

November 2, 2018

Internal Revenue Service  
CC:PA:LPD:PR (REG-115420-18)  
Room 5203  
PO Box 7604  
Ben Franklin Station  
Washington, DC 20044

Dear Sir or Madam:

An area where additional Qualified Opportunity Zone (QOZ) guidance would be particularly helpful is the application of the Opportunity Zone incentives to Qualified Opportunity Fund (QOF) investments in start-up companies issuing QOZ stock or QOZ partnership interests. For many such start-up companies only a limited amount of QOF dollars would be used towards the purchase, construction, or rehabilitation of tangible property, and more QOF dollars would be used towards operations. The preamble to the Proposed Regulations acknowledges this point by requesting comments about the appropriateness of expanding the working capital safe harbor concept to the development of business operations within a QOZ, which would be beyond the working capital safe harbor provided in the Proposed Regulations for the development of tangible property.

Example: Assume a start-up entity engaged in biomedical or software development is already leasing building space at market value rates within a designated QOZ and has \$20,000 of equipment consisting of chairs, tables, computers, and additional furnishings. Assume that the start-up entity has a need for the purchase of additional new tangible property of at least \$70,000 in connection with an expansion, but any additional costs are for license fees and workforce compensation to be used in technology development. Assume further that a QOF intends to make a \$1 million investment in the start-up in exchange for an equity interest with such funds to be used towards property purchases and operational costs. This means that over \$900,000 would be spent towards operational costs over an extended period.

The start-up operations are being conducted through a QOZ partnership. Therefore, the QOF does not need to consider how the operating partnership's intangibles fit within the QOF's 90% test or the application of the active conduct of business requirement with respect to the QOF's activities because the QOF only owns a partnership interest.

**A. Active Conduct of a Business Requirement.** The first question will be the future definition to be given to active conduct of a business. Hopefully, a safe harbor will be established that would allow the operating entity to be treated as engaged in an active conduct of a business if, at the time that the QOF investment is made, there is a reasonable expectation that within some designated period the entity will generate revenue. This is the approach used for New Markets Tax Credit purposes, pursuant to Reg. 1.45D-1(d)(4)(iv). If this hurdle cannot be overcome, it would seem that true start-ups would never be eligible to receive QOF investments.

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**B. Substantially All Tangible Property Qualifying as QOZ Business Property.** If the first hurdle can be overcome, the second question to confirm is that the “substantially all” aspect of the QOZ Business requirements are met. In the example above, it would seem that such requirement is met. Tangible property that meets the QOZ Business Property definition represents more than 70% of the total tangible equipment (\$70,000/\$90,000). The QOZ Business Property status is met because (1) \$70,000 in new tangible equipment is acquired after 2017, (2) the original use of the new equipment is within the QOZ, and (3) throughout the period that the QOF has an interest in the entity, the tangible property will be used exclusively within the QOZ.

The substantially all test must be satisfied annually by the entity in which the QOF holds an interest throughout the entire period that the QOF holds such interest. In situations where the purchase or improvement of tangible property is relatively small and most of the QOF dollars go towards operational costs, it seems that the 70% test for tangible property could fail if additional tangible property is not purchased or improved going forward. This occurs because the older equipment has minimal book value as time passes and the newer equipment will also decline in book value. At some point, the book value of the new equipment in the operating entity during the potential ten year plus term can also be minimal, absent the purchase of new equipment or substantial improvement through expansion.

One approach to addressing the substantially all test in situations where it has initially been met but then might lapse with the change in tangible property values would be to confirm that Section 1400Z-2(d)(3)(B) will provide a five-year grace period. This provision states that tangible property which ceases to be QOZ business property can maintain such status for five years. Application of this safe harbor can be very useful and provides time for determining whether new property or improvement is necessary to maintain such status after the grace period.

As a related point, additional guidance should also address how to apply the substantially all test in the context of leased building space used by a start-up. The leased building space would seem to represent the lease of tangible property. Is the answer to simply determine how the financial statement reflects such item, if at all? Any amount allocated to an existing lease of building space would have a negative impact on the 70% test because the original use of such building space originated prior to 2018, and could be treated as not acquired.

**C. Use of Intangible Property in the QOZ.** A third question is the requirement that a substantial portion of the intangible property is used in the active conduct of a business in the QOZ, as stated in the proposed regulations. Assume that the goal of a start-up’s operation is to license its developed intangible product to organization across the world. Can the fact that the operating entity will have a large portion of its licenses with parties outside of the QOZ prevent this requirement from being met? Alternatively, is it sufficient if the development of the intangible assets occurs exclusively within the QOZ, regardless of the source of the revenue or end users? On this point, note that Section 1400Z-2(d)(2)(D)(III) applies the requirement that property be used in a QOZ only to tangible property, but not to intangibles.

A related part of this third question is the requirement that at least 50% of the gross income of the QOZ Business is derived from the active conduct of a business in the QOZ, as stated in the proposed

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regulations. If the majority of a start-up's revenue is derived from licensing intangible to parties outside the QOZ, would this prevent such requirement from being met? Again, the fact that the start-up operations related to the development of the technology occurs exclusively within the QOZ should be sufficient.

Another important aspect of this third question is that Section 1397C(d)(4) is excluded from the requirements that must be met for QOZ Business status. This provision prevents eligibility for businesses consisting predominantly of the development or holding of intangibles for sales or licenses but is not specifically cross referenced as part of Section 1400Z-2(d)(3)(A)(ii). If it is correct that businesses engaged in the development of intangibles are permitted QOZ Businesses, then it would be very useful for additional guidance to address the application of the rules in that context.

**D. Working Capital Safe Harbor for Operations.** A fourth question is the development of a working capital safe harbor for holding cash to be used towards business operations. This point surfaces in connection with the nonqualified financial property limitation that cash (and certain other assets) be less than 5% of the unadjusted tax basis of the entity's assets, except for reasonable working capital. In the context of the QOZ partnership interest or QOZ stock held by the QOF, it would be equally useful to permit an extended period for such entity to use cash towards operations.

This point is very important toward an understanding of whether expected representations that would need to be provided by the operating partnership to the QOF have been met and the issuance of any opinions that the entity in which the QOF invests is engaged is a QOZ Business. It would be common for businesses to prepare detailed schedules to illustrate how invested dollars would be spent and that schedule could be applied to establish a safe harbor for the use of QOF dollars towards operations.

**E. Extending Working Capital Safe Harbor to Other Requirements.** Through the QOZ Property definition, a critical component of the use of QOF cash by a partnership or corporation in which a QOF makes an investment is the purchase or substantial improvement of tangible property. Some level of QOZ Business Property purchase or substantial improvement is needed which is determined based on the level of existing tangible property. To avoid an unnecessary purchase of tangible property upfront and delay any such additional investment, a fifth point that would be very useful to have guidance stating that any working capital safe harbor for operations can also be used to also create a safe harbor that would allow the substantially all tangible property requirement to be met during the period that the entity is proceeding in a manner substantially consistent with the scheduled operations, regardless of the amount of new property purchased during such period. This would be equivalent to a similar rule established to provide a safe harbor for intangible property when the 31-month safe harbor for property development is established.

Prop. Reg. 1.1400Z-2(d)-1(d)(5)(v) and (vi) provide a safe harbor for the active conduct of business and the use of intangible property during the period (with a 31 month maximum) that an operating entity is engaged in scheduled acquisition, construction, and/or substantial improvement of tangible property within a QOZ. A similar safe harbor should be developed when the QOF dollars are applied primarily towards operations.

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**F. Pre-Existing Operating Entity--Satisfying QOZ Business Property 70% Substantially All Requirement Following QOF Investment.**

A sixth question relates to having the QOF make an investment in a pre-existing partnership or corporation that does not meet the QOZ Business Property requirements on the date of the QOF investment but meets such requirements within the time of the working capital safe harbor requested above. The preamble to the proposed regulations requests comments on whether there is a statutory basis that might qualify a greater number of pre-existing entities.

The statute reads that the QOZ Business Property requirement with respect to the operating entity must be met "as of the time such interest was acquired" by the QOF. The words within quotes are found throughout the Internal Revenue Code. Reading such words to require that an operating partnership or corporation must already have satisfied the QOZ Business Property requirement prior to the QOF investment is too narrow, would not serve any specific policy point, and would require unnecessary restructuring to satisfy such a reading.

For the following reasons, it would seem that the statute provides flexibility to allow the operating partnership to satisfy the QOZ Business Property requirements some period following the QOF investment:

1. The statute acknowledges that a new partnership or corporation can be organized for the purpose of being a QOZ Business, and not having to meet such status at the time of the QOF investment. This flexibility allows for an expansive interpretation to be given to "as of the time such interest was acquired."
  2. The statute requires that during substantially all of the QOF's holding period in the operating partnership or corporation, such entity qualifies as a QOZ Business. The use of "substantially all" acknowledges that the QOZ Business requirements do not need to occur starting on Day 1 of the QOF investment.
  3. As defined, the QOZ Business Property term contemplates a future acquisition or substantial improvement of property and that QOF investment dollars are applied towards meeting such status. In general, operating entities do not meet the QOZ Business status at the time of the QOF investment.
  4. If an existing operating entity is required to have QOZ Business status prior to the QOF investment, this requirement could be satisfied by restructuring or other alternative procedures. For example, it might be possible for the existing operating partnership to transfer its assets into a new entity and have the QOF invest in the new entity to allow for the use of the grace period available for new entities. Alternatively, it might be possible to provide debt financing to the existing operating entity to allow for the purchase of sufficient QOZ Business Property to qualify the operating entity prior to the QOF investment and the elimination of such financing with the QOF investment. It should be totally unnecessary to require that a pre-existing entity undergo such additional steps to have a qualifying investment.
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Future IRS guidance should provide clarity that any working capital safe harbor period developed for the use of cash towards operations would also cover the period that the operating entity needs to qualify as a QOZ Business. The example described at the beginning of this letter should be eligible for QOZ Business status, even though the operating partnership is not a QOZ Business at the time of the QOF investment.

**G. Effect of Bringing Clarity to Having QOFs Invest in Start-Up Operations.** The use of QOZ dollars towards start-up businesses for operational use could be very attractive because the potential upside appreciation from the development of intangible assets can have a much higher return for investors than the potential appreciation from tangible property. The possible exclusion of all future appreciation from capital gain taxation can be a real incentive for investments in designated QOZs.

Further, a start-up business's success will trigger the need for expansion and the further use of QOF dollars for property development within a QOZ. If the practical effect is to limit the use of QOF dollars to real estate development, there is only so much of such development that can be achieved in isolation. Allowing businesses to relocate to or expand their operations in QOZs and effectively using QOF dollars towards operations (rather than only tangible property development) can really be a beneficial mechanism for improvement.

I hope these comments useful to the discussions regarding future QOZ guidance and tech industries.

Respectfully,

  
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