December 28, 2018

Office of Associate Chief Counsel (Income Tax and Accounting)
Attention: Erika C. Reigle and Kyle C. Griffin
Internal Revenue Service (I.RS)
1111 Constitution Avenue, NW
Washington, D.C. 20224

CC:PA:LPD:PR
(REG-115420-18)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Via Federal eRulemaking Portal

Re: Comments on REG-115420-18: Investing in Qualified Opportunity Funds (Guidance Under §1400Z-2)

Dear Ms. Reigle and Mr. Griffin:

On behalf of the members of the Novogradac Opportunity Zones Working Group (OZ Working Group), we are responding to the Internal Revenue Service (IRS) Notice Document Citation Number REG-115420-18: Investing in Qualified Opportunity Funds (the Regulations).

We are encourage by the Regulations and we extend our gratitude to the Department of Treasury (Treasury) and the IRS for being responsive to our prior comments and for taking a thoughtful approach to resolving many issues.

Our comments, set forth in the appendix to this letter, identify additional issues arising under the Regulations and provide recommended solutions. We also respond to specific requests solicited by Treasury and the IRS.

In addition to the Regulations, we look forward to any additional published guidance including another round of proposed regulations. We want to take this opportunity to remind you of our letter dated November 26, 2018 where we address a narrow list of priority issues expected in the forthcoming guidance. Our comments in our November 26, 2018 letter may also help inform revisions to this first round of Regulations.

The members of the OZ Working Group are participants in the community development finance field, and include investors, lenders, for-profit and nonprofit developers, community development financial

institutions, community development entities, trade organizations and other related professionals. These stakeholders are working together to suggest consensus solutions to technical opportunity zones (OZ) incentive issues and provide recommendations to make the OZ incentive more efficient in delivering benefits to low-income communities.

We appreciate your consideration of these comments and look forward to an opportunity to discuss these issues further during the public hearing scheduled for January 10, 2019.

Yours very truly,

Novogradac & Company LLP

By

Michael J. Novogradac, Managing Partner

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By

John S. Sciarretti, Partner

CC: Michael Novey, Office of Tax Policy, Treasury

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Attachments: Comments on REG-115420-18: Investing in Qualified Opportunity Funds (Guidance Under §1400Z-2)

A. Definitions of "original use" and "substantial improvement"

(i) Allow Qualified Opportunity Zone Businesses to apply the substantial improvement test on an aggregate asset basis.

Background

Qualified Opportunity Zone Business Property (QOZBP) must have its original use in a qualified opportunity zone (QOZ) commence with a Qualified Opportunity Fund (QOF) or a Qualified Opportunity Zone Business (QOZB), or the QOF or QOZB must substantially improve the property.[1] Property is treated as substantially improved by the QOF or a QOZB only if, during any 30-month period beginning after the date of acquisition of such property, additions to 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.[2] The term "with respect to such property"[3] suggests that a business can meet the substantial improvement test on an aggregate basis. "With respect to" means "concerning"[4] or to "say what something relates to"[5]. Property acquired to be used in the same trade or business as existing property relates to the existing property in that they are both concerning or related to the same trade or business. The substantial improvement requirement was designed to provide a means for existing businesses operating in opportunity zones to be able to qualify for QOF capital to expand. A narrow interpretation of the substantial improvement requirement would limit substantial improvements to merely renovating existing property, which would severely limit the ability of existing businesses in opportunity zones to qualify for QOF incented equity capital, particularly existing operating businesses. A narrow interpretation would also create administrative difficulty in determining what qualifies as an addition to existing property as opposed to the creation of separate and distinct new property.

Recommendation

To facilitate the qualification of an existing business as a QOZB, the final regulations should clarify that, at the election of the taxpayer, the substantial improvement requirement can be met by a business on an aggregate basis - where the acquisition of tangible property over any 30-month period exceeds the aggregate adjusted basis of existing tangible property held by the business at the beginning of a 30-month period.

Example 1:

On January 1, 2019, QOF P purchased the assets of business A for $5 million. Business A is an existing widget manufacturing business in a QOZ. QOF P allocated $4 million of the $5 million purchase price to various items of tangible property used to manufacture widgets. The original use of the tangible property in a QOZ did not commence with QOF P. QOF P allocated $1 million of the purchase price to

[1] IRC §1400Z-2(d)2(D).
[2] IRC §1400Z-2(d)2(D)(ii), emphasis added.
[3] We note that the proposed regulations did not include the "with respect to" qualification contained in the statute. It is unclear if this was an intentional effort to limit or further define what qualifies for purposes of the additions to basis requirement.
[4] Macmillan online dictionary.
[5] Collins online dictionary.

intangible property to be used in the active conduct of business A in the QOZ. QOF P plans to invest an additional $5 million in business A for the purchase of additional machinery and equipment to expand its production in the QOZ. The acquired tangible property cannot qualify as QOZBP unless it is substantially improved by QOF P, because QOF P was not the first to use the property in the QOZ. The acquired property is in good working order and does not need to be renovated or otherwise directly improved. If QOF P could apply the substantial improvement test on an aggregate basis, the $5 million of additional machinery and equipment purchases would allow the acquired tangible property to qualify as QOZBP.

Example 2:

On January 1, 2019, QOF P invests $5 million in partnership B and partnership B purchased the assets of business A for $5 million. Business A is an existing widget manufacturing business in a QOZ. Partnership B allocated $4 million of the $5 million purchase price to various items of tangible property used to manufacture widgets. The original use of the tangible property in a QOZ did not commence with partnership B. Partnership B allocated $1 million of the purchase price to intangible property to be used in the active conduct of business A in the QOZ. QOF P plans to invest an additional $5 million in partnership B for the purchase of additional machinery and equipment to expand its production in the QOZ. The existing tangible property acquired for $4 million cannot qualify as QOZBP unless it is substantially improved by partnership B, because partnership B was not the first to use the property in the QOZ. The acquired property is in good working order and does not need to be renovated or otherwise directly improved. If partnership B could apply the substantial improvement test on an aggregate basis, the $5 million of additional machinery and equipment purchases would allow the acquired tangible property to qualify as QOZBP.

(ii) Allow vacant or underutilized property to be treated as original use property.

<u>Background</u>

The proposed regulations ("Regulations") ask whether some period of abandonment or under-utilization of tangible property erase a property's history of prior use in the QOZ and if so, should such a fallow period enable subsequent productive utilization of the tangible property to qualify as "original use".

Vacant buildings in low-income communities are public safety hazards, crime magnets and represent a financial drain on the community by reducing the value of neighboring properties. Many vacant buildings may not need significant renovation, but the ability to acquire the property, make modest improvements and attract a business will produce jobs and housing and turn otherwise underutilized property into an income earning, tax generating asset for the community.

Unless the final regulations provide an exception for abandoned or underutilized property, many vacant buildings in QOZs are likely to remain vacant due to the substantial improvement requirement to spend more than the acquisition cost on improvements.

<u>Recommendation</u>

To facilitate the improvement of vacant or underutilized property, the final regulations should provide that for property vacant or idle for at least a one-year, use before that period is disregarded for

purposes of determining original use, similar to rules provided under Section 1394 for enterprise zone facility bonds.[6]

B. Special Rules for Pass-through Entities

(i) Clarify that the optionality provided to partnerships or partners in making the gain deferral election extends to each partner in a multi-tiered partnership ownership structure and, if so, the yearend of which partnerships dictate when a partner's 180-day election deferral period begins.

Background

The Regulations include special rules for partnerships and other pass-through entities, and for taxpayers to whom these entities pass through income and other tax items. Under these rules, the pass-through entities or their investors can invest in a QOF and elect to defer recognition of eligible gain realized by the pass-through entity. Specifically, the Regulations provide that, to the extent that a partnership does not elect to defer capital gain then the partner generally may elect to defer its distributive share of the gain.[7] The 180-day period with respect to the partner's distributive share of eligible gains generally begins on the last day of the partnership taxable year in which the partner's allocable share of the partnership's eligible gain is taken into account under IRC §706(a).[8]

The Regulations do not clarify the following:

- Whether the optionality provided to partnerships or partners in making the gain deferral election extends to each partner in a multi-tiered partnership structure.
- Which partnership's taxable year-end determines the beginning of the 180-day period in a multi-tier partnership structure.

Recommendation

- The optionality provided to partnerships or partners should extend to each partner in a multi-tiered partnership structure.
- The beginning of the 180-day period should be the last day of the partnership taxable year with respect to the partnership in which the partner electing to defer the gain is directly invested.

Example:

Facts: On March 31, 2018, Partnership P sold all of its property for a capital gain and closed its books on that date. P did not make an election to defer the gain under 1400Z-2. S, a calendar year partnership owns 99 percent of P and like P, S did not make an election to defer its distributive share of P's capital

[6] Treas. Reg §1.1394-1(h) provides: "Original use requirement for purposes of qualified zone property. In general, for purposes of §1397C(a)(1)(B), the term original use means the first use to which the 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. For this purpose, de minimis incidental uses of property, such as renting the side of a building for a billboard, are disregarded."
[7] Proposed Treas. Reg. §1.1400Z-2(a)-1(c)(2).
[8] Proposed Treas. Reg. §1.1400Z-2(a)-1(c)(2)(iii).

gain under 1400Z-2. T, an individual, owns 99 percent of S. T would like to make an election to defer the distributive share of gain T realized through S by making an eligible investment in a QOF.

Recommended Answer: Final regulations should provide that the beginning of T's 180-day period begins on December 31, 2018, the last day of S's taxable year.

(ii) *Clarify that additions to the basis of a pass-through investment in a QOF also apply to the beneficial owner's investment in the pass-through entity.*

Background

IRC §1400Z-2 provides for a step-up in basis for investments subject to a deferral election that are held at least five and at least seven years. After making an investment in a QOF equal to the amount of the elected gain to be deferred, an investor's initial basis in their interest in the QOF is zero. If the investment is held at least five years, the taxpayer's basis is increased by 10-percent of the deferred gain.[9] For investments held two more years–for at least seven years–the taxpayer's basis is increased by an additional 5-percent of the deferred gain.[10] Furthermore, a taxpayer who holds a QOF investment for a period of at least 10 years may elect to adjust the basis of their investment to equal the fair market value of the investment.[11] The Regulations include special rules for partnerships (and other pass-through entities), and for taxpayers holding an interest in these entities. Under these rules, either the entities or their beneficial owners can invest in a QOF and thus defer recognition of eligible gain. However, the Regulations do not address whether additions to the basis of a partnership or other pass-through entity's investment in a QOF also apply to the basis of the beneficial owner's investment in the pass-through entity.

Recommendation

The final regulations should provide that additions to the basis of a partnership or other pass-through entity's investment in a QOF for holding the investment for five, seven and 10-years flow through as additions to the basis of a taxpayer's investment in the pass-through entity that invested in a QOF.

(iii) Clarify that §1231 gains of pass-through entities are eligible for deferral by the pass-through entity.

Background

The Regulations define "eligible gain" under §1400Z-2 as recognized gain "treated as capital gain for Federal income tax purposes." The treatment of §1231 gains as capital gain or ordinary is generally made at the partner, not partnership, level. Partnerships are required to report §1231 gains and losses separately.[12] The same rule applies for S corporations.[13] By separately stating §1231 gains and losses, individual partners or shareholders can determine whether, based on their other §1231 gains or losses, they have capital gains and losses or ordinary gains and losses pursuant to IRC §1231(a).

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[9] IRC §1400Z-2(b)2(B)(iii).
[10] IRC §1400Z-2(b)2(B)(iv).
[11] IRC §1400Z-2(c).
[12] IRC §702(a)(3).
[13] Treas. Reg. § 1.1366-1(a)(2)(ii).

Because the determination of whether §1231 gains or §1231 losses are treated as capital gains and capital losses or ordinary gains and ordinary losses is made after a determination of all of a taxpayer's §1231 gains and §1231 losses for the tax year and prior years, it is unclear if a partnership or S corporation is able to make a deferral election for §1231 gains. Final regulations should clarify that a partnership or S corporation can make an election to defer §1231 gains at the pass-through entity level.

Recommendation

IRC §1231(a)(1) provides that if §1231 gains exceed §1231 losses for a taxable year, such gains and losses shall be treated as long-term capital gains or long-term capital losses, as the case may be. Since the Regulations provide that a partnership or other pass-through entity may elect to defer all or part of a capital gain to the extent that it makes an eligible investment in a QOF,[14] the final regulations should clarify that §1231 gains are eligible for deferral at the pass-through entity level, which is consistent with legislative intent. Specifically, final regulations should define eligible gains to include, gain recognized on the sale or exchange of business property as defined in §1231(b) - similar to rules under §1400B(e)(1) (regarding the exclusion of qualified capital gain from DC Zone property).[15] Adopting this definition would clarify that partnerships can invest §1231 gains in a QOF and make a deferral election.

C. Attributes of Included Income When Gain Deferral Ends

(i) Allow a taxpayer to use the specific identification method when disposing of a portion of its interests in a QOF.

Background

The Regulations request comments whether methods other than FIFO and pro-rata methods should be permitted when a taxpayer disposes of less than all of its fungible interests in a QOF. The Regulations require that any such alternative methods must both provide certainty as to which fungible interest a taxpayer disposes of and allow taxpayers to comply easily with the requirements of section 1400Z-2(a)(1)(B) and (b),which require that certain dispositions of an interest in a QOF cause deferred gain to be included in a taxpayer's income.

Recommendation

The final regulations should also allow taxpayers to use the "specific-identification method" if adequate identification is made, similar to methods permitted for identifying the attributes when a taxpayer sells less than all of its fungible interests in stock under Treasury Regulation §1.1012-1(c).

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[14] Prop Reg. §1.1400Z-2(a)-1(c)(1).

[15] §IRC 1400B(e)(1) (Repealed 3/23/18) provides that "qualified capital gain" eligible for exclusion includes gain recognized on the sale or exchange of (A) a capital asset, or (B) property used in the trade or business (as defined in section 1231(b)).

D. QOF Investments and the 10-Year Hold Benefit

(i) Eliminate the fixed end-date with respect to the basis step-up election for an investment held for at least 10 years.

Background

The statute provides in the case of any investment held by the taxpayer for at least 10 years and with respect to which the taxpayer makes an election, 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.[16] The Regulations propose a fixed 20 ½ year end date until 2047 for the basis step-up election.[17] Treasury specifically has requested comments as to (1) the proposed fixed 20 ½-year end date for the basis step-up election; and (2) whether the Regulations should include an alternative to incentivizing investors to disinvest shortly before any fixed end date for the basis step-up election.

Recommendation

Treasury should eliminate the fixed end-date with respect to the basis step-up election for an investment held for at least 10 years. The fixed end-date is not consistent with the statute, which only requires that a taxpayer hold its investment for a period of at least 10 years. Eliminating the fixed end-date reduces the likelihood of a rapid sell-off of QOF investments in 2047 to avoid paying additional capital gains tax, which will artificially reduce asset prices in QOZs.

(ii) Provide relief when a QOF sells appreciated property to redeem a taxpayer's interest in the QOF held for at least 10 years.

Background

In the case of any QOF investment held by the taxpayer for at least 10 years and with respect to which the taxpayer makes an election, the basis of such property shall be equal to the fair market value (FMV) of such investment on the date that the QOF investment is sold or exchanged. Thus, a taxpayer must sell their QOF interest in order to realize the 10-year hold benefit.

A traditional exit strategy for private equity funds normally entails a liquidation of fund assets followed by a redemption of fund investors. Under this traditional private equity arrangement, it is unclear how a QOF partnership investor could receive the 10-year gain exclusion benefit on the sale of qualified opportunity zone property ("QOZP"). This is because any gains realized by a QOF when it liquidates it assets will be taxed to QOF partners even though a partner has held its investment for 10 years.

The requirement for a taxpayer to sell its QOF interest (to achieve a FMV step-up) rather than the underlying property, impairs the marketability of taxpayer QOF investments and therefore their value. This decrease in value, due to a lack of marketability, potentially offsets any tax benefit that taxpayers receive for investing in a QOZ, which is inconsistent with the legislative intent of the statute.
Example:

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[16] IRC §1400Z-2(c).
[17] Prop Reg. §1.1400Z-2(c)-1(b).

T, a calendar year taxpayer, invested $1 million of gain in P, a QOF partnership, on September 15, 2019 and P makes a $1 million investment in QOZP on the same day. On September 17, 2029, T sells its investment in P for $1.5 million and makes an election to treat its basis in its investment in P as the FMV of $1.5 million. During the interim, T would have previously increased its basis in its investment in P by $100,000 at the five year mark, and an additional $50,000 at the seven year mark, and further by $850,000 when it recognized the remainder of the deferred income of $850,000 on December 31, 2026. Before the fair market value election, T's basis in P was $1 million, and the FMV election allows T to further increase its basis in P by $500,000, to $1.5 million. As such, no gain would be included in T's gross income for the tax year ended December 31, 2029 from the sale of T's investment in P.

Assume similar facts as above except that P sells its QOZBP on September 16, 2029, in order to have the liquidity necessary to redeem its partner's investments. Under this scenario, P does not have the opportunity to make an election to exclude the gain from the sale of the underlying property even though T held its investment in P for 10-years. As a result, T would be required to recognize its distributive share of the realized gain ($500,000) for the tax year ended December 31, 2029 and the basis of T's investment would be increased by $500,000 with respect to the recognized gain thereby making the election under IRC §1400Z-2(c) ineffective as T's basis is already equal to FMV.

<u>Recommendation</u>

The final regulations should provide relief for taxpayers that have held an investment in a QOF for at least 10 years in situations where a QOF sells all its appreciated property before a taxpayer sells its interest in the QOF. Specifically, Treasury should provide, in the case of a QOF partnership (or other pass-through investment) held by a taxpayer for at least 10 years, and with respect to which a taxpayer makes an election in a redemption year, the taxpayer receives an increase in the basis of their investment equal to their distributive share of gain realized by a QOF from the sale of underlying property. This increase in basis will offset any gains realized when a taxpayer's investment is redeemed by a QOF in the redemption year.

Example:

Continuing with the above example. Assuming T is eligible to make an election to increase the basis of T's investment by $500,000, T's basis would be $2 million in the year of redemption ($1 million beginning basis, plus $500,000 gain, plus $500,000 FMV basis increase). Redemption proceeds from P to T of $1.5 million would result in a $500,000 loss to T which would offset T's distributive share of the gain realized when P sold the QOZBP.

E. Valuation Methodology for Applying the 90-Percent and 70-Percent Asset Tests

(i) Allow QOFs and QOZBs to elect to use the unadjusted cost basis method to value tangible assets even if they they have an applicable financial statement.

<u>Background</u>

Limitations of applicable financial statements

For purposes of the calculation of the 90-percent asset test in IRC §1400Z-2(d)(1) by the QOF, the Regulations generally require a QOF to use the asset values that are reported on the QOF's applicable financial statement for the taxable year, as defined in Treas. Reg. §1.475(a)-4(h) of the Income Tax Regulations. If a QOF does not have an applicable financial statement, the Regulations require the QOF to use the cost of its assets. Treasury and the IRS requested comments on the suitability of both of these valuation methods, and whether another method, such as tax-adjusted basis, would be better for purposes of assurance and administration.

Treas. Reg. § 1.475(a)-4(h) generally defines an applicable financial statement as follows:

a. A GAAP financial statement that is required to be filed with the Securities and Exchange Commission (SEC), such as a 10-K;
b. A GAAP financial statement that is filed with a Federal agency other than the IRS, provided that the taxpayer generally makes significant use of the financial statement's values in most of the significant management functions of the taxpayer's business and the use is related to the management of all or substantially all of the taxpayer's business; or
c. A GAAP financial statement that meets all of the following requirements:
    1. A certified audited financial statement, which is certified by an independent public accountant from a Registered Public Accounting firm, and is certified to be a "clean" opinion, a qualified "subject to" opinion, or a qualified "except for" opinion,
    2. The statement is given to creditors for purposes of making lending decisions, given to equity holders for purposes of evaluating their investment in the taxpayer, or provided for other substantial non-tax purposes,
    3. The taxpayer reasonably anticipates the statement will be directly relied on for the purposes for which it was given or provided, and
    4. The taxpayer generally makes significant use of the financial statement's values in most of the significant management functions of the taxpayer's business and the use is related to the management of all or substantially all of the taxpayer's business.

Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(3)(ii) also generally uses the same principles in determining the values of a QOZB's assets for purposes of calculating the percentage of tangible property owned or leased in the trade or business that is QOZBP.

Mandating the use of applicable financial statements to value tangible property is not a suitable valuation method for several reasons, including the following:

First, GAAP generally requires that <u>tangible property</u> be carried at its adjusted book value. The adjusted book value of property does not necessarily approximate original cost or fair value as the original cost of

an asset is continually reduced by accumulated depreciation, accumulated amortization or impairment. This conservative presentation of a business's financial position under GAAP does not provide investor certainty and unfairly understates a business's QOZBP making it an unsuitable valuation method.

Second, GAAP generally requires investments be carried at adjusted book value. The adjusted book value of an investment does not necessarily approximate its original cost or fair value, as the original cost of the investment is required to be reduced for any book losses, cash distributions, or impairment. This conservative presentation of a business's financial position under GAAP does not provide investor certainty and unfairly understates a business's investments in qualified opportunity zone partnerships and stock making it an unsuitable valuation method.

Third, GAAP has consolidation rules that could cause a QOF to report on its balance sheet 100 percent of the assets of a subsidiary business and to also report an amount on its balance sheet to reflect the interests other owners of the subsidiary business have in the assets reported on the QOF's balance sheet. In such a circumstance, guidance is needed as to the manner in which a QOF would measure its QOZP.

Fourth, Treas. Reg. § 1.475(a)-4 provides a safe harbor to dealers in securities to use the values of positions reported on certain financial statements as the FMV of the positions for purposes of the mark-to-market rules. The safe harbor is based on the principle that if a mark-to-market method used for financial reporting is sufficiently consistent with the requirements of the mark-to-market rules and if the financial statement using the mark-to-market method has certain indicia of reliability, then the values used on that financial statement are appropriate values for purposes of the mark-to-market rules. QOFs investing in QOZBP are not likely to use a mark-to-market method for financial reporting and therefore are unlikely to value tangible property at market value.

Finally, QOFs are required to measure the 90-percent asset test on the last day of the first six-month period of the taxable year of the QOF, and on the last day of the taxable year of the QOF.[18] Businesses normally have their financial statements audited on an annual basis and therefore it is not customary for businesses to have a certified audited financial statement that provides asset balances on the last day of the first six-month period of the taxable year. A further complexity is timing, as a QOF may not receive an audit in its first year or two of operations. Guidance would need to be provided as to how a QOF transitions between years when a certified audited financial statement is received and years where one is not.

We also note that while many QOFs may prefer to provide certified audited GAAP financial statements to their investors, this mandatory rule will cause some QOFs to choose to not have financial statements audited or, if audited, not prepared on a GAAP basis. Treasury should not create a rule that incents QOFs to not prepare GAAP financial statements for their investors and/or to not have financial statements audited.

Definition of cost

If a QOF does not have an applicable financial statement, the Regulations generally require the QOF to value each asset for purposes of the 90-percent asset test using the QOF's cost of each asset. However,

[18] IRC §1400Z-2(d)(1).

the Regulations do not clarify whether the term "cost" means unadjusted cost, tax-adjusted cost or some other cost basis. We believe that "cost" for such assets should generally be defined as the unadjusted tax basis of such assets determined under IRC §1012. The use of unadjusted cost basis will prevent a reduction in the contribution of qualifying assets to the 90-percent and 70-percent assets tests over time simply because of depreciation. To the extent that Treasury is concerned that fully depreciated assets will be retained by a QOF or QOZB merely to include in the 90-percent or 70-percent asset test, a rule could be provided that assets are only included to the extent they are used in the trade or business of the QOF or QOZB.

Recommendation

The final regulations should allow all QOFs and QOZBs to have the option to elect to use the unadjusted cost basis methodology to value tangible assets regardless of whether or not they have an applicable financial statement within the meaning of Treas. Reg. § 1.475(a)-4(h).

Unadjusted cost should be determined in accordance with the principles of IRC §1012. Unadjusted cost should be used, as opposed to adjusted tax basis, because the mere passage of time and accumulation of depreciation expense should not cause a QOF to fail the 90-percent asset test or a QOZB the 70-percent asset test.

If the final regulations continue to mandate the use of an applicable financial statement, if one exists, then the final regulations should clarify that all of the requirements for an applicable financial statement as set out in Treas. Reg. § 1.475(a)-4(h) must be met, including the significant business use requirement.

(ii) Allow pre-existing entities the option to use adjusted tax basis for valuing assets purchased before 2018.

Background

The Regulations request comments on whether there is a statutory basis for additional flexibilities that might facilitate qualification of a greater number of pre-existing entities across broad categories of industries. Pre-existing entities operating in a QOZ before 2018 are likely to have a substantial amount of tangible property that was purchased prior to 2018, thus preventing such businesses from being a QOZB.

Recommendation

Allow pre-existing entities to use adjusted tax basis for valuing assets purchased before 2018 and held as of the end of 2017. This will reduce the dollar value of existing property that cannot qualify as QOZBP, which will facilitate qualification of a greater number of pre-existing entities across broad categories of industries.

(iii) Limit 90%-test noncompliance penalties to the portion of aggregate assets of a QOF that are funded with gains for which a deferral election was made.

Background

The statute requires a QOF that fails the 90-percent test to pay a penalty for each month it fails to maintain the 90-percent asset requirement in an amount equal to the product of:

(A) the excess of:

(i) the amount equal to 90-percent of its aggregate assets, over

(ii) the aggregate amount of QOZP held by the fund,

multiplied by

(B) the underpayment rate established under IRC §6621(a)(2) for such month.[19]

In the case of any investment in a QOF, only a portion of which consists of investments of gain to which an deferral election is in effect, such investment shall be treated as 2 separate investments, consisting of (i) one investment that only includes amounts to which the deferral election applies, and (ii) a separate investment consisting of other amounts, the QOZ benefits shall only apply to the investment to which a deferral election is in effect.

The Regulations clarify that deemed contributions under IRC §752(a) (increases in liabilities) do not constitute and investment in a QOF and therefore QOZ benefits do not apply to these amounts.[20]

Based upon the forgoing, the statute could be interpreted to assess a QOF or its beneficial owners a penalty based upon a shortfall in relation to its aggregate assets, regardless of the source of financing for those assets, even though QOZ benefits generally accrue only to the portion of QOF assets funded with eligible gains to which a deferral election is made. Consequently, the penalty under such an interpretation would be disproportionate to the gain deferral benefits in a QOF that acquired assets with mixed funds and/or debt.

Recommendation

The final regulations should provide that the 90-percent asset test penalty only apply to the portion of aggregate assets funded with eligible gains to which a deferral election is made.

In the event Treasury believes they do not have regulatory authority to disregard assets not funded with gains to which a deferral election is made, then with respect to the penalty, the final regulations should provide the following:

- The term aggregate assets with respect to the 90-percent asset test penalty calculation means gross assets of the QOF less any assets funded by liabilities of the QOF; and
- Taxpayers shall have reasonable cause and therefore no penalty is imposed on any failure in proportion to the aggregate assets not funded by eligible gains to which a deferral election is made.

F. Working Capital and Ancillary Safe Harbors

We applaud Treasury for providing the safe harbors that allow QOZBs to hold funds for up to 31-months for the acquisition, construction, or improvement of real and other tangible property and provide ancillary safe harbors for other rules applicable to QOZBs. The following comments request further expansion and clarification of the safe harbors provided in the Regulations.

[19] IRC §1400Z-2(f)(1).
[20] Prop Reg. §1.1400Z-2(e)-1(a)(2).

(i) Working capital assets designated for operating expenditures should also be treated as reasonable.

Background

Under the Regulations, working capital assets are treated as reasonable if:[21]

(A) amounts are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone;
(B) there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets and under the schedule the working capital assets must be spent within 31 months of the receipt by the business of the assets; and
(C) the working capital assets are actually used in a manner that is substantially consistent with amounts designated in writing.

Treasury requested comments on whether any further expansion of the "working capital" concept beyond the acquisition, construction, or rehabilitation of tangible business property to the development of business operations in the opportunity zone would be appropriate.

New and expanding operating businesses need working capital to cover expenditures such as payroll, inventory and occupancy costs during the start-up phase and therefore working capital designated for start-up operating expenditures should be included in the safe harbor.

Recommendation

The final regulations should expand the "reasonable working capital" concept to include working capital assets designated for necessary operating expenses consistent with the ordinary start-up or expansion of a business, if expended as designated by a written schedule over a 31-month period.

(ii) Provide an extension of time to the safe-harbor period for disruptions beyond a business's control

Background

Treasury requests comments whether the 31-month working capital safe harbor and ancillary safe harbors that protect a business during the working capital period are adequate and if there any statutory basis for additional relief.

It is not uncommon for real estate and other projects to experience delays that are beyond the businesses control such as delayed permitting and other municipal approvals, contract disputes, supply embargos, labor stoppages, extreme weather events and national disasters. Additional flexibility is needed to give investors comfort that businesses experiences these unforeseen delays will not be disqualified.

[21] Prop Reg. §1.1400Z-2(d)-1(d)(5)(iv).

Recommendation

The final regulations should provide that certain disruptions in a business's continuous construction or continuous effort towards completion within the 31-month period that are beyond a business's control will not be considered as indicating that the business is outside the Working Capital Safe Harbor. In such circumstances, qualification under the Working Capital Safe Harbor would be determined based on the relevant facts and circumstances. This is similar to relief provided for business disruptions under Notice 2018-59 concerning the beginning and continuous construction requirements for energy property.

(iii) Allow all businesses a 31-month grace period to become a QOZB regardless as to the amount of working capital assets held by the business.

Background

It is unclear the extent to which a business has a grace period to qualify as a QOZB. In order for investments in corporations and partnerships to qualify as opportunity zone property, the statute requires that:

i) as of the time such interest was acquired, such corporation/partnership was an QOZB (or, in the case of a new corporation/partnership, such corporation/partnership was being organized for purposes of being an QOZB);[22] and
ii) during substantially all of the QOF's holding period for such interest such corporation/partnership qualified as an QOZB.[23]

The Regulations establish a safe harbor that allows an opportunity zone business to hold reasonable amounts of working capital assets for up to 31-months for the acquisition, construction, or improvement of tangible property. Businesses that comply with this safe harbor qualify for three additional safe harbors:

(i) First, any gross income earned on reasonable amount of working capital reserves is treated as satisfying the gross income requirement;
(ii) Second, a substantial portion of intangible property of a business complying with the reasonable working capital safe harbor is deemed to be used in the active conduct of a trade or business in the opportunity zone; and
(iii) Third, if some of a business's financial property is treated as being a reasonable amount of working capital, and if the tangible property (referred to in the designation of the use of working capital for the acquisition, construction, and/or substantial improvement of tangible property) is expected to satisfy QOZBP requirements as a result of the planned expenditure of those working capital assets, then the tangible property designated is not treated as failing to satisfy those requirements, solely because the scheduled consumption of the working capital is not yet expended.

There is some confusion whether a business that plans to serially-draw capital from investors and/or lenders and therefore holds an insufficient amount of working capital reserves to cover planned

[22] Prop Reg. §1.1400Z-2(d)-1(c)(2)(i)(B) & Prop Reg. §1.1400Z-2(d)-1(c)(3)(ii).
[23] Prop Reg. §1.1400Z-2(d)-1(c)(2)(i)(C) & Prop Reg. §1.1400Z-2(d)-1(c)(3)(iii).

expenditures, also has a 31-month grace period to become a QOZB. Specifically, commentators have questioned whether a business with working capital assets that are less than the planned QOZBP expenditures can treat all planned QOZBP expenditures (designated in writing) as satisfying QOZBP requirements for the 31-months.

Recommendation

The final regulations should provide all eligible business have at least 31-months to qualify as a QOZB as long as the QOF reasonably expects, at the time the QOF makes its initial investment in the entity, the entity will qualify as a QOZB within 31-months as represented by a written schedule consistent with the ordinary start-up of such trade or business.

Moreover, the final regulations should provide that certain disruptions in a business's continuous effort towards qualification within the 31-month period that are beyond a business's control will not be considered as indicating that the business is outside of the safe harbor period. In such circumstances, qualification would be determined based on the relevant facts and circumstances. As noted earlier, this is similar to relief provided for business disruptions under Notice 2018-59 concerning the beginning and continuous construction requirements for energy property.

Finally, if an otherwise qualified business becomes unqualified during a QOFs holding period, final regulations should provide for a cure period. Under this cure period, an unqualified business would be treated as qualified if the business becomes qualified within 12-months after the date the QOF becomes aware (or reasonably should have become aware) of the failure to qualify. This is similar to the cure period provided under the NMTC incentive for failure to satisfy the substantially-all test.[24]

G. Definition of Substantially All

(i) Keep the substantially all percentage at 70-percent and generally require real property businesses to hold 90-percent of tangible property inside a QOZ.

Background

The Regulations specify that if at least 70-percent of the tangible property owned or leased by a trade or business is QOZBP, then the trade or business is treated as satisfying the substantially all requirement of §1400Z-2(d)(3)(A)(i). We applaud Treasury for choosing a 70-percent requirement. Allowing up to 30-percent of a business's tangible property to be unqualified will enable a greater number of pre-existing entities across broad categories of industries to access patient equity capital from QOFs. Furthermore, the 70-percent threshold allows operating businesses using transient assets both inside and outside of the QOZ (e.g. delivery vehicles, laptops, offsite inventory) to qualify.

Some commentators have expressed concern that the 70-percent requirement is too low to implement the intent of Congress. This concern is heightened by the combined effect of the 70-percent substantially-all requirement with the 90-percent asset requirement of a QOF, which could mathematically result in only 63-percent of investments in a QOF being used to fund QOZBP. Such that as much as 37-precent of investments in a QOF could be funding property or other assets outside a QOZ.

[24] Treas. Reg §1.45D-1(e)(6).

While we understand this concern, we do not believe that Treasury should address the concern by increasing the substantially all percentage. Such an action would cause many worthy businesses that are operating in a QOZ to fail to qualify due to their having a modest amount of pre-existing or transient assets.

Recommendation

Given that the concern relates to QOF investments outside a QOZ, and real property investments are a greater concern than operating businesses, Treasury should consider adopting an additional rule for rental real estate trades or businesses. Under this additional rule, 90-percent of the tangible property of a rental real estate trade or business would need to be located in a QOZ. Such a modification would discourage QOF investments in QOZBs holding rental real estate outside of a QOZ, which aligns with Congressional intent. In short, to be QOZBP, (A) 70-percent of the tangible property of a rental real estate businesses would need to be (i) purchased after December 31, 2017 and (ii) either original use property or substantially improved property, and (B) 90-percent of the tangible property of a rental real estate business would generally need to be used in a QOZ. An exception to the 90-percent rental real estate requirement would be for real property straddling a QOZ as discussed below.

(ii) Modify the tangible property requirement for real property straddling a QOZ.

Background

Among other requirements, substantially-all of the use of tangible property must be used in a QOZ during substantially all of a QOF's or QOZB's holding period to be considered QOZBP. Some businesses own and lease contiguous real property that straddles multiple census tracts, where some tracts are QOZs and some are not. Neither the statute nor the Regulations offer specific guidance regarding such businesses. Under similar place-based tax incentives (i.e., Enterprise Zones and DC Zones)[25], rules provided that if the amount of real property located within the zone was substantial compared to the amount of real property located outside of the zone; and the real property that was located outside of the zone was contiguous to part or all of the real property located inside the zone, then all of the property was deemed to be inside a qualified zone.

Recommendation

Final regulations should provide that businesses using real property that straddles census tracts inside and outside of a QOZ can treat all of the real property as being located in the QOZ if (i) the amount of real property located inside the QOZ is substantial compared to the amount of real property located outside the QOZ, and (ii) the real property located outside of the QOZ is contiguous to part or all of the real property located inside the QOZ. Furthermore, final regulations should provide that all tangible personal property used by the business either on or within this contiguous real property, is considered used in a QOZ.

Real property located within the QOZ should be considered substantial if the unadjusted cost of the real property inside a QOZ is greater than the unadjusted cost of real property outside of the QOZ.

[25] With respect to Enterprise Zone Property see: §1397C(f) and with respect to DC Zone Property see: Joint Comm. Staff, Gen Expln. of '97 Tax Legis. (JCS-23-97), 12/17/97, p. 99.

(iii) Provide a safe harbor for satisfying the QOZBP definition of substantially all for purposes of holding period and use in a qualified opportunity zone.

Background

The Regulations do not provide a definition of the term "substantially-all" for purposes of determining whether during substantially all of a QOF or QOZB's holding period of property, substantially-all of the use of such property was in a qualified opportunity zone.

Recommendation

The Regulations should include a safe harbor that provides that a QOF or QOZB is deemed to satisfy the QOZBP requirement that during substantially-all of a QOF or QOZB's holding period of tangible property, substantially-all of the use of such property was in a qualified opportunity zone, so long as such property is used in a QOZ, or within a reasonable period of time after the date the QOF or QOZB becomes aware (or reasonably should have become aware) such property is not being used in a QOZ, such property is returned to use in a QOZ or disposed of. This is similar to the cure period provided under the NMTC incentive for failure to satisfy the substantially-all test.

H. Required Use of Intangible Property

(i) Clarify the requirement that a substantial portion of the intangible property of a QOZB be used in the active conduct of a trade or business in the QOZ.

Background

The Regulations provide with respect to any taxable year, a substantial portion of the intangible property of a QOZB is used in the active conduct of a trade or business in the qualified opportunity zone. Final regulations should provide (i) the meaning of the term substantial, (ii) the meaning of the phrase "used in the active conduct of a trade or business", (iii) a method for measuring the portion of intangible property used in a business, and (iv) a method for determining whether a business's intangible property is used in the QOZ.

Recommendations

The meaning of the term substantial

The final regulations should define the term substantial as - at least 40-percent, similar to the meaning of the term substantial as it relates to tangible property under the NMTC incentive.[26] This will enable operating businesses to qualify despite the fact that they may sell or license to others a portion of their intellectual property.

The meaning of the phrase "used in the active conduct of a trade or business"

The final regulations should provide the meaning of the phrase "used in the active conduct of a trade or business" to mean - the commercial use of intangible property for the management, development,

[26] Treas. Reg. 1.45D-(d)(4)(i)(B).

manufacturing, and sale or lease of goods and services to generate gross income. This definition should include the development of intangibles for sale as long as a substantial amount (40 percent) of the services to develop the intangibles are performed in the QOZ which will allow QOZ's to lure technology companies which possess an enormous capacity to transform communities.

A method for measuring whether the intangible property used in the active conduct of a business is substantial.

The final regulations should provide that the portion of intangible property used in the active conduct of a business is determined based upon the portion of gross income generated by the commercial use of intangible property for the management, development, manufacturing, and sale or lease of goods and services (including intangibles developed in the QOZ) over total gross income from the use of intangible property.

Example:

A, a software company located in a QOZ, owns various software licenses, some of which A purchased from other developers and some of which A substantially developed in the QOZ. During 2019, A's gross income from software licenses purchased totaled $3 million and A's gross income from software licenses that were substantially developed in the QOZ totaled $7 million. As a result, 70-percent of A's intangible property is used in the active conduct of a trade or business in the QOZ.

A method for determining whether a business' intangible property is used in the QOZ

The final regulations should provide that the situs of where a business's intangible property is used in the active conduct of a trade or business is consistent with where a businesses' tangible property is used in the active conduct of a trade or business. Determining where a business's intangible property is being used can be complex and time consuming for operating businesses. Different factors for determining where intangible property is used (such as where an entity uses its tangible property; where an entity's employees perform services; and where a business's customers are located) can be weighted differently by different taxpayers and is likely to lead to uncertainty. Given these complications, the absence of an objective standard for determining the situs of where intangible property is used will likely lead to a disproportionate amount of real estate investments in opportunity zones. Accordingly, we recommend that Treasury adopt an objective standard for determining where intangible property is being used in the active conduct of a business based upon a single factor of where a business's tangible property is being used. If 50-percent of a business's tangible property is being used in the opportunity zone then 50-percent of the business's intangible property that is used in the active trade or business is also used in the opportunity zone. Using a tangible property standard for determining the situs where intangible property is being used in an active trade or business is consistent with the statute's QOZBP requirements.

I. Becoming a QOF

(i) Clarify that "month" means a period-of-time between the same dates in successive calendar months.

Background:

If a taxpayer that is classified as a corporation or partnership for Federal tax purposes is eligible to be a QOF, the taxpayer may self-certify that it is a QOF.[27] The self-certification requires a taxpayer to identify the first taxable year that the eligible entity wants to be a QOF and the first month (in that initial taxable year) in which the eligible entity wants to be a QOF. Investments before the first month are not eligible for deferral and the computation of any penalty does not take into account any months before the first month identified by a QOF.

The term "month" as used differently in different sections of the IRC. Month can mean (i) each of the 12 periods into which a calendar year is divided or (ii) a period-of-time between the same dates in successive calendar months. Neither the statute nor the Regulations define the term "month". As a result, there is confusion around the end of first six-month period when a QOF is required to perform the 90-percent asset test.

Example:

A QOF formed a fund in May 2018 and accepted a deferred gain investment on May 25. If the term "month" means a calendar month then their first six-month testing date will be October 31, 2018 (a period of five-months and six days after formation). If the term "month means a period of time between successive calendar months, then their first six-month testing date will be November 25, 2018.

Recommendation:

Treasury should define the term "month" in the final regulations to mean a period-of- time between the same dates in successive calendar months in order to provide a consistent amount of time before the first six-month test is required.

J. Eligible Taxpayers

(i) Allow capital gains realized by a member of a consolidated return group to be invested by other members of the consolidated return group.

Background

The Regulations provide special rules for partnerships and other pass-through entities that permit a partnership to elect deferral under section 1400Z-2 and, to the extent that the partnership does not elect deferral, provide rules that allow a partner to do so. The Regulations clarify the circumstances under which each can elect and clarify when the applicable 180-day period begins. In connection with these rules, Treasury specifically requests whether taxpayers need additional details regarding analogous treatment for pass-through entities that are not partnerships.

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[27] Prop Reg. §1.1400Z-2(d)-1(a)(1).

IRC §1501 provides that an affiliated group of corporations connected through common ownership may elect to file a consolidated return in lieu of separate returns. The basic principle of the consolidated return is that the group is taxed on its consolidated taxable income after the elimination of intercompany profit and loss, as if it were a single entity. This includes netting all capital gains and losses generated by all members of the consolidated return group.

Neither the statute nor the Regulations address whether capital gains of one member of a consolidated return group of corporations can be treated as capital gain of other members of the consolidated return group so that gains may be aggregated under a single deferral election by the consolidated return group for purposes of the QOZ statute.

Example:

Corp. B and Corp. C are connected in an affiliated group with common parent Corp. A and file a consolidated return with A. In 2018, Corp. B and C realize capital gains of $2 million and $500,000, respectively.

Can Corporation A, B or C make an election to defer $2.5 million of gain on behalf of the consolidated return group, if Corporation A, B or C makes a $2.5 million eligible investment in a QOF?

Recommendation

To provide greater flexibility to consolidated return groups and therefore more investments in QOZs, the final regulations should provide that capital gains generated by a member of consolidated return group are treated as generated by the consolidated return group for purposes of QOZ statute. Similarly, QOF investments made by a member of a consolidated return group are treated as made by the consolidated return group for purposes of the QOZ rules. For purposes of these aggregation rules, any member of a consolidated return group that elected to be a QOF would be excluded, as would any of its subsidiaries.

In order to properly-account for the gain realized by one member that is invested and deferred by another member, Treasury should provide that the investing member book a loss to offset the gain recognized by the non-investing member. This would effectively eliminate the gain for the consolidated group return for the taxable year upon consolidation and move the deferral and any future recognition to the investing member.

K. 180-Day Period

(i) Provide optionality to real estate investment trust (REIT) shareholders for determining when the 180-day election deferral period begins.

Background

Under an example provided in the Regulations, if an individual REIT shareholder receives a capital gain dividend, the shareholder's 180-day period with respect to that gain begins on the day on which the dividend is paid. However, the shareholder will not know the character of its REIT distribution unless the REIT specifically identifies the dividend as a capital gain dividend or until they receive a Form 1099-DIV, which could be up to 30-days after the end of the taxable year. The Regulations provide that partnership gains that are passed through to a partner may be deferred by the partner within 180-days of either the sale that generated the gain or the last day of the partnership's tax year.

<u>Recommendation</u>

Similar to partners in a partnership, the final regulations should provide REIT shareholders with optionality for when the beginning of the 180-day period begins for capital gain dividends because the character of the dividends may not be known for 30 days after the tax year ends (when 1099s are required to be provided to the taxpayer). Accordingly, the 180-day period for a REIT shareholder should begin on the 30th day after the last day of the REIT's taxable year, not the date the dividend is paid. Alternatively, for situations in which the shareholder knows (or receives information) regarding the character of the dividend the shareholder may choose to begin its 180-day period on the date the dividend is paid.

L. Eligible Investments

(i) Clarify that only investments in QOFs made in cash are eligible for the gain deferral election.

<u>Background</u>

Taxpayers may elect to temporarily defer taxation on capital gains (and receive other benefits) on the amount of capital gains timely invested in a QOF. Neither the statute nor the Regulations provide any direct tracing requirement of the gain dollars to the investment in the QOF, nor do they provide a direct tracing requirement of the investment in a QOF to the investment in QOZP. The statute and the Regulations are also silent as to whether a taxpayer's investment needs to be made with cash or whether it can be made with a contribution of property to a QOF. The final regulations should provide clarity whether eligible investments in a QOF have to be made with cash.

<u>Recommendation</u>

The final regulations should provide that eligible investments may only be in cash. Allowing taxpayers to make eligible investments in the form of property contributions may influence taxpayers to contribute appreciated property to a QOF, which may provide tax benefits beyond that intended by Congress under the statute.

Example

In 2019 T, an eligible taxpayer, realized a $20 million capital gain and timely invested $18 million in cash and $2 million of stock with a basis of zero in QOF P. QOF P immediately invested the $18 million (90 percent of $20 million) in cash in QOZP. In 2026 after seven years, T is required to include $17 million (85 percent of $20 million) of the previously deferred gain in gross income. Assume in 2030 QOF P still holds the stock with a zero basis and the stock is still valued at $2 million, and QOF P still holds the QOZP which is valued at $18 million. T sells her investment in QOF P for the value originally invested in 2019 of $20 million. Assume T had no other income or loss or cash distributions with respect to her investment over the holding period. T would have no gain or loss on sale of the investment.

M. Typographical Errors

The Working Group also wants to bring your attention the following typographical errors in the Regulations:

- Proposed Treasury Regulation §1.1400Z-2(a)-1(b)(8)(i) and (iii): It is unclear in Examples 1 and 3 whether the years 2022 and 2023, respectively, refer to the date the investment was sold or if these are errors and should instead be replaced with 2026, which is the required year of inclusion defined in §1400Z-2(a)(2)(B). If the dates are meant to be the year of sale, then this fact will need to be added to the examples.
- Proposed Treasury Regulation §1.1400Z-2(d)-1(d)(2)(i)(A): This section is related to QOZBP owned by a QOZB. The reference in the proposed regulation is to IRC §1400Z-2(d)(2)(D)(i)(I), which relates to QOZBP owned by a QOF. The reference should be to IRC §1400Z-2(d)(3)(A)(i).
- Proposed Treasury Regulation §1.1400Z-2(d)-1(d)(5)(viii)(C): “ not yet doubled” should be “not yet more than doubled”.
- Proposed Treasury Regulation §1.1400Z-2(d)-1(e)(2): Reference to “1400Z-2(C)(i)” should be “1400Z-2(d)(2)(C)(i)”.