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Re: Recommendations for Legislative and Regulatory Modifications to Opportunity Zone Incentive

We write as a broad coalition of stakeholders to make recommendations to the Biden administration to improve and strengthen the Opportunity Zones (“OZ”) incentive, which provides tax benefits for qualifying investments in low-income communities. With such improvements, the OZ incentive will be well positioned to play a key role in a “build back better” agenda that supports historically underserved communities.

The Opportunity Zones incentive is an ambitious advance in place-based policymaking designed to boost private investment across a wide range of activities in eligible low-income communities—including thousands of Black and brown neighborhoods that have experienced decades of underinvestment. Even during a time of deep partisan divisions, this policy has enjoyed broad bipartisan support from state and local leaders and federal policymakers alike. Since its passage into law in December 2017, the OZ incentive has spurred the investment of billions of dollars into low-income communities across the country. Novogradac’s most recent [survey](#) of the Qualified Opportunity Funds (“QOFs”) listed on their directory reported more than \$15 billion of capital invested as of December 31, 2020, up more than \$3 billion from the end of August of that year. This number likely represents only a fraction of the total amount of investment in designated communities to date.

There are more than 8,700 Opportunity Zones census tracts across the 50 states, District of Columbia, and the U.S. territories. Governors and state executives were tasked with designating 25 percent of their jurisdiction’s low-income census tracts as Opportunity Zones; in doing so, they employed a variety of methods to determine their map of OZs, and in the end, the vast majority of designated OZ communities are among the highest-need places across a range of socioeconomic metrics. Residents of Opportunity Zones experience an average poverty rate of 26 percent according to the latest 2019 data, a median family income less than two-thirds the national level, on average, and an average life expectancy three years shorter than the national

figure. Of the 31.5 million Americans living in OZs across the 50 states and DC, 57 percent belong to a minority group, compared to 39 percent of the overall U.S. population.

Though we are still in the early phase of the market's development, the OZ incentive is already showing its promise and fulfilling its intent to bring resources to long-overlooked communities. OZ investors are placing their capital in projects and businesses in places like rural Indiana, the Black Belt of Alabama, and Rust Belt cities across the Midwest. Furthermore, OZ financing is supporting a diverse set of investments, from affordable and workforce housing, to new commercial space for first-time entrepreneurs, to brownfield redevelopment, to high-growth businesses. In Selma, AL, OZ impact investors are restoring the historic St. James Hotel. In Wilmington, DE, a vertical farming startup and OZ business named Second Chances Farm is helping formerly incarcerated individuals rejoin their community with good, green jobs. And in South Los Angeles, The Beehive business accelerator is leveraging OZ dollars to seed a new generation of Black and brown entrepreneurs. Throughout the country, the OZ incentive has spurred unlikely new partnerships and community-based collaboration aimed at improving the lives of local residents.

The policy's implementation has not been entirely smooth, however. Reporting and transparency requirements were stripped out due to its passage via budget reconciliation as part of the *Tax Cuts and Jobs Act* ("TCJA"). The first years of the market have been heavily tilted towards investment in real estate, in part due to the fact that it took the Department of the Treasury longer to propose rules addressing the more complex issues facing operating OZ businesses. In addition, while a two-year period to implement a new statutory provision is not uncommon, the wait kept many stakeholders and much-needed capital on the sidelines, which can be detrimental for a time-limited incentive. And shortly after regulations were finally in place, the COVID-19 pandemic upended market activity mere weeks into what was anticipated to be the milestone year in the OZ market's development.

The Opportunity Zones incentive is well on its way toward making its intended impact in struggling communities across the country, but its effectiveness could be enhanced through a number of targeted improvements to both the regulations and underlying statute. OZs should be part of the discussion about economic relief and recovery in the wake of COVID-19; it is an important new tool that can be deployed to bolster communities hardest hit by the pandemic. It is also fundamentally about changing investor behavior and improving how capital markets serve low-income communities, making it a powerful plank in the administration's agenda to advance racial equity. Thoughtful improvements to establish additional guardrails, encourage investment in new and existing businesses, and accelerate market development will position OZs to play an important role in the pandemic recovery.

As this administration considers changes to the OZ incentive as part of its effort to revive the economy in the wake of the crisis, we strongly caution against pursuing major changes to the incentive that may disrupt the fragile and still-developing OZ market. Investors and communities alike are just beginning to feel comfortable with the final regulations and emerging

market norms, particularly in light of the COVID-19 pandemic, and further policy uncertainty could freeze investment in communities that need it most.

We believe the following recommendations would significantly improve the guardrails and impact of this incentive without resulting in undue disruption to communities or market participants. We welcome the opportunity to discuss these and other potential enhancements to the OZ policy.

I. Legislative Recommendations

Reporting and Transparency Requirements

The OZ tax incentive was enacted without reporting and transparency requirements for QOFs and investors due to the reconciliation rules in the U.S. Senate, which removed these provisions from the original bill. Although the Internal Revenue Service (“IRS”) has implemented some reporting requirements under its general taxpayer compliance authority in connection with the filing of returns, the omission of robust reporting requirements, in particular, has been the basis for much of the criticism of the policy. The establishment of a robust reporting regime enjoys bipartisan support in Congress, as well as support from local elected officials, think tanks, and other industry stakeholders. There is a significant appetite for enacting reporting requirements as soon as possible, so OZ stakeholders and policymakers alike may better understand the effectiveness and impact of the OZ incentive and may consider ways to further improve the incentive.

Recommendation:

We strongly support the immediate establishment of reporting and transparency requirements for OZ investments in a manner that protects confidential information. Senator Tim Scott’s bipartisan [*Improving and Reinstating the Monitoring, Prevention, Accountability, Certification, and Transparency Provisions of Opportunity Zones \(IMPACT\) Act*](#) is one proposal that would achieve these goals. The *IMPACT Act* is a comprehensive reporting regime that would significantly enhance efforts to evaluate the OZ policy and guard against abuse, while striking an appropriate balance between the need for more granular measurement data and the imperative to protect confidential taxpayer information. The *IMPACT Act* requires reporting by QOFs and investors and imposes penalties for failing to comply with the reporting requirements, with allowances made for reasonable cause. The *IMPACT Act* also provides for Treasury to produce an annual report on national OZ activity that looks at aggregated data, such as the number of funds, total assets, and distribution of investments, and tracks socioeconomic indicators of OZ communities over time.

Early Sunset of High-Income OZ Tracts

By most measures of socioeconomic well-being, OZs are among the highest-need communities in the United States. However, a small percentage of tracts nominated by governors and designated by the Secretary of the Treasury – while technically qualifying under the definition of a low-income community or the rule allowing some adjacent tracts for designation – are in fact

high median income tracts and do not align with the underlying intent of the law. The continued designation of these tracts as OZs risks undermining the integrity of the broader policy, creating a perception of distorting the flow of capital away from higher-need areas.

Recommendation:

We recommend that legislation provide an early sunset of OZ designations for tracts that exceed a certain threshold of median family income. However, we recommend that there be careful consideration of factors that should mitigate disqualification of tracts that are critical to local revitalization efforts, including those in distressed urban cores, and that states have a level of flexibility in retaining disqualified tracts that meet certain criteria, such as a high poverty rate. In addition, states should have the ability to replace disqualified tracts with new tracts designated as OZs. Finally, it is critical that this legislation provide grandfathering rules for QOFs to deploy existing investments and complete existing projects in disqualified tracts, while precluding QOFs from undertaking new projects in disqualified zones. Failure to include reasonable grandfathering rules would upset many existing investments and commitments and undermine investor confidence in the OZ program.

Allowance of Fund-to-Fund Investments

Under the current OZ statute, a taxpayer must make an investment *directly* into a QOF in order to have a qualifying investment, and a QOF is not permitted to invest in another QOF. Thus, aggregator or feeder funds for QOFs are not currently allowed. This can prevent the pooling of smaller investments to make a more impactful QOF investment, or prevent investments in diversified pools of QOFs. According to members of this coalition, a typical investment in a highly distressed area is relatively small, around \$3-\$5 million, but large investors, such as banks, corporations, and large family offices, have minimum investment levels and QOF sizes that greatly exceed that. As a result, the largest deals attract a great deal of capital from institutional investors, whereas the community-based projects have a hard time accessing capital. In addition, direct investment in multi-asset QOFs is difficult as a result of red tape. An intermediary investment structure, such as a feeder fund, would not only make these small OZ projects possible but would also allow smaller investors to make direct, diversified investments in QOFs.

Recommendation:

We recommend that legislation allow for qualifying investments to be made into aggregator or feeder funds. Such legislation would need to provide sufficient time for feeder funds to make investments into QOFs, and would need rules to prevent dilution of investments into OZs while permitting the feeder fund to cover overhead and operation of the fund.

Extension of Deadline for OZ Benefits

The OZ statute was originally drafted in 2016 with a deadline for investment and realization of gains in 2026. The OZ incentives are also time-driven, providing for exclusion of a portion of the deferred gain for QOF interests held for five and seven years before the 2026 realization event, and exclusion of the appreciation in the QOF interest after holding it for 10 years. The statute was enacted at the end of 2017, but many ambiguities remained in the OZ rules that

prevented investment activity until the final regulations were released two years later. The OZ marketplace finally began to hit its stride late in 2019 as increased regulatory clarity, higher levels of investment, and emerging market norms combined to encourage broader participation from a diverse group of stakeholders. But shortly thereafter, the COVID-19 pandemic had a chilling effect on OZ investments. As a result of these factors, the OZ statute has not had sufficient time to foster investment before the upcoming investment deadline and realization event in 2026.

This conclusion is supported by a [national survey of OZ stakeholders](#) conducted by EIG in May 2020. When asked what action the federal government could take to ensure that the OZ policy is an effective tool for economic recovery, the most common response (64 percent) was to extend the deferral deadline beyond 2026.

Recommendation:

We recommend that legislation extend the 2026 deadline for investment and realization of gains to allow for the full benefits intended by the statute.

Interim Gains

Under the OZ statute, gains realized on the sale of investments in QOFs that have been held for at least 10 years are excluded from gross income. Current regulations provide a mechanism for exclusion of gain from the sale of the underlying business assets held at the QOF or a lower-tier entity level after the QOF has been held for 10 years. However, gain on the sale of business assets held less than 10 years is included income. A traditional private equity or venture capital fund will liquidate investments in operating businesses and reinvest the proceeds into other operating businesses at various times over a period of years. If a QOF engages in such activity, the QOF investor will not realize the full 10-year gain exclusion benefit, even if the proceeds are reinvested into subsequent OZ investments. This limitation has discouraged many traditional private equity and venture capital investors from investing in operating businesses in OZs.

Recommendation:

We recommend that legislation defer recognition of gain on the sale of OZ business interests by a QOF as long as the sale proceeds are reinvested into other OZ property within a 12-month period.

Federal Funding for States and Communities

States and local communities need additional resources to successfully develop and implement local OZ strategies that will benefit their residents and attract impactful levels of investment in local businesses. Community leaders have expressed the need for technical assistance, pre-development and risk mitigating capital, and dedicated personnel to coordinate OZ strategies, interface with local stakeholders, and conduct outreach to investors and project sponsors. Funding of states and local communities for these purposes would align with the goal of the Build Back Better plan to “advance[] racial equity, small business creation, and homeownership in low-income urban, rural, and tribal communities.”

Recommendation:

We recommend legislation that creates a federal fund, housed within the Department of the Treasury (“Treasury”), the Community Development Financial Institutions Fund, or the Department of Housing and Urban Development, that distributes money to states for use towards implementing OZ strategies. Such legislation could include preconditions for states to receive funding and/or limitations on the proportion of the funds that can be used for administrative expenses, as well as criteria to ensure the funding goes to projects with a high impact.

II. Regulatory Recommendations

Treasury and the IRS have done a considerable amount of work, including consideration of comments made by hundreds of stakeholders, to provide guidance to implement the OZ statute. This guidance has been critical to providing much-needed certainty so that OZ investments and projects could move forward. We believe that certain modifications should be made to the regulatory regime to maximize the OZ incentive’s impact on low-income communities. However, we caution against a broader reopening of the guidance, as it could create uncertainty, which will deter investors and make it difficult for QOFs to raise and deploy capital into these communities.

Reporting Requirements

Treasury and the IRS have implemented reporting requirements for QOFs and investors using Form 8996, *Qualified Opportunity Fund*, and Form 8997, *Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments*. Treasury and the IRS have authority to require the reporting of additional information to ensure compliance with the OZ requirements.

Recommendation:

Forms 8996 and 8997 should be amended to capture additional information, such as inclusion events, and to ensure compliance with the OZ requirements. We refer to our prior [comment letter](#) on Form 8996 dated November 29, 2019, and our [comment letter](#) on Form 8997 dated December 2, 2019 for specific recommendations.

Additional Flexibility for Affordable Housing

The OZ incentive can be a valuable tool to attract private capital to create more affordable rental housing. However, affordable housing developers that intend to rehabilitate or convert existing property to affordable housing projects have a very difficult time meeting the requirement that either original use of the property commence in the OZ or that the property be substantially improved. The substantial improvement threshold is even more challenging for affordable housing projects in expensive urban areas, which is often where such housing is most acutely needed.

Recommendation:

Additional flexibility could be provided through modification of the original use and/or substantial improvement requirements. We recommend that Treasury and the IRS issue

regulations allowing property converted from market-rate to affordable rental housing to be considered “original use” property, similar to the special exceptions for vacant property and brownfields in the existing regulations. Regulations could provide that property converted from market-rate to affordable would be considered “original use” provided the property is subject to a recorded Land Use Restriction Agreement (“LURA”) requiring a minimum set-aside that at least 40 percent of all units are affordable to households earning 80 percent or less of the area median income.

Regulations could also treat existing affordable rental housing as “substantially improved” if improved by more than an insubstantial amount and subject to a LURA as described above. “More than insubstantial” could be defined as in excess of 20 percent of the unadjusted cost basis of such property, consistent with the Low-Income Housing Tax Credit (“LIHTC”) standard.¹

Includible Gain Relief for LIHTC Investments

The existing regulations provide a special computation of deferred gain inclusion for qualifying investments in a QOF partnership or S corporation, which requires investors to recognize a greater portion of deferred gain, even if the fair market value of their investments has declined. This is likely to hit LIHTC partnerships disproportionately hard, because LIHTC investments generally do not appreciate in value due to the long-term land use restrictions for these projects. Modifying the inclusion rules for LIHTC partnerships would permit investors to recognize tax benefits for any decrease in value of their investment upon inclusion of the deferred gain, which would increase the value of the incentive and encourage more affordable rental housing investment in OZs.

Recommendation:

We recommend that Treasury and the IRS modify the regulatory computation of includible deferred gain so as to not adversely affect LIHTC activity. Please refer to our prior [comment letter](#) to Treasury and the IRS dated July 1, 2019 where we recommended regulatory language to achieve this modification.

New Markets Tax Credit Pairing Fixes

While there is overlap between the goals of the OZ incentive and the New Markets Tax Credit (“NMTC”) to encourage the flow of capital into low-income communities, it is often difficult for an investor to be eligible for both incentives. This is due to existing NMTC regulations that have the effect of encouraging investments to be made in the form of loans rather than equity interests, because investors in entities making loans have greater protection from recapture under a reasonable expectations test. Controlling equity interests are not eligible for the reasonable expectations protection. Without reasonable expectations protection from recapture, investors generally perceive the compliance risk as too great and are unwilling to enter into such transactions.

¹ We recognize that legislation may be necessary to change the substantial improvement requirement in this context.

Recommendation:

We recommend that Treasury and the IRS modify the NMTC regulations to relax the controlling equity definition to increase protection from recapture, which would provide the certainty necessary for Community Development Entities (“CDEs”) to invest in QOFs.

Certification of QOFs

The OZ statute does not provide any requirements for the certification of QOFs, but instead grants authority to Treasury to prescribe regulations providing rules for certification. The final regulations established a certification process whereby partnerships and corporations that meet the statutory requirement of having a purpose of investing in QOZ property may self-certify as QOFs. We believe that one of the primary factors leading to the proliferation of investment in OZs has been this streamlined certification process. Implementing a certification process that would require government approval in advance of investments would likely result in significant delays and deter smaller funds from forming, thus hindering the flow of capital into needy communities.

Recommendation:

We recommend that Treasury and the IRS retain the self-certification process that has allowed the rapid creation of new funds and investments. To the extent the new administration determines it appropriate to collect additional information as part of the certification process, we strongly recommend that such requirements continue to be applied on a self-certification basis, and any changes apply only prospectively to new QOFs. In addition, we urge the new administration balance the usefulness of any additional collection of information against the burden imposed by the additional collection, and specifically ease any newly adopted certification requirements for small QOFs that have less capital.

Pre-Existing Businesses

Congress intended existing businesses with expansion and growth potential to qualify for OZ tax benefits. In his press release announcing the introduction of the *Investing in Opportunity Act*, Senator Tim Scott (R-SC) wrote, “The *Investing in Opportunity Act* can provide the chance that entrepreneurs and small businesses are looking for to grow, innovate and create jobs,” underscoring that this incentive was intended to draw capital to OZs both to help existing businesses grow, as well as to spur creation of new businesses. However, the requirement that OZ business property must have been acquired after December 31, 2017 and used in the OZ for substantially all of the entity’s holding period makes it difficult for existing businesses to qualify as an OZ business. Such existing business are therefore unable to raise additional equity capital from QOFs.

Recommendation:

We recommend that Treasury and the IRS issue regulations modifying these requirements as they apply to pre-existing businesses. For example, the substantial improvement test could be modified to allow tangible property purchased on or before December 31, 2017 to be treated as qualified property if the business makes other substantial investments, such as the acquisition of

new tangible property, that exceeds the basis of existing property during the substantial improvement period, similar to the rule for related party leases of tangible personal property. Regulations would also need to clarify that for purposes of the “substantially all of the use” for “substantially all of the holding period” of the QOZ Property requirement, the holding period requirement begins upon the certification of the QOF.

Remove Taint of Nonqualifying Property

Under the statute, property must be purchased after December 31, 2017, and either substantially improved or originally used in the OZ, to be considered qualifying business property. As a result, property acquired before 2018 or property acquired in a nontaxable transaction would not qualify. However, there was some question as to whether, if nonqualifying property was substantially improved, the portion that was substantially improved could be considered qualifying business property. In the preamble to the final regulations, Treasury and the IRS answered that question in the negative because it would impose administrative burdens for both taxpayers and the IRS to track improvements. This rule is inconsistent with the treatment of leasehold improvements and improvements to land, which can qualify under the regulations. In addition, taxpayers generally must track improvements separately for accounting purposes and depreciation purposes, so there is no additional burden.

Recommendation:

We recommend that Treasury and the IRS issue regulations to provide that nonqualifying property does not “taint” any new improvements made by a QOF or OZ business by treating any nonqualifying property incorporated into a new property as a separate asset for purposes of the OZ requirements.

OZ Preference for Federal Building Projects

Executive Order 13946 directs the U.S. General Services Administration (“GSA”) to prioritize consideration of sites in OZs when choosing the location for future federal government buildings and leases. This order incentivizes investment by the federal government in locations that are in need of new jobs and economic activity and, if implemented, could be extremely impactful. However, as of the date of this writing, no regulations have been issued to implement this preference system for OZs.

Recommendation:

We recommend that GSA issue regulations implementing this executive order and outlining the favorable scoring mechanism for federal government projects in OZs.

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For additional regulatory suggestions, we refer to our prior [comment letter](#) to Treasury and the IRS dated July 1, 2019. We appreciate your consideration of these recommendations and welcome the opportunity to discuss these issues with you further. If you have any questions about these recommendations, please contact Catherine Lyons, Director of Policy & Coalitions at the Economic Innovation Group, at catherine@eig.org.

Sincerely,

Alliant Strategic Housing Funds
American Idea Foundation
Arctaris Impact Fund
Bedrock Detroit
Blueprint Local
Bridge Investment Group
California Forward
CalOZ
Catalyst Opportunity Funds
CohnReznick LLP
Community Development Venture Capital Alliance
Community Reinvestment Fund, Inc.
Council of Development Finance Agencies (CDFA)
Develop LLC
DL3 Realty
Dauby O'Connor & Zaleski, LLC
Economic Innovation Group
EJF Capital
Erie Downtown Development Corporation
Fundrise
Greatwater Opportunity Fund
Institute for Portfolio Alternatives
KPMG
Launch Pad
Local Initiatives Support Corporation (LISC)/National Equity Fund (NEF)
LOCUS
National Development Council
NES Financial
Novogradac
Obsidian Investment Partners
Opportunity Alabama
Peachtree Providence Partners
Plante Moran
Polsinelli
Post Harvest Technologies
Redbrick LMD, LLC
Small Business Majority
SMB Intelligence
SoLa Impact/Black Impact Fund
Sorenson Impact Center
Sorenson Impact Foundation
The Enterprise Center
The Hip Hoppreneuer
The Opportunity Exchange

U.S. Chamber of Commerce
U.S. Impact Investing Alliance
YWCA

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