

Internal Revenue Service
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December 19, 2018

RE: IRS REG-115420-18, Opportunity Zones

We are writing to offer additional comments concerning the proposed regulations that provide guidance under new section 1400Z-2 of the Internal Revenue Code (Code) relating to the implementation of Opportunity Zones (Section 13823) enacted in the Tax Cuts and Jobs Act of 2017.

While the Opportunity Zones (OZ) incentive has potential to attract more investment capital and development talent to revitalize low- and moderate-income census tracts, its current inadequate regulatory structure risks significant unintended consequences that could result in displacement of the very people who should be helped by improvements in their community and creation of jobs close to where they currently live. We are writing to encourage you to adopt comprehensive reporting requirements, so the impact of the OZ incentive may be accurately assessed, and to develop clear definitions of abuse, as allowed in the statute, to avoid the potential for fraud and displacement that would ultimately increase the cost of the initiative and turn the initiative in to a costly tax shelter.

The OZ incentive allows taxpayers to rollover unrealized capital gains into new equity investments in designated communities. Qualifying equity investments are broadly defined and can include real estate (residential or commercial) or operating businesses. If the taxpayer holds the qualifying investment for ten years, then they can mark-up the investment's tax basis to its new fair market value when sold or exchanged, effectively eliminating any capital gains tax obligation. As a result, the OZ incentive creates its greatest tax benefits for investments with the greatest capital appreciation; more capital appreciation results in more implicit tax benefit.

The OZ incentive's theory of change presumes that ten-year equity investments in low-income communities will yield positive economic outcomes for those communities. Significantly, the OZ incentive does not involve a competitive application process or any targeting to directly benefit low-income people. By comparison, the Low-Income Housing Tax Credit (LIHTC) and the New Markets Tax Credit (NMTC) typically pass through intermediary organizations with a track record of successful and responsive community development. The LIHTC and NMTC entail reporting and governmental oversight to confirm compliance with their income-targeting provisions, which are an important safeguard to ensure that the taxpayer's investment is well spent.

We are concerned about what types of housing will be built with the OZ incentive. Qualified Opportunity Zones are defined based on high poverty rates or low incomes of its residents. According to US Census data, more than half of OZ renters are currently "housing cost-burdened," meaning that they pay over 30 percent of their income towards rent. Among low-income households, the portion of currently housing cost-burdened residents is closer to 80 percent. Will investors use the OZ incentive to build affordable housing for mixed-income communities? Or will the forgiveness of capital gains – with no cap on the increase in the tax basis of the investment – motivate investors to build rental housing with price points that displace current residents? It would be tragic if taxpayers made OZ investments only in higher-priced rental housing, contributing to the elimination of affordable housing that initially qualified the community for OZ designation. This potential unintended consequence could result in displacement and concentrations of poverty contrary to the spirit of the law.

With this context for our comments, we focus on two key areas: 1) defining and preventing abuse and 2) reporting requirements to track the outcomes of the OZ incentive.

I. Rules to prevent abuse

Discussion

The Opportunity Zone legislation directs the Secretary to “prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including ... (C) rules to prevent abuse.”¹ Until Treasury clarifies the definition of “abuse” and how this authority will be exercised, taxpayers will be cautious in seeking and developing OZ investments. The legislation does not indicate what types of abuse the Secretary should give special attention to, other than what is “necessary or appropriate to carry out the purposes of this section.”²

Anti-abuse provisions in the Code vary significantly, each crafted for a particular subsection in the Code. The American Bar Association’s peer-reviewed tax journal cites a general definition of anti-abuse provisions as rules “designed to prevent a taxpayer from achieving a result which is inconsistent with a dominant policy of the law by altering the tax consequences which would otherwise have flowed from a transaction to others more consistent with that policy.”³ While many anti-abuse rules focus on tax avoidance as a necessary element,⁴ that does not fully capture the policy violation that should be the focus of anti-abuse rules of OZ incentives. It would be a tragic outcome if OZ investments contributed to the elimination of the affordable housing that initially qualified the community for OZ designation.

We are concerned that OZs could unintentionally harm residents without adequate parameters to guard against displacement or prevent predatory capital from becoming an eligible investment. NHC believes that any investments targeted specifically at distressed communities with the purpose of deferring an investor’s capital gains taxes must demonstrate a community benefit and demonstrate that it does not displace residents or eliminate affordable housing without a plan for replacement to be eligible for the tax incentive. Changes in the mix of sizes and types of housing or reduction of units should not be considered abuse if supported by market studies and high vacancy in the housing size/units that are changed or eliminated, provided no residents are displaced.

¹ Section 1400Z-2(e)4(C).

² Section 1400Z-2(f) addresses the consequences of a failure of the Qualified Opportunity Fund (QOF) to maintain the ‘90 percent’ investment standard.

³ Frank V. Battle, Jr. *The Appropriateness of Anti-Abuse Rules in the U.S. Income Tax System* 48 TAX LAWYER 801 (1995).

⁴ Another commenter summarized the Code’s anti-abuse provisions as follows:

Many (but by no means all) anti-abuse rules focus on the purpose, motive or intent of the taxpayer in determining whether the anti-abuse rule should apply. Some anti-abuse rules are triggered by a transaction that has as its principal purpose the avoidance of the principles of the applicable provision; some others merely require “a” principal purpose. Some anti-abuse rules explicitly require a finding of tax avoidance as a principal purpose. Some rules equate a principal purpose of circumventing the underlying purpose of the applicable provision as constituting tax avoidance. *Some require no purpose at all – just a result “inconsistent with the purpose” of the rule at hand.* [emphasis added]

Requested Regulation

Taxpayers and QOFs need clarity on the definition of prohibited abuse.

We suggest that the Secretary issue regulations, as directed by the statute, to define abuse as any investment that does not provide a direct and sustained community benefit to the residents living in the census tract. We recommend that in Opportunity Zones, “abuse” be defined as:

“a partnership, entity, plan, or arrangement that is inconsistent with the purposes of the OZ statute, which seeks to create opportunity in communities where:

(A) the poverty rate for such tract is at least 20 percent, or

(B) (i) in the case of a tract not located within a metropolitan area, the median family income for such tract does not exceed 80 percent of statewide median family income, or

(ii) in the case of a tract located within a metropolitan area, the median family income for such tract does not exceed 80 percent of the greater of statewide median family income or the metropolitan area median family income (AMI).

Subparagraph (B) shall be applied using possession-wide median family income in the case of census tracts located within a possession of the United States.

Penalty for “abuse” - Should a residential development fail to meet these criteria, capital gains must be paid on the percent of the investment not affordable to families below 80 percent of AMI. If the average cost of a unit is not affordable to families under 125 percent of AMI, then the entire development should be excluded from OZ treatment.

Tresury should also eliminate any benefit if the new development displaces residents of housing affordable to households at or below 80 percent of AMI or eliminates any affordable housing and does not replace it with housing affordable at the same or lower income levels in the same or adjacent areas. Benefits should not be eliminated where a market study and high vacancy rates at the property evidence low demand for the eliminated units.

II. Annual Reporting on Investments and Outcomes

Discussion

The Tax Cuts and Jobs Act statute does not describe any reporting requirements, but the Conference Report was explicit about Congressional expectations related to annual reporting requirements:

The Secretary or the Secretary’s delegate is *required* to report annually to Congress on the opportunity zone incentives beginning 5 years after the date of enactment. The report *is* to include an assessment of investments held by [the] qualified opportunity fund[s] nationally and at the State level. To the extent the information is available, the report *is* to include the number of qualified opportunity funds, the amount of assets held in qualified opportunity funds, the composition of qualified opportunity fund investments by asset class, and the percentage of qualified opportunity zone census tracts designated under the provision that have received qualified opportunity fund investments. The report *is* also to include an assessment of the impacts and outcomes of the investments in those areas on economic

indicators including job creation, poverty reduction and new business starts, and other metrics as determined by the Secretary.⁵ [*emphasis added*]

Treasury has direct experience collecting and analyzing the type of data necessary for this task: the primary example is the CDFI Fund's operation of the NMTC program in cooperation with the IRS. Every year, the CDFI Fund receives data on the economic outcomes of projects that were funded with qualified NMTC equity investments.⁶ In any given year, the CDFI Fund receives reports on outstanding portfolios of over \$20 billion in NMTC qualified low-income community investments. The Community Investment Impact System (CIIS) is the web-based data collection system that NMTC "allocates" use to submit their Institution Level Reports (ILRs) and Transaction Level Reports (TLRs) to the CDFI Fund. The ILR provides summary organizational, financial, lending and impact data about the institution submitting the report. The TLR provides detailed information on the loans and investments made by the institution in low-income communities.

Treasury also successfully collected data on small business loans and investments enrolled in the State Small Business Credit Initiative (SSBCI) from 2011-17. Treasury's SSBCI program received and analyzed data on more than 21,000 loans and investments exceeding \$10 billion. The annual data collection included census tract location, financing amount, other simultaneous financing, NAICS code, year of incorporation, sales and number of full time equivalent (FTE) jobs.

Treasury has consistently demonstrated the capacity to design a data collection system for a reasonable number of variables in QOFs and QOZ Property with a light touch that will not discourage use of the incentive.

Recommended Annual Reporting Requirements

NHC recommends that the Treasury Department issue a Request for Information (RFI) on the collection of data from Opportunity Funds that are registered with the IRS so that it may prepare a detailed report to Congress as required by the Conference Report. This will allow early adopters of QOFs to be aware of potential reporting requirements and to offer comments on any issues involving collection and reporting. We believe these data points will already be collected as part of any QOF's standard business procedures and that annual reporting to Treasury outside of the procedures for filing tax returns will not be an undue burden. Among the data points for consideration, we recommend:

1. The number of assets held in qualified opportunity funds
2. The composition of qualified opportunity fund investments by asset class of QOZ Property (QOZ stock, QOZ partnership interest, or QOZ business property)
3. The percentage of qualified opportunity zone census tracts designated under the provision that have received qualified opportunity fund investments
4. Date of investment
5. Census tract of QOZ Business Property (for all investments)
6. The dollar amount of the investment in QOZ property
7. The number of rental housing units at the time of acquisition
8. The number of rental housing units in each QOZ property that are affordable to a household earning less than 80 percent of AMI or less than 125 percent of AMI in contiguous tracts before the QOF investment

⁵ Conference Report to Accompany H.R. 1 - Tax Cuts and Jobs Act, p. 539, December 15, 2017.

⁶ The CDFI Fund has allocated \$3.5 billion in NMTC each year since 2010. Allocates report on the outcomes of the qualified low-income community investments for seven years after deployment.

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9. The number of rental housing units in each QOZ property that are affordable to a household earning less than 80 percent of AMI or less than 125 percent of AMI in contiguous tracts 12 months after the QOF investment
10. The number of rental housing units existing in the QOZ Business Property before the QOF investment, after "substantial improvement" is complete
11. The number of housing units in each QOZ property that were sold
12. The number of units sold in each QOZ property that were sold at affordable prices
13. The number of residents displaced by the creation of business in the QOZ
14. The number and location of any replacement units created
15. The number of FTE jobs created within 24 months as the result of the investment.

We are hopeful that, with the right guardrails, the Opportunity Zones program can successfully direct capital to low-income communities in need of revitalization. Thank you for taking our comments into consideration and we welcome the opportunity to comment on future action surrounding Opportunity Zones. Please contact David Dworkin at davidmdworkin@nhc.org or 202-442-2121 x234 with any questions.

Sincerely,

California Housing Partnership
Consumer Federation of America
Grounded Solutions Network
National Affordable Housing Trust
National Housing Trust
National Low Income Housing Coalition
National NeighborWorks® Association
Opportunity Finance Network
Prosperity Now
Stewards of Affordable Housing for the Future