May 28, 2021

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2021-28)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2021-28 Public Comment Invited on Recommendations for 2021-2022 Priority Guidance Plan

Dear Ladies and Gentlemen:

On behalf of the Novogradac Opportunity Zones Working Group (the "OZ Working Group"), we submit the following suggestions in response to Notice 2021-28, requesting suggestions for items to include on the Internal Revenue Service's (Service or IRS) 2021 – 2022 Priority Guidance Plan. We are pleased at the invitation to provide Priority Guidance Plan items. We believe our suggestions will increase the effectiveness and efficiency of the Opportunity Zones (OZ) incentive, while decreasing areas of uncertainty.

The OZ Working Group includes investors, syndicators, lenders, community development entities (CDEs), community development financial institutions (CDFIs), for-profit and nonprofit developers, consultants, law firms, and other community development professionals who work together to suggest consensus solutions to technical OZ incentive issues and provide recommendations to make the OZ incentive more efficient in delivering benefits to low-income communities.

By providing guidance in the suggested areas, the Service would:

- Resolve significant issues relevant to a broad class of taxpayers – current and potential investors, qualified opportunity funds, and qualified opportunity zone businesses;
- Reduce controversy, thereby lessening burdens on taxpayers and the Service as each attempts to navigate to an appropriate resolution; and
- Promote a uniform approach for taxpayers.

For your convenience, the recommendations have been summarized in the attached Executive Summary and are listed in what we believe to be in the order of highest priority. However, we believe each recommendation should be considered, as each helps provide clarity that will improve the ability of the OZ incentive to generate impact to targeted communities. We then discuss each item on the list in greater detail, with suggested paths forward where it is appropriate, based upon consensus among OZ Working Group members.

Our comments reflect the work of more than one hundred member organizations participating on numerous conference calls and countless drafting sessions over several years. We trust you will find our comments useful and instructive. All of the OZ Working Group's previous comments regarding these issues, as well as many others, can be found on our website (www.novoco.com/group/node/44001/group-listing/published-comment-letters/public).

The following comments, considerations, and recommendations specifically relate to regulatory changes. Because many of the proposed revisions to the regulations clarify policies that many industry participants have thought were already implicit in the regulations, we believe it would be helpful if the proposed changes, at the option of the taxpayer, could be relied on for periods prior to their effective date. Otherwise, taxpayers will receive no additional comfort that transactions structured before the effective date will be allowed to rely on any of the clarifications and guidance provided in the proposed regulations.

We appreciate the opportunity to submit our suggestions for issues that should be included on the 2021-2022 Priority Guidance Plan. With further guidance, we believe that the OZ incentive can be an even more effective tool in restoring economic growth throughout the country. We commend the Department of Treasury and IRS for their continuing efforts to improve and clarify tax guidance for the OZ incentive in order to ensure its continuing success. Thank you in advance for your time and consideration.

Please do not hesitate to contact us if you have any questions regarding our comments or if we can be of further assistance. We would be happy to discuss our comments in further detail.

Yours very truly,

Novogradac and Company LLP

By

John Sciarretti, Partner

Attachments:

Response to Notice 2021-28 Public Comment Invited on Recommendations for 2021-2022 Priority Guidance Plan

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Recommendations for 2021-2022 Priority Guidance Plan
Executive Summary

We believe these comments, considerations and recommendations concerning existing OZ rules and regulations, if pursued and adopted by Treasury, will increase the effectiveness and efficiency of the OZ incentive.

1. **Election to choose a deemed inclusion event.**

   Sections 1.1400Z2(b)-1(c)(1) and 1.1400Z2(c)-1(b)(1) should be amended to permit an eligible taxpayer to elect to choose a deemed inclusion event whereby the original deferral is taxed at the applicable rate in the year of election without forgoing the 10-year hold benefit.

2. **Satisfying the 70-percent tangible property standard during the working capital safe-harbor period(s)**

   We recommend that section 1.1400Z2(d)-1(d)(3)(vi)(D)(1) be amended to provide that businesses satisfying the three requirements of the working capital safe harbor are deemed to satisfy the 70-percent test and the section 1397C qualified OZ business requirements during the working capital safe harbor period(s).

3. **Reasonable capitalized fees paid to related parties in conjunction with self-constructed property**

   We request IRS to issue a revenue procedure which provides guidance to determine how to apply the related party rules of section 179(d)(2) to components of self-constructed property. We recommend that reasonable fees (fees that reflect common, arms-length market pricing) paid by a QOF or qualified OZ business to a related party for the development, redevelopment or construction of tangible property are not treated as failing the purchase requirements under section 179(d)(2) as modified by section 1400Z-2(e)(2).

4. **Clarifying that improvements to purchased property satisfy original use requirements**

   Section 1.1400Z2(d)-2(b)(3) should be amended to state that improvements made to tangible property by its owner satisfy the original use requirements as purchased property for the amount of such improvements.

5. **Clarification of the phrase "not more than an additional 24 months" under federally declared disasters**

   Section 1.1400Z2(d)-1(d)(3)(v)(D) should be amended to clarify the meaning of the phrase "not more than an additional 24-months to consume working capital assets". The regulations should clarify that all businesses located in a federally declared disaster area otherwise meeting the requirements of the working capital safe harbor qualify for the additional 24-months, if they need it, regardless of the term of the disaster period.

6. **Valuation of assets contributed to a qualified OZ business**

   We recommend that Treasury and IRS clarify whether all businesses automatically receive an additional 24 months or if the additional time is based on need. If based on need, clarify whether businesses are required to justify the necessary extension. If the extension is automatic, we recommend that section 1.1400Z2(d)-1(d)(3)(v)(D) be amended to clarify that all businesses otherwise meeting the requirements of the working capital safe harbor automatically qualify for the additional 24-months.

7. **Deferral of gain arising from an inclusion event from the disposition of an entire interest or a partial interest in a related QOF**

   Section 1.1400Z2(a)-1(b)(11)(iv) should be amended to clarify that gains arising from an inclusion event with a related party QOF may be considered eligible gains under section 1400Z-2(a)(1)(A) even though the taxpayer may be related to the QOF within the meaning of section 1400Z-2(e)(2) as a result of their investment in the QOF.

8. **Return of a contribution in the event of a federally declared disaster**

   Section 1.1400Z2(a)-1(c)(6)(iii)(A) should be amended to provide clarification that a return of a contribution due to a federally declared disaster will not result in an eligible investment being recharacterized as a nonqualifying investment.

9. **Addition of rules that stimulate investment in affordable housing**

   To encourage investment in affordable housing, the final regulations should be amended to allow properties that are converted from market-rate to affordable housing to be considered original use property, to modify the definition of substantial improvement for all affordable rental housing projects, and to modify the special amount includible rule for passthrough entities that investment in affordable rental housing.

10. **Addition of rules that stimulate investment in operating businesses**

    To encourage investment in operating businesses, the final regulations should be amended to modify the application of the existing substantial improvement test for pre-existing operating businesses in OZs, to create a portion of business rule for qualified OZ businesses, and to modify the rules for mobile tangible property.

11. **Preservation of qualified opportunity zone property after the qualified opportunity zone designation expires**

    Sections 1.1400Z2(d)-1 and 1.1400Z2(d)-2 should be amended to add clarification that QOFs can preserve compliance with qualified opportunity zone property requirements after the OZ designation expires until December 31, 2047. Furthermore, section 1.1400Z2(f)-1(b) should be amended to add clarification that qualified reinvestments can be made by QOFs after the qualified opportunity zone designation expires on December 31, 2028 until December 31, 2047 provided the reinvestment zone meets the requirements of a low-income community at the time of the reinvestment.

12. **Valuing a QOF's tangible assets under the applicable financial statement methodology on the last day of the first 6-month period of the QOF's taxable year**

    Section 1.1400Z2(d)-1(b)(3) should be amended to make clear that QOFs or qualified OZ businesses using certified audited financial statements under US GAAP as their applicable financial statement for valuing owned or leased property are not required to use a certified audited financial statement as of the last day of the first 6-month period of its taxable year as long as the method for valuing the property is consistent with the method used in its certified audited financial statements as of the last day of its taxable year.

13. Earnings on recently contributed property, capitalized organizational and start-up costs, and the 90-percent test

Section 1.1400Z2(d)-1(b)(2)(i)(B) should be amended to provide that a qualified opportunity fund (QOF) may determine compliance with the 90-percent investment standard (the "90 percent test") by excluding from both the numerator and the denominator the following: earnings on disregarded recently contributed property and capitalized organizational and start-up costs (such as selling commissions, organizational expenses, offering expenses, and similar expenses).

14. Solely disregarded assets and the 90-percent test

The Form 8996 instructions should be modified to state that when all of a QOF's assets are disregarded for the 90 percent test, yielding a 0/0 ratio for Part 2, Lines 8 and/or 11, the QOF should enter 1.00.

15. Clarifying what constitutes working capital assets and "subsequent infusions of working capital assets"

Section 1.1400Z2(d)-1(d)(3)(vi) should be amended to clarify that a business may benefit from one or more 31-month periods, for a total of 62 months regardless of the source of the infusion(s) of working capital assets. Also, any loan commitments that satisfy the three requirements under section 1.1400Z2(d)-1(d)(3)(v)(A) through (C) can be considered working capital assets and payments made on behalf of a business by a debt provider (e.g. construction lender) can be considered subsequent infusions of working capital assets.

Recommendations for 2021 – 2022 Priority Guidance Plan

1. Election to choose a deemed inclusion event

a. The Issue

A potential increase in the long-term capital gains tax rate would effectively punish early investors who catalyzed investment into opportunity zones. In exchange for making much needed investments into low-income communities, investors deferred long-term capital gains at the current rate of 23.8 percent, including the net investment income tax of 3.8 percent, with the understanding that the taxes on those gains would be deferred until 2026. With a potentially significant increase in the long-term capital gains tax rates, one of the primary incentives for making these investments would be negated, which is not consistent with the spirit of the statute.

b. Proposed Resolution

The final regulations should be amended to provide for a special election permitting taxpayers to choose a deemed inclusion event whereby the original deferral is taxed at the applicable rate in the year of election without forgoing the 10-year hold benefit.

Section 1.1400Z2(b)-1(c)(1) should be amended to add paragraph (v) as follows:

An eligible taxpayer elects to choose a deemed inclusion event whereby the original deferral is taxed at the applicable rate in the year of election.

Section 1.1400Z2(c)-1(b)(1) should be amended to add paragraph (vi) as follows:

The occurrence of a deemed inclusion event described in section 1.1400Z2(b)-1(c)(1)(v) which addresses an eligible taxpayer that elects to choose a deemed inclusion event whereby the original deferral is taxed at the applicable rate in the year of election.

2. Satisfying the 70-percent tangible property standard during the working capital safe-harbor period(s)

a. The Issue

Substantially-all (70-percent) of a qualified OZ business' tangible property is required to be qualified OZ business property. Many start-up qualified OZ businesses hold tangible property that does not meet the requirements to be qualified OZ business property because it was purchased before December 31, 2017 or purchased from a related party and often this non-qualified tangible property is temporarily in excess of the 30 percent threshold. Moreover, a qualified OZ business is required to use tangible and intangible property within the OZ and derive 50 percent of its gross income from active conduct of business in the OZ. Start-up businesses require time for the development of a trade or business in which tangible and intangible property can be used and gross income can be generated. It appears that section 1.1400Z2(d)-1(d)(3)(vi)(D)(1), added by correcting amendments published on April 1, 2020, was meant to address start-up business issues discussed above, however, the language is unclear and has created confusion for taxpayers. The amendment appears to provide that businesses satisfying the three requirements of the working capital safe harbor are deemed to satisfy the requirements of qualified OZ business property during the working capital safe harbor period(s), but it makes no mention of the 70-percent test or the section 1397C requirements in which qualified OZ businesses are required to satisfy. Furthermore, it goes on to say "however such property is not qualified opportunity zone business property for any purpose" which seems to contradict the general rule.

b. Proposed Resolution

In order to address start-up business issues related to tangible property discussed above we recommend the following amendments to section 1.1400Z2(d)-1(d)(3)(vi)(D)(1) to provide that businesses satisfying the three requirements of the working capital safe harbor are deemed to satisfy the 70-percent test and the section 1397C qualified OZ business requirements during the working capital safe harbor period(s) as follows:

> Working capital. If paragraph (d)(3)(v) of this section treats property of an entity that would otherwise be nonqualified financial property as being a reasonable amount of working capital because of compliance with the three requirements of paragraphs (d)(3)(v)(A) through (C) of this section, the entity satisfies the requirements of section ~~1400Z-2(d)(2)(D)(i)~~ 1400Z-2(d)(3)(A)(i) and (ii) only during the working capital safe harbor period(s) for which the requirements of paragraphs (d)(3)(v)(A) through (C) of this section are satisfied; however such property is not qualified opportunity zone business property for any purpose.

3. **Reasonable capitalized fees paid to related parties in conjunction with self-constructed property**

a. The Issue

In real estate development, it is common practice for the project owner to contract with affiliates for developer and/or the general contractor services. Payments by a project owner to a developer are used to provide reasonable compensation for development services and to reimburse out-of-pocket costs. Payments by a project owner to an affiliated general contractor are primarily used by the general contractor to pay unrelated subcontractors for property and services provided to the general contractor for the benefit of the project owner and a portion is retained by the general contractor for reasonable profit, overhead and general requirements of the general contractor. Affiliated developer and general contractors will often be related to the project owner within the meaning of section 179(d)(2) as modified by section 1400Z-2(e)(2) and it is not clear how this related party purchase rule applies to self-constructed property. Accordingly, investments in a substantial number of real estate assets, including affordable rental housing, are at risk of not satisfying the section 179(d)(2) purchase requirement and therefore not qualifying as qualified OZ business property.

Example – Affordable Housing Project

An affordable housing project entity- Entity B contracted with an affiliated developer and general contractor to develop affordable housing project in an OZ that qualifies for low income housing tax credits. Both the developer and general contractor are related to Entity B within the meaning of section 179(d)(2) as modified by section 1400Z-2(e)(2). It is a common business practice for Entity B to contract with affiliates to ensure that the project meets the required standards of the state. The state's Qualified Allocation Plan limits developer fees to 10 percent of project costs and contractor fees to a percentage of construction hard costs as follows: contractor profit-6 percent; contractor overhead-2 percent; and general requirements-6 percent. All payments over and above the limited contractor fees are paid to unrelated sub-contractors. The project requires the OZ incentive to close a financing gap but Entity B is concerned that the project will not satisfy the requirements to be qualified OZ business property due to the related party payments to affiliates.

b. Proposed Resolution

We request IRS to issue a revenue procedure which provides guidance to determine how to apply the related party rules of section 179(d)(2) to components of self-constructed property. We recommend that reasonable fees (fees that reflect common, arms-length market pricing) paid by a QOF or qualified OZ business to a related party for the development, redevelopment or construction of tangible property are not treated as failing the purchase requirements under 179(d)(2) as modified by section 1400Z-2(e)(2). We suggest that payments made by a QOF or qualified OZ business to a related party contractor or developer be considered reasonable to the extent the amounts are paid forward to unrelated subcontractors for property and/or services and to the extent amounts retained by the related party contractor for overhead and profit, reflect common, arms-length market pricing in a transaction not limited by section 179(d)(2).

4. Clarifying that improvements to purchased property satisfy original use requirements

a. The Issue

In the preamble to the final regulations Treasury and the IRS provide that improvements made to non-qualified property owned by a taxpayer and used in an OZ do not satisfy the original use requirement even though leasehold improvements are expressly treated as separate property for purposes of original use. Their reason hinges on their determination that administrative burdens that would arise for taxpayers and the IRS from tracking improvements made to such non-qualified property would significantly exceed those arising from the tracking of lessee improvements.

Similar to leasehold improvements, a taxpayer generally must separately track and capitalize direct and allocable indirect amounts paid to improve a unit of property owned by the taxpayer.[1] Accordingly, there are no additional administrative burdens from tracking these improvements.

This treatment negatively impacts many tax credit transactions such as those involving low-income housing tax credits and historic tax credits. These transactions are often centered on improvements to property that was owned and used prior to 2018 but that due to transfer restrictions and expenses it is not feasible to transfer the property in a manner that would make them eligible for qualification thru substantial improvement. As a result, these entities are precluded from making an eligible investment to improve the property even though the investment may be substantial compared to the property's adjusted basis.

Treasury and IRS should provide that tangible property improvements made to non-qualified property are not disqualified from satisfying the original use requirements similar to the rules provided for leasehold improvements and other self-constructed property.

Example

Entity A purchased a certified historic building for $2 million on December 15, 2017 in a census tract that was later designated as an OZ. Entity A made plans to invest $20 million to substantially rehabilitate the building over 30 months beginning on June 30 2018, qualifying Entity B for federal rehabilitation tax credits. Legislation passed in 2017 requires a taxpayer to claim the rehabilitation tax credit over five years beginning in the year the rehabilitation expenditures are placed in service (reducing the value of the credit) unless a taxpayer qualifies for the transition rule. Taxpayers

[1] Treas. Reg. §1.263(a)-3(d).

qualifying for the transition rule can claim the entire credit in the year the rehabilitation expenditures are placed in service – substantially increasing their value. Because Entity A owned the building on January 1, 2018, it qualifies for the transition rule. If Entity A were to transfer the property to another owner after January 1, 2018, the building will no longer qualify for the rehabilitation tax credit transition rule – substantially reducing its value. Because the building was purchased before January 1, 2018, the building does not meet the requirements of qualified OZ business property for Entity A. Therefore, unless the $20 million of improvements (required to be separately tracked for depreciation and rehabilitation tax credit purposes) can satisfy the original use requirement, Entity A will not qualify for an opportunity zones investment.

b. Proposed Resolution

Section 1.1400Z2(d)-2(b)(3)(ii) should be amended as follows:

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

5. Clarification of the phrase "not more than an additional 24 months" under federally declared disasters

a. The Issue

Section 1.1400Z2(d)-1(d)(3)(v)(D) provides that, if a qualified OZ business is located in an OZ within a federally declared disaster, that business "may receive not more than an additional 24 months to consume its working capital assets." Every state and all five permanently-inhabited territories of the United States have received a federal disaster declaration as a result of COVID-19, starting January 20, 2020 and ongoing as of the date of this letter. Notice 2020-39 confirmed that the regulation on federally declared disasters applies to the COVID-19 pandemic disaster. Taxpayers have several questions about the additional time allotted:

- Do all businesses automatically receive 24 months if they need it?
- Are businesses required to justify the necessary extension?

b. Proposed Resolution

We recommend that Treasury and IRS clarify whether all businesses automatically receive an additional 24 months or if the additional time is based on need. If based on need, clarify whether businesses are required to justify the necessary extension. If the extension is automatic, we recommend that section 1.1400Z2(d)-1(d)(3)(v)(D) be amended to clarify that all businesses otherwise meeting the requirements of the working capital safe harbor automatically qualify for the additional 24-months as follows:

> (D) Federally declared disasters. If the qualified opportunity zone business is located in a qualified opportunity zone within a federally declared disaster (as defined in section 165(i)(5)(A)), the qualified opportunity zone business may automatically receive not more than an additional 24 months to consume its working capital assets as needed, as long as it otherwise meets the requirements of paragraph (d)(3)(v) of this section.

6. Valuation of assets contributed to a qualified OZ business

a. The Issue

For the purposes of this 70-percent test, property purchased or constructed for fair market value is permitted to be valued using an Alternative Valuation Method under which the property is valued at its unadjusted cost basis under section 1012 or section 1013. Other property that is not purchased or constructed for fair market value is required to be valued according to its fair market value as of each applicable testing date. As a result, a qualified OZ business' purchased assets (which are typically good assets) are permitted to be valued using a fixed number, while the qualified OZ business's contributed assets (which are always bad assets) are required to use a fluctuating number for the 70-percent test. This required fair market value method of valuation can cause a qualified business to become unqualified if property appreciates during a QOF's investment.

Example

Entity A, a qualified OZ business, is formed with a $8 million cash contribution from a QOF and a contribution of land with a fair market value of $2 million from a non-QOF partner. Entity A uses the $8 million to construct a qualifying asset building on the contributed land. Entity A does not have applicable financial statements and chooses to use the alternative valuation method to value its tangible property for its 70-percent tests. As of the first testing date after the building is placed in service, the value of the qualified OZ business' tangible property totals $10 million, of which $8 million, or 80 percent, is qualifying property. By year 5 after placement in service, the land has appreciated in value to $4 million. Under the alternative valuation method, the constructed building is required to be valued at its unadjusted cost basis of $8 million, but the land is required to be valued at its fair market value of $4 million. Due to the appreciation of the contributed land, Entity A's qualifying property percentage will be calculated at 67 percent, falling below the required 70-percent threshold.

b. Proposed Resolution

Section 1.1400Z2(d)-1(b)(4)(ii)(B) should be amended to permit taxpayers to use the unadjusted cost basis of contributed property by reference to the unadjusted cost basis of the property in the hands of the contributor. If no such amount can be so established, the unadjusted cost basis of the building will be deemed to be the fair market value of the contributed property on the first relevant testing date. Rules similar to these are used to determine the unadjusted basis of leased property for purposes of degerming whether a building has been substantially rehabilitated under section 1.48-12.

7. Deferral of gain arising from an inclusion event from the disposition of an entire interest or a partial interest in a related QOF

a. The Issue

Section 1.1400Z2(a)-1(b)(11)(iv) provides that gain arising from an inclusion event from the disposition of an entire interest or a partial interest in a QOF is eligible for deferral provided all of the requirements of section 1400Z-2(a)(1)(A) are met. Section 1400Z-2(a)(1)(A) requires, among other things, that the gain arise from the sale to, or exchange with, an unrelated person. Section 1.1400Z2(a)-1(b)(11)(iv) further provides that for purposes of determining whether such gain is eligible gain under section 1400Z-2(a)(1)(A) and this paragraph (b)(11)(iv)(A), the eligible taxpayer should treat such inclusion gain as if it was originally realized upon the occurrence of the inclusion event rather than on the sale or exchange that gave rise to the eligible gain to which the inclusion event relates.

Many taxpayer investors are related persons to QOFs under section 1400Z-2(e)(2) because they hold more than a 20 percent interest in the QOF. Guidance is needed to clarify whether gain realized from an inclusion event is exempt from the related party requirements because under section 1.1400Z2(a)-1(b)(11)(iv) the eligible taxpayer is required to treat the gain as from an inclusion event rather than on the sale or exchange that gave rise to the eligible gain to which the inclusion event relates.

Example – Deferral of incremental gain by a QOF investor

On December 15, 2019, Investor X made an eligible investment in the amount of $1,000,000 in QOF A for a 50 percent interest in QOF A. On June 15, 2020 QOF A was forced to redeem Investor X's investment for $1,000,000 due to difficulty in finding a suitable investment. Investor X wishes to elect to defer the $1,000,000 inclusion gain arising from the redemption of the original QOF investment (an inclusion event) by investing the inclusion gain in QOF B, but is uncertain whether Investor X's 50 percent interest in QOF A will prevent Investor X from deferring the inclusion gain. Further clarification of these results would reduce taxpayer uncertainty.

b. Proposed Resolution

Section 1.1400Z2(a)-1(b)(11)(iv) should be amended to clarify that gains arising from an inclusion event with a related party QOF may be considered eligible gains under section 1400Z-2(a)(1)(A) even though the taxpayer may be related to the QOF within the meaning of section 1400Z-2(e)(2) as a result of their investment in the QOF as follows:

(A) In general. Gain that is otherwise required to be included in gross income under section 1.1400Z2(b)-1(e)(1), whether from the disposition of an entire interest in a QOF or a disposition of a partial interest, may be eligible for deferral under section 1400Z-2(a)(1), provided that all of the requirements to elect to defer gain under section 1400Z-2(a)(1)(A) are met. For purposes of determining whether such gain is eligible gain under section 1400Z-2(a)(1)(A) and this paragraph (b)(11)(iv)(A), the eligible taxpayer should treat such inclusion gain as if it was originally realized upon the occurrence of the inclusion event rather than on the sale or exchange that gave rise to the eligible gain to which the inclusion event relates.

(B) For purposes of paragraph (b)(11)(iv)(A), gains arising from an inclusion event shall not be treated as a sale or exchange with a related party even though an eligible taxpayer may be related to a QOF within the meaning of section 1400Z-2(e)(2), as a result of their investment in the QOF.

8. Return of a contribution in the event of a federally declared disaster

a. The Issue

Under section 1.1400Z2(a)-1(c)(6)(iii)(A)(1), to the extent the transfer of property to a QOF partnership is characterized other than as a contribution, such as a characterization as a sale under section 707, the transfer is not treated as being made in exchange for a qualifying investment.

Due to the ongoing COVID-19 pandemic, some QOFs that had identified a single project for investment have determined that the project is no longer feasible and as a result, are returning eligible contributions to investors. Many times, these contributions are returned to investors in a tax year after the tax year in which these investors elected to defer the capital gains. Further clarification is needed that a return of a contribution due to a federally declared disaster will not result in an eligible investment being recharacterized as a nonqualifying investment.

b. Proposed Resolution

Section 1.1400Z2(a)-1(c)(6)(iii)(A) should be amended to add paragraph (3) as follows:

Federally declared disasters. An otherwise qualifying contribution that is returned to a QOF partner by a QOF partnership due to a federally declared disaster will not be recharacterized as not treated as being made in exchange for a qualifying investment.

9. Addition of rules to stimulate investment in affordable housing

a. The Issue

The OZ incentive can be a valuable tool to attract more private capital to affordable rental housing but certain regulatory barriers have made affordable rental housing investments in OZs significantly less feasible, making it difficult for affordable rental housing projects in OZs to compete for market-rate capital from non-bank investors. However, modification of certain provisions contained in the final regulations could help to level the playing field.

b. Proposed Resolution

- Amend section 1.1400Z2(d)-2(b)(3)(i) to allow properties that are converted from market-rate to affordable rental housing to be considered original use property, thereby not requiring a level of investment that may be cost prohibitive.

- Amend section 1.1400Z2(d)-2(b)(4) to modify the definition of substantial improvement for all affordable rental housing projects. The regulations require that an existing property be improved by at least the property's cost in order to qualify, which is often not feasible for affordable housing projects. To encourage investment in affordable housing, we recommend that the substantial improvement threshold for affordable housing projects be reduced to the greater of $6,800 per unit or 20 percent of the adjusted basis of the acquired property over a 24-month period, similar to the requirements under the low-income housing tax credit (LIHTC) incentive.

10. Addition of rules that stimulate investment in operating businesses

a. Issue #1

Pre-Existing Businesses

Expanding the ability of pre-existing businesses in OZs to qualify as eligible OZ businesses is an ideal means of promoting job creation and retention. However, current OZ regulations make it difficult for these existing businesses to qualify for OZ investment due to the regulations' treatment of their ownership of existing property as nonqualifying property. In order for a business to qualify for OZ investment, substantially-all (70-percent) of its tangible property must be purchased after December 31, 2017. For example, a small manufacturing company that owns tangible property with an adjusted basis of $300,000 would need to acquire $700,000 of additional tangible property in order to be considered a qualified OZ business under current OZ regulations. This investment requirement is not feasible for most businesses that operated in OZs before the OZ incentive was enacted. We recommend the following regulatory modifications in order to stimulate more investment and thus the creation and retention of jobs in pre-existing operating businesses in OZs.

b. Proposed Resolution #1

- Modify the application of the existing substantial improvement test for pre-existing operating businesses in OZs. The modification would allow tangible property purchased on or before December 31, 2017 to be treated as qualified property if the business acquires new tangible property over a 30-month period that exceeds the aggregate adjusted basis of all of the existing property at the beginning of the 30-month period. In the example noted above, this would reduce the new tangible property acquisition requirement to $300,001.
- Create a portion of business rule for qualified OZ businesses. The new markets tax credit (NMTC) program regulations enable an existing business that does not qualify for investment as a whole to maintain separate books and records for the portion of its business that does qualify, thus enabling that portion of the wider business to qualify for NMTC investment. A similar rule for the OZ incentive would enable many more pre-existing businesses in OZs and portions of existing businesses expanding into an OZ to qualify for OZ investment.

c. Issue #2

Start-up Businesses

Gains realized on the sale of investments in QOFs that are held for at least 10 years are excluded from gross income, at the election of the taxpayer. A traditional private equity or venture capital fund holds and liquidates investments in operating businesses at different times over a number of years and the proceeds from the disposal of each investment are often recycled into substitute investments. Under this traditional private equity arrangement, a QOF investor will not realize the full 10-year gain exclusion benefit if a QOF were to sell some of its qualified OZ business investments before 10 years even if the proceeds are re-invested into subsequent OZ investments. This limitation has discouraged many traditional private equity and venture capital investors from investing in operating businesses in OZs.

d. Proposed Resolution #2

In order to encourage investment in start-up businesses in OZs, we recommend that you consider the automatic deferral of any gains realized on the sale of an investment before 10 years by a QOF as long as the proceeds are reinvested in replacement OZ investment by that QOF within a 12-month period.

e. Issue #3

The final regulations provide with respect to any taxable year, a substantial portion (defined as 40 percent) of the intangible property of a qualified OZ business is required to be used in the active conduct of a trade or business in the qualified OZ. For this purpose, tangible property is considered used in the active conduct of a trade or business in an OZ if: (1) the use of the intangible property is normal, usual, or customary in the conduct of the trade or business; and (2) the intangible property is used in the OZ in the performance of an activity of the trade or business that contributes to the generation of gross income for the trade or business. This definition falls short of clarifying what it means to use the property and how a business determines where intangible property is used. This lack of clarity has left certain types of technology operating businesses in the dark as to whether their use of intangible property is qualified and therefore has inhibited investment in many operating businesses in OZs.

f. Proposed Resolution #3

We recommend modifying the regulations or the provision of sub-regulatory guidance to give clarity to what it means to use intangible property, as follows:

- The phrase "used in the active conduct of a trade or business" be defined as the commercial use of intangible property for the management, development, manufacturing, and sale or lease of goods and services to generate gross income. This definition would include the development of intangibles for sale as long as a substantial amount (40 percent) of the services to develop the intangibles are performed in the OZ.
- Provide that the portion of intangible property used in the active conduct of a business is determined based upon the portion of gross income generated by the commercial use of intangible property for the management, development, manufacturing, and sale or lease of goods and services (including intangibles developed in the OZ) over total gross income from the use of intangible property.
- Provide that the situs of where a business' intangible property is used in the active conduct of a trade or business is consistent with where a business' tangible property is used in the active conduct of a trade or business.

11. Preservation of qualified opportunity zone property after the qualified opportunity zone designation expires

a. The Issue

QOF compliance hinges on the direct or indirect continuous use of qualified OZ business property in an OZ. In addition, qualified OZ businesses are required to continuously derive at least 50 percent of their total gross income within an OZ and use a substantial portion of their intangible property in the active conduct of such business within an OZ.

Section 1400Z-2 does not contain specific statutory language that expressly permits QOFs to satisfy qualified opportunity zone property requirements for existing investments after the termination of the designation of a zone on December 31, 2028. As a result, taxpayers are uncertain how they can maintain compliance.

Furthermore, section 1.1400Z2(f)-1(b) provides, if a QOF receives proceeds from the return of capital or the sale or disposition of some or all of its qualified opportunity zone property and reinvests some or all of the proceeds in qualified opportunity zone property by the last day of the 12-month period beginning on the date of the distribution, sale, or disposition, then the proceeds, to the extent that they are so reinvested, are treated as qualified opportunity zone property. However, this provision does not address whether reinvestments made after the termination of the zone designations in 2028 can likewise be treated as qualified opportunity zone property. Consequently, taxpayers are uncertain whether qualified reinvestments can be made after 2028.

b. Proposed Resolution

Sections 1.1400Z2(d)-1 and 1.1400Z2(d)-2 should be amended to add clarification that QOFs can preserve compliance with qualified opportunity zone property requirements after the OZ designation expires until December 31, 2047 (similar to the extension of availability of the section 1400Z-2(c) election provided in section 1.1400Z2(c)-1(c)) as follows:

> Section 1.1400Z2(d)-1(d)(7): **Extension of compliance after zone termination**. The ability to satisfy qualified opportunity zone business requirements in paragraphs (d)(1)(i) through (iii) of this section is not impaired solely because, under section 1400Z-1(f), the designation of one or more qualified opportunity zones ceases to be in effect. The preceding sentence does not apply after December 31, 2047.

> Section 1.1400Z2(d)-2(e): **Extension of compliance after zone termination**. The ability to satisfy qualified opportunity zone business property requirements in paragraphs (b), (c), and (d) of this section is not impaired solely because, under section 1400Z-1(f), the designation of one or more qualified opportunity zones ceases to be in effect. The preceding sentence does not apply after December 31, 2047.

Section 1.1400Z2(f)-1(b) should be amended to add clarification that qualified reinvestments can be made by QOFs after the qualified opportunity zone designation expires on December 31, 2028 until December 31, 2047 provided the reinvestment zone meets the requirements of a low-income community under section 45D(e) at the time of the reinvestment, as determined based on the most recent data published by the Bureau of the Census as follows:

> Section 1.1400Z2(f)-1(b)(3): **Reinvestments after zones termination.** A QOF's reinvestment of some or all of the proceeds described in paragraph (b)(1) is not impaired solely because, under section 1400Z-1(f), the designation of one or more qualified opportunity zones ceases to be in effect provided the reinvestment zone meets the requirements of a low-income community under section 45D(e) at the time of the reinvestment, as determined based on the most recent data published by the Bureau of the Census. The preceding sentence does not apply after December 31, 2047.

12. Valuing a QOF's tangible assets under the applicable financial statement methodology on the last day of the first 6-month period of the QOF's taxable year

a. The Issue

Section 1400Z-2(d)(1) provides that a QOF must measure compliance with the 90 percent test on the last day of the first 6-month period of its taxable year and on the last day of its taxable year. Section 1.1400Z2(d)-1(b)(3) provides that an acceptable measure of the values of assets for the 90 percent test and 70-percent test is the value as reported on the QOF's or qualified OZ business' applicable financial statement within the meaning of section 1.475(a)-4(h) for the reporting period.

Applicable financial statements within the meaning of section 1.475(a)-4(h) include a certified audited financial statement that is prepared in accordance with U.S. GAAP; that is given to creditors for purposes of making lending decisions, given to equity holders for purposes of evaluating their investment in the eligible taxpayer, or provided for other substantial non-tax purposes; and that the taxpayer reasonably anticipates will be directly relied on for the purposes for which it was given or provided. To the extent that a business uses certified audited financial statements, it is common business practice for those financial statements to be audited once, annually, at the end of their fiscal year. QOFs and qualified OZ businesses using the applicable financial statement method, are concerned that they may be required to have their financial statements audited twice a year to coincide with the applicable testing dates which causes undue financial and administrative burdens.

b. Proposed Resolution

Sections 1.1400Z2(d)-1(b)(2)(i)(A) and 1.1400Z2(d)-1(b)(2)(ii)(A) should be amended to make clear that QOFs and qualified OZ businesses using a certified audited financial statement that is prepared in accordance with U.S. GAAP as its applicable financial statement are not required to use an certified audited financial statement as of the last day of the first 6-month period of its taxable year as long as the method for valuing the property is consistent with the method used in its certified audited financial statements as of the last day of its taxable year as follows:

> (i)(A) In general. To meet the 90-percent investment standard in section 1400Z-2(d)(1), on a semiannual basis, a QOF may value its assets using the applicable financial statement valuation method set forth in paragraph (b)(3) of this section, if the QOF has an applicable financial statement within the meaning of section 1.475(a)-4(h), or the alternative valuation method set forth in paragraph (b)(4) of this section. During each taxable year, a QOF must apply consistently the valuation method that it selects under paragraph (b) of this section to all assets valued with respect to the taxable year. A QOF using a certified audited financial statement that is prepared in accordance with U.S. GAAP as its applicable financial statement is not required to use a certified audited financial statement as of the last day of the first 6-month period of its taxable year as long as the method for valuing the property is consistent with the method used in its applicable financial statements as of the last day of its taxable year.
>
> (ii)(A) A) In general. For purposes of the fraction set forth in paragraph (d)(2)(ii)(A) of this section, the owned or leased tangible property of a qualified opportunity zone business may be valued using the applicable financial statement valuation method set forth in paragraph (b)(3) of this section, if the qualified opportunity zone business has an applicable financial statement within the meaning of section 1.475(a)-4(h), or the alternative valuation method set forth in paragraph (b)(4) of this section. During each taxable year, the valuation method selected under this paragraph (b) must be applied consistently to all tangible property valued with respect to the taxable year. A qualified opportunity zone business using a certified audited financial statement that is prepared in accordance with U.S. GAAP as its applicable financial statement is not required to use a certified audited financial statement as of the last day of the first 6-month period of its taxable year as long as the method for valuing the property is consistent with the method used in its applicable financial statements as of the last day of its taxable year.

13. Earnings on recently contributed property, capitalized organizational and start-up costs, and the 90-percent test

a. The Issue

For the purpose of the 90-percent test, QOFs may disregard property which was contributed up to six months before a testing date[2]. The final regulations are silent whether earnings on that disregarded property can also be disregarded. The final regulations also do not address whether capitalized organizational, startup or similar costs can be disregarded for purposes of the 90-percent test, although the preamble to the final regulations provides:

[2] Treas. Reg. 1.1400Z2(d)-1(b)(2)(B)

> [M]ere expenses arising from organizing a QOF or day-to-day operations with regard thereto (such as selling commissions, organization expenses, offering expenses, and similar expenses) do not result in any QOF asset cognizable for Federal income tax purposes and therefore are not taken into account to any extent in determining satisfaction of the 90-percent investment standard.

We recommend that section 1.1400Z2(d)-1(b)(2)(i)(B) be amended to provide that a QOF may determine compliance with the 90-percent test by excluding from both the numerator and the denominator the following: earnings on disregarded recently contributed property and capitalized organizational and start-up costs (such as selling commissions, organizational expenses, offering expenses, and similar expenses). Otherwise, many QOFs are likely to fail the 90-percent test leading to unreasonable penalties.

Example

On October 1, 20xx, a QOF partnership receives eligible contributions totaling $1,000,000. On the same day, the QOF incurs $50,000 of organizational costs and deposits the remaining $950,000 into an interest-bearing account thru December 31, 20xx. During this 3-month period, the QOF deposited earnings of $3,000.

For its December 31, 20xx 90-percent test, the QOF chose to disregard the $950,000 of cash from both the numerator and denominator of the 90-percent test as it was received as a contribution not more than six months before the test from which it is being excluded and has been held continuously in cash. Unless QOF is able to disregard the earnings and organizational costs, QOF will be subject to the penalty under section 1400Z-2(f)(1).

b. Proposed Resolution

Amend section 1.1400Z2(d)-1(b)(2)(i)(B) to provide that a qualified opportunity fund may determine compliance with the 90-percent test by excluding from both the numerator and the denominator the following: earnings on disregarded recently contributed property and capitalized organizational and start-up costs (such as selling commissions, organizational expenses, offering expenses, and similar expenses) as follows:

> Option for QOFs to disregard recently contributed property, earnings on recently contributed property and organizational and start-up costs. A QOF may choose to determine compliance with the 90-percent investment standard by excluding from both the numerator and denominator of the test any property that satisfies all the criteria in paragraphs (b)(2)(i)(B)(1) through (5) of this section. A QOF need not be consistent from one semiannual test to another in whether it avails itself of the option in this paragraph (b)(2)(i)(B).
>
> 1) The amount of the property was received by the QOF partnership as a contribution or by the QOF corporation solely in exchange for stock of the corporation;
>
> 2) The contribution or exchange occurred not more than 6 months before the test from which it is being excluded; and

3) Between the date of the fifth business day after the contribution or exchange and the date of the semiannual test, the amount was held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less.

4) Earnings on property satisfying all the criteria in paragraphs (b)(2)(i)(B)(1) through (3) that occurred not more than 6 months before the test from which it is being excluded; and

5) Capitalized organization and start-up expenses (such as selling commissions, organizational expenses, offering expenses, and similar expenses).

The instructions to Form 8996 should also be revised to exclude these items from the definition of "total assets."

14. Solely disregarded assets and the 90-percent test

a. The Issue

In the event a QOF is able to choose to disregard all of its assets from lines 6, 7, 9, and 10. The resulting ratio equals 0/0 - an undefined number - for Lines 8 and 11. The Form 8996 instructions do not provide guidance under this scenario, which is common in the initial tax year of a QOF.

b. Proposed Resolution

Update Form 8996 instructions to provide when all of a QOF's assets are disregarded for the 90-percent test, yielding a 0/0 ratio for Part 2, Lines 8 and/or 11, the QOF should enter 1.00.

15. Clarifying what constitutes working capital assets and "subsequent infusions of working capital assets"

a. The Issue

Section 1.1400Z2(d)-1(d)(3)(v)(E) provides that tangible property may benefit from multiple 31-month periods for up to a total of 62 months, provided (among other criteria found in paragraph (d)(3)(vi)) that "the subsequent infusions of working capital assets form an integral part of the plan covered by that initial working capital safe harbor period." The current guidance does not clarify what constitutes "subsequent infusions of working capital assets" and as a result, there is uncertainty whether businesses may benefit regardless of the source of the subsequent infusions. Taxpayers also question whether loan commitments that satisfy the three requirements under section 1.1400Z2(d)-1(d)(3)(v)(A) through C can be considered working capital assets and whether payments made on behalf of a business by a debt provider (e.g. construction lender) can be considered subsequent infusions of working capital assets.

Example

QOF A forms a domestic C corporation B to develop a large mixed-use real estate development that will consist of commercial and residential real property, owning almost all of the equity of B in exchange for cash. To raise additional working capital for the mixed-use real estate development, B also will borrow cash under a new construction loan agreement with an unrelated lender. B has a master written plan for the completion of the commercial and residential real property over a 55-month period. The plan provides that the commercial real property will be completed over a 30-month schedule and subsequently, the residential real property will be completed over a 25-month schedule. The plan further provides that a portion of the commercial real property is unable to be used in a trade or business after the completion of the commercial real property since that portion of the commercial real property will be unusable during the residential construction phase. Pursuant to B's original master plan for the completion of the real estate development, B uses all of the equity for the completion of the commercial real property (as required by the construction lender) and uses subsequent infusions of construction loan proceeds for the residential development phase. The construction lender oversees the disbursements of all construction payouts which are made as work is completed – a typical arrangement required by construction lenders.

Unless construction draws can be considered subsequent infusions of working capital assets, B's working capital safe-harbor period ends when B completes his equity spend - leaving B without the protection of the companion safe-harbors for tangible property, intangible property and gross income.

b. Proposed Resolution

In order to provide clarity to the meaning of subsequent infusions of working capital and flexibility to businesses with a master plan that includes debt financing we propose the following amendments to section 1.1400Z2(d)-1(d)(3)(vi):

> (A) Maximum 62-month safe harbor for start-up businesses. Property described in paragraphs (d)(3)(vi)(B), (C), and (D) of this section may benefit from one or more 31-month periods, for a total of 62 months, in the form of multiple overlapping or a sequential application of the working capital safe harbor if—
>
> (1) Each application independently satisfies all of the requirements in paragraphs (d)(3)(v)(A) through (C) of this section;
>
> (2) The working capital assets from an expiring 31-month period were expended in accordance with the requirements in paragraphs (d)(3)(v)(A) through (C) of this section;
>
> (3) The subsequent infusions of working capital assets (regardless of the source) form an integral part of the plan covered by the initial working capital safe harbor period; and
>
> (4) Each overlapping or sequential application of the working capital safe harbor includes a substantial amount of working capital assets (which may include available but undrawn debt commitments) ~~debt instruments described in section 1221(a)(4)~~).
>
>> (i) Special rule for available but undrawn debt commitments. Available but undrawn debt commitments are deemed to be working capital assets if all of the requirements in paragraphs (d)(3)(v)(A) through (C) of this section are satisfied with respect to the undrawn debt commitment amount.
>>
>> (ii) Lender payments on behalf of a borrower. Subsequent infusions of working capital assets include lender payments made on behalf of the borrower.