July 3, 2018

Michael Novey
United States Department of the Treasury
Washington, DC

Re: Opportunity Zones

Dear Mike:

Thank you for meeting with us on behalf of the Tax Credit and Equity Financing Committee ("Tax Credit Committee") of the American Bar Association Forum on Affordable Housing and Community Development Law ("ABA Forum")[1]. It was a pleasure discussing issues related to qualified opportunity zones. You asked us to highlight issues that were preventing investments from closing, as these would be the highest priority for government guidance. Here is our list of priority items:

1. What Taxpayer must do the investing, and when? Many capital gains arise in partnership contexts, where the gain to the partner arises by allocation from the partnership. As a result, investors don't know whether the investment in a QO Fund must be made by the partner or the partnership. Similarly, in the case of consolidated groups, investors are unsure whether the group investment must be made by each member in accordance with its particular gain, or can one investment be made by a member of the group? Finally, can a group of investors who have gains form a partnership, and have that invest, alongside other investors, in an Opportunity Fund? Or does the "taxpayer" have to be the direct investor in the QO Fund?

[1] The three of us hold or have held positions in the ABA Forum, and we are all active in the Tax Credit Committee. In preparing this letter, we consulted with many of our colleagues and members of the Tax Credit Committee. However, we prepared this letter in our own capacities, and it does not represent an official statement or position of the American Bar Association or any of its Sections, Forums, or Committees.

Our recommendation is that the investment might be made by any of the foregoing; in the case of an investment by a partner, it should be able to rely on any reasonable method to determine the gain it will be allocated and the start of the 180-day period in those situations where it has not yet received a K-1 at the time of the investment. As you might imagine, this is a fundamental question to closing transactions, because taxpayer have to know who should be signing the agreements and providing the investment.

2. <u>What kind of entities can a Qualified Opportunity Fund Be</u>? We would like to think that this question has an obvious answer. The answer should be any entity that qualifies as a corporation or a partnership for federal income tax purposes can be a QO Fund. However, Section 1400Z-2(d) refers to "any investment vehicle ***organized as*** a corporation or partnership," and many investors are worried that limited liability companies (whether having two or more members and taxed as partnerships, or electing to be taxed as corporations) are ineligible because they are not "organized" as corporations or partnerships. This question is "on the edge" as far as preventing investments from closing, since investors can assure the treatment by simply not using LLCs. Of course this is inefficient in many circumstances, and it's hard to imagine that there is a reason to not apply Section 7701 principles to this question. We would hope that this would be easily addressed in an FAQ, but we would understand if it doesn't meet your standard.

3. <u>What gains are eligible for Opportunity Fund tax deferral</u>? The title of Section 1400Z-2 refers to "capital gains," but the actual statute only refers to "gains." While a sale of corporate stock almost always gives rise to capital gain, sales of other assets may give rise to 1231 gain, or depreciation recapture under Section 291, 1245 and 1250. Sections 1245 and 1250 include words to the effect of "such gain shall be recognized notwithstanding any other provision of this subtitle." Section 291 refers to 20% of gain associated with previously taken depreciation, and it provides that that it "shall be treated as gain which is ordinary income under Section 1250 …" And, there are other provisions of law which address gains that are not accorded "capital gain" treatment, most notably Section 582(c), which provides that sales or exchanges of bonds, debentures, notes or certificates or other evidences of indebtedness by certain financial

institutions are not considered the sale or exchange of a capital asset.

Accordingly, potential investors are unsure of how much they should be investing, and this is slowing or stopping transactions from closing. In this regard, we note that Section 1031 (like kind exchanges) has a statutory exception from the application of Sections 291, 1245 and 1250, but many have observed that the principles should be the same. Of course, having the new provisions override these provisions will maximize the amount of investment; while we are not writing as advocates, we do observe that investors need a clear statement of the law in order to move these transactions to closure. One possible interpretation is that gains that are subject to depreciation recapture or ordinary income treatment are eligible for inclusion in a fund, and most of the favorable treatment, but they will be treated as giving rise to ordinary income when the taxable event (or December 31, 2026) occurs.

4. Eligibility of property which is being newly constructed, rehabilitated or augmented. Answering this question is very crucial to closing investments. Many proposed transactions involve new construction which will take time, or the rehabilitation of existing facilities, based on the 30-month test of 1400Z-2(d)(2)(D)(ii). That section considers property substantially improved only if during "any 30-month period beginning after the date of acquisition … additions to basis with respect to such property in the hands of the qualified opportunity fund exceed an amount equal to the adjusted bases at the beginning of such 30-month period …" This raises several important questions:

    a. Evidence of the Planned Activity. Section 1400Z-2(d)(2)(B)(iii) and (C)(iii) requires that "during substantially all of the qualified opportunity zone fund's holding period for the such stock/interest, such corporation/partnership qualified as a qualified opportunity zone business." Accordingly, if a corporation or partnership acquires property with a plan to undertake new construction or to make additions to basis over any 30-month period after acquisition, is the property a "qualified opportunity zone business" while it is awaiting construction or rehabilitation? Does the rehabilitation have to be "in place", with actual tenants or use while the rehabilitation is going on?

Our recommendation is that if a taxpayer has reasonable written evidence of a plan to meet the additions to basis requirement within 30 months of acquisition (or perhaps longer, e.g., five years, because the statutes refers to "any" 30-month period), then there shall be a presumption that the business is a qualified opportunity zone business unless subsequent facts make clear that this presumption was not warranted.

b. Additions to Basis with Respect to Such Property. The statute refers to "additions to basis ***with respect to*** such property," indicating that the additional work need not be a rehabilitation. Is it sufficient if a Fund buys a housing development and also constructs an adjacent and appropriately sized community center or playground that passes the basis requirements? The second building or improvement would seem to be "with respect to" the first. We recommend that the basis in new construction and improvements be applied to pass the 30-month test if the Fund can reasonably demonstrate that these items are with respect to the used property. Another alternative might be to apply the "substantially related and subordinate" rules that apply to tax-exempt bond transactions.

c. Reasonable Working Capital. While new construction, rehabilitation or "with respect to" construction is pending, are the funds which will pay for the "new construction/rehabilitation/construction with respect to" exempt from the "nonqualified financial property" ("NQFP") rules of Section 1397C(b)(8)? Failure to have such an exemption would cause most investments in Qualified Opportunity Zone Stock or Qualified Opportunity Zone Partnership Interests that invest in construction projects to have more than 5% NQFP. Thus the entire investment would fail to be Qualified Opportunity Zone Property and cause a catastrophic failure of the 90% penalty test.

We recommend that such funds be considered reasonable "working capital" (and therefore, ***not*** nonqualified financial property) if used to pay for the costs of a reasonable and diligently undertaken project that meets requirements like those we have suggested for the 30-month rule,

as described above. We would be pleased to provide you with an illustration of similar rules that apply to new markets tax credit transactions. Similarly, for QO Funds that invest directly in Qualified Opportunity Zone Business Property, where the new construction, rehabilitation or "with respect to" construction is pending, we recommend that such funds be considered reasonable working capital using a 30-month rule and therefore not negatively impact the 90% test during the 30-month period. We note that Section 1400Z-2(f)(3) provides that no penalty for failing to meet the 90% test shall be imposed where there is reasonable cause for such failure. Combined with the regulatory authority provided to the Service under Section 1400Z-2(d)(4), we believe the Service has the authority to promulgate regulations providing for reasonable working capital.

5. Pre-Investment Financing. All projects require the certainty of an investment. However, typically, taxpayers cannot easily dispose of assets (to generate gains) on such a certain schedule. For example, many housing developments take more than a year to build, and call for capital investments in installments. Because this time frame extends over more than 180 days, taxpayers wanting to maintain these long-settled timelines would be unable to use a particular gain to fund all the contributions required. In anticipation of this problem, developers might arrange financing in anticipation of these capital contributions, or the investor might loan amounts into the project entity, to be replaced by gain investments as the investor generates them, provided that the actual partnership or stock interest is acquired for cash, as required by the Code provision. We believe that this is consistent with the requirements of Section 1400Z-2, but we are identifying this in case it inspires any special interest from the IRS or Treasury.

6. Grace Periods for Investing and the Measurement Dates. Section 1400Z-2(d)(1) requires that the QO Fund hold at least 90 percent of its assets in QOZ property, determined by the average of the percentage of qualified opportunity zone property held in the fund as measured (A) on the last day of the first 6-month period of the taxable year of the fund, and (B) on the last day of the taxable year of the fund. This raises several questions that are impeding investment, with

taxpayers unwilling to invest until they know how the measuring dates will work:

a. How does averaging work? The averaging requirement raises many questions. First, does the fund just determine its percentages on the two dates? We note that the 6-month reference appears to only apply to the "first" such date, or is it supposed to be the earliest possible 6-month period ***each year*** of the QO Fund's existence? What is being averaged? The fair market value of the assets? Their basis? Their original basis at the time of their acquisition by the fund? Our suggestion is that a fund determine its percentage of QOZ property six-months after formation, and the last day of the taxable year, and that this average must equal or exceed 90 percent to avoid the penalty of subsection (f).

   For example, if the fund was a calendar year taxpayer formed on March 1, and it had 80 percent of its assets in QOZ property on September 1 (i.e., 6 months later), and 100 percent on December 31 (i.e., the end of the year), then the average would be 90 percent, and the test would be passed. We do not have a good suggestion for valuation. In the spirit of using "any reasonable method," perhaps computations should be made using "unadjusted basis" (recognizing that adjusted basis could yield nonsensical results on account of bonus depreciation), unless and until the taxpayer elects to obtain an appraisal and use ***that.***

b. How is the first 6-month period measured? If an investment closes on June 27 for a calendar year fund, does the 6-month period end on June 30, or December 27? And if it is the latter, does the fund apply the test on both December 27 and again on December 31, just 4 days later? We recommend that (i) for the first time, the test should be first performed on the date that is six months after the entity is formed and at the end of the tax year that immediately follows that date, and (ii) in subsequent years, the test should be performed on the date that is six months from the start of the tax year, and the final day of such taxable year. For example, a calendar year fund formed on October 1, 2018 would

measure compliance on April 1, 2019 and December 31, 2019, and then on June 30 and December 31 of each year thereafter.

7. Other Technical Issues. These are other questions and technical points that we would hope could be addressed in guidance.

    a. Active Business. The guidance should confirm that leasing activities, particularly the leasing of residential real estate constitutes a QOZ business. As you know, Section 1400Z-2 points the reader to certain subsections of 1397C for additional definitions. While the pointers do ***not*** send the reader to the subsections of Section 1397C that limit potential leasing (including residential and certain personal property leasing) activities, investors are concerned that the IRS might apply such rules.

       For example, many Code sections send the reader to the related party rules of Section 267(b), and tax practitioners generally apply the rules of section 267(c) as well, even though they are not incorporated by the original pointer. The lack of guidance on this point is preventing those who often invest in Section 42-eligible housing developments from investing their gains in Opportunity Zones, seeming to frustrate the purpose of the section. It would be sufficient for guidance to note that, of the provisions in Section 1397C, only those specifically identified in Section 1400Z-2 (i.e., paragraphs (2), (4), and (8) of section 1397C(b)) apply.

    b. "Non-permitted businesses". Section 1400Z-2 refers to Section 144(c)(6)(B) for a list of businesses that are not permitted for Opportunity Zone businesses. Section 1397C has the same reference to Section 144(c)(6)(B), plus it adds many farming businesses to the excluded list. For the same reasons as discussed in the preceding paragraph, it might be helpful for the IRS to say that only the list in Section 144(c)(6)(B) is prohibited, or to observe that "farming businesses are a permitted investment."

c. References to "Substantially all." As we have discussed, the Code provision includes the phrase "substantially all" five times, and we recommend that the IRS publish guidance defining this term for purposes of section 1400Z-2. Where the reference is to time, we recommend that the phrase be applied with a combination of a percentage, along with an initial phase-in and exceptions for reasonable cause.

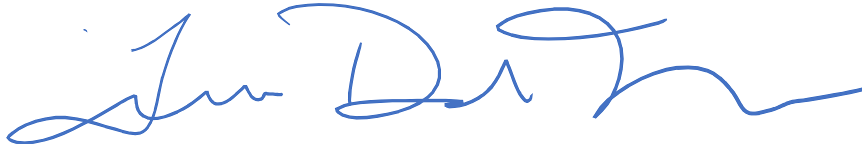
d. Separate funds of non-gains money. It is possible to read 1400Z-2 to provide that ***separate*** funds that make use of only non-gains money can qualify for the benefits of the post-10-year basis step-up of subsection (c). That seems inconsistent with the implication of subsection (e), but that subsection actually addresses ***joint*** funds of both gain and non-gain money, while subsection (c), read by itself, simply states that benefit is available without referring to the source of the investment. The IRS could settle this question by issuing guidance on this point.

e. Taxing the Operation and Distributions of the Opportunity Zone Business. We are anticipating that when an Opportunity Fund owns a partnership interest or corporate stock or Opportunity Zone Business Property, this investment will generally be taxed in the ordinary way. For example, if a partnership in which the fund invests generates income, the Opportunity Fund will get a K-1, and report its share of the income; if such a partnership borrows money and makes a distribution to its partners, including the Opportunity Fund, this will be taxed or not under the usual rules that apply to distributions to partners (e.g., a distribution in excess of basis generally results in capital gain to the partner). Similarly, if the corporation in which the fund owns stock generates corporate level income, it will be subject to the applicable tax rules for corporations; if it makes a distribution to its stockholders, including the Opportunity Fund, this distribution will be subject to the normal tax rules that apply to distributions to stockholders. We see people making various assertions about alternate tax treatments for these items that goes beyond the specific deferrals and non-taxability that appears in Section 1400Z-2, and it may be useful for the IRS to clarify this tax treatment or identify those situations where a special rule might apply.

f. Any Reasonable Method. Several of the questions we and others have raised might be best addressed by the IRS adopting an "any reasonable method" or "any reasonable method, consistently applied" standard. The IRS has used this standard many times; for example, a brief review of the Treasury Regulations indicates that this phrase appears 119 times.

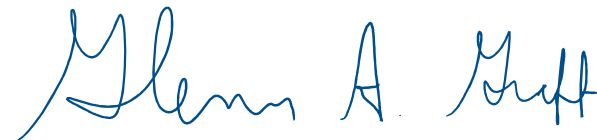
We hope that these are useful observations that will assist in the preparation of FAQs or other guidance. As indicated, answers to these questions would go a long way towards getting these transactions to close. Of course you should not hesitate to contact us with your thoughts and questions.

Very truly yours,



Forrest David Milder, Nixon Peabody, LLP, Former Chair of the ABA Forum and member of the Tax Credit Committee of the ABA Forum

B. Susan Wilson, Enterprise Community Investment, Inc., Co-chair of the Tax Credit Committee of the ABA Forum



Glenn A. Graff, Applegate & Thorne-Thomsen, P.C., Member of the Governing Committee of the ABA Forum and former Co-chair and current member of the Tax Credit Committee of the ABA Forum