Forum on Affordable Housing &
Community Development Law

December 28, 2018

CC:PA:LPD:PR (REG-115420-18) Room 5203
Internal Revenue Service
P.O. Box 7604
December 28, 2018
Ben Franklin Station
Washington, DC 20044
Attention: Erika C. Reigle of the Office of Associate Chief Counsel (Income Tax and Accounting), Kyle C. Griffin of the Office of Associate Chief Counsel (Income Tax and Accounting),

Michael Novey, U.S. Department of the Treasury, Michael.Novey@Treasury.gov

and uploaded to the Federal Rulemaking Portal at
https://www.regulations.gov/comment?D=IRS-2018-0029-0001

**Re: Guidance Regarding Investing in Qualified Opportunity Funds (Reg-115420-18)**

Dear Ms. Reigle, Mr. Griffin and Mr. Novey:

As active members of the Tax Credit and Equity Financing Committee of the American Bar Association Forum on Affordable Housing and Community Development Law,[1] we wish to submit the following comments on the proposed regulations on Qualified Opportunity Zones ("QOZs").

1. **Residential Rental Housing for Qualified Opportunity Zone Businesses ("QOZBs")**

Based on our experience in affordable housing and community development, we believe that the Qualified Opportunity Zone incentives have the potential to be helpful in the development of affordable housing and workforce housing in QOZs. We were encouraged by Revenue Ruling 2018-29 which addressed a Qualified Opportunity Fund ("QOF") owning residential rental housing. However, this ruling did not address the ownership of such rental housing by a partnership or corporation qualifying as a QOZB. Given that Revenue Ruling 2018-29 already allows residential rental housing, we think that it is a

[1] The three of us hold or have held positions in the ABA Forum, and we are all active in the Tax Credit and Equity Financing Committee. In preparing this letter, we consulted with many of our colleagues and members of the Tax Credit and Equity Financing 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.

small change to explicitly provide that a QOZB can own residential rental housing (and even non-residential rental housing) to the same extent as a QOF. We note that one of the requirements to be a QOZB is that 50% of the gross income of a QOZB be derived from the active conduct of a trade or business in a QOZ. See Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(5)(i). However, the regulations addressing the active conduct of a trade or business have been reserved. Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(5)(ii)(B).

The term active conduct of a trade or business is used in a number of different parts of the Internal Revenue Code and the Treasury Regulations issued thereunder (the "Regulations"). We think the one that makes the most sense to apply in this context is the one that is used with respect to New Markets Tax Credits ("NMTC") in I.R.C. Section 45D. In arriving at this conclusion, we note that census tracts that qualify for QOZ benefits must meet the NMTC requirements for qualifying census tracts in Section 45D. NMTCs also have a similar purpose of trying to drive investment into low-income communities. Furthermore, while there are significant additional provisions in Section 45D and the applicable Regulations which interpret and modify the definition of a "qualified active low-income community business,"[2] the NMTC requirements apply an active conduct test in I.R.C. Section 45D(2)(A)(i) which is nearly identical to the active conduct test in Section 1397C(b)(2) relevant to QOZs. Therefore, in the absence of guidance, it makes sense to apply an active conduct of a trade or business standard that is similar to those used for NMTC purposes.

As provided in Regulations Section 1.45D-1(d)(4)(iv), the conduct of a business by a qualified low-income community business will be considered to be "active" for purposes of I.R.C. Section 45D if, at the time a qualified community development entity makes a capital or equity investment in, or loan to, the entity, the community development entity reasonably expects that the entity will generate revenues (or, in the case of a nonprofit corporation, engage in an activity that furthers its purpose as a nonprofit corporation) within 3 years after the date the investment or loan is made. Similarly, we believe that the active conduct requirement for a QOZB should be satisfied if at the time the QOF makes the investment into the QOZB, the QOF reasonably expects the QOZB will generate revenue within 3 years after the QOF's investment is made.

## 2. Applicable Financial Statements

[2] We note that I.R.C. § 45D specifically excludes the rental of residential rental property from the definition of a qualified business for NMTC purposes by reference to I.R.C. § 1397C(d). In contrast, I.R.C. § 1400Z-2 notably does not include any cross reference to I.R.C. § 1397C(d) or otherwise prohibit the rental of residential rental property. We believe that this signals Congressional intent that QOZBs may engage in residential rental property.

The QOZ incentive requires that QOFs invest 90% of their assets in Qualified Opportunity Zone Property ("QOZP") and that at least 70% of the tangible property owned or leased by QOZBs must be Qualified Opportunity Zone Business Property ("QOZBP") (respectively, the "90% Test" and the "70% Test"). I.R.C. § 1400Z-2(d)(1) & (3)(A); Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(3). I.R.C. Section 1400Z-2 is silent as to how such measurements are to be made. The Proposed Regulations require that QOFs and QOZBs that have Applicable Financial Statements ("AFS") as defined in Regulation Section 1.475(a)-4(h), use the values on such AFS and that those without an AFS use the cost of the assets. See Prop. Treas. Reg. § 1.1400Z-2(d)-1(b) & (d)(3).

We believe it is inappropriate to require that QOFs and QOZBs use AFS. First, AFS are defined as being on U.S. GAAP. U.S. GAAP may reflect different assets than are recognized for federal income tax purposes and the methods of capitalizing such assets can differ significantly. For example, Accounting Standards Codification Topic 842 effectively requires lessees to capitalize every long-term lease on their balance sheets. This would be true even for operating leases which are not considered an asset for federal income tax purposes. Thus, under a U.S. GAAP approach, there will be lease assets on a balance sheet that would not be present for federal income tax purposes. We do not think there was a Congressional intent to delegate to U.S. GAAP accounting the determination of assets and asset amounts to be used for the 90% and 70% Tests, especially when U.S. GAAP can have significantly different asset types and methods of capitalization.

Second, U.S. GAAP accounting mandates the use of depreciation, amortization and impairment. The use of such an approach could result in a QOF or QOZB failing their respective 90% or 70% Test merely from the non-cash occurrence of depreciation.

**Example 1**

Assume T has a $10,000,000 capital gain and elects to defer such a gain as provided in I.R.C. Section 1400Z-2. The $10,000,000 is invested on July 15, 2018 into a new QOF and such date is within 180 days of the date of the sale or exchange that generated eligible capital gain. The QOF files IRS Form 8896 and selects July 2018 as the first month of QOF status. The QOF immediately invests $9,000,000 into newly constructed residential rental property that has never been placed in service and otherwise qualifies as QOZBP and thus also qualifies as QOZP. The remaining $1,000,000 is held in non-interest-bearing cash accounts for use as operating deficits reserves and replacement reserves. On its face, 90% of the QOF's assets have been invested in QOZP and would seem to meet the statutory requirements. However, for U.S. GAAP purposes, there would be some depreciation on the residential property. Any amount of depreciation would

> result in less than 90% of the QOF assets being invested in QOZP. We do not believe that reflection of GAAP depreciation should cause a QOF or QOZB to fail their respective 90% and 70% Tests.

Third, we note that Regulation Section 1.475(a)-4(h) is a provision that applies to dealers in securities. The provision has many requirements to have an AFS and we would expect hardly any QOFs or QOZBs would meet the requirements to have an AFS. Thus, there is substantial uncertainty as to how and when a QOF or QOZB would have an AFS.

We believe that the proper approach is for QOFs and QOZBs to be allowed to use the original unadjusted cost of acquiring their assets as provided in Section 1012. Such an approach would use the actual outlay of funds to acquire such assets and reflects the Congressional desire that QOFs and QOZBs invest their assets in appropriate property. It also allows for normal federal income tax rules to be used as to defining assets and the proper capitalization into such assets. An analogous approach is used under the NMTC requirements for purposes of calculating the percentage of tangible property used in an NMTC qualifying census tract. <u>See</u> Treas. Reg. § 1.45D-1(d)(4)(i)(B). In addition, this approach will avoid the unintended consequence that QOFs and QOZBs may choose not to have U.S. GAAP financial statements in order to avoid being forced to use AFS.

To the extent there is a concern that property may over time no longer be used and be inappropriately included in the 70% and 90% Tests, we note that assets that are not used in a trade or business of the QOF or QOZB would be non-qualifying assets for purposes of these tests. <u>See</u> I.R.C. § 1400Z-2(d)(2)(D)(i) ("The term qualified opportunity zone business property means tangible property <u>used in a trade or business</u> of the qualified opportunity fund if . . .") (emphasis added). Thus, the statute has already addressed such a concern by requiring that assets no longer used in the trade or business will not help a QOF or QOZB satisfy the applicable 90% or 70% Test.

### 3. <u>Aggregation of Assets for Purposes of the Substantial Improvement Requirement</u>

QOFs and QOZBs are allowed to have property that was previously used in a QOZ if they substantially improve the property by having additions to basis with respect to such property in excess of the adjusted basis of such property prior to the beginning of the 30-month period. I.R.C. § 1400Z-2(d)(2)(D)(ii). However, it is unclear how this requirement is applied where a QOF or QOZB may use multiple assets in its trade or business.

> **<u>Example 2</u>**

> Assume that a QOZB acquires a factory building and land for $5,000,000 with $500,000 allocable to land and $4,500,000 allocable to the building. The QOZB plans to invest $5,000,000. Of this amount, $2,000,000 will be used on roof repair and other improvements capitalized into the building. The QOZB will spend another $2,000,000 on bringing machinery into the building to be used for the manufacture of goods. The machinery is not permanently affixed to the building and would not be classified as a part of the building for federal tax purposes. An additional $1,000,000 will be used to build an adjacent building that will also be used in the manufacturing trade or business.
>
> If the substantial improvement test only looks to additions to basis with respect to the building itself, the building would not be deemed to be substantially improved and would not qualify as QOZBP.
>
> On the other hand, the QOZB is in the manufacturing business and the acquired building is part of that business. If the QOZB is allowed to aggregate all of the capital expenditures it incurs within 30 months that relate to or expand that manufacturing trade or business carried on at that building, then the building, the new equipment and the new adjacent building would all qualify.

We think the above example illustrates how a restrictive interpretation of the substantial improvement requirement will prevent many businesses from being formed or expanding in a QOZ. We also note that Congress stated that the additions to basis have to be "with respect to such property". The phrase "with respect to" is an unusual choice of words with the phrase commonly meaning "concerning" or "with regard to". We think this phrase is broad enough to refer to improvements that relate to the property but are not physically part of the property. For these reasons, we believe that for purposes of the substantial improvement requirement, an asset should be considered to be substantially improved if there are additions to basis by the QOF or QOZB with respect to the specific asset or other assets used in the trade or business.

## 4. <u>Reasonable Working Capital for QOFs</u>

Due to the stringent 180-day requirement for taxpayers to invest into a QOF, QOFs cannot rely on capital calls from investors who may not know if they will have timely gains to invest while a QOF substantially improves property. Congress provided for a 30-month rehabilitation period for property regardless of whether the property was held directly by a

QOF or by a subsidiary entity qualifying as a QOZB. Cash needed to implement a 30-month rehabilitation should be considered QOZBP for purposes of the 90% Test because the QOF has reasonable cause to hold such funds. Proposed Regulation Section 1.1400Z-2(d)-1(d)(5)(vii) provides a safe harbor for working capital assets held by a QOZB, but this safe harbor does not apply to working capital held at the "upper tier" by a QOF. To fulfill the Congressionally mandated ability for a QOF to rehabilitate property directly, we recommend that the Internal Revenue Service exercise its regulatory authority under Section 1400Z-2(d)(4) and designate that under rules similar to those provided in Proposed Regulation Section 1.1400Z-2(d)-1(d)(5)(vii), a QOF has reasonable cause and will not be subject to a penalty for failure to meet the 90% Test due to holding reasonable working capital for construction of new buildings or rehabilitation of existing buildings or other creations or expansions of businesses.

**Example 3**

Investors have $20,000,000 of capital gain on July 15, 2018. Investors invest the $20,000,000 of capital gain in OZ Rehab Fund on August 1, 2018. OZ Rehab Fund has a purpose of investing in QOZBP and will self-certify as a QOF starting on July 1, 2018. On August 1, 2018 OZ Rehab Fund spends $5,000,000 to purchase land and a building located in a QOZ. OZ Rehab Fund spends the remaining $15,000,000 on rehabilitation costs, $500,000 a month for 30 months.

Assets as of December 31, 2018

| | |
|---|---|
| $5,000,000 | Acquired Building |
| $2,500,000 | Rehabilitation Work in Process |
| $7,500,000 | Total Qualified Opportunity Zone Business Property |
| $12,500,000 | Remaining cash to be spent on rehabilitation. |

37.5% of assets are QOZBP as of 12/31/18.
62.5% of assets held in cash waiting to be spent on rehabilitation, as of 12/31/18.

Because OZ Rehab Fund has less than 90% of its assets invested in QOZB at the end of the year (there is only one measuring period for OZ Rehab Fund in 2018 pursuant Proposed Regulation Section 1.1400Z-2(d)-(1)(a)(2)(i)), OZ Rehab Fund would be subject to penalties under I.R.C. Section 1400Z-2(f). By the implementation of a reasonable cause exception for QOF that is substantially similar to the working capital rules for QOZBs, this result is avoided and QOFs would be able to invest directly in constructing assets to a similar extent as QOZBs.

5. **Delays and Reasonable Working Capital**

For purposes of the reasonable working capital safe harbor for QOZBs, the Proposed Regulations do not address the consequences of delays that are beyond the control of the business. We recommend that there should be permitted exceptions. We observe that there is precedent in the somewhat similar safe harbor that applies to the "begun construction" test that applies to many renewables. Notice 2018-59 provides a lengthy list of permitted delays, including delays due to: severe weather conditions, natural disasters, difficulties in obtaining permits or licenses, government requests regarding public safety, security, or similar concerns; problems with the manufacture of custom components or specialized equipment of limited availability, labor stoppages, the presence of endangered species, problems with financing, and supply shortages.

6. **Status of Projects During 31-month Working Capital Period**

We recommend that the regulations state that projects under development in accordance with the 31-month safe harbor are considered to be qualified, regardless of the non qualified financial property test or whether they are owned directly or indirectly. This could be accomplished by revising Section 1.1400Z-2(d)-1(d)(5)(vii) to read as follows: "(vii) Safe harbor for property developed in compliance with requirements. If a project is developed in compliance with the three requirements of paragraph (d)(5)(iv)(A)-(C) and if the tangible property referred to in paragraph (d)(5)(iv)(A) is expected to satisfy the requirements of section 1400Z-2(d)(2)(D)(1), that tangible property is not treated as failing to satisfy those requirements solely because the scheduled consumption of the working capital is not yet complete, or the property is not yet used in a trade or business."

7. **Beginning Testing Date for 90% Test**

A QOF is tested for compliance with the 90% requirement of Section 1400Z-2(d) at the last day of the first 6-month period of the taxable year of the Fund. The Regulations do not specify what is to be done for a month that starts (and therefore, typically ends) in the middle of a calendar month. We recommend that the IRS offer taxpayers the opportunity to choose ***either*** the corresponding day of the month that is 6 months later or the end of the last month that is not more than 6 months later. The regulations for making Subchapter S elections provide that the days are computed in this way.

**8. Testing Dates for QOFs Begun In the Second Half of a Year**

The Proposed Regulations adopt a rule requiring a QOF to undertake the 90% Test at the end of its first year, if this is earlier than six months after formation. We recommend that the first 6-month testing date be the end of the first six-month period, even if it would extend into the next calendar year, unless the taxpayer elects to use the final day of its tax year. Failure to make such a change may serve to strongly discourage taxpayers from forming funds or investing in the second half of each year, since the fund will have far less time to deploy its funds.

Very truly yours,

Glenn A. Graff

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