TAX SECTION
State Bar of Texas

Discussion Outline:
Comments Regarding Proposed Regulations under Section 1400Z-2 of the Code
July 9, 2019

I. Allocations and Distributions with respect to Profits Interests (Prop. Reg. 1.1400Z2(b)-1(c)(6)(iv)(B) and -1(c)(6)(iv)(D)(1))

- The Proposed Regulations properly recognize that a profits interest received for services does not represent a qualifying investment in a qualified opportunity fund, or QOF, and so is not eligible for the fair market value basis election of Code Section 1400Z-2(c).

- The Proposed Regulations, however, create a trap for the unwary for the taxpayer that both makes a valid capital gain rollover into a QOF and also receives a profits interest for services because of the requirement in the Proposed Regulations that "all" allocations and distributions to be made in accordance with a fixed "allocation percentage," which in the case of a profits interest is calculated as the "highest share of residual profits."

- In QOFs with tiered distribution waterfalls, this rule results in a denial of some of the tax benefits intended by Congress for a valid capital gain rollover. It effectively causes the profits interest for services to "taint" a valid capital gain rollover.

  > *EXAMPLE 1*: X timely rolls capital gains into a QOF for a 10% percentage interest (in exchange for contributing 10% of the capital). In addition, the investors representing the other 90% of the capital agree that if the QOF achieves an 8% preferred return, any profits above that 8% "hurdle" will be allocated 80% in proportion to capital and 20% to X as carried interest for services. The "allocation percentage" for X's carried interest is thus about 64%.[1]
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  > Because the Proposed Regulations do not distinguish between profits earned below vs. above the hurdle, 64% of X's profits *below* the hurdle are deemed to be in respect of the carried interest (even though they factually are not) and denied QOF tax benefits (even though factually earned in respect of the capital interest).

- This rule is causing well advised taxpayers to hold their carried interest through separate regarded entities, making the rule effectively elective.

- We suggest that allocations and distributions in respect of profits interests should be defined in the negative, as the allocations and distributions that are *not* in respect of a taxpayer's capital interest. Alternatively, final regulations could provide a safe harbor instead of mandate that taxpayers use a one-size-fits-all method.

[1] In the carry tier of the waterfall, for every $100 earned, X receives $28, which is comprised of $10 for its capital interest and $18 as carried interest (20% of the other $90). Thus, the "highest share of residual profits the mixed-funds partner would receive with respect to" the carry is 18/28, or about 64%.

II. "Substantially All" of a Holding Period (Prop. Reg. 1.1400Z2(d)-1(c)(5))

- We agree conceptually with defining "substantially all" of a holding period as 90%, but we have concerns regarding how to administer this test.

- In particular, it is unclear how to administer asset testing on an annual basis when compliance with the 90% holding period test is based on the entire holding period.

  > *EXAMPLE 2*: QOF X invests 100% of its assets in Partnership Y, which is intended to qualify as qualified opportunity zone business, or QOZB. However Partnership Y fails to meet all the QOZB requirements for the first six months of QOF X's holding period. Thereafter, Partnership Y at all times meets the QOZB requirements.
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  > Once QOF X achieves a 5-year holding period in the Partnership Y interests, the 90% holding period requirement is met. However, QOF X seemingly must report a failed asset test for years 1 through 4, even though the test will retroactively be passed for the entire holding period upon the fifth anniversary of the investment.

- We respectfully request that a QOF or QOZB should be permitted to use an assumed overall holding period (including future periods) in assessing whether it meets the 90% holding period requirement. This assumed overall period can be limited to the lesser of 10 years or the remaining useful life of the asset.

- Another option to provide greater certainty, at least for QOZB interests, would be to give a "start-up" QOZB a grace period of 1 year to achieve QOZB compliance. In the context of the 10-year holding period contemplated by the statute, this would also broadly align with a 90% holding period requirement of the Proposed Regulations.

III. Additional Miscellaneous Issues, Time Permitting

- *QOF Inside Gain Election (1.1400Z2(c)-1(b)(2)(ii)(1))*: We appreciate the accommodation that permits investors with 10-year holding periods to exclude capital gain reported to them from QOFs. However, we note that a sale of an asset by a QOF might generate some ordinary income recapture or other "hot asset" items. Because Code Section 1400Z-2(c) operates through an increase in basis to fair market value, the intent appears to be eliminate *all* gain when exiting an investment, not just capital gain. Unless final regulations better accommodate "multi-asset QOFs," there will continue to be bias towards more complex "parallel QOF" structures.

- *Section 1231 Capital Gain Rollover Timing (1.1400Z2(a)-1(b)(2)(iii)):* We agree that Section 1231 gains cannot be determined until the end of the year, and therefore it is appropriate for the 180-day period for a capital gain rollover to commence at year-end for

Section 1231 gains. However, to increase flexibility for investors with 1231 gains to participate in QOF investments, we respectfully request that the IRS consider adopting a rule similar to the rule for capital gains realized in pass-thru entities, and permit taxpayers to elect to start the 180-day period either on the actual date the 1231 gain is realized or year-end.

- *Triple Net Lease Determination (1.1400Z2(d)-1(d)(5)(ii)(B)(2))*: We respectfully request clarification on the definition of "triple net lease." In particular, we recommend that a landlord who performs services in respect of taxes, insurance, maintenance and utilities may pass through those costs to a tenant without causing a failure of the "active trade or business" test, even though the mere passing through of the cost might otherwise cause such a lease to be defined as a triple net lease for other purposes.

- *Placed in Service Determination (1.1400Z2(d)-1(c)(7))*: We respectfully request clarification regarding when a taxpayer may treat real property as satisfying the original use requirement, and we suggest that taxpayers should be free to elect to have the original use of real property improvements measured either from when such property is placed in service for depreciation purposes or when the first (temporary or permanent) certificate of occupancy is granted under local law in respect to such real property.