

July 16, 2018

Mr. Scott Dinwiddie
Associate Chief Counsel
Income Tax & Accounting
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Priority Guidance Request on Opportunity Zones

Dear Mr. Dinwiddie:

On behalf of the members of the Novogradac Opportunity Zones Working Group (the OZ Working Group), we are requesting immediate guidance on priority issues regarding various provisions of Internal Revenue Code Section (IRC) 1400Z-2.

While we identified numerous items needing guidance in our previous letter dated March 9, 2018, we are requesting the Department of Treasury (Treasury) and the Internal Revenue Service (IRS) focus their immediate attention on providing quick answers to the following eleven questions. Based upon our collective experiences, the lack of guidance around these priority issues are the most common barriers to taxpayer investment. We are hopeful that guidance on these items can be quickly provided through IRS FAQs. We have narrowed this guidance request to those areas that are both hindering investment in opportunity zones and we believe are readily addressable by the IRS through its FAQs page.

We have divided our priority guidance request into five sections:

- A. Gains eligible for deferral;
- B. Application of opportunity zones to partnerships;
- C. Qualification of temporary cash reserves;
- D. Qualification of opportunity zone businesses; and,
- E. Tax implications of debt.

Our guidance request with respect to each of the identified issues is structured in three parts:

- 1. The question;
- 2. A proposed response; and,
- 3. A brief explanation of the issue.

The members of the OZ Working Group are participants in the community development finance field, and include investors, lenders, for-profit and nonprofit developers, community development financial institutions, community development entities, trade organizations and other related professionals. These stakeholders are working together to suggest consensus solutions to technical opportunity zone incentive issues and provide recommendations to make the opportunity zones incentive more efficient in delivering benefits to low-income communities.

We appreciate your consideration of these comments and look forward to an opportunity to discuss these issues further.

Yours very truly,

Novogradac & Company LLP

Novogradac & Company LLP



By
Michael J. Novogradac, Managing Partner

By
John S. Sciarretti, Partner

CC: Michael Novey, Office of Tax Policy, Treasury
Julie Hanlon-Bolton, ITA, IRS

Attachments: Recommendations for Guidance on Opportunity Zones

Recommendations for Guidance on Opportunity Zones

A. Gains eligible for deferral

Q1 Are ordinary gains eligible for deferral?

A1 Proposed Response:

Gains eligible for deferral include all gains from the sale of property (other than property held for sale to customers in the ordinary course of business) including short-term and long-term capital gains, Section 1231 gains, and ordinary gains.

Analysis:

It is unclear whether ordinary gains realized by a taxpayer are eligible for tax deferral, such as gains from depreciation recapture under IRC §1245; IRC §1250; and IRC §291; or the sale of debt instruments under IRC §582. The statute simply refers to “gains” from the sale or exchange of property with no mention of the required character of the gains.¹ However, both the statute title (“Special rules for capital gains invested in opportunity zones”) and the conference report might be read to imply the intent of Congress that only “capital” gains qualify. To the contrary, the proposed statute as initially introduced in Congress referenced “capital gains”,² but subsequent legislation introduced in a later Congress was amended to exclude the term “capital”,³ implying that all “gains” were intended to be eligible. The enacted statute similarly excluded the limit to “capital” gain. In order to clear-up this confusion among taxpayers, we ask that you make it clear which type of gains qualify.

B. Application of opportunity zones to partnerships

Q2 For gains realized by a partnership, who is considered the “taxpayer” for purposes of investing in a Qualified Opportunity Fund (“Opportunity Fund”)?

A2 Proposed Response:

For gains realized by a partnership, either the partnership that realized the gain or any of the partners allocated the gain is considered the “taxpayer” for purposes of investing in an Opportunity Fund. For tiered partnerships, either the lower-tier partnership, any intervening partnerships, the upper-tier partnership or any partner in the upper-tier partnership can make

¹ IRC §1400Z-2(a)(1)

² See S.2868 and H.R. 5082, 114th Congress, 2d Session

³ See S.293 and H.R. 828, 115th Congress, 1st Session

the election. A partnership electing to invest gain in an Opportunity Fund must notify all of its partners of the election and investment in an Opportunity Fund to prevent duplication.

Analysis:

For gains realized by a partnership, it is unclear whether the partners or the partnership is the taxpayer for purposes of making an investment in an Opportunity Fund for purposes of deferring gains arising from the sale of partnership property. Many taxpayers realize gains through partnerships, so it is crucial that they know which entities qualify as a taxpayer for purposes of investing in Opportunity Funds.

Q3 If Taxpayer realizes a gain, and invests in a partnership, and the partnership, in turn, invests in an Opportunity Fund within 180 days of Taxpayer realizing the gain, may Taxpayer elect to defer the realized gain under Section 1400Z-2?

A3 Proposed Response:

If Taxpayer realizes a gain, and invests in a partnership, and the partnership, in turn, invests in an Opportunity Fund within 180 days of Taxpayer realizing the gain, Taxpayer may elect to defer the realized gain under Section 1400Z-2. If Taxpayer elects to defer gain, Taxpayer must reduce their basis in their partnership investment and the partnership, in turn, reduces its basis in the Opportunity Fund.

Analysis:

It is unclear whether a taxpayer investing in an Opportunity Fund indirectly through an intermediate partnership qualifies for the opportunity zone benefits. In order for Opportunity Fund investments to achieve the scale intended by Congress, it is crucial that Opportunity Fund managers have the ability to diversify investments and manage timely exits within a fund. Traditional private equity funds hold a number of investments and liquidate them at different times over a number of years and the proceeds from the disposal of each investment are distributed to investors, or recycled into substitute investments. It is unclear how effectively an Opportunity Fund can operate under this traditional private equity approach and enjoy the five, seven and ten-year hold gain exclusion benefits provided for in the statute.⁴ This is because any gains realized by a Opportunity Fund partnership, when a fund liquidates individual investments, will flow-through to its partners irrespective of the five, seven and ten year hold benefits; benefits which generally can only be realized upon the sale or exchange of an Opportunity Fund interest.

One way Opportunity Fund managers can achieve diversity and better manage timely exits is to permit taxpayers to use an intermediate partnership to invest in an Opportunity Fund. Allowing the use of intermediate partnerships would be similar to the rule for the qualified small business (QSB) stock gain deferral incentive under IRC §1045, where taxpayers are permitted to invest in replacement QSB stock through a purchasing partnership.⁵ The use of an intermediate partnership would allow Opportunity Fund managers to pool capital in an upper-tier partnership

⁴ IRC§1400Z-2(c)

⁵ Treas. Reg. 1.1045-1(c)(1)(i)

for further investment into multiple single-project lower-tier Opportunity Funds. As lower-tier Opportunity Fund investments mature, the upper-tier intermediate partnership could sell its lower-tier Opportunity Fund interests, rather than the underlying Qualified Opportunity Zone Property (“Opportunity Zone Property”). The five, seven and ten year hold benefits would track with each separate Opportunity Fund investment, such that the disposition of one investment would not affect the hold benefits of other partnership Opportunity Fund investments. This strategy would enable Opportunity Fund managers to diversify their investment pool and efficiently manage exits.

C. Qualification of temporary cash reserves

Q4 Are cash reserves held by an Opportunity Fund for investment in Qualified Opportunity Zone Property considered Qualified Opportunity Zone Property?

A4 Proposed Response:

Cash reserves held by an Opportunity Fund for investment in Qualified Opportunity Zone Property is considered Opportunity Zone Property for a period of twelve-months following investment in an Opportunity Fund.

A4 Proposed Alternative Response:

To the extent an Opportunity Fund fails the requirement to hold 90% of its assets in Opportunity Zone Property, and that failure is due, all or in part, to cash reserves held by the Opportunity Fund (for twelve months or less from receipt of funds from an investor) for investment in Opportunity Zone Property, the Opportunity Fund will be deemed to have reasonable cause and no penalty will be imposed to the extent the failure is attributable to the cash reserves.

Analysis:

The opportunity zones statute explicitly states that Treasury guidance is needed to provide reasonable time for an Opportunity Fund to reinvest the return of capital from the sale of investments in Opportunity Zone Property. Likewise, Opportunity Funds need adequate time to assemble and underwrite initial Opportunity Zone Property investments. The 180 day time requirement for taxpayer investments in Opportunity Funds to qualify for deferral is independent of whether an Opportunity Fund is ready to invest in Opportunity Zone Property. As a result, Opportunity Funds may be unable to accept investor capital within the 180 day time requirement. In order to provide adequate time to make Opportunity Zone Property investments, cash investments received by an Opportunity Fund should be treated as invested in Opportunity Zone Property to the extent cash is invested within the twelve-month period beginning on the date the cash is received by the Opportunity Fund. This provision of time to invest is similar to the time permitted to community development entities to invest taxpayer equity under the new markets tax credit program.⁶

⁶ §1.45D-1(c)(50)(iv)

If Treasury does not believe they have regulatory authority to make the determination, then we ask that Treasury state that an Opportunity Fund has reasonable cause for holding cash reserves for twelve months or less from receipt of funds from an investor, such that a penalty would not be imposed.

Q5 Are cash reserves held by an Opportunity Fund for the acquisition and/or improvement of property considered Qualified Opportunity Zone Business Property (“Opportunity Zone Business Property”)?

A5 Proposed Response:

Cash reserves held by an Opportunity Fund during a thirty-month period for the acquisition and improvement of property is considered Opportunity Zone Business Property for the thirty months period following the later of the receipt of cash or the acquisition of property to be improved.

A5 Proposed Alternative Response:

If an Opportunity Fund fails the requirement to hold 90% of its assets in Opportunity Zone Property, then to the extent that failure is due to cash reserves held by the Opportunity Fund for the acquisition and improvement of property, and the cash reserves are held thirty months or less from the later of the receipt of cash or the acquisition of property to be improved, then the Opportunity Fund will be deemed to have reasonable cause and no penalty will be imposed to the extent the failure is attributable to the cash reserves held for the acquisition and improvement of property.

Analysis:

It is unclear whether cash reserves held by an Opportunity Fund for the acquisition and improvement of property, can be considered Opportunity Zone Business Property. Many proposed transactions involve the acquisition and improvement of property, which takes time. Because taxpayers are required to invest gains in a fund within 180 days, Opportunity Funds acquiring and improving property are likely to have cash reserves that exceed the 10% limit for a period until reserves are sufficiently drawn down to acquire and improve the property. We recommend that Treasury provide a safe harbor where cash reserves held for acquisition and improvement of property are considered Opportunity Zone Business Property for a period of thirty-months following the later of the receipt of cash or the acquisition of property to be improved. This recommendation is consistent with the time allotted for the substantial improvement test.⁷

If Treasury believes they do not have regulatory authority to make the determination, then we ask that Treasury state that an Opportunity Fund has reasonable cause for holding cash reserves for thirty-months following the later of receipt of cash or the acquisition of property to be improved, such that a penalty would not be imposed.

⁷ IRC §1400Z-2(d)(2)(D)(ii)

Q6 Are cash reserves held by a Qualified Opportunity Zone Business (“Opportunity Zone Business”) for the acquisition and/or improvement of property considered non-qualified financial property?

A6 Proposed Response:

Cash reserves held by an Opportunity Zone Business during a thirty-month period for the acquisition and improvement of property is treated as a reasonable amount of working capital and therefore not non-qualified financial property for the thirty months period following the later of the receipt of cash or the acquisition of property to be improved.

Analysis:

It is unclear to what extent cash reserves held by an Opportunity Zone Business for the acquisition and improvement of property is considered non-qualified financial property (NQFP).⁸ For purposes of IRC §1400Z-2, less than 5% of the average of the aggregate unadjusted bases of the property of an Opportunity Zone Business may be attributable to NQFP. Opportunity Zone Businesses acquiring and improving property are likely to have cash reserves that exceed the 5% limit for a period until reserves are sufficiently drawn down to acquire and improve property. We recommend that Treasury provide a safe harbor where cash reserves held for acquisition and improvement of property within thirty-months after the later of the receipt of cash or the acquisition of property to be improved be treated as a reasonable amount of working capital and therefore not non-qualified financial property. This recommendation is similar to the safe harbor for reasonable working capital under the new markets tax credit program⁹ with substitution of twelve-months with thirty-months to be consistent with the time permitted for property to be considered substantially improved under the opportunity zones statute.¹⁰

D. Qualification of Opportunity Zone Businesses

Q7 What does the term “substantially all” mean?

A7 Proposed Response:

For purposes of 1400Z-2, substantially all means 70%.

Analysis:

It is unclear what the term “substantially-all” means for qualification of an Opportunity Zone Business. In order for a business to qualify, substantially all of the business’ tangible property must be Opportunity Zone Business Property.¹¹ Similar substantially all standards in other place-based tax incentive statutes have been interpreted to mean 70% -85%. We ask that you

⁸ Nonqualified financial property means debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property specified in regulations; except that such term shall not include reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or debt instruments described in section 1221(a)(4).

⁹ Treas. Reg. §1.45D-1(d)(4)(i)(E)(2)

¹⁰ IRC §1400Z-2(d)(2)(D)(ii)

¹¹ §1400Z-2(d)(ii)(D)

clarify the meaning of substantially all. We recommend a 70% standard, consistent with the “substantially all” asset standard adopted for qualified asset transfers in tax-free reorganizations under IRC §368.¹²

Q8 How long does a business have to become an Opportunity Zone Business after receiving an investment from an Opportunity Fund?

A8 Proposed Response:

A partnership or corporation will be deemed to be an Opportunity Zone Business if the Opportunity Fund reasonably expects, at the time the Opportunity Fund invests in the partnership or corporation, the partnership or corporation will become an Opportunity Zone Business.

Safe Harbor:

A partnership or corporation will be deemed to have a reasonable expectation that an entity will become an Opportunity Zone Business, if the entity operates as an Opportunity Zone Business no later than twelve- months after the date of investment by the Opportunity Fund.

Analysis:

It is unclear whether a business has a grace period to qualify as an Opportunity Zone Business. In order for investments in corporations and partnerships to qualify as Opportunity Zone Property, the statute requires that:

- i) as of the time such interest was acquired, such corporation/partnership was an Opportunity Zone Business (or, in the case of a new corporation/partnership, such corporation was being organized for purposes of being an Opportunity Zone Business);¹³ and,
- ii) during substantially all of the Opportunity Fund’s holding period for such interest such corporation/partnership qualified as an Opportunity Zone Business.¹⁴

New businesses that are being organized for the purpose of being an Opportunity Zone Business and existing businesses that are expanding within or into opportunity zones will need time to acquire and/or improve tangible property and put such property to active use in opportunity zones. We recommend that a business be deemed qualified as long as the Opportunity Fund reasonably expects, at the time the Opportunity Fund makes its investment in the entity, the entity will qualify for substantially all of the Opportunity Fund’s holding period of its investment, similar to the safe harbor for qualified businesses under the new markets tax credit program.¹⁵

¹² Rev. Proc. 77-37

¹³ IRC§1400Z-2(d)(2)(B)(i)(II) & IRC§1400Z-2(d)(2)(C)(ii)

¹⁴ IRC§1400Z-2(d)(2)(B)(i)(III) & IRC§1400Z-2(d)(2)(C)(iii)

¹⁵ Treas. Reg. 1-45D-1(d)(4)(iv)(A)

Furthermore, we recommend that Opportunity Funds be provided a safe harbor where they will be deemed to have a reasonable expectation that the entity will become an Opportunity Zone Business, if the entity operates as an Opportunity Zone Business no later than twelve- months after the date of investment in the Opportunity Zone Business.

Q9 Can residential rental property businesses be Opportunity Zone Businesses?

A9 Proposed Response:

Residential rental property businesses can be Opportunity Zone Businesses.

Analysis:

It appears residential rental property businesses can qualify as an Opportunity Zone Business. The Enterprise Zone statute at IRC §1397C(b) defines eight requirements for a business to qualify as an Enterprise Zone Business, the opportunity zones statute incorporates only three of these requirements for a business to qualify as an Opportunity Zone Business as follows:

- 1) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business;¹⁶
- 2) a substantial portion of the intangible property of such entity is used in the active conduct of any such business;¹⁷ and
- 3) less than 5% of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.¹⁸

Noticeably absent from the opportunity zones statute is any direct reference to the Enterprise Zone qualified business requirements of IRC §1397C(d)(2), which specifically excludes residential rental property from the term “qualified business”. We believe that the exclusion of this reference was intentional and therefore residential rental property businesses can qualify as Opportunity Zone Businesses. Many proposed transactions involve residential rental property and taxpayers need to be certain that such businesses qualify. We recommend that you affirm this is the case.

¹⁶ IRC §1397C(b)(2)

¹⁷ IRC §1397C(b)(4)

¹⁸ IRC §1397C(b)(8)

E. Tax Implications of Debt

Q10 Are debt financed returns of capital that do not exceed a partner's basis in its Opportunity Fund interest considered sales or exchanges for purposes of the end of the tax deferral period?

A10 Proposed Response:

Debt financed returns of capital (or a reduction in a partner's share of partnership liabilities that is treated as a distribution) that do not exceed a partner's basis in its Opportunity Fund interest, are not considered sales or exchanges for purposes of the end of the tax deferral period.

Analysis:

It appears that debt financed returns of capital, or a reduction in a partner's share of partnership liabilities that is treated as a distribution, that do not exceed a partner's basis in its Opportunity Fund interest do not result in a sale or exchange for purposes of the end of the deferral period under §1400Z-2.

Partnerships owning appreciated property oftentimes return portions of their partner's capital by refinancing the property. Debt-financed returns of capital, or a reduction in a partner's share of partnership liabilities that is treated as a distribution, are generally not taxable unless the cash distributed exceeds the partner's basis in its partnership interest. A partner's share of partnership liabilities (as determined under §752) are included in the partner's basis. As a result, debt borrowed inside a partnership and distributed to a partner generally receives similar tax treatment as debt borrowed by a partner outside the partnership and secured by the partner's interest in the partnership. Confusion has arisen whether a debt financed return of Opportunity Fund capital would similarly be deferred under §1400Z-2, or whether such return of capital would be deemed a sale or exchange and therefore the end of the deferral period. Many proposed transactions involve the development of property that is likely to be refinanced as property appreciates. Residual proceeds from refinancing are likely to be used to return capital to Opportunity Fund partners. Taxpayers looking to participate in these transactions need to know whether such distributions have any tax implications for purposes of §1400Z-2. We recommend that you affirm debt financed returns of capital, or a reduction in a partner's share of partnership liabilities that is treated as a distribution, that do not exceed a partner's basis in its Opportunity Fund interest, are generally not treated as sales or exchanges for purposes of IRC §1400Z-2.

Q11 Is a taxpayer's share of liabilities of an Opportunity Fund partnership considered a separate investment in an Opportunity Fund under the mixed funds provision in the statute?

A11 Proposed Response:

A taxpayer's share of liabilities of an Opportunity Fund partnership is not considered a separate investment in an Opportunity Fund.

Analysis:

It is unclear whether a taxpayer's share of liabilities of an Opportunity Fund partnership are treated as a separate investment for purposes of the mixed funds provision of the opportunity zones statute.¹⁹ Taxpayers holding an Opportunity Fund investment for at least ten years are permitted to make an election to adjust the basis in their investment to its fair market value on the date that the investment is sold or exchanged.²⁰ The effect of this provision is to exclude from taxation gains on appreciation of their Opportunity Fund interest. This exclusion benefit is only available to investments of gain.²¹

There is confusion as to whether a partner's share Opportunity Fund liabilities are considered a separate investment, thereby limiting the amount of gains that are eligible for exclusion under the ten-year hold benefit. This confusion stems from the fact that under IRC §752, any increase in a partner's share of the liabilities of a partnership, shall be considered as a contribution of money by such partner to the partnership.²²

Taxpayers looking to invest in partnership Opportunity Funds need to know whether their share of partnership liabilities are treated as a separate investment and if so, whether a ratable portion of the fair market value of their investment is required to be allocated to this share of liabilities, thereby limiting the amount of gains that are eligible for exclusion. We recommend that Treasury clarify that a partner's share of allocable liabilities is not treated as a separate investment in an Opportunity Fund.

We note, if Treasury were to treat a partner's share of allocable liabilities as a separate investment in an Opportunity Fund, then presumably a partner would be permitted to defer gains equal to their allocable liabilities. This result appears inconsistent with the policy objectives of the incentive.

¹⁹ IRC §1400Z-2(e)(1)

²⁰ IRC §1400Z-2(c)

²¹ IRC §1400Z-2(e)(1)(B)

²² IRC §752(a)