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Deputy Commissioner for Services and Enforcement
Internal Revenue Service
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Washington, DC 20055

RE: Investing in Qualified Opportunity Funds REG-120186-18

July 1, 2019

Dear Deputy Commissioner Wielobob:

The 10 undersigned community, housing, civil rights, consumer and other advocacy organizations appreciate the opportunity to submit comments on the Internal Revenue Service's (IRS) proposed regulations governing investments in Qualified Opportunity Funds (QOF).[1] The stated purpose of the Opportunity Zone program is "to encourage economic growth and investment in designated distressed communities (qualified opportunity zones) by providing federal income tax benefits to taxpayers who invest new capital" in Qualified Opportunity Zones (QOZ).[2]

It is essential that the IRS limit the generous tax benefits exclusively to those investments that actually flow into Opportunity Zones and provide potential economic benefit to the residents and communities in order to achieve the program's goals. Many of the existing and proposed rules provide flexibility or safe harbors for QOFs or Qualified Opportunity Zone Businesses (QOZBs) to allow investments or economic activity *outside* Opportunity Zones while still receiving tax benefits, taking potential investments away from the very places the Opportunity Zone program is supposed to improve.

The Opportunity Zone program offers significant tax benefits for the investors in QOFs that meet the IRS rules governing allowable investments in QOZs and QOZBs. *Forbes* magazine wrote that the program could become "one of the biggest tax giveaways in American history."[3] QOF investors can defer capital gains taxes, reduce capital gains tax liabilities for maintaining QOF investments and receive a total exemption from all capital gains earnings on QOF investments held for at least a decade. Pitchbook called the tax-free treatment of QOF profits after a decade the program's "most staggering tax benefit."[4]

Given the size and scope of the tax benefits provided to investors, it is imperative that the IRS rules prevent revenue losses from investments that do not even go into Opportunity Zones. The IRS must finalize rules that minimize the leakage of investment and economic activity to areas outside the Opportunity Zones. Every dollar that flows outside the Opportunity Zones provides substantial tax benefits that may provide minimal or no economic benefit to the designated neighborhoods.

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[1] 84 Fed. Reg. 84. May 1, 2018 at 18652 et seq.
[2] *Ibid.*
[3] Bertoni, Steven. "An unlikely group of billionaires and politicians has created the most unbelievable tax break ever." *Forbes*. July 18, 2018.
[4] Sostheim, Joelle and Jordan Beck. Pitchbook. "A Window of Opportunity: An Overview and Analysis of Opportunity Zones." February 21, 2019, at 8.

The Opportunity Zone program has the laudable goal of encouraging private capital to flow into lower-income communities. But the program has structural limitations in design and implementation that already pose considerable hurdles to the program achieving its stated purpose. The program is a more generous version of prior place-based tax incentives like Empowerment Zones that largely failed to deliver tangible benefits for the targeted communities.[5] Additionally, the program lacks any performance standards that would ensure that these investments provide tangible benefits to the residents of Opportunity Zones, such as requiring investments in affordable housing, local jobs, or local service providing non-profit organizations.

The designation of the qualified Opportunity Zones already included many gentrifying neighborhoods and high-cost booming metropolitan areas. Real estate and investment advisors have recommended that QOFs invest in places like Baltimore, Denver, Honolulu, Los Angeles, New York City, Oakland, Portland, Philadelphia, San Francisco, San Jose, and Seattle[6] that are among the highest rental cost areas and where it can take more than 80 hours of minimum wage work per week to pay for a one-bedroom apartment, according to the National Low Income Housing Coalition.[7] The Opportunity Zone investments are likely to exacerbate the housing affordability crisis in many high-cost housing areas that could displace existing lower-income households and households of color.

The proposed IRS rules allow investors to claim tax benefits for investments that are not even located in Opportunity Zones. The IRS recognizes that as little as 40 percent of the QOF investments could end up in the Opportunity Zones while still satisfying various asset and investment tests.[8] Other proposed rules and safe harbor provisions further allow QOFs and QOZBs to minimize investments into Opportunity Zones or make investments that benefit the investor without providing much economic benefit to the community.

The cumulative impact of these tax loopholes will drain federal revenue while eroding the ability of the Opportunity Zone program to achieve its stated purpose to incentivize private investment in distressed communities. The proposed tax rules will exacerbate the tendency that investors are most likely to pour money into the most economically expanding metropolitan areas and gentrifying areas that would raise housing costs and displace lower-income residents of color. Allowing QOFs to receive substantial tax benefits for investments outside the Opportunity Zones will make it less likely that those Opportunity Zones that are most undercapitalized will receive the investments the program was intended to encourage. Finally, the size of the tax break reduces federal revenues that could have otherwise been used to serve these communities.

In considering these proposed rules, the IRS must focus on the interests of the residents and communities of Opportunity Zones not primarily the interests of investors by providing maximum flexibility to enjoy tax breaks without serving the intended goals of the program. The IRS should consider the proposed rules through the lens of ensuring that the highest possible proportion of

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[5] Weaver, Timothy. "The Problem With Opportunity Zones." *CityLab*. May 16, 2018.
[6] Fundrise. "Top 10 Opportunity Zones in the U.S." Available at https://fundrise.com/education/blog-posts/the-top-10-opportunity-zones-in-the-united-states. Accessed June 2019; Develop LLC. "Opportunity Zone Index." Available at www.developadvisors.com/opportunity-zones-index/. Accessed April 2019; Coes, Christopher A. and Tracy Hadden Loh. Locus-Smart Growth America. "National Opportunity Zones Ranking Report." December 2018 at 5.
[7] National Low Income Housing Coalition. "Out of Reach 2018." 2018 at 12 and 13.
[8] 84 Fed. Reg. 84 at 18670.

QOF and QOZB investment and economic activity flow into and provide economic benefit to Opportunity Zones.

Pro-rate all tax benefits solely to the investments and business activity within Opportunity Zones

The proposed (and prior proposed) rules establish many tests for QOFs and QOZBs to qualify as legitimate Opportunity Zone investments (90 percent asset test, 70 percent substantially all tangible property test, 90 percent substantially all holding period test, 70 percent substantially all usage test, and other qualitative and quantitative metrics). The IRS should pro-rate the tax benefits of the Opportunity Zone program to reflect the investments that actually flow into Opportunity Zones. For example, the proposed rules allow QOFs to count the entirety of property purchases that cross outside Opportunity Zone boundaries as qualified investments; the IRS should pro-rate the tax benefits to only cover the proportion of the property investment that is within the Opportunity Zone.

Reject consideration of aggregate substantial improvement test

The proposal considers allowing QOFs or QOZBs to satisfy the substantial improvement test based on improvements to a portfolio of "tangible property to be grouped by location in the same or contiguous QOZ" rather than on an asset-by-asset basis.[9] The substantial improvement test requires investors to spend as much improving properties as it cost to purchase them within 30 months of acquisition.[10]

The purported aim of the suggested aggregate substantial improvement test is to simplify assessment of substantial improvement and provide compliance flexibility for QOFs with many, diverse assets within one or several contiguous QOZs.[11] The Economic Innovation Group suggests that *all* tangible property of a QOZB should be allowed to be considered as one asset for the purposes of meeting the substantial improvement test.[12] EIG does not specify whether that should include properties in non-contiguous QOZs, which the Treasury Department did not propose and should not consider.

Allowing aggregated substantial improvement could easily allow considerable portions of tangible property to languish unimproved while QOFs focus their investments on a few or higher priced assets. It also would allow QOFs to focus their substantial improvements on the most economically vibrant and gentrifying Opportunity Zones while allowing purchased assets to remain unimproved in less economically fortuitous Opportunity Zones.

For example, a QOF could purchase ten multifamily apartment buildings priced at $10 million each (for a total of $100 million); allowing aggregated substantial improvement would allow a QOF to make $100 million in upgrades to 5 of the purchased buildings to make them luxury apartment buildings while letting 5 of the buildings remain unimproved, leaving the tenants in those buildings without any benefit from the Opportunity Zone investments and potentially exacerbating the

9 84 Fed. Reg. 84 at 18655.
10 §1.1400Z(2)(d)(1)(c)(4)(ii) and §1.1400Z(2)(d)(1)(c)(8).
11 84 Fed. Reg. 84 at 18655.
12 Economic Innovation Group. "IRS publishes second round of proposed OZ guidance." April 23, 2019.

problems caused by the reduction of safe and habitable affordable housing opportunities in gentrifying neighborhoods.

The asset-by-asset substantial improvement requirement helps to ensure that every tangible real property would receive substantial improvements within 3 years. The Treasury Department should not pursue provisions that would allow QOFs to leave assets unimproved while meeting an aggregate substantial improvement test.

Clarify and strengthen anti-abuse provisions (§1.1400Z(2)(f)(1)(c)):

The proposed anti-abuse provision is vague and unenforceable and could allow QOFs to fail to advance the purpose of the Opportunity Zone program to spur economic growth in disadvantaged communities while reaping substantial tax benefits. The IRS must strengthen the anti-abuse provisions and provide guidance that clarifies that investments will be disallowed if they exploit safe harbors or other loopholes in the existing, proposed or future regulations to capture tax benefits while providing no or minimal tangible economic benefit to residents and communities within Opportunity Zones.

The proposed anti-abuse language states that "if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of [the statute], the Commissioner can recast a transaction" for tax purposes.[13] The provision states that "whether a transaction is inconsistent" with the statute would be "based on all the facts and circumstances."[14]

This language is vague and almost impossible to enforce. The two-fold purpose of the statute is both to provide substantial tax incentives and to spur investment in distressed communities. Almost every investment will be aimed to capture a tax benefit that would "achieve a tax result" that is not inconsistent with the tax liability reducing purpose of the statute. The "facts and circumstances" assessment allows the IRS to consider any criteria to determine whether it believes the investment purpose satisfies the statutory purpose. This open-ended factfinding would be unlikely to determine that any investment failed to meet the statutory purpose, especially given that there are no reporting requirements to evaluate whether an investment is in fact benefitting residents and businesses in QOZs or displacing them.

The IRS should substantially strengthen and clarify the proposed anti-abuse provisions. First, the assessment should be on the investment result and not on the tax result. It is difficult to imagine a transaction that did not aim to reduce the QOFs tax liability, but it is easy to imagine an investment that aimed to skirt the goal of the statute to productively invest substantially all of its assets in distressed communities. The IRS should clarify that it would recast all transactions where the *investment* result was inconsistent with the purpose of encouraging "economic growth and investment in designated distressed communities,"[15] with an aim towards ensuring that the investments provide tangible economic benefits to the residents of communities of Opportunity Zones. Moreover, the IRS should remove the "significant purpose" language that requires the agency to demonstrate that the motivation ("purpose") of any given transaction was to achieve an inconsistent tax (or

[13] Proposed §1.1400Z(2)(f)(1)(c).
[14] Proposed §1.1400Z(2)(f)(1)(c).
[15] 84 Fed. Reg. 84 at 18652.

investment) result. Instead, the language should be focused on whether the investment outcome achieved the statutory purpose.

The proposed anti-abuse clause should read: "Accordingly, if a significant outcome of a transaction is to achieve an investment result that is inconsistent with the purpose of the statute to encourage economic growth and investment in designated distressed communities, the Commissioner can recast the transaction (or series of transactions) for Federal tax purposes."

Additionally, the IRS should add anti-abuse provisions that delineate that failing to meet or intending to circumvent the provisions aimed at directing investment into Opportunity Zones (such as the 90 percent asset test, the "substantially all" tests, an assessment of "reasonable working capital," etc.) would be inconsistent with the purpose of the statute. It should also clarify that investments that do not provide economic benefits to the residents of Opportunity Zones would be inconsistent with the purposes of the statute. Finally, the IRS should consider adding tax penalties for failing to meet investment tests other than the 90 percent asset test, which is the only specified provision that incurs a tax penalty.[16]

Strengthen "substantially all" definitions and pro-rate tax benefits to proportion of property and usage within Opportunity Zones

The Opportunity Zone program's various "substantially all" provisions should focus the vast majority of the QOF and QOZB investments and operations within QOZ neighborhoods. Business or trade entities must meet several "substantially all" tests to be considered QOZBs eligible for purchase or investment by QOFs. The previous tranche of regulations established that QOZBs must own or lease "substantially all" (defined as 70 percent) of its tangible property within Opportunity Zones.[17] The proposed rules define substantially all for a QOZB's usage (70 percent[18]) and for its holding period (90 percent[19]).

The 70 percent thresholds for tangible property and usage are too low. Less than three-quarters does not seem to be equivalent to "substantially all." The IRS should consider raising all of the substantially all tests to 90 percent to parallel the statutory directive that at least 90 percent of QOF assets must be invested within Opportunity Zones.[20] Indeed, the IRS recognizes that weakening these proposed test standards further could provide sizeable tax benefits for investment activity outside of Opportunity Zones. The regulatory analysis notes:

> Setting the [substantially all] threshold lower would allow investors in certain QOF's to receive capital gains tax relief while placing a relatively small portion of its investment within a QOZ. A lower threshold would increase the likelihood that a taxpayer may receive the benefit of the preferential treatment on capital gains without placing in service more tangible property within a qualified opportunity zone.[21]

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[16] Proposed §1.1400Z-2(f)(a).
[17] §1.1400Z-2(d)(2)(d)(3). 83 Fed. Reg. 209. October 29, 2018 at 54294.
[18] Proposed §1.1400Z-2(d)(1)(c)(6) and proposed §1.1400Z-2(d)(2)(iv). 84 Fed. Reg. 84 at 18688 and 18689.
[19] Proposed §1.1400Z-2(d)(1)(c)(5) and proposed §1.1400Z-2(d)(2)(iii). 84 Fed. Reg. 84 at 18688 and 18689.
[20] Pub. L. 115-97 §1400Z-2(d)(1). December 22, 2017.
[21] 84 Fed. Reg. 84 at 18670.

The IRS also notes that cumulative effect of the proposed asset and substantially all tests allow QOFs and QOZBs to satisfy the requirements with only 40 percent of assets in use inside of Opportunity Zones.[22] These tests work in conjunction, so 90 percent of the QOF assets must be directed to QOZ, where 70 percent is invested in tangible property that is in use 70 percent of the time and held for 90 percent of the time (0.9 assets x 0.7 property x 0.7 usage x 0.9 percent holding = 0.4, or 40 percent). The IRS concludes that the result is "a QOF could satisfy the requirements […] with just 40 percent of its assets effectively in use within a qualified opportunity zone."

Qualified Opportunity Funds should not be able to satisfy the "substantially all" tests with only 40 percent of assets actively invested in Opportunity Zones. Even if all the "substantially all" tests were raised to 90 percent, a fund could satisfy the cumulative tests with 66 percent of assets actively in use within QOZs. This still seems short of "substantially all" but matches the statutory language on the asset test and would provide considerably more investment than the proposed rule.

In conjunction with raising the substantially all tests, the IRS should consider pro-rating the 10-year capital gains tax benefit to the portion of the assets that are actually directed within Opportunity Zones. The QOFs should either receive a default pro-rated tax benefit on regulatory test limits (the cumulative 40 percent under the proposed rule or 66 percent if all the tests were raised to 90 percent) or provide documentation demonstrating that a higher proportion of assets, tangible property, usage, and holding period went into QOZs. The purpose of the Opportunity Zone program is to encourage economic growth specifically in the designated QOZs, and therefore the capital gains tax exemption should only be applied to the proportion of investment that actually flowed into Opportunity Zones.

Close "substantial improvement" loopholes related to unimproved land, vacant buildings, and special rule on improving structures that skirt the Opportunity Zone purpose

The proposed regulations provide substantial flexibility for QOFs to purchase unimproved land and vacant buildings without upgrading or improving these assets. Similarly, the proposed regulations allow QOFs to meet the substantial improvement requirements to tangible property only on buildings (discounting the cost of the land), which could allow QOFs to speculate on land with modest structural assets. These proposed provisions allow QOFs and QOZBs to purchase assets in Opportunity Zones while making limited or no improvements to the property. This creates incentives for investors to stockpile and hold properties as speculative land assets that could have been used for affordable housing or small business development. These loopholes significantly undermine the purpose of the Opportunity Zone program to incentivize investments to "encourage economic growth" in distressed communities.

Eliminate the unimproved land loophole (§1.1400Z-2(d)(1)(c)(8)(ii)(B)): The proposed regulations provide substantial flexibility for QOFs to purchase unimproved land without making substantial improvements.[23] The unimproved land is required to be used in a trade or business, but the IRS notes that "land is a crucial business asset for numerous types of operating trades or

[22] *Ibid.*
[23] Proposed §1.1400Z-2(d)(1)(c)(8)(ii)(B) and proposed §1.1400Z-2(d)(4)(iii)(B). 84 Fed. Reg. 84 at 18688 and 18690.

businesses."[24] It further suggests that requiring that unimproved land be substantially improved could incentivize non-economic uses or business decisions.[25]

The proposed rule encourages speculation in unimproved land. The proposed rule allow investments in unimproved land without making substantial improvements as long as the land was used in a trade or business. A QOF could operate unimproved land as a parking lot, install shipping containers to run a self-storage business, or lease it to a related construction business that could stage equipment or supplies. An article in the *National Law Review* suggested that QOF buyers could require sellers to demolish existing structures in order to purchase unimproved land in order to take advantage of the absence of improvement requirements.[26]

The IRS recognizes that the proposed regulatory treatment of unimproved land "could lead to tax results that are inconsistent with the purposes" of the program and asks if special "anti-abuse rules" are needed to prevent these transactions that amounted to land banking.[27] The IRS should close this loophole and require investors to make the same substantial improvements to unimproved land that they would to other properties so that the land can be used productively to spur economic growth.

Absent eliminating the loophole entirely, the IRS should substantially strengthen the anti-abuse provisions for unimproved land. The proposed anti-abuse provisions are vague and unenforceable. There is no definition or description of "land banking," for example, so it is impossible to know what kinds of land investments might constitute land banking that would draw heightened IRS scrutiny.[28] And the proposed rules state that investors might lose tax benefits "If the land is unimproved or minimally improved and the QOF or the QOZB purchases the land with the expectation, an intention or a view not to improve the land by more than an insubstantial amount within 30 months."[29]

These provisions must be strengthened. First, the IRS should establish a threshold for "more than insubstantial amount" (such as 33 percent of basis, or increasing the value by one-third, far lower than the 100 percent basis requirement for "substantial improvement"). Secondly, the test should be based upon improvement outcome and not expectation or intent of the QOF or QOZB, which would require the IRS to prove not only that the investors did not improve the land but also *intended* to leave the land unimproved or minimally improved. Finally, additional anti-abuse measures must be established to prevent QOFs or QOZBs from selling the unimproved parcel within the 30-month window unless more than insubstantial improvements have been made.

Eliminate the vacant structure loophole (§1.1400Z-2(d)(1)(c)(7)(i)): The proposed rule allows QOFs or QOZBs to purchase buildings or structures that have been vacant for five years without requiring that the building be substantially improved. The proposed rule treats the purchases of these vacant structures as "original use,"[30] meaning that the investors need not make substantial

[24] 84 Fed. Reg. 84 at 18654 to 18655.
[25] *Ibid.*
[26] Miller, David S. "The second set of proposed Opportunity Zone regulations." *National Law Review*. April 30, 2019.
[27] 84 Fed. Reg. 84 at 18655.
[28] To avoid confusion with the over 170 non-profit, community-oriented land banks operating around the country to return vacant land and vacant structures to productive use, we recommend that Treasury replace the phrase "land banking" with a more descriptive term such as "warehousing" or "stockpiling," that is then defined in the regulation.
[29] Proposed §1.1400Z-2(f). 84 Fed. Reg. 84 at 18691.
[30] Proposed §1.1400Z-2(d)(1)(c)(7)(i). 84 Fed. Reg. 84 at 18688.

improvements.[31] The *National Law Review* called the vacant building provision "generous."[32] The IRS should not exempt vacant buildings from the substantial improvement requirements.

The proposed provision creates a perverse incentive for QOFs to purchase vacant buildings to capture the tax benefits of the program without any commensurate requirement that they provide additional economic activity or benefit within the Opportunity Zone. It allows a building to remain essentially vacant and unimproved but merely switch ownership to a QOF. Vacant buildings can drag down property values and contribute to blight or crime, but they are also potential community assets that could be put into service for residential housing, small businesses or community redevelopment.[33] The proposed rule could freeze the stock of vacant properties in Opportunity Zones if investors rushed in to capitalize on this loophole.

This provision is subject to a similar type of abuse as the unimproved land provision: QOF investors could purchase vacant properties, make no or minimal improvements, and hold the properties as a speculative real estate investment, providing no economic benefit to the residents or communities of the Opportunity Zone. It could even encourage strategic vacancies where property owners might displace residents or businesses to make the property more attractive to QOF investors. Or it could encourage persistent vacancies, if QOFs pressure owners to leave buildings vacant in order to receive the benefit of not having to substantially improve formerly vacant buildings. In many of the QOZs, continually increasing rents and limited affordable housing options are threatening to displace residents and businesses, and the unimproved land and vacant structure loopholes would prevent communities from leveraging the many potential benefits of unused land in their communities.

The IRS should eliminate the vacant building loophole that treats all buildings vacant for 5 years or more as "original use," thus exempting these investments from the substantial improvement requirement. If the IRS determines to differentiate between vacant buildings based on the length of vacancy, it should require the vacancy determination to run backwards from the date the census tract was qualified as QOZ. This will ensure that only buildings that were vacant before the designation qualify, thereby eliminating the incentive for a property owner to strategically cease occupancy of the building. Finally, the IRS should develop strong, clear, and enforceable anti-abuse rules to prevent QOFs from speculative investment in vacant buildings.

Narrow the special rules for substantial improvements on buildings versus improvements on land (§1.1400Z-2(d)(4)(ii)(A): The proposed rules provide a considerable reduction in the requirement that purchases be substantially improved for land with buildings. The proposed rule would exempt the cost of the land from the substantial improvement requirement, allowing the QOF to make substantial improvements to the building based on the cost basis of the structure not the entire value of the purchased property.[34]

This provision is far too broad. It would allow or even encourage QOFs or QOZBs to purchase expensive parcels of land that included modest buildings; the investor could make improvements to

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31 §1.1400Z(2)(d)(1)(c)(4)(ii) and §1.1400Z(2)(d)(1)(c)(8).
32 Miller, David S. "The second set of proposed Opportunity Zone regulations." *National Law Review*. April 30, 2019.
33 *See* Mallach, Alan. Lincoln Land Institute and Center for Community Progress. "The Empty House Next Door." 2018.
34 Proposed §1.1400Z-2(d)(4)(ii)(A). 84 Fed. Reg. 84 at 18690.

the modest building – for example doubling the footprint of a garage or storage facility – and satisfy the substantial improvement requirements.[35] It also could have the unintended effect of discouraging investments in areas with lower land prices, since in higher land-value areas the adjusted basis for the substantial improvement of the buildings would be more attractive. This could further incentivize the concentration QOF investments into higher-cost areas which would likely raise housing and other costs and lead to more displacement of lower-income residents of color.

The IRS should consider adding anti-abuse provisions to prevent QOFs from exploiting the land-structure substantial improvement basis distinction to speculate on higher-priced land assets with lower-value structures. Alternately, the IRS should consider significantly narrowing its applicability so that it could only be used in lower-land value markets or properties and/or on properties where the structure constituted a substantial portion of the value of the property.

Eliminate or pro-rate rules allowing including all real estate straddling opportunity zone boundaries (§1.1400Z-2(d)(5)(viii))

The proposed rules allow QOFs and QOZBs to consider the entirety of property that includes square footage outside Opportunity Zones for purposes of meeting the substantially all tests and the gross income tests. The proposed rule states that if the square footage within the QOZ is "substantial as compared" to the square footage outside the QOZ and contiguous to the property in the QOZ, "then, all the property is deemed to be located within a QOZ."[36] The discussion of the proposed rule suggests that the substantial comparison means that the property contains more square footage inside than outside the Opportunity Zone or potentially if the value of the property inside the Opportunity Zone exceeds the property value outside the Opportunity Zone.[37]

This proposed rule essentially allows up to half of property investments to be outside QOZs. The IRS should revisit this proposed rule and tighten its applicability to ensure that QOF investments do not flow outside of Opportunity Zones. First, the IRS should dramatically increase the percentage test so that 75 percent (or higher) of the square footage of the property falls within Opportunity Zones. Second, the IRS should pro-rate the capital gains tax benefits based on the percentage of the square footage within the Opportunity Zone; investors should not receive a capital gains tax exemption for holding land or property for a decade outside of Opportunity Zones.

Tighten or eliminate safe harbors for gross income requirement (§1.1400Z-2(d)(5)(i))

The proposed rules clarify the requirements that QOZBs must derive 50 percent of their gross income "from the active conduct of such business" within Opportunity Zones.[38] The proposal provides clarity that QOZBs need not generate half of their sales within QOZs, but that half of their gross earnings must originate from within Opportunity Zones. These provisions are intended to ensure that the QOZBs actually operate and generate economic activity within the Opportunity Zones.

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[35] Starczewski, Lisa M. "The second set of proposed Opportunity Zone regulations: Where are we now?" *Tax Management Memorandum*. Vo. 60, No. 9. April 22, 2019 at 3.
[36] Proposed §1.1400Z-2(d)(2)(5)(viii).
[37] 84 Fed. Reg. 84 at 18658.
[38] Proposed §1.1400Z-2(d)(5)(i). 84 Fed. Reg. 84 at 18690; 26 USC 1397C(b)(2).

But the gross income test allows up to half of the income of the QOF or QOZB to be generated *outside* the Opportunity Zones. If the intention of the Opportunity Zone program is to generate additional activity *within* Opportunity Zone distressed communities, allowing up to half of the gross income to be generated outside these areas allows considerable leakage of economic activity outside the areas the Treasury Department has designated for economic revitalization.

The IRS should raise the gross income test to 75 percent. The 50 percent gross income test is based upon the requirements for the Empowerment Zone programs, but this test may be too generous and inappropriate for Opportunity Zones. There were far fewer federal Empowerment Zones; there were only 100 urban EZs each with a population no larger than 4,000 people (or under half a million people across the whole country).[39] In contrast, there are an estimated 35 million residents living in over 8,700 census tracts that are qualified Opportunity Zones.[40] It is simply easier and more practical to have a higher portion of gross income coming from Opportunity Zones than from Empowerment Zones.

The overly generous 50 percent gross income test is further compromised by three safe harbor rules that make it even easier to satisfy the gross income test (two labor input tests and a property-operations test). A QOZB need only satisfy any one of the three tests or a separate "facts and circumstances" assessment to meet the income test. Most businesses or trades will be able to meet one of these tests. Indeed, KMPG called these provisions "very helpful safe harbors."[41] A Buchanan, Ingersoll & Rooney attorney stated these safe harbors were "broad, flexible income sourcing rules" that would cover most businesses or industries.[42]

Strengthen safe harbors on labor inputs based on hours or compensation (§1.1400Z-2(d)(5)(i)(A) and §1.1400Z-2(d)(5)(i)(B)): The labor tests allow a QOZB to meet the 50 percent income if at least half of their labor inputs (employees, contractors, and service providers) occurred within the Opportunity Zone based on hours or based on compensation.[43] While the safe harbor based on hours would ensure that the majority of workers would be within the Opportunity Zone, the safe harbor based on compensation does not require the majority of workers or work occur in Opportunity Zones. It would only require the most highly compensated employees work in the Opportunity Zones. Importantly, there is no requirement or guidance that directs or encourages QOBZs to recruit, hire, and train residents of Opportunity Zones to become QOBZ employees.

The safe harbor based on 50 percent of compensation would allow a few highly paid QOF or QOZB employers to work in the Opportunity Zone while many, low-paid workers toiled outside the Opportunity Zone, even outside the United States. For example, a single executive working at QOZB (leased or owned) office in an Opportunity Zone that imported and marketed apparel could

[39] 42 USC §11501(a)(2)(A) and §11501(c)(2)(C).
[40] U.S. Department of the Treasury. [Press release]. "Treasury, IRS announce final round of Opportunity Zone designations." June 14, 2018
[41] KPMG. "A New Path Forward: Summary and Observations on the Proposed Opportunity Zone Regulations Published in the Federal Register on May 1, 2019." 2019 at 11.
[42] Starczewski, Lisa M. "The second set of proposed Opportunity Zone regulations: Where are we now?" *Tax Management Memorandum*. Vo. 60, No. 9. April 22, 2019 at 15.
[43] Proposed §1.1400Z-2(d)(5)(i)(A) and §1.1400Z-2(d)(5)(i)(B).

be paid more than hundreds of garment workers in the developing world,[44] satisfying the compensation labor input test even though virtually no jobs were created in the Opportunity Zones or even the United States. The IRS should raise the compensation percentage considerably (perhaps to 75 percent) to ensure that it does not allow a small number of highly-paid employees to satisfy this labor input test. In addition, the IRS should consider not allowing a QOZB to satisfy the 50 percent gross income test by the labor compensation input alone.

Clarify safe harbor property-operations test (§1.1400Z-2(d)(5)(i)(C)): The third safe harbor test requires QOBZs to both hold tangible property and perform operations or management within the Opportunity Zone necessary to generate 50 percent of the gross income.[45] KPMG suggests that this test would allow a company to maintain management functions within an Opportunity Zone while the rest of the employees would be outside QOZs and still satisfy the 50 percent gross income test.[46]

This proposed safe harbor is vague, qualitative and difficult to enforce to ensure that the management or operations performed solely within the zone are necessary to generate half the gross income. The IRS explanatory examples suggest that both managing and storing equipment within a QOZ for a landscaping business that primarily performed services outside the QOZ would meet this test but merely having a post office box within the QOZ would not.[47] These two examples are not especially illuminating because it explains what the extremes might be but does not provide any guidance or explanation of more nuanced examples that are likely to be more common. It may be easy for the IRS to determine that merely holding a post office box does not satisfy the test and that a landscaping operation (equipment warehouse) and management facility does satisfy the test. The IRS should establish clear standards for the property-operations safe harbor test that identifies examples that would not meet either of the labor input tests but would satisfy or fail to meet the property-operations test.

Eliminate or substantially clarify "facts and circumstances" test (§1.1400Z-2(d)(5)(i)(D)): QOBZ that do not meet any of the three safe harbor tests could satisfy the gross income requirement by meeting a "facts and circumstances" test. The proposed rule states that a QOZB could satisfy the test "Based on all the facts and circumstances, at least 50 percent of the gross income of a trade or business is derived from the active conduct of a trade or business in the QOZ."[48] The vague facts and circumstances test requires the IRS to assess unknown metrics to determine whether the entity meets the 50 percent gross income test. The listed example that satisfies the facts and circumstances test generates half its income in the QOZ and would not need to rely on the proposed safe harbor provisions to satisfy the gross income test.[49]

The IRS should raise the gross income test from 50 percent to 75 percent and eliminate or substantially tighten the proposed safe harbors. The IRS should raise the labor input compensation safe harbor from 50 percent to 75 percent, consider requiring that QOZBs meet two of the three

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[44] An executive that was paid $1 million would make more than 500 garment workers in Bangladesh, according to International Labor Organization figures. Huynh, Phu. International Labor Organization. "Asia-Pacific Garment and Footwear Sector Research Note." Iss. 8. October 2017 at 3.
[45] Proposed §1.1400Z-2(d)(5)(i)(C).
[46] KPMG. "A New Path Forward: Summary and Observations on the Proposed Opportunity Zone Regulations Published in the Federal Register on May 1, 2019." 2019 at 12.
[47] 84 Fed. Reg. 84 at 18659 and 18690.
[48] Proposed §1.1400Z-2(d)(5)(i)(D).
[49] Proposed §1.1400Z-2(d)(5)(i)(E)(3).

safe harbors rather than any one of them, and clarify what would be considered in a facts and circumstances review. Finally, the IRS should establish special anti-abuse rules to ensure that the majority of QOZB operations and income are based or occur in Opportunity Zones.

Safe harbor provisions for reasonable amount of working capital too generous (§1.1400Z-2(d)(5)(iv))

The proposed working capital safe harbor provisions may allow QOFs to skirt the 90 percent asset test. Qualified Opportunity Funds are required to invest 90 percent of their funds into tangible property, businesses or assets within Opportunity Zones, meaning less than 10 percent of the QOF holdings can be in cash, cash equivalents or other financial instruments.[50] Qualified Opportunity Zone Businesses cannot hold more than 5 percent of their assets in non-qualified financial property except for "reasonable amounts of working capital."[51]

The proposed rule clarifies that working capital can be used to expand a business not only to develop real estate,[52] but the safe harbors effectively allow QOZBs to maintain potentially large holdings of working capital indefinitely, providing a means for QOFs to evade the 90 percent asset test. QOZBs are required to have a written, scheduled plan to spend working capital, and spend their working capital within 31 months consistent with the plan.[53] But the proposed safe harbors allow almost indefinite extensions that essentially obviate that time limitation.

The proposed safe harbor provisions effectively extend the 31-month limit if the delay was due to government inaction related to permitting or certifications.[54] Additionally, the proposed rules allow a QOZB to "benefit from multiple overlapping or sequential applications of the working capital safe harbor."[55] One example in the regulations provides an additional loophole for adding working capital or extending the timeframe in which it must be spent by re-capitalizations of existing QOZBs, for example purchasing additional equity stakes and developing new working capital plans.[56]

These proposed provisions effectively allow a QOF to shift non-qualified financial assets into a QOZB repeatedly and restart the working capital timeframe. A QOF could recapitalize an existing QOZB repeatedly and each time restart the 31-month clock.[57] Or a QOZB could slowly apply for government construction or business permits to be permanently covered by the government delay safe harbor.

The IRS should tighten these provisions to ensure that these safe harbors do not become a loophole that allow QOFs to evade the 90 percent asset test and ensure that the funds are actually productively invested within the Opportunity Zones to fulfill the purpose of the statute. The working capital safe harbor provisions make it easier for QOFs to shift working capital cash or cash

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50 Pub. L. 115-97 §1400Z-2(d)(1). December 22, 2017.
51 §1.1400Z-2(d)(4)(iii) and 26 USC §1397C(b)(8) and (e).
52 Proposed §1.1400Z-2(d)(5)(iv)(A).
53 §1.1400Z-2(d)(4)(iv)(A-C).
54 Proposed §1.1400Z-2(d)(5)(iv)(C); §1.1400Z-2(d)(5)(iv)(B). 83 Fed. Reg. 209. October 29, 2018 at 54295.
55 Proposed §1.1400Z-2(d)(5)(iv)(D).
56 Proposed §1.1400Z-2(d)(5)(iv)(E)(2).
57 Starczewski, Lisa M. "The second set of proposed Opportunity Zone regulations: Where are we now?" *Tax Management Memorandum*. Vo. 60, No. 9. April 22, 2019 at 17 to 18.

equivalents into wholly-owned QOZB subsidiaries to essentially avoid meeting the 90 percent asset test.

Add limitations and anti-abuse provisions to proposed safe harbor for inventory in transit (§1.1400Z-2(d)(1)(c)(4)(iii))

The proposed rule allows QOFs and QOZBs to consider inventory in transit as Opportunity Zone property to satisfy the 90 percent asset test and the substantially all tests for property and holding period (90 percent) or use (70 percent). The proposed rules allow the consideration of "inventory (including raw materials) of trade or business does not fail to be used in QOZ solely because the inventory is in transit."[58] KPMG suggests that inventory could "be a good asset" to meet the 90 percent asset test or 70 percent substantially all property tests.[59] It is possible to imagine a QOZB that held considerable assets in warehouses or in shipping containers in transit outside Opportunity Zones that would provide no or limited economic benefit to Opportunity Zone residents or communities but would nonetheless satisfy the tests that substantially all of the business occurred within the Opportunity Zone.

The IRS should clarify how higher inventory values would be considered. The proposed rule's use of the word "solely" implies that, under some conditions, inventory would not count towards satisfying the substantially all tests. The Treasury Department should establish a limited percentage of inventory (capped at 15 or 20 percent of assets) that could be counted towards satisfying the substantially all tests and create special inventory anti-abuse rules to ensure that QOZBs or QOFs do not exploit the inventory safe harbor to evade the 90 percent asset test or substantially all tests.

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Strong IRS rules governing Qualified Opportunity Fund investments are essential to ensuring that the program's tax benefits are limited to the investments that actually flow into the Qualified Opportunity Zones and benefit local residents and communities. These comments identify some, but not all of the areas in the proposed rules that must be strengthened so that the program meets its purpose to direct investments and economic activity to the residents and communities in Opportunity Zones. The IRS should significantly strengthen the proposed rules in order to constrain the ability of investors to reap the exceedingly generous tax benefits of the program without substantially investing in distressed communities.

Americans for Financial Reform Education Fund
Americans for Tax Fairness
Bargaining for the Common Good
Main Street Alliance
National Coalition for the Homeless
National Consumer Law Center (on behalf of its low-income clients)
National Fair Housing Alliance
New Jersey Citizen Action
Prosperity Now
Woodstock Institute

[58] Proposed §1.1400Z-2(d)(1)(C)(4)(iii). 84 Fed. Reg. 84 at 18688.
[59] KPMG. "A New Path Forward: Summary and Observations on the Proposed Opportunity Zone Regulations Published in the Federal Register on May 1, 2019." 2019 at 13.