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Report No. 1407
January 10, 2019

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

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

The Honorable William M. Paul
Principal Deputy Chief Counsel and
Deputy Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1407 – Report on Proposed Qualified Opportunity Zone Regulations under Section 1400Z-2*

Dear Messrs. Kautter, Rettig, and Paul:

I am pleased to submit Report No. 1407, commenting on proposed regulations (the "**Proposed Regulations**") and Rev. Rul. 2018-29 issued on October 19, 2018, by the Department of the Treasury and Internal Revenue Service (together, "**Treasury**") under the "qualified opportunity zone" ("**QOZ**") provisions of the Code, which were added by new Section 1400Z-2 in the legislation informally known as the Tax Cuts and Jobs Act of 2017.

Congress enacted Section 1400Z-2 to encourage investment in low-income communities by allowing for deferral of capital gains that are properly reinvested in those areas. We commend the Treasury for its efforts in providing substantial and timely guidance. The Proposed

Regulations clearly embody a flexible approach to the QOZ rules and the comments and recommendations in this Report are proffered in the spirit of promoting this flexibility in a manner that balances many competing objectives.

This Report does not address all aspects of the QOZ regime or the Proposed Regulations, but rather it focuses on the issues that we believe are most in need of clarification in the near term. These issues include many of those on which the Treasury has requested comment, as well as certain additional questions we believe are most significant and should be addressed through future guidance.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this Report, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Karen G. Sowell

Karen G. Sowell
Chair

Enclosure

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Report No. 1407

New York State Bar Association Tax Section

REPORT ON PROPOSED QUALIFIED OPPORTUNITY ZONE REGULATIONS UNDER SECTION 1400Z-2

January 10, 2019

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I. Introduction

This Report[1] comments on proposed regulations (the "**Proposed Regulations**")[2] and Rev. Rul. 2018-29[3] issued on October 19, 2018 by the Department of the Treasury and Internal Revenue Service (together, "**Treasury**") under new Section 1400Z-2.[4] The Proposed Regulations were issued in order to implement the "qualified opportunity zone" ("**QOZ**") provisions of the Code, which were added by the legislation informally known as the Tax Cuts and Jobs Act of 2017 (the "**Act**").[5]

This Report does not address all aspects of the QOZ regime or the Proposed Regulations, but rather it focuses on the issues that we believe are most in need of clarification in the near term. These issues include many of those on which the Treasury has requested comment, as well as certain additional questions we believe are most significant and should be addressed through future guidance. This Report also does not discuss the provisions of Section 1400Z-1, which relate to the designation of the QOZs themselves. We note that according to the preamble to the Proposed Regulations (the "**Preamble**"), Treasury intends to issue additional proposed regulations, which will invite comments on the issue of reinvestment of gains by "qualified opportunity funds" ("**QOFs**"), among other things.[6] We expect to submit additional comments in connection with forthcoming guidance.

Congress enacted Section 1400Z-2 to encourage investment in low-income communities by allowing for deferral of capital gains that are properly reinvested in those areas. We commend the Treasury for its efforts in providing substantial and timely guidance on Section 1400Z-2. The Proposed Regulations clearly embody a flexible approach to the QOZ rules and the comments and recommendations in this Report are proffered in the spirit of promoting this flexibility in a manner that balances many competing objectives.

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[1] The principal author of this Report was Jonathan Talansky, with significant drafting by Gregory Lucas, Nikolai Karetnyi, David Levy, Lea Li, Michael Schulman, Peter Connors, James Brown, Marcy Geller, Jennifer Ray, Roger Lorence, Mariya Khvatskaya, Tyler Robbins, and Daniel Altman. Substantial contributions were made by Robert Cassanos, Andy Braiterman, Robert Kantowitz, Stephen Land, Michael Schler, and Karen Gilbreath Sowell. Helpful comments from Alan Blecher, Jonathan Brenner, Jason Factor, Michael Hurwitz, Stuart Leblang, John Lutz, David Miller, Andrew Needham, Elliot Pisem, Eric Sloan, and Linda Swartz, are also reflected in the Report. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] REG-115420-18, Federal Register Vol. 83, No. 209, October 29, 2018 at 54279-54296.

[3] 2018-45 IRB 765 (the "**Revenue Ruling**"). The Revenue Ruling was issued along with the Proposed Regulations and addresses certain critical elements of the "substantial improvement" and "original use" requirements discussed at length in this Report.

[4] Except as otherwise noted, all "Section" references in this Report are to sections of the Internal Revenue Code of 1986, as amended (the "**Code**").

[5] The Act is formally known as "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97. As used in this Report, and as defined in Section 1400Z-1(a), a QOZ is a population census tract that meets the definition of a "low-income community" under Section 45D and that is designated as such based on a nomination by governors and certification by Treasury. There are currently over 8,700 QOZs in all 50 states, the District of Columbia, Puerto Rico, and the Virgin Islands.

[6] A QOF is defined in Section 1400Z-2(d), as described below. All qualifying investments under the QOZ regime will flow through QOFs.

II. Summary of Recommendations

Our recommendations, discussed in greater detail in section IV of this Report, are summarized below.

1. Original Use and Substantial Improvement

- The "**Original Use Requirement**" (as defined below) should be based on the physical presence of property within a QOZ and whether the property has been used in its current form in such QOZ. If proposed technical corrections are enacted, however, we acknowledge that where property has been previously used in its current form, the location of such use would not be relevant for purposes of the Original Use Requirement.

- If Treasury allows a period of abandonment or underutilization of tangible personal property to erase its prior use for purposes of the Original Use Requirement, such period should be at least 5 years.

- The first holding of the Revenue Ruling that the Original Use Requirement is "not applicable" to land should be confirmed. However, if Treasury allows an extended period of abandonment or underutilization of tangible personal property to erase the prior use of such tangible personal property for purposes of the Original Use Requirement, Treasury should require a longer period for real property.

- QOFs and QOZBs (as defined below) should be able to satisfy the Original Use Requirement with respect to newly constructed property that has yet to be occupied or used in a business, including real properly constructed by the QOF or QOZB itself.

- Treasury should consider whether it may be appropriate to permit the value of land to be ignored for purposes of the QOF and QOZB tests where the improvements to be built on the land would otherwise have caused the land to qualify as QOZBP (as defined below) but for the failure to meet the "**Purchase Requirement**" (as defined below).

- Treasury should adopt a framework that evaluates land and improvements as a single "unit" for purposes of the "substantial improvement" requirement (the "**SI Requirement**") wherein additions to the basis of the land itself would be aggregated with the amount spent on improvements.

- In order to rely on the SI Requirement with respect to real property improvements and attain the benefits of the Revenue Ruling by not having to separately improve the land, the value of the property being improved should represent some minimum percentage of the value of the land.

- Demolition work, to the extent it results in an increase to the basis of the land, should count towards the substantial improvement of the land for the purposes of the SI Requirement.

- Treasury should provide additional clarity on how each "project" is separately defined and, relatedly, how QOFs and QOZBs can satisfy the "with respect to" standard under the SI Requirement. Expenditures and improvements that are substantially related to acquired property and serve the needs of the users of the acquired property should be treated as additions to basis "with respect to" such property for purposes of the SI Requirement.

- Treasury should consider anti-abuse rules aimed at preventing taxpayers from using the SI Requirement to circumvent the policies of the QOZ rules, such as by passively benefiting from the appreciation in value of QOZ real estate.

2. Pass-Through Entities

- Treasury should consider whether taxpayers with eligible capital gains should be permitted to invest in QOFs through aggregator or "feeder" vehicles.

- Partners of partnership that do not make a deferral election should be permitted to make such deferral elections with respect to their distributive share of items of gross eligible gains.

- Additional Form 8949 instructions should be provided to give more clarity to partners with respect to the appropriate reporting of deferral elections.

- For partners of a non-electing partnership that does not provide sufficient information with respect to each item of gross eligible gain, Treasury should consider whether the partners may make a deferral election with respect to the net amount of capital gain from the partnership, as reflected on the Schedule K-1.

3. The 180-Day Rule

- Treasury should confirm that capital gains from an installment sale are only eligible for deferral where the original sale or exchange took place in 2018 or later and should clarify how the 180-day rule would apply in the installment sale context more generally.

- Treasury should consider whether final regulations should provide relief for partners in partnerships who seek to reinvest in QOFs during the time period between the end of the partnership's 180-day period and the last day of the partnership's taxable year in which the partner's share of the partnership's gain is taken into account under Section 706(a).

- In order to prevent potential abuse, Treasury should consider how long a partnership needs to be in existence for it to be an eligible taxpayer to make a deferral election, and for its partners to be able to make an election of their distributive shares of gains recognized through the partnership. The alternative 180-day windows should be turned off where a partnership is formed with a primary purpose of extending the 180-day window.

- Treasury should adopt a rule for REIT capital gain dividends under which a REIT shareholder's 180-day period begins on the last day of the REIT's taxable year, rather than on the date that the dividend is paid to the REIT shareholder.

4. Fungible QOF Interests – FIFO and Pro Rata Methods

- The final regulations should not include the "**FIFO Method**" and the "**Pro Rata Method**" (as defined below).

- For acquisitions and partial dispositions of fungible stock consisting of either "**Mixed Interests**" or "**Mixed Eligible Interests**" (as defined below), (1) taxpayers should be permitted to identify which shares of stock acquired have what attributes for purposes of Section 1400Z-2 and, on a partial disposition of those shares, identify which of those share are disposed of using the same method as provided for under current law for purposes of determining basis and holding period of such shares and (2) mandated FIFO Method should be used in the absence of adequate identification.

- For partnership interests consisting of either Mixed Interests or Mixed Eligible Interests, whether or not fungible, Treasury should specify that all "Ineligible Interests" (as defined below) be treated as a single interest separate from all Eligible Interests and that each Eligible Interest either acquired on a day different from the acquisition date of any other Eligible Interest or representing deferred gain of a character different than the character of gain of any other Eligible Interest be treated as a "separate" interest.

5. 2047 Termination of Gain Exclusion Election

- Treasury should allow for an automatic basis step-up election for QOF interests immediately before December 31, 2047 (if such a date is retained in the final regulations).

6. Pre-Existing Entities

- Treasury should consider whether there are requirements that should be relaxed with respect to entities that acquired QOZBP prior to the date that the Proposed Regulations were issued (but after January 1, 2018) using eligible capital gains invested by taxpayers, but that may not have complied with all the QOZ requirements.

- Final regulations should also contain rules regarding QOFs that were disregarded entities at the time property was acquired, for example by allowing QOZBP to have been acquired by the QOF (or QOZB) or a predecessor entity (which may include a disregarded entity) after December 31, 2017.

7. Business and Investment Start-Up Periods

- Treasury should consider adopting a rule clarifying that where an arrangement (in which investors contribute their share of capital to a QOF, along with an interest-like component, and these amounts are distributed to earlier investors to align all of the equity percentages) is in substance a single equity contribution by a group of investors over a limited safe harbor period of 12 months, Section 707 will not apply to deny QOZ benefits.

- Treasury should look to the regulations promulgated under Section 45D as a basis for final regulations defining a reasonable start-up period during which any new corporation or partnership organized for the purpose of becoming a QOZB will not fail to qualify as such simply because it is in the start-up phase.

- We recommend that Treasury promulgate rules providing that a new corporation or partnership that otherwise qualifies as a QOZB will be deemed to be engaged in the active conduct of a trade or business if, at the time a QOF acquires its interest in such entity, the QOF reasonably expects that the entity will generate revenues satisfying the gross income test in Section 1397C(b)(2) within three years.

8. The Working Capital Safe Harbor

- Treasury should expand the "working capital safe harbor" (the "**WC Safe Harbor**") to include any working capital reasonably expected to be used for the formation or acquisition of a new QOZ business, or reflected in the business plan, marketing plan, or development plan of an existing business and reasonably expected to be used in the business.

- Final regulations should include examples of plans and schedules that will and will not satisfy the WC Safe Harbor, with particular focus on the specificity required.

- Treasury should clarify that any amounts that are spent in a manner that would have qualified under the WC Safe Harbor if they had been included on the schedule will be treated as satisfying the WC Safe Harbor so long as any deviations or modifications resulted from legitimate commercial considerations and were not effectuated with a principal purpose of avoiding the NQFP (as defined below) limitation.

9. QOZB Income Sourcing

- Treasury should issue guidance clarifying that a corporation or partnership will satisfy the requirements of Section 1397C(b)(2) if 50 percent of the total gross income of such entity is derived from the active conduct of a trade or business within all QOZs in which such entity conducts such trade or business.

- Treasury should adopt rules governing the determination of the source of income as inside or outside a QOZ and such rules should be based on the income-sourcing rules promulgated under Section 45D.

10. <u>Single-Tier vs. Two-Tier QOZ Structures</u>

- Treasury should consider whether final regulations could reduce the distinctions between single- and double-tier QOZ structures by, for example, providing for a safe harbor with a similar effect to the WC Safe Harbor.

- Property in the process of improvement by a QOF should be treated as satisfying the SI Requirement while such work is in progress.

11. <u>Profits Interests and Non Pro-Rata Economic Interests</u>

- Final regulations should provide that interests in a QOF partnership issued for services are Ineligible Interests. If the interest is issued for both capital and services, it should be bifurcated.

- Final regulations should address situations in which a QOZB issues equity to a QOF in respect to services provided by holders of interests in the QOF.

- Arm's length special allocations and disproportionate economics should be respected where the economic rights associated with the Eligible Interests are commensurate with those of Ineligible Interests held by unrelated parties in the same QOF.

- Final regulations should adopt a general anti-abuse rule to prevent the improper shifting of economic value between related taxpayers or between different interests held by the same taxpayer.

12. <u>Section 1231 Gains</u>

- Final regulations should clarify the deferral mechanics for Section 1231 gains.

13. <u>Treatment of Leases</u>

- Treasury should confirm that leased property, whether or not leased from a related party, is to be taken into account at cost for purposes of the Sub All Test.

- Final regulations should require substantially all of the use of any tangible property leased by a QOF or a QOZB to be in a QOZ.

- Treasury should provide that leased property need not satisfy the Purchase Requirement or the Original Use Requirement in order to qualify under the Business Property Test.

14. Loss Attributable to Section 1400Z-2 Basis

- Final regulations should clarify the results under Sections 1400Z-2(b)(2)(B)(iii) and (iv), where a taxpayer's QOF investment becomes worthless or is otherwise disposed of in a taxable transaction with zero amount realized.

15. QOZ Basis Issues and Subchapter K

- Treasury should clarify the rules regarding a QOF's inside basis in its own assets.

- For purposes of determining the amount of deferred gain included in income under Section 1400Z-2(b) on the Gain Trigger Date (as defined below), only Section 1400Z-2 basis is taken into account, and Section 705 principles still otherwise apply to a taxpayer's interest in a QOF.

- Final regulations should confirm that (subject to depreciation recapture and anti-duplication principles) the Section 1400Z-2(c) basis step up is to "gross fair market value" to account for partnership liabilities.

- Treasury should confirm that Section 751 requires a partner to recognize ordinary income on a sale of a QOF partnership interest in an amount that would be allocated to the partner on the QOF partnership's sale of its hot assets.

- In the case of an investment by a partnership in a QOF, final regulations should confirm that the basis increases under Sections 1400Z-2(b)(2)(B)(iii) (fifth anniversary increase), -2(b)(2)(B)(iv) (seventh anniversary increase), -2(b)(2)(B)(ii) (December 31, 2026, increase), and -2(c) (ten year increase) occur both with respect to the partnership's interest in the QOF and the partners' interests in the partnership.

- Treasury should clarify whether or not a taxpayer with eligible gains may contribute a non-cash asset in kind to a QOF and make a deferral election that relies on such in-kind contribution.

- Final regulations should provide an anti-duplication rule for determinations of basis, income and loss to avoid double counting of the same economic benefits or losses.

16. Prohibited Businesses

- Final regulations should provide that the "alcoholic beverages" restriction is limited to traditional "liquor stores" that sell alcoholic beverages to retail customers for consumption off premises, and not to restaurants, wineries, breweries or distilleries.

17. Offsetting-Positions Transactions

- Treasury should consider a rule excluding from eligible gain treatment any gain recognized with respect to a transaction entered into in order to generate eligible gain.

- If Treasury retains the offsetting position rule, it should consider limiting its scope in certain respects.

18. Failure to Qualify as a QOF and Reasonable Cause

- Final regulations should clarify the QOZ penalty and relief provisions, especially the "reasonable cause" and "willful neglect" standards.

III. Background – Section 1400Z-2 and the Proposed Regulations[7]

A. Section 1400Z-2: Special Rules for Capital Gains Invested in QOZs

Section 1400Z-2 allows a taxpayer to elect to defer capital gains to the extent that such gains are timely invested in a QOF during the 180-day period beginning on the date of such sale or exchange. For these purposes, the gains must arise from a sale to, or exchange with, an unrelated person.[8] Any deferred amounts are included in income in the taxable year which includes the earlier of (1) the date on which the investment is sold, and (2) December 31, 2026 (such earlier date, the "**Gain Trigger Date**").[9] Additionally, where the taxpayer holds the QOF investment for at least ten years, Section 1400Z-2(c) allows for an election (the "**Gain Exclusion Election**") to increase the basis of the investment to equal its fair market value on the date of its sale or exchange.

The statute provides that the taxpayer's initial basis in the QOF investment is zero, and the basis is increased to reflect the gain recognized on the Gain Trigger Date. If, prior to the Gain Trigger Date, the taxpayer achieves a five year holding period, a basis increase equal to 10 percent of the deferred gain is allowed, and if the taxpayer achieves a seven year holding period by such date, there is an additional increase equal to 5 percent of the deferred gain.[10]

Section 1400Z-2(d) contains the definitional provisions for QOFs. A QOF is an investment vehicle organized for the purpose of investing in "qualified opportunity zone property" ("**QOZP**") and that holds at least 90% of its assets in QOZP, as measured based on an average of two semiannual testing dates (the "**90% Test**").[11] QOZP consists of "qualified opportunity zone stock," "qualified opportunity zone partnership interests," (together, "**QOZB Interests**") and "qualified opportunity zone business property" ("**QOZBP**"). QOZBP is defined

[7] The following summary is not an exhaustive outline of the statutory provisions, but instead focuses on the portions of the QOZ rules that are most germane to the Proposed Regulations (and this Report).

[8] Section 1400Z-2(e)(2) provides that for purposes of the QOZ provisions, relatedness is defined under Section 267(b) or 707(b)(1), substituting 20 percent for 50 percent.

[9] Section 1400Z-2(a)(1), (b). Under Section 1400Z-2(b)(2), the amount includible on such date cannot exceed the excess of the fair market value of the investment as of such date and the taxpayer's basis in the investment. This rule allows a taxpayer to receive the tax benefit of any depreciation in value of the QOF investment prior to such date.

[10] Section 1400Z-2(b)(2)(B).

[11] The statute also imposes a monthly penalty on a QOF that fails to meet the 90% Test, equal to the amount of the failure multiplied by the Section 6621(a)(2) underpayment rate. Section 1400Z-2(f)(3) sets forth a reasonable cause exception to the penalty.

as tangible property used in a trade or business of the QOF, where (1) the QOF acquired such property for cash from an unrelated person in a non-carryover basis transaction after December 31, 2017 (the "**Purchase Requirement**"),[12] (2) either the QOF is the "original user" of such property (the "**Original Use Requirement**"),[13] or the QOF "substantially improves" the property (the "**SI Requirement**"), and (3) during substantially all the QOF's holding period for such property, substantially all of the use of such property was in a QOZ ((1) through (3), the "**Business Property Test**"). Section 1400Z-2(d)(ii) states that the SI Requirement is met only if, during any 30-month period beginning on the date of acquisition of the property, "additions to basis" with respect to the property in the hands of the QOF exceed the adjusted basis of the property in the hands of the QOF at the beginning of such period. The statute does not define the Original Use Requirement.

For an interest in a subsidiary corporation or partnership to qualify as a QOZB Interest, it must be acquired by the QOF from the corporation or partnership solely in exchange for cash after December 31, 2017, and at the time of issuance, as well as during substantially all of the QOF's holding period for such interest, the subsidiary must qualify as a "qualified opportunity zone business" ("**QOZB**").[14] Finally, a QOZB is a trade or business (other than certain enumerated businesses[15]) in which substantially all of the tangible property owned or leased is QOZBP (the "**Sub All Test**"), and which satisfies the following requirements set forth in Section 1397(C)(b): (1) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (2) a substantial portion of the intangible property of such entity is used in the active conduct of the business; and (3) less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property ("**NQFP**").[16]

Section 1400Z-2(e) contemplates that taxpayers may hold interests in QOFs funded through eligible gains and other capital ("**Mixed Funds**"). In such cases, the QOF investment is bifurcated and treated as two separate interests – "**Eligible Interests**" and "**Ineligible Interests**," each as defined herein.

[12] The Purchase Requirement cross references the "purchase" definition in Section 179(d)(2).

[13] House Republicans have proposed striking the words "in the qualified opportunity zone" from Section 1400Z-2(d)(2)(D)(i)(II) such that the Original Use Requirements would require that "the original use of such property commences with the qualified opportunity fund." *See* Tax Technical and Clerical Corrections Act Discussion Draft, U.S. House of Representative Committee on Ways and Means, January 2, 2019.

[14] Section 1400Z-2(d)(2)(B), (C).

[15] A QOZB cannot operate a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises (the "**Prohibited Businesses**").

[16] Section 1400Z-2(d)(3)(A). NQFP includes "debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, and annuities," but does not include "reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less." Section 1397C(e)(1). The NQFP restriction is discussed in this Report in the context of the WC Safe Harbor.

B. Key Provisions of the Proposed Regulations

1. Proposed Regulations Section 1.1400Z-2(a)-1

Proposed Regulations Section 1.1400Z-2(a)-1 provides definitions and related operating rules for applying Section 1400Z-2. The terms "eligible taxpayer," "eligible gain," and "eligible interests" are defined in Proposed Regulations Section 1.1400Z-2(a)-1(b). An "eligible taxpayer" includes any person that may recognize gains for purposes of federal income tax accounting. "Eligible gain" is any capital gain that would be recognized before January 1, 2027, but for Section 1400Z-2(a)(1), and that does not arise from a related-party transaction. This regulatory section further provides special rules for the treatment of gains under Section 1256 contracts and straddles.[17] An "eligible interest" is an equity interest issued by a QOF, including preferred stock and partnership interests with special allocations, but excluding debt instruments as defined in Section 1275(a)(1) and Treasury Regulations Section 1.1275-1(d).

Proposed Regulations Section 1.1400Z-2(a)-1(b)(4) provides rules governing the 180-day reinvestment period. Generally, the 180-day period begins on the day on which the gain would have been recognized, but for the election under Section 1400Z-2.[18] In the case of a capital gain dividend by a real estate investment trust (a "**REIT**"), the period begins on the day on which the dividend is paid.[19] Additionally, a taxpayer may continue to defer previously deferred gain by reinvesting the proceeds of a sale of a QOF interest in another QOF in a timely fashion. Proposed Regulations Section 1.1400Z-2(a)-1(b)(5) provides for the preservation of the tax attributes of the deferred gain once triggered. Where a taxpayer holds fungible interests in a QOF that were acquired at different times and disposes of a portion of those interests, Proposed Regulations Section 1.1400Z-2(a)-1(b)(6) provides that the first-in-first-out method ("**FIFO Method**") must be used to identify which interests are disposed of, and if a portion of fungible interests acquired on a single day are disposed of, the rules mandate the pro-rata method of identification (the "**Pro-Rata Method**").

Proposed Regulations Section 1.1400Z-2(a)-1(c) provides special rules for pass-through entities, including rules regarding deferral elections by partnerships, how partners may elect to defer passed-through gains under Section 1400Z-2(a)(2) in cases where the partnership does not elect to defer, and on how the 180-day period is calculated for such partners. A welcome aspect of the Proposed Regulations provides that where a partnership realizes eligible capital gains, either the partnership or any of its partners may elect to defer such gain. In the case of a partner, the 180-day period may begin on the last day of the partnership's taxable year.[20] Proposed Regulations Section 1.1400Z-2(a)-1(c)(3) provides that analogous rules apply to S corporations, trusts, and estates.

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[17] Proposed Regulations Section 1.1400Z-2(a)-1(b)(2)(iii), (iv).

[18] Proposed Regulations Section 1.1400Z-2(a)-1(b)(4)(i).

[19] Proposed Regulations Section 1.1400Z-2(a)-1(b)(4)(ii)(B).

[20] Proposed Regulations Section 1.1400Z-2(a)-1(c)(2)(iii)(A).

2. Proposed Regulations Section 1.1400Z-2(c)-1

Proposed Regulations Section 1.1400Z-2(c)-1 addresses the Gain Exclusion Election, and provides that the election is not available for dispositions after December 31, 2047. This section of the Proposed Regulations also clarifies that the exclusion from gross income is not impaired solely because a designation of a QOZ ceases to be in effect.[21]

3. Proposed Regulations Section 1.1400Z-2(d)-1

Proposed Regulations Section 1.1400Z-2(d)-1 provides guidance on (1) self-certification as a QOF, (2) the valuation of a QOF's assets, (3) qualification of various types of property as QOZP, and (4) qualification as a QOZB. These rules also permit pre-existing entities to qualify as QOFs.[22]

For purposes of valuing a QOF's assets under the 90% Test, if the QOF has an applicable financial statement (within the meaning of Treasury Regulations Section 1.475(a)-4(h)), then the values of the assets shown on that statement are used. Otherwise, the QOF's cost of such assets are used.

Proposed Regulations Section 1.1400Z-2(d)-1(c)(7) reserves comment on the Original Use Requirement, and clarifies that to satisfy the SI Requirement with respect to a building located on land within a QOZ, only additions to basis of the building are taken into account, and no separate SI Requirement applies with respect to the land.[23] Proposed Regulations Section 1.1400Z-2(d)-1(d) defines QOZB, and, importantly, provides a 70% standard for the Sub All Test.[24]

The Proposed Regulations provide for a working capital safe harbor (the "**WC Safe Harbor**") for purposes of the NQFP restriction. Specifically, under Proposed Regulations Section 1.1400Z-2(d)-1(d)(5)(iv), working capital assets are treated as reasonable in amount (and therefore not as NQFP) if all of the following three requirements are satisfied: (1) the amounts are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ, (2) there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets, and under such schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets, and (3) the working capital assets are actually used in a manner that is substantially consistent with the first two requirements.

The Proposed Regulations confirm that meeting the WC Safe Harbor also will enable a QOZB to satisfy the other two requirements of Section 1397C(b), and, significantly, where WC Safe Harbor working capital is being used to produce tangible property that is expected to meet

[21] As a general matter, the QOZ designation expires for census tracts after ten years, and this had caused some concern amongst taxpayers intending to hold QOF investments beyond such time. *See* Section 1400Z-1(f).

[22] Proposed Regulations Section 1.1400Z-2(d)-1(a)(3).

[23] See discussion of the Revenue Ruling below.

[24] Proposed Regulations Section 1.1400Z-2(d)-1(d)(3)(i).

the SI Requirement, then the in-process property will not be treated as failing the SI Requirement solely because the scheduled consumption of the working capital is not yet complete.[25]

4. Proposed Regulations Section 1.1400Z-2(e)-1

Proposed Regulations Section 1.1400Z-2(e)-1 addresses the treatment of mixed-fund investments in a QOF and states that deemed contributions of money described in Section 752(a) do not create or increase an investment in a QOF and the basis increase resulting from the deemed contribution is therefore not taken into account in determining the partner's investment in the QOF.

C. Revenue Ruling 2018-29

The Revenue Ruling addresses a QOF that purchases an existing building located on land in a QOZ. Sixty percent ($480x) of the $800x purchase price for the property is attributable to the value of the land and forty percent ($320x) is attributable to the value of the existing building, which was previously used as a factory. Within 24 months after the date of the QOF's purchase, it invests an additional $400x in converting the building to residential rental property. The Revenue Ruling contains the following holdings: (1) the Original Use Requirement cannot be met with respect to the building, (2) the Original Use Requirement is not applicable to the land on which the building is located, (3) the substantial improvement of the building is measured by the QOF's additions to the adjusted basis of the building, and (4) measuring substantial improvement to the building by additions to the QOF's adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located. The Revenue Ruling does not analyze the treatment of the land under the 90% Test, which suggests that as long as a building on land is substantially improved, the land is counted as a good asset (or is ignored).

IV. Detailed Discussion of Recommendations

A. Original Use and Substantial Improvement

In order for property to qualify as QOZBP, it must meet the Original Use Requirement or the SI Requirement. The Proposed Regulations address in-process improvements funded by WC Safe Harbor working capital. Other than the Revenue Ruling, the Proposed Regulations provide no other guidance on these requirements. In the Preamble, Treasury solicited comments on "all aspects of the definition of 'original use' and 'substantial improvement.'" We believe that in order for the QOZ rules to accomplish their intended goals, these statutory standards must be given additional content. In this Report we have not described, or even summarized, all of the considerations we deem relevant to the analysis, but instead have focused on those aspects of the requirements that are likely to arise with more frequency and for which taxpayers need more immediate guidance.

[25] Proposed Regulations Section 1.1400Z-2(d)-1(d)(5)(vii).

1. Original Use

(a) Tangible Personal Property

We recommend that final regulations clarify that the Original Use Requirement focuses on whether the property has been used in its current form by anyone other than the QOF. We believe that "use" should be construed as actual use and not mere presence. Therefore, the mere fact that tangible personal property was held for sale in a QOZ (as inventory) should not preclude satisfaction of the Original Use Requirement by a QOF that acquires such property and uses it in a QOZB (or by a subsequent QOF or QOZB that itself holds the property as inventory). Treasury has also requested comment on whether a period of abandonment or underutilization of tangible personal property can erase its prior use in a QOZ. We note that under the "empowerment zone" provisions of the Code, for purposes of determining whether property is "qualified zone property," if property is vacant for at least a one year period, any use prior to that period is disregarded in determining whether the "original use" requirement is met.[26] Whether or not this rule is a good analogue to the QOZ tests, we believe that incorporating a similar provision under Section 1400Z-2 would be difficult to square with Congressional intent and would result in tax motivated transactions in which QOZBP would be held dormant and then sold to a QOF. Instead, we generally support a plain meaning of the Original Use Requirement.[27] If Treasury does adopt a "dormancy period" under the Original Use Requirement, we believe that a period of at least 5 years would be necessary to prevent abuse for personal property. Finally, if a QOZB acquired heavily refurbished personal property (for example, a vehicle) that had been previously used in the QOZ but that is no longer in substantially the same form, then we believe the property should be able to satisfy the Original Use Requirement.

(b) Real Property

Consistent with our recommendation set forth above, we agree with the holding of the Revenue Ruling to the effect that the Original Use Requirement is "not applicable" to land (which we take to mean that a QOF *cannot*, by definition, be the original user of land), and we recommend that final regulations confirm this principle more broadly. However, if Treasury allows an extended period of abandonment or vacancy to erase prior use of real property, we believe that in order to prevent abuse, a period longer than the 5 year period we recommended for personal property is necessary.

The Revenue Ruling, which involved a purchase of an existing building previously used as a factory and erected prior to 2018, leaves open the question of whether a period of non-use would make the Original Use Requirement available for real property, and therefore the adoption of such a period would not, in our view, be inconsistent with the Revenue Ruling.

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[26] Treasury Regulations Section 1.1394-1(h).

[27] We note that under Section 168(k), there are various exceptions to "original use" based on certain instances of transitory ownership. *See*, *e.g.*, Treasury Regulations Section 1.168(k)-1(b)(3)(iii)(A). *See also* New York State Bar Association Tax Section Report No. 1405, at 40-41.

We also recommend that Treasury confirm in final regulations that QOFs and QOZBs may satisfy the Original Use Requirement with respect to newly constructed property that has yet to be occupied or used in a business, including real properly constructed by the QOF or QOZB itself. Although situations in which a QOF or QOZB constructs a new building on purchased land may be covered by our recommendation described below regarding the SI Requirement, there are circumstances (such as a QOF that contemplates the construction of a building or other improvements on land that is ground leased) where the SI Requirement may be technically inapplicable and where permitting the Original Use Requirement to be met would further the purposes of Section 1400Z-2.

Treasury should also consider whether it may be appropriate to permit the value of land to be ignored for purposes of the QOZB and QOF tests where the improvements to be built on the land would otherwise have caused the land to qualify as QOZBP but for the failure to meet the Purchase Requirement. For example, suppose that a taxpayer seeks to enter into a joint venture with other investors who have eligible capital gains, and construct an apartment building on the land. The construction will require expenditures well in excess of the value of the land, and perhaps four or five times its value. The taxpayer does not want to dispose of more than 80% of the land, and therefore will remain a related party with respect to the QOZB when the land is contributed to the QOZB.[28] The investors' cash is used in a manner that satisfies the WC Safe Harbor. While the construction in progress would appear to clearly meet the Original Use Requirement, a QOZB may be unable to satisfy the Sub All Test at each testing date if the land itself is counted as tangible property that is not QOZBP.[29] We believe that fact patterns such as these are commonplace, and it is unclear what policy goals are served by forcing the current landowner to either divest itself of more than 80% of the project or enter into a complex ground lease with the joint venture in order to be able to qualify the project under the QOZ rules. Ignoring the value of the land in these cases would allow development to occur in a way that does not create a bias against landowners who happen to own their properties at the time of the enactment of the QOZ rules. It would also be consistent with the Revenue Ruling's approach of ignoring the value of land for certain purposes in a manner that fosters development.

2. *Substantial Improvement*

(a) Unimproved Land or Land with Minimal Improvements

We believe that further guidance is critical under the SI Requirement and the Original Use Requirement as applied to unimproved or vacant land (which may include land with relatively minor existing improvements or land with a building that requires demolition).[30] Acquiring raw land for ground-up development is a common transactional pattern in many QOZs

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[28] We note that this Report does not address in detail the Purchase Requirement. However, we would note that this rule in many cases gives rise to the need for significant restructuring and complex arrangements. A current owner of land in a QOZ cannot contribute the land to a joint venture with a QOF and treat the land as QOZBP. The Purchase Requirement instead compels the landowner to sell the land to a third party or to enter into sub-optimal ground lease structures with the joint venture.

[29] The WC Safe Harbor would presumably not help because it does not treat the cash as QOZBP prior to its being converted into tangible property, but instead insulates the cash from NQFP characterization.

[30] Similar concerns arise where a QOZB acquires land with improvements or structures that will not be part of the new development.

and is implicitly approved in the example set forth in Proposed Regulations Section 1.1400Z-2(d)-1(d)(5)(vii). In urban areas in particular, land value can be significant, and we understand that the legal uncertainties associated with these investments are likely chilling QOZ investment activity. The Revenue Ruling deals only with the acquisition of land together with an existing building, and leaves open the question of unimproved land. While the Revenue Ruling expressly holds on its facts that the land at issue *need not* be improved, it is not clear whether land *can* be "substantially improved" (under Section 1400Z-2) under different facts.

The Preamble states that "[E]xcluding the basis of land from the amount that needs to be doubled under [the SI Requirement] for a building to be substantially improved facilitates repurposing vacant buildings in qualified opportunity zones." We believe that the rules must go further and provide more clarity to taxpayers who seek to redeploy capital gains to fund impactful, ground-up real estate development projects involving assets such as affordable housing, hotels, office and industrial properties.

Accordingly, we recommend that the final regulations adopt a framework that evaluates land and improvements as a single "unit" for purposes of the SI Requirement (such proposal, the "**Unitary Standard**"). Under the Unitary Standard, if a QOF or QOZB acquires vacant land for $X, the SI Requirement would require another $X to be invested in improvements to the land. We believe that applying the QOZ rules in this manner manifests a reasonable interpretation of the statutory phrase "additions to basis with respect to the property," as being broader than a strict evaluation of the land's basis.[31] Instead, the SI Requirement would look at the entire development site and determine the additions to basis with respect to the site (including the land). For these purposes, additions to the basis of the land itself would be aggregated with the amount spent on improvements. Suppose a QOZB acquires land in a QOZ for $250. What is the analysis under the SI Requirement if the QOZB spends $200 on construction of a building and $50 on fixing the land? We believe that under these facts, so long as the $250 is spent within the statutory 30-month period, the land and the building should allow the QOZB to qualify. Not only is this consistent with one of the goals of the QOZ legislation, but it would be a natural interpretation of the example in Proposed Regulations Section 1.1400Z-2(d)-1(d)(5)(vii), which clearly suggests that a purchase of raw land followed by construction on that land is an appropriate way to satisfy the SI Requirement. Furthermore, final regulations should allow land to be treated as meeting the SI Requirement while the improvements are in process, using the principles of Proposed Regulations Section 1.1400Z-2(d)-1(d)(5)(vii).[32]

[31] We note that the language in the Proposed Regulations is slightly different than the statutory language. Specifically, Proposed Regulations Section 1.1400Z-2(d)-1(c)(8)(i) provides that "…tangible property is treated as substantially improved by a QOF only if, during any 30-month period beginning after the date of acquisition of the property, *additions to the basis of the property* in the hands of the QOF exceed an amount equal to the adjusted basis of the property at the beginning of the 30-month period in the hands of the QOF" (emphasis added). We recommend that the regulatory language be modified to conform to the language in Section 1400Z-2(d)(2)(D)(i)(II).

[32] We would note that the concept of "retroactive" qualification of property is contained in the Proposed Regulations. Specifically, under Proposed Regulations Section 1.400Z-2(d)-1(d)(5)(vii), in process improvements are not treated as failing the SI Requirement while cash is being expended under the WC Safe Harbor. However, we believe that this rule should be applicable beyond situations where the WC Safe Harbor is relevant, including in cases where activity is being conducted at the QOF level. *See* discussion in Section IV.H.

Applying the SI Requirement in this manner will, in our view, prevent inappropriate results in the case of an acquisition of land with minimal improvements. The Proposed Regulations and the Revenue Ruling would seem to permit capital expenditures equal to the value of the improvements to satisfy the SI Requirement, which apparently results in qualification of both the land and the building. Where the improvements are not substantial in relation to the value of the land, we believe that such a rule is not within the scope of Congressional intent, since at the extreme they would permit taxpayers to "land bank" by sitting on mostly unproductive land for the requisite ten year holding period and ultimately realizing the appreciation in the land on a tax-free basis. While the "trade or business" and "active conduct" requirements found within the QOZ rules do limit this strategy to some degree, they are insufficient to prevent abuse in many cases.

(b) The Revenue Ruling

We recognize that the Unitary Standard described above may appear at odds with the Revenue Ruling, at least in so far as the Revenue Ruling treats acquired land and improvements as two separate assets under the QOZ rules. However, we believe that the Revenue Ruling should be limited to its facts. Accordingly, we recommend that Treasury adopt a rule establishing that in order to rely on the SI Requirement with respect to real property improvements and attain the benefits of the Revenue Ruling by not having to separately improve the land, the value of the property being improved must represent some minimum percentage of the value of the land. We have considered what minimum percentage would be required in these cases, and we note that in the Revenue Ruling, the value of the building was equal to 2/3 of the value of the land. We would support such a threshold, but in any event the standard chosen should ensure that taxpayers are not able to "bootstrap" land appreciation into the QOZ benefit. We believe that the Unitary Standard for the SI Requirement, together with the more limited application of the Revenue Ruling, represents a reasonable way to apply the QOZ rules to different categories of QOZ real estate projects while remaining true to Congressional intent and the policies underlying Section 1400Z-2.

(c) Demolition

A number of uncertainties exist in the context of QOZ parcels that are in need of remediation due to environmental toxins or other hazardous conditions. It is our understanding that in many situations, heavy environmental clean-up (which often entails demolition and other activities) can take years to complete, and in some cases may represent a significant portion (even a majority) of the cost of the project. Because the QOZ rules are focused on census tracts that may be blighted or in disrepair, we believe that final regulations should address these situations.

Suppose a QOF acquires a site for $250, and incurs $200 of expenses in demolishing the building, and $100 in erecting a new building. We believe that the Unitary Standard we have proposed would permit the SI Requirement to be satisfied under these facts. We recommend that Treasury clarify that the demolition work, to the extent it results in an increase to the basis of the land, counts towards the substantial improvement of the land, and that under these facts, the SI Requirement will be met in light of the $205 of total spending.

(d) Additions to Basis "with respect to" QOZBP

We believe that the final regulations should provide additional clarity on how each "project" is separately defined and, relatedly, how QOFs and QOZBs can satisfy the "with respect to" standard under the SI Requirement. For example, if a QOZB acquires five separate but contiguous parcels of land in a QOZ for $100x, and seeks to qualify all five parcels by constructing a building on one of the parcels at a cost of $100x, the final regulations should clarify that the parcels all must be a part of the same "project" or "site" in order to be treated as improved by the single building. Similarly, when it comes to assets such as affordable housing complexes, a QOZB may acquire a property and carry out construction that takes the form of direct improvements to the acquired buildings, as well as the creation of recreation centers, playgrounds, and other ancillary structures. We recommend that Treasury adopt final regulations providing that expenditures and improvements that are substantially related to acquired property and serve the needs of the users of the acquired property will be treated as additions to basis "with respect to" such property for purposes of the SI Requirement. We also recommend that Treasury consider whether anti-abuse rules are needed in order to prevent taxpayers from using these aspects of the SI Requirement to circumvent the policies of the QOZ rules by, among other things, passively benefiting from the appreciation in value of real estate located in QOZs.

B. Pass-Through Entities

1. Aggregator or Feeder Funds

As described in Part III.B, the Proposed Regulations allow both a partnership as well as its partners to make a gain deferral election, and they provide special timing rules with respect thereto.[33] Since it is common for investment gains to be realized through such structures, these rules will allow taxpayers to elect deferral under the QOZ rules without the need for burdensome restructuring, and we support the Proposed Regulations in this regard.

Consistent with the general "aggregate" partnership theory embodied in the Proposed Regulations, we also recommend that Treasury consider whether the taxpayers with eligible capital gains should be able to invest in QOFs through aggregator or "feeder" vehicles. The statute does not appear to permit this structure currently, since Section 1400Z-2 requires that "the taxpayer" realizing the gain be the one to invest in a QOF. To reduce administrative complexity, such a rule could require that such entities be wholly owned by investors with eligible gains. Permitting these structures may facilitate a more streamlined onboarding process for QOFs, and obviate the need for direct privity between the individual taxpayers with eligible gains and the QOFs themselves.[34] Instead, two or more investors with eligible gains that seek to invest in the same QOF could do so through a feeder entity. However, we acknowledge the additional complexity that could result from such a rule, including those relating to tax basis that are discussed at length in Section IV.O.

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[33] Our recommendations relating specifically to the 180-day period in the partnership context are described in Part C.2.

[34] Additionally, under the current rules, the Gain Exclusion Election is only available when interests in the QOF are sold, so permitting aggregation in this manner reduces the number of sellers in these transactions.

2. *Partnership Distributive Share Issues*

The Proposed Regulations anticipate that taxpayers will make deferral elections on Form 8949, which will be attached to their U.S. federal income tax returns for the taxable year in which the gain otherwise would have been recognized. Draft form instructions to this form were released on November 14, 2018 (the "**Draft Form Instructions**"). According to the Draft Form Instructions, taxpayers should report the underlying gain as they would under current rules, without making any adjustment, and report the deferral of the eligible gain separately. Investments in different QOFs, or in the same QOF on different dates (or with different character), are reported on separate line items on the form, however eligible gains of the same character from different transactions that are invested on the same date in the same QOF could be grouped together. Taxpayers are not required to trace or allocate the funds invested in a QOF to a specific gain being deferred, but the investment in the QOF must have occurred within the 180-day period beginning on the date the deferred gain was realized. We offer the following examples to illustrate the mechanics of these rules in the partnership context:

> Example 1. Individual A is a partner in P, an entity treated as a domestic partnership for U.S. federal income tax purposes and is a calendar year taxpayer. A owns a 30% capital interest in P, and all items of income, deduction, gains and losses in P are allocated pro rata in proportion to the partners' capital interests. Both A and P are calendar year taxpayers. On April 3, 2018, P sells Blackacre to a buyer that is less than 20% related to P, realizing a $100 gain that will be recognized on that day as a long-term capital gain, absent a deferral election. P can invest the gain into a QOF by September 30, 2018 and make a deferral election with respect to that gain.
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> Example 2. Same as Example 1, except that in 2018, P also sells Whiteacre to an unrelated party, recognizing a loss of $80 that would be treated as a long-term capital loss. P has no other capital gains or losses in 2018. Although P only has $20 net capital gain for year 2018, P can make a deferral election with respect to the entire $100 of eligible gain it recognized from selling Blackacre, and invest $100 in a QOF by September 30, 2018.
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> Example 3. Same as Example 2, except that P does not make a deferral election with respect to the gain it recognized from selling Blackacre. A receives a Schedule K-1 from P in early 2019, indicating that her share of 2018 net long-term capital gain from P is $6, representing her 30% share of P's net long-term capital gain of $20. Absent the QOZ rules, A will report her $6 net long-term capital gain from P as a line item on Form 8949. Based on the Draft Form Instructions, it seems that A is only able to defer her net capital gain from P, instead of her entire $30 share of gain from the sale of Blackacre.

It is unclear whether the result illustrated in Example 3 is intended. Outside the partnership context, taxpayers are free to make a deferral election with respect to gross capital gains from some transactions, while carrying forward gross capital losses from other transactions. As illustrated by Example 2, if the partnership itself makes the deferral election, it could make the election with respect to items of gross capital gain, thereby, affording partners in the electing partnerships the QOZ tax benefit with respect to their shares of such gross gain items.

Example 4. Same as Example 3, except that shortly after selling Blackacre, P informs its partners that it does not intend to make a deferral election with respect to gain from that sale, and informs its partners of their shares of the gain, which for A is $30. A invests $30 in a QOF within 180 days of the disposition of Blackacre. Later in the same year, P sells Whiteacre with a $80 long-term capital loss. After taxable year 2018 ends, P provides its partners with Schedule K-1s, which reflect A's share of P's net long-term capital gain as $6. It is unclear if and how A will be able to make the deferral election for her entire $30 investment in the QOF.

Non pro-rata economics and more elaborate partnership waterfalls can exacerbate some of the issues noted above.

Example 5. Same as Example 4, except that P does not make distributions and allocations to its partners pro rata to its partners' capital interests. Instead, P uses targeted allocations, and has a distribution waterfall where after reaching a specified internal rate of return for all partners (the "IRR hurdle"), A will receive a 20% promote allocation. A also has a 30% capital interest in P. In 2018, immediately after the disposition of Blackacre, P's income and gains reach the IRR hurdle, and A would be entitled to 35% of all 2018 items of income and gain based on P's results as of that point. P informs its partners that it does not intend to make a deferral election with respect to its gain from selling Blackacre, and informs its partners of their shares of the gain, which for A is $35. A invests $35 in a QOF within 180 days of the disposition of Blackacre. Later in the same year, P sells Whiteacre with a $80 long-term capital loss. After the sale of the Whiteacre at loss, at the end of 2018, income of P is no longer above the IRR hurdle, and A will not be entitled any promote distribution. Based on the targeted allocation, A is entitled to only 30% of all items of income, deductions, gains and losses. A's distributive share of net long-term capital gain reflected on the Schedule K-1 of P is only $6. It is unclear if and how A will be able to make the deferral election with her entire $35 investment in the QOF.

As illustrated by the above examples, the elective timing rules for partners in a non-electing partnership under Proposed Regulations Section 1.1400Z-2(a)-1(c)(2) put pressure on partnerships to provide information to partners before the end of the taxable year. For partnerships that do not make allocations and distributions purely pro rata based on percentage interests, it is also unclear how to determine a partner's share of a particular item of gross gain before the end of the taxable year. In addition, an eligible capital gain with respect to the partnership may be ineligible for a partner because of the relatedness level, and the partnership may not be able to disclose the identity and beneficial ownership of the purchaser when it recognizes gain. When partnerships do not provide partners with information regarding their shares of items of capital gain within 180 days after the close of the relevant taxable year, it is impossible for partners to make deferral elections with respect to eligible gains that they recognize through partnerships.

More importantly, based on the Proposed Regulations and the Draft Form Instructions, it is not clear whether partners in a non-electing partnership can make a deferral election with respect to their shares of the gross amount of an item of eligible gain recognized by the Partnership. Even if such elections were permissible, the notion of the distributive share of a gross capital gain item is not meaningful for many partnerships with more complicated economic waterfalls as described above. To allow for gain deferral elections with respect to distributive shares of gross items of capital gain from a partnership, information from the partnership to its partners with respect to each item of capital gain it recognizes will be required. For partnerships like investment funds making hundreds of transactions producing capital gains and losses, this could be burdensome or, more likely, impossible.

Since the QOZ rules and the Proposed Regulations do not affirmatively require partnerships to provide QOZ-related information to its partners when the partnerships do not make deferral elections with respect to partnership-level capital gains, it is up to the partnership and its partners to negotiate whether the partnership will provide such information. We recommend that partners of non-electing partnerships be permitted to make gain deferral elections with respect to their distributive share of items of gross eligible gains. Further, we recommend that additional Form 8949 instructions be provided to give more clarity to partners with respect to the appropriate reporting of deferral elections. Finally, for partners of a non-electing partnership that does not provide sufficient information with respect to each item of gross eligible gain, Treasury should consider whether the partners may make a deferral election with respect to net amount of capital gain from the partnership, as reflected on the Schedule K-1.

C. The 180-Day Rule

Under Section 1400Z-2(a)(1)(A), a taxpayer that seeks to defer gain through investment in a QOF has only a 180-day period to do so, beginning on the date of the sale or exchange giving rise to the gain. Proposed Regulations Section 1.1400Z-2(a)-1(b)(4)(i) provides that the 180-day period generally "begins on the day on which the gain would be recognized for Federal income tax purposes if the taxpayer did not elect under section 1400Z-2 to defer recognition of that gain." Proposed Regulations Section 1.1400Z-2(a)-1(b)(4)(ii) offers four examples illustrating how the 180-day rule would apply in the contexts of (1) regular-way trades of stock, (2) capital gain dividends received by RIC and REIT shareholders, (3) undistributed capital gains received by RIC and REIT shareholders, and (4) additional deferral of previously deferred gains. The Preamble requests comments on whether final regulations should include exceptions to the 180-day rule and whether the final regulations should include additional illustrations of the application of the 180-day rule in various circumstances (and if so, which circumstances). Although we believe the four examples provided in the Proposed Regulations are helpful, there are numerous other circumstances in which similar illustrations would be welcome.

1. Installment Sales

We believe that an application of the 180-day rule that would permit taxpayers to invest installment sale proceeds in respect of pre-2018 realization events would be counter to the intent of the QOZ rules. Section 1400Z-2 is intended to incentivize taxpayers to realize capital gains and invest the proceeds in QOZs. For gains that are already triggered, but not recognized because of the installment sale rules, such incentive is not necessary, and is therefore outside of the ambit of the rules. We recommend that final regulations confirm that capital gains from an installment sale are only eligible for deferral where the original sale or exchange took place in 2018 or later.

We also recommend that the final regulations clarify how the 180-day rule would apply in the installment sale context more generally. A strict reading of the statute requires that the 180-day period begins on the date of the sale or exchange. If regulations do not address installment sales more directly, the taxpayers may be unable to defer gains from an installment sale recognized more than 180 days after the sale, unless the taxpayer elected out of the installment method. On the other hand, if Treasury were to adopt a rule that began the 180-day period on the date that an installment payment is received, it should consider whether such a rule would permit abusive transactions that artificially extended the gain deferral window well beyond the statutory 180-day period.

2. Flow-Through Entities

The Proposed Regulations provide helpful clarification and flexibility with respect to capital gains realized by partnerships, as described above. The Proposed Regulations provide two time windows during which partners can make their QOF investment. First, the investment can be made within 180 days after the last day of the partnership's taxable year in which the partner's share of the partnership's gain is taken into account under Section 706(a). Alternatively, a partner may elect instead to use the partnership's deferral period – that is, the 180-day period starting on the date the partnership recognized the gain.

We commend the Treasury for affording flexibility to partners in partnerships, many of whom do not receive information from their partnerships in real time. However, we believe that Treasury should consider whether final regulations should provide relief for partners in partnerships who seek to reinvest in QOFs during the time period between these two alternative reinvestment windows. This quirk of the timing rule can be illustrated through the examples below:

> Example 6. Same as Example 1, except that P does not make a deferral election, and therefore A will have to take into account in 2018 her share of the $100 gain recognized by P on April 3, 2018. Assuming that the buyer of Blackacre is also not more than 20% related to A, A can make a deferral election with respect to her $30 share of the gain and invest $30 into a QOF by June 29, 2019 (which is 180 days after the last day of P's taxable year) to defer taxation on her share of P's gain.
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> Example 7. Same as Example 6, except that shortly after the sale of Blackacre, P notifies its partners that it does not intend to make a deferral election with respect to the gain it recognized from the sale. A identifies an opportunity to invest in a QOF in August 2018. Under the elective rule, A can treat its 180-day period with respect to her share of the gain as being the same as P's 180-day period, and thus invest $30 into a QOF in August 2018 and make the deferral election. However, if the closing of the QOF is delayed, and A is not able to invest $30 in the QOF until October 2018, A cannot make a deferral election with respect to her $30 investment in the QOF under either of the elective rules.

Example 7 highlights a somewhat arbitrary timing constraint for partners in a partnership. For eligible gain recognized by the partnership in the first half of its taxable year, there will be a "dead zone" between the end of the 180-day period starting upon the partnership's recognition of the gain, and the beginning of the 180-day period beginning on the last day of the partnership's tax year. Treasury should consider whether it is within its authority to permit QOF investment by partners of non-electing partnerships during the period between the two 180-day windows, as there appears to be no good reason for such artificial "dead zone."

3. Anti-Abuse Rule

The use of partnerships can allow taxpayers to avoid certain restrictions under the QOZ rules, as illustrated by the following examples.

> Example 8. A owns a 30% tenancy in common interest in Blackacre. B and C own the rest of the interest in Blackacre. A, B and C intend to sell Blackacre on April 3, 2019, which will result in a $100 gain for the entire property, and A's $30 gain will be treated as long-term capital gain. A will recognize $30 gain upon disposition of Blackacre, absent a deferral election with respect to the gain. A can invest $30 in a QOF by September 30, 2019 and make a deferral election with respect to the $30 gain from selling Blackacre.
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> Example 9. Same as Example 8, except that A has not identified a QOF to invest in, so A convinces B and C to form Q, a calendar year partnership, by contributing their tenancy in common interests in Blackacre to Q in exchange for partnership interests in Q. Q then sells Blackacre on April 3, 2018 for a $100 gain. Q notifies its partners that it does not intend to make a deferral election with respect to gain it recognized from selling Blackacre. Shortly after the close of the 2018 taxable year, A makes a $30 investment into a QOF, and makes a deferral election with respect to capital gain it recognized through Q.
>
> Example 10. Same as Example 8, except that the potential buyer of Blackacre is 50% related to A (while unrelated to B and C), so A cannot make a deferral election with respect to the gain it recognized from selling its tenancy in common interest in Blackacre. A convinces B and C to form Q, a calendar year partnership, by contributing their tenancy in common interests in Blackacre to Q in exchange for partnership interests in Q. After the sale of Blackacre, Q can invest the $100 gain it recognized from selling Blackacre in a QOF by September 30, 2018 and make a deferral election with respect to that gain, because the buyer is less than 20% related to Q.

As illustrated by these examples, the elective rules under Proposed Regulations Section 1.1400Z-2(a)-1(c) can be used to expand the time window of investment or to circumvent the restrictions of gains recognized from related party sales. This type of planning could be curtailed by allowing a partnership to make a deferral election only if the partnership has been in existence and has held the asset for some specified minimum period of time. Treasury should consider how long the partnership needs to be in existence for it to be an eligible taxpayer to make a deferral election, and for its partners to be able to make an election of their distributive shares of gains recognized through the partnership. At a minimum, we recommend that Treasury consider an anti-abuse rule that would turn off the alternative 180-day windows where a partnership is formed with a primary purpose of extending the 180-day window.

4. REIT Capital Gain Dividends

Example 2 of Proposed Regulations Section 1.1400Z-2(a)-1(b)(4)(ii) states that "[i]f an individual RIC or REIT shareholder receives a capital gain dividend . . . the shareholder's 180-day period with respect to that gain begins on the day on which the dividend is paid." Because Section 857(b)(3) generally provides that (1) REIT capital gain dividends can only be declared on the net capital gain of the REIT, which will not even be verifiable until the REIT's taxable year has ended, and (2) a REIT has until 30 days after the close of its taxable year to identify a dividend as a capital gain dividend, taxpayers will not know whether a REIT dividend would be eligible for deferral through investment in a QOF until after the 180-day period has already expired.[35] This contrasts with the treatment of partnership gains in Proposed Regulations Section 1.1400Z-2(a)-1(c)(2), which provides that, to the extent a partnership does not elect to defer eligible capital gain, each partner may elect to invest that gain in a QOF, with the 180-day period beginning on the last day of the partnership's taxable year. There does not seem to be any apparent reason that partners in a partnership should be treated differently than REIT shareholders for purposes of the 180-day rule. In both contexts, without a special timing rule, the taxpayer may not become aware of the eligibility to make an eligible investment in a QOF until over 180 days after the distribution was made. Accordingly, we recommend that Treasury adopt a rule for REIT capital gain dividends under which the 180-day period begins on the last day of the REIT's taxable year, rather than on the date that the dividend is paid to the REIT shareholders. Such a rule would put REIT shareholders in a similar position to partners for purposes of the 180-day rule.

The considerations described above highlight the disparate treatment under the Proposed Regulations between REIT shareholders who hold their shares directly versus those REIT shareholders who hold their REIT shares through partnerships. Whereas the former face the possibility that their REIT capital gain dividends will be ineligible for investment in a QOF, the latter could receive the same dividend but, due to the operation of Proposed Regulations Section 1.1400Z-2(a)-1(c)(2), would benefit from a 180-day period that begins on the last day of the partnership's taxable year.

D. Fungible QOF Interests - FIFO and Pro Rata Methods

The Proposed Regulations generally require taxpayers to use the FIFO Method for determining which interests in a QOF have been disposed of when, on a single day, the taxpayer disposes of less than all its otherwise fungible interests (where such interests were acquired on different days). Under this method, the earliest acquired of such fungible interests are treated as disposed of first. Fungible interests may be equivalent shares of stock in a corporation or partnership interests with identical rights. In cases where capital gains with different attributes are invested in a QOF on the *same* day, such that the FIFO Method is insufficient to determine which of the resulting QOF interests were sold in a subsequent disposition of some but not all of these interests, the Proposed Regulations mandate the Pro Rata method.

The Proposed Regulations specify that the FIFO method determines (1) whether such interest was either subject to a gain deferral election ("**Eligible Interest**") or not subject to such

[35] In fact, a REIT may even pay a capital gain dividend with respect to capital gain realized later in the year.

an election ("**Ineligible Interest**")[36], when the taxpayer holds both types of interests (together "**Mixed Interests**"), (2) the character of gain recognized when the taxpayer holds Eligible Interests that represent deferred gain with different tax attributes (e.g., either short-term or long-term gain) ("**Mixed Eligible Interests**"), and (3) the extent of any basis step up in an Eligible Interest prior to 2027 by reason of its holding period.[37] The FIFO Method is thus relevant only for certain, specifically enumerated purposes. For example, after 2026, the FIFO Method is potentially relevant only if the fungible interests in the QOF are Mixed Interests, since the FIFO Method does not apply after 2026 if the taxpayer holds only fungible Eligible Interests acquired at different times (i.e., satisfies the 10 year holding period on different dates).[38] Consequently, the FIFO Method does not cover what would seem to be a likely scenario – namely, where a taxpayer will meet the 10-year holding period on a rolling basis with respect to qualifying investments it made over a period of time into a QOF.

> Example 11. P invests $50 of long term capital gain into a QOF on December 1, 2018, and then another $50 of long term capital gains into the QOF on December 1, 2019. On June 30, 2029, P sells half of its QOF interest and seeks to make a Gain Exclusion Election. Curiously, the FIFO Method does not apply for purposes of determining what portion of the interests sold on that day have met the requisite holding period, as that is not one of the purposes described in Proposed Regulations Section 1.1400Z-2(a)-1(b)(6)(ii).

The Proposed Regulations require taxpayers to use the Pro Rata Method of identification if, after application of the FIFO Method, the taxpayer is treated as disposing of less than all interests that were acquired on one day and that are either Mixed Interests or Mixed Eligible Interests. Under the Pro Rata Method, a proportionate allocation must be made to determine which interests were disposed of. Although the Proposed Regulations do not state that the Pro Rata Method is limited to fungible interests, they imply that the method is intended to be so limited (as is the FIFO Method), and the Preamble indicates that the Pro Rata Method is to be used "where the FIFO method does not provide a complete answer."[39]

The Proposed Regulations do not address whether non-economic differences (*e.g.*, voting and non-voting) or small economic differences (*e.g.*, redemption rights for different dates close in time) result in QOF interests being non-fungible. The Proposed Regulations also do not address whether the requirement to use these methods could be avoided by holding fungible interests with different tax attributes indirectly through different entities.[40]

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[36] Proposed Regulations Section 1.1400Z-2(e)-1 refers to an "investment of money" not subject to an election constituting an Ineligible Interest. It is unclear why the Proposed Regulations include this reference to "money," which the statute does not. We do not think it is needed, for example, to coordinate with the related rule that deemed contributions of money under Section 752 does not create a separate investment. While other requirements under Section 1400Z-2 limit the practical ability of a QOF to accept in-kind contributions, we recommend that Treasury clarify whether the QOZ rules permit in-kind contributions to QOFs.

[37] Proposed Regulations Section 1.1400Z-2(a)-1(b)(6)(ii).

[38] The FIFO Method does apply for purposes of determining the 10-year holding period of an Eligible Interest if the taxpayer also holds fungible Ineligible Interests.

[39] If the Pro Rata Method is adopted, whether its application is limited to fungible interests should be clarified.

[40] Basis and holding period of stock is normally determined under Section 1012 on an account by account basis, to facilitate broker reporting of basis. The Proposed Regulations appear not to use that approach and instead appear to

The rationale for the FIFO and Pro Rata Methods is unclear. These proposals are not contemplated in the statute or legislative history. They seem primarily intended to limit the extent to which taxpayers are permitted to otherwise maximize their benefits under Section 1400Z-2 when determining which interests, if fungible, are disposed of when less than all fungible interests are disposed of.[41] We are unaware of any evidence, however, that Congress intended for the benefits of Section 1400Z-2 to be limited in this manner. On the contrary, doing so would seem inconsistent with Congress' decision not to include in the final legislation containing Section 1400Z-2[42] a proposal passed by the Senate that would have mandated the use of a FIFO Method for stock (but not for partnership interests).[43]

For stock, current law provides a clear and administratively workable means for taxpayers and the government to make the determinations under Section 1400Z-2 that are relevant to partial dispositions of fungible Mixed Interests and fungible Mixed Eligible Interests. More specifically, under current law, on the disposition of some but not all shares of identical stock with non-identical basis or holding periods, a taxpayer is permitted to specifically identify which shares of stock are being disposed of (and a FIFO Method is used only as a default).[44] In our view, if the FIFO and Pro Rata Methods were not adopted, this rule would support permitting the use of a specific identification method for purposes of determining the tax attributes of identical stock in a QOF when less but not all of such stock is disposed of. It would also have the virtue of reducing complexity insofar as it would avoid introducing yet another parallel set of operating rules relevant particularly for QOZ purposes. For this reason, and because Congress recently rejected a legislative FIFO proposal, we recommend that final regulations generally rely on current law for making these determinations for stock, instead of adopting the FIFO and Pro Rata Methods.

The rationale for the mandatory FIFO and Pro Rata Methods for QOF partnership interests is even less clear. We agree with the proposals' premise that a workable application of Section 1400Z-2 to Mixed Interest and Mixed Eligible Interest requires the interests' separation into their components. We do not believe, however, that this separation should be limited to Mixed Interests and fungible Mixed Eligible Interests. Furthermore, for Mixed Eligible Interests, we do not believe that this separation should be limited to periods before 2027 (as provided for under the Proposed Regulations). For the statute to work, this separation should be extended to non-fungible Mixed Eligible Interests. To clarify how this separateness is established and maintained, we further recommend that final regulations explicitly state that tax attributes of the components of Mixed Interests and Mixed Eligible Interests are determined as though they are acquired and held by different taxpayers. Finally, for the same reasons that we recommend rejecting the FIFO and Pro Rata Methods for stock, we recommend taxpayers be permitted to identify which fungible separate partnership interest is disposed of and on which

require the FIFO and pro rata methods to be applied across accounts. If these proposals are adopted, it would be helpful to clarify whether the methods apply across accounts.

[41] Current law would permit the specific identification method for only identical stock. *See* Treasury Regulations Sections 1.1012-1(c); 1.358-2.

[42] P.L. 115-97.

[43] 115 H.R. 1, EAS, § 13533, pp. 246, 247

[44] *See* Treasury Regulations Section 1.1012-1(c).

such interest a distribution is made, with proration mandated only in the absence of adequate identification.

We recommend that the final regulations address more directly and clearly the separation of partnership interests consisting of Mixed Interests or Mixed Eligible Interests because the basis and holding periods of partnership interests under current law is determined on a unified basis, for purposes of contributions, allocations, distributions and dispositions, regardless of whether the interest is unitized or represents different economic rights (e.g., preferred and common interest in the partnership). For example, if a partner contributes $100 to a partnership in exchange for an interest worth $100 and then, after a year, when such interest has doubled in value, contributes another $100 for an additional interest worth $100 and thereafter, but within the year, sells a third of her interest for $100 (to an unrelated party and not the partnership), the partner would recover only a third of her basis ($66) and thus recognize gain of $34, and a third of that gain would be short-term and the other two-thirds would be long-term (assuming no "hot assets" in the partnership or other basis adjustments, e.g., by reason of partnership allocations during the period of the investment). If instead of selling the one-third interest to an unrelated party, the partner redeemed from the partnership a third of her interest for $100, no gain would be recognized, and the partner's basis would be reduced by $100.[45]

In contrast to the "unified" interest approach taken by subchapter K, Section 1400Z-2(e) contemplates that Mixed Interests are treated as separate interests. Similarly, Mixed Eligible Interests must be separated into their component parts to determine the tax consequences of dispositions of and distributions on such interests.

For example, suppose in the example above the first purchased interest was acquired in 2018 as an Eligible Interest, and the second had identical rights and was an Ineligible Interest acquired thereafter. Instead of assuming that the one-third interest is sold for $100, however, assume that after 10 years from the first investment, a quarter of the Mixed Interest is sold for $100, implying that, after the second contribution, the Mixed Interest appreciated from $300 to $400 and that economically one-third of that $100 appreciation is attributable to the Ineligible Interest.

We believe that the correct tax policy result is (1) for $85 of deferred gain to be recognized in 2026, resulting in the Mixed Interest having an aggregate basis of $200, and (2) the exclusion of all gain in the subsequent sale of the one-quarter interest to the extent such sale is attributable to the Eligible Interest. Our recommendation would reach that result by treating each interest as though it were held by a different taxpayer and by permitting the taxpayer to specify which portions of each interest are being sold. If the taxpayer were to specify that only the Eligible Interest is sold, then no gain would be recognized. If the taxpayer failed to specify, a pro rata portion of each would be treated as sold (i.e., one-quarter of the $33.33 of appreciation attributable to the Ineligible Interest recognized).

If, in this example, the taxpayer did not sell the one-quarter interest for $100 but instead redeemed one-quarter of the interest for $100, our recommendation would permit the taxpayer to

[45] *See* Treasury Regulations Section 1.1223-3.

specify on which interest the distribution is treated as made. The distribution would thus reduce basis to zero of whichever interest selected, and thus would not trigger gain in either case. However, the identification could have a significant impact of the amount of gain subsequently recognized if there is further appreciation.

Suppose, for example, that the taxpayer treated all of the distribution as attributable to the Eligible Interest, resulting in the value of the Eligible Interest decreasing from $266.67 to $166.67 of the then total value of $300 (or 55.56%), and sometime later sold all the Mixed Interest for $400 (i.e., the Mixed Interest appreciated by $100 after the distribution). The taxpayer would recognize $77.77 of gain in respect of the Ineligible Interest ($400*44.44%-$100) and no gain in respect of the Eligible Interest. Now suppose instead that the taxpayer specified the $100 distribution was attributable to the Ineligible Interest, thereby recovering all the basis in such interest and resulting in its value decreasing from $133.33 to $33.33 of the total then value of $300 (or 11.11%). The subsequent sale of all the Mixed Interest for $400 would result in only $44.44 of gain attributable to the Ineligible Interest and no gain in respect of the Eligible Interest.

A summary of our recommendations regarding the FIFO and Pro Rata Methods are set forth below:

- We recommend that the final regulations not include the FIFO and Pro Rata Methods.

- For acquisitions and partial dispositions of fungible stock consisting of either Mixed Interests or Mixed Eligible Interests, we recommend that (1) taxpayers be permitted to identify which shares of stock acquired have what attributes for purposes of Section 1400Z-2 and, on a partial disposition of those shares, identify which of those share are disposed of using the same method as provided for under current law for purposes of determining basis and holding period of such shares and (2) mandated FIFO be used in the absence of adequate identification.

- For partnership interests consisting of either Mixed Interests or Mixed Eligible Interests, whether or not fungible, we recommend that final regulations specify that all Ineligible Interests be treated as a single interest separate from all Eligible Interests and that each Eligible Interest either acquired on a day different from the acquisition date of any other Eligible Interest or representing deferred gain of a character different than the character of gain of any other Eligible Interest be treated as a "separate" interest. We further recommend that the final regulations clarify that "separate" for this purpose means that the tax consequences of allocations, distributions and dispositions of each separate interest are determined as though it were held by a different taxpayer. Finally, when one or more separate interests have the same economic rights ("**Fungible Separate Partnership Interests**") we recommend that (1) the regulations permit a taxpayer to specify (x) which Fungible Separate Partnership Interests are disposed of when less than all Fungible Separate Partnership Interests are disposed of and (y) on which Fungible Separate Partnership Interests a distribution is made when a distribution is made on any Fungible Separate Partnership Interests and (2) if the taxpayer fails to specify, then the disposition or distribution be prorated across Fungible Separate Partnership Interests based on their relative values.

E. 2047 Termination of Gain Exclusion Election

Prior to the issuance of the Proposed Regulations, commenters raised a multitude of concerns relating to the ability to make a Gain Exclusion Election in light of the expiration of the QOZ designations on December 31, 2028.[46] We commend Treasury for addressing this squarely by providing in Proposed Regulations Section 1.1400Z-2(c)-1(a) that "the ability to make an election under Section 1400Z-2(c) for investments held for at least 10 years is not impaired solely because, under Section 1400Z-1(f), the designation of one or more qualified opportunity zones ceases to be in effect." The Gain Exclusion Election would have nearly been rendered null if the expiration of QOZ designation precluded the election.

However, the Proposed Regulations then provide that this relief "does not apply to elections under section 1400Z-2(c) that are related to dispositions occurring after December 31, 2047." The Preamble describes that this date provides a minimum of 20.5 years for a taxpayer that makes the latest possible investment in a QOF to hold its investment before losing the ability to make a disposition that may be accompanied by a Gain Exclusion Election. In other words, the Proposed Regulations would allow taxpayers who make the investment at the latest possible time permitted by the statute to hold the investment for the full ten year holding period, plus another ten years.

The Preamble specifically states that the additional ten-year period was inserted to avoid situations where the taxpayer may have to dispose of the QOF interest shortly after completion of the required ten-year holding period. Otherwise, a taxpayer might diverge from "otherwise desirable business conduct" or may lose the statutory benefit. Treasury has requested comments on whether some other time period would better align with taxpayers' various economic incentives. Treasury has raised the question of whether future regulations should provide for a presumed basis step-up election immediately before the ability to elect a basis step-up expires. We commend this proposal and recommend that the final regulations allow for an automatic basis step-up election immediately before December 31, 2047 (if such a date is retained in the final regulations) so that taxpayers may take advantage of the benefits of such election.

F. Pre-Existing Entities

Generally, the Proposed Regulations provide that pre-existing entities may qualify as QOFs if such entities meet the QOZ requirements as of the relevant testing dates, and in particular, the requirement that QOZBP must be acquired after December 31, 2017.[47] We commend Treasury for this aspect of the Proposed Regulations. Nonetheless, we believe that additional flexibilities are likely necessary to allow more pre-existing entities to qualify as QOFs.

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[46] Section 1400Z-1(f). It is not unclear why Congress did not include a provision in the statute that addresses this timing point, as it did under the D.C. Enterprise Zone provision of Section 1400B(b)(5).

[47] Proposed Regulations Section 1.1400Z-2(d)-1(a)(3).

Specifically, Treasury should consider whether there are requirements that should be relaxed with respect to entities that acquired QOZBP prior to the date that the Proposed Regulations were issued (but after January 1, 2018) using eligible capital gains invested by taxpayers, but that may not have complied with all the QOZ requirements, including by reason of the fact that some of those requirements did not even exist at the time of the property acquisition. For example, assume a taxpayer and a group of other investors recognized capital gains in February 2018 and contributed the proceeds to an investment vehicle, which then further contributed the proceeds to an existing entity, which purchased QOZBP from an unrelated seller on April 7, 2018. Some time in late 2018 or early 2019, the taxpayer desires to elect deferral with respect to those gains, and would need to certify the existing entity as of April 7. However, the taxpayer capitalized the existing entity (for which it desires QOF treatment) through an investment vehicle, and not directly, and the investment vehicle was not the taxpayer that realized the gain.[48]

We recommend that final regulations contain rules regarding entities that taxpayers desire to treat as QOFs but were disregarded entities at the time property was acquired. Consider the following example:

> Example 12. LLC is a disregarded entity for U.S. tax purposes, and is wholly owned by PRS, a regarded entity that owns many assets and could not qualify as a QOF. LLC acquires property X (which otherwise qualifies as QOZBP) on March 1, 2018. Later in 2018, or in 2019, investors with eligible gains want to invest their gains in the development and improvements of property X. They desire to cause LLC to self-certify as a QOF prior to their investment, however, regardless of when the QOF designation will take effect, it is possible that property X will *never* qualify for treatment as QOZBP, since it was acquired (for tax purposes) by PRS, an entity that was not, and will never be, a QOF. Instead, LLC will have to arrange for a new sale of property X to a QOF with different ownership.

We recommend that Treasury consider whether it could address this situation by adopting a rule to the effect that QOZBP will be treated as acquired by a QOF from an unrelated party after December 31, 2017 if such property was acquired by a predecessor entity of the QOF (which may include a disregarded entity) after December 31, 2017.

G. Business and Investment Start-Up Periods

We note that many funds raise capital in a series of stages over a defined time period, typically 6-12 months. It is typical for later investors in these funds to invest in any assets of the fund at cost, by contributing their share of fund investments and expenses to the fund, along with an interest-like component. These amounts are distributed to the earlier investors to align all of the equity percentages. Many advisers have expressed concern that many of these arrangements may be treated as disguised sales of equity (at least where the QOF at issue is a tax partnership) and therefore preclude later investors from making deferral elections with respect to the investments (since they would be treated as having acquired interests from earlier investors and

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[48] If Treasury permits investments in QOFs through aggregator vehicles, as discussed in Section IV.B.1, this particular fact pattern would not be problematic.

not directly from the QOF). We recommend that Treasury consider adopting a rule clarifying that where such an arrangement occurs over a limited safe harbor period of 12 months, (i) it will be treated for U.S. federal income tax purposes as a single equity contribution by each investor, and (ii) Section 707 will not apply to deny QOZ benefits.

The definition of QOZB Interests explicitly contemplates that a newly organized corporation or partnership can be a QOZB.[49] At the same time, however, the statute requires that, during "substantially all" of the QOF's holding period for such stock or partnership interests, the entity qualify as a QOZB.[50] An entity will not qualify as a QOZB unless, among other things (1) it is engaged in a trade or business, (2) at least 50 percent of its total gross income is derived from the active conduct of such business, and (3) substantially all of its tangible property is QOZBP. For any new entity that requires more than a few months to become operational, these requirements would be difficult, if not impossible, to satisfy because QOZB status is tested every six months and start-up activities that do not rise to the level of a trade or business arguably do not qualify. In the absence of rules that reconcile these conflicting provisions, the number of new businesses eligible for QOZ benefits would be severely limited, which would discourage the establishment of new businesses in QOZs.

We recommend that Treasury issue regulations defining a reasonable start-up period during which any new corporation or partnership organized for the purpose of becoming a QOZB will not fail to qualify as such simply because it is in the start-up phase. The regulations promulgated under Section 45D, the New Markets Tax Credit, serve as appropriate precedent.

The New Markets Tax Credit provides an annual tax credit to investors that contribute cash to a community development entity ("**CDE**") that uses the funds to make equity investments in new or pre-existing qualified active low-income community businesses. A qualified active low-income community business is any corporation or partnership if it is engaged in the active conduct of a qualified business and satisfies certain other requirements, including a gross income requirement identical to the 50 percent gross income test set forth in Section 1400Z-2(d)(3)(A)(ii).[51] Under Treasury Regulations Section 1.45D-1(d)(4)(iv), an entity is treated as engaged in the active conduct of a trade or business for purposes of this test if, at the time of its investment, the CDE reasonably expects that the entity will generate revenues within three years after the date the investment is made.

The similar policy goals of Sections 45D and 1400Z-2 provide strong support for the view that the substantially identical statutory language of the two provisions (including the language in Section 1397C(b)(2) incorporated by reference into Section 1400Z-2) should be interpreted in a similar manner. Thus, we recommend that Treasury promulgate rules providing that a new corporation or partnership that otherwise qualifies as a QOZB will be deemed to be engaged in the active conduct of a trade or business if, at the time a QOF acquires its interest in such entity, the QOF reasonably expects that the entity will generate revenues satisfying the gross income test in Section 1397C(b)(2) within three years.

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[49] *See* Sections 1400Z-2(d)(2)(B)(i)(II) and (C)(ii).

[50] *See* Sections 1400Z-2(d)(2)(B)(i)(III) and (C)(iii).

[51] Section 45D(d)(2); Treasury Regulations Section 1.45D-1(d)(4)(i).

Even if a start-up satisfies or is deemed to satisfy the trade or business requirement, it will not achieve QOZB status unless all of its tangible property (owned or leased) is QOZBP. A business in the initial stages of development may not yet own or lease any tangible property, however. To ensure that such a business has a reasonable opportunity consistent with its business needs to acquire or lease tangible property for use in a QOZ, we recommend that Treasury issue rules allowing new corporations or partnerships engaged in a trade or business to be treated as satisfying the Business Property Test under certain circumstances, and for a reasonable period of time, where the business plan calls for substantially all of the tangible property of the entity to be QOZBP.

H. The Working Capital Safe Harbor

We commend Treasury for adopting the WC Safe Harbor and we believe that it will enable taxpayers to hold and deploy working capital in an orderly and commercially reasonable manner. The WC Safe Harbor operates at the QOZB level. Under Section 1400Z-2(d)(3)(A)(ii), an entity will not be considered a QOZB unless, among other things, it satisfies the requirements of Section 1397C(b)(8), which limits the entity's ability to hold NQFP. As defined in Section 1397C(e), NQFP specifically excludes a reasonable amount of working capital in the form of cash, cash-equivalents, and certain short-term debt instruments. Proposed Regulations Section 1.1400Z-2(d)-1(d)(5)(iv) provides that any such working capital assets will be treated as reasonable in amount if (1) they are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone, (2) there is a written schedule that is consistent with the ordinary start-up of a trade or business for the expenditure of the assets that calls for the working capital to be spent within 31 months, and (3) the amounts are actually used in a manner that is substantially consistent with their designation and the schedule of expenditures.

Although the WC Safe Harbor provides welcome guidance, the Proposed Regulations do not offer any specificity regarding the characteristics of a qualifying schedule or the consequences of spending some or all of the working capital in a manner that deviates from the schedule, including for purposes not specified in the schedule, or failing to spend all of the capital within the 31-month period. They also do not address the treatment of working capital that is needed for businesses that are not asset-heavy. For example, service businesses will often require working capital for formation, acquisition, or expansion pending revenue sufficient to cover expenses, including, for example, amounts held to pay employees and independent contractors. This raises concerns that a business still in the early stages of development or growth might fail to achieve QOZB status even if it satisfies the WC Safe Harbor. Moreover, as drafted, the WC Safe Harbor, which by its terms is limited to "the acquisition, construction, and/or substantial improvement of tangible property," is much narrower than the statutory language, which permits a reasonable amount of working capital without regard to the specific manner in which it is deployed. This creates uncertainty as to the meaning of (and the very application of) the WC Safe Harbor in the context of an operating business. Section 1400Z-2 clearly is aimed at incentivizing the establishment of operating businesses, as well as real estate development, in QOZs and should not be interpreted in a manner that could inappropriately inhibit the establishment of new operating businesses in QOZs.

We recommend that Treasury expand the WC Safe Harbor to include any working capital reasonably expected to be used for the formation or acquisition of a new opportunity zone business, or reflected in the business plan, marketing plan, or development plan of an existing business and reasonably expected to be used in the business. We further recommend that any final regulations include examples of plans and schedules that will and will not satisfy the WC Safe Harbor, with particular focus on the specificity required. For example, we do not believe that a schedule that calls for the expenditure of cash "for QOZ projects in the east coast of the United States" (for instance) should pass muster under the WC Safe Harbor. Conversely, a schedule that provides that cash will be spent in connection with a defined set of particular projects ought to qualify.[52] As discussed in Section IV.J, we also recommend that QOFs be permitted to rely on the WC Safe Harbor when operating a QOZ business directly and not through a QOZB.

Guidance is also necessary with respect to the treatment of any working capital included on a schedule of expenditures that meets the WC Safe Harbor requirements, but that, for *bona fide* business reasons, is spent in a manner that deviates from the schedule or is not spent within the prescribed 31-month period. In the former instance, we recommend that Treasury clarify that any such amounts that are spent in a manner that would have qualified under the WC Safe Harbor if they had been included on the schedule will be treated as satisfying the WC Safe Harbor so long as any deviations or modifications resulted from legitimate commercial considerations and were not effectuated with a principal purpose of avoiding the NQFP limitation. Guidance in this particular area will be important in situations where an identified project or projects are abandoned midstream for bona fide business purposes, requiring the taxpayer to adjust the schedule accordingly.

Finally, as described in Section IV.A.2,[53] we believe that final regulations should more broadly permit QOFs and QOZBs to treat property as QOZBP where improvements to such property are in process. The Proposed Regulations, in our view, unduly limit this concept by tying it to the WC Safe Harbor. We believe that even outside the WC Safe Harbor, such as in the case of a QOF that holds assets directly, property that is being improved <u>must</u> be treated as qualifying property during the pendency of such improvements.

I. QOZB Income Sourcing

Under Section 1400Z-2(d)(3)(A)(ii), a QOZB must satisfy Section 1397C(b)(2), which requires that "at least 50 percent of the total gross income of *such entity* is derived from the active conduct of *such business*." This language does not map neatly onto the definition of QOZB, which provides no antecedent for the phrase "such entity" and does not limit the phrase "such business" to a business conducted in a QOZ. In its original context, however, Section 1397C(b)(2) refers to any corporation or partnership if every trade or business of the corporation or partnership is the active conduct of a qualified business within an empowerment zone. Given the underlying policy of the QOZ provisions and the original meaning of Section 1397C(b)(2), it

[52] For example, in the context of the accumulated earnings tax, a corporation, otherwise subject to such tax, may avoid the tax by showing that its earnings and profits were accumulated for "the reasonable needs of the business". Section 533(a).
[53] *See* fn. 30.

seems clear that Congress intended the gross income requirement to apply to any corporation or partnership seeking status as a QOZB and that only gross income derived within a QOZ could qualify as "good" income.

We recommend that Treasury issue guidance clarifying that a corporation or partnership will satisfy the requirements of Section 1397C(b)(2) if 50 percent of the total gross income of such entity is derived from the active conduct of a trade or business within all QOZs in which such entity conducts such trade or business. Further, we recommend that Treasury adopt rules governing the determination of the source of income as inside or outside a QOZ for purposes of this provision. Any such rules should be designed not only to allow taxpayers to assess with certainty whether the income test is satisfied, but also to ensure that otherwise eligible businesses with operations and service providers within QOZs are not disqualified merely because of income earned with respect to activities occurring or services provided outside QOZs.

In this latter respect, income sourcing rules based on those found in Sections 861 through 865 would not be an appropriate mechanism for implementing Section 1400Z-2's goal of increasing investment and activity in QOZs, as such rules would, among other consequences, deny the benefits of the QOZ provisions to a taxpayer who creates products in the QOZ for sale outside the QOZ. For example, under a traditional delivery-based sourcing rule that treats areas outside a QOZ in the same manner as a foreign country, a manufacturer whose tangible assets are located in a QOZ and whose employees produce items in a facility inside a QOZ would fail to generate "good" income with respect to any such items delivered outside the QOZ. Similarly, an information technology business could not satisfy the gross income requirement with royalties earned for the use of its software outside the QOZ, even if development of the software and any technical support therefor occurs entirely at offices maintained by the business inside the QOZ. In fact, under conventional sourcing rules, businesses that could satisfy the gross income requirement would largely be limited to real estate and on-site service businesses located within QOZs, a result more restrictive than the statutory language would require. In many of the cases posited above, business activity and jobs are created within the QOZs no less than is the case with more "localized" businesses.

A better basis for income-sourcing rules in the QOZ context would be those used to source income for purposes of the New Markets Tax Credit in Section 45D, which, like Section 1400Z-2, was enacted to encourage investment in distressed communities. To satisfy the definition of qualified active low-income community business, a corporation or partnership must derive at least 50 percent of its total gross income from the active conduct of a qualified business within a designated community. The language of this income test requirement is identical to the income test requirement imposed on QOZBs.

Treasury has issued regulations interpreting this gross income requirement for purposes of the New Markets Tax Credit. Under Treasury Regulations Section 1.45D-1(d)(4)(i)(A), an entity is deemed to have satisfied the gross income requirement if either (1) at least 50 percent of the use of the entity's tangible property (whether owned or leased) is within any low-income community[54] or (2) at least 50 percent of the services performed for such entity by its employees

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[54] This percentage is determined based on a fraction the numerator of which is the average value of the tangible property owned or leased by the entity and used by the entity during the taxable year in a low-income community

are performed in a low-income community.[55] An entity may also satisfy the gross income requirement based on all the facts and circumstances.[56]

We recommend that Treasury issue guidance adopting comparable, if not identical, income-sourcing rules for purposes of the gross income requirement under Section 1400Z-2. One modification we would recommend is that any component of the gross income requirement that is based on the services performed for the QOZB should take into account both employees as well as independent contractors. Sections 1400Z-2 and 45D are similar statutes with virtually identical underlying policy goals. Importing the same or similar income-sourcing rules into the QOZ context would properly emphasize the statute's policy goals by ensuring that businesses operate and employ personnel substantially within QOZs and create employment opportunities there, regardless of whether, under the standard income-sourcing rules of Sections 861 through 865, the income would have its source within such zone.

J. Single-Tier vs. Two-Tier QOZ Structures

The QOZ rules create a number of critical distinctions between QOZBP held directly by QOFs, and QOZBP held through a subsidiary QOZB entity. As a general matter, holding qualifying property through a QOZB provides more flexibility to taxpayers. These important differences have resulted in tax motivated structuring involving QOZ investments.

The primary benefits to a QOF (and its investors) of investing through a QOZB are as follows:

- A QOF that holds QOZBP directly is subject to the 90% Test,[57] whereas a QOZB must meet the (70%) Sub All Test.[58]

- The Sub All Test to which a QOZB is subject applies only to tangible property held by the QOZB. While a QOZB must also use a "substantial portion" of its intangible assets in its QOZ business, the intangible assets themselves need not be purchased or otherwise satisfy the requirements applicable to QOZBP. Therefore, a QOZB in many cases can hold significant intangibles without impacting

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and the denominator of which is the average value of the tangible property owned or leased by the entity and used by the entity during the taxable year. Property owned by the entity is valued at its cost basis as determined under Section 1012. Property leased by the entity is valued at a reasonable amount established by the entity. *See* Treasury Regulations Section 1.45D-1(d)(4)(i)(B)(1).

[55] This percentage is determined based on a fraction the numerator of which is the total amount paid by the entity for employee services performed in a low-income community during the taxable year and the denominator of which is the total amount paid by the entity for employee services during the taxable year. If the entity has no employees, the entity is deemed to satisfy this services performed requirement and the gross income requirement if at least 85 percent of the use of the entity's tangible property (whether owned or leased) is within any low-income community. *See* Treasury Regulations Section 1.45D-1(d)(4)(i)(C).

[56] *See* Treasury Regulations Section 1.45D-1(d)(4)(i)(A).

[57] Section 1400Z-2(d)(1).

[58] Section 1400Z-2(d)(3)(A)(i); Proposed Regulations Section 1.1400Z-2(d)-1(d)(3). Although a QOF that holds assets through a QOZB is still subject to the 90% Test, it may treat all of the interests in a subsidiary entity as qualifying property for these purposes so long as the entity meets the Sub All Test.

qualification. A QOF, in contrast, is subject to a flat 90% Test that takes into account all of its assets. Accordingly, even a small amount of intangible property can cause a loss of QOF status.

- The WC Safe Harbor applies only to QOZBs but not to QOFs that directly own assets. Therefore, in addition to being subject to the less forgiving 90% Test applicable to all its assets, a QOF can fail to qualify as a result of holding cash or other working capital, even if the working capital is governed by a schedule that calls for deployment in a reasonable and prompt manner.

In a narrow set of circumstances, it could be advantageous to hold QOZBP directly instead of through a QOZB. First, the statute does not restrict QOFs from directly operating a Prohibited Business, whereas a QOZB may not engage in such a business.[59] Furthermore, under Section 1400Z-2(d)(3)(A)(ii), a QOZB is subject to certain requirements of Section 1397C(b). These provisions include a prohibition on holding 5% or more of the entity's assets in NQFP. If a QOF will hold NQFP constituting more than 5% but less than 10% of its assets (and cannot otherwise qualify for the WC Safe Harbor), it would be well advised to hold its assets directly instead of through a QOZB. Finally, by cross referencing Section 1397C(b)(2), the rules require that at least 50 percent of the total gross income of a QOZB must be derived from the active conduct of the QOZ business. There is no apparent "active conduct" or similar standard applicable to QOFs holding business assets directly.

The policy justifications for these disparities in treatment are difficult to discern. Yet, the Preamble explicitly acknowledges and tacitly approves of them:

> "The 70 percent requirement for a trade or business will give QOFs an incentive to invest in a qualified opportunity zone business rather than owning qualified opportunity zone business property directly. For example, consider a QOF with $10 million in assets that plans to invest 100 percent of its assets in real property. If it held the real property directly, then at least $9 million (90 percent) of the property must be located within an opportunity zone to satisfy the 90 percent asset test for the QOF. If instead, it invests in a subsidiary that then holds real property, then only $7 million (70 percent) of the property must be located within an opportunity zone. In addition, if the QOF only invested $9 million into the subsidiary, which then held 70 percent of its property within an opportunity zone, the investors in the QOF could receive the statutory tax benefits while investing only $6.3 million (63 percent) of its assets within a qualified opportunity zone."

It is difficult to imagine that Congress intended to afford QOFs less flexibility in holding cash as working capital, and it appears equally unlikely that Congress intended to allow QOFs, but not QOZBs, to operate Prohibited Businesses. Instead, these results seem to be accidents of the statutory framework. We suggest that Treasury consider whether final regulations could reduce the distinctions between single- and double-tier structures by, for example, providing for a safe harbor at the QOF level with a similar effect to the WC Safe Harbor. At the very least, we recommend that property in the process of substantial improvement by a QOF be treated as satisfying the SI Requirement while such work is in process, in precisely the manner in which

[59] Section 1400Z-2(d)(3)(A)(iii); Proposed Regulations Section 1.1400Z-2(d)-1(d)(6).

Proposed Regulations Section 1400Z-2(d)-1(d)(5)(vii) applies at the QOZB level. Alternatively, Congress could consider a statutory amendment that would put single- and double-tier QOFs on equal footing, at least with respect to some of the key elements set forth above. We believe that doing so would obviate unnecessary structuring and administrative complexity, especially for taxpayers compelled to form new entities for the sole purpose of creating tiered structures.

K. Profits Interests and Non Pro-Rata Economic Interests

1. Background

Proposed Regulations Section 1.1400Z-2(a)-1(b)(3)(i) provides that an "eligible interest" in a QOF includes "preferred stock or a partnership interest with special allocations." For QOFs that are partnerships, various issues arise where an investor holds an interest in the QOF that is entitled to special allocations or that has a right to a disproportionate percentage of profits.[60] Indeed, it will not be uncommon for a taxpayer to contribute cash to a QOF and receive both a capital interest and a profits interest ("**Profits Interest**").[61] Section 1400Z-2(c) appears on its face to provide a taxpayer making a Gain Exclusion Election with a basis equal to the full fair market value of the "investment" in the QOF, without distinguishing between the different economic rights that may be encompassed by the unitary "investment" in the QOF.[62] Yet, neither the statute nor the Proposed Regulations specifically address the tax treatment of the appreciation in Profits Interests.

Consider the following examples:

Example 13. Venture capital firm V invests $10,000 of eligible gains in a QOF partnership, and receives an interest entitling V to a preferred return, as well as a certain minimum equity multiple upon a sale of the investment. The arrangement is arm's length. Section 1400Z-2 appears to permit V to make a Gain Exclusion Election with respect to the entirety of its interest, assuming the various QOZ requirements are satisfied.

Example 14. Individual P is a promoter of investment funds. P raises $10,000 of capital from third party investors and forms a fund classified as a partnership for tax purposes. P is granted a Profits Interest in the fund entitling him to 20% of the profits, after the investors have received a minimum rate of return on their invested capital. P invests no capital in the fund. The fund certifies as a QOF and holds QOZBP for 10 years, at which point P and the limited partners sell their interests, and P receives $1000 in the sale. Clearly P cannot make the Gain Exclusion Election in connection with the sale because P did not acquire its Profits Interest with eligible gains. In fact, P did not acquire the interest in exchange for any investment at all.

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[60] Many of the issues discussed in this section could also arise for QOFs formed as C corporations (but not subchapter S corporations).

[61] We note that this discussion is not limited to profits interests as defined under Rev. Proc. 91-32. Profits interests are generally discussed as a proxy for any partnership interest that provides for economics disproportionate to the investor's capital investment.

[62] On the unitary treatment of partnership interests, *see, e.g.,* Rev. Rul. 84-53, 1984-1 C.B. 159 (partner that is both a limited partner and general partner has a unitary outside basis in the partnership).

Example 15. The facts are the same as in Example 14, however P invests $100 of capital in exchange for a 1% interest in the fund and the same 20% of profits.

A question arises under Section 1400Z-2 as to whether P can make the Gain Exclusion Election with respect to all the sales proceeds under the facts of Example 15. Indeed, the proper treatment of P becomes more difficult if one were to imagine investments of smaller amounts of eligible gains, perhaps even de minimis amounts. An equity interest entitling the holder to special (non-pro rata) allocations in a QOF may in fact qualify for the benefits of the statute. Thus, a "carried interest" or "promoted interest" does not appear to be automatically disqualified from being treated as an eligible interest solely on account of the fact that the holder is entitled to economics that are disproportionate to invested capital. The Proposed Regulations and their reference to "special allocations" certainly appear to contemplate this result.

Section 1400Z-2(e) provides for the treatment of Mixed Interests in a QOF to the extent the taxpayer invests eligible capital gains and other capital. The bifurcated treatment of Mixed Interests presents a framework for analyzing the treatment of a taxpayer such as P in the examples above, who receives a Profits Interest combined with another interest in the QOF. The Mixed Fund rule does not, however, provide guidance on how a single investment by a taxpayer is to be divided into its component parts or on whether a stated bifurcation will be respected in all cases. Because such interests are ubiquitous in partnership structures, taxpayers require more specific guidance.

2. Compensatory vs. Non-compensatory Interests

We believe it to be clear under the statute that while a Profits Interest (or any other equity in a QOF) purchased for cash can be an Eligible Interest, an interest issued for services cannot. This is because equity in a QOF received for services cannot be said to have been received in exchange for an "investment," as Section 1400Z-2 requires. We recommend that Treasury consider clarifying this principle in final regulations. Such a rule would also confirm that even a single interest must be treated as two separate interests if received for both capital and services. In these cases, a partial or full disposition of the taxpayer's interest will require a proper allocation of proceeds. In this regard, we recommend that the Treasury adopt a rule that requires a taxpayer to allocate any consideration based on the manner in which the proceeds would be distributed under the governing documents of the QOF.

Any rule governing the bifurcation of compensatory (and thus ineligible) and noncompensatory (and thus eligible) interests in a QOF must also take into account the treatment of the QOF's interest in a subsidiary QOZB. Section 1400Z-2(d)(2)(B) and (C) require that a QOF acquire interests in a QOZB "solely in exchange for cash." In certain scenarios, a QOF may acquire an interest in a QOZB for cash but also may be granted a non pro-rata carried interest in the QOZB, in order to compensate a service provider that holds equity at the QOF level. This may occur, for example, where there are other QOFs that own interests in the QOZB and that do not participate in any such carried interest. In these circumstances, we recommend that such QOZB interest be treated as entirely qualifying, with the bifurcation being applied at the QOF level, since the substance of such an arrangement is a cash investment by a QOF in a QOZB together with a compensatory grant of equity to a service provider at the QOF level. Further, we recommend that final regulations clarify that compensatory interests in a QOF will not cause such QOF to be treated as receiving interests in a QOZB for services, thereby precluding qualification as a QOZB.

3. Anti-Abuse Considerations

The determination of whether a particular QOF interest is an Eligible Interest or an Ineligible Interest becomes more fraught where a taxpayer itself (or through related or affiliated investors) holds both categories of interests. In these cases, taxpayers will be incentivized to shift the economics to the interest received in exchange for eligible capital gains and away from the interest received for other capital. Where these shifts occur between different interests held by the same taxpayer, improper QOZ benefits may be achieved without impacting the relative economic rights as between the partners. Consequently, we believe it is important to consider whether certain arrangements should be subject to scrutiny as to whether the taxpayers has shifted allocations (and thus, value) among the various types of interests in a manner that does not have economic effect apart from maximizing QOZ benefits. In all events, we believe that the general rule should provide that bifurcation is based on relative fair market values of the interests being evaluated.

Determining whether value has been improperly shifted from a compensatory interest to an Eligible Interest may require an analysis of the services provided, which could raise complex valuation issues. However, the difficulty may be mitigated by comparing the rights associated with the purported Eligible Interests to those relating to the interests of other holders who invest only cash in the QOF (whether in exchange for Eligible Interests, Ineligible Interests, or both). This comparison can also help in evaluating the legitimacy of noncompensatory interests that taxpayers seek to treat as Eligible Interests. For example, if an investor contributes $50 of eligible gain to a QOF and $50 of other capital, while there is no requirement that the economic entitlements with respect to the two separate investments be equivalent, a true arm's length arrangement would presumably result in comparable rights (and value). Needless to say, where these interests are held by separate (and unrelated) investors, market forces will generally ensure that rights to distributions are not tax motivated. Accordingly, we believe that if anti-abuse rules are adopted, they should contain a presumption that special allocations and disproportionate economics will be respected where the arrangement is the result of arm's length negotiations with unrelated parties and where the economic rights associated with purported Eligible Interests are commensurate with those of Ineligible Interests held by unrelated parties in the same QOF. They should also take into account whether there are tax indifferent parties investing in the QOF, and the QOZ status of the various participants.

We considered recommending specific approaches that could be deployed in ensuring that value is not improperly shifted between related taxpayers or between different interests held by the same taxpayer. We ultimately recommend the adoption of a general anti-abuse rule with certain prescribed "facts and circumstances" and factors that should be taken into account (as illustrated above), as well as presumptions that may apply under certain circumstances.

L. Section 1231 Gains

The Proposed Regulations provide that gain is eligible for deferral if it is treated as a capital gain for U.S. federal income tax purposes. When taxpayers dispose of business property in a taxable transaction, the gain or loss is usually a Section 1231 gain or loss. Whether such gain or loss is treated as ordinary or capital is determined under special rules set forth in Section 1231. When taxpayers dispose of depreciable property (Section 1245 property or Section 1250 property) at a gain, all or part of the gain will first be recognized as ordinary income under the depreciation recapture rules, and any remaining gain will be a Section 1231 gain. To determine the treatment of Section 1231 gains and losses, first the taxpayer will combine all its Section 1231 gains and losses for the year, and if it has a net Section 1231 loss, it is ordinary loss; if it has a net Section 1231 gain, it is ordinary income up to the amount of its Section 1231 losses from the previous five years that have not been recaptured, and the rest, if any, is long-term capital gain.

Therefore, the character of Section 1231 gains can be determined only after cross-netting the transactions for a tax year. Section 1231 gains pose various issues and uncertainties under the QOF rules.

> Example 16. Calendar year taxpayer individual A is in the business of rental real estate. A disposed of an apartment building A had held for longer than one year on April 3, 2018, realizing a $100 gain, of which $30 was treated as depreciation recapture, and the remaining $70 would be treated as Section 1231 gain. A realizes a $40 Section 1231 loss from a separate transaction on August 1, 2018. On November 1, 2018, A realizes another $20 Section 1231 gain. In the previous 5 years, A took ordinary deductions of net Section 1231 loss, of which $35 has not been recaptured.

With respect to the April transaction, the $30 depreciation recapture will always be treated as ordinary income (unless it represents "unrecaptured Section 1250 gain," which is a species of capital gain taxed at a maximum rate of 25%), and therefore, it should not be treated as eligible gain for QOZ purposes. Regarding the Section 1231 items, absent the QOZ rules, Section 1231 gains and losses in the same year will first be netted against each other, and A will have a net $50 Section 1231 gain from 2018 ($70+$20-$40); then $35 will be recognized as ordinary income to recapture prior net Section 1231 loss deductions. The remaining $15 net Section 1231 gain will be treated as long-term capital gain for 2018. It is unclear whether the deferral election is available for (i) both (and either of) the $70 and $20 gross Section 1231 gains from the April and November transaction, or (ii) only the $15 Section 1231 gain after the recapture of prior losses (or perhaps the $50, computed prior to the recapture of unrecaptured Section 1231 losses).

On one hand, the language in the Proposed Regulations seems to only allow deferral of a gain that is "treated as a capital gain," and A cannot treat a particular item of Section 1231 gain as capital gains unless and until it has determined its net $15 amount from its Section 1231 items. On the other hand, Section 1231 items are preferred items, in the sense that net gains enjoy long-term capital gain treatment. It seems a rather harsh result to treat Section 1231 items in a less favorable manner than normal capital gains and losses, where the QOF rules generally allows a taxpayer to defer gross capital gain, and carry forward capital losses. However, allowing deferral elections with respect to gross items of Section 1231 gains will allow taxpayers to use its Section 1231 losses to offset other unrelated ordinary income. We believe that Treasury should consider whether this result is consistent with the intent of the QOZ regime and the Proposed Regulations.

If the deferral election is available with respect to the gross Section 1231 gains of $70 and $20, presumably A can make two investments into QOFs, one of $70 by September 30, 2018, and one of $20 by April 30, 2019 to defer both items of gross Section 1231 gain, and will be able to take an ordinary deduction of $40 with respect to the Section 1231 loss. Under the QOF rules, the attributes of A's deferred gain will be preserved, so if the $70 reinvested Section 1231 gain receives a 15% basis increase (to $10.50) and is then recognized on Dec. 31, 2026, the gain recognized on such date will be $59.50 of Section 1231 gain. But should the $59.50 of gain be subject to recapture of prior net Section 1231 losses? And if so, which five-year window is relevant for this purpose: 2012 through 2017, the five years prior to when the original Section 1231 gain would be recognized had A not made the QOF investment and election, or perhaps 2020 through 2025, the five-year period preceding the recognition of the deferred Section 1231 gains? Should A be required to amend its 2018 return so that its 2018 Section 1231 losses are used to offset the Section 1231 gains now being recognized in 2026?

It seems that a recapture should be required in this situation, because otherwise A would not only have deferred the recognition of its Section 1231 gain, but it also would have converted the recapture portion of such gain from ordinary income to capital gain by investing it in a QOF, and we do not believe that this character conversion effect is an intended benefit under the QOZ rules. Furthermore, even if recapture is required, because A was able to use its gross Section 1231 loss in 2018 to offset its unrelated ordinary income, the election effectively would have enabled A to defer tax on ordinary income, which may also be inconsistent with the statute and the Proposed Regulations. If Treasury were to issue regulations allowing an election with respect to gross Section 1231 gains, rules should also be issued to prevent A from currently using its current deduction of gross Section 1231 losses against ordinary income.

If final regulations only allow a deferral election with respect to the $15 net Section 1231 gain treated as long-term capital gain, a separate issue arises with respect to the appropriate 180-day period with respect to such gain. It appears that there are alternative approaches. First, because A has to recapture prior unrecaptured Section 1231 losses, A can only make deferral elections for gains from transactions that resulted in additional Section 1231 gains after full recapture of prior Section 1231 losses. Under this approach, A can only invest the $15 during the 180-days beginning November 1, 2018. Since A recognized Section 1231 loss in August, after the April transactions that gave rise to the first Section 1231 gain, if A had made a QOF investment immediately after the April transaction, significant uncertainty could result.[63]

The alternative approach would be to start the 180-day clock at the end of the relevant taxable year. At that time, the taxpayer can determine the amount of net Section 1231 gain it will recognize in that year, which will be treated as capital gain under the Code. This approach is similar to the way in which the election operates with respect to capital gains recognized through a non-electing partnership.

We also note that Section 1231 gains give rise to a number of interpretive difficulties when realized at the partnership level. Under Section 702(a)(3), the determination of whether Section 1231 gains are treated as capital gains is made at the partner level. Therefore, it is

63 The same problem also exists if the net Section 1231 gains are ratably allocated to all Section 1231 gain transactions.

unclear whether a partnership itself can defer that gain through a QOF investment, as the ultimate character determination is done by each partner, and depends on the partner's Section 1231 items from other sources.

M. Treatment of Leases

1. Background

The 90% Test is satisfied by a QOF only if it holds 90 percent of its assets in QOZP, measured as the average of the percentage of such property held on two prescribed semiannual testing dates. As described above, QOZP includes QOZBP and QOZB Interests.[64] As defined in Section 1400Z-2(d)(2)(D), QOZBP comprises any tangible property used in a trade or business of the QOF, but only if the property satisfies the enumerated conditions comprising the Business Property Test.

Under Sections 1400Z-2(d)(2)(B) and (C), stock in a corporation and interests in a partnership will be QOZP in the fund's hands if, among other things, at the time of acquisition and during substantially all of the fund's holding period, the corporation or partnership is a QOZB. Under Section 1400Z-2(d)(3), a QOZB is a trade or business if, among other things, substantially all of the property owned *or leased*[65] by the corporation or partnership is QOZBP, *i.e.*, tangible property that satisfies the Business Property Test applied *mutatis mutandis* at the business level.[66] As described above, the Proposed Regulations establish a 70% standard for the Sub All Test.

The Proposed Regulations also provide that, for purposes of the 90% Test, the value of each asset is the QOF's cost of the asset unless the QOF has an "applicable financial statement," in which case, the value of each asset of the fund is the value of the asset as reported on its applicable financial statement for the relevant reporting period.[67] Similar rules are proposed for purposes of the Sub All Test.[68]

Depending on how they are interpreted, these requirements can lead to absurd results both with respect to property leased by a QOF and with respect to property leased by a QOZB. More specifically, under one potential literal reading, the plain language of the statute would allow a QOF to lease property that is never used in a QOZ while effectively making it impossible for a QOZB to lease property without risking its QOZB status. We offer certain

[64] Section 1400Z-2(d)(2)(A).

[65] We assume that, for purposes of Section 1400Z-2, leased property is property subject to a lease that is respected as such for U.S. federal income tax purposes (a "true" lease) and not a lease that transfers ownership of the property to the nominal lessee. Any other interpretation would render superfluous the language in the statute that distinguishes property leased from property owned. Except as otherwise noted, any references to leases in this Report include only leases that are "true" leases for U.S. federal income tax purposes.

[66] *See* Section 1400Z-2(d)(3)(A)(i).

[67] *See* Proposed Regulations Section 1.1400Z-2(d)-1(b).

[68] Proposed Regulations Section 1.1400Z-2(d)-1(d)(3)(ii).

recommendations below that we believe avoid confusion and abuse and permit the use of leased property in QOZBs, a result we believe is consistent with clear Congressional intent.

2. *Treatment of Leased Property at the QOF Level*

The 90% Test applies only to property that the QOF "holds." Because the term "hold" connotes ownership, the Business Property Test seems to apply only to that which the QOF owns. Consequently, the Business Property Test appears to have no application to property that the QOF leases.[69] Accordingly, at first blush, leased property does not figure in a QOF's 90% Test percentage irrespective of the nature of the property.[70]

This result is consistent with the policy of Section 1400Z-2 insofar as it is designed to incentivize only new capital investment in property, as there is no such investment in a fair market value lease. At the same time, however, this result allows funds to avoid the "substantially all use in the zone" requirement with respect to leased property, which means that a QOF could use leased property primarily or even exclusively outside the QOZ. It is unlikely that this is what Congress intended, as the statute's objective is to incentivize investment and business activity within QOZs.

The "DC Zone" provisions of former Section 1400B[71] serve as a reasonable guide for the interpretation of Section 1400Z-2. Prior to its repeal in early 2018, Section 1400B provided a similar capital gain exemption for investment in distressed communities and contained asset and business property tests that are in many respects nearly identical to the 90% Test and the Business Property Test in Section 1400Z-2. Prior to its repeal, Section 1400B excluded from gross income "any qualified capital gain from the sale or exchange of any 'DC Zone asset' held for more than 5 years."[72] A "DC Zone asset" was any DC Zone business stock, any DC Zone partnership interest, and any DC Zone business property.[73] The definitions of "DC Zone business stock" and "DC Zone partnership" interest were largely identical to those of the corresponding terms in Section 1400Z-2. For an equity interest in an entity to qualify as a DC Zone asset, the issuing entity had to be a DC Zone business during substantially all of the taxpayer's holding period. The definition of "DC Zone business property," on the other hand, differed in subtle but important ways from its QOZ counterpart. "DC Zone business property," like QOZBP, included any tangible property that satisfies the prescribed "acquired by purchase" and "original use" requirements. But where Section 1400Z-2(d)(2)(D)(i)(III) requires that substantially all of the use of the property be in a QOZ, Section 1400B(b)(4)(A)(iii) required that substantially all of the use of the property be in a "DC Zone *business*" (as opposed to a

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[69] *McFeely v. Comm'r*, 296 U.S. 102, 107 (1935) ("In common understanding to hold property is to own it. In order to own or hold one must acquire."). *See also United States v. Ninety-Nine Diamonds*, 139 F. 961, 971 (8th Cir. 1905) ("'To own' is defined 'to hold as property; to have a legal or rightful title to; to have; to possess'….").

[70] One might argue that, because the fund "holds" the leasehold interest, the leasehold interest should be taken into account as a "bad" intangible asset. But an on-market lease would have no value and zero cost basis and therefore would not alter the fund's 90% Test percentage in any event.

[71] Section 1400B was repealed on March 23, 2018 pursuant to Section 401(d)(4)(A), Div. U of P.L. 115-141.

[72] See Section 1400B(a) as in effect prior to its repeal pursuant to Section 401(d)(4)(A), Div. U of P.L. 115-141 on March 23, 2018.

[73] *See* Section 1400B(b)(1) as in effect prior to its repeal.

"*DC Zone*"). Presumably, this "use in the *business*" requirement was designed to achieve parity between the requirements imposed on businesses conducted directly by the taxpayer and those operated through a subsidiary corporation or partnership in which the taxpayer owned an equity interest.

Unlike a QOZB, which is defined in Section 1400Z-2, the term "DC Zone business" was defined by reference to the definition of "enterprise zone business" in Section 1397C and included both "qualified business entities" and "qualified proprietorships." Sections 1397C(b)(3) and (c)(2) require that "a substantial portion of the use of the tangible property of [the entity or proprietorship, as applicable,] (whether owned *or leased*) is within [a DC Zone]."[74] Accordingly, a taxpayer could not qualify for DC Zone tax benefits with respect to any tangible property unless: (1) in the case of owned tangible property, such property satisfied the "acquired by purchase" and "original use" requirements and substantially all of the use of the property was in the business and (2) *all* tangible property used in the business, *whether owned or leased*, was used in a DC Zone *a substantial portion of the time*. Thus, a taxpayer was free to lease tangible property for use in a purported DC Zone business without regard to whether such property was owned by a related party or previously used in a DC Zone, but its eligibility for DC Zone tax benefits would be jeopardized if the business did not use the leased tangible property within a DC Zone a substantial portion of the time.

Although the legislative history of Section 1400Z-2 does not provide any detail on this point, the differences between the definitions of DC Zone business property and QOZBP appear to be the result of a Congressional desire to impose a more stringent "substantially all use in the zone" requirement for QOZBs instead of the "substantial portion of use in the zone" standard of Section 1400B. Because the 90% Test considers only tangible property "held" by the QOF, however, property leased directly by a QOF escapes the usage requirement altogether.

3. Treatment of Leased Property at the QOZB Level

Section 1400Z-2(d)(3) provides that a trade or business will qualify as a QOZB if, among other things, "substantially all of the tangible property owned *or leased* by the taxpayer is QOZBP (determined by substituting 'qualified opportunity zone business' for 'qualified opportunity fund' each place it appears in [Section 1400Z-2(d)(2)(D))]."[75] Thus, the statute explicitly contemplates that a QOZB may lease tangible property and that, at the QOZB level, QOZBP will include any leased tangible property that, *vis-à-vis* the QOZB, satisfies the Business Property Test.

The plain meaning of the QOZB definition, however, appears to contain an internal inconsistency since tangible property leased by a QOZB cannot, by definition, attain QOZBP status: tangible property will not constitute QOZBP in the hands of a QOZB unless (1) it was acquired by the QOZB by purchase, (2) its original use in the QOZ begins with the QOZB, *and* (3) during substantially all of the QOZB's holding period for the property, substantially all of its use is in a QOZ. Property that fails to satisfy any of these three requirements will not be considered QOZBP. If these requirements are applied literally, it is difficult to conclude that a

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[74] *Id*. (emphasis added).

[75] *Id*. (emphasis added).

QOZB can satisfy *any* of these requirements with respect to leased property. Tangible property leased by a QOZB would never be QOZBP because, axiomatically, it will not have been acquired by purchase.[76] In addition, it would be impossible for a QOZB to satisfy the Original Use Requirement except in rare cases. A QOZB would fail the Original Use Requirement with respect to any leased premises in the QOZ previously leased to another tenant and any leased movable property that was previously used in the QOZ. Even if a QOZB is the first tenant to occupy a leased QOZ premises, the "original use" of the premises arguably commences with the lessor in its business of leasing property. Finally, a QOZB does not really have a "holding period" in leased property. Accordingly, notwithstanding that a QOZB's leased tangible property has at all times been used inside the QOZ, it would fail to qualify except in rare circumstances, a result seemingly at odds with the aim of the legislation.

If the value of leased property were treated as a non-qualifying asset, then, an otherwise eligible business that requires indoor space (*e.g.*, office space, retail space, or industrial space) and wishes to lease its plant and equipment would likely find it impossible to qualify as a QOZB and would be forced to purchase and construct its own real estate in the QOZ prior to commencing operations. It does not seem likely that Congress intended to restrict a QOZB's ability to lease property.

We have considered whether it is preferable to interpret the statutory language with respect to a QOZB's leased property by treating the property as QOZBP if it satisfies the Business Property Test in the hands of the landlord.[77] But such a reading would allow the QOZB to bolster its asset test compliance using the landlord's property and, thereby, acquire larger amounts of non-qualifying tangible property than would otherwise be permitted. Such a reading would be directly contrary to the policy of conferring benefits only on those taxpayers that make meaningful investments in a QOZ.

Interpreting Section 1400Z-2 to require leased property of a QOZB to satisfy the Purchase Requirement and Original Use Requirement of the Business Property Test leads only to absurd outcomes or a statute without meaning or effect insofar as leased property is concerned. It is unambiguously clear from the definition of QOZB that Section 1400Z-2 contemplates that a QOZB may lease property and that such property can constitute QOZBP. The only construction that does not render the leased property provisions of the statute a nullity and provides some meaning to the language of Section 1400Z-2(d)(3)(A)(i) is to require leased property of a QOZB to satisfy the "substantially all use in the zone" requirement in Section 1400Z-2(d)(2)(D)(i)(III) but not the Purchase Requirement and Original Use Requirement in Section 1400Z-2(d)(2)(D)(i)(I) and (II). We believe that applying traditional rules of statutory construction in this manner is well within Treasury's authority and would further what we believe are the policy objectives of the QOZ provisions.[78]

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[76] One might argue that a QOZB could satisfy the "acquired by purchase" requirement by purchasing a leasehold interest in the property from the original lessee. The leasehold interest itself is an intangible asset, however, and, therefore, not encompassed by the definition of QOZBP.

[77] This would require the QOZB lessee to obtain certifications from the landlord as to the satisfaction of the "original use" requirement and the cost or U.S. GAAP value of the leased property.

[78] As a result of the related party restrictions associated with the Purchase Requirement, we expect many joint ventures between land owners and QOFs to utilize lease structures in lieu of contributions of the land to the joint

4. *Effect of Proposed Regulations*

The Proposed Regulations do not address these issues explicitly, but the proposed rules for asset valuation may affect the treatment of property leased by a QOZB. Under the Proposed Regulations, for purposes of the Sub All Test, tangible property is generally taken into account at the value of the property as reported on the entity's applicable financial statement, which includes a certified audited financial statement that is prepared in accordance with U.S. GAAP, or, in the absence of an applicable financial statement, at cost.

For U.S. federal income tax purposes, a taxpayer entering into an at-market lease has no basis in the leased property. As a result, any leased tangible property that is taken into account at cost will not affect the percentage of a QOZB's tangible property treated as QOZBP. This effectively excludes the leased property from the "substantially all use in the zone" requirement and allows the QOZB to lease non-qualifying tangible property with impunity—the same issue that arises at the QOF level because, under the 90% Test, leased property is (apparently) ignored.

It is not clear how U.S. GAAP would affect the percentage of qualifying assets of a QOZB that values tangible property as reported on its applicable financial statement.[79] If a lease or leased property is assigned any value (other than zero) for purposes of Section 1400Z-2, however, then, as discussed above, under a straightforward application of the statutory language, it would be impossible for it to satisfy the Purchase Requirement and almost impossible for it to satisfy the Original Use Requirement. In such case, neither the lease nor the leased property would generally be characterized as QOZBP, even if all of the use was in the applicable QOZ. Moreover, it is not even clear what the impact is of the inability of leased property to qualify as QOZBP. The Sub All Test only applies to tangible property of a QOZB. While a leasehold interest is an intangible asset, the statute somewhat confusingly refers to "tangible property owned or leased," creating an interpretive dilemma.

5. *Recommendations*

We believe that the QOZ rules are best interpreted as requiring that every QOF and every QOZB use all of its tangible property (whether owned or leased) predominantly in a QOZ. Interpreting the statute to mandate that substantially all of the use of leased tangible property must occur in a QOZ does not create an undue burden on businesses or hinder their ability to use leased property, and it would prevent the use of a lessor's property to shield the lessee's ownership of non-qualifying property. Moreover, such an interpretation would not require an awkward reading of the statute and is consistent with the requirements imposed on businesses attempting to qualify as DC Zone businesses under Section 1400B.

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venture. These arrangements are quite common, underscoring the need for clear guidance on the appropriate treatment of leases under the QOZ rules.

[79] We understand that, for U.S. GAAP purposes, a true lease is generally reflected at a value of zero.

Accordingly, we recommend that Treasury clarify that, for purposes of the Sub All Test, all leased property, whether or not leased from a related party,[80] is to be taken into account at cost. As noted above, this would ensure that property leased by a QOZB does not adversely affect the QOZB's satisfaction of the Sub All Test. We further recommend that Treasury exercise the anti-abuse authority granted in Section 1400Z-2(e)(4) to issue guidance requiring substantially all of the use of any tangible property leased by a QOF or a QOZB to be in a QOZ. This recommendation is consistent with the treatment of leased property under former Section 1400B, from which much of the QOZ provisions are derived and, more importantly, with the policy underlying the statute. It would also harmonize treatment of leased property at the QOF level with that of leased property at the QOZB level. Finally, we recommend that Treasury clarify that leased property need not satisfy the Purchase Requirement or the Original Use Requirement in order to qualify under the Business Property Test.

N. Loss Attributable to Section 1400Z-2 Basis

Section 1400Z-2(b)(2)(B)(iii) and (iv) provide for basis increases at year 5 and year 7. The amount of gain taken into account on the Gain Trigger Date is equal to the excess of (1) the lesser of (x) the gain originally excluded and (y) the fair market value of the investment, over (2) the taxpayer's basis. This rule has the effect of permitting an offset against the triggered gain for any depreciation in the value of the investment. Suppose a taxpayer invests \$100 of eligible gain in a QOF in 2019 and is credited with a basis increase of \$10 in 2024. What is the result if the taxpayer's QOF investment becomes worthless or is otherwise disposed of in a taxable transaction with zero amount realized in 2025? It seems clear from a policy perspective that the taxpayer should not be able to claim a taxable loss in respect of the basis increase under Section 1400Z-2, as those basis adjustments are intended to function solely as a reduction in the amount of deferred gain that must be included in income. However, it is not clear that this result prevails under the statute. Accordingly, we recommend that Treasury address this fact pattern in final regulations.

O. QOZ Basis Issues and Subchapter K

Where a QOF is organized as a partnership for U.S. federal income tax purposes, the determination of inside and outside basis over the life of the QOF investment is subject to significant uncertainties. These questions leave taxpayers unsure about the treatment of income allocations and distributions, nonrecourse deductions, the appropriate computation of gain on the Gain Trigger Date, and the application of the Gain Exclusion Election. In this section we describe some of these uncertainties and request that Treasury provide clarifying guidance. In

[80] There is no sound policy reason to differentiate between leases based on the identity of the lessor. For example, a rule prohibiting leases with related parties would preclude the owner of unimproved real estate from leasing the real estate to a related entity for development by such related entity, but would permit a lease and development of the same property by an unrelated person. The purchase of property from a related person is prohibited by Section 1400Z-2(d) because the policy underlying Section 1400Z-2 is to have taxpayers re-deploy capital to QOZ investments—a sale of opportunity zone property from a taxpayer to a related taxpayer could serve to defeat this policy as no capital is being re-deployed. The same cannot be said of a lease of premises where the capital invested in the QOF is attributable to the sale of an existing non-opportunity zone asset and is being used to build a new business.

many cases we believe that a general anti-duplication concept should be applied in order to ensure that economic income and losses are not taken into account twice.[81]

1. QOF's Basis in its Assets

Nothing in Section 1400Z-2 provides rules regarding a QOF's inside basis in its own assets. If a QOF uses $100 of invested gain to purchase property, under the normal basis rules, the QOF should have an initial basis of $100 in that property. Treasury should confirm this interpretation or alternatively clarify that a QOF must adjust its asset basis to correspond to the holders' bases in the QOF interest under Section 1400Z-2(b)(2)(B).

If final regulations were to require a QOF to adjust its inside basis in this manner, presumably the QOF would also need to increase such basis as investors' outside basis increased pursuant to Sections 1400Z-2(b) and (c). Tracking such increases, especially in tiered partnership situations (which will be the case in many QOF-QOZB structures), would be complex. Permitting the QOF's inside basis to be determined under default tax principles would seem to be consistent with the statute's focus on the investors' investment in the QOF, which arguably is the only asset whose basis is impacted by the QOZ rules.

2. Taxpayer's Basis in its QOF Interest

Section 1400Z-2(b)(2)(B)(i) provides that, except as otherwise provided, the "taxpayer's basis in the investment shall be zero." It does not specify for what purpose the taxpayer's basis in the QOF is zero.[82] Section 1400Z-2(b)(2)(B) provides for increases in outside basis in three circumstances: (1) in the case of an investment held for at least five years, the basis of the investment is increased by ten percent of the deferred gain, (2) in the case of an investment held for at least seven years, the basis is increased by five percent of the deferred gain, and (3) when the deferred gain is included in income (on the earlier of the date on which the investment is sold or exchanged, or December 31, 2026), basis is increased by the amount of gain recognized. Section 1400Z-2(c) provides for an increase in basis, in the case of any investment held by the taxpayer for at least ten years and with respect to which the taxpayer makes a Gain Exclusion Election, to the fair market value of the investment on the date the investment is sold or exchanged. In this section, these QOZ-specific basis rules will be referred to as "**Section 1400Z-2 basis**."

It is not entirely clear how these rules interact with the usual basis rules under subchapter K. ("**Section 705 basis**"). Generally, under Section 722, a partner's basis in its partnership interest includes the basis of property and money contributed to the partnership. Section 752(a) provides that any increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership. Under Section 705(a)(1), a partner increases the

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81 In this section, unless otherwise noted, all QOFs and QOZBs are assumed to be partnerships for U.S. federal income tax purposes, although similar issues arise where such entities are Subchapter S corporations or members of consolidated groups.

82 We note, however, that Section 1016(a)(38) now provides that "[p]roper adjustment in respect of the property shall in all cases be made . . . to the extent provided in subsections (b)(2) and (c) of section 1400Z-2." Treasury should consider the application of this rule.

basis of its partnership interest by his distributive share of the partnership's taxable income and tax-exempt income. A partner's tax basis is likewise generally decreased by the amount of money and the basis of property distributed by the partnership, and by the partner's distributive share of losses from the partnership.

There are a number of possible ways to apply the basis principles of Section 1400Z-2. One reading of Section 1400Z-2(b)(2)(B) is that, for purposes of determining the amount of deferred gain included in income under Section 1400Z-2(b) on the Gain Trigger Date, only Section 1400Z-2 basis is relevant, but that Section 705 basis principles otherwise apply to the taxpayer's interest in the QOF. Under this interpretation, where a sale or exchange of the interest occurs on the Gain Trigger Date the transaction would need to be bifurcated into two pieces: recognition of the original deferred gain under Section 1400Z-2(b)(2)(A), and recognition of additional gain or loss (if any) under Section 1001 with application of Section 705 basis rules. A second reading of Section 1400Z-2(b)(2)(B) is that a taxpayer's Section 705 basis is also treated as being equal to zero, until such basis is increased under the Section 1400Z-2 rules. A third reading is that Section 1400Z-2(b) basis is the only basis calculation for a QOF for all purposes (including for determining the consequences of partnership operations and distributions), which could result in distortions in the amount of deferred gain that is triggered, and even in double taxation.

We recommend that in order to achieve the most sensible results under Section 1400Z-2, Treasury should adopt the following rules in final regulations: (1) in determining the amount of deferred gain included in income under Section 1400Z-2(b) on the Gain Trigger Date, only Section 1400Z-2 basis is taken into account; (2) a taxpayer generally does not have Section 705 basis in its investment in the amount of its deferred gain invested in the QOF, until the times set forth in Section 1400Z-2(b) and (c) (but at such times, the basis increases occur for all purposes); and (3) a taxpayer otherwise computes its Section 705 basis under generally applicable rules. The examples below illustrate these recommendations:

> Example 17. Taxpayer contributes $100 of deferred gain to a QOF in 2019, is allocated no gain or loss, and sells his investment in 2022 for $110. Upon sale, Section 1400Z-2(b)(2) provides that the taxpayer must include in gross income the excess of $100 (the gain originally excluded) over the taxpayer's basis in the investment (which is $0 under Section 1400Z-2(b)(2)(B)(i)). However, the taxpayer has received $110. Consequently, it seems clear that the transaction should be bifurcated, with the taxpayer first recognizing $100 of gain under Section 1400Z-2(b)(2), and an additional $10 of gain under Section 1001.

The technical basis for the additional $10 of gain is that Section 1400Z-2(b)(2)(B)(ii) requires the taxpayer to increase its basis in the QOF investment by the $100. This adjustment should be deemed to happen immediately before the sale. Then, under Section 1001, the taxpayer recognizes additional gain in an amount equal to the excess of the amount realized ($110) over the newly computed basis of $100.

> Example 18. Same facts as Example 17, but taxpayer is allocated $10 of taxable income from the QOF in 2020, and. As above, on sale, the taxpayer must include in gross income the excess of $100 over the taxpayer's basis in the investment. The taxpayer's

Section 1400Z-2 basis is still zero (notwithstanding the fact that the investor was allocated $10 of income), the taxpayer would recognize $100 of gain (the original amount of the gain deferred) under Section 1400Z-2(b). If the sale is bifurcated, the investor's basis for purposes of determining Section 1001 gain (in other words, the Section 705 basis) would include both $100 under Section 1400Z-2(b)(2)(B)(ii) and the basis resulting from the $10 taxable income allocation, such that the investor would recognize no additional gain under Section 1001. In total, the taxpayer would have been taxed on $110, equal to the amount received.

If the taxpayer's Section 1400Z-2 basis included $10 resulting from the taxable income allocation, the taxpayer's gain under Section 1400Z-2(b)(2) would be only $90, with another $10 recognized under Section 1001. While the taxpayer would, in the aggregate, be taxed on the same $110, recognition under Section 1001 could create differences in the character of the gain recognized. Any such differences would arguably contravene the intent of the statute, which is to require the recognition of the entirety of the deferred gain ($100) through the medium of Section 1400Z-2.

If the taxpayer's Section 1400Z-2 basis *and* the taxpayer's Section 705 basis were both zero (that is, if the rule in Section 1400Z-2(b)(2)(B) were read to deny the taxpayer Section 705 basis for the $10 income allocation), the investor could potentially be taxed on a total of $120, notwithstanding that the investor received only $110 from the investment.

Increases in basis attributable to liabilities of a QOF or a lower tier QOZB give rise to similar issues. Under Section 752(a), the partner's increase in a share of partnership liabilities is treated as a contribution of money by the partner to the partnership and generally increases the partner's basis in the partnership. If these increases in basis were not taken into account under Section 1400Z-2, it would lead to distortive results.

Example 19. Taxpayer contributes $100 of deferred gain to a QOF in 2019, is allocated a $10 share of partnership liabilities, and sells his investment in 2022 for $100. On sale, the taxpayer must include in gross income the excess of $100 over his basis in the investment. The taxpayer's Section 1400Z-2 basis is still zero (notwithstanding his share of partnership liabilities), and the taxpayer would recognize $100 of gain (the amount of the gain deferred) under Section 1400Z-2(b)(2). For purposes of Section 1001, however, the investor's amount realized would be $110, including $100 in cash and $10 in relief from his share of partnership liabilities.[83] If the sale is bifurcated, the taxpayer's basis for purposes of determining Section 1001 gain would include the Section 1400Z-2(b)(2) gain recognized and the $10 share of partnership liabilities, such that the investor would recognize no additional gain under Section 1001.

If, instead, the taxpayer's Section 1400Z-2 basis included $10 resulting from the partner's share of liabilities, the taxpayer's gain under Section 1400Z-2(b)(2) would be only $90, perhaps with another $10 of gain recognized under Section 1001. Again, such a reading may result in a different mix of short-term and long-term capital gain, a result that seems contrary to the statute, which presumably is intended to require the recognition of the "full" $100 of deferred gain (with

[83] Section 752(d).

its attendant attributes). Stated differently, the additional $10 of basis under Section 752 should not, in our view, impact the amount of deferred gain to be included in income under Section 1400Z-2(b)(2). Similarly, if the liability allocation were ignored for purposes of both Section 1400Z-2 basis and Section 705 basis, the taxpayer would recognize $110 of gain even though the taxpayer only received $100.

Based on the examples and illustrations above, we recommend that final regulations provide that, for purposes of determining the tax consequences on the Gain Trigger Date, a taxpayer's Section 1400Z-2 basis is determined solely under Section 1400Z-2(b)(2)(A), that any such basis increase is then taken into account for general tax purposes (including Section 1001), and that Section 1400Z-2(b)(2)(A) does not override the Section 705 basis rules that otherwise apply in determining the tax consequences of a sale or exchange of the interest on such date.

3. Impact of Distributions on Basis

The uncertainties regarding basis determinations under Section 1400Z-2 can become even more pronounced where distributions are made to the taxpayer prior to the Gain Trigger Date.

> Example 20. Same facts as Example 18, but the taxpayer receives a distribution of $10 in 2021. Since the taxpayer's Section 705 basis is adjusted for the $10 of income allocated for 2020, the distribution does not result in the recognition of gain or loss and does not terminate any of the taxpayer's QOZ benefits with respect to its QOF interest. As a result of the distribution, the Section 705 basis is reduced by $10 to equal zero. Upon the sale in 2022, the taxpayer must include in gross income the excess of $100 (the gain originally excluded) over the taxpayer's basis in the investment (which is $0 under Section 1400Z-2(b)(2)(B)(i)). No further gain is recognized under Section 1001.

In this example, failing to adjust the Section 705 basis for the $10 of income allocation results directly in the double taxation of that income.

> Example 21. Taxpayer contributes $100 of deferred gain to a QOF in 2019. In 2024, once the QOF has been held for five years, the taxpayer's outside basis in the QOF is increased to $10 under Section 1400Z-2(b)(2)(B)(iii).[84] The taxpayer then receives a distribution of $10 from the QOF.[85] The taxpayer then sells the QOF investment for $100 in 2025.

Assuming the year five basis increase applies for both Section 1400Z-2 basis purposes and Section 705 basis purposes, the taxpayer should not be subject to tax on the $10 distribution (in other words, the taxpayer should not be treated under Section 731 as having sold any portion of the QOF interest), and the taxpayer's Section 705 basis would be reduced to zero. It then must

[84] We assume this basis increase occurs on the five-year anniversary of the investment, though the statute is not explicit on this point.

[85] The distribution may be matched by basis resulting from the investor's share of partnership's liabilities, or by an allocation of taxable income. In many cases, however, a business may have economic income in excess of taxable income (for example, because of bonus depreciation).

be determined whether this reduction of Section 705 basis correspondingly reduces Section 1400Z-2 basis—that is, whether the taxpayer's Section 1400Z-2 basis would be $0 or $10. Upon the sale of the investment for $100 in 2025, if the taxpayer's Section 1400Z-2(b) basis has been reduced to $0 as a result of the distribution, the taxpayer will recognize gain of $100 under Section 1400Z-2(b)(2). If, consistent with our recommendation, the taxpayer's Section 1400Z-2(b) basis remains at $10 even after the distribution, the taxpayer would recognize gain of $90 under Section 1400Z-2(b)(2) and additional gain of $10 under Section 1001. The latter result is arguably more consistent with the statutory language, which appears to mandate that a taxpayer's Section 1400Z-2(b) basis is not affected by any basis adjustments other than those that occur by operation of Sections 1400Z-2(b)(2)(B) and 1400Z-2(c).

4. Suspended Losses and Section 704(d)

Assuming the QOF takes a cost basis in its own property, inside basis will exceed outside basis. Thus, it is possible that the QOF will allocate losses to its partners in excess of their outside basis. Generally, Section 704(d) provides that a partner's distributive share of partnership loss is allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Under Treasury Regulations Section 1.704-1(d)(1), such suspended loss is allowed as a deduction at the end of the first succeeding partnership taxable year, and subsequent partnership taxable years, to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero.

There are several open questions, again involving the basis rule in Section 1400Z-2(b)(2)(B). As discussed above, Treasury should confirm that this rule does not override Section 705 basis rules generally.

> Example 22. An investor contributes $100 of deferred gain to a QOF in year 1, is allocated $10 in taxable income and year 2, and is allocated $10 of loss in year 3. Presumably the investor's basis for purposes of Section 704(d) at the end of year 2 is at least $10 (as a result of the $10 taxable income allocation), such that the investor is able to use the $10 loss allocated in year 3.

However, we recommend that Treasury clarify that Section 1400Z-2(b)(2) does "override" the Section 705 basis rules for the limited purpose of denying outside basis for the deferred gain until the basis is increased under Sections 1400Z-2(b) and (c). For example, if the investor in Example 22 were not allocated the income in year 2, the $10 of loss in year 3 would be suspended under Section 704(d).

Once the QOF has been held for five years, the taxpayer's outside basis in the QOF would be increased to $10 under Section 1400Z-2(b)(2)(B)(iii). Assuming the year 5 basis increase applies for both Section 1400Z-2 basis purposes and Section 705 basis purposes, $10 of losses should be "freed," bringing the taxpayer's basis back down to $0 under Section 705. However, consistent with our recommendation described above, the taxpayer's Section 1400Z-2 basis is not reduced to $0 by dint of the $10 distribution, and the results of a subsequent sale are as described in Example 25.

5. Basis Increase Under the Gain Exclusion Election

Section 1400Z-2(c) provides that, "[i]n the case of any investment held by the taxpayer for at least ten years and with respect to which the taxpayer makes an election under this clause, the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged." It is not clear how this provision applies in various common situations.

We recommend that the final regulations should provide that (subject to the discussion below regarding depreciation recapture and non-duplication of deductions), the Section 1400Z-2(c) basis step up is to "gross fair market value," to account for partnership liabilities.

> Example 23. Taxpayer contributes $100 of deferred gain to a QOF in year 1, is allocated $10 share of partnership liabilities from the QOF, and sells his investment in year 11 for $150. Immediately before the sale, the investor's basis in the QOF is $110, including the investor's share of liabilities, or $100 without including the partner's share of liabilities. If the Gain Exclusion Election increases the basis to net fair market value (in other words, the net equity value of the QOF interest, which is typically computed net of debt), the outside basis in the QOF will be adjusted to $150. However, the taxpayer's amount realized will include relief from his share of partnership liabilities ($10). Thus, the taxpayer would recognize $10 of gain. If instead the outside basis is increased to gross fair market value ($160), the taxpayer will recognize no gain or loss on sale.

We believe that a basis increase that is gross of liabilities is, as a general matter, the result that is most consistent with the statute and with the principle in the Proposed Regulations to the effect that Section 752 liability allocations do not give rise to Mixed Funds. This rule, which is discussed below, stands for the proposition that appreciation in value that is attributable to the debt financed portion of a QOZ investment will still be eligible for QOZ benefits. We believe that it is important for the Treasury to confirm this result including through examples.[86]

The use of leverage is certainly an important component of the development and substantial repositioning of assets and businesses (whether inside or outside of QOZs). The statute does not offer sufficient guidance regarding the operation of the Gain Exclusion Election in many common scenarios. We believe that clarification is needed, including through examples in the final regulations.

6. Depreciation Recapture and the Gain Exclusion Election

None of the statute, legislative history nor Proposed Regulations address how Section 751 should be applied when a partnership interest in a QOF is held at least ten years and the taxpayer makes a Gain Exclusion Election. The tax policy question is whether Section 1400Z-2(c) should be applied to such sales in a manner that allows taxpayers to avoid recognizing ordinary income under Section 751, in particular in respect of the recapture of depreciation deductions previously taken, for example, on Section 1245 property (as defined in Section

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[86] The consequences of these determinations can become rather significant where liabilities are substantial and where such liabilities funded distributions to the investor prior to the Gain Exclusion Election.

1245(a)(3)). These depreciation deductions may be comprised in large part of nonrecourse deductions.

Section 751 is generally intended to prevent taxpayers from avoiding the recognition of ordinary income attributable to unrealized gain on their share of unrealized receivables (including Section 1245 property) or inventory (together with unrealized receivables, "hot assets") held by the partnership when they either sell partnership interest or receive certain distributions. In general, when a partner sells its interest in a partnership that holds hot assets, Section 751(a) requires the partner to recognize ordinary income in respect of its share of the amount of income that would be allocated to the partner on a disposition of such hot assets for their fair market value. This income recognition is required regardless of whether the partner would otherwise recognize gain or loss on the sale of the partnership interest, and to the extent such ordinary income exceeds the gain otherwise recognizable, the partner recognizes a loss on the sale. Section 751(b) generally treats distributions that have the effect of changing a partner's relative interest in the partnership's hot assets (but excluding inventory unless substantially appreciated) in part as a sale or exchange between the partner and partnership of such hot assets for other property (or vice versa).

For example, assume a partnership invests $100 in Section 1245 property and over the depreciation period allocates $50 of depreciation deductions to a partner. When the partner sells its partnership interest, provided that the partner would be allocated $50 of ordinary income on the sale of the Section 1245 property, the partner would be required to recognize $50 of ordinary income, even if the sale would have otherwise resulted in less than $50 of gain. If the partner instead received a distribution of cash that resulted in its having no further interest in the Section 1245 property, the partner would recognize $50 of ordinary income as a result of the distribution.

When a partner's basis in its QOF partnership interest is increased to fair market value by reason of a sale of such interest and a Gain Exclusion Election, we recommend that Treasury confirm that Section 751 requires the partner to recognize ordinary income in an amount that would be allocated to the partner on the partnership's sale of its hot assets. More specifically, in the above example, even if Section 1400Z-2(c) otherwise were to eliminate the recognition of gain from the sale of the partnership interest, the partner would recognize under Section 751(a) $50 of ordinary income (and, presumably, a corresponding $50 of capital loss). In other words, prior depreciation allocated to the partner would be offset by ordinary income, effectively converting those prior ordinary losses into a capital loss. We do not believe that Section 1400Z-2(c) should be applied in a manner that protects the taxpayer from Section 751 and having to recapture prior depreciation deductions.[87]

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[87] If Treasury believes that Section 1400Z-2 does not require recapture in these situations, we believe the only clear path for achieving such a result would be through the application of Section 743, perhaps by analogy to the adjustment to a partner's share of basis in partnership-level assets upon the partner's death if the partnership has in place a Section 754 election. Under that approach, the step up in basis to fair market value would result in a corresponding step up to fair market value in the partner's share of the partnership's basis in its assets, just as such adjustment would occur at the partner's death, provided that the partnership has in place a Section 754 election. We are unsure whether this result is supported by the statute or whether it goes beyond the intended benefits of the QOZ rules. On this, we note that the Senate Report only refers to the exclusion of capital gains. *See* S. Rep. No. 115-466, at 537-38 (2017) ("The provision provides for the temporary deferral of inclusion in gross income for *capital gains*

7. Partnership Level Gain Deferral

The uncertainties surrounding tax basis under the QOZ rules are not limited to QOFs or QOZBs, but also extend to partnerships that hold interests in QOFs. The Proposed Regulations provide that a partnership is an "eligible taxpayer" and may elect to defer recognition of some or all of its eligible gains. If a partnership properly makes an election, then the partnership defers recognition of gain under the rules of Section 1400Z-2 and the deferred gain is not included in the distributive shares of the partners under Section 702 and is not subject to Section 705(a)(1). Any amount of deferred gain that an electing partnership subsequently must include in income under Sections 1400Z-2(a)(1)(B) and (b) is recognized by the electing partnership at the time of inclusion and is subject to Sections 702 and 705(a)(1) at that time. The ability for a partnership to elect gain deferral raises a number of questions regarding capital account and basis determinations at the electing partnership level, including in situations where a partner of the electing partnership sells its interest in the partnership.

> Example 24. Assume partnership AB, owned equally by A and B, owns land with outside tax basis of \$500 and a fair market value of \$1000, reflected on the books of the partnership at \$500. Each of A and B has a capital account and outside tax basis of \$250. AB sells the land and recognizes a capital gain of \$500. AB properly elects to defer the \$500 of gain and invests that amount in a QOF, distributing the remaining \$500.[88] Under the Proposed Regulations, the \$500 of deferred capital gain is not included in the partners' distributive shares and does not increase their outside tax basis. As a result of the book-up and subsequent distribution of cash, each of A and B should have a capital account of \$250 and an outside tax basis of \$0. AB should own the QOF interest with a book value of \$500 and tax basis of \$0. Five years after the partnership invests in the QOF, the partnership's basis in the QOF is increased to \$50 under Section 1400Z-2(b)(2)(B)(iii).

Treasury should confirm that this basis increase results in a corresponding basis increase for A and B in their partnership interests, under Section 705(a)(1)(B). The purpose of Section 705(a)(1)(B) is to ensure that any event that results in a permanent increase in the partnership's basis in its assets, without a corresponding current or future effect on its taxable income, is also reflected in the partners' outside bases.[89] Without such an outside basis adjustment, the partner could ultimately recognize gain upon liquidation or other disposition of the partner's interest in the partnership interest. In the case of a QOF, if outside basis is not increased when the partnership increases its basis in the QOF, the increase in QOF basis would be temporary rather than permanent. For example, if the partnership sells the QOF after five years for \$500, the partnership would recognize gain of \$450, which would increase the partners' outside basis

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reinvested in a qualified opportunity fund and the permanent exclusion of *capital gains* from the sale or exchange of an investment in the qualified opportunity fund.") (emphasis added).

[88] It is not clear whether, upon sale of the land, the partners' capital accounts are increased to \$500 each, or whether the capital accounts continue to reflect the book value of the land before the sale. For purposes of this discussion, we assume the partnership books up its investment at the time of sale, notwithstanding that the gain is deferred.

[89] *See, e.g.*, Rev. Rul. 96-10, 1996-1 C.B. 138. For example, in PLR 9616015, a partner contributed to a partnership land that was subject to special basis provisions under the Alaska Native Claims Settlement Act. The partnership was entitled to increase its basis in the land at some point after the contribution, and the IRS held that the partners' outside basis should be correspondingly increased at that time.

accordingly. If the partners' outside basis had not been increased on the fifth anniversary by \$50, the partners would recognize \$50 of gain upon distribution of the \$500. Furthermore, if instead A were to sell its partnership interest five years after the investment for \$250, and did not have a corresponding basis increase, A would recognize \$250 of gain, even though A's share of the gain inside the partnership at that point is only \$225.

Similarly, Treasury should confirm that the basis increases under Sections 1400Z-2(b)(2)(B)(iv) (seventh anniversary increase), -2(b)(2)(B)(ii) (December 31, 2026, increase), and -2(c) (ten year increase) occur both with respect to the partnership's interest in the QOF and the partners' interests in the partnership.

Another question is whether the partnership's deferred gain is accelerated if one of the partners sells an interest in the partnership. The Proposed Regulations treat the partnership itself as the "eligible taxpayer," so a disposition by a partner generally should not cause a disposition by the partnership. That is, a disposition by a partner has not caused the partnership to "cash out" of the investment. Thus, the better answer is that gain should not be accelerated upon a sale by a partner.

Any rules must also address the treatment of the buyer of an interest in the electing partnership. In the example above, if the QOF increases in value to \$1000 and A sells its partnership interest to C for \$500 in year 3, A would recognize gain of \$500, but the partnership would continue to hold the QOF investment with a tax basis of \$0. The buyer (C) would have an initial outside tax basis of \$500 and share of inside tax basis of \$0. Thus, if the partnership had a Section 754 election in effect in the year of sale between A and C, C should be entitled to a Section 743 adjustment with respect to the QOF investment of \$500. Five years after the partnership's original investment in the QOF, when the partnership is now owned by A and C, the partnership would increase its basis in the QOF by \$50 (ten percent of the original deferred gain of \$500). Assuming that basis increase results in a corresponding outside basis increase to the partners, A would increase its outside tax basis to \$25. It is unclear how the basis increase should impact C's outside basis and Section 743 adjustment.

Similar issues arise on the seventh anniversary of the partnership's investment in the QOF and when the remaining original deferred gain is recognized in 2026.

> Example 25. Assume partnership AB, owned equally by A and B, elects to defer \$500 of capital gain and invests that amount in a QOF. On the fifth and seventh anniversary, the partnership's tax basis in its QOF interest is increased to \$50 and \$75, respectively, and presumably the partners' outside basis is increased by a corresponding amount. On December 31, 2026, the partnership recognizes the remaining \$425 of gain and increases its basis in the QOF to \$500. The partners take into account \$425 of gain and their outside bases are adjusted accordingly. After the tenth anniversary of the QOF investment, A sells A's interest to C for \$1000. There is no mechanism pursuant to which A can elect to increase its outside basis in the partnership to fair market value, notwithstanding that the partnership could have elected to increase its basis in the QOF to fair market value if the partnership had sold its interest in the QOF. Thus, A recognizes gain of \$750. C's outside basis in the partnership interest purchased from A is \$1000 (its

cost). In the next year, the partnership sells the QOF for $3000 and makes a Gain Exclusion Election pursuant to Section 1400Z-2(c) for the basis of the QOF at the time of sale to equal $3000. The partnership liquidates, distributing $1500 each to B and C. With respect to B, as discussed above, the partnership's election to increase the basis of the QOF interest should correspondingly increase B's outside basis in the partnership to $1500 (B's share of the basis increase of $1250 plus B's $250 outside basis immediately prior to the increase). If a similar adjustment is made to C's outside basis, C's outside basis in the partnership would increase from $1000 to $2250, and C would recognize a loss of $750. In effect, the sale from A to C would result in A recognizing a gain and C recognizing an offsetting loss.

We recommend that Treasury address these situations in the final regulations, including by adopting more flexible rules when it comes to the application of QOZ basis adjustments through tiers of partnerships.

Treasury should also clarify the treatment of partner-level Section 743(b) adjustments when a partnership elects to defer gain. If a partner has a negative Section 743(b) adjustment in the capital asset sold by the partnership, is that adjustment carried over to the QOF investment? For example, assume a partnership owns a capital asset worth $100 and with zero tax basis. Partner A owns a 50% interest in the partnership and has a negative Section 743(b) adjustment with respect to the property of $50. If the partnership sold the capital asset and did not make a deferral election, partner A would recognize $100 of gain (A's share of the partnership-level gain, plus A's $50 negative Section 743(b) adjustment). If the partnership elects to defer the gain and invests it in a QOF, it is unclear whether A still recognizes the $50 negative Section 743(b) adjustment or whether, instead, that basis adjustment attaches to the QOF interest.[90] In the latter case, presumably the negative Section 743(b) adjustment would be taken into account when the partnership sells or exchanges the QOF interest, or if earlier, on December 31, 2026.

8. Section 752 and Mixed Fund Issues

Section 1400Z-2(e) provides for a bifurcation of an investor's interest in a QOF where a portion (but not all) of the QOF interest is acquired using eligible capital gains. Prior to the enactment of the Proposed Regulations, many commentators had expressed concern that any indebtedness incurred by a QOF taxed as a partnership would be treated as giving rise to a "mixed fund" as a result of the operation of Section 752(a), which generally treats increases in liability allocation as deemed cash contributions. The Proposed Regulations clarify that the deemed contribution is not treated as such for purposes of the QOF rules.[91]

We support the position taken by the Proposed Regulation on this issue, as the alternative would have created significant impediments to financing QOZ projects with construction loans, bank facilities, and even working capital lines of credit.

[90] *Cf.* Treasury Regulations Sections 1.743-1(h)(1), -1(h)(3).

[91] Proposed Regulations Section 1.1400Z-2(e)-1(a)(2). We assume that this rule is broad enough to cover allocations of nonrecourse liabilities under Treasury Regulations Section 1.752-3 as well as allocations of recourse liabilities for which a partner bears the economic risk of loss under Treasury Regulations Section 1.752-2, including personal guarantees of partnership debt.

The Treasury has requested comment on whether there may be circumstances in which not treating the deemed contribution under Section 752(a) as creating a separate QOF investment may be considered abusive or otherwise problematic. We have not identified particularly abusive scenarios, however we have observed that the rule permits a tax-free return funded entirely with debt. Assuming the Gain Exclusion Election takes into account debt inside a partnership (which is addressed in subsection 5 above), a group of taxpayers may contribute equity to a QOF, which then borrows heavily against acquired property on a nonrecourse basis. After the ten year hold period is satisfied (but prior to December 31, 2047), the investors may sell the QOF interest at a large profit and a large realized gain (inclusive of the debt), none of which would be recognized as a result of the election. Because of the changes we are recommending, including with regard to the application of Section 752 and the basis step up to equal gross fair market value, taxpayers would effectively be able to disinvest tax-free from a QOZ far before ten years have expired. We think this may be cause for concern. One way to address this would be to condition access to the beneficial provisions we are describing on not mortgaging-out of the QOZ investment within ten years if the Treasury believes such transactions are abusive. Such mortgaging-out is common in real estate investments, however, and banning them may make leveraged partnership QOFs less attractive investments.

We also note that there are other circumstances in which a taxpayer may be treated as having made a contribution to an entity despite the fact that no cash was contributed. For instance, in the compensation context, Treasury Regulations Section 1.83-6(d) provides that "if a shareholder of a corporation transfers property to an employee of such corporation or to an independent contractor (or to a beneficiary thereof), in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee or independent contractor." We see no policy reason why such a deemed contribution could not be eligible for a gain deferral election under Section 1400Z-2(a). If such deemed contributions are found not to be eligible for a deferral election, then it stands to reason that (similar to Section 752(a) deemed contributions), they should not give rise to Mixed Fund treatment either.

Relatedly, we believe that Treasury should clarify in final regulations whether a taxpayer with eligible gains may contribute a non-cash asset in kind to a QOF and make a deferral election that relies on such in-kind contribution. Both the statute as well as the Proposed Regulations appear to contemplate only cash contributions to QOFs. Any contributed property would not itself be QOZBP, nor would a further contribution of such property to a QOZB result in the receipt of a qualifying interest by the QOF. Permitting in-kind contributions would implicate questions of valuation, as well as complexities relating to tax basis and gain recognition with respect to the transferred property, Section 704(c) consequences where the QOF is taxed as a partnership, and the proper application of the SI Requirement. Yet, nowhere in Section 1400Z-2 is there a technical requirement that the "amount invested" by the shareholder be in the form of cash,[92] and we do not believe there is a compelling policy reason for such a

[92] This is in contrast to the definitions of "qualified opportunity zone stock" and "qualified opportunity zone partnership interest," both of which must be acquired by the QOF "solely in exchange for cash." Sections 1400Z-2(d)(2)(B), (C).

limitation. Consequently, we recommend that Treasury clarify whether an eligible investment in a QOF may be made in property other than cash.

9. Anti-Duplication Rules

In light of the numerous questions and computational uncertainties that we have observed under Section 1400Z-2, we recommend that the final regulations contain a generally applicable anti-duplication rule providing that determinations of basis, income and loss must be carried out in a manner that avoids the double counting of the same economic benefits or losses. We believe that such a rule is primarily necessary for QOFs and QOZBs (and electing taxpayers) taxed as partnerships, but it may also be relevant for corporate entities as well. An anti-abuse rule such as this one seems clearly within the scope of Treasury's authority set forth in Section 1400Z-2(e)(4)(C).

P. Prohibited Businesses

Section 1400Z-2(d)(3)(A)(iii) sets forth the seven Prohibited Businesses for a QOZB. Proposed Regulations Section 1400Z-2(d)-1(d)(6) paraphrases Section 144(c)(6)(B), which include a reference to "any store the principal business of which is the sale of alcoholic beverages for consumption off premises." The legislative history does not shed light on the meaning of these terms. We recommend that Treasury confirm that the "alcoholic beverages" restriction be limited to its clear meaning, *e.g.*, a traditional "liquor store" that sells alcoholic beverages to retail customers for consumption off premises, and not to restaurants and other similar establishments that produce or serve alcoholic beverages on premises primarily for sale to customers consuming the beverages on the premises.

Q. Offsetting-Positions Transactions

Proposed Regulations Section 1.1400Z-2(a) provides that gain is not treated as "eligible gain" (and thus not eligible for deferral under Section 1400Z-2(a)(1)) if such gain is from a position that is or has been part of an "offsetting-positions transaction." For this purpose, an offsetting-positions transaction is a transaction (including a straddle) in which a taxpayer has substantially diminished its risk of loss from holding one position with respect to personal property by holding one or more other positions with respect to personal property (and regardless of whether either of the positions is with respect to actively traded personal property).

The offsetting-positions transaction rule does not appear in the statutory language, and there is no reference to such a concept in the legislative history. As a result, it is not entirely clear why Treasury determined that gain from an offsetting-positions transaction should be excluded from eligible gain treatment. Based on language in the Preamble, however, it appears that the government was concerned that a taxpayer could get the benefits of the QOZ regime with respect to gain realized on one position in an offsetting-positions transaction while the taxpayer was able to take into account a loss in one or more other positions in such transaction.[93]

[93] Specifically, the Preamble states: "The Treasury Department and the IRS considered allowing deferral under Section 1400Z-2(a)(1) for a net amount of capital gain related to a straddle (as defined in section 1092(c)(1)) after

We have considered whether the offsetting-positions transaction rule should be included in final regulations. Specifically, the straddle rules provide generally that any loss with respect to a straddle position may be taken into account for a taxable year only to the extent that the amount of such loss exceeds any unrecognized gain with respect to one or more offsetting positions.[94] For this purpose, the term "unrecognized gain" includes the amount of gain realized but not recognized with respect to a position.[95] Where the amount of unrecognized gain in an offsetting position is realized but not recognized, we believe that the result under current law is that any loss that had been suspended would be recognized when the corresponding gain is ultimately recognized as a result of a subsequent transaction or event (although the straddle rules are silent on this point). The important point here is that, in the straddle context, the deferral of gain from the disposition of a straddle position would not permit the current recognition of an otherwise suspended loss.

> Example 26. Taxpayer owns one share of stock in a publicly-traded company ("Pubco") with a basis of $20. When the stock is trading for $100, taxpayer buys a put option with respect to one share of Pubco stock in exchange for a premium of $10. The put option subsequently lapses unexercised, resulting in taxpayer's realization of a $10 capital loss. Assuming that the put option was not part of an identified straddle, such loss is deferred in its entirety so long as it does not exceed the unrecognized gain in the Pubco share held by taxpayer. If taxpayer subsequently sells the Pubco share for $100, and is permitted to make a gain-deferral election with respect to the $80 of gain realized on the sale, the $10 of deferred loss from the put option would continue to be deferred because there would remain $80 of unrecognized gain (*i.e.*, the Pubco share gain was realized but not recognized). Thus, while the Preamble language suggests that it might be sensible (although complicated) for a taxpayer to be permitted to defer $70 of gain in this case (*i.e.*, its net gain from both positions in the offsetting-positions transaction), the operation of the straddle rules generally would have the same effect by continuing to suspend the $10 put option loss at least until the suspended gain is recognized.

It might be argued, however, that it would be overly-generous for a taxpayer investing in a QOF to eliminate 15% of its deferred gain (assuming that it holds its QOF interest for seven years by December 31, 2026), while permitting the taxpayer ultimately to recognize all of its loss in an offsetting position with respect to the original position giving rise to the invested gain. If this is a concern, the straddle regulations could be amended to provide that any loss suspended under the straddle rules would be eliminated in the same proportion as any elimination of gain in one or more offsetting positions as a result of the QOZ rules. Alternatively, this rule could be adopted in the final QOZ regulations.

With respect to offsetting-positions transactions that do not form part of a straddle (*i.e.*, because such positions are not with respect to actively traded property), it is not clear that the deferral of gains on one of the positions should raise a meaningful tax policy concern. Specifically, because such transactions are not subject to the straddle rules, the tax law currently

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the disposition of all positions in the straddle. However, such a rule would pose significant administrative challenges."

94 Section 1092(a)(1)(A).

95 Section 1092(a)(3)(A)(ii).

permits a taxpayer to recognize loss with respect to a loss position while indefinitely deferring gain in an offsetting gain position. If a taxpayer in such a case is generally permitted to recognize tax loss while deferring an offsetting tax gain, it is reasonable to think that such a taxpayer should able to realize such gain but defer its recognition through investment in a QOF (whether such gain is realized before or after recognition of the offsetting loss). In other words, why should the tax law treat the gain realization by such a taxpayer any different than gain realization by a taxpayer not holding its gain position as part of a non-straddle offsetting-positions transaction?

On the other hand, we note the government may indeed have an interest in preventing taxpayers from entering into offsetting positions with the specific purpose of generating gain to be invested in a QOF, whether or not it currently recognizes the loss (which will depend on whether the positions constitute a straddle). There are two similar, yet distinct policies at play when it comes to offsetting-positions transactions. The first is whether taxpayers should be able to "manufacture" gains and thereby access the benefits of the QOZ rules. Second, even if the taxpayer did not enter into offsetting positions for this purpose, there is a question of whether only the net gain for such positions ought to be entitled to QOZ benefits. We believe the first policy issue is of greater concern than the second. Accordingly, we think it would be worth considering a rule that would exclude from eligible gain treatment any gain recognized with respect to a transaction entered into in order to generate eligible gain.

If the offsetting-positions transaction rule is retained, we believe that the government should significantly reduce its scope because, in its current form, the rule could significantly disrupt the ability of taxpayers to invest in QOFs. First, a taxpayer that is a partner in an investment fund, such as a hedge fund, may wish to defer some or all of its share of the capital gain recognized by the fund during a year, but may have significant difficultly ascertaining whether any of the fund's positions giving rise to otherwise eligible gain had ever been part of an offsetting-positions transaction. Second, the rule applies even if all of the other positions in the offsetting-positions transaction have given (or in the future will give) rise to gain (rather than loss). It is difficult to see what tax policy is being achieved by the rule where there was no loss in an offsetting position. Third, the rule applies even if the position was part of an offsetting-positions transaction for only a short period of time and/or it was part of such a transaction years or even decades earlier.[96] If Treasury otherwise determines that the rule is necessary, we recommend excluding from its application offsetting-positions transactions where no offsetting position was in held on or after the date the TCJA was enacted. We note that this might be accomplished by striking the words "or has been" from the Proposed Regulations, and adopting an anti-abuse rule as discussed above to police transactions where hedges are unwound shortly before sale.

[96] We note in this regard that since the rule applies to non-actively traded property, it could potentially disallow entirely non-abusive transactions. For example, if an individual owns a business and entered into a contract to sell the business fifteen years ago, but shortly thereafter terminated the contract with the seller, then *any* gain recognized in the future on the sale of that business would not be eligible for deferral since it is "from a position that is or has been part of an offsetting positions transaction." We are doubtful that this was Treasury's intention in enacting the rule and recommend that Treasury reconsider the breadth of the rule.

R. Failure to Qualify as a QOF and Reasonable Cause

Section 1400Z-2(f) provides that a QOF that fails to meet the 90% Test is subject to a monthly penalty determined based on the Section 6621(a)(2) underpayment rate. Section 1400Z-2(f)(3) states that a QOF is not subject to a penalty if it is shown that such failure is due to reasonable cause. We believe that further guidance is needed in order to assist taxpayers in evaluating the risk of failing to meet the QOF requirements at one or more testing dates. Of particular importance to QOZBs that will conduct tangible property construction and improvement is the manner in which the WC Safe Harbor interacts with the qualification requirement, the determination of penalties and the reasonable cause exception.

The retrospective nature of the WC Safe Harbor creates a number of open questions, as the following example illustrates:

> Example 27. A QOF is properly formed and funded, and acquires a real estate development project in a QOZ through a QOZB. Pre-development costs, due diligence, entitlements and permitting, and other expenses are funded with a combination of debt and equity. Following the acquisition of the property, the construction work begins and the QOZB complies in all respects with the WC Safe Harbor. On one or more testing dates during the construction period, but for the WC Safe Harbor, the amount of cash and other working capital held by the QOZB would exceed 5% of its assets. At the end of the 31-month period beginning with the date on which the QOZB raised its cash, the QOZB determines that it was unable to spend working capital "substantially consistently" with the working capital schedule.

It is not clear under the circumstances described in this example whether (1) the QOF will be treated as never having qualified, (2) the QOF will be treated as having qualified until the date on which the WC Safe Harbor determination was made (that is, the end of the WC Safe Harbor period), and (3) what penalties will apply to the QOF. These questions are critical to the taxpayers that invested eligible capital gains into the QOF, because they need to know whether they will still be entitled to deferral of their gains until the end of the WC Safe Harbor period.

A relief provision based on reasonable cause will likely be an important component of QOZ planning and risk management. Due to the highly technical and periodic nature of many of the QOZ requirements, as well as the fact that a QOF by its nature is a long-life vehicle, taxpayers need additional clarity in this area. Giving content to the reasonable cause standard will be especially critical during the early stages of the QOZ regime, when interpretive questions are likely to be both more numerous and more nettlesome.

Under the REIT rules, a failure to satisfy the various statutory requirements can generally be cured if the failure was due to reasonable cause and not due to willful neglect, although the cure may also require the REIT to pay a penalty tax and to meet other procedural requirements. The REIT rules, most of the penalty provisions in the Code, and various other provisions (40 Code sections in total) grant relief for certain failures that are "due to reasonable cause and not [due] to willful neglect" (the "**Reasonable Cause/Willful Neglect Standard**"). By contrast, four penalty relief provisions apply where there was reasonable cause for the bad conduct and the actor "acted in good faith" (the "**Reasonable Cause/Good Faith Standard**"). A number of regulatory provisions also use each standard. In particular, the Reasonable Cause/Good Faith Standard is used in Section 6664, which provides exceptions to the accuracy-based penalties of Sections 6662, 6662A, and 6663. Part 20.1 of the Internal Revenue Manual (the "**Penalty Handbook**") describes the IRS's policies regarding penalty provisions, including the application of the reasonable cause standards. The Penalty Handbook stresses that the interpretation of reasonable cause is intended to be consistent across the various penalty provisions where the term appears. The Penalty Handbook also notes that:

> The wording used to describe reasonable cause provisions varies. Some IRC penalty Sections also require evidence that the taxpayer acted in good faith or that the taxpayer's failure to comply with the law was not due to willful neglect. See specific [Internal Revenue Manual] sections for the rules that apply to a specific IRC penalty section.

Thus, the Penalty Handbook suggests that the Reasonable Cause/Willful Neglect Standard has two elements: the presence of reasonable cause and the absence of willful neglect.

This interpretation is consistent with other authorities, which have given each of these two prongs a distinct meaning. The regulations governing the failure-to-file and failure-to-pay penalties (relief from which is governed by the Reasonable Cause/Willful Neglect Standard) explain that reasonable cause exists if the taxpayer uses "ordinary business care and prudence"[97] in carrying out the duties imposed by the Code but is nonetheless unable to comply (or, in the case of a failure to pay a tax, would have experienced undue hardship by complying).

In requesting further clarification of the QOZ penalty and relief provisions, we acknowledge that a number of aspects of QOF penalties and decertification have been expressly reserved by the IRS and Treasury until additional guidance is issued. Specifically, the Preamble notes that forthcoming regulations "will address, among other issues, the applicability of the Section 1400Z-2(f)(1) penalty and conduct that may lead to potential decertification of a QOF." Similarly, these forthcoming regulations will also provide guidance on the delegation of authority set forth in Section 1400Z-2(e)(4)(B), which authorizes regulations to ensure that a QOF has "a reasonable period of time to reinvest the return of capital from investments in [QOZBs], and to reinvest proceeds received from the sale or disposition of [QOZBP]." We appreciate the fact that not all the uncertainties surrounding the QOF provisions can be adequately addressed at one time. However, it is important to emphasize that appropriate tax planning requires an understanding of the risks and "downside" scenarios, which is especially true where sponsors assume fiduciary duties to investors in QOFs. Therefore, we respectfully request that Treasury provide more detailed rules regarding the penalty provisions of the QOZ rules (particularly in the WC Safe Harbor context) and the factors that would be taken into account when evaluating whether a failure is due to reasonable cause. As is the case with most factual standards, examples would also be helpful in the QOF penalty context.

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[97] Treasury Regulations Section 301.6651-1(c)(1).