CATALYTICA
CAPITAL

December 17, 2018

Ms. Erika C. Reigle
Mr. Kyle C. Griffin
Associate Chief Counsel
Income Tax & Accounting
CC:PA:LPD:PR (REG-115420-18), Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklin Station, Washington, DC 20044

RE: <u>REG-115420-18</u>

Dear Ms. Reigle and Mr. Griffin:

We appreciate the opportunity to provide our written comments to the above-referenced proposed regulations pertaining to the Opportunity Zone provisions of the Internal Revenue Code (specifically I.R.C. Sections 1400Z-1 & 1400Z-2). On behalf of Catalytica Capital, LLC, a Qualified Opportunity Fund sponsor and managing entity, we are submitting the following comments and recommendations for your consideration.

On October 19, 2018, the Internal Revenue Service ("IRS") unveiled its long-awaited guidance on the Opportunity Zone program. The proposed regulations provide helpful guidance on a range of topics and questions that have been discussed since the passage of the Tax Cuts and Jobs Act, but there are still several outstanding questions and areas of ambiguity requiring further guidance and examples. The items below represent the most pressing issues we have identified in the proposed regulations with accompanying recommendations as to how the IRS can approach addressing these questions and issues in subsequent guidance.

<u>Original Use and Substantial Improvement</u>

The proposed regulations and Revenue Ruling 2018-29 provide specific guidance pertaining to the substantial improvement requirement for real property with a structure. However, the regulations do not directly address how the original use test should apply to vacant land and the IRS has invited comments and feedback on this very issue. We recommend that the IRS adopt the position that land can never have an "original use" and that substantial improvements are not required in the case of the acquisition by a Qualified Opportunity Fund ("QOF") or Qualified Opportunity Zone Business ("QOZB") of vacant land. While this recommendation clarifies that substantial improvements will not be required on the acquisition of vacant land, there must be a business or active real estate project operating at the site within 30 months following acquisition of the property by a QOF or QOZB. This same policy would be applicable to real property with a structure to be completely demolished by the QOF or QOZB or real property with a structure that has remained vacant for three full calendar years prior to the QOF or QOZB's acquisition of the subject property.

A related issue is defining original use. The standard should be actual commercial use of the structure or tangible property. Accordingly, if a certificate of occupancy has not been received for a structure, the property has not been used prior to being utilized by a QOF or QOZB in the respective zone. However, this policy should not be applicable to a structure where more than 50% of the total capital investment needed for completion was spent prior to December 31, 2017.

Rollover or Exchange of Fund Interests and Assets

Another important issue clarified by the proposed regulations is the sale or exchange by a taxpayer of its QOF interest and reinvestment of the proceeds in a different QOF during the required holding period. The regulations make clear that a taxpayer can rollover a QOF interest into a different QOF within 180 days of selling or exchanging the previous QOF interest. However, a taxpayer seeking to do so must dispose of its entire previous QOF interest. While the complete disposition requirement seeks to conform with the statutory requirements, we recommend allowing a QOF investor to sell a divisible interest in a QOF and reinvest into another QOF, even if the investor has not sold or exchanged its entire original investment. If this is not possible based on the statute, subsequent guidance should clarify that investments of the same gain made at different times by the investor are treated as separate investments for purposes of the complete sale or exchange requirement. The proposed regulations seem to permit this already, but it would be helpful to have it clarified in further examples.

Despite the clear guidance provided to investors, the regulations do not likewise address a QOF's recycling of assets by selling Qualified Opportunity Zone Property and replacing that property within a reasonable period of time with other Qualified Opportunity Zone Property. We recommend that a QOF be permitted to do so in the same manner as an investor with the same 180-day period for selecting a new Opportunity Zone investment. We also propose that this recycling of assets by a QOF not trigger a taxable event and not begin a new holding period for investors and the QOF. Finally, if the investor has provided authorization to the fund manager, a QOF should be permitted to swap QOF investments on behalf of an investor into a new QOF as described in the preceding paragraph. Providing QOF managers the ability to transfer assets and investments freely without triggering a taxable event or penalizing investors is essential for QOFs and investor participation.

Working Capital Safe Harbor

When a QOF invests in a QOZB, that business cannot hold five percent or more of its assets in nonqualified financial property with an exception for working capital for a project or business. The regulations provide a 31-month period for working capital to be expended if done pursuant to a written plan and other documentation requirements. However, there is an outstanding question as to whether this safe harbor is applicable for allowing a QOZB to satisfy the "substantially all" test, requiring 70 percent of its assets to be Qualified Opportunity Zone Property.

The proposed regulations and introductory comments suggest this was the likely intent of the safe harbor, but the actual language of the regulation suggests the safe harbor is applicable solely for purposes of not running afoul of the nonqualified financial property requirements in I.R.C. Section 1397. We recommend that subsequent guidance clarifies that the safe harbor is applicable for satisfying the requirements of I.R.C. 1397 in addition to the definition of Qualified Opportunity Zone Property under I.R.C. 1400Z-2. Furthermore, the same working capital safe harbor should be applicable to QOFs that acquire Qualified Opportunity Zone Property directly instead of investing in a QOZB that acquires such property. We believe these recommendations are in line with the intent and thought process behind the IRS's working capital safe harbor contained in the currently proposed regulations.

Qualified Opportunity Fund Certification and Asset Testing

To maintain QOF status, a QOF must hold at least 90 percent of its assets in Qualified Opportunity Zone Property. The proposed regulations allow a QOF to identify the taxable year it chooses as well as the month for when its QOF status becomes effective. A deferral election for making an investment in a QOF can only be made if the investment is made in a qualifying entity. Accordingly, a QOF must certify as such an entity by the time it begins taking investments.

A significant issue arises under the statute and proposed regulations for a QOF that wants to begin taking investments now (December 2018) or towards the end of a calendar year. If the QOF operates with a calendar year tax filing period, it will have to have invested 90 percent of its assets (investment proceeds) in Qualified Opportunity Zone Property by the end of the calendar year in which it takes its first investment. This could be a major issue when the IRS Form 8996 is filed in the second half of the year.

The problem is perhaps mitigated in part by the 31-month working capital flexibility provided to investments in QOZBs by a QOF. However, this asset testing issue does require that a QOF have a project lined up immediately and may involve special structuring to accommodate making the qualified investment before the end of December. We recommend that the IRS provide a grace period for the first asset testing period for each QOF or use its authority to invoke a reasonable cause exception to avoid the imposition of penalties and disqualified investments in these circumstances where a QOF used its best efforts to deploy the capital in satisfaction of the 90 percent asset test.

Inside vs. Outside Basis and Investor Exit Strategies

Another major question that remains unanswered concerns an investor's exit from a QOF. Under the current statute and proposed regulations, an investor receives a basis increase equal to fair market value for its interest in a QOF upon selling or exchanging that interest. However, a QOF's sale of assets could trigger a taxable gain which would be passed through to investors if the QOF is a pass-through entity. This is due to the difference between the investor's outside basis in its interest in a QOF versus the QOF's basis in Qualified Opportunity Zone Property.

A typical multi-asset fund provides investors with an exit strategy that involves selling fund assets and distributing the proceeds to investors. Absent guidance or a statutory change extending the basis step-up to a QOF's sale of assets, there will be an influx of single asset funds to allow investors to exit tax-free. In the alternative, QOFs will have to incur significant legal and transactional costs for complex structures to facilitate a QOF's holding of a diverse class of assets without triggering an unnecessary taxable event for investors. Furthermore, that potential taxable event that could result is not in accord with Congressional intent in crafting this program. We recommend adopting a policy which would allow a QOF to elect to increase the basis of an asset upon a sale of that asset by the QOF if the asset was held by the QOF for 10 years or more (including the holding period of any previously exchanged assets).

Qualified Opportunity Zone Businesses Issues

In interpreting "substantially all," the proposed regulations provide that 70 percent of a QOZB's owned or leased tangible property must be Qualified Opportunity Zone Property—meaning that the property was acquired in 2018 or after and its first use is in an Opportunity Zone or that it is substantially improved. These requirements limit the pool of potential business investments to companies that may be relocating or building a new site. However, what about a service company that leases space in an OZ or a start-up in a co-working/incubator space?

Until there is more clarity in this area, and potentially a more flexible standard for what constitutes a QOZB, this new program may garner interest focused primarily on real estate projects. For this program to reach its full potential, there must be an alternative policy for determining whether a business can be considered a QOZB. We recommend that in the case of a QOZB which leases, rents or occupies space as per an agreement for consideration, the lease, rental or occupancy term must begin on or after December 31, 2017. Furthermore, if the lease, rental or occupancy term commences before the QOZB receives an investment from a QOF, the QOZB must spend on site improvements or capital purchases an amount equal to the total lease, rental or occupancy payments made for the lease, rental or occupancy period which occurs prior to receiving an investment from a QOF up to a maximum period of 30 months. If the lease, rental or occupancy term commences after the QOZB receives an investment from a QOF, there shall be no additional investment or capital purchases required by the business to be considered a QOZB.

Finally, any requirements regarding an active business and the source of income for a QOZB should be based on where the income-generating activities are performed by the business and not the location of the customer.

We appreciate your time and consideration in reviewing our comments. We also commend your efforts in this important undertaking of ensuring the Opportunity Zone's success and compliance with the law and Congressional intent. We look forward to discussing these comments with you.

Best regards,

/s/ Jaime Reichardt

Jaime Reichardt
Managing Director

/s/ Benjamin Ellis

Benjamin Ellis
Managing Director