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Qualified Opportunity Fund Update: Likely Biden Administration Changes & New Rules for Non-US Investors & Working Capital Safe-Harbor

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Sir Richard Branson famously said, "It's only by being bold that you get anywhere." This spirit certainly applies to the qualified opportunity fund ("QOF") rules enacted as part of the Tax Cut & Jobs Act of 2017.[2] The QOF regime is a daring legislative venture that marries tax benefits to long-term investments in low-income communities.[3] And like all ventures into uncharted territory, there are likely to be unanticipated detours and adjustments along the way, especially following a change in leadership, such as the one that the United States just experienced. In this Legal Update, we'll explore changes to the rules likely to be pursued by the Biden administration and explain regulations proposed by the Internal Revenue Service (the "IRS") on April 14, 2021 (the "Proposed Regulations") that address how non-US investors can take advantage of the QOF rules and explain how a 24-month expansion of the working capital safe-harbor for federally declared disasters may be tweaked to work better.[4]

I. Likely Biden Administration Changes to the QOF Rules

During the 2020 presidential campaign, then-candidate Biden made three proposals to improve the operation of the QOF rules: (1) encourage partnerships between QOFs and non-profits or other community-oriented organizations, (2) direct the IRS to review tax benefits and ensure that benefits are directed to projects with clear community benefits and (3) enhance reporting requirements by QOFs to disclose the impact that the projects are having on local communities.[5] These three themes are likely to form the basis of amendments to the QOF rules to be proposed by the Biden administration.

A. Encouraging Joint Ventures

At this time, we do not have any transparency as to how the Biden administration would propose to encourage joint ventures between local communities and QOFs. The Biden administration's "Build Back Better Agenda," which is the administration's economic recovery plan, provides that one goal for qualified opportunity zone ("QOZ") program reform would be to incentivize QOFs to partner with non-profit or community-oriented organizations, and jointly produce a "community benefit plan" for each QOF investment, with a focus on generating jobs for low-income residents and otherwise improving the finances of households within QOZs.[6] It is not clear what kind of incentives could be offered to QOFs to partner with local community organizations. Given the overall tenor of the Biden proposals, however, we would not be surprised to see employment tax

credits (or other credits) offered for employment of individuals who are resident in QOZs and meet certain income or other types of wealth caps. QOF investments do not offer any current income incentives; QOF benefits only apply to deferral of gains on the funds used to invest in the QOF and from dispositions of the QOF investment itself. There is significant room to amend the rules to provide employment tax incentives during the life of the venture.

B. Enhanced Reporting

The original version of the QOF legislation contained enhanced reporting requirements.[7] However, these provisions were not included in the final version of the legislation. In November 2019, shortly following revelations that then-Treasury Secretary Steven Mnuchin allegedly manipulated the creation of a particular QOZ for personal benefit, Congressional interest in enhanced reporting resurfaced.[8] Senator Ron Wyden, now the Chairman of the Senate Finance Committee, and Congressman Richard Neal, the Chairman of the House Ways and Means Committee, proposed identical bills to require enhanced reporting of QOF investments (together, the "Wyden-Neal Bills").[9] These bills were ultimately not enacted. It is likely, however, given the positions of the sponsors as the heads of the two tax writing committees, that the Wyden-Neal Bills will serve as the model for any enhanced reporting legislation. We note the Economic Innovation Group, a coalition of QOF investment groups, has recently written Treasury to support enhanced reporting.[10]

It's also worth noting that the Wyden-Neal bills would have made substantive changes to the QOF rules. The announcements from the Biden administration, however, do not indicate support for these substantive changes (but nor do they reject them).

Under the Wyden-Neal Bills, QOFs would be subject to annual information reporting containing the names of their investors, the value of the property that they hold, their number of employees, and detailed information regarding real property held and improved by such QOF. QOFs would also be required to publish these reports on internet websites. In addition, persons who invest in QOFs would also be subject to significant reporting responsibilities. The failure to file either report would result in a $10,000 penalty.

Months before the introduction of the Wyden-Neal Bills, House Ways and Means Committee Members Ron Kind and Mike Kelly introduced HR 2593.[11] HR 2593 likewise would have required increased reporting by QOFs. HR 2593 would have asked QOFs to provide essentially the same information as would have been required in the Wyden-Neal Bills and the basic reporting requirements follows those bills. This legislation also would have required disclosure of the business conducted by the QOF and certifications as to compliance with the QOF rules. HR 2593 proposed penalties of $500 per day for each day late that the reports were filed, subject to a $200,000 cap. HR 2593 did not contain provisions for investor reporting.

Thirdly, Senator Corey Booker proposed a bill (S. 1344) that would have required the Treasury Department to provide enhanced reporting to Congress on QOFs beginning five years after passage of the bill.[12] In contrast to the Wyden-Neal Bills and HR 2593, S. 1344 did not place explicit reporting requirements on QOFs. Instead, it more closely hewed to the provisions of the original QOF legislation that were deleted. Under S. 1344, the IRS would have been authorized to specify information that it would collect from QOFs to enable the IRS to make its required reports.

Last, in 2019, Senator Rick Scott, one of the seven Republican Senators who, on January 6, 2021, voted against certifying the 2020 presidential election results on the basis of unfounded claims of election fraud, and has threatened "massive backlash" against "woke" corporations,[13] also proposed legislation that would have required robust reporting by QOFs and their investors. His proposed legislation, known as the Improving and Reinstating the Monitoring, Prevention, Accountability, Certification, and Transparency Provisions of Opportunity Zones, or the "IMPACT Act," would have required detailed information on the number of employees of the QOF and underlying qualified opportunity zone businesses ("QOZBs"), in addition to the information required in the versions of the similar legislation described above. His bill would have imposed penalties capped at $50,000. Investors who failed to include all relevant information on their filings would have been subject to penalties of $5,000. The IMPACT Act would also have required detailed information to be filed by the Treasury Department on the QOZs themselves. It is unclear as to whether the IMPACT Act is part of his proposed massive backlash or whether these provisions will find their way into bipartisan legislation.

C. Community Impact Statements

At the current time, it's not clear how a new requirement for community impact statements might work. It's possible that the substantive provisions of the Wyden-Neal Bills will serve as a model for curtailing certain types of projects in favor of ones that seek to refurbish low-income neighborhoods for the existing residents of such neighborhoods. Under the Wyden-Neal Bills, QOZBs would have excluded self-storage properties, stadium properties and housing projects unless 50% or more of the units are rent-restricted and occupied by individuals whose income is 50% or less than the area median income. In the original Wyden-Neal bills, these changes would have been effective as of the original date of enactment of the QOF rules. Hopefully, if these provisions do serve as the basis for future changes, they will apply only to projects undertaken after the passage of new legislation.

II. New Rules Affecting Non-US Persons Investing in QOFs

The Proposed Regulations establish requirements that certain non-US persons and partnerships with non-US partners must meet in order to be eligible to make an election under Section 1400Z-2(a) of the Internal Revenue Code of 1986, as amended (the "Code") to defer capital gain that would otherwise have been subject to US federal income tax until December 31, 2026 (a "deferral election") by way of a QOF contribution. The deferral election is dependent upon the taxpayer investing a corresponding amount in a qualifying investment in a QOF within 180 days of the date of the sale or exchange.[14] Importantly, the Proposed Regulations provide mechanisms for reducing or eliminating withholding on dispositions of US real property interests (Code § 1445), effectively-connected income ("ECI," Code § 1446(a)), and dispositions of interests in partnerships engaged in the conduct of a US trade or business (Code §1446(f)).

Non-US persons are generally subject to net US income tax on amounts that are effectively connected with the conduct of a trade or business within the United States.[15] To ensure the collection of tax, the Code imposes withholding requirements on payments or allocations of ECI to non-US persons. Specifically, under Code §§ 1445, 1446(a), and 1446(f), certain transferees or payors are required to withhold a specified percentage of the sales proceeds, distributions or other payments that would be payable to non-US persons and pay the same over to the IRS as tax remittances. The amount of

withholding under these provisions is intended to serve as a proxy for the amount of the non-US person's substantive tax liability but, in any given case, may not match the actual amount of tax due. A non-US person that directly or indirectly is engaged in a trade or business in the United States must file a US income tax return and pay any tax due or receive a refund of any over-withholding.

Until the promulgation of the Proposed Regulations, no rules had been issued that coordinated the deferral election for QOF investments with the withholding rules in Code §§ 1445, 1446(a), and 1446(f). The Proposed Regulations provide detailed procedures under which a non-US person can avoid US withholding until the end of the deferral period in 2026 on deferred gain by obtaining a stand-by letter of credit from a US bank. These procedures will allow the non-US person to roll-over the full amount of the gain recognized into a QOF investment and then pay the deferred tax liability in 2026.

A. Security-Required Person

The starting point for these procedures is the definition of a "security-required person." A security-required person is either (i) a foreign person other than a partnership or (ii) a specified partnership.[16] A specified partnership is a partnership, whether non-US or US formed, that meets one of the following three tests: (1) an ownership test, (2) a closely-held test, and (3) a gain or asset test.[17] The ownership test is met if, at the time of transfer, 20% or more of the capital or profits interests in the partnership are owned (directly or indirectly through one or more partnerships, trusts, or estates) by one or more nonresident aliens or non-US corporations.[18] The closely-held test is met if, at any time during a look-back period (the period that begins on the later of the date that is one year before the date of the transfer or the date on which the partnership was formed, and that ends on the date of the transfer), a partnership has 10 or fewer direct partners that own 90% or more of the capital or profits interests in the partnership.[19] The gain or asset test is met if either: (i) the amount of gain from the transfer exceeds $1 million or (ii) at any time during a look-back period (as defined above), the value of the partnership's assets that are US real property interests or assets used in a US trade or business exceeds 25% of the total value of the partnership's assets.[20]

B. Security-Required Gain

The second step is for the security-required person to determine if it has "security-required gain." Security-required gain is gain that arises from a "covered transfer."[21] Generally, a covered transfer is a transfer subject to Code §§ 1445, 1446(a), or 1446(f) withholding.[22] More specifically, there are four categories of covered transfers:[23]

1. A disposition of a US real property interest that would be subject to withholding under Code § 1445;
2. A disposition of an interest in a partnership that generates ECI;
3. A disposition of property by a specified partnership that gives rise to ECI; and
4. A disposition or distribution of property by a partnership other than a specified partnership if any resulting gain would be included in the ECI of a security-required person.

A covered transfer does not include any disposition if no withholding would have been required on the transfer.[24]

C. The Eligibility Certificate and Deferral Agreement

A security-required person with security-required gain may apply for an "eligibility certificate" from the IRS with respect to that gain.[25] The application must generally include the following: (i) certain information about the security-required person and the covered transfer; (ii) an agreement for the deferral of tax and provision of security (a "Deferral Agreement"); (iii) an agreement with a US agent to receive notices from the IRS (likely an accounting firm); and (iv) acceptable security that secures the amount of the security-required gain for which the eligibility certificate is being obtained.[26] The application includes a requirement for the non-US person to obtain and then provide a US taxpayer identification number.[27]

The IRS has stated that it intends to issue eligibility certificates no later than 90 days after its receipt of a completed application.[28]

In general, under the Deferral Agreement, the security-required person agrees to do the following: (a) timely file a federal income tax return and pay any tax liability due on the security-required gain when required; (b) report any security-required gain in accordance with the Treasury regulations under the QOF rules; (c) provide security to the IRS with respect to any tax liability due on security-required gain; and (d) appoint a US person to act as the security-required person's limited agent for certain purposes specified in the Deferral Agreement.[29] An event of default under the deferral agreement is an "inclusion event" that triggers recognition of the security-required gain.[30] The Deferral Agreement will specify the defaults upon which an event of default may be based, which may include a determination that the security is no longer adequate to protect the IRS's interests or a change in the creditworthiness of the issuer of a letter of credit, among others.[31]

Most importantly, the security to be provided to the IRS to guarantee the payment of tax must be in the form of an irrevocable standby letter of credit issued by a US bank. The notional amount of the standby letter of credit may be less than the tax due on the recognized gain that is subject to US federal income tax. If the amount of the standby letter of credit is for less than the full amount of tax due on the recognized gain, the amount that the non-US person may contribute as a qualified contribution to the QOF is proportionally reduced.

To illustrate this point, the Proposed Regulations include the following example. A security-required foreign taxpayer realizes $100,000 in gain, which would be eligible for deferred withholding. If the taxpayer invests the entire gain in a QOF, it would be able to make a valid deferral election with respect to the full amount. The taxpayer applies for an eligibility certificate with respect to that gain and receives it before timely filing their federal income tax return for the tax year in which the gain would be recognized. However, the eligibility certificate specifies a permitted deferral amount of $75,000. Under the Proposed Regulations, the deferral election is limited to that amount and therefore only $75,000 of the gain invested in the QOF is considered a qualifying investment, so no deferral election can apply to the remaining $25,000 investment.[32]

The Proposed Regulations allow a security-required person to submit its eligibility certificate to a withholding agent and the withholding agent can use the certificate as a basis for reducing or eliminating withholding under Code §§ 1445, 1446(a), and 1446(f). In addition, the Proposed Regulations modify the rules in Treasury Regulation §§ 1.1446-3 and 1.1446-6 to allow a partnership to use an eligibility certificate in determining its ECI (Code § 1446) withholding tax liability.[33] Treasury Regulation § 1.1446-3 currently allows a partnership to consider certain partner

level deductions and losses certified in accordance with Treasury Regulation § 1.1446-6 in determining its Code § 1446 tax. When determining installments of Code § 1446 tax, to ensure that the reduction in ECI by the permitted deferral amount is fully taken into account, the eligibility certificate must be considered before the effectively connected items are annualized.[34]

D. Parallel Regime for Non-US Persons That Are Not Security-Required Persons

The preamble to the Proposed Regulations states that a security-required person that does not act quickly enough to avoid withholding (i.e., does not obtain an eligibility certificate *before* the transfer) will nonetheless be able to take advantage of the proposed rules, albeit without avoiding withholding. Such a person may make a qualified investment in a QOF and claim a credit or refund of any amount withheld by obtaining an eligibility certificate and submitting the eligibility certificate to the IRS with its credit or refund claim. The Proposed Regulations, however, do not explicitly contain such rules.

E. Effective Date

The Proposed Regulations will apply to any covered transfer that occurs after the date that the Proposed Regulations are published as final Treasury Regulations in the Federal Register. The Proposed Regulations provide that taxpayers should not submit applications for eligibility certificates before such date and any applications submitted before such date will not be processed by the IRS.

III. Working Capital Safe Harbor Plans in the Case of a Federally Declared Disaster

A QOZB cannot have 5% or more of its assets in "nonqualified financial property."[35] Amounts held as working capital are not treated as nonqualified financial property if such working capital is deployed within 31 months pursuant to a written schedule and certain other requirements are met.[36] If a QOZ is designated as a federally declared disaster area, the related QOZB may be eligible to extend the time period to deploy its working capital beyond 31 months for an additional 24 months as long as the QOZB otherwise satisfies the working capital safe harbor.[37] In Notice 2021-10, the IRS permitted QOZBs that held working capital before June 30, 2021, to take advantage of the 24 month extension in light of the COVID-19 pandemic.[38]

Under the final regulations issued in 2019, the QOZB must expend its working capital pursuant to the 24-month extension in a manner substantially consistent with the original, pre-disaster written designation in which the amount of working capital assets subject to the working capital safe harbor are designated and according to the original, pre-disaster written schedule for expending such amounts.[39] Commenters expressed a need for additional regulatory guidance regarding the operation of the 24-month extension, and pointed out that in some cases, the post-disaster environment facing the QOZB may render the original plan suboptimal or even infeasible.

In response, the Proposed Regulations provide flexibility for QOZBs to revise or replace the original written designation and written plan, provided that the remaining working capital assets are expended within the original 31-month period, increased by the additional 24 months in response to the federally declared disaster.[40] Further, a new or revised written designation of the amount of

working capital assets and reasonable written schedule for expending that amount may be used only if adopted not later than 120 days after the close of the incident period with respect to the disaster.[41] These Proposed Regulations apply to taxable years beginning after the date that the Proposed Regulations are published as final Treasury Regulations in the Federal Register, but a taxpayer may rely on the proposed rule for taxable years beginning after December 31, 2019.[42] Thus, the Proposed Regulations allow changes to working capital plans necessitated by the COVID-19 pandemic.

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Endnotes

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[2] P.L. 115-97, § 13823.

[3] For our prior coverage of the QOF rules, please see https://www.mayerbrown.com/en/perspectives-events/publications/2020/04/irs-updates-qualified-opportunity-fund-regulations-on-april-1-2020, https://www.mayerbrown.com/en/perspectives-events/publications/2019/12/irs-issues-final-qualified-opportunity-fund-regulations, https://www.mayerbrown.com/en/perspectives-events/publications/2019/12/irs-issues-final-qualified-opportunity-fund-regulations, https://www.mayerbrown.com/en/perspectives-events/publications/2019/04/mayer-brown-analyzes-second-set-of-qualified-opportunity-fund-regulations, and https://www.mayerbrown.com/en/perspectives-events/publications/2018/08/gain-deferral-using-qualified-opportunity-zone-inv.

[4] REG-121095-19.

[5] Curry, *Biden Targets O-Zones for Reforms in Racial Economic Equity Plan* (Tax Notes doc 2020-28905) (July 29, 2020).

[6] The Biden administration's "Build Back Better Agenda" can be found at https://joebiden.com/racial-economic-equity/.

[7] *See* Joint Explanatory Statement of the Committee of Conference (HR 1), p. 400 (2017).

[8] Cumings, *Wyden and Dems Launch Multi-Prong Crackdown on O-Zones* (Tax Notes doc 2019-42291) (November 7, 2019).

[9] Copies of the Wyden-Neal Bills are available at Tax Notes Document Services (2019-42254).

[10] *See* comment letter from the Economic Innovation Group to Mark Mazur, deputy assistant secretary policy, Department of Treasury, re: *Recommendations for Legislative Regulatory Modifications to Opportunity Zone Incentive* (March 11, 2021).

[11] H.R. 2593 – 116th Congress: To require the secretary of the Treasury to collect data and issue a report on the opportunity zone tax incentives enacted by the 2017 tax reform legislation, and for other purposes. A copy of HR 2593 is available at Tax Notes Document Services (2019-42268).

[12] S. 1344 – 116th Congress: A bill to require the secretary of the Treasury to collect data and issue a report on the opportunity zone tax incentives enacted by the 2017 tax reform legislation, and for other purposes.

[13] Scott, *Dear woke Corporate America, beware of the backlash that's coming* (Fox Business April 19, 2021) https://www.foxbusiness.com/politics/sen-rick-scott-work-corporate-america-backlash.

[14] Code § 1400Z-2(a); Code § 1400Z-2(b).

[15] Code §§ 871(b), 882(a).

[16] Prop. Treas. Reg. § 1.1400Z2(a)-2(b)(1).

[17] Prop. Treas. Reg. § 1.1400Z2(a)-2(b)(3).

[18] Prop. Treas. Reg. § 1.1400Z2(a)-2(b)(3)(i).

[19] Related partners are treated as a single partner. Prop. Treas. Reg. § 1.1400Z2(a)-2(b)(3)(ii).

[20] Prop. Treas. Reg. § 1.1400Z2(a)-2(b)(3)(iii).

[21] Prop. Treas. Reg. § 1.1400Z2(a)-2(c)(1).

[22] Prop. Treas. Reg. § 1.1400Z2(a)-2(c)(2).

[23] Prop. Treas. Reg. § 1.1400Z2(a)-2(c)(2)(i)(A)-(D).

[24] Prop. Treas. Reg. § 1.1400Z2(a)-2(c)(2)(ii).

[25] Prop. Treas. Reg. § 1.1400Z2(a)-2(d)(2).

[26] Prop. Treas. Reg. § 1.1400Z2(a)-2(d)(3). Acceptable security is defined as an irrevocable standby letter of credit issues by a US bank that meets certain capital and other requirements. Prop. Treas. Reg. § 1.1400Z2(a)-2(d)(6)(ii).

[27] *Id*.

[28] Prop. Treas. Reg. § 1.1400Z2(a)-2(d)(1).

[29] Prop. Treas. Reg. § 1.1400Z2(a)-2(d)(4)(ii).

[30] Prop. Treas. Reg. § 1.1400Z2(a)-2(d)(4)(iii).

[31] *Id*.

[32] Prop. Treas. Reg. § 1.1400Z2(a)-1(a)(3)(v)(A), Example 1.

[33] Prop. Treas. Reg. § 1.1446-3(b)(2)(i)(B)(1); Prop. Treas. Reg. § 1.1446-6(c)(1)(iv).

[34] *Id*.

[35] Nonqualified financial property includes debt, stocks, partnership interests and various other financial instruments. Treas. Reg. § 1.1400Z2(d)-1(d)(3)(iv).

[36] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)(B).

[37] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)(D).

[38] On March 13, 2020, President Donald Trump declared the COVID-19 pandemic a nationwide emergency pursuant to Section 501(b) of the Stafford Act, and this designation of a nationwide federally declared disaster is still in place.

[39] *Id*.

[40] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)(D).

[41] *Id*. Under the Proposed Regulations, an "incident period" has the meaning given to it by 44 CFR 206.32(f), which defines an "incident period" as the time interval during which the disaster-causing incident occurs. At present, the "incident period" associated with the COVID-19 pandemic federal disaster declaration, which is national in scope, remains open as of the writing of this Legal Update.

[42] Prop. Treas. Reg. § 1.1400Z2(d)-1(e)(2)(ii).

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