Opportunity Zones
WORKING GROUP™
hosted by Novogradac

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CC:PA:LPD:PR
(REG-121095-19)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Via Federal eRulemaking Portal

Re: REG-121095-19 (Requirements for Certain Foreign Persons and Certain Foreign-Owned Partnerships Investing in Qualified Opportunity Funds and Flexibility for Working Capital Safe Harbor Plans)

Dear Ladies and Gentlemen:

On behalf of the Novogradac Opportunity Zones Working Group (the "OZ Working Group"), we submit the following comments in response to Notice of Proposed Rulemaking REG-121095-19 - Requirements for Certain Foreign Persons and Certain Foreign-Owned Partnerships Investing in Qualified Opportunity Funds and Flexibility for Working Capital Safe Harbor Plans, issued April 14, 2021 (the "Proposed Regulations").

We extend our gratitude to the Department of Treasury and the IRS for their efforts to provide additional clarity on the Opportunity Zone (OZ) rules and regulations through the continued issuance of proposed regulations and for being responsive to our comment letters regarding the previous Notices of Proposed Rulemaking related to the OZ incentive.

The OZ Working Group includes investors, syndicators, lenders, qualified opportunity funds (QOFs), 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.

Specifically, we make the following comments and recommendations:

Flexibility for Working Capital Safe Harbor Plans

Background

Under the existing OZ regulations, qualified opportunity zone businesses (QOZBs) are permitted to hold no more than 5 percent of the average unadjusted bases of their property as nonqualified financial property[1]. The regulations allow an exception whereby cash, cash equivalents, or debt

[1] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(iv)

instruments with a term of 18 months or less are treated as reasonable working capital if the QOZB meets three requirements:

- The amounts are designated in writing for the development of a trade or business in a qualified OZ including when appropriate the acquisition, construction, and/or substantial improvement of tangible property in such a zone.
- There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets. Under the schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets.
- The working capital assets are actually used in a manner that is substantially consistent with the writing and written schedule described above.[2]

The Proposed Regulations provide flexibility for QOZBs to revise or replace the original written designation and written plan, provided that the remaining working capital assets are expended within the original regulatorily required 31-month period, increased by not more than 24 additional months provided in response to a federally declared disaster.[3] Additionally, the new or revised written designation and schedule must be adopted not later than 120 days after the close of the incident period of the disaster.[4]

Issue #1 - Proposed rule for amending and re-writing working capital written plans due to federally declared disasters

Discussion

The Proposed Regulations are unclear whether all QOZBs automatically receive a full 24 months or a portion thereof, and whether taxpayers are required to articulate why they need the additional time.

Recommendation

The Proposed Regulations should clarify that the 24-month extension is automatic for QOZBs located in federally declared disaster areas. Alternatively, if the extension is not automatic, the Proposed Regulations should clarify the criteria necessary to qualify for the additional time and provide examples of any necessary supporting documentation.

Issue #2 - Written plan changes due to reasons other than federally declared disasters

Discussion

The Proposed Regulations do not address relief for modifications to working capital written plans for changes in circumstances that are outside of the context of a federally declared disaster. This omission implies that a QOZB cannot modify its plan in any way except for a federally declared disaster. Practitioners have interpreted the "substantially consistent standard" in the final regulations to allow for QOZBs to make reasonable modifications to a written plan to address commonly occurring changes in developing a trade or business or changes in business

[2] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)
[3] Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)(D)
[4] Ibid.

circumstances that do not rise to the level of a disaster declaration. We believe this should be the case.

Recommendation

The Proposed Regulations should provide examples where a QOZB can make reasonable modifications to its written plan and schedule to address commonly occurring changes in developing a trade or business or changes in business circumstances that do not rise to the level of a disaster declaration without violating the "substantially consistent standard." For example, a change in size, unit mix, location (i.e. move to an alternative opportunity zone) or use of a building (e.g. hotel to residential) due to governmental requirements or a change in business climate. As well as a reassignment of working capital to address price volatility or adjustments to operating business strategy to align with changes in the marketplace. The proposed regulations should also clarify that the proposed rule for federally declared disasters was intended to address significant changes to the written plan over a longer period of time.

Issue #3: Determination made to return investments to taxpayers

Discussion

The final regulations issued in December 2019 incorporate a modified version of the disguised sale rules for purposes of determining when an investor makes a qualifying investment in a QOF. These modified rules generally are used to recharacterize transactions which, in form, are contributions of eligible gain from an investor to a QOF followed by a distribution to the investor but which, in substance, constitute a return of the investor's eligible gain. The disguised sale rules are modified so that: (1) they apply not just to contributions of non-cash property but also to contributions of cash; and (2) the exception to debt-financed distributions generally does not apply.[5] We believe that there should be a bright line exception to this rule in the event that a QOF contribution is returned to a taxpayer because of the QOF's failure to find a suitable investment due to a federally declared disaster.

Recommendation

In the event that it is no longer feasible for a QOF to invest the taxpayer's gain into qualified opportunity zone property due to a federally declared disaster, we recommend that the Proposed Regulations provide for a bright line exception providing that a QOF's return of a taxpayer's investment due to a federally declared disaster will not be recharacterized as a nonqualifying investment.

Requirements for Certain Foreign Persons and Certain Foreign-Owned Partnerships Investing in Qualified Opportunity Funds

Background

The Proposed Regulations allow foreign investors that meet the definition of a "security-required person" that receive an eligibility certificate issued by the IRS to make a gain-deferral election for an investment into a QOF.[6] A "security-required person" is defined as a either a foreign person

[5] Treas. Reg. § 1.1400Z2(a)-1(c)(6)(iii)(A)(2)
[6] Prop. Treas. Reg. § 1.1400Z2(a)-2(b)

(other than a partnership) or a "specified partnership."[7] A specified partnership is defined using an ownership test, a "closely-held" test, and a gain or asset test.[8]

The Proposed Regulations define "eligibility certificate" with respect to a security-required gain, as a document issued by the IRS that provides the permitted deferral amount.[9] The Proposed Regulations also provide that the IRS will make a determination with respect to a complete application for an eligibility certificate not later than the 90th day after the date that all information necessary for the IRS to make a determination is received.[10]

The application for an eligibility certification will require a security-required person to:

1. Disclose certain information about the person and the investment
2. Enter into a tax-deferral agreement and security agreement
3. Enter into an agreement with a U.S. agent
4. Provide proof of acceptable security for the future payment of taxes on the deferred capital gain[11]

Issue #1 - Exclusion of U.S. partnerships from definition of security-required persons

Discussion

The Proposed Regulations include U.S. partnerships in the definition of security-required persons that would be required to obtain an eligibility certificate from the IRS specifying the deferral amount[12]. Under the existing regulations, if a U.S. partnership makes a deferral election, the previously deferred gain is included by the U.S. partnership with the same tax attributes in the year of inclusion. These attributes include those considered by sections 1(h), 1222, 1231(b), 1256, and any other applicable provisions of the Internal Revenue Code."[13] This implies that the U.S. partnership would be required to withhold on its foreign partners at the time of inclusion of the deferred gain, thereby ensuring that the deferred tax will be subject to collection.

Recommendation

We recommend that Treasury remove U.S. partnerships with foreign investors from the definition of security-required persons.

Issue #2: Eligibility Certificates

Discussion

Taxpayers generally have only 180 days from the date of a capital gain recognition event to defer that gain through investment into a QOF. These 180 days may not be sufficient for a security required person to prepare an application, wait for the IRS decision (up to 90 days after the date that all information necessary for the IRS to decide is received), and make an investment in a

[7] Prop. Treas. Reg. § 1.1400Z2(a)-2(b)(1)
[8] Prop. Treas. Reg. § 1.1400Z2(a)-2(b)(3)
[9] Prop. Treas. Reg § 1.1400Z2(a)-2(d)(1)
[10] Ibid
[11] Prop. Treas. Reg § 1.1400Z2(a)-2(d)(2)
[12] Prop. Treas. Reg § 1.1400Z2(a)-2(b)(3)
[13] Treas. Reg. § 1.1400Z2(a)-1(c)(1)(i

QOF, particularly because it is not clear when the IRS will view an application to be complete. We believe that the imposition of this additional burden on security required persons, before they can invest in a QOF, is bound to curtail foreign investment in OZs.

Recommendation

We recommend that the IRS permit security required persons to enter into a tax-deferral agreement and security agreement and submit the required information at the time the deferral election is made with their tax return, thereby lessening the burden on taxpayers and the government and increasing foreign investment in OZs.

Issue #3: Acceptable Security

Discussion

The Proposed Regulations refer only to "an irrevocable standby letter of credit" as acceptable security.

Recommendation

Treasury and the IRS should expand the types of acceptable security to include bonds, such as recapture bonds, that were used in the past to secure against potential Low-Income Housing Tax Credit recapture events. Bonds are often less onerous to obtain than a letter of credit, while still providing sufficient security for the possible liability.

Issue #4: Timing of eligibility and withholding certificates

Discussion

The Proposed Regulations are unclear on the process and timing of taxpayers applying for and receiving eligibility certificates and withholding certificates and therefore whether foreign persons would be able to obtain certificates in time to avoid withholding.

Recommendation

The Proposed Regulations should allow for simultaneous application for both an eligibility certificate and a withholding certificate.

Issue #5: Guidance for foreign taxpayers prior to issuance of final regulations

Discussion

Proposed Regulations provide that foreign investors may not make a deferral election without an eligibility certificate and that taxpayers should not submit applications for eligibility certificates before the date the rules are finalized. As a result, it is not clear how or whether a foreign investor can make a deferral election by investing in a QOF before the rules are finalized.

Recommendation

We recommend that Proposed Regulations make it clear that foreign investors can rely on existing regulations which allow foreign investors to defer eligible gains provided they irrevocably waived

any benefits available under an applicable U.S. income tax convention that would exempt the gains from being subject to federal income tax at the time of inclusion.[14]

We appreciate your consideration of these comments. If you have any questions regarding our comments please contact John Sciarretti at john.sciarretti@novoco.com or 330-365-5403.

Yours very truly,

Novogradac & Company LLP

By

John S. Sciarretti, Partner

[14] Treas. Reg. §1.1400Z2(a)-1(b)(11)(ix)(A)(2)