HISTORIC
TAX CREDIT
COALITION

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Room 5203
Internal Revenue Service
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Attention: Erika C. Reigle of the Office of Associate Chief Counsel (Income Tax and Accounting), Kyle C. Griffin of the Office of Associate Chief Counsel (Income Tax and Accounting), Regina L. Johnson

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and uploaded to the Federal Rulemaking Portal at https://www.regulations.gov/comment?D=IRS-2018-0029-0001

RE: Comments to the Proposed Regulations under Section 1400Z-2 of the Internal Revenue Code

Ladies and Gentlemen:

We are writing with regard to the recently Proposed Regulations (the "Proposed Regulations") under Section 1400Z-2 of the Internal Revenue Code of 1986, as amended (the "Code"), in our capacities as chair and vice chair of The Historic Tax Credit Coalition (the "HTCC"). The HTCC is a national nonprofit organization comprised of a variety of stakeholders that recognize the importance of the federal historic rehabilitation tax credit ("HTC") provided by Section 47 of the Code, including architects, developers, preservation consultants, syndicators, investors, lawyers and accountants. In addition to ensuring the future of the HTC, coalition members advocate for important improvements that would make the credit a more efficient and effective means of financing the rehabilitation of historic and older buildings.

As may you know, while tax reform modified the HTC, in the Tax Cuts and Jobs Act of 2017, the same legislation that created the Opportunity Zone incentive, Congress once again decided that the tax code should contain incentives for rehabilitating historic structures nationwide. The HTC does just that, spurring revitalization from urban

downtowns to small-town Main Streets to rural America. The HTC is inherently a very flexible credit. It can be used to finance a building that will host almost any business type. Very common uses include housing, retail and other commercial goods and services, community service providers, small businesses, and other uses that provide shelter, jobs, accommodation, and goods and services for low-income areas and underserved communities.

Through Fiscal Year 2017, the HTC has created more than 2.54 million good-paying local jobs, leveraged $131.8 billion in private investment in our communities, used $25.2 billion in tax credits to generate more than $29.8 billion in federal tax revenue, and preserved more than 43,328 buildings that form the historic fabric of our nation.[1] The credit is used in both larger urban areas and smaller towns. The HTC also works effectively with other economic development incentives and is frequently paired with the New Markets Tax Credit or the Low-Income Housing Tax Credit. The HTC is also a powerful investment for rehabilitation in our nation's most challenged communities. In FY2017, 79% of HTC projects nationwide were in low-income or high poverty census tracts.[2]

We want to begin by applauding the significant and substantial effort made by the Internal Revenue Service and the Department of the Treasury in producing the Proposed Regulations. We believe that the Proposed Regulations represent an excellent effort at facilitating the implementation of the Opportunity Zone incentive provided in Section 1400Z-2. What follows are our suggestions for clarification or interpretation that we believe would build on this outstanding start, especially to enable it to pair effectively with long-standing incentives like the HTC.

Recommendations

Active Trade or Business.

As you know, the statute and Proposed Regulations contemplate two basic structures for projects in Opportunity Zones, projects which are directly owned by a Qualified Opportunity Fund ("Opportunity Fund"), and projects which are indirectly owned, i.e., owned by a partnership or corporation ("Subsidiary Entity") in which the Opportunity Fund invests.

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[2] https://www.nps.gov/tps/tax-incentives/taxdocs/tax-incentives-2017annual.pdf

[2] Ibid.

When property is directly owned, the relevant Opportunity Zone term is "qualified opportunity zone business property," and Section 1400Z-2(d)(2)(D)(i), defines that term, in part, by reference to "*property used in a trade or business*." When property is indirectly owned, the relevant opportunity zone term is "qualified opportunity zone business," and Section 1400Z-2(d)(3)(A), and by reference, Section 1397C(b)(2), define that term, in part, by reference to a requirement that "*at least 50 percent of the total gross income of such entity is derived from the active conduct of such business*."

A common structure of HTC transactions is the "lease pass through," in which one entity, ("Landlord"), owns a building that is being rehabilitated, and then passes the HTC to a tenant entity ("Master Tenant") pursuant to Section 50(d)(5) of the Code. In such a transaction, the Landlord typically acquires the property, obtains permits and approvals, assembles the development team and funds required to rehabilitate the property, and undertakes all of the rehabilitation work until it places the rehabilitated structure in service. It then leases the building to the Master Tenant, which either uses the building itself, or, in turn, subleases the property to others, from whom it collects rent.

The Opportunity Zone incentive should be expected to enable the Landlord to access investments from Opportunity Funds, which would be important to provide funds so that the rehabilitation could be completed. Of course, as noted above, the Landlord will become a lessor of the property pursuant to the terms of Section 50(d) once it concludes its development activities. This raises the concern of whether (A) leasing is considered to be (A) an "*active* trade or business," so that a Subsidiary Entity (such as the "Landlord" entity described here) might own the building, or (B) leasing is simply a "trade or business," requiring that an Opportunity Fund directly own the building in order to qualify for the incentives associated with Opportunity Zones. Of course, this concern arises even in traditional leasing activities that are not associated with the HTC. In addition, if the Landlord's activities are not considered an active trade or business, then it is presumably ineligible for the 31-month safe harbor for rehabilitation of used properties provided by the Proposed Regulations.

We recommend that the regulations provide clarity that the lease structure provided in Section 50(d) of the Code does not disqualify the project from being considered an "active" trade or business. The concept of an "active" trade or business appears in several places in the Code and regulations. The similar new markets tax credit provisions (Section 45D of the Code) apply an active conduct test in Section 45D(2)(A)(i), which is nearly identical to the active conduct test of Section 1397C(b)(2) incorporated into the definition

of "qualified opportunity zone business" by Section 1400Z-2(d)(3)(A)(ii), and relevant here. While there are additional provisions in Section 45D and the applicable regulations which interpret and modify the definition of "qualified active low-income community business," the Section 45D rules fundamentally provide that a trade or business is considered active if the entity reasonably expects that the business will generate revenues within 3 years after the date that the investment is made. Of course, there are favorable and contrary provisions as well; the passive activity rules of Section 465 generally treat leasing as passive, while the foreign tax credit regulations indicate that hiring others to manage rental property is not active, implying that self-management ***is*** active.

Consistent with the objective of the Opportunity Zone incentive, we recommend that the regulations adopt a rule similar to the one of Section 45D which is another tax provision intended to provide investment capital for low-income communities, i.e., that the expectation of generating revenue within 3 years constitutes an active trade or business. Alternatively, we recommend a rule in which projects which will be leased to others who are expected to use them in an active trade or business (such as leasing or subleasing to residential or commercial tenants) should be sufficient.

Finally, as discussed below, we suggest that the 3-year rule we contemplate here might be extended for phased rehabilitations, as discussed below.

<u>The 31-month Safe Harbor.</u>

We applaud the provision in the Proposed Regulations which treats a project that is constructed or rehabilitated in substantial compliance with a 31-month written plan as generally complying with the requirements to be engaged in an active trade or business, and treats funds held pursuant to that plan as not being non-qualified financial property.

We offer five suggestions:

1. Treatment of Income From Consistent Activities. Many rehabilitations are done "in place," with the building or project generating income from tenants, even as the rehabilitation is being completed. This is sometimes referred to as a "rolling rehabilitation" and is particularly helpful for large projects where one floor or section of the building is typically rehabilitated at a time. The Proposed Regulations treat the cash investments made by the owner as eligible to be characterized favorably. We suggest that the example at Section 1.1400Z-2(d)-1(d)(5)(viii)(B)(2) make clear that income generated by the operation of a building that is located in an opportunity zone, and which reasonably expects to be qualified property when the rehabilitation is completed, is also counted in computing the active trade or business test.

2. Phased Rehabilitations. Section 47(c)(1)(B)(ii) contemplates rehabilitations that are eligible for the HTC even though they will be completed in phases that could take 60 months (as opposed to the more common 24-month rule), provided there are plans and specifications for such a phased rehabilitation. We recommend that the safe harbor include a 60-month safe harbor where the taxpayer has such plans and specifications, recognizing that the rehabilitation will still have to pass the 30-month test that the Opportunity Zone rules require by statute. Similarly, as noted above, we recommend that the Proposed Regulations consider a reasonable expectation of revenue after 60 months (as opposed to 3 years) be treated as an active trade or business where the 60-month rule applies to a project.

3. Delays. The Proposed Regulations do not address the consequences of delays that are beyond the control of the business. We recommend that there should be permitted exceptions. We observe that there is precedent in the somewhat similar safe harbor that applies to the "begun construction" test that applies to many renewable energy incentives. Notice 2018-59 provides a lengthy list of permitted delays, including delays due to: severe weather conditions, natural disasters, difficulties in obtaining permits or licenses, government requests regarding public safety, security, or similar

concerns; problems with the manufacture of custom components or specialized equipment of limited availability, labor stoppages, the presence of endangered species, problems with financing, and supply shortages.

4. Demolition. Consistent with the HTCC's mission, we encourage that the 31-month safe harbor require expenditures at least equal to the cost of any building that is demolished after acquisition, notwithstanding that any such cost would generally be capitalized into the cost of land under applicable tax law.

5. Qualification of Tangible Property During 30-Month Substantial Improvement Period. Though the 31-month rule is not technically connected to the 30-month substantial improvement period, as noted in the preamble to the Proposed Regulations, the intent of the 31-month rule appears to be to enable the Subsidiary Entity to satisfy the qualified opportunity zone business requirements during the substantial improvement period. We recommend clarifying that tangible property that is within the 30-month improvement period will be treated as qualified opportunity zone business property if the property ultimately meets the "substantially improved" definition at the end of such period. We respectfully observe that Section 1.1400Z-2(d)-1(d)(5)(vii) of the proposed regulations seems more complicated than is necessary by its references to the treatment of financial property, which may or may not be present in a particular situation. Accordingly, we recommend that the section be modified slightly to read as follows:

> (vii) Safe harbor for property developed in compliance with requirements. If a project is developed in 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), 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, or the property is not yet used in a trade or business.

The 70 Percent Test.

For many existing owners of historic properties located in low-income areas now designated as Opportunity Zones, a new incentive such as this has been long sought as an additional way to attract capital to their proposed redevelopment properties. Lack of capital, not lack of vision, has stymied rehabilitation plans.

The Proposed Regulations provide that the term "substantially all" means 70 percent in the context of qualified opportunity zone businesses. It is not clear how that rule would apply to already owned property which is the subject of a significant rehabilitation. We urge the IRS to adopt a regulation by which a qualified opportunity zone business might start with property already owned prior to 2018, and incur rehabilitation or other costs "with respect to" the property such that the qualifying post-2017 costs would exceed 70 percent of the sum of the owner's basis in the already owned building and the otherwise qualifying costs.

For example, assume that a Subsidiary Entity has owned property since 2016 with a basis on January 1, 2019 of $2 million. If the entity now incurs $7 million of expenditures during a 30-month period, and this building is the only tangible asset of the Subsidiary Entity, then the Subsidiary Entity would be considered to have passed the 70 percent "substantially all" test because 77 percent ($7 million divided by $9 million) of its tangible assets is qualified opportunity zone business property.

Alternatively, the regulations might treat the existing building shell as one property owned by the Fund or the subsidiary entity, and the rehabilitation as another, and analyze the substantially all test based on the ownership of these two assets.

The Six-Month Test for Opportunity Fund Status.

An Opportunity Fund is tested for compliance with the 90 percent requirement of Section 1400Z-2(d) at the last day of the first 6-month period of the taxable year of the Fund. Section 1.1400Z-2(d)-1(a)(2) of the Proposed Regulations provides that this "means the first 6 months each of which is in the taxable year and in each of which the entity is a QOF." Unfortunately, the regulations do not specify what is to be done for a month that starts (and therefore, typically ends) in the middle of a calendar month. We note that the draft form on the IRS website simply asks for the taxpayer to identify the calendar month in which the fund elected to become an Opportunity Fund. We understand that the IRS may have been trying to ease the mathematical and record-keeping burden on taxpayers by having the first 6-month test end at the end of a calendar month. However, this serves the

contrary purpose of reducing a taxpayer's first 6-month period. For example, if an Opportunity Fund was formed, and elected to be treated as an Opportunity Fund, on May 24, 2018, then using 6-months from the first day of May would run until October 31, 2018, thereby reducing the 6-month period by 24 days.

We respectfully observe that such an interpretation would be contrary to the announced intent of making it easier to comply. Indeed, an end of the month rule would seem to be an improper reduction from the statutory mandate.

We suggest that the IRS offer taxpayers the opportunity to choose ***either*** the corresponding day of the month that is 6 months later or the end of the last month that is not more than 6 months later. We note that there is precedent for using the actual day: the regulations for making Subchapter S elections provide that the days are computed in this way. We further note that this election would only apply to a business's first year; in future years, the 6-month point ***would*** come at the end of the sixth month.

In addition, we note that the Proposed Regulations adopt a rule requiring an Opportunity Fund to undertake the 90 percent test at the end of its first year, if this is earlier than six months after formation. We note that this will likely serve to seriously discourage taxpayers from forming Opportunity Funds in the second half of the year. For example, a fund formed on May 1 will have until November 1, a full 6 months to first be tested, while a fund formed on October 1 will only have 3 months. This seems to frustrate the plain Congressional provision which would give the taxpayer a "first" 6-month period. We recommend that the first 6-month testing date be the end of the first six-month period, regardless of whether this period straddles two tax years, unless the taxpayer elects to use the final day of its tax year. Once again, this treatment would only apply to a business's first 6-month testing date; in future years, the taxpayer would have two 6-month testing points, and they ***would*** come at the end of the sixth month and the taxable year.

<u>Basis reduction</u>.

The rules requiring a zero basis for Opportunity Fund investments have the potential to create a large number of technical problems.

For example, in a "single tier" HTC transaction, a taxpayer is required to reduce its basis in the property by the amount of HTCs claimed. It is unclear how this can work with the Opportunity Zone requirement that the investment have a zero basis. The basis reduction associated with claiming tax credits is either impossible or requires an investor to

contribute other cash or borrow funds in order to have sufficient basis to absorb the reduction. As an illustration, assume that a partnership acquired a building for $2 million, and rehabilitated it for another $2 million, and wished to finance this entire project with an Opportunity Fund investment. The $2 million rehabilitation would generate a $400,000 tax credit and a $400,000 basis reduction, but the investor's basis in the Opportunity Fund would already be at zero.

This is not the only situation in which the zero basis rule associated with Opportunity Fund investments interacts badly with other tax rules. For example, because of the rules that do not allow a taxpayer's basis to go below zero, an investor's share of losses from the investment might be suspended pending either allocations of income, or the 10 percent and 5 percent basis increases that are called for by the Opportunity Zone rules. It is not clear whether an investor can take suspended losses against the 10 and 5 percent basis increases. Furthermore, if the taxpayer does so use them, what amount should now be recognized on December 31, 2026. We suggest that the IRS may want to have two kinds of basis computations for Opportunity Fund investments, with the basis computation under Section 1400Z-2 (zero basis to start, and 10 percent and 5 percent increases after the 5 and 7 year holding periods) only applying to the recognition of gain recognized under Section 1400Z-2, and all other basis computations being done in the usual manner under applicable tax law. In any event, we respectfully request that the Proposed Regulations make clear that any basis reduction does not impair the ability of a taxpayer to claim the HTC, even if this would otherwise reduce the taxpayer's basis in its interest below zero.

Leased Property.

Section 1400Z-2 has a requirement that substantially all of the tangible property ***owned or leased*** by the taxpayer meet the requirements of Section 1400Z-2(d)(2)(D); that paragraph also requires that to qualify for the incentive, the tangible property be "acquired … by purchase."

When a lessee of property (as opposed to the landlord) plans to use funding from the Opportunity Fund incentive, these requirements appear to be inconsistent. In any case, it is not clear how property that is leased would be valued for purposes of the substantially all requirement.

We recommend that the term "lease" as used here apply to leases in which the lessee is considered the owner of the property. Thus, any lease that is characterized as a purchase

for tax purposes would use the discounted valuation of the property as the purchase price and the two provisions could work together.

There are other alternatives. The regulations could provide that leased property be valued at a "reasonable amount" similar to the treatment in the new markets tax credit regulations. Section 1.45D-1 of the regulations provides that "Property leased by the entity is valued at a reasonable amount established by the entity." Or, even if the lease ***is*** treated as a lease for tax purposes, the entity could present value the lease payments using an appropriate discount rate (e.g., 110% of the applicable federal rate), approximating Section 467 principles. Finally, the regulations could provide that in the case of property leased to a Subsidiary Entity, the "acquired by purchase" and "substantial improvement" tests (and possibly the 31-month safe harbor) should be applied to the Subsidiary Entity's landlord, with the leased property then considered qualified opportunity zone business property in the hands of the Subsidiary Entity.

HTC Additional Information

The federal HTC as we know it today was enacted in 1981 to stimulate the American economy struggling to emerge from a deep recession. This legislation greatly expanded a modest 10% historic property credit enacted in 1976. It was considered a way to even the playing field for private investment and better balance the flow of real estate capital between new construction and existing buildings. The HTC was part of a broader package of incentives to promote economic growth. The initial legislation put a 25% credit in place for certified historic rehab, a 20% credit for non-residential buildings at least 40 years old and a 15% credit for non-residential buildings at least 30 years old.

The 1981 law was retained and modified as part of the 1986 Tax Reform Act to 20% and 10% credits for historic and non-historic older buildings respectively. HTC-eligible properties under today's law must be income producing and depreciable. Owner-occupied properties are not eligible. The program is jointly administered by the National Park Service (from application to placement in service) and the Internal Revenue Service (for tax compliance) and is codified under Section 47 of the Code. The HTC was considered again by Congress in the Tax Cuts and Jobs Act of 2017 and the 20% credit for historic

buildings was retained, though modified to a 5-year credit delivery schedule, and the 10% credit for non-historic buildings was eliminated.

The HTC attracts significant capital to low-income neighborhoods such as those the Opportunity Zone incentive seeks to support. These new investments are often catalytic, starting a cycle of economic revitalization, encouraging additional investments, raising property values and creating a safer and more secure living and business environment.

We thank you for your consideration of these comments, and we would be pleased to discuss them with you if you consider that appropriate.

Sincerely,

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