Opportunity Zone Rules Leave Out Data Reporting, Penalty Details.

- **Unclear if Treasury will provide a third set of regulations**
- **"Substantial improvement" likely to be re-litigated**

Proposed rules on opportunity zones left some holes—such as the breadth of data the government has the authority to collect on the funds and how the Internal Revenue Service will handle penalties.

The extent to which the IRS and Treasury Department will provide answers is unclear. Officials have said publicly that there will be three tranches of rules, with the April 17 batch being the second (REG-120186-18). But a Treasury official told reporters when the rules were released that the department doesn't have a set plan for a third round, and this latest batch could be the last "depending on the reactions of people invested in opportunity zones."

The 2017 tax law allowed those with profits from stock and other investments to defer tax on those gains if they invested the money in opportunity funds in select areas within 180 days of the sale of the stock or other asset, under tax code Section 1400Z-2. Investors can then shield part of the gain from tax if they hold onto the investment for long enough, and avoid capital gains tax on the appreciation of the opportunity fund investment altogether if they hold onto it for a decade.

Investors and think tanks are unlikely to keep their reactions quiet, particularly on the issue of data reporting, as people with capital gains to spend are rushing into a market with little to no required transparency. Whether the incentives get an extension from Congress may also depend on whether proponents can plausibly showcase the tax breaks' ability to lift low-income communities out of poverty.

Data Deep-Dive

The IRS issued a seven-page request for comments on how it should track the progress of the funds, or lack thereof. Comments can address areas like which sources and methods the government should use to collect data and how often it should be collected, the IRS said.

Procedural rules in the Senate meant that in order to pass the tax law, Republicans had to remove from the legislation a requirement for Treasury to report on the incentives' effects to Congress. The original authors of the opportunity zones legislation, Sens. Cory Booker (D-N.J.) and Tim Scott (R-S.C.), are planning to introduce a bill to reinstate those requirements.

Fund managers will have to file a Form 8996, reporting the amount of assets in the fund and the portion of assets that qualify for the tax breaks. This should enable Treasury to report some statistics, such as the number of funds and the aggregate amount of their investment, the IRS said in the comment request. But that information "lacks sufficient granularity," the document said.

Lisa Zarlenga, a partner at Steptoe & Johnson LLP and former tax legislative counsel at Treasury, said she expects a third round of regulations to address this issue, although there are other ways to go about mandating disclosure of information.

“They could probably do this in forms—they could expand the self-certification form to include this information,” Zarlenga said.

She added that while the IRS may want the protection of a regulation finalized after a proposal-an--comment process, they have released new forms and instructions before without that public input.

Cody Evans, a Stanford Graduate School of Business student who has researched the incentives and formed his own fund to invest in renewable energy in the Bay Area, called this issue “the elephant in the room.”

“We’re at a point where the legislation has been law for almost a year and a half and there are still no reporting requirements,” he said.

Investors have set up more than 100 funds with $26 billion in investing capacity, according to a list compiled by accounting and consulting firm Novogradac & Co. LLP.

Treasury may have prioritized questions of fund formation and structuring first, simply because there would be nothing to track in the first place if no one knew how to use the incentives, Evans said.

Penalties

The same logic applies to calculating and imposing penalties, which the agency also has yet to address: You can’t punish someone for breaking the rules if they don’t have any rules to work with.

The law imposes a penalty on funds that fail a test of whether at least 90 percent of their assets are held in “qualified opportunity zone property,” a classification that comes with its own percentage threshold tests.

The regulations said the IRS and Treasury expect to address rules under Section 1400Z-2(f)—the section describing the penalty, along with the information reporting requirements in separate regulations, forms, or publications.

“We don’t really know what the computation would be with the 90 percent test,” said Steve Kreinik, a partner at the accounting firm EisnerAmper in Miami, who focuses on tax and wealth advising. He added that if the IRS issues additional rules, penalties would likely be addressed.

Independent Contractors

The proposed rules provided three safe harbors for following a standard implemented by the first round of regulations—namely, that 50 percent of the fund’s gross income stem from active business conduct within its opportunity zone.

Two of those safe harbors allow businesses to base that 50 percent standard on services performed by employees and independent contractors. One safe harbor relies on the number of hours worked, and the other uses money paid for those services.

The extent to which the term “independent contractors” should apply is somewhat murky, said Forrest Milder, a partner at Nixon Peabody in Boston who focuses on tax-advantaged projects.

“I’m not exactly sure how you should know,” he said, suggesting that resellers could potentially fall into the definition, depending on the government's interpretation of the term. That could throw off the fund's ability to stay above the 50 percent threshold.

The rules did allow a "fact-and-circumstances" test to potentially catch anyone who didn't meet the safe harbor qualifications.

Substantially Improving a Business

An area likely to elicit blowback from businesses and investors is the way the proposed rules would apply to what is known as the "substantial improvement test" to operating businesses.

If a fund isn't just building a property or business from scratch, it has to "substantially improve" the business or property it buys by investing an amount at least equal to the price it paid in the acquisition. This is a relatively easier calculation to make when it comes to real estate as opposed to operating businesses, practitioners said.

The proposed rules would require funds to measure this improvement on an asset-by-asset basis, something the IRS acknowledged in the regulatory text would be difficult to quantify for operating businesses with diverse assets. The IRS asked for comments on the decision.

John Lettieri, president and CEO of the Economic Innovation Group, described this as a major footfall in otherwise very business-friendly regulations, given the accounting difficulties it creates. EIG helped create the incentives and has been lobbying Congress, Treasury, and the White House on them.

"Complexity is a subsidy to larger incumbents and advisers," he said. "The standard can be or should be the standard that Congress set, but the path to get there should be user-friendly."

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