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Opportunity zone hearing on proposed regulations: Oral comments highlight need for greater clarity for investments to move forward

The IRS and U.S. Treasury Department on February 14, 2019, held a hearing on the first round of proposed regulations for the opportunity zones provisions.

The proposed regulations were released in October 2018. Read KPMG's report of initial impressions about the proposed regulations under the opportunity zone measures: ***TaxNewsFlash***

Overall impressions from the hearing

The biggest takeaway from the hearing was the wide swath of industries in attendance. The potential for unprecedented infusions of capital into opportunity zones across the nation and in U.S. possessions is causing businesses and investors alike to rethink traditional investment strategies to align with the opportunity zones rules.

Those making oral comments at the hearing included representatives from affordable housing, small business, family office, and, investment groups; state and local community representatives; Native American and veterans groups; as well as the American Bar Association, other state bar associations, and service providers such as law firms and CPA firms.

Many commentators argued for stricter investment and project oversight to ensure that the residents and businesses of opportunity zones realize tangible benefits in the form of job creation and lasting economic community impacts.

Commentators' concerns were aired before a panel of six Treasury and IRS officials and a capacity audience. In addition to the 23 commentators scheduled to speak, two speakers were heard at the invitation of Associate Chief Counsel Scott Dinwiddie who allowed those in the audience to add their own comments.

The hearing lasted for over four hours. Comments were diverse, but a number of issues surfaced that many commenters concluded were critical to opportunity zone projects moving forward. These issues are summarized below by topic.

50% gross income requirement

Pursuant to section 1400Z-2(d)(3)(A)(iii), the proposed regulations require that for each tax year at least 50% of the gross income of a qualified opportunity zone business (QOZB) is derived from the active conduct of a trade or business **in the qualified opportunity zone**.

Since many businesses derive income from the sale of goods and services outside of a single census tract, commentators expressed concern that this rule could significantly limit the ability of local operating businesses to be QOZBs. Further, this result would be contrary to congressional intent.

Even for those businesses that might qualify under this rule, it would impose enormous new administrative burdens to track and report the location of each source of business income, they said. In addition, many start-up businesses may not generate any meaningful operating income for some period of time. Commentators suggested that similar to the New Markets Tax Credit (NMTC) regulations—Reg. section 1.45D-1(d)(4)(i)(A)—a QOZB should be deemed to satisfy the 50% gross income test based upon a percentage of its property located in the qualified opportunity zone (QOZ).

Active conduct of a trade or business

Under the proposed regulations, a QOZB must be engaged in the active conduct of a trade or business in the QOZ. However, under general tax law principles, start-up businesses may not be treated as engaged in a trade or business generally until they open their doors and start serving customers. Commentators recommended a safe harbor for start-up businesses to allow them to be treated as engaged in the active conduct of a trade or business if, at the time that the qualified investment is made, there is a reasonable expectation that within some designated period of time the business will generate revenue. This approach is available under the NMTC program. See Reg. section 1.45D-1(d)(4)(iv)(A) and the discussion under "Substantial improvement" below.

Self-certification process and data collection

Currently, an entity may elect to self-certify to be treated as a qualified opportunity fund (QOF) on Form 8996, *Qualified Opportunity Fund,* both for initial self-certification and for annual reporting of compliance with the 90% asset test by attaching this form to its federal income tax return for the relevant tax years. See section 1400Z-2(d)(1).

Commentators encouraged the IRS and Treasury to adopt more rigorous reporting requirements for QOFs in order to promote transparency. Many commentators were concerned that without such oversight, projects would be built without taking into account whether there was a positive economic impact to the community and would thus fail to provide economic benefits to local residents such as job creation and access to goods and services. Additionally, this transparency could increase the likelihood of sustainable community transformation and development, they said.

Vacant property / original use

Generally, a QOF must have at least 90% of its assets invested in QOZB property based upon the average of its assets as of the last day of the first six-month period and on the last day of the tax year of the fund. See Section 1400Z-2(d)(1).

While, according to the current guidance, land is not treated as original use property—see Rev. Rul. 2018-29—it is not clear whether land is included in the numerator, denominator, or not included at all for purposes of satisfying the 90% asset test and the QOZB asset requirements. It is also not clear

whether a lease of land is considered an intangible asset that is included in the denominator of the 90% test, but separately categorized from the tangible assets for purposes of the QOZB asset requirements.

Commentators requested that the rules provide that land is a qualifying asset for purpose of the QOF's 90% asset test and the QOZB asset requirements. Commentators also requested that the regulations clarify that QOZB property may be constructed or improved upon leased land and clarify how leased land will be treated and/or valued under the QOF's 90% asset test and the QOZB asset requirements. This issue was especially relevant to Native American communities that own land that, under law, may not be sold but may be subject to a ground lease. It is also relevant to many operating businesses that want to lease space and operate within a qualified zone.

Substantial improvement

QOZB property includes property that is substantially improved by the QOF. A building located on land within a QOZ is treated as substantially improved if, during any 30-month period beginning after the date of acquisition of the building, additions to the taxpayer's basis in the building exceed an amount equal to the taxpayer's adjusted basis of the building at the beginning of such 30-month period. Section 1400Z-2(d)(2)(D)(ii).

Further, the fact that the cost of the land within the QOZ upon which the building is located is not included in the taxpayer's adjusted basis in the building does not mean that the taxpayer is required to separately substantially improve such land for it to qualify as QOZ business property. See Prop. Reg. section 1.1400Z-2(d)-1(c)(8)(i) and (ii). See also Rev. Rul. 2018-29.

Commentators requested that the IRS and Treasury provide that, notwithstanding the 30-month substantial improvement period specified in the statute, taxpayers should be allowed to extend the improvement period due to extenuating circumstances outside the taxpayer's control. The IRS and the Treasury have provided such relief in the energy credit area, which takes into account a taxpayer's continuous efforts to complete construction of a qualifying energy facility based on the relevant facts and circumstances, they said. See IRS Notice 2013-29.

Remove barriers to multi-asset funds

The opportunity zone rules provide that if a taxpayer elects, the basis of a QOF investment held for at least 10 years will be equal to the fair market value of such investment on the date such investment is sold or exchanged. Section 1400Z-2(c).

Currently, a QOF cannot dispose of an asset without triggering a taxable event. Commentators are concerned that QOF investors may not receive the intended 10-year capital gain exclusion due to "interim" gains generated during the lifetime of the QOF. This issue has inhibited QOF activity, they said, and has been a significant deterrent to investments in operating businesses when the spreading of risk is essential to a QOF and its investors.

Commentators requested that the IRS and Treasury provide that no gain or loss should be recognized on a QOF's sale or exchange of QOZB property to the extent the QOF reinvests in new QOZ property within one year (or, in the case of a QOF organized as a partnership, to the extent the QOF distributes the proceeds in complete redemption of a taxpayer's investment in such fund that has been held for at least 10 years).

Valuation methodology for applying the 90% and 70% asset tests

For purposes of the calculation of the QOF's 90% asset test and the QOZB asset tests, the proposed regulations generally require a QOF / QOZB to use the asset values that are reported on the QOF /

QOZB's applicable financial statement for the tax year. See Prop. Reg. sections 1.1400-2(d)-1(b) and 1.1400Z-2(d)-1(d)(3)(ii).

If a QOF and QOZB do not have applicable financial statements, the proposed regulations generally allow the QOF / QOZB to use the cost of its assets. The IRS and Treasury requested comments on the suitability of both of these valuation methods, and whether another method, such as adjusted tax basis, would be better.

Commentators stated that measuring compliance with those tests using GAAP basis financials is burdensome and may have unintended consequences. They recommended that the final regulations should allow all QOFs and QOZBs to have the option to elect to use the unadjusted cost basis methodology to value tangible assets regardless of whether or not they have an applicable financial statement.

Working capital safe harbor

Currently the proposed regulations allow a QOZB a safe harbor of up to 31 months to deploy cash for the acquisition, construction, and improvement of tangible property and satisfy the QOZB asset requirements. See Prop. Reg. section 1.1400Z-2(d)-1(d)(5)(iv).

Commentators requested that the safe harbor be expanded to also apply to QOFs.

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