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January 10, 2019

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

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

Dear Commissioner Rettig:

Enclosed please find comments with respect to the proposed regulations regarding investments in qualified opportunity funds under section 1400Z-2. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

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

Sincerely,

Eric Solomon
Chair, Section of Taxation

Enclosure

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**AMERICAN BAR ASSOCIATION
SECTION OF TAXATION**

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

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

Principal responsibility for preparing these Comments was exercised by Mark E. Wilensky. Significant contributions were made by Maurice Holloway, Scott Barnes, Jeff Gurney, Andrea Whiteway, T.J. Anthony, Christopher Cunningham, Megan Jones, Elizabeth Stieff, Michael Hirschfeld, Philip Hirschfeld, Libin Zhang, Dustin Covello, Leila Vaughan, Susan Reaman, Walter Calvert, Jessica Millett, Laura Luko, Elizabeth Feldmeir, Katie Gerber, David Shapiro, Erik Loomis, Argyrios Saccopoulos, Brian Dethrow, Eli Akhavan, Martin Pollack, Brad Borden, Steven Kennedy, Derek Kershaw, Brad Gould, and Lou Weller. The Comments have been reviewed by Todd Keator, Chair of the Real Estate Committee, Adam M. Cohen, Council Director for the Partnerships and LLCs and Real Estate Committees, Jeanne Sullivan of the Section’s Committee on Government Submissions, and Eric Sloan, Vice-Chair of Government Relations for the Tax Section.

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

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Date: January 10, 2019

EXECUTIVE SUMMARY

These Comments are in response to Proposed Regulations under section 1400Z-2¹ with respect to changes made by last year's tax legislation (the "Act").² Opportunity zones were added to the Internal Revenue Code by the Act. Opportunity zones are an economic development tool designed to spur economic development and job creation in distressed communities. We commend the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") for their commitment to provide expedited guidance, and we ask that Treasury and the Service consider the following recommendations in the finalization of the initial set of Proposed Regulations under section 1400Z-2 published in the Federal Register on October 29, 2018 ("Proposed Regulations"). We also ask Treasury and the Service to consider our additional recommendations for forthcoming guidance. We note that there are a number of other issues needing guidance relating to investments in opportunity zones that we intend to address in further comments at a later time.

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

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

- I. Comments regarding the 180-day election period and the gain-deferral election with respect to a partner's distributive share of gain from partnerships:
 - A. Taxpayers should be allowed to treat all section 1231 gain that cannot be definitively characterized as capital gain prior to the end of the taxable year as capital gain for purposes of section 1400Z-2.
 - B. Partners should be allowed to disaggregate gains recognized by the partnership and separately choose between the two allowable 180 day election periods for each gain.

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

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

- C. Partners in partnerships should be allowed to true up (or down) their investment in a QOF in the event of a discrepancy between the amount of capital gain the partner believed in good faith to be the correct amount and the actual gain reported to the partner on a Schedule K-1.
 - D. Capital gain allocated to a partner for purposes of the gain-deferral election under section 1400Z-2(a) should include a special allocation of capital gain that is respected under section 704(b) and the applicable Regulations.
- II. The fixed end date of December 31, 2047 for the basis step-up election in section 1400Z-2(c) should be eliminated. If continuing to mandate a fixed end date, taxpayers should be allowed to elect a basis step-up to fair market value without disposing of their investment in a QOF.
- III. QOFs should be allowed to use “cost” for purposes of the 90% gross asset test in all events, where cost is defined as unadjusted basis for Federal tax purposes with certain adjustments.
- IV. Comments regarding the working capital safe harbor and the safe harbor for property on which working capital is expended:
- A. The 31-month working capital safe harbor should be extended to address delays out of the control of a “qualified opportunity zone business” (“QOZB”) and also to address staged cash contributions.
 - B. The safe harbor for property on which working capital is expended should be delinked from the 31-month working capital safe harbor and have a separately determined safe harbor period.
 - C. The working capital safe harbor should be extended to real estate or other business assets directly owned by QOFs and not only to real estate development by QOZBs.
 - D. The working capital safe harbor should be expanded beyond real estate development to the development of other business operations in a QOZ.
- V. Comments regarding the separate investment rule for partners who are allocated a share of a QOF’s liabilities under section 752:
- A. Investors in QOFs should be permitted to apply the partnership basis rules under section 705, as extended by section 752, to their interest in a QOF, and investors should be permitted to deduct their distributive share of losses from the QOF to the extent of their basis in the interest.
 - B. The requirement in section 1400Z-2(e)(1) to treat as two separate investments (i) the investment to which a gain-deferral election under

section 1400Z-2(a) applies and (ii) the investment to which the gain-deferral election does not apply, should not require the creation of two separate partnership interests for purposes of subchapter K for a partner with either mixed funds or an allocable share of partnership liabilities.

- C. Non-liquidating cash distributions should not result in a sale or exchange of the investment in a QOF except to the extent that the partner is considered to have sold its interest under section 731(a).
- D. Gain includible under section 1400Z-2(b) should include the value of prior non-liquidating distributions of property by the QOF.
- E. Taxpayers should be required in all events to recognize gain deferred under section 1400Z-2(a) in connection with a liquidating distribution by a QOF.
- F. Additional anti-abuse provisions to address certain debt-financed distributions to an investor are unnecessary.
- G. The basis step-up election under section 1400Z-2(c) should include the basis attributable to the partner's allocable share of debt.

VI. Comments for future guidance, including future Proposed Regulations, regarding the acquisition by purchase, substantial improvement, and original use requirements in section 1400Z-2(d)(2)(D):

- A. Leased property should either be treated as acquired by purchase and/or be valued at the lease's fair market value for purposes of the 90% asset test.
- B. Land held in connection with the construction of substantial improvements to property should be treated as a "good asset" for purposes of the 90% asset test of the QOF in circumstances involving the construction of other improvements notwithstanding that the land may have been acquired by capital contribution from a partner or the land itself is not substantially improved.
- C. QOFs or QOZBs should be allowed to use the aggregate basis of related assets in determining whether the substantial improvement requirement has been achieved, and should be permitted to rely on certain safe harbors for purposes of determining whether assets may be aggregated.
- D. Taxpayers should be permitted to rely on certain safe harbors for purposes of determining whether movable property satisfies the original use requirement.
- E. Taxpayers should be permitted to rely on certain safe harbors for purposes of determining whether real property satisfies the original use requirement.

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DISCUSSION

I. Comments Regarding the 180-Day Election Period and the Gain-Deferral Election with respect to a Partner's Distributive Share of Gain from a Partnership

This portion of the Comments addresses the 180-day election period and the gain deferral election for a partner's distributive share of gain from partnerships.

A. Whether All Section 1231 Gains Recognized by a Taxpayer during the Taxable Year Are Eligible Gains

1. Background

Section 1400Z-2(a)(1) allows taxpayers to defer recognized gain from gross income by investing the gain in a QOF. The Proposed Regulations provided that section 1400Z-2 only applies to "eligible gain," defined as gain treated as capital gain.³ To qualify for the gain-deferral election, taxpayers must invest the gain within 180 days after the transaction giving rise to the gain.⁴

Under section 1231, gain from the sale of business-use property held for more than one year ("section 1231 property") is treated as long-term capital gain ("section 1231 gain") if the section 1231 gain exceeds the losses recognized from the sale of section 1231 property ("section 1231 losses") during the taxable year.⁵ If section 1231 losses exceed section 1231 gain for a taxable year, then the section 1231 gains and section 1231 losses recognized during the taxable year are not treated as gains from the sale or exchange of capital assets (i.e., they are ordinary income items).⁶ Section 1231 recapture rules may also apply to treat section 1231 gain as ordinary income.⁷

Section 702(a)(3) requires each partner to take into account separately the partner's distributive share of section 1231 gains and losses. Partners therefore take into account their distributive shares of a partnership's section 1231 gains and losses in addition to any other section 1231 gains or losses recognized outside the partnership.

2. Recommendation

We recommend that the final Regulations allow taxpayers to treat all section 1231 gain that cannot be definitively characterized as capital gain prior to the end of the taxable year as capital gain for purposes of the gain-deferral election in section 1400Z-2(a).

³ Prop. Reg. § 1400Z2(a)-1(b)(2)(i).

⁴ I.R.C. § 1400Z-2(a)(1).

⁵ I.R.C. §§ 1231(a)(1), (b)(1).

⁶ I.R.C. § 1231(a)(2).

⁷ I.R.C. § 1231(c).

3. Explanation

Section 1231 gains that are treated as long-term capital gains appear to come within the definition of eligible gain. Section 1231 gains treated as ordinary income would not appear to come within the definition of eligible gain. The character of section 1231 gains depends upon the total amount of section 1231 gain recognized throughout a taxable year. Consequently, taxpayers who recognize section 1231 gain before the end of the taxable year may not be able to determine whether the gain will ultimately be characterized as capital gain or ordinary income. Section 1231 losses or additional section 1231 gains recognized later in the year may affect the character of earlier-recognized section 1231 gain. The inability to determine the character of section 1231 gain at the time the gain is realized may create untenable situations for taxpayers who wish to invest such gain in a QOF prior to the end of the taxable year but cannot definitively establish that the gain will be eligible gain at the time the investment decision is required.

Treasury and the Service may rely upon the plain language of section 1400Z-2(a), which provides for exclusion of any “gain,” to support this position. Furthermore, but for the technical characterization of section 1231 gain resulting from its relationship to section 1231 losses, all section 1231 gain similarly derives from the sale of property held for use in a trade or business.

The passthrough of section 1231 gains and losses from a partnership exacerbates the challenge of partners characterizing such gains as capital gain. For instance, a partner may recognize section 1231 gain early in a taxable year, but not find out until after the end of the taxable year that the partner’s share of partnership section 1231 loss exceeds the partner’s recognized section 1231 gain. That subsequent characterization would disqualify the earlier-recognized section 1231 gain from section 1400Z-2 deferral and exclusion, if such gain did not come within the definition of eligible gain. By clarifying that all section 1231 gain comes within the definition of eligible gain, Treasury and the Service would resolve uncertainty and eliminate the prospects of hardships that could be suffered by partners.

B. Whether a Partner Can Disaggregate Gains Recognized by the Partnership and Separately Choose Between 180-Day Election Periods for Each Gain

1. Background

The Proposed Regulations provide generally that a partnership may elect to defer entity-level gain under section 1400Z-2 within 180 days after the transaction giving rise to eligible gain.⁸ Section 702(a)(1)-(2) requires partnerships to separately state capital gains and losses. The Treasury Regulations under Section 702 provide that a partner’s distributive share of such separately stated capital gains and losses shall be the partner’s share of the combined net amount of such gains and losses of the partnership.⁹ If the partnership does not make the QOF election with respect to an eligible gain, a partner may elect to defer some or all eligible gains included in

⁸ Prop. Reg. § 1.1400Z2(a)-1(c)(1)(i).

⁹ Reg. §§ 1.702-1(a)(1)-(2).

the partner's distributive share.¹⁰ The 180-day period can be one of two start dates for a partnership's eligible gain that passes through to a partner. First, the 180-day period can start "on the last day of the partnership taxable year in which the partner's allocable share of the partnership's eligible gain is taken into account under section 706(a)" (the "General Rule").¹¹ Second, the partner "may elect to treat the partner's own 180-day period with respect to the partner's distributive share of that gain as being the same as the partnership's 180-day period" (the "Elective Rule").¹² Analogous rules apply to S corporations, trusts, and estates.¹³

2. Recommendations

We recommend that the final Regulations clarify that a partner may elect to defer eligible gains included in the partner's distributive share on a separate basis despite the fact that such gains are reported to the partner on the partner's K-1 on an aggregate basis (along with capital losses).

We also recommend that the final Regulations clarify that a partner's ability to use the General Rule to elect to defer some or all of an eligible gain is made on a gain-by-gain basis such that the partner may elect to use the General Rule for some partnership eligible gains occurring during the tax year but use the Elective Rule for other partnership eligible gains occurring during the same tax year.

Furthermore, we recommend that the final Regulations clarify that if a partner elects to use the General Rule for a portion of a partnership's eligible gain, such partner may use the Elective Rule to defer some or all of the balance of such gain not deferred using the General Rule.

We also recommend that the final Regulations provide that a partnership is not required to adjust a partner's distributive share of capital gains and losses where the partner elects to defer some or all of an eligible gain using the General Rule.

3. Explanation

If a partnership elects to invest only a portion of its eligible gain in a QOF, questions arise regarding a partner's ability to invest all or a portion of the eligible gain that the partnership did not elect to invest. To illustrate, a partnership may recognize gains in multiple separate transactions during a tax year and allocate such gains to its partners. Where the partnership has not made an election to invest all of its eligible gains from different transactions in a QOF, the Proposed Regulations provide that the partners may elect to defer their distributive shares of the portion of the eligible gains not deferred by the partnership with two different periods available to make such election.

The Regulations under section 702, requiring each partner to take into account the partner's distributive share of the aggregate gains and losses of the partnership, create uncertainty regarding a partner's ability to make the deferral election under the Proposed Regulations on a gain-by-gain basis where the partnership itself does not elect to defer all or a portion of the gains. We

¹⁰ Prop. Reg. § 1.1400Z2(a)-1(c)(2)(ii)(B).

¹¹ Prop. Reg. § 1.1400Z2(a)-1(c)(2)(iii)(A).

¹² Prop. Reg. § 1.1400Z2(a)-1(c)(2)(iii)(B).

¹³ Prop. Reg. § 1.1400Z2(a)-1(c)(3).

recommend that Treasury and the Service provide guidance that each partner can elect to defer gain on a gain-by-gain basis and that a partner may separately choose to use either the General Rule or Elective Rule or a combination of both with respect to each gain.

For partners using the General Rule, requiring partnerships to monitor partners' application of section 1400Z-2(a) would create an unworkable administrative burden on partnerships. Accordingly, we recommend the final Regulations leave such record keeping to the partners.

C. Whether Capital Gain for Purposes of the Gain Deferral Election Includes a Special Allocation of Capital Gain Having Substantial Economic Effect

1. Background

Section 1400Z-2(a)(1) allows taxpayers to elect to defer recognized gain by investing the gain in a QOF. The gain-deferral election only applies to eligible gain.¹⁴

2. Recommendation

We recommend that the final Regulations clarify that a special allocation of capital gain to a partner that has substantial economic effect under section 704(b) and applicable regulations qualifies for the gain-deferral election under section 1400Z-2(a).

3. Explanation

The example in the Proposed Regulations¹⁵ deals with a partnership having five identical partners where capital gain of the partnership is allocated equally among all the partners. The example indicates that the first partner can invest its full share of the gain in a QOF and defer gain. We believe it would be helpful to clarify by adding to the example that if the partnership specially allocates eligible gain among its partners in a manner that has substantial economic effect within the meaning of section 704(b) and applicable regulations, then each partner may invest its share of the capital gain by investing in a QOF. Thus, if the partnership specially allocated more than \$200 of eligible gain to one partner (with a resulting smaller allocation of eligible gain to at least one other partner) and the allocation has substantial economic effect, then such partner could elect to defer that gain by an investment in a QOF.

II. Comment Regarding the End Date of the Step-Up Election in Section 1400Z-2(c)

This portion of the Comments addresses the fixed end date for the section 1400Z-2(c) basis step-up election under the Proposed Regulations.

¹⁴ Prop. Reg. § 1400Z2(a)-1(b)(2)(i).

¹⁵ Prop. Reg. § 1.1400Z2(a)-1(c)(2)(iii)(C).

A. Background

For QOF investments held for at least ten years and with respect to which the taxpayer makes an election, the basis of the interest in the QOF will be the fair market value of the investment when sold.¹⁶ The Proposed Regulations extend that time period and propose a fixed end date of December 31, 2047, for the basis step-up election. The proposed end date is approximately 20½ years after the latest date in late June 2027 when an eligible taxpayer may make an investment that is part of the election to defer gain under section 1400Z-2(a).¹⁷

In the preamble to the Proposed Regulations, Treasury and the Service specifically requested comments as to (1) the proposed fixed end date of December 31, 2047, for the basis step-up election; and (2) whether the Proposed Regulations should include an alternative to incentivizing investors to disinvest shortly before any fixed end date for the basis step-up election.¹⁸

B. Recommendation

We recommend that the final Regulations eliminate the fixed end date for the basis step-up election.

Furthermore, if continuing to mandate a fixed end date, we recommend that the final Regulations provide for a basis step-up election to fair market value without requiring disposition of the investment.

C. Explanation

The preamble to the Proposed Regulations states that the step-up in basis after the ten year holding period is an incentive “integral” to the primary purpose of the provision.¹⁹ Attracting and maintaining capital in the low-income communities designated as a QOZ pursuant to section 1400Z-1 will lead to the long-term commitment needed to build these communities. By not requiring an ending date to liquidate any related investment, such investors would be incentivized to maintain their QOF investments for an extended period of time, in furtherance of the stated goals of QOFs. Regardless of whether such a fixed liquidation date exists, taxpayers must maintain the same records and Treasury and the Service will face the same issues. However, eliminating the fixed end date reduces the likelihood that investors will seek to sell their investments prior to the fixed end date, creating a “dumping” of assets to avoid paying additional capital gains tax.

A similar concept of allowing for no capital gains tax due on appreciation for certain types of investment, already exists in section 1202.²⁰ Under section 1202, a taxpayer is permitted to

¹⁶ I.R.C. § 1400Z-2(c).

¹⁷ Prop. Reg. § 1.1400Z2(c)-1(b).

¹⁸ 83 Fed. Reg. 54283.

¹⁹ 83 Fed. Reg. 54283.

²⁰ I.R.C. § 1202(a)(4).

exclude gain (subject to certain dollar limitations) on the sale of qualified small business stock.²¹ Congress enacted section 1202 to incentivize investments in small businesses, an aim similar to that of QOFs. According to its legislative history, section 1202 was intended to provide “targeted relief for investors who risk their funds in new ventures and small businesses” and encourage investments in such businesses.²² Like section 1400Z-2, section 1202 requires that a taxpayer hold the stock for a certain period of time to be eligible for the exclusion; however, section 1202 does not limit when the taxpayer can dispose of the stock. Provided that the taxpayer complies with the procedural requirements, the taxpayer can take advantage of the exclusion regardless of when in the future the taxpayer makes a disposition of the stock. To incentivize the investments contemplated in QOZs, not requiring a sale of such investments on a fixed date will encourage these investments to be held for investment and not tax-driven purposes.

Likewise, a similar concept exists in the context of like kind exchanges in which a taxpayer can defer gain if the taxpayer exchanges the property for a “like kind” property.²³ The taxpayer does not recognize gain until the taxpayer sells the replacement property. The like kind exchange rules do not require the taxpayer to sell the replacement property by a particular point in time to obtain the benefits of deferral. Instead, the onus is on the taxpayer to maintain records regarding the initial acquisition of the relinquished property and the subsequent acquisition of any replacement property.

In the event that Treasury and the Service continue to mandate a fixed end date for each investment, they should include an alternative option to avoid a mass sale of QOFs immediately prior to the fixed end date. Specifically, Treasury and the Service could allow taxpayers to make a basis step-up election as of the fixed end date allowing taxpayers to step-up their basis in their QOF equity to fair market value at such time without any sale or liquidation being required. Fair market value should be determined in the same manner as the determination of asset value for other purposes of section 1400Z-2 (i.e., the 90% asset test). Alternatively, Treasury and the Service could choose to utilize the “qualified appraisal” rules already set forth in the Regulations under section 170. This alternative would also eliminate the incentive for investors to dispose of QOF investments immediately prior to the fixed end date for purely tax reasons, namely, to avoid additional capital gains tax on appreciation of their rolled over investment assets. However, this alternative would be more complex than simply eliminating the fixed end date, as it would require taxpayers to determine the fair market value of the QOF investment in the absence of a sale or exchange.

III. Comment Regarding the Determination of Asset Value for Purposes of the 90% Asset Test

This section of the Comments addresses the suitability of using either asset values reported on the QOF’s applicable financial statement or, if not applicable, the cost basis of assets for purposes of the calculation of the 90% asset test in section 1400Z-2(d)(1).

²¹ I.R.C. § 1202(c).

²² H. Rep. No. 111, 831, 103d Cong, 1st Sess. (1993).

²³ I.R.C. § 1031.

Section 1400Z-2(d)(1) requires a QOF to hold at least 90% of its assets in “qualified opportunity zone property” (“QOZP”) determined by the average of the percentage of QOZP held in the fund as measured on the last day of the first 6-month period of the taxable year of the fund, and on the last day of the taxable year of the fund (the “90% asset test”).

A. Background

The Proposed Regulations provide that in valuing a QOF’s assets for purposes of the 90% asset test under section 1400Z-2(d)(1), if the QOF has an applicable financial statement within the meaning of Regulation section 1.475-4(h) for the taxable year, then the value of each asset of the QOF is the value of the asset as reported on the QOF’s applicable financial statement for the relevant reporting period (generally every six months).²⁴ If the QOF does not have an applicable financial statement for the taxable year, then the value of each asset of the QOF is the QOF’s “cost” of the asset.²⁵

The Proposed Regulations also generally use the above principles in determining the value of a QOZB’s assets.²⁶

B. Recommendation

We recommend that the final Regulations provide that a QOF should always be allowed to use “cost” for purposes of the calculation of the 90% asset test.

²⁴ Prop. Reg. § 1.1400Z2(d)-1(b)(1). Reg. § 1.475(a)-4(h) defines applicable financial statement to include:

- (i) A GAAP financial statement that is required to be filed with the Securities and Exchange Commission (SEC), such as a 10-K.
- (ii) A GAAP financial statement that is filed with a Federal agency other than the Service, provided that the taxpayer generally makes significant use of the financial statement’s values in most of the significant management functions of the taxpayer’s business (and the use is related to the management of all or substantially all of the taxpayer’s business).
- (iii) A GAAP financial statement that meets all of the following requirements:
 - a. A certified audited financial statement, which is certified by an independent public accountant from a Registered Public Accounting firm, and is certified to be a “clean” opinion, a qualified “subject to” opinion, or a qualified “except for” opinion,
 - b. The statement is given to creditors for purposes of making lending decisions, given to equity holders for purposes of evaluating their investment in the taxpayer, or provided for other substantial non-tax purposes,
 - c. The taxpayer reasonably anticipates the statement will be directly relied on for the purposes for which it was given or provided, and
 - d. the taxpayer generally makes significant use of the financial statement’s values in most of the significant management functions of the taxpayer’s business (and the use is related to the management of all or substantially all of the taxpayer’s business).

²⁵ Prop. Reg. § 1.1400Z2(d)-1(b)(2).

²⁶ Prop. Reg. § 1.1400Z2(d)-1(d)(3)(ii).

Furthermore, we recommend that the final Regulations add a definition of “cost” based on unadjusted basis of the asset, with certain modifications as described herein.

C. Explanation

As an initial matter, we note that Treasury and the Service have flexibility under section 1400Z-2 to adopt an appropriate valuation methodology. We believe that Treasury and the Service should exercise this flexible authority to provide as much certainty for investors as possible. Certainty will cause more investment into QOZs, promoting the Congressional intent underlying the enactment of section 1400Z-2. Unfortunately, adopting the applicable financial statement standard does not provide investor certainty, for at least two reasons.

First, it is possible for an asset to exist for generally accepted accounting principles (“GAAP”) purposes but not for tax purposes, or vice versa, and an asset may be treated differently for GAAP purposes and tax purposes. Similar issues have arisen for purposes of the asset tests for real estate investment trusts (“REITs”), for which the denominator of “total assets” is determined in accordance with GAAP.²⁷ For example, under GAAP’s Accounting Standards Codification (“ASC”) 842, as added by Accounting Standards Update (“ASU”) 2016-02, certain leases in 2019 and later for the lessee are treated as giving rise to an intangible right-of-use asset with a value equal to the present value of the lease, as well as a lease liability of generally the same amount. A lease of real property would give rise to a significant asset on the tenant’s balance sheet for GAAP purposes, even if the lease is at a fair market value rent. ASC 842 illustrates that relevant GAAP rules change frequently and serve very different purposes (e.g., conservative presentation of a business’s financial position) than section 1400Z-2 (e.g., encouraging private investment into QOZs). When amending GAAP, the Federal Accounting Standards Board will not be cognizant of the effect on QOFs, which could cause QOFs to fall out of compliance with the 90% asset test despite no change in operations or assets.

Second, a lesson from the REIT asset tests is that mere fluctuations in asset values may cause a violation of the asset tests, which can cause investor uncertainty and administration issues. Accordingly, section 856(c)(4) provides that a REIT which meets its asset tests at the close of a quarter shall not lose its REIT status because of a discrepancy during a subsequent quarter between the value of its various investments and such requirements, unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition. Furthermore, a REIT which does not meet such requirements by reason of a discrepancy existing immediately after the acquisition of any security or other property which is wholly or partly the result of such acquisition has 30 days after the close of the quarter to cure the discrepancy. Even if the final Regulations adopt a similar safe harbor, however, a QOF may find itself failing the 90% asset test upon the acquisition of a new QOZ investment due to subsequent fluctuations in values, which would discourage new QOZ investments.

Further, the rule in the Proposed Regulations that requires a QOF to use an applicable financial statement if one exists but otherwise use cost may create unintended consequences over the life of some QOFs. It is anticipated that some QOFs may only begin to prepare applicable

²⁷ Reg. § 1.856-2(d)(3). See, e.g., PLR 200813009 (Dec. 13, 2007), PLR 201129007 (Apr. 6, 2011), and PLR 201236006 (June 7, 2012).

financial statements in a taxable year subsequent to their initial year for which they elect to be QOFs. For instance, a closely held QOF that initially does not prepare applicable financial statements may be required to prepare such statements when seeking to raise additional debt or equity capital from institutional investors. The Proposed Regulations would allow such a QOF to use cost prior to preparing applicable financial statements, but it would no longer be permitted to use cost when it prepares an applicable financial statement. Further, this QOF may qualify under the cost methodology but not under the applicable financial statement methodology. This result does not seem appropriate, given that the QOF would have had no change in operations or assets. A QOF in this scenario would be discouraged from preparing applicable financial statements in order to raise additional capital, which would undermine Congress's intent that section 1400Z-2 encourage investment in QOZs.

For the above reasons, the reliance on GAAP to value assets for QOF purposes is problematic.²⁸

In adopting a cost method, we note that the Proposed Regulations do not define "cost" precisely. It is anticipated that most tangible assets acquired by QOFs and QOZBs will be acquired by purchase. We believe that "cost" for such assets should generally be defined as the unadjusted tax basis of such assets determined under section 1012, which provides assurance and ease of administration. Using unadjusted tax basis is more appropriate than using a valuation method that changes over time (such as adjusted tax basis) because a fluctuating valuation method could penalize a QOF that invests in depreciable property that has been substantially depreciated or expensed. Different depreciable methods, such as bonus depreciation, may result in significant differences in adjusted tax basis of assets over time. Such a QOF would have furthered the Congressional intent underlying section 1400Z-2 by investing in a QOZ, but could nonetheless fail the 90% asset test given the low adjusted basis of its qualifying tangible assets.

If unadjusted tax basis is used to determine cost, an ancillary issue arises, namely how long should a purchased asset remain on a QOF's balance sheet? Fortunately, section 199A and its proposed regulations provide extensive guidance regarding the determination of unadjusted tax basis, which may be applied in the QOF context with some modifications. Adopting similar rules would be appropriate because the provisions of section 199A and section 1400Z-2 were enacted simultaneously and both serve the Congressional purpose of encouraging capital investment. The modifications we suggest are as follows:

²⁸ If the final Regulations continue to incorporate the applicable financial statement method, the final Regulations should at least clarify that all of the requirements for an applicable financial statement as set out in Reg. § 1.475(a)-4(h) must be met, particularly the significant business use requirement. If the answer is in the affirmative, some additional examples may be helpful to clarify what facts and circumstances lead to significant business use. Reg. § 1.475(a)-4(h) was promulgated in the context of mark to market accounting for dealers in securities, who use their applicable financial statements in different ways from potential QOFs that invest in real estate and other less liquid assets.

Further, if the final Regulations incorporate the applicable financial statement method, the final Regulations should incorporate a safe harbor to alleviate the resulting uncertainty. For instance, the final Regulations should incorporate a rule that would allow a QOF to rely on historic valuations if the QOF has not materially changed the makeup of its assets since the time it first elected QOF status (and qualified for the 90% asset test).

- The unadjusted tax basis of a purchased asset should be counted for the 90% asset test during the greater of (i) the asset’s recovery period or (ii) ten years. Ten years is appropriate because a ten year period is the minimum holding period required to obtain the tax basis step-up under section 1400Z-2(c), which helps with QOF administration and has precedent in section 199A(b)(6)(B).
- If a QOF engages in a section 1031 like kind exchange or other nonrecognition transaction, the unadjusted tax basis of the replacement property should be the same as the unadjusted tax basis of the relinquished property in order to properly reflect the actual (initial) investment in the QOZ.
- Section 743(b) adjustments and section 734(b) adjustments should count as unadjusted tax basis.

The foregoing discussion relates to the definition of “cost” for purchased assets. An ancillary issue is determining “cost” for assets acquired by a QOF through a nonrecognition transaction, such as a capital contribution under section 721.

For example, an individual investor purchased depreciable real property in 2008 for \$1,000. After 10 years of depreciation, the property has an adjusted tax basis of \$750 and a value of \$2,000 in 2018, when the individual contributes the property to a QOF in exchange for \$2,000 of QOF interests, in a section 721(a) nonrecognition transaction.

We believe that, in this instance, using either unadjusted tax basis or adjusted tax basis as cost is not appropriate due to the potential for distortion for contributed assets, such as the property in the above example with a \$750 adjusted tax basis, \$1,000 unadjusted tax basis, and \$2,000 contributed value. The better rule is to use a section 704(b) book value for the asset, which approximates the cost to the QOF in terms of the value of the QOF interests that were issued to acquire the property. For the property in the above example, its section 704(b) book value of \$2,000 would approximate its fair market value at the time of the contribution. Like the case with unadjusted tax basis, the section 704(b) book value should be counted during the greater of (i) the property’s recovery period or (ii) ten years.

Similar valuation principles would apply to a QOF or lower-tier entity that is not a partnership, such as a C corporation, for which the value for a contributed asset would be the value of the C corporation stock issued in connection with the contribution.

IV. Comments Regarding the Working Capital Safe Harbor and the Safe Harbor for Property on Which Working Capital Is Expended

This section of the Comments addresses the working capital safe harbor under the Proposed Regulations for QOFs that invest in QOZBs that acquire, construct or rehabilitate tangible business property and the safe harbor for property on which working capital is expended.

Section 1400Z-2(d)(3)(A)(ii) provides that to meet the definition of a QOZB, the business must satisfy the requirements of paragraphs (2), (4), and (8) of section 1397C(b):

- Gross income requirement. Section 1397C(b)(2) requires that for each taxable year at least 50% of the gross income of a QOZB be derived from the active conduct of a trade or business in the QOZ.
- Use of intangible property requirement. Section 1397C(b)(4) requires that, with respect to any taxable year, a substantial portion of the intangible property of a QOZB is used in the active conduct of a trade or business in the QOZ.
- Nonqualified financial property limitation. Section 1397C(b)(8) limits the average aggregate unadjusted bases of the property of a QOZB that may be attributable to nonqualified financial property. Section 1397C(e)(1), which defines the term nonqualified financial property for purposes of section 1397C(b)(8), excludes from that term reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less (working capital assets).

The Proposed Regulations provide a safe harbor for a reasonable amount of working capital (the “Working Capital Safe Harbor”).²⁹ Under the Working Capital Safe Harbor, for purposes of applying section 1397C(e)(1) to the definition of QOZB, working capital will be treated as “reasonable” if the following three requirements are met:

- The amounts are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ;
- There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets. Under the schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets;
- The working capital assets must actually be used in a manner that is substantially consistent with the two requirements (1) and (2) listed immediately above.

The Proposed Regulations also provide several complementary QOZB safe harbors (collectively, the “QOZB Safe Harbor”), as follows:

- For purposes of applying the 50% test in section 1397C(b)(2), if any gross income is derived from property that meets the Working Capital Safe Harbor test, then that gross income is counted toward the satisfaction of the 50% test;³⁰
- For purposes of applying the use requirement in section 1397C(b)(4) with respect to intangible property, the use requirement will be treated as satisfied during any

²⁹ Prop. Reg. § 1.1400Z2(d)-1(d)(5)(iv).

³⁰ Prop. Reg. § 1.1400Z2(d)-1(d)(5)(v).

period in which the business is proceeding in a manner that is substantially consistent with the Working Capital Safe Harbor test;³¹ and

- If some financial property is treated as a reasonable amount of working capital under the Working Capital Safe Harbor, and if tangible property in a QOZ is expected to meet the requirements of qualified opportunity zone business property (“QOZBP”) as a result of the planned expenditures of those working capital assets, then the tangible property will not be treated as failing the requirements of QOZBP solely because the scheduled consumption of the working capital is not yet complete.³²

A. Whether the 31-Month Working Capital Safe Harbor Should Be Extended to Address Delays Outside of the QOZB’s Control and to Address Staged Cash Contributions

1. Background

The preamble to the Proposed Regulations states that the 31-month safe harbor was intended to provide greater specificity on how a QOZB could satisfy the statutory requirements to encourage more investment in QOZs. The 31-month period was chosen to minimize “the distortion that may arise between purchasing existing property and sufficiently rehabilitating that property versus constructing new property,” since the substantial improvement test is based on a 30-month time period.³³ The preamble to the Proposed Regulation states that less than 31 months would have stifled investments into a QOF because taxpayers would be concerned that the QOF could not deploy the working capital fast enough to meet the requirements. Conversely, according to the preamble to the Proposed Regulations, longer than 31 months would permit taxpayers to receive tax benefits for multiple years before the money would be invested into a QOZ.

2. Recommendation

We recommend that the final Regulations provide for an extension of the 31-month Working Capital Safe Harbor in various common circumstances, including: (i) allowing for the 31-month period to begin to run only when construction or reconstruction commences; (ii) allowing for the QOZB up to a 12-month period from the date cash is received to start the clock on the 31-month period; and (iii) allowing the QOZB one additional 12-month extension period of the 31-month period, if required.

3. Explanation

Many practitioners were concerned about the ability of a QOZB to meet certain requirements, particularly the requirement in section 1400Z-2(d)(3)(A)(ii) (which cross-references section 1397C(b)(8)) that less than five percent of a QOZB’s assets be attributable to nonqualified

³¹ Prop. Reg. § 1.1400Z2(d)-1(d)(5)(vi).

³² Prop. Reg. § 1.1400Z2(d)-1(d)(5)(vii).

³³ 83 Fed. Reg. 54288.

financial property (the “NQFP Requirement”), in light of the significant amounts of cash often needed to fund the initial stages of a real estate development or construction project. The Working Capital Safe Harbor appears to be a reasonable framework to address these practical cash needs while ensuring that working capital assets comply with the NQFP Requirement. It is evident that Treasury and the Service are attempting to ensure that section 1400Z-2 will be workable for real estate transactions, and the Working Capital Safe Harbor is a welcome first step in encouraging participation in QOFs, although additional flexibility is needed to avoid foot faults and for staged development projects.

There are many situations where the Working Capital Safe Harbor may need to be extended, such as when a business is not immediately able to identify property for substantial improvement within the QOZ, where obtaining permits to construct or rehabilitate property is delayed or, in situations where businesses are being formed to become a QOZB and are still in the start-up mode.

Consequently, we recommend that the current 31-month period begin to run when the construction or reconstruction commences, and that the QOZB has up to a 12-month period from the date the cash is received to start the clock on the 31-month period with one additional 12-month extension period if required. Such extension should be supported by evidence of the underlying cause of the delay, as well as evidence that the QOZB is using commercially reasonable efforts to progress the predevelopment as quickly as possible under the circumstances.

a. Extension for Delays or Other Events Outside the QOZB’s Control

First, the final Regulations should include an extension in the event of construction delays or other events out of the control of the QOZB. A real estate development project could be delayed for any number of reasons, including delayed permits or variances, other extensive municipal processes or approvals, construction delays, extreme weather events, embargoes on supplies, union disruptions, or even terrorist activities. We recommend an initial 12-month extension period, with one additional 12-month extension period if required, supported by evidence provided by the QOZB of the underlying cause of the delay in spending its working capital assets, as well as evidence that the QOZB is using commercially reasonable efforts to progress the development as quickly as possible under the circumstances.

Moreover, a business may not be able to immediately identify property for substantial improvement within the QOZ especially in situations where businesses are being formed to become a QOZB and are still in the start-up mode. We believe the above situations are just some of the circumstances for which an additional 12-month period is warranted so that a business will qualify as a QOZB notwithstanding it has not immediately deployed its cash and the Working Capital Safe Harbor is not available.

Precedent for such a rule is found in the new markets tax credit (“NMTC”) regulations. Under the NMTC regulations, a qualified community development entity (“CDE”) may treat cash that it holds directly after receiving it from an equity investor as invested by it in a qualified low-income community investment, but only to the extent that the cash is so invested within the 12-

month period beginning on the date the cash was paid by the investor to the qualified community development entity.³⁴

Also, similar to the rehabilitation credit (which allows the taxpayer to select the commencement of its rehabilitation period),³⁵ the Working Capital Safe Harbor 31-month period should commence when the construction or reconstruction begins.

b. Staged Cash Contributions

Second, there should be a mechanism to address staged equity contributions. Phased development projects are common in real estate transactions, so cash or other working capital assets may be contributed to the QOZB at different times, especially since investors in the QOF may not be able to control the timing of their capital events which provide the cash for their QOF contributions.

We recommend that each contribution of cash from a QOF to a QOZB should have its own 31-month period, and for this purpose the first-in-first-out (“FIFO”) method should be used by the QOZB to identify which cash was spent by the QOZB. This would allow a QOZB to accept cash contributions from a QOF on a rolling basis, provided that the QOZB has a plan to spend those specific funds within a 31-month period.

B. Whether the QOZB Safe Harbor Should Be Delinked from the 31-Month Working Capital Safe Harbor and Have a Separately Determined Safe Harbor Period

1. Background

The QOZB Safe Harbor is causing significant concern and confusion, and has the potential to significantly deter investment in QOZs for large scale projects. Under the QOZB Safe Harbor, the QOZB can treat its tangible property as QOZBP for the same 31-month period during which it is spending its working capital assets pursuant to the Working Capital Safe Harbor, and then the QOZB is effectively deemed to be using its tangible property in a trade or business before that trade or business is operational. This is a helpful framework to address the “ramp up” period that many practitioners were hoping for. However, the QOZB Safe Harbor as drafted implies a cliff effect, so that, for example, an entity could fail to be a QOZB in month 32 if its trade or business is not yet operational due to unanticipated contingencies, even if it has complied with the terms of the Working Capital Safe Harbor and spent its working capital assets as planned over the 31-month period. Many in the real estate community are now concerned that they cannot invest in a QOF unless the underlying project is expected to be fully complete with 31 months.

2. Recommendation

We recommend that the final Regulations separate and delink the QOZB Safe Harbor from the 31-month time period proposed for the Working Capital Safe Harbor. Instead, the QOZB Safe

³⁴ Reg. § 1.45D-1(c)(5)(iv).

³⁵ I.R.C. § 47(c)(1)(B)(i).

Harbor should include an 18-month predevelopment period, a 36-month construction period, and a 12-month reasonable cause extension, with one additional 12-month extension period if required.

Furthermore, in the case of staged development projects, we recommend that a QOZB should be able to hold raw undeveloped land for a period of 24 months in conjunction with property being developed that is covered by the QOZB Safe Harbor.

3. Explanation

The Proposed Regulations explicitly link the Working Capital Safe Harbor with the QOZB Safe Harbor, but there is no apparent reason to create such a link. The Working Capital Safe Harbor addresses the ability of the QOZB to comply with the NQFP Requirement in its early years, while the QOZB Safe Harbor creates a fixed deadline for the QOZB to begin using its tangible property in a trade or business. It is entirely possible that a QOZB can spend its working capital assets in accordance with the Working Capital Safe Harbor over a 31-month period and also comply with the NQFP Requirement in month 32, but not yet begin using its assets in a trade or business in month 32 because those assets are still being constructed.

Understandably, and as noted in the preamble, there is a concern that investors in a QOF can enjoy the tax benefits of section 1400Z-2 for a number of years before their investments are fully deployed in a QOZ. However, as discussed below, there are a number of factors that should be considered in determining whether a QOZB is out of compliance with section 1400Z-2, rather than a fixed 31-month deadline. For this reason, we recommend that the QOZB Safe Harbor be available as a separate safe harbor from the Working Capital Safe Harbor.

If the Working Capital Safe Harbor operates separately from the QOZB Safe Harbor, the QOZB Safe Harbor should be modified to instead address the factors set forth below.

a. Predevelopment Period

A QOZB should have a period of up to 18 months for predevelopment activities, including design, site preparations, applications for zoning changes or other variances, extensive municipal processes or approvals, environmental remediation, etc. Many of the QOZs are likely areas that have not been previously developed, so projects would not be “shovel ready” at the time the QOF contributes cash into the QOZB. In the case of areas that are not “as-of-right”, a zoning change or other variance would be needed to begin development. This process often requires a lengthy application process including inspections, traffic studies, public hearings, and review by various committees. For waterfront property, additional review and approvals are required, including in certain instances a permit from the United States Army Corps of Engineers. For example, to get a zoning change approved in New York City, the Uniform Land Use Review Procedure can take anywhere from 18 months to 3 years.

The Proposed Regulations do permit an entity intending to be a QOF to choose the taxable year, as well as the first month in that taxable year, when its QOF status begins. Perhaps this was intended to allow a QOZB to begin certain predevelopment activities in advance of electing QOF status. Unfortunately, the majority of these predevelopment activities cannot be done until the property is acquired. Since the QOZB is going to need the cash invested by the QOF in order to

acquire the property and begin predevelopment, it cannot commence these activities before the QOF invests in the QOZB. Therefore, predevelopment activities cannot occur before commencement of the QOZB Safe Harbor as included in the Proposed Regulations.

To avoid abusive situations, this 18-month predevelopment period could be available only to QOZBs that demonstrate that they are undertaking predevelopment activities (e.g., zoning applications, environmental cleanup, etc.) and that they are using commercially reasonable efforts to progress the predevelopment as quickly as possible under the circumstances. Additionally, to the extent that construction actually begins before the end of the 18-month predevelopment period, commencement of the 36-month construction period could immediately start as described below.

b. Construction Period

QOZBs should have a period of 36 months for construction. Many large scale construction projects, particularly those in urban areas, can easily take 36 months to construct.

c. Reasonable Cause Extension

QOZBs should be able to extend their construction period for any delays in the development project. Construction delays, backordered supplies, union disruptions, and other unforeseen circumstances are normal course in real estate development, and other force majeure events such as extreme weather, potential trade disruptions or supply embargoes, or even terrorist activities could affect the ultimate timing to complete a real estate project. The tax incentives available to QOF investors should not be put at risk because of an unintentional and unavoidable delay.

We recommend an initial 12-month extension period, with one additional 12-month extension period if required, supported by evidence of the QOZB of the underlying cause of the delay in progressing its construction, as well as evidence that the QOZB is using commercially reasonable efforts to progress the development as quickly as possible under the circumstances.

To avoid abusive situations, a QOZB could be required to keep in its files a good faith schedule of how it plans to finish construction during its initial 36-month construction period. The 12-month reasonable cause extensions would only be available to QOZBs that demonstrate that they suffered an unreasonable delay and that they were otherwise making commercially reasonable efforts to complete the construction within the initial 36-month period.

Notably, the 12-month predevelopment period, the 36-month construction period, and the 12-month reasonable cause extension add up to total of 60 months, which is the extended amount of time in section 47(c)(1)(B)(ii) for phased rehabilitation projects meeting the requirements of the rehabilitation credit. Pursuant to section 47(c)(1)(B)(ii), rehabilitation needs to be completed generally within 24 months, but phased rehabilitations can be done over 60 months. If the baseline time period to rehabilitate an existing building under the rehabilitation credit in section 47 is 24 months, and given that many of the real estate projects that will be undertaken in the QOZs will be ground up development projects or significant renovations requiring possible rezoning and extensive construction, an initial 18-month predevelopment period plus a 36-month construction period would be a more realistic timeframe to fully construct or develop real estate projects in

QOZs. The proposed 31-month period in the QOZB Safe Harbor would only permit shovel-ready and fully entitled projects to be considered for eligibility, without any room for approvals, permits, entitlements, errors or unavoidable delays. Failure to afford the 12-month predevelopment period would put projects that cannot be shovel-ready by the end of 2019 at a disadvantage to other projects. Without the additional 12-month predevelopment period, investors may have to wait until after the end of 2019 to invest in some QOFs, and lose the benefit of the 5% basis step-up after seven years that would be allowed to investors who are able to invest prior to the end of 2019.

d. Staged Projects and Undeveloped Land

Since many sites in QOZs could be developed into separate projects, perhaps even on separate but adjacent tax lots, a QOZB should be able to hold raw undeveloped land for a period of 24 months without any adverse effect on its ability to meet the requirement that “substantially all” of the tangible property owned or leased by the QOZB is QOZBP,³⁶ provided that (1) the QOZB is actively developing property as QOZBP pursuant to the QOZB Safe Harbor, (2) the undeveloped land was acquired initially by the QOZB at the same time as the property being developed as QOZBP, and (3) the land is contiguous (directly or economically) to the property being developed as QOZBP.

C. Whether the 31-Month Working Capital Safe Harbor Should Be Extended to Real Estate or Business Assets Directly Owned by QOFs

1. Background

Section 1400Z-2(d) defines a QOF as –

any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property, determined by the average of the percentage of qualified opportunity zone property held in the fund as measured-

(A) on the last day of the first 6-month period of the taxable year of the fund, and

(B) on the last day of the taxable year of the fund.

QOZP, in turn, includes property which is qualified opportunity zone stock, qualified opportunity zone partnership interests, or QOZBP. QOZBP, in turn, is defined as “tangible property used in a trade or business of the qualified opportunity fund” if the property meets certain additional requirements, including that the property’s original use in the zone commences with the QOF or that the property is substantially improved by the fund. Substantial improvement requires that the fund make additions to the basis of the property within a 30-month period in an amount equal to the adjusted basis of the property at the beginning of the 30-month period.

³⁶ I.R.C. § 1400Z-2(d)(3)(A)(i); Prop. Reg. § 1.1400Z2(d)-1(d)(1)(i).

Cash is not QOZBP, but is included in determining the total assets of the fund (i.e., it is in the denominator but not the numerator of the fraction that must equal at least 90%). Too much cash held by a QOF may therefore cause it to fail to meet the 90% requirement and subject it to monthly penalties under section 1400Z-2(f)(1). Section 1400Z-2(f)(3) provides that “[n]o penalty shall be imposed under this subsection with respect to any failure if it is shown that such failure is due to reasonable cause.”

2. Recommendation

We recommend that the final Regulations extend any Working Capital Safe Harbor that is applicable to a QOZB to a QOF’s direct investments in real estate or business assets. Accordingly, we recommend that the working capital of a QOF that holds assets directly either be deemed to be QOZBP, be disregarded in calculating the 90% asset test of the QOF, or be treated as a basis for meeting the reasonable cause exception under section 1400Z-2(f)(3).

3. Explanation

In contrast to the 90% asset test, in order to treat the stock or partnership interests of a portfolio company held by a QOF as QOZP, the Proposed Regulations require only 70% of the tangible assets of a QOZB to qualify as QOZBP.³⁷ Because cash is not a tangible asset, a partnership or corporation’s cash (or other non-tangible) holdings will not affect the calculation under the 70% test (in contrast to the 90% test applied at the QOF level). However, section 1400Z-2(d)(3)(A)(ii) imports the requirement of section 1397C(b)(8) for a partnership or corporation to be a QOZB. Section 1397C(b)(8) limits the “nonqualified financial property” that such entity can hold to less than five percent. Section 1397(e) excludes from the definition of nonqualified financial property reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less. The Proposed Regulations add the safe harbor described above, allowing a portfolio company held by a QOF to hold nonqualified financial assets to the extent they meet the tests laid out in Proposed Regulations.³⁸

Any Working Capital Safe Harbor that is applicable to a QOF business conducted through a portfolio company should be extended to QOFs making direct investments in real estate or business assets. The working capital of a QOF that holds assets directly can either be deemed to be QOZBP, be disregarded in calculating a QOF’s 90-percent test, or be treated as a basis for meeting the reasonable cause exception under section 1400Z-2(f)(3). Such a change to the Proposed Regulations would provide parity for economically similar arrangements without artificially favoring tiered structures, allowing QOFs to invest in QOZs in the most practical and efficient way as dictated by the needs of the investment.

Although the restriction of section 1397C(b)(8) is not relevant to the direct holdings of the QOF, because the 90% asset test compares the QOZP to the total assets of the QOF, including working capital, a QOF itself cannot hold a meaningful amount of working capital. Accordingly, any QOF that makes its investments directly or through a disregarded entity, rather than through a

³⁷ Prop. Reg. § 1.1400Z2(d)-1(d)(3)(i).

³⁸ Prop. Reg. § 1.1400Z2-1(d)(5)(iv).

lower-tier partnership or corporation, is unable to retain enough cash at once to substantially improve its property in the QOZ as required under section 1400Z-2(d)(2)(D)(ii). As a result, the QOF is forced to use a tiered structure with ownership of a regarded entity in order to be able to hold adequate working capital to comply with the 90% asset test. This structuring disparity provides a trap for the unwary that was not likely intended. Section 1400Z-2 was drafted with an intention to allow a QOF to acquire property directly and expend funds to substantially improve that property. Accordingly, the most straightforward way to achieve this legislative goal is to treat cash held for the specific purpose of meeting the substantial improvement test as QOZBP under similar standards as the Working Capital Safe Harbor for indirect investments.

In addition, section 1400Z-2(f)(3) waives penalties with respect to a failure to meet the 90% asset test that is due to reasonable cause. This can provide the statutory basis for additional relief for working capital that is held by a QOF making direct investments.

D. Whether the Working Capital Safe Harbor Should Be Expanded Beyond Real Property Development

1. Background

The Proposed Regulations provide a Working Capital Safe Harbor for QOFs investing in QOZBs that acquire, construct, or rehabilitate tangible business property. While the safe harbor benefits and is valuable for QOF investments in capital projects, its usefulness tends to be limited to real property development projects.

The preamble to the Proposed Regulations requests comments about the appropriateness of any further expansion of the “working capital” concept beyond the acquisition, construction, or rehabilitation of tangible business property to the development of business operations in the opportunity zone.

2. Recommendation

We recommend that the final Regulations revise the Working Capital Safe Harbor to accommodate the use of working capital assets to fund operating costs of a new or expanding QOZB, to read as follows:

(iv) Safe harbor for reasonable amount of working capital.³⁹ Solely for purposes of applying section 1397C(e)(1) to the definition of a QOZB under section 1400Z-2(d)(3), working capital assets are treated as reasonable in amount for purposes of sections 1397C(b)(2) and 1400Z-2(d)(3)(A)(ii), if all of the following three requirements are satisfied:

(A) Designated in writing. These amounts are designated in writing for (i) the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone, as defined in section 1400Z-1(a) *and/or* (ii) *expenditure on operating costs of the QOZB within*

³⁹ Prop. Reg. § 1.1400Z2(d)-1(d)(5)(iv), with recommended additional language in emphasis.

the zone. Examples of operating costs within a zone would include, but not be limited to, wages and salaries of employees working in the zone, rent, maintenance, and utility costs for facilities and equipment located in the zone, and similar expenditures directly and proximately related to operations occurring within the zone.

(B) Reasonable written schedule. There is a written schedule consistent with the ordinary start-up *or expansion* of a trade or business for the expenditure of the working capital assets. Under the schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets.

(C) Property consumption *or operating expenditures* consistent. The working capital assets are actually used in a manner that is substantially consistent with paragraph (d)(5)(iv)(A) and (B) of this section.

3. Explanation

The Code has numerous tax incentive provisions for capital projects serving low-income populations and communities, including the low-income housing tax credit, the new markets tax credit and the rehabilitation credit (also referred to as the “historic tax credit”). Similar to the opportunity zone provisions, the new markets tax credit requires that less than five percent of the average unadjusted bases of the property of a qualified active low-income business may be attributable to nonqualified financial property. The Regulations under section 45D also explicitly provide a safe harbor for a reasonable amount of working capital so “the proceeds of a capital or equity investment or loan by a Community Development Entity that will be expended for construction of real property within 12 months after the date the investment or loan is made are treated as a reasonable amount of working capital.”⁴⁰

The framework of sections 1400Z-1 and 1400Z-2 clearly envisions that the program will serve to provide such incentives by providing a structure that expressly enables investment broadly in a QOZB without any restriction in its scope requiring that such investment be limited to capital projects.

However, the limited scope of the Working Capital Safe Harbor in the Proposed Regulations (being available only for acquisition, construction, and/or substantial improvement of tangible property) limits its usefulness to a QOZB that needs to retain more significant “working capital” in order to support a start-up period for operations, which necessitates retaining more cash than an amount that is typically considered reasonable working capital. This is often necessary because the QOZB may not be able to support its operational expenses until it fully ramps up production, operations and orders.

⁴⁰ Reg. § 1.45D-(1)(d)(4)(i)(E)(2).

V. Comments Regarding the Application of the Separate Investment Rule for Partners Having an Allocable Share of a QOF's Liabilities Under Section 752

This section of the Comments addresses the application of the separate investment rule in section 1400Z-2(e) for partners having an allocable share of a QOF's liabilities under section 752.

A. Whether Sections 705 and 752 Apply to Determine the Basis of the Taxpayer's Investment in a QOF

1. Background

Section 1400Z-2(b)(2)(B)(i) provides that a taxpayer's basis in a QOF investment shall be zero except for the basis increases of 10 and 15% of the deferred gain provided in section 1400Z-2(b)(2)(B) and the basis increase to fair market value provided in section 1400Z-2(c).

A partner's basis in her partnership interest ordinarily increases by the amount of cash and the basis of property she contributes and decreases by the amount of cash and the basis of property distributed to her by the partnership, but not below zero. A partner who receives distributions in excess of basis in her partnership interest recognizes gain equal to such excess. By providing for a zero basis with respect to gain deferred via a QOF investment (except for the basis increases that facilitate the specific tax benefits intended for QOF investors), section 1400Z-2 preserves the deferral (rather than the complete exclusion) of the deferred gain. However, the partnership basis rules provide for additional adjustments to basis. Section 705(a) provides for increases to a partner's basis in her partnership interest for her distributive share of partnership taxable income and decreases for the amount of cash and the basis of any property distributed to her. Section 752 treats an increase to a partner's share of partnership liabilities as a cash contribution which under section 705 increases the partner's basis in her partnership interest, and treats a decrease in a partner's share of partnership liabilities as a cash distribution which under section 705 decreases the partner's basis in her partnership interest.

2. Recommendation

We recommend that the final Regulations explicitly state that, other than providing for an original zero basis for a contribution of rollover gain as needed to preserve deferral of the original gain, the partnership basis rules of section 705, including section 752, apply to an investment in a QOF that is treated as a partnership for federal income tax purposes.

We further recommend that the final Regulations clarify that an investor in a QOF that is treated as a partnership for federal income tax purposes may deduct losses from the QOF to the extent of her basis in the interest, subject to applicable restrictions and limitations.

3. Explanation

A zero basis in a partnership interest negatively impacts a partner's ability to deduct losses allocated by the partnership during the life of the investment. If a partnership allocates losses to its partners, section 704(d) provides that a partner's distributive share of such losses is allowed only to the extent of the partner's basis in the partnership. Often, section 465 may apply to limit the

amount of losses to the amount treated as “at risk” and section 469 may apply to disallow passive losses for partners who do not materially participate in the business.

Treasury and the Service should expressly clarify that, notwithstanding section 1400Z-2(b)(2)(B)(i), the outside basis of a partnership interest in a QOF partnership is adjusted for actual and deemed contributions and distributions (including deemed contributions and distributions under section 752) and for allocations of partnership items to the partners. Treasury and the Service should further clarify that to the extent losses of a partnership allocated with respect to a partnership interest acquired with eligible gains do not exceed the basis of the such interest, investors may deduct such losses (subject to all relevant restrictions and limitations).

The Proposed Regulations do not explicitly state that the zero basis rule of section 1400Z-2(b) does not prevent a partner from increasing outside basis due to the deemed contribution that results from an allocation of liabilities to her under section 752. Because a partner may ordinarily deduct losses only to the extent of her basis in a partnership, the application of the partnership basis rules to a QOF will impact a partner’s ability to deduct losses. By providing clarity with respect to an investor’s basis increases and decreases as well as deductibility of a partner’s distributive share of losses with respect to an investment in a QOF partnership, investors would be assured of the application of the usual partnership rules in the context of a QOF, subject to the limited exception of not increasing a partner’s investment with respect to cash that constitutes a rollover investment of gain (except as specifically provided in sections 1400Z-2(b) and (c)).

If the usual partnership basis rules are inapplicable because of the zero basis rule in section 1400Z-2(b), adverse tax consequences would follow for taxpayers investing in QOF partnerships that would impede the intended benefits of QOZs. For example, if a partner’s basis in her partnership begins at zero and is not increased for her distributable share of income, when the partner receives a distribution of cash corresponding to the income allocated to her, the partner would be subject to double taxation, with an instance of tax on the allocation of income and a second instance of tax on the distribution which exceeds basis.

B. Whether Investors with Mixed Funds or an Allocable Share of Partnership Liabilities Must Treat Their Interest in a QOF as Two Separate Partnership Interests for Purposes of Subchapter K

1. Background

Section 1400Z-2(e)(1) requires a taxpayer to treat as two separate investments the combination of an investment to which a section 1400Z-2(a) gain-deferral election applies and an investment of any amount to which such an election does not apply (the “mixed fund rule”). This is repeated in the Proposed Regulations.⁴¹ The Proposed Regulations further provide that deemed contributions of money under section 752(a) do not result in the creation of an investment in a QOF.⁴² Consequently, a partner’s increase in outside basis is not taken into account in determining

⁴¹ Prop. Reg. §1.1400Z2(e)-1(a)(1).

⁴² Prop. Reg. §1.1400Z2(e)-1(a)(2).

what portion of the partner's interest in a partnership is subject to the deferral election under section 1400Z-2(a).

Treasury and the Service requested comments on whether there may be certain circumstances in which not treating the deemed contribution under section 752(a) as creating a separate investment for purposes of section 1400Z-2(e)(1) may be considered abusive or otherwise problematic.⁴³

2. Recommendation

We recommend that the final Regulations clarify that the mixed fund rule merely sets forth the proposition that an investor in a QOF that is taxed as a partnership may hold both a "Qualified Interest" for which a gain-deferral election does apply, and a "Non-Qualified Interest" for which a gain-deferral election does not apply, that the Qualified Interest includes any portion of the interest attributable to debt allocated to the cash portion of the interest under section 752(a), and that the tax benefits under the QOF statute, including those provided by section 1400Z-2(c), apply only to the investor's Qualified Interest. As part of this clarification, the Treasury and the Service should clarify that a mixed fund investment in a QOF taxed as a partnership does not require the creation of two separate partnership interests for purposes of applying Subchapter K to a QOF.

3. Explanation

Section 1400Z-2(e)(1) sets forth the rule that if only a portion of an investment in a QOF consists of gain to which an election under section 1400Z-2(a) applies, then the investment is treated as two separate investments. This so-called mixed fund rule clarifies that the tax benefits under 1400Z-2 applies only to the Qualified Interest.

We believe that the operation of section 752(a) to a Qualified Interest should not result in application of the mixed fund rule, and so should not result in the creation of a Non-Qualified Interest separate from the investor's Qualified Interest. In other words, when a partner's only contribution to a QOF is cash creating a Qualified Interest, the single interest held by that investor, including any portion associated with debt allocated under section 752, should be a Qualified Interest (with qualifications discussed below relating to treatment of the basis adjustment regime contained in section 1400Z-2).

This is consistent with the long-held Treasury position that the holder of different interests in the same partnership is treated as holding a single interest in the partnership.⁴⁴ For example, the holder of a general partner interest and a limited partner interest, or a preferred interest and a common interest (or any combination thereof) under non-tax state law is considered to hold a single interest for Federal income tax purposes. Additionally, if a partner acquires an initial interest by contribution of property and later augments that interest by purchasing the interest of another partner, the combined interests have a single basis for tax purposes. This rule is consistent with the "capital accounting" treatment applying within the partnership, where the partnership maintains a

⁴³ 83 Fed. Reg. 54285-86.

⁴⁴ See Rev. Rul. 84-53, 1984-1 C.B. 159.

single capital account for each partner for purposes of measuring substantial economic effect of allocations under section 704(b).⁴⁵

These premises are further reflected in the general income tax law, for example the rules applying to the computation of gain on the disposition of a portion of a larger property.⁴⁶ This “one basis” approach seems correct because the concept is so woven into the fabric of the Subchapter K basis rules that they could not work rationally if a partner’s various interests in a partnership were segregated for basis purposes.

We do not believe that the rules applying to a QOF taxed as a partnership should deviate from the general scheme of Subchapter K. Creating separate partnership interests for an investor’s multiple investments in single QOF taxed as partnership would create numerous problems and complexities.

Assuming that section 752(a) deemed contributions do not create or increase an investment in the QOF described in section 1400Z-2(e)(1)(A)(ii), it would appear that Subchapter K should operate independently of the opportunity zone rules, and that pursuant to Subchapter K principles, a partner with a share of partnership liabilities in basis would be entitled to claim losses, deductions and receive cash distributions to the extent of such basis applying the normal rules of Subchapter K and subject to the various provisions that may impose tax liability, e.g. section 707.

One area of concern would be when such a QOF makes distributions of cash (or other property) to the investor, discussed below. A separate partnership interest rule would also create other complications, including, for example, the application of section 704(c) to contributions of property to a QOF taxed as a partnership, the holding period rules under the Regulations,⁴⁷ and the capital accounting rules under section 704(b).⁴⁸

C. Whether Non-Liquidating Cash Distributions by a QOF Result in Taxable Gain under Section 731(a)

1. Background

In the case of a distribution by a partnership to a partner, section 731(a)(1) provides that gain is not recognized by the partner, except to the extent that any money distributed exceeds the adjusted basis of the partner’s interest in the partnership immediately before the distribution. Section 731(a)(2) provides that loss is not recognized by the partner except on a distribution in liquidation of the partner’s interest in the partnership where no property is distributed to the partner other than money, unrealized receivables, and inventory. Any gain or loss recognized under section

⁴⁵ Reg. § 1.704-1(b)(2)(iv)(b).

⁴⁶ Reg. § 1.61-6(a) (requiring equitable apportionment of basis).

⁴⁷ Reg. § 1.1223-3(b)(3) (providing that deemed contributions and distributions under section 752 are generally disregarded for purposes of making holding period determinations).

⁴⁸ Query whether the QOF would need to create parallel capital accounts for an investor with separate partnership interests and, if so, how would it coordinate its “inside the partnership” accounting with the investor’s “outside the partnership” reporting for its Qualified Interest and Non-Qualified Interest.

731(a) is considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner. For purposes of this discussion, the word “distribution” refers to a transaction properly treated as a distribution from a partnership to a partner under section 731(a) for Federal income tax purposes, and not, for example, as a sale or exchange under section 707(a)(2)(B) or section 751(b).

Section 1400Z-2(b)(1) provides that the taxpayer must include deferred gain in income in the taxable year which includes the earlier of (a) the date on which the investment is sold or exchanged, or (b) December 31, 2026.

2. Recommendation

We recommend that the final Regulations clarify that a distribution of money other than in liquidation of a partner’s interest does not result in a sale or exchange of the investment under section 1400Z-2(b)(1), except to the extent that the partner is considered to have sold its interest under otherwise applicable rules of section 731(a).

3. Explanation

It is unclear what events will be considered a sale or exchange of the investment for purposes of section 1400Z-2(b)(1). There is concern that even a routine cash distribution to a partner from a QOF classified as a partnership for Federal income tax purposes may be viewed as a sale or exchange of the investment, thus causing the partner to include deferred gain in gross income.

Generally, section 731(a) determines when a distribution to a partner is considered to be a sale or exchange of the partner’s interest in the partnership. Our recommendation is that the same section 731(a) standard be adopted for purposes of determining whether a sale or exchange of the investment has occurred under section 1400Z-2(b)(1), at least with respect to distributions of money other than in liquidation of a partner’s interest.

Adopting the same standard is appropriate because both sections 731(a) and 1400Z-2 share a similar purpose of deferring gains except when it is no longer possible to do so. Section 731(a), and the rest of the rules comprising subchapter K generally, was intended to facilitate the transfer of property to and from a partnership in accordance with valid business purposes, including making distributions to partners.⁴⁹ Section 731(a) generally permits a distribution to a partner up to the point that any built-in gain in the partner’s partnership interest can no longer be deferred, either in the outside tax basis of the partner in the partnership or in the tax basis of distributed property. To the extent that the built-in gain can no longer be deferred, section 731(a) considers the partner to have sold its interest in the partnership. Similarly, section 1400Z-2 is designed to defer gains. An investor in a QOF will have a similar built-in gain in its investment because the investor will have contributed eligible gains, but will not have received outside tax basis from the contribution of those gains under section 1400Z-2(b)(2)(B)(i). Therefore, the purpose and existing rules of section 731(a) align well with the purpose and existing rules of section 1400Z-2, and it makes sense that

⁴⁹ S. Rep. No. 1622, 96, 83d Cong, 2nd Sess. (1954).

both should employ the same standard to determine when a partner is considered to have sold or exchanged its interest, at least in the case of a non-liquidating distribution of money.

Consider the following example:

Example 1

Partner A invests eligible gains of \$100 in a QOF. A takes an initial outside tax basis in the QOF of \$0. The deferred gain is \$100. Each year, positive adjustments to A's outside tax basis in the QOF offset negative adjustments. A holds its interest for 5 years and A's outside tax basis is increased to \$10 under section 1400Z-2(b)(2)(B)(iii). The amount of deferred gain is \$90.

In this example, we believe that the Proposed Regulations should provide that the QOF should be able to make a distribution to A in an amount up to \$10 before A will be considered to have sold or exchanged its interest in the QOF. We reach this conclusion that normal section 731(a) principles should apply because A's deferred gain is preserved in the outside tax basis of A's investment in the QOF, to be recognized on a future sale or exchange of A's investment or in the taxable year that includes December 31, 2026, whichever comes first. In the event that gain is recognized on the distribution under section 731(a), we believe that the Proposed Regulations should provide that the deferred gain associated with the QOF investment should only be recognized to the extent that gain is recognized under section 731(a). The distribution should not be treated as a complete transfer of the interest in the QOF, which would create a cliff effect for taxpayers who may not control the precise amounts of distributions made to them and where even a small distribution subject to section 731(a) sale treatment could result in triggering a very large amount of deferred gain.

The standard of section 731(a) is appropriate even when the fair market value of the investment decreases. Section 1400Z-2(b)(2)(A) provides that the amount of gain included in gross income in the taxable year which includes the earlier of (a) the date on which the investment is sold or exchanged, or (b) December 31, 2026, is the excess of (1) the lesser of the amount of gain excluded under section 1400Z-2(a)(1) or the fair market value of the investment on the applicable date, over (2) the taxpayer's tax basis in the investment. In the example above, if the fair market value of A's investment in the QOF decreases by \$40 and A sells its interest in year 6, A would include the same amount of gain in gross income regardless of whether the QOF makes a distribution prior to the sale. If the QOF does not make a distribution to A, A includes \$50 in gross income (\$60 fair market value of the investment minus \$10 outside tax basis in investment). If the QOF makes a \$10 distribution to A, A includes \$50 in gross income (\$50 fair market value of the investment, consisting of \$60 less the \$10 distribution, minus \$0 outside tax basis in investment).

D. Whether Gain Includible Under Section 1400Z-2(b) Should Include the Value of Prior Non-Liquidating Distributions of Property by a QOF

1. Background

Section 732(a)(1) provides that the basis of property other than money distributed by a partnership to a partner other than in liquidation of the partner's interest generally will be its

adjusted basis to the partnership immediately before the distribution. However, section 732(a)(2) provides that the basis of such distributed property will not exceed the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction. Section 732(b) provides that the basis of property other than money distributed by a partnership to a partner in liquidation of the partner's interest is an amount equal to the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction.

2. Recommendation

We recommend that the final Regulations provide that in the case of a distribution of property other than money, the fair market value of a taxpayer's investment in a QOF for purposes of determining the amount includable in gross income under section 1400Z-2(b)(2)(A) includes the fair market value at the date of distribution of any property previously distributed to the taxpayer by the QOF on account of the interest.

3. Explanation

In the case of a distribution of property other than money, the deferral provided under sections 731(a) and 732(a) may be greater than the deferral provided under section 1400Z-2(b)(1).

Consider the following example:

Example 2

Partner A invests eligible gains of \$100 in a QOF. A takes an initial outside tax basis in the QOF of \$0. The deferred gain is \$100. Each year, positive adjustments to A's outside tax basis in the QOF offset negative adjustments. After A has held its interest for 3 years, the QOF makes a distribution of nondepreciable property worth \$90 to A. A takes a basis of \$0 in the property under section 732(a)(2). After A has held its interest for 4 years, A sells its investment in QOF for \$10.

Under normal rules, A should include \$10 of the \$100 deferred gain in gross income under section 1400Z-2(b)(2)(A). The remaining \$90 of deferred gain would be preserved in the lower adjusted tax basis of the distributed asset, and would be recognized when (and if) A disposes of the distributed asset. Unless guidance is issued to the contrary, A could continue to defer the \$90 gain indefinitely.

E. Whether a Taxpayer Should Recognize Gain Deferred Under Section 1400Z-2(a) in Connection with a Liquidating Distribution by a QOF

1. Background

In the case of a distribution by a partnership to a partner, section 731(a)(1) provides that gain is not recognized by the partner, except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. Section 731(a)(2) provides that loss is not recognized by the partner except on a distribution in

liquidation of the partner's interest in the partnership where no property is distributed to the partner other than money, unrealized receivables, and inventory. Any gain or loss recognized under section 731(a) is considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner. For purposes of this discussion, the word "distribution" refers to a transaction properly treated as a distribution from a partnership to a partner under section 731(a) for Federal income tax purposes, and not, for example, as a sale or exchange under section 707(a)(2)(B) or section 751(b).

2. Recommendation

We recommend that the final Regulations clarify that the deferred gain under section 1400Z-2(a) is recognized immediately before a liquidating distribution by the QOF, thereby increasing the partner's outside tax basis in its investment under section 1400Z-2(b)(2)(B)(ii), and thereby decreasing the amount of gain recognized under section 731(a), if any.

3. Explanation

In the case of a distribution in liquidation of a partner's interest in a QOF partnership, the deferred gain under section 1400Z-2(a) should be included in gross income in connection with the distribution, regardless of whether any gain or loss is recognized under section 731(a). The simple reason for this is that the partner will not have a continuing interest in the partnership, and therefore the gain can no longer be preserved in the outside tax basis of its partnership interest.

F. Whether Special Anti-Abuse Provisions Are Required to Address Certain Debt-Financed Distributions

1. Background

Treasury and the Service have requested comments whether there may be circumstances in which not treating the deemed contribution under section 752(a) as creating a separate investment for purposes of the mixed fund rule may be considered abusive or otherwise problematic.⁵⁰

2. Recommendation

We do not believe that the final Regulations need to create a special anti-abuse rule to address potential abuses resulting from treating an investment in a QOF and a partner's allocable share of the QOF's liabilities under section 752 as a single partnership interest for tax purposes.

3. Explanation

A single partnership interest rule applied to investments in a QOF might lend itself to abuse. For example, the rule might permit an investor to defer gain into a QOF, only to have the QOF then procure a loan the proceeds from which are then distributed to the investor in an amount equal to its original investment. By permitting a single interest to which the rules under section 752

⁵⁰ 83 Fed. Reg. 54285-86.

apply, arguably the Treasury and the Service would permit such an investment to be “cashed out” which could call into question the policy premises for the program.

There are, however, a number of responses to such criticism. First, it is far from clear that such a transaction would be economically feasible or that investors would seek to engage in such transactions were they possible to structure. In addition, arguably such a transaction would not necessarily subvert the policy premises of the program, since the cash out would merely replace the original investment with that of a lender, but the transaction would not fundamentally alter the fact that the amount of the original investment remained invested in the opportunity zone, albeit that the investor’s cash investment had been replaced. This scenario does raise a more fundamental issue under Subchapter K, namely whether an investor that cashed out in this manner remained a partner in the QOF. Rather than interpret section 1400Z-2(c) or (e)(1) broadly either to deny section 752 basis to the interest or to create a separate partnership interest to address the possible abuse, applying the body of law that already exists under Subchapter K should provide Treasury and the Service with the tools to combat any such issues. For example, the Service might argue that the substance of the investment was illusory and assert that the investor has no investment in the QOF under either the income tax common law applying to Subchapter K or under the statutory analog to the common law under section 7701(o).

G. Whether the Basis Step-Up Under Section 1400Z-2(c) Includes the Basis Attributable to the Partner’s Allocable Share of Debt

1. Background

Section 1400Z-2(e)(1) requires a taxpayer to treat as two separate investments the combination of an investment to which a section 1400Z-2(a) gain-deferral election applies and an investment of any amount to which such an election does not apply. This is repeated in the Proposed Regulations.⁵¹ The Proposed Regulations further provide that a deemed contribution of money under section 752(a) does not result in the creation of a separate investment in a QOF (the “section 752 No Separate Investment Rule”).⁵² Consequently, a partner’s increase in outside basis is not taken into account in determining what portion of the partner’s interest in a partnership is subject to the deferral election under section 1400Z-2(a).

Section 1400Z-2(c) provides a special rule (the “-2(c) Step-Up”) that in the case of any qualified investment held by the taxpayer for at least 10 years and with respect to which the taxpayer makes an election under that provision, “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.” Absent debt financing, it is clear that the -2(c) Step Up eliminates gain, regardless of whether it constitutes depreciation recapture. Whether this result should apply where the depreciation has been debt financed is discussed below.

⁵¹ Prop. Reg. §1.1400Z2(e)-1(a)(1).

⁵² Prop. Reg. §1.1400Z2(e)-1(a)(2). References in this Part G to a QOF are to a QOF treated as a partnership for Federal income tax purposes.

2. Recommendation

While we recognize that Treasury's decision to adopt the section 752 No Separate Investment Rule does not necessarily require the conclusion that the portion of a partner's interest in a QOF whose basis is derived from section 752 (the "Debt-Financed Portion") must qualify for a -2(c) Step-Up, we recommend that the final Regulations make clear that the -2(c) Step Up is calculated with reference to the gross fair market value of the investment, except to the extent that Treasury and the Service determine that Congress did not intend for the -2(c) Step Up to eliminate the recapture of the portion of losses that exceeds the taxpayer's investment.

3. Explanation

Examples 3a and 3b below illustrate the circumstances in which this issue can arise:

Example 3(a) (Acquisition Indebtedness Not Fully Depreciated At Time of Sale)

Assume that partner A invests eligible gains of \$100 in a QOF. A would take an initial outside basis in its QOF interest of \$0. Thereafter, the QOF incurs partnership liabilities that are allocable under section 752 to A in the amount of \$100. The QOF invests the eligible gains and the proceeds of the borrowing in a QOZB. A would take an outside basis in the QOF of \$100. A would be entitled to claim losses, deductions and receive nontaxable distributions of cash from the QOF to the extent of its \$100 outside basis. Independently of the treatment of section 752 liabilities, if A holds the interest until 2026, A would recognize the previously deferred capital gain in 2026 and would increase A's tax basis in the interest by \$100.

Assume further that at the end of 10 years, the QOF's assets have doubled in value (assume that A's share of the gross value is now \$400) and assume that A claimed deductions in the amount of \$50 during the 10 year period prior to the sale of its investment. Immediately before the -2(c) Step-Up, A would have an outside basis in the QOF of \$150. Upon sale of the interest for its net fair market value of \$300, A would have an amount realized of \$400 (\$300 cash equal to the net value of the interest plus \$100 share of partnership liability relief). If the -2(c) Step-Up is determined to be the \$300 "net fair market value" of A's interest in the QOF, A would recognize gain of \$100 (\$400 amount realized less \$300 of basis).

This does not seem to be the right answer. While we appreciate that there is a policy question as to whether the \$50 of debt-financed losses that A claimed while holding the QOF should be recaptured on the sale (this point will be the subject of one of our recommendations below), we do not believe it is appropriate to cause A to recognize the other \$50 of gain which is attributable to the portion of the partnership debt which was not used by A to claim deductions or tax-free distributions from the QOF.

Example 3(b) (Post-Year 10 Debt-Financed Distributions)

Assume that partner A invests eligible gains of \$100 in a QOF. A would take an initial outside basis in its QOF interest of \$0. The QOF invests the eligible gains in a QOZB. Independently of the treatment of section 752 liabilities, if A holds the interest until 2026, A would recognize the previously deferred capital gain in 2026 and would increase A's tax basis in the interest by \$100. After 10 years, when the value of the QOF's assets have doubled, the entity incurs debt, the proceeds of which are distributed to the partners and A's share of such distribution is \$100.

Later that year, A sells its interest in the QOF for \$100 (A's share of the value of the QOF's assets is \$200 and his share of the QOF's debt is \$100). Immediately before the sale and the -2(c) Step-Up, the "net fair market value of A's interest is \$100 and his tax basis is \$100. Accordingly, if the -2(c) Step-Up brings A's basis in the interest to "net fair market value", the amount of the -2(c) Step-Up would be zero so that A would have taxable gain on the sale in the amount of \$100.

Again, this result does not seem right. If there had been no borrowing after year 10 and A had simply sold his interest for its value of \$200, he would have enjoyed the same economic result (\$200 cash) as in Example 3b, but he would have also enjoyed a -2(c) Step-Up in basis to 200 so that he would have recognized no taxable gain on the sale. We do not believe that the policy behind this legislation warrants a difference in treatment between these two situations.

While the concerns identified in these examples would be remedied if Treasury and the Service were to calculate the -2(c) Step-Up by reference to the "gross fair market value" (the "GFMV Approach") of the QOF being sold, we appreciate that it is appropriate to ask whether this treatment goes "too far." To illustrate this, we would observe the following:

- In Example 3(a), while the GFMV Approach would prevent A's share of the portion of the acquisition debt that was not used to support loss allocations from reducing A's -2(c) Step-Up, this approach would also provide A with a -2(c) Step-Up that would shield A from taxable recapture of the loss deductions that were debt-financed.
- In Example 3(b), while the GFMV Approach would prevent A's share of the debt that financed the post-year 10 distribution from reducing A's -2(c) Step-Up, the approach would have the same result if the debt-financed distribution had occurred before year 10, at a time when a sale would not have been entitled to the -2(c) Step-Up.

Clearly, where to draw the line is a policy question requiring Treasury and the Service to decide just how much benefit Congress intended to provide investors in QOFs in order to accomplish the goals of this legislation. Treasury and the Service have adopted a version of the

GFMV Approach in other contexts, for instance, in Regulations under section 362 adopting a gross value approach for valuing partnership interests.⁵³

While this is undoubtedly an area in which reasonable people may differ, here is how we believe the lines should be drawn:

- Proposition 1: Provided a QOF investor would not recognize gain if the QOF's assets were foreclosed upon immediately prior to the sale of its interest in the QOF, the investor's share of the QOF's debt (viewed from the perspective of the date of sale), use of the GFMV approach should be allowed (even if the gain eliminated includes depreciation recapture) because the debt financing is not generating a tax benefit greater than what Congress could reasonably have expected.⁵⁴
- Proposition 2: The investor's share of partnership liabilities that funded debt-financed distributions should not reduce the amount of the -2(c) Step-Up regardless of whether such distributions were made before or after the close of the 10-year period because in all such cases there will not be a -2(c) Step-Up unless the investor holds for the requisite 10-year period and the receipt of cash a few years earlier than a post-year 10 sale can reasonably be viewed, from a policy perspective, as not constituting the type of tax benefit that Congress would have thought to be excessive in legislation clearly intended to involve real estate.
- Proposition 3: To the extent that (a) an investor's share of the partnership's liabilities at the time of the sale is greater than (b) the largest amount of such debt that would not cause the investor to recognize foreclosure gain, then:
 - use of the GFMV approach should be allowed to the extent of the amount referred to in clause (b) of this Proposition 3; and
 - the excess of the amount referred to in clause (a) of Proposition 3 over the amount referred to in clause (b), unless it is included within Proposition 2, involves a policy decision, which only Treasury and the Service can make, as to whether the exemption from recapture of previously claimed debt-

⁵³ Reg. § 1.362-3(c)(4)(ii). The gross value approach adopted in that Regulation follows the recommendation made in a Section committee report. Partnerships and LLCs Committee, ABA Tax Sec., *Comments on the Application of Section 362(e) to Partnership Interests* (2011).

⁵⁴ Our belief that the step-up can eliminate depreciation recapture in this context (i.e., where losses claimed do not exceed the taxpayer's equity investment) is based upon the plain language of the statute. If Congress had intended to grant a step-up only in an amount equal to the economic appreciation in value between the date of acquisition and the date of sale, they could easily have said that. But the language they used was a step-up to fair market value which clearly goes further. It is hard to believe that Congress didn't appreciate the difference between these two concepts; but if that is the case, we believe that the fix to the very clearly statutory language should be made by Congress, not Treasury and the Service.

financed losses in amounts exceeding the investor’s investment (which would result under the GFMV approach) is a benefit that is materially different from the benefit that Congress intended to provide in order to incentivize investment in QOFs.

VI. Additional Comments For Forthcoming Guidance Regarding the Acquisition by Purchase, Substantial Improvement, and Original Use Requirements in Section 1400Z-2(d)(2)(D)

This section of the Comments addresses various aspects of the acquisition by purchase, substantial improvement, and original use requirements under section 1400Z-2(d)(2)(D).

Among other requirements, section 1400Z-2 requires that each QOF own QOZBP, either directly or indirectly (through qualifying equity interests in one or more QOZBs).⁵⁵ QOZBP is tangible property used in a trade or business of the QOF (or QOZB) that meets three requirements: an acquired by purchase requirement, a substantial use requirement, and an original use requirement.

Section 1400Z-2(d)(1) provides, as a requirement for any QOF, that it meet the 90% Asset Test.

Section 1400Z-2(d)(3)(A)(i) provides, as a requirement for any QOZB, that “substantially all of the tangible property owned or leased by the taxpayer” is QOZBP. The Proposed Regulations, in turn, provide that “substantially all” requirement for this purpose is satisfied if “at least 70 percent of the tangible property owned or leased by the trade or business” is QOZBP.⁵⁶

A. Whether Leased Property Should Be Treated As Acquired by Purchase and Whether Its Value Should Be the Lease’s Fair Market Value For Purposes of the 90% Asset Test of the QOF and Substantially All Requirement of a QOZB

1. Background

Section 1400Z-2(d)(2)(D)(i)(I) requires that the QOZBP in question be “acquired by the qualified opportunity fund by purchase (as defined in section 179(d)(2)) after December 31, 2017.” Section 1400Z-2(d)(2)(D)(iii) provides that for purposes of subparagraph (A)(i),⁵⁷ the related person rule of section 179(d)(2) is applied pursuant to paragraph (8).⁵⁸ In other words, property must be acquired from an unrelated party (applying the rules of section 267(b) and 707(b)(1) by substituting 20% for 50%) and not from a decedent, and the property’s basis after the acquisition must not be determined by reference to the transferor’s basis.

⁵⁵ I.R.C. § 1400Z-2(d)(2)(A).

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

⁵⁷ We believe that the intended reference was to Section 1400Z-2(d)(2)(D)(i).

⁵⁸ We believe that the intended reference was to Section 1400Z-2(e)(2).

2. Recommendation

We recommend that future guidance, including future Proposed Regulations, clarify that property leased by a QOZB from an unrelated party may meet the acquisition by purchase requirement of section 1400Z-2(d)(2)(D)(i)(I).

Furthermore, we recommend that future guidance, including future Proposed Regulations, clarify that the value of a lease for purposes of the 90% asset test is the fair market value of the leasehold and not the value of the property covered by the lease.

3. Explanation

The acquisition-by-purchase requirement in section 1400Z-2(d)(2)(D)(i)(I) is designed to ensure that QOZBP is not recycled by taxpayers who merely transfer it between related parties. This supports the Congressional policy goal of sparking new investment in QOZs. However, in attempting to prevent abuse by relying on the term “purchase” under the section 179 definition, the language raises the question as to whether QOZBP can be acquired by lease. We suggest two ways that guidance can address this question: First, by making clear that property leased from an unrelated party can meet the acquisition test; and second, by clarifying that only the leasehold interest in property should be valued and included in the asset tests of a fund and/or a QOZB. These two recommendations are complementary and can be implemented together. Either one of them could also be implemented independently and may be sufficient to avoid a serious and presumably unintended impediment to QOZB qualification.

Many businesses may be more efficiently formed with property leased from an unrelated party than with property in which outright ownership is obtained from an unrelated party. For example, sound business judgment compels many businesses to lease land or retail space rather than acquire fee simple ownership of the land or buildings. Consistent with accommodating such sound business judgment, the statute specifically contemplates that a QOZB is a trade or business in which all the property “owned or leased by the taxpayer” must be QOZBP.⁵⁹ To be QOZBP, the property must meet the requirement that QOZBP be acquired “by purchase (as defined in section 179(d)(2)).” The statute would seem to contradict itself unless the section 179(d)(2) definition of such term includes the acquisition of a leasehold interest (regardless of whether such term in common parlance is thought to include leases).

The text of section 179(d)(2) is broad enough to support the inclusion of leasehold acquisitions. A QOZB’s acquisition of a leasehold interest in property arguably is within the meaning of “any acquisition of property” because a leasehold is a property right.⁶⁰ Moreover, the other requirements of section 179(d)(2) are met if the lessor is not a related party, a member of the same controlled group, or a person from whom the lessee obtains a carryover basis or basis under section 1014(a).⁶¹

⁵⁹ I.R.C. § 1400Z-2(d)(3)(A)(i).

⁶⁰ I.R.C. § 179(d)(2); *see also* Reg. § 1.179-4(c).

⁶¹ Note that, since the lessee has no basis in the leased property, it does not have a carryover basis or a basis under section 1014(a).

We recommend that guidance also make clear that leased property in which the lessor meets the unrelated party requirements of section 179(d)(2) can be QOZBP when held directly by a QOF. QOZBP should be defined consistently regardless of whether the QOZBP is held in a QOZB or by a QOF directly. If there are concerns regarding the broader implications of such guidance, it would be reasonable to confine such guidance as being for purposes of section 1400Z-2. The limited scope of such guidance would be justified by the specific need to reconcile section 1400Z-2(d)(3)(A)(i)'s reference to property leased by a QOZB with the requirement that such property be "purchased" by a QOZB within the meaning of section 179(d)(2).

Our second recommendation is that guidance also clarify the manner in which leasehold interests are valued or accounted for in the asset tests for both QOFs and QOZBs. It would be reasonable and consistent with the purposes of the statute if only the value of the leasehold interest itself were included, rather than the full fair market value of the property. This would be consistent with the fact that the value of just the leasehold would be the value indirectly reflected in the relevant QOZB stock or partnership interests for purposes of the QOF's 90% asset test. In many cases the value of the leasehold may be zero (for example, for a typical on-market lease in which the value of the property rights obtained is equal to the present value of the promise to continue to pay rent).

Failure to implement either one of these recommendations could lead to significant uncertainty regarding whether businesses qualify as QOZBs. Consider a typical business in which a retail storefront is leased at arm's length from an unrelated party in a QOZ. Even if the storefront is new construction or substantially improved real estate, and even if the business represents a brand new investment of precisely the sort intended to be incentivized by the QOZ rules and meets all the other requirements for QOZBs, current guidance is insufficient for the business to know whether or not it qualifies. If the retail storefront leased by the taxpayer must be included in the denominator of the QOZB asset test, if such property is deemed to fail the acquisition test because it is not "purchased" by the QOZB, and if this property "leased by the taxpayer" must be valued at fair market value in the hands of its owner, then there is little chance for any such business to qualify as a QOZB because the value of fee simple title to the storefront would overwhelm the value of the other business assets. Note that in this context, either of the two recommendations presented here would be sufficient for the business to gain clarity as to its qualification as a QOZB (although both could be implemented and could complement each other).

B. Whether Land Held in Connection with Construction or Substantial Improvements to Property Will Be Treated as a "Good Asset" for Purposes of the 90% Asset Test

1. Background

The original use and substantial improvement requirements require that either the original use of the property in the QOZ commence with the QOZB⁶² or that the QOZB substantially

⁶² For simplicity, we refer herein to the person that owns tangible property and seeks to qualify it as QOZBP as the QOZB, even though it is possible for property directly owned by a QOF to qualify as QOZBP. Our recommendations, and their justifications, apply equally to property held directly by a QOF.

improve the property.⁶³ If the use of the property in the QOZ does not commence with the QOZB, then the QOZB must substantially improve the property, which requires an additional investment over a 30-month period that exceeds the adjusted basis of the property at the beginning of the period.⁶⁴

2. Recommendations

We recommend that future guidance, including future Proposed Regulations, clarify that self-constructed property that is newly constructed after December 31, 2017, but is constructed on land that was contributed to and not purchased by the QOF (or by the QOZB in the case of property held through a partnership or corporation that operates a QOZB) is treated as purchased for purposes of section 1400Z-2(d)(2)(D)(i)(I) and meets the original use requirement of section 1400Z-2(d)(2)(D)(i)(II). We suggest incorporating the rules of Regulations under section 168⁶⁵ relating to self-constructed property for this purpose.

Furthermore, we recommend that future guidance, including future Proposed Regulations, clarify the treatment of land in a few critical ways:

- We recommend that where an improvement to land is treated as a good asset, the land upon which it is placed is a good asset as well, despite the fact that such land cannot meet the original use test and may not itself be substantially improved. We also recommend treating as QOZBP an amount of land that is limited in size to the amount reasonably consistent with facilitating an investment in the improved building under the facts and circumstances.
- We recommend extending the treatment of land accompanying an improvement as QOZBP to improvements other than building improvements. Or, in the alternative, if the land accompanying an improvement other than a building cannot be treated as QOZBP, it should be excluded from both the numerator and the denominator so that it will not be treated as a bad asset for the QOF or QOZB.
- We also recommend treating an improvement to land that increases the basis of such land by more than the basis of the land as meeting the substantial improvement test even if a structure on the land is not improved.

3. Explanation

a. Self-Constructed Property on Contributed Land

Like section 1400Z-2, section 1400N (providing Gulf Opportunity Zone tax benefits) required property to be purchased as defined in section 179(d). Notice 2006-77 implemented the section 1400N rules, and provided that the purchase requirement of section 179 could be satisfied

⁶³ I.R.C. § 1400Z-2(d)(2)(D)(i)(II).

⁶⁴ I.R.C. § 1400Z-2(d)(2)(D)(ii).

⁶⁵ Reg. § 1.168(k)-1(b)(4)(iii).

by applying rules similar to the self-constructed property rules for depreciation under the Regulations to section 168.⁶⁶ Similarly, regulations under section 1400L of the Code (providing New York Liberty Zone tax benefits), define acquisition of property by purchase by cross reference to Regulation section 1.168(k)-1(b)(4)(iii) which treats property constructed by the taxpayer as “acquired” and therefore purchased.

Accordingly, an acquisition by purchase does not necessarily exclude self-constructed property on land acquired by contribution. Explicitly allowing taxpayers who own land in a QOZ to contribute that land to a QOF (which may then contribute the land to a partnership or corporation that operates a QOZB) and treat self-constructed property that meets the requirements of Regulation section 1.168(k)-1(b)(4)(iii) as meeting the purchase requirement of section 1400Z-2(d)(2)(D)(i)(I) would provide certainty to taxpayers who own land in QOZs that may be developed. The self-constructed property would then also qualify as original use, and the property would meet the requirements of section 1400Z-2(d)(2)(D)(i). Whether the contributed land would be treated as “acquired by purchase” would be separately evaluated under section 179(d)(2)(C).

For example, assume that L owns unimproved land in a QOZ with a value of \$200,000. L contributes \$400,000 of roll-over gain from another investment and M contributes \$400,000 of roll-over gain from another investment to a partnership that elects to be a QOF. The QOF contributes the \$800,000 cash and L contributes the unimproved land to JV, which is formed as a partnership, in exchange for interests in JV. JV uses all of the cash within 31 months to construct an apartment building on the land, which it then operates as a rental property. Assuming a continued apartment building value of \$800,000 and land value of \$200,000, JV should be treated as a QOZB notwithstanding that the apartment building was constructed on land acquired by contribution from a partner.

b. Treatment of Land as a “Good Asset”

Consistent with Congressional intent, the Proposed Regulations and Revenue Ruling 2018-29 (“Revenue Ruling”)⁶⁷ provide that for purposes of the substantial improvement requirement, the basis attributable to land on which a building sits is not taken into account in determining whether the building has been substantially improved. The supplementary background to the Proposed Regulations states that, “excluding the basis of land from the amount that needs to be doubled under [the substantial improvement rule] for a building to be substantially improved facilitates repurposing vacant buildings in qualified opportunity zones.”⁶⁸

This is a common sense rule, since requiring an overinvestment in tangible property due to the presence of basis in land seems to serve no real purpose. Similarly, it would seem that an

⁶⁶ Reg. § 1.168(k)-1(b)(4)(iii).

⁶⁷ Rev. Rul. 2018-29, 2018-45 I.R.B. 765. The Revenue Ruling was issued contemporaneously with the Proposed Regulations.

⁶⁸ 83 Fed. Reg. 54279, 54279. The rule is set forth in Proposed Regulation section 1.1400Z2(d)-1(c)(8)(ii) which states, in part, “Under Section 1400Z-2(d), measuring a substantial improvement to the building by additions to the QOF’s adjusted basis in the building does not require the QOF to separately substantially improve the land upon which the building is located.”

absence of a requirement to increase the basis of land itself would facilitate the repurposing of vacant or otherwise underutilized land.

Congressional intent to stimulate economic activity in distressed communities can be furthered both by encouraging new property to be built or brought into the zone, and by putting existing property to new use within the zone. However, as recognized in the Revenue Ruling, given the permanence of land, land can never have its original use in a QOZ commencing with a QOF. Moreover, it is not appropriate to require that land be separately subject to a substantial improvement requirement as this would preclude qualification of many of the investments that the QOZ rules are specifically designed to incentivize.

The limited scope of the Revenue Ruling raises questions regarding the treatment of land that lies just beyond the ambit of the scenario described in the guidance, for instance unimproved land where a use is anticipated that will require development of smaller buildings or non-building improvements. We recommend that the approach of the Revenue Ruling be (1) clarified and potentially narrowed in respect of the amount or value of land that is sheltered by substantial improvements to buildings and (2) expanded to include other types of tangible property and property whose original use commences in a QOZ (in addition to substantially improved property).

The Proposed Regulations and the Revenue Ruling both leave unclear whether and to what extent land is treated as a good asset for purposes of the 90% asset test, in the case of a QOF, or the substantially all requirement, in the case of a QOZB. We propose that the final Regulations clarify that in the circumstance where an improvement to land is treated as a good asset, that the land upon which it is placed is a good asset as well, despite the fact that such land may not itself be substantially improved and, as recognized by the Proposed Regulations and Revenue Ruling, such land cannot meet the original use test. It is similarly unclear whether the Ruling includes any implicit limit on the amount of land that is treated as a good asset when a building located on the land is improved. Consider, for example, an outhouse located on a 100-acre QOZ tract that is substantially improved by virtue of a new coat of paint and installing a new door. Presumably the entire 100-acre tract should not thereby be treated as a good asset.

The Revenue Ruling provides its accommodation for land with respect to “land within the qualified opportunity zone upon which the building is located,” which could be interpreted to treat as a good asset (1) only the actual square footage of the land on which the footprint of the improved building overlaps, (2) an amount of land that is limited in size to the amount reasonably consistent with facilitating an investment in the improved building under the facts and circumstances, or (3) any land, no matter how extensive, as long as there is any improved building, no matter how inconsequential, located somewhere upon it (the outhouse example). We suggest that approach (2) is the most reasonable middle-ground approach and that final guidance should clarify this.

Approach (2) would also facilitate an expansion of the relief granted in the Revenue Ruling to other contexts where appropriate. For example, while the Revenue Ruling applies only to the substantial improvement of purchased buildings, there is no principled or statutory basis to deny similar treatment to buildings that are newly constructed (i.e., that are intended to satisfy the alternative prong that the original use commences with the QOF or QOZB). A QOF that purchases and improves a distressed building and the underlying land should not be treated differently than

a QOF which purchases the same type and amount of land and erects an entirely new building of the same type as the first QOF. The limited nature of the guidance in the Revenue Ruling could result in the absurd situation where the former QOF qualifies and the latter does not.

While we understand that buildings are the type of significant and large-scale investment that the QOZ rules may have been specifically intended to incentivize, the statute is not written to favor buildings, or even to favor large investments over small ones, so long as the asset tests are passed. If land – at least, an amount of land consistent with supporting an otherwise qualifying investment – is to be exempt from the original use and substantial improvement requirement in the context of buildings, it should also be exempt from these requirements when limited to an amount (under the facts and circumstances) necessary to support other types of investment in substantially improved or original use property. Examples might include newly constructed windmills, natural gas wells and pipelines in a rural QOZ that may bring jobs and economic growth to the area.

Lastly, the Revenue Ruling raises a question of how to characterize a substantial improvement that adds to the basis of the land itself. For example, a QOZ tract might be environmentally remediated or converted into a farm or timber grove. To avoid arbitrarily favoring some industries over others, and to be consistent with the accommodation in the Revenue Ruling, land should not be a hindrance in meeting the QOF or QOZB asset tests in these contexts either.

For example, environmental remediation costs generally qualify as expenses incurred for “permanent improvements or betterments made to increase the value of any property” which may be capitalized and added to the basis of property under sections 263(a) and 198. While some of these sorts of costs may be properly capitalized into land, as noted above, a requirement that significant costs be expended in respect of land is artificial, especially where such costs are being expended to facilitate improvements to the land which are to be tested for substantial improvement. Consistent with the other industries for which relief from an unrealistic substantial improvement of land requirement has been granted, improvements to land should be considered as separate qualifying assets, irrespective of whether they double the basis in the land itself.

Because the ultimate test for any QOF will be whether it can potentially generate sufficient returns and value over the required 10-year holding period, it makes sense that such costs are to be counted toward the substantial improvement test for related improvements under section 1400Z-2(d)(2)(D)(ii). In other words, since the tax benefits under the statute are predicated on the QOF realizing significant long-term gains, we think investor profit motive will provide adequate protection against QOFs that might seek to underutilize QOZBP while still meeting the original use or substantial improvement requirement.

C. Whether the Basis of Related Assets May Be Aggregated for Purposes of Satisfying the Substantial Improvement Requirement

1. Background

For property to be QOZBP, it must meet the substantial improvement test described above. The QOF (or the QOZB if assets are not held directly by the QOF) must make additions to the basis of the property in an amount in excess of the adjusted basis of such property at the beginning of a 30-month testing period under section 1400Z-2(d)(2)(D)(ii).

2. Recommendation

We recommend that future guidance, including future Proposed Regulations, allow substantial improvement in a QOF to be achieved on an aggregate basis based on the facts and circumstances.

We recommend offering a safe harbor in the case of assets that are located or stored on a single tract of land, or contiguous tracts, within a QOZ and which are purchased as part of the same investment decision.

Furthermore, we recommend adopting a test similar to the one set forth in Regulations under section 1250,⁶⁹ which sets forth a test under which adjacent buildings may be aggregated and treated as a single item of section 1250 property. Under this test, structures may be aggregated if they are “operated as an integrated unit (as evidenced by their actual operation, management, financing, and accounting).”

3. Explanation

The Code does not provide any guidance for QOFs with respect to whether the term “such property” in section 1400Z-2(d)(2)(D)(ii) can refer to aggregations of assets, or whether (or to what extent) identifiably separate assets must separately meet a substantial improvement test.

Treasury and the Service have authority to determine the meaning of the term “such property,” and it is reasonable for such term to refer to a collection of related assets. Subjecting each asset of a QOF (or QOZB) to a separate substantial improvement requirement is impractical and in many cases against sound business judgment. For many operating businesses other than real estate, the substantial improvement test would be impossible to meet if it required an existing business acquired by a QOF to be substantially improved on an asset-by-asset basis. However, even in the context of real estate, on a single tract of land purchased by a QOF, one building may be in need of only very minor improvements and a related adjacent building may be in disrepair, needing capital improvements well in excess of the purchase price allocable to the overall investment.

The issue of how aggregation affects the substantial improvement analysis is illustrated with the following example:

Example 4

A QOF makes an investment in land on which there is an office building that requires substantial improvement and a parking garage, serving the office building, which does not require further improvement. The QOF invests \$150, and of that amount, \$50 is allocated to each of the land, the parking garage, and the dilapidated office building. \$105 is then invested in improving the office building. Pursuant to the Revenue Ruling, the basis

⁶⁹ Reg. § 1.1250-1(a)(2)(ii).

in the land is not considered in determining whether the substantial improvement test is met for the buildings; and if the test is met for the buildings, the land is a good asset that counts in the numerator and the denominator of the 90% asset test.

Whether the 90% asset test is met in the foregoing example depends on whether the office and the parking garage are treated as part of the same property or not. If they are treated as parts of the same property, then the \$100 investment to purchase “such property” is exceeded by the \$105 spent on substantial improvement, and so the property in the aggregate is substantially improved and 100% of the QOF’s assets are qualifying QOF assets. However, if the unimproved parking garage is treated as a separate item of property, then the asset test is as follows:

Good Assets:

Land	\$50
Office	\$50 + \$105 = \$155
Total	\$205

Bad Assets:

Garage	\$50
Percentage of good assets:	$\$205/\$255 = \sim 80.4\%$

The percentage would be lower to the extent that some portion of the land is treated as a bad asset because the garage was not substantially improved.

Treating the garage as separate property therefore causes the QOF to fail the 90% asset test. The regulations should give taxpayers clear guidance on whether and under what circumstances aggregation is appropriate.⁷⁰ Even within a single building, there are ordinarily a variety of fixtures, machinery, appliances and furnishings that may be accounted for in separate line items of a balance sheet. The substantial improvement test should not depend on how assets are described on a balance sheet for financial accounting purposes.

In most cases, segregation of assets in order to determine substantial improvement on an asset-by-asset basis does not further the legislative purpose of incentivizing high quality investments in QOZs. Such a test would create perverse incentives under which investors would allocate their capital improvements in inefficient and unnatural ways in order to ensure that each separate asset is substantially improved. Instead, allowing investors and operators to determine in their business judgment where to focus capital expenditures within a real estate or other business with respect to their investment decision will best serve the legislative purposes. Moreover, requiring excessive segregation of assets would create traps for the unwary and problems with administrability.

⁷⁰ Query, for example, what if the parking garage consists of the lower floors of the same structure? What if those lower floors are separately titled? What if the garage is a separate structure, but physically attached? What if it is not attached, but adjacent and part of the same legal parcel? What if it is on a separate legal parcel, but the garage still serves the office exclusively? What if the garage serves the office and also the public? What if the garage and office are not adjacent and not physically related in any way, but are part of the same investment decision because the seller of both assets requires both assets to be purchased as part of the same transaction? Where does one draw the line?

We suggest that two safe harbors be adopted for aggregating assets and measuring whether the aggregate assets are substantially improved. First, assets that are on the same tract, or contiguous tracts, of a QOZ and which are purchased as part of the same investment decision should benefit from a safe harbor treating them as an aggregate asset for purposes of measuring substantial improvement. Assets purchased under a single contract from the same seller should benefit from a rebuttable presumption that such assets are part of the same investment decision. Other factors could include documentation of the investment decision by showing how the QOF has modeled the investment performance as a single investment and by showing board resolutions or other similar governance documents under which the investment is authorized.

Second, a QOF should be able to aggregate assets on the same tract or contiguous tracts of a QOZ under an objective test, even in the absence of evidence regarding whether the assets are part of the same investment decision. We recommend that an appropriate test, in the context of real property, could be the one set forth under the Regulations to section 1250, which sets forth a test under which buildings may be aggregated and treated as a single item of section 1250 property.⁷¹ Under this test, structures may be aggregated if they are “operated as an integrated unit (as evidenced by their actual operation, management, financing, and accounting).” An identical test existed under former Regulations under section 167⁷² and continues to be cited in private letter rulings regarding whether property, in the aggregate, is treated as residential or nonresidential.⁷³ Permitting buildings to be aggregated under this same standard would serve the purpose of consistency in the Code in general as well as the legislative purposes of the QOF rules in particular.

D. Safe Harbors for Determining Whether Movable Property (Including Abandoned and Underused Property) Satisfies the Original Use Requirement

1. Background

Property is QOZBP only if (among other requirements) “the original use of such property in the qualified opportunity zone commences with the QOF or the QOF substantially improves the property.”⁷⁴ The original use requirement (as an alternative to substantial improvement) applies to tangible property, which includes both real estate and movable property.

Section 1400Z-2 does not provide any specific rules for movable property, and the preamble to the Proposed Regulations solicits comments on the proper treatment of movable property. The preamble to the Proposed Regulations further solicits comments on whether a period of underutilization or non-use should enable subsequent productive utilization of the property to qualify as original use.⁷⁵

⁷¹ Reg. § 1.1250-1(a)(2)(ii).

⁷² Reg. § 1.167(j)-3(b)(1)(ii).

⁷³ See, e.g., PLR 201243003 (July 24, 2012).

⁷⁴ I.R.C. § 1400Z-2(d)(2)(D)(i)(II).

⁷⁵ 83 Fed. Reg. 54280.

2. Recommendations

We recommend that future guidance, including future Proposed Regulations, provide that movable property be treated as never used in a QOZ if, during each year in the 5-year period ending on the date of the acquisition of the property, it was located primarily outside of any QOZ and that no more than 20% of its use was within a QOZ. In the case of any group of assets, such as a delivery fleet or a laptop computer pool made available to travelling employees, where the assets are interchangeable, we recommend that the determination be made on an aggregate basis rather than with regard to each delivery vehicle or computer.

We further recommend, with respect to movable property, that underused or unused assets be subject to the following rules for purposes of the original use requirement:

- Movable property located within a QOZ (for instance, at a garage) that is not actually used for any business purpose within a year be treated as not used during that year.
- Movable property that is used within a QOZ, but for an amount of time or number of uses that represent less than 20% of the amount of time or number of uses that would reasonably be expected of a fully used asset, be treated as not used during that year.

We further recommend that future guidance, including future Proposed Regulations, provides that the purchaser of assets is entitled to rely upon a certification under penalties of perjury from the seller that the purchased assets satisfy the foregoing requirements, provided that the purchaser does not have actual knowledge that the certification is false and does not receive a notice that the certification is false. Such a certification should not be required, as in many circumstances it would be unreasonable to ask a seller for that certification, but if received it should create an irrebuttable presumption barring actual knowledge or notice that the certification is false.

3. Explanation

While section 1400Z-2 requires that the original use of property in an opportunity zone be made by a QOZB or QOF (or, if not, that the QOZB or QOF substantially improve property), it does not require that the original use of property be in a QOZ. This seems consistent with the intent of the statute to promote economic development in QOZs. There is no requirement that movable property used by a QOZB be constructed in the QOZ, and as such there seems to be no reason to favor purchase of new property over purchase of used property. Indeed, many businesses buy used equipment and vehicles as a matter of course, and denying a QOZB the ability to buy used property would put it at a competitive disadvantage relative to a non-QOZ business.

It therefore is important to clearly identify when movable property should be treated as having been used in a QOZ and to provide bright-line rules that are easily applied in a commercial context, especially in cases that might be borderline, such as:

- Vehicles regularly accepting packages or making deliveries within a QOZ; or

- Computers and other mobile electronics that are carried by workers who spend time within a QOZ, whether or not their regular offices are based in a QOZ.

To address issues relating to these sorts of movable property, we suggest a rule that any movable property not be treated as used in a QOZ if its primary location (such as an office in which a computer is normally based or a garage in which a vehicle is normally parked overnight) is outside any QOZ and if less than 20% of its time in use is in a QOZ. Such a determination may be difficult in the case of a large group of assets, such as delivery fleets, where the assets are maintained as a pool and readily interchangeable. In such a case a determination could be made on an aggregate basis.

Because movable property may have a long useful life, it is unrealistic to expect purchasers in all cases to determine the history of use of the movable property and determine that at no time was it ever used within a QOZ.

Similar issues are presented to the purchaser of a corporation who must determine whether that corporation ever was a U.S. real property holding corporation and whether withholding is required. Such purchasers are afforded relief by the provisions relating to sections 897 and 1445 and the Treasury Regulations thereunder. Section 897 provides that a corporation is not a U.S. real property interest if the taxpayer establishes that it was not a U.S. real property holding corporation at any time during the five-year period ending on the date of disposition.⁷⁶ Similarly, a purchaser is not required to withhold upon the acquisition of an interest in a U.S. corporation if it receives a certification under penalties of perjury that the corporation was not a U.S. real property holding corporation at any time during the five-year period ending on the date of disposition.⁷⁷ The purchaser cannot rely on that certification if the purchaser has actual knowledge that the certification is false or receives a notice that the certification is false.⁷⁸

A similar rule could be applied both in the case of property actively used outside a QOZ and to property that was largely unused. In the case of actively used property, the test could be applied based on time used within a QOZ relative to time used outside a QOZ over the five-year testing period. In the case of property located within a QOZ that is underused, or unused, the test could be made by reference to how an asset would be used if it were fully utilized. For instance, if a truck might be expected to be used as an active delivery vehicle for 250 days a year but was used for only 15 days in a year, that truck could be treated as not used in a QOZ – even if all 15 days of its use were within a QOZ.

⁷⁶ I.R.C. § 897(c)(1)(A)(ii)(II).

⁷⁷ Reg. § 1.1445-2(c)(3).

⁷⁸ Reg. § 1.1445-2(c)(3)(ii).

E. Safe Harbors for Determining Whether Real Property Satisfies the Original Use Requirement

1. Background

Although land can never be treated as acquired for the first use within the zone, buildings and other improvements on the land that are newly constructed could be purchased by a QOF or QOZB for original use.

2. Recommendation

We recommend that future guidance, including future Proposed Regulations, provide that the original use of newly constructed real estate begins at the first time that the improvement is occupied and used for the conduct of the activity for which it was intended by the owner or any tenant. This standard would exclude any occupancy for purposes of building out tenant improvements, but would include any occupancy for the owner's or the tenant's ultimate intended use of the space.

Alternatively, we recommend that the forthcoming Proposed Regulations provide that the original use of newly constructed real estate begins at the first time that the owner occupies the improvement for its ultimate intended use or the owner delivers possession of the leased real estate to a tenant.

3. Explanation

In order for a QOF or QOZB to reliably determine whether its acquisition of real estate with completed new construction will satisfy the "original use" test, a QOF or QOZB must be able to determine whether the property has already been used prior to its acquisition. In particular, clarification is needed with respect to potential activities of a seller (who may be the developer) that could cause the property to be considered already used prior to the property's acquisition by the QOF or QOZB. In some cases, a developer may develop property and begin to enter into leases and may even allow tenants to occupy the leased premises prior to selling the completed project to the ultimate buyer. It is not clear at what point such a developer itself has begun to use the property. Accordingly, it can be difficult for a QOF or QOZB to identify whether property offered for sale by a developer will satisfy the original use requirement. The forthcoming Proposed Regulations should adopt a clear standard with respect to real estate improvements and original use in order to provide certainty to a QOF or a QOZB that will acquire newly constructed real estate for its trade or business.