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COMMENTARY

NEW TREASURY REGULATIONS MAY OPEN FLOODGATES FOR FOREIGN INVESTMENT IN OPPORTUNITY ZONES, BUT QUESTIONS ON TAX IMPLICATIONS REMAIN

MICHAEL SHAW [*]

Foreign taxpayers may have a new avenue to avoid gain recognition from U.S. businesses and real estate: distressed American neighborhoods.

In a set of proposed rules released by the Treasury Department on April 12, the Internal Revenue Service set out requirements for certain foreign persons and foreign-owned partnerships to qualify for Opportunity Zone treatment.[1] Opportunity Zones are a federal designation of certain lower income areas for which investment can produce various tax benefits for taxpayers. Opportunity Zones are among the biggest creations in the 2017 Tax Cuts and Jobs Act, the Trump administration's overhaul of the Internal Revenue Code.[2]

The primary Opportunity Zone tax benefit comes from loosening the requirements for "like-kind" exchange treatment. Prior to the Tax Cuts and Jobs Act, to swap real property without triggering capital gains recognition, the exchanged property had to be of like-kind and held for productive use in a trade or business found in.[3] While technically outside the "like-kind" statue purview, the Opportunity Zone Program works like §1031 like-kind exchanges when investors divert gains from real estate and other qualified business activities located within designated Opportunity Zones into Opportunity Funds. These Opportunity Funds don't have to deal exclusively in like-kind property to recognize the tax benefit which has appeared to be a huge driver in Opportunity Zone investment.[4]

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[*]J.D. Candidate, Class of 2022, Arizona State University Sandra Day O'Connor College of Law.

[1] Prop. Treas. Reg. § 121095-19, 86 Fed. Reg. 19585 (Apr. 14, 2021)

[2] Mary Margert Frank and Jennings Heussner, *Opportunity Zones*, DARDEN CASE NOTE UVA-C-2429

[3] IRC §1031(a)(1)

[4] Libin Zhang (Nov. 20, 2020), *Three Years of Opportunity Zones and Outlook for 2021*, BLOOMBERG TAX, retrieved from https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3736450

Prior to the proposed regulation, Opportunity Funds were solely a domestic tax vehicle. This is because foreign taxpayers are subject to withholding on gains from U.S. business and real estate interests under an "Effectively Connected To" test.[5] Prior IRS comments published after the TCJA passed were unclear on how non-U.S. persons with gains located inside Opportunity Zones would be treated for tax purposes. The legislative intent of Opportunity Zones as a domestic economic driver coupled with the IRS's rules regarding withholding of gains of foreign real property interests quelled non-American appetite for early Opportunity Zone investment.[6]

Yet even with the proposed rules set to change, questions regarding timing and future implications for foreign Opportunity Zone investors remain. While the Opportunity Zone component of the TCJA received bipartisan support,[7] the Biden administration's intent to change various provisions of the TCJA call future applicability into question.

In any case, foreign investors interested in utilizing Opportunity Zones for expanded like-kind exchange treatment will want to act fast. As the provision and proposed regulations are written, the 10 percent capital gains deferral is only available to investments in Opportunity Funds made by the end of 2021, and the entire program is set to expire by 2026.[8]

In the meantime, the Treasury Department will receive comments and requests for public hearings on the rules until June 11, 2021.[9]

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[5] Lydia O'Neal (Apr. 12, 2021), *IRS Opens Doors for Foreign Investors in Opportunity Zones*, BLOOMBERG TAX, https://www.bloomberglaw.com/product/tax/bloombergtaxnews/true/X1P0VRP4000000?bna_news_filter=true#jcite

[6] *Id*.

[7] Press Release, Sen. Cory Booker, Booker, Wyden, Lewis, Neal Request GAO Study on Opportunity Zones (Nov. 7, 2019), https://www.booker.senate.gov/?p=press_release&id=1011

[8] Lydia O'Neal (Apr. 13, 2021), *Foreign Investors Face Hurdles Under New Rules*, BLOOMBERG TAX, https://www.bloomberglaw.com/product/tax/bloombergtaxnews/daily-tax-report/X86DNJ58000000?bna_news_filter=daily-tax-report#jcite

[9] Prop. Treas. Reg. § 121095-19, 86 Fed. Reg. 19585, 19586 (Apr. 14, 2021)