

December 27, 2018

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

To Whom It May Concern:

We write as a broad coalition of stakeholders to provide comments in response to the Notice of Proposed Rulemaking, Investing in Qualified Opportunity Funds, issued October 29, 2018 (“NPRM”).¹ We are grateful for the work of staff at the Department of the Treasury and Internal Revenue Service (“Service”) to produce the NPRM and prioritize guidance that will facilitate the use of the Qualified Opportunity Zone (“QOZ”) tax incentives to the benefit of designated low-income communities nationwide.

We applaud the approach that Treasury has taken on a number of key issues. For example, the proposed 31-month safe harbor at the QOZ Business level will help many QOF investors to structure investments and time the acceptance of capital.² Additionally, we strongly support the proposed definition of “substantially all” pertaining to the amount of a QOZ Business’s tangible assets located in a QOZ. The proposed 70-percent threshold achieves the right balance to ensure that Qualified Opportunity Funds (“QOFs”) will not be discouraged from investing in QOZ operating businesses as Congress intended.³ Both of these rules should be finalized and, as detailed in the attached comments, Treasury should consider whether additional guidance in these areas is needed.

The proposed regulations address a range of other issues, including that all capital gains are eligible for the incentive;⁴ that partners may invest and defer partnership level gains in QOFs if the partnership does not;⁵ that debt of a QOF taxed as a partnership is not treated as an additional investment by the partners;⁶ and that QOF investors may hold their interests in QOFs and make the basis step-up election until 2047.⁷ Final regulations should include all of these proposed rules.

Looking beyond the scope of the current NPRM, the lack of clarity on several other key issues is preventing many QOFs from forming and significantly limiting the nature and extent of new investment in designated communities. As detailed in the attached comments, guidance is urgently needed in the following areas:

¹ 83 Fed. Reg. 54279, REG-115420-18.

² Prop. Reg. § 1.1400Z2(d)-1(5)(iv).

³ Prop. Reg. § 1.1400Z2(d)-1(d)(3).

⁴ Prop. Reg. § 1.1400Z2(a)-1(b)(2).

⁵ Prop. Reg. § 1.1400Z2(a)-1(c).

⁶ Prop. Reg. § 1.1400Z2(e)-1(a)(2).

⁷ Prop. Reg. § 1.1400Z2(c)-1(b).

- **Final regulations should remove barriers that prevent multi-asset QOFs from forming so that capital can flow to QOZ communities.** Guidance providing a reasonable period of time for QOFs to invest and reinvest funds, as well as clarity that investors’ tax benefits will not be compromised when a QOF sells and reinvests in qualifying investments, will allow QOFs to form and invest as Congress intended.
- **Final regulations should interpret the statute in ways that encourage and enable QOF investments in operating businesses, as well as real estate projects.** Clarity is needed regarding how operating businesses can meet the “gross income test” to qualify as a QOZ Business, and how their property can meet the “substantial improvement test” to be considered QOZ Business Property.
- **Future proposed regulations should include reporting requirements that will provide basic information about investments in QOZ communities to inform investment and policy decisions.**

Additional guidance is welcome on a host of other important issues, a few of which we touch on in the attached comments. However, without adequate guidance in the three key areas noted above, the QOZ tax incentive will fail to achieve the impact Congress intended. The attached comments make recommendations for the content of final regulations, but we urge Treasury to move quickly on these critical issues and, if more expedient, to do so in subregulatory guidance.

Finally, we request the opportunity for John Lettieri, President and CEO of the Economic Innovation Group, to speak on behalf of this coalition at the public hearing (REG-115420-18) on January 10, 2019 for approximately 10 minutes. His comments will concern the priority issues included in this enclosed comment letter.

Thank you for the opportunity to comment on this NPRM. We appreciate your consideration of the attached recommendations, and look forward to the issuance of final regulations and future rounds of proposed rulemaking that will facilitate much-needed investment in communities across America. If you have any questions about this letter, please contact John Lettieri at john@eig.org or (202) 839-3713.

Sincerely,

Access Ventures
ACON Investments
Advantage Capital
Alliant Strategic
Arctaris Impact Fund
Bridge Investment Group
California Forward
Calvert Impact Capital
Capalino & Company

Center for American Entrepreneurship
Chicago Community Loan Fund
CliftonLarsonAllen
CohnReznick LLP
Community Capital Management
Community Development Bankers Association
Community Development Venture Capital Alliance
Community Reinvestment Fund, Inc.
Detroit Opportunity Fund LLC
Develop LLC
Dauby O'Connor & Zaleski, LLC
Economic Innovation Group
EJF Capital
Fund for Our Economic Future
Fundrise
Hancock Whitney Bank
High Ridge Venture Partners
Homecoming Capital
Institute for Portfolio Alternatives
International Franchise Association
KeyBank
KPMG LLP
Launch NY, Inc.
Launch Tennessee
Low Income Investment Fund (LIIF)
Local Initiatives Support Corporation (LISC)
Maycomb Capital
National Development Council
National Foundation for Affordable Housing Solutions, Inc.
NES Financial
Newark Venture Partners
Novogradac & Co.
Opportunity Alabama
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Plante Moran, PLLC
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Reinvestment Fund
Rural Community Assistance Partnership
Rural Opportunity Initiative
SMB Intelligence
Sorenson Impact Center
Sorenson Impact Foundation
Stonehenge Capital Company, LLC
The Enterprise Center

The Governance Project
U.S. Impact Investing Alliance
Urban Atlantic
Virtua Capital Management, LLC
War Horse Cities
Weller Development Company

Enclosure:
Comments on Proposed Regulations Regarding Investing in Qualified Opportunity Funds (REG–115420–18)

cc:
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David Kautter, Assistant Secretary of the Treasury for Tax Policy, Department of the Treasury
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Mike Novey, Associate Tax Legislative Counsel, Office of Tax Policy, Department of the Treasury
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Comments on Proposed Regulations Regarding Investing in Qualified Opportunity Funds (REG–115420–18)

U.S. economic growth has been deeply uneven in the years following the Great Recession, bypassing a large share of American communities. The Qualified Opportunity Zone (“QOZ”) tax incentive, originally introduced as the *Investing in Opportunity Act*⁸ and enacted as part of the *Tax Cuts and Jobs Act of 2017* (“TCJA”),⁹ was designed to encourage private investment in low-income communities that have often struggled to achieve meaningful growth in local employment or businesses. New section 1400Z-2 provides certain tax incentives for investors that invest in Qualified Opportunity Funds (“QOFs”), which in turn invest in Qualified Opportunity Zone Property (“QOZ Property”), including both interests in Qualified Opportunity Zone Businesses (“QOZ Businesses”) and Qualified Opportunity Zone Business Property (“QOZ Business Property”). Importantly, the statute generally provides that if an investor holds a qualifying interest in a QOF for at least 10 years, when the QOF interest is sold, the investor may elect to step-up the basis in the QOF interest to fair market value, so that the appreciation in the investor’s QOF interest will not be subject to tax (“10-year tax benefit”).¹⁰

A. Regulations Should Facilitate Formation of QOFs

It is clear from the statutory text that Congress intended to incentivize investments in QOFs that are truly “funds” – that is, vehicles for investors to pool capital and spread risk across a portfolio of investments, facilitating investment activity at scale in low-income communities. A true fund reduces risk for investors because it can collect capital from a number of participants and invest in several businesses – some of which may fail, some of which may take years to develop, and some of which may succeed and grow rapidly, with opportunities to obtain additional capital or grow beyond the QOZs where they began. At the moment, the majority of QOFs we have seen form are not funds in this sense, but rather are single project entities typically investing in real estate. Treasury should use the authority Congress granted to issue guidance that will further congressional intent to incentivize investment at a large scale through funds – and not just single projects.

One reason funds have failed to form is that the proposed regulations do not provide sufficient time for fund managers to raise and deploy capital. Under the proposed rules, a QOF has less than six months – and sometimes as little as a few days – to raise and deploy at least 90 percent of its funds into qualifying investments. The practical result is that a fund must have investments identified and vetted before it can raise capital, and it cannot accept new investments in the weeks prior to the testing dates to ensure it has time to make the investments. This makes raising capital from investors, who themselves only have 180 days from the date they recognize a gain to make a QOF investment, extremely and unnecessarily challenging. Similar timing questions have been raised about the reinvestment of proceeds if a QOF sells property. A second reason QOFs thus far have formed primarily to invest in single projects is uncertainty regarding whether

⁸ Investing in Opportunity Act, S.293, 115th Cong. (2017).

⁹ Internal Revenue Code (“Code”) sections 1400Z-1 and 1400Z-2. Unless otherwise stated, section references are to the Internal Revenue Code of 1986, as amended, and to the Treasury Regulations thereunder.

¹⁰ Section 1400Z-2(c).

the 10-year basis step-up benefit will be lost if the QOF sells its investments before the investor sells his or her QOF interest. Thus, QOFs are often limiting themselves to a single project so that, if necessary, the QOF interest, rather than the underlying asset, can be sold to ensure that investors receive the intended tax benefit from a 10-year holding period.

Final regulations should provide QOFs sufficient time to invest and reinvest cash in qualifying investments in the manner Congress intended. In addition, final regulations should provide assurance that investors will receive the intended tax benefits of a 10-year hold, even if a QOF sells one qualifying investment and reinvests in another (or redeems a partner's complete interest in the QOF that has been held for 10 years).

1. Ensure QOFs have time to raise and deploy (or redeploy) capital

At least 90 percent of the assets of a QOF must be QOZ Property, including QOZ Business interests (whether stock or partnership interests) and QOZ Business Property, measured by averaging the QOF's percentage of QOZ Property on the last day of the first six months of the tax year and on the last day of the tax year.¹¹ This mirrors a similar asset test in the New Markets Tax Credit ("NMTC") context, in which a qualified community development entity ("CDE") must meet semi-annual testing periods to make qualifying investments with the cash it has received. If the QOF fails to meet the 90-percent asset test, a penalty will generally apply; however, no penalty shall be imposed if the failure is due to "reasonable cause." In addition, Congress gave the Treasury Department broad regulatory authority to craft "such regulations as may be necessary or appropriate to carry out the purposes of [section 1400Z-2]," including "rules to ensure that a qualified opportunity fund has a reasonable period of time to reinvest" cash returns.¹²

The NPRM preamble indicated that future guidance will address the reasonable timeframe for reinvestment of sale proceeds, but the NPRM provided no guidance regarding a reasonable period of time for investment of fund capital in the first instance. The NPRM did provide that a QOF could elect the first month in which to be treated as a QOF, which may give some QOFs a few additional months in their first year to invest funds – if they form in the first half of their tax year. But this is insufficient to provide a reasonable period of time to deploy funds into a portfolio of QOZ Businesses and projects, and the NPRM implies that QOFs will have less than six months – perhaps only a few days – to initially deploy funds. Effectively, if this were the rule, QOFs would be unable to accept investments in the weeks before a testing date.¹³ Already, we are seeing funds that will not accept new investments because year end is nearing. The lack of clarity on this point is preventing QOFs from forming, impeding congressional intent for capital to flow through QOFs to investments in low-income communities.

¹¹ Section 1400Z-2(d)(1).

¹² Section 1400Z-2(e)(4).

¹³ Many QOFs organized as partnerships will have a calendar year end, and without additional flexibility, it will be hard for them to accept new investments in the weeks prior to their June 30 and December 31 testing dates. The practical effect of a rigid reading of the QOF asset test would be to make it difficult for investors realizing gains at the end of their tax year to invest in QOFs in the latter weeks of the 180-day period, effectively shortening the window Congress gave investors to use this tax incentive.

It was clear to Congress that a QOF fund manager cannot instantly invest funds in qualifying operating businesses and projects upon raising capital; thoughtful investment takes time. Nor is it practical to expect all QOFs to pre-identify and pre-arrange a full portfolio of qualifying investments *before* raising capital. The statute’s direct reference to the need for regulatory guidance providing a “reasonable period of time” to reinvest funds is clear evidence of congressional intent that fund managers have sufficient time to invest funds and meet the QOF asset test, even when reinvesting funds from a single asset disposition. Certainly, the fact that fund managers need sufficient time to build a portfolio of investments at the outset is so evident that Congress did not feel it was necessary to specifically mention it in the statute. But it is clear, from the structure of the incentive to the specific mention of investment timing, that Congress intended for this incentive to draw capital to QOFs and for QOFs to invest in a portfolio of QOZ Businesses. Treasury has ample authority to carry out the statute’s purposes in this regard by clearly providing in final regulations a reasonable time to invest the funds QOFs receive at the outset from their investors.

Recommendations:

In the usual course, investors often sign commitments to provide cash as the fund manager requests it to make investments, often over the course of approximately three years. But this cannot be the case with a QOF, as its investors have only 180 days from their sale of a prior asset to put the funds in a QOF. The proposed regulations helpfully provide up to 31 months for QOZ Businesses to make investments (or improvements) in QOZ Business Property.¹⁴ Ideally, a similar start-up grace period could be given to QOFs that have a written plan for the deployment of capital and that do, in fact, deploy the capital in qualifying investments within the 31-month time frame, while still acknowledging that a QOF will generally need to meet the 90-percent asset test semi-annually after this start-up period. This would be easy to understand and administer – for both QOFs and the IRS – reducing the administrative burden of the regulation and providing clear space for QOFs to start to form and invest.

At the very least, final regulations should provide that for 12 months after receipt of any cash proceeds (from new investment, from returns on investments, or from the sale of QOZ Business Property), such cash (or certain cash equivalents) will be deemed to be QOZ Property for purposes of the 90-percent asset test if it is invested in qualifying investments by the end of the 12-month period. In such case, Treasury would not need to alter the regular, semi-annual testing dates, but the QOF would be allowed to count the cash as invested in QOZ Property if it ultimately was invested in QOZ Property within the 12-month period. This type of general rule is clearly within Treasury’s authority, as this is precisely what is done in a similar context in the NMTC regulations. Although the NMTC statute has no grace period for a CDE’s investment (or reinvestment) of cash proceeds from a sale, Treasury provided that cash held by a CDE may be treated as invested in a qualifying investment to the extent it is appropriately invested within 12 months of the day it was received.¹⁵ Similar concerns prompted the adoption of the asset test in the NMTC context, and the 12-month grace period has worked well in that context to balance the need to meet the asset test on one hand with the practical need of the CDE managers for time to prudently invest on the other. We are not aware of any systemic gaming of that standard and we understand that funds nearly always are invested as planned; thus, there is no significant problem

¹⁴ Prop. Reg. § 1.1400Z2(d)-1(5)(iv).

¹⁵ See Treas. Reg. § 1.45D-1(c)(5)(iv) and (d)(2).

with retroactive failures to meet the NMTC asset tests. In addition, there would be no incentive for investors to “park” funds in QOFs for the deferral benefit, because the lack of return on the cash balances would be a significant economic disincentive. Rather, the natural economic incentive would be to move cash from the QOF to the portfolio company investments, where better returns can be expected, as quickly as possible.

This 12-month test based on the NMTC regulations would provide a minimum amount of flexibility for a QOF to invest or reinvest funds received. For newly formed QOFs that are gathering funds from investors, however, it is reasonable for the deployment of capital to take longer, as there are more investments to be made and additional pressures on investors to get their funds into a QOF. Another alternative would be for final regulations to provide a QOF with an initial grace period of 12-18 months from the time the QOF is formed before it must participate in its first semi-annual asset testing date, coupled with a more general rule that all cash received by a QOF will be treated as invested in qualifying investments if, within 12 months of receipt, the cash is actually so invested. A 12- to 18-month grace period, together with more general flexibility to take a year to deploy any cash coming in, would provide newly formed QOFs the additional time needed to invest in a full portfolio of QOZ Businesses.

Finally, Treasury could rely on the authority provided in the statute to refrain from imposing penalties on a QOF if a failure to meet the 90-percent asset test is due to reasonable cause. Regulations could provide that the failure of a QOF to meet the test during the first 31 months of its existence is due to reasonable cause, to the extent the failure is due to holding excess cash (or cash equivalents), and provided that it is using reasonable efforts to invest such cash in QOZ Businesses. At a minimum, the failure of a QOF to meet the 90-percent asset test should be considered due to reasonable cause to the extent that the failure was due to excess cash that is ultimately invested within 12 months of receipt.

2. Ensure the intended 10-year tax benefit is available to investors

Congress intended that QOFs be able to reinvest proceeds into new QOZ Property, free of taxation on recognized interim gains, so long as the funds remain invested in the QOF. The statute directs Treasury to prescribe rules ensuring a “reasonable period of time to reinvest” capital returned to QOFs from investments in QOZ Property.¹⁶ In doing so, Congress understood that the duration of QOF investments would vary from one holding to the next for a variety of reasons, and that provision needed to be made to allow proceeds returned to QOFs to be reinvested without disrupting the tax benefit to a QOF’s investors. Indeed, it would be self-defeating for normal fund activity by the QOF to interfere with the intended tax benefit to the QOF’s investors.

A taxpayer’s ability to exclude gains on an investment held at least 10 years in a QOF is “integral to the primary purpose of the provision,” and a major motivating factor for investors.¹⁷ However, if the appreciation in the value of QOF assets is taxed during the 10-year period

¹⁶ Section 1400Z-2(e)(4)(B).

¹⁷ NPRM, Explanation of Provisions, section V.B. See also NPRM, Economic Analysis, section 2.d.v.

whenever a QOF sells its assets, then the 10-year benefit for investors is illusory. That could not have been Congressional intent.

The NPRM indicated that future regulations will address the timing of the reinvestment of QOF gains from the sale of portfolio assets and invited comment on both the timing and the tax treatment of such gains.¹⁸ In addition, the NPRM indicated that Treasury will evaluate the widest range of statutorily permissible possibilities for addressing these concerns. In this case, the statute links the tax benefit to the duration of a taxpayer's investment in a QOF itself, as opposed to the duration of the QOF's investment in any particular holding. Fears that QOF investors will not receive the intended 10-year tax benefit due to "interim" gains during the lifetime of the fund have inhibited QOF activity – including the formation of funds and the structuring of multi-asset funds – and have been a significant deterrent to investment in operating businesses, where the spreading of risk is essential and a QOF often will have little or no control over the timing of an "exit."

Recommendation:

Treasury should provide clarity, either in final or future regulations, that no gain or loss should be recognized on a QOF's sale or exchange of QOZ Property to the extent the QOF reinvests in new QOZ Property within one year (or, in the case of a QOF organized as a partnership, to the extent the QOF distributes the proceeds in complete redemption of a taxpayer's investment in such fund that has been held for at least 10 years). In addition, regulations should clarify that the QOF's basis in the new property should be determined in accordance with the principles of section 1031(d).

B. Regulations Should Encourage Investment in Operating Businesses

As noted above, Congress designed this incentive to work by pooling capital in QOFs, which could in turn invest in portfolio companies with assets and operations in QOZs. While the spreading of risk through a diversified real estate fund may certainly be desirable, this risk-sharing feature of funds is critical for investing in businesses, as it is even more difficult to ascertain which operating businesses will be successful, especially when they are starting out. Thus, Congress' use of a fund structure is a strong indication that they intended the QOZ incentive to spur new investment in operating businesses. In addition, the text of the statute refers explicitly to investments in QOZ Businesses (whether corporations or partnerships) as the kind of investment that QOFs are created to make. Although real estate investment can bring important new infrastructure and improvements to the built environment in a low-income community, the QOZ tax incentive was intended to be more than just a real estate development incentive. Operating businesses, which will fill buildings and create jobs for zone residents, are a critical component of the congressional design for encouraging lasting economic activity and growth in QOZs across the country. Therefore, it is imperative that Treasury interpret the statute with an eye toward how the tests apply to operating businesses.

Treasury can further congressional intent for the QOZ incentive to spur investment in operating businesses by providing clarity in several key areas. First, because there is great risk and

¹⁸ NPRM, Explanation of Provisions, section VI.C.

variability in return from investments in businesses, fund formation is critical to investment in operating businesses. Thus, as discussed above, QOFs will need adequate time to make investments as well as clarity regarding the tax treatment for their investors of sales and reinvestments during the life of the fund. Second, since the NPRM was released, there has been significant confusion regarding how operating businesses meet the gross income test for QOZ Businesses. Finally, operating businesses need clarity regarding how their tangible property can meet the requirements to be QOZ Business Property.

1. Clarify the QOZ Business Gross Income Test

The statute defines a QOZ Business as “a trade or business” that, among other things, “satisfies the requirements of paragraphs (2), (4), and (8) of section 1397C(b).”¹⁹ Paragraph (2) of section 1397C(b) requires that “at least 50 percent of the total gross income of such entity is derived from the active conduct of such business.”²⁰ A reasonable read of these provisions together, and the clear intent of Congress, is that at least 50 percent of the total gross income of the QOZ Business be income derived from the active conduct of its trade or business. The NPRM, however, appears to go beyond the statute and adds an additional requirement: that “at least 50 percent of the gross income ... is derived from the active conduct of a trade or business *in the qualified opportunity zone* [emphasis added].”²¹

This rule could dramatically narrow the scope of businesses eligible for QOF investment, thereby reducing the potential economic benefits of new investment within designated QOZ communities. Many businesses in today’s economy – both by design and necessity – seek to reach customers wherever they can be found, offering goods and services far beyond the limits of their local neighborhood. Furthermore, the rule would place a large and unnecessary compliance burden on businesses that receive QOF investments to determine how much of their income comes from within a QOZ versus that which comes from non-QOZ sources. For these reasons, the inclusion of the gross income sourcing rule has generated profound concern among potential QOF investors, local businesses, and other interested stakeholders.

It is unclear whether adding this significant restriction was intended, or was merely an error in drafting, as there was no discussion of this in the preamble. Certainly, if Treasury and the Service intended to add a far-reaching new restriction in regulations, there should have been a discussion of the reasons for such an addition. Further, the additional compliance burden it would place on QOZ Businesses, as well as the disqualification of many otherwise eligible businesses from the ability to receive QOF investment, should have been weighed against the clear statutory intent to boost investment in operating businesses when evaluating the burden of the NPRM. Thus, it is quite possible that this is merely a drafting error that can simply be corrected in final regulations by striking the final phrase “in the qualified opportunity zone.”

Recommendation:

Treasury should remove this added requirement by striking the words “in the qualified opportunity zone” from the final section 1.1400Z-2(d)-1(5)(i) regulation. Even if Treasury

¹⁹ Section 1400Z-2(d)(3)(A)(ii).

²⁰ Section 1397C(b)(2).

²¹ Prop. Reg. § 1.1400Z-2(d)-1(5)(i) (emphasis added).

believes there should be a requirement for a QOZ Business to derive 50 percent of its gross income from the active conduct of a trade or business *within a QOZ*, if Treasury followed the rule Treasury provided in the NMTC context, all QOZ Businesses would meet the requirement. The NMTC statute requires that 50 percent of the total gross income of a qualified active low-income community business be derived from the active conduct of a qualified business within a low-income community,²² similar to the requirement that Treasury has imposed in the proposed regulations. However, because it would be difficult to track the location from which income is derived, Treasury provided alternative options for meeting this test in the NMTC regulations. The NMTC regulations provide that an entity is deemed to meet the gross income requirement if 50 percent of the use of its tangible property is within a low-income community.²³ Because a QOZ Business must have at least 70 percent of its tangible property in use in a QOZ per the proposed regulations, if Treasury interprets the QOZ Business gross income requirement in the same way it did in the NMTC context, all QOZ Businesses would easily meet the gross income test as well.

2. Allow QOZ Businesses to meet the “substantial improvement” test on an aggregate basis

Substantially all – or 70 percent, per the proposed regulations – of the tangible property owned or leased by a QOZ Business must be QOZ Business Property.²⁴ To qualify as QOZ Business Property, tangible property must be used in a trade or business, and among other things, must have its original use in the QOZ commence with the QOZ Business or the QOZ Business must substantially improve the property.²⁵ The statute further provides that “property shall be treated as substantially improved . . . only if, during any 30-month period . . . additions to basis . . . exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period . . .”²⁶ Of course, in the context of an operating QOZ Business, it could be quite difficult and administratively burdensome to try to meet this test on an asset-by-asset basis. Certain assets, such as equipment or office furniture, do not easily lend themselves to substantial improvement through a more than doubling in basis. But such a requirement is not necessary, and the NPRM requested comments regarding what additional flexibility final regulations could include to facilitate qualification of “a greater number of pre-existing entities across broad categories of industries” as QOZ Businesses.²⁷

Congress intended that both new and existing businesses with expansion and growth potential qualify for QOF investment. For example, in his press release announcing the introduction of the *Investing in Opportunity Act*, Senator Tim Scott (R-SC) wrote, “The Investing in Opportunity Act can provide the chance that entrepreneurs and small businesses are looking for to grow, innovate and create jobs,” underscoring that this incentive was intended to draw capital to QOZs both to help existing businesses grow and to spur creation of new businesses. The same point has been emphasized repeatedly in public statements and congressional hearings on Opportunity

²² See section 45D(d)(2)(A)(i).

²³ Treas. Reg. § 1.45D-1(d)(4)(i)(A).

²⁴ Prop. Reg. § 1.1400Z-2(d)-1(d)(3).

²⁵ Section 1400Z-2(d)(2)(D)(i).

²⁶ Section 1400Z-2(d)(2)(D)(ii).

²⁷ NPRM, Explanation of Provisions, section VI.D.

Zones by Republican and Democratic policymakers alike. Treasury has the authority to issue regulations to carry out the purposes of the QOZ incentive and to minimize burden on the regulated entities. In this case, Treasury could provide that the substantial improvement test may be met by a QOZ Business on an aggregate basis, whereby if the QOZ Business more than doubled its basis in its aggregate business assets over a 30-month period, it would be treated as having substantially improved its business assets. This would fulfill the fundamental purpose of the substantial improvement test while reducing ambiguity and complexity for a wide range of QOZ Businesses and their investors alike. Allowing an existing business in the QOZ to qualify as a QOZ Business and receive QOF investments if it makes new investments equal to or exceeding its basis in its current property within 30 months harmonizes congressional intent to benefit existing businesses while also ensuring that significant new investment is made in the specified QOZ.

Recommendation:

Treasury guidance should provide that all of the tangible property of a trade or business will be treated as a single property for purposes of the QOZ Business Property substantial improvement test, unless a QOZ Business chooses to elect out of this provision. To prevent abuse, the substantial improvement test should clarify that additions to basis do not include property previously placed in service in a QOZ.

Thus, for example, assume a business existing in a QOZ on 1/1/2020 has \$100x of tangible business property in the zone. Assume that over the next 30 months, it improves existing property and purchases new property (none of which was previously in service in the zone) at a total cost of \$120x. The business would be considered to have substantially improved its existing business property and, provided other requirements are met, to have \$220x in QOZ Business Property.

C. Reporting Requirements

Basic data on QOZ activity is essential to determine whether the policy is delivering the intended benefits to residents of designated communities as well as to understand how it can be improved in future iterations. Therefore, we urge Treasury to develop and include reporting requirements for QOFs in the final regulations. For example, the *Investing in Opportunity Act*²⁸ is a useful starting point, as it directed Treasury to collect data on QOF activity and provide regular reports to Congress on the use of the incentive in designated communities.

Recommendation:

At a minimum, Treasury should require QOFs to report transaction information by providing an inventory of investments by QOZ, including the amount invested in each QOZ, and limited information about the nature of the investment (real estate or operating business, type of real estate property, industry/sector of business). This would provide adequate information without creating an undue reporting burden for QOFs.

²⁸ Investing in Opportunity Act, S.293, 115th Cong. (2017).

D. Additional Comments

1. Valuation of Assets

The statute is silent regarding how to value assets for purposes of the QOF 90-percent asset test and the QOZ Business tangible asset test. The proposed regulations provide that a QOF or QOZ Business must value its assets for purposes of their respective assets tests using either the values reported on an applicable financial statement (if the entity has such a financial statement), or the cost of the assets (if it has no applicable financial statement).²⁹ Reporting assets values in accordance with GAAP accounting may lead to significantly different results than reporting at cost and create disparities in reporting and compliance between those entities with and without audited financial statements. Additionally, using GAAP accounting values would be administratively burdensome, requiring a QOF or QOZ Business to project the value of their assets for ten years to ensure that the fund and its investors will be able to qualify for the benefits intended under the statute. These difficulties would discourage the use of audited GAAP financial statements, to the detriment of the organizations, their investors, and the public.

Recommendation:

The final regulations should provide that all entities may elect to value their assets for purposes of the QOF 90-percent asset test and the QOZ Business tangible asset test using the original cost basis of the asset. This would provide a consistent rule for asset valuation for all QOFs and QOZ businesses, while minimizing burden and avoiding creation of a disincentive for the use of GAAP financial statements.

2. Original Use of Vacant Property

To qualify as QOZ Business Property, tangible property must meet an “original use” or “substantial improvement” requirement. Either “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.”³⁰

The proposed regulations provide that the value of land is not taken into account in determining whether an existing building on such land has been substantially improved.³¹ The improvements only need to double the owner’s basis in the building, and the basis of the land is excluded in that calculation. This rule does not address application of the substantial improvement test to vacant land, and questions have arisen as to how vacant land can qualify as QOZ Business Property, either as original use or as property that is substantially improved.

Treasury requested comments on how to determine “original use” for tangible property, including real and movable property, and whether some period of vacancy or underutilization should allow property to qualify as original use.³² Congress intended to stimulate economic activity in distressed communities, which often have empty storefronts, warehouses, or factories.

²⁹ Prop. Reg. § 1400Z-2(d)-1(b); Prop. Reg. § 1.1400Z2(d)-1(d)(3)(ii).

³⁰ Section 1400Z-2(d)(2)(D)(i)(II).

³¹ Prop. Reg. § 1.1400Z-2(d)-1(c)(8)(ii).

³² NPRM, Background.

Just as used property can be brought into the QOZ and have its “original use” in a QOZ Business, vacant property within the QOZ that is given new use by a QOZ Business should be considered to meet the “original use” test to encourage the use of zone property that is currently under-utilized.

Recommendations:

Final regulations should provide that if property, including land, has been vacant or unutilized for at least a one-year period including the date of zone designation, its use in the trade or business of a QOF or QOZ Business will be considered “original use” within the QOZ. This is consistent with Treasury regulations in the Enterprise Zone context, where a similar “original use” test was considered satisfied if property in the zone was put to use after having been vacant for one year.³³ In addition, guidance should clarify that the period of vacancy is determined with respect to only that portion of the property acquired by the QOF or QOZ Business, and de minimis incidental uses of property should be disregarded.

In addition, Treasury should provide in final regulations or subregulatory guidance examples of how land can be substantially improved. Such an example could provide that in a rural QOZ, improvements to the land to make it useful for farming, such as leveling or planting on the land, could qualify as substantial improvement of the land. For an urban QOZ, the construction or improvement of a building on the land can significantly increase the value of the land, and thus could constitute substantial improvement of the land.

3. “Substantially All” Threshold

The proposed regulations provide a 70-percent threshold for defining whether “substantially all” of a QOZ Business’s tangible assets are located in a zone.³⁴ This proposed rule provides essential flexibility for operating businesses whose assets may move or not fall neatly within a census tract.

Recommendations:

We strongly urge Treasury to retain the 70-percent threshold. However, additional guidance (including subregulatory guidance) regarding how QOZ Businesses may meet the “substantially all” tangible asset test may be needed in some circumstances. For example, a manufacturing business with the vast majority of its employees in an urban QOZ may not have access to a storage facility within the QOZ. If it imports raw materials from outside the QOZ, they may take months to arrive and must be stored in a facility outside the QOZ before use. In addition, the business must store finished goods temporarily before sale to customers. Thus, Treasury guidance providing that raw materials in transit to a QOZ and manufactured goods temporarily stored or in transit to customers outside a QOZ will be considered used in the QOZ would help ensure that manufacturing businesses, which can provide needed jobs for QOZ residents, can qualify as QOZ Businesses and receive QOF funding.

Additionally, there may be some circumstances in which the flexibility is not needed and additional guidance may serve to prevent opportunities for abuse. For example, businesses that

³³ Treas. Reg §1.1394-1(h)

³⁴ Prop. Reg. § 1.1400Z2(d)-1(d)(3).

engage principally in the development or leasing of real estate may not always require the same kind of regulatory flexibility as operating businesses, since their primary tangible asset, the real estate, will remain fixed within a QOZ for the life of the investment. Perhaps additional measures could be considered in the case of “real estate” QOZ Businesses (e.g., requiring that a higher proportion of the real property be located in a QOZ). We note that without additional clarity regarding how land may qualify as QOZ Business Property (discussed above) or how debt of a QOZ Business will be treated, real estate businesses are relying on the flexibility of the 70-percent threshold to ensure they can qualify as QOZ Businesses and make investments in QOZs even in the face of uncertainty. Additionally, we have heard of situations where QOZ boundaries, particularly in urban areas, may cut through the middle of a block – even through the middle of a building – making it practically impossible to develop some real property in the QOZ without also developing some property outside the QOZ. Given that the QOZ-adjacent census tract may be just as distressed as the QOZ (because not all needy communities could be designated as QOZs), development outside the QOZ may not be unwarranted or abusive. Therefore, Treasury should carefully consider what additional guidance is necessary in the regulations, and whether additional flexibility in particular situations could quickly be provided as needed in subregulatory guidance.