MEMO

Subject: **Opportunity Zones – Vacant Property Threshold**
From: **John Lettieri, President & CEO, Economic Innovation Group**
Date: **September 20, 2019**

Background

Section 1400Z-2, added by Public Law 115-97 (the Tax Cuts and Jobs Act), provides tax incentives for investors to make equity investments in qualified opportunity funds (QOFs) that will in turn invest in qualified opportunity zone business property (QOZ Business Property), either directly or indirectly through qualified opportunity zone businesses (QOZ Businesses) operating in qualified opportunity zones (QOZs). To qualify as QOZ Business Property, tangible property must be acquired by the entity after December 31, 2017, by purchase from an unrelated person, and either its original use in the QOZ commences with the QOF or QOZ Business or the QOF or QOZ Business substantially improves the property.[1]

The proposed regulations define original use as occurring when property is first placed in service in the QOZ.[2] The proposed regulations further provide that the use of vacant property in the QOZ qualifies as original use if the property has been vacant or unused for an uninterrupted period of at least five years.[3]

The Problem: A Five-Year Vacancy Period is Too Long to Achieve the Goals of the QOZ Statute

If the use of property that is currently sitting vacant and unused satisfies the original use requirement, it would encourage businesses to use and invest capital in dilapidated or underutilized property consistent with the purpose of the statute. However, a five-year period for vacancy is unnecessarily long and impedes valuable economic activity in areas struggling with vacancy, blight, and an eroding tax base.

- When the QOZ incentive was originally introduced in Congress as the Investing in Opportunity Act, the bill was intended to "develop blighted properties" and combat "the crisis of closing business[es]."[4] Revitalization of a depressed community includes the conversion and new use of abandoned storefronts and other vacant commercial space. The introduction of a new business to use currently vacant property results in new capital investment and economic activity in the low-income community.

[1] I.R.C. § 1400Z-2(d)(2)(D)(i).
[2] Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(7)(i).
[3] Prop. Treas. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(B)(6), (c)(7)(i), (d)(2)(i)(B)(6), (d)(2)(i)(C).
[4] "Senator Scott Introduces the Bipartisan Investing in Opportunity Act," (Feb. 2, 2017), https://www.scott.senate.gov/media-center/press-releases/senator-scott-introduces-the-bipartisan-investing-in-opportunity-act.

- As noted in the comment letter submitted by the National Community Stabilization Trust,[5] research has shown links between property vacancy and crime[6] and violence,[7] negative community health outcomes,[8] fire risk,[9] and neighborhood property values.[10] Thus, the surrounding community is better served if the period a property is vacant is minimized.
- Congress intended this incentive to be implemented promptly. From the timeframes for nomination of the QOZs by state governors and designation by Department of the Treasury, to the expiring incentives that place a premium on investments made within the first two years, the statute evidences congressional intent that this provision be used to catalyze investment quickly.
- An example of how the five-year vacancy rule is negatively impacting projects was recently brought to our attention by a member of the EIG Opportunity Zones Coalition. The project involves a plan to develop a 1960s vintage office building that has been vacant since 2015. The sponsor is converting the building into a mixed-use project with workforce housing, retail, and parking. Because the property has only been vacant for four years, the only way to obtain the QOZ benefits would be to wait and purchase the building next summer, the point at which the building will have been vacant for five years and qualify under the rule in the proposed regulations. This would delay the development of the workforce housing and associated benefit to the community by at least a year while the building sits unused. Furthermore, because the QOZ investment would not be made until 2020, the investors will fail to receive the seven-year basis step-up.[11]

Recommended Vacancy Period

Final regulations should provide that the use of property in a QOZ that has been vacant or unused for an uninterrupted period of at least one year, *including the date of designation of that QOZ*, is treated as original use. This is the same standard used in the Enterprise Zone context,

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5 National Community Stabilization Trust, *Proposed Rule Regarding "Investing in Opportunity Funds," REG-120186-18*, at 1-2 (July 2, 2019).
6 Lin Cui, Randall Walsh, "Foreclosure, vacancy and crime," Journal of Urban Economics, Volume 87 (May 2015), available at https://www.sciencedirect.com/science/article/pii/S0094119015000029; Eric Klinenberg, "The Other Side of 'Broken Windows,'" The New Yorker (Aug. 23, 2018), available at https://www.newyorker.com/books/page-turner/the-other-side-of-broken-windows.
7 Charles C. Branas, David Rubin, Wensheng Guo, "Vacant Properties and Violence in Neighborhoods," ISRN Public Health (Sept. 2013), available at https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3693396/.
8 Kyungsoon Wang, Dan Immergluck, "The Geography of Vacant Housing and Neighborhood Health Disparities After the U.S. Foreclosure Crisis," Cityscape, Volume 20 No. 2 (2018), available at https://www.jstor.org/stable/26472173?seq=1#page_scan_tab_contents.
9 SE Schachterle, D Bishai, W Shields, et al, "Proximity to Vacant Buildings is Associated with Increased Fire Risk in Baltimore, Maryland Homes," Injury Prevention Volume 18 (2012), available at http://injuryprevention.bmj.com/content/18/2/98.
10 Hye-Sung Han, "The Impact of Abandoned Properties on Nearby Property Values," Housing Policy Debate, Volume 24, 2014, available at https://www.tandfonline.com/doi/abs/10.1080/10511482.2013.832350.
11 Section 1400Z-2(b)(2)(B)(iv).

which requires that if property has been vacant for at least one year, *including the date of zone designation*, it is treated as original use.[12]

Including the Date of Zone Designation Within the Period of Vacancy Would Alleviate Treasury's Concerns

- The preamble to the proposed regulations rejected recommendations for a one-year period of vacancy, citing the potential for owners of property already situated in a QOZ to intentionally cease occupying the property for 12 months to increase its marketability.[13]
- However, this concern is inapplicable if Treasury and the Service adopt our recommended approach. Under this approach, the property would be required to have been vacant at the time the QOZ was designated. Requiring that the one-year period of vacancy include the date of zone designation would prevent abuse from investors intentionally keeping property vacant. Property owners would have been unaware prior to the QOZ designation that the property would qualify for the QOZ incentive, and the rule would only benefit property that had been vacant at the time of designation due to causes unrelated to the tax incentive.
- The office building in the example above has been vacant since 2015 and would fall under this rule. Because the building was vacant at the time of designation of the QOZ, its vacancy at that time likely stems from its undesirability in the market, possibly its 1960s vintage architecture, rather than any action by its owner to make the property vacant in order to qualify for QOZ benefits. Yet the action to keep the property vacant for another year would be an action undertaken in order to qualify for QOZ benefits, and seems directly contrary to the purpose of the current vacancy rule.
- We note that since the last QOZ designations occurred on June 14, 2018, any vacant property placed in service after finalization of the regulations would have to have been vacant more than 12 months to qualify. For example, vacant property that is placed in service on December 1, 2019, in a QOZ that was designated on June 14, 2018, would have to have been vacant since at least June 14, 2018, to qualify under our recommendation.

Final Regulations Should Also Permit De Minimis Use

- Many "vacant" buildings have some minimal occupation of the building to serve a maintenance function, e.g., to ensure that the pipes do not burst. In addition, some buildings are substantially vacant—for example, a small convenience store in the corner of an otherwise vacant multi-story building. We believe that final regulations should clarify that some small amount of use will not prevent the building from being considered vacant.

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[12] Treas. Reg. § 1.1394-1(h).
[13] 84 Fed. Reg. 18,652, 18,654, *Explanation of Provisions*, § I.B. (May 1, 2019).

- The Enterprise Zone regulations disregard de minimis incidental use in determining whether property is considered vacant. For example, renting the side of a building for a billboard does not prevent the property from being treated as vacant.[14]

[14] *Id.*

MEMO

Subject: **Opportunity Zones – Anti-Abuse Rules**
From: **John Lettieri, President & CEO, Economic Innovation Group**
Date: **September 20, 2019**

Background

Section 1400Z-2, added by Public Law 115-97 (the Tax Cuts and Jobs Act), provides tax incentives for investors to make equity investments in qualified opportunity funds (QOFs) that will in turn invest in qualified opportunity zone business property (QOZ Business Property), either directly or indirectly through qualified opportunity zone businesses (QOZ Businesses) operating in qualified opportunity zones (QOZs).

Section 1400Z-2(e)(4)(C) specifically grants authority to Treasury to prescribe regulations to prevent abuse. The proposed regulations provide a broad anti-abuse rule:

> "if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of section 1400Z-2, the Commissioner can recast a transaction (or series of transactions) for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 1400Z-2. Whether a tax result is inconsistent with the purposes of section 1400Z-2 must be determined based on all the facts and circumstances."[1]

The proposed regulations do not provide any safe harbors or examples of facts and circumstances showing activities that are or are not abusive. However, the preamble to the proposed regulations identifies as abusive certain uses of land:[2]

> [T]he Treasury Department and the IRS recognize that, in certain instances, the treatment of unimproved land as qualified opportunity zone business property could lead to tax results that are inconsistent with the purposes of section 1400Z-2. For example, a QOF's acquisition of a parcel of land currently utilized entirely by a business for the production of an agricultural crop, whether active or fallow at that time, potentially could be treated as qualified opportunity zone business property *without the QOF investing any new capital investment in, or increasing any economic activity or output of, that parcel*. In such instances, the Treasury Department and the IRS have determined that the purposes of section 1400Z-2 would not be realized, and therefore the tax incentives otherwise provided under section 1400Z-2 should not be available. If a significant purpose for acquiring such unimproved land was to achieve that inappropriate tax result, the general anti-abuse rule set forth in proposed §1.1400Z2(f)-1(c) . . . would apply to treat the acquisition of the unimproved land as an acquisition of non-qualifying property for section 1400Z-2 purposes.[3]

[1] Prop. Treas. Reg. § 1.1400Z2(f)-1(c)(1).
[2] 84 Fed. Reg. 18,652, 18,655 & 18,669, *Explanation of Provisions*, §§ I.B; X (May 1, 2019).
[3] 84 F.R. at 18,655 (emphasis added).

The preamble to the proposed regulations also emphasizes that land must be held in a trade or business and not for investment.[4] In addition, the proposed regulations provide a backstop to prevent insubstantial improvements of land. Specifically, a QOF may not rely on the proposed rule excluding land from the original use or substantial improvement requirements if the land is unimproved or minimally improved and the QOF or QOZ Business purchases the land with an expectation, an intention, or a view not to improve the land by more than an insubstantial amount within 30 months after the date of purchase.[5]

<u>The Problem: The Anti-Abuse Rule Could Have Chilling Effects on Certain "Good" Transactions While Not Sufficiently Deterring "Bad" Transactions</u>

Strong anti-abuse rules are critical to ensuring the integrity of the emerging QOZ market and preventing bad actors from benefitting from the QOZ incentives. At the same time, the anti-abuse rules should not be so broad or onerous as to have a chilling effect on investors to engage in the economic activity and development in low-income communities that was intended by the statute. A broad, purpose-based anti-abuse rule, without any guidance on what is and is not considered to violate the purpose could have the opposite effect, with bad actors taking an overly aggressive approach and good actors taking an overly conservative one.

Overall, we support a strong anti-abuse rule that is flexible enough for the IRS to address scenarios that it has not yet considered. However, we believe there are some relatively simple ways to shut down certain abuses. In addition, we believe that clarifications in the form of examples and/or safe harbors could provide some much-needed clarity without sacrificing the flexibility of the IRS to use the anti-abuse rule against unforeseen scenarios.

<u>Specific Recommendations to Implement the Anti-Abuse Rule</u>

- Because the anti-abuse rule is purpose-based, we believe that a general statement of the purpose of section 1400Z-2 would be helpful in applying the anti-abuse rule.
- We believe that final regulations could adopt some targeted rules to shut down certain potential abuses.
    - First, we believe that a robust certification and reporting regime will help ensure transparency and minimize abuse (or at least provide the IRS with information to help detect abuse).
        - Form 8996 currently requires that a QOF include the following information in its organizing documents: (1) statement of its purpose of investing in QOZ Property, and (2) description of the QOZ Business(es) that the QOF expects to engage in. Requiring actual disclosure of this information on the Form 8996 would provide an additional check that the QOF is operating consistent with the purposes of section 1400Z-2.

[4] 84 F.R. at 18,654-55.
[5] Prop Treas. Reg. § 1.1400Z2(d)-1(f).

        - Requiring a "clean hands" certification by QOF managers on Form 8996 that they have not been indicted, charged with or convicted of, or had a civil judgment rendered against them, for fraud, embezzlement, forgery, theft, or certain other offenses within the past three years, similar to the New Markets Tax Credit allocation application, would weed out bad actors.
        - Requiring the reporting of information (including information concerning the nature and location of assets, activities, income, and employees) that is relevant to determining whether the QOZ requirements are satisfied is well within Treasury's authority, and such additional transparency would deter bad actors. We refer you to our comment letter dated May 31, 2019 in response to the Request for Information on Data Collection and Tracking for Qualified Opportunity Zones.
    - Second, there are some concerns that, with the 70-percent "substantially all" threshold, up to 30 percent of a rental real estate QOZ Business's property could be located outside of and have no true connection with a QOZ. Adoption of an additional location requirement for real estate businesses would ensure that the economic activity of real estate businesses is located in and benefitting the QOZ.
        - We strongly support the adoption of a 70-percent "substantially all" requirement for tangible property, as it provides much-needed flexibility where certain property of the QOZ Business fails to meet one of the tests for QOZ Business Property (e.g., some property was owned before 2018) or, for legitimate business purposes, must be located outside of a QOZ.
        - However, we believe that permitting the holding of 30 percent of real property outside the QOZ is inconsistent with the purpose of section 1400Z-2. Thus, final regulations could require that a greater percentage (e.g., 90 percent) of the tangible property owned or leased by a real property QOZ Business must be either located within a QOZ or contiguous to a QOZ. This 90-percent threshold would be in addition to the 70-percent asset test, which would otherwise remain unchanged for all other purposes of section 1400Z-2(d)(3)(A)(i) (including the ability to hold small amounts of property that do not qualify as QOZ Business Property).
    - Third, final regulations should prevent circumvention of the sin business limitation by engaging in such a business at the QOF level or by leasing to such a business by providing that the use of property in an enumerated sin business prevents such property from qualifying as QOZ Business Property.
        - The de minimis use (e.g., 5 percent or less) of property in a sin business should be excluded to avoid foot-faults.
- Further clarity is needed on how much and what kinds of improvement or capital investment in land will be sufficient to not run afoul of Prop Treas. Reg. § 1.1400Z2(d)-1(f) or the general anti-abuse rule.
    - We are hearing that the anti-abuse rule coupled with the statements in the preamble have been a significant hurdle for land-related deals. For example, some have interpreted the statements in the preamble as requiring a QOZ Business that wants to make capital improvements to land (e.g., farmland, timberland, brownfields) to also own the business

that operates that land. However, that fundamentally changes the investment—the real estate business and the operating business are very different investments that attract very different investors.

  - This confusion is having a chilling effect on land deals, which has a particularly negative impact on rural QOZs.
  - Examples illustrating what kind of land improvements violate (e.g., simply paving the land for a parking lot) and do not violate (e.g., planting a timber farm; making capital improvements to an existing farm to build farm structures, acquire grazing animals, plant crops, and install irrigation systems; or remediating a brownfield and leasing it for productive use) the anti-abuse rule would also be helpful.
  - A safe harbor threshold of expenditures to constitute more than an insubstantial amount would provide greater certainty so that land-related projects can move forward. We believe additions to basis constituting at least 25 percent of the basis of the land would be a sufficient safe harbor threshold to prevent abuse.

- Final regulations (or separate guidance) could include a safe harbor to steer QOFs towards activities that are most likely to further the purposes of section 1400Z-2.
  - Such a safe harbor could leverage existing (or future) federal, state, or local programs that ensure that the QOF's activities deliver well-defined and measured benefits to communities, such as the independent certification of nonprofit benefit corporations that currently exists in a number of states.
- Finally, although not an anti-abuse rule per se, guidance on the reasonable cause exception to the penalty for failure of a QOF to satisfy the 90-percent test would provide welcome clarity.
  - Existing guidance on the reasonable cause exception to the failure to file penalty is not helpful, as the considerations and factual scenarios are completely different.

MEMO

Subject: **Opportunity Zones – Aggregation of Assets for Purposes of the Substantial Improvement Test**
From: **John Lettieri, President & CEO, Economic Innovation Group**
Date: **September 20, 2019**

Background

Section 1400Z-2, added by Public Law 115-97 (the Tax Cuts and Jobs Act), provides tax incentives for investors to make equity investments in qualified opportunity funds (QOFs) that will in turn invest in qualified opportunity zone business property (QOZ Business Property), either directly or indirectly through qualified opportunity zone businesses (QOZ Businesses) operating in qualified opportunity zones (QOZs). To qualify as QOZ Business Property, tangible property must be acquired by the entity after December 31, 2017 by purchase from an unrelated person, and either its original use in the QOZ commences with the QOF or QOZ Business or the QOF or QOZ Business substantially improves the property.[1] If held through a QOZ Business, "substantially all" of the tangible property must constitute QOZ Business Property.[2]

Property is treated as substantially improved "only if, during any 30-month period . . . additions to basis with respect to such property in the hands of the qualified opportunity fund [or QOZ Business] exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period . . . ."[3]

The Problem: Asset-by-Asset Application of the Substantial Improvement Test Is Unworkable for Operating Businesses

The preamble to the May 2019 proposed regulations states that the substantial improvement requirement is applied on an asset-by-asset basis.[4] However, this requirement would be nearly impossible for operating businesses to satisfy and does not reflect the manner in which businesses typically expand, add value, or increase their economic activity. Many assets, such as equipment or office furniture, do not easily lend themselves to substantial improvement through a more than doubling of basis. Furthermore, the recordkeeping and compliance requirements for asset-by-asset application of the substantial improvement test to an operating business would be extremely burdensome.

Consider a simplified example where a QOZ Business starts a new restaurant business in a QOZ. Because of budget constraints, the QOZ Business decides to refurbish equipment that

[1] I.R.C. § 1400Z-2(d)(2)(D)(i); Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(2)(i)(A), (C).

[2] I.R.C. § 1400Z-2(d)(3)(A)(i). For this purpose, the proposed regulations define "substantially all" as 70 percent of the tangible property. Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(1)(i), (d)(3).

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

[4] 84 Fed. Reg. 18,652, 18,655, *Explanation of Provisions*, § I.B. (May 1, 2019).

has previously been used in the QOZ, so it cannot rely on the original use test. The QOZ Business acquires three ovens for $4,000 each, two refrigerators for $3,000 each, and twenty tables for $500 each. Two of the ovens end up needing extensive improvements of $10,000 each, while the third only needs $3,000 of improvements. One refrigerator requires $6,000 of improvements while the other requires $2,000. Each table requires $250 of improvements.

Overall, the QOZ Business acquired the assets for $28,000 and spent $36,000 on improvements. However, when viewed on an asset-by-asset basis, only two of the ovens and one of the refrigerators has been substantially improved. These assets represent less than 70 percent of the value of the tangible assets, and so the QOZ Business flunks the substantially all requirement.

Recommended Aggregation Approach

We recommend that the final regulations adopt an aggregation approach and permit businesses to adopt one of two safe harbors to aggregate certain related assets for purposes of determining whether assets have been substantially improved.

- Investment Decision Safe Harbor[5]
    - Under this safe harbor, assets of a QOZ that are purchased as part of the same investment decision and are part of the same trade or business would be treated as an aggregate asset for purposes of measuring substantial improvement.
    - The Investment Decision Safe Harbor should be limited to operating businesses in order to prevent potential abuses by QOFs or QOZ Businesses that purchase multiple adjacent parcels with the intent to only improve one of them.
    - The same trade or business limitation is intended to prevent a similar ability on the part of operating businesses to acquire multiple businesses and improve or expand only one of them.
    - All assets acquired as part of the same investment decision, including those assets that are not actually improved (such as new assets that are acquired as part of the same investment decision) should be aggregated. In addition, all expenditures to improve those assets that are improved (even if it would not qualify as substantial with respect to that particular asset) and all expenditures to acquire those assets that are not improved should be aggregated.

[5] A variation of this safe harbor was also recommended by the American Bar Association (ABA) Section of Taxation. ABA Section of Taxation, *Comments on Proposed Regulations Regarding Investment in Qualified Opportunity Funds Under Section 1400A-2*, at 39-42 (Jan. 10, 2019).

- Section 1250 Property Safe Harbor[6]
  - Under a second proposed safe harbor, assets would be aggregated if they would meet the "integrated unit" test for treatment as a single item of section 1250 property.[7]
  - Under this safe harbor, structures may be aggregated if they are "operated as an integrated unit (as evidenced by their actual operation, management, financing, and accounting)."
  - Similar to the Investment Decision Safe Harbor, all assets operated as an integrated unit, including those assets that are not actually improved (such as new assets that are acquired and operated as an integrated unit), should be aggregated. In addition, all expenditures to improve those assets that are improved (even if it would not qualify as substantial with respect to that particular asset) and all expenditures to acquire those assets that are not improved should be aggregated.
  - This safe harbor would apply to both operating and real estate businesses, as we believe the integrated unit limitation would prevent potential abuses associated with the purchase multiple adjacent parcels with the intent to only improve one of them.
- Either of these safe harbors would solve the problem for the restaurant business in the example above. Because the QOZ Business purchased the ovens, refrigerators, and tables as part of a single investment decision, and they are operated as an integrated unit, they would be treated as a single asset acquired for $28,000. The QOZ Business would be treated as making $36,000 in improvements to this aggregate asset, which would, accordingly, be treated as substantially improved.
- By creating safe harbors, rather than mandatory aggregation rules, operating businesses would not be forced into using asset aggregation. An elective approach is important because there are situations in which it may not make sense to aggregate assets.

<u>An Aggregation Approach is Consistent with Both the Purpose and Language of the Statute</u>

- When the QOZ incentive was originally introduced in Congress as the "Investing in Opportunity Act," the bill was intended to "create new channels for investment in small businesses, support entrepreneurs, develop blighted properties."[8]
- The substantial improvement test was likely included in the statute in order to encourage the improvement of existing property in the QOZ and ensure that new economic activity and investment is made in the QOZ for businesses that already own property.

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[6] This safe harbor was similarly recommended by the ABA Section of Taxation. *Id.*

[7] *See* Treas. Reg. § 1.1250-1(a)(2)(ii). Although section 1250 applies only to certain depreciable real property, this safe harbor should apply to any tangible property that meets the integrated unit test, regardless of whether such property constitutes "section 1250 property" as that term is defined in section 1250(c).

[8] "Senator Scott Introduces the Bipartisan Investing in Opportunity Act," (Feb. 2, 2017), https://www.scott.senate.gov/media-center/press-releases/senator-scott-introduces-the-bipartisan-investing-in-opportunity-act.

- The Department of the Treasury and the Internal Revenue Service recognized the need for more flexible rules to achieve the purposes of the statute and requested comments on the potential advantages and disadvantages of adopting an aggregate approach for substantial improvement:

> *The Treasury Department and the IRS have considered the possibility, however, that an asset-by-asset approach might be onerous for certain types of businesses. For example, the granular nature of an asset-by-asset approach might cause operating businesses with significant numbers of diverse assets to encounter administratively difficult asset segregation and tracking burdens, potentially creating traps for the unwary. As an alternative, the Treasury Department and the IRS have contemplated the possibility of applying an aggregate standard for determining compliance with the substantial improvement requirement, potentially allowing tangible property to be grouped by location in the same, or contiguous, qualified opportunity zones. Given that an aggregate approach could provide additional compliance flexibility, while continuing to incentivize high-quality investments in qualified opportunity zones, the Treasury Department and the IRS request comments on the potential advantages, as well as disadvantages, of adopting an aggregate approach for substantial improvement.*[9]

- An aggregate approach is more consistent with the language of the statute referring to additions to basis "with respect to such property," which suggests a more flexible approach than "of the property" adopted by the proposed regulations.
- The aggregation approach is consistent with the purposes of the QOZ statute to encourage investment in small, entrepreneurial businesses, which tend to be operating businesses. One key advantage of an aggregation approach is that operating businesses could satisfy the QOZ Business Property requirements even if they previously owned and used equipment in the QOZ as long as substantial new investment is made in the property, which is precisely what Congress intended. Without such a rule, operating businesses will be forced to newly lease or purchase their equipment solely to become eligible to receive QOF investment, even if business considerations dictate otherwise. Similarly, real estate development businesses may be forced to acquire multiple structures that will be operated as a functional unit, such as an office building and parking garage, in separate entities, which is inefficient and serves no policy goal.
- The aggregation approach also avoids potential burden with an overly granular approach to defining an asset. For example, should various systems and fixtures be treated as separate assets? What about materials and supplies? The administrative burden of an asset-by-asset approach would be enormous for businesses and the IRS alike, and would lead to outcomes contrary to the purpose of the law.

[9] 84 Fed. Reg. at 18,655, *Explanation of Provisions*, §I.B.

MEMO

Subject: **Opportunity Zones – Structuring Exit After 10-Year Holding Period**
From: **John Lettieri, President & CEO, Economic Innovation Group**
Date: **September 20, 2019**

Background

Section 1400Z-2, added by Public Law 115-97 (the Tax Cuts and Jobs Act), provides tax incentives for investors to make equity investments in qualified opportunity funds (QOFs) that will in turn invest in qualified opportunity zone business property (QOZ Business Property), either directly or indirectly through qualified opportunity zone businesses (QOZ Businesses) operating in qualified opportunity zones (QOZs). Under the statute, in the case of any investment in a QOF held by the taxpayer for at least 10 years, the taxpayer may elect to increase the basis to the fair market value of such investment on the date that the investment is sold or exchanged.[1] The proposed regulations provide that, when a QOF partner's basis in a qualifying QOF partnership interest is adjusted under section 1400Z-2(c), the basis of the partnership interest is adjusted to an "amount equal to the fair market value of the interest, including debt."[2] This 10-year basis step-up rule is potentially the most significant of the QOZ tax incentives and has been a focus of investors.

The statute anticipates that investors will exit from an investment in a QOF by selling their interest in the QOF. However, the typical investment fund disposes of all or a portion of its assets (either by selling equity interests in a portfolio company or causing the portfolio company to sell its assets) and distributes the proceeds to its investors. Recognizing this, the proposed regulations provide some flexibility to structure exits as sales at the QOF level. The proposed regulations provide relief by allowing a QOF investor who has held its investment in a QOF for at least 10 years to make an election to exclude from gross income capital gain from the sale or disposition of QOZ Property by the QOF that is reported on the investor's Schedule K-1 (the "K-1 Rule").[3] Just as important, the K-1 Rule preserves the investor's increase in the basis of its QOF interest from such gain, which prevents a subsequent distribution of the sales proceeds from generating additional gain to the investor.[4]

The proposed regulations also mitigate the potential negative consequences of the so-called "hot asset" rules. The hot asset rules require recognition of ordinary income instead of capital gain upon the sale of a partner's interest to the extent the amount received is attributable to hot assets of the partnership.[5] Then the transferor's capital gain or loss on the sale of the partnership interest is equal to the difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 and the amount of ordinary income or loss determined under section 751(a).[6] Thus, if there would be no gain on the sale of a partnership

[1] I.R.C. § 1400Z-2(c).
[2] Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i).
[3] Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii).
[4] *See* Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii)(C) (last sentence).
[5] I.R.C. § 751(a). In addition, ordinary income is recognized upon a distribution of property from the partnership that changes the partner's respective share of hot assets. I.R.C. § 751(b).
[6] Treas. Reg. § 1.751-1(a)(2).

interest in the absence of section 751 as a result of the application of section 1400Z-2(c), a partner still would recognize its distributive share of ordinary income on any hot asset and would be deemed to have a capital loss equal to the amount of such ordinary income. Hot assets are generally assets of a partnership that would generate ordinary income, including inventory, unrealized receivables, and depreciation recapture.[7]

The application of the hot asset rules to the sale of a QOF interest or QOZ Property could undermine the benefit of the 10-year basis step-up rule, because many taxpayers cannot make current use of the offsetting capital loss, effectively leaving them with full or partial inclusion of the 10-year appreciation. This issue is particularly critical for investments that would generate depreciation recapture, such as solar, wind, and other clean energy investments, machinery and equipment, and real estate. The proposed regulations address this issue by providing that, when an investor sells a qualifying investment in a QOF partnership after the 10-year holding period, a special deemed adjustment is made to the inside basis of QOF partnership assets immediately before the sale so as to mimic a cash purchase of the investment when a section 754 election is in effect, with the result that ordinary income is not triggered (the "Deemed Section 754 Election").[8]

<u>The Problem: Although Proposed Regulations Provide Some Relief, There Are Gaps That Do Not Fully Facilitate Sales of QOZ Businesses or QOZ Business Property</u>

Exit issues have been some of the most significant factors preventing deals from going forward. Investors have been concerned that they will not receive the benefit of the 10-year basis step-up intended by Congress because of the above-described disconnect between the way funds and their investors typically exit investments and the interaction between section 1400Z-2 and the hot asset rules. We applaud both the K-1 Rule and the Deemed Section 754 Election and believe they establish a practical framework to address problems that are seriously affecting the market. However, there are some gaps in these rules that need to be filled if these rules are to fully achieve their purpose.

In particular, investors still believe that the only transaction that fully preserves the 10-year basis step-up where hot assets are involved is the sale of the QOF interest by the investor (and, even in that scenario, it is not clear that the Deemed Section 754 Election applies to the sale of a QOF interest if the hot assets are held at the QOZ Business level). As discussed above, however, that is not the natural exit strategy if a QOF holds multiple businesses, as investors may not want to dispose of their interests in all of the businesses and a buyer may not want to acquire all of the businesses. Although the proposed regulations permit sales of QOZ Business interests through the K-1 Rule, the rule does not protect gain attributable to hot assets. Thus, investors are forced to incur the cost of forming multiple stand-alone QOF structures (and to avoid multi-tier QOF structures) so that they can sell a QOF interest upon exit after 10 years.

In creating the Opportunity Zone incentive, Congress created a two-tiered structure consisting of QOFs as investment vehicles organized for the purpose of investing in QOZ Businesses. When Congress used the term "fund," it was likely thinking of traditional

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[7] I.R.C. § 751(c), (d).
[8] Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i).

investment funds, which are instruments for investors to pool capital and spread risk across a portfolio of investments.[9] At the moment, the majority of QOFs we have seen are not funds in the traditional sense, but rather are single-project entities, primarily because of the uncertainty in exiting the investments after 10 years. If Congress had intended for QOZ investments to occur only through single-project entities, it would not have needed to create a two-tiered structure.

As discussed further below, the questions that remain unanswered are: (1) how sales of property by QOZ Businesses after the 10-year holding period are treated under the K-1 Rule; (2) whether ordinary income from hot assets sold by the QOF or QOZ Business could be excluded by the investor under either the K-1 Rule or the Deemed Section 754 Election; and (3) whether the Deemed Section 754 Election applies to the sale of a QOF interest if the hot assets are held at the QOZ Business level. In addition, the final regulations should clarify that the phrase "including debt" in Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i) results in a step-up in basis under section 1400Z-2(c) of the full amount realized by an investor, as described below.

Finally, the proposed regulations do not permit reliance on the proposed 10-year basis step-up rules. Investors have expressed concern that they need to make investment decisions now and need clarity on how to achieve the 10-year benefit described in these rules in the future. In particular, some investors are trying to pre-negotiate terms of exits from QOF investments during the transaction stage in order to provide long-term certainty and transparency for both the investor and investee.

<u>Recommended Approach to 10-Year Basis Step-Up Rules</u>

We believe that the proposed regulations adopt the appropriate framework to resolve these issues by enabling taxpayers to exclude certain tiered-up asset gains (the K-1 Rule) and to step up the inside basis of assets to avoid ordinary income from hot assets as a result of sales of partnership interests (the Deemed Section 754 Election). We believe that final regulations should simply fill in the gaps in these rules, as discussed below.

1. <u>Final Regulations Should Clarify that the K-1 Rule Applies to Asset Sales by a QOZ Business</u>

A QOF may structure an exit from an investment in a QOZ Business either by disposing of its equity interest in the QOZ Business or by causing the QOZ Business to dispose of its assets, but it is not clear how the latter is treated under the K-1 Rule. The proposed K-1 Rule only applies when a "QOF partnership or QOF S corporation disposes of qualified opportunity zone property." A disposition of an equity interest in a QOZ Business is clearly a disposition of QOZ property by the QOF. Under the current proposed rule, however, it is not clear whether causing a disposition of assets by a lower-tier QOZ Business partnership can qualify for the K-1 Rule. Because this kind of asset sale is commonly used by investment funds in structuring exits, it should be accommodated by the final regulations.

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

We believe that Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii) could be expanded to include such capital gains, which also would be ultimately reported on the Schedule K-1 issued by the QOF to the investor (after being reported on the Schedule K-1 issued by the QOZ Business partnership to the QOF).

2. Final Regulations Should Provide Relief from Hot Asset Treatment for Asset Sales Via the K-1 Rule

The Deemed Section 754 Election only applies when "a QOF partner's basis in a qualifying QOF partnership interest is adjusted under section 1400Z–2(c)," so it provides relief from hot asset treatment only upon the sale of a QOF interest. The proposed K-1 Rule works by excluding capital gain that is reported on an investor's Schedule K-1; it does not exclude ordinary income attributable to hot assets, nor does it adjust the asset basis to eliminate such gain. As a result, under the proposed regulations, when a QOF partnership or a QOZ Business partnership disposes of a hot asset, the Deemed Section 754 Election would not apply, and, accordingly, it appears that the QOF or QOZ Business would recognize ordinary income. This ordinary income would then be allocated to QOF investors on a Schedule K-1, and the K-1 Rule would not apply because the income would not be capital gain. As a result, it appears that ordinary income from hot assets sold by the QOF or QOZ Business would not be able to be excluded by the investor under either the K-1 Rule or the Deemed Section 754 Election. This gap in the proposed rules is particularly problematic for depreciation recapture, which cannot be separated from the rest of the asset that generates capital gain.

We believe that this gap can be filled by extending the K-1 Rule to cover not only capital gains but also ordinary income if it is recognized as part of the sale of QOZ Business Property that would constitute a trade or business.[10] The Deemed Section 754 Election technically applies only to the sale of partnership interests, making the K-1 Rule a better fit to address asset sales. In addition, the Deemed Section 754 Election may be overly broad in the context of sales of QOZ Business partnership interests, as it would also eliminate gain allocable to nonqualifying interests in the QOF. Thus, the Schedule K-1 Rule may better address that scenario as well, leaving the Deemed Section 754 Election to apply only to the sale of QOF partnership interests (with the clarification suggested above where the hot assets are held at the QOZ Business level). We note that expanding the K-1 Rule to address these gaps has the added benefit of increasing the investor's basis in its QOF interest for such income to prevent the expected subsequent distribution of cash from the sale to the investor from generating gain.[11]

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[10] We anticipate that such a rule would permit a QOZ Business, for example, to sell one or more rehabilitated buildings or an entire operating business. However, we do not believe that sales of inventory in the ordinary course of a QOZ Business' trade or business should be excluded under the K-1 Rule, even if such sales occur after the 10-year holding period.

[11] *See* Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii)(C) (last sentence).

3. Final Regulations Should Clarify that the Deemed Section 754 Election Applies when Hot Assets Are Held at the QOZ Business Level

It is not entirely clear whether the Deemed Section 754 Election applies to the sale of a QOF interest if the hot assets are held at the QOZ Business level. This should be clarified by the final regulations. In particular, Prop Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i) should be revised to clarify that deemed adjustments to the basis of assets of a QOZ Business partnership also will be made by applying the ordinary rules for multi-tier partnerships assuming that valid section 754 elections had been in place for the QOF partnership and each QOZ Business partnership.[12] Alternatively, an example could be added to illustrate this point.

4. Final Regulations Should Clarify that a Partner's Basis Reflects Debt

The proposed rule in Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i) has created some confusion for investors because it is not clear whether the phrase "including debt" results in a gross or net calculation. We believe that the better interpretation is that the basis step-up is to the full amount realized (i.e., the gross calculation), which would include the fair market value of the partner's interest in the QOF plus relief from the partner's share of partnership debt.[13] However, clarity is needed to avoid a net calculation, so that partners of a QOF partnership do not recognize any residual gain resulting from their share of partnership debt after meeting the requisite 10-year holding period, consistent with the intent of the statute that investors do not recognize gain on a QOF investment held for at least 10 years. This could be accomplished by adding an example illustrating the computation of the basis step-up where QOF partnership debt is involved.

Reliance on the Proposed Regulations

The preamble to the proposed regulations provides that taxpayers may generally rely on the proposed rules, except for the rules of Prop. Treas. Reg. § 1.1400Z2(c)-1 relating to the 10-year basis step-up, because these rules do not apply until January 1, 2028.[14] Despite this reasoning, investors have expressed concern that they need to make investment decisions now and need assurance that they will receive the 10-year benefit described in these rules in the future. Accordingly, we recommend that the Department of Treasury and the Internal Revenue Service amend the proposed regulations to permit current reliance on the rules in Prop. Treas. Reg. § 1.1400Z2(c)-1 or retroactive reliance back to the date of publication in the Federal Register, May 1, 2019.

[12] *See* Rev. Rul. 87-115, 1987-2 C.B. 163 (providing that the optional adjustment to basis under section 743 will be available to both an upper-tier partnership (UTP) and a lower-tier partnership (LTP) when there is a sale or exchange of a partnership interest in UTP, and both UTP and LTP have made an election under section 754).
[13] *See* Treas. Reg. § 1.1001-2(a).
[14] 84 Fed. Reg. 18,652, 18,669, *Proposed Effective/Applicability Dates* (May 1, 2019).