Opportunity Zones
WORKING GROUP™
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July 1, 2019

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

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

Via Federal eRulemaking Portal

Re: Comments on REG-120186-18: Investing in Qualified Opportunity Funds (Guidance Under §1400Z-2)

Dear Ms. Reigle and Mr. Griffin:

On behalf of the members of the Novogradac Opportunity Zones Working Group (OZ Working Group), we are responding to the Internal Revenue Service (IRS) Notice Document Citation Number REG-120186-18: Investing in Qualified Opportunity Funds (the Regulations).

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

Our comments, set forth in the appendix to this letter, identify issues arising under the Regulations, provide recommended solutions, and include suggested Regulation line edits.

The OZ Working Group has taken several opportunities in the past to provide comments on the proposed regulations, submitting a letter on November 26, 2018 which addressed a narrow list of priority issues, as well as the formal comment letter submitted on December 28, 2018 in regards to the first tranche of proposed OZ regulations. The OZ Working Group revisited both of these earlier submissions and the proposed guidance in the first set of regulations released in Fall 2018 in preparing this most recent comment letter.

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

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

We appreciate your consideration of these comments and we are available to provide any additional insight and background regarding our comments you may desire. We look forward to an opportunity to discuss some of these issues further during the public hearing scheduled for July 9, 2019.

Yours very truly,

Novogradac & Company LLP

By

Michael J. Novogradac, Managing Partner

Novogradac & Company LLP

By

John S. Sciarretti, Partner

CC: Michael Novey, Office of Tax Policy, Treasury

Julie Hanlon-Bolton, ITA, IRS

Scott Dinwiddie, Associate Chief Counsel

Attachments:

Comments on REG-120186-18: Investing in Qualified Opportunity Funds (Guidance Under §1400Z-2)

Novogradac Opportunity Zones Working Group
Comments on Opportunity Zones Proposed Regulations
July 1, 2019

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I. Investor

A. Section 1231 Gains

1. Rule

a) The proposed regulations provide that the only gain arising from Section 1231 property that is eligible for deferral under Section 1400Z-2(a)(1) is capital gain net income for a taxable year. The net amount is determined by taking into account the capital gains and losses for a taxable year on all of the taxpayer's Section 1231 property. The 180-day eligible investment period with respect to any capital gain net income from Section 1231 property for a taxable year begins on the last day of the taxable year.

2. Issues

a) The proposed regulations limit the investment of Section 1231 gains to "net" Section 1231 gains, which is inconsistent with the Internal Revenue Code. Section 1231(a)(1) provides that if Section 1231 gains exceed Section 1231 losses for a taxable year, such gains and losses shall be treated as long-term capital gains or long-term capital losses, as the case may be. As such, to the extent a taxpayer has net Section 1231 gains, the gross Section 1231 gains are treated as capital gains and the gross Section 1231 losses are treated as capital losses.

b) The proposed regulations, if effective for investments made prior to the regulations being finalized, disqualify some existing investments of Section 1231 gains.

c) By not starting the 180 day eligible investment period for Section 1231 gains until the end of the taxable year, planned OZ investments are being unnecessarily delayed or stalled.

(1) Furthermore, such a rule creates burdensome timing rules when a business owner sells a business. For example, the sale of a business on April 1st could result in capital gain being recognized on April 1st and having to be invested within 180 days of that date (no later than September 28th), while the net Section 1231 gain from the transaction would not be determinable (and the 180 investment period would not begin) until the end of the taxable year, December 31st for a calendar year taxpayer. Therefore, the business owner would unnecessarily not be able to invest all the gain (i.e., capital gain and net Section 1231 gain) recognized in the sale transaction on a single date into a qualified opportunity fund.

(2) Such a rule also means Section 1231 gains realized in 2019 will not be eligible for the full 15 percent basis adjustment based on a 7-year holding period unless invested on, but not before or after, December 31, 2019.

(3) We note that the IRS recently announced on its OZ FAQ website a transitional rule for 2018 net Section 1231 gains invested in 2018.

d) The proposed regulations are not entirely clear as to whether a partnership with Section 1231 gains can elect to invest partnership net Section 1231 gains in a QOF.

3. Recommendations

a) Allow taxpayers to invest "gross" Section 1231 gains to the extent they have "net" Section 1231 gains. Section 1231(a)(1) provides that if Section 1231 gains exceed Section 1231 losses for a taxable year, such gains and losses shall be treated as long-term capital gains or long-term capital losses, as the case may be. As such, to the extent a taxpayer has net Section 1231 gains, the gross Section 1231 gains are treated as capital gains and the gross Section 1231 losses are treated as capital losses. The proposed regulations in their current form allow a taxpayer to make an election under Section 1400Z-2(a)(1) with respect to gross capital gains, as opposed to net capital gains. There is no reason that Section 1231 gains, once determined to be capital gains, should be treated differently.

We note that under Section 1231(a)(2), to the extent a taxpayer's Section 1231 losses exceed Section 1231 gains in a taxable year, such gains and losses are not treated as gains and losses from sales or exchanges of capital assets. As such, a taxpayer would not be permitted to make an election under Section 1400Z-2(a)(1) if they have net Section 1231 losses.

b) Provide that any Section 1231 gains invested prior to finalizing the proposed regulations, whether net or gross, will be considered eligible gains, so long as the investment otherwise complies with opportunity zone requirements. Such a rule would be consistent with the guidance in the first set of regulations and the language in those regulations permitting taxpayers to rely on the proposed guidance. In the alternative, at a minimum, provide that any Section 1231 gains invested prior to June 1st be considered eligible. Selecting a June 1 date would allow a one month grace period from the formal release of the second tranche of regulations for taxpayers to have a reasonable opportunity to learn of the new proposed limitation on investments of Section 1231 gains in QOFs.

c) Similar to the 180 day optionality provided to partners with respect to allocable partnership capital gains, taxpayer's recognizing Section 1231 gains should have the option to invest those gains within 180 days of the sale of the property or within 180 days of the end of the tax year. To the extent a taxpayer were to invest Section 1231 gains in a QOF within 180 days of the sale of property, and ultimately have net Section 1231 losses for the taxable year, such investment would be a mixed funds investment.

d) Consistent with the proposed regulations, which provide that a partnership or other pass-through entity may elect to defer all or part of a capital gain to the extent that it makes an eligible investment in a QOF, the final regulations should more clearly confirm that a partnership or S corporation may elect to defer gross Section 1231 gains at the pass-through entity level provided the pass-through entity's Section 1231 gains exceed its Section 1231 losses for the taxable year. Specifically, final regulations should clarify that a partnership or S corporation is a taxpayer for purposes of Prop. Reg. Sec. 1.1400Z2(a)-1(b)(2)(iii), Gains from section 1231 property.

4. Suggested line edits:
Prop. Reg. Sec. 1.1400Z2(a)-1(b)(2)(iii)

~~**The only gain arising from section 1231 property that is eligible for deferral under section 1400Z-2(a)(1) is capital gain net income for a taxable year.**~~ **To the extent a taxpayer's section 1231 gains for any taxable year exceed the section 1231 losses for such year, such gross section 1231 gains are eligible for deferral under section 1400Z-2(a)(1).** This ~~**net amount**~~ **calculation** is determined by taking into account the ~~**capital**~~ gains and losses for a taxable year on all of the taxpayer's section 1231 property. The 180-day period described in paragraph (b)(4) of this section with respect to any capital gain ~~**net**~~ income from section 1231 property for a taxable year begins on the last day of the taxable year~~.~~**, or, at the election of the taxpayer, the 180-day period that begins on the day on which the gain would be recognized for Federal income tax purposes if the taxpayer did not elect under section 1400Z-2 to defer recognition of that gain. Gross section 1231 gains invested prior to the effective date of this paragraph (b)(2)(iii) are eligible for deferral under section 1400Z-2(a)(1).**

B. 10-year Sale of Interest in a QOF Partnership

1. Rule

a) Prop. Reg. Sec. 1.1400Z2(c)-1(b)(2) provides, "If 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, and immediately prior to the sale or exchange, the basis of the QOF partnership assets are also adjusted, such adjustment is calculated in a manner similar to a section 743(b) adjustment had the transferor partner purchased its interest in the QOF partnership for cash equal to fair market value immediately prior to the sale or exchange assuming that a valid section 754 election had been in place."

2. Issues

a) Additional regulatory guidance would be helpful that more clearly states that the basis of the partnership interest is adjusted to an amount equal to the fair market value of the QOF interest plus the partner's share of debt (gross fair market value).

b) It is unclear if the statement that "the basis of the QOF partnership assets are also adjusted" is deemed to occur for purposes of the transferor's basis and gain calculations, or, if the basis of the QOF partnership assets are adjusted in the hands of the QOF partnership, such that the increase or decrease to the basis of partnership property occurs with respect to the transferee partner.

c) If the basis of a QOF partnership's assets are adjusted in the hands of the QOF partnership, it is unclear the extent to which such basis adjustments flow through to assets held by QOZB partnerships owned by the QOF partnership.

d) It is unclear if a QOF partnership's assets are adjusted if a Section 754 election is not in place.

e) If a QOF partnership's assets are adjusted if a Section 754 election is not in place, it is unclear if a similar rule applies for QOZB partnerships owned by a QOF partnership.

3. Recommendations

a) Provide a simple "no gain or loss" rule that upon an election under Section 1400Z-2(c), the sale or exchange of a QOF interest held for at least ten years, including a sale or exchange of a QOF partnership interest, generates no gain or loss to the selling taxpayer.

(1) In the event that Treasury chooses to not adopt a simple "no gain or loss" rule, Treasury should clarify that the basis of a partnership interest is adjusted to an amount equal to the gross fair market value of the QOF interest determined by taking into account the partner's allocable share of any debt of the QOF partnership.

(a) Also, clarify that the gross fair market value of the QOF interest cannot be less than the partner's allocable share of non-recourse financing. Similar to Section 7701(g), the fair market value of a QOF interest should not be treated as less than the amount of any nonrecourse indebtedness to which the property is subject.

b) Confirm that partnership property is adjusted to fair market value with respect to both the transferee (as provided in Section 743) and transferor (in a manner similar to a Section 743 adjustment).

c) Confirm that basis adjustments flow through to the assets held by QOZB partnerships owned by a QOF partnership.

d) Confirm that a QOF partnership's assets are adjusted whether or not a Section 754 election is in place. This appears to be the intended treatment by Treasury, as the language in the proposed regulation reads "assuming that a valid section 754 election *had been* (italics added) in place" and does not read "assuming that a valid section 754 election *is* in place".

(1) Confirm that a similar rule applies for QOZB partnerships owned by a QOF partnership.

e) As an alternative, the final regulations could provide the transferor and transferee the option to elect to treat the basis adjustment as if a Section 754 election were in place whether or not the election was made. Providing this flexibility would provide greater confidence to QOF investors that they will receive the beneficial basis adjustment as intended by the QOZ incentive.

4. Suggested lined edits:

Prop. Reg. Sec. 1.1400Z2(c)-1(b)(2)(i)

If 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 **gross** fair market value of

the interest, including debt, and immediately prior to the sale or exchange, the basis of the QOF **and, to the extent the QOF owns interests in QOZB partnerships, QOZB** partnership assets are also adjusted, such adjustment is calculated in a manner similar to a section 743(b) adjustment had the transferor partner purchased its interest in the QOF, **and the QOF partnership purchased its interest in any QOZB** partnership**s**, for cash equal to fair market value immediately prior to the sale or exchange assuming that a valid section 754 election had been in place **whether or not a valid section 754 is actually in place. The fair market value of the QOF partnership interest, and any QOZB partnership interests held by the QOF partnership, shall generally equal the cash and other property received by the selling partner plus the amount of the partner's allocable share of partnership indebtedness immediately prior to the sale or exchange.** This paragraph (b)(2)(i) applies without regard to the amount of deferred gain that was included under section 1400Z-2(b)(1), or the timing of that inclusion. **Similar to section 7701(g), the fair market value of a QOF or any QOZB partnership interest shall be treated as not less than the amount of any nonrecourse indebtedness to which the property is subject.**

(ii) The following example illustrates the rules of paragraph (b)(2)(i).

(A) Example 1—

(1) <u>Facts.</u> On January 1, 2019, A and B form Q, a QOF partnership, each contributing $100 for a 50 percent interest and each electing to defer $100 of eligible gain under section 1400Z-2(a). On January 2, 2019, Q contributes the $400 to Z, a QOZB partnership. Also on January 2, 2019, Z obtains a nonrecourse loan commitment from a bank for $800. Z constructs a commercial building which is placed in service on June 1, 2020. On January 3, 2029 (after 10 years) A's basis of its investment in Q is $330, including its allocable share of debt of $400, and A transfers its partnership interest in Q to T for $200 in cash. A makes an election under Section 1400Z-2 to adjust the basis in its partnership interest to FMV.

(2) <u>Partner basis adjustment.</u> Under paragraph (b)(2)(i) of this section, immediately prior to the transfer, A's basis in its investment, including A's allocable share of debt of Q is adjusted to $600.

(3) QOF partnership basis adjustments. Under paragraph (b)(2)(i) of this section, immediately prior to the sale Q's basis in its investment in Z with respect to A and T is adjusted to $600 including Q's allocable share of debt of $400.

(4) QOZB partnership basis adjustments. Under paragraph (b)(2)(i) of this section, immediately prior to the sale, Z's basis in its assets are adjusted upward by $270 with respect to Q.

C. 10-year Gain Exclusion Provision for Partnerships and S Corporations

1. Rule

a) The proposed regulations allow an investor in a QOF partnership or QOF S corporation to elect to exclude from gross income its allocable share (to the extent attributable to such investor's qualifying investment) of the capital gain from the disposition of QOZ property by the QOF partnership that is reported on a Schedule K-1, provided that the disposition occurs after the investor has held its QOF interest at least 10 years. This election to exclude amounts from gross income applies only to capital gains from the sale of QOZP by the QOF allocated to the QOF investor, and not to amounts characterized as ordinary income (such as depreciation recapture of Section 1245 assets, inventory, etc.) or attributable to the sale by a QOZB partnership of QOZB assets.

2. Issues

a) The proposed regulations do not appear to allow an investor in a QOF partnership to exclude its allocable share of QOF partnership capital gain attributable to capital gain allocated to a QOF from the sale of QOZB assets by a QOZB partnership.

b) This gain exclusion rule differs from the rule governing the sale of a QOF partnership interest in that this gain exclusion rule does not allow the exclusion from gross income any ordinary income attributable to the disposition of assets by either the QOF or QOZB partnership.

3. Recommendations

a) For taxpayers that have held an investment in a QOF for at least 10 years, Treasury should expand the gain exclusion rule to generally apply to all gains attributable to the sale by a QOF or a QOZB of appreciated QOF or QOZB property. Specifically, Treasury should

provide, in the case of a QOF partnership (or S corporation) held by a taxpayer for at least 10 years, and with respect to which a taxpayer makes an election, the taxpayer may exclude ordinary and capital gains from the sale of any property by a QOF or QOZB to the extent such a sale represents the disposition by the QOF or QOZB of property used in a trade or business.

(1) Such exclusion should not include the disposition of property that generates ordinary income and is attributable to the sale of property in the ordinary course of operating a trade or business.

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(c)-1(b)(2)(ii)(A)

(1) In general. For purposes of section 1400Z-2(c), if a taxpayer has held a qualifying investment (as determined under §1.1400Z2(b)-1(c)(6)(iv)) in a QOF partnership or QOF S corporation for at least 10 years, and the QOF partnership or QOF S corporation disposes of qualified opportunity zone property after such 10 year holding period, the taxpayer may make an election to exclude from gross income some or all of the ~~**capital**~~ gain, **capital or ordinary**, arising from such disposition reported on Schedule K-1 of the QOF partnership or QOF S corporation and attributable to the qualifying investment. To the extent that the Schedule K-1 of a QOF partnership or QOF S corporation separately states ~~**capital**~~ gains arising from the sale or exchange of any particular qualified opportunity zone property, the taxpayer may make an election with respect to such separately stated item.

(2) Gains from the disposition of QOZB assets. For purposes of section 1400Z-2(c), if a taxpayer has held a qualifying investment (as determined under §1.1400Z2(b)-1(c)(6)(iv)) in a QOF partnership or QOF S corporation for at least 10 years, the taxpayer may make an election to exclude from gross income some or all of the allocable gain, capital or ordinary, arising from the disposition of QOZB property.

(3) Gains from the sale of property in the ordinary course of a trade or business. ~~**Section 1231 gains. An election described in paragraph (b)(2)(ii)(A)(1) of this section may be made only with respect to capital gain net income from section 1231 property for a taxable year to the extent of net gains determined under section 1231(a) reported on**~~

~~**Schedule K-1 of a QOF partnership or QOF S corporation.**~~ **The preceding paragraphs (A)(ii)(1) and (2) do not include gains from the sale of property in the ordinary course of the operation of a taxpayer's trade or business, such as gains from the sale of inventory or other property to customers.**

As an alternative, if Treasury is reluctant to adopt the prior recommendation, Treasury could further limit the prior rule by providing that such asset sales must be pursuant to a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within 3 years from the close of the taxable year during which the first of a series of dispositions occur. (See Treas. Reg. Sec. 1.332-4(a)(1)).

D. 10-year Gain Exclusion for Real Estate Investment Trust

1. Rule

a) In the sale or disposition of property held by a QOF REIT, a REIT shareholder who has held their qualifying investment for 10 years or more, is permitted to apply a zero percent tax rate to the capital gain dividend arising from the sale.

2. Issues

a) Applying a zero percent tax rate for federal income tax purposes may trigger state tax liability in states which conform to the federal tax code by using federal taxable income as a starting point for the state income tax calculation. If a taxpayer has capital losses, such capital gains would be offset by capital losses, thus the taxpayer would not receive a 10-year QOZ benefit.

b) Gain from the sale of Section 1245 property by a QOF REIT may generate ordinary income, which is not excluded under this rule.

3. Recommendations

a) In the case of a QOF REIT qualifying interest held by a taxpayer for at least 10 years, and with respect to which a taxpayer makes an election, the taxpayer may exclude capital gain dividends.

b) Similarly, in the case of a QOF REIT qualifying interest held by a taxpayer for at least 10 years, and with respect to which a taxpayer makes an election, the taxpayer may exclude ordinary dividend income attributable to QOF REIT Section 1245 recapture.

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(c)-1(e)(1)(ii)

If, on the date identified, the shareholder had held that qualifying investment in the QOF REIT for at least 10 years, then the shareholder may ~~**apply a zero percent tax rate to that**~~ **make an election to exclude from gross income some or all of the:**

(A) Capital gain dividend attributable to the qualifying investment~~, or part thereof.~~; and

(B) Ordinary dividend income attributable to QOF REIT section 1245 recapture.

E. Special amount includible rule for partnerships and S corporations

1. Rule

a) 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:

(1) 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

(2) The gain that would be recognized on a fully taxable disposition of the qualifying investment that gave rise to the inclusion event.

2. Issue

a) This special rule is not consistent with the statute which provides that the amount of gain included in gross income on the earlier of the date the investment is sold or exchanged or December 31, 2026 is the excess of:

(1) The lesser of the amount of gain excluded when the investment was made, or the fair market value of the investment at the date the investment is sold or exchanged or 12/31/2026, as applicable, over

(2) The taxpayer's basis in the investment.

We understand that the special inclusion rule included in the proposed regulations is intended to prevent taxpayers from avoiding recognizing deferred gain on the earlier of a sale or exchange or December 31, 2026 when the fair market value of their QOF pass-through interests have diminished due to debt financed distributions. However, this rule creates inconsistent and inequitable results for debt financed losses attributable to periods before December 31, 2026 as compared to losses incurred after.

These inequitable results have had the unintended consequence of adversely affecting the ability to develop low-income housing tax credit (LIHTC) and other impactful community development properties in opportunity zones. LIHTC investors do not anticipate realizing appreciation on their housing investments due to regulatory agreements that require restricted rents for 30 years, or more. Likewise other impact investors do not invest primarily for financial return but for social returns realized by low-income community residents as a result of their investments. This means the 10-year gain exclusion benefit is generally less valuable for tax credit and other impact investors. The general 2026 inclusion rule, however, as provided for in the statute, provides a benefit to tax credit investors for the typical loss in value over time for affordable housing tax credit investments and a potential benefit to other community impact investors placing equity capital in higher risk, deeply targeted community investments. The proposed regulations modify the statutory 2026 inclusion rule in a manner that reduces the value of the OZ incentive to LIHTC and other impact investors and as a result, many aspiring investors have turned away from affordable housing and community development investments in QOZs.

3. Recommendation

Amend the proposed rule to provide the definition of fair market value is based on the net value excluding debt plus prior cash distributions. Such a rule would prevent the artificial reduction of investment value through debt financed distributions, would avoid inconsistent and inequitable results for debt financed losses attributable to periods before December 31, 2026, as compared to losses incurred after, and would attract more investment to affordable housing and other impactful community development projects in QOZs.

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(b)-1(e)(4)

[I]n 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:

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

(ii) The excess of:

(A) the lesser of:

~~**(B) The remaining deferred gain, less any basis adjustments pursuant to section 1400Z-2(b)(2)(B)(iii) and (iv);**~~ **(1) the remaining deferred gain,** or

~~**(ii) The gain that would be recognized on a fully taxable disposition of the qualifying investment that gave rise to the inclusion event.**~~ **(2) the fair market value of the investment, excluding debt, 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, December 31, 2026, over**

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

F. Effect of Inclusion Event on 10-year FMV Basis Election

1. Rule

a) Under Prop. Reg. Sec. 1.1400Z2(c)-1(b)(2)(i), if 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, and immediately prior to the sale or exchange, the basis of the QOF partnership assets are also adjusted, such adjustment is calculated in a manner similar to a Section 743(b) adjustment had the transferor partner purchased its interest in the QOF partnership for cash equal to fair market value immediately prior to the sale or exchange assuming that a valid section 754 election had been in place. *This paragraph (b)(2)(i) applies without regard to* the amount of deferred gain that was included

under section 1400Z-2(b)(1), or *the timing of that inclusion*. *(Emphasis added.)*

2. Issues

a) Whether an inclusion event terminates a taxpayer's right to elect to adjust the basis of an interest in a QOF held for at least 10 years to fair market value under Prop. Reg. Sec. 1.1400Z2(c)-1(b)(1).

b) Whether an inclusion event terminates a taxpayer's right to elect to adjust the basis of an interest in a QOF held for at least 10 years to fair market value under Prop. Reg. Sec. 1.1400Z2(c)-1(b)(2)(i).

c) Whether an inclusion event terminates a taxpayer's right to elect to exclude from gross income some or all of capital gain arising from a QOF disposition of property under the special election rules for QOF partnerships and QOF S corporations of Prop. Reg. Sec. 1.1400Z2(c)-1(b)(2)(ii).

3. Recommendations

a) Confirm that the statement in paragraph (b)(2)(i) regarding the right to elect to adjust the basis of an interest in a QOF held for at least ten years to fair market value without regard to the amount of deferred gain that was included under Section 1400Z-2(b)(1), or the timing of that inclusion, applies with respect to paragraph (b)(1)(i).

b) Confirm which inclusion events do not terminate a taxpayer's right to elect to adjust the basis of an interest in a QOF held for at least 10 years to fair market value and do not terminate a taxpayer's right to make the special election under Prop. Reg. Sec. 1.1400Z2(c)-1(b)(2)(ii).

c) Provide illustrative list of inclusion events that do and do not affect the 10-year hold benefit under Section 1400Z-2(c) as follows:

(1) Inclusion events provided for under Prop. Reg. Sec. 1.1400Z2(b)-1(c) that reduce the 10-year hold benefit under Section 1400Z-2(c):

- (1)(i) –A transfer of a qualifying investment, to the extent of the portion transferred.
- (2)(i) – Termination or liquidation of a QOF.
- (2)(ii) – Liquidation of a QOF owner, to the extent treated as a sale
- (3) – Transfer by gift.
- 6(iii) – Partnership distributions, to the extent the distribution reduces the relative ownership of the QOF partnership.

- (7)(ii)(A) – Distribution of property by an S corporation to the extent treated as a sale.
- (7)(iii)(B) – Aggregate change in ownership of an S corporation by more than 25 percent.
- (9)(i) – Dividends equivalent to redemptions under Section 302(d).
- (10)(ii)(b) – Transfer of assets by a corporation under Section 381 to the extent of boot received.
- (11)(i)(A) - Distribution of stock under Section 355, to the extent of the fair market value of the shares of the controlled corporation and the boot received.
- (12)(ii) – Reorganizations under Section 368(a)(1)(E) or transactions under Section 1036 to the extent of a decrease of proportionate interest.
- (13) – A transfer of a qualifying interest under Section 304.

(2) Inclusion events provided for under Prop. Reg. Sec. 1.1400Z2(b)-1(c) that do not reduce the 10-year hold benefit under Section 1400Z-2(c):

- (1)(ii) – A distribution to the extent it doesn't reduce relative ownership of the QOF.
- (2)(ii)(B) Distribution to 80-percent distributee when Section 337(a) doesn't apply.
- 6(iii) – Partnership distributions, to the extent the distribution doesn't reduce the relative ownership of the QOF partnership.

d) (7)(iv)(a) – Conversion of an S corporation to a partnership to the extent the conversion doesn't reduce relative ownership.

4. Suggested line edits:
End of Prop. Reg. Sec. 1.1400Z2(c)-1(b)(1)(i)

This paragraph (b)(1)(i) applies without regard to the amount of deferred gain that was included under section 1400Z-2(b)(1), or the timing of that inclusion. To the extent an inclusion event is described in paragraphs 1.1400Z2(b)-1(c)(1)(ii), (c)(2)(ii)(B), (c)(6)(ii), and (c)(7)(iv)(A) this paragraph (b)(1)(i) applies without regard to such inclusion event, or the timing of that inclusion.

After end of Prop. Reg. Sec. 1.1400Z2(c)-1(b)(2)(i)

To the extent an inclusion event is described in paragraphs 1.1400Z2(b)-1(c)(1)(ii), (c)(2)(ii)(B), (c)(6)(ii), and (c)(7)(iv)(A) this paragraph (b)(1)(ii) applies without regard to such inclusion event, or the timing of that inclusion.

Prop. Reg. Sec. 1.1400Z2(c)-1(b)(2)(ii)(A)(1)

This paragraph (b)(2)(ii)(A)(1) applies without regard to the amount of deferred gain that was included under section 1400Z-2(b)(1), or the timing of that inclusion. To the extent an inclusion event is described in paragraphs 1.1400Z2(b)-1(c)(1)(ii), (c)(2)(ii)(B), (c)(6)(ii), and (c)(7)(iv)(A) this paragraph (b)(2)(ii)(A)(1) applies without regard to such inclusion event, or the timing of that inclusion.

G. Transfer of Qualifying Interest by Reason of Death

1. Rules

a) Section 1400Z-2(e)(3) provides in the case of a decedent, amounts recognized under this section shall, if not properly includible in the gross income of the decedent, be includible in gross income as provided by Section 691.

b) Section 1014(a) generally provides that the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death.

c) Pursuant to Prop. Reg. Sec. 1.1400Z2(b)-1(c)(4)(i)(A), a transfer of a qualifying interest by reason of death to the deceased owner's estate is not an inclusion event.

2. Issue

a) Is the basis of the qualifying interest in the hands of an heir inherited before December 31, 2026 the carryover basis or fair market value less remaining deferred gain?

3. Recommendation

a) Clarify that the value of the qualifying interest in the hands of an heir inherited before December 31, 2026 is fair market value less remaining deferred gain.

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(b)-1(d)(1)(iv)

For purposes of section 1400Z-2(b)(2)(B) and 1400Z-2(c), the holding period of a qualifying investment held by a taxpayer who received that qualifying investment as a gift that was not an inclusion event, or by reason of the prior owner's death, includes the time during which that qualifying investment was held by the donor or the deceased owner, respectively. **The basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent, after December 31, 2026, shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death. The basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent, before January 1, 2027, shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death less any remaining deferred gain.**

H. Consolidated Rules

1. Rule

a) Pursuant to Prop. Reg. Sec. 1.1400Z2(g)-1(b), a QOF corporation cannot be a subsidiary member of a consolidated group and section 1400Z-2 applies separately to each member of a consolidated group. Therefore, for example, the same member of the group must both engage in the sale of a capital asset giving rise to gain and timely invest an amount equal to some or all of such gain in a QOF (as provided in section 1400Z-2(a)(1)) in order to qualify for deferral of such gain under section 1400Z-2.

2. Issues

a) Whether QOF corporations incorporated as subsidiary members of a consolidated group prior to May 1, 2019 when the second tranche of proposed regulations were released may continue to be treated as members of a consolidated group for purposes of Section 1400Z. This rule did not exist prior to the second tranche of regulations and many taxpayers, acting in good faith, moved forward with investments structured with the QOF as a subsidiary member of a consolidated group and relied upon this structure for the tax benefit which induced the investment.

b) Whether in the case where a member of a consolidated group different from the member of the group that engaged in the sale of a capital asset giving rise to gain, timely invested the amount of such gain in a QOF prior to May 1, 2019 when the second tranche of proposed regulations were officially released qualifies for deferral of such gain under section 1400Z-2.

3. Recommendations

a) Provide a grandfather clause for eligible investments in a QOF incorporated as a subsidiary member of a consolidated group and/or where a member of the consolidated group different from the member of the group that engaged in the sale of a capital asset giving rise to gain made the investment of such gain prior to June 1, 2019 (to provide a one month grace period from when the second tranche of proposed regulations were published).

(1) In the alternative, provide an exception to the inclusion rules for QOF corporations incorporated as subsidiary members of a consolidated group prior to June 1, 2019 (to provide a one month grace period from when the second tranche of proposed regulations were published) and restructured within 12 months of the effective date of the final regulations under the following two options:

(a) Option 1: QOF subsidiary-corporation contributes assets to a newly formed QOF partnership in exchange for a partnership interest under Section 721. The QOF subsidiary corporation then liquidates under Section 332 into its parent corporation.

(b) Option 2: QOF subsidiary-corporation liquidates into its parent corporation under Section 332. The parent corporation contributes the assets received from QOF subsidiary-corporation to a newly formed QOF partnership in exchange for a partnership interest under Section 721

b) Reconsider the general rule that doesn't allow a different member from the member of the consolidated group that engaged in the sale of a capital asset giving rise to gain to make the investment of such gain. The Opportunity Zones Working Group is working on a more detailed recommendation regarding the consolidated group opportunity zone rules, requesting that QOFs be allowed to be members of a consolidated group and one member of a consolidated group be allowed to invest gains in a QOF recognized from another member of the consolidated group.

II. Qualified Opportunity Fund

A. Option to Disregard Recently Contributed Property to a QOF

1. Rule

a) A QOF may choose to exclude property that meets the following three criteria from both the numerator and denominator of the 90 percent asset test. First, the property was contributed to the QOF solely in exchange for a partnership interest or stock. Second, the contribution occurred not more than six months before the test from which it is excluded. Third, between the date of the contribution and the date of the asset test, the amount was held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less.

2. Issue

a) If the QOF elects to exclude all recently contributed property in the first 6-month testing period for a newly formed QOF, both the numerator and denominator of the testing fraction would be zero resulting in an undefined mathematical result.

3. Recommendation

a) Rather than excluding recently contributed property that satisfies all the criteria from both the numerator and denominator, Treasury should provide that under this elective provision the recently contributed property is treated as QOZP in both the numerator and the denominator.

b) Treasury could also consider an additional requirement, similar to a rule provided in the context of the New Markets Tax Credit regulations, that recently contributed property is only treated as QOZP by virtue of this election to the extent that the property is invested in QOZP before the next testing date that occurs after the end of the six month period that begins upon receipt of the property by the QOF.

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(d)-1(b)(4)

A QOF may **treat as qualified opportunity zone property for purposes of** ~~**choose to determine**~~ compliance with the 90-percent asset test ~~**excluding from including in the numerator and denominator of the test**~~ any property that satisfies all the criteria in paragraphs (b)(4)(i) through (iii) of this section.

B. Debt Financed Distributions

1. Rules

a) The proposed regulations clarify that a distribution of cash by a QOF partnership to an investor generally does not trigger gain to the extent the distribution does not exceed the investor's basis in the QOF.

b) It appears that a debt financed distribution of cash within two years of receipt of a qualified investment of eligible gain in a QOF partnership will generally disqualify an investor's original transfer of eligible gain to the QOF partnership from beneficial QOZ treatment to the extent the distribution is a disguised sale taking into account modifications to Reg. Sec. 1.707-5(b) (a property contribution safe harbor relating to debt financed distributions). Modifications to this safe harbor require partners to treat any cash contributed as if it were noncash property and to disregard any basis for their share of liabilities.

2. Issues

a) Investors need confirmation that an otherwise qualified investment of eligible gain is generally disqualified to the extent of a debt financed distribution of cash within two years of making the contribution.

b) Investors need confirmation that an otherwise qualified investment of eligible gain is generally not disqualified to the extent of a debt financed distribution of cash after two years of making the contribution.

c) Investors need confirmation that guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures within two years of making the contribution do not disqualify an investment.

d) Investors need explicit examples of when a debt financed distribution would and would not be presumed to be a disguised sale under the modified rules.

3. Recommendations

a) Clarify whether an otherwise qualified investment of eligible gain is generally disqualified to the extent of a debt financed distribution of cash within two years.

b) Confirm that an otherwise qualified investment of eligible gain is generally not disqualified and therefore is generally disqualified and not an exclusion event to the extent of a debt financed distribution of cash after two years.

c) Confirm that Reg. Sec. 1.707-4 (Disguised sales of property to partnership; special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures) applies for purposes of determining if a distribution reduces a taxpayer's qualifying investment.

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(a)-1(b)(10)(ii)(A)(2)

Reductions in investments otherwise treated as contributions. To the extent any transfer of cash or other property to a partnership is not disregarded under paragraph (b)(10)(ii)(A)(1) of this section (for example, it is not treated as a disguised sale of the property transferred to the partnership under section 707), the transfer to the partnership will not be treated as a section 1400Z-2(a)(1)(A) investment to the extent the partnership makes a **debt financed** distribution to the partner **during the two year period that begins on the date of the transfer of cash or property to the partnership. To the extent a distribution by the partnership during the two year period is not treated as part of a sale under Reg. Sec. 1.707-4 (related to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures) the investment is not reduced.** ~~**and the transfer to the partnership and the distribution would be recharacterized as a disguised sale under section 707 if:**~~

~~**(i) Any cash contributed were non-cash property; and**~~

~~**(ii) In the case of a distribution by the partnership to which §1.707-5(b) (relating to debt-financed distributions) applies, the partner's share of liabilities is zero.**~~

C. Carried Interest

1. Rules

Services rendered to a QOF are not considered the making of an eligible investment. If a taxpayer receives an eligible interest in a QOF for services rendered to a QOF or to a person in which the QOF holds any direct or indirect equity interest, then the interest received by the

taxpayer in the QOF is considered as creating a mixed funds investment with separate interests for the qualifying interest and the non-qualifying interest.

a) The allocation percentages of separate QOF partnership interests are determined based on the relative capital contributions attributable to the qualifying and non-qualifying investments. In the event a partner receives a profits interest for services rendered to the QOF partnership, the allocation percentage to such partner shall be calculated with respect to the profit interest (non-qualifying interest), based on the highest share of residual profits the mixed funds partner would receive with respect to that interest. With respect to any remaining interests, the percentage interests for the capital interests is based on the relative capital contribution attributable to the qualifying investments.

2. Issue

a) It is unclear how a taxpayer holding both a qualifying investment and a non-qualifying profits interests for services in a QOF are to implement the highest share of residual profits rule.

3. Recommendations

a) Treasury should incorporate into the profits interest for services rule a cross reference to Section 1061 which defines the term "applicable partnership interest." In general, an "applicable partnership interest" is any interest in a partnership, which directly or indirectly, is transferred to the taxpayer in consideration for the performance of "substantial services" by the taxpayer or any other related person. Under Section 1061(c)(4), an applicable partnership interest does not include: (1) any interest in a partnership directly or indirectly held by a corporation; or (2) any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital based on the amount of capital contributed (at the time of the receipt of such partnership interest) or the value of such interest is subject to tax under Section 83 either upon receipt or upon vesting.

b) Treasury should clarify that the highest share of residual profits the mixed funds partner would receive with respect to "applicable partnership interest" is determined by the highest share of residual profits less a reasonable return on a partner's capital interest considering all facts and circumstances at the time of the receipt of such partnership interest.

(1) Example: In June 2019, taxpayers G and L each invest $100 in QOF P in exchange for partnership interests and each properly make an election under Section 1400Z-2(a) to defer $100 of gain. QOF P's partnership agreement provides that cash is distributed as follows:

- First, 100 percent of all cash flow to L and G until the cumulative distributions equal the original capital invested plus 8 percent per annum.
- Second, thereafter, cash flows in excess of distributions made in step 1 are distributed 40 percent to L and 60 percent to G.

In July 2030, L sells its investment in P for $200 and G sells its investment in P for $300. In allocating the selling price among G's interests, $200 applies to the capital interest and $100 applies to the profits interest.

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(b)-1(c)(6)(iv)(D)

Allocation percentages. The allocation percentages of the separate interests shall be determined based on the relative capital contributions attributable to the qualifying investment and the non-qualifying investment. In the event a partner receives a profits interest in the partnership for services rendered to or for the benefit of the partnership, the allocation percentages with respect to such partner shall be calculated based on:

(1) With respect to the profits interest received, the highest share of residual profits the mixed-funds partner would receive with respect to that interest; ~~**and**~~

(2) With respect to the remaining interest, the percentage interests for the capital interests described in the immediately preceding sentence~~.~~**,**

(3) For purposes of this paragraph (c)(6)(iv)(D), a profits interest is an "applicable partnership interest" as defined in section 1061(c).

(4) For purposes of paragraph (c)(6)(iv)(D)(1) the highest share of residual profits a partner receives with respect to the "applicable partnership interest" is determined by the highest share of residual profits less a reasonable return on any capital interests held by the partner considering all facts and circumstances at the time of the receipt of such partnership interests.

(5) Example: In June 2019, taxpayers G and L each invest $100 in QOF P in exchange for partnership interests and each properly make an election under Section 1400Z-2(a) to defer $100 of gain. QOF P's partnership agreement provides that cash is distributed as follows:

- **First, 100 percent of all cash flow to L and G until the cumulative distributions equal the original capital invested plus 8 percent per annum.**
- **Second, thereafter, cash flows in excess of distributions made in step 1 are distributed 40 percent to L and 60 percent to G.**

In July 2030, L sells its investment in P for $200 and G sells its investment in P for $300. In allocating the selling price among G's interests, $200 applies to the capital interest and $100 applies to the profits interest.

III. Qualified Opportunity Zone Business Property

A. Substantial Improvement Test – Asset-by-Asset v. Aggregate Application of Test

1. Rule

a) For purposes of determining whether tangible property is substantially improved, the regulations propose an asset-by-asset application of the test as opposed to assessing the improvement of tangible property in the aggregate. Treasury stated in the preamble to the regulations that it is still considering an aggregate basis option and requested comments regarding the advantages and disadvantages of an aggregate approach.

2. Issue

a) Under Section 1400Z-2, property is treated as substantially improved by the QOF or a QOZB only if, during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the QOF or QOZB

exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the QOF or QOZB. The term "with respect to such property" suggests that a business can meet the substantial improvement test on an aggregate basis. "With respect to" means "concerning" or to "say what something relates to". Property acquired to be used in the same trade or business as existing property relates to the existing property in that they are both concerning or related to the same trade or business. The substantial improvement requirement was designed to provide a means for existing businesses operating in opportunity zones to be able to qualify for QOF capital to expand. A narrow interpretation of the substantial improvement requirement would limit substantial improvements to merely renovating existing property on an asset by asset basis, which would severely limit the ability of existing businesses in opportunity zones to qualify for QOF incented equity capital, particularly existing operating businesses. A narrow interpretation would also create administrative difficulty in determining what qualifies as an addition to existing property as opposed to the creation of separate and distinct new property.

3. Recommendations

a) To facilitate the qualification of an existing business as a QOZB, the substantial improvement requirement may be met by a QOF or QOZB on an aggregate basis at the election of the taxpayer - where the acquisition of tangible property over any 30-month period exceeds the aggregate adjusted basis of existing tangible property held by the QOF or QOZB at the beginning of a 30- month period.

(1) Example: On January 1, 2019, QOF P invests $5 million in partnership B and partnership B purchases the assets of business A for $5 million. Business A is an existing widget manufacturing business in a QOZ. Partnership B allocated $4 million of the $5 million purchase price to various items of tangible property used to manufacture widgets. The original use of the tangible property in a QOZ did not commence with partnership B. Partnership B allocated $1 million of the purchase price to intangible property to be used in the active conduct of business A in the QOZ. QOF P plans to invest an additional $5 million in partnership B for the purchase of additional machinery and equipment to expand its production in the QOZ. The existing tangible property acquired for $4 million cannot qualify as QOZBP unless it is substantially improved by partnership B, because partnership B was not the

first to use the property in the QOZ. The acquired property is in good working order and does not need to be renovated or otherwise directly improved. If partnership B could apply the substantial improvement test on an aggregate basis, the $5 million of additional machinery and equipment purchases would allow the acquired tangible property to qualify as QOZBP.

b) Alternatively, with respect to the substantial improvement of buildings, Treasury could narrow the applicability of the aggregate basis election by adopting rules similar to former Reg. Sec. 1.167(j)-3(b)(1)(ii) which provided that in any case where two or more buildings or structures on a single tract or parcel (or contiguous tracts or parcels) of land are operated as an integrated unit (as evidenced by their actual operation, management, financing, and accounting), they may be treated as a single building for purposes of the substantial improvement requirement.

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(d)-1(c)(8)(i)

In general. Except as provided in paragraph (c)(8)(ii) of this section, for purposes of paragraph (c)(8)(i) of this section, tangible property is treated as substantially improved by a QOF only if, during any 30-month period beginning after the date of acquisition of ~~**the**~~ **tangible** property, additions to the basis of the property in the hands of the QOF exceed an amount equal to the adjusted basis of ~~**the**~~ **tangible** property at the beginning of the 30-month period in the hands of the QOF. **At the election of the taxpayer, tangible property is treated as substantially improved by a QOF only if, during any 30-month period beginning after the date of acquisition of tangible property, the sum of additions to the basis of the tangible property in the hands of the QOF and the acquisition of tangible property by the QOF exceed an amount equal to the aggregate adjusted basis of tangible property at the beginning of the 30-month period in the hands of the QOF.**

Prop. Reg. Sec. 1.1400Z2(d)-1(d)(4)(i)

In general. Except as provided in paragraph (d)(4)(ii) of this section, for purposes of paragraph (d)(2)(i)(B) of this section, tangible property is treated as substantially improved by a qualified opportunity zone business only if**,** during any 30-month period beginning after the date of acquisition of tangible property, additions to the basis of ~~**such**~~ tangible

property in the hands of the qualified opportunity zone business exceed an amount equal to the adjusted basis of ~~**such**~~ tangible property at the beginning of such 30-month period in the hands of the qualified opportunity zone business. **At the election of the taxpayer, tangible property is treated as substantially improved by a qualified opportunity zone business only if, during any 30-month period beginning after the date of acquisition of tangible property, the sum of additions to the basis of the tangible property in the hands of the qualified opportunity zone business and the acquisition of tangible property by the qualified opportunity zone business exceed an amount equal to the aggregate adjusted basis of tangible property at the beginning of such 30-month period in the hands of the qualified opportunity zone business.**

B. Improvements to Non-Qualifying Property

1. Rules

a) Section 1400Z-2(d)(2)(D)(i) defines QOZBP as tangible property purchased from an unrelated party after December 31, 2017 that either (i) has its original use in the zone commencing with the QOF or is substantially improved by the QOF within a 30-month period.

b) Prop. Reg. Sec. 1.1400Z2(d)-1(c)(7)(ii) provides that lessee improvements to leased property satisfy the original use requirement as purchased property for the amount of unadjusted cost basis of such improvements.

2. Issue

a) The regulations do not clearly provide that improvements to existing property satisfy the original use requirement as purchased property similar to lessee improvements when such improvements are made to existing property owned by a QOF or QOZB that does not qualify as QOZBP, for example, because (i) the existing property was purchased before December 31, 2017; (ii) the existing property was purchased from a related party; or (iii) the improvements to the existing property are not substantial.

3. Recommendation

a) Clarify that improvements made to nonqualified property used in a QOZ satisfy the original use requirements as purchased property similar to lessee improvements and are treated as separate property for purposes of Section 1400Z-2(d)(2)(D)(i).

(1) Example 1: A QOZB purchases land from a related party and therefore the land does not qualify as QOZBP under Section 1400Z-2(d)(2)(D)(i)(I). The QOZB improves the land by constructing a distribution center using a Section 1400Z-2(a)(1)(A) qualifying investment within a 31-month (working capital) period. At the end of the 31-month period, the distribution center is placed in service within the meaning of Section 168(i) and is used in the active conduct of a trade or business. The distribution center is considered QOZBP even though the land upon which it was built is not QOZBP.

(2) Example 2: A QOZB purchases a building used as a distribution center from a related party as defined by Section 1400Z-2(d)(2)(D)(i)(I), and therefore, the building is not considered QOZBP. The QOZB does not improve the existing distribution center but instead constructs an additional structure to the existing building to be used as a loading dock. The QOZB constructs the loading dock using a Section 1400Z-2(a)(1)(A) qualifying investment within a 31-month (working capital) period. At the end of the 31-month period, the loading dock is placed in service within the meaning of Section 168(i) and is used in the active conduct of a trade or business. The loading dock is considered QOZBP even though the distribution center to which it is attached is not QOZBP.

4. Suggested line edits:

After Prop. Reg. Sec. 1.1400Z2(d)-1(c)(7)(ii)

(iii) Improvements made by a QOF to property owned. Improvements made by a QOF to property owned by the QOF satisfy the original use requirement in section 1400Z-2(d)(2)(D)(i)(II) as purchased property for the amount of the unadjusted cost basis under section 1012 of such improvements.

We also recommend that Treasury include examples, similar to Examples 1 and 2 above, in the final regulations.

C. Substantially All of the Usage of Tangible Property

1. Rules

a) To qualify as QOZBP, substantially all of the use of QOF property must be in a QOZ. Prop. Reg. Sec. 1.1400Z2(d)-1(c)(4)(i)(D) provides that "[i]n the case of tangible property that is owned or leased by the QOF, during substantially all of the QOF's holding period for the

tangible property, substantially all of the use of the tangible property was in a qualified opportunity zone."

b) Substantially all is defined as 70 percent for determining usage of tangible property in a qualified opportunity zone. Prop. Reg. Sec. 1.1400Z2(d)-1(c)(6) provides that "[a] trade or business of an entity is treated as satisfying the substantially all requirement of paragraph (c)(4)(i)(D) of this section if at least 70 percent of the use of the tangible property is in a qualified opportunity zone."

c) Proposed regulations contain an asset aggregation 70 percent usage test. Prop. Reg. Sec. 1.1400Z2(d)-1(c)(9)(i) provides that "[w]hether a QOF has satisfied the 'substantially all' threshold set forth in paragraph (c)(6) of this section is to be determined by a fraction-- (A) The numerator of which is the total value of all qualified opportunity zone business property owned or leased by the QOF that meets the requirements in paragraph (c)(4)(i) of this section; and (B) The denominator of which is the total value of all tangible property owned or leased by the QOF, whether located inside or outside of a qualified opportunity zone."

2. Issue

In determining whether substantially all of the use of tangible property by a QOF was in the QOZ, is the test applied on an asset-by-asset basis or on an aggregate basis considering all of the tangible property owned by the QOF? The regulation appears to contain a circular reference in 1(c)(9) that includes a reference to qualified opportunity zone business property, wherein the 1(c)(9) calculation is being used by 1(c)(6) to assist in determining if the property is qualified opportunity zone business property. Paragraph 1(c)(6) appears to create a test to determine if a QOF trade or business meets a tangible property use test, as opposed to determining if property used by a QOF in a trade or business satisfies the use requirement.

3. Recommendation

For purposes of determining whether substantially all of the use of the tangible property by a QOF was in the QOZ, the determination of where tangible property was used should be determined on an asset-by-asset basis. The apparent circular reference in 1(c)(9) should be removed.

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(d)-1(c)(6)

Substantially all of the usage of tangible property by a QOF in a qualified opportunity zone. ~~**A trade or business of an entity**~~ **Tangible property** is

treated as satisfying the substantially all requirement of paragraph (c)(4)(i)(D) of this section if at least 70 percent of the use of the tangible property is in a qualified opportunity zone.

Prop. Reg. Sec. 1.1400Z2(d)-1(c)(9) as follows should be deleted.
~~**(9) Substantially all of tangible property owned or leased by a QOF—**~~

~~**(i) Tangible property owned by a QOF. Whether a QOF has satisfied the "substantially all" threshold set forth in paragraph (c)(6) of this section is to be determined by a fraction –**~~

~~**(A) The numerator of which is the total value of all qualified opportunity zone business property owned or leased by the QOF that meets the requirements in paragraph (c)(4)(i) of this section; and**~~

~~**(B) The denominator of which is the total value of all tangible property owned or leased by the QOF, whether located inside or outside of a qualified opportunity zone.**~~

D. Unimproved Land

1. Rule

a) The proposed regulations provide that the original use and substantial improvement requirements are not applicable to unimproved land. Instead, land generally is eligible to be QOZBP if it is used in a trade or business (within the meaning of Section 162) of a QOF or QOZB and purchased or leased after December 31, 2017. However, a QOF may not treat land as QOZBP if the land is unimproved or minimally improved and the QOF or the QOZB 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. The stated policy behind this rule is to avoid land banking and or the continued use of land (e.g., agrarian use) without any economic improvement.

2. Issues

a) What does it mean to improve land by more than an insubstantial amount? This requirement appears to contradict the exception to the substantial improvement rules with respect to land as anything more than insubstantial by definition is substantial.

b) Whether land can qualify as QOZBP if the land is under an existing building that is not substantially improved, and therefore not QOZBP.

3. Recommendations

a) Provide that unimproved land acquired by a QOF or QOZB does not need to be improved by more than an insubstantial amount if (i) the use of the land by the QOF or QOZB is an integral part of the trade or business of the QOF or QOZB and (2) the QOF or QOZB reasonably expects its use of the land to generate economic activity which was not reasonably expected to occur by the owner of the land prior to its purchase and use by the QOF or QOZB.

b) Provide a safe harbor whereby capital investments of at least 20 percent of the cost basis of the land within a 30-month period beginning on the date of purchase by the QOF or QOZB in a trade or business that is using the acquired land will be deemed as improving the land by "more than an insubstantial" amount.

c) Provide that land under existing buildings that are not substantially improved should be separable from the existing buildings such that if the QOF or QOZB uses or improves the land as part of its trade or business and the land otherwise meets the tests for being QOZBP, the land is QOZBP.

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(d)-1(f)

Notwithstanding the preceding sentence, a QOF may not rely on the proposed rules in paragraphs (c)(8)(ii)(B) and (d)(4)(ii)(B) of this section (which concern the qualification of land as QOZBP) if the land is unimproved or minimally improved and the QOF or the QOZB 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~~.~~ **unless the QOF or QOZB reasonably expects its purchase and use of the land in a trade or business to generate additional economic activity with respect to the land which was not reasonably expected to occur otherwise.**

(1) For purposes of this paragraph (f), "an insubstantial amount" is 20 percent which is determined by a fraction:

(i) the numerator of which is the unadjusted cost basis of improvements made to or on the land within 30 months after the date of purchase; and

(ii) the denominator of which is the unadjusted cost basis of the land at the beginning of the 30-month period in the hands of the QOF or QOZB.

(2) The following example illustrates the principles of this

paragraph (f). Example. A landscaping business purchases a vacant tract of land in a qualified opportunity zone and its officers and employees will manage the daily operations of the business within the qualified opportunity zone. The land is rightly sized to store equipment, supplies, and plants and trees held for sale, that taken together, are a material factor in the generation of income for the business. The purchase and use of the land by the trade or business is expected to generate additional economic activity with respect to the land which was not reasonably expected to occur otherwise. A QOF may rely on the proposed rules in paragraphs (c)(8)(ii)(B) and (d)(4)(ii)(B) of this section.

E. Vacant Property

1. Rule

a) The proposed regulations require property to be unused for an uninterrupted period of at least 5 years to be considered original use when acquired by the QOF or QOZB.

2. Issues

a) An uninterrupted 5-year unused or vacancy period is unnecessarily lengthy and will deter eligible investors from investing in property unused or vacant less than 5 years even when the investment would improve the QOZ as otherwise intended. Recent studies indicate that the longer a property is unused or vacant, the more significant the negative impact (such as declining property values and increased crime rate) is to the surrounding community.

b) The term unused or vacant can be read as too restrictive as many buildings are substantially unused or vacant over a period of time, but not 100 percent unused or vacant due to limited, seasonal and transitory rental activity.

3. Recommendations

a) Adopt a special rule for property unused or vacant before the designation of the tract as a QOZ, and a separate rule for property that was not unused or vacant at the time of the designation of the tract as a QOZ.

(1) As recommended by the Opportunity Zones Coalition, property unused or vacant before the designation of the tract as a QOZ, a period of at least 1 year should apply.

(2) For property that was not unused or vacant before the designation of the tract as a QOZ, define the unused or vacancy period as at least 2 years in order to encourage timely investments in more recently abandoned properties that would otherwise negatively impact other investments in the QOZ.

(a) Define the vacancy period as 1 year if the building is classified as blighted by local authorities or the building is part of a community revitalization plan as determined by a governmental authority.

b) Modify the term unused or vacant to "substantially unused or substantially vacant". Provide that a property is considered substantially unused or substantially vacant if the portion that is unused or vacant is substantial when compared to the portion that is occupied.

(1) Provide a safe harbor that states a building is considered substantially vacant if greater than 70 percent based on square footage of vacant space to square footage of a building as a whole is vacant.

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(d)-1(c)(7)(i)

(7) Original use of tangible property acquired by purchase—

(i) In general. For purposes of paragraph (c)(4)(i)(C) of this section, the original use of tangible property in a qualified opportunity zone commences on the date any person first places the property in service in the qualified opportunity zone for purposes of depreciation or amortization (or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner). **If property has been substantially unused or vacant for an uninterrupted period of at least 2 years, original use in the qualified opportunity zone commences on the date after that period when any person first so uses or places the property in service in the qualified opportunity zone.** For purposes of this paragraph (c)(7), if property has been **substantially** unused or vacant **in a census tract prior to that tract being designated as a qualified opportunity zone,** for an uninterrupted period of at least ~~5~~ **1** year~~s~~, **or**

property has been classified as blighted by local authorities or the building is part of a community revitalization plan as determined by a governmental authority and has been substantially unused or vacant for an uninterrupted period of at least 1 year, original use in the qualified opportunity zone commences on the date after that period when any person first so uses or places the property in service in the qualified opportunity zone. **For purposes of this paragraph (c)(7), a building is substantially unused or vacant if more than 70 percent of the building, measured by the square footage of useable space, has been unused or vacant.** Used tangible property satisfies the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone. If the tangible property had been so used or placed in service in the qualified opportunity zone before it is acquired by purchase, it must be substantially improved in order to satisfy the requirements of section 1400Z-2(d)(2)(D)(i)(II).

F. Original Use – Demolition of Existing Property

1. Rule

a) Section 1400Z-2(d)(2)(D)(i)(II) requires that original use of property acquired by a QOF or QOZB commence with the QOF or QOZB or that the QOF or QOZB substantially improves the property. Prop. Reg. Sec. 1.1400Z2(d)-1(c)(7)(i) clarifies that "original use" begins on the date property is placed in service in the QOZ for purposes of depreciation or amortization.

2. Issue

a) Whether a QOZB can treat a used building purchased for demolition and replacement construction as QOZBP during the period before the used building is demolished if the QOZB expects to replace the property with property expected to satisfy the requirements of QOZBP and the demolition and replacement is designated in a reasonable written schedule that meets the requirements of Prop. Reg. Sec. 1.1400Z2(d)-1(d)(5)(iv).

3. Recommendation

a) Treasury should provide that property that is demolished pursuant to the development of a trade or business in a qualified opportunity zone (as defined in Section 1400Z–1(a)), including when appropriate the acquisition, construction, and/or substantial improvement of tangible property in such a zone, is QOZBP during the period before the property is demolished, if the demolition is pursuant to a reasonable written schedule that meets the requirements of Prop.

Reg. Sec. 1.1400Z2(d)-1(d)(5)(iv).

4. Suggested line edits:

Amend Prop. Reg. Sec. 1.1400Z2(d)-1(d)(5) by adding new subparagraph (ix), and renumbering current (ix) to (x), to read as follows:

(ix) Safe harbor for property purchased for demolition and replacement. If paragraph (d)(5)(iv) of this section treats some financial property as being a reasonable amount of working capital because of compliance with the three requirements of paragraph (d)(5)(iv)(A) through (C) and if some of the tangible property referred to in paragraph (d)(5)(iv)(A) is designated to be discarded or demolished and replaced with tangible property referred to in paragraph (d)(5)(iv)(A) having a value of not less than the tangible property discarded or demolished and the replacement property satisfies the requirements of section 1400Z2(d)(2)(D)(1) as a result of the planned expenditure of those working capital assets, then the tangible property that is discarded or demolished is not treated as failing to qualify as QOZBP solely because the property is discarded or demolished. The following example demonstrates the principle in the preceding sentence:

(a) Facts. QOF F creates a business entity E to construct and lease commercial real estate and acquires almost all of the equity of E in exchange for cash. E purchases land and an occupied building that E intends to demolish and replace with a newly constructed building over 31 months. Demolition and replacement construction is expected to commence in 6 months after the existing tenants' leases expire. E has a written plan and a 31-month schedule illustrating the planned uses of cash which includes demolition and replacement of the existing building. E's assets were expended in a manner consistent with the plan and schedule.

(b) Analysis. The existing building is not treated as failing to qualify as QOZBP solely because the property is discarded or demolished.

G. Inventory In-Transit

1. Rule

a) The proposed regulations clarify that inventory (including raw materials) of a trade or business does not fail to be used in a QOZ solely because the inventory is in transit from a vendor to a facility of the trade or business that is in a QOZ, or from a facility of the trade or business that is in a QOZ to customers of the trade or business that are not

located in a QOZ.

2. Issue

a) Inventory (including raw materials in storage outside of a QOZ) is a non-qualified asset potentially disqualifying some manufacturers who store raw materials off-site due to capacity constraints or store finished inventory off-sight to be more accessible (shorter delivery times) to their customer base.

3. Recommendation

a) Permit taxpayers an annual election to exclude raw materials and finished inventory from the numerator and denominator of the 70 percent use of tangible property test and the 90 percent investment standard test for QOF direct investments in QOZBP.

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(d)-1(c)(4)(iii)

Safe harbor for inventory in transit. In determining whether tangible property is used in a qualified opportunity zone for purposes of section 1400Z-2(d)(2)(D)(i)(III), and of paragraphs (c)(4)(i)(D), (c)(6), (d)(2)(i)(D), and (d)(2)(iv) of this section, inventory (including raw materials) of a trade or business does not fail to be used in a qualified opportunity zone solely because the inventory is in transit--

(a) From a vendor to a facility of the trade or business that is in a qualified opportunity zone; or

(b) From a facility of the trade or business that is in a qualified opportunity zone to customers of the trade or business that are not located in a qualified opportunity zone.

A QOF may choose to determine compliance with the 90-percent asset test pursuant to section 1400Z-2(d)(1) and a QOZB may choose to determine compliance with the substantially all test pursuant to section 1400Z-2(d)(3)(A)(i) by excluding from both the numerator and denominator of the test fraction, inventory (including raw materials). A QOF or a QOZB need not be consistent from one semi-annual test to another in whether it avails itself of this option.

H. Self-Constructed Property

1. Rule

a) To qualify as QOZBP, property must generally be acquired by purchase (as defined in Section 179(d)(2)).

2. Issue

a) It is unclear the extent to which self-constructed property satisfied the purchase requirement.

3. Recommendation

a) Adopt a rule for self-constructed property that provides that "property manufactured, constructed, or produced for use by a taxpayer in its trade or business is considered to be acquired by purchase as the taxpayer manufactures, constructs, or produces the property."

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(d)-1(c)(4)

In general. Tangible property used in a trade or business of a QOF is qualified opportunity zone business property for purposes of paragraph (c)(1)(iii) of this section if the requirements of paragraphs (c)(4)(i)(A) through (~~E~~**EH**) of this section, as applicable, are satisfied.

(F) In the case of tangible property manufactured, constructed, or produced by a QOF, the property is manufactured, constructed, or produced for use by a QOF or QOZB with the intent to use such property in a trade or business in a qualified opportunity zone.

Prop. Reg. Sec. 1.1400Z2(d)-1(d)(2)(i)

(F) In the case of tangible property manufactured, constructed, or produced by a QOZB, the property is manufactured, constructed, or produced for use by a QOF or QOZB with the intent to use such property in a trade or business in a qualified opportunity zone.

I. Related Party Fees

1. Rules

a) The definition of QOZBP as articulated in Section 1400Z-2(d)(2)(D)(i) includes a requirement that tangible property be acquired by the QOF from an unrelated party referencing the Section 179(d) definition of purchase (substituting 20 percent for 50 percent).

b) The proposed regulations require that buildings purchased by a QOF and located on land wholly within a QOZ be substantially improved as measured by the QOF's additions to the adjusted basis of the building. For a building purchased by a QOZB which is located wholly within a QOZ, substantial improvement to the tangible property is measured by the QOZB's additions to the adjusted basis of the building.

2. Issues

a) Whether capitalized fees paid to a related party for services with

respect to the development or redevelopment of tangible property,

(1) are considered an addition to adjusted basis for purposes of measuring the substantial improvement of property,

(2) cause the property to fail to qualify as QOZBP, or

(3) qualify as QOZBP.

3. Recommendation

a) Clarify that reasonable capitalized fees paid to a related party with respect to the development or redevelopment of tangible property,

(1) are considered an addition to adjusted basis for purposes of measuring the substantial improvement of property,

(2) do not cause the property to fail to qualify as QOZBP, and

(3) qualify as QOZBP to the extent the tangible property the fees are paid "with respect to" is QOZBP.

4. Suggested line edits:

Add the following subparagraph (G) to Prop. Reg. Sec. 1400Z2(d)-1(c)(4)

(G) Exception for reasonable related party expenditures. For purposes of paragraph (d)(1)(c)(4)(A), reasonable expenditures paid by a QOF to a related party for services that are properly includible in computing the basis of property under the taxpayer's method of accounting are not treated as failing the purchase requirements under 179(d)(2).

Add the following subparagraph (G) to Prop. Reg. Sec. 1.1400Z2(d)-1(d)(2)(i)

(G) Exception for reasonable related party expenditures. For purposes of paragraph (d)(1)(d)(2)(i)(A), reasonable expenditures paid by a QOF to a related party for services that are properly includible in computing the basis of property under the taxpayer's method of accounting are not treated as failing the purchase requirements under 179(d)(2).

J. Real Property Straddling a QOZ

1. Rules

a) For real property straddling a QOZ, the first sentence of Prop. Reg. Sec. 1.1400Z2(d)-1(d)(5)(viii) adopts Section 1397C(f) "for purposes of satisfying the requirements in this paragraph (d)(5)". Paragraph (d)(5) incorporates by reference the rules of Section 1397C for determining whether a trade or business is operating in a zone.

b) Section 1397C(f) provides rules for the treatment of businesses straddling enterprise zone census tracts, which is applied by reference to QOZBs straddling QOZ census tracts.

c) The second sentence of Prop. Reg. Sec. 1.1400Z2(d)-1(d)(5)(viii) provides: "If the amount of real property based on square footage located within the qualified opportunity zone is substantial as compared to the amount of real property based on square footage outside of the qualified opportunity zone, and the real property outside of the qualified opportunity zone is contiguous to part or all of the real property located inside the qualified opportunity zone, then all of the property is deemed to be located within a qualified opportunity zone."

2. Issues

a) Whether the rule for real property straddling a QOZ applies for purposes of determining QOZBP broadly or whether the straddling rule is limited to the Section 1397C tests incorporated by reference. More specifically, whether the "for purposes of satisfying the requirements in this paragraph (d)(5)" limitation contained in the first sentence of Prop. Reg. Sec. 1.1400Z2(d)-1(d)(5)(viii), applies to limit the application of the second sentence.

b) Language contained in the preamble to the proposed regulations conflicts with language provided in the proposed regulations. The preamble states:

> *"Real 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."*

However, the language in the proposed regulations provides:

> *"If the amount of real property based on square footage located within the qualified opportunity zone is substantial as compared to the amount of real property based on square footage outside of the qualified opportunity zone, and the real property outside of the qualified opportunity zone is contiguous to part or all of the real property located inside the qualified opportunity zone, then all of the property is deemed to be located within a qualified opportunity zone."*

3. Recommendations

a) The rule for real property straddling a QOZ should apply for purposes of determining QOZBP broadly, and not be limited to the Section 1397C(f) tests incorporated by reference.

b) Confirm that the language in the preamble is in error, and the language provide in the regulation is controlling. The determination of what is considered "substantial" should be based on the same form of measurement that is used in the regulation for comparing what portion of the real property is inside a qualified opportunity zone and what portion is outside the qualified opportunity zone.

4. Suggested lined edits:

The following paragraph with suggested line edits should be added to Prop. Reg. Sec. 1400Z2(d -1(c)(4) and Prop. Reg. Sec. 1400Z2(d)-1(d)(2)(i) and Prop. Reg. Sec. 1400Z2(d) -1(d)(5)(viii) should be deleted.

Real property straddling a qualified opportunity zone. For purposes of satisfying the requirements in this paragraph (d)(5) **and all other purposes of section 1400Z-2**, when it is necessary to determine whether a qualified opportunity zone is the location of services, tangible property, business functions, section 1397C(f) applies (substituting "qualified opportunity zone" for "empowerment zone"). If the amount of real property based on square footage located within the qualified opportunity zone is substantial as compared to the amount of real property based on square footage outside of the qualified opportunity zone, and the real property outside of the qualified opportunity zone is contiguous to part or all of the real property located inside the qualified opportunity zone, then all of the property is deemed to be located within a qualified opportunity zone **for all purposes of section 1400Z-2. Real property located within the qualified opportunity zone is considered substantial if the amount of real property based on square footage inside a qualified opportunity zone is greater than the amount of real property based on square footage outside of the qualified opportunity zone.**

IV. Qualified Opportunity Zone Business

A. Qualified Opportunity Zone Business in the Zone

1. Rule

a) A QOZB means a trade or business (i) in which substantially all of the tangible property owned or leased by the taxpayer is QOZBP, which satisfies the requirements of Section 1397C(b)(2), (4), and (8). The

proposed regulations contain numerous references to a trade or business "in ***the*** qualified opportunity zone" (emphasis added).

2. Issue

a) Whether various references to "the" qualified opportunity zone mean various OZ requirements must be satisfied within one QOZ or, in the alternative, various requirements are applied by including all the QOZs in which property is used in a trade or business.

3. Recommendation

a) Clarify that various references to "the" opportunity zone is to be read as one or more opportunity zones.

4. Suggested line edits:

At the end of Prop. Reg. Sec. 1.1400Z2(a)-1(a)

For purposes of regulations under section 1400Z-2 references to "a" "an" or "the" qualified opportunity zone includes one or more qualified opportunity zones.

B. Grace Period for Businesses to Become Qualified

1. Rules

a) To be 'qualified opportunity zone business property', tangible property must be used in a trade or business of a QOF.

b) Section 1400Z-2(d)(2)(B)(i)(III) and (C)(ii) provide that to qualify as QOZP, stock or a partnership interest must be in a corporation or partnership that is a QOZB at the time of acquisition or "such (corporation or partnership) was being organized for purposes of being a qualified opportunity zone business". This language acknowledges that a start-up period is anticipated. The regulations address the use of working capital within a 31-month period but not whether the QOZB must also use its tangible property in a trade or business in the QOZ during that 31-month period or any other period. The second tranche of regulations expands the working capital safe harbor to include the development of a trade or business but does not clarify the result if the QOZB is not using the tangible property in the zone by the end of the 31-month period.

c) The regulations state that "[a] business may benefit from multiple overlapping or sequential applications of the working capital safe harbor, provided that each application independently satisfies all of the requirements" articulated in the regulations. The example provided in the proposed regulations (Example 2) demonstrates the use of successive working capital periods with respect to separate plans by the same business. The first working capital period is for an investment dedicated

to the development of new technology. The second working capital period is for an investment dedicated to a separate software application.

2. Issues

a) Whether a QOF or QOZB is permitted a grace period to use tangible property in a trade or business to qualify as QOZBP.

b) Whether a QOZB receiving serial capital contributions under a common written plan must use 70 percent of its tangible property within 31 months of the first capital contribution, or, in the alternative, must use cash equal to the first capital contribution within 31 months, but is not required to use its tangible property in the QOZ by the end of the 31-month period associated with the first capital contribution. For example, if in January 2019 a QOF contributes cash to a QOZB to develop real property pursuant to a written plan and an ordinary start-up period is 36 months to use the developed property in the QOZ and in January 2020 the QOF contributes additional cash pursuant to the same plan to continue developing the same property, does the first capital contribution continue to qualify under the working capital safe harbor for the 31-month period attributable to the second safe harbor?

c) Whether a QOZB that ceases to be qualified has a grace period to requalify.

3. Recommendations

a) Provide that a QOZB which uses a contribution of working capital within its applicable 31-month period, but does not use tangible property in a trade or business in the QOZ by the end of the 31-month period, continues to receive the benefit of the working capital and related safe harbors as long as the QOZB diligently and reasonably continues to develop the trade or business, and uses tangible property in a trade or business in the QOZ within a reasonable period of time based on the facts and circumstances.

(1) Alternatively, provide a 12-month grace period for a QOF to use tangible property in a trade or business, with such grace period beginning no earlier than after a 31-month period to acquire, construct and/or improve tangible property or develop a trade or business. As an additional alternative, Treasury could provide that the activity of developing a QOZB is a trade or business whether or not the trade or business has begun.

b) Provide that if a QOZB receives serial capital contributions under a common written plan, the QOZB is not required to use 70 percent of its tangible property in the QOZ within 31-months of the first capital

contribution, rather, the QOZB must use cash equal to the first capital contribution within 31 months, but is not required to use 70 percent of its tangible property in the QOZ by the end of the 31-month period associated with the first capital contribution.

c) Provide that if a previously qualified business becomes unqualified during a QOF's holding period, the QOZB has 12 months from the time the failure to qualify is identified by the QOF, or reasonably should have been, to become a qualified business. Under this cure period, a previously qualified business would be treated as qualified if the business becomes qualified within 12 months. This is similar to the cure period provided under the New Markets Tax Credit incentive for failure to satisfy the substantially-all test.

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(d)-1(d)(5)(vii)

Safe harbor for property on which working capital is being expended. If paragraph (d)(5)(iv) of this section treats some financial property as being a reasonable amount of working capital because of compliance with the three requirements of paragraph (d)(5)(iv)(A)-(C) and if the tangible property referred to in paragraph (d)(5)(iv)(A) is expected to satisfy the requirements of section 1400Z2(d)(2)(D)(1) as a result of the planned expenditure of those working capital assets, then that tangible property is not treated as failing to satisfy those requirements ~~**solely**~~ because the scheduled consumption of the working capital is not yet complete **and, once the scheduled consumption of working capital is complete, because the tangible property is not used in a trade or business before the end of the 12 months beginning on the date the consumption of the last sequential application of working capital pursuant to paragraph (d)(5)(iv)(D) is complete.**

Add Prop. Reg. Sec. 1.1400Z2(d)-1(d)(7) to provide:

If a previously qualified opportunity zone business becomes unqualified during a QOF's holding period, the business has 12 months from the time the failure to qualify is identified by the QOF, or reasonably should have been, to become a QOZB. Under this cure period, a previously qualifying QOZB is treated as qualified during the period it doesn't qualify if the business becomes a QOZB within 12 months from the date the failure to qualify is identified by the QOF, or reasonably should have been.

C. Property that a QOF Leases

1. Rule

   a) To qualify as QOZBP, the terms of the lease of property by a QOF or QOZB are required to be market rate (that is, the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity zone as determined under Section 482 and all Section 482 regulations in this chapter) at the time that the lease was entered into.

2. Issues

   a) The purpose of Section 482 is to require that compensation for any intercompany transaction conform to the level that would have applied had the transaction taken place between unrelated parties, all other factors remaining the same. Although the principle can be simply stated, the actual determination of arm's-length compensation is notoriously difficult. Imposing this standard on leases between unrelated parties (where the lease is generally presumed to be arm's length) will cause undue administrative burden and cost for QOFs and QOZBs and may obstruct investment.

   b) We note that it is common practice for local governments to negotiate below-market leasing arrangements with unrelated third parties in order to attract new business and induce new development. Local governments offer these incentives because they benefit from increased investment in the community (similar to the opportunity zones incentive). Excluding property leased under negotiated discounted terms will reduce the bargaining power of local governments seeking to attract new business and new development to QOZ.

3. Recommendation

   a) The final regulations should limit the requirement for leases to be arm's length to leasing arrangements between related parties. Leasing arrangements between unrelated parties should generally be presumed to be negotiated under arms-length terms.

4. Suggested line edits:

   Prop. Reg. Sec. 1.1400Z2(d)-1(c)(4)

   (B) In the case of property that the QOF leases--

   (1) Qualifying acquisition of possession. The property was acquired by the QOF under a lease entered into after December 31, 2017;

~~**(2) Arms-length terms. The terms of the lease were market rate (that is, the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity zone as determined under section 482 and all section 482 regulations in this chapter) at the time that the lease was entered into; and**~~

(~~3~~**2**) Additional requirements for leases from a related person. If the lessee and the lessor are related parties, paragraph (c)(4)(i)(B)**(3),** (4) and (5) of this section must be satisfied.

(3) Arms-length terms. The terms of the lease were market rate (that is, the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity zone as determined under section 482 and all section 482 regulations in this chapter) at the time that the lease was entered into;

D. Intangible Property

1. Rules

a) The proposed regulations provide that, for purposes of determining whether a substantial portion of the intangible property of a QOZB is used in the active conduct of a trade or business, the term "substantial portion" means at least 40 percent.

b) We note that the proposed regulations contain QOZB compliant working capital examples that contemplate the development inside a QOZ of intangible property (software development) for use outside a QOZ.

2. Issues

a) What constitutes the "use" of intangible property in the active conduct of a trade or business?

b) How does a business measure the percentage of use in the active conduct of a trade or business?

c) How does a business determine when intangible property is being used in a QOZ?

3. Recommendations

a) Intangible property may be used directly by a trade or business to facilitate the provision of services or sale or lease of tangible property to customers (direct use intangible property). A trade or business may also sell or lease intangible property to customers (indirect use intangible property). For direct use intangible property, a general rule should provide the meaning of the phrase "used in the active conduct of a trade or business" to mean - the commercial use of intangible property for the management, development, manufacturing, and sale or lease of goods and/or services to generate gross income. For indirect use intangible property, a safe harbor should provide that intangibles developed for sale or lease are "used in the active conduct of a trade or business" if a substantial amount (40 percent) of the services and property to develop the indirect use intangibles are conducted by the trade or business.

b) Treasury should provide that the portion of intangible property used in the active conduct of a business is determined based upon the portion of gross income generated by the direct and/or indirect use of intangible property in the active conduct of a trade or business over total gross income from the use of direct and/or indirect intangible property.

c) Determining where Direct and Indirect Intangible Property is Used

(1) Treasury should provide that the situs of where a business's direct use intangible property is used in the active conduct of a trade or business is consistent with where a business's tangible property is used in the active conduct of a trade or business. Determining where a business's direct use of intangible property is being used can be complex and time consuming for operating businesses. Different factors for determining where intangible property is used (such as where an entity uses its tangible property; where an entity's employees perform services; and where a business's customers are located) can be weighted differently by different taxpayers and is likely to lead to uncertainty. Given these complications, the absence of an objective standard for determining the situs of where direct use intangible property is used would likely diminish the ability of the OZ incentive to spur operating businesses. Accordingly, Treasury should adopt an objective standard for determining where direct use intangible property is being used in the active conduct of a trade or business based upon a single factor of where a business's

tangible property is being used. If 50 percent of a business's tangible property is being used in the opportunity zone then 50 percent of the business's direct use intangible property is used in the opportunity zone. Using a tangible property standard for determining the situs where direct use intangible property is being used in an active trade or business is consistent with the statute's QOZBP requirements.

(2) Treasury should provide that the situs of where a business's indirect use intangible property is used in the active conduct of a trade or business is consistent with where the services and property used to develop the indirect use intangible property is located.

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

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(d)-1(d)(5)(ii)(A)

In general. Section 1400Z-2(d)(3) incorporates section 1397C(b)(4), requiring that, with respect to any taxable year, a substantial portion of the intangible property of an opportunity zone business is used in the active conduct of a trade or business in the qualified opportunity zone. For purposes of section 1400Z-2(d)(3)(ii) and the preceding sentence, the term substantial portion means at least 40 percent.

(1) Direct use of intangible property in the active conduct of a trade or business. Intangible property used directly by a trade or business to facilitate the provision of services or sale or lease of tangible property to customers (direct use intangible property) is treated as used in the active conduct of a trade or business if it is used for the management, development, manufacturing, and sale or lease of goods and/or services to generate gross income.

(2) Indirect use of intangible property in the active conduct of a trade or business. Intangible property developed for sale or lease to customers (indirect use of intangible property) is treated as used in the active conduct of a trade or business if a substantial amount (40 percent) of the services and property to develop the indirect use intangibles are conducted by the trade or business.

(3) Measuring the portion of intangible property used. The portion of intangible property used in the active conduct of a business is determined based upon the portion of gross income generated by the direct and/or indirect use of intangible property in the active conduct of a trade or business as defined in this section (d)(5)(ii)(1) and (2) over total gross income from the use of direct and/or indirect intangible property.

(4) Determining where direct use intangible property is used. A business's direct use of intangible property is treated as being used in a qualified opportunity zone if at least 50 percent of a business's tangible property is being used in the opportunity zone.

(5) Determining where indirect use intangible property is used. The portion of a business's indirect use intangible property treated as being used in a qualified opportunity zone is equal to the portion of the business's tangible property and services necessary to develop indirect use intangible property located in a qualified opportunity zone.

E. Working Capital Safe Harbor

1. Rules

a) The regulations expand the working capital safe harbor to include the development of a trade or business in the QOZ, thus extending the safe harbor to operating businesses.

b) The regulations clarify that a QOZB that needs more than 31 months to comply with the written plan does not lose the benefit of the safe harbor if the delay is attributable to waiting for government action the application for which is completed during the 31-month period. The regulations do not explicitly state that delays in government action are the only allowed exception for failure to comply with a 31-month plan.

2. Issues

   a) The regulations do not explicitly provide relief for non-governmental delays.

   b) There is confusion whether a business that plans to serially-draw capital from investors and/or lenders and therefore holds an insufficient amount of working capital reserves to cover planned expenditures, also has a 31-month grace period to become a QOZB. Specifically, commentators have questioned whether a business with working capital assets that are less than the planned QOZBP expenditures can treat all planned QOZBP expenditures (designated in writing) as satisfying QOZBP requirements for the 31-month period.

3. Recommendations

   a) Provide that certain disruptions, that are beyond a business's control, to the business's continuous efforts to use working capital within the 31-month period substantially consistent with its written plan will not cause the business to lose the benefits of the working capital safe harbor. In such circumstances, qualification under the working capital safe harbor will be determined based on the relevant facts and circumstances. This is similar to relief provided for business disruptions under Notice 2018-59 concerning the beginning and continuous construction requirements for energy property. Non-governmental delays should include a force majeure, such as acts of nature, economic forces, etc.

   b) The final regulations should clarify that if planned QOZBP expenditures are included in the designation and written schedule of planned expenditures then the planned expenditures can be treated as satisfying QOZBP requirements for 31 months even though the planned expenditure of working capital assets, additional calls for equity contributions, or planned draws on debt financing facilities are not complete.

4. Suggested line edits:

   Prop. Reg. Sec. 1.1400Z2(d)-1(d)(5)(iv)(C)
   Property consumption consistent. The working capital assets are actually used in a manner that is substantially consistent with paragraphs (d)(5)(iv)(A) and (B) of this section. If consumption of the working capital assets is delayed **due to unforeseen disruptions beyond the control of the QOZB such as severe weather conditions, natural disasters, labor stoppages, financing delays, supply shortages, or** ~~by~~ waiting for governmental action the application for which is complete, that delay does not cause a failure of this paragraph (d)(5)(iv)(C).

Prop. Reg. Sec. 1.1400Z2(d)-1(d)(5)(vii)

Safe harbor for property on which working capital is being expended. If paragraph (d)(5)(iv) of this section treats some financial property as being a reasonable amount of working capital because of compliance with the three requirements of paragraph (d)(5)(iv)(A) through (C) and if the tangible property referred to in paragraph (d)(5)(iv)(A) is expected to satisfy the requirements of section 1400Z2(d)(2)(D)(1) as a result of the planned expenditure of those working capital assets, then that tangible property is not treated as failing to satisfy those requirements solely because the scheduled consumption of the working capital **and other sources of capital designated in paragraph (d)(5)(iv)(A)** is not yet complete.

F. Leases to "Sin Businesses"

1. Rule

a) An identified list of "sin businesses" do not qualify as QOZBs.

2. Issue

a) A sin business may be an eligible lessee under the proposed regulations.

3. Recommendation

a) As recommended by the OZ Coalition, provide that the definition of a QOZB excludes businesses that lease more than a de minimis amount (e.g., more than 5 percent) of their property to a "sin business." We note that Treasury adopted a similar limitation under the NMTC incentive.

4. Suggested line edits:

Prop. Reg. Sec. 1.1400Z2(d)-1(d)(6)

Trade or businesses described in section 144(c)(6)(B) not eligible.

Pursuant to section 1400Z-2(d)(3)(A)(iii), the following trades or businesses **and businesses leasing more than a de minimis amount of property to the following trades or businesses** described in section 144(c)(6)(B) cannot qualify as a qualified opportunity zone business. **For purposes of this paragraph (d)(6), a de minimis amount means more than 5 percent based upon net rentable square feet for real property and based upon value for all other tangible property.**

V. Applicability

A. Applicability Dates

1. Rule

a) The preamble to the regulations provide that the proposed

regulations regarding the 10-year basis adjustment in Prop. Reg. Sec. 1.1400Z2(c)-1 do not apply until January 1, 2028.

2. Issue

   a) Not finalizing the rules regarding the 10-year basis adjustment regulations now creates uncertainty for investors who would like to be able to rely upon the rules in Prop. Reg. Sec. 1.1400Z2(c)-1 to determine their ability to receive the ten year hold OZ investment benefits.

3. Recommendation

   a) Permit investors and QOFs the ability to rely on the rules in Prop. Reg. Sec. 1.1400Z2(c)-1. Provide that any adjustments or changes to the current rules only apply to QOF investments made after the adjustments or changes are released in future regulations, unless existing investors or QOFs choose to apply the adjusted or changed regulations.