Opportunity Zones WORKING GROUP™
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December 29, 2020

Donald Graves
Department of Treasury, Transition Team Lead

Re: Regulatory Recommendations Around Potential Modifications to OZ Incentive

Dear Mr. Graves

The Novogradac Opportunity Zones Working Group (OZ Working Group) was founded to identify and address technical and administrative issues that arise under the federal opportunity zones (OZ) incentive. The OZ Working Group includes qualified opportunity funds (QOFs), community development entities, community development financial institutions, investors, syndicators, lenders, 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 the government to make the OZ incentive more efficient in delivering benefits to residents and businesses in low-income communities.

Since its enactment in 2017, the OZ incentive has been a driving force behind an enormous influx of investment capital into low-income communities throughout the United States. Novogradac conducts a rolling survey of a select subgroup of QOFs that tracks actual investments made into QOFs and businesses in these communities, with the total reported equity investment received by QOFs to date exceeding $13 billion. While official statistics are not yet available, governmental estimates of cumulative investments into OZs are as high as $75 billion with significant additional investment expected to continue through the remaining life of the OZ incentive.

Prior to the election, President-elect Joe Biden introduced his Build Back Better plan, which includes several proposed modifications to the OZ incentive. These proposed changes have since been included in the Biden-Harris transition plan for racial equity. We applaud the President-elect's support of the OZ incentive and understand his desire to maximize the incentive's impact through his stated goals of focusing on job creation for low-income residents and otherwise providing direct financial benefits to households within the OZs.

To implement many of the President-elect's plans of improving and strengthening the OZ incentive through regulatory action, we make the following recommendations. We also welcome the opportunity to meet with members of the Biden transition team to discuss these recommendations and other potential enhancements to the OZ incentive.

## **QOF Certification**

The Internal Revenue Code (IRC) does not provide any requirements for the certification of QOFs, but instead grants authority to the Secretary of the Treasury to prescribe regulations providing rules for certification. The final regulations issued by the Treasury Department (Treasury) established a simple certification process whereby partnerships and corporations that meet the statutory requirement of having a purpose of investing in qualified

OZ property may self-certify as QOFs. The OZ Working Group believes that one of the primary factors leading to the proliferation of investment in OZs has been the simple certification process prescribed by the final regulations. We understand the policy to ensure OZ benefits align with clear economic, social and environmental benefits to a community; however, we recommend that great care be taken with any modification to the certification process to ensure that these actions do not suppress the flow of capital that is desperately needed in these disadvantaged communities. We recommend that you consider the following guidelines in implementing any modifications:

- Allow established QOFs to be grandfathered under the current self-certification rules to protect existing investments and investment commitments.

- Implement any additional commitments that newly formed QOFs must agree to through the current self-certification process. The self-certification process avoids unneeded regulatory burdens, including approval bottlenecks and resulting delays in investment in disadvantaged communities. Self-certification also greatly reduces the burden on the government.

- Scale newly adopted prospective self-certification requirements, such that smaller funds have less restrictive and burdensome regulatory requirements. For example, the level of regulatory requirements for certification could be based on the amount of capital a fund raises. Additional certification requirements are likely to have a disproportionately burdenseome effect on smaller funds as they have proportionately fewer compliance resources. If additional certification requirements are overly burdensome for smaller funds, such additional burdens are likely to discourage the formation of many new funds, which would inhibit the flow of capital to distressed communities.

**QOF Decertification**

Neither the IRC nor the regulations provide guidance around circumstances that would lead to involuntary decertification of QOFs, though the preamble to the final regulations does provide that the Treasury and the Internal Revenue Service (IRS) continue to consider circumstances under which involuntary decertification would be warranted, and intend to propose guidance regarding those circumstances. The final regulations also reserve a section to address decertification at a future time. We agree with the Treasury and the IRS that certain actions or lack of actions should lead to decertification of funds. We encourage that any rules around decertification be clearly demarcated. We believe that involuntary decertification should only be warranted if a QOF exhibits willful and continuous noncompliance with the rules for an extended period of time. For example, this could include a QOF that willfully fails to achieve the 90% investment standard for a period of three consecutive testing dates or a QOF that consistently willfully fails to comply with mandatory reporting requirements. Unclear or unreasonable circumstances leading to decertification are likely to inhibit investment that is desperately needed in OZs.

**Rules that Stimulate Investment in Affordable Housing**

President-elect Biden's transition plans discuss the OZ incentive's use to promote housing affordability. 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:

- 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.

- 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% of the adjusted basis of the acquired property over a 24-month period, similar to the requirements under the low-income housing tax credit incentive.

- Modify the special amount includible rule for passthrough entities for QOFs that invest in affordable rental housing. Affordable housing investors are not likely to enjoy the 10-year appreciation benefit of the incentive due to the long-term land use restrictions that affordable housing project owners agree to. As a result, the OZ incentive is less valuable to these types of investments. Making modifications to this special rule to allow affordable housing investors to recognize tax benefits for any decrease in value of their affordable housing investment at the 2026 inclusion date, instead of waiting to the later date of sale, increases the value of the incentive and encourages more affordable rental housing investment in OZs.

**Rules that Stimulate the Investment in Operating Businesses**

*Pre-Existing Businesses*

One of President-elect Biden's stated goals is to promote job growth within OZs. 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%) of their tangible property must be purchased after Dec. 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:

- 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 Dec. 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) incentive 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.

*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.

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.

*Use of Intangible Property*

The final regulations provide with respect to any taxable year, a substantial portion (defined as 40%) 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 opportunity zone. For this purpose, tangible property is considered used in the active conduct of a trade or business in a QOZ 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 qualified opportunity zone 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.

We recommend modifying the regulations or the provision of subregulatory 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%) 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 qualified opportunity zone) 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.

**Extended COVID-19 Compliance Relief**

In response to the Federal disaster declarations, the IRS issued Notice 2020-23 and Notice 2020-39, which extended certain time-sensitive actions and provided other relief to taxpayers affected by COVID-19. As we remain under a state of national emergency, we request further extension of the following time-sensitive actions:

- Provide extended relief whereby if the last day of a taxpayer's 180-day investment period within which a taxpayer must make an investment into a QOF falls on or after April 1, 2020, and before June 30, 2021, the last day of the investment period will be postponed to June 30, 2021.

- Provide extended relief for QOFs whose last day of the first six-month period of the taxable year or last day of the taxable year falls within the period beginning on April 1, 2020, and ending on June 30, 2021, by waiving penalties for failure of the QOF's 90% investment standard by establishing that the failure is due to reasonable cause under IRC Section 1400Z-2(f)(3).

- Extend until June 30, 2021, the period in which QOFs and qualified OZ businesses may disregard when determining any 30-month substantial improvement period.

- Extend through June 30, 2021, the date through which working capital assets intended to be covered by the working capital safe harbor are eligible for up to an additional 24 months to be expended.

- Provide that any QOF with a 12-month reinvestment period to reinvest proceeds received by the QOF from the return of capital or the sale or disposition of some or all of the QOF's QOZP that includes any day that falls within the period beginning Jan. 20, 2020, through Dec. 31, 2020, receives up to an additional 12 months to reinvest and that the period beginning Jan. 20, 2020, through Dec. 31, 2020, is disregarded.

- Provide relief to businesses by confirming that qualified OZ businesses that are forced to rework or dramatically alter their plans for the development of a trade or business and, as a consequence, their written plans and schedules, as a result of the impact of a federally declared disaster, are not considered to fail the working capital safe harbor requirement to use working capital assets in a manner substantially consistent with their written plan and schedule.

We appreciate your consideration of our comments. We welcome the opportunity to discuss these issues with you further.

Very truly yours,

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