September 17, 2018

RE: OPPORTUNITY ZONE – ISSUES RELATING TO LEASED PROPERTY

Set forth below are further observations on the issue of leased property used by a Qualified Opportunity Zone Business.

Treatment of Leases. Section 1400Z-2(d)(3)(A) defines a qualified opportunity zone business (a "QOZ Business") as "a trade or business (i) 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 paragraph (2)(D)) ….

Section 1400Z-2(d)(2)(D)(i) defines qualified opportunity zone business property ("QOZ Business Property") as

> "tangible property used in a trade or business of the qualified opportunity fund if -
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> (I) such property was acquired by the qualified opportunity fund by purchase (as defined in section 179(d)(2)) after December 31, 2017,
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> (II) the original use of such property in the qualified opportunity zone commences with the qualified opportunity fund or the qualified opportunity fund substantially improves the property, and
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> (III) during substantially all of the qualified opportunity fund's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone."

Thus, section 1400Z-2(d)(2)(D)(i) imposes three distinct requirements for tangible property to qualify as a "good" asset for a QOZ Business. It must be acquired by purchase, its original use in the Qualified Opportunity Zone must begin with the Qualified Opportunity Fund, and during substantially all of the Qualified Opportunity Fund's holding period, substantially all of its use must be in a Qualified Opportunity Zone.

The treatment of leased property under section 1400Z-2 raises some troubling issues. If leased property is to be subjected to the provisions of section 1400Z-2(d)(2)(D)(i), many otherwise "good" QOZ Businesses will fail to meet the statutory requirements.

As a preliminary matter, it is worth noting that, although leased property can be both tangible or intangible, a lease itself is always an intangible asset – a distinction that the statute does not appear to appreciate. As discussed below, the problematic aspects of the statute arise if leased tangible property is subject to the purchase and original use requirements of section 1400Z-2(d)(2)(D)(i).

Acquired by Purchase. The first requirement is that the leased property be acquired by "purchase." The entry into a lease that is treated as a lease for US federal income tax purposes is by definition not a purchase of the leased property. Accordingly, property - whether premises or equipment - the use of which is obtained by a "true" lease could never satisfy the first requirement.

The only way to give effect to the "purchase" requirement in the case of leased property would be to require that the lease itself be acquired by purchase, i.e., property held by a taxpayer under a lease would only be eligible to be QOZ Business Property if the taxpayer purchased the position of lessee from the original lessee of the property. Thus, another person would have had to have leased the premises or property in question from a third party and the QOZ Business would then purchase the leasehold interest from such other person. This result is absurd on its face.

Such as reading – which subjects an intangible asset (the lease itself) to the purchase requirement – cannot be reconciled with the definition of QOZ Property that includes only tangible property nor with the original use requirement (discussed below).

Original Use. Moreover, even the purchase of the leasehold interest by the QOZ Business would not be sufficient to qualify the leased premises or property as QOZ Business Property under section 1400Z-2(d)(2)(D)(i), because leased property and the purchased leasehold interest would both fail the original use requirement of section 1400Z-2(d)(2)(D)(i). As the original use of the premises or property would have at least begun with the lessee from which the QOZ Business purchased the leasehold interest, the QOZ Business would have failed to satisfy the second requirement.[1]

Arguably, the original use requirement could be satisfied for movable property if the QOZ Business purchased the leasehold interest in tangible property outside the Qualified Opportunity Zone and brought the property for the first time into the Qualified Opportunity Zone.[2] Such QOZ Business would then be the "original user" in the Qualified Opportunity Zone. This would mean that the statute was constructed to require QOZ Businesses to purchase the leasehold interest from businesses not in the Qualified Opportunity Zone, an absurd result.

Under this reading of section 1400Z-2(d)(3)(A)(i), even if the leasehold was acquired by purchase, the "original use" requirement would only be satisfied with respect to immovable (i.e., real) property leased by a QOZ Business if the premises were constructed after December 31, 2017 or if the QOZ Business substantially improved the leased property by spending amounts with respect to the leasehold equal to the purchase cost of the leasehold. Presumably, this latter requirement could be satisfied by small expenditures in the case of the purchase of market leasehold interests. Nevertheless, applying the original use requirement to leased property in this manner is at best strained.

Thus, the original use requirement when applied to tangible property by a QOZ Business leads to absurd results.[3] Such a constrained reading of the requirements of section 1400Z-2(d)(2)(d)(2) and (3)

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[1] Arguably, this original use requirement could be satisfied under these facts if the lessee was merely an intermediary, which would require the QOZ Business - intended to benefit low-income communities - to utilize inefficient intermediaries to conduct its business, a result so absurd as not to merit discussion. In addition, even if the use of an intermediary was actually contemplated by the statute (which is doubtful), step transaction and substance over form principles could easily cause any intermediary to be disregarded and the OZ Business not satisfying the "purchase" requirement as a result.

[2] Note that imposing this requirement would require a QOZ Business (and its lessor) to know if the leased property had ever been used in the Opportunity Zone in which the QOZ Business intended to use such property.

[3] A similar absurd result ensues if a QOZ Business is in the business of leasing to third parties equipment purchased by the QOZ Business. That QOZ Business would satisfy the purchase requirement with respect to such property and it would also satisfy the original use requirement if it leased such property out to other businesses in the Opportunity Zone. Its customer base could not include another QOZ Business, however, because the equipment leased by such

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when applied to leased property would require a QOZ Business operating in a Qualified Opportunity Zone to determine if it was the "first user" of the leased property and, if it was not, find another lessor in the Qualified Opportunity Zone from which it could lease new property or, even more irrational, lease the property outside of the Qualified Opportunity Zone and bring the property into the Qualified Opportunity Zone for its use.

Use in the Qualified Opportunity Zone. The use requirement should apply to leased property as the QOZ Business should be operating primarily in Qualified Opportunity Zones and should have its assets (leased or otherwise) in the Qualified Opportunity Zone. No tortured reading or absurd result ensues from imposing this requirement with respect to leased property.

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Any reading of section 1400Z-2(d)(2) and (3) that subjects leased property to the purchase and original use requirements is contrary to settled rules of statutory construction, leading only to absurd results that cannot be countenanced. Statutory interpretation begins with the text itself,[4] and the ordinary and plain meaning of the text of a statute should generally govern its interpretation.[5] If the meaning is plain from the text, the court does not need to look for other sources of meaning. In such instance, there is no need for construction.[6]

When the meaning of the words is not plain or the results that obtain from such plain reading are cruel, irrational, or absurd, however, corollary rules to these fundamental tenets of statutory construction apply.[7] Thus, the Supreme Court has repeatedly held that a statutory interpretation that leads to an absurd result cannot stand.[8] Accordingly, a court generally must not and will not follow

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other QOZ Business would not satisfy the original use requirement for such other QOZ Business unless such other QOZ Business was the first lessee.

[4] Desert Palace, Inc. v. Costa, 539 U.S. 90, 98 (2003) ("Our precedents make clear that the starting point for our analysis is the statutory text." (citing Connecticut Nat. Bank v. Germain, 503 U.S. 249, 253–254 (1992)).

[5] U.S. v. Lehman, 225 F. 3d 426 (4th Cir. 2000) ("In the absence of a specific indication to the contrary, words in the statutes will be given their common, ordinary and accepted meaning, and the plain language of the statute should be afforded its plain meaning."). Courts will not look behind a statutory pronouncement when the language of the statute is clear and unambiguous. See Petroleum Tide Rock Corporation of Texas, Inc. v. U.S., 939 F.2d 1165 (5th Cir. 1991) (finding that, where the plain language of the statute is unambiguous, a court cannot interpret the statute to circumvent the plain language in the statute).

[6] Rubin v. United States, 449 U.S. 424, 430 (1981) ("When we find the terms of a statute unambiguous, judicial inquiry is complete, except 'in "rare and exceptional circumstances."'" (citing TVA v. Hill, 437 U.S. 153, 187, n. 33 (1978), quoting Crooks v. Harrelson, 282 U.S. 55, 60 (1930)); United States v. Wittberger, 18 U.S. 76, 95-96 (1820) (where there is no ambiguity in the words, there is no need for construction.); Caminetti v. United States, 242 U.S. 470, 490 (1917) (calling plain meaning a well-established rule.); United States v. Missouri Pacific R.R.Co., 278 U.S. 269, 278 (1929).

[7] "But if in any case the plain meaning of a provision, not contradicted by any other provision in the same instrument, is to be disregarded, because we believe the framers of that instrument could not intend what they say, it must be one in which the absurdity and injustice of applying the provision to the case would be so monstrous that all mankind would without hesitation unite in rejecting the application." Sturges v. Crowninshield, 17 U.S. 122, 4 Wheat. 122 (1819).

[8] See United Steelworkers of America v. Weber, 443 U.S. 193 (1979); Fallbrook Irrigation Dist. V. Bradley, 164 U.S. 112 (1896); United States v. Kirby, 74 U.S. 482 (1868). See also Green v. Bock Laundry Mach. Co., 490 U.S. 504,

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the plain meaning of the statutory language if a literal interpretation of a statute would lead to an absurd result. In addition, also relevant here, when the Congress amends a statute, "the presumption is that the amendment is intended to have real and substantive effect."[9]

Interpreting section 1400Z-2 as requiring leased property of a QOZ Business to satisfy the purchase and original use requirements of section 1400Z-2(d)(2)(D)(i)(I) and (II) can lead only to absurd outcomes or a statute without meaning or effect insofar as leased property is concerned. Neither result is consistent with basic principles of statutory construction. It is clear from the definition of a QOZ Business that a QOZ Business is entitled to lease property and that such property can constitute QOZ Business Property. The only construction that does not render the leased property provisions of the statute a nullity and provides some meaning to the language of section 1400Z-2(d)(3)(A)(i) is to require leased property of a QOZ Business to satisfy the requirements of section 1400Z-2(d)(2)(i)(III) but not those of section 1400Z-2(d)(2)(D)(i)(I) and (II).[10] Applying traditional rules of statutory construction in this manner to implement the Opportunity Zone legislation is consistent with the powers and obligations of the Treasury Department.

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527-29 (1989) (Scalia, J. concurring in judgment). For a detailed discussion of the absurdity doctrine and its origin, see Manning, The Absurdity Doctrine, 116 Harv. L. Rev. 2387 (2003).

9 See Stone v. Immigr'n & Naturaliz'n Serv., 514 U.S. 386, 397 (1995).

10 The origin of this absurd result in section 1400Z-2(d)(3)(A)(i) stems from the close adherence of the language of section 1400Z-2 to the language of sections 45D and 1400B (the New Markets Tax Credit (NMTC) and the D.C. Empowerment Zone provisions, among other Empowerment Zone provisions).

The NMTC provides an annual tax credit to an investor who contributes cash to a community development entity (CDE) which must use the funds to make equity investments in new or pre-existing low income community (LIC) businesses. The NMTC provisions are completely unconcerned with whether a LIC business is new or old or whether a LIC business owns its property or leases its property. In fact, the NMTC does not contain any rules governing the "purchase" or "original use" of property inside a low income community, and a LIC business is free to acquire used property. The NMTC is quite concerned, however, with the location in which the property is used and, thus, contains a strict requirement that the property of a LIC business, "whether owned or leased," is used in the low income community. This appears to be the origin of the words "owned or leased" in section 1400Z-2(d)(3)(A)(i), and the purpose of that language is to ensure that tangible property of a QOZ business is used in the opportunity zone regardless of whether the property is owned by the business or leased by the business.

Conversely, like section 1400Z-2, the D.C. Empowerment Zone provisions exempts qualifying capital gains and thus are unconcerned with leased property (after all, a taxpayer cannot experience a capital gain with respect to leased property) beyond ensuring that leased property is used inside the D.C. Empowerment Zone. Thus, the D.C. Empowerment Zone provisions are unconcerned with whether an Empowerment Zone business uses leased property, whether such leased property was used previously in the Empowerment Zone, or whether such leased property is used outside the Empowerment Zone. The Empowerment Zone provisions impose strict requirements, however, on "purchased" property which are identical to those contained in section 1400Z-2(d)(2)(D). By melding the leased property language from the NMTC with the purchased property language from the Empowerment Zone provisions in section 1400Z-2(d), the Congress was trying to require that: (i) a QOZ Business that purchases tangible property satisfy the "purchase," "original use," and "substantially all use" requirements of section 1400Z-2(d)(2)(D); and (ii) any property leased by the QOZ Business satisfy the "substantially all use" requirement of section 1400Z-2(d)(D)(i)(III). This construction (requiring leased property of a QOZ Business to satisfy the requirements of section 1400Z-2(d)(2)(i)(III) but not those of section 1400Z-2(d)(2)(D)(i)(I) and (II)) is the only statutory interpretation that gives meaning to each word without producing absurd results. It is also true to the policy underlying the statutory language.