July 1, 2019

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Room 5203
Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Washington, D.C. 20044

Re: Internal Revenue Service's Proposed Rules for Investing in Qualified Opportunity Funds

To whom it may concern:

The undersigned state economic development officials write to provide comments on the IRS's recently proposed regulations under the Opportunity Zone incentive. This is a follow-up to earlier sets of comments dated September 24, 2018, and December 28, 2018, that previous co-signatory state officials sent to the Office of Information and Regulatory Affairs and the Internal Revenue Service. This third set of comments is primarily focused on the proposed rules that were published in the Federal Register on May 1, 2019, and that are open to public comment until July 1, 2019. The issues we would like to focus on include greater flexibility in determining whether the Substantial Improvement requirement has been met; additional flexibility and clarification of the tax treatment of rolled-over Opportunity Fund capital; allowing for additional flexibility for the 90-Percent Requirement for new Opportunity Funds; reasonable but real reporting requirements for Opportunity Funds; and proposals for future legislative consideration. This letter details these issues and recommends that the IRS consider them during the regulatory review process. Finally, we acknowledge that there are a number of other technical points in the proposed regulations that would benefit from clarification – we are not attempting to address these items in this letter. We note that individual states and the undersigned officials may have further, individual comments and that this letter does not prevent them from sending separate comments.

The rules should provide additional flexibility in determining if the Substantial Improvement requirement has been met.

The proposed regulations require that Opportunity Zone business property meet either the Original Use Requirement or the Substantial Improvement Requirement. While used tangible property may qualify as Original Use in some instances, in cases where property that was utilized by another user in an Opportunity Zone is sold to the Opportunity Fund or Opportunity Zone Business, the tangible property must meet the Substantial Improvement Requirement. The preamble to the proposed regulations provide that the Substantial Improvement Requirement is determined on an asset-by-asset basis.

The preamble to the proposed regulations also provided that the Internal Revenue Service had contemplated the possibility of applying an aggregate standard, rather than the current asset-by-asset standard, in determining if the Substantial Improvement Requirement has been met. As stated in the preamble, this approach would allow tangible property to be grouped by location in the same, or contiguous, Opportunity Zones. In the preamble, the Internal Revenue Service specifically requested additional comments on the advantages and disadvantages of an aggregate approach as opposed to the current asset-by-asset approach.

We remain concerned that the determination of the Substantial Improvement Requirement on an asset-by-asset basis, rather than an aggregate basis, may be burdensome to operating businesses in particular. Further, it may not be possible to refurbish or improve these particular assets in order to satisfy the Substantial Improvement Requirement. A requirement of individual asset calculations and recordkeeping will make the Opportunity Zone investment process cumbersome and difficult in a way not intended. We encourage the Internal Revenue Service to apply this test on an aggregate basis rather than the current asset-by-asset basis with respect to operating businesses. This change would decrease the administrative burden for operating businesses.

The rules should provide sufficient flexibility for Opportunity Funds to reinvest interim gains in Qualified Opportunity Zone Property in a timely manner without incurring a penalty or triggering a taxable event.

The proposed regulations suggest that when an Opportunity Fund, treated as a partnership for federal income tax purposes, realizes a gain from the sale of Qualified Opportunity Zone Property before the end of the 10-year holding period, the partners are subject to income tax even if the sales proceeds are reinvested in Qualified Opportunity Zone Property. The proposed regulations provide that the proceeds from the sale of Qualified Opportunity Zone Property that generates gain may then be reinvested, but the gain is first subject to income tax even though the holding of the cash sales proceeds by the Opportunity Fund for reinvestment will not subject the Opportunity Fund to a penalty as long as the proceeds are reinvested within 12 months. We believe revised guidance on this issue is merited and we encourage the Internal Revenue Service to be as flexible as permissible, within the bounds of law, in allowing Opportunity Funds to reinvest sale proceeds in Qualified Opportunity Zone Property within a certain period of time without incurring penalty and without triggering a taxable event.

As indicated in our previous letters in September 2018 and December 2018, we remain concerned that preventing Opportunity Funds from reinvesting capital proceeds from the sale of Qualified Stock and Partnership Interests without triggering a taxable event would reduce the incentive for Opportunity Funds to invest in operating businesses. As they stand, these provisions present substantial investment uncertainty for Opportunity Funds and could work to reduce the willingness of Opportunity Funds to enter into these investments in operating businesses.

The regulations could provide further flexibility for Opportunity Funds to reinvest interim gains in Qualified Opportunity Zone Property in a timely manner without subjecting the investors to income tax on such gains. The Internal Revenue Service could also consider establishing a minimum length of time that an Opportunity Fund would be required to hold Qualified Opportunity Zone Property such that the Opportunity Fund could, thereafter, sell such Qualified Opportunity Zone Property and reinvest the sales proceeds without triggering a taxable event.

The rules should provide sufficient timing flexibility for new Opportunity Funds to meet the requirements of the 90-Percent Requirement.

The most recent tranche of regulatory guidance provided a degree of flexibility with respect to cash held by an Opportunity Fund with respect to the 90-Percent Asset Requirement. However, we continue to recommend that the regulations include a provision that provides Opportunity Funds with additional flexibility in meeting the requirements of the 90-Percent Asset Requirement following the inception of a qualifying entity being treated as an Opportunity Fund.

In a typical investment timeline, it takes a fund a minimum of 18 to 30 months to raise capital from investors and appropriately deploy it across a balanced portfolio. Under the proposed rules, an Opportunity Fund may apply the 90-Percent Asset Requirement without taking into account any investment received in the preceding six months. Under these regulations, an Opportunity Fund has a minimum of six months and a maximum of 12 months to deploy new capital that it has raised before being subjected to a possible penalty for failure to satisfy the 90-Percent Asset Requirement. Instead, we would recommend a change that would allow a minimum of 12 months for investments to be made before a penalty under the 90-Percent Asset Requirement.

As the rules are currently framed, the timeline remains short and could be highly demanding for a newly-formed Opportunity Fund. For example, if an Opportunity Fund with testing dates of June 30 and December 31 were to receive a cash influx on July 1, under the current regulations the July 1 influx would not be taken into account for the December 31 testing date but would be taken into account for the following June 30 testing date. In this case, the fund has had nearly 12 months to invest the new capital in qualifying projects. However, if a fund with the same testing dates were to receive new capital on December 30, that capital would also be excluded from the December 31 testing date and taken into account for the following June 30 testing date. In this case, the fund would have had just over 6 months to invest the new capital.

The current structure could delay or discourage the formation of potential Opportunity Funds. We ask the Internal Revenue Service to consider extending the option to disregard recently contributed property to contributions or exchanges that occurred not more than 12 months before the test from which it is being excluded, rather than the six months in current regulations, establishing a minimum of 12 months for investments to be made. Such a provision would provide additional flexibility for an Opportunity Fund, within a more realistic timeline, to establish an investment portfolio that meets the intent of the law.

The rules should encourage simple, unobtrusive reporting requirements for Opportunity Funds.

The IRS recently issued an RFI focused on reporting requirements. We believe that in order to track the efficacy of the Opportunity Zone program and identify areas of improvement and modification for the future, Opportunity Funds should be required to provide a set of information sufficient to give the public confidence about the initiative. We ask that reporting requirements enable analysis regarding the effectiveness of the program without being overly burdensome. In our December 2018 letter, we proposed that Opportunity Funds be required to report, at a *minimum*, on the specific Opportunity Zones in which they have capital deployed, the amount of capital deployed, and the eventual appreciation of that capital. Beyond this preliminary suggestion, we are highly interested in the RFI responses and look forward to the ideas and solutions that the responses may provide. Transparency, accountability, and functionality are greatly important principles that should be applied in this case.

Future legislation should consider extending the 7-year holding period benefit for an additional year.

While this issue may require legislative amendment, we ask that the following be considered: the seven-year tax benefit and the deferment of taxation on capital gains for an additional year. The process of producing federal regulatory guidance related to Opportunity Zones has been extensive and has required a longer time period than was likely expected when the legislation set the date for the expiration of the seven-year tax benefit. We would welcome discussion of federal legislation that would extend the expiration of this benefit. This change could be accomplished through legislation in multiple ways and would allow additional time for development of thoughtful investment portfolios.

The ability for re-designation of zones or additional designations should be considered for future legislation.

Now that we state officials are in the process of working on the ground with municipalities and potential participants in this program including developers and businesses, some of us are encountering certain problems with boundaries set during the designation phase. Some of these problems involve, for example, census tract boundaries that split industrial areas into multiple tracts, tracts that were designated by previous state administrations and seem less sensible to new administrations, or tracts that were designated prior to the drafting of the regulations and that now do not appear to have significant investment potential. We would like the opportunity to amend zone boundaries, to supplement the current zones with a small number of additions, or a hybrid approach. We would welcome the consideration of future mechanisms to address these concerns.

We hope that Treasury and the Internal Revenue Service strongly consider our comments and suggestions as they continue to promulgate regulations under Investing in Opportunity Funds. If Treasury and the Internal Revenue Service would like to better understand or clarify our comments, we would gladly welcome the opportunity for an extended discussion. Thank you for your consideration.

Sincerely,

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