March 7, 2022

Ms. Lily Batchelder
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Ave., NW, Room 3120
Washington, DC 20220

Re: Introduction to Novogradac Opportunity Zones Working Group and regulatory changes for your consideration

Dear Assistant Secretary Batchelder:

On behalf of the Novogradac Opportunity Zones Working Group (the OZ Working Group), we would like to congratulate you on your confirmation as the Assistant Secretary for Tax Policy and to introduce you to our OZ Working Group. We also would also like to ask you to consider certain regulatory changes that we believe would improve the opportunity zone (OZ) incentive under existing law.

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, accountants, attorneys and other community development stakeholders 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.

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. As of Dec. 2021, the total reported equity investment received by QOFs exceeded $24 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.

President Joe Biden's plan to Build Back Better by Advancing Racial Equity includes proposed modifications to the OZ incentive. We applaud the President'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. We also generally agree with recommendations made by the House Ways and Means Subcommittee on Oversight (Subcommittee) in its Dec. 20, 2021 letter to the Department of the Treasury (Treasury) where it recommended that Treasury improve the incentive under existing law by (1) modifying the certification process, (2) implementing reporting requirements and (3) tasking Treasury with proper oversight, beyond the Internal Revenue Service (IRS). We respectively ask Treasury to exercise caution when making such changes to ensure they do not suppress the flow of capital that is so desperately needed in OZs. Our recommendations attached to this letter include those suggested by the Subcommittee as well as certain proposals that we believe are essential to increasing investment in affordable housing and operating businesses in OZs. We also make suggestions intended to provide clarity and facilitate compliance for start-up businesses.

Our recommendations reflect the work of nearly 100 OZ Working Group 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 OZ incentive has shown a promising trajectory since the final regulations were issued in December 2019 and we think that there is good reason to believe that the reach, diversity, and economic impacts of OZ investment will only continue to increase in the coming years as the administration further refines the incentive. We respectfully request that great care be taken to ensure that any modifications do not suppress this momentum and thus the flow of capital that is desperately needed in these disadvantaged communities.

We appreciate the opportunity to introduce ourselves and submit our recommendations. We commend Treasury and IRS for their continuing efforts to improve and clarify tax guidance for the OZ incentive in order to ensure its continuing success.

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. Thank you in advance for your time and consideration.

Yours very truly,

Novogradac & Company LLP

By

John S. Sciarretti, Partner

Attachment:

cc: Tom West, Deputy Assistant Secretary for Domestic Business Tax;
Natasha Sarin, Counselor for Tax Policy and Implementation;
Michael Novey, Associate Tax Legislative Counsel

A. Regulatory Actions to Achieve President Biden's Goals for the OZ Incentive

1. Rules that Stimulate Investment in Affordable Housing

President Biden's transition plans discussed 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 (LIHTC) incentive.

- Modify the special amount includible rule for passthrough entities[1] 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.

- Amend the final regulations to add clarification that qualified reinvestments can be made by QOFs after the qualified opportunity zone (QOZ) designation expires on Dec. 31, 2028 until Dec. 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.

2. Rules that Stimulate the Investment in Operating Businesses

Pre-Existing Businesses

One of President 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

[1] §1.1400Z2(b)-1(c)(6)

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 opportunity zone business (QOZB) 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:

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 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.

2. Create a portion of business rule for QOZBs. 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[2]. 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. In other words, if you invest millions of dollars in a QOZ – why should it matter if the entity in which you are investing has other assets outside the QOZ.

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 QOZB is required to be used in the active conduct of a trade or business in the QOZ. For this purpose, intangible 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 QOZ in the performance of an activity of the trade or business that contributes to the generation of gross income for the trade or business[3]. 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 sub-regulatory guidance to give clarity to what it means to use intangible property, as follows:

[2] §1.45D-1(d)(4)(iii)
[3] Reg §1.1400Z2(d)-1(d)(3)(ii)

- 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 property 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 property and services (including intangibles developed in the QOZ) 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.

- Provide a safe-harbor that provides that if a business meets the 50% gross income requirement at 60% or more, the business is deemed to meet the 40% intangible property use test.

3. Qualified Opportunity Fund Certification and Decertification

Qualified Opportunity Fund 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 Treasury established a simple certification process whereby partnerships and corporations that meet the statutory requirement of having a purpose of investing in QOZP 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 burdensome 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.

Qualified Opportunity Fund 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 IRS continue to consider circumstances under which involuntary decertification would be warranted, and intend to propose guidance regarding those circumstances. 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.

4. Data Collection and Monitoring

Employ the Community Development Financial Institutions Fund (CDFI Fund) to collect data and monitor the incentive.

The Subcommittee recommended that Treasury allocate dedicated agency staff (beyond the IRS) to conduct proper oversight of the program and to collect and share data. One cost effective method of information collection would be to use the already established CDFI Fund Awards Management Information System (AMIS) to report a standard set of administrative and financial information (fund-level and transaction-level) with a standard set of definitions and instructions provided by Treasury/IRS before the initial reporting period. AMIS is the web-based data collection system that NMTC allocatees use to submit data annually on businesses that were financed with qualified NMTC equity investments. Institution Level Reports (ILRs) provide summary organizational, financial, lending, and impact data about the institution submitting the report. Transaction Level Reports (TLRs) provide detailed information on the investments made by the institution in low income communities.

B. <u>Regulatory Actions to Provide Clarity and Facilitate Compliance for Start-up Businesses</u>

1. Clarify what it means to be in a Working Capital Safe Harbor (WCSH) period.

The primary focus of the working capital safe harbor (WCSH) in the regulations is on the nonqualified financial property (NQFP) requirement in section 1397C which essentially defines what a "reasonable amount of working capital" is in the context of working capital assets that are being used to develop a trade or business and/or acquire, construct or rehabilitate tangible business property. The WCSH is also a tool to help businesses manage the QOZB requirements during the start-up phase. Businesses qualifying for the 31-month or 62-month WCSH are provided additional safe harbors with respect to the requirements that: (1) 50% of the gross income of a QOZB be derived in the active conduct of a trade or business in a QOZ, (2) a substantial portion of the intangible property of a QOZB be used in the active conduct of a trade or business in a QOZ, and (3) 70% of tangible property be qualified opportunity zone business property. Businesses qualify for these additional safe harbors only while they are in a WCSH period. The regulations do not define what it means to be in a WCSH period. One could take the position that a business is only in a WCSH period while it possesses working capital assets. Additionally, based on the examples in the regulations it appears that the working capital can be solely funded through equity investments and not debt. This narrow interpretation limits the usefulness of the WCSH for many start-up businesses that are required to expend their QOF equity in the early stages of the start-up period – leaving them with no working capital assets or working capital funded by equity rather than debt and therefore uncertainty of whether they can rely on the WCSH for the remainder of their start-up period.

For example, assume QOF G creates a partnership H to acquire land and construct a commercial building and acquires equity of H in exchange for cash on Date 1. H writes a plan with a 31-month schedule which shows the use of all of the Date 1 cash to acquire the land on Date 1. Additional capital for the construction phase of the project is expected to be provided by draws on a construction loan that H has secured. As a result, H will not possess working capital assets from QOF equity or otherwise after Date 1 during the start-up period for the business.

In order to address this uncertainty, we recommend that the regulation define WCSH period as the 31-month period beginning with the date of infusion of working capital assets, regardless of when the working capital assets are consumed during that 31-month period and that working capital assets can be funded using any source - not only equity.

2. Clarify that related party expenditures for services to construct property satisfy the purchase requirement.

The regulations provide that tangible property manufactured, constructed, or produced by an eligible entity satisfies the from a person that is not a related person if the manufacture, construction, or production begins after Dec. 31, 2017 and the materials and supplies used to manufacture, construct, or produce the property are qualified opportunity zone business property.[4] Practitioners have interpreted this rule to mean that expenditures paid at arms-length prices by an eligible entity to construct a property (e.g. developer fee) would satisfy the purchase requirement, even if paid to a related party. The current regulations permit a QOZB to construct its own property and it should not matter whether it uses its own employees to do so or retain the services of a related party to do so. We believe this should be the case. The correct interpretation of this rule is particularly important in the context of constructed property because it is common for eligible entities developing or redeveloping property in OZs to employ the services of related party developers and general contractors.

[4] Reg §1.1400Z2(d)-2(b)(iii)

The regulations should provide an example where an eligible entity pays expenditures at arm's length prices to a related party for services to construct property without violating the purchase requirement as defined by section 179(d)(2).

3. Clarify that timely related-party reimbursements of predevelopment expenditures satisfy the purchase requirement.

Joint ventures between sponsor-developers and QOZBs often require the QOZB to reimburse the developer for pre-development expenditures paid to advance projects from conceptual phase to construction phase (e.g. architectural and engineering fees, permits, taxes, etc.) before the joint venture was established. The regulations do not address whether such reimbursements to related party sponsor-developers would satisfy the purchase requirement. We believe that this should be the case for expenditures incurred within a reasonable time-frame before the reimbursement. Similar rules under the NMTC incentive use a 24-month period and so do other rules in the IRC.

The regulations should clarify that reimbursements to related parties for reasonable expenditures incurred within 24-months of the reimbursement satisfy the purchase requirement as defined by section 179(d)(2). The regulations should also provide for additional time for reimbursements to qualify in the event of Federally-declared disasters.

4. Allow contributed property to be valued at fair market value at the time the property is contributed.

The 70% test generally applies to purchased or constructed property as follows:

1. A QOZB's purchased or constructed property is valued at its unadjusted cost basis (i.e. initial purchase or construction cost).[5]

2. Any other property of a QOZB is valued according to its fair market value as of each testing date.[6]

In other words, the QOZB's purchased assets (which are normally good assets) use a fixed number, while a QOZB's contributed assets (which are always bad assets) use a fluctuating number for the 70% test.

For example, assume a QOZB is funded with $6 million of cash and receives a contribution of land valued at $2 million. The QOZB spends the $6 million on the purchase and construction of qualifying assets by the next applicable testing date. The business satisfies the 70% test on the testing date, because the $6 million of qualifying assets is 75% of the $8 million in total assets.

A few years later, the local real estate market has appreciated by 50%. The nonqualifying contributed land is now worth $3 million, which is the relevant value for the 70% test. The purchased and constructed qualifying assets are worth $9 million but are still valued at $6 million. The QOZB fails the 70% test because the $6 million of qualifying assets is only 67% of the $9 million of total assets.

[5] Reg §1.1400Z2(d)-1(b)(iv)(2)(A)
[6] Reg §1.1400Z2(d)-1(b)(iv)(2)(B)

Valuing contributed property (bad assets) based on fluctuating market values creates uncertainty and is counter-intuitive to the objective of the incentive—to increase property values in OZs.

The regulations should provide that for purposes of the 70% test, contributed property is valued at a fixed number at each testing equal to the fair market value of the property at the time the property is contributed.

5. Clarify that the six-month cure period is available to new businesses that have never been qualified.

If a business causes a QOF to fail the 90% investment standard on a semiannual testing date, the QOF is nevertheless allowed to treat its equity investment (stock or partnership interest) in that business as QOZP (i.e., a good asset) for that semiannual testing date if the trade or business corrects the failure within six months of the date on which the business lost its qualification.[7] Marking the beginning of the six-month cure period from the time the business "lost its qualification" implies that the business first had to be qualified. If this is the correct interpretation, then no cure-period exists for a new business being organized for purposes of being a QOZB, which is not consistent with the objective of the incentive to spur new business investment.

The regulations should provide that in the case of a new business, the six-month cure period begins on the date that the QOF becomes aware (or reasonably should have become aware) of the failure. This modification is consistent with the cure period provided to community development entities under the NMTC incentive.[8]

6. Clarify that QOFs can preserve compliance after QOZ designations expire on December 31, 2028.

QOZ designations expire on December 31, 2028.[9] The final regulations are silent on how QOFs can preserve compliance on investments held after this expiration date resulting in uncertainty as to whether a taxpayer can comply. This uncertainty is likely to suppress investment into QOZs.

The final regulations should be amended to add clarification that QOFs can preserve compliance with qualified opportunity zone property and income requirements after the OZ designation expires on December 31, 2028 until December 31, 2047 (the last day a 10-year hold election to exclude gain is available[10]). 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 under section 45D(e) at the time of the reinvestment.

[7] §1.1400Z2(d)-1(d)(6)(i)
[8] §1.45D-1(e)(6)
[9] §1400Z-1(f)
[10] §1.1400Z2(c)-1(c)