November 26, 2018

Mr. Scott Dinwiddie
Associate Chief Counsel
Income Tax & Accounting
CC:PA:LPD:PR (REG-115420-18), room 5203,
Internal Revenue Service,
PO Box 7604,
Ben Franklin Station, Washington, DC 20044

Dear Mr. Dinwiddie:

On behalf of the members of the Novogradac Opportunity Zones Working Group (the OZ Working Group), we extend our gratitude to the Department of Treasury (Treasury) for issuing Proposed Regulations §1400Z-2(a)-1, 2(c)-1, 2(d)-1, 2(e)-1 (the “Regulations”) and Revenue Ruling 2018-29. The Regulations and revenue ruling clearly demonstrate that Treasury and IRS are being responsive to the comments they received and are taking a thoughtful approach to guidance covering the issues raised.

The preamble to the Regulations indicates that additional published guidance (including another round of proposed regulations) is forthcoming, as the Regulations do not address all of the significant issues identified. We are requesting that Treasury’s forthcoming guidance address a narrow list of priority issues set forth in the appendix to this letter. Taxpayer uncertainty around these issues is hindering investment in opportunity zones. The OZ Working Group will be submitting comments to the first tranche of Regulations under a separate letter.

We have divided our priority guidance request into two sections: (A) formal guidance to be addressed in the next round of proposed regulations; and (B) informal guidance to be addressed by Treasury notices, revenue rulings or IRS FAQs.

Our guidance request list with respect to each of these sections is based upon our collective experience and highlights the priority issues that, if left unresolved, will keep the most investors from investing in Qualified Opportunity Funds.

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 zone incentive issues and provide recommendations to make the opportunity zones incentive more efficient in delivering benefits to low-income communities.

We appreciate your consideration of these comments and look forward to an opportunity to discuss these issues further.

Yours very truly,

Novogradac & Company LLP

By

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Attachments: Priority Request for Further Guidance on Opportunity Zones

Priority Request for Further Guidance on Opportunity Zones
Opportunity Zones Working Group Hosted by Novogradac & Company LLP

A. Formal Guidance Request

A.1. Qualified Opportunity Funds ("Opportunity Fund(s)") need time to invest.

Are cash reserves held by an Opportunity Fund designated for investment in Qualified Opportunity Zone Property ("Opportunity Zone Property") considered Opportunity Zone Property?

Proposed Response:

Cash reserves held by an Opportunity Fund for investment in Opportunity Zone Property is considered Opportunity Zone Property for a period of twelve-months following investment in an Opportunity Fund.

Cash reserves held by an Opportunity Fund for the construction or substantial improvement of Qualified Opportunity Zone Business Property ("Opportunity Zone Business Property") is considered Opportunity Zone Property for a period of thirty-months following the beginning of construction or improvement of such Opportunity Zone Property.

Analysis:

Opportunity Funds need time to make investments. The opportunity zones statute explicitly states that Treasury guidance is needed to provide reasonable time for an Opportunity Fund to reinvest the return of capital from the sale of investments in Opportunity Zone Property. Likewise, Opportunity Funds need adequate time to assemble and underwrite initial Opportunity Zone Property investments. The 180-day time requirement for taxpayers to invest in Opportunity Funds to qualify for deferral is independent of whether an Opportunity Fund is ready to invest in Opportunity Zone Property. As a result, under current guidance, Opportunity Funds may be unable to accept investor capital within the 180-day time requirement. Furthermore, based upon guidance in the Regulations, calendar year Opportunity Funds that receive investments in December will only have a one-month testing period. To provide adequate time to make Opportunity Zone Property investments, cash investments received by an Opportunity Fund should be treated as invested in Opportunity Zone Property to the extent cash is invested within the 12-month period beginning on the date the cash is received by the Opportunity Fund. This provision of time to invest is similar to the time permitted to community development entities to invest taxpayer equity under the New Markets Tax Credit (NMTC) program.[1]

If Treasury believes they do not have regulatory authority to make this determination, then we ask that Treasury state that an Opportunity Fund has reasonable cause for holding cash reserves for 12 months or less from receipt of funds from an investor, such that a penalty would not be imposed.

Furthermore, the statute provides that Opportunity Funds have at least 30 months to substantially improve property but it is unclear to what extent cash reserves held by the Opportunity Fund during the improvement period violate the 90 percent investment

[1] Reg. §1.45D-1(c)(5)(iv)

requirement. Likewise, Opportunity Funds constructing new property also need time to construct. Opportunity Funds constructing or improving property are likely to have cash reserves designated for the construction or improvement of such property that exceed the 10 percent limit. We recommend that Treasury provide a safe harbor where cash reserves designated for the construction or the improvement of property be considered Opportunity Zone Business Property to the extent cash is expended within a 30-month period following the beginning of construction or improvement of such property similar to the time allotted for the substantial improvement test.

If Treasury believes it does not have regulatory authority to make this determination, then we ask that Treasury state that an Opportunity Fund has reasonable cause for holding cash reserves designated for the construction improvement of property for 30 months following the beginning of the construction or improvement of such property designated for construction or improvement.

A.2. Relief for Sales of Opportunity Zone Property Before 10 Years

Can gains realized by an Opportunity Fund from the sale or exchange of Opportunity Zone Property, be deferred if they are reinvested in replacement Opportunity Zone Property within a 12-month period beginning on the date of the sale or exchange?

Proposed Response:

Opportunity Funds can elect to defer gains realized from the sale of Opportunity Zone Property as long as the proceeds from the sale or exchange are reinvested in replacement Opportunity Zone Property within a 12-month period beginning on the date of the sale or exchange.

Analysis:

The legislative history under IRC §1400Z-2 provides that "The second main tax incentive in the bill excludes from gross income the post-acquisition capital gains on investments in opportunity zone *(sic)* funds that are held for at least 10 years."[2]

This legislative history does <u>not</u> state the main incentive is excluding from gross income post-acquisition capital gains on investments in opportunity zone property held for at least 10 years. This legislative history focuses on post-acquisition capital gains on **<u>investments in opportunity funds</u>** held for at least 10 years, as opposed to post-acquisition capital gains on **<u>investments in opportunity zone property</u>** held for at least 10 years. If Congress intended for Opportunity Funds to be taxed on gains at the fund level, during the 10-year period, then Congress could have designed the statute such that the 10-year fair market value basis election apply to **<u>opportunity zone property</u>** held for 10 years by the fund.

Taxing Opportunity Funds on gains from the sale of Opportunity Zone Property that is reinvested in Opportunity Zone Property conflicts with the expressed intent of the incentive.

[2] Opportunity Zones PL 115-97 Conference Report, Senate Amendment

The statute directs Treasury to prescribe regulations as may be necessary or appropriate to carry out the intent of Congress, including rules to ensure an Opportunity Fund has a reasonable period to reinvest the return of capital from investments in Opportunity Zone Property.[3] Taken together, this authority is persuasive regarding the legislative intent to provide for the deferral of interim gains as long as the proceeds are reinvested in substitute Opportunity Zone Property within a reasonable period.

As such, we recommend Treasury allow Opportunity Funds to elect to defer recognition of gains realized from the sale or exchange of Opportunity Zone Property if the proceeds from the sale or exchange are reinvested in replacement Opportunity Zone Property within a 12-month period beginning on the date of the sale or exchange. Under this deferral election, the Opportunity Fund's basis in the replacement Opportunity Zone Property should be equal to the Opportunity Fund's basis in the Opportunity Zone Property that was sold or exchanged. This carryover basis will preserve any gains not recognized in the event that a subsequent sale is not followed by the reinvestment in replacement Opportunity Zone Property within a 12-month period.

Example:

On Sept. 15, 2018, T, a calendar-year taxpayer, invested $1 million of gain in P, an Opportunity Fund partnership, and P immediately makes a $1 million investment in Opportunity Zone Property. On Sept. 16, 2022 (after four years), P sells the Opportunity Zone Property for $1.5 million and reinvests all of the proceeds in replacement Opportunity Zone Property within 12 months. Under the recommended guidance, if P elects to defer the $500,000 gain, P's basis in the replacement Opportunity Zone Property is $1 million.

A.3. Debt-Financed Distributions

Are debt-financed returns of capital (or a reduction in a partner's share of partnership liabilities that is treated as a distribution) that do not exceed a partner's basis in its Opportunity Fund interest, considered sales or exchanges that trigger the end of the tax deferral period?

Proposed Response:

Debt-financed returns of capital (or a reduction in a partner's share of partnership liabilities that are treated as a distribution) that do not exceed a partner's basis in its Opportunity Fund interest, are not considered sales or exchanges that trigger the end of the tax deferral period.

Analysis:

It appears that debt-financed returns of capital, or a reduction in a partner's share of partnership liabilities that is treated as a distribution, that do not exceed a partner's basis in its Opportunity Fund interest do not result in a sale or exchange for purposes of the end of the deferral period under §1400Z-2.

[3] IRC §1400Z-2(e)(4)(B)

Partnerships owning appreciated property oftentimes return portions of their partner's capital by refinancing the property. Debt-financed returns of capital, or a reduction in a partner's share of partnership liabilities that is treated as a distribution, are generally not taxable unless the cash distributed exceeds the partner's basis in its partnership interest. A partner's share of partnership liabilities (as determined under §752) are included in the partner's basis. As a result, debt borrowed inside a partnership and distributed to a partner generally receives similar tax treatment as debt borrowed by a partner outside the partnership and secured by the partner's interest in the partnership. Confusion has arisen whether a debt financed return of Opportunity Fund capital would similarly be deferred under §1400Z-2, or whether such return of capital would be deemed a sale or exchange and therefore the end of the deferral period. Many proposed transactions involve the development of property that is likely to be refinanced as property appreciates. Residual proceeds from refinancing are likely to be used to return capital to Opportunity Fund partners. Taxpayers looking to participate in these transactions need to know whether such distributions have any tax implications for purposes of §1400Z-2. We recommend that Treasury affirm debt-financed returns of capital, or a reduction in a partner's share of partnership liabilities that is treated as a distribution, that do not exceed a partner's basis in its Opportunity Fund interest, are not treated as sales or exchanges that trigger the end of the tax deferral period for purposes of IRC §1400Z-2.

A.4. Feeder Partnerships

If Taxpayer realizes a gain, and invests in a partnership, and the partnership, in turn, invests in an Opportunity Fund within 180 days of Taxpayer realizing the gain, may Taxpayer elect to defer the realized gain under Section 1400Z-2?

Proposed Response:

If Taxpayer realizes a gain, and invests in a partnership, and the partnership, in turn, invests in an Opportunity Fund within 180 days of Taxpayer realizing the gain, Taxpayer may elect to defer the realized gain under Section 1400Z-2. If Taxpayer elects to defer gain, Taxpayer must reduce their basis in their partnership investment and the partnership, in turn, reduces its basis in the Opportunity Fund.

Analysis:

It is unclear whether a taxpayer investing in an Opportunity Fund indirectly through an intermediate partnership qualifies for the opportunity zone benefits. For Opportunity Fund investments to achieve the scale intended by Congress, it is crucial that Opportunity Fund managers have the ability to diversify investments and manage timely exits within a fund. Traditional private equity funds hold a number of investments and liquidate them at different times over a number of years and the proceeds from the disposal of each investment are distributed to investors, or recycled into substitute investments. It is unclear how effectively an Opportunity Fund can operate under this traditional private equity approach and enjoy the five-, seven- and 10-year hold gain exclusion benefits provided for in the statute.[4] This is

[4] IRC §1400Z-2(c)

because any gains realized by a Opportunity Fund partnership, when a fund liquidates individual investments, will flow-through to its partners irrespective of the five-, seven- and 10-year hold benefits; benefits which generally can only be realized upon the sale or exchange of an Opportunity Fund interest.

One way Opportunity Fund managers can achieve diversity and better manage timely exits is to permit taxpayers to use an intermediate partnership to invest in an Opportunity Fund. Allowing the use of intermediate partnerships would be similar to the rule for the qualified small business (QSB) stock gain deferral incentive under IRC §1045, where taxpayers are permitted to invest in replacement QSB stock through a purchasing partnership.[5] The use of an intermediate partnership would allow Opportunity Fund managers to pool capital in an upper-tier partnership for further investment into multiple single-project lower-tier Opportunity Funds. As lower-tier Opportunity Fund investments mature, the upper-tier intermediate partnership could sell its lower-tier Opportunity Fund interests, rather than the underlying Opportunity Zone Property. The five-, seven- and 10-year hold benefits would track with each separate Opportunity Fund investment, such that the disposition of one investment would not affect the hold benefits of other partnership Opportunity Fund investments. This strategy would enable Opportunity Fund managers to diversify their investment pool and efficiently manage exits.

A.5. An objective standard is needed for active conduct in the Opportunity Zone.

What does it mean for an entity to be in the "active conduct of a trade or business in the opportunity zone" for purposes of meeting the Qualified Opportunity Zone Business ("Opportunity Zone Business") requirements?

Proposed Response:

A trade or business is treated as being engaged in the "active conduct" of a trade or business in the opportunity zone if, at the time an Opportunity Fund makes an investment in the entity, the Opportunity Fund reasonably expects that the entity will generate revenues within three years after the date of the investment from the use of at least 50 percent of its tangible property in the opportunity zone.

Analysis:

The phrase active conduct of a trade or business has different meanings in different sections of the IRC. Given the identical statutory language of IRC §45D and §1397C(b)(2) and the similar objectives of the NMTC provisions and opportunity zone provisions, the gross income test of section 1400Z-2(d)(3)(A)(ii) should be interpreted in a manner similar to the gross income requirements for qualified businesses under the NMTC program. Under the NMTC program an entity will be treated as engaged in the active conduct of a trade or business if, at the time the Opportunity Fund makes an investment in the entity, the Opportunity Fund reasonably expects that the entity will generate revenues within three years after the date of the investment.

[5] Treas. Reg. 1.1045-1(c)(1)(i)

Furthermore, the Regulations require that the active conduct of the trade or business must be derived in the opportunity zone. Determining where a business's gross income is derived can be complex and time consuming for operating business. Factors for determining where income is derived (such as where an entity uses its property; where its employees perform services; and where its customers are located) are weighted differently by different taxing authorities which leads to uncertainty. Given these complications, the absence of an objective standard for determining the situs of gross income will likely lead to a disproportionate amount of real estate investments in opportunity zones. Accordingly, we recommend that Treasury adopt an objective standard for determining where gross income is earned based upon the 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 gross income is deemed to be derived from the opportunity zone. A tangible property standard for the situs of gross income is consistent with the statutes Opportunity Zone Business Property requirements.

A.6. Leased Property as Opportunity Zone Business Property

How does an Opportunity Zone Business determine whether its leased property is Opportunity Zone Business Property?

Proposed Response:

Only leased property classified as a finance lease by an Opportunity Zone Business is required to be Opportunity Zone Business Property. True operating leases are exempt from the tangible property requirement because Opportunity Zone Business Property is required to be purchased.

Analysis:

Opportunity Zone Property must be "purchased." Opportunity Zone Business Property means tangible property used in a trade or business of the Opportunity Zone Business if such property was acquired by purchase by the Opportunity Zone Business from an unrelated party after Dec. 31, 2017, and that satisfies other requirements.

The term "purchase" is defined in IRC §179(d)(2) and generally means the cost of the property as defined under IRC §1012. A true operating lease for federal income tax purposes is generally not an acquisition of tangible property by "purchase." Under a true operating lease, for federal income tax purposes, a lessee pays rent for the use of property and the lessor is considered the owner of the tangible property being leased. Thus, the lessee will not own the tangible asset for federal income tax purposes.

There are certain types of leases of property where amounts paid ostensibly as rent are treated as part of the purchase price for Federal income tax purposes. These leases are called finance leases and are in substance purchases under IRC §179 and therefore under IRC §1400Z-2. Accordingly, only finance leases should be required to be Opportunity Zone Business Property for Opportunity Zone Businesses and true operating leases should be exempt from this requirement.

A.7. Opportunity Zone Businesses without working capital need time to qualify.

Does a business have a grace period to become an Opportunity Zone Business following an investment from an Opportunity Fund?

Proposed Response:

Businesses are deemed Opportunity Zone Businesses as long as the Opportunity Fund reasonably expects, at the time the Opportunity Fund makes its investment in the entity, the entity will qualify for substantially all of the Opportunity Fund's holding period of its investment.

Analysis:

It is unclear whether a business has a grace period to qualify as an Opportunity Zone Business. In order for investments in corporations and partnerships to qualify as Opportunity Zone Property, the statute requires that:

> i) as of the time such interest was acquired, such corporation/partnership was an Opportunity Zone Business (or, in the case of a new corporation/partnership, such corporation was being organized for purposes of being an Opportunity Zone Business); and,
>
> ii) during substantially all of the Opportunity Fund's holding period for such interest such corporation/partnership qualified as an Opportunity Zone Business.

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

- First, any gross income earned on reasonable amount of working capital reserves is treated as satisfying the gross income requirement;
- Second, a substantial portion of intangible property of a business complying with the reasonable working capital safe harbor is deemed to be used in the active conduct of a trade or business in the opportunity zone; and
- Third, reasonable working capital designated for purchases expecting to satisfy tangible property requirements are not treated as failing to satisfy those requirements solely because the scheduled consumption of the working capital is not yet expended.

Unfortunately, the grace period that the safe harbor establishes for businesses to qualify only applies to businesses with working capital. Businesses serially drawing capital from investors and/or lenders and therefore not holding working capital reserves are not eligible for the safe harbors and therefore do not have time to qualify.

The following example illustrates this limitation:

> **Facts**. On Dec. 15, 2018, Taxpayer H invested $5 million of capital gains in QOF T, a calendar-year Opportunity Fund. QOF T immediately acquired from partnership P a partnership interest in P, solely in exchange for $5 million of cash. P immediately purchased land in an opportunity zone for the $5 million. P's only other assets consist of $5 million of

> equipment that P purchased in 2017. P had written plans to construct a $10 million commercial building within the next 30 months using serial draws from a bank construction loan and therefore has no working capital assets.
>
> Once the building is complete, P expects to satisfy the tangible property requirements because 75 percent of P's property will be Opportunity Zone Business Property, however, on Dec. 31, 2018; the amount of Opportunity Zone Business Property owned by P is only 50 percent ($5 million of land over $10 million of total assets). Because P has no working capital assets, P cannot rely on the tangible property safe harbor, which treats planned expenditures as qualified property. As a result, QOF T will fail the 90 percent investment standard for 2018 because P does not satisfy the Opportunity Zone Business requirements.

As the above example illustrates, new businesses being organized for the purpose of being an Opportunity Zone Business and existing businesses that are expanding within or into opportunity zones will need time to acquire and/or improve tangible property and put such property to active use in opportunity zones.

We recommend that a business be deemed qualified as long as the Opportunity Fund reasonably expects, at the time the Opportunity Fund makes its investment in the entity, the entity will qualify for substantially all of the Opportunity Fund's holding period of its investment, similar to the safe harbor established for qualified businesses under the NMTC Program.[6]

[6] Treas. Reg. 1-45D-1(d)(4)(iv)(A)

B. Informal Guidance Request

B.1. Qualification of vacant land (where an existing building is not situated) as Opportunity Zone Business Property.

- While the Regulations and revenue ruling specifically address the treatment of land where it is located under an existing building, the regulations do not specifically address how to treat unimproved land, where an existing building is not situated.
- Example
  - **Facts:** In 2018, QOF H, an Opportunity Fund, purchased vacant land located in an opportunity zone for $800,000 and constructed a $500,000 building on the land.
  - **Question:** Is the original use test inapplicable to the land for purposes of the Opportunity Zone Business Property determination, or must the land be substantially improved by reference to costs expended to construct the building, such that the cost of the newly constructed building must exceed the $800,000 adjusted basis of the land?

B.2. Whether substantial improvements after Dec. 31, 2017 to property purchased before Dec. 31, 2017 can be considered separate Opportunity Zone Business Property.

- Example
  - **Facts.** In 2017, Partnership P purchased a commercial building located in an opportunity zone for $1 million. The building is the only asset owned by P. In June 2018, QOF T, an Opportunity Fund, invested $3 million in Partnership P and P had written plans to use the money to substantially improve the building in accordance IRC §1400Z-2(d)(2)(D)(ii) over the next 30 months.
  - **Question.** Assuming that P satisfies the three requirements of Prop Reg § 1.1400Z-2(d)(d)(5)(iv)(A)-(C), can the improvements to the building be treated as separate tangible property for purposes of the 70 percent tangible property requirement of paragraph (d)(1)(i)?

B.3. Whether the 70 percent substantially all test must be met at the time of investment for existing entities.

- The Regulations state that an existing corporation or partnership must be an Opportunity Zone Business at the time the Opportunity Fund acquires the stock or partnership interest in such entity.
- Example
  - **Facts.** On Dec. 31, 2018, Taxpayer H invested $5 million of capital gains in QOF T, a calendar year Opportunity Fund. QOF T immediately acquired an interest in partnership P (an existing partnership), solely in exchange for $5 million of cash. P immediately purchased land in an opportunity zone for $5 million. P's only other assets consist of $5 million of equipment that P purchased in 2017. P had written plans to construct a $10 million commercial building within the next 18 months using staged draws from a bank construction loan and therefore held no working capital assets on Dec. 31, 2018. Once the building is constructed, P expects to satisfy the Opportunity Zone Business requirements because 75 percent ($15 million over $20 million) of P's tangible property will be Opportunity Zone Business Property.

- **Question.** Does QOF T's investment in existing business P satisfy the Qualified Opportunity Zone Partnership Interest requirements on Dec. 31, 2018?

B.4. Whether non-original use property acquired by an Opportunity Fund or an Opportunity Zone Business is considered opportunity zone business property during the 30-month period it is being substantially improved.

- Example
  - **Facts.** On Dec. 1, 2018, Taxpayer H realized $1 million of capital gains and immediately invested $1 million in QOF T, an Opportunity Fund. On Dec. 31, 2018, QOF T immediately acquired a building located in an opportunity zone for $1 million. The $1 million building was the sole asset of QOF T on Dec. 31, 2018. QOF T plans to make $2 million of additions to the basis of the building over the next 12 months thereby substantially improving the building in accordance with IRC §1400Z-2(d)(2)(D)(ii) and lease the building to a manufacturing business.
  - **Question.** Is the building deemed to be Opportunity Zone Business Property while it is being improved so that QOF T satisfies the 90 percent investment standard on Dec. 31, 2018?

B.5. Whether residential rental property can qualify as an Opportunity Zone Business.

- IRC §1400Z-2 incorporates only three of the eight requirements to be a qualified business under IRC §1397C(b). Noticeably absent from §1400Z-2 is the reference to IRC §1397C(d)(2), which specifically excludes residential rental property from the term "qualified business." This omission appears to be intentional.
- The facts of Rev. Rul. 2018-29 infer that residential rental property is a qualified business, however, in the ruling the residential rental property is owned directly by the QOF, not indirectly through an Opportunity Zone Business.
  - **Question**. Can a real property business that rents residential real property to others be an Opportunity Zone Business?