What to Know about the Second Round of Proposed Opportunity Zones Regulations

ECONOMIC INNOVATION GROUP / Washington, DC

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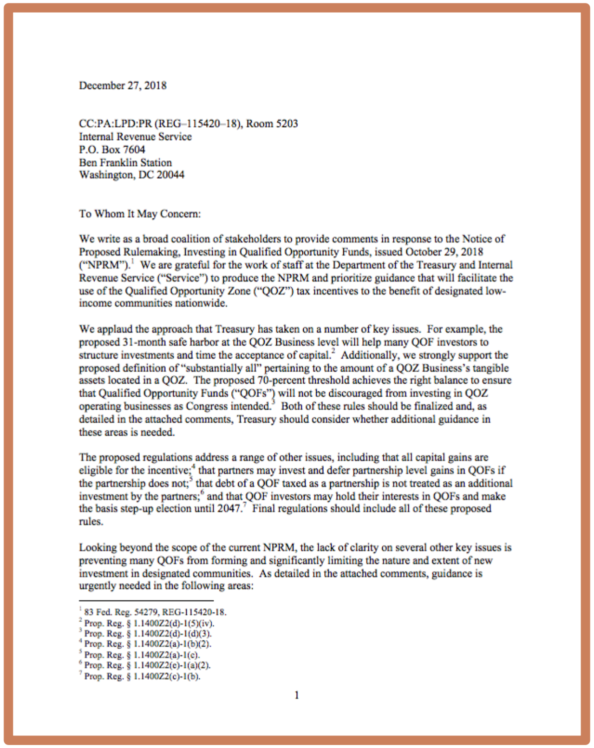
Recent Updates

Effective Implementation, Alignment, and Transparency

- Second Round of Proposed Regulations
  - Comments due July 1, Hearing scheduled for July 9
  - EIG's initial summary of the regulations
- RFI on Data Collection - Comments due May 31
- RFI from US Dept. of Housing & Urban Development - Comments due June 17
- White House Opportunity and Revitalization Council Implementation Plan
  - Scott Turner named Executive Director, kicks off listening tour
  - White House Opportunity Conference
- S. 1344 introduced on May 8 to reinstate reporting requirements and expand transparency
- Forthcoming proposed legislation to provide a one year extension of deferral date through end of 2027



December 27, 2018

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

To Whom It May Concern:

We write as a broad coalition of stakeholders to provide comments in response to the Notice of Proposed Rulemaking, Investing in Qualified Opportunity Funds, issued October 29, 2018 ("NPRM").[1] We are grateful for the work of staff at the Department of the Treasury and Internal Revenue Service ("Service") to produce the NPRM and prioritize guidance that will facilitate the use of the Qualified Opportunity Zone ("QOZ") tax incentives to the benefit of designated low-income communities nationwide.

We applaud the approach that Treasury has taken on a number of key issues. For example, the proposed 31-month safe harbor at the QOZ Business level will help many QOF investors to structure investments and time the acceptance of capital.[2] Additionally, we strongly support the proposed definition of "substantially all" pertaining to the amount of a QOZ Business's tangible assets located in a QOZ. The proposed 70-percent threshold achieves the right balance to ensure that Qualified Opportunity Funds ("QOFs") will not be discouraged from investing in QOZ operating businesses as Congress intended.[3] Both of these rules should be finalized and, as detailed in the attached comments, Treasury should consider whether additional guidance in these areas is needed.

The proposed regulations address a range of other issues, including that all capital gains are eligible for the incentive;[4] that partners may invest and defer partnership level gains in QOFs if the partnership does not;[5] that debt of a QOF taxed as a partnership is not treated as an additional investment by the partners;[6] and that QOF investors may hold their interests in QOFs and make the basis step-up election until 2047.[7] Final regulations should include all of these proposed rules.

Looking beyond the scope of the current NPRM, the lack of clarity on several other key issues is preventing many QOFs from forming and significantly limiting the nature and extent of new investment in designated communities. As detailed in the attached comments, guidance is urgently needed in the following areas:

[1] 83 Fed. Reg. 54279, REG-115420-18.
[2] Prop. Reg. § 1.1400Z2(d)-1(5)(iv).
[3] Prop. Reg. § 1.1400Z2(d)-1(d)(3).
[4] Prop. Reg. § 1.1400Z2(a)-1(b)(2).
[5] Prop. Reg. § 1.1400Z2(a)-1(c).
[6] Prop. Reg. § 1.1400Z2(e)-1(a)(2).
[7] Prop. Reg. § 1.1400Z2(c)-1(b).

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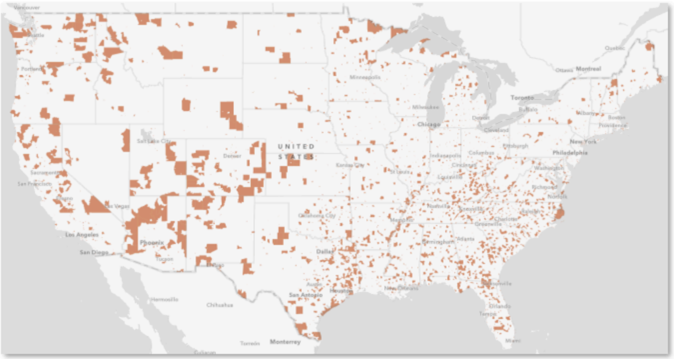
Takeaways: Second Round of Proposed Rules

The success of this policy starts with a regulatory framework that facilitates investment into new and growing operating businesses and improves the built environment in Opportunity Zones.

The second round of proposed rules addresses many key gating issues and provides clarity needed for investors and fund managers to deploy capital.

- ✓ Provides clarity to investors on the timing requirements for capital deployment and reinvestment, as well as Opportunity Fund exits
- ✓ Issues guidance on the applications of tests outlined in the statute for leased property
- ✓ Defines key terms and their applications, such as original use, substantially all, and substantial improvement
- ✓ Provides additional flexibility for the working capital safe harbor and the 50% gross income test



Opportunity Fund Operations

EIG

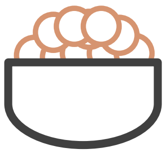
May 2019

Key Issues: Opportunity Fund Operations

Life Cycle of an Investment

- QOF Formation
  - Satisfaction of 90% asset test

- Operation
  - Distributions to investors
  - Dispositions of assets/reinvestment



- Exit/Wind-Up

Key Issues: Opportunity Fund Operations

Qualified Opportunity Fund Formation

- 90% Asset Test - Average of percentage measured at the end of six months and at the end of the taxable year

- Proposed regulations provide option to disregard working capital received within six months for purposes of the 90% test
  - Opportunity funds effectively have a minimum of six months (and potentially up to nearly 12 months) to deploy capital once received from investor

- Valuation of assets can be based on either value reported on applicable financial statement or unadjusted cost basis
  - Same valuation option applies for requirement that 70% of a qualified opportunity zone business's tangible property be qualified opportunity zone business property

Key Issues: Opportunity Fund Operations

Operation

- Basis in Opportunity Fund
  - Outside basis starts at zero
  - Increased by allocable share of debt and operating income
  - Increased by 10% and 5% basis increases after holding five and seven years, respectively
  - Inside basis is carryover, which creates inside-outside basis disparity

- Distributions not in excess of basis are not inclusion events and do not trigger deferred gain

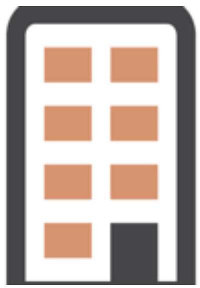
- Interim Gains
  - 12-month reinvestment period, if proceeds held as working capital
  - Does not trigger deferred gain
  - However, flow-through income is taxable to investors

Key Issues: Opportunity Fund Operations

Exit/Wind-Up

- Sale of Qualified Opportunity Fund Interests
  - Election to step-up basis of qualified opportunity fund assets to avoid "hot asset" income

- Fund Sale of Qualified Opportunity Zone Property
  - Election to exclude qualified opportunity fund capital gains (from sale of qualified opportunity zone property) reported on K-1



Operating Businesses

EIG

Key Issues: Operating Business

- Working Capital Safe Harbor
  - Extended to operating businesses
  - Extension for delays attributable to waiting for government action
  - Multiple 31 month-periods

- 50% Gross Income Test
  - Qualified opportunity zone business must derive at least 50% of its gross income from active conduct of trade or business "in the qualified opportunity zone"
  - New safe harbors
    - Services performed in the zone (by hours)
    - Services performed in the zone (by amount paid)
    - Tangible property and management in the zone

- Intangible Assets: 40% of intangible property must be used in the active conduct of a trade or business in the opportunity zone

Key Issues: Operating Business

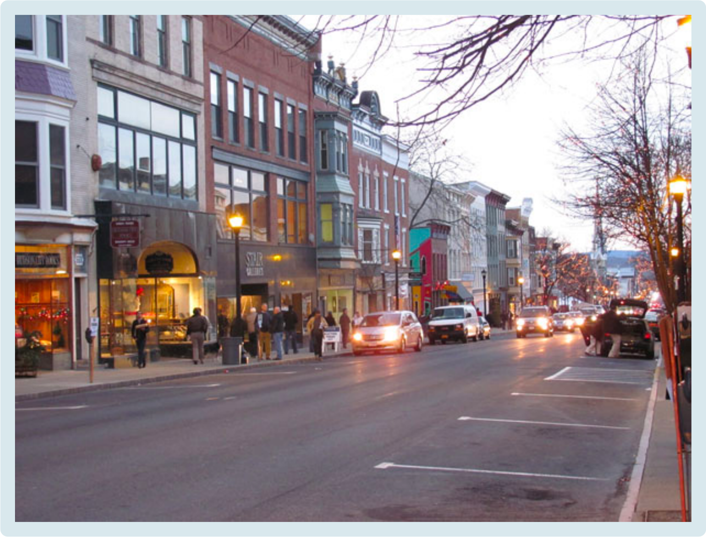
- Leased Property
  - Treated as qualified opportunity zone business property if meet certain requirements
  - No original use or substantial improvement requirement
  - Related party leases permitted if meet certain requirements
  - Valuation = present value of lease payments

- Original Use and Substantial Improvement
  - Original use of tangible property commences on date placed in service in the opportunity zone for purposes of depreciation or amortization
  - Substantial improvement determined asset by asset

Real Estate

Key Issues: Real Estate

- Ownership or operation of real property (including leasing) constitutes **active conduct of a trade or business**
  - "Merely" entering triple net lease is not active conduct
- Treatment of IRC Section **1231 gains**
  - Net section 1231 gains are eligible for deferral
  - 180-day investment period begins on last day of tax year
- **Original use or substantial improvement**
  - Placed in service in the opportunity zone
  - Buildings vacant for five years treated as original use
  - No substantial improvement requirement for unimproved land



Q&A

Next Steps: Submit Comments and Sign Up to Testify

- Second Round of Proposed Regulations
  - Comments due July 1
  - Hearing scheduled for July 9, submit request to testify by July 1
- RFI on Data Collection
  - Comments due May 31
- RFI from US Department of Housing & Urban Development
  - Comments due June 17

Appendix

Select Resources for Additional Information

Our Research and Resources:

- The State of Socioeconomic Need and Community Change in Opportunity Zones (December 2018)
- Opportunity Zones: The Map Comes Into Focus (June 2018)
- 2018 Distressed Communities Index (2018)
- Additional information can be found on our website.

External Resources:

- Novogradac | Opportunity Zone Resource Center
- Drexel University | Nowak Metro Finance Lab
- The Governance Project | Opportunity Zones
- Accelerator for America | Opportunity Zones
- Internal Revenue Service | Opportunity Zones FAQ
- U.S. Treasury Department | Opportunity Zone Resources
- NCSHA | Opportunity Zone Fund Directory
- Council of Development Finance Agencies | Opportunity Zones
- Georgetown's Beeck Center | Opportunity Zones
- Impact Framework for Investors | OZ Framework

Opportunity Zones Coalition

The **Opportunity Zones Coalition** is a group of organizations working together with a broad array of public and private stakeholders to ensure the timely and effective implementation of the policy.

If you are interested in learning more about the Coalition, please contact info@eig.org.

Access Ventures
Alliant Strategic
Advantage Capital
Arctaris
Bridge Investment Group
CA FWD:
Calvert Impact Capital
Capalino+Company
Capital Impact Partners
Chicago Community Loan Fund
CLA
CohnReznick
Community Capital Management
CDBA Community Development Bankers Association
CDVCA Community Development Venture Capital Alliance
CRF USA
Detroit Opportunity Fund
Economic Innovation Group
EJF Alternative Asset Management
The Enterprise Center
Fundrise
Fund for Our Economic Future
Hancock Whitney Bank
IPA Institute for Portfolio Alternatives
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Kirkland & Ellis LLP
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