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Section of Taxation

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July 1, 2019

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Proposed Regulations Regarding Investments in Qualified Opportunity Funds Under Section 1400Z-2

Dear Commissioner Rettig:

Enclosed please find comments on the proposed regulations regarding qualified opportunity funds under section 1400Z-2 of the Internal Revenue Code. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
William M. Paul, Deputy Chief Counsel (Technical), Internal Revenue Service
Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury
Audrey W. Ellis, Attorney-Advisor, Department of the Treasury
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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

Comments on Proposed Regulations Regarding Investments in Qualified Opportunity Funds Under Section 1400Z-2

These comments (the "Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Steven R. Schneider, Steven Kennedy, Jennifer Ray, Natasha Khemani, Sarah R. Haradon, Brad Gould, Thomas J. Phillips, Leila Vaughan, Alan S. Lederman, Kimberly Majure, Patrick Browne, Eric Janowak, Carol P. Tello, Brian Tschosik, Scott Barnes, Richard Blumenreich, Walter Calvert, Joseph B. Darby III, Michael DePompei, Elizabeth Feldmeir, Megan Jones, Sam Kamyans, Norman Lencz, Susan Reaman, and David Shechtman.

The Comments have been reviewed by Sarah R. Haradon, a Vice Chair of the Partnerships & LLCs Committee, Grace Kim, Chair of the Partnerships & LLCs Committee, Ossie Borosh, Chair of the Real Estate Committee, and Jeanne Sullivan of the Section's Committee on Government Submissions.

Although members of the Section of Taxation may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section's diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: July 1, 2019

EXECUTIVE SUMMARY

These Comments are in response to the Proposed Regulations (the "Proposed Regulations") under section 1400Z-2[1] with respect to changes made by 2017 tax legislation (the "Act").[2] Opportunity zones were added to the Internal Revenue Code (the "Code")[3] by the Act. Opportunity zones are an economic development tool designed to spur economic development and job creation in distressed communities. We commend the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") for their commitment to provide expedited guidance, and we ask that Treasury and the Service consider the following recommendations in the finalization of the Proposed Regulations under section 1400Z-2 published in the Federal Register on October 29, 2018, updated by the Proposed Regulations under section 1400Z-2 published in the Federal Register on May 1, 2019 (collectively, the "Proposed Regulations").

Section 1400Z-2, in conjunction with section 1400Z-1, provides federal income tax benefits to taxpayers who invest in businesses located within opportunity zones. Section 1400Z-2 provides two main tax incentives to encourage investment in a "qualified opportunity zone" ("QOZ" or "qualified opportunity zone"), (1) the deferral of inclusion in and, after a period of years, partial elimination of gross income for certain gains to the extent that corresponding amounts are invested in a "qualified opportunity fund" ("QOF"), and (2) the exclusion from gross income of the post-acquisition gains on investments in QOFs that are held for at least 10 years. The Proposed Regulations address and clarify many issues raised by section 1400Z-2. As discussed in detail below, we believe that clarification or revision of the Proposed Regulations would further assist taxpayers in determining the extent to which these tax benefits apply to their investments in QOFs.

Specifically, we respectfully recommend that Treasury and the Service provide additional guidance under section 1400Z-2 on the following important issues:

I. An interest in a QOF acquired from a person other than a QOF is an eligible interest even if the seller did not make a section 1400Z-2(a) gain deferral election with respect to such interest or acquired the interest before the eligible entity was certified to be a QOF.

II. A taxpayer with mixed-funds investments should be allowed to elect to treat a distribution as made disproportionately with respect to a nonqualifying investment to minimize the circumstances in which distributions will cause an inclusion event.

[1] References to "section" are to a reference of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[2] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, 131 Stat. 2054 (2017) (sometimes referred to as the "Tax Cuts and Jobs Act" or "TCJA").

[3] Internal Revenue Code of 1986, as amended.

III. Section 743(b)-type basis adjustments, applicable in the case of taxpayers selling interests in QOF partnerships, should also apply to asset sales by QOFs and lower-tier entities.

IV. In the case of taxpayers owning a profits interest in a QOF partnership, the amount of gain allocable to the profits interest for purposes of eliminating the gain under Proposed Regulation section 1.1400Z2(c)-1(b)(2)(ii) should be based on the actual section 704(b) gain associated with the profits interest in the year of sale and not the highest possible residual profits percentage under the partnership agreement.

V. Pro rata divisions of QOF partnerships into two or more QOFs should not create inclusion events as long as the partners are not reducing the equity interest in their qualifying investments as a result of the division.

VI. Retain the rules in the Proposed Regulations regarding timing of basis adjustments under section 1400Z-2(b)(2)(B)(ii) as a result of an inclusion event and under Section 1400Z-2(c) as a result of a basis step-up election.

VII. Gain arising from an inclusion event should qualify as eligible gain for deferral under section 1400Z-2(a) regardless of whether it represents all or a portion of the taxpayer's deferred gain in the qualifying investment.

VIII. The aggregate change in ownership rule applicable to S corporations investing in QOFs should be eliminated or otherwise require an aggregate decrease in ownership of more than 50%. Moreover, the final regulations should provide an exhaustive list of events that can cause a decrease in a shareholder's ownership for this purpose.

IX. QOFs or lower-tier entities doing business in a QOZ should be able to satisfy the substantial improvement requirement for purchased tangible property on an aggregate basis, with certain limitations.

X. An intended investment in a QOF should be treated as an additional FIRPTA withholding tax exemption.

XI. A QOZB should be treated as engaged in the active conduct of a trade or business if the QOZB is operating as a trade or business for purposes of section 162 and otherwise meets the QOZB requirements under section 1400Z-2(d)(3)(A), and further recommend that such term include special rules for start-up entities. Also, while we do not recommend extending the section 1397C requirements to the QOF, it would be helpful to allow QOFs to utilize the working capital safe harbor currently only available to QOZBs.

XII. Retain the percentage requirements as designated in the Proposed Regulations and include clarification and examples of the application of the 90% substantially all *holding period* threshold. The final regulations should allow the interests of a partnership or corporation held by a QOF to be treated as QOZB interests during substantially all of the QOF's holding period where such partnership or corporation becomes a QOZB within 12 months of the QOF's acquisition of interests in it.

XIII. Provide guidance as to the circumstances that may be treated as reasonable cause in the context of section 1400Z-2, providing that events that are beyond the control of the QOF or QOZB constitute reasonable cause.

XIV. Proposed Regulation section 1.1400Z-2(f)-1(c) adequately deals with Treasury and the Service's concern that the treatment of unimproved land as QOZBP could lead to tax results that are inconsistent with the purpose of Section 1400Z-2 by utilizing a "significant purpose test" to determine inappropriate investment activity.

XV. Provide a rule analogous to the QOF reinvestment rule for QOF subsidiaries that reinvest proceeds from the disposition of qualified opportunity zone business property.

XVI. Provide that a QOF REIT shareholder may exclude a designated capital gain dividend from gross income instead of permitting the shareholder to apply a zero percent tax rate to such dividend. Further, the notice time period should be revised as follows: ". . . a date that the QOF REIT designates in a notice provided to the shareholder not later than ten business days after the QOF REIT designates the capital gain dividend . . ."

XVII. The vacancy period prior to purchase by a QOF or QOZ Business period should be defined as either: (i) two years vacant; or (ii) five years where the building has less than 25% of rentable square footage rented and/or occupied.

XVIII. The 180-Day Period for investing section 1231 gains should be aligned with the rules governing the investment of non-section 1231 capital gains allocable by a partnership to a partner, so that, in the case of a taxpayer's direct and indirect recognition of section 1231 gains, the taxpayer may elect to commence its 180-Day Period using either: (i) the Year-End Commencement Rule; or (ii) a rule equivalent to the Elective Rule under which the 180-Day Period commences on the date of the actual sale or exchange. Alternatively, if the Year-End Commencement Rule generally remains in place, we recommend a "grandfathering" exception whereby a taxpayer that recognized a section 1231 gain in a taxable year ending on or before December 31, 2019 may use either the Year-End Commencement Rule or a rule equivalent to the Elective Rule.

XIX. Include Treasury's general interpretation that leased tangible property meeting certain criteria should be treated as QOZBP for purposes of satisfying the 90% asset test under section 1400Z-2(d)(1) and the substantially all requirement under section 1400Z-2(d)(3)(A)(i). Include Treasury's conclusion that leases of tangible property between related parties may be treated as QOZBP so long as certain additional standards and safeguards are met. Adopt the proposed position that leases between related parties be evaluated under the arm's-length standards of section 482. We believe that the two additional requirements proposed by Treasury and the Service with respect to related party leases – that prepayment of rent not exceed 12 months and that, in the case of tangible personal property, the lessee must purchase within 30 months an amount of tangible personal property equal to the value of the leased tangible property for use in the applicable QOZ – are reasonable and beneficial in promoting the objectives of the legislation. However, in the case of leases of tangible property between unrelated parties (using the 20% standard for testing related party status under section 1400Z-2(e)(2)), such leases should not be tested under section 482 standards, and instead should be given a presumption of meeting the standard of market rate lease unless either there is clear evidence that the lease structure is intentionally abusive in its structure or there is evidence that the parties, though unrelated, do not have adverse interests or otherwise are not negotiating in good faith to protect and pursue their respective interests. We also agree with and endorse the proposed alternative methodologies for valuing leased tangible property for purposes of the 90% asset test and the "substantially all" requirements.

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DISCUSSION

I. Comment Regarding Whether an Interest in a QOF Acquired from a Person Other Than a QOF is an Eligible Interest

A. Background

Section 1400Z-2(a)(1) allows taxpayers to elect to defer recognized gain by investing the gain into a QOF. The Proposed Regulations allow a taxpayer to make a section 1400Z-2(a)(1) investment by acquiring an eligible interest in a QOF within the meaning of Proposed Regulation section 1.1400Z2(a)-1(b)(3)(i) ("eligible interest") from a person other than the QOF.[4] For purposes of section 1400Z-2, an eligible interest in a QOF is an equity interest issued by the QOF, including preferred stock or a partnership interest with special allocations.[5] If a taxpayer makes an election under section 1400Z-2(a) by acquiring an eligible interest in a QOF from a person other than the QOF, then the amount of the taxpayer's investment is the amount of cash and/or fair market value of the other property, as determined immediately before the exchange, that the taxpayer exchanges for the eligible interest in the QOF.[6] It is unclear, however, whether an eligible interest includes an interest acquired from a person other than the QOF with respect to which the seller did not make a section 1400Z-2(a) election.

Also, under the Proposed Regulations, pre-existing eligible entities within the meaning of Proposed Regulation section 1.1400Z2(d)-1(a)(1) ("eligible entity") may become a QOF, provided all of the other requirements of section 1400Z-2 are met.[7] It is unclear whether, after the entity becomes a QOF, previously outstanding interests are treated as eligible interests.

B. Recommendations

We recommend that the final regulations clarify that an eligible interest is an equity interest issued by a QOF and that the seller of a QOF interest is not required to make a section 1400Z-2(a) election in order for the buyer to make a section 1400Z-2(a) election upon acquisition of the seller's interest in the QOF.

We also recommend that the final regulations clarify that an eligible interest includes an interest in an eligible entity issued before the eligible entity becomes a QOF.

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[4] Prop. Reg. § 1.1400Z2(a)-1(b)(9)(iii), 84 Fed. Reg. 18652 (May 1, 2019) (the "May Notice of Proposed Rulemaking") and REG-115420-18, 83 Fed. Reg. 54279 (Oct. 29, 2018) (the "October Notice of Proposed Rulemaking").

[5] Prop. Reg. § 1.1400Z2(a)-1(b)(3)(i).

[6] Prop. Reg. § 1.1400Z2(a)-1(b)(10)(iii).

[7] Prop. Reg. § 1.1400Z2(d)-1(a)(3).

C. Explanation

If a taxpayer wishes to acquire an interest in an existing QOF from a person other than the QOF, questions arise as to what is an eligible interest, particularly where a taxpayer is acquiring an interest from a founder who either had no capital gain to defer under section 1400Z-2(a) or otherwise chose not to make a section 1400Z-2(a) election with respect to its interest. Treasury and the Service should clarify that this interest is still an eligible interest for purposes of section 1400Z-2 and the regulations thereunder. Neither the statute nor the Proposed Regulations limit eligible interests to interests in a QOF with respect to which a taxpayer has made a section 1400Z-2 election. As such, it appears that a taxpayer wishing to make a section 1400Z-2 election with respect to a gain could purchase an interest in a QOF from a person who previously acquired an interest in the QOF even though no section 1400Z-2 election was previously made with respect to the purchased interest.

The final regulations should also clarify that an eligible interest includes interests issued by an eligible entity before the entity becomes a QOF. In many cases, a founder of an eligible entity may have had no reason initially to make the eligible entity a QOF, and would have only certified the entity as a QOF at a later time when investors looking to make a section 1400Z-2 election were considering acquiring an interest in the entity. Neither the statute nor Proposed Regulations limit eligible interests to interests in a QOF issued after the eligible entity becomes a QOF. Thus, it appears that a taxpayer should be able to make a section 1400Z-2 election with respect to a gain by purchasing an interest in a QOF from a person who acquired such interest prior to the time in which the entity became a QOF.

II. Comment Regarding Whether a Taxpayer That Has a Mixed-Funds Investment Must Account for Investments Separately

A. Background

Section 1400Z-2(e) provides special rules for mixed-funds investments. Specifically, if a taxpayer makes an investment in a QOF and only a portion of that investment consists of capital gain for which a deferral election under section 1400Z-2(a) is in effect, the investment is treated as two separate investments, one "qualifying investment" and one "nonqualifying investment."[8] The rules of section 1400Z-2(a), (b), and (c) (including the deferral and basis increase rules) apply only to the qualifying investment. The Proposed Regulations provide that a mixed-funds investment can occur if a taxpayer contributes to a QOF cash in excess of the partner's eligible section 1400Z-2 gain or property with a value in excess of its basis, or if a partner receives an interest in the QOF in exchange for services (a "carried interest").[9]

The Proposed Regulations provide that a partner holding a mixed-funds investment will be treated as holding a single partnership interest with a single basis and capital account for all purposes of subchapter K, but not for purposes of section 1400Z-2. Solely for purposes of section 1400Z-2, the mixed-funds partner is treated as holding two interests, and all partnership items, such as

[8] Prop. Reg. § 1.1400Z2(b)-1(c)(6)(iv)(A).

[9] Prop. Reg. § 1.1400Z2(a)-1(b)(9), -1(b)(10).

section 704(b) allocations, debt allocations, and distributions, affect qualifying and non-qualifying investments proportionately, based on the relative allocation percentages of each interest.[10]

The preamble to the May Notice of Proposed Rulemaking provides, as an example, a situation where a partner contributes to a QOF partnership $200, half of which is a qualifying investment. Partnership debt of $20 is allocated to the partner, so the partner's total outside basis in the QOF is $120 ($0 for the qualifying investment contribution, $100 for the nonqualifying investment contribution, and $20 as a result of the debt allocation). For purposes of section 1400Z-2, the partner's total basis must be bifurcated between the qualifying investment and the nonqualifying investment. The partner's basis in the qualifying investment is $10 ($0 for the qualifying investment and $10 under section 752(a), or half of the partner's total debt allocation). The partner receives a distribution of $40, which is deemed distributed half with respect to each investment. This distribution does not result in section 731(a) gain, because the partner has sufficient total outside basis. However, the distribution results in a partial inclusion event under section 1400Z-2(a) of $10 ($20 deemed distributed minus $10 basis, in each case with respect to the qualifying investment).[11]

Treasury and the Service requested comments on this approach, including the potential complexity and whether an ordering rule treating the distribution as attributable to the qualifying or non-qualifying investment first would be appropriate.

B. Recommendation

We generally agree with the approach in the Proposed Regulations, but we recommend that the final regulations allow a taxpayer to elect to treat a distribution as made disproportionately with respect to a nonqualifying investment to minimize the circumstances in which a distribution with respect to a nonqualifying investment causes a qualifying investment to be deemed "sold or exchanged." As discussed below, this electivity is necessary in situations in which the taxpayer's basis in its qualifying and nonqualifying investments is not proportionate to the respective allocation percentages. Furthermore, this electivity is consistent with the Proposed Regulations' stated goal of treating the qualifying investment and nonqualifying investment as separate interests for purposes of section 1400Z-2.

C. Explanation

The example in the preamble to the Proposed Regulations discussed above demonstrates the harsh, and we believe unnecessary, result that may occur if a taxpayer has a mixed-funds investment and receives a distribution of cash. The Proposed Regulations require a taxpayer to bifurcate its partnership interest for purposes of section 1400Z-2 and deem basis increases (including those resulting from allocations of net profits and increases in share of partnership debt) to be spread proportionately between the qualifying and nonqualifying investments, generally based on relative capital contributions. They also deem cash distributions to be made proportionately. When a taxpayer's basis in the qualifying investment is proportionately less than its basis in the

[10] Prop. Reg. § 1.1400Z2(b)-1(c)(6)(iv)(B).

[11] 84 Fed. Reg. at 18663.

nonqualifying investment, the result is that a taxpayer may not be able to access all of the basis in its nonqualifying investment, and a portion of the distribution is treated as a "sale or exchange" of the qualifying investment.

A mixed-funds investor's basis in its qualifying and nonqualifying investments may differ in at least three situations: when the nonqualifying investment is obtained for cash, when the nonqualifying investment is received in exchange for a contribution of built-in gain property and section 704(c) allocations have been made to the investor with respect to that property, or when the investor has made an additional investment in the QOF resulting in a shift in allocation percentages.

In the case of a mixed-funds investment created by an investment of cash in excess of a taxpayer's eligible section 1400Z-2 gain, we recommend that Treasury and the Service allow an investor to determine the investment (qualifying, nonqualifying, or a portion of each) with respect to which it receives a distribution. In the example in the preamble, the taxpayer invested \$100 of eligible section 1400Z-2 gain and an additional \$100 of nonqualifying cash. Even if there were no debt allocation to the taxpayer from the partnership, the taxpayer should be able to withdraw its entire nonqualifying investment without causing a deemed sale or exchange of its qualifying investment. The taxpayer did not receive benefits under section 1400Z-2 in exchange for the contribution of the nonqualifying cash and should not suffer a consequence under section 1400Z-2 for its withdrawal.

Similar issues arise if a mixed-funds investment is created as a result of the contribution of built-in gain property and a taxpayer has been allocated section 704(c) gain with respect to the contributed property. For example, assume a taxpayer has \$60 of eligible gain and transfers nondepreciable property with a fair market value of \$100 and tax basis of \$60 to a QOF partnership. The taxpayer's qualifying investment is worth \$60, and the partner's nonqualifying investment is worth \$40. Both investments have a basis of zero for section 1400Z-2 purposes. The QOF later sells the contributed property for \$100 and allocates \$40 of tax gain to the taxpayer under section 704(c). Under the Proposed Regulations, this tax gain is allocated to the taxpayer's nonqualifying investment, which now has a basis of \$40 for section 1400Z-2 purposes. The taxpayer is now in the same position as if it had sold the property first and then invested \$100 cash in the QOF. For the reasons discussed above, the taxpayer should be able to receive a distribution of \$40, wholly with respect to the nonqualifying investment, without resulting in a sale or exchange of the qualifying investment.

Finally, an investor may also need flexibility to determine the investment with respect to which a distribution is made if there is a change in allocation percentages. Under the Proposed Regulations, allocation percentages would change if an investor with a mixed-funds investment makes an additional investment in the QOF. For example, assume a taxpayer initially contributes \$200 to a QOF, of which half is a qualifying investment for which the taxpayer gets zero basis. The taxpayer is allocated \$20 of partnership debt and \$20 of taxable income. The taxpayer's basis in its QOF interest for subchapter K purposes is \$140 (\$100 nonqualifying cash plus \$20 debt allocation plus \$20 income allocation). Under the Proposed Regulations, the taxpayer's basis in its qualifying interest is \$20 and in its nonqualifying interest is \$120. If the partnership distributed \$40 to the taxpayer, the taxpayer would not recognize gain under section 731(a). The taxpayer also would not be treated as selling its qualifying investment, because the distribution would be treated as made proportionately to the two investments, or $20 each, and the taxpayer has basis of at least $20 in each investment.

If instead, the taxpayer contributes an additional $200 of eligible section 1400Z-2 gain at a time when the value of the QOF has not changed, and then receives a $40 distribution that is not treated as a disguised sale, the taxpayer would have an inclusion event under the method in the Proposed Regulations. Immediately before the distribution, the value of the taxpayer's qualifying and nonqualifying investments are $300 and $100, respectively. The taxpayer's basis in its qualifying investment for purposes of section 1400Z-2 is $25 ($10 of taxable income previously allocated with respect to the qualifying investment plus $15, or 75% of the debt allocation). Of the $40 distribution, $30 is deemed to be made with respect to the qualifying investment, and the taxpayer has an inclusion event with respect to $5 of the investment ($30 distribution minus $25 basis). In this example, making an additional qualifying investment decreases the amount of cash the taxpayer can withdraw from the QOF. As above, there is no policy reason for the distribution here to cause the taxpayer to be deemed to have sold a portion of its qualifying investment. All of these issues could be addressed by allowing a taxpayer to choose the investment with respect to which it receives a distribution. We do not believe such an election will materially increase the complexity of the mixed-funds investment rules.

III. Comment Regarding Whether 743(b)-Type Basis Adjustments Apply to Dispositions of Qualified Opportunity Zone Property Where Investors Have Held Qualifying Investments for at Least Ten Years

A. Background

The Proposed Regulations eloquently address the mechanic of the statutory exception of gains from dispositions of qualifying QOF partnership interests within the meaning of Proposed Regulation section 1.1400Z2(b)-1(a)(2)(xvii) ("qualifying QOF partnership interests") after ten years under section 1400Z–2(c) through a deemed section 743(b) adjustment immediately prior to the sale of the interest (the "section 743(b) adjustment approach"). Specifically, when the basis of the qualifying QOF partnership interest is adjusted to an amount equal to the fair market value of the interest, including debt, immediately prior to the sale or exchange, the basis of the QOF partnership assets are also adjusted. Such inside basis adjustment is calculated in a manner similar to a section 743(b) adjustment had the transferor partner purchased its interest in the QOF partnership within the meaning of Proposed Regulation section 1.1400Z2(b)-1(a)(2)(xiii)) ("QOF partnership") for cash equal to fair market value immediately prior to the sale or exchange assuming that a valid section 754 election had been in place.[12] The section 743(b) adjustment approach works well to ensure that the taxpayer selling a qualifying investment does not recognize any gain or loss on the sale, consistent with the statutory intent.

The Proposed Regulations provide a rule similar in intent with respect to sales of qualified opportunity zone property ("QOZP") by a QOF partnership or QOF S corporation within the meaning of Proposed Regulation section 1.1400Z2(b)-1(a)(2)(xiv) ("QOF S Corporation"), allowing a taxpayer holding a qualified investment in the QOF for at least ten years to elect to

[12] Prop. Reg. § 1.1400Z2(c)-1(b)(2)(i).

exclude from gross income some or all of the capital gain arising from such disposition reported on Schedule K–1 of the QOF partnership or QOF S Corporation and attributable to the qualifying investment (the "asset gain elimination election").[13] Although the asset gain elimination election demonstrates a clear intent for parity between QOF interest sales and asset sales at the QOF level or below, the actual mechanics and net results are not in parity. Further, the asset gain elimination election does not address asset sales by a lower-tier partnership conducting a qualified opportunity zone business ("QOZB partnership") in which the QOF partnership or QOF S Corporation owns an interest.

B. Recommendation

We recommend that the final regulations replicate the section 743(b) adjustment approach applicable to sales of qualifying QOF partnership interests for sales of QOZP by QOFs (including QOF partnerships and QOF S Corporations) and QOZB partnerships.

C. Explanation

The consistent application of the section 743(b) approach reaches the correct result of exempting the gain relating to the taxpayer's QOF interest, regardless of whether the disposition is of a QOF interest, QOF assets, or a disposition of assets by a QOZB partnership. There does not appear to be a policy reason for drawing a distinction between the method of disposition. Further, the existence of a distinction creates uncertainty in a QOF investor's projected tax benefits and continues the problem of forcing taxpayers to sell QOF interests if they are to obtain the full intended benefit of the election allowed under section 1400Z-2(c) (the "-2(c) Step-up")[14]. For example, if a portion of the gain attributable to the disposition of a qualifying QOF partnership interest relates to "hot" assets under sections 751(c) or (d), the Proposed Regulations make it clear that the deemed section 743(b) adjustment on the sale of a qualifying QOF partnership interest steps up the bases in such ordinary income assets, but because the asset gain elimination election for asset sales by the QOF partnership itself is limited to capital gain, an asset sale by the QOF partnership would cause the investor to recognize such ordinary income. Similar rules should apply to avoid ordinary income in the case of asset sales by QOF S Corporations for a taxpayer owning a qualified investment for at least ten years.

Further, if the sale were at the level of the QOZB partnership, which is very likely, the asset gain elimination election does not appear to apply at all. However, if the deemed section 743(b) approach were to apply to a lower-tier QOZ partnership regardless of the method of sale, a consistent tax treatment would apply, which we believe is the intent of the rules.

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[13] Prop. Reg. § 1.1400Z2(c)-1(b)(2)(ii).

[14] The -2(c) Step-up is discussed more fully later.

IV. Comment Regarding Whether a Partner That Receives a Profits Interest in a QOF in Exchange for Services Must Use Its Highest Residual Profits Percentage as Its Allocation Percentage

A. Background

In the case of a partner holding a mixed-funds investment, all partnership section 704(b) allocations, debt allocations, and distributions affect the qualifying and non-qualifying investments proportionately, based on the relative allocation percentages of each interest.[15] Allocation percentages are generally based on the relative capital contributions for each investment. However, in the case of a partner that receives a profits interest for services, the allocation percentage with respect to the carried interest is the highest share of residual profits the partner would receive with respect to that interest, and the allocation percentage with respect to any capital interest held by that partner is determined based on relative qualifying and nonqualifying investments.[16]

Under the asset gain elimination election, after a taxpayer has held a qualifying investment in a QOF partnership for at least ten years, if the QOF partnership disposes of QOZP after such ten-year holding period, the taxpayer may elect to exclude from gross income some or all of the capital gain arising from such disposition reported on Schedule K-1 of the QOF partnership and attributable to the qualifying investment.[17] The Proposed Regulations do not define the amount of gain "attributable to the qualifying investment" in the case of a mixed-funds investment.

B. Recommendation

For purposes of the asset gain elimination election, we recommend that the final regulations provide that the amount of gain attributable to the qualifying and nonqualifying investments is proportionate to each investment's share of section 704(b) gain with respect to the property, rather than the "allocation percentages" set by the mixed-funds rules.

C. Explanation

It appears that Treasury and the Service were attempting to put the taxpayer in the same position (to the extent possible) if the QOF sold QOZP or the taxpayer sold its interest in the QOF, in either case after the taxpayer held a qualifying investment for ten years. In the case of a sale of interests, presumably the amount of the sale price allocable to the qualifying and nonqualifying investments would be based on the relative fair market value of the investments at that time. Similarly, the amount of asset gain eligible for the asset gain elimination election should be based on the relative amount of economic gain allocable to each of the qualifying and nonqualifying investments. In turn, those amounts would be based on the sharing ratios of the qualifying and nonqualifying investments at the time of sale, not necessarily based on the highest share of residual profits the carried interest might theoretically have received. For example, assume a taxpayer makes a $100

[15] Prop. Reg. § 1.1400Z2(b)-1(c)(6)(iv)(B).

[16] Prop. Reg. § 1.1400Z2(b)-1(c)(6)(iv)(D).

[17] Prop. Reg. § 1.1400Z2(c)-1(b)(2)(ii).

qualifying investment in a QOF, for 50% of the QOF, and also receives a carried interest that depends on the hurdle that is met. The QOF invests the $100 in QOZP. If the value of the property increases by 20%, the carried interest will receive 10% of the appreciation. If the value of the property increases by 30%, the carried interest will receive 15% of the appreciation. If the property value increases by 40%, the carried interest will receive 20% of the appreciation. Any remaining gain after the carried interest receives its distribution is split among the capital partners in accordance with their percentage interests. After the taxpayer has held its investment in the QOF for at least ten years, the QOF sells the property for $120. The carry is entitled to $2 (10% of the appreciation of $20). Half of the remaining $18 gain, or $9, is allocated to the taxpayer with respect to its capital interest. In this example, $9 should be eligible for the asset gain elimination election, as that is the amount earned with respect to the qualifying investment. By contrast, if the "allocation percentages" from the mixed-fund investment rules are applied, the carried interest would be deemed to have a 40% share of the gain allocable to the mixed-funds investment, or $4.40 (40% * $11 gain allocable to the taxpayer), and only $6.60 would be eligible for the asset gain elimination election. This does not seem to be an appropriate result.

V. Comment Regarding Whether Pro Rata Divisions of QOF Partnerships Should Create Inclusion Events

A. Background

Under the Proposed Regulations, an inclusion event results, in general, from a transfer of a qualifying investment in a transaction that reduces or terminates a taxpayer's direct (or, in the case of partnerships, indirect) equity interest in the qualifying investment.[18] Moreover, as a general rule, except as otherwise provided in Proposed Regulation section 1.1400Z2(b)-1(c), an inclusion event occurs to the extent that "a taxpayer receives property that is treated as a distribution for federal income tax purposes, whether or not the receipt reduces the taxpayer's ownership of the QOF."[19] The Proposed Regulations further provide that "an actual or deemed distribution of property (including cash) by a QOF partnership to a partner with respect to its qualifying investment is an inclusion event only to the extent that the distributed property has a fair market value in excess of the partner's basis in its qualifying investment."[20]

The Proposed Regulations also provide that the distribution by a QOF corporation (as defined in Proposed Regulation section 1.1400Z2(b)-1(a)(2)(x)) ("QOF corporation") of a subsidiary in a transaction to which section 355, or so much of section 356 as relates to section 355, applies is not an inclusion event if both the distributing corporation and the controlled corporation are QOFs immediately after the final distribution, except to the extent the taxpayer receives boot. For this purpose, "each of the distributing corporation and the controlled corporation is treated as a QOF immediately after the final distribution if the corporation satisfies the certification requirements in

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[18] Prop. Reg. § 1.1400Z2(b)-1(c)(1)(i), -1(c)(6)(i).

[19] Prop. Reg. § 1.1400Z2(b)-1(c)(1)(ii).

[20] Prop. Reg. § 1.1400Z2(b)-1(c)(6)(iii).

§ 1.1400Z2(d)-1 immediately after the final distribution and holds at least 90 percent of its assets in qualified opportunity zone property on the first testing date after the final distribution."[21]

B. Recommendation

We recommend that the final regulations provide that pro rata divisions of QOF partnerships into two or more QOF partnerships pursuant to section 708 are not treated as inclusion events so long as the amount of a taxpayer's equity interest in its qualifying investment remains the same, albeit spread across more than one QOF.

C. Explanation

In general, an inclusion event occurs to the extent that a transfer reduces or terminates a taxpayer's equity interest in its qualifying investment for federal income tax purposes. A pro rata division of a QOF partnership in which the QOF partners within the meaning of Proposed Regulation section 1.1400Z2(b)-1(a)(2)(xii) ("QOF partners") only receive interests in a second QOF partnership or assets that are immediately contributed to a second QOF partnership would not terminate or reduce a QOF partner's equity interest in its qualifying investment. Instead, following a pro rata division, a QOF partner's equity interest in its qualifying investment in a QOF partnership would be divided among two or more QOF partnerships resulting from the division. The fair market value of interests or assets actually or deemed distributed to a QOF partner as a consequence of the partnership division may be in excess of such investor's basis in its QOF partnership interest, but the QOF partner has not reduced the overall equity interest in its qualifying investment. As such, no inclusion event is appropriate if a distribution of property from a QOF partnership is part of a division in which there has been no reduction in the equity interest of the QOF partner's qualifying investment. The ability to divide a QOF partnership without creating an inclusion event could provide QOF partners with more liquidity for their interests if the original QOF partnership holds more than one asset. Moreover, not treating pro rata divisions of QOF partnerships as inclusion events would provide parity with the treatment of section 355 transactions for QOF corporations.

VI. Comment Regarding Whether the Timing of Basis Adjustments Under Section 1400Z-2(b)(2)(B)(ii) as a Result of an Inclusion Event or Under Section 1400Z-2(c) as a Result of a -2(c) Step-up Should Occur as Set Forth in the Proposed Regulations

A. Background

Section 1400Z-2(b)(2)(B)(i) provides that an electing taxpayer's initial basis in a qualifying investment is zero, with adjustments to be made as provided elsewhere under section 1400Z-2. Section 1400Z-2(b)(2)(B)(ii) provides for upward basis adjustments to a taxpayer's qualifying investment upon the recognition of gain previously deferred upon initial investment in the QOF. In addition, under section 1400Z-2(b)(2)(B)(iii) and (iv), a taxpayer's basis in its qualifying investment is increased by an amount equal to ten percent of the amount of deferred gain in the case of a qualifying investment held for five years, and then again by an amount equal to an additional five percent of the amount of deferred gain for a qualifying investment held for seven

[21] Prop. Reg. § 1.1400Z2(b)-1(c)(11)(i)(B)(1)-(3).

years. Finally, section 1400Z-2(c) allows taxpayers to elect to adjust the basis of qualifying investments to fair market value on the date the investment is sold or exchanged in the case of any investment held for at least ten years.

The Proposed Regulations provide that basis adjustments under section 1400Z-2(b)(2)(B)(ii) are made immediately after the previously deferred gain is included in the investor's income. If the basis adjustment is made as a result of an inclusion event, the basis adjustment is made before determining the other tax consequences of the inclusion event.[22]

The Proposed Regulations also confirm that, if the taxpayer makes a -2(c) Step-up election, the basis adjustment is made immediately before the taxpayer disposes of the qualifying investment. Under the section 743(b) adjustment approach, the bases of the QOF partnership's assets are also adjusted immediately prior to the sale or exchange of the qualifying investment in a manner similar to the adjustments that would have been made to the partnership's assets if the transferor partner had purchased the qualifying investment for cash equal to fair market value immediately prior to the sale or exchange and the partnership had a valid section 754 election in effect.[23]

Treasury and the Service requested comments on the proposed rules regarding the timing of these basis adjustments.

B. Recommendations

We recommend that the final regulations retain the provision in the Proposed Regulations that basis adjustment under section 1400Z-2(b)(2)(B)(ii) occurs immediately after previously deferred gain is included in the investor's income, and before determining other tax consequences of the inclusion event, if any.

We also recommend that the final regulations retain the provision in the Proposed Regulations that the -2(c) Step-up and asset basis adjustments made pursuant to the 743(b) adjustment approach occur immediately before the taxpayer disposes of its interest in the QOF.

C. Explanation

We agree that the basis adjustment under section 1400Z-2(b)(2)(B)(ii) should occur before other tax consequences of the inclusion event are calculated, if any. Section 1400Z-2 requires recognition of previously deferred capital gain, and Proposed Regulation section 1.1400Z2(a)-1(b)(5) provides that the gain included has the same attributes in the year of inclusion that it would have had if the tax on the gain had not been deferred. However, if other provisions of the Code are applied before the inclusion is calculated under section 1400Z-2(b)(1), taxpayers could end up with a result other than what was intended under section 1400Z-2.

Generally, if a taxpayer invests cash or property into a partnership, its initial basis in its partnership interest is equal to the basis of the contributed property under section 722. Section 1400Z-

[22] Prop. Reg. § 1.1400Z2(b)-1(g)(1)(i).

[23] Prop. Reg. § 1.1400Z2(c)-1(b)(2)(i).

2(b)(2)(B)(i) overrides this general rule by providing that a taxpayer's initial basis in its QOF interest (to the extent of a qualifying investment) is zero. If a taxpayer recognizes any previously deferred gain as a result of an inclusion event, the taxpayer can increase its basis in its QOF partnership interest by the amount of the gain recognized, which may give the taxpayer a basis in its partnership interest equal to the basis the taxpayer would have had under section 722 if section 1400Z-2 had not applied. This would allow the taxpayer to rely on its basis for other provisions of the Code (*e.g.*, sections 704(d), 731(a), or 737).

In addition, in the case of a sale of the qualifying investment resulting in an inclusion event, it is most consistent with the policy of section 1400Z-2 to cause the taxpayer to recognize previously deferred capital gain, to increase the basis in its qualifying investment accordingly, and then to determine the other consequences of the sale. This ordering preserves the attributes of the original deferred gain and then otherwise treats the taxpayer as if it had invested cash not subject to section 1400Z-2 for purposes of determining the remaining consequences of the transaction.

In addition, the Proposed Regulations provide that the basis adjustment upon making the -2(c) Step-up election occurs immediately before the taxpayer disposes of its qualifying investment. This is consistent with the language of section 1400Z-2(c), which provides that the taxpayer's basis of such property (*i.e.*, its qualifying QOF interest) shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged. Having this basis adjustment occur immediately before the taxpayer disposes of its investment leads to the result that no gain or loss is realized as a result of the disposition. In addition, the section 743(b) adjustment approach prevents the taxpayer from recognizing ordinary income as a result of the application of section 751(a) to the sale of the qualifying investment. Allowing the basis adjustment under section 1400Z-2(c) to occur immediately before the disposition of the investment allows the taxpayer to calculate the appropriate amount of adjustment to the QOF partnership's assets to prevent application of section 751(a), and to avoid recognizing any gain in the taxpayer's qualifying investment.

Accordingly, we recommend that the final regulations retain the timing provisions for the basis adjustments under section 1400Z-2(b)(2)(B)(ii) and 1400Z-2(c).

VII. Comment Regarding Whether Gain Arising from an Inclusion Event Qualifies as Eligible Gain for Deferral under Section 1400Z-2(a) Regardless Whether It Represents All or a Portion of the Taxpayer's Deferred Gain

A. Background

The Proposed Regulations provide that the gain to which a deferral election applies is included in gross income in the taxable year that includes the earlier of: (1) the date of an inclusion event or (2) December 31, 2026.[24] In general, inclusion events are defined as a reduction of an interest in a QOF.[25] In the case of a taxpayer who has made an election under section 1400Z-2(a) to defer some but not all of an eligible gain within the meaning of Proposed Regulation section 1.1400Z2(a)-

[24] Prop. Reg. § 1.1400Z2(b)-1(b).

[25] Prop. Reg. § 1.1400Z2(b)-1(c)(i).

1(b)(2)(i) ("eligible gain"), the term eligible gain includes the portion of that eligible gain with respect to which no election has been made.[26]

B. Recommendation

We recommend that the final regulations provide that gain arising from an inclusion event be treated as eligible gain that a taxpayer may elect to defer under section 1400Z-2(a), regardless whether representing part or all of the taxpayer's deferred gain.

C. Explanation

If a taxpayer acquires an interest in a QOF in connection with a gain-deferral election under section 1400Z–2(a), and a subsequent sale or exchange of the taxpayer's entire interest triggers an inclusion of the deferred gain, the Proposed Regulations provide that the gain is eligible gain for purposes of a deferral election under section 1400Z–2(a).[27]

The Proposed Regulations currently limit the eligible gain amount for inclusion events in connection with a QOF interest to complete disposition of interests. According to the preamble to the October Notice of Proposed Rulemaking,

> Deferring an inclusion otherwise mandated by section 1400Z-2(a)(1)(B) in this situation is permitted only if the taxpayer has disposed of the entire initial investment without which the taxpayer could not have made the previous deferral election under section 1400Z-2. The complete disposition is necessary because section 1400Z-2(a)(2)(A) expressly prohibits the making of a deferral election under section 1400Z-2(a)(1) with respect to a sale or exchange if an election previously made with respect to the same sale or exchange remains in effect.[28]

We believe that any gain arising from an inclusion event, whether representing all or part of the deferred gain, is not a gain to which a previous section 1400Z-2(a) election has been made, but represents new gain that should be eligible for deferral under section 1400Z-2(a). To illustrate, suppose a taxpayer elects to defer an eligible gain by investment in a QOF partnership. In year 3, the QOF partnership distributes cash to the taxpayer exceeding the taxpayer's basis in its qualifying investment, resulting in an inclusion event of a portion of the taxpayer's qualifying investment. No deferral election has previously been made with respect to this gain, and the gain ought to be eligible for deferral under section 1400Z-2(a).

[26] Prop. Reg. § 1.1400Z2(a)-1(b)(2)(ii).

[27] Prop. Reg. § 1.1400Z2(a)-1(b)(4)(ii)(D), Ex. (4).

[28] 83 Fed. Reg. at 54281.

VIII. Comment Regarding Whether an Aggregate Change in Ownership of Greater Than 25% of an S Corporation That Owns a Qualified Investment Should Be Treated as a Complete Disposition of the S Corporation's Qualified Investment

A. Background

The Proposed Regulations provide that a so-called "aggregate change in ownership" of an S corporation that owns a qualified investment is an inclusion event with respect to the S corporation's entire qualified investment (the "aggregate change in ownership rule").[29] If applicable, any remaining deferred gain in the S corporation's qualified investment is includible in the S corporation's gross income and neither the basis adjustments under section 1400Z-2(b)(2)(B)(iii) or (iv) or the -2(c) Step-up apply to the qualified investment after that date.[30] For this purpose, an aggregate change in ownership occurs "if, immediately after any change in ownership of the S corporation, the percentage of the stock of the S corporation owned directly by the shareholders who owned the S corporation at the time of its deferral election has decreased by more than 25 percent," measuring the ownership percentage of each shareholder separately and then aggregating all decreases.[31]

The Proposed Regulations provide examples of what may result in a decrease in ownership, including the sale of shares, redemption of shares, the issuances of new shares, or the occurrence of section 381(a) transactions.[32] The use of the terms "may" and "for example" indicate that this is not an exhaustive list of transactions that could cause a decrease in ownership.

The aggregate change in ownership rule is unique to S corporations owning qualified investments in QOFs. There is no analogous inclusion event for partnerships owning a qualified investment in a QOF. By contrast, in the case of partnerships owning a qualified investment, "the inclusion rules . . . apply to transactions involving any direct or indirect partner of the QOF to the extent of such partner's share of any eligible gain of the QOF."[33]

B. Recommendations

We recommend that the final regulations eliminate the aggregate change in ownership rule for S corporations from the list of inclusion events. If retained in the final regulations, an inclusion event should only apply if there is an aggregate change in ownership of more than 50 percent of the stock of an S corporation.

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[29] Prop. Reg. §§ 1.1400Z2(b)-1(c)(7)(i)(E), -1(c)(7)(iii)(A).

[30] Prop. Reg. §1.1400Z2(b)-1(c)(7)(iii)(A).

[31] Prop. Reg. §1.1400Z2(b)-1(c)(7)(iii)(B).

[32] Prop. Reg. §1.1400Z2(b)-1(c)(7)(iii)(B).

[33] Prop. Reg. §1.1400Z2(b)-1(c)(6)(i).

Furthermore, we recommend that the final regulations provide an exhaustive list of events that can cause a decrease in ownership for purposes of the aggregate change in ownership rule.

C. Explanation

We believe that the aggregate change in ownership rule should be eliminated. S corporations should not lose the benefits of section 1400Z-2, including the -2(c) Step-up, simply because of the disposition of shares by one or more shareholders. Neither partnerships nor C corporations are subject to the complete elimination of all tax benefits under section 1400Z-2 on account of a change in ownership.

The preamble to the May Notice of Proposed Rulemaking states that the purpose of the inclusion events is "to prevent taxpayers from 'cashing out' a qualifying investment in a QOF without including in gross income any amount of their deferred gain."[34] However, section 1377(a)(1) generally provides that the items of income of the S corporation are pro-rated among all shareholders on a per share, per day basis over the course of the taxable year. Section 1377(a)(2) provides that in certain circumstances where a shareholder's interest is terminated, the S corporation and the "affected shareholders" within the meaning of that section can agree to an interim closing of the books, resulting in the allocation of items of income among the shareholders based upon their ownership before and after the termination event. Unless the relevant persons unanimously elect to close the S corporation's books, the provisions of section 1377(a)(1) conflict with the stated objective of the aggregate change in ownership rule as the gain from the inclusion event will be allocated among all shareholders as of the end of the S corporation's taxable year and not just those who were shareholders who deferred gain under section 1400Z-2.

If the aggregate change in ownership rule is retained, we ask that the final regulations provide a clear definition of what can cause a decrease in ownership. The Proposed Regulations list four specific transactions without defining the types or classes of transactions that qualify as a change in ownership for purposes of this rule. For instance, it is unclear if gifts of shares of S corporation stock are considered transfers for purposes of the rule.

Moreover, if the aggregate change in ownership rule is retained, we believe that the threshold should be more than 50 percent. This would be consistent with other rules involving significant changes in the ownership of an S corporation that are treated as the equivalent of a new entity. For example, Treasury Regulation section 1.1362-5(a) provides that when more than 50 percent of the stock of a former S corporation has changed hands, the Secretary should generally allow the former S corporation to re-elect S corporation status earlier than the five-year moratorium on re-election under section 1362(g).

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[34] 84 Fed. Reg. at 18661.

IX. Comment Regarding Whether Substantial Improvement Requirement for Purchased Property May Be Satisfied in the Aggregate

A. Background

Among other requirements, in order for property to qualify as "qualified opportunity zone business property" within the meaning of section 1400Z-2(d)(2)(D), "the original use of such property commences with the qualified opportunity fund or the qualified opportunity fund substantially improves the property."[35] For this purpose,

> [P]roperty shall be treated as substantially improved by the qualified opportunity fund only if, during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the qualified opportunity fund exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the qualified opportunity fund.[36]

The statute does not provide any guidance on whether the term "such property" in the foregoing provisions can refer to aggregations of assets, or whether (or to what extent) identifiably separate assets must separately meet a substantial improvement test. In the preamble to the May Notice of Proposed Rulemaking, Treasury and the Service stated that under the Proposed Regulations, the determination of whether the substantial improvement requirement is satisfied for purchased tangible property is made on an asset-by-asset basis but requested comments on whether an aggregate approach might be more appropriate.[37]

B. Recommendation

We recommend that the final regulations adopt an aggregate approach to substantial improvement for both real estate and operating businesses where the facts and circumstances indicate assets are held by a single trade or business or are operated as an integrated unit.

C. Explanation

The statutory language requiring substantial improvement of "such property" is not defined in terms of whether it refers to the assets of a QOF or QOZB partnership in aggregate or each asset individually. Treasury has authority to interpret the term "such property", and we believe it is reasonable to interpret it to mean a collection of assets that form a business or an investment. To require an asset-by-asset approach may be impractical and may be contrary to business judgment. Allowing the aggregation of assets would still incentivize investors to bring much needed capital resources to QOZs, and by allowing investors or business owners seeking investment through QOFs, the aggregate approach encourages productive uses of that capital. We do not view an aggregate approach as facilitating abusive transactions provided that some limitation is imposed on the assets which may be aggregated together. Rather, an aggregate approach facilitates sound

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[35] I.R.C. § 1400Z-2(d)(2)(D)(i)(II).

[36] I.R.C. § 1400Z-2(d)(2)(D)(ii).

[37] 84 Fed. Reg. at 18655.

business decisions that still infuse as much new capital into a business or real estate investment as is spent acquiring assets that have already been used in the QOZ. The asset-by-asset approach could force businesses to spend more improving an asset that is not in need of improvement, leaving less capital available to devote to a related asset that would benefit from the additional capital.

We suggest that an aggregate approach be adopted within a single trade or business and with respect to real property that is situated on the same tract, contiguous tracts, or that is otherwise operated as an integrated unit. In our comments to the Proposed Regulations submitted on January 10, 2019, we recommended two safe harbors be adopted for aggregating assets and measuring whether the aggregate assets are substantially improved, as follows:

> First, assets that are on the same tract, or contiguous tracts, of a QOZ and which are purchased as part of the same investment decision should benefit from a safe harbor treating them as an aggregate asset for purposes of measuring substantial improvement. Assets purchased under a single contract from the same seller should benefit from a rebuttable presumption that such assets are part of the same investment decision. Other factors could include documentation of the investment decision by showing how the QOF has modeled the investment performance as a single investment and by showing board resolutions or other similar governance documents under which the investment is authorized.
>
> Second, a QOF should be able to aggregate assets on the same tract or contiguous tracts of a QOZ under an objective test, even in the absence of evidence regarding whether the assets are part of the same investment decision. We recommend that an appropriate test, in the context of real property, could be the one set forth under the Regulations to section 1250, which sets forth a test under which buildings may be aggregated and treated as a single item of section 1250 property. Under this test, structures may be aggregated if they are "operated as an integrated unit (as evidenced by their actual operation, management, financing, and accounting)." An identical test existed under former Regulations under section 167 and continues to be cited in private letter rulings regarding whether property, in the aggregate, is treated as residential or nonresidential. Permitting buildings to be aggregated under this same standard would serve the purpose of consistency in the Code in general as well as the legislative purposes of the QOF rules in particular.[38]

We are not of the view that all assets should be aggregated regardless of their relationship to each other. For example, a QOF should not be permitted to acquire two unrelated buildings, convert one into an expensive hotel and leave the second unrelated building in disrepair.

We also believe that QOFs and QOZB partnerships should be entitled to aggregate tangible personal property with real property, so long as both are connected to the same business or investment. For example, if a vacant factory building is purchased, and then machinery is promptly installed which costs more than the price of the purchased factory, such factory should be viewed

[38] ABA Tax Section, *Comments on the Proposed Regulations Regarding Investments in Qualified Opportunity Funds Under Section 1400Z-2* 42 (2019) available at: https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/011019comments.pdf.

as meeting the substantial improvement test. We note that the Proposed Regulations now determine "substantial improvement" as applied to purchased tangible personal property, by reference to adjusted basis. However, immediate expensing now applies to purchased used and new tangible personal property. Thus, adjusted basis of tangible personal property is, after applying Section 1016, zero. This has the practical effect of providing a windfall to QOFs and QOZB partnerships by almost eliminating any requirement of substantial improvement with respect to purchased used tangible personal property. Conversely, this has the practical effect of preventing QOFs and partnerships from taking their costs of any permissibly aggregated (as requested above) new purchased tangible property into account to achieve substantial rehabilitation. To more accurately reflect economic outlays, we suggest that, at least for used and new tangible personal property, a more realistic measure be used, such as original cost.

X. Comment Regarding Whether an Intended Investment in a QOF Should Be Treated as an Additional FIRPTA Withholding Tax Exemption

A. Background

The FIRPTA withholding rules provide that, in case of any disposition of a U.S. real property interest ("USRPI") within the meaning of section 897(c) by a non-U.S. person, the transferee (*e.g.*, the buyer) is generally required to act as a withholding agent and typically must withhold 15% of the amount realized on such disposition.[39] In addition, under section 897(a)(1), a non-U.S. person's gain or loss from the disposition of a USRPI is treated as effectively connected income with a U.S. trade or business ("ECI"). Thus, a non-U.S. person that is subject to tax under FIRPTA is required to file a Form 1120-F or a Form 1040NR.

Section 1445(b) and applicable regulations[40] provide several FIRPTA withholding exemptions, generally based on documentation provided by the seller to the transferee at or prior to the time of the disposition.[41] Additionally, either the transferor or the transferee may apply for a withholding certificate from the Service to reduce or eliminate withholding under section 1445, and the Service will act on such an application within 90 days of receipt.[42]

Nonetheless, if the selling non-U.S. person does not qualify for an exemption, the buyer's withholding obligation could create a cash flow constraint that adversely affects the non-U.S. person's ability to reinvest otherwise eligible capital gains in a QOF within the 180-day period required by section 1400Z-2(a)(1)(A). Similarly, the application process for withholding certificates issued by the Service could also create cash flow constraints given the 90-day review period. This waiting period could delay a transaction and limit the non-U.S. person's ability to reinvest in a QOF within the applicable 180-day period.

[39] I.R.C. § 1445(a).

[40] Reg. § 1.1445-1.

[41] I.R.C. § 1445(b).

[42] Reg. § 1.1445-3(a). The Service has authority to either grant or deny such applications for withholding certificates. *Id.*

In particular, 15% withholding on the amount realized with respect to a taxable disposition of a USPRI could have a materially adverse effect on investment of any gain from the disposition. We believe this to be contrary to the purpose of section 1400Z-2, which was intended to encourage economic investment in economically distressed areas.[43]

B. Recommendations

For these reasons, we recommend that the final regulations provide an additional FIRPTA withholding tax exemption for certain non-U.S. investors, to the extent that capital gain from a disposition of a USRPI is timely invested in a QOF in accordance with the requirements of section 1400Z-2.

Specifically, we recommend that the withholding tax exemption be available in the following conditions:

- On or shortly before the disposition of the USRPI, the non-U.S. investor provides the withholding agent with valid documentation certifying its intention to enter into a gain recognition agreement ("GRA") similar to that under section 367 and applicable regulations, which includes a statement certifying the non-U.S. investor's basis in the USRPI being disposed, as well as the amount of gain that will be invested in a QOF within the required 180-day period.

- The non-U.S. investor files such GRA along with a timely U.S. federal income tax return for the taxable year of the disposition of the USRPI.

- The non-U.S. investor files an annual statement with its U.S. federal income tax return, including the following information:

  (i) date of USRPI disposition;

  (ii) the amount realized, basis, and gain arising from the disposition of the USRPI (the "FIRPTA gain");

  (iii) the amount of FIRPTA gain invested or intended to be invested in a QOF (the "QOF investment");

  (iv) date the QOF investment was made (or statutory deadline for the QOF investment, if one has not already been made) and sufficient identification of the QOF investment, if known;

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[43] "The provision provides two main tax incentives to encourage investment in qualified opportunity zones." H.R. CONF. REP. NO. 115-466, at 538 (2017). These are the (i) temporary deferral of inclusion in gross income for capital gains that are reinvested in a QOF and (ii) exclusion from gross income of the post-acquisition capital gains on investment in QOFs that are held for at least ten years. We note that there is no indication in either the legislative history to Pub. L. No. 115-97 or the 2018 Blue Book that QOZ investment benefits should only be available to U.S. persons.

(v) a statement regarding continued ownership of the QOF investment (or, alternatively, the date of the non-U.S. investor's disposition of the QOF investment);

(vi) a statement regarding the amount of gain (if any) recognized on or before December 31, 2026, and the amount of U.S. federal income tax paid thereon; and

(vii) a statement certifying completion of all documentation and filings, as required under 1400Z et seq.

- The non-U.S. investor files a form similar to Form 8838 ("Consent to Extend the Time to Assess Tax Under section 367 – Gain Recognition Agreement"), agreeing to extend the period of limitations on assessment of tax with respect to the amount of deferred FIRPTA gain.

C. Explanation

We believe that an exemption from FIRPTA withholding under these circumstances is consistent with the overall policy objective to encourage investment in Qualified Opportunity Zone property, while ensuring transparency with respect to the extent of the benefit taken by non-U.S. persons and protecting U.S. revenue interests.

XI. Comments Regarding the Definition of a Trade or Business for QOZBs; Whether Additional Rules Are Needed in Determining If a Trade or Business Is Actively Conducted; and, Whether It Would Be Appropriate or Useful to Extend the Requirements of Section 1397C Applicable to QOZBs to QOFs.

A. Whether additional rules are needed in determining whether a QOZB is in the active conduct of a trade or business.

1. Background

Section 1400Z-2(d)(3)(A)(ii) incorporates section 1397C(b)(2), which requires at least 50% of the total gross income of a QOZB be derived from the *active conduct of a trade or business* within a QOZ.

While the definition of an "active conduct of a trade or business" remains reserved under Proposed Regulation section 1.1400Z2(d)-1(d)(5)(ii)(B), Proposed Regulation section 1.1400Z2(d)-1(d)(2)(ii) defines "trade or business" to mean a trade or business within the meaning of section 162. In addition, Proposed Regulation section 1.1400Z2(d)-1(d)(5)(ii)(B)(2) and (3) provide that solely for the purposes of section 1400Z–2(d)(3)(A), the ownership and operation (including leasing) of real property is the active conduct of a trade or business. However, merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business by such taxpayer. The term "trade or business" means a trade or business within the meaning of section 162.

2. Recommendation

We recommend that a QOZB should be treated as engaged in the active conduct of a trade or business if the QOZB is operating as a trade or business for purposes of section 162 and otherwise meets the QOZB requirements under section 1400Z-2(d)(3)(A), and further recommend that such term include special rules for start-up entities and portions of a business that meet the QOZB requirements. We also recommend that an entity may be treated as a QOZB for the duration of a QOF's investment if, at the time the QOF acquires its interest in the QOZB, the QOF does not have control over the QOZB and the QOF reasonably expects the entity will satisfy the requirements to be a QOZB.

3. Explanation

Section 162(a) permits a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business. Interestingly, section 162 does not define what a trade or business means. However, the Supreme Court in *Commissioner v. Groetzinger*,[44] provides some useful interpretation:

> Of course, not every income-producing and profit-making endeavor constitutes a trade or business. The income tax law, almost from the beginning, has distinguished between a business or trade, on the one hand, and "transactions entered into for profit but not connected with ... business or trade," on the other. See Revenue Act of 1916, §5(a) Fifth, 39 Stat. 759. Congress "distinguished the broad range of income or profit producing activities from those satisfying the narrow category of trade or business." Whipple v. Commissioner, 373 U.S. 193, 197 [11 AFTR2d 1454] (1963). We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

Consequently, we believe that if an entity meets the requirements of a QOZB as provided under section 1400Z-2(d)(3)(A) (excluding any businesses described in section 1400-Z 2(d)(3)(iii) referencing section 144(c)(6)(B)) with continuity and regularity and that its primary purpose for engaging in the activity is for income or profit, then it should be treated as engaged in the active conduct of a trade or business.[45].

Moreover, similar to the Proposed Regulations' expansion of the "active conduct of a trade or business" to include ownership and operation (including leasing) of real property, such definition

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[44] 480 U.S. 23, 35 (1987).

[45] The Preamble to the proposed regulations states, "However, these proposed regulations provide that the ownership and operation (including leasing) of real property used in a trade or business is treated as the active conduct of a trade or business for purposes of section 1400Z–2(d)(3). No inference should be drawn from the preceding sentence as to the meaning of the ''active conduct of a trade or business'' for purposes of other provisions of the Code, including section 355." See preamble to REG-120186-18, 84 Fed. Reg. 18652, 18689 (May 1, 2019. This Preamble language appears to signal that the section 355 active conduct standard may not be appropriate for opportunity zone businesses in all circumstances. Consequently, we relied more heavily on the NMTC regulations interpretation of the active conduct of a trade or business for qualified active low-income community businesses (QALICBs) which also incorporates the active conduct of a trade or business standard under section 1397C.

should encompass portions of a business and entities that are starting up to become actively conducted trades or businesses. The Code recognizes that startup businesses do require earlier stage investment, as the business is forming itself, and allows for the deduction of $5,000 of business startup costs under section 195. The remainder of such start-up costs are deducted ratably over the 180-month period beginning with the month in which an active trade or business begins. To be a start-up cost, the expenditure must have otherwise been deductible as an ordinary and necessary business expense under section 162. Just as the Proposed Regulations allow QOFs certain timing flexibility for reinvesting the return of capital from the sale or disposition of some of the QOF's QOZ business property,[46] there should likewise be an allowance for some start-up time before requiring the section 162 concept of a trade or business to apply to a newly forming business.

It is apparent from the statutory language defining QOZ business property, that start-up businesses were intended to qualify as QOZBs. Section 1400Z-2(d)(2)(B)(i)(II) relating to QOZ stock provides, "that at the time such interest was acquired, such corporation was a QOZB *(or, in the case of a new corporation, such corporation was being organized for purposes of being a QOZB…"* (Emphasis added). Similar language is found under section 1400Z-2(d)(2)(C)(i)(ii) relating to a QOZ partnership interest.

Consequently, we recommend that the Proposed Regulations adopt rules for start-up QOZBs and portions of a business that are similar to the rules relating to qualified active low-income community business under the new markets tax credit (NMTC) regulations (which also incorporate the active conduct of a trade or business definition of section 1397C).[47] Thus, for purposes of the opportunity zone provisions, an entity will be treated as engaged in the active conduct of a trade or business if, at the time the QOF acquires QOZ stock or a QOZ partnership interest, the QOF reasonably expects that the entity will generate revenues within three years after the date the acquisition.[48] Moreover, if a portion of an entity's business is treated as being located in a QOZ applying the QOZB requirements to that separate portion of the entity's trade or business, then that portion of the entity's business would qualify as a QOZB similar to the NMTC portions of a business rule. [49]

Finally, we recommend that that an entity may be treated as a QOZB for the duration of a QOF's investment, if at the time the QOF acquires its interest in the QOZB, the QOF does not have control over the QOZB and the QOF reasonably expects the entity will satisfy the QOZB requirements to be a QOZB. This is similar to the NMTC rules for investments in qualified census tracts.[50] Such treatment is consistent with the opportunity zone statutory framework that encourages and

[46] Prop. Reg. § 1.1400Z2(f)-1(b).

[47] I.R.C. § 45D(d)(3); Reg. § 1.45D-1(d)(4)(i)(A).

[48] Reg. § 1.45D-1(d)(4)(iv).

[49] Reg. § 1.45D-1(d)(4)(iii).

[50] Reg. § 1.45D-1(d)(6)(i), (ii).

incentivizes investors to remain invested in the QOF for at least 10 years, while providing investor confidence at the time the investment is made into the QOF. For purposes of a QOF interest in a QOZB, we suggest control means a more than 50% interest.

B. Whether it would be appropriate or useful to extend the requirements of section 1397C applicable to QOZBs to QOFs.

1. Background

Section 1400Z-2(d)(3)(A)(ii) provides that in order to meet the definition of a QOZB, the business must satisfy the requirements of paragraphs (2), (4), and (8) of section 1397C(b). Proposed Regulation section 1.1400Z-2(d)-1(d)(5) further clarifies that the operation of section 1397C requirements is incorporated by reference to provide the following:

Gross income requirement. Section 1400Z-2(d)(3)(A)(iii) incorporates section 1397C(b)(2), requiring that for each taxable year at least 50% of the gross income of a qualified opportunity zone business is derived from the active conduct of a trade or business in the qualified opportunity zone.

Use of intangible property requirement. Section 1400Z-2(d)(3) incorporates section 1397C(b)(4), requiring that, with respect to any taxable year, a substantial portion of the intangible property of an opportunity zone business is used in the active conduct of a trade or business in the qualified opportunity zone.

Nonqualified financial property limitation. Section 1400Z-2(d)(3) incorporates section 1397C(b)(8), limiting in each taxable year the average of the aggregate unadjusted bases of the property of a qualified opportunity zone business that may be attributable to nonqualified financial property. Section 1397C(e)(1), which defines the term nonqualified financial property for purposes of section 1397C(b)(8), excludes from that term reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less ("working capital assets").

The Proposed Regulations also provide a series of helpful safe harbors to determine if the 50% gross income requirement is met based on where the QOZB's tangible property and management, employees, and independent contractors are located. Even if the safe harbors cannot be met, the Proposed Regulations provide that a QOZB can meet the 50% of gross income test based on all the facts and circumstances.[51]

2. Recommendation

We do not believe that the section 1397C requirements should be extended to the QOF. Nonetheless, it would be helpful to allow QOFs a safe harbor similar to the 31-month working capital safe harbor for development of a trade or business in the qualified opportunity zone as well as acquisition construction, and/or substantial improvement of tangible property.

[51] *See* Prop. Reg. § 1.1400Z2(d)-1(d)(5)(A)-(D).

3. Explanation

The statutory scheme contemplates a QOF investing directly in QOZBP, or indirectly through a partnership or shareholder interest in a QOZB. For QOFs, the term QOZB means tangible property used in the trade or business of the QOF,[52] but there is no further reference to the QOZB requirements for QOFs under the opportunity zone provisions.

Both sets of Proposed Regulations have provided specific guidance regarding the application of the section 1397C provisions in the context of a QOZB. To require a QOF to follow these rules now would raise many additional structuring and technical issues including the type of qualifying assets (tangible or intangible), and potential nonqualified financial property limitations. It seems sufficient that a QOF be subject to the trade or business standard under section 162 (including our recommendations to provide a special rule for start-ups and portions of a business) to ensure that the QOF is operating and is using its QOZBP in a trade or business within a QOZ. Also, the 90% asset test provides similar protections as the nonqualified financial property limitation.

While acknowledging the different statutory requirement for QOFs and QOZBs, both entities encounter the same difficulties when acquiring QOZBP.[53] In particular, it would be helpful to allow QOFs to utilize a safe harbor similar to the 31-month the working capital safe harbor for development of a trade or business in the qualified opportunity zone as well as acquisition construction, and/or substantial improvement of tangible property. Treasury and the Service have authority to craft regulations to carry out the purposes of the statute, including "rules to ensure that a qualified opportunity fund has a reasonable period of time to reinvest" cash returns.[54] Treasury and the Service have already considered and applied analogous flexibility in the safe harbor for working capital, when crafting the QOF reinvestment rule to allow relief from application of the 90% asset test if failure to meet the 12-month deadline is attributable to delay in government action the application for which is complete.[55]

XII. Comments Regarding Definitions of "Substantially All"

A. Background

Section 1400Z-2(d)(2) includes multiple uses of the term "substantially all" for purposes of determining whether a QOF meets the 90% asset requirement of section 1400Z-2(d)(1). Section 1400Z-2(d)(2)(B)(i)(III) provides that in order to be qualified opportunity zone stock, "during substantially all of the QOF's holding period for such stock, such corporation qualified as a QOZB." Section 1400Z-2(d)(2)(C)(iii) similarly provides that in order to be a qualified

[52] I.R.C. § 1400Z-2(d)(2)(D)(i).

[53] Section 1400Z-2(d)(3) provides the definition of a QOZB. See below.

[54] Section 1400Z-2(e)(4)(B).

[55] See preamble to REG-120186-18, 84 Fed. Reg. 18652, 18660 (May 1, 2019).

opportunity zone partnership interest, "during substantially all of the QOF's holding period for such interest, such partnership qualified as a QOZB."

Section 1400Z-2(d)(2)(D)(i)(III) provides that in order for property to be QOZBP, "during substantially all of the QOF's holding period for such property, substantially all of the use of such property was in a QOZ."

Section 1400Z-2(d)(3) provides that a QOZB "means a trade or business in which substantially all of the tangible property owned or leased by the taxpayer is QOZBP (determined by substituting 'QOZB' for 'QOF' each place it appears in paragraph (2)(D)." The October Proposed Regulations provide that solely for purposes of this paragraph of the Code, the "substantially all" requirement is interpreted as a 70% threshold.[56]

The April Proposed Regulations similarly apply a 70% "substantially all" threshold for purposes of the requirement that substantially all of the *use* of property by a QOF (or by a QOZB) be in a QOZ.[57] In contrast, the April Proposed Regulations provide that for purposes of the uses of the phrase "substantially all" that relate to the *holding period* of the QOF in the QOZ stock or QOZ partnership interest and that relate to the *holding period* for the QOZBP (by the QOF or the QOZB), "substantially all" is interpreted as a 90% threshold.[58]

B. Recommendation

We recommend that the final regulations retain the percentage requirements as designated in the Proposed Regulations and include clarification and examples of the application of the 90% substantially all *holding period* threshold. We further recommend that the final regulations allow the interests of a corporation or partnership held by a QOF to be treated as QOZB interests during substantially all of the QOF's holding period where such partnership or corporation becomes a QOZB within 12 months of the QOF's acquisition of interests in it.

C. Explanation

Treasury's definitions of "substantially all" preserve the asset tests as meaningful requirements while allowing taxpayers the type of leniency that may be necessary to make investments in furtherance of the goals of the QOZ program.

It might seem clear that, for example, in the case of a ten-year holding period, 90% of that holding period would be nine years. However, in the context of annual asset tests, it is unclear how taxpayers may use that in structuring their QOZ projects. Taxpayers need clarity as to whether and how a QOF may own stock in a corporation or interests in a partnership that does not qualify as a QOZB for ten percent of its holding period (e.g., one year in the case of a ten-year holding

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[56] Prop. Reg. § 1.1400Z2(d)-1(d)(3)(i).

[57] Prop. Reg. § 1.1400Z2(d)-1(d)(6).

[58] Prop. Reg. § 1.1400Z2(d)-1(d)(5).

period), and whether and how a corporation or partnership may still qualify as a QOF or QOZB if it does not meet the "substantially all of the use" (70%) test during one year of a ten-year holding period for an asset.

For example, assume QOF was formed on January 1, year 1 and is a partnership that owns 99% of the partnership interests of QOZB, formed on the same date. QOZB has established a new chain of restaurants all within QOZs. Early in year 10, QOZB adds several new restaurant locations that are not in QOZs, and as a result, effective March 1, year 10, QOZB no longer meets the 70% substantially all of the tangible property test of section 1400Z-2(d)(3). Can the QOZB partnership interests be treated as QOZ property for QOF if QOF sells its interests in QOZB early in January or February of year 11?

As another illustration, assume the following. QOF was formed on January 1, year 1 and is a partnership that owns 70% of the partnership interests of QOZB, formed on the same date. Land owner owns 30% of the partnership interests of QOZB, which it received in exchange for its contribution of a raw land that it has owned since prior to 2018 and which QOZB will substantially improve by converting it to multi-unit residential rental property. The unimproved land cannot be QOZ property, because it was not acquired by purchase. However, ultimately the newly constructed building likely can be treated as QOZ property if self-constructed property is treated as acquired by purchase.[59] QOZB's construction costs will exceed 70%, but such expenditures will not exceed 70% until January 1, year 2. Although QOZB may meet the working capital safe harbor, it does not have any tangible assets that can be treated as not failing to meet the requirements of section 1400Z-2(d)(2)(D)(i) (because its only tangible asset was not acquired by purchase.) QOF plans to own its QOZB partnership interests and QOZB plans to own and operate the property until at least year 11. It is not until the end of year 10 that QOF appears to have met the 90% of the holding period test. Because asset tests are calculated on an annual basis, for years 1 through 10, the percent of the holding period in which QOZB meets the 70% substantially all of the tangible property test of section 1400Z-2(d)(3) is as follows: year 1, 0%, year 2, 50%, year 3, 66.66%, year 4, 75%, year 5, 80%, year 6, 83.33%, year 7, 85.71%, year 8, 87.5%, year 9, 88.89%, year 10, 90%. Accordingly, QOF would owe penalties with respect to years 1 through 9. Until year 10, i.e., in years 1 through 9, section 1400Z-2(d)(2)(C)(iii) would disqualify the partnership from being a qualified opportunity zone business.

The application of the holding period test as a percentage of the total holding period of the QOZB interest by the QOF for purposes of an annual asset test subjects the QOF in the second example above to penalties despite what appears to be a project that is consistent with the legislative intent of sections 1400Z-1 and 1400Z-2. In contrast, it appears to allow the QOF in the first example to add ineligible assets toward the end of the QOF's holding period, with a potential to exclude gain

[59] In our comment letter dated January 10, 2019, we recommended treatment of self-constructed property as meeting the acquired by purchase requirement even if it is constructed on land acquired by contribution. *See* ABA Comment Letter to Treasury and the Service on Proposed Regulations Regarding Investments in Qualified Opportunity Funds Under Section 1400Z-2, at 36-37.

on those ineligible assets on disposition, despite the potential for abuse by acquiring non QOZB assets in anticipation of a disposition.

In contrast, interpreting the substantially all holding period requirement to allow an initial grace period for a partnership or corporation owned by a QOF to become a QOZB would provide QOZ investors a reasonable grace period to construct or acquire original use assets where the entity may initially need to acquire tangible assets that will not meet the acquired-by-purchase requirement. Such a grace period would facilitate new investment into a QOZ without forcing current owners of property within a QOZ to sell the property outright in order to see that development happen.

Section 1298(b)(2) allows corporations a start-up period of up to two years if the corporation will not be a passive foreign investment company after the start-up period. Although section 1400Z-2 does not designate a start-up period, its use of the term "substantially all" acknowledges that a partnership or corporation may not be able to qualify as a QOZB at all times while held by a QOF, and allowing a start-up period or grace period is a practical and useful way to foster use of the QOZ program in a manner that is consistent with its intent.

XIII. Comments Regarding Penalties

A. Guidance Regarding Reasonable Cause in the Context of Section 1400Z-2(f)

1. Background

Section 1400Z-2(f)(3) provides that "no penalty shall be imposed under this subsection with respect to any failure if it is shown that such failure is due to reasonable cause."

"Reasonable cause" is used elsewhere in the Code and defined in regulations. For example, section 6651 provides a penalty exception for a failure to file a tax return or pay tax where the failure is "due to reasonable cause and not due to willful neglect". Treasury clarified that reasonable cause requires "a satisfactory showing that [the taxpayer] exercised ordinary business care and prudence in providing for the payment of [the taxpayer's] tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship … if [the taxpayer] paid on the due date."[60]

Section 856 treats a real estate investment trust that fails to satisfy certain income tests due to reasonable cause and not willful neglect as having met those requirements if it files a schedule disclosing such failure. The regulations look to the real estate investment trust's "ordinary business care and prudence."[61]

Section 6724(a) provides that "no penalty shall be imposed under this part with respect to any failure if it is shown that such failure is due to reasonable cause and not to willful neglect." The regulations elaborate that reasonable cause for failure to comply with required information reporting exists if there are "significant mitigating factors with respect to the failure", "the failure

[60] Reg. § 301.6651-1(c)(1).

[61] Reg. § 1.856-7(c)(1).

was caused events beyond the filer's control", and the filer must have "acted in a responsible manner" before and after the failure.[62]

2. Recommendation

We recommend that the final regulations provide guidance as to the circumstances that may be treated as reasonable cause in the context of section 1400Z-2, providing that events that are beyond the control of the QOF or QOZB constitute reasonable cause.

3. Explanation

Although some parallels may be drawn to the definitions of reasonable cause elsewhere in the Code, because of the complexities of section 1400Z-2, it would be helpful to have guidance specific to section 1400Z-2. Certain potential pitfalls are of particular concern to taxpayers investing in QOZs that may deter investment.

For example, a QOF that invests in a partnership or corporation that strives to meet the working capital safe harbor may encounter a delay other than due to a delay in government action. Although its working capital may still be good working capital under section 1397C outside the safe harbor, the tangible property no longer has the benefit of the safe harbor for property on which working capital is being expended under Proposed Regulation section 1.1400Z2(d)-1(d)(5)(vii). That QOF may then be treated as failing to meet the 90% Asset Test.

A second example where a QOF may seek to make qualifying investments but could inadvertently fail to include the QOF or QOZB's reliance on representations of a seller that property has been vacant for an uninterrupted period of at least five years, but it is later discovered that the property was not vacant for the entirety of the five-year period. Unless a QOF or QOZB is actually permitted to rely on a certificate of vacancy (similar to a certificate of non-foreign status under section 1445[63]), the QOF may fail to meet the 90% Asset Test as a result.

Events beyond the control of a QOF or QOZB cannot be avoided with ordinary business care and prudence. The treatment of events beyond the control of the QOF or QOZB that cause a QOF to fail to meet the 90% Asset Test as constituting reasonable cause would provide reassurance to potential QOZ investors that they will not inadvertently find their QOZ investment subject to penalties despite their good faith best efforts to comply.

[62] Reg. § 301.6724-1(a)(2).

[63] Reg.§ 1.1445-2 allows a transferor to rely on a certification of non-foreign status from a transferee of a U.S. real property interest in determining whether the transferor must withhold under section 1445. A certificate of vacancy could serve a similar purpose of permitting reliance buy a QOF or QOZB purchaser.

XIV. Whether Anti-Abuse Rules under Section 1400Z-2(e)(4)(C), in Addition to the General Anti-Abuse Rule, Are Needed to Prevent Such Transactions or "Land-Banking" by QOFs or Qualified Opportunity Zone Businesses, and on Possible Approaches to Prevent Such Abuse.

A. Background

The preamble to the Proposed Regulations states:

> Under section 1400Z-2(d)(2)(D)(i)(II) and these proposed regulations, land can be treated as qualified opportunity zone business property for purposes of section 1400Z-2 only if it is used in a trade or business of a QOF or qualified opportunity zone business. As described in part III.D. of this Explanation of Provisions, only activities giving rise to a trade or business within the meaning of section 162 may qualify as a trade or business for purposes of section 1400Z-2; the holding of land for investment does not give rise to a trade or business and such land could not be qualified opportunity zone business property. . . .
>
> [t]he Treasury Department and the IRS recognize that, in certain instances, the treatment of unimproved land as qualified opportunity zone business property could lead to tax results that are inconsistent with the purposes of section 1400Z-2. For example, a QOF's acquisition of a parcel of land currently utilized entirely by a business for the production of an agricultural crop, whether active or fallow at that time, potentially could be treated as qualified opportunity zone business property without the QOF investing any new capital investment in, or increasing any economic activity or output of, that parcel. In such instances, the Treasury Department and the IRS have determined that the purposes of section 1400Z-2 would not be realized, and therefore the tax incentives otherwise provided under section 1400Z-2 should not be available. If a significant purpose for acquiring such unimproved land was to achieve that inappropriate tax result, the general anti-abuse rule set forth in proposed §1.1400Z2(f)-1(c) (and described further in part X of this Explanation of Provisions) would apply to treat the acquisition of the unimproved land as an acquisition of non-qualifying property for section 1400Z-2 purposes.

A. Recommendation

Proposed Regulation section 1.1400Z2(f)-1(c) adequately deals with the concern that the treatment of unimproved land as qualified opportunity zone business property could lead to tax results that are inconsistent with the purpose of section 1400Z-2 by utilizing a "significant purpose test" to determine inappropriate investment activity. In addition, the requirement that land can only be treated as qualified opportunity zone business property for purposes of section 1400Z-2 if it is used in a trade or business of a QOF or in a qualified opportunity zone business implements the requirement that land be put to some productive use.

B. Explanation

The example given in the explanation of the provisions is inappropriate. In many states many of the population census tracts designated as a low-income community are in rural areas with no real prospects for economic development other than through farming or ranching. Certainly, some manufacturing jobs might be created in qualified opportunity zones in rural areas, but from an investor's standpoint, money spent on single purpose buildings in rural areas for a specific manufacturing company generally will not generate an upside in the investment. In fact, most special purposes manufacturing facilities in rural areas are very difficult to sell and usually bring less than the original construction costs.

Farming and ranching activities will, in virtually every case, create new capital investment in the land and improvements and will provide jobs and economic activity for the low-income community.

Perhaps a better example of "land banking" is the purchase of a tract of land for use as an unimproved gravel parking lot with nothing more. The operation of the parking lot will meet the trade or business test but, under the "significant purpose" test, if the QOF cannot establish a purpose other than an investment purpose, the Service can recast the transaction. This example could be juxtaposed to an example where a QOF acquires through a QOZB a tract of land to be used for a parking lot for the benefit of a to-be-built multi-story commercial office building which, under the city's zoning ordinance, must have a parking facility to support the tenants of the office building.

XV. Comments Regarding Whether a Rule Analogous to the QOF Reinvestment Rule Should Apply to QOF Subsidiaries That Reinvest Proceeds from the Disposition of Qualified Opportunity Zone Business Property

A. Background

1. QOF Reinvestment Rule

Generally, a QOF is required to hold at least 90% of its assets in QOZP, generally measured by the average of percentages on the last day of the first six-month period of the taxable year of the QOF and the last day of the taxable year of the QOF.[64] Section 1400Z-2(e)(4)(B) provides that the Secretary shall prescribe regulations to ensure a QOF has a reasonable period of time to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests, and to reinvest proceeds received from the sale or disposition of QOZP.

The April Proposed Regulations provide that if a QOF receives proceeds from the return of capital or the sale or disposition of some or all of its QOZP opportunity zone property by the last day of the 12-month period beginning on the date of the distribution, sale, or disposition, then the proceeds, to the extent that they are so reinvested, are treated as QOZP for purposes of the 90% asset test, but only to the extent that prior to the reinvestment in QOZP the proceeds are continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less.[65] The April Proposed Regulations further provide that if reinvestment of the proceeds is delayed by waiting for governmental action the application for which is complete, that delay does not cause a failure of the 12-month requirement.[66] The preamble to the April Proposed Regulations clarifies that a QOF may reinvest proceeds from the sale of an investment into another type of qualifying

[64] I.R.C. § 1400Z-2(d)(1).

[65] Prop. Reg. § 1.1400Z2(f)-1(b).

[66] *Id.*

investment. For example, a QOF may reinvest proceeds from a sale of an investment in qualified opportunity stock into qualified opportunity zone business property.

The preamble to the April Proposed Regulations explains that the QOF reinvestment rule is intended to allow a QOF adequate time in which to reinvest proceeds from QOZP. For example, if a QOF, shortly before a testing date, sells QOZP, that QOF should have a reasonable amount of time in which to bring itself into compliance with the 90% asset test.

2. QOF Subsidiaries

Interests in QOF subsidiaries can qualify as QOZP for purposes of satisfying the 90% asset test.[67] Among other requirements, the QOF subsidiary generally must qualify as a qualified opportunity zone business, which requires that substantially all of the tangible property owned or leased by the QOF subsidiary must be qualified opportunity zone business property.[68] The October Proposed Regulations specify that "substantially all" in this context means 70%.[69]

B. Recommendation

We recommend that the final regulations provide a rule analogous to the QOF reinvestment rule for QOF subsidiaries that reinvest proceeds from the disposition of qualified opportunity zone business property.

C. Explanation

The same considerations that support the QOF reinvestment rule support having an analogous rule applicable to QOF subsidiaries. Both QOFs and QOF subsidiaries are subject to similar asset composition tests. In the case of a QOF, the QOF reinvestment rule allows the QOF a reasonable time to reinvest the proceeds from the sale or disposition of QOZP while remaining in compliance with the 90% asset test. In the case of a QOF subsidiary, it would be helpful to have a similar rule that allows a QOF subsidiary a reasonable time to reinvest the proceeds from the sale or disposition of qualified opportunity zone business property while remaining in compliance with the 70% asset test. In both cases the rationale is the same—that the QOF or QOF subsidiary should not be considered to fail its applicable asset test solely because it moves its funds from one qualifying investment to another within a reasonable time period.

Second, the QOF reinvestment rule will not achieve its intended purpose if is limited solely to investments that the QOF makes directly. Typically, a QOF will be organized in a two-tier structure where the QOF serves as a holding company for ownership interests in one or more QOF subsidiaries that it does not intend to sell. Those QOF subsidiaries are the owners of qualified opportunity zone business property, and the QOF subsidiaries will be the ones that make any sales of that property and reinvest proceeds. For example, if a QOF owns an interest in a QOF subsidiary

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[67] I.R.C. § 1400Z-2(d)(2).

[68] I.R.C. § 1400Z-2(d)(3)(A)(i).

[69] Prop. Reg. § 1.1400Z2(d)-1(d)(3).

that operates a business from inside a qualified opportunity zone and owns delivery trucks that qualify as qualified opportunity zone business property, the QOF subsidiary, and not the QOF, will be the party that makes any sales of the trucks and reinvests the proceeds. Accordingly, the QOF reinvestment rule will not reach many of the sales and reinvestments to which it was intended to apply unless extended to sales and reinvestments of QOF subsidiaries.

Therefore, we recommend that the final regulations provide a rule analogous to the QOF reinvestment rule for QOF subsidiaries.

XVI. Comments on the Eligibility for, and the Operational Mechanics of, the Proposed Rules Regarding the Special Ability of QOF REITs to Pay Tax-Free Capital Gain Dividends to Ten-Plus-Year Investors

A. Background

The Proposed Regulations authorize QOF real estate investment trusts ("QOF REITs") to designate special capital gain dividends, not to exceed the QOF REIT's long-term gains on sales of QOZ property. The shareholder may apply a zero percent tax rate to such designated capital gain dividends.

The Proposed Regulations require that a QOF REIT provide a notice to its shareholder not later than one week after the QOF REIT designates the capital gain dividend.

B. Recommendation

We recommend that the final regulations provide that a QOF REIT shareholder may exclude a designated capital gain dividend from gross income instead of permitting the shareholder to apply a zero percent tax rate to such dividend.

For greater clarity and flexibility with respect to the time by which a QOF REIT must provide notice to its shareholders, we recommend that the final regulations revise the notice time period as follows: ". . . a date that the QOF REIT designates in a notice provided to the shareholder not later than *ten business day*s after the QOF REIT designates the capital gain dividend . . ."

C. Explanation

The general approach of the QOF program is to permit the complete exclusion from taxable income (via a basis step-up) of gain realized on an investment in a QOF that is held for at least ten years. This is very different than the zero percent tax rate approach proposed for QOF REIT capital gain dividends ("Proposed Approach"), which has significant negative consequences for taxpayers.

Complete exclusion means that the income is not reported on the taxpayer's return at all. The Proposed Approach, in contrast, will result in the QOF REIT's designated capital gain dividends being reported on the taxpayer's return, which could, notwithstanding the zero percent rate applicable to such dividends, (i) push the taxpayer into a higher marginal income tax bracket, (ii) subject the taxpayer to the net investment income tax, and (iii) result in phase-outs of various tax benefits that phase out as a taxpayer's income reaches certain thresholds.

The Proposed Approach would also make it more difficult for the benefit of QOF REIT capital gain designations to carry over for state income tax purposes in states that conform to federal income tax law with respect to the QOF program. The income tax laws of most states conform to federal income tax law without further action by the state such that benefits of the QOF program generally carry over for state income tax purposes. A majority of states with individual income taxes use federal adjusted gross income as their starting point for calculating individual income tax liability. Several states begin with federal taxable income. Most states with corporate income taxes use federal taxable income (often with some state specific adjustments) as the starting point for calculating corporate income tax liability. The benefit of the zero federal income tax rate will not carry over to these states because the approach used in the Proposed Regulations of applying a zero percent federal income tax rate generally will leave the dividends in taxable income for state income tax purposes. Thus, a significant benefit of the QOF program, the carryover of the program benefits for state income tax purposes, is lost because of the failure to implement the QOF REIT designated capital gain dividends as an exclusion from gross income.

The time requirements applicable for notice provisions in the Code are frequently stated in terms of "business days." Use of a "week" as a notice period can result in a very short time period for implementation when intervening weekends are taken into account. Accordingly, using a notice period of "ten business days" would better conform to typical federal income tax law notice provisions and provide greater flexibility to a QOF REIT to implement compliance without adversely affecting the objective of assuring prompt dissemination of notice to the QOF REIT's shareholders.

XVII. Comment Regarding the Length of the Vacancy Period Prior to Purchase by a QOF or QOZB

A. Background

The Proposed Regulations provide that, if a building or other structure has been vacant for at least five years prior to being purchased by a QOF or a qualified opportunity zone business, the purchased building or structure will satisfy the original use requirement.

The preamble to the Proposed Regulations requests comments on this provision, including the length of the vacancy period and how such standard might be administered and enforced.

B. Recommendation

We believe that the vacancy period should be defined as either: (i) two years vacant or (ii) five years where the building has less than 25% of rentable square footage rented and/or occupied.

This will encourage investment in the community and the vacancy and/or occupancy thresholds can be certified to by the investor.

C. Explanation

An uninterrupted five-year vacancy period is too long for most businesses and does not consider that many buildings may be underutilized even if not completely vacant. Note many derelict buildings have either low-paying tenants to ensure pipes are not bursting, or to generate some income to pay property taxes, or these buildings have squatters, who are trespassing and not paying rent, but a municipality or state may recognize their occupancy. As a result, a five-year period will deter investments in the communities because buildings may not meet the requirement to be "vacant" and studies show that the longer a property is vacant, the more a community suffers a significant negative impact (e.g. high crime and low property values).

XVIII. Comments Regarding the Time Period for Investment of Section 1231 Gain in a QOF

A. Background

Under section 1400Z-2(a)(1)(A), QOZ tax benefits are conditioned on the investment of capital gain from a sale or exchange of any property into a QOF "during the 180-day period beginning on the date of such sale or exchange" (the "180-Day Period"). A taxpayer that is allocated a distributive share of capital gain through a partnership interest may determine its 180-Day Period, at such taxpayer's option, by treating such period as commencing either (1) on the date the partnership recognizes the capital gain under the Elective Rule or (2) at the end of the partnership's taxable year under the General Rule.[70]

Capital gains, in general, are recognized in connection with the sale or exchange of assets by reference to section 1221. Gains from the sale or exchange of section 1231 property likewise is treated as capital gain; however, section 1231(a)(1) limits the amount of a taxpayer's section 1231 gain by netting against such gain for the taxable year the taxpayer's non-recaptured net section 1231 losses (the "1231 Netting Rule"). Those amounts consist of ordinary section 1231 losses in the five most recent preceding taxable years.[71] Thus, if a taxpayer has $100 of ordinary section 1231 losses in year 1, and $150 of section 1231 gain in year 2, only $50 of the year 2 gain is capital gain. Partners in a partnership with a distributive share of section 1231 gain compute their net section 1231 gain at the partner level.[72]

With respect to deferring capital gain recognized under section 1231, Proposed Regulation section 1.1400Z2(a)-1(b)(2)(iii) provides the following rule with respect to commencement of the 180-Day Period (the "Year-End Commencement Rule"):

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[70] Prop. Reg. § 1.1400Z2(a)-1(c)(2)(iii).

[71] *See generally* I.R.C. § 1231(c).

[72] I.R.C. § 702(a)(3).

> The only gain arising from section 1231 property that is eligible for deferral under section 1400Z-2(a)(1) is capital gain net income for a taxable year. This net amount is determined by taking into account the capital gains and losses for a taxable year on all of the taxpayer's section 1231 property. The 180-day period described in [Proposed Regulation section 1.1400Z2(a)-1(b)(4)] with respect to any capital gain net income from section 1231 property for a taxable year begins on the last day of the taxable year.[73]

The preamble to the Proposed Regulations, as relates to section 1231, provides (emphasis provided):

> In addition, the preamble [to the October Proposed Regulations] stated that some capital gains are the result of Federal tax rules deeming an amount to be a gain from the sale or exchange of a capital asset, and, in many cases, *the statutory language providing capital gain treatment does not provide a specific date for the deemed sale*. Thus, [the October Proposed Regulations] addressed this issue by providing that, except as specifically provided in the proposed regulations, the first day of the 180-day period set forth in section 1400Z–2(a)(1)(A) and the regulations thereunder is the date on which the gain would be recognized for Federal income tax purposes, without regard to the deferral available under section 1400Z–2. Consistent with [the October Proposed Regulations] and *because the capital gain income from section 1231 property is determinable only as of the last day of the taxable year*, these proposed regulations provide that the 180-day period for investing such capital gain income from section 1231 property in a QOF begins on the last day of the taxable year.[74]

B. Recommendation

We recommend aligning the 180-Day Period for investing section 1231 gains with the rules governing the investment of non-section 1231 capital gain allocable by a partnership to a partner, so that, in the case of a taxpayer's direct and indirect (e.g., through a partnership) recognition of section 1231 gains, the taxpayer may elect to commence its 180-Day Period using either (i) the Year-End Commencement Rule or (ii) a rule equivalent to the Elective Rule under which the 180-Day Period commences on the date of the actual sale or exchange. Alternatively, if the Year-End Commencement Rule generally remains in place, we recommend a grandfathering exception whereby a taxpayer that recognized a section 1231 gain in a taxable year ending on or before December 31, 2019 may use either the Year-End Commencement Rule or a rule equivalent to the Elective Rule.

C. Explanation

The preamble, as relates to section 1231 gains, suggests section 1231 lacks a rule for determining the specific date on which a transaction giving rise to section 1231 gain occurs.[75] The preamble

[73] Prop. Reg. § 1.1400Z2(a)–1(b)(2)(iii).

[74] *See* preamble to REG-120186-18.

[75] *Id.* Compare section 1259 which provides that the date of a constructive sale is the date on which the taxpayer entered into the transaction giving rise to the constructive sale. We note that specifying the date of a constructive sale has limited relevance to a calendar year taxpayer because the gain would be included for the taxable year of the sale. Instead, the relevance of specifying an actual date in the context of section 1259 appears to achieve the practical goal

subsequently asserts that section 1231 gain is determinable "only as of the last day of the taxable year."[76] Presumably, this conclusion is premised on the 1231 Netting Rule. However, consistent with section 1231 in general, section 1231(a) does not compel a date on which to determine whether a taxpayer has a net section 1231 gain. While section 1231(a)(1) references "taxable year" as the measurement period for determining the existence of net section 1231 gain, and using a year-by-year determination is administratively simple, such reference to taxable year does not preclude a taxpayer from determining its section 1231 gain during the taxable year if sufficient information is available. Such a taxpayer may then make necessary adjustments, if any, when additional information is available. Thus, the Year-End Commencement Rule is not clearly required by section 1231. Rather, a taxpayer should be able to determine its section 1231 gain as information is available for QOF investment purposes. Notably, because a taxpayer makes the gain deferral election on Form 8949 and attaches that form to its tax return, it is likely that by the time the election form is due sufficient information will be available to accurately determine the amount of section 1231 gain. If a taxpayer using a rule equivalent to the Elective Rule for a section 1231 gain later determines it has "over-invested" in a QOF (due, for example, to an unanticipated section 1231 loss allocated to the taxpayer by a partnership), then the taxpayer necessarily will be subject to the rules relating to mixed funds because it will have invested more than its net gain amount as reported on its tax return for the year.

Disallowing the use of a rule equivalent to the Elective Rule for a taxpayer recognizing a section 1231 gain will lead to results inconsistent with the QOZ rules. For example, a taxpayer may sell substantially all of its business assets consisting of self-created goodwill and a building on February 28, 2019, giving rise to a section 1221 capital gain and a section 1231 gain, all of which is capital gain after application of sections 1231(a)(1) and 1231(c). Since the taxpayer has a single business, it is in a position to know its total capital gain for the year and should be able to commence its 180-Day Period as of February 28, 2019. Pursuant to a plain reading of section 1400Z-2(a)(1)(A), the taxpayer has 180 days as of the date it recognizes capital gain to invest in a QOF. Here, the taxpayer has recognized the gain on February 28, 2019, but the Proposed Regulations turn off (and delay) the 180-Day Period. Because section 1400Z-2 makes no distinction between section 1231 gain and non-section 1231 capital gain, the Proposed Regulations appear to have crafted a rule that is inconsistent with the plain language under section 1400Z-2.[77]

We recognize that partners in partnerships determine their section 1231 gain by netting their gains and losses as separately stated items.[78] This observation, however, does not justify the Year-End Commencement Rule. While the presence of separately stated items may suggest that a partner should wait until the end of its taxable year to net those items, we note that separately stated items are a function of certain gains and losses impacting each partner differently, hence the need to

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of identifying the date of sale in order to use the market price of the underlying security subject to the constructive sale.

[76] *See* preamble to REG–120186–18, 84 Fed. Reg. 18652, 18659 (May 1, 2019).

[77] If the Year-End Commencement Rule were to remain for section 1231 gains, the taxpayer in this example would face the odd situation of having two separate 180-Day Periods arising from a single sale transaction – one commencing on February 28, 2019 with respect to the sale of the goodwill and another commencing December 31, 2019 with respect to the sale of the building.

[78] I.R.C. § 702(a)(3).

separately state them. Notably, capital gains under section 1221 are also separately stated items,[79] and the Proposed Regulations allow taxpayers the flexibility to use either the Elective Rule or the General Rule for such gains. Taking advantage of such flexibility is presumably premised on the partner receiving information from the partnership to make such determination. This information should be just as readily available for section 1231 gains.

Alternatively, if the Proposed Regulation's Year-End Commencement Rule remains in effect, a taxpayer who invested, or will invest, a section 1231 gain arising from a disposition of section 1231 property in a taxable year ending on or before December 31, 2019 should be grandfathered from the Year-End Commencement Rule and permitted to make a qualifying investment of such gain based on a rule equivalent to the Elective Rule. A grandfathering approach is a fair rule given that such taxpayers made, or will make, investments consistent with the language of section 1400Z-2(a)(1)(A), under which the 180-Day Period commences on the date of such sale or exchange.[80]

XIX. Treasury Request for Comments on All Aspects of the Proposed Treatment of Leased Tangible Property

A. Background

1. Uncertain issues prior to issuance of second set of regulations

Prior to Treasury's issuance of its second round of Proposed Regulations on April 17, 2019,[81] there was considerable uncertainty about how leased tangible property would be treated under section 1400Z-2. First, the definition of QOZBP stipulated, among other elements, that QOZBP was tangible property "acquired by the qualified opportunity fund by *purchase* (as defined in section 179(d)(2)) after December 31, 2017…"[82] The cross-reference to section 179(d)(2) further indicated that the purchased property must not be acquired from "a person whose relationship to the person acquiring it would result in the disallowance of losses under section 267 or 707(b)."[83] Meanwhile, section 1400Z-2(e)(2) provides that, for purposes of that section 1400Z-2, "related person" has the definition set forth in sections 267(b) and 707(b)(1) but substitutes 20% in place of 50% each place it occurs in section 267(b) or section 707(b)(1).

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[79] I.R.C. § 702(a)(1), (2).

[80] Absent such a grandfathering rule, (1) a calendar year taxpayer that in good faith (and before December 31, 2018) invested section 1231 gain from a 2018 sale or exchange will be denied QOF tax benefits and (2) a calendar-year taxpayer that recognizes a section 1231 gain in 2019 must re-invest that gain on December 31, 2019 (*i.e.*, and coincidentally, 12/31) in order to qualify for the full basis step-up benefit under section 1400Z-2(b)(2)(B)(iv) for QOF investments held at least seven years.

[81] REG-120186-18, 84 Fed. Reg. 18652 (May 1, 2019).

[82] I.R.C. § 1400Z-2(d)(2)(D)(i) (emphasis added).

[83] I.R.C. § 179(d)(2)(A).

Although there were drafting glitches in the statute that made the exact application of the related party rules of section 179(d)(2) somewhat uncertain, the concern was that tangible property would be QOZBP only if it was *purchased* from an *unrelated party* as determined by *substituting 20% for 50%* in sections 267(b) and 707(b)(1)).

An even greater concern was that leased tangible property appeared to be a "bad asset" for purposes of the 90% asset test under section 1400Z-2(d)(1) and for purposes of the "substantially all" requirement under section 1400Z-2(d)(3)(A)(i) [84] (the 90% asset test and the "substantially all" requirements are sometimes referred to herein as the "Two Tests"). The term "substantially all" for purposes of the latter test was defined in the first set of Proposed Regulations as meaning 70% or more, but the first guidance left unanswered two key issues: 1) whether leased tangible property was included only in the denominator of the percentage calculations (the numerator appeared to be limited to QOZBP, which, by definition, seemed to require tangible property acquired by "purchase" rather than by lease), and 2) how leased tangible property should be valued for purposes of implementing these percentage calculations under the Two Tests.

2. Treasury guidance in second set of Proposed Regulations on leased tangible property

Treasury and the Service in the second set of Proposed Regulations provided a number of favorable rules and interpretations with respect to the treatment of leased tangible property under section 1400Z-2. Treasury and the Service, in turn, have asked for broad comments on all aspects of the treatment of leased tangible property. For this reason, it is appropriate to quote the entirety of the preamble on this subject:

> The purposes of sections 1400Z-1 and 1400Z-2 are to increase business activity and economic investment in qualified opportunity zones. As a proxy for evaluating increases in business activity and economic investment in a qualified opportunity zone, these sections of the Code generally measure increases in tangible business property used in that qualified opportunity zone. The general approach of the statute in evaluating the achievement of those purposes inform the proposed regulations' treatment of tangible property that is leased rather than owned. The Treasury Department and the IRS also recognize that not treating leased property as qualified opportunity zone business property may have an unintended consequence of excluding investments on tribal lands designated as qualified opportunity zones because tribal governments occupy Federal trust lands and these lands are, more often than not, leased for economic development purposes.
>
> Given the purpose of sections 1400Z-1 and 1400Z-2 to facilitate increased business activity and economic investment in qualified opportunity zones, these proposed regulations would provide greater parity among diverse types of business models. If a taxpayer uses tangible property located in a qualified opportunity zone in its business, the benefits of such use on the qualified opportunity zone's economy would not generally be expected to vary greatly depending on

[84] This latter provision requires that, in order for a trade or business to qualify as a "qualified opportunity zone business," such business must (among other elements) be one in which "substantially all" of the tangible property owned or leased by the taxpayer is QOZBP.

whether the business pays cash for the property, borrows in order to purchase the property, or leases the property. Not recognizing that benefits can accrue to a qualified opportunity zone regardless of the manner in which a QOF or qualified opportunity zone business acquires rights to use tangible property in the qualified opportunity zone could result in preferences solely based on whether businesses choose to own or lease tangible property, an anomalous result inconsistent with the purpose of sections 1400Z-1 and 1400Z-2.

Accordingly, leased tangible property meeting certain criteria may be treated as qualified opportunity zone business property for purposes of satisfying the 90-percent asset test under section 1400Z-2(d)(1) and the substantially all requirement under section 1400Z-2(d)(3)(A)(i). The following two general criteria must be satisfied. First, analogous to owned tangible property, leased tangible property must be acquired under a lease entered into after December 31, 2017. Second, as with owned tangible property, substantially all of the use of the leased tangible property must be in a qualified opportunity zone during substantially all of the period for which the business leases the property.

These proposed regulations, however, do not impose an original use requirement with respect to leased tangible property for, among others, the following reasons. Unlike owned tangible property, in most circumstances, leased tangible property held by a lessee cannot be placed in service for depreciation or amortization purposes because the lessee does not own such tangible property for Federal income tax purposes. In addition, in many instances, leased tangible property may have been previously leased to other lessees or previously used in the qualified opportunity zone. Furthermore, taxpayers generally do not have a basis in leased property that can be depreciated, again, because they are not the owner of such property for Federal income tax purposes. Therefore, the proposed regulations do not impose a requirement for a lessee to "substantially improve" leased tangible property within the meaning of section 1400Z-2(d)(2)(D)(ii).

Unlike tangible property that is purchased by a QOF or qualified opportunity zone business, the proposed regulations do not require leased tangible property to be acquired from a lessor that is unrelated (within the meaning of section 1400Z-2(e)(2)) to the QOF or qualified opportunity zone business that is the lessee under the lease. However, in order to maintain greater parity between decisions to lease or own tangible property, while also limiting abuse, the proposed regulations provide one limitation as an alternative to imposing a related person rule or a substantial improvement rule and two further limitations that apply when the lessor and lessee are related.

First, the proposed regulations require in all cases, that the lease under which a QOF or qualified opportunity zone business acquires rights with respect to any leased tangible property must be a "market rate lease." For this purpose, whether a lease is market rate (that is, whether the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity zone) is determined under the regulations under section 482. This limitation operates to ensure that all of the terms of the lease are market rate.

Second, if the lessor and lessee are related, the proposed regulations do not permit leased tangible property to be treated as qualified opportunity zone business property if, in connection with the lease, a QOF or qualified opportunity zone business at any time makes a prepayment to the lessor (or a person related to the lessor within the meaning of section 1400Z-2(e)(2)) relating to a period of use of the leased tangible property that exceeds 12 months. This requirement operates to prevent inappropriate allocations of investment capital to prepayments of rent, as well as other payments exchanged for the use of the leased property.

Third, also applicable when the lessor and lessee are related, the proposed regulations do not permit leased tangible personal property to be treated as qualified opportunity zone business property unless the lessee becomes the owner of tangible property that is qualified opportunity zone business property and that has a value not less than the value of the leased personal property. This acquisition of this property must occur during a period that begins on the date that the lessee receives possession of the property under the lease and ends on the earlier of the last day of the lease or the end of the 30-month period beginning on the date that the lessee receives possession of the property under the lease. There must be substantial overlap of zone(s) in which the owner of the property so acquired uses it and the zone(s) in which that person uses the leased property.

Finally, the proposed regulations include an anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement for purchases of real property (other than unimproved land). In the case of real property (other than unimproved land) that is leased by a QOF, if, at the time the lease is entered into, there was a plan, intent, or expectation for the real property to be purchased by the QOF for an amount of consideration other than the fair market value of the real property determined at the time of the purchase without regard to any prior lease payments, the leased real property is not qualified opportunity zone business property at any time.[85]

i. Treasury Request for Comments

The Treasury Department and the IRS request comments on all aspects of the proposed treatment of leased tangible property. In particular, a determination under section 482 of whether the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity zone takes into account the simultaneous combination of all terms of the lease, including rent, term, possibility of extension, presence of an option to purchase the leased asset, and (if there is such an option) the terms of purchase. Comments are requested on whether taxpayers and the IRS may encounter undue burden or difficulty in determining whether a lease is market rate. If so, how should the final regulations reduce that burden? For example, should the final regulations describe one or more conditions whose presence would create a presumption that a lease is (or is not) a market rate lease? Comments are also requested on whether the limitations intended to prevent abusive situations through the use of leased property are appropriate, or whether modifications are warranted.[86]

B. Recommendations

1. We agree with and endorse Treasury's general interpretation that leased tangible property meeting certain criteria should be treated as QOZBP for purposes of satisfying the 90% asset test under section 1400Z-2(d)(1) and the substantially all requirement under section 1400Z-2(d)(3)(A)(i).

[85] 84 Fed. Reg. 18652, 18656-57.

[86] *Id.* at 18657.

2. We also agree with and endorse Treasury's conclusion that leases of tangible property between related parties may be treated as QOZBP so long as certain additional standards and safeguards are met.

3. We recommend that Treasury and the Service adopt the proposed position that leases between related parties be evaluated under the arm's-length standards of section 482.

4. We believe that the two additional requirements proposed by Treasury and the Service with respect to related party leases – that prepayment of rent not exceed 12 months and that, in the case of tangible personal property, the lessee must purchase within 30 months an amount of tangible personal property equal to the value of the leased tangible property for use in the applicable QOZ – are reasonable and beneficial in promoting the objectives of the legislation.

5. However, we further recommend that, in the case of leases of tangible property between unrelated parties (using the 20% standard for testing related party status under section 1400Z-2(e)(2)), such leases should not be tested under section 482 standards, and instead should be given a presumption of meeting the standard of market rate lease unless either there is clear evidence that the lease structure is intentionally abusive in its structure or there is evidence that the parties, though unrelated, do not have adverse interests or otherwise are not negotiating in good faith to protect and pursue their respective interests.

6. We also agree with and endorse the proposed alternative methodologies for valuing leased tangible property for purposes of the Two Tests.

C. Explanation.

The critically important determination made by Treasury and the Service is that leased tangible property can qualify as QOZBP provided that certain requirements are met, including 1) the lease is entered into after December 31, 2017, 2) the leased tangible property is used in a trade or business of the QOF, 3) during substantially all the QOF's holding period for the tangible property, substantially all of the use of the tangible property is in a QOZ, and 4) the lease must be a market rate lease. Additional requirements are imposed if the lease of tangible property is between related parties.

We strongly endorse this overall scheme proposed by Treasury, including Treasury's determination not to impose an original use requirement for leased tangible property. We specifically endorse the determination to apply the rules to all leases entered into after December 31, 2017, and to apply the "substantially all/substantially all" requirement to the use of leased tangible property.

We also endorse the general concept of a market rate lease, requirement, but with the following further observations and suggestions. Proposed Regulation section 1.1400Z2(d)-1(c)(4)(i)(B)(2) provides that, with respect to all leases of tangible property to a QOF (whether such lease is between related or unrelated parties), in order for such leased tangible property to meet the definition of QOZBP, the lease must, *inter alia*, meet the following requirement:

> (2) **Arms-length terms**. The terms of the lease were market rate (that is, the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity

zone as determined under section 482 and the regulations thereunder) at the time that the lease was entered into…

We note at the outset that section 482 by its terms applies to transactions between related parties[87] and we think that if a lease of tangible property is entered into between a QOF and an unrelated party[88] that in fact no arm's-length analysis is required – and certainly not under section 482. The terms of a lease (or other business transaction) between truly unrelated parties does not need to be tested any further as to whether it is arm's-length, because section 482 itself inherently assumes, in the very definition of the arm's-length standard, that the self-interest of each respective party to a transaction will result in an appropriate financial arrangement.[89]

Treasury and the Service have no obvious reason to impose a special arm's-length standard on the financial terms and conditions of a lease transaction between unrelated[90] parties with respect to tangible property, because the parties themselves have self-interest as an incentive to arrive at economically appropriate terms. True arm's-length lease terms may well vary from "standard" or "average" market terms and conditions, because markets are varied and diverse, and it seems likely to be more discouraging to flexible market business arrangements if the regulations seek to impose any specific set or combination of standard terms and conditions on the marketplace for this important purpose. As Treasury and the Service recognized in the context of acquisitions of

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[87] The first sentence of I.R.C. § 482, which applies to tangible property, reads as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The second sentence of I.R.C. § 482 addresses intangible property and is not relevant to the provisions of the Proposed Regulation which specifically address leases of tangible property.

[88] We assume that "related person" test should be within the meaning of I.R.C. § 1400Z-2(e)(2).

[89] Reg. § 1.482-1(a)(1) states in relevant part: "The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer."

Reg. § 1.482-1(b)(1) states in relevant part: "In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's-length result)."

[90] We believe that for purposes of distinguishing "related" and "unrelated" persons, Treasury and the Service should consider whether any application of section 482 under these regulations should be based on a 20% rather than a 50% test.

undeveloped land, there are a myriad of arrangements that can and do have bona fide purposes, and imposing overly detailed and stringent regulations would be counter-productive.[91]

Rather, we propose that the regulations treat lease transactions between unrelated parties (using the standard of 20% for determining whether parties are related) as having a presumption that such relationships are market rate leases, subject to rebuttal if either there is clear evidence that the lease structure is intentionally abusive (including if structured solely for tax-motivated reasons) or there is evidence that the parties, though unrelated, do not have adverse interests or otherwise are not negotiating in good faith to protect and pursue their respective interests. Section 482 itself recognizes that unrelated parties have every incentive to engage in arms-length transactions, and therefore the regulations should not try to second guess market forces unless there is a strong and compelling reason to do so.

On the other hand, we recognize and concur that careful scrutiny should be given to a lease of tangible property between related parties in the context of treating such property as QOZBP. However, the standards that determine whether a lease transaction is a bona fide lease should be addressed by the voluminous tax authority[92] applicable to determining whether a lease is a capital lease (*i.e.*, the financing of a sale of property) versus a true lease, and should not analyzed for this purpose solely (or even predominantly) under section 482.

Determining whether a nominal lease transaction should be characterized as a lease or a sale can be critical in determining whether the tangible property should be treated as QOZBP.[93] We recognize a legitimate concern that related parties could structure a lease to be unreasonably favorable to a QOF or QOZB, with the intention of transferring extra value from the lessor to the lessee (or vice versa). This type of non-market arrangement goes to the very heart and purpose of section 482, and seems to be an appropriate area in which to apply its principles. In the context of leasing, contract terms that might (or might not) be subject to abuse could include below-market or above-market rents, unusual rent holidays, tenant build-out allowances, reversion of tenant improvements to a related landlord under section 109, and similar arrangements. In general, related-party leases should be treated in the same manner as all related-party transactions – namely, subject to scrutiny by the Treasury and the Service under the broad and well-defined principles of section 482. We do not believe the regulations need to

[91] The preamble to the April Regulations, in addressing unimproved land, states as follows:

> Moreover, land is a crucial business asset for numerous types of operating trades or businesses aside from real estate development, and the degree to which it is necessary or useful for taxpayers seeking to grow their businesses to improve the land that their businesses depend on will vary greatly by region, industry, and particular business. In many cases, regulations that imposed a requirement on all types of trades or businesses to substantially improve (within the meaning of section 1400Z-2(d)(2)(D)(i)(II) and (d)(2)(D)(ii)) land that is used by them may encourage noneconomic, tax-motivated business decisions, or otherwise effectively prevent many businesses from benefitting under the opportunity zone provisions. Such rules also would inject a significant degree of additional complexity into these proposed regulations.

[92] *See supra* note 6.

[93] We note that so long as the lease transaction is entered into after December 31, 2017, and the other criteria are met, it will not matter whether a transaction between unrelated parties is a lease of tangible property or a sale of tangible property.

provide any additional restrictions or guidance other than simply affirming the applicability of section 482 to related-party leasing arrangements.

We note that the regulations do impose two additional requirements for related party leases. First, there is a prohibition on a substantial pre-payment of rent (more than 12 months or rent paid in advance) and this is identified as being for the purpose of assuring that capital contributed to a QOF or QOZB should be used for capital expenditures rather than mere pre-payment of operating expenses. We recognize this as an appropriate rationale for the proposed policy. The second limitation is that where tangible personal property is leased from a related party, then the lessee must also purchase and place in service within 30 months an amount of tangible personal property that equals the value of the leased property. This mimics in some respects the requirements that apply with respect to substantial improvement to purchased tangible property, and again comes within the policy prerogatives of Treasury and the Service to encourage the purchase and use of new tangible property in QOZs. We do not think either of these two requirements will place undue burdens on the implementation of projects in QOZs.

Although section 482 is appropriate to test certain economic terms of leases, we note that there is also other authority providing highly developed standards to determine whether a leasing transaction is a lease or a sale, including both case law and detailed guidance from the Service.[94] Persons active in the real estate industry or the equipment leasing industry are intimately familiar with the tax rules and limitations applicable to leasing arrangements, and it does not seem necessary – or beneficial – to add significant additional complexity to an area that already has a long-established framework for understanding and analyzing transactions.

For these reasons, we recommend that Treasury and the Service modify the Proposed Regulations to make it clear that section 482 will apply to related party leases for the traditional purpose of assuring that such transaction will clearly reflect income. The scope of section 482 is well understood, and parties can take appropriate steps – including seeking valuation and other opinions – to document that lease terms are consistent with a market rate lease.

On the other hand, we recommend that section 482 should not apply to leases between unrelated parties (using a 20% standard for related party status, consistent with section 1400Z-2(e)(2), and instead the Proposed Regulations should be modified such that unrelated party leases are given a presumption of being market rate leases unless there is clear evidence that the lease structure is intentionally abusive (including if it is structured solely for tax-motivated reasons) or there is evidence that the parties, though unrelated, do not have adverse interests or otherwise are not negotiating in good faith to protect and pursue their respective interests.

Finally, Treasury and the Service should expressly note and recognize that traditional guidance applicable to leasing transactions should also be incorporated into determining the federal tax consequences of a leasing structure within the context of section 1400Z-2. In particular, the guidance provided by Revenue Procedure 2001-28 and the extensive case law interpreting

[94] Rev. Proc. 2001-28, 2001-1 C.B. 1156, provides detailed guidance on the Service's ruling position on whether a transaction should be characterized as a lease or a sale for federal income tax purposes.

economic substance and bona fide leasing arrangements will provide a more-than-adequate framework for determining whether leasing relationships should be respected.