July 1, 2019

Via Federal eRulemaking Portal at www.regulations.gov

Internal Revenue Service
CC:PA:LPD:PR (REG-120186-18), Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: REG-120186-18 (Proposed Regulations on Investing in Qualified Opportunity Funds)

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 May 1, 2019 ("NPRM").[1] We are grateful for the work of staff at the Department of the Treasury and Internal Revenue Service ("IRS") (hereinafter collectively referred to as "Treasury") 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. Most importantly, these proposed rules have addressed many critical questions related to how the incentive can be used to support local operating businesses in designated communities. For example, the proposed safe harbors for the gross income test provide greater certainty regarding the ways in which a business can achieve eligibility.[2] Additionally, we strongly support the proposed rules for leased property, which provide practical flexibility to operating businesses in keeping with the purpose of the statute.[3] Furthermore, we applaud the extension of the working capital safe harbor to the development of a trade or business,[4] so that it may be applied to operating businesses, as well as the proposed rules allowing for valuation based on unadjusted cost basis of property,[5] which reduces burden. Final regulations should include all of these proposed rules.

However, there are still some issues that we believe could require additional clarification in the final regulations. As detailed in the attached comments, additional clarification is needed in the following key areas:

- **Final regulations should provide additional clarity so that the rules work as intended to encourage qualified opportunity fund ("QOF") investments in operating businesses.** Most importantly, final regulations should permit the substantial improvement test to be applied on an aggregate basis. Otherwise it will be nearly

[1] 84 FR 18652, REG-120186-18.
[2] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(i).
[3] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(2)(i)(B).
[4] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(iv).
[5] Prop. Treas. Reg. § 1.1400Z2(d)-1(b)(3).

impossible for operating businesses to satisfy the substantial improvement test. In addition, clarity is needed regarding how businesses will meet the requirement that a substantial portion of their intangible property be used in the active conduct of a trade or business within the QOZ as well as when the active conduct of such a business must begin.

- **Final regulations should provide additional timing flexibility for QOFs to make and exit investments.** QOFs need time to deploy capital as well as time to liquidate their investments, and guidance should permit QOFs sufficient time to do so without facing a penalty.
- **Final regulations should provide additional clarity to both QOZ Businesses and investors.** The attached comments address several areas for additional clarity, including the treatment of nonqualifying property that is significantly improved, the timing of elections with respect to eligible section 1231 gains, and the application of the rules regarding exits after 10 years where assets are held by a lower tier QOZ Business.
- **Final regulations should provide clear rules to prevent abuse.** We support the use of strong anti-abuse rules and transparent reporting requirements to discourage taxpayers from taking advantage of the QOZ provisions in a manner that was unintended by Congress. However, the rules need to be sufficiently clear so as not to discourage activities that reflect real economic investment in low-income communities.

We realize it is an inherently complex undertaking to write rules to coordinate the new QOZ statute with other provisions of the Internal Revenue Code.[6] Where possible, we would encourage Treasury to consider ways to simplify the rules in finalizing them, for example, by incorporating standards or concepts from other Code provisions and coordinating the rules applicable to QOFs and QOZ Businesses where possible. The attached comments highlight a few areas where this is possible.

Thank you for the opportunity to comment on this NPRM. We request the opportunity for John Lettieri, President and CEO of the Economic Innovation Group, to speak on behalf this Coalition at the public hearing (REG-115420-18) on July 9, 2019 for approximately 10 minutes. His comments will concern the priority issues included in this enclosed comment letter.

We appreciate your consideration of the attached recommendations and look forward to the issuance of final regulations that will facilitate much-needed investment in communities across America. If you have any questions about these comments, please contact John Lettieri at john@eig.org or (202) 839-3713.

Sincerely,

ACON Investments
Alliant Strategic Housing Funds

[6] Unless otherwise stated, section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and to the Treasury Regulations thereunder.

Alphametic LLC
Arctaris Impact Fund
Blueprint Local
Bridge Investment Group
California Forward
CalOZ
Calvert Impact Capital
Catalyst Opportunity Fund
Chicago Community Loan Fund
CliftonLarsonAllen
CohnReznick LLP
Community Capital Management
Community Development Bankers Association
Community Development Venture Capital Alliance
Community Reinvestment Fund, Inc.
Dauby O'Connor & Zaleski, LLC
Develop LLC
DL3 Realty
Economic Innovation Group
EJF Capital
Fund for Our Economic Future
Fundrise
Goodcity
Greatwater Opportunity Capital
Homecoming Capital
Institute for Portfolio Alternatives
International Franchise Association
KeyBank
Kirkland & Ellis
KPMG
Launch NY Inc
Launch Tennessee
LIIF
LISC
Mayer Brown
National Development Council
National Foundation for Affordable Housing Solutions, Inc.
NES Financial
Newark Venture Partners
Novogradac & Company
Opportunity Alabama
Opportunity Finance Network
Our Opportunity
Peachtree Providence Partners
Plante Moran
Polsinelli

PwC
Quicken Loans
R and C Brown
Redbrick LMD, LLC
Reinvestment Fund
Riaz Capital
Rural Opportunity Initiative
Small Business Majority
SMB Intelligence
Sorenson Impact Center
Sorenson Impact Foundation
Stonehenge Capital Company, LLC
The Enterprise Center
The Governance Project
U.S. Impact Investing Alliance
Virtua Capital Management, LLC
WarHorseCities
Weller Development Company

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Hon. Charles Rettig, Commissioner, Internal Revenue Service
Dan Kowalski, Counselor to the Secretary, Department of the Treasury
Krishna Vallabhaneni, Tax Legislative Counsel, Department of the Treasury
Michael Desmond, Chief Counsel, Internal Revenue Service
Holly Porter, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
John Moriarty, Deputy Associate Chief Counsel (Income Tax & Accounting), Internal Revenue Service
Bryan Rimmke, Attorney-Advisor, Department of the Treasury
Colin Campbell, Jr., Attorney Advisor, Department of the Treasury
Mike Novey, Associate Tax Legislative Counsel, Department of the Treasury
Erika C. Reigle, Attorney (Income Tax & Accounting), Internal Revenue Service
Kyle C. Griffin, Attorney (Income Tax & Accounting), Internal Revenue Service

Enclosure:
Comments on Proposed Regulations Regarding Investing in Qualified Opportunity Funds (REG-120186-18)

Comments on Proposed Regulations Regarding Investing in Qualified Opportunity Funds (REG-120186-18)

A. Regulations Should Encourage Formation of Operating Businesses

As we discussed in our prior comment letter dated December 27, 2018, the formation and investment in operating businesses is critical to ensuring long-term economic growth and permanent jobs in low-income communities. We commend Treasury for the changes in the NPRM that enabled this tax incentive to be available for operating businesses, in particular, the gross income safe harbors, the leasing rules, extension of the working capital safe harbor, and the simplified valuation methods. However, there are a few additional clarifications that we believe are necessary to permit the incentives to fully benefit operating businesses.

1. The "Substantial Improvement" Test Should Be Applied 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 (the "70-percent asset test").[7] To qualify as QOZ Business Property, tangible property owned by the QOZ Business must be acquired by the entity after December 31, 2017 by purchase from an unrelated person, and either its original use in the QOZ commences with the QOZ Business or the QOZ Business substantially improves the property.[8] Property is treated as substantially improved "only if, during any 30-month period . . . additions to basis with respect to such property in the hands of the [QOF] exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period . . ."[9]

The substantial improvement test was likely included in the statute in order to encourage the improvement of existing property in the QOZ and ensure that new economic activity and investment is made in the QOZ for businesses that already own property. The preamble to the NPRM states that the substantial improvement requirement is applied on an asset-by-asset basis.[10] This requirement will be nearly impossible for operating businesses to satisfy. Certain assets, such as equipment or office furniture, do not easily lend themselves to substantial improvement through a more than doubling of basis. The NPRM recognized the difficulty that an asset-by-asset approach creates for operating businesses and requested comments on the potential advantages and disadvantages of adopting an aggregate approach for substantial improvement:

> The Treasury Department and the IRS have considered the possibility, however, that an asset-by-asset approach might be onerous for certain types of businesses. For example, the granular nature of an asset-by-asset approach might cause operating businesses with significant numbers of diverse assets to encounter

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[7] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(1)(i), (d)(3).
[8] Section 1400Z-2(d)(2)(D)(i); Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(2)(i)(A), (C).
[9] Section 1400Z-2(d)(2)(D)(ii). Compare Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(8)(i) and -1(d)(4), which inexplicably remove the phrase "with respect to such property" in stating the 30-month safe harbor.
[10] NPRM, *Explanation of Provisions*, § I.B.

> administratively difficult asset segregation and tracking burdens, potentially creating traps for the unwary. As an alternative, the Treasury Department and the IRS have contemplated the possibility of applying an aggregate standard for determining compliance with the substantial improvement requirement, potentially allowing tangible property to be grouped by location in the same, or contiguous, qualified opportunity zones. Given that an aggregate approach could provide additional compliance flexibility, while continuing to incentivize high-quality investments in qualified opportunity zones, the Treasury Department and the IRS request comments on the potential advantages, as well as disadvantages, of adopting an aggregate approach for substantial improvement.[11]

The American Bar Association Taxation Section ("ABA") in its comment letter dated January 10, 2019 suggested two safe harbors for aggregating assets and measuring whether aggregate assets are substantially improved. First, assets that are on the same tract, or contiguous tracts, of a QOZ and which are purchased as part of the same investment decision should benefit from a safe harbor treating them as an aggregate asset for purposes of measuring substantial improvement (the "Investment Decision Safe Harbor"). Assets purchased under a single contract from the same seller should benefit from a rebuttable presumption that such assets are part of the same investment decision. Second, assets should be aggregated if they would be treated as a single item of section 1250 property (the "Section 1250 Property Safe Harbor").[12] Under this test, structures may be aggregated if they are "operated as an integrated unit (as evidenced by their actual operation, management, financing, and accounting)."[13]

An advantage of an aggregation approach is that operating businesses could qualify as QOZ Businesses even if they previously owned and used equipment in the QOZ. Without such a rule, operating businesses are forced to newly lease or purchase their equipment solely to become eligible for QOF investment, even if business considerations dictate otherwise. In addition, real estate development businesses may acquire multiple structures that will be operated as a functional unit, such as an office building and parking garage, but make improvements only to the office building, which doubles the basis of the entire unit. Without an aggregate approach, the business would be forced to put the parking garage in a separate entity if its value would cause the QOZ Business not to satisfy the substantially all test. Moreover, it is not clear whether an asset-by-asset approach would treat various systems and fixtures separately, which would result in significant burden even for real estate businesses. We believe that an aggregate approach is consistent with the language of the statute referring to additions to basis "with respect to such property," which suggests a more flexible approach than "of the property" adopted by the proposed regulations.

The aggregation approach would need to include appropriate limitations to prevent abuse. For example, without such considerations, a real estate development business could acquire contiguous lots but build a structure on only one of them, effectively bootstrapping the unimproved property into QOZ Business Property.

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[11] NPRM, *Explanation of Provisions*, § I.B.
[12] Treas. Reg. § 1.1250-1(a)(2)(ii).
[13] ABA Section of Taxation, *Comments on Proposed Regulations Regarding Investment in Qualified Opportunity Funds Under Section 1400A-2*, at 39-42 (Jan. 10, 2019).

Finally, we note that it would be helpful to provide further clarity to QOZ Businesses, QOFs, and investors that property meeting the substantial improvement requirement at the conclusion of the requisite 30-month period will be treated as having met the substantial improvement requirement during that 30-month period and will be treated as QOZ Business Property during that time. Although this appears to be the intended rule under the current proposed regulations, without this clarification, some investors are concerned that assets will not be treated as QOZ Business Property *until* they are substantially improved, thus causing the QOZ Business to have held a "bad asset" for 30 months and putting the qualification of the business as QOZ Business in jeopardy.

Recommendations:
We recommend adoption of the aggregation safe harbors recommended by the ABA, with a couple modifications. First, the Investment Decision Safe Harbor should be limited to operating businesses in order to prevent potential abuses by QOFs or QOZ Businesses that purchase multiple adjacent parcels with the intent to only improve one of them. Second, the final regulations should clarify what is aggregated for purposes of applying the substantial improvement rule. We believe that the most straightforward application of an aggregation approach is to aggregate all of the assets acquired pursuant to the Investment Decision Safe Harbor or integrated pursuant to the Section 1250 Property Safe Harbor, including those assets that are not actually improved (such as new assets that are acquired as part of the same investment decision), and aggregate all expenditures to improve those assets that are improved (even if it would not qualify as substantial with respect to that particular asset) and all expenditures to acquire those assets that are not improved. We believe that this rule would better conform with the statutory language and the purpose of the substantial improvement test to encourage new economic activity and investment in the QOZ without posing an insurmountable hurdle by requiring the improvement of each and every asset.

In addition, Treasury should clarify in final regulations that assets that have met the substantial improvement requirement within the required 30-month period are treated as meeting the substantial improvement requirement during the period in which they were substantially improved, i.e., the property should be deemed to qualify as QOZ Business Property retroactively to the date at which it was acquired by the QOF or QOZ Business.

2. Inventory in Transit Rule Should be Expanded

As discussed above, to qualify as a QOZ Business, the 70-percent asset test must be satisfied.[14] For this purpose, the 70 percent is determined by a fraction the numerator of which is the total value of all QOZ Business Property owned or leased by the QOZ Business that meets the requirements of Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(2)(i) (including the acquisition and original use/substantial improvement requirements), and the denominator of which is the total value of all tangible property owned or leased by the QOZ Business, whether located inside or outside of a QOZ.[15] To qualify as QOZ Business Property, substantially all of the tangible property must be used within a QOZ during substantially all of the QOF's or QOZ Business'

[14] Section 1400Z-2(d)(3)(A)(i).
[15] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(3)(i) and (ii).

holding period of the property.[16] For this purpose, "substantially all of the use" is defined as 70 percent (the "70-percent use test") and "substantially all of the holding period" is defined as 90 percent.[17]

The NPRM helpfully provides that inventory (including raw materials) of a trade or business will not fail to be treated as *used* in the QOZ for purposes of the 70-percent use test solely because the inventory is in transit to or from a vendor or customer outside of the QOZ.[18] The preamble to the NPRM requests comments as to whether inventory (including raw materials) should be excluded from both the numerator and denominator of the 70-percent asset test for QOZ Business Property.[19] It is not entirely clear whether inventory is properly included in the numerator of the 70-percent asset test, as it is not clear whether it would satisfy the original use or substantial improvement test. Nonetheless, the denominator appears to broadly include all property of the QOZ Business "whether located inside or outside the qualified opportunity zone."[20] If inventory is included in the denominator but not the numerator, the QOZ Business is more likely to fail the 70-percent asset test, notwithstanding that there is no policy reason to treat inventory differently than other business assets. While some taxpayers may take the position that inventory is properly included in both the numerator and denominator, some more conservative taxpayers may not, thus leading to horizontal inequity. Excluding inventory from both the numerator and denominator thus results in more consistent treatment and is consistent with Congressional intent to spur investment in operating businesses.

<u>Recommendation:</u>
Final regulations should provide that inventory (including raw materials) in transit to or from a vendor or customer outside of the QOZ should be excluded from both the numerator and denominator of the 70-percent asset test for QOZ Businesses in addition to treating it as used in the QOZ for purposes of the 70-percent use test.

3. *Intangible Property Rule Should Be Clarified*

The proposed regulations issued in October 2018 required, through the cross-reference in the statute to section 1397C(b)(4), that a substantial portion of the intangible property of an QOZ Business be used in the active conduct of a trade or business in the QOZ.[21] The NPRM defines the term "substantial portion" to mean at least 40 percent.[22] We appreciate the provision of a clear definition for the meaning of the term "substantial portion," and we believe that this definition should be retained in final regulations.

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[16] Section 1400Z-2(d)(2)(D)(i)(III).
[17] Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(5) and (6); (d)(2)(iii) and (iv). The preamble to the NPRM suggested that the combination of these thresholds could result in a QOF satisfying the substantially all standards with as little as 40 percent of the tangible property being used in the QOZ: "Multiplying these shares together (0.9 × 0.7 × 0.7 × 0.9 = 0.4) generates the result that a QOF could satisfy the requirements of section 1400Z–2 under the proposed regulations with just 40 percent of its assets effectively in use within a qualified opportunity zone." NPRM, *Special Analysis*, § I.C.2.b. We note that this statement is misleading, as it combines percentages measuring different things (such as percentage of assets and periods of time).
[18] Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(4)(iii).
[19] NPRM, *Explanation of Provisions*, § I.C.
[20] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(3)(ii)
[21] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(ii)(A).
[22] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(ii)(A).

Despite this, it remains unclear how QOZ Businesses will meet the requirement that at least 40 percent of their intangible property be used in the active conduct of a trade or business within the QOZ or how such use in the QOZ will be measured. For example, where are goodwill and going concern value considered used if the business is headquartered in the QOZ but certain value-adding activity, such as sales or research, are conducted outside the QOZ? We believe that intangibles that are generated and used by the business, such as goodwill, going concern value, customer lists, workforce in place, and know how, should be located where the associated employees or assets are located. However, we are concerned that companies could effectively set up "intangible boxes" in the QOZ by placing more passive income-generating intangibles in the QOZ without any significant other activity in the QOZ. For example, if a company owns a patent or copyright that is generating licensing income within the QOZ but the work to create the intangibles was done outside the QOZ, the intangible should not be considered used in the active conduct of a trade or business within the QOZ.

Recommendation:
Final regulations should provide guidance, including examples, that intangible property will be considered used in the active conduct of a trade or business of the QOZ Business in the QOZ, if that property is used by or in connection with the QOZ Business's employees or tangible property located in a QOZ. Examples should provide that merely holding income-generating intangibles, such as the licensing of patents, copyrights, or similar intangible property, without associated employee or asset activity, will not qualify as use in the active conduct of a trade or business in the QOZ.[23]

4. Gross Income Test and Multiple QOZs

The proposed regulations issued in October 2018 required that at least 50 percent of the gross income of a QOZ Business be derived from the active conduct of a trade or business in the QOZ.[24] Some stakeholders have expressed apprehension that the gross income requirement will not be met if the QOZ Business has a trade or business that operates in multiple QOZs, given that the gross income test is based on a singular phrasing of "in *the* QOZ." Because QOZ Businesses with successful business models may expand into other QOZs over time, any rule that prevents QOZ Businesses from operating in multiple QOZs would be self-defeating.

Recommendation:
Final regulations should provide that a QOZ Business may elect to meet the gross income test by aggregating its trade or business activities in all QOZs in which the QOZ Business operates. Such QOZs do not need to be contiguous tracts. Alternatively, Treasury could revise the wording of Prop. Reg. § 1.1400Z2(d)-1(d)(5)(i) to require that at least 50 percent of the gross income of a QOZ Business is derived from the active conduct of a trade or business in *a* QOZ.

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[23] We note that Example 2 in Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(iv)(E), which is illustrating the multiple applications of the working capital safe harbor, seems to contemplate the result recommended in this section. However, it would be helpful to more clearly set this forth.

[24] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(i). The NPRM did not change this requirement, though it helpfully provided a few safe harbors for satisfying the requirement.

5. Time for Determining Active Conduct of a Trade or Business

The NPRM clarifies that a single QOZ Business may benefit from multiple overlapping or sequential applications of the working capital safe harbor to different infusions of capital.[25] Nonetheless, there is some concern that examples in the proposed regulations illustrating overlapping periods could be read to suggest that an active trade or business must exist at the end of the first 31-month period. Such an interpretation is problematic on a few fronts.

First, it could preclude very significant development projects that are anticipated to take longer than 31 months. One could envision, for example, a project to transform a block of dilapidated, partially vacant buildings into a mixed-use development that includes retail, office space, including work-share space for start-up businesses, and work-force housing. Such a project is likely to take more than 31 months to complete, yet it is precisely the type of project that the OQZ provision was intended to incentivize. Forcing the developer to break the project into phases, so that an active trade or business can begin after 31 months may not make business or economic sense.

Second, the effect of a 31-month time limit on the active trade or business requirement on start-up businesses is uncertain, as it is not always clear at which point a start-up business becomes active. For example, it could take years for a new business to perform a build-out, acquire equipment, and begin generating revenues.

Third, any rule requiring an active trade or business after 31 months would set up a "cliff effect" negating the section 1397C requirements to the beginning of the 31-month period. This would create a trap for the unwary.

In addition, the NPRM provides that a "trade or business" is defined by reference to a trade or business for purposes of section 162.[26] The NPRM reserves generally on the definition of active conduct, but it does clarify that the definition includes the ownership and operation (including leasing); however, merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business.[27] There have been questions about what constitutes "merely" entering into a triple-net-lease. For example, if the QOZ Business regularly enters into such leases for the purpose of making a profit, could it rise to the level of a trade or business? The Supreme Court has stated:

> We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.[28]

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[25] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(iv)(D).
[26] Prop. Treas. Reg. § 1.1400Z2(c)-1(c)(4)(ii), (d)(2)(ii), (d)(5)(ii)(B)(3).
[27] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(ii)(B)(1) and (2)
[28] *Comm'r v. Groetzinger*, 480 U.S. 23 (1987).

Recommendations:
Final regulations should clarify that, as long as the QOZ Business is making progress towards an active trade or business and is still within a working capital safe harbor, it continues to satisfy the section 1397C requirements. Alternatively, final regulations could provide a separate time period, which is longer than 31 months, for satisfying the active trade or business requirement that is not linked to the working capital safe harbor.

Final regulations should also clarify that a certain level of activity with respect to triple-net leases may rise to the active conduct of a trade or business.

6. *Permitting Businesses to Hold Subsidiaries*

Many businesses are organized using more complex structures than a single operating entity. However, the statute and proposed regulations appear to only contemplate a two-tier structure: a QOF that owns one or more QOZ Businesses. In particular, without further guidance, the rules appear to treat stock or a partnership interest in a subsidiary as nonqualified financial property of a QOZ Business, making it impossible for QOZ Businesses to own any substantial interests in a subsidiary. There does not seem to be a policy rationale for treating an interest in an operating subsidiary (as opposed to a portfolio equity interest in an unrelated company) as nonqualified financial property.

In the context of section 351, contributions to an investment company do not qualify for nonrecognition treatment. For this purpose, an investment company includes a corporation more than 80 percent of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities.[29] The regulations provide a look-through rule for 50-percent owned subsidiaries, disregarding the stock of the subsidiary and treating the shareholder as owning a ratable share of the subsidiary's assets for purposes of measuring the shareholder's investment assets.[30] A similar look-through rule could be adopted for purposes of the nonqualified financial property rules. Looking through the subsidiaries would add flexibility to permit multi-tier structures but prevent such structures from being used to circumvent the QOZ rules by permitting subsidiaries to hold assets outside the QOZ.

Recommendation:
Final regulations should create a look-through rule for stock or a partnership interest in a 50-percent owned subsidiary of a QOZ Business for purposes of applying the nonqualified financial property rules.

B. Regulations Should Provide Timing Flexibility for QOFs

In creating the Opportunity Zones incentive, Congress created a tiered structure consisting of QOFs, which are investment vehicles organized for the purpose of investing in stock and partnership interests of lower-tier entities, known as QOZ Businesses. When Congress used the

[29] Treas. Reg. § 1.351-1(c)(1)(ii).
[30] Treas. Reg. § 1.351-1(c)(4).

term "fund," it was likely thinking of traditional investment funds, which are instruments for investors to pool capital and spread risk across a portfolio of investments.[31] 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 become profitable, and some of which may succeed and grow rapidly. At the moment, the majority of QOFs we have seen are not funds in this sense, but rather are single-project entities. If Congress had intended for QOZ investments to occur only through single-project entities, it would not have needed to create a two-tiered structure.

One key reason that funds are organizing as single-project entities is that, under the current rules, QOFs do not have sufficient time to raise and deploy capital for multiple projects or the ability to exit various investments based on market conditions.[32] At least 90 percent of the assets of a QOF must be QOZ Property[33] or QOZ Business Property,[34] 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 (the "90-percent test").[35] This statutory requirement applies for a fund to qualify as a QOF for purposes of receiving qualifying investments from investors, with an exception that is described below.

1. QOFs Need Time to Deploy Capital

The NPRM provides that for purposes of meeting the 90-percent test on a testing date, the QOF may exclude from both the numerator and denominator of the computation any investments received within the last six months that are held in cash, cash equivalents, or debt instruments with a term of 18 months or less.[36] We appreciate that some leeway has been granted in providing QOFs time to invest newly received capital. But this six-month period is insufficient for QOFs to be able to raise and deploy at least 90 percent of their funds into qualifying investments. Thoughtful investment takes time; so does expending capital into a portfolio of QOZ Businesses and projects. Compounding the issue of deploying capital is raising it—investors only have 180 days from the date they recognize a gain to make a QOF investment, making it so that QOFs are unable to control the timing of when they accept capital from investors. In the usual case, 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. If the final regulations do not provide additional timing

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[31] When not otherwise defined, Congress intends that words be given their ordinary meaning. S*ee Bd. of Cty. Comm'rs of Kay Cty., Okla. V. Fed. Hous. Fin. Agency,* 754 F.3d 1025, 1028-29 (D.C. Cir. 2014) ("Moreover, where a statute's terms are undefined, our interpretation is guided by the terms' 'regular usage,'" citing *Lopez v. Gonzales,* 549 U.S. 47, 53 (2006)).

[32] Another significant reason funds are organizing as single-project entities is to facilitate exiting the fund tax-free after 10 years. These rules are discussed below in Section D.3.

[33] QOZ Property includes either interests held in a lower tier entity – QOZ stock or QOZ partnership interests – or directly held QOZ business property. Section 1400Z-2(d)(2)(A).

[34] QOZ Business Property is defined as tangible property used in a trade or business that meets the following requirements: (1) the property was acquired by purchase after December 31, 2017; (2) the original use of the property in the QOZ commences with the QOF or the QOF substantially improves the property, and (3) during substantially all of the QOF's holding period for such property, substantially all of the use of such property was in a QOZ. Section 1400Z-2(d)(2)(D).

[35] Section 1400Z-2(d)(1).

[36] Prop. Treas. Reg. § 1.1400Z2(d)-1(b)(4).

flexibility, a manager of a QOF may be forced to choose between upsetting the expectations of investors because their eligible gains will expire before a capital call can be made or calling capital that a QOF is not yet prepared to deploy and risking penalties for failing to meet the 90-percent test.

We believe that Treasury has broad authority to provide additional timing relief. Congress gave Treasury 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.[37] In addition, if the QOF fails to meet the 90-percent test, the consequence is a penalty; however, no penalty shall be imposed if the failure is due to "reasonable cause."[38] Treasury has the authority to define what constitutes reasonable cause for this purpose, and has permitted some flexibility in start-up periods in other contexts. For example, for purposes of the New Markets Tax Credit, the statute requires that the credit allowance date be tested *immediately* and every 12 months thereafter, but the regulations permit an initial investment period of 12 months.[39] In addition, for purposes of the diversification requirements for variable annuity, endowment, and life insurance contracts, the regulations provide a one-year start-up period for non-real estate segregated asset accounts and a five-year start-up period for real estate segregated accounts, notwithstanding that the statue contains no such time periods.[40] Further, for purposes of the minimum distribution requirements for private foundations, the statute provides for a reasonable cause exception, and the regulations adopt a reduced distribution requirement for a four-year start-up period.[41]

We also note that the mechanism for implementing the six-month minimum investment period – excluding the investments from both the numerator and denominator of the 90-percent test – can lead to some anomalous results. For example, if all the QOF owns is contributed cash, the computation results in 0 percent qualifying assets, notwithstanding it is intended to help the QOF satisfy the 90-percent test while deploying the cash.

Recommendations:
Final regulations should modify the NPRM to provide that a QOF may count as a "good asset" (i.e., include in the numerator of the 90-percent calculation) any investments received within the last 12 months that are held in cash, cash equivalents, or debt instruments with a term of 18 months or less. In such case, Treasury would not need to alter the regular, semi-annual testing dates or the structure of the NPRM, 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. At a minimum, final regulations could provide a full 12-month initial start-up period for the QOF, but retain the current six-month elective cash exclusion thereafter.

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[37] Section 1400Z-2(e)(4)(B).
[38] Section 1400Z-2(f)(3).
[39] Section 45D(a)(3); Treas. Reg. § 1.45D-1(c)(5)(iv).
[40] Treas. Reg. § 1.817-5(c)(2).
[41] Section 4942(g)(2)(C); Treas. Reg. § 53.4942(a)-3(b)(4)(i).

2. QOFs Need Time to Exit Investments

We applaud the NPRM for providing additional flexibility in the manner in which a QOF investor may exit its investment after 10 years without recognizing gain.[42] However, as a QOF starts divesting itself of assets after a 10-year holding period, it will begin accumulating amounts of cash in excess of that allowed under the 90-percent test. Investors need assurance that the winding down of a QOF will not disrupt the tax benefit and trigger penalties for failure to meet the 90-percent test. Much like how QOFs need reasonable time to deploy capital into new investments, they also need reasonable time to exit—in other words, the ability to sell off their assets over a certain period of time. It would be deeply disruptive to communities designated as QOZs as well as the marketplace if QOFs were forced to sell off all their assets at once.[43]

The NPRM does not address a winding down period during which the QOF may hold capital in excess of that allowed under the 90-percent test while it is exiting investments. Elsewhere in the Code, property must be distributed to investors within a certain period of time (up to three years) pursuant to a "plan of liquidation."[44] Treasury has the authority to adopt a similar concept here, by providing that any failure to satisfy the 90-percent test while carrying out a plan of liquidation constitutes reasonable cause.[45]

Recommendation:
Final regulations should allow QOFs to adopt a plan of liquidation in accordance with which the QOF may exit investments and return capital to investors. Consistent with the rules under section 332, QOFs should be given three years to complete their liquidation, during which period the QOF should not be subject to the penalty for failing to meet the 90-percent test.

C. Regulations Should Provide Clarity to QOZ Businesses

1. Period of Vacancy to Satisfy Original Use

The NPRM provides that if property has been vacant or unused for an uninterrupted period of at least five years, use of that property in the QOZ qualifies as original use.[46] The NPRM rejected recommendations for a one-year period of vacancy, citing the potential for owners of property already situated in a QOZ to intentionally cease occupying the property for 12 months to increase its marketability.[47] However, this concern is inapplicable if Treasury adopts the standard from the Enterprise Zones context, which requires that if property has been vacant for at least one year, *including the date of zone designation*, use in the QOZ shall be treated as original use.[48] The requirement that the one-year period of vacancy include the date of zone designation

[42] This is discussed in more detail in Section D.3
[43] Indeed, the proposed regulations issued in October 2018 recognized this concern when it permitted the 10-year basis step-up election to be made with respect to dispositions made until December 31, 2047. Prop. Treas. Reg. § 1.1400Z2(c)-1(c).
[44] *See* sections 332(b)(3), 562(b)(2); Treas. Reg. §§ 1.332-2(c), 1.332-4.
[45] Section 1400Z-2(f)(3).
[46] Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(B)(6), (c)(7)(i), (d)(2)(i)(B)(6), (d)(2)(i)(C).
[47] NPRM, *Explanation of Provisions*, § I.B.
[48] Treas. Reg. § 1.1394-1(h).

would prevent abuse from investors intentionally keeping property vacant, because the vacancy of the property would be required to predate the designation of the QOZ.

We note many "vacant" buildings have some minimal occupation of the building to serve a maintenance function, e.g., to ensure that the pipes do not burst. Even if Treasury does not adopt the shorter vacancy period, we believe that final regulations should clarify that some minimal maintenance will not prevent the building from being considered vacant.

Recommendation:
Final regulations should provide that the use of property in a QOZ that has been vacant or unused for an uninterrupted period of at least one year, including the date of designation of that QOZ, shall be treated as original use. Final regulations should also clarify that a de minimis amount of building usage to serve a purely maintenance function, and not for purposes of operating a trade or business, will not prevent the structure from being considered vacant for purposes of this rule.

2. *Treatment of Delays for Working Capital Safe Harbor*

The proposed regulations issued in October 2018 provided a period of up to 31 months for QOZ Businesses to invest capital in the "acquisition, construction, and/or substantial improvement of tangible property," commonly referred to as the working capital safe harbor.[49] The NPRM expanded this safe harbor to "amounts for the development of a trade or business, including when appropriate the acquisition, construction, and/or substantial improvement of tangible property," a change we strongly support.

The NPRM also provides an exception for a QOZ Business that is unable to deploy working capital assets within the 31-month period due to delay caused by waiting for governmental action the application for which is complete.[50] We applaud this extension of the working capital safe harbor for delays such as permitting. However, this exception is very narrow in application; other events that are beyond the QOZ Business's control could similarly cause the QOZ Business to fail to meet its 31-month written plan for expending capital. Analogous guidance already exists for determining whether a taxpayer was disrupted from efforts to complete a project due to factors beyond its control in Notice 2018-59[51] and Notice 2016-31.[52] These notices, dealing with the construction of energy credit projects, list several disruptions that will not result in the taxpayer being considered to have failed to make required efforts to complete the project, including severe weather conditions, natural disasters, delays in obtaining permits or licenses, delays at the written request of a governmental entity, labor stoppages, inability to obtain specialized equipment of limited availability, presence of endangered species, financing delays, and supply shortages.

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[49] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(iv).
[50] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(iv)(C).
[51] 2018-28 I.R.B. 196, § 6.03 (providing a non-exclusive list of excusable disruptions for purposes of section 48 investment tax credits).
[52] 2016-23 I.R.B. 125, § 4.02(2) (providing a similar list for purposes of section 45 production tax credits), *clarifying and modifying* Notice 2013-29 § 5.02(2), 2013-20 I.R.B. 1085.

Recommendation:
Final regulations should provide that delays in the consumption of working capital assets resulting from events beyond the control of the QOZ Business, such as those listed in Notice 2018-59 § 6.03 and Notice 2016-31 § 4.02(2), will not cause the QOZ Business to fail to meet the requirements of the working capital safe harbor.

3. Real Property Straddles Rule Should be Expanded

For purposes of the safe harbors for the gross income test, the NPRM provides a rule for determining the location of real property located in more than one census tract based on section 1397C(f). The NPRM provides that if the amount of real property based on square footage located within the QOZ is substantial as compared to the amount of real property based on square footage outside of the QOZ, and the real property outside of the QOZ is contiguous to part or all of the real property located inside the QOZ, then all of the property is deemed to be located within a QOZ.[53] The preamble to the NPRM requests comments as to whether there exist circumstances under which Treasury could apply principles similar to those of section 1397C(f) for other requirements of section 1400Z-2.[54]

The census tracts that comprise QOZs are the smallest geographic area by which the U.S. Census Bureau tracks data and are intended to average about 4,000 inhabits. Census tracts may not be drawn to coincide with natural boundaries. In conversations with investors, it has been a frequent issue for a QOF to own or consider purchasing real property that straddles the boundaries of a QOZ, for which not all of the property is located within the QOZ. Although it is not entirely clear, it appears that under the proposed rules, to the extent property extends outside of the QOZ, it would not qualify as QOZ Business Property and would count against the QOZ Business for purposes of the 70-percent asset test and the 70-percent use test.[55] When most of the property is located within the QOZ, investment and new business activity on that property will benefit the designated community consistent with the purpose of section 1400Z-2. That a portion of property extends beyond arbitrarily drawn lines should not discourage investments that can create new jobs and spur economic development.

Recommendation:
Final regulations should provide that the real property straddling rule of Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(viii) applies in determining whether property is located within the QOZ for purposes of whether such property qualifies as QOZ Business Property under Prop. Treas. Reg. § 1.1400A2(d)-1(d)(2).

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[53] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(viii). We note that there is an inconsistency between the text of the proposed regulations and the preamble, which states that "[r]eal property located within the qualified opportunity zone should be considered substantial if *the unadjusted cost* of the real property inside a qualified opportunity zone is greater than *the unadjusted cost* of real property outside of the qualified opportunity zone." (Emphasis added.) NPRM, *Explanation of Provisions*, § III.A. We assume that the regulation text governs, but confirmation of this point would be helpful.
[54] NPRM, *Explanation of Provisions*, § III.A.
[55] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(3)(i) and (ii), (d)(2)(iii) and (iv).

4. Self-Constructed Property Should Meet the "Purchase" Requirement

Consistent with the statute, Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(2)(i)(A) requires tangible property owned by a QOF or QOZ Business to be "acquired by the [QOF or QOZ Business] after December 31, 2017, by purchase as defined by section 179(d)(2) from a person who is not a related person within the meaning of section 1400Z–2(e)(2)." However, neither the statute nor the regulations address when self-constructed property will be treated as meeting this requirement. We do not believe that Congress intended to treat ground-up constructions differently from substantial improvements and, thus, believe that self-constructed property should be treated as purchased for purposes of the QOZ rules.

Regulations under other statutory provisions, such as the depreciation rules in section 168(k), include special rules for treating self-constructed property as acquired by purchase. In particular, under Treas. Reg. § 1.168(k)-1(b)(4)(iii)(A), property manufactured, constructed, or produced for use by a taxpayer in its trade or business generally is deemed to be acquired by purchase on the date that the taxpayer begins manufacturing, constructing, or producing the property.[56]

Recommendation:
Final regulations should provide that self-constructed property is treated as purchased for purposes of Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(2)(i)(A). Final regulations could look to rules similar to Treas. Reg. § 1.168(k)-1(b)(4)(iii)(A). However, the beginning of self-construction should not be an all-or-nothing concept; if a small amount of construction began before 2018 and the property was substantially constructed after December 31, 2017, we believe that the recommendations in section C.5., immediately below, should apply.

5. Tangible Property Incorporating Modest Amounts of Nonqualifying Property Should Not Be Tainted

There has been some confusion about how the proposed regulations apply where a substantial improvement incorporates a modest amount of nonqualifying property. For example, assume that a QOZ Business has nonqualifying property worth $10 million – it could represent land or a structure that was purchased before 2018 or from a related party, or pre-acquisition development costs incurred by a related party and capitalized to the property. The QOZ Business expends $100 million to improve the property. We believe that the $100 million improvements should constitute a qualifying asset and the $10 million original property should constitute a nonqualifying asset for purposes of applying the substantial improvement test, rather than the $10 million nonqualifying asset tainting the entire asset.

The NPRM notes that Treasury is studying circumstances under which property has not been purchased but has been "overwhelmingly improved" by a QOF or a QOZ Business may be treated as satisfying the original use requirement.[57] Under the proposed regulations, original use in the zone generally commences when tangible property owned by a QOF or QOZ Business is first placed in service in the zone. This raises a similar question of whether tangible property

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[56] *See also* section 1400N(d)(3) (adopting a similar rule for Gulf Opportunity Zones); former section 1400L(b)(20(D) (adopting similar rule for New York Liberty Zones).
[57] NPRM, *Explanation of Provisions*, § I.B.

incorporating a modest amount of nonqualifying property may be treated as QOZ Business Property meeting the original use test because it is treated as property newly placed in service in the zone. For example, the fact that a building contains a modest amount of property that was acquired from a related party or was acquired before December 31, 2017 should not taint a building that has been overwhelmingly improved by the QOF or QOZ Business.

For purposes of determining whether property has been "overwhelmingly improved," Treasury could look to guidance under other Code sections. Rev. Rul. 94-31[58] concluded that a replacement wind turbine would qualify as "originally placed in service" even though it contained some used property, provided the fair market value of the used property was not more than 20 percent of the facility's total value (the cost of the new property plus the value of the used property) (the "80-20 Rule").[59] The 80-20 Rule—and the inverse rule that any facility in which more than 20 percent of the value is derived from the prior facility continues to have the placed in service date of the prior facility—has been applied in a variety of contexts.[60]

Some have expressed concern that adopting a rule similar to the 80-20 Rule could effectively dilute the 70-percent asset test, freeing up 30 percent of the QOZ Business' assets to invest outside of a QOZ. Because the 80-20 Rule applies to property that is overwhelmingly improved, we believe that it would encourage transformative investments that have the potential to make the largest impacts in a QOZ. However, an 80-20 Rule would need to be balanced with protections to ensure that it does not facilitate investments that are inconsistent with the purpose of the statute.

Finally, there have been questions about whether fees paid by a QOZ Business to a related party for the development of property will result in QOZ Business Property being treated as acquired from a related party. For example, if a QOZ Business controlled by a real estate developer acquires property from an unrelated person and then enters into an arm's-length development agreement with the related real estate developer, are the capitalized fees treated as nonqualifying property? We believe that, as long as the statutory requirements are satisfied (i.e., the eligible gain is realized upon a sale to an unrelated party and the QOZ Business Property is acquired from an unrelated party), post-acquisition agreements should not result in a nonqualifying asset, as long as the agreement has arm's-length terms.

Recommendations:
Final regulations should clarify that nonqualifying property does not "taint" any new improvements made by a QOF or QOZ Business. For this purpose, Treasury should provide rules treating any nonqualifying property incorporated into a new property as a separate asset for purposes of the 70-percent asset test.

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[58] 1994-1 C.B. 16.
[59] Rev. Rul. 94-31 cited Rev. Rul. 68-111, 1968-1 C.B. 29, which held that a railroad locomotive constituted new section 38 property—under the pre-1986 investment tax credit provisions—where the cost of used materials and parts was not more than 20 percent of the total cost of materials and parts used in constructing the locomotive.
[60] *See, e.g.*, CCA 200347024 (Nov. 21, 2003) (describing "numerous Private Letter Rulings" issued on the topic and concluding that the 80-20 Rule states a legal test and not a safe harbor); Notice 2010-54, 2010-40 I.R.B. 403 (stating the 80-20 Rule for purposes of refined coal facilities); Notice 2016-31, 2016-23 I.R.B. 1025, § 6 (reaffirming that the 80-20 Rule continues to apply in determining the placed in service date of qualified facilities under section 45).

In addition, for purposes of the purchase and original use requirements, Treasury should consider adopting a rule similar to the 80-20 Rule in the context of QOZ Business Property. In particular, tangible property owned by a QOF or QOZ Business should be treated as QOZ Business Property meeting the purchase and original use requirements even though it contains some property that does not satisfy section 1400Z-2(d)(2)(D)(i)(I), provided the fair market value of such nonqualifying property is not more than 20 percent of the tangible property's total value (the additions to basis of the new property plus the value of the nonqualifying property). In order to prevent abuse of the 80-20 Rule, final regulations could provide that the fact that a QOZ Business takes advantage of the 80-20 Rule while simultaneously acquiring other unrelated property located outside a QOZ will be taken into account in applying the general anti-abuse rule and the reasonable cause exception to the 90-percent test.

Finally, the final regulations should clarify that property may be manufactured, constructed, or produced by a related party for use by a QOF or QOZ Business, so long as it is manufactured, constructed, or produced pursuant to an arm's-length arrangement.

D. Regulations Should Provide Clarity to Investors on the Benefits of the Statute

1. Treatment of Section 1231 Gains

Section 1231 deals with the netting of gains and losses from the sale of property used in a trade or business, which is referred to as "section 1231 property." Net gains from the sale of section 1231 property are taxed as long-term capital gain while net losses are taxed as ordinary losses.[61] The NPRM helpfully clarifies that net section 1231 gains are eligible for deferral under the QOZ rules.[62] The NPRM also provides that the 180-day period for investment of net section 1231 gains in a QOF begins on the last day of the taxable year in which such gain is realized.[63] The preamble to the NPRM explained that this was "because the capital gain income from section 1231 property is determinable only as of the last day of the taxable year."[64] This is true even if the taxpayer is fairly certain that it will not recognize any section 1231 losses during the tax year. In any event, the amount of the net section 1231 gain would be determined before the taxpayer files its tax return for the taxable year of the gain.

This proposed rule limits the incentives for taxpayers with net section 1231 gains during 2019. Because these taxpayers cannot make qualifying investments until 2020, and based on the time-limited nature of the statute and the recognition of all invested gains at the end of 2026, such taxpayers lose the opportunity to benefit from the seven-year basis step-up rule.[65] This result seems inconsistent with congressional intent to encourage qualifying investments of gains from the sale of capital assets by providing specified tax benefits for making such investments.

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[61] Section 1231(a)(1), (a)(2).
[62] Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(2)(iii).
[63] Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(2)(iii).
[64] NPRM, *Explanation of Provisions*, § IV.
[65] Section 1400Z-2(b)(2)(B)(iv). We note that this is no longer an issue for investments made in 2018, as the IRS updated its Opportunity Zones Frequently Asked Questions to clarify that the 1231 gain rule in the NPRM does not need to be applied to investments made during a tax year ending before May 1, 2019. https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions (updated June 24, 2019).

Further, it is not clear why the proposed regulations limit the eligible gains to *net* section 1231 gains. Section 1231 provides that if a taxpayer has a net section 1231 gain, then *all* section 1231 gains and losses are treated as capital gains and losses.[66] Accordingly, we believe that all such 1231 gains should be treated as eligible gains.

Recommendations:
Final regulations should provide a rule similar to Prop. Treas. Reg. § 1.1400Z2(a)-1(c)(2)(B) (regarding the election for partners to invest partnership level gains) to allow investors to elect to begin the 180-day period for investment upon the date of the sale of section 1231 property. The election would not be available if, at the time the investor files its tax return for the year the gain was recognized, the investor does not ultimately recognize net section 1231 gain as of the end of the taxable year.

The final regulations should also provide that, if the taxpayer has net section 1231 gains for a taxable year, then all section 1231 gains for that year are treated as eligible gains.

2. Partner's Basis Should Reflect the Value of Debt

Section 1400Z-2(c) provides that, for a taxpayer who has held its investment in a QOF for at least 10 years, the basis of the investment shall be equal to the fair market value of the investment on the date the investment is sold or exchanged. The NPRM provides that for a QOF organized as a partnership, when a QOF partner's basis in a qualifying QOF partnership interest is adjusted under section 1400Z-2(c), then the basis of the partnership interest is adjusted to an "amount equal to the fair market value of the interest, including debt."[67]

This proposed rule has created some confusion for investors because it is not clear whether the phrase "including debt" results in a gross or net calculation, and there are no examples illustrating how such value is calculated. We believe that the better interpretation is that the basis step-up is to the full amount realized, which would include the fair market value of the partner's share of assets of the QOF plus relief from the partner's share of debt, because that is what a willing buyer would pay.[68] However, clarity is needed that partners of a partnership QOF do not recognize any residual gain resulting from their share of partnership debt after meeting the requisite 10-year holding period, consistent with the intent of the statute that investors do not recognize gain on a QOF investment held for at least 10 years.

Recommendation:
Final regulations should provide an example to show that the investor's share of partnership debt is included in an investor's basis step-up, and a QOF partner does not recognize gain on its share of partnership debt when it sells its QOF interest after holding the interest for the requisite 10-year period.

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[66] Section 1231(a)(1).
[67] Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i).
[68] *See* Treas. Reg. § 1.1001-2(a).

3. Additional Flexibility for Exits After 10-Year Holding Period

The basis step-up rule of section 1400Z-2(c) is unusual in the context of a fund, because it requires the investor to sell its interest in the QOF, which does not have a market and likely has limited value given the time-limited nature of this incentive, in order to exit its investment and not recognize gain. The typical venture fund disposes of its assets and distributes the proceeds to its investors. The NPRM provides relief on this issue and some flexibility to structure exits as sales at the QOF level. The NPRM allows a QOF investor who has held its investment in a QOF for at least 10 years to make an election to exclude from gross income capital gain from the sale or disposition of QOZ Property by the QOF that is reported on the investor's Schedule K-1 (the "K-1 Rule").[69]

The NPRM also mitigates the potential negative consequences of the hot asset rules that could require the recognition of ordinary income by a QOF partner for items such as depreciation recapture.[70] Specifically, the NPRM provides that, when an investor sells a qualifying investment in a QOF partnership after the 10-year holding period, a special deemed adjustment is made to the inside basis of QOF partnership assets so as to mimic a cash purchase of the investment when a section 754 election is in effect, with the result that ordinary income is not triggered (the "Deemed Section 754 Election").[71]

We applaud these rules in the NPRM, but note that they are incomplete. It is not clear how sales of property by QOZ Businesses after the 10-year holding period are treated under the K-1 Rule and whether such gains can be excluded, given that the rule by its terms only refers to dispositions of QOZ Property by QOFs. If the QOZ Business is organized as a partnership, the capital gain will flow up to investors on their Schedules K-1 in the same manner. However, the language of the K-1 Rule applies only to exclude *capital* gain reported on the investors' Schedules K-1, and the Deemed Section 754 Election only applies to sales of QOF interests. Thus, ordinary income from hot assets sold by the QOF or QOZ Business would not be able to be excluded by the investor under either rule. This is particularly problematic for depreciation recapture, which cannot be separated from the rest of the asset that generates capital gain. But it should also apply to the sale of all hot assets if done as part of the sale of an entire trade or business. We do not believe that sales of inventory in the ordinary course of a QOZ Business' trade or business should be excluded under the K-1 Rule or Deemed Section 754 Election. In addition, it is not clear whether the Deemed Section 754 Election applies to the sale of a QOF interest if the hot assets are held at the QOZ Business level.

As a final issue, the preamble to the NPRM provides that taxpayers may generally rely on the proposed rules in the NPRM, except for the rules of Prop. Reg. § 1.1400Z2(c)-1 relating to the 10-year basis step-up, because these rules do not apply until January 1, 2028.[72] Despite this reasoning, investors need to be able to make investment decisions now and need assurance that they will receive the 10-year benefit described in these rules in the future. The 10-year benefit is

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[69] Prop. Treas. Reg. § 1400Z2(c)-1(b)(2)(ii).

[70] The hot asset rules under section 751(a) would result in ordinary income equal to the amount of any section 1250 recapture and an offsetting capital loss in the same amount. *See* Treas. Reg. § 1.751-1(a)(2).

[71] Prop. Treas. Reg. § 1400Z2(c)-1(b)(2)(i).

[72] NPRM, *Proposed Effective/Applicability Dates*.

one of the main incentives of the QOZ provision, and investors will not invest in QOFs without certainty regarding the benefits of the investment.

Recommendations:
Final regulations should provide that the K-1 Rule in Prop. Reg. § 1400Z2(c)-1(b)(2)(ii) also applies to income reported on the investors' Schedule K-1 from the QOF resulting from the sale or disposition of QOZ Business Property by a QOZ Business. For this purpose, the flow through of either depreciation recapture or gain from the sale of other hot assets as part of the sale of a trade or business should be treated as excluded gain and not subject to hot asset treatment under section 751(a). In addition, final regulations should clarify that the Deemed Section 754 Election of Prop. Reg. § 1400Z2(c)-1(b)(2)(i) is applicable if the hot assets are held at the QOZ Business level.

Finally, Treasury should amend the NPRM to permit current reliance on the rules in Prop. Treas. Reg. § 1.1400Z2(c)-1 or retroactive reliance back to the date of publication in the Federal Register, May 1, 2019.

4. *Amount of Deferred Gain Inclusion for QOF Partnerships and S Corporations*

Section 1400Z-2(b)(2)(A) provides that, in the case of a qualifying investment in a QOF held on December 31, 2026, the amount of gain included in gross income is equal to the excess of:

> (i) the lesser of the amount of [deferred gain] or the fair market value of the investment as determined as of [December 31, 2026], over
>
> (ii) the taxpayer's basis in the investment.

In contrast, the NPRM provides that, in the case of an inclusion event involving a qualifying investment in a QOF partnership or S corporation, or in the case of a qualifying investment in a QOF partnership or S corporation held on December 31, 2026, the amount of gain included in gross income is equal to the lesser of:

> (i) The product of:
>
> > (A) The percentage of the qualifying investment that gave rise to the inclusion event; and
> >
> > (B) The remaining deferred gain, less any basis adjustments pursuant to section 1400Z–2(b)(2)(B)(iii) and (iv); or
>
> (ii) The gain that would be recognized on a fully taxable disposition of the qualifying investment that gave rise to the inclusion event.[73]

This rule is not discussed in the preamble, but it may be intended to prevent taxpayers from reducing the fair market value of investments in QOF partnerships (and thereby the amount of

[73] Prop. Treas. Reg. § 1.1400Z2(b)-1(e)(4).

deferred gain included on December 31, 2026) through debt-financed distributions that would not otherwise trigger an inclusion event under the proposed rules. We agree that the rules should prevent debt-financed distributions from artificially diminishing the recognition of deferred gain. However, this rule would treat allocations of debt-financed deductions and losses in the same manner as debt-financed distributions because such allocations also reduce an investor's basis in a QOF partnership.

This rule would adversely affect the ability to form various tax credit partnerships through QOFs. Because allocations of debt-financed losses from such partnerships would reduce an investor's basis in a QOF partnership, the above rule will require such investors to recognize a greater portion of deferred gain, even if the fair market value of their investments has declined in the interim. This is likely to hit low-income housing tax credit ("LIHTC") partnerships disproportionately hard, because LIHTC investments generally do not appreciate due to regulatory agreements that require restricted rents for 30 years or more.

Recommendation:
In an effort to target the effect of debt-financed distributions without adversely affecting activity encouraged by the Code through the provision of tax credits, final regulations should modify the computation of deferred gain. Final regulations could provide that, in the case of an inclusion event involving a qualifying investment in a QOF partnership or S corporation, or in the case of a qualifying investment in a QOF partnership or S corporation held on December 31, 2026, the amount of gain included in gross income is equal to the product of:

(i) The percentage of the qualifying investment that gave rise to the inclusion event; and

(ii) the excess of:

(A) the lesser of (1) the remaining deferred gain, or (2) the fair market value of the investment, excluding debt,[74] plus cumulative distributions received with respect to such interest as of the inclusion date or, in the case of a qualifying investment in a QOF partnership or S corporation held on December 31, 2026, over

(B) any basis adjustments pursuant to section 1400Z-2(b)(2)(B)(iii) and (iv).

[74] Final regulations should include an example clarifying that "fair market value of the investment, excluding debt" means that fair market value will be measured on a net, rather than gross, basis. *Compare* Section D.2, above (discussing meaning of "including debt" for purposes of section 1400Z-2(c) 10-year basis step-up). In addition, this example should clarify that section 7701(g) does not apply in determining the fair market value of the investment, excluding debt.

E. Regulations Should Provide Rules to Prevent Abuse and Clarify Areas of Non-Abuse or Reasonable Cause

1. Clarify General Anti-Abuse Rule

Strong anti-abuse rules are critical to ensuring the integrity of the emerging Opportunity Zones market. Section 1400Z-2(e)(4)(C) specifically grants authority to Treasury to prescribe regulations to prevent abuse. The statute incentivizes economic activity and development in low-income communities through investor-level tax benefits. As a result, regulations should balance the need for clear guidance to encourage investors to execute investments in low-income communities with the need to prevent abuse.

The NPRM proposes a broad anti-abuse rule: "if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of section 1400Z-2, the Commissioner can recast a transaction (or series of transactions) for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 1400Z-2. Whether a tax result is inconsistent with the purposes of section 1400Z-2 must be determined based on all the facts and circumstances."[75] We support a strong anti-abuse rule that is flexible enough for the IRS to address scenarios that it has not yet considered. However, the proposed anti-abuse rule is potentially very far reaching, and further parameters could help avoid a chilling effect on transactions. The preamble to the NPRM requests comments on this proposed anti-abuse rule, including whether additional details regarding what tax results are inconsistent with the purposes of section 1400Z-2 or examples of types of abusive transactions would be helpful.[76] We believe that some additional guidance as to what Treasury believes is inconsistent with the purposes of section 1400Z-2, including examples of both abusive and non-abusive transactions, will help to provide meaningful guidance for taxpayers in complying with, and for the IRS in enforcing, the requirements of section 1400Z-2 without sacrificing flexibility. A general statement of the purpose of section 1400Z-2 would be helpful in this regard.

The NPRM identifies as abusive in several places the use of land in a trade or business without the investment of any new capital in such land.[77] Further, while the NPRM provides that land does not need to meet the requirement for original use or substantial improvement, the regulations also contain a rule that a QOF may not rely on this proposed rule if the land is unimproved or minimally improved and the QOF or QOZ Business purchases the land with an expectation, an intention, or a view not to improve the land by more than an insubstantial amount within 30 months after the date of purchase.[78] The combination of these rules provides a murky result: that land need not be substantially improved, but it must be improved by more than an insubstantial amount. Further clarity is needed on how much and what kinds of improvement or capital investment in land will be sufficient to not run afoul of Prop Treas. Reg. § 1.1400Z2(d)-1(f) or the general anti-abuse rule. A safe harbor threshold of expenditures to constitute more than an insubstantial amount would provide greater certainty so that land related projects can move forward. We believe additions to basis constituting at least 25 percent of basis would be

[75] Prop. Treas. Reg. § 1.1400Z2(f)-1(c)(1).
[76] NPRM, *Explanation of Provisions*, § X.
[77] NPRM, *Explanation of Provisions*, §§ I.B; X.
[78] Prop Treas. Reg. § 1.1400Z2(d)-1(f).

sufficient for this purpose. These rules should make clear, with appropriate examples, that "land banking" transactions will not be permitted to qualify for QOZ benefits. At the same time, examples should be provided to demonstrate that the investment of new capital into a productive use of land, such as the establishment of a new timber or farm operation, that otherwise meets the requirements of the statute and regulations should not run afoul of the anti-abuse rule.

In addition, as discussed above,[79] while we support adoption of an 80-20 rule for overwhelming improvements, such a rule must be balanced with protections to ensure that it does not facilitate investments that are inconsistent with the purpose of the statute. Specifically, final regulations could provide that the fact that a QOZ Business takes advantage of the 80-20 Rule while simultaneously acquiring other unrelated property located outside a QOZ is a factor to be taken into account in applying the general anti-abuse rule.

Recommendations:
In final regulations, Treasury should provide a statement of the general purpose of section 1400Z-2 and examples to illustrate what behavior is considered abusive and not abusive. At least one example should illustrate what level of improvement or capital investment in land is sufficient to avoid the anti-abuse and non-reliance rules. For example, certain improvements to land used in a trade or business should be considered more than insubstantial, such as environmental remediation or planting crops or timber. In addition, Treasury should provide a 25-percent safe harbor threshold to satisfy more than an insubstantial amount. Finally, final regulations could treat application of the 80-20 rule while simultaneously acquiring unrelated property outside the QOZ as a factor indicating a significant purpose that is inconsistent with the statute. The recommended guidance would provide investors greater certainty without sacrificing needed flexibility for the IRS to enforce the statute.

2. Safe Harbor for Independent Certification

Although a flexible approach to anti-abuse generally is appropriate to ensure that the IRS has the necessary tools to combat abusive transactions, providing a safe harbor for QOFs may allow taxpayers to gain additional certainty while steering funds towards activities that are most likely to further the purposes of section 1400Z-2. In particular, a safe harbor from the general anti-abuse rule could be provided to QOFs that undergo an independent certification process that ensures that their activities are directed towards delivering well-defined and measured benefits to communities located in a QOZ.

The independent review process for nonprofit benefit corporations might serve as a model for this independent certification safe harbor. Since 2010, at least 33 states and the District of Columbia have passed benefit corporation legislation.[80] This legislation is designed to ensure that a benefit corporation furthers one or more specific public benefits, which could be adapted to benefits that further the purposes of section 1400Z-2, such as the creation of new jobs in a QOZ.

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[79] *See supra* Section C.5.
[80] Model benefit corporation legislation (hereinafter the "Model Act") is available at https://benefitcorp.net/attorneys/model-legislation.

In general, a benefit corporation must satisfy a third-party standard used to assess performance of the benefit corporation and meet a variety of detailed rules.[81] The standard must be developed by an entity with an independent governing body that has no material financial relationship with the benefit corporation or any of its subsidiaries. The standard must use a balanced multi-stakeholder approach, including a public comment period of at least 30 days to develop the standard and must satisfy various other transparency requirements. There are a number of independent organizations that provide these certifications, such as B Labs, which assesses social and economic performance

Recommendation:
Final regulations (or separate guidance) should include a safe-harbor, which provides that the IRS will not assert the general anti-abuse rule with respect to QOFs that obtain independent certification, similar to the third-party standard adopted under benefit corporation legislation, demonstrating that the QOF's activities further specified, measurable public benefits in a QOZ.

3. Separate Threshold for Location of Property in Real Estate Businesses

The definition of "substantially all" as 70 percent for purposes of the QOZ Business Property asset test allows up to 30 percent of the tangible property of a trade or business to be located outside of a QOZ.[82] It also may allow up to 30 percent of the tangible property of a trade or business to fail to meet one of the other tests for QOZ Business Property (i.e., the requirement for purchase from an unrelated party after December 31, 2017 and the original use/substantial improvement tests). Our prior comment letter dated December 27, 2018 noted that real estate businesses may not need the location-based flexibility that this threshold was intended to provide to operating businesses, since their primary tangible assets, the real estate, will remain fixed in location. There are concerns that up to 30 percent of a rental real estate QOZ Business's property could be located outside of and have no connection with a QOZ. However, the flexibility of this 70-percent threshold is needed for operating businesses and to allow real estate businesses to have small amounts of nonqualifying property.

Recommendation:
Final regulations should require that a greater percentage (e.g., 90 percent) of the tangible property owned or leased by a real property QOZ Business must be either located within a QOZ or contiguous to a QOZ. This 90-percent threshold would be in addition to the 70-percent asset test, which would otherwise remain unchanged for all other purposes of section 1400Z-2(d)(3)(A)(i) (including the ability to hold small amounts of property that do not qualify as QOZ Business Property). However, it would ensure that the economic activity of real estate businesses is benefitting the QOZ.

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[81] *See* Model Act § 102 (definition of third-party standard). The benefit corporation must also deliver an annual benefit report, which includes, among other things, a description of the ways in which the benefit corporation pursued a specific public benefit during the year and an assessment of the overall social and environmental performance of the benefit corporation, prepared in accordance with a third-party standard. *See* Model Act § 401.
[82] Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(3).

4. Avoidance of the "Sin Business" and Section 1397C Limitations

Section 1400Z-2(d)(3)(A) imposes certain requirements on QOZ Businesses, such as the prohibition on the operation of "sin businesses" and application of the gross income, intangible, and nonqualified financial property requirements of section 1397C, but the statute does not apply these requirements to trades or businesses operated directly by a QOF. This inconsistent treatment in the statute was likely unintentional. In addition, the statute does not prohibit QOZ Businesses from leasing real property to these "sin businesses." The preamble to the NPRM requests comments as to whether the 1397C requirements should be applied at the QOF level,[83] though it does not mention the sin business requirements.

We are concerned that, without further guidance, taxpayers may attempt to circumvent the purpose of the sin business limitation and the gross income requirement under section 1397C(b)(2) by conducting "bad" activities at the QOF level. However, we note that the other 1397C requirements may not need to be applied to QOFs. Specifically, the intangible requirement of section 1397C(b)(4) and the nonqualified financial property limitation of section 1397C(b)(8) would be largely redundant of the 90-percent test if applied at the QOF level and would cause an unnecessary compliance burden.

<u>Recommendations:</u>
Final regulations should prevent circumvention of the sin business limitation by providing that the use of property in a trade or business consisting of a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store, the principal business of which is the sale of alcoholic beverages for consumption off premises, prevents such property from qualifying as QOZ Business Property. The de minimis use (e.g., 5 percent or less) of property in a sin business should be excluded to avoid footfaults.

Final regulations should also provide that the definition of a QOZ Business excludes businesses that lease more than a de minimis amount (e.g., more than 5 percent) of its property to a sin business. Treasury adopted a similar limitation under the NMTC incentive, wherein an investment in a business engaged in the rental of real property is not a qualified investment to the extent a lessee of the real property is a sin business.[84]

Further, final regulations should provide that the gross income requirement under section 1397C also applies to QOZ Business Property held directly at the QOF level. For simplification, the nonqualified financial property limitation and intangible requirement under section 1397C should not be applied at the QOF level.

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[83] NPRM, *Explanation of Provisions*, § III.D.
[84] Treas. Reg. § 1.45D-1(d)(5)(ii).

5. *Ensuring Transparency Through Reporting*

The statute provides Treasury with broad authority to prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 1400Z-2, including rules for the certification of QOFs and rules to prevent abuse.[85]

We believe that a robust reporting regime will help ensure transparency and minimize abuse (or at least provide the IRS with information to help detect abuse). We refer you to our comment letter dated May 31, 2019 in response to the Request for Information on Data Collection and Tracking for Qualified Opportunity Zones in which we recommended adoption of the reporting framework originally introduced in the *Investing in Opportunity Act* and recently introduced in bipartisan legislation, S. 1344 and H.R. 2593. We believe that Treasury has the authority to collect most or all of that information (including information concerning the nature and location of assets, activities, income, and employees), as it is relevant to determining whether the QOZ requirements are satisfied.

In addition, Form 8996 currently requires that a QOF include in its organizing documents a statement of its purpose of investing in QOZ Property, a description of the QOZ Business(es) that the QOF expects to engage in, either directly or indirectly through a first-tier operating entity. We believe this information should be disclosed on the Form 8996 as an additional check that the QOF is operating consistent with the purposes of section 1400Z-2.

The New Markets Tax Credit allocation application requires fund managers to certify that they have not been indicted, charged with or convicted of, or had a civil judgement rendered against them, for fraud, embezzlement, forgery, theft or certain other offenses within the past three years.[86] A similar certification by a QOF manager would be appropriate as part of its self-certification to prevent bad actors from attempting to abuse the rules.

Recommendations:
Treasury should implement a robust reporting regime to enable it to enforce section 1400Z-2 and uncover abuse. This reporting regime should include, among other things, information concerning the nature and location of assets, activities, income, and employees. It should also include a statement of the QOF's purpose for investing in QOZ Property and a description of the QOZ Business(es).

Treasury should also require a "clean hands" certification for managers of a QOF on the Form 8996 (or successor self-certification form), similar to the certifications included in the New Markets Tax Credit allocation application.

6. *Guidance on Reasonable Cause*

If a QOF fails to satisfy the 90-percent test, it must pay a penalty for each month in which it fails to satisfy the test.[87] No penalty shall be imposed if it is shown that the failure is due to

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[85] Section 1400Z-2(e)(4)(A), (C).
[86] *See New Markets Tax Credit Allocation Application*, Assurances and Certifications #12-17, at viii-xi.
[87] Section 1400Z-2(f)(1).

reasonable cause.[88] Treasury has the authority to determine whether reasonable cause is shown and thus could provide specific facts and circumstances that will be taken into account.

Treasury should provide guidance on the circumstances in which reasonable cause may be satisfied to avoid the penalty for failure to satisfy the 90-percent test. For example, a QOF could be formed, accept investments, and begin to carry out a business plan, only for that business plan to fail to materialize for any of a number of reasons, causing the QOF to fail to meet the 90-percent test. If the QOF exercised ordinary business care and prudence in creating and executing its business plan, and it attempts to find a qualifying investment, it should be found to have reasonable cause.

In the context of New Markets Tax Credits, Treasury has permitted investments in a certified community development financial institution ("CDFI") by non-real estate qualified active low-income community businesses to be treated as continuously invested in a qualified low-income community investment and thus not trigger recapture of the credits.[89] Similarly, an investment of excess cash in a CDFI could be treated as reasonable cause for purposes of the QOF's failure to satisfy the 90-percent test.

In addition, satisfaction of the independent certification safe harbor and application of the 80-20 rule while simultaneously acquiring unrelated property outside the QOZ, discussed above, could also be considered factors in determining whether a QOF has reasonable cause for failure to meet its 90-percent test.

Recommendations:
Final regulations should include factors to consider in determining whether a QOF has reasonable cause for its failure to meet the 90-percent test. Factors could include exercise of ordinary business care and prudence in creating and executing its business plan, attempts to locate qualifying investments, investment of cash in a CDFI, satisfaction of the independent certification safe harbor discussed above, and application of the 80-20 rule while simultaneously acquiring unrelated property outside the QOZ. Final regulations should also include examples to illustrate when reasonable cause will and will not be satisfied.

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[88] Section 1400Z-2(f)(3).
[89] *See* Treas. Reg. § 1.45D-1(d)(10)(ii).