Qualified opportunity zones: promise remains (or does it?)

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This article is an update on the Qualified Opportunity Zone program, which was established by the Tax Cuts and Jobs Act. The article examines the program's current status, possibilities, and challenges. This article is a current snapshot of the status and possibilities of a once-bipartisan legislative program, the present challenges and obstacles internal to the program's technical requirements, and the threats posed by two Category 5 storms blowing from different directions, one now happening and the other clearly visible on the horizon.

Few recent developments in federal tax law have evoked as much speculation and scholarly froth as the law and regulations creating Qualified Opportunity Zones ("QOZs") and their related benefits. The law is contained in Internal Revenue Code ("IRC") Sections 1400Z-1 and 1400Z-2 (the "QOZ Law"), added by the Tax Cuts and Jobs Act in 2017.[1] Much more has now been written with the addition of the voluminous final regulations and three "guidance" precursors to the regulations. Given the ectomorphic form of the law itself, the regulations were clearly necessary. Yet, full-on pursuit of QOZ programs and their attractive features has been hampered until recently by lack of clarity in certain key areas.

Early in 2020, it appeared that the regulations had answered the most important remaining questions, and that sponsors of both real estate and non-real estate programs had enough clarity to proceed with their plans. The outlook for both community uplift and a more generous public appraisal of QOZ programs had improved. As of 3/1/2020, the overriding question was whether sponsors and investors would step up. The table was set. Then two outside factors intervened. First, an epic "black swan event," the pandemic, threw the entire world economy (and certainly the real estate economy) off track. Second, the outlook for QOZ programs was cast into doubt by the November 2020 presidential election, as the originally-bipartisan QOZ Law became weaponized. We treat each of these later in the article.

QOZ law basics

The QOZ Law provides two levels of benefits: (1) on the initial capital gain recognition event, they are a means for U.S. taxpayers to both defer and (depending on timing) reduce payment of federal capital gains tax for a recognition event after 12/31/2017, and (2) they are a means of full avoidance of federal capital gain attributable to reinvestment of the original gain amount into qualifying assets. A realization of full benefits requires investment in one or more Qualified Opportunity Funds that in turn invest in

Qualified Opportunity Zone business property, either directly or through qualified opportunity zone businesses ("QOZBs") operating in QOZs, as detailed below.

Not all states have conformed to the QOZ provisions. Thus, the tax benefits may accrue at only a federal and not state level, depending on the jurisdiction.

While the designation of QOZ census tracts was originally expected to be fixed and immutable for the duration of the program, the overarching effect of the COVID-19 pandemic has pushed Congress to consider stretching certain program boundaries as a tool for economic recovery.

On 6/4/2020, the IRS released Notice 2020-39,[2] which provides additional time to meet numerous requirements under Section 1400Z-2 and its now numerous implementing regulations. It also allows extensions with respect to certain QOZ requirements affected by COVID-19. The Notice also reaffirms the previous guidance offered in IRS Notice 2020-23[3] (which also extended certain QOZ deadlines).

Under the QOZ Law, U.S. taxpayers who have recognized short or long-term capital gain may invest the cash equivalent of their recognized gain into a Qualified Opportunity Fund within (originally) 180 days of their gain recognition date.[4] Provided that the gain is invested into a qualified asset and meets certain timing and deployment tests,[5] the investor can expect deferral of their original capital gain recognition until 12/31/2026 and, if the new investment is held more than 10 years, permanent non-recognition of federal long-term capital gain on the appreciation of that asset, which must ultimately be sold by 12/31/2047. Investors who elect this course and fund their Qualified Opportunity Fund by 12/31/2021 also pay less tax as of 12/31/2026 because their basis in the asset sold is increased by 10%, which effectively reduces the amount of deferred gain recognized by 10%.

Milestones met and missed; new challenges

The legislation's original community uplift goals were primarily the establishment of sustainable businesses, ongoing sources of employment, and the creation of new housing. Not surprisingly, the institutional real estate community reacted first, drawing fire from community advocates who viewed this activity as gentrification, or more pointedly skimming the cream from the opportunities provided without adding concomitant value to the community.

The development of "going businesses" in Zones has been disappointingly slower, in part due to the paucity of legal definition until final and proposed regulations were released in December 2019. Hoped for public-private partnerships and community foundation involvement have also been slow to emerge. The regulations are generally favorable to investment, though frequently demanding in their detail.

Unfortunately, starting three months after release of the regulations, many investment initiatives beginning to gain traction were at least temporarily derailed by the pandemic's effect on financial markets, making "re-start" dates highly uncertain as lenders and investors reevaluated their positions.

Anecdotal information and industry surveys to date suggest that developers and program sponsors for the most part remain committed to their projects, but that substantial new obstacles have arisen in the form of lender-related difficulties[6] and entitlement processing delays.[7] Also, there are increasing reports of failure of non-simultaneous exchanges in the current environment, with intended exchangors forming and investing in Qualified Opportunity Funds ("QOFs") as drop-back strategies.

Another layer of complication lies in the evolving tax proposals of the Biden campaign platform. Discomfort is felt by many high-income and high net worth taxpayers arising from the Biden campaign's QOZ Law motif that the law should "not exacerbate wealth inequality." Counterbalancing this, many potential investors who exited the equity markets and recognized 2020 gain around the early-year market downturn (and possibly casting a weather eye on post-election market volatility) now have reason to weigh the advantages of a QOZ investment against the probability of uncertainty in equities (and probably also tax law) in the years ahead.

The pandemic has also raised concerns about the percentage-testing framework for operating businesses defined in the December 2019 regulations and elsewhere in QOZ Law. With high percentages of employees and independent contractors working from home for the indefinite future, including offsite use of intangible property, major new compliance issues are presented. Luckily, new guidance released in May 2020 eased one burden. When applying the 90% asset test, ensuring that a QOZF qualifies under the QOZ rules, QOZFs do not need to take into account investments made in the preceding six months as long as the new assets are held in cash, cash equivalents, or debt instruments with a term of 18 months or less.

Where are the opportunities?

In light of improved understanding of how to utilize QOZ benefits in more diverse situations, this article encourages pursuit of innovative business models that align community needs with business goals. This value is core to the legislation. Enrolling local government and community stakeholders in the vision and correcting misconceptions about QOZ Law are not just desirable but critical. In building local alliances, nonprofit organizations can play a key mediating role as trusted proxies for underserved demographic groups in these communities to better gain acceptance and leverage results.

For QOZ investors, there is no substitute for thoroughly understanding the needs of the local community in order to create sustainable investment. Most investment opportunities in Zones will require some form of public agency approval, including development entitlements, use permits, and perhaps zoning changes.

Each Zone locale typically has at least four distinct groups of opinion leaders or gatekeepers: elected officials, agency staff, "stakeholder" organizations, and local residents. These officials and opinion leaders must be aligned with the investment goals and development vision. Parallel programs (for

instance, New Market Tax Credits or available property tax exemptions) may be “stacked” atop QOZ benefits, and there can be considerable local expertise brought to bear.

Because by this time many cities and counties have fixed preferences for the kinds of investment they wish to see, early engagement and quality communication are important. Nonprofit involvement can hasten and smooth the process, reducing friction.

Perceived gentrification and loss of existing housing stock should be addressed at the earliest possible date, including through interviews with occupants who may be displaced. For QOZ residential development programs, these concerns can be mitigated by such initiatives as moving existing houses to vacant lots and renovating them, creating a mixed-use element for neighborhood retail space, and partnering with a nonprofit job development program for employee training.

With the creation of new jobs, Zone payroll may leave the area if employees live elsewhere. Coordination with other QOZ developers may increase the opportunity for those workers to both live and work in the area, a double benefit.[8]

Another essential element is the extent to which the energy and creativity of millennial and younger residents and entrepreneurs can be harnessed. Micro-businesses, popups, and artisanal businesses generally require less capital and less startup time. They are uniquely attuned to neighborhood needs and can be grown in a Zone.

Certain areas of focus consistent with these factors are presented in the following pages.

Microcap local small business fund

Such opportunities can fall into two categories: (1) traditional businesses less sensitive to public health regulation, and (2) agile businesses conceived in part to minimize public health risks requiring social distancing. This approach should gain more attention in the near term as real estate overhead is now more challenging because customers are reluctant to be indoors in close quarters. Mall shopping and traditional restaurants and bars are two examples of business models negatively impacted by the COVID-19 restrictions.

A well-designed fund structure could step into the gap currently not filled by traditional SBA financing, SBA micro-loans, and like programs, and would provide equity to community-serving businesses (retailers, service companies, food trucks, produce stands, florists, popup enterprises, and the like), which not only provide jobs but also fill much-needed service gaps in underserved areas. The types of businesses envisioned normally have low barriers to entry and can be started on a relative shoestring.

These equity investment programs might be partnered with lending programs of fintech companies in order to make revolving lines more affordable to entrepreneurs. The investor could receive stock (convertible preferred or common), and as a program requirement would have the assurance that

accounting and cash management functions conform to certain standards. Periodic financial reports would be provided. Skills training would be available to the entrepreneurs.

Recent regulatory clarification provides that such businesses can be sold and proceeds reinvested within the 10-year holding period, provided that interim gains are taxable as inclusion events.[9] This salability provides operating flexibility for the fund. Here, one finds opportunities to collaborate with local zoning authorities, community funds, and nonprofits in adapting "best of breed" approaches from other cities that have injected life into moribund neighborhoods by inviting a lively, safe street life. Notably, legislation introduced in the U.S. House of Representatives (Rep. John R. Curtis, H.R. 6529) would extend QOZ treatment to investments, including those not deemed to be capital gains, into small businesses impacted by COVID-19. If passed, this legislation would widen planning opportunities for investing in local microcap businesses.

Co-working environments

Sturdy commercial buildings obsolete for their original use are ideal QOZ target investments for co-working adaptation. The reasons are numerous. First, the low-cost basis of the improvements makes it far more likely that a QOF or QOZB will be able to meet the standard of investment in excess of basis of improvements[10] which the QOZ Law requires. Second, the relative speed and simplicity of renovation is attractive. Third, cost segregation studies will provide an attractive depreciation feature. Fourth, the creation of a magnet for startup and early-stage talent is highly attractive to host communities. Fifth, successful startups can be incented to stay in a Zone, inviting more commercial renovation. Finally, co-working environments feed small local service businesses in the Zone.

Cities that have aggressively encouraged these developments do so knowing that a vibrant co-working culture can attract angel and venture funding to a community, setting the wheel of renewal in motion.

Technology incubators

Continuing the focus on lower-cost QOZ investment, technology startups need inexpensive office space, affordable but highly talented labor, and ongoing support. Incubators help kick-start the innovation process by providing the foundational expertise such early stage companies need to start and eventually scale.

While the combination of tax postponement and tax holiday offered by the QOZ Law would seemingly be attractive to organizers and managers of incubators, this reality has not (with few exceptions) been the experience to date. The traditional model of startup investment governing companies emerging from an incubator has continued to prevail, and proximity to talent and capital resources continue to be the dominant consideration.

Additionally, there is the impediment of having to stay within a Zone as a company grows (at least for the most part) in order to retain QOZ benefits. Perhaps more than any other area of QOZ growth, this

area cries out for state and local carrot-and-stick policy enactments which will push and pull incubator growth into Zones. Larger tech participants in incubator activity are publicly all about social justice and bold stances at this time, but their day-to-day practices frequently fall short. A modest investment into QOZ incubators and their support structure offers an authentic means of engagement with a diverse community.

Also, communities within Zones can provide local young tech-savvy or tech-ready job candidates[11] from local magnet and charter schools, already college-bound, as well as local tax or other incentives. Seasoned venture personnel will be integrated into the process and community, sharing their expertise but also offering their own investors a richer value proposition.

Community foundations, well-networked with major tech companies that support them, can make a world of difference as initiators and cheerleaders for such programs. The greatest challenge may be selling angel and venture investors, normally relentlessly bottom line-oriented, on the values of this approach, aiding them in recognizing the evolving norms of social and demographic equity. In some respects, "risk investors" can be the most wary of new investing models, despite their obvious advantages.

Medical and long-term care

COVID-19 has been a frightening lesson in the inadequate design and operation of current long-term and elder care facilities. Simply put, many such facilities have become deathtraps for the frailest. For those with the least resources or greatest medical vulnerabilities such as compromised immune systems, the experience has been even worse.

This limitation of care options strongly suggests that an overall redesign of facilities incorporating superior ventilation and air treatment, sterile environments, sunlight, and breakdown of personal isolation (and on the other hand well-designed isolation rooms for those at extreme risk) will be required to reduce infection and mortality in future outbreaks of disease. Cost will certainly be a major factor; setting aside the possibility of assistance from public programs, the easiest way to reduce cost is to buy inexpensive obsolete structures and retrofit them. This is the same logic used for co-working environments and should be an attractive model for reasons of cost basis, cost segregation studies, cash flow, and job creation.

Moreover, a safer facility is easier to market to families, who often pay the costs of such facilities on behalf of their loved ones. The facility itself would stay in the zone, meeting the 10-year rule, and if a safer facility meets its promises, its cash flow performance would enable it to eventually sell for a superior capitalization rate.

One apparent planning challenge will be to structure the lease to the facilities operator in such a way that it does not collide with the "triple-net-lease" bar in the QOZ Law.[12] A QOZB must be conducting an active trade or business, so structuring using solely triple-net-leases is problematic.

Under the proposed regulations and only for the purposes of determining whether a trade or business qualifies as a QOZB, the ownership and operation – including leasing – of real property qualifies as an active conduct of a trade or business. However, this requirement has been clarified such that merely entering into a triple-net-lease with respect to real property owned by a taxpayer does not constitute an active conduct of a trade or business by such taxpayer. Indeed, triple-net-leases are deemed to constitute passive activities similar to holding publicly traded stock or securities. Should the taxpayer's sole business consist of a single triple-net-lease of a property, the final regulations confirm that the taxpayer does not carry out an active trade or business with respect to that property.[13] However, an investment in both the real property and the operating business may well be structured in such a way that it constitutes an active trade or business under Section 469.

However, if a project involves multiple short-term leases on a triple-net basis in a multi-tenant building, the active business requirement can be met by showing that the landlord performs active property management and leasing activities, distinguishing his or her involvement from a traditional triple-net-lease of a single building.[14]

In a less-complicated way, QOZ Law can help disadvantaged communities hurdle the endemic lack of medical treatment facilities such as dialysis clinics, medical offices, urgent care, "FQ"-licensed medical facilities, and pharmacies.

Production of for-sale low/moderate income or workforce housing

The true opportunity in this area arises from the difficulties that low-moderate income housing builders have in assembling the crazy-quilt of financing necessary to create the housing, which in its owner-occupied form is typically deed-restricted. This area has received significant attention since the QOZ Law was enacted, but a dominant model has not emerged.

The related QOF product envisioned is a QOZB which provides financial assistance to buyers who would not otherwise qualify in a form that avoids nonqualified financial property rules. The value of the underlying property would be determined by an appraisal at the 10-year mark. At that time (or perhaps before with certain caveats), the participation interest of the QOZB could be financed out. Program criteria would be written to assure a rate similar to a higher-yield bond with the QOZ and potentially other tax benefits adding to higher effective yield. The most likely partners for this endeavor are community foundations and social purpose investment funds, which can typically act far more quickly and with less red tape than can state or local agencies offering bond programs. Current conditions arising out of COVID-19 create more risks and also opportunities in this area.

Multifamily rental housing

Equity participation programs are common in the rental housing space, particularly for market-rate projects. The helpful liberalization of the use of long-term ground leases by those whose ownership predates 1/1/2018 allows the landowner to avoid sale (and its recognition event) and still harness long-

term benefit from the ground lease. Provided certain tests are met, the ground lessor can invest in the ground lessee QOZB and thus participate in QOZ Law benefits of the new housing improvements[15] constructed without the constraints of the "related person" rule.[16]

The most frequent models are likely to contain a modest base rent figure plus either a percentage rent component or a component based on cost of living increase (possibly both). Most normally, the lease would be senior and unsubordinated to the remainder of the financing and priced by the market like a triple-net investment. These properties also could be mixed-use properties to provide greater community appeal.

Creating an integrated QOZ investment that meets the needs of the community will provide a runway for future phases of investment. Once community trust and investor trust are established, momentum follows. Multi-dimensional programs will be more likely to draw influential community partners and local government support. The QOZ benefits stand apart from other incentives and thus can be "stacked" to create an incentive model that is not only turbocharged in its tax attributes but also more socially impactful.

One excellent example is a program sponsor in the Northeast whose QOZ-related project is the rehabilitation of a certified historic structure. This entity will receive QOZ Law benefits, federal and state tax credits for rehabbing the historic structure, and energy credits for retrofitting for energy efficiency.

It is also encouraging that in July 2020, the New Market Tax Credits program was augmented as Treasury's Community Development Financial Institutions Fund ("CDFI Fund") announced that $3,548,485,000 in new tax credit allocations were awarded to 76 Community Development Entities in 30 states (one-fifth of the investments will be made in rural areas, which is also encouraging). Careful planning is particularly needed to maximize QOZ-created benefits when linked with other programs, and timing is always of the essence.

Some of the QOZ investment models above are only suitable for urban Opportunity Zones. Of course, Congress also had rural areas in mind when drafting this legislation, as demonstrated from the sheer number and size of non-urban census tracts designated as Zones. When studied in detail, these maps disclose thinly populated areas where conditions underlying the designation of a given census tract exhibit an embedded, normally multi-generational pattern of poverty, unemployment, or underemployment, complicated by unfavorable social conditions such as high rates of alcoholism and drug use. Examples include the large number of Zones with a preponderance of Native American population (throughout the West for the most part), former coal-mining areas (Appalachians), and areas where "industrialization" of agriculture has cut adrift many small communities historically reliant on small farming.

Congress did not have a ready answer for Zones in need of uplift but lacking the infrastructure to attract new business. The truth is that frequently a chasm exists between the needs of a community and the adequacy of its infrastructure necessary to accept investment. This gap may be service and transportation infrastructure (roads, rail, air terminals, power supply, warehousing, drinking water, or wastewater treatment), or human infrastructure (vocational job training, social services, health services, childcare, or basic education). The infrastructure gap frequently also consists of a lack of trained government personnel, particularly at the local agency level, as well as an adequate budget, to process QOZB proposals and development applications. Frequent agency shortfalls include lack of planning, environmental, traffic, and engineering staff. Local agencies without adequate staffing are then constrained to hire outside consulting help at considerable expense.

Many promising QOZ proposals have already been stymied by the inherent infrastructure runway several years long before a project can lift off. As of July 2020, when this article was written, one promising prospect in the newest wave of federal funding legislation being negotiated was a widely-supported proposal to fund over one trillion dollars to local governments for a wide variety of applications. This would undoubtedly help address the inadequacy of staffing resources.

The infrastructure gap is already being addressed in other ways. Congress has at least provided funding to the U.S. Department of Commerce's Economic Development Administration ("EDA") to underwrite a significant grant program to enable local agencies to begin to fill the infrastructure gap. As of the writing of this article, almost 400 grants have been made, either to be directly applied to a particular Zone or for application in adjacent tracts which will support activity within a Zone.

The EDA Opportunity Zones website is a trove of information on the grant purposes, locations, local agencies, and grant amounts. The site states that EDA "provides strategic investments through competitive grants that foster job creation and attract private investment to support development in economically distressed areas…." The purposeful direction of this grant program is also evidenced by EDA's encouragement to communities to "think of Opportunity Zone Investment as a new arrow in their quiver" and that the agency intends to "encourage public/private partnerships."

At this point, QOZ investment takes a hard turn off the four-lane highway of familiar linear project planning and execution into more rugged terrain. Long-term vision, team-building, and endurance are required to execute complex projects like these. In addition to pursuit of grants like those of EDA, stacking other grant or support programs or state and local tax concessions may be required.

An obstacle to a desirable project may be that its financial promise lies in cash flow more than long-term appreciation, and there may not be enough projected capital gain at the end of the minimum 10-year holding period to attract investors. For example, large-scale solar installations require significant infrastructure investment for "uptake" of the power produced locally, and the project's panels may be technologically obsolete in 10 years. In contrast, light manufacturing (e.g., furniture or building materials, particularly in light of proliferating tariffs on foreign goods) takes advantage of available labor

and raw materials and may be able to market directly to customers via the internet. Certain agricultural investments (orchards, vineyards, or pulpwood plantations) can also be excellent opportunities, even if not great engines of employment.

The report card

Two notable events in August 2020 underscored the Trump Administration's commitment to the QOZ program. The first was an August 2020 release by the GSA committing the government to a program of leasing or building agency facilities in Zones and not central business districts wherever possible. This was a policy announcement, therefore lacking in specifics, but the potential job creation, local employee housing, and creation of additional neighborhood-serving QOZBs are tantalizing to consider.

The second was the publication by the Council of Economic Advisors ("CEA") of an August 2020 economic study titled "The Impact of Opportunity Zones: An Initial Assessment."[17] The CEA report analyzed data through 2019, which was largely extracted from both SEC filings and voluntary industry reports to a database maintained by Novogradac, a private accounting and consulting firm.

A number of encouraging early-stage findings were made. The report reconciled the two databases in concluding that approximately $75,000,000,000 had been raised for QOZ investment through 12/31/2020. This sum, the report concludes, represented approximately 21% of the aggregate investment into QOZ tracts for all purposes during the relevant time period. Approximately $52,000,000,000 of the aggregate sums raised is estimated to be invested for QOZ tax-advantaged purposes. Private equity investment in QOFs and QOZBs grew at a rate 29% higher than the rate applicable to non-qualified tracts.

CEA projects that at least 1,000,000 persons will be lifted out of poverty and into self-sufficiency as the result of QOZ investment, decreasing poverty in Zones by an estimated 11%. Along those lines, real estate appreciation in Zones was estimated at 29% since program inception (a conclusion also supported by Zillow data), considerably higher than non-Zone real estate. There was found to be a concomitant high increase in value of single-family homes, creating equity which can be realized by the owner through refinancing or sale. Specifically, the report concludes that there has been $11,000,000,000 growth in Zone-located home equity to date, 47% of which is attributable to owner-occupants.

The report went to some length to favorably compare and contrast this program with other categories of programs, notably direct payment programs (direct financial assistance to recipients). "Place-based" programs such as New Market Tax Credits were also compared and contrasted, with particular comment on their narrower application. One assumes that in an election year there will be other studies forthcoming, perhaps some more critical.

Looking for hope

While the tax code and regulations can be forbidding and esoteric, the QOZ Law in practice casts a wide net of clear benefits to a diverse and vertical mix of taxpayers, as demonstrated by the following example. Note that all investments discussed below are done through a QOZF structure.

We shall assume a project to be located in South Los Angeles. Buy-in has been achieved from the city staff and elected officials as well as stakeholder not-for-profits — genuine community contributors — that provide services such as literacy training, job training, homeless support, employment assistance, art programs, child care, community gardens, and domestic abuse survival.

A suitable parcel of real estate can either be purchased in a Zone, or in compliance with the rules leased for a term, including a lease from a public agency. Ideally, the target property should be near mass transit. The property (exclusive of land cost) can then be improved by qualifying expenditures in excess of the cost basis of any existing improvements at date of purchase,[18] allowing time for entitlements to be pursued and received.[19]

Based on community needs, the developer may decide to develop a mixed-use property, with housing above businesses such as either neighborhood-serving uses such as hair salons and restaurants or retail stores (or if the direction is entrepreneurial, a startup incubator). The housing would address community needs by its allocation of pricing as low-income, moderate, or market-rate units. Within the limits of fair-housing laws, some housing preference for local workforce can be provided. Agency approvals may also include a prevailing wage requirement, a benefit to the community if local contractors are employed.

The developer would at each stage engage with local government and stakeholder groups as well as business owners leasing space in the development. An energized and continuous local conversation will generate cross-incentives and a healthy buzz to the benefit of all, certainly including the developer and its investors. The not-for-profit partners will provide a bridge into the local community, and if community support is attained and leveraged, support for follow-up projects will emerge. If desired, certain businesses can partner with select nonprofits to provide jobs to the community, both cost-effective as a labor source and a means of gaining neighborhood support.

New businesses in the community can leverage this goodwill. Those providing much-needed local services, often in short supply in the types of neighborhoods designated as Opportunity Zones, will find a ready market of customers. Retailers historically averse to depressed neighborhoods will also more easily be able to reconsider a decision to open in a Zone due to the incentives provided and ability to partner in the community (in our new reality, corporate outreach and diversity initiatives are increasingly expected and scrutinized).

Startup incubators will obtain inexpensive office space, the ability to partner with local schools for talent (including student internships), and the ability to shelter capital gains from investments in startup

companies. The participation of established venture talent in the opportunity zone neighborhoods will reflect positively on the funds in a time when social responsibility and giving back are highly valued among investors. Increasingly, certain institutional investors focusing on alternative funds are diversifying their portfolios to include those that have a social or diversity element. Los Angeles has a rich "Silicon Beach" startup scene along with local outposts of such heavyweights as Amazon and Google.

Tenants, including low-income and moderate-income persons, will find affordable new housing convenient to jobs and transit, shopping, and service options, while also being located in a thriving community. Neighborhoods will improve in diversity and quality of life. Despite the backlash from COVID-19, housing densification is inevitable long-term, and thus multi-story mixed-use properties will continue to increase.

Community funds and other local nonprofits can and should seize the opportunity to use their standing, relationships, and experience in the local community to further their missions of improving the community. By assertively forging partnerships with those creating housing and jobs, they improve their story for larger contributors – a critical step as their performance and results are more closely examined. Cultural and creative groups will find homes. Community gardens and outdoor gathering areas can be established as public/private open space in courtyards of the development, respecting both the need for community and social distancing norms. A paragon of the above, Los Angeles-based Homeboy Industries, has built a successful restaurant and bakery on a unique model: by giving gang members an option – a job – beyond staying in a gang.

Overall, by planning the QOZ project correctly and working with the local community, the social and tax benefits will increase the likelihood of success compared to a standard development. The QOZ provisions were created specifically to benefit economically challenged neighborhoods and provide incentive to turn them into vibrant and successful ones. Wise entrepreneurs will take advantage of these opportunities.

The near-term landscape

The effect of the pandemic upon QOZ programs may be one step more severe than its effect upon routine real estate investment programs. The toll taken on the industry since 3/1/2020 is of course far worse than initially expected (but no worse than most other asset classes). What we now know is that the underwriting requirements for construction and permanent financing have stiffened significantly, loan processing times have been lengthened, and lenders' attention has been diverted to more immediate portfolio performance issues. Public agencies' processing of entitlement applications and the conversion of public hearings to Zoom or equivalents has extended critical dates. For QOZ programs in particular, investors have one eye on projected needs for cash reserves and the other eye on QOZ timing requirements. As a result, consideration of such investments is more frequently delayed.

Now on the horizon is the Biden campaign platform, whose tax proposals amount to a sea change in the law. The probability of this plan becoming a reality increases exponentially if the Senate is flipped. For many observers, the most challenging proposal is the proposed increase in the capital gains tax rate to 39.6%. This change would create a substantial tax increase "gotcha" for those already invested in a QOZ project, as the capital gains on most of the initial investment was merely deferred. To be fair, this possibility has been widely foreseen for some time, but it is a real deterrent to potential investors. Hopefully, room for legislative adjustment in favor of those already invested in a socially-beneficial program will allow them to avoid the trap.

Commentators have speculated that higher capital gains rates may actually increase the attractiveness of the QOZ program, but when other proposed changes are also considered, this assertion may be a dubious proposition. In order to encourage midlevel, community-focused business and real estate ventures that require a longer planning and funding runway, the expiration date for QOZ investments could be lengthened by several years. This, especially combined with the extension of basis step-up provisions, would serve to counteract both additional "anti-abuse" strictures and near-term financing constraints.

Critics of the program have railed against "abuses," and while there have certainly been instances that invite criticism, the fact that "first adopters" in the real estate industry have immediately found clever ways of making money and still complying with the law should shock nobody.

Have the critics' heads been in the sand for the last 50 years? Sound policy suggests that the pitchforks and torches be stowed and attention instead paid to practical adjustments in the program that will promote public-private partnerships and joint ventures with nonprofits. Woke obsession with "abuses" does not invite investors and program sponsors.

The devil is indeed in the details here, and a course correction will be far more productive than a witch hunt. In that vein, additional reporting requirements that better enable analysis of dollars invested, jobs created, new community services provided, and new workforce housing units built will be useful. In fairness, the current Biden proposals broadly propose to incent programs which partner with nonprofits and community organizations which operate in Zones (see discussion above). It is hoped that reader input directed to policy makers on this point will emphasize the need for production of concrete economic benefits for all and clear, easy-to-apply standards in order to attract investors.

Finally, community foundations and those operating in the same space should step forward forcefully in advocating incentives and enablement. Overall, their positive participation in concrete QOZ programs has been anemic and leadership in this sector is barely visible.

Conclusion

A law that in its infancy was begotten as the product of an outwardly-happy political mixed marriage now faces a different future. The parents have ceased speaking to each other and have fallen into

recrimination. The custody battle is on. What are the prospects for the program's adolescent years? It may be joint custody, with frequent tussles between parents, or one party or the other may be adjudged by the public to be the primary custodial parent. Which will it be? Wisdom, we urge, lies always in the best interests of the child, who should know that it is loved equally by both parents (even for different reasons), and that its future is secure. So should it be here.

For more information on this topic and to answer any questions you may have, please contact your regular Withers attorney or the authors of this piece.

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Footnotes

1 P.L. 115-97, 12/22/2017.

2 Notice 2020-39, 2020-26 IRB 984.

3 Notice 2020-23, 2020-18 IRB 742.

4 However, for instances in which the 180-day rule falls between 4/1/2020 and 12/31/2020, Notice 2020-39, issued 6/4/2020, unexpectedly extended the final date in all such cases to 12/31/2020, providing additional flexibility for some.

5 These have also been liberalized for some by Notice 2020-39.

6 Many lenders have reassigned loan processing staff to new workout cases, forbearance requests, and portfolio evaluation. Underwriting standards have been stiffened throughout the industry and financing for a number of asset classes requiring intense public use (retail, restaurants, theaters as examples) has been seriously curtailed or made altogether unavailable. The pandemic backwash in the lending industry now appears likely to hamper financing for two years or more.

7 Public agency staff may have been depleted by furlough, reassignment, or diversion of funding. Hearings and application and plan processing are frequently delayed or rescheduled. Public hearings held online are clumsy at best and running behind schedule. Pandemic-related matters take priority on the agendas of elected bodies.

8 Unfortunately, the prospect of a prolonged pandemic has created another level of uncertainty arising from "shelter-in-place" ("SIP") orders and the prospective inability of workers in a QOZ-located business to continue to work within the Zone to the extent required to satisfy the "50% of gross income" revenue requirement of the regulations. It is hoped that Treasury will soon enact guidance providing that the 50% rule is tolled for the period of time that a particular QOZ was under a State of Emergency, whether federal, state, or local.

9 Reg. 1.1400Z2(a)-1(b)(1).

10 Reg. 1.1400Z2(a)-1(b)(11).

11 The well-known Cristo Rey model combining an academic program and part-time work is an example. Tech-oriented charter schools are a similar source of talent.

12 Reg. 1.1400Z2(d)-1(d)(3)(iii).

13 Reg. 1.1400Z2(d)-1(d)(3)(iii)(B).

14 Reg. 1.1400Z2(d)-1(d)(3)(iii)(C).

15 The land itself is not a qualifying asset, however.

16 Reg. 1.1400Z2(d)-2(b)(1)(i).

17 See https://www.whitehouse.gov/wp-content/uploads/2020/08/The-Impact-of-Opportunity-Zones-An-Initial-Assessment.pdf.

18 Reg. 1.1400Z2(d)-2(b)(4).

19 See Regs. 1.1400Z2(a)-1(b)(1), Regs. 1.1400Z2(d)-2(b)(4), Regs. 1.1400Z-2(d)(2)(D).