Opportunity Zones
WORKING GROUP™
hosted by Novogradac

June 3, 2022

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2022-21)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2022-21 Public Comment Invited on Recommendations for 2022-2023 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 2022-21, requesting suggestions for items to include on the Internal Revenue Service's (Service or IRS) 2022 – 2023 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, 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.

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

- Resolve significant issues relevant to a broad class of taxpayers – current and potential investors, QOFs, and qualified opportunity zone businesses (QOZBs);
- 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.

Our comments reflect the work of a broad cross-section of OZ stakeholders 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 2022-2023 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 2022-21 Public Comment Invited on Recommendations for 2022-2023 Priority Guidance Plan

Contents

Recommendations for 2022 – 2023 Priority Guidance Plan

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

a. The Issue

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 qualified opportunity zone (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 OZ 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.

b. Proposed Resolution

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. 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.

3. 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 QOZB 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 QOZB is located in a QOZ within a federally declared disaster (as defined in section 165(i)(5)(A)), the QOZB 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.

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

a. The Issue

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 OZ business property.[1] 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

[1] Reg §1.1400Z2(d)-2(b)(iii)

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.

b. Proposed Resolution

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

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

a. The Issue

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.

b. Proposed Resolution

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.

6. 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.[2] Accordingly, there are no additional administrative burdens from tracking these improvements.

[2] Treas. Reg. §1.263(a)-3(d).

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 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 OZs 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.

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

a. The Issue

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).[3]

[3] Reg §1.1400Z2(d)-1(b)(iv)(2)(A)

2. Any other property of a QOZB is valued according to its fair market value as of each testing date.[4]

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.

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.

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.

8. 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 Resolutions

- 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

[4] Reg §1.1400Z2(d)-1(b)(iv)(2)(B)

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.

- Amend section §1.1400Z2(b)-1(c)(6) to 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.

9. 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 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.

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 QOZBs. 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 QOZB 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 QOZB is required to be used in the active conduct of a trade or business in the QOZ. 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.

10. 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.

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

a. The Issue

Section 1.1400Z2(d)-1(d)(6)(i) provides that 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 qualified OZ property (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. 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.

b. Proposed Resolution

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.[5] In order to clarify that the cure-period applies to a newly formed business that has yet to qualify as a QOZB, we propose the following amendment to section 1.1400Z2(d)-1(d)(6)(i):

(A) For purposes of the 90-percent QOZB holding period requirements set forth in sections 1400Z-2(d)(2)(B)(i)(III), 1400Z-2(d)(2)(C)(iii), and 1400Z-2(d)(2)(D)(i)(III), if a trade or business causes the QOF to fail the 90-percent investment standard on a semiannual testing date, the QOF may treat the stock or partnership interest in that trade or business as qualified OZ property for that semiannual testing date provided the trade or business corrects the failure by 6 months from the date that the QOF becomes aware (or reasonably should have become aware) of the failure. ~~within 6 months of the testing date on which the stock or partnership interest lost its qualification.~~

12. Preservation of qualified OZ property after the QOZ 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, QOZBs 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.

[5] §1.45D-1(d)(6)

Section 1400Z-2 does not contain specific statutory language that expressly permits QOFs to satisfy qualified OZ 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 OZ property and reinvests some or all of the proceeds in qualified OZ 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 OZ 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 OZ 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 OZ 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 QOZB 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 QOZs 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 OZ 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 QOZs 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 QOZ 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.

13. 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 QOZB's 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 QOZBs 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 QOZBs 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 QOZB may be valued using the applicable financial statement valuation method set forth in paragraph (b)(3) of this section, if the QOZB 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 QOZB 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.

14. 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[6]. 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:

> [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 QOF may determine compliance with the 90-percent test by excluding from both the numerator and the denominator the following: earnings

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

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."

15. 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.