5 Times Square
New York, NY

Tel: +1 212 773 3000
ey.com

Internal Revenue Service
CC:PA:LPD:PR (REG-120186-18))
Room 5203
PO Box 7604
Ben Franklin Station
Washington, DC 20044

July 1, 2019

Re: request for amended and/or transitional guidance for investments in qualifying opportunity zones ("QOZs") under Section 1400Z-2 due to unintended collateral consequences (REG-120186-18)

I. Background and Summary of Issues

Ernst & Young LLP ("**EY**" or "we") submits this comment letter in response to the second set of proposed regulations issued on April 17, 2019[1] (the "**Proposed Regulations 2**") under Section[2] 1400Z-2 to request additional guidance and transitional relief on behalf of our client, a financial institution. Our client is a calendar-year taxpayer that is a member of a group of corporations that file a consolidated return for US federal income tax purposes. In accordance with the time limits imposed by the QOZ regime, near the end of 2018 our client invested its eligible capital gains into a corporate qualified opportunity fund ("**QOF**") that would be part of its affiliated group in the absence of certain provisions of Proposed Regulations 2.

While we appreciate the generally taxpayer-favorable guidance provided in both the first set of Proposed Regulations issued on October 19, 2018 ("Proposed Regulations 1") and Proposed Regulations 2, we believe that some unintended and potentially disruptive consequences may result from the release of Proposed Regulations 2. The most recently released regulations are especially challenging for corporate groups that have already reorganized their internal structures to comply with Proposed Regulation 1 and the consolidated return rules as they stood as of December 31, 2018, and that now potentially find themselves out of compliance. Outlined in more detail below are recommendations for revised and/or additional guidance to be issued under Section

[1] REG-120186-18 (April 17, 2019).

[2] Except as otherwise expressly provided, all references herein: to "Section" or "§," are to Sections of the Internal Revenue Code of 1986, as amended (the "Code"); to "Regulations," are to US Treasury regulations promulgated thereunder; to "Treas. Reg. §," are to Sections of the Regulations; and to the "IRS" or the "Service," are to the Internal Revenue Service. Except as otherwise expressly provided, all statements should be implicitly qualified by the phrase "for US federal income tax purposes."

EY
Building a better working world
5 Times Square
New York, NY
Tel: +1 212 773 3000
ey.com

1400Z-2. Specifically, our recommendations focus on retroactive and prospective adjustments that may be made to provide for: i) a valid QOF self-certification on Form 8996 for corporate QOFs that meet the requirements to be members of an affiliated group of corporations that have elected to file a consolidated return under Section 1502; and ii) transition rules to allow for corporate QOFs to convert to partnerships without accelerating gain recognition in the event that Proposed Regulations 2 cause distortive taxable income results; or iii) a new set of rules that allow corporate QOFs to remain members of consolidated federal income tax return filing group, but incorporate appropriate adjustments to allow the QOZ regime to function as intended.

We believe amended and/or transitional guidance in these areas would not only encourage continuing taxpayer interest and investment in QOZs, but would also be in keeping with Treasury and the Internal Revenue Service's ("**IRS's**") express desire to reassure taxpayers that they may proceed confidently under a unique regime with significant uncertainty and time-limited benefits.[3]

II. Overview of Applicable QOZ Tax Law and Select Related Guidance

The Tax Cuts and Jobs Act of 2017 ("**TCJA**")[4] introduced Sections 1400Z-1 and -2, which were designed to incentivize taxpayers to invest capital gains into economically distressed communities designated as QOZs through QOFs, which are investment vehicles organized as corporations or partnerships. Receiving any QOZ tax benefits begins with investing capital gain into a QOF. The capital gain must arise from a sale or exchange with an unrelated party that occurred within the previous 180 days. Investing in QOFs gives rise to both tax deferral and exemption opportunities, as summarized below:

- **Deferral**: Upon investment of capital gain into a QOF, the invested gain is deferred from inclusion in the taxpayer's gross income until the earlier of the taxpayer selling the QOF investment, December 31, 2026, or an "inclusion event."[5]

[3] To encourage taxpayers to begin investing in QOFs, the Preambles to Proposed Regulations 1 and 2 provide that taxpayers may generally rely, pursuant to Section 7805(b)(2), on the proposed regulations prior to their finalization..

[4] House-Senate Conference Report for H.R. 1, the "Tax Cuts and Jobs Act."

[5] An "inclusion event" generally arises from a taxpayer's transfer of an investment in a QOF in a transaction that either reduces the taxpayer's equity interest in the QOF or, unless an exception applies, involves the receipt of property (e.g., cash, securities, assets other than stock) in a transaction treated as a distribution for US federal income tax purposes, even if the distribution does not result in the reduction of the taxpayer's ownership of the QOF. Proposed Regulations 2 define such events to include, *inter alia*, liquidations that are taxable under Section 331 and those that are eligible for nonrecognition under Section 332.

- **Reduction (partial exemption)**: When the deferral period expires, if the QOF investment was held for five or more years, the gain included in gross income is reduced by 10 percent; if the investment was held for seven or more years, the gain included in gross income is reduced by 15 percent.
- **Exclusion (full exemption)**: When the taxpayer eventually exits the QOF, if the QOF investment was held for ten or more years, the taxpayer is permanently exempt from paying capital gains tax on gain realized from the sale of the QOF investment (or, in some cases, the sale of the QOF's assets).

a. Certifying a QOF

QOFs must be self-certified and hold at least 90 percent of their assets in QOZ property, calculated by averaging the percentage invested at the midpoint and endpoint of the QOF's fiscal year. Section 1400Z-2(e)(4) allows Treasury to prescribe regulations for the certification of QOFs. Proposed Regulations 1 generally permit any taxpayer that is a corporation or partnership for tax purposes to self-certify as a QOF as long as the entity meets relevant statutory requirements. Proposed Regulations 1 permit the IRS to determine the time, form, and manner of the self-certification through forms and instructions and/or related guidance. Form 8996, QOF, is the designated form for initial self-certification and for annual reporting of compliance with the 90-Percent asset test. Form 8996 is to be attached to taxpayers' timely filed federal income tax return for the applicable tax year, including extensions.

b. Consolidated Return Rules for QOFs

Special rules apply to corporate QOFs that are members of an affiliated group of corporations filing a consolidated federal income tax return. Among other rules, Proposed Regulations 2 specify that a QOF corporation owned by members of a consolidated group is not a member of that consolidated group and cannot file as part of the consolidated tax return. Rather, the QOF corporation must file a stand-alone Form 1120, US Corporation Income Tax Return.

c. Weight of Proposed Regulations

Currently, the only regulatory guidance available to implement the QOZ regime are Proposed Regulations 1 and 2. Proposed regulations are not accorded the same weight as final or even temporary regulations, which have the same weight as final regulations for a designated period. Proposed regulations do not have full force and legal effect

unless and until they are adopted as final regulations. Prior to adoption, proposed regulations may be withdrawn or modified at any time. Taxpayers generally may not rely on proposed regulations for planning purposes, except if there are no applicable final or temporary regulations in force and there is an express statement in the preamble to the proposed regulations that taxpayers may rely on them currently. Proposed Regulations 1 and 2 provide for such reliance as long as taxpayers apply the proposed regulations consistently and in their entirety. If there are applicable final or temporary regulations in force, taxpayers may only rely on proposed regulations for planning purposes in the limited circumstance that the preamble to the proposed regulations contains an express statement permitting taxpayers to rely on them currently, notwithstanding the existence of the final or temporary regulations.[6] While there are no final regulations directly applicable to the QOZ regime, there are final regulations in the consolidated return regime that overlap, and potentially conflict, with portions of the QOZ regime.

III. Recommendations

a. Retroactive Changes

It is recommended that Proposed Regulations 2 be amended to allow newly required stand-alone QOF corporate filers to have valid self-certifications on Form 8996 by filing Form 8996 after the due date of their 2018 return.

Many taxpayers that invested in a QOF corporation in 2018 ("**QOF Taxpayers**"), are currently unable to have valid, certified QOFs in spite of being fully compliant with section 1400Z-2 and Proposed Regulations 1, which were released in 2018. This is because the ability for a QOF to have a valid self-certification on Form 8996 is directly tied to meeting the statutory deadline for filing a federal income tax return. Some QOF Taxpayers' consolidated tax return filing groups duly filed extensions for the 2018 calendar year by April 15, 2019, the due date for an originally filed domestic corporate return.[7] These QOF Taxpayers have a QOF that qualified as a member of the affiliated group of corporations filing a consolidated return under Section 1504; accordingly, no separate extension was required to be done by the QOF corporation to extend its time for filing beyond the original due date.

---

[6] Articulation of the weight of proposed regulations, as excerpted from the Internal Revenue Manual ("**IRM**"), the official compilation of internal guidelines for IRS personnel: https://www.irs.gov/irm/part32/irm_32-001-001#idm139647505373120

[7] Section 6072.

Building a better
working world

5 Times Square
New York, NY

Tel: +1 212 773 3000
ey.com

Pursuant to currently Proposed Regulations 2, which were not released until April 17, 2019 (after the due date for filing a corporate extension for a calendar-year domestic C corporation), it is not possible for the QOFs established by the QOF Taxpayers described above to file a federal income tax return by the due date. This is because, as stand-alone filers that did not file extensions by April 15th,[8] the QOF corporations would be forced to consider the original due date of April 15th as the date by which they are bound to file in order to be considered to have filed timely. In other words, the extended due date available to most taxpayers would not be an option to the corporate QOF with respect to making a valid self-certification under the QOZ regime. Even if late, the QOF corporation would still be required to file an income tax return, and the tax consequences to the QOF Taxpayers would be late filing and payment penalties on any tax that was due as of April 15th. The failed QOF certification would also have a domino effect in that there could be no valid gain deferral election if the QOF Taxpayers do not have a valid QOF into which to invest as a starting point.

In the absence of abuse, there is little basis for deconsolidating the QOF corporation under the applicable statutes for the QOZ regime.[9] Further, deconsolidating the QOF corporation is in direct contravention of existing tax law applicable to the affiliated group consolidation regime, including statutes and final regulations applicable to affiliated groups that file consolidated returns.[10] Under these rules, once a parent corporation makes an election to file on a consolidated basis, all subsidiaries that meet the applicable ownership requirements must also join in the filing by providing their consent. The regime is not truly elective on a member-by-member basis within the group. If a newly formed or acquired subsidiary opts not to join, the consequence is that all members must file a separate return. Accordingly, a corporate taxpayer group may not have some members included in the filing while some remain out. A recent private letter ruling ("**PLR**") addressed the mandatory nature of the regime in the context of newly joining members.[11]

---

[8] Section 6081 and Treas. Reg. §1.6081-1.

[9] Section 1400Z-2 grants Treasury specific authority to draft regulations under the QOZ regime to address a list of designated issues. Under Section 1400Z-2(e)(4), the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including-
(A) rules for the certification of qualified opportunity funds for the purposes of this section,
(B) rules to ensure a qualified opportunity fund 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 qualified opportunity zone property, and
(C) rules to prevent abuse.

[10] Sections 1501, 1504(a)(1) and (2); Treas. Reg. §1.1502-75(a) and (b).

[11] At issue in PLR 201726015 (April 5, 2017) is a subsidiary not joining in the filing of an existing federal consolidated return group despite being in the chain of ownership and meeting the requisite ownership levels. In particular, note the following statement: "The Taxpayer states that 'at the time of the preparation of the relevant

EY
Building a better working world
5 Times Square
New York, NY
Tel: +1 212 773 3000
ey.com

In addition to the technical reasons for including a corporate QOF in the filing of a consolidated return, there are also economic reasons for not deconsolidating a corporate QOF. Deconsolidation likely would cause distortion in the overall corporate group's taxable income due to potentially trapped losses in some members that are no longer able to be offset against the taxable income of other members. Preventing such distortion is one of the primary advantages of the consolidated return regime.[12]

QOF Taxpayers find themselves in the challenging position of balancing two sets of conflicting regulations, Proposed Regulations 2 and existing final regulations in the consolidated return regime. Because the consolidated return regulations are final, a position that is inconsistent with those regulation may be considered a position contrary to rule or regulation. Thus, under these circumstances, it is anticipated that QOF Taxpayers may need to rely on the final consolidated return regulations to the extent they conflict with Proposed Regulations 2. The consolidated return regulations would view a taxpayer's corporate QOF as a member of an affiliated group filing a consolidated income tax return.

For the technical and economic reasons discussed above, corporate QOFs that were members of consolidated return filing groups for the 2018 tax year generally will be compelled to participate in the 2018 consolidated return filing of the group. It is recommended that such corporate QOFs' self-certifications on Form 8996 be viewed as valid whether or not the final version of Proposed Regulations 2 ultimately requires the deconsolidation of a corporate QOF. In the event of deconsolidation, it is also recommended that cross-references be included to and from the consolidated return statute and regulations to alert taxpayers to the non-member status of corporate QOFs.

b. Prospective Changes

It is further recommended that Proposed Regulations 2 be amended either to (i) incorporate transition rules that would enable newly deconsolidated QOFs to convert to partnerships without triggering an inclusion event; or (ii) develop a set of QOF-specific adjustments required for QOF corporations that are members of consolidated federal income tax return filing groups.

Date 2 U.S. federal income tax returns Accounting Firm 1 [the return preparer] mistakenly believed that the inclusion of Sub 1 in the Consolidated Return was voluntary, not mandatory."

[12] Treas. Reg. §1.1502=11(a).

5 Times Square
New York, NY

Tel: +1 212 773 3000
ey.com

Assuming corporate QOFs are designated as non-members of consolidated return filing groups in the final version of Proposed Regulations 2, some form of transition rules may be necessary to enable QOF Taxpayers to adjust to a non-distortive tax structure post-2018. As discussed above, it is generally not advisable for a corporate group to have its members file on a stand-alone basis as this approach is likely to lead to excessive taxable income in some members and stranded losses in others. This problem could be avoided to a large extent by converting the deconsolidated corporate QOF into a partnership. While partnerships are not eligible members of a consolidated return filing group, the partners into which their income and loss flow may be. By having a corporate QOF convert into a partnership, economic distortion may be avoided to the extent that the partnership's income and losses flow into corporate members of a consolidated group. One significant downside of converting a corporate QOF into a partnership, however, would be the administrative cost and burden associated with filing an additional federal income tax return for the partnership, Form 1065, US Return of Partnership Income, and related Schedules K-1.

Conversions introduce additional administrative and potentially legal consequences. A conversion may be more or less complicated depending on whether the corporate member is a limited liability company ("**LLC**") or "per se" corporation such as an "Inc." For instance, it may be possible for an LLC to file a retroactive entity classification election change for tax purposes only under various pieces of relief guidance available to taxpayers. In contrast, a per se corporation such as an "Inc." would first need to legally convert to an LLC or partnership; a retroactive election pre-dating the date of formation of the new type of legal entity would not be an option in this case. Accordingly, the recommended transition guidance should not require a corporate QOF to have converted to a partnership effective January 1, 2019.

Any transition guidance around the conversion discussed above also would need to consider the negating effect of an inclusion event. The acceleration of deferred gain that results from an inclusion event is a concern because of the events that are deemed to occur in the process of converting. When an entity taxable as a corporation converts to a partnership, it is treated as if the corporation distributed all of its assets and liabilities to its shareholders in liquidation of the corporation, with the shareholders contributing all of the distributed assets and liabilities to a newly formed partnership immediately thereafter.[13] When a member of a consolidated corporate group liquidates into its domestic parent, such liquidation is generally accorded nonrecognition treatment under

[13] Treas. Reg. §301.7701-3(g)(1)(ii).

EY
Building a better working world
5 Times Square
New York, NY
Tel: +1 212 773 3000
ey.com

Section 332. Pursuant to Proposed Regulations 2, liquidations under Section 332 would give rise to an inclusion event that results in the immediate taxation of gain that was originally earmarked for deferral, a cornerstone benefit of the QOZ regime.[14] Any transition guidance would need to provide a mechanism for allowing these types of conversions to be "nonevents" for QOZ purposes for some designated period.

As an alternative to the above recommendations, Treasury may continue to permit corporate QOFs to be members of consolidated return filing groups. Adjustments to Proposed Regulations 2 may be made to fully coordinate the QOZ regime and its intended purpose with the consolidated return regulations. Although the consolidated return regulations as a whole are voluminous, the specific sections that potentially would require special considerations for QOF corporations are limited to Treas. Reg. Secs. 1.1502-13 (intercompany transactions, 1.1502-19 (excess loss accounts), and 1.1502–32 (investment adjustments). These regulations may be amended to avoid the creation of negative basis and potential duplication of losses that could be the unintended result of certain consolidated return regime scenarios. As a back-stop, the government could also put taxpayers on notice that it has the authority to challenge inappropriate application of the rules under the authority granted by Section 1400Z-2(e)(4).

IV. Conclusion

To alleviate the burdens of certain unintended consequences, we have made various recommendations for revisions to Proposed Regulations 2 throughout this letter. In summary, we respectfully request that QOF Taxpayers be allowed a curative mechanism to allow for valid QOF self-certifications on Form 8996 for corporate QOFs newly deconsolidated by Proposed Regulations 2. In addition, we urge Treasury to draft transition period guidance regarding entity classification choice for QOF Taxpayers that committed potentially large sums of capital into the QOZ regime in the time-limited manner required. Most QOF Taxpayers endeavored to proceed in a manner consistent with available guidance at the time they decided to participate in the QOZ program. This type of relief would prevent the government from penalizing QOF Taxpayers who acted in good faith by complying with the rules applicable at the time of their QOF formation. It should be noted that, if Treasury elects to pursue the entity classification choice route, the transition period guidance would need to temporarily turn off the

[14] Pursuing a liquidation through an alternative set of steps (e.g., having another corporate member of the group come in as an owner of the corporate QOF prior to liquidating) would not avoid this issue as liquidations covered by Section 331 are also considered inclusion events.

"inclusion event" triggers of a Section 332 or 331 liquidation, which is what would be required to convert a QOF corporation into a partnership in a manner that is not disruptive to the operation of the QOZ regime.

Alternatively, we encourage Treasury to reconsider its hesitancy around making the adjustments necessary to allow the consolidated return regime to function as intended in conjunction with the QOZ regime. It should be emphasized that there is nothing objectionable about having a corporate QOF for the following reasons: (i) corporations are specifically permitted as designated QOF vehicle under the statute; (ii) there was nothing to suggest that deconsolidation would occur in the case of a corporate QOF in the statute or Proposed Regulations 1; and (iii) establishing a corporation that is a member of a consolidated group is administratively easier and more cost-efficient when considering the fact that a separate return would not need to be filed.