The Real Estate Roundtable

June 28, 2018

The Honorable David J. Kautter
Assistant Secretary of Tax Policy
U.S. Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable William M. Paul
Chief Counsel (Acting)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Guidance Regarding Opportunity Zones under Section 1400Z–2

Dear Assistant Secretary Kautter and Chief Counsel Paul:

On behalf of The Real Estate Roundtable, I am pleased to provide comments regarding the recently authorized Opportunity Zone tax incentive program. We believe the new tax incentives available for qualifying Opportunity Zone investments offer a potentially powerful incentive to channel long-term investment in low-income communities throughout the country, thus spurring job creation and economic development. Moreover, since real estate development and redevelopment is a key component of any region's economic strength and growth, we strongly view real estate investment activities as a major aspect of successfully implementing the Opportunity Zone program.

Qualified Opportunity Fund Certification Process

Under the *Tax Cuts and Jobs Act*,[1] a Qualified Opportunity Fund (QOF) is an investment vehicle, structured as a corporation or a partnership, organized for the purpose of investing in Qualified Opportunity Zone Property. As noted in the Frequently Asked Questions document released by the Internal Revenue Service (IRS) in April (updated as of June 7, 2018), in order to become a QOF, an eligible taxpayer self certifies by completing a form and attaching the form to the taxpayer's federal income tax return. No approval or action by the IRS is required.

[1] Formally entitled *An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018*, Pub. L. No. 115-97 (Dec. 22, 2017).

Some commentators have suggested that regulators should create a vetting process in which potential QOFs are "screened" by the federal government for specific social purposes or objectives before investments are made and placed.[2] At least one commentator has suggested that Treasury should impose a specific, quantitative test related to the net impact that an Opportunity Zone investment has on the number of affordable housing units in an area.

Treasury should implement the statute consistent with its structure and intent. Treasury review of the organizational documents of a QOF would create an unnecessary "bottleneck" that would delay economic investment in low-income communities. In contrast to prior and existing tax incentives for designated low-income areas, Opportunity Zones are designed to reach scale and facilitate widespread participation. Overly stringent requirements related to QOF certification or the placement of investments would deter and discourage real estate projects that can help transform an economically distressed area, create employment opportunities for local residents, and expand the local tax base. Only a simple, streamlined regulatory framework will allow Opportunity Zones to unlock capital and achieve a magnitude of investment in low-income communities that results in transformational economic development and job growth.

In a streamlined federal process built around self-certification of QOFs and market-driven investment decisions, private capital will flow to its best use while local authorities will continue to have ultimate authority over new projects and developments.

Deferral or Exclusion of Capital Gain

10-year holding period requirement. The *Tax Cuts and Jobs Act* provides that a designation as a Qualified Opportunity Zone (QOZ) remains in effect for the period beginning on the date of the designation and ending at the close of the 10th calendar year beginning on or after such date of designation. Treasury recently released Notice 2018-48 (June 20, 2018) designating Opportunity Zones in all 50 states, five territories, and the District of Columbia. In order to avoid any uncertainty, Treasury should clarify that a QOF investment made in 2019 or later, held for 10 or more years, and sold after December 31, 2028 qualifies for the tax basis increase and exclusion of gain under section 1400Z-2(c). Treasury should adopt rules similar to those under the new markets tax credit (NMTC). Under the NMTC rules, an investment can qualify for NMTC benefits as long as the investment is located in a census tract that qualified at the time the initial investment closed—*i.e.*, at the time the community development entity distributes the cash proceeds from the qualified investment to the qualified business. See, *CDFI Fund Frequently Asked Questions, Updated 2017, Question 24*.

[2] The new markets tax credit (NMTC), which provides a larger tax benefit in the form of a tax credit to prospective investors than the incentives in the Opportunity Zone program, includes specific statutory rules regarding the purpose of the investing entity. The qualifying investment vehicle – a community development entity – must have a primary mission of serving or providing investment capital for low-income communities or low-income persons, maintain accountability to the community, and must be certified by the Treasury Secretary. The investor requirements, combined with the annual limit on allocated credits, necessarily constrains the scope and impact of the NMTC program. No similar rules or requirements were included in the Opportunity Zone legislation.

The statutory language and legislative intent of the provision strongly suggest the exclusion of gain applies to investments made in designated Opportunity Zones and held for at least 10 years, irrespective of the census tract's status when the investment is sold. Specifically, the statute provides that "[i]n the case of any investment held by the taxpayer for at least 10 years . . . the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged." Applying the exclusion to such gain ensures that Opportunity Zones can mobilize capital and attract new investment through the entire duration of the QOZ designation.

Deferral of reinvested Opportunity Fund gain. Similar to a like-kind exchange under section 1031, Treasury should adopt rules that allow taxpayers to defer gain if the proceeds from the sale of a QOF investment are reinvested in QOF property within a reasonable period of time. Specifically, Opportunity Zone rules should permit QOFs to sell qualified tangible assets that are taken into account in meeting the 90-percent asset test without triggering gain, provided the proceeds are promptly reinvested in qualified property within a QOZ. Treasury rules could parallel those for the new markets tax credit, which provide that if amounts received with respect to a qualified low-income investment are reinvested within 12 months, the amounts are treated as continuously invested in a qualified low-income community investment. Treas. Reg. §1.45D-1(d)(2).

This would incentivize taxpayers to continue to hold property through the fund in the QOZ. It would also avoid penalizing an investor who holds a partnership interest in a QOF for the required 10-year holding period, but the QOF itself buys and sells Opportunity Zone investments during the holding period.

Qualified Opportunity Fund Asset Test

A Qualified Opportunity Fund (QOF) potentially is subject to penalty unless 90 percent of its assets consist of Qualified Opportunity Zone (QOZ) property, as measured on specific testing dates – the last day of the first 6-month period of the taxable year of the fund and the last day of the taxable year of the fund. The penalty is the differential between the percentage of assets invested in QOZ Property and the 90 percent amount, multiplied by the underpayment interest rate. The 90-percent asset test has been interpreted by some commentators as a strict requirement that a QOF must deploy new capital within six months. We believe this would be an overly restrictive interpretation of the statute and should be clarified to reflect typical real estate fundraising and investment timelines.

The construction or rehabilitation of real estate may take much longer than six months to complete. During the construction or rehabilitation process, cash and cash equivalents may be a large portion of the assets held by the fund. QOFs should have a longer runway to invest their capital and comply with the 90 percent test—this would be consistent with the manner in which real estate investment actually occurs and the extended timeline that Congress provided for a QOF to acquire property, make substantial improvements, and place that property back into service within the QOZ in order to satisfy the definition of Qualified Opportunity Zone Business Property (QOZBP). To the extent the QOF receives cash from investors that is intended to be used and ultimately will be used to complete a QOZ project, the fund's capital should be considered a qualified asset during the construction or renovation period. Treasury should adopt a rule that cash and cash equivalents will qualify as QOZBP under IRC Section 1400Z-2(d)(2)(D) for a period of at least 30 months after "new capital" has been raised.

Similar tax treatment applies in comparable situations. For example, the real estate investment trust (REIT) rules treat new capital as a qualifying asset for purposes of the real estate asset test and treat the investment income related to new capital as qualifying income for purposes of the real estate income test. *See* I.R.C. §856(c)(5)(B) (REIT asset test) and I.R.C. §856(c)(3)(I) (REIT income test). Treasury regulations provide an 18-month grace period in which a business can be treated as an Enterprise Zone business, and further provide a 3-5 year startup period if the business reasonably believes it will qualify and makes "bona fide efforts" to do so. I.R.C. §1394(b)(3)(B)(ii) and Treas. Reg. §1.1394-1(c).

Real Estate as an Opportunity Zone Investment

A QOF can invest in real estate directly or indirectly through a QOZ business, QOZ partnership interest or QOZ stock. Either way, the original use of such property in the Opportunity Zone must commence with the QOF, or the property must be substantially improved. Substantial improvement occurs if, during the 30-month period after the date of acquisition of the property, additions to the tax basis of the property in the hands of the QOF (or QOZ business) exceed the tax basis of the property at the beginning of the 30-month period. As a general policy matter, in line with the legislative intent, the "original use" and "substantially improved" standards should apply to real estate in a way that maximizes the flow of investment and creation of jobs in Opportunity Zones.

Original use test. The Opportunity Zone statute does not define the term "original use". Treasury should use its regulatory authority to create a flexible test for what constitutes the original use of QOZ property. The Enterprise Zone regulations under section 1397C define original use as the first use to which property is put within the zone. For purposes of section 1394, if property is vacant for at least a one-year period, including the date of zone designation, use prior to that period is disregarded for purposes of determining original use. *De minimis*, incidental uses of property, such as renting the side of a building for a billboard, are disregarded. *See* Treas. Reg. §1.1394-1(h). Implementing regulations should clarify that if a building is unused or vacant for a significant period of time, a new investment in the building is considered an original use for purposes of qualifying as Opportunity Zone property.

Substantial improvement test – time limitation. Treasury should clarify that notwithstanding the 30-month substantial improvement period, taxpayers can extend the improvement period due to extenuating circumstances outside the taxpayer's control. The IRS and Treasury have provided such relief in the energy credit area under section 45, which take into account a taxpayer's continuous efforts to complete construction of a qualifying energy facility based on the relevant facts and circumstances. Under the guidance, a taxpayer can still satisfy the continuous efforts requirement if there are certain disruptions that are beyond the taxpayer's control that affect the continuity of the construction. Examples of such disruptions include: severe weather, natural disasters, licensing and permitting delays, labor stoppages, financing delays of less than six months, delays caused by federal or state agencies, supply shortages, the presence of endangered species, and the inability to acquire specialized equipment. IRS Notice 2013-29. Allowing an extension of the 30-month period due to unforeseeable or unanticipated factors would promote greater investment and economic development in Opportunity Zones by removing a major source of tax risk and investor uncertainty. Such guidance would recognize the real world realities of complex real estate projects while allowing Opportunity Zone investors to move forward, in good faith, with major investments in low-income communities.

Treasury should also consider adopting Opportunity Zone rules that facilitate phased real estate renovations, a common approach used in significant projects that generate extensive benefits for the surrounding community. The rules written for the historic rehabilitation tax credit would be a good starting point. Under those rules, the taxpayer is permitted two principal means of satisfying the substantial rehabilitation test. The first method is to select a 24-month period (rather than a 30-month period) and determine if the "qualified rehabilitation expenditures" during that 24-month period exceed the greater of the adjusted tax basis of the building, or $5,000.[3] The second method is a special 60-month test that may be applied to the rehabilitation of buildings that will be completed in phases over a longer period of time. Under this test, the taxpayer is permitted to look back 60 months prior to the placed in service date (or other last day of the measuring period selected by the taxpayer in the year the building is placed in service) to see if the mathematical test has been satisfied. For both methods, a taxpayer can take into account qualified rehabilitation expenditures incurred during the same rehabilitation process by any other person having an interest in the building. For example, a lessee may include the expenditures of the lessor for purposes of applying the substantial rehabilitation test. *See* Treas. Reg. 1.48-12(b)(2)(vi)).

Substantial improvements and treatment of land. In addition, Treasury should clarify that the acquisition of land by a QOF will be deemed to meet the requirement that qualifying property be acquired by the QOF after December 31, 2017, provided that the real property located on the land (*e.g.*, building) is substantially improved by the QOF within 30 months of its acquisition. Such result would parallel the treatment of land under the District of Columbia Enterprise Zone Program, which allowed real estate (both the building and the land on which the building was located) to qualify as DC Zone business property if the building was substantially improved during a 24-month period. I.R.C. §1400B(b)(4)(B)(i) . Thus, even if the QOF acquires the land from a related party (who owned the land prior to enactment of the *Tax Cuts and Jobs Act*), the improved real estate would constitute QOZBP. In so doing, Treasury would encourage investors to convert unimproved, underutilized land in low-income communities into productive real estate assets that attract new businesses and create jobs.

In short, Treasury should clarify and implement the Opportunity Zone original use and substantial improvement tests in a manner that promotes investment in existing real estate—which will ultimately improve communities, boost local tax revenue, and spur job growth.

Other Regulatory Issues

Clarification of the following issues in the rulemaking process will accelerate investment and economic development in Opportunity Zones by removing lingering taxpayer uncertainty. Specifically, implementing guidance should:

- clarify that the rental business rules under section 1397C(d)(2) do not disqualify real estate from eligibility for Opportunity Zone benefits;

[3] The adjusted tax basis of the building for this purpose is determined as of the beginning of the first day of the 24-month period, or of the holding period of the building, whichever is later. Therefore, qualification is determined under a simple mathematical calculation as to whether the qualified expenditures incurred as of the placed in service date exceed the adjusted tax basis of the building looking back 24 months (or to the beginning of the holding period, if less than 24 months).

- clarify that a taxpayer eligible to defer gain under section 1400Z-2(a)(1) includes individuals, partnerships, REITs and S corporations. As such, the election to defer gain should be made at the partnership or S corporation level. Also, if the taxpayer is a partnership, the partnerships may allocate deferred gain separate from realized gain with respect to a sale of an asset if the partnership elects to only defer a portion of the gain. *See, e.g.*, IRC Section 108(i). Finally, a taxpayer should include any United States Person as defined in IRC Section 7701(a)(30) or foreign person subject to withholdings under IRC Section 1445 (FIRPTA);

- consistent with the operative provisions of the statute, clarify that the exclusion of gain election under section 1400Z-2(a)(2) applies with respect to all gains, notwithstanding the language in the subtitle, which only refers to "capital gains";

- if the exclusion of gain election under section 1400Z-2(a)(2) is limited only with respect to "capital gains", clarify that the application of this exclusion will apply at the investor level where the character of gain is determined, and make clear that this election applies to all gains treated as capital under Subchapter P;

- for purposes of the rule requiring that substantially all of the tangible property owned or leased by a QOZ business be QOZ business property, clarify that "substantially all" means 70 percent or more, similar to section 368 and I.R.S. Rev. Proc. 77-37;

- clarify that a QOF can be organized as a limited liability company for state law purposes and still meet the statutory requirement in section 1400Z-2 that the QOF be organized as a corporation or partnership for federal income tax purposes;

- similar to the new markets tax credit under Treas. Reg. §1.45D-1(d)(4)(B), clarify that the test for determining whether a QOF has 90 percent of its assets invested in QOZBP is measured by the cost basis of its assets, as determined under section 1012;

- clarify that a distribution of refinancing proceeds to a QOF investor is treated as a sale or exchange of the investment in the QOF only to the extent (and at the time) that the receipt of such proceeds is recognized as gain by the QOF investor;

- consistent with the basis rules under section 1400Z-2(c), clarify that the property acquired by a QOF, to the extent allocable to the investment by the QOF investor, includes any portion of the property acquired by the QOF with debt issued by the QOF;

- clarify that 20 percent related party standard under section 1400Z-2(e)(2) applies to section 1400Z-2(a)(1) (gain elected for deferral) and section 1400Z-2(d)(2)(D)(i)(I) (purchase as defined under section 179(d)(2) regarding the acquisition of QOZ property); and

- seek to promote capital formation and economic development in Opportunity Zones by coordinating and harmonizing existing regulatory regimes that encourage investment in low-income communities. Guidance under the *Community Reinvestment Act*, for example, provides that federal agencies will presume that certain investments in new markets tax credit-eligible community development entities are community development activities that promote economic development. *See* Interagency Questions and Answers Regarding

Community Reinvestment § __.12(g)(3) – 1 (2016), 81 Fed. Reg. 48505, 48526 (July 25, 2016). Treasury should work with the Federal Reserve Board of Governors and the Federal Deposit Insurance Corporation to issue similar guidance clarifying that an Opportunity Zone investment presumptively qualifies for credit under the *Community Reinvestment Act*.

Next Steps – Enhancing Opportunity Zones to Maximize Capital Formation, Investment, and Jobs in Low-Income Communities

Substantial improvement test – basis increase. The basis increase requirement in the substantial improvement test for QOZ property is a significant hurdle for real estate projects, notwithstanding the capital-intensive nature of rehabilitating, renovating, or repositioning real estate. Requiring property improvements to exceed the tax basis of the property at the time of acquisition is a much higher standard than the substantial improvement requirement that applies for other purposes. For example, a private activity bond (PAB) used for the acquisition of an existing building can qualify as tax-exempt if the rehabilitation expenditures incurred by the acquirer in the two years after the date of acquisition (or date the bond was issued, if later) equal or exceed 15 percent of the portion of the acquisition cost financed with the net proceeds of the bond issuance. I.R.C. §147(d). The cost of building improvements can qualify for the low-income housing tax credit (LIHTC) if the rehabilitation expenditures made over a 24 month period represent at least 20 percent of the adjusted basis of the building (or $6,800 per low-income unit, if greater). I.R.C. §42(e).

The Administration should consider seeking legislative modifications to the Opportunity Zone program that would extend eligibility to significant property renovation and value-add projects, which are otherwise unlikely to meet the statutory substantial improvement test. A modified test could greatly expand the impact of the program in low-income, urban communities. In these distressed areas, existing, dilapidated, and underutilized buildings, rather than open land, comprise the majority of real estate in need of investment and revitalization. Specifically, the Administration should seek a reduction in the percentage of project costs that must be attributable to improvements relative to the acquisition cost of the property. A standard that is closer to the tests for the LIHTC or PABs would cover a larger universe of buildings in urban areas and spur greater economic development and job creation in struggling communities.

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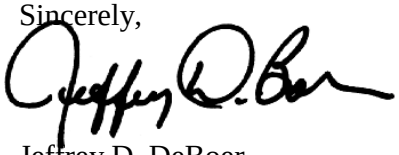
Opportunity Zones offer enormous potential to channel investment and spur economic growth in low-income communities. Real estate construction and improvements are long-term, capital-intensive undertakings that yield permanent, lasting benefits for the community. Real estate investment is an economic multiplier and a catalyst for permanent, lasting job creation.[4] Taxes derived from real estate ownership and its sale/transfer represent the largest source — approaching 70 percent — of local tax revenues, helping to pay for schools, roads, law enforcement and other essential public services.

[4] The real estate industry employs over 13 million Americans—more than one in every 10 full-time U.S. workers. This includes jobs in construction, planning, architecture, building maintenance, management, environmental consulting, leasing, brokerage, mortgage lending, accounting and legal services, interior design and many more.

For all of these reasons, the ability of Opportunity Zones to unlock private capital for real estate investment will be a principal determinant of the program's effectiveness. Opportunity Zone implementing guidance should seek to maximize the flow of real estate investment, capital, and jobs into the designated communities.

The Real Estate Roundtable looks forward to working with you as you consider the many issues arising in the implementation of the program. Please do not hesitate to contact me or Ryan McCormick, Real Estate Roundtable Senior Vice President and Counsel, at (202) 639-8400 with any questions or requests for additional information.

Sincerely,



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