June 18. 2019

CC:PA:LPD:PR (REG-120186-18)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: **OPPORTUNITY ZONE GUIDANCE** REG-120186-18

Dear Sir or Madam:

The following requests further clarity with respect to the second set of Opportunity Zone ("OZ") proposed regulations issued on April 17, 2019 ("Round Two Guidance") addressing the requirements in Section 1400Z-2 of the Internal Revue Code. Thank you for the efforts and lengthy discussions to develop guidance that assists the implementation of the OZ provisions.

Round Two Guidance requests comments on many issues. It would be an overwhelming undertaking to attempt to address all areas where additional clarity might be helpful. Many additional areas will very likely be raised by others. The comments below are limited to certain points and do not address all areas where further clarification could be helpful. Hopefully, the combination of comments by multiple practitioners will cover most areas and allow investments to be made with the best assurance for compliance.

1. Timing on Section 1231 Net Capital Gain Investments in QOF. Round Two Guidance clarifies that Section 1231 net capital gain is available for investments in a Qualified Opportunity Fund ("QOF") for 180 days commencing on the last day of the tax year. As drafted, investments of proceeds from the sale of Section 1231 assets in advance of the last day of the applicable year are ineligible for a qualifying investment in the QOF.

To the extent that cash is needed in a QOF for investments, alternative structures could be developed to have an unrelated third party initiate development work and have such undeveloped project purchased through the QOF structure or possibly have third-party financing provided to the QOF structure and have all or a portion of such debt amount paid with the Section 1231 net capital gain amount that is properly invested in a QOF.

It would seem unnecessary to reconfigure an investment in a QOF based on the required timing presented by the Round Two Guidance with respect to Section 1231 net capital gain when sale proceeds are available. It would be helpful if taxpayers have the opportunity to invest Section

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1231 capital gain dollars prior to the last day of their tax year. The timing of an investment can be made with the understanding that the eligible investment amount could be reduced or eliminated (and actually be considered a partially nonqualifying investment) based on further sale transactions during the tax year.

To some degree this would provide the same flexibility as available to members of a pass-through entity that incurs capital gain during a tax year, where the general rule states that investment can commence on the last day of the tax year but an elective rule is available to allow the members to make the investment following the sale date.

2. Application of 31-Month Safe Harbor for Application of Cash Investments When Delayed by Government Action. Round Two Guidance states that governmental delays after applications have been completed do not cause a failure of the 31-month safe harbor with respect to the Section 1397C(e)(1) nonqualified financial property requirement. A similar exception exists for another provision.

Clarification regarding what is provided by the governmental approval extension would be helpful. One interpretation is that any period between the submission of an application for government approval and receiving such approval is tacked on to the 31-month period. Read literally, that is a fair reading because the consumption of the cash could be ready to be applied.

A narrower reading is that any government approval period is not added to the 31-month period if either (a) the application submission could have been made earlier to accelerate the government approval process or (b) the cash is not ready to be spent during the government approval period because of other non-government contingencies in addition to the government approval process. Another question is whether the government approval exception is available only when such approval is received after the 31-month period or can the government approval period be tacked on even if obtained prior to the end of the 31-month period.

3. Purchase of Qualifying Equity Interest in a QOF from an Investor. Round Two Guidance states that a qualifying investment can be made by acquiring an outstanding eligible interest in a QOF from another person and that the amount of the investment is the cash and other property paid for the eligible interest.

How is this provision applied to the purchaser?

Does the purchaser need to have recognized capital gain within 180 days prior to the purchase of the eligible interest to have a qualifying purchase? It would seem that is a necessary step but it is not stated.

It is interesting that the guidance states that when property is used to purchase an outstanding eligible interest, the fair market value of property is the amount deemed invested. In contrast, appreciated property could not have been contributed to a QOF in exchange for an eligible interest.

Is this favorable statement acknowledging that the purchaser of an outstanding eligible interest would be eligible for the post-purchase tax free appreciation benefit, even though the purchaser might not be eligible for the deferred gain benefits because the investment is not linked to any capital gains? More clarity would be needed to reach this result because the guidance states that the post-investment tax free appreciation is available only for the portion of the eligible investment for which a proper election to defer capital gain is in effect. If no initial capital gain deferral election has been made, then it would seem that the post-investment tax-free appreciation benefit is unavailable.

4. Substantially All (70%) of the Use of the Qualifying Tangible Property Must in in a OZ.

Certain OZ businesses have operations involving moveable tangible property that is transferred to areas outside an OZ, whether daily with nightly storage back in the OZ or that is operated by the customer and left continually outside of the OZ. In determining whether substantially all (70%) of the qualifying tangible property is used in an OZ, safe harbors should be made available.

When testing the substantially all 70% use requirement , it is very possible that the application of the mathematical tests provided through the GAAP financial statement or the alternative valuation method with respect to the aggregate tangible property (which would include both moveable and non-moveable tangible property) might initially satisfy this requirement. However, the business success can result is an increasing amount of manufactured tangible property that is made available and used outside of an OZ that could lead to challenges in satisfying the mathematical test and attempting to limit the portion of a business that is considered within a QOF structure or take some additional action to separate the portion of tangible property that is used outside of an OZ. This concern could result in the abandonment of developing an OZ business because of the efforts needed throughout the minimum 10-year holding period.

Businesses that comply with the "qualified opportunity zone business property" requirements and satisfy the Round Two Guidance that 50% of the gross income of such qualifying business is derived from the active conduct of a business in the OZ should be also deemed in compliance with the requirement that substantially all of the use of the qualifying tangible property is in an OZ.

The following are points for consideration in developing safe harbors for the substantially all (70%) use requirement:

a. With respect to the requirement that 50% of the gross income of a qualifying business is derived from the active conduct of a business in the OZ, Round Two Guidance addresses the situation where an OZ business has movable equipment used outside of an OZ. For purposes of this separate requirement, the guidance concludes that if a landscaper's headquarters are in a qualified opportunity zone, the business' daily operations (occurring within and outside the qualified opportunity zone) are managed by the officers and employees from its headquarters, and all of its equipment and supplies are stored within the headquarters facilities or elsewhere in the OZ, then the management activity and the storage of equipment and supplies in the qualified opportunity zone are each considered necessary to generate 50 percent of the gross income of the trade or business and such income is considered derived within the OZ.

The conclusion that the daily operations of landscaping equipment outside the OZ does not negate the 50% gross income requirement should also be considered to support the position that the use of the equipment outside the OZ can be ignored for purposes of the substantially all use requirement. A solution that can be considered with respect to the substantially all use requirement is that if the OZ business satisfies the 50% gross income requirement, then the use of movable equipment outside the OZ should not prevent such equipment from also satisfying the substantially all requirement.

It is understood that the source of the 50% gross income requirement and the substantially all use requirement are two distinct separate requirements. However, there is a commonality of purposes with respect to both requirements in that if the revenue is treated as derived from the active conduct of a business in the OZ, then the use of the tangible property should be considered consistent with such result.

b. There are two categories of movable tangible property that need to satisfy the substantially all use requirement. First, there is equipment that is owned by an OZ business, operated by the employees of the OZ business outside of an OZ, and regularly returned to the OZ. Landscaping equipment would be in this category. Second, there is tangible property that is owned by the OZ business, provided to customers outside of an OZ business through a lease, service contract, or other arrangement, operated by the customers, and eventually returned to the OZ business at the end of the arrangement. Machinery that contains software, which is not sold but made available through a long term arrangement with the customer and required to be returned would be in this category.

The first category regarding moveable tangible property that is operated by employees of the OZ business outside of the OZ and returned regularly to the OZ business should automatically be treated as satisfying the substantially all use requirement consistent with the landscaping equipment example applied to the 50% gross income test.

The second category regarding moveable tangible property that is provided on a long term basis to customers for their operation outside of a OZ business should also not be counted negatively in the substantially all 70% calculation. To the extent that the revenue attributable to such equipment is treated as derived from the active business within the OZ, the same conclusion should apply to treat such equipment as either totally included or totally excluded from the numerator and denominator with respect to the substantially all (70%) use requirement.

i. Round Two Guidance accepts that inventory (including raw materials) that is in transit from an operation within an OZ to customers at a location outside an OZ does not impact the substantially all (70%) requirement. This statement acknowledges that the fact that tangible property manufactured or otherwise developed within the OZ is not negatively taken into account just because such tangible property is transferred outside the OZ. This special rule addresses the transit of tangible property in situations where the link to the manufactured units (and the use by the manufacturer) is broken by a sale or other disposition.

Consideration should be given to extending this special provision to tangible property that is leased or otherwise made available to customers outside the OZ business. A position can be developed that it should not matter whether tangible property is transferred by an OZ business to customers outside the OZ through a sale, a lease, or through a service contract. In all such situations, the OZ business can be said to relinquish possession of the tangible property and such property could be treated as no longer used by the OZ business.

ii. The substantially all use requirement should focus on the tangible property that is operated and used by the OZ business and not such property that is operated and used by the third party customer.

c. While more limiting that the prior two suggested approaches, another approach that can be considered would be to treat tangible property that is deemed operated pursuant to a "service contract," as defined in Section 7701(e), as continued to be used by the OZ business.

One reason for the enactment of Section 7701(e) was to not treat arrangements with tax exempt entities as leases subject to special depreciation rules. To the extent that the arrangement is considered as a service contract, it is considered as continuing to be used by the OZ business and, as such, the fact that the revenue is considered derived from the business in the OZ should equally apply to treat the tangible property as used in the OZ.

This approach would develop a more limited exception because it would need to be evaluated through factors distinguishing a lease from a service contract and consideration would need to be given to whether unrelated business income can be present with respect to any owner of the OZ business that is a tax-exempt organization.

d. An additional approach is that long term lease arrangements that are beyond a specific percentage of the tangible property expected life or depreciable period would be treated as not used by the OZ business during such lease period, regardless of whether such property is treated as sold under general tax principles.

e. Another approach is to create a safe harbor that treats tangible property that is manufactured within an OZ or that is enhanced or maintained with technology that is developed or sourced within the OZ as used within the OZ.

Technology that is developed or sourced within a OZ might need to be combined with tangible property to provide a useable machine. The tangible property might not function without the technology that is developed or sourced from within the OZ. If the technology could be simply downloaded from the internet, there would not be any issue regarding the substantially all use requirement . However, in those instances where technology needs to be combined with tangible property for implementation and such technology is then made available to customers through a lease, service contract, or other arrangement, the fact that tangible property is a component for the transfer of the technology introduces the substantially all use requirement. The tangible property is merely the means to provide the technology to customers.

This all ties back to the same underpinnings used in reaching safe harbors for the requirement that 50% of the gross income of a qualifying business is derived from the active conduct of a business in the OZ. Additional safe harbors can be discussed and developed but it would be simpler to allow the 50% gross income safe harbors to also be available for the substantially all use requirement, particularly because a common purpose is served. Of course, these OZ businesses need to have a sufficient amount of additional tangible property that meets the OZ business property requirements.

This request for safe harbors on this point is required because an alternative would be to structure the customer arrangements as sales to utilize the special rule provided for tangible property in transit to customers. It would seem unnecessary and disruptive for parties to have to structure an arrangement as a sale with possible rights to return the equipment in a manner that would qualify for tax purposes.

5. Substantial Portion (40%) of Intangible Property is Used in Active Conduct of Business in a OZ. Clarity regarding the use of intangible property would be helpful.

While not specifically stated, the licensing of software to parties outside of an OZ seems permissible without having to consider the 40% requirement. First, unlike the substantially all (70%) use requirement for tangible property that requires use in an OZ, the intangible property requirement only requires that such property be used in the active conduct of a business in an OZ. Intangible property developed by software engineers and made available (whether by sale or license) to customers outside the OZ seems permissible because the use of the software by customers would not be taken into account and only the use of the software by the engineers within the OZ is taken into account in applying the 40% requirement. Second, the guidance regarding the 50% gross income requirement confirms that a startup business that develops software applications with a vast majority of its sales to consumers outside the OZ is permissible. This statement indicates that the use of the software by the customers is ignored in the application of the 40% intangible property requirement.

A real question can arise when a business has its main operation in an OZ and a R&D facility outside of a OZ. The R&D facility builds on the existing intangible property. What measuring method should be used to apply the 40% requirement between the different locations? One approach would be that if 50% of the gross income of a software licensing business is considered derived from the active conduct of a business in an OZ, then the requirement that 40% of the intangible property is used in the active conduct of a business in an OZ would also be met.

A similar (but somewhat smaller) issue arises when employees are able to work from home on technology development. To the extent that employees are permitted to work from their homes for convenience purposes, rather than mandated for business reasons, workers should be considered as working at the employer's location. This "convenience of the employer" approach has been adopted by some jurisdictions for local income tax purposes and could be applied as a general rule to conclude that intangible property is used in the active conduct of a business in an OZ.

6. Substantial Improvements to Building with Capital Gains Dollars Linked to Current Owners.

The preamble to Round Two Guidance states:

> The Treasury Department and the IRS are also studying the circumstances under which tangible property that had not been purchased but has been overwhelmingly improved by a QOF or a qualified opportunity zone business may be considered as satisfying the original use requirement and request comment regarding possible approaches.

A potentially challenging situation is when a building within an OZ is in need of substantial renovations. Business operations are run through such building and the owners of the business have capital gains available for investment. The approach of creating a new QOF structure, whereby the existing building is leased to a newly-formed operating company ("OpCo") primarily owned by a new QOF has the following obstacles, in addition to the complexity and need for a deep understanding of the OZ provisions:

a. The purpose of the arrangement would be solely to try to utilize the favorable leasing provisions of the Round Two Guidance between related parties. However, the lease of the existing building would need to be at market terms. OpCo would be leasing the building from the existing entity and then leasing the improved building back to the existing entity. Any rent would be a circular cash flow.

b. OpCo could make substantial improvements to the building in an amount that would be considered "overwhelmingly improved," which would be considered as purchased and qualifying as original use.

c. Query if the rental arrangement between such related parties can be considered the active conduct of a business.

d. The arrangement would need to allow the capital gain investors in the QOF to benefit only from the post-investment tax-free appreciation of the building to the extent associated with the future increase in the value of the building improvements. The investors in the QOF could not benefit from the increased value of the operating business.

e. Restructuring the arrangement to have the capital gain dollars invested through a QOF to the existing entity has the challenge that the substantial improvements to the building might not be sufficient to have the qualifying business property be at least 70% of the aggregate tangible property, but this would be a case-by-case determination.

A possible solution would be to allow the specific improved property to be treated as an isolated asset even though it is part of the larger business, in situations where an existing business within an OZ has a need for substantial improvements and the current owners are interested in investing capital gains pursuant to the OZ provisions. This is a variation of the "portion of a business" rule that has been permitted pursuant to Reg. 1.45D-1(d)(4)(iii) with respect to New Markets Tax Credit arrangements. The post-investment appreciation eligible for tax-free status can be linked to the additional percentage ownership that would be available when the cash contributed is compared against the market value of the business entity at time of contribution. More work would be needed to develop this solution but need to first understand if there is a willingness to go down this path.

Rehabilitating buildings through the use of the OZ provisions by existing owners is an important part of improving distressed areas. From a policy standpoint, it would seem like a good administration of the tax provisions to provide a simplified alternative approach to existing owners of a business who are already in distressed areas designated as OZs.

7. NMTC Reasonable Amount of Working Capital Safe Harbor. Arrangements can be developed where QOF dollars and New Markets Tax Credit (NMTC) financing are both made available to an entity from different sources for development within an OZ. Some operations are not eligible for both, as in the case of a business consisting predominantly of the development or holding of intangibles for sale or license, but might (in certain circumstances) nonetheless be able to use the "portion of the business" exception of Reg. 1.45D-1(d)(4)(iii).

The OZ guidance provides a 31-month safe harbor to hold cash for either real estate development or operations that meet certain requirements in compliance with the "nonqualified financial property" 5% limitation. In contrast, the NMTC provides a 12-month safe harbor for cash used towards the construction of real property, but no specific safe harbor for cash amounts held for equipment purchases or for operations. Taxpayers can attempt to illustrate amounts that also satisfy the "reasonable amounts of working capital" held in cash but institutional investors that provide the source of funds eligible for NMTC might be uncomfortable without a specific safe harbor stated.

It would be helpful if the guidance could provide a statement to the effect that OZ businesses that utilize the 31-month safe harbor for tangible property development or operations (as provided under the Round Two Guidance) would also be eligible to use the 31-month period for the same costs with respect to the NMTC nonqualified financial property limitation, as an illustration of a reasonable amount of working capital held in cash.

Respectfully,

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