

2022

Rebuilding Puerto Rico with Opportunity Zones Incentives, 56 UIC L. Rev. 27 (2022)

Adam Wallwork

Gary Hecimovich

Follow this and additional works at: <https://repository.law.uic.edu/lawreview>



Part of the [Law Commons](#)

Recommended Citation

Adam Wallwork & Gary Hecimovich, Rebuilding Puerto Rico with Opportunity Zones Incentives, 56 UIC L. Rev. 27 (2022)

<https://repository.law.uic.edu/lawreview/vol56/iss1/2>

This Article is brought to you for free and open access by UIC Law Open Access Repository. It has been accepted for inclusion in UIC Law Review by an authorized administrator of UIC Law Open Access Repository. For more information, please contact repository@jmls.edu.

REBUILDING PUERTO RICO WITH OPPORTUNITY ZONE INCENTIVES

ADAM WALLWORK AND GARY HECIMOVICH*

When Hurricane Maria hit Puerto Rico in September 2017, after more than a decade of economic recession, outward migration, and fiscal crisis, it caused catastrophic damage to the island's infrastructure, its people, and its businesses. In response, Congress enacted bipartisan legislation that used a new federal tax incentive program for economically distressed communities known as "qualified opportunity zones" ("QOZs"). The QOZ program provides very favorable tax treatment of investments in virtually any trade or business located within a low-income census tract designated by state and territorial governors and the mayor of the District of Columbia to encourage new capital investment by U.S. businesses in Puerto Rico. Taxpayers who invest in QOZs (through specialized investment vehicles known as "qualified opportunity funds" or "QOFs") and hold the investment for certain prescribed periods of time can (1) defer capital gain invested in the fund through 2026, (2) receive forgiveness of a portion of the deferred gain, and (3) exclude gain from post-acquisition appreciation in the investment from the federal income tax base. The Bipartisan Budget Act of 2018 transformed all of Puerto Rico's low-income communities, along with certain contiguous tracts, into opportunity zones, making approximately 98 percent of the island into a federally-designated opportunity zone, where new investments, under certain conditions, may be eligible for capital gains deferral and relief, as well as unlimited tax-free appreciation through 2047.

This article explains how Puerto Rico's unique status under the federal opportunity zone program, enhanced by local legislation, may make tax incentives a fundamental feature of many U.S. taxpayers' business strategy for investing in Puerto Rico. And, as a matter of policy, this article's in-depth examination of Puerto Rico's concatenated framework for incentivizing local priority projects in opportunity zones provides an important case study for policymakers across the country considering their own counterparts to the federal opportunity zone program, as more and more jurisdictions adopt local laws designed to channel some of the more than \$75 billion in private capital that has flowed into distressed communities under the federal program toward specified projects that benefit local communities and their residents.

I.	INTRODUCTION.....	28
II.	THE UNIQUE STATUS OF PUERTO RICO AS A QUALIFIED OPPORTUNITY ZONE	37
III.	FEDERAL TAX INCENTIVES FOR INVESTING IN OPPORTUNITY ZONES... 39	
	A. Qualified Opportunity Zones	39
	B. Qualified Opportunity Funds.....	41

*Adam Wallwork is a Manager and Gary Hecimovich is a Partner in the Washington National Tax Office of Deloitte Tax LLP. Their practice focuses on federal income tax credits and incentives.

This article does not constitute tax, legal, or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader's particular situation.

C. Qualified Opportunity Zone Property	43
D. Qualified Opportunity Zone Businesses.....	43
E. Qualified Opportunity Zone Business Property	48
F. Combining QOZ Incentives with Other Tax Incentive Programs.....	55
IV. PUERTO RICO QUALIFIED OPPORTUNITY ZONE PROGRAM	55
A. Priority Project within Puerto Rico’s Opportunity Zones	57
B. Exemption Certificate	59
C. Tax Benefits Under Act 60	60
V. CONCLUSION.....	70
APPENDIX A: QUALIFIED OPPORTUNITY ZONES NATIONWIDE.....	71

I. INTRODUCTION

On December 22, 2017, Congress authorized the creation of “qualified opportunity zones” as part of the 2017 tax reform legislation, popularly known as the Tax Cuts and Jobs Act of 2017 (“TCJA”),¹ and later expanded its scope to include most of Puerto Rico under the Bipartisan Budget Act of 2018.² Section 1400Z-1 of the Internal Revenue Code of 1986, as amended (“Code” or “I.R.C.”) provides for the designation of certain economically distressed communities, where under certain conditions set forth in section 1400Z-2, new investments may be eligible for preferential tax treatment.³ A total of 8,764 QOZs have been designated in all 50 states, the District of Columbia, and five U.S. territories to spur economic development by providing tax incentives for investors who invest new capital in businesses operating in one or more QOZs.⁴ Approximately 11 percent of the U.S. population lives in a QOZ,⁵ and nearly 12 percent of all inhabited census tracts in the United States are QOZs.⁶

1. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054, 2184, § 13823 (Dec. 22, 2017) (codified, as amended, at section 1400Z-1 and section 1400Z-2).

2. Bipartisan Budget Act of 2018, Pub. L. No. 115-123, 132 Stat. 64, 161 § 41115 (Feb. 9, 2018) (codified, as amended, at section 1400Z-1(b)(3)).

3. I.R.C. §§ 1400Z-1 and 1400Z-2, added by the legislation commonly known as the Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054, 2184, § 13823(a) (Dec. 22, 2017), as amended by Bipartisan Budget Act of 2018, Pub. L. No. 115-123, 132 Stat. 64, 161 § 41115 (Feb. 9, 2018) (codified as amended at section 1400Z-1 and section 1400Z-2).

4. See Notice 2018-48, 2018-28 I.R.B. 9 (Jul. 9, 2018) (listing 8,762 census tracts designated as QOZs), as amplified by Notice 2019-42, 2019-29 I.R.B. 352 (Jul. 15, 2019) (adding two additional census tracts in Puerto Rico pursuant to automatic designation procedures under section 1400Z-1(b)(3)).

5. White House Opportunity and Revitalization Council, *Report to the President from the White House Opportunity and Revitalization Council*, 1, 143 (Dec. 2019) (“Nearly 35 million Americans live in communities designated as Qualified Opportunity Zones. . .”).

6. 8,764 QOZ census tracts of 74,134 inhabited U.S. census tracts (11.82%). See Community Development Financial Institutions Fund (CDFI Fund), U.S. Dep’t of the Treasury, *List of Designated Qualified Opportunity Zones* (Dec. 14, 2018) (QOZs); U.S.

The QOZ program is intended to encourage investment in distressed communities by providing federal tax benefits to investors, through QOFs, in designated “low-income communities,” as defined by section 45D(e) of the Code. This section requires that a population census tract satisfy one of the following criteria for economic distress:⁷

- (1) The poverty rate for the tract is at least 20 percent;⁸
- (2) For a tract not located in a metropolitan area, the median family income for the tract does not exceed 80 percent of the statewide (or possession-wide) median family income;⁹
- (3) For a census tract in a metropolitan area, the median family income for the tract does not exceed 80 percent of greater of (a) the statewide (or possession-wide) median family income or (b) the metropolitan area median family income;¹⁰
- (4) The tract (a) has a population of less than 2,000, (b) is located in an empowerment zone, and (c) is contiguous with a low-income community that has a poverty rate of at least 20 percent or a median family income that does not exceed 80 percent of the statewide median (or, if relevant, the metropolitan area median family income);¹¹ or
- (5) The tract (a) is located in a high-migration rural county with a net outward migration of at least 10 percent of the county’s population during a 20-year period ending with the year in which the most recent census was conducted and (b) the median family income for the tract does not exceed 85 percent of the statewide (or possession-wide) median family income.¹²

Census Bureau, Annual Estimates of the Resident Population for the United States, Regions, States, and the District of Columbia: April 1, 2010 to July 1, 2020 (NST-EST2020) (listing the resident population of the United States as 329,484,123); U.S. Census Bureau, 2010 Census Geographic Entity Tallies by State and Type, available at: www2.census.gov/geo/docs/maps-data/data/geo_tallies/2010talliesbystate.xls [perma.cc/ED8Y-D2KB] (last visited: Sept. 7, 2022) (listing 74,134 U.S. census tracts in the United States and its territories, excluding 366 “water only” census tracts).

7. I.R.C. § 1400Z-1(a)–(e) (providing criteria for designation of low-income communities, together with certain of their contiguous tracts, as QOZs); H.R. Rep. No. 115-466, 163 Cong. Rec., 537-540 (Dec. 15, 2017) (explaining that opportunity zones are being established to allow for “the designation of certain low-income community population census tracts as qualified opportunity zones, where low-income communities are defined in Section 45D(e),” and provide “tax incentives to encourage investment in qualified opportunity zones.”).

8. I.R.C. § 45D(e)(1)(A).

9. I.R.C. § 45D(e)(1)(B)(i).

10. I.R.C. § 45D(e)(1)(B)(ii).

11. I.R.C. § 45D(e)(4).

12. I.R.C. § 45D(e)(5).

Nearly 98 percent of all QOZs (8,566) satisfy the above criteria for being a low-income community; the remaining 198 census tracts designated as QOZs are contiguous with a low-income community designated as a QOZ and have a median family income that does not exceed 125 percent that of the low-income community with which the tract is contiguous.¹³

Electing taxpayers are able to defer, and in some cases permanently exclude, certain capital gains and section 1231 gains realized on or before December 31, 2026, by investing in a QOF.¹⁴ Section 1231 gains are gains arising from the disposition (including involuntary conversion) of depreciable or real property used in a trade or business that is held for more than one year.¹⁵ Depreciable and real property used in a trade or business are excluded from the definition of a capital asset under section 1221(a)(2) of the Code.¹⁶ However, gain from the sale, exchange or involuntary conversion of such property may nonetheless qualify for long-term capital gains treatment under section 1231.¹⁷ Section 1231 property includes (i) real property used in the trade or business and held for more than one year, (ii) depreciable property used in the trade or business and held for more than one year, (iii) a copyright, literary, musical, or artistic composition, (iv) cut timber or timber sold under a cutting contract with a retained economic interest to the extent considered as arising from a sale or exchange by reason of Code section 631(a) or (b), (v) coal with a retained economic interest that is held for more than one year before disposal by the owner under section 631(c) of the Code, (vi) domestic iron ore with a retained economic interest that is held for more than one year before disposal by the owner under section 631(c) of the Code, (vii) harvested crops on land used in the taxpayer's trade or business and held for more than one year, and (viii) livestock held within prescribed holdings periods.¹⁸ Generally, section 1231 gives taxpayers the benefit of paying capital gains tax rates on gains recognized from sales and exchanges of section 1231 property, while enabling them to treat losses from sales and exchanges of that property as ordinary losses.¹⁹

The ability to defer, and potentially escape, taxation on certain capital gains is valuable to investors who would otherwise be required to

13. I.R.S. Notice 2018-48, 2018-28 I.R.B. 9 (Jul. 9, 2018). *See also* Notice 2019-42, 2019-29 I.R.B. 352 (Oct. 10, 2019) (both collectively list every designated qualified opportunity zone). *See also* I.R.C. § 1400Z-1(e) (limiting contiguous tracts other than low-income communities to not more than 5% of the population census tracts designated in a state, U.S. territory or the District of Columbia).

14. I.R.C. § 1400Z-2(a)(1)(A); I.R.C. § 1400Z-2(b)(2)(B)(iii); I.R.C. § 1400Z-2(b)(2)(B)(iv).

15. I.R.C. § 1231(a)(3)(A); I.R.C. § 1231(b)(1)– (4); Treas. Reg. § 1.1231-1(c)(1)– (5); Treas. Reg. § 1.1231-1(e)(1).

16. I.R.C. § 1221(a)(2).

17. I.R.C. § 1231(a)(1).

18. *See* I.R.C. § 1231(a)(3)(A)(i); I.R.C. § 1231(b)(1)– (4); Treas. Reg. § 1.1231-1(c)(1)– (5) (defining transactions to which section 1231 applies).

19. I.R.C. § 1231(a)(1)– (2).

pay a liability in an earlier year.²⁰ The immediate recognition of income from the disposition of assets is a cost that taxpayers who invest in a QOF can temporarily avoid.²¹ For the same reason that income earned five years from now is less valuable than income earned today, due to the time-value money, the potential to earn interest in the interim and the risk of inflation, the cost of a tax liability payable in five years is less than it would be if income on a disposition of a capital asset were subject to immediate taxation.²² The ability to defer taxation on section 1231 property is even more valuable, since taxpayers with section 1231 gains and losses can defer the gains and recognize the losses at ordinary income rates (currently, maxing out at 40.8 percent, including the 37 percent ordinary income tax and 3.8 percent net investment income tax) and recognize the losses more than five years later at capital gains rates (currently, maxing out at 23.8 percent, including a 20 percent tax on long-term capital gains, plus a 3.8 percent net investment income tax).²³ In the absence of deferral, the recapture rules under section 1231(c) generally require net section 1231 losses recognized within five years of a net section 1231 gain for a taxable year to be recaptured as ordinary income, rather than capital gain.²⁴ Thus, in certain circumstances, the taxpayer's ability to defer section 1231 gain from QOF investments may result in a permanent 17 percent tax rate arbitrage, along with the normal time-value differential that accompanies the deferral of income tax until 2027 on gains recognized as early as 2017.²⁵ To be eligible for deferral of eligible gain (that is, capital gain or section 1231 gain), within 180 days of an actual or deemed sale or exchange, the taxpayer must generally invest cash or other property in a QOF.²⁶

The 2017 TCJA²⁷ created opportunity zones to spur economic development in depressed communities throughout the United States by providing tax benefits to investors who make qualifying investments in

20. See generally Christopher H. Hanna, *The Real Value of Tax Deferral*, 61 FLA. L. REV. 203, 203 (2009) (“[D]eferral of gain is not as serious as outright exemption, but it is the next best thing.”) (internal quotations omitted).

21. I.R.C. § 1400Z-2(a)-(b).

22. See Hanna, *supra* note 20, at 203 (“Even if tax rates remain constant over time, there is a time value of money benefit in deferring the payment of taxes.”).

23. See Blake Christian & Joseph Darby, *O-Zone Alchemy: Turning Net 1231 Gains Into Gross 1231 (Gains and Losses)*, BLOOMBERG LAW NEWS (Mar. 4, 2020), news.bloombergtax.com/daily-tax-report/o-zone-alchemy-turning-net-1231-gains-into-gross-1231-gains-and-losses [perma.cc/3C6E-PSTQ]; Adam Wallwork & Gary Hecimovich, *COVID-19 Relief for Opportunity Zone Funds and Investors*, 71 CLEV. ST. L. REV. (2022) (forthcoming).

24. I.R.C. § 1231(c)(1)-(2).

25. See Christian & Darby, *supra* note 23.

26. See I.R.C. § 1400Z-2(a)(1)(A); Treas. Reg. § 1.1400Z2(c)-1(b)(1) (restricting fair market value basis step up election after 10-year holding period to “[a]n eligible taxpayer who makes a deferral election with respect to, or acquires by reason of a transaction that is not an inclusion event, a qualifying investment in a QOF. . .”).

27. An Act to Provide the Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, §13823(a), 131 Stat. 2054, 2184 (Dec. 22, 2017) (commonly known as the “Tax Cuts and Job Act of 2017” or “TCJA”).

such zones.²⁸ In exchange for a lower capital gains rate that decreases based on the length of the investment, investors that realize gain from a sale or exchange of a capital asset or business property held for more than one year (known as section 1231 gain) can put those dollars to work in a meaningful and productive way under a tax stimulus program designed to grow jobs, inspire entrepreneurship, and improve the local economy in lower-income communities across the country designated as QOZs.²⁹

35 million Americans live in the 8,764 census tracts that have been designated as QOZs,³⁰ which generally cover economically distressed areas that have been economically left behind as the rest of the American economic has surged ahead.³¹ Every state, the District of Columbia, and five U.S. territories have QOZs. Puerto Rico has 863.³² The average poverty rate of QOZs is 26.4 percent.³³ 54 percent of the country's census tracts that have lived in poverty since 1980 are QOZs,³⁴ and more adults in opportunity zones lack a high school diploma than have a college

28. I.R.C. §§ 1400Z-1, 1400Z-2, added by An Act to Provide the Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, §13823(a), 131 Stat. 2054, 2184 (Dec. 22, 2017) (commonly known as the "Tax Cuts and Job Act of 2017" or "TCJA"), as amended by Bipartisan Budget Act of 2018, Pub. L. No. 115-123, 132 Stat. 64, 161 § 41115 (Feb. 9, 2018), codified, as amended, at I.R.C. § 1400Z-1(b)(3) (providing special rules for the automatic designation of opportunity zones in Puerto Rico).

29. See I.R.C. § 1400Z-2(a)(1)(A) (providing for the deferral of certain gain rolled over into a qualified opportunity fund); I.R.C. § 1400Z-2(b)(2)(B)(iii) (increasing by 10 percent the adjusted basis in a taxpayer's qualified opportunity fund investment after a holding period of 5 years); I.R.C. § 1400Z-2(b)(2)(B)(iv) (further increasing by another 5 percent a taxpayer's adjusted basis in a qualified opportunity fund after a 7-year holding period); I.R.C. § 1400Z-2(c) (increasing, after a 10-year holding period, a taxpayer's adjusted basis in a qualified opportunity fund to the fair market value of the investment at the election of the taxpayer upon a sale or exchange); Treas. Reg. § 1.1400Z2(a)-1(b)(11)(i)(A)-(C) (defining gains eligible for deferral for purposes of the QOZ program); Executive Order No. 13853 (Dec. 12, 2018) (establishing the White House Opportunity and Revitalization Council and describing the purposes of the QOZ program).

30. White House Opportunity and Revitalization Council, *supra* note 5, at 143. (stating that "[n]early 35 million Americans live in communities designated as Qualified Opportunity Zones.")

31. S. 4065, 117th Cong. § 2 (introduced Apr. 7, 2022); H.R. 7467, 117th Cong. § 2 (introduced Apr. 7, 2022) ("The 8,764 population census tracts designated as qualified opportunity zones under section 1400Z-1 of the Internal Revenue Code of 1986 span across all 50 States, the District of Columbia, and 5 Territories and overwhelmingly represent communities that have been economically left behind as the American economy has surged forward.")

32. See Notice 2018-48, 2018-28 I.R.B. 9 (Jul. 9, 2018), as amplified by Notice 2019-42, 2019-29 I.R.B. 352 (Jul. 15, 2019). The U.S. possessions where QOZs have been designated are American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands. See I.R.S. Notice 2018-48, 2018-28 I.R.B. 9 (Jul. 9, 2018), as modified by, I.R.S. Notice 2019-42, 2019-29 I.R.B. 352 (Jul. 15, 2019) (increasing from 861 to 863 the total number of QOZs in Puerto Rico).

33. H.R. 7467, 117th Cong. § 2 (introduced Apr. 7, 2022) (setting forth findings of fact with respect to the census tracts designated as qualified opportunity zones under section 1400Z-1 of the Internal Revenue Code of 1986).

34. *Id.*

degree.³⁵

The federal QOZ program created by the TCJA under sections 1400Z-1 and 1400Z-2 of the Code, together with complementary state and local legislation,³⁶ established a range of new geographically-focused economic incentives for private sector investors designed to connect private capital to businesses located in relatively impoverished parts of the United States with little or no economic growth since the end of the Great Recession.³⁷

Governors (other than the Governor of Puerto Rico) and the Mayor of the District of Columbia generally chose which census tracts should be designated as QOZs from among those eligible for designation based on (1) having a poverty rate of at least 20 percent (“high-poverty tracts”),³⁸ (2) having a median income at least 20 percent below that in the surrounding state, territory or metropolitan area, whichever is higher (“low-income tracts” and together with high-poverty tracts, collectively, the “low-income communities”),³⁹ or (3) being contiguous with a high-poverty or low-income tract designated as a QOZ and having a median income not exceeding 125 percent that of the qualifying contiguous

35. *Id.*

36. *See, e.g.*, OHIO REV. CODE ANN. § 122.84 (2021) (10% Ohio QOZ credit); CONN. GEN. STATE. § 32-9t(g)(1) (2012) (Connecticut QOZ credit priority); P.R. S.B. 1147, *An Act to create the Puerto Rico Economic Development and Opportunity Zones Act of 2019*, Act No. 21-2019, Statement of Motives, at *3 (Apr. 14, 2019) (“[D]evelopments designated as Priority Projects within opportunity zones are hereby declared as a compelling interest [of the Government of Puerto Rico] pursuant to this Act, since they shall, among other things, attract private investment to the Island that otherwise would not exist, thus helping its economic development and creating jobs at such a critical time for Puerto Rico’s economy.”).

37. *See* Jared Bernstein & Kevin A. Hassett, *Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas*, ECONOMIC INNOVATION GROUP 1, 16–20 (Apr. 2015) (proposing that Congress permit a “stepped up” capital gains basis for taxpayers who roll over unrealized gains from a “stock market [that] has reached all-time highs” into investments in enterprises within qualifying investment zones as a means of “stimulating economic growth and facilitating the creation of new jobs in areas of the country struggling the most . . . [i]n the aftermath of the Great Recession, [with] long-term unemployment, slow growth, and a lack of quality employment . . .”). *See also* Treas. Reg. § 1.1400Z2(f)-1(c)(1) (“The purposes of section 1400Z-2 and the section 1400Z-2 regulations are to provide specified Federal income tax benefits to owners of QOFs to encourage the making of longer-term investments, through QOFs and qualified opportunity zone businesses, of new capital in one or more qualified opportunity zones and to increase the economic growth of such qualified opportunity zones.”).

38. I.R.C. § 1400Z-1(a) (“For the purposes of this subchapter, the term “qualified opportunity zone” means a population census tract that is a low-income community that is designated as a qualified opportunity zone.”); I.R.C. §1400Z-1(c)(1) (defining the term “low-income community” as having “the same meaning as when used in section 45D(e)” for purposes of the New Markets Tax Credit); I.R.C. § 45D(e)(1) (generally defining a “low-income” community as any population census tract if: (1) the poverty rate for such tract is at least 20 percent; or (2) the median family for such tract does not exceed 80 percent of the statewide median family income, or for a census tract in a metropolitan area, 80 percent of the metropolitan area median family income, if higher than the statewide median).

39. I.R.C. § 1400Z-1(a); I.R.C. §45D(e)(1).

census tracts (“eligible contiguous tracts”).⁴⁰ Congress automatically designated all of Puerto Rico’s low-income communities, together with their respective eligible contiguous tracts, as QOZs, exempting the commonwealth from the formal nomination and designation process applicable to all other jurisdictions of the United States.⁴¹

Following the enactment of the TCJA, federal and, increasingly, state and local tax incentives have been targeted to eligible taxpayers that roll over capital gains from prior investments into longer-term business development investments in regions in need of economic development.⁴² In the wake of widespread economic hardship throughout the United States caused by the SARS-CoV-2 (COVID-19) pandemic, with restaurants, bars, gyms, malls, retail stores, hotels, theatres, sports arenas, concert halls, and other customer-facing businesses shuttered or operating at reduced capacity to minimize the public’s exposure to the virus, a number of legislative proposals have been introduced in Congress to expand the scope or impact of federal tax incentives created under the QOZ program. Including, but not limited to, bills that would respectively designate certain small businesses affected by COVID-19 as eligible recipients of tax-advantaged capital under section 1400Z-2,⁴³ establish a new 30-percent federal income tax credit for pharmaceutical, medical device, and

40. I.R.C. § 1400Z-1(e) (authorizing the designation by any state of not more than 5 percent of its total number of qualified opportunity zones from among those population census tracts that are contiguous with a low-income community that is designated as a qualified opportunity zone, provided that the median family income of the contiguous tract does not exceed 125 percent of the median family income of the low-income community with which the tract is contiguous).

41. See Bipartisan Budget Act of 2018, Pub. L. No. 115-123, §41115, codified, as amended, I.R.C. §1400Z-1(b)(3). See also I.R.S. Notice 2019-42, 2019-29 I.R.B. 352 (Jul. 15, 2019) (“Section 41115 of the Bipartisan Budget Act of 2018, P.L.115-123 (BBA), enacted on February 9, 2018, added § 1400Z-1(b)(3) to the Code. Section 1400Z-1(b)(3) provides that each population census tract that is a low-income community (LIC) in Puerto Rico shall be deemed certified and designated as a QOZ effective on December 22, 2017, the date on which the TCJA was enacted. Thus, 100 percent of Puerto Rico’s LICs are deemed certified [as QOZs].”).

42. For the policy rationale behind the geographically targeted QOZ tax incentives, see Senate Majority Leader Mitch McConnell (R-Ky), 164 CONG. REC. 23, S617, S618 (Feb. 6, 2018) (describing the special tax incentives under the opportunity zone program as a creative new solution to stimulate job creation and wage growth in many struggling rural areas, small cities and suburbs across the United States left behind by an uneven economic recovery in which 75% of the new jobs that were created from 2010 to 2016 went to major metropolitan areas and only 3% went to rural America); Press Release, Sen. Tim Scott (R-S.C.), *‘Opportunity zones’ aim to give neighborhoods an economic boost* (Apr. 27, 2018) (explaining that opportunity zones were being designated in neighborhoods that remained downtrodden 10 years after the Great Recession as “part of a new initiative included in the federal tax law passed [in 2017,] designed to encourage investments in low-income areas left behind by the economic recovery.”); Adam S. Wallwork & Linda B. Schakel, *Primer on Qualified Opportunity Zones*, 159 TAX NOTES 945, 946–55 (May 14, 2018) (collecting citations relating to the opportunity zone program’s legislative history).

43. H.R. 6529, 116th Cong., 2d Sess., § 1 (introduced Apr. 17, 2020) (“COVID-19-Impacted Small Business Opportunity Zone Act”).

personal protective equipment production in certain QOZs,⁴⁴ and designate all of Puerto Rico as a QOZ.⁴⁵ This last bill, introduced on July 6, 2020 by Jenniffer González-Cólon (R-P.R.), Puerto Rico's non-voting member of the U.S. House of Representatives, would further expand the special status of Puerto Rico under the QOZ Program, which already includes a higher proportion of QOZs, as a percentage of population, than any other U.S. state or possession.⁴⁶ Puerto Rico's 863 population census tracts designated as QOZs exceeds the number of tracts designated in every other U.S. jurisdiction, except for California, which has 879 QOZ census tracts, and exceeds every other U.S. jurisdiction as a percentage of population.⁴⁷

The chart in Appendix A illustrates the impact of section 1400Z-1(b)(3)'s automatic designation of all of Puerto Rico's low-income communities as QOZs, compared to other jurisdictions that were generally limited to several QOZs not exceeding 25 census tracts or, if larger, 25 percent of the state's total number of low-income communities.⁴⁸

Investments by U.S. taxpayers in Puerto Rico through October 2027 may result in reduced capital gains, potentially permanently, from prior investments that are rolled over within 180 days into a specialized fund, operating in one of Puerto Rico's QOZs, as well as the ability to realize tax-free gains from any post-acquisition appreciation in the value of the taxpayer's investment in such a fund after a 10-year holding period.⁴⁹

44. H.R. 6930, 116th Cong., 2d Sess., § 201 (introduced May 19, 2020, passed House Apr. 5, 2022) (establishing a new general business credit under Code Section 38(b) known as the distressed zone pharmaceutical and medical device production credit and limiting the credit to production activities within a population census tract (A) which has been designated as a QOZ under Section 1400Z-1 of the Code, and (B) which has a poverty rate in excess of 30 percent for the calendar year prior to the calendar year in which the bill is enacted).

45. H.R. 7492, 116th Cong., 2d Sess. (introduced Jun. 6, 2020).

46. See I.R.S. Notice 2018-48, 2018-28 I.R.B. 9 (Jul. 9, 2018), as modified by I.R.S. Notice 2019-42, 2019-29 I.R.B. 352 (Jul. 15, 2019) (listing a total of 863 population census tracts in Puerto Rico designated as QOZ, more than any other U.S. state or possession, except for California).

47. See I.R.S. Notice 2018-48, 2018-28 I.R.B. 9 (Jul. 9, 2018), as modified by I.R.S. Notice 2019-42, 2019-29 I.R.B. 352 (Jul. 15, 2019); Community Development Financial Institutions Fund, U.S. Dep't of the Treas., *List of Designated Qualified Opportunity Zones* (Dec. 14, 2018). See also Bipartisan Budget Act of 2018, Pub. L. No. 115-123, § 41115, codified, as amended, at I.R.C. § 1400Z-1(b)(3) (exempting Puerto Rico from the 25% limit on "low-income communities" eligible from designation as QOZs discussed below).

48. Compare I.R.C. § 1400Z-1(b)(3) ("Each population census tract in Puerto Rico that is a low-income community shall be deemed to be certified and designated as a qualified opportunity zone, effective on the date of the enactment of Public Law 115-97."), with I.R.C. § 1400Z-2(d)(1)-(2) ("Except as provided by . . . subsection [1400Z-2](b)(3), the number of population census tracts in a State that may be designated as qualified opportunity zones may not exceed 25 percent of the number of low-income communities in a State. . . . If the number of low-income communities in a State is less than 100, then a total of 25 of such tracts may be designated as qualified opportunity zones.").

49. See I.R.C. § 1400Z-2(a)(1), (b)(2)(B)(iii), (b)(2)(B)(iv) and (c); Treas. Reg. §

Congress enacted a special provision for Puerto Rico following Hurricanes Maria and Irma that exempted the island from certain quantitative limits on the number of lower-income census tracts that could be designated as QOZs in order to encourage its redevelopment.⁵⁰ Ten percent (10 percent) of all QOZs nationwide are in Puerto Rico, and 98 percent of the island is a QOZ,⁵¹ meaning that investments in Puerto Rico are generally investments in QOZs—nowhere else is this geographically targeted economic stimulus so concentrated and so firmly enshrined in local tax policy.⁵²

Whenever U.S. taxpayers structure an investment in Puerto Rico through a self-certified investment vehicle, known as a QOF, incentives become available, which, as illustrated below, sometimes allow investors to reduce their tax burden and earn tax-free income. This article

1.1400Z2(a)-1(c)(8)(iii)(B) (providing an elective rule for a partner in a partnership that realizes eligible gain from a person unrelated to the partner or the partnership, pursuant to which the 180-day period may begin as late as the date on which the partnership's federal income tax return is due, without extensions, for the taxable year in which the partnership realized the applicable eligible gain); Treas. Reg. § 1.1400Z2(a)-1(c)(9)(i) ("If an S corporation, a nongrantor trust, or a decedent's estate realizes an eligible gain, then rules analogous to the rule [for partnerships under Treas. Reg. § 1.1400Z2(a)-1](c)(7) and (i) . . . apply to that entity and to its shareholders or its beneficiaries, as the case may be, to the extent they receive or are deemed to receive an allocable share of the eligible gain.") (emphasis added). A nongrantor trust or estate generally has a taxable year ending on December 31, with federal income tax returns due by April 15 of the following year, or, if April 15 of that year falls on a Saturday, Sunday, or federal holiday, on the next succeeding business day.

50. Bipartisan Budget Act of 2018, Pub. L. No. 115-123, 132 Stat. 161, § 41115 (Feb. 9, 2018).

51. See Government of Puerto Rico, *Opportunity Zone Program Presentation*, DEPARTMENT OF ECONOMIC DEVELOPMENT AND COMMERCE, www.ddec.pr.gov/images/Opportunity-Zone-Program-Presentation-english-version.pdf [perma.cc/6R3E-N6Y] (last visited May 23, 2022).

52. I.R.S. Notice 2019-42, 2019-29 I.R.B. 352 (Jul. 15, 2019) (describing the unique process under section 1400Z-1(b)(3) of the Code that led 100 percent of Puerto Rico's low-income communities and eligible contiguous tracts to be designated as QOZs); P.R. Act No. 60-2019, § 6070.54 ("It shall be the Public Policy of the Government of Puerto Rico: . . . To transform Puerto Rico into an investment destination for Qualified Opportunity Funds that invest in Priority Projects within Qualified Opportunity Zones."). According to the Legislative Assembly of Puerto Rico, "The unique treatment given to Puerto Rico under this federal legislation is one of the best tools available to Puerto Rico for economic development which we must maximize. Since Puerto Rico will be competing with other states as an investment destination, the Government of Puerto Rico deems it critical to adopt an incentive legislation for Qualified Funds that invest in Priority Projects within Opportunity Zones and that are not covered under incentive laws in effect. The tax incentives established in this legislation are directed to ensuring that the rate of return yielded by a Priority Project within Qualified Zones exceeds those offered by the States. . ." P.R. S.B. 1147, *An Act to create the Puerto Rico Economic Development and Opportunity Zones Act of 2019*, Act No. 21-2019, Statement of Motives (Apr. 14, 2019). The Government of Puerto Rico has also said that "... which now forms part of the Puerto Rico Incentives Code. . . which will allow the most vulnerable zones to have a more just and favorable economic situation. . ."; See also Press Release, P.R. Fiscal Agency & Financial Advisory Auth., *Government Reveals List of Commercial Activities for Opportunity Zones* (Aug. 21, 2019) (emphasis added) [hereinafter P.R. FAFAA Press Release].

summarizes the federal tax benefits from QOZ investments under section 1400Z-2 of the Code, as well as the Economic Development and Opportunity Zones provisions more recently enacted in the Puerto Rico Incentive Code of 2019 (Act 60).⁵³

This article begins with an explanation of the QOZ program and Puerto Rico's unique place in that program, as the only jurisdiction where virtually all population census tracts have been designated as QOZs. It then goes on to discuss Puerto Rico's local framework for prioritizing, and collecting information from, specified QOZ projects located in Puerto Rico. While still in its infancy, the local tax and development incentives provided by Puerto Rico for investments in opportunity zones may offer other policymakers around the country with a blueprint for encouraging developers to disclose details of various projects that are receiving a share of local tax revenues, through conformity with the federal income tax code or otherwise, including the impact of those projects on employment and other economic indicators in the local area, that might not otherwise be available at the federal level and may be necessary for governors, mayors and legislators to decide how to target their tax expenditures in a manner that maximizes their impact on the economy of disadvantaged communities.

II. THE UNIQUE STATUS OF PUERTO RICO AS A QUALIFIED OPPORTUNITY ZONE

This section provides a brief overview of the special tax rules related to Puerto Rico that make investing in opportunity zones there uniquely complex. This section also provides some background information on how the federal and local opportunity zone program fits into the broader history of tax incentive legislation that has promoted Puerto Rico's economic development over the years.

Puerto Rico is considered part of the United States for many federal laws but not the income tax laws — meaning that residents of the island do not pay federal income taxes on their Puerto Rican-source income.⁵⁴ Entities organized in Puerto Rico are generally classified as foreign persons and Puerto Rico is generally treated as a foreign country under the Code.⁵⁵ In addition to splitting tax authority with Puerto Rico, the United States has also used special tax rules to assist Puerto Rico in obtaining employment-producing investments from U.S. companies, including the section 936 possessions tax credit repealed in 2006, which

53. P.R. Act No. 60-2019, §§ 6070.54 - 6070.69 (Jul. 1, 2019) (establishing various incentives for "Priority Projects in Opportunity Zones," including, but not limited to a transferrable Puerto Rico tax credit, reduced tax rates for certain businesses operating in Puerto Rico QOZs that receive tax-advantaged capital, and expedited permitting procedures for all such businesses).

54. *See* I.R.C. § 933(1) (exempting bona fide residents of Puerto Rico from U.S. taxation).

55. I.R.C. § 7701(a)(4) and (9) (defining "domestic" entities as those organized and the "United States" for purposes of the Code as including only the 50 states and DC).

encouraged many U.S. pharmaceutical and life-science companies to transfer their intangible assets to Puerto Rico.⁵⁶

The United States has provided special tax incentives for U.S. taxpayers to make employment-producing investments in Puerto Rico throughout the modern history of Puerto Rico.⁵⁷ These U.S. federal income tax incentives have been a primary engine of its economic growth since 1948.⁵⁸ Under prior law, U.S. corporations with business operations in Puerto Rico could elect under section 936 to reduce their U.S. tax on certain Puerto Rican-sourced income. The loss of this tax benefit has been considered by some as a cause of the island's acute recession since 2006.⁵⁹ For this reason, Puerto Rican officials became early advocates for opportunity zones and ultimately secured a privileged place within the federal QOZ program that the island's leaders hope will bring more than \$600 million in new U.S. investments into an economy that has shrunk by more than 22 percent since section 936 was repealed.⁶⁰

As part of the Bipartisan Budget Act of 2018, Congress added a special rule for Puerto Rico in section 1400Z-1(b)(3).⁶¹ Under section 1400Z-1(b)(3), all of Puerto Rico's 837 low-income communities ("LICs"), together with 26 tracts contiguous with such LICs, were automatically qualified, designated and certified as QOZs, effective December 22, 2017. The special rule exempted Puerto Rico from the limitation imposed on all states, the District of Columbia and other U.S. possessions that no more than 25 percent of the jurisdiction's LICs could be designated as QOZs. As

56. U.S. Gen. Accounting Office, Report to the Chairman, Committee on Finance, U.S. Senate, *Puerto Rico and the Section 936 Tax Credit* (GAO/GGD-93-109), 4 (June 1993) [hereinafter 1993 GAO Report on Section 936]; Joint Comm. on Taxation, *An Overview of the Special Tax Rules Related to Puerto Rico and an Analysis of the Tax and Economic Policy Implications of Recent Legislative Options* (JCX-24-06), 50-53 (June 23, 2006) [hereinafter 2006 JCT Report on P.R. Tax Policy].

57. 2006 JCT Report on P.R. Tax Policy, *supra* note 56, at 50-57 ("The special tax treatment of possessions corporations began to have a significant impact on the economy of Puerto Rico in the late 1940s and . . . [i]n 1976, Congress indicated that the special tax treatment for possessions corporations had played an important role in Puerto Rico economic development.").

58. Fin. Oversight & Mgmt. Bd. for P.R., *Revised Fiscal Plan for Puerto Rico*, 11-12 (Mar. 27, 2019) ("[I]n 1976, Section 936 of the Federal tax code was introduced to promote investments by companies that could transfer their 'intangible assets' to Puerto Rico, and thereby shift profits to the Island. These Section 936 companies, which were mostly in the pharmaceuticals and life sciences industries, became a pillar of Puerto Rico's economy, creating valuable local supply chains, increasing local banking deposits, and contributing substantial tax revenue.").

59. Scott Greenberg & Gavin Ekins, *Tax Policy Helped Create Puerto Rico's Fiscal Crisis*, TAX FOUNDATION (June 30, 2015), www.taxfoundation.org/tax-policy-helped-create-puerto-rico-fiscal-crisis/ [perma.cc/SYK2-GPW9]; Fin. Oversight & Mgmt. Bd. for P.R., *Revised Fiscal Plan for Puerto Rico*, 11-12 (Mar. 27, 2019) (describing section 936's repeal and its impact on the island's economy).

60. Letter from Hon. Jenniffer Gonzalez-Colon (D-PR) & Hon. Jose E. Serrano (D-PR) to Ways & Means Comm. Chairman Kevin Brady & Chairman Orin Hatch (Dec. 12, 2017) (discussing QOZs); *see also* P.R. FAFAA Press Release, *supra* note 52, at 2 (Aug. 21, 2019).

61. Bipartisan Budget Act of 2018, Pub. L. No. 115-123, 132 Stat. 161, § 41115, (Feb. 9, 2018).

a result, Puerto Rico, with less than one-twelfth the population of California, has nearly as many QOZs, and, because 44 percent of Puerto Rico residents live in poverty, 98 percent of Puerto Rico is designated as a QOZ.⁶² This makes Puerto Rico an important testing ground for the development of local tax policies, shaped by the federal tax incentives in QOZs.⁶³ Puerto Rico's concentration of QOZ census tracts, and its comparative poverty relative to other states and possessions of the United States, make the QOZ program's ability to generate capital inflows and increase employment and economic activity within Puerto Rico a crucial barometer for local policymakers in other jurisdictions of the United States to understand, consider and evaluate as they develop their own tax, legal and regulatory framework for QOZ investment.⁶⁴

III. FEDERAL TAX INCENTIVES FOR INVESTING IN OPPORTUNITY ZONES

A. Qualified Opportunity Zones

This section provides an introduction to the QOZ program, including key concepts, definitions and rules. This section explains how the program provides for the special treatment of capital gains investment in QOZs and gives an example that illustrates how the program's federal tax incentives allow taxpayers to defer (and potentially avoid) taxation on certain gains realized before and after their investment in a lower-income census tract designated as a QOZ. Because many of the concepts underlying the federal opportunity zone program are incorporated into Puerto Rico's incentives for Priority Projects within Opportunity Zones, it is necessary to understand the federal QOZ program first, before delving into the local program designed to encourage investment in opportunity zones located in Puerto Rico.

62. P.R. FAFAA Press Release, *supra* note 52, at 1–2 (Aug. 21, 2019) (stating that “the Opportunity Zones initiative, which now forms part of the Puerto Rico Incentives Code,...represents an opportunity to promote the development of several economic sectors throughout 98 percent of the Island, which will allow the most vulnerable zones to have a more just and favorable economic situation”); Fin. Oversight and Mgmt. Bd. for P.R., *Revised Fiscal Plan for Puerto Rico*, 6 (Mar. 27, 2019) (discussing the 44% poverty rate in Puerto Rico, which is the highest in the United States).

63. For examples of local tax statutes incorporating the federal opportunity zone tax incentives, *see, e.g.*, OH. REV. CODE ANN. § 122.84 (2021) (providing an opportunity zone investment credit); MD. CODE, ECON. DEV., § 6-1008(b) (2019) (providing an opportunity zone enhancement of 6% to 6.25% for wages paid within a QOZ under the More Jobs for Marylanders tax credit); IND. CODE, ANN., § 6-3.1-34-17(c) (2022) (providing a 5% increase of the Indiana Redevelopment Tax Credit in the case of investments made in a redevelopment site located in a federally designated QOZ).

64. *See generally* P.R. Comm. of Priority Projects in Opportunity Zones, Res. 19-01, *To Approve and Adopt the Initial Priority Projects within Opportunity Zones List* (Aug. 19, 2019) (“Puerto Rico[s] unique treatment under this federal legislation [sections 1400Z-1 and 1400Z-2 of the Federal Internal Revenue Code] represents one of the best economic development tools with remarkable potential for new investment in the island.”).

Opportunity zones are census tracts, in which taxpayers can roll over their capital gains on a tax deferred basis, with the potential to earn tax-free appreciation for decades.⁶⁵ The TCJA added sections 1400Z-1 and 1400Z-2 to the Code to provide U.S. taxpayers, holding an estimated \$6.1 trillion of unrealized capital gains as of the end of 2017, with an incentive to reinvest their capital in pockets of the United States where tens of millions of Americans continue to suffer economically more than a decade after the Great Recession ended in June 2009.⁶⁶ While U.S. stock markets lost some ground in the early months of the COVID-19 pandemic, the S&P 500 Index, NASDAQ Composite Index and Dow Jones Industrial Average all reached record highs by the end of 2020, despite the devastating loss of jobs and life throughout the United States caused by the pandemic.⁶⁷ A similar phenomenon has emerged in real estate, as median single-family home prices rose year-over-year in the third quarter of 2020 in all 181 metropolitan areas tracked by the National Association of Realtors for the first time since 1980.⁶⁸ The fact that stock markets and home prices remained above their values at the end of 2017 may indicate a similar or greater amount of unrealized capital gains in the marketplace as when the opportunity zone program was originally devised.⁶⁹

65. See I.R.C. § 1400Z-1(a) (defining a “qualified opportunity zone” as “a population census tract that is a low-income community,” within the meaning of I.R.C. § 45D(e), “that is designated as a qualified opportunity zone” in accordance with certain procedures set forth in I.R.C. § 1400Z-1(b)); I.R.C. § 1400Z-2(a)–(c) (describing the tax deferral and reduction benefits associated with indirect investments, through QOFs, in a QOZ census tract).

66. See *The Promise of Opportunity Zones: Hearing Before the Joint Econ. Comm.*, 115th Cong., 2d Sess. (May 17, 2018) (statement of John Lettieri, Co-Founder & President, Economic Innovation Group (EIG)) (“Our analysis of Federal Reserve data found an estimated \$6.1 trillion of unrealized capital gains held by U.S. households and corporations as of the end of 2017. So even a small fraction of these gains reinvested into Opportunity Zones would constitute the largest economic development initiative in the country.”).

67. Hamza Sharan and Heather Long, *Promise of a better 2021 fuels market’s record highs*, WASH. POST (Dec. 31, 2020), www.washingtonpost.com/business/2020/12/31/stock-market-record-2020 [perma.cc/WFT8-G6TC] (“The U.S. stock market ended 2020 at all-time highs, enriching the wealthy and capping off a soaring comeback despite a deadly pandemic that has killed more than 340,000 Americans and left millions jobless and hungry.”).

68. See *Metro Home Prices Increase in All Areas in Third Quarter of 2020*, NAT’L ASS’N OF REALTORS (Nov. 12, 2020), www.nar.realtor/newsroom/metro-home-prices-increase-in-all-areas-in-third-quarter-of-2020 [perma.cc/5JP8-66YL] (noting that every metropolitan statistical area tracked by the National Association of Realtors’ broad-based survey showed sales price increases during the third quarter of 2020); Nicole Friedman, *Home Prices Are Rising Everywhere in the U.S.*, WALL ST. J. (Nov. 12, 2020), www.wsj.com/articles/home-prices-are-rising-everywhere-in-the-u-s-11605220823 [perma.cc/GY2M-HFQE] (“This broad-based rally for single-family homes marked the first time since 1980 that every metro area tracked by NAR [the National Association of Realtors] posted an annual price increase in the same quarter, NAR said.”).

69. On the last day of trading in 2017, the S&P 500 had a value of 2,673.61, which had risen to 3,756.07 by the end of 2020, an increase of 40.49 percent, while the Dow Jones Industrial Average rose from a value of 24,719.22 at the end of 2017 to 30,606.48 by the end of 2020, an increase of 23.82 percent, and the tech-heavy NASDAQ

New economic data has also begun to emerge that points toward the potentially significant increase in investment in opportunity zones that federal tax incentives available under section 1400Z-2 may be having thus far.⁷⁰ The Council of Economic Advisors estimated in an August 2020 assessment of the initial impact of opportunity zones that “by the end of 2019, Qualified Opportunity Funds had raised \$75 billion in private capital,” and “that \$52 billion—or 70 percent—of the \$75 billion is new investment” in opportunity zones through 2019, representing an amount of increased investment in these economically distressed communities that would not have occurred without the economic development incentive provided under the TCJA that cuts taxes on capital supplied to low-income communities that have been designated as QOZs.⁷¹

Taxpayers who invest in qualified opportunity zone property (“QOZ Property”) through a self-certified investment vehicle, known as a QOF, can defer — and in certain circumstances eliminate — the recognition of capital gains rolled over into such a fund within 180 days of a capital gains recognition event.⁷²

B. Qualified Opportunity Funds

A QOF is any self-certified investment vehicle which is organized as a corporation or partnership for federal income tax purposes for the purpose of investing in QOZ Property (other than another QOF) that holds at least 90 percent of its assets in such property.⁷³ To be eligible to be a QOF, the entity must be organized under the laws of one of the 50 states, a federally-recognized Native American tribe, the District of Columbia, or a U.S. possession where a QOZ has been designated, provided that an

Composite increased in value by 81.34 percent from 6,903.39 at the end 2017 to 12,888.28 at the end of 2020. See Akin Oyedele, *Stocks Finish Best Year Since 2013: Here's What You Need to Know*, BUS. INSIDER (Dec. 29, 2017), www.yahoo.com/news/stocks-finish-best-since-2013-210051481.html [perma.cc/Y5PH-TFYV]; Sharan & Long, *supra* note 67. See also *Metro Home Prices Increase in All Areas in Third Quarter of 2020*, *supra* note 68 (describing the year-over-year rise in single-family home sales prices across the country).

70. The White House Council of Economic Advisers, *The Impact of Opportunity Zones: An Initial Assessment*, 15–18 (Aug. 2020) [hereinafter *Initial Assessment of Opportunity Zones*].

71. *Id.*

72. See I.R.C. § 1400Z-2(a)(1) (excluding from gross income for the taxable year amounts realized from the sale to, or exchange with, an unrelated person of any property that is reinvested in qualifying equity of a QOF within 180 days of the realization of such gain); I.R.C. § 1400Z-2(b)(2)(A)(iii) (increasing the basis in a qualifying QOF by 10 percent after the five-year anniversary of the investment, if such anniversary occurs before 2027); I.R.C. § 1400Z-2(b)(2)(A)(iv) (increasing investment basis in a QOF by another 5 percent of the taxpayer’s qualifying investment in such entity to the extent the seven-year investment anniversary is reached on or before December 31, 2026); I.R.C. § 1400Z-2(c) (allowing a fair-market-value basis step-up election following the 10-year anniversary of a taxpayer’s investment in a QOF), effectively eliminating post-acquisition appreciation gain from the investment from the U.S. tax base).

73. Treas. Reg. § 1.1400Z2(d)-1(a)(1).

entity organized under the laws of a U.S. possession is only eligible to be a QOF if it is organized for the purpose of investing in QOZ Property that relates to a trade or business operated in the U.S. possession in which the entity is organized.⁷⁴ The QOF must hold at least 90 percent of its assets in QOZ Property (the “90 percent investment standard”), determined by the average of the percentages of QOZ Property in the fund as of specified testing dates. The first testing date is measured on the last day of the first 6-month period of the taxable year of the fund or the last day of the taxable year of the fund, whichever is earlier (each, a “semiannual testing date”).⁷⁵ A calendar year QOF will generally have testing dates on June 30 and December 31 every year after its first QOF tax year.⁷⁶ In the first or last year of the QOF’s existence, however, the QOF may have only one QOZ Property testing date, since the QOZ regulations define the last day of the “first six-month period of the taxable year of the fund [to mean] the first six months each of which is in the taxable year and in each of which the entity is a QOF.”⁷⁷ In other words, if an eligible entity elects to self-certify as a QOF after the sixth month of a 12-month taxable year, or chooses to self-decertify as a QOF before the seventh month of a 12-month taxable year, the QOF’s 90 percent investment standard with respect to QOZ Property only takes into account the QOF’s assets on the last day of the QOF’s taxable year.⁷⁸

A QOF must elect to become a QOF on the initial Form 8996, Qualified Opportunity Fund, filed with a timely-filed federal income tax return (including extensions) for the first year in which the applicable entity intends to self-certify as a QOF.⁷⁹ For each subsequent tax year in which the QOF self-certification is effective, the QOF must annually complete a Form 8996 filed with a timely federal income tax return (including extensions) to either certify its compliance with the 90 percent investment standard for the tax year or compute a penalty owed on the shortfall each month based on the applicable federal income tax underpayment rate under I.R.C. § 6621(a)(1), computed quarterly by the Internal Revenue Service (“IRS”).⁸⁰

74. See Treas. Reg. § 1.1400Z2(d)-1(a)(1)(ii)(B) (restricting QOFs organized in possessions to those operating a trade or business, directly or indirectly, in American Samoa, Guam, Puerto Rico, the Northern Mariana Islands or the U.S. Virgin Islands).

75. Treas. Reg. § 1.1400Z2(d)-1(a)(2)(iv)(A) (“[T]he phrase first six-month period of the taxable year of the fund means the first six months each of which is in the taxable year and in each of which the entity is a QOF. Thus, if an eligible entity becomes a QOF in the seventh or later month of a 12-month taxable year, the 90-percent investment standard in section 1400Z-2(d)(1) considers only the QOF’s assets on the last day of the QOF’s taxable year.”).

76. I.R.C. § 1400Z-2(d)(1).

77. Treas. Reg. § 1.1400Z2(d)-1(a)(2)(iv)(A).

78. *Id.*

79. See I.R.C. § 1400Z-2(f); I.R.S., Instructions to Form 8996, Qualified Opportunity Fund (Jan. 2021).

80. *Id.*

C. Qualified Opportunity Zone Property

QOZ Property includes qualified opportunity zone stock (“QOZ Stock”), qualified opportunity zone partnership interests (“QOZ Partnership Interest”), or qualified opportunity zone business property (“QOZ Business Property”).⁸¹ The QOF’s investments must be made in QOZs and may be comprised of either direct or indirect investments in the development of a trade or business in a QOZ, including, when appropriate, the acquisition, construction, and/or substantial improvement of tangible property (including commercial buildings), equipment, and residential rental or nonresidential rental property in the QOZ.⁸² Any indirect investment by a QOF in QOZ Business Property must be stock or a partnership interest in a QOZ business (“QOZB”) acquired after 2017 solely in exchange for cash.⁸³

D. Qualified Opportunity Zone Businesses

A QOZB is an entity organized under the law of the United States or the law of one of the 50 states, a federally-recognized Native American tribal government, the District of Columbia, or a U.S. possession, including Puerto Rico, that is classified as a partnership or corporation (not a disregarded entity) for U.S. federal income tax purposes.⁸⁴ For this purpose, a corporation or partnership that is organized in Puerto Rico or another U.S. possession may only qualify as a QOZB if it is organized for the purpose of investing in QOZ property that relates to a trade or business operated in the U.S. possession in which the entity is organized.⁸⁵ In addition, a QOZB must (1) hold at least 70 percent of its owned or leased tangible property in QOZ Business Property used in a QOZ (based on the number of days’ use between two consecutive semi-annual QOF asset testing dates), (2) hold less than 5 percent of the unadjusted basis of its property in nonqualified financial property, including debt, stock, partnership interests, options, futures/forward contracts, warrants, notional principal contracts, annuities and cash, other than reasonable amounts of working capital held in the form of cash, cash equivalents and debt instruments for no more than 31 months from the date of receipt and spent in accordance with a written working capital plan and schedule

81. I.R.C. § 1400Z-2(d)(2)(A).

82. *Id.*

83. I.R.C. § 1400Z-2(d)(2)(A)(i)-(ii); I.R.C. § 1400Z-2(d)(2)(B)-(C); I.R.C. § 1400Z-2(d)(3)(A)(i) (defining a “qualified opportunity zone business” as, among other things, “a trade or business . . . in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property (determined by substituting ‘qualified opportunity zone business’ for ‘qualified opportunity fund’ each place it appears in [I.R.C. § 1400Z-2(d)](2)(D). . .”).

84. Treas. Reg. § 1.1400Z2(d)-1(a)(1)(i) (defining the term “eligible entity” for purposes of limiting the type of entities that may elect to be QOFs or satisfy the requirements of being a QOZB). *See also* Treas. Reg. § 301.7701-2; Treas. Reg. § 301.7701-3.

85. Treas. Reg. § 1.1400Z2(d)-1(a)(1)(ii)(b)(1).

(the “Working Capital Safe Harbor”), (3) derive 50 percent of its gross income from an active business in a QOZ (generally based on hours worked, salaries paid for work or the physical location of tangible property and management functions performed within a QOZ), (4) use at least 40 percent of its intangible property in the active conduct of such business, and (5) not be in the business of operating a private or commercial golf course, country club, massage parlor, hot-tub, suntan or gambling facility, or liquor store.⁸⁶ A QOZB is treated as engaged in such a “sin business” if 5 percent or more of its gross income, the value of its tangible property or the net rentable square feet of its real property is attributable to a golf course, country club, massage or tanning parlor, hot-tub facility, spa, gambling facility or store principally in the business of selling alcohol for consumption off premises.⁸⁷

Because QOZBs have a lower threshold for qualifying investments than QOFs (70 percent of the QOZB’s tangible property versus 90 percent of the QOF’s assets), they are authorized to hold unlimited amounts of intangible property, provided that at least 40 percent of the intangible property of the QOZB is normally, usually or customarily used by the QOZB in the active conduct of a trade or business in a QOZ in a manner that contributes to the generation of gross income for the trade or business both inside and outside of a QOZ, and may hold working capital for periods of 31 months or less. Many QOZ investments utilize a two-tiered structure: a QOF invests at least 90 percent of its assets in QOZB stock or partnership interests of an entity or several entities that reinvest at least 70 percent of that capital in QOZ Business Property. As a result, QOF investors may qualify for benefits, although as little as 63 percent of their deferred-gain capital may be invested in the zone (i.e., 70 percent of 90 percent of the QOF investments).⁸⁸

For example, consider a real estate development company organized as a QOF corporation with \$20 million in assets that the corporation plans to spend on the acquisition and construction of buildings. If the QOF invested all its assets directly in real estate, at least 90 percent (or \$18 million) of its assets must be located within a QOZ and constitute QOZ Business Property. If instead, the QOF invests \$18 million

86. See I.R.C. § 1400Z-2(d)(3), incorporating I.R.C. §§ 1397C(b)(2), (4), (8) and 1397C(e) (establishing rules for gross income, intangible property and “nonqualified financial property”), and I.R.C. § 144(c)(6)(B) (describing seven “sin” businesses); Treas. Reg. § 1.1400Z2(d)-1(d)(3)(ii)(A) (defining 40% as a “substantial portion of the intangible property” used by a QOZB in a QOZ); Treas. Reg. § 1.1400Z2(d)-1(d)(2)(i) (defining “substantially all of the tangible property owned or leased by the [QOZB]” to mean 70%); Treas. Reg. § 1.1400Z2(d)-2(d)(4)(ii) (defining “substantially all of the use” of tangible property by a QOF or QOZB to mean 70% of the number of days between two consecutive semiannual testing dates); Treas. Reg. § 1.1400Z2(d)-1(d)(3)(i) (providing safe harbors for 50% gross income requirement of a QOZB).

87. See Treas. Reg. § 1.1400Z2(d)-1(d)(4)(ii) (setting forth a 5% de minimis threshold for “sin businesses” enumerated in section 144(c)(6)(B) of the Code).

88. I.R.S., Investing in Qualified Opportunity Funds, REG-115420, 83 Fed. Reg. 54279, 54288–54289 (Oct. 29, 2018). See also I.R.S., Dep’t of the Treas., Opportunity Zones Frequently Asked Questions, Q&A No. 52 (Nov. 2, 2021).

in a QOZ Partnership Interest or QOZ Stock of a first-tier operating subsidiary, classified for federal income tax purposes as a corporation or partnership and organized for the purpose of carrying on a trade or business in a QOZ as a QOZB, then only 70 percent of the QOF's \$18 million investment in the subsidiary, or \$12.6 million, must be invested in QOZ Business Property within an opportunity zone. In this two-tier structure, the real estate development company would only need to commit \$12.6 million of its \$20 million investment (63 percent) in the QOF toward investments in QOZ Business Property, leaving up to \$7.4 million in free capital to invest, through the QOF and QOZB, in real estate outside of a QOZ. Specifically, the QOF could invest up to \$2 million (10 percent) of its \$20 million in total assets in real estate outside of a QOZ and the QOZB could invest up to \$5.4 million (30 percent) of its \$18 million in total assets in non-QOZ real estate that is not used in a sin business, so long as the QOZB invests its remaining \$12.6 million in tangible business property in a QOZ that satisfies the requirements for being QOZ Business Property.⁸⁹

On the other hand, QOFs can invest directly in their own businesses without certain restrictions—such as golf courses and casinos—in which a QOZB could not engage directly, lending a degree of flexibility and optionality to the QOZ program where local development tax incentives for hotels, resorts and casinos often can be accommodated within a two-tier opportunity zone investment structure.⁹⁰ An example in final regulations issued on December 17, 2019, under section 1400Z-2, confirms that a QOF may operate a commercial golf course or other “sin business” directly, without violating any anti-abuse rule established by those regulations, even though the business could not be carried on through a QOZB operating entity.⁹¹

Electing taxpayers that reinvest eligible gains in a QOF within 180 days of realizing the gain from a transaction with an unrelated person (using a more-than-20-percent relatedness test for entities under section 1400Z-2(e)(2)) may exclude that gain from gross income until December 31, 2026, unless the QOF investment is sold earlier, and partially eliminate up to 15 percent of the capital gain rolled over into the QOF from federal income tax if they hold their interest in a QOF for at least 7 years.⁹² However, if at any time before December 31, 2026, the taxpayer sells, exchanges or otherwise disposes of its interest in the QOF, all remaining gains deferred pursuant to the QOF investment, not otherwise reduced by basis step-ups on the fifth and seventh anniversaries of the

89. See I.R.S., Investing in Qualified Opportunity Funds, REG-115420, 83 Fed. Reg. 54279, 54289 (Oct. 29, 2018).

90. See I.R.C. § 1400Z-2(d)(3)(A)(iii), incorporating I.R.C. § 144(c)(6)(B) as a restriction on QOZBs, not QOFs.

91. See Treas. Reg. § 1.1400Z2(d)-1(d)(4)(iv)(B), Example 2 (“The ownership and operation of the golf course at the QOF level will not disqualify the QOF because the prohibition on businesses described in section 144(c)(6)(B) is not applicable at the QOF level.”).

92. I.R.C. § 1400Z-2(a)(1)(A), (b)(1), (b)(2)(B)(iii) and (b)(2)(B)(iv).

taxpayer's investment, as well as any post-acquisition appreciation in the value of that investment, will be recognized in gross income in the taxable year in which the sale, exchange or other disposition of the interest in the QOF takes place.⁹³

While taxpayers must recognize at least 85 percent of their deferred capital gains on or before December 31, 2026, those who continue holding the QOF interest until the tenth anniversary of their investment in the QOF can dispose of the investment tax-free at any time before 2048.⁹⁴ Moreover, the final regulations provide a gross income exclusion for eligible taxpayers who hold a qualifying investment in a QOF partnership or QOF S corporation for at least 10 years, under which a taxpayer may elect to exclude from gross income their distributive share of all gains and losses from all sales or exchanges of noninventory property by the QOF or any of its QOZBs or other partnership(s) owned directly or indirectly through one or more partnerships by the QOF, as reported on Schedule K-1 of the QOF.⁹⁵ It is this last incentive providing U.S. taxpayers with the ability to permanently exclude both capital gains and ordinary income from their taxable income derived from the disposition of a QOF, QOZB or their respective property that has attracted billions of dollars of private capital into QOZs so far, including hotels, resorts and casinos lining Puerto Rico's shores, as well as manufacturing and services businesses that make up major sectors of the island's economy.⁹⁶

Example: On September 1, 2018, Taxpayer A triggers a \$100,000 capital gain from the sale of stock to an unrelated party (\$200,000 proceeds less \$100,000 basis), which would otherwise be taxed at an effective tax rate of 23.8 percent (including capital gains tax and net investment income tax). On February 15, 2019, Taxpayer A invests \$100,000 into a QOF partnership which uses these proceeds to acquire QOZ Property. Taxpayer A may elect on IRS Form 8949, Sales and Other Dispositions of Capital Assets, to defer the \$100,000 capital gain on its 2018 federal income tax return. Taxpayer A holds its \$100,000 investment in the QOF until at least February 15, 2029, but not later than December 31, 2047, at which time Taxpayer A's sale or exchange of this QOF investment is eligible for a second election that will allow Taxpayer A to step-up its basis in the QOF investment to fair market value ("FMV") at the time of the sale or exchange and exclude from gross income any

93. I.R.C. § 1400Z-2(b)(1)(A).

94. I.R.C. § 1400Z-2(b)(1), (b)(2)(B)(iii), (b)(2)(B)(iv) and (c).

95. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii)(A).

96. See The National Conference of State Housing Boards (NCSHB), *Opportunity Zone Fund Directory* (Dec. 17, 2019) (listing 196 multi-asset qualified opportunity funds with values up to \$10 billion); NOVogradac OPPORTUNITY FUNDS LISTING TOTALS (June 30, 2022), www.novoco.com/resource-centers/opportunity-zone-resource-center/opportunity-funds-listing [perma.cc/RFP5-K5QD] (listing \$30.49 billion in funds raised reported by 1,097 QOFs as of June 30, 2022); Jena Tess Fox, *JLL: Puerto Rico offers opportunities for hotel investors*, HOTEL MANAGEMENT (June 18, 2019), www.hotelmanagement.net/own/jll-puerto-rico-offers-opportunities-for-hotel-investors [perma.cc/7VEJ-BB9S9] (discussing QOZ investments in Puerto Rico's hotel industry).

gain on the appreciation of its investment that exceeds the original \$100,000 investment. For purposes of this example, assume that capital gains and net investment income tax rates from 2018 through 2029 remain constant (i.e., at a total rate of 23.8 percent), and that, at the time Taxpayer A sells its interest in the QOF or a qualifying QOF passthrough investment, the initial investment has appreciated to \$500,000, and all of the \$400,000 gain from post-acquisition appreciation in the QOF investment would be taxed at an ordinary income rate of 39.6 percent, due to the QOF's holdings of inventory and accounts receivable described in section 751 of the Code, plus a 3.8 percent net investment income tax, for a total effective federal income tax rate of 43.4 percent. Based on these assumptions, the following table reflects Taxpayer A's tax deferral and reduction benefits resulting from the QOF investment over 10 years. As it shows, Taxpayer A's total tax cost outside of the QOZ program would be \$197,400 on a total of \$500,000 in gain, \$100,000 of which was capital gain and \$400,000 of which was ordinary income. Under the QOZ program, the taxpayer paid just \$20,230 in tax on the same \$500,000 in realized gain, or 10.25% of the tax that would otherwise be due and owing to the IRS.

Election #1 Front End Benefit – Capital Gain Deferral and Basis Step-Up				
2018	2024	2026	12/31/2026	2029 to 2047
Defer paying tax of \$23,800 (\$100,000 x 23.8%, based on presumed capital gains rate of 20%, plus 3.8% net investment income (NII) tax)	\$2,380 (10% of tax forgiven at 5-year holding period by virtue of \$10,000 basis step-up)	\$1,190 (5% of tax forgiven at 7-year holding period by virtue of \$5,000 basis step-up)	Regardless of holding period, taxpayer must pay \$20,230 on deferred gain (effectively 17% capital gains tax rate, plus 3.23% NII tax, or 20.23%)	
\$0	\$0	\$0	\$20,230	

Election #2 Back End Benefit – Gain Exclusion and Basis Step-Ups				
2019	2024	2026	12/31/2026	2029 to 2047
\$100,000 investment in QOF made within 180-days = zero outside basis in QOF	\$10,000 QOF outside tax basis increase	\$5,000 QOF outside tax basis increase	\$85,000 QOF outside tax basis increase	QOF investor makes FMV basis step-up election, excluding from the taxpayer's income all \$400,000 in gain arising from such QOF investment's disposition. Investor avoids paying 2029 tax of \$173,600 (\$400,000 x 43.4% = 39.6% ordinary income tax rate, plus 3.8% NII tax)
<i>Total Tax Paid by Taxpayer A with QOF Investment</i>				
None	None	None	\$20,230	None

Total Tax Payable by Taxpayer A without QOF Investment				
\$23,800	None	None	None	\$173,600

E. Qualified Opportunity Zone Business Property

The definition of QOZ Business Property is fundamental to determining a QOF's or QOZB's compliance with the QOZ rules regardless of whether a QOF invests in QOZ Property directly or does so through a QOZ Partnership Interest or QOZ Stock in a QOZB classified for federal income tax purposes as a partnership or corporation, respectively. That is because, at the QOF level, 90% of the assets of the QOF must be invested in QOZ Property, including, in the case of any direct investment by the QOF, tangible property that satisfies the requirements for being QOZ Business Property, as well as qualifying ownership interests in one or more QOZBs.⁹⁷ At the QOZB level, at least 70% of all the eligible entity's

97. I.R.C. §1400Z-2(d)(2).

tangible property must be QOZ Business Property.⁹⁸

Section 1400Z-2(d)(2)(D) and regulations thereunder define “qualified opportunity zone business property” as tangible property used in a trade or business of the QOF or a QOZB in which such QOF invests (each, an “eligible entity”) if:

1. In the case of property that is owned by the eligible entity, such property was acquired by the QOF or QOZB after December 31, 2017 (a) by purchase (as defined in I.R.C. § 179(d)(2)) from a person who is not a “related person” under I.R.C. § 1400Z-2(e)(2) (as defined below), or (b) by self-construction of such property, to the extent physical work of a significant nature begins with the eligible entity after December 31, 2017;
2. In the case of property that is owned by the eligible entity, the original use of such property in the QOZ commences with the QOF or QOZB, or such property is substantially improved by the QOF or QOZB;
3. In the case of property that is leased by the eligible entity, a qualified acquisition of possession of such property was made by a QOF or QOZB under a lease entered into after December 31, 2017, the terms of which reflect common arms’-length pricing in the locale that includes the QOZ where such property is located as determined under I.R.C. § 482 and regulations thereunder, provided that such terms are presumed to be arms’-length if the eligible entity leases the property from a person that is not a related person within the meaning of I.R.C. § 1400Z-2(e)(2) (as defined below) or is a state or local government entity. In addition, for leases between related persons, the QOF or QOZB may prepay more than 12 months’ rent and, if the lease is of tangible personal property (as opposed to real property), the eligible entity that acquires such tangible personal property pursuant to a lease must also acquire, within a period of 30 months after the tangible personal property is acquired or, if earlier, the last day of the lease term, (a) ownership of other tangible property that is QOZ Business Property, having a value at least equal to the value of the leased tangible personal property, and (b) there must be substantial overlap between the QOZ(s) in which the owner of the QOZ Business Property so acquired uses it and the QOZ(s) in which that person uses the leased tangible personal property; and
4. During substantially all (at least 90%) of the QOF’s or QOZB’s holding period for such property, substantially all (at least 70%) of the use of such property was in a QOZ.⁹⁹

For purposes of the definition of QOZ Business Property, a “related person” is any person in a relationship, with respect to the QOF or QOZB, that acquires tangible property described in any of the following categories under I.R.C. §§ 267(b) and 707(b)(1), determined in accordance with the applicable rules for constructive ownership under each section, as modified by I.R.C. § 1400Z-2(e)(2):¹⁰⁰ (1) an individual’s

98. I.R.C. § 1400Z-2(d)(3)(A)(2); Treas. Reg. § 1.1400Z2(d)-1(d)(2)(i).

99. I.R.C. § 1400Z-2(d)(2)(A)(iii); Treas. Reg. § 1.1400Z2(d)-2(d)(3).

100. I.R.C. § 1400Z-2(e)(2); Treas. Reg. § 1.1400Z2(a)-1(b)(39) (defining a “related person” for purposes of the QOZ program).

siblings, spouse, ancestors and lineal descendants;¹⁰¹ (2) a partnership and a person owning more than 20% of the capital or profits interest in the partnerships;¹⁰² (3) two partnerships in which the same person owns more than 20% of the capital or profits interest;¹⁰³ (4) a corporation and an individual shareholder who owns more than 20% of the value of the stock;¹⁰⁴ (5) a parent-subsidiary controlled group of two or more corporations involving a chain of corporations in which the common parent corporation owns more than 20% of the voting power and value of the stock of one corporation, and one of the other corporations owns more than 20% of the voting power or value of another corporation;¹⁰⁵ (6) a brother-sister controlled group of two or more corporations in which five or fewer persons (individuals, estates or trusts) own more than 50% of the voting power or more than 50% of the value of each corporation (taking into account identical stock ownership with respect to each corporation);¹⁰⁶ (7) a grantor and a fiduciary of any trust;¹⁰⁷ (8) fiduciaries of different trusts (if one person is the grantor of both trusts);¹⁰⁸ (9) a fiduciary of a trust and a beneficiary of that trust;¹⁰⁹ (10) a fiduciary of a trust and a beneficiary of another trust (if the same person is grantor of both trusts);¹¹⁰ (11) a corporation and a fiduciary of a trust that owns more than 20% of the value of the stock (or the trust's grantor owns more than 20% of the value);¹¹¹ (12) a tax-exempt organization and a person or individual (or the individual's family) who controls the organization;¹¹² (13) a corporation and a partnership if the same person owns more than 20% of the value of the stock and more than 20% of the capital or profits interest in the partnership;¹¹³ (14) two or more S corporations owned more than 20% (by value) by the same person;¹¹⁴ (15) an S corporation and a C corporation if the same person owns more than 20% of the value of each;¹¹⁵ and (16) an executor and a beneficiary

101. I.R.C. § 267(b)(1).

102. I.R.C. § 707(b)(1)(A), as modified by I.R.C. § 1400Z-2(e)(2).

103. I.R.C. § 707(b)(1)(B), as modified by I.R.C. § 1400Z-2(e)(2).

104. 26 § 267(b)(2), as modified by I.R.C. § 1400Z-2(e)(2).

105. I.R.C. § 1563(a)(1), as modified by I.R.C. § 267(b)(3) and (f)(1), as modified by I.R.C. § 1400Z-2(e)(2); Treas. Reg. § 1.1400Z2(a)-1(b)(39).

106. Note that due to a potential drafting error, I.R.C. § 1400Z-2(e)(2) requires substituting "more than 20 percent" for "more than 50 percent" in the "controlled group" definition under I.R.C. § 267(f)(1)(A), which, in turn, substitutes "more than 20 percent" for "at least 80 percent" stock ownership requirements in the parent-subsidiary controlled group definition under I.R.C. § 1563(a)(1), but has no effect on lowering the "more than 50 percent" stock ownership requirement for a brother-sister controlled group in I.R.C. § 1563(a)(2). See I.R.C. § 1563(a)(2), as modified by I.R.C. § 267(f)(1), as modified by I.R.C. § 1400Z-2(e)(2); Treas. Reg. § 1.1400Z2(a)-1(b)(39).

107. I.R.C. § 267(b)(4).

108. I.R.C. § 267(b)(5).

109. I.R.C. § 267(b)(6).

110. I.R.C. § 267(b)(7).

111. I.R.C. § 267(b)(8), as modified by I.R.C. § 1400Z-2(e)(2).

112. I.R.C. § 267(b)(9).

113. I.R.C. § 267(b)(10), as modified by I.R.C. § 1400Z-2(e)(2).

114. I.R.C. § 267(b)(11), as modified by I.R.C. § 1400Z-2(e)(2).

115. I.R.C. § 267(b)(12), as modified by I.R.C. § 1400Z-2(e)(2).

of an estate (except in the case of a sale to satisfy a pecuniary bequest).¹¹⁶ A buyer and seller of property are unrelated if they do not have a relationship that makes them a “related person” within the meaning of section 1400Z-2(e) of the Code.

The QOZ rules provide that the “original use” of tangible property acquired by purchase in a QOZ commences on the date any person first places the property in service in the QOZ for purposes of depreciation or amortization (or first uses it in a manner that would allow for depreciation or amortization if that person were the property’s owner).¹¹⁷ Generally, tangible property that is manufactured, constructed or produced for use by a QOF or QOZB with the intent to use such property in a trade or business in a QOZ and with respect to which the manufacture, construction or production begins after December 31, 2017, is automatically deemed to satisfy the acquisition by purchase from an unrelated party and original use requirements as of the date such construction begins.¹¹⁸ For this purpose, manufacture, construction, or production of property by an eligible entity begins when physical work of a significant nature begins.¹¹⁹ For example, excavation for footings, pouring the concrete pads, or the driving of foundation pilings into the ground for a facility being constructed on-site would be work of a significant nature. Physical work of a significant nature does not include preliminary activities such as clearing a site, test drilling to determine soil conditions, or excavation to change the contours of the land, or planning or designing, securing financing, exploring, or researching.¹²⁰ In addition, under a safe harbor available for QOFs and QOZBs that are self-constructing tangible property, physical work of a significant nature will not be considered to begin before the taxpayer incurs or pays more than 10% of the total cost of the property, excluding (i) the cost of land and (ii) preliminary activities such as planning or designing, securing financing, exploring, or researching.¹²¹ If tangible property was previously placed in service in the QOZ by another taxpayer before it was acquired by the QOF or QOZB, then the tangible property generally must be substantially improved by the QOF or QOZB to satisfy the definitional requirements. Exceptions to this rule apply to the following types of tangible property:

1. Vacant Property. Real property, including buildings and land, that has been vacant or otherwise “significantly unused” (collectively, “vacant property”) for an uninterrupted period before the QOF or QOZB’s purchase of either (1) at least one calendar year, if the vacancy period began on or before July 8, 2018 (the “one-year

116. *Id.*

117. Treas. Reg. § 1.1400Z2(d)-2(b)(3)(i)(A).

118. Treas. Reg. § 1.1400Z2(d)-2(b)(1)(iii)(A).

119. Treas. Reg. § 1.1400Z2(d)-2(b)(1)(iii)(B) (reference to Treas. Reg. § 1.168(k)-1(b)(4)(iii)).

120. Treas. Reg. § 1.168(k)-1(b)(4)(iii)(B)(2).

121. Treas. Reg. § 1.1400Z2(d)-2(b)(1)(iii)(C).

vacancy requirement”), or (3) at least three years, if the vacancy period began on or after July 9, 2018 (the “three-year vacancy requirement”). For this purpose, a building or land is considered to be in a state of vacancy if the property is “significantly unused,” meaning that more than 80 percent of the building or land, as measured by the square footage of useable space, is not currently being used.¹²² For vacant and unused tangible property that meets either the one-year or three-year vacancy requirement, the original use is treated as commencing in the QOZ on the date, after the vacancy period ends, that any person first uses or places the property in service in the QOZ in a manner that would allow depreciation or amortization to be claimed with respect to such property if the user were the property’s owner.¹²³

2. Tenant Improvements. Improvements made to leased property by a lessee where the lessee owns the improvements will be treated as satisfying both the original use requirement and acquired by purchase requirement for the amount of the unadjusted costs basis under I.R.C. § 1012.¹²⁴
3. Buildings Located on Brownfield Sites. A QOF or QOZB that purchases a parcel of land that is a brownfield site, as defined by section 101 of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (42 U.S.C. 9601), may treat all land and structures composing the brownfield site as satisfying the original use requirement for QOZ Business Property, if, within a reasonable period, the applicable entity makes investments in the site to ensure it meets basic environmental and safety standards.¹²⁵
4. Property Acquired from Governments in Foreclosure. Real property that a state or local government acquired through foreclosure, abandonment, bankruptcy, or other involuntary transfer and subsequently sold to a QOF or QOZB is considered to meet the original-use requirement for QOZ Business Property.
5. Inventory. Inventory (including raw materials) of a trade or business produced by a QOF or QOZB after December 31, 2017, is deemed to satisfy both the acquisition by purchase requirement and the original use requirement.¹²⁶ Thus, if at least 70% of the use of inventory is within a QOZ during at least 90% of the QOF

122. Treas. Reg. § 1.1400Z2(d)-2(b)(3)(i)(B); I.R.S. Notice 2018-48, 2018-28 I.R.B. 9; I.R.S. Notice 2019-42, 2019-29 I.R.B. 352.

123. Treas. Reg. §§ 1.1400Z2(d)-2(c)(3)(iii)(A).

124. Treas. Reg. § 1.1400Z2(d)-2(b)(3)(ii).

125. Treas. Reg. § 1.1400Z2(d)-2(b)(3)(iv).

126. Treas. Reg. § 1.1400Z2(d)-2(b)(2)(ii).

or QOZB's holding period, it will generally be considered QOZ Business Property.¹²⁷ In determining whether the 90% investment standard for QOFs or the 70% tangible property requirement for QOZBs is satisfied, a QOF or QOZB may choose to exclude the value of all inventory (including raw materials) of the trade or business from both the numerator and denominator of the applicable test, if applied consistently with respect to all semiannual tests of the QOF and QOZB during the tax year.¹²⁸

"Substantially improved" property is tangible property if, during any 30-month period beginning after the date of acquisition of such property, additions to the basis with respect to such property in the hands of the QOF or QOZB exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the QOF or QOZB (the "30-month substantial improvement period").¹²⁹

In general, if a QOF or QOZB purchases a building located on land wholly within a QOZ, a substantial improvement to the purchased property is measured by the eligible entity's additions to the basis of the building, as determined under section 1012 of the Code, excluding the basis allocable to the land.¹³⁰ Unimproved land that is within a QOZ cannot be "original use" property but does not generally need to be substantially improved to be QOZ Business Property, if it is acquired by purchase from an unrelated person described in requirement #1 of the QOZ Business Property definition above.¹³¹ Notwithstanding the foregoing rule, however, land that is purchased by an eligible entity with an expectation or intention to improve the land by no more than an insubstantial amount must be substantially-improved to be QOZ Business Property.¹³² In determining whether a QOF or QOZB intends to improve land by more than an insubstantial amount, so that substantial improvement of land is not required, the IRS will consider expenditures by the eligible entity capitalized to the basis of the land. Such as, grading or clearing the land, remediating contaminated land, or the entity's acquisition of related QOZ Business Property that facilitates the use of the land in the trade or business of the QOF (for example, a beach-resort owner's acquisition of fences for use in a QOZ beach resort to prevent erosion).¹³³

The final QOZ regulations permit certain expenditures during the 30-month substantial improvement period to be aggregated for purposes of determining whether the substantial improvement requirement is met.

127. *See id.*

128. Treas. Reg. § 1.1400Z2(d)-1(b)(2)(iii).

129. I.R.C. § 1400Z-2(d)(2)(D)(ii).

130. Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iv) (reference to I.R.C. § 1400Z-2(d)(2)(D)(ii)).

131. Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iv)(B)-(C).

132. *Id.*

133. Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iv)(C).

First, under a functionality-based aggregation method, an eligible entity can aggregate purchased QOZ Business Property with non-original use tangible property that is being substantially improved for purposes of satisfying the substantial improvement requirement so long as the improvement (i) is in a contiguous QOZ as the non-original use property, (ii) is used in the same trade or business as the non-original use property, and (iii) improves the functionality of the non-original use property.¹³⁴

For example, a hotel, which is not newly constructed, may include the acquisition of new items of tangible personal property, such as towels, linens, and chairs (purchased items that cannot be substantially improved). When determining whether renovations to the hotel satisfy the substantial improvement requirement, those items cannot be included to meet the substantial improvement test of a separate apartment complex held by the same entity.¹³⁵ Second, under a building aggregation method, an eligible entity can measure substantial improvement based on the aggregate adjusted basis and improvements made with respect to buildings in an eligible building group. An eligible building group is either (a) a group of buildings located within a single parcel of land described in a single deed, or (b) a group of buildings, each of which (i) is located entirely within two or more contiguous parcels of land that share common boundaries or would share common boundaries but for the interposition of a road, street, railroad, stream or similar property, (ii) are operated exclusively by the eligible entity, (iii) share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; and (iv) are operated in coordination with, or reliance upon, one or more of the trades or businesses (for example, supply chain interdependencies or mixed-use facilities).¹³⁶

The final regulations on investing in QOFs also provide that tangible property that is being substantially improved by a QOF, but that has not yet been placed in service, may be treated as QOZ Business Property throughout the 30-month substantial improvement period if certain requirements are met. For this rule to apply, the QOF must reasonably expect that before the end of such 30-month period, (i) additions to the basis of such property will meet the substantially-improved property test, (ii) the property will be placed in service and used in the eligible entity's trade or business in a QOZ, and (iii) all other QOZ Business Property requirements with respect to the property will have been met with respect to the property.¹³⁷

134. Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iii).

135. Treas. Reg. § 1.1400Z2(d)-2(b)(4)(iii)(D)(1).

136. Treas. Reg. § 1.1400Z2(d)-2(b)(4)(v).

137. Treas. Reg. § 1.1400Z2(d)-2(b)(4)(ii).

F. Combining QOZ Incentives with Other Tax Incentive Programs

Because QOZ tax incentives are realized through gross income exclusions under section 1400Z-2, not federal tax credits, investors in opportunity zone projects may efficiently combine the tax deferral and potential reduction of a QOF investment with federal income tax credits, including, as applicable, new markets tax credits for 98% of QOZs that are also LICs under section 45D(e), historic tax credits under section 47, renewable energy investment and production tax credits under sections 48 and 45, respectively, and low-income housing tax credits under section 42 (“LIHTCs”), together with tax-exempt housing bonds under section 142(d) through which LIHTCs may be realized, as well as passthrough deductions for qualified business income under section 199A.¹³⁸ Even other federal income tax exclusions, like those for qualified small business stock, with a shorter holding period for forgiveness, can be efficiently combined as an insurance policy against an early exit from a 10-year QOF investment.¹³⁹

Puerto Rico offers a comprehensive framework for incentivizing priority projects in opportunity zones built to complement the federal QOZ incentives and mirror its rapid investment timeline. This framework will be the subject of the remainder of this article.

IV. PUERTO RICO QUALIFIED OPPORTUNITY ZONE PROGRAM

Puerto Rico has its own range of local development tax incentives to supplement the federal tax benefits achieved by rolling over capital gains into real estate development projects located in one of Puerto Rico’s opportunity zones. These local opportunity zone tax benefits extend beyond those that have long been available for investors in Puerto Rico’s tourism, manufacturing, film, agriculture, and green energy sectors.¹⁴⁰

138. See I.R.C. § 45D(d)(2)(A)(i)–(iii); Treas. Reg. §1.45D-1(d)(4)(i)(A)–(C) (requiring nexus to a low-income community for investments to qualify for new markets tax credits); I.R.C. § 45D(e) (defining “low-income community” for purposes of the new markets tax credit); I.R.C. § 1400Z-1(c)(1) and 1400Z-1(e)(2) (requiring at least 95% of QOZ census tracts to be “low-income communities” within the meaning of I.R.C. § 45D(e)); I.R.S. Notice 2018-48, 2018-28 I.R.B. 9 (Jul. 9, 2018), as modified by, I.R.S. Notice 2019-42, 2019-29 I.R.B. 352 (Jul. 15, 2019) (listing 8,566 LICs designated as QOZs and 198 non-LIC contiguous tracts designated QOZs).

139. See Jonathan Talansky & Nikolai Karetnyi, *Get in the Q: The Alphabet Soup of QOZ and QSBS Tax Benefits*, 164 TAX NOTES 2217, 2222–2227 (2019) (providing strategies for combining the QOZ rules with the qualified small business regime under section 1202).

140. See generally P.R. Dep’t of Econ. Dev. and Com., *Opportunity Zones Program*, www.ddec.pr.gov/images/Opportunity-Zone-Program-Presentation-english-version.pdf [perma.cc/SXW3-EDDP] (last visited Aug. 17, 2022) (describing Puerto Rico opportunity zone tax incentives for affordable housing, residential or commercial property, industrial use property, and substantial improvement of existing properties for commercial use, sale or rent, as examples of eligible activities that may qualify for local benefits to exempt business in QOZs even though they would not otherwise be

On May 14, 2019, Puerto Rico enacted the Puerto Rico Opportunity Zone Act to provide a comprehensive tax incentive framework for encouraging those considering opportunity zone investments to make those investments in Puerto Rico. On July 1, 2019, Puerto Rico consolidated approximately 76 laws and programs that promote investment in Puerto Rico under the Incentives Code of Puerto Rico, 2019 P.R. Act No. 60 (“Act 60” or the “Puerto Rico Incentives Code”), which includes incentives for investing in Puerto Rico’s 863 QOZs.¹⁴¹ The Puerto Rico Department of Economic Development and Commerce issued *Regulation No. 9222, Reglamento De Zonas De Oportunidad en Puerto Rico* (MO-DEC-012), applicable to the regulation of opportunity zones in Puerto Rico on October 9, 2020 (the “Puerto Rico Opportunity Zone Regulations”).¹⁴²

Act 60’s provisions, together with the Department of Economic Development and Commerce’s Puerto Rico Opportunity Zones Regulations, are intended to align local tax law with U.S. tax benefits afforded to QOF investors under the QOZ provisions and to supplement those benefits “to create a favorable environment to attract investment to

eligible for other Puerto Rico tax incentive programs). For example, Puerto Rico provides significant tax incentives, including a tax credit of up to 50% of the amount invested in tourist-related activities, and a 90-percent income tax exemption for tourism development income, of an exempt business with respect to certain hotels, golf courses and tourist-related projects. *See* Puerto Rico Tourist Development Act of 2010, P.R. Act No. 74-2010, §§ 3(a)(1)(A)(i) and 5(a)(1) (Jul. 10, 2010). Bona fide farmers who derive 51 percent or more of their gross income, or production/investment value from an agriculture business, as an operator, owner or tenant, may also be entitled to a 90 percent income tax exemption from income derived directly from an agricultural business operating under a tax decree from the Secretary of the Department of Economic Development and Commerce. *See* P.R. Act No. 225-1995, § 10(a) (Dec. 1, 1995); P.R. Act No. 60-2019, §1020.08(a). Film projects in which 80 percent of the production expenses in Puerto Rico are for Puerto Rico residents, as well as infrastructure projects exceeding \$5 million involving the development or substantial expansion in Puerto Rico of studios or other facilities for the international transmission of television images or other media, may also be eligible tax credits equal to 40 percent of those amounts disbursed in connection with all Puerto Rico production expenses, except for payments made to nonresidents, which are eligible for a 20 percent credit if made in connection with Puerto Rico production expenses. P.R. Act No. 27-2011, Art. 7.3(e) (Mar. 4, 2011). Taxpayers who obtain 15-year tax exemption decrees under the Puerto Rico Incentives Code for green energy activities, including energy produced from renewable sources, and producers and manufacturers of highly-efficient electric power generation system, may be eligible for (i) a flat income tax rate of 4 percent in Puerto Rico with respect to income generated from green energy activities; (ii) a 50 percent exemption from municipal taxes; (iii) a 75 percent exemption from municipal construction excise taxes for contractors and subcontractors of the exempt business; and (iv) a 75 percent exemption from personal and real property taxes. *See* P.R. Act No. 60-2019, P.R. H. B. 1635, at §§ 2072.03(d), 2072.03(e), 2072.03(f), 2072.04(e).

141. P.R. Act No. 60-2019, P.R. H. B. 1635, at §§ 6070.54 - 6070.67 (Jul. 1, 2019) (defining an “Exempt Business” and an “Eligible Business”; an “Exempt Business” is an “Eligible Business” that holds an exemption decree granted under section 6070.60 of Act 60).

142. P.R. Dep’t of Econ. Dev. and Com., *Reglamento De Zonas De Oportunidad en Puerto Rico*, Reg. No. 9222, §§ 6070.55-1 - 6070, 68-1 (Oct. 9, 2020).

Opportunity Zones located in Puerto Rico” by “aggressively establishing the most attractive tax, regulatory, and economic framework for a Qualified Opportunity Fund.”¹⁴³ In addition to the preferential income tax treatment, Puerto Rico’s incentives statute for opportunity zones provides for reductions in other local taxes for a period of 15 years and a transferable tax credit of up to 25% of cash contributed to a qualified opportunity fund within the meaning of section 1400Z-2(d)(1), which conducts business in Puerto Rico.¹⁴⁴ These provisions, among other benefits such as an expedited permitting process, are intended to make Puerto Rico’s market more appealing for investors looking to take advantage of opportunity zones.¹⁴⁵ To qualify for Act 60 benefits, a taxpayer must undertake a “Priority Project” and then obtain an exemption certificate. Each of these requirements is described further below.

A. Priority Project within Puerto Rico’s Opportunity Zones

Puerto Rico’s Committee on Priority Projects within Opportunity Zones (“Committee”) has designated each of the following a Priority Project that will be eligible for Puerto Rico QOZ benefits from August 19, 2019 until the Committee amends the list adopted in *Resolution 19-01, To Approve and Adopt the Initial Priority Projects within Opportunity Zones List*, dated August 19, 2020, which remains effective as of the date of this publication:

- (1) the development, acquisition, construction or substantial improvement of a low-income housing project within the meaning of section 42(g) or designated as such by the Puerto Rico Department of Housing;
- (2) the development, acquisition, construction or substantial improvement of other residential property for sale or rent;
- (3) the development, acquisition, construction or substantial improvement of commercial property for sale or rent;
- (4) the development, acquisition and construction or the substantial improvement of industrial real property for sale or rent; and
- (5) the substantial improvement of any existing commercial property for sale or rent.¹⁴⁶

143. P.R. S.B. 1147, *An Act to create the Puerto Rico Economic Development and Opportunity Zones Act of 2019*, Act No. 21-2019, Statement of Motives (Apr. 14, 2019).

144. P.R. Act No. 60-2019, § 6070.56(i)(1)–(3) (defining the maximum investment credit as 25% of the amount of cash contributed by all investors in exchange for stocks or interest in a QOF, when such cash is (a) used by the QOF in its trade or business in a PR QOZ or (b) used to acquire stock or partnership interests in a QOZB which carries on such a trade or business in a PR QOZ).

145. P.R. S.B. 1147, *An Act to create the Puerto Rico Economic Development and Opportunity Zones Act of 2019*, Act No. 21-2019, Statement of Motives (Apr. 14, 2019).

146. P.R. FAFAA Press, *supra* note 52, at 2–3 (Aug. 21, 2019) (“FURTHER RESOLVED, that the activities herein described will be in effect [as Priority Projects within Opportunity Zones] until the Committee amends this Resolution, but never less

Although the Committee's directive does not define the "substantial improvement of existing property" that qualifies a project for Puerto Rico tax benefits, QOZ Business Property takes its meaning in the Puerto Rico Opportunity Zone Act and Puerto Rico Opportunity Zone Regulations thereunder from section 1400Z-2(d)(2)(D) of the U.S. Internal Revenue Code.¹⁴⁷ Section 1400Z-2(d)(2)(D)(ii) of the Code treats tangible property as "substantially improved" by a QOF or QOZB only if, during any 30-month period beginning after the date of acquisition of such tangible property, additions to the basis of such tangible property in the hands of the QOF or QOZB exceed an amount equal to the adjusted basis of such tangible property at the beginning of such 30-month period in the hands of the QOF or QOZB. Notably, the Puerto Rico Opportunity Zone Regulations (MO-DEC-012) published by the Department of Economic Development and Commerce in October 2020 generally provide that terms, phrases or concepts, such as "substantial improvement" or "substantially improved" property, that are not otherwise defined in the Internal Revenue Code of Puerto Rico or the Puerto Rico Opportunity Zone Regulations "will have the same meaning that they have in . . . the U.S. Internal Revenue Code."¹⁴⁸ This includes federal income tax regulations discussed above that allow certain expenditures on functionally-related property and building groups to be aggregated to satisfy the substantial improvement requirement with respect to non-original use tangible property.¹⁴⁹ Moreover, other provisions of the Puerto Rico Opportunity Zone Regulations, relating to the concept of a "significant expansion," which is necessary for a project to qualify for Puerto Rico investment tax credits after a project is placed in service, specifically incorporate the "requirements provided [for substantial improvement] in Section 1400Z-2(d)(2)(D)(ii) of the U.S. Internal Revenue Code and federal regulations for opportunity zones published for these purposes."¹⁵⁰ This includes those reviewed above with respect to the aggregation of building groups and functionally-related original-use property for purposes of more than doubling the basis of the tangible business property under the substantial-improvement test.¹⁵¹ Thus, it is expected that Priority Projects for existing buildings would likewise

than one (1) year, pursuant to Section 6070.60(a)(1) of the Code.").

147. P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico, Reg. No. 9222, § 6070.55-1(b) (Oct. 9, 2020) ("For purposes of the provisions of Economic Development Opportunity Zones established in the Code and this Regulation, *unless expressly provided otherwise*, the other *terms, phrases or concepts* used in these Regulation, will have the same meaning that they have in the Code, the Internal Revenue Code, the *Federal Internal Revenue Code*, and their *respective regulations*." (emphasis added) [original translation].

148. *Id.*

149. *Id.*

150. P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico, Reg. No. 9222, § 6070.56(i)(1)-3 (Oct. 9, 2020) (defining "significant expansion" for purposes of the Puerto Rico Internal Revenue Code and the Puerto Rico Opportunity Zone Regulations) [original translation].

151. *Id.*

require more than doubling the basis of such real property within any 30 months (excluding the value of any land) for the improvements to qualify for local tax incentives.

B. Exemption Certificate

Undertaking a Priority Project is not enough for Puerto Rico tax benefits to accrue, however. Unlike self-certified QOFs, which confer benefits on investors without Treasury's imprimatur, QOFs and QOZBs cannot become exempt businesses entitled to Puerto Rico tax benefits before applying for, and being granted, an exemption certificate under Act 60 from the Director of the Industrial Tax Exemption Office ("Director"), or the director of any office that succeeds it, attached to the Department of Economic Development and Commerce of Puerto Rico.¹⁵²

Among other things, the business seeking such a certificate must either be a QOF which exclusively invests in Puerto Rico's opportunity zones or be a QOZB in which such a QOF invests.¹⁵³

Further, there is an up-front cost to taxpayers seeking benefits under the Puerto Rico incentives program for the Economic Development of Opportunity Zones.¹⁵⁴ Article 6070.66(d)-2(b) of the Puerto Rico Opportunity Zones Regulations provides the following schedule of fees charged by the Industrial Tax Exemption Office for reviewing each application for a decree or tax credit under the Puerto Rico Incentives Code's provisions establishing incentives for Priority Projects located in QOZs within Puerto Rico:¹⁵⁵

Type of Request	Transaction Fee	Charge for Service
Decree Request	\$5.00	\$5,000.00
Tax Credit Application	\$5.00	\$500.00

In addition, while the U.S. federal opportunity zone program can be effectively combined with any number of federal and local tax incentive programs, Puerto Rico's opportunity zone incentives may not be combined with certain Puerto Rico tax benefits provided to incentivize tourism, manufacturing, green energy, and the film industry, and so the value of these opportunity zone benefits compared to other economic development tax incentives in Puerto Rico must be carefully weighed.

Nevertheless, for many projects that are beyond the scope of these other Puerto Rico incentive programs, such as most office and commercial rental projects in Puerto Rico, the benefits offered under the Puerto Rico Opportunity Zone Act may provide a useful boost to the

152. See P.R. Act No. 60-2019, § 6070.60 (setting forth criteria for establishing "priority projects" and granting exemption certificates).

153. P.R. Act No. 60-2019, § 6070.55(a)(20)-(21) (defining an "Exempt Business" and an "Eligible Business"; an "Exempt Business" is an "Eligible Business" that holds an exemption decree granted under section 6070.60 of Act 60).

154. P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico, Reg. No. 9222, § 6070.66(d)-2(b) [original translation].

155. *Id.*

federal incentives available for opportunity zone investments.

C. Tax Benefits Under Act 60

The tax benefits under the Puerto Rico QOZ program generally apply for a period of 15 years and are limited to “exempt businesses” (and investments in such businesses) which have received a discretionary tax-exemption decree from the Director.¹⁵⁶ To be eligible, the business must be formed as a Puerto Rico or U.S. corporation, partnership, limited liability company, or joint venture which satisfies the requirements under section 1400Z-2(d) for being a QOF or QOZB.¹⁵⁷ Further, the QOF or QOZB’s activity must be a designated Priority Project, or the entity must request such designation through a letter addressed to the Committee.¹⁵⁸

To be designated a Priority Project, a business must show that its income-producing activity in one or more opportunity zones in Puerto Rico (known as an “eligible zone”) “will contribute to the diversification, recovery, or social and economic transformation of the community of the eligible zone.”¹⁵⁹ In addition, the QOF or QOZB that applies for an exemption certificate must be engaged in a business activity that is carried out entirely within one or more eligible zones in Puerto Rico.¹⁶⁰

Thus, while a U.S. multinational corporation that invests capital gain in a QOF could use that QOF to fund a variety of projects in QOZs located in several U.S. states and Puerto Rico, the fund’s Puerto Rico operations would only be eligible for Puerto Rico’s opportunity zone tax benefits if they were carried on through a separate QOZB that only invests in areas of Puerto Rico that have been designated as opportunity zones under section 1400Z-1(b)(3) of the Code.¹⁶¹ Neither a multinational corporation, with international operations that are by definition outside of a QOZ, nor its QOF subsidiary that does business in multiple states, would be an entity eligible to apply for, or receive, an opportunity zone tax exemption decree from the Puerto Rican government, although a QOZB owned by either such entity potentially could.¹⁶²

156. P.R. Act No. 60-2019, § 6070.60 (setting forth criteria for establishing “priority projects” and granting exemption certificates).

157. See P.R. Act No. 60-2019, § 6070.55(a)(20)–(21) (defining an “Exempt Business” and an “Eligible Business”; an “Exempt Business” is an “Eligible Business” that holds an exemption decree granted under section 6070.60 of Act 60).

158. P.R. Act No. 60-2019, § 6080.55(a)(20)(B).

159. P.R. Dep’t of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico, Reg. No. 9222, Article 6070.55-1(a)(35) (Oct. 9, 2020) (defining an “eligible zone”) [original translation].

160. P.R. Dep’t of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico, Reg. No. 9222, Article 6070.55-1(a)(24) (Oct. 9, 2020) (defining an “eligible business” that can qualify for a Puerto Rico tax exemption decree) [original translation].

161. P.R. Dep’t of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico, Reg. No. 9222, Article 6070.55-1(a)(24)(i) (“The [eligible business’s] business activity is carried out entirely in an eligible zone.”) [original translation].

162. P.R. Dep’t of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico, Reg. No. 9222, Article 6070.55-1(a)(24) (defining an eligible entity for

Finally, the entity carrying on the business must not be eligible for a tax exemption decree under Puerto Rico's Act to Promote the Export of Services, the Economic Incentives Act for the Development of Puerto Rico, the Puerto Rico Tourism Development Act of 2010, the Green Energy Incentives Act of Puerto Rico, or the Puerto Rico Film Industry Economic Incentives Act. Investors in Priority Projects through such exempt businesses are eligible for the following benefits for 15 years.¹⁶³

Benefit #1 - Investment Tax Credit for Eligible Investments.

Puerto Rico allows taxpayers to earn a transferable investment tax credit of up to 25 percent based on the amount of cash invested by a taxpayer in a QOF which carries on a trade or business in Puerto Rico directly or which is reinvested by the QOF into a QOZB which carries on such a trade or business.¹⁶⁴ Puerto Rico also allows a transferrable investment tax credit of up to 25 percent equal to the cash invested directly by any taxpayer in a QOZB exempt business that carries on a business in Puerto Rico, so long as there is at least one QOF investor in such QOZB exempt business in compliance with section 1400Z-2(d)(2) of the Code (defining qualified opportunity zone stock and a qualified opportunity zone partnership interest).¹⁶⁵

Any investors' cash investment in a QOF or QOZB that is an exempt business, including capital contributions from taxpayers, such as Puerto Rico residents, that are eligible to elect deferral of capital gains for U.S. tax purposes under I.R.C. § 1400Z-2(a)(1)(A), can qualify for the Puerto Rico tax credit.¹⁶⁶ As indicated, direct investments by a taxpayer in a QOZB (rather than through a QOF) may be eligible for Puerto Rico tax credits even though no U.S. federal income tax advantages would be available for such investments under section 1400Z-2 of the Code.¹⁶⁷ Subject to a minimum tax credit of 5 percent and a maximum credit of 25 percent, the Committee determines the amount of the taxpayer's opportunity zone credit based on (a) the project's job creation potential, (b) its contribution to the fields of education, health, and housing, (c) the amount of the

purposes of the Puerto Rico Opportunity Zone Act) [original translation].

163. P.R. Act No. 60-2019, at § 6080.55(a)(20)(B).

164. P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico, Reg. No. 9222, Article 6070.55-1(a)(19) (defining an "eligible investment" for Puerto Rico investment tax credit purposes) [original translation].

165. P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico, Reg. No. 9222, Article 6070.55-1(a)(19)(iii) (defining certain "eligible investments" for Puerto Rico tax credit purposes directly in a QOZB so long as the investment by the QOF is "in compliance with Section 1400Z-2(d)(2) of the U.S. Internal Revenue Code") [original translation].

166. See P.R. Act No. 60-2019, § 6070.55(a)(9), § 6070.55(a)(16) and § 6070.56(i)(3)(A)(i)-(ii).

167. Compare P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico, Reg. No. 9222, Article 6070.55-1(a)(19)(iii) (permitting cash contributed to a corporation or partnership that is an exempt business (including a QOZB) to qualify as an "eligible investment" for purposes of the Puerto Rico tax credit), with I.R.C. § 1400Z-2(a)(1) (restricting tax benefits for QOZ investments under the federal program to investments made by eligible taxpayers directly in a QOF, which must hold 90% of its assets in QOZ Property, including certain investments in QOZBs).

investment the exempt business makes in lands, buildings, machinery, and equipment, (d) the project's potential effect on the economy and (e) the needs of the geographic area. The credit is available in four annual installments, beginning in the year in which the QOF or QOZB either (a) finishes the total construction of a Priority Project, or (b) in the case of a project that does not require construction, commences operations, or (c) after finishing construction, makes a "significant expansion" of the real property so constructed.¹⁶⁸

The Puerto Rico Opportunity Zone Regulations define a Priority Project's total construction to be completed when more than 90 percent of the total construction has been carried out.¹⁶⁹ In addition, these regulations define a "significant expansion" after construction of Priority Project is complete as one in which an exempt business satisfies the requirements for a "substantial improvement" under section 1400Z-2(d)(2)(D)(ii) of the Code and regulations thereunder.¹⁷⁰ Thus, if a taxpayer makes an eligible investment in a QOF or QOZB that is an exempt business after construction of the eligible project is completed, the taxpayer may qualify for the credit in four equal annual installments, beginning in the year in which the QOF or QOZB makes a "substantial improvement" of the real property so constructed, as that concept is defined for U.S. tax purposes.¹⁷¹ As discussed, a "substantial improvement" or "substantially improved" property is tangible property if, during any 30-month substantial improvement period beginning after the date of acquisition of such property, additions to the basis with respect to such property in the hands of the QOF or QOZB exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the QOF or QOZB.¹⁷² Thus, under the Puerto Rico Opportunity Zone Program, after construction of an eligible project is finalized, the QOF's and QOZB's ability to more than double its adjusted tax basis in a building during any applicable 30-month substantial improvement period may allow new investors in the exempt business to potentially qualify for a Puerto Rico tax credit of between 5 percent and 25 percent, based on the amount of cash ultimately invested in the eligible entity holding the tax-exemption decree granted by the Government of Puerto Rico.¹⁷³ Any amount of the Puerto Rico opportunity zone investment tax credit not used in a year can be carried forward indefinitely until it is exhausted, and may be sold or transferred to third parties. In the case of a sale of the credit, Puerto Rico exempts from tax

168. P.R. Act No. 60-2019, § 6070.56 (i)(1), 6070.56(i)(3)(A), (i)(7)(B) 6070.56(i)(6)(A)(i), 6070.56(i)(6)(B).

169. P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico (MO-DEC-012), Reg. No. 9222, Article 6070.56(i)(1)-2(c)(1) (Oct. 9, 2020).

170. P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico (MO-DEC-012), Reg. No. 9222, Article 6070.56(i)(1).

171. *Id.*

172. I.R.C. § 1400Z-2(d)(2)(D)(ii).

173. P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico (MO-DEC-012), Reg. No. 9222, Article 6070.56(i)(1)-3 (Oct. 9, 2020).

the purchase price received therefor.¹⁷⁴ However, Puerto Rico does require a basis adjustment which reduces the exempt business's tax basis in its eligible investment for Puerto Rico tax purposes by the amount used as an investment tax credit under the Priority Projects within Qualified Opportunity Zones program under the Puerto Rico Incentives Code.¹⁷⁵

Benefit #2 - Exempt Income from Asset Sales Reinvested in Puerto Rico QOZ. The Puerto Rico Incentives Code and Opportunity Zone Regulations provide that, during the 15-year tax exemption period of a QOF or QOZB covered by a Puerto Rico opportunity zone exemption decree, the QOF or QOZB exempt business is exempt from Puerto Rico tax on gain realized from the sale or exchange of any asset if the exempt business invests an amount equal to the amount realized in the sale or exchange in compliance with the requirements of section 1400Z-2(d)(2)(A)(iii) of the U.S. Internal Revenue Code.¹⁷⁶ Act 60 provides that “[n]o gains or losses shall be recognized by an exempt business in the sale or exchange of assets made during its exemption period if the exempt business invests an amount equal to the amount realized in the sale or exchange pursuant to the requirements of Section 1400Z-2(d)(1) of the U.S. Internal Revenue Code.”¹⁷⁷ The provision further provides that, “[i]f the sale or exchange occurs after the expiration of a designation under Section 1400Z-1(f) of the U.S. Internal Revenue Code, the requirements of Section 1400Z-2(d)(1) of the U.S. Internal Revenue Code shall continue to apply for purposes of this subsection [relating to the local tax exemption for an exempt business's sale or exchange of assets in Puerto Rico].”¹⁷⁸ Section 1400Z-2(d)(1) of the Code requires that QOFs hold at least 90 percent of their assets in QOZ Property. This includes QOZ Business Property held directly and QOZ Partnership Interests or QOZ Stock issued by a QOZB that must hold at least 70 percent of its tangible property in QOZ Business Property, determined annually based on the average amount of assets held in the form of QOZ Property on two semiannual testing dates. I.R.C. § 1400Z-2(d)(1) does not apply to QOZB exempt businesses directly, although the conditions of the Puerto Rico Incentives Code could be considered met if the proceeds of a sale or exchange by a QOZB exempt business were reinvested in accordance with its 70 percent QOZ Business Property requirement.¹⁷⁹

174. P.R. Act No. 60-2019, § 6070.56 (i)(1), 6070.56(i)(3)(A), (i)(7)(B) 6070.56(i)(6)(A)(i), 6070.56(i)(6)(B).

175. P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico (MO-DEC-012), Reg. No. 9222, Article 6070.56(i)(4)-1(a) (Oct. 9, 2020).

176. See P.R. Act No. 60-2019, § 6070.56(f); P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico (MO-DEC-012), Reg. No. 9222, Article 6070.56(f)-1 (Oct. 9, 2020) [original translation].

177. P.R. Act No. 60-2019, § 6070.56(f).

178. *Id.*

179. See 26 U.S.C.S. § 1400Z-2(d)(1) (2017) (defining a QOF as an entity that holds 90% of its assets in QOZ Property, including QOZ Business Property or QOZ Partnership Interests or QOZ Stock issued by a QOZB); 26 U.S.C.S. § 1400Z-2(d)(3)(A)(i) (2017) (requiring that “substantially all” of a QOZB's tangible property be in the form of QOZ Business Property); Treas. Reg. § 1.1400Z2(d)-1(d)(2) (“A trade

The Puerto Rico Opportunity Zone Regulations provide that, in order for a QOF or QOZB exempt business to satisfy the requirements for not recognizing any gain on the sale or exchange of its assets, when the sale or exchange is made during the 15-year exemption period of its opportunity zone tax-exemption decree, (1) the investment by the exempt business must “be in [QOZ Business] Property defined under Section 1400Z-2(d)(2)(A)(iii) of the Federal Internal Revenue Code,” (2) “the period to reinvest [the amount realized in such property] will be twelve (12) months from the sale or total or partial exchange of the assets of the Exempt Business,” and (3) “the assets must be used in the Eligible Activity” of the business in a QOZ located in Puerto Rico.¹⁸⁰ In other words, a QOZB exempt business must use the proceeds of its asset sale to reinvest in tangible property used in the active conduct of a trade or business in an opportunity zone located in Puerto Rico in order to avoid local tax under this provision.¹⁸¹ Like the Puerto Rico Incentives Code, the Puerto Rico Opportunity Zone Regulations make clear that the exemption from tax on the sale or exchange of an asset will continue to apply to a QOF or QOZB operating under a tax-exemption decree in Puerto Rico after the expiration of QOZs for federal income tax purposes under section 1400Z-1(f) of the Code. The Department of Economic Development and Commerce provides the following example of the operation of this principle in its regulations:¹⁸²

Example: Corporation X is an Exempt Business engaged in the commercial rental of a building that it owns in an Eligible Zone [i.e., a QOZ located in Puerto Rico]. The effective date of the Decree is July 1, 2020. The building has a tax base of \$250,000. On December 1, 2034, after the Opportunity Zone designation has expired, Corporation X sells the building for \$600,000. Corporation X will not be taxed on the gain on the

or business of an eligible entity satisfies the 70-percent tangible property standard if at least 70 percent of the tangible property owned or leased by the trade or business is qualified opportunity zone business property (as defined in §1.1400Z2(d)-2).”)

180. P.R. Dep’t of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico (MO-DEC-012), Reg. No. 9222, Article 6070.56(f)-1(a) [original translation].

181. The Puerto Rico Incentives Code generally defines an eligible activity of an exempt business as the activity for which a tax-exemption decree is allowed under the applicable provisions of the Incentives Code. See P.R. Dep’t of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico (MO-DEC-012), Reg. No. 9222, Article 6070.55-1(a)(18) (definition the net income from the development of opportunity zone in Puerto Rico as the exempt business’s income generated from operation of an “eligible activity”). See also P.R. Act No. 60-2019, § 1020.01(a)(22) (defining the developer in terms of “the construction, development or administration of a project or eligible activity of an Exempt Business”) (emphasis added).

182. Compare 26 U.S.C.S. § 1400Z-1(f) (2017) (sunsetting QOZs for federal income tax purposes 10 years after their designation in 2018), with P.R. Dep’t of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico (MO-DEC-012), Reg. No. 9222, Article 6070.56(f)-1(b) (providing that if the sale or exchange occurs after the expiration of the designation of a census tract as a QOZ under section 1400Z-1(f) of the Code, the requirements applicable to QOZ Business Property under section 1400Z-2(d)(2)(A)(iii) will continue to apply for purposes of the Puerto Rico Incentives Code) [original translation].

sale if it reinvests at least \$600,000 in property that would have qualified as Opportunity Zone business property located in Puerto Rico within 12 months from December 1, 2034. If Corporation X invests \$550,000, the gain of \$350,000 will be taxable because the Exempt Business did not invest an amount equal to the amount made in the sale.¹⁸³

This example demonstrates that the Government of Puerto Rico views the benefit of exemption from Puerto Rico tax for sales and exchanges of assets by QOF and QOZB exempt businesses as a cliff rather than a slope. In the second example, the exempt business invested \$11 out of every \$12 (91.67 percent) received from its asset sale in QOZ Business Property but received none of the benefit of the Puerto Rico tax exemption for a sale or exchange of assets reinvested in such property, because \$50,000 of the total amount realized was not invested in QOZ Business Property by the end of the 12-month reinvestment window.¹⁸⁴

Benefit #3 - Exempt Interest Income. Interest income is exempt from commonwealth and municipal taxation on amounts loaned to QOF and QOZB exempt businesses, thus decreasing their cost of capital.¹⁸⁵ Under the regulations issued by the Puerto Rico Department of Economic Development and Commerce's regulations, any person or entity is exempt from paying any tax imposed by the Internal Revenue Code of Puerto Rico, and local business licenses and trade taxes under the Municipal License Tax Act, on interest paid by an exempt business on bonds, promissory notes and other obligations of the exempt business received for development, construction, rehabilitation or improvements to the exempt business, or to the repayment of existing debts of an exempt business, provided that the funds from those existing debts were originally incurred either for development, construction, rehabilitation or improvements of such business.¹⁸⁶

Article 6070.56(h)-1(b) of the Puerto Rico Opportunity Zones Regulations provides an additional limitation on the Puerto Rico tax exemption for interest paid by a QOF or QOZB by requiring that for the exemption to apply, the lender must provide the proceeds of any loan under a bond, promissory note or other obligation "directly to the exempt business" that has been issued a tax-exemption decree by the Government of Puerto Rico under the local opportunity zone program.¹⁸⁷ For example, if a QOF invests in a QOZB that operates exclusively in a QOZ

183. P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico (MO-DEC-012), Reg. No. 9222, Article 6070.56(f)-1(c) [original translation].

184. *Id.*

185. P.R. Act No. 60-2019, § 6070.56(h)(1).

186. P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico (MO-DEC-012), Reg. No. 9222, Article § 6070.56(h)-1(a) (Oct. 9, 2020) [original translation]. *See also* P.R. Act No. 113-1974 (Jul. 10, 1974) (known as the "Municipal License Tax Act" under P.R. Act No. 60-2019, § 1020.01(a)(40)).

187. P.R. Act No. 60-2019, § 6070.56(h)(1); P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico (MO-DEC-012), Reg. No. 9222, Article § 6070.56(h)-1(b) ("The proceeds of the bond, promissory note or other obligation must be granted directly to an Exempt Business.") [original translation].

located in Puerto Rico and the QOZB has been granted an exemption certificate for Priority Projects within Opportunity Zones under section 6070.60 of the Puerto Rico Incentives Code, then only loans made directly to the QOZB exempt business will qualify the lender for tax-exempt paid or credited on bonds, notes or other obligations pursuant to section 6070.56(h) of the Puerto Rico Incentives Code.¹⁸⁸

In addition, Article 6070.56(h)-1(c) of the Puerto Rico Opportunity Zone Regulations provides that the Puerto Rico tax exemption on interest paid or credit on bonds, promissory notes or other obligations of a QOF or QOZB exempt business is limited to the following types of debt instruments:

- (1) A loan to finance the development, construction, rehabilitation, or improvements to an Exempt Business under the provisions related to the Economic Development of Opportunity Zones in the [Puerto Rico Incentives] Code and [Puerto Rico Opportunity Zone] Regulations;
- (2) A loan for the acquisition of property to be used by an Exempt Business in its operation in Puerto Rico; or
- (3) Any other obligation or loan designated by the Commissioner [of Financial Institutions, created by virtue of P.R. Act No. 4-1985, as amended, known as the 'Office of the Commissioner of Financial Institutions Act,' or any other law successor or analog thereto],¹⁸⁹ with the approval of the public sector members of the Financial Board [within the Financial Institutions Commissioner's Office] and the Secretary of the Department of Economic Development and Commerce of Puerto Rico.¹⁹⁰

Benefit #4 - Exempt Dividend Income. Dividend income and distributions from earnings and profits attributable to the opportunity zone net income generated by a QOF or QOZB exempt business in a Puerto Rico QOZ is exempt from tax. The exemption for dividend distributions extends to subsequent distributions of earnings and profits from opportunity zone net income made by a taxpayer that received a tax-exempt dividend from an exempt business. Such distributions are also exempt from Puerto Rico's alternative minimum tax, the alternative basic tax on individuals and the accumulated earnings tax penalty on corporations that improperly accumulate surplus corporate earnings instead of distributing their earnings to shareholders. Dividends and distributions from exempt businesses are not subject to municipal tax in Puerto Rico.¹⁹¹

Benefit #5 - Reduced Rate Income Tax. A fixed 18.5 percent tax rate

188. *See id.*

189. P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico (MO-DEC-012), Reg. No. 9222, Article § 6070.55-1(a)(9) (defining the "Commissioner" for purposes of these regulations) [original translation].

190. P.R. Dep't of Econ. Dev. and Com., Reglamento De Zonas De Oportunidad en Puerto Rico (MO-DEC-012), Reg. No. 9222, Article § 6070.56(h)-1(b) [original translation]. *See also* P.R. Act No. 60-2019, § 1020.01(a)(38) (defining the "Financial Board" to mean "the Financial Board within the Financial Institutions Commissioner's Office" for purposes of the Puerto Rico Incentives Code).

191. P.R. Act No. 60-2019, §§ 6070.56(e), 6070.58(f).

applies to net income earned by certain QOF and QOZB exempt businesses from Puerto Rico QOZs.¹⁹² This is a significant reduction from the maximum income tax rate in Puerto Rico of 37.5 percent for corporations and 33 percent for individuals.¹⁹³

Benefit #6 – Reduced Rate on Withholding Tax. A fixed 18.5 percent tax rate applies to withholding tax on rents, royalties and licensing fees paid by an exempt business to nonresident individuals, corporations and foreign partnerships engaged in a Puerto Rico trade or business.¹⁹⁴ Like Puerto Rico’s exemption for interest earned on exempt businesses’ debt, this Puerto Rico tax exemption applies to parties contracting with a QOF and QOZB exempt business so that Priority Projects cost less to construct or substantially improve.

Benefit #7 – Exemption from Property Tax. A 25 percent exemption from municipal and state personal and real property taxes that municipalities can raise to 75 percent with respect to the property of a QOF or QOZB exempt business used in its development, organization, construction, establishment or operation of a business covered by an exemption certificate, which municipalities may increase to 75 percent.¹⁹⁵

Benefit #8 – Exemption from Construction Excise and Municipal Tax. A 25 percent exemption for QOF and QOZB that qualify as exempt businesses from the construction excise tax imposed by municipalities, which is generally approximately 4 percent to 5 percent of the cost of the project,¹⁹⁶ and municipal license fees, municipal license taxes, and other municipal taxes levied by municipal ordinance on the business activities of exempt businesses, which municipalities can raise to 75 percent.¹⁹⁷

Benefit #9 – Exemption from Other Municipal Tax. A 25 percent exemption is available for QOFs and QOZBs that qualify as exempt businesses, and their contractors and subcontractors from any municipal tax, levy, or duty imposed for the construction of works that are to be used by the applicable business in opportunity zone-related activities in the municipality.¹⁹⁸ Municipalities, at their discretion, can also increase these tax exemptions for exempt businesses, contractors and subcontractors to a maximum of 75 percent, to the extent the municipality deems it beneficial to promote the development of the applicable business activity in a particular geographic area.¹⁹⁹ To do so, the exempt business

192. P.R. Act No. 60-2019, § 6070.56(a).

193. P.R. LAWS ANN. tit. 13, § 30061(a) (2011); P.R. Code §1021.01(a)), as amended by 2015 P.R. Act No. 72, effective May 29, 2015, and as amended by 2018 P.R. Act No. 257, effective Dec. 10, 2018 (providing the income tax for individuals); P.R. LAWS ANN. tit. 13, §§ 30071, 30072 (2011 P.R. Code §§ 1022.01, 1022.02), as amended by 2018 P.R. Act No. 257, effective Dec. 10, 2018 (providing the income tax for corporations).

194. P.R. Act No. 60-2019, § 6070.56(c)(1).

195. P.R. Act No. 60-2019, § 6070.57(b), as amended by P.R. Act No. 40-2020 (Apr. 16, 2020).

196. Jeanelle Alemar-Escabí, Edgar Ríos-Méndez, Alemar-Escabí & Ríos-Méndez, 7320-2nd T.M., Business Operations in Puerto Rico, Chapter 4.J (2019).

197. P.R. Act No. 60-2019, at §6070.58(a), 6070.58(e).

198. P.R. Act No. 60-2019, at § 6070.58(d).

199. P.R. Act No. 60-2019, at § 6070.58(e).

developing a Priority Project must submit an application to the municipality in which the project is located setting forth the additional exemption requested, the type of project or business activity, the total investment in the municipality, the direct jobs created by the project in the municipality and any other information requested by the municipality.²⁰⁰

Benefit #10 – Priority of Payment. Puerto Rico has also established a credit priority system for “Priority Projects” within opportunity zones, whereby tax credits and other incentives payable under the opportunity zone program come first in order of priority of payment, only behind payments made pursuant to an emergency response program.²⁰¹

Benefit #11 – Tax Deferred Capital Gain and Appreciation Basis Step-Up. A tax deferral is allowed on capital gains for amounts invested in a QOF in Puerto Rico and appreciation basis step-up is permitted under similar rules to those adopted under federal legislation. Thus, taxpayers that invest in Priority Project in Puerto Rico through QOFs may realize federally and locally tax-free gains on a sale of the QOF after a holding period of at least 10 years.

Benefit #12 – Expedited Permitting. A swift permit evaluation and issuance process for exempt businesses established by the Puerto Rico Opportunity Zone Act consolidates all permit processing in Puerto Rico at all levels of government under the exclusive jurisdiction of the Permit Management Office.²⁰² Most non-environmental permits for Priority Projects within Opportunity Zones must be issued under the Permit Management Office’s streamlined procedures within 10 business days after the permitting application has been filed by an exempt business with such office, including permits for urban development, construction, land subdivision and others for the Development of the Priority Project.²⁰³ A streamlined environmental review and compliance certification process for Priority Projects in Opportunity Zones provides that most environmental evaluations, impact studies, adjudications and certifications will be completed by the Permit Management Office within 20 business days.²⁰⁴ Moreover, any procedure under Puerto Rico law where it is required to notify interested parties with respect to the Priority Project or work connected with the project shall be deemed satisfied by publication of a single notice in two newspapers of general circulation in Puerto Rico.²⁰⁵

Although QOZBs that are delayed in their expenditure of working capital assets in accordance with a written plan and schedule while waiting for governmental action on a complete application, or for up to 24 months after a federally-declared disaster in the QOZ census tract

200. P.R. Act No. 60-2019, § 6070.58(g).

201. P.R. Act No. 60-2019, §§ 6070.56(j), 6070.69(i).

202. P.R. Act No. 60-2019, 6070.69(c)–(h).

203. P.R. Act No. 60-2019, 6070.69(f).

204. P.R. Act No. 60-2019, 6070.69(d)–(e).

205. P.R. Act No. 60-2019, 6070.69(g).

where a project is being developed,²⁰⁶ they may continue to rely on the working capital safe harbor under Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v). Such delays may cause delays in funding of a QOZB that are not so protected, and could cause benefits under the federal opportunity zone program to be lost.²⁰⁷ This might occur, for instance, if governmental delays cause such uncertainty with respect to the viability of a project that investors delay funding a QOF until after the December 31, 2021, deadline for reducing capital gains rolled over into a QOF.²⁰⁸ Puerto Rico's streamlined procedure for issuing permits to QOZ projects helps reduce delays that might otherwise prove costly to investors and fund managers.

This powerful constellation of tax incentives may offer many U.S. investors in Puerto Rico a wide array of potential opportunities. In addition, legislation enacted by Puerto Rico in April 2020 will ensure that bona fide residents of Puerto Rico are eligible to receive local tax benefits that mirror, for Puerto Rico income tax purposes, the tax deferral and partial elimination of capital gains invested in a QOF, along with the permanent exclusion of post-acquisition gains, that such investors would be able to achieve for federal income tax purposes, if they were subject to federal income tax.²⁰⁹ The Puerto Rico legislation was enacted after the IRS and U.S. Treasury Department made clear in final regulations issued under section 1400Z-2 of the Code that individuals and entities not subject to federal capital gains tax, including bona fide residents of Puerto Rico, are ineligible for the federal tax benefits under the QOZ program.²¹⁰

206. See I.R.S. Notice 2020-39, 2020-26 IRB 984 (Jun. 5, 2020), as modified by Notice 2021-10, 2021-7 IRB 888 (Feb. 16, 2021) (providing a 24-month extension to the 31-month working capital safe harbor period for projects with a written working capital plan and schedule in place by March 30, 2021, that provides for the expenditure of cash, cash equivalents or debt instruments with a term of 18 months or less on the development of a trade or business in a QOZ).

207. Compare Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)(C) (deeming property consumption by QOZB to be consistent with reasonable working capital plan and schedule expending such capital within 31 months if the delay is caused by waiting for governmental action on an application completed by the entity), with Treas. Reg. § 1.1400Z2(d)-1(b)(2)(i)(B) (including no such exception for the QOF's safe harbor period for expending recently-contribution property converted to working capital assets).

208. See I.R.C. § 1400Z-2(b)(2)(B)(ii) (allowing an increase in basis for investors that invest in a QOF and hold that investment for at least five years before December 31, 2026, i.e., pre-2022 investors).

209. Compare P.R. Act No. 60-2019, § 1031.06 (Jul. 1, 2019), as amended by P.R. Act No. 2020-40 (Apr. 16, 2020) (providing tax deferral and reduction for QOF investments based in Puerto Rico, regardless of the taxpayer's status as a U.S. federal income taxpayer), with I.R.C. § 1400Z-2(a)-(c) (providing similar tax benefits for U.S. taxpayers), and Treas. Reg. § 1.1400Z2(a)-1(b)(11)(i)(B) (requiring, among other things, that capital gains be "subject to Federal income tax" in order to allow deferral of capital gains invested in a QOF, reduction those gains and post-acquisition gain nonrecognition through 2047).

210. Treas. Reg. § 1.1400Z2(a)-1(b)(11)(i)(B) (defining "eligible gain" (i.e., gain eligible for deferral and reduction potential under I.R.C. § 1400Z-2) as capital gains and qualified section 1231 gains that "would be recognized for Federal income tax purposes and subject to tax under subtitle A of the Code before January 1, 2027 (subject to Federal income tax), if section 1400Z-2(a)(1) did not apply to defer

This new feature of Puerto Rico's opportunity zone tax break, combined with the local tax credits and income tax benefits described above should provide additional incentives for Puerto Rico residents to invest in QOZ projects, even if they cannot receive U.S. federal income tax benefits from their QOF investments.²¹¹

V. CONCLUSION

Puerto Rico has long benefitted from U.S. federal income tax incentives to encourage investment on the island. Until 2006, U.S. corporations could avail themselves of the possessions tax credit under section 936 of the Code to receive a tax benefit for investments in Puerto Rico. Since the expiration of the credit under section 936, a similar federal tax incentive for investment in Puerto Rico has not existed.²¹²

The Government of Puerto Rico sees in the federal opportunity zone program an incentive with the power to transform its economy by attracting private capital from the United States into potential new business opportunities on the island.²¹³ It hopes that the federal incentives for businesses, combined with recently-enacted local development incentives, will attract private investment that otherwise may not exist, thus stimulating its economic development and recovery from Hurricane Maria and creating jobs at a critical time for Puerto Rico's economy. Under Act 60, Puerto Rico has established a highly-competitive local tax, regulatory and economic framework for U.S. investors, receiving a federal tax benefit, who reinvest capital gains into a Puerto Rican business. These new incentives for Puerto Rico's opportunity zone investors allow U.S. taxpayers to receive local tax benefits for projects not otherwise entitled to tax exemptions, credits, and other incentives under other local development incentive programs in Puerto Rico for those engaged in the tourism, manufacturing, and green energy sectors. Because of Puerto Rico's status as the most highly-concentrated area of opportunity zones in the United States, these new local opportunity zone incentives will be closely watched by investors, as well as state lawmakers looking to craft their own legislation with the purpose of promoting investment in their own federally-designated opportunity zones.

recognition of the gain.”).

211. P.R. Act No. 60-2019, § 1031.06 (Jul. 1, 2019), as amended by P.R. Act No. 2020-40 (Apr. 16, 2020).

212. See Fin. Oversight and Mgmt. Bd. for P.R., *Revised Fiscal Plan for Puerto Rico*, 11-12 (Mar. 27, 2019) (describing the impact of section 936's repeal on the Puerto Rican economy).

213. P.R. FAFAA Press Release, *supra* note 52, at 1-2 (Aug. 21, 2019) (affirming that the Government of Puerto Rico considers the U.S. federal opportunity zone program “a positive step towards improving Puerto Rico's economy in a holistic way.”).

APPENDIX A: QUALIFIED OPPORTUNITY ZONES NATIONWIDE



