CUTTING EDGE COUNSEL
LEGAL STRATEGIES FOR A NEW ECONOMY

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March 17, 2021

The Honorable Patrick Toomey
Senate Committee on Banking, Housing & Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Amendment to Opportunity Zone Law

Dear Senator Toomey,

In response to your recent request for legislative proposals to foster economic growth and capital formation, our firm Cutting Edge Counsel urges Congress to amend the Opportunity Zone law adopted in 2017 to clarify that its most important tax benefit is available to any taxable investor and not limited to those investing rolled over capital gains.

The Current Law

The Opportunity Zone law (Subchapter Z of the Internal Revenue Code, comprising Section 1400Z-1 et seq.) was adopted as part of the Tax Cuts and Jobs Act of 2017. Its purpose was to incentivize investment in low-income communities designated as Opportunity Zones. It did so by providing three tax benefits for investors in a Qualified Opportunity Fund (QOF) -- which is a fund 90% of whose assets comprise qualified Opportunity Zone property.

Subsection (a) of Section 1400Z-2 provides for an election to defer tax on capital gains rolled over into a QOF. Subsection (b) describes the step up in basis of that rolled-over deferred gain if held in the QOF for at least five or seven years before the 2026 tax event.

Subsection (c) of Section 1400Z-2 then provides as follows:

> (c) SPECIAL RULE FOR INVESTMENTS HELD FOR AT LEAST 10 YEARS.—In the case of ***any investment*** held by the taxpayer for at least 10 years and with respect to which the taxpayer makes ***an election under this clause***, the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged. [Emphasis added.]

It seems clear that the term “any investment” is to be construed broadly in order to give effect to its plain meaning. Had Congress intended to restrict this provision to only investments as to which an election was made under clause (a) (i.e. to rolled-over capital gains), it would not make sense to use the term “any investment.” It would have been more specific.

In addition, the reference to “an election under this clause” cannot refer to an election to defer capital gains tax, because that election is made under subsection (a), not subsection (c). If the language quoted above had instead referred to “an election under this section,” then that might be consistent with an intent to refer to an election to defer capital gains. But that is not what it says, and we cannot assume that “this clause” and “this section” mean the same thing. Elsewhere in the Tax Cuts and Jobs Act we find references to a “section” and a “clause.” A “clause” always refers to a subsection or other smaller subdivision of a section, and never to an entire section.

Hence, it appears that the Congressional intent of this statute is that the benefit of tax-free capital gains from an investment in a QOF held for ten years is available both to an investment of rolled-over capital gains and to any other investment of after-tax capital.

And it should be noted that of the three tax benefits of an investment in a QOF, this is ultimately the most valuable by far (depending, of course, on actual performance of a particular QOF), even if it receives less attention because it has no immediate effect on an investor’s taxes.

The Confusion

Nonetheless, there is a widespread assumption – fostered by the IRS – that this third tax benefit is only available to investors of rolled-over capital gains. This is not a mere technical issue. This is a fundamental reinterpretation of the law in a way that excludes the vast majority of Americans who do not have capital gains to roll over. Ultimately, what is at stake here is whether the Opportunity Fund law primarily benefits only wealthy investors with capital gains to roll over, or whether it is an inclusive tool that is available to *all* Americans.

The proposed Opportunity Zone rules released by the IRS on October 19, 2018, included the following statement in part V at page 17:

> The basis step-up election under section 1400Z-2(c) is available only for gains realized upon investments that were made in connection with a proper deferral election under section 1400Z-2(a).

That release did not provide any discussion or analysis for how this conclusion was reached. Our firm wrote to the IRS at that time pointing out the apparent mistake. When the final rules were subsequently issued on December 18, 2019, there was no overt statement such as that quoted above, but the IRS still seemed to maintain their position.

For example, on page 439 of the final rules we find the following statement:

> (iii) Limitation on the 10-year rule. As required by section 1400Z-2(e)(1) (treatment of investments with mixed funds), section 1400Z-2(c) applies only to the portion of an investment in a QOF that is a qualifying investment.

But this statement seems deceptively overbroad, because section 1400Z-2(e)(1) applies in a very limited situation. Section 1400Z-2(e)(1) reads as follows:

> (1) TREATMENT OF INVESTMENTS WITH MIXED FUNDS.—In the case of any investment in a qualified opportunity fund only a portion of which consists of investments of gain to which an election under subsection (a) is in effect—
>
> > (A) such investment shall be treated as 2 separate investments, consisting of—
> >
> > > (i) one investment that only includes amounts to which the election under subsection (a) applies, and
> >
> > > (ii) a separate investment consisting of other amounts, and
> >
> > (B) subsections (a), (b), and (c) shall only apply to the investment described in subparagraph (A)(i).

This section specifically addresses a situation where a single investment consists partially of rolled-over capital gains and partially of after-tax money. In that case, only the capital gains portion gets the tax benefits, and the after-tax investment does not – inexplicably including the subsection (c) benefit of tax-free capital gains for investments held in the QOF for ten years, though one wonders if that was simply a drafting error. This section does not address the situation where an investor without capital gains is simply investing after-tax money. And yet, the IRS seems to have extrapolated from this to assume that any investment of after-tax money should not be eligible for the subsection (c) tax benefits – even though, as explained earlier, that conclusion is contrary to the plain meaning of subsection (c).

Moreover, there does not appear to be any policy reason why an investment of after-tax money (including the after-tax portion of a “mixed funds” investment) should not be eligible for the subsection (c) tax benefits. Our reading of the history of Subchapter Z, including comments by its original proponents, suggests that it was never the purpose of the Opportunity Zone law to reward capital gains. Rather, the purpose was to incentivize investment in low-income communities. Offering a tax benefit to those with capital gains was simply a means to achieving that purpose, not the purpose in itself.

The Proposed Clarifying Amendment

This entire issue can be easily resolved by making a slight change to omit the reference to subsection (c) from subsection (e)(1). **Hence, we urge Congress to amend section 1400Z-2(e)(1)(B) as follows:**

(B) subsections (a)~~,~~ and (b)~~, and (c)~~ shall only apply to the investment described in subparagraph (A)(i).

As a result of this amendment, the after-tax portion of any mixed investment will be eligible for the subsection (c) benefit of tax-free capital gains for investments held in the QOF for ten years; and it will be more clear that this subsection (c) benefit is available to any investor of after-tax money, as it appears Congress originally intended.

Conclusion

The purpose of encouraging investment into low-income communities can be most effectively achieved by broadening the pool of capital that can be invested in QOFs and by broadening the class of investors who can take advantage of this tax benefit by so investing. We believe this small change in the law will result in much more investment going into QOFs.

And when residents of low-income communities can themselves invest in QOFs and have a voice in how QOF capital is deployed, we can be much more confident that low income communities will actually benefit from those investments, while helping to lift more people out of poverty and contributing to thriving local economies. This could be truly transformative.

Thank you for your consideration. Please contact us with any questions or to discuss this proposal.

Sincerely,

Cutting Edge Counsel

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