testimony.pdf [<https://perma.cc/NG9G-SD7E>]. For more on Ms. Ludwig’s thoughts on preventing abuse and promoting affordable housing see *The Promise of Opportunity Zones: Hearing on S. Hrg. 115-297 Before the J. Econ. Comm.*, 115th Cong. 47–55, 68–69 (2018) (statement of Terri Ludwig, Chief Executive Officer, Enterprise Community Partners).

Z states “[a] designation as a qualified opportunity zone shall remain in effect for the period beginning on the date of the designation and ending at the close of the 10th calendar year beginning on or after such date of designation.”¹²⁸ Thus, once the U.S. Department of Treasury has approved and certified the nominated census tracts for QOZ status, the tract retains its QOZ status for ten years.¹²⁹ The census data that the designations rely on are completed every ten years.¹³⁰ This data creates an issue because there may be major developments to a census tract that does not accurately reflect the status of that tract, thereby creating another avenue for disparity amongst non-low-income and low-income QOZs. The goal of the QOZ program was to spur growth and assist low-income communities.¹³¹ If the status of the communities has changed, the law must ensure that those who need the assistance are being served.

The 2020 census could alter the status of certain tracts; prior census data may have qualified the tract, but due to changes, the same tract in 2020 may not qualify for QOZ status. The reverse is also possible; certain tracts may not have qualified for QOZ status according to prior census data but may qualify under the 2020 census data. This mismatch creates another hurdle to overcome the disparity because “[i]f a tract grows and sees an influx of new people into its population and that population becomes wealthier, that might make it no longer ‘low-income,’ and could throw off the tract’s eligibility.”¹³²

The proposed amendment would require that each tract be reassessed according to the 2020 census data. For the tracts that were designated prior to the 2020 census data and no longer qualify for QOZ status based upon their original designation method, the governor may look at whether the tract can qualify through other means. If a QOZ is no longer a low-income tract under the 2020 census data but is able to qualify as a non-low-income tract under the QOZ program, the QOZ designation remains. If the tract no longer qualifies for QOZ designation by any means, the amendment proposes that the governor must look at the percentage at which the tract no longer qualifies. If the tract is within a designated threshold (agreed upon in the legislature), say for illustrative purposes, 30% over the maximum income level allowed, the QOZ designation shall be

128. I.R.C. § 1400Z-1(f).

129. *What are Opportunity Zones and How Do They Work?*, *supra* note 14.

130. *See About the 2020 Census*, U.S. CENSUS BUREAU (Jan. 31, 2019), <https://www.census.gov/programs-surveys/decennial-census/2020-census/about.html> [<https://perma.cc/TAJ2-ZR6D>].

131. *What are Opportunity Zones and How Do They Work?*, *supra* note 14.

132. Lydia O’Neal, *2020 Census Could Expand Opportunity Zones Chosen for Tax Breaks*, BLOOMBERG TAX (Sept. 23, 2019, 1:45 AM), <https://news.bloombergtax.com/daily-tax-report/2020-census-could-expand-opportunity-zones-chosen-for-tax-breaks> [<https://perma.cc/B8PV-VNNT>].

grandfathered and maintain its QOZ designation according to the original ten-year qualifying period. However, if the QOZ has surpassed the threshold level, the governor may petition the U.S. Treasury to maintain the original QOZ status if the governor can show (a) substantial hardship and loss to the pre-existing investments and (b) reliance of the investors on the tract's QOZ status.

In the event that a tract loses its QOZ status and cannot be grandfathered into the program through either of the methods above, the investors may choose to (a) accelerate recognition of their capital gain tax on the original deferred capital gains and receive a step-up in basis of the additional gain, or in the event of a loss, the loss will be net upon the original deferred gain, at the time at which the tract is no longer qualified for QOZ designation; or (b) receive preferential choosing of a new QOZ investment and delay recognition of capital gains tax until December 31, 2031.

This one-time requirement to reassess each QOZ, according to the 2020 census data, provides a more accurate depiction of the status of a census tract and would allow for the program to work more effectively according to the goals of Congress. The reassessment of the tracts is essential to build the QOZ program on a strong foundation. The 2020 census data will be a closer representation of the composition of the tracts because it provides a closer timespan from the start of the program to the census data (two-year timespan) than the data from the last census to the start of the program. Further, by providing a process to grandfather in original QOZ tracts that do not qualify under the 2020 census data, the amendment will address the potential hardships of the investors, while also addressing the disparity between low-income and non-low-income QOZ investments. While recognizing that the reclassification process may pose a significant detriment to investors who currently participate in the QOZ program, the statutory amendment provides a balanced choice for investors who may lose their QOZ status.

For the tracts that no longer qualify for the QOZ program, this amendment provides two different avenues for the investors. The first avenue to accelerate the recognition allows investors to recoup some of their money that they invested into their QOF and QOZ, while also allowing the federal government to receive the revenue from the deferred capital gain. While the investors may have to accelerate their recognition of capital gains tax on the original deferred amount, in the event of a gain, the investors receive a step-up in basis of any additional gain existing at the time that the former QOZ tract is no longer deemed eligible. In the event of a loss, the investor will be able to use that loss like any other investment and offset their capital gain with the resulting loss. Thus, the

investors will have an option to essentially accelerate the timeframe of recognition on their QOZ investment without too much of a hinderance to their tax planning strategies. Further, the mechanisms of the QOZ program are maintained because the investors can defer their capital gains, and the federal government can still collect capital gain tax and ensure tax revenue.

The second option of a preferential choice of a new QOZ allows the investors to still participate in the QOZ program and provides preferential treatment for the displaced investors to maintain cooperation with the program. By allowing the investors to receive preferential treatment in choosing a new QOZ project and extending the timeframe to recognize capital gains tax, the second option incentivizes investors to maintain their participation in the program and allows for a more seamless transition into a new project after being displaced.

Each of these options allow investors to choose whether they would like to maintain participation in the QOZ program or whether they would like to stop participation in the program and reassess their options. Option one allows the investors to receive some type of benefit for their participation in the program yet allows the federal government to collect capital gain tax revenue—an aspect of the QOZ program that investors are aware of when choosing to participate in the program. On the other hand, option two may appeal to the investors to ultimately continue participation in a program that does its best to balance the needs of the community, the federal government, and the private investors.

CONCLUSION

In order to incentivize investments that align with the spirit of the QOZ program, any changes to the QOZ program will need to address the overall needs of the low-income communities, the private investors, and the federal government. These three groups of people are the main stakeholders in the QOZ program; thus, addressing any adjustments to the QOZ program to these stakeholders should promote participation. By amending the Code to include a reclassification process, the legislature can participate in identifying the current, most needy low-income communities and assist in closing the gap between investments into non-low-income tracts and low-income tracts. This Comment's proposed solution enables the QOZ program and its investors to be more aligned with Congress's intent to serve communities in need by directing a flow of investment to low-income QOZs and ensuring that QOZ tracts are a better representation of its current residents through the 2020 census data.