Opportunity Zones
WORKING GROUP™
hosted by Novogradac

August 29, 2019

Office of Associate Chief Counsel (Income Tax and Accounting)
Attention: Erika C. Reigle and Kyle C. Griffin
Internal Revenue Service (IRS)
1111 Constitution Avenue, NW
Washington, D.C. 20224

CC:PA:LPD:PR
(REG-120186-18)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Supplemental Letter – Comments on Consolidated Rules (Comments on REG-120186-18: Investing in Qualified Opportunity Funds (Guidance Under §1400Z-2))

Dear Ms. Reigle and Mr. Griffin:

In our letter dated July 1, 2019, the Novogradac Opportunity Zone Working Group (the OZ Working Group) provided comments (the Comment Letter) in response to the second tranche of Treasury Regulations released April 18, 2019 (the Regulations). This letter is intended to clarify and provide further commentary to the Comment Letter regarding the provision in the Regulations which excludes a QOF corporation from being a subsidiary member of a consolidated group, and the definition of "taxpayer" for purposes of capital gain realized by subsidiary members of a consolidated group eligible for investment in a qualified opportunity fund (QOF).

This letter additionally lends our support to other comment letters submitted to Treasury on this subject, including comment letters submitted by the American Bar Association ("ABA") (Section of Taxation and the Forum on Affordable Housing and Community Development Law), the American Bankers Association, EY, the Local Initiatives Support Coalition, Enterprise Community Partners and the New York State Bar Association. We support these comment letters generally, with specific points of support discussed in this letter.

The OZ Working Group reiterates its recommendations made in the Comment Letter. We repeat those recommendations here in order based on priority of impact to low-income

communities:

1. Reconsider the general rule that doesn't allow a different member from the member of the consolidated group that engaged in the sale of a capital asset giving rise to gain to make the investment of such gain. The OZ Working Group requests that QOFs be allowed to be members of a consolidated group and one member of a consolidated group be allowed to invest gains in a QOF realized by another member of the consolidated group.
2. Provide a grandfather clause for eligible investments in a QOF incorporated as a subsidiary member of a consolidated group and/or where a member of the consolidated group is different from the member of the group that engaged in the sale of a capital asset giving rise to gain made the investment of such gain prior to June 1, 2019 (to provide a one month grace period from when the second tranche of proposed regulations were published);
3. If Treasury does not consider the above recommendations reasonable, the OZ Working Group recommends an exception to the inclusion rules for QOF corporations incorporated as subsidiary members of a consolidated group prior to June 1, 2019 (to provide a one month grace period from when the second tranche of proposed regulations were published) and restructured within 12 months of the effective date of the final regulations so that the restructuring will not result in an inclusion event.

The OZ Working Group emphasizes the significance of these recommendations to the economic impact of the Opportunity Zones on economically distressed communities. Further, we support and add our voice to the many other comments that the complexity of reconciling the consolidated reporting provisions is outweighed by the economic benefit to underserved communities achieved by permitting a QOF to participate as a member subsidiary of a consolidated group.

Treasury has expressed concern with reconciling the existing rules for consolidated reporting with the Opportunity Zone rules. We believe these concerns have been addressed and in many cases resolved by the comment letters already submitted. This letter summarizes and emphasizes critical feedback provided by the OZ Working Group and other previously submitted comment letters.

Consider All Members of a Consolidated Group as a Single Taxpayer for Purposes of Section 1400Z-2

The regulations controlling consolidated groups consider all members of the group severally liable for its tax liabilities, as computed under the section 1502 regulations.[1] However, capital

[1] Treas. Reg. section 1.1502-6(a).

gains of group members are taken into account on a consolidated basis.[2] Capital gains and losses are specifically not taken into account on a separate entity basis.[3] For example, Section 1222 capital gains are not determined separately but are determined on a consolidated basis for the group as a whole.[4] Consistent with these well-established rules governing the tax liability of consolidated reporting specifically with respect to capital gain, we recommend that the Treasury consider all members of a consolidated group as a single taxpayer for purposes of Section 1400Z-2. If a subsidiary of a consolidated group incurs capital gain, its sister subsidiary should be able to invest the gain in a QOF in order to participate in the Opportunity Zone tax benefits as both subsidiary members are liable for the capital gain incurred.

This is especially significant to investments in affordable housing. Certain taxpayers are subject to regulatory restrictions on the types of investments particular subsidiaries of a consolidated group can make. For example, a regulated bank is precluded from making non-banking business real estate investments unless it meets certain Community Reinvestment Act (CRA) exceptions. Real estate investments need to be made by other affiliates of the bank's consolidated group; e.g., a non-bank subsidiary of the parent holding company of the consolidated group. Often capital gains are generated in a consolidated member different from the member who is permitted by regulations to invest the gains in a real estate transaction.

Similarly, life insurance companies often elect to be treated for tax purposes as a consolidated group. Life insurance companies that sell different lines of insurance must be organized as holding companies and comply with regulations restricting their investment activity and the transfer of funds between members. The entity member incurring the capital gain may not be permitted to invest in low-income housing projects. In addition, there are non-tax statutory accounting considerations that might lead an insurance company to make a LIHTC investment in one state subsidiary versus another.

Finally, non-regulated companies may be structured for business purposes as a consolidated group where one member of the group incurs capital gain but is unable to invest in low-income housing without suffering adverse business and/or economic consequences. Accordingly, the proposed regulations as drafted may effectively prohibit many regulated and non-regulated companies from making Opportunity Zone related investments in low-income housing projects.

An example cited multiple times in the previously submitted comment letters is of investments by banks in affordable housing through a community development corporation ("CDC"). The role of the CDC is established and long-standing in assisting bank investments in low-income communities. This situation demonstrates the negative economic impact to low-income communities of the proposed regulations. The bank entity recognizing capital gain may not be,

[2] Treas. Reg. section 1.1502-11(a)(3).
[3] Treas. Reg. section 1.1502-12(j).
[4] Treas. Reg. section 1.1502-22(a).

and is generally not, the division of the bank able and/or permitted to invest in affordable housing, as banks generally are structured to invest in low-income housing projects through a CDC which is incorporated as a separate member of the consolidated group. The CDC is typically not the subsidiary member of the group which incurs the capital gain. Not permitting the bank to invest capital gains incurred by a subsidiary member through a sister subsidiary CDC will limit the amount of investment used to develop affordable housing in low-income communities.

Suggested line edits to Prop. Reg. Sec. 1.1400Z2(b)-1(c):

> (15) Transfer within an affiliated group. A transfer by sale or otherwise of QOF corporate stock among members of an affiliated group within the meaning of section 1504 is not, for purposes of this section, an inclusion event.
>
> (1~~5~~6) Other inclusion and non-inclusion events. Notwithstanding any other provision of this paragraph (c), the Commissioner may determine by published guidance that a type of transaction is or is not an inclusion event.

Suggested line edits to Prop. Reg. Sec. 1.1400Z2(g)-1(c):

> Qualifying investments by members of a consolidated group.
>
> (1) In General. Except as otherwise provided in this section or in §1.1400Z2(b)-1, section 1400Z-2 applies separately to each member of a consolidated group.
>
> (2) Capital gain investment. Where a member of a consolidated group ~~Therefore, for example, the same member of the group must both~~ engages in the sale of a capital asset giving rise to gain and a different member of the same consolidated group timely invests an amount equal to some or all of such gain in a QOF (as provided in section 1400Z-2(a)(1)) in order to qualify for deferral of such gain under section 1400Z2~~.~~, the transaction shall be deemed to have occurred as follows:
>
> That member of the consolidated group which engaged in the sale of the capital asset giving rise to gain ("S") is deemed to have made the qualifying QOF investment and sold such investment to the investing member ("B") in an intercompany sale.

Suggested line edits to Prop. Reg. Sec. 1.1400Z2(g)-1(d):

> Tiering up of investment adjustments provided by section 1400Z-2.
>
> (1) Where the member which sold a capital asset at a gain is the QOF investor. Basis increases in a qualifying investment in a QOF under sections 1400Z-2(b)(2)(B)(iii), 1400Z-2(b)(2)(B)(iv), and 1400Z-2(c) are treated as satisfying the

requirements of §1.1502-32(b)(3)(ii)(A), and thus qualify as tax-exempt income to the QOF owner. Therefore, if the QOF owner is a member of a consolidated group and is owned by other members of the same group (upper-tier members), the group members increase their bases in the shares of the QOF owner under §1.1502-32(b)(2)(ii). However, there is no basis increase under §1.1502-32(b)(2)(ii) in shares of upper-tier members with regard to basis increases under section 1400Z-2(c) and the regulations at § 1.1400Z2(c)-1 unless and until the basis of the qualifying investment is increased to its fair market value, as provided in section 1400Z-2(c) and the regulations at §1.1400Z2(c)-1.

(2) Investments described under § 1.1400Z2(g)-1(c)(2).

(i) Basis increases under sections 1400Z-2(b)(2)(B)(iii) and 1400Z-2(b)(2)(B)(iv). If S is a member of a consolidated group and is owned by other members of the same group (upper-tier members), the group members increase their bases in the shares of S under § 1.1502-32(b)(2)(ii) by the basis increase amount calculated under sections 1400Z-2(b)(2)(B)(iii) and 1400Z-2(b)(2)(B)(iv). No basis increase is made to B's basis in the QOF interest, nor to the upper-tier members' basis in B shares.

(ii) Basis increase as a result of section 1400Z-2(c). Group members increase their bases in the shares of B under § 1.1502-32(b)(2)(ii) by the amount of gain excluded from B's income due to an election under section 1400Z-2(c), consistent with paragraph (d)(1) of this section.

Suggested line edits to Prop. Reg. Sec. 1.1400Z2(g)-1(f):

(f) Examples. The following examples illustrate the rules of this section.

(2) Example 2. Operation of §§ 1.1400Z2(g)-1(c)(2) and 1.1400Z2(g)-1(d)(2).

(i) Facts. Same as Example 1, except that B, another member of the P group, contributes $500 to Q and properly elects to defer gain. In 2029, B sells its interest in Q to an unrelated party at its fair market value of $800.

(ii) Analysis.

(A) Operation of § 1.1400Z2(g)-1(c)(2). S is deemed to have made a qualifying investment in Q, then sold that investment to B in an intercompany sale for $500. B's basis in Q is $500. S has $500 of deferred gain, realized when Q is disposed of outside of the consolidated group.

(B) 5-year and 7-year basis increase and § 1.1502-32 tier-up. In 2023, when B has held the stock of Q for five years, under § 1400Z-2(b)(2)(B)(iii), S redetermines its

deferred gain under § 1.1502-13(c)(6)(ii) to exclude from gross income $50 (10 percent of $500, the amount of gain deferred by reason of section 1400Z-2(a)(1)(A)). Thus, P (an upper-tier member) increases its basis in S's stock by $50 under § 1.1502-32(b)(2)(ii). Similarly, in 2025, when S has held the stock of Q for seven years, under § 1400Z-2(b)(2)(B)(iv), S redetermines its deferred gain to exclude an additional $25 (5 percent of $500) from gross income, and P increases its basis in S's stock by an additional $25).

(C) S's recognition of deferred capital gain in 2026. B did not dispose of its Q stock prior to December 31, 2026. Therefore, under section 1400Z-2(b)(1)(B) and § 1.1400Z2(b)-1(b)(2), S's deferred capital gain is included in S's income on December 31, 2026. The amount of gain included under section 1400Z-2(b)(2)(A) is $425 ($500 of deferred gain less S's $75 exclusion from gross income). P's basis in S increases by $425.

(D) B sells the stock of Q after 10 years. At the time of the sale, B has owned the Q stock for over 10 years, and elects under section 1400Z-2(c) to increase its stock basis in Q from $500 (see the analysis in this Example 2 in paragraph (f)(2)(ii)(A) of this section) to the fair market value of Q on the date of the sale, $800. As a result of the election, B's basis in Q is $800 and B has no gain on the sale of Q stock. Additionally, the $300 basis increase in Q is treated as tax-exempt income to B pursuant to paragraph (d) of this section. Thus, P increases its basis in P's B stock by $300 under § 1.1502-32(b)(2)(ii).

(~~2~~3) Example~~2~~ 3. Computation and application of the attribute reduction amount under §1.1502-36(d) when S owns a QOF

Provide a grandfather clause for QOF investments made prior to the release of the second tranche of regulations

In forming and pricing agreements and investments, investors may have relied in good faith upon the availability of dividends received deductions and the ability to consider QOF gains and losses together with those of the other members of the consolidated group. The consolidated group member who is the parent of the QOF will not be permitted to claim the benefit of the 100 percent dividends received deduction if the QOF stock is not considered stock for purposes of Section 1504, as the dividend from the QOF will not be considered a qualified dividend from an affiliated group member.[5] We express our support of the recommendation submitted previously by the ABA: Section of Taxation that a QOF C corporation be considered a member of an affiliated group for purposes of the 100 percent dividends received deduction.

[5] IRC § 243(b)(2)(A).

If Treasury does not permit a QOF to be organized as a subsidiary member of a consolidated group, we recommend the following line edits to address the problem regarding the dividends received deduction.

Suggested line edits to Prop. Reg. Sec. 1.1400Z2(g)-1(b)(1):

> QOF stock not stock for purposes of affiliation--(1) In general. Stock in a QOF corporation (whether qualifying QOF stock or otherwise) is not treated as stock for purposes of determining whether the issuer is a member of an affiliated group within the meaning of section 1504. However, stock in a QOF corporation is treated as stock for purposes of determining whether the issuer is a member of an affiliated group within the meaning of section 1504 when calculating the dividends received deduction pursuant to section 243(b)(2)(A). Therefore, a QOF corporation can be the common parent of a consolidated group, but a QOF corporation cannot be a subsidiary member of a consolidated group.

Prior to the second tranche of proposed regulations released April 18, 2019, Treasury provided no indication that QOFs would be prohibited from being structured as subsidiary members of consolidated groups. As a result, many investors participated in the Opportunity Zone program by structuring a QOF as a subsidiary member of a consolidated group. The success of these structures depends not only upon the Opportunity Zone benefit but also upon the economic treatment between members of a consolidated group. The proposed regulations may upset settled contractual and economic relationships, formed and priced in good faith under a framework in which Opportunity Zone benefits and intercompany transaction treatment co-exist.

We recognize certain difficulties in reconciliation as between the consolidated return regulations and the Opportunity Zone rules. These difficulties must be resolved to allow QOFs to remain subsidiary members of consolidated groups – either as a matter of course or under a grandfathering regime. We note that the ABA addressed these difficulties with specificity including Treasury's concerns with reconciling Treas. Reg. sections 1.1502-13, 1.1502-19, and 1.1502-32. We support the ABA's recommended approaches to reconciliation of the consolidated return and Opportunity Zone rules.

We recommend that QOFs be permitted to be subsidiary members of a consolidated group. In lieu of that, we repeat our recommendation from the Comment Letter that if a QOF C corporation cannot be a subsidiary member of a consolidated group, the final Regulations should provide a grandfather clause for eligible investments in a QOF incorporated as a subsidiary member of a consolidated group. Also, provide a grandfather clause where the QOF investing member of the consolidated group is different from the member of the group that engaged in the sale of a capital asset giving rise to gain. These grandfather clauses should apply to investments made prior to June 1, 2019 (to provide a one month grace period from when the

second tranche of proposed regulations were published). We also express our support of the recommendations provided by the other previously submitted comment letters on this issue including the recommendation by the ABA: Section of Taxation that a QOF C corporation be grandfathered and eligible to continue to file as a subsidiary member of a consolidated group.

Suggested line edits to Prop. Reg. Sec. 1.1400Z2(g)-1(b):

> (3) Effective date. This paragraph (b) applies to QOF corporations which were not subsidiary members of a consolidated group prior to June 1, 2019.

Treasury Should Permit a Period and Method for Deconsolidation

In addition to the impact on already entered-into investments and agreements, unwinding these structures could yield negative results. Requiring the QOF to deconsolidate from the consolidated group may not be permitted under existing rules and regulations without adversely affecting the entire consolidated group. Forcing the QOF to deconsolidate from the group could create adverse economic consequences not anticipated by the QOF investors and the other members of the consolidated group at the time the QOF was incorporated and funded. Such consequences might include recognition of gain by the investing consolidated group which the Opportunity Zone rules are meant to defer or exclude, recognition of gain by the investing consolidated group as a result of excess loss account (ELA) recognition upon deconsolidation, attribute reduction for the QOF, and/or inadvertent deconsolidation from the consolidated group of a member shareholder of the QOF if the QOF merges into that member. The ABA's comment letter addresses deconsolidation implications in detail.

In order to avoid unfair treatment resulting in negative economic treatment of taxpayers who contributed capital to QOF investments prior to the Regulations being published, the OZ Working Group recommends an exception to the inclusion rules for QOF corporations incorporated as subsidiary members of a consolidated group prior to June 1, 2019 (to provide a one month grace period from when the second tranche of proposed regulations were published) and restructured within 12 months of the effective date of the final regulations so that the restructuring will not result in an inclusion event.

A rule permitting QOF C corporations to restructure as partnerships, for example, would encourage the continued investment in the opportunity zone and allow the QOF to receive similar economic treatment. In addition to our recommendation, we recommend that Treasury consider the recommendations proposed by other organizations including the ABA: Section of Taxation wherein the ABA recommends both retrospective and prospective solutions to deconsolidation. Both alternatives provided by the ABA would avoid early QOF investors from losing the beneficial tax treatment relied upon in good faith in their QOF investments.

We appreciate your consideration of these comments and we are available to provide any additional insight and background regarding our comments you may desire.

Yours very truly,

Novogradac & Company LLP

By

Michael J. Novogradac, Managing Partner

Novogradac & Company LLP

By

John S. Sciarretti, Partner

CC: Michael Novey, Office of Tax Policy, Treasury

Julie Hanlon-Bolton, ITA, IRS