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July 1, 2019

Via Federal eRulemaking Portal
at www.regulations.gov

Internal Revenue Service
CC:PA:LPD:PR (REG-120186-18)

Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

RE: *Comments on Proposed Regulations Concerning the Deferral of Gain Recognition on Amounts Reinvested in Qualified Opportunity Funds*

Dear Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury ("Treasury") and Internal Revenue Service (the "IRS" or "Service") in the Notice of Proposed Rulemaking (REG-120186-18) issued on April 17, 2019 (the "Proposed Regulations"). The Proposed Regulations provide guidance regarding the application of Section 1400Z-2 of the Internal Revenue Code of 1986, as amended (the "Code") that was enacted on December 22, 2017 by Section 11011 of "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Public Law 115-117 commonly referred to as the Tax Cuts and Jobs Act of 2017 (the "TCJA").

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed comments on the Proposed Regulations.

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July 1, 2019

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend Treasury and the Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to submit comments with respect to the Proposed Regulations.

Sincerely,

Christina A. Mondrik, Chair
State Bar of Texas, Tax Section

July 1, 2019

COMMENTS ON PROPOSED REGULATIONS CONCERNING THE DEFERRAL OF GAIN RECOGNITION ON AMOUNTS REINVESTED IN QUALIFIED OPPORTUNITY FUNDS

These comments on the Proposed Regulations (the "Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Chris M. Goodrich, Vice Chair of the General Tax Committee, and Nathan Smithson, Co-Chair of the Partnership and Real Estate Tax Committee. Argyrios Saccopoulos reviewed the Comments and made substantive suggestions. Jeffry M. Blair also reviewed the Comments and made suggestions on behalf of the Committee on Government Submissions ("COGS").

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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I. INTRODUCTION

These Comments are provided in response to Treasury's and the IRS's requests for comments on the Proposed Regulations concerning the deferral of gain recognition on amounts reinvested in qualified opportunity funds. Code Section 1400Z-2 was enacted on December 22, 2017 as part of the TCJA. Code Section 1400Z-2 permits the deferral of certain gains on the sale of property where such funds are invested in a qualified opportunity fund (a "QOF"). As a result of such deferral, taxpayers making permissible investments may be able to defer the taxation of capital gains until the earlier of the date that such investment is sold or exchanged or December 31, 2026. In order for such investment to be valid, substantially all of the fund's assets must be timely invested in appropriate property.

The Proposed Regulations were issued to provide taxpayers with guidance with respect to the types of gains that may be deferred, timing of investments and methods for determining qualification within the Code Section 1400Z-2 rules. We commend Treasury and the IRS for its efforts in issuing the Proposed Regulations. We also appreciate the opportunity to comment on the Proposed Regulations.

We respectfully offer the comments and suggestions described below.

II. PROPOSED REGULATION SECTION 1.1400Z2(d)-1(b)(4) (Six Month Rule)

Under the Proposed Regulations, an investment vehicle must hold at least 90% of its assets in qualified opportunity zone property to qualify as a QOF. A QOF must meet this 90% test every six months. In addition, the Proposed Regulations require that if a QOF acquires interests in an entity, at least 70% of the tangible property owned or leased by that entity must be qualified opportunity zone property for that entity to be treated as engaged in a qualified opportunity zone business (a "QOZB") and be treated as qualified opportunity zone property.

Under Proposed Regulations section 1.1400Z2(d)-1(b)(4), rollover cash received by a QOF in the immediately preceding 6 months (i.e., cash in respect to which a taxpayer makes the election contemplated in Section 1400Z-2(a)(1)) does not need to be considered for purposes of the 90% test, provided the cash is continuously held as cash or invested in cash equivalents or debt instruments having terms of 18 months or less. However, this rule does not apply to cash held by partnerships or corporations that have issued qualified opportunity zone partnership interests or qualified opportunity zone stock to the QOF, respectively (either, a "QOF Subsidiary"). There appears to be a trap for the unwary in a situation where a QOF receives cash and due to some business need immediately invests that cash into a QOF Subsidiary. The trap is that the cash may count against the QOF Subsidiary's satisfaction of the 70% test (e.g., if the 31-month working capital safe harbor can't be met as of a testing date due to construction costs and scheduling not yet being known to the QOF Subsidiary in the first few months). This failure of the QOF Subsidiary to satisfy the 70% test in turn could result in the 90% test not being satisfied for QOF.

Proposed Regulations section 1.1400Z2(d)-1(b)(4) appears to have the purpose of giving taxpayers additional time within which to deploy recently received capital contributions, but a QOF Subsidiary could also need leeway in deploying capital, where there is a business need for

the QOF to immediately invest cash into the QOF Subsidiary. Moreover, even without a business need to hold cash in a QOF Subsidiary, taxpayers should not be penalized for simply choosing to hold cash in the bank account of an operating subsidiary instead of a parent. Accordingly, we respectfully recommend that the six-month period contemplated in Proposed Regulation section 1.1400Z2(d)-1(b)(4) apply regardless of whether the QOF or its QOF Subsidiary is holding the cash. We believe that this 6 months leeway will allow the QOF Subsidiary sufficient time to satisfy the "reasonable working capital" exception (e.g., the 31-month working capital safe harbor).

III. PROPOSED REGULATIONS SECTION 1.1400Z2(a)-1(b)(2)(iii) (Section 1231 Gains)

Section 1231 property (which generally consists of depreciable property used in a trade or business) is subject to special treatment under the Code. Gains and losses from Section 1231 property are netted. If the netted section 1231 gains and losses for a year result in a net section 1231 gain, then such gain is treated as a long-term capital gain for federal income tax purposes. If the netted section 1231 gains and losses produce a net loss, then such loss is treated as an ordinary loss. Net section 1231 gains that receive capital gain treatment qualify as capital gain eligible for rollover treatment under Section 1400Z-2. Whether section 1231 gains are capital gains is determined at the partner level rather than the partnership level, and therefore a partner must combine all of their section 1231 gains and losses to determine if there is capital gain treatment. Since the determination as to whether a taxpayer has a net section 1231 gain can't be made until the end of that taxpayer's taxable year, Proposed Regulations section 1.1400Z2(a)-1(b)(2)(iii) indicates that the 180-day investment period for 1231 gain doesn't start to run until the last day of the tax year in which the 1231 gain would otherwise have been recognized (i.e. if such gain was not deferred under 1400Z-2). We believe that this sets up a trap for the unwary because an investment in a QOF prior to the last day of a year in which a 1231 gain is realized would be disqualified from Section 1400Z-2(a) treatment since the investment occurred prior to the start of the 180-day rollover period. We respectfully request that the IRS adopt a rule similar to partners electing deferral of partnership capital gains permitting the 180-day period to run from the last day of the partnership's taxable year ***or*** the date of sale (pursuant to Proposed Regulations section 1.1400Z2(a)-1(c)(2)(iii)). In such an instance, the taxpayer making the investment could continue to bear the risk that the amount of gains invested would not qualify as section 1231 gain, but could still have a chance for deferral treatment if the gain does qualify a net section 1231 gain.

IV. PROPOSED REGULATIONS SECTION 1.1400Z2(d)-1(d)(5)(vii) (31-Month Working Capital Safe Harbor)

In respect to the 31-month working capital safe harbor under Proposed Regulation section 1.1400Z2(d)-1(d)(5)(iv), we respectfully believe that a clarification may be needed. We respectfully believe that the reference in Proposed Regulation section 1.1400Z2(d)-1(d)(5)(vii) to "section 1400Z-2(d)(2)(D)(1)" should be changed to either "section 1400Z-2(d)(2)(D)" or "section 1400Z-2(d)(2)(D)(i)."

V. PROPOSED REGULATIONS SECTION 1.1400Z2(d)-1(d)(5)(ii)(A) (Intangible Property)

Proposed Regulations section 1.1400Z2(d)-1(d)(5)(ii)(A) provides that a substantial portion of a QOZB's intangible property must be used in the active conduct of that business in the relevant qualified opportunity zone ("OZ"). Proposed Regulations section 1.1400Z2(d)-1(d)(5)(ii)(A) defines "substantial portion" as forty percent. However, this proposed regulation fails to provide any rules for determining when and to what extent intangible property is used in or outside of an OZ.

Under most state property laws, intangible property is generally treated as being located where the owner of that property is located. A significant issue can arise where a business has several business locations. For example, a business could have a main management and operations headquarters within an OZ and a technology research and development facility located outside of an OZ. As between these two sites, the Proposed Regulations do not provide sufficient rules on how to determine or measure where the technology is located. Further, the Proposed Regulations do not explain whether or to what extent the requisite use of the intangible property should be treated as being used by the intangible property owner located in the OZ or the extent that the intangible property should be treated as used by customers located outside of the OZ.

We respectfully request additional guidance with respect to how to determine when and to what extent intangible property will be treated as used in the active conduct of a trade or business. In addition, Proposed Regulations section 1.1400Z2(d)-1(d)(5)(i)(C) provides that, if the management and operations necessary to generate 50% or more of the OZ business' gross income are performed in the OZ, then that business is considered to be conducted within the OZ. We respectfully recommend that a similar rule be adopted in respect to intangible property.

VI. PROPOSED REGULATIONS SECTION 1.1400Z2(d)-1(d)(5)(ii)(B)(2) (Triple-Net-Lease Definition)

Proposed Regulations section 1.1400Z2(d)-1(d)(5)(ii)(B)(2) refers to the term "triple-net-lease" with respect to real property but does not define it. The Proposed Regulations simply indicate that merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not active conduct of a trade or business by such taxpayer. For purposes of Code Section 199A, IRS Notice 2019-07 defines a triple-net-lease as a lease which "requires the *tenant or lessee to pay* taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities." Notice 2019-07, 2019-9 IRB 740 (Emphasis added.) However, courts have determined that the appropriate test for determining which taxpayer is able to take ordinary and necessary deduction under Code Section 162 with respect to the property subject to a triple-net-lease is not based on who bears the costs for ad valorem taxes, insurance, maintenance and utilities, but rather who performs the services attendant to dealing with the ad valorem taxes, insurance, maintenance and utilities. Consequently, if a landlord (or its employees, agents or contractors) performs the services attendant to dealing with the ad valorem taxes, insurance, maintenance and utilities, but the landlord has the right to bill the tenant for all expenses associated with ad valorem taxes, insurance, maintenance and utilities, plus perhaps a small percentage service fee (e.g., 1-3%), such a "landlord-performance" triple-net-lease should not

disqualify the relevant real estate subject to that lease from being an active trade or business. We respectfully recommend that the Proposed Regulations be supplemented to clarify the circumstances under which a triple-net-lease will be treated as an active conduct of a trade or business.

VII. PROPOSED REGULATIONS SECTION 1.1400Z2(d)-1(c)(7) (Placed in Service Rule)

We believe that Proposed Regulations Section 1.1400Z2(d)-1(c)(7) should be clarified to permit a QOF to elect to have the original use of real property improvements measured either from when such property is placed in service for depreciation purposes or when the first (temporary or permanent) certificate of occupancy is granted under local law in respect to such real property. This formulation of the rule would avoid uncertainty in determining the date of original use in cases where there is a delay between the date on which construction of improvements is sufficiently complete to enable the real property's intended use and the date on which a tenant or others actually begin using that improvement, e.g., the initial lease up period for a multi-family residential apartments. Compare Treasury Regulations sections 1.46-3(d)(2), 1.150-2(c) and 1.179-4(e). Accordingly, we respectfully request that Proposed Regulations Section 1.1400Z2(d)-1(c)(7) be clarified to permit QOFs to elect to have the original use of real property improvements measured either from such property is placed in service for depreciation purposes or when the first (temporary or permanent) certificate of occupancy is granted under local law in respect to such real property.

VIII. PROPOSED REGULATIONS SECTION 1.1400Z2(d)-1(c)(5)) (90% Holding Period Requirement)

Proposed Regulations section 1.1400Z2(d)-1(c)(5) provides guidance with respect to the requirements that (1) a corporation or partnership qualify as a QOZB during "substantially all" of a QOF's holding period for interests thereof, and (2) tangible property must meet certain usage requirements during "substantially all" of the QOF's holding period thereof. In each case, "substantially all" of a holding period is now defined as 90% of the holding period.

This guidance may be difficult to administer in the context of annual tax accounting periods that include only portions of multi-year holding periods. A holding period will be ongoing as a QOF files yearly tax returns and reports the results of its asset tests, however, whether a QOF meets the 90% holding period requirement can only be correctly assessed in light of a full and completed holding period.

For example, if a QOF invests all of its assets in a QOF Subsidiary that fails to meet all of the QOZB requirements for a period of six months in its first year, then the initial period of non-qualification would represent more than 10% of the holding period until the QOF reaches a five-year holding period in the QOF Subsidiary equity. Proposed Regulations section 1.1400Z2(d)-1(c)(5) appears to require a QOF to report a failed asset test and pay a penalty tax during this time, since the term "holding period" cannot, without explicit guidance, include assumed future periods. However, once a five-year holding period is actually achieved, the QOF will, retrospectively, turn out to have been compliance with the holding period requirement for the entire five-year period.

In light of these difficulties, we respectfully request that Proposed Regulations section 1.1400Z2(d)-1(c)(5) be revised to permit taxpayers to elect to apply the 90% holding period requirement either (1) to the taxpayer's actual holding period as of a testing date or (2) the taxpayer's "projected holding period," which must include a reasonable assessment of asset qualification in future periods. To limit this accommodation, proposed regulations could limit a "projected holding period" to an overall ten-year period (in order to align with the ten-year holding period requirement of Code Section 1400Z-2(c)); or, if less in the case of tangible property, the remaining useful life of the asset as determined for federal income tax purposes.

In the event that this request is not adopted, we respectfully suggest that taxpayers should be provided an alternative test for a QOF parent to treat interests in a QOF Subsidiary as qualified opportunity zone business property during an initial start-up period of noncompliance with the QOZB rules, as the statutory language in Code Section 1400Z-2(d)(2)(B)(i)(II) and -2(d)(2)(C)(ii) seem to relax the need for strict QOZB compliance in the case of "new" entities that are "organized for purposes of being a qualified opportunity zone business." Such "new" entities could be explicitly granted a 1-year grace period for start-up operations to achieve full QOZB compliance, which, in the context of an expected ten-year holding period, would align with the 90% holding period requirement of the current Proposed Regulations.

IX. PROPOSED REGULATIONS SECTION 1.1400Z2(b)-1(c)(6)(iv)(D)(1)) (Allocation Percentage for Profits Interests)

Proposed Regulations section 1.1400Z2(b)-1(c)(6)(iv)(D)(1) requires a holder of a profits interest in a QOF to consider all allocations and distributions to have been made in respect of the profits interest based on the "highest share of residual profits" a mixed-funds partner would receive with respect to that profits interest.

We recognize that it is inappropriate for a profits interest received for services to qualify for the fair market value basis election under Code Section 1400Z-2(c). However, the chosen method for distinguishing between allocations and distributions to the qualifying and non-qualifying investments has a significant negative impact on qualifying investments in that even though every dollar of profit is not "residual," every dollar of profit must be allocated as if it were.

To illustrate, suppose that a sponsor puts up 10% of the capital in a QOF (which capital is funded by a valid capital gain rollover under Code Section 1400Z-2(a)), and is, in consideration of its management services, also entitled to a 20% carried interest after achieving a 8% internal rate of return. Profits that are earned below this 8% "hurdle" rate are allocated in a 90:10 ratio in accordance with capital. Once the hurdle is achieved, profits are allocated in a 72:28 ratio (because the investor's 90% bears a 20% carried interest). Of the amount allocated to the sponsor in this residual tier, about 64% is attributable to the carried interest (assume a $100 residual allocation of which $28 is allocated to the sponsor; $18 out of the $28, or about 64%, is carried interest). Because this "allocation percentage" of about 64% governs "all" allocations and distributions – even, apparently, those allocated below the hurdle – most of the sponsor's 8% return on its own capital investment, earned on exactly the same terms as the 90% investor, is artificially converted

into deemed profits interest allocations that build up the capital account in respect of the non-qualifying investment, for which there is no tax-free exit under Code Section 1400Z-2(c).

A well-advised taxpayer can easily avoid the harsh outcome of this rule simply by holding a carried interest through a separate regarded entity. Choosing a different, equally valid route for allocating profits up the chain through tiers of partnerships to the ultimate holders therefore has a huge difference in the ultimate holders' tax liability, without any corresponding substantive difference.

In order to avoid creating disparate outcomes for essentially identical investments, we respectfully suggest that the allocations and distributions in respect of a profits interest be segregated from and measured as the excess beyond the allocations and distributions that are made in respect of the mixed-funds taxpayer's qualifying investment.

X. PROPOSED REGULATIONS SECTIONS 1.1400Z2(c)-1(b)(2)(i) & 1.1400Z2(c)-1(b)(2)(ii)(1) (Rules for Section 1400Z-2(c) Gain)

Proposed Regulations section 1.1400Z2(c)-1(b)(2)(i) provides that if an investor in an QOF is taxed as a partnership and makes the election contemplated in Section 1400Z-2(c) (the "FMV Basis Election") upon its sale of QOF interests after 10 years:

- The investor's basis in its qualifying investment in the QOF is adjusted immediately before the investor sells or exchanges such interest so that its basis equals the fair market value of such interest plus the investor's share of the QOF's partnership liabilities under Section 752; and

- The basis of the QOF's partnership assets are also adjusted, solely with respect to the investor, in a manner similar to the adjustments which would have been made to those assets if (i) the investor had purchased the interest for cash equal to the fair market value of those assets as of the effectiveness of the FMV Basis Election and (ii) the QOF partnership had a valid Section 754 election in effect. Thus, this rule appears to mitigate the potential negative consequences of the Code Section 751 hot asset rules.

The effect of these rules is to eliminate any gain upon the investor's sale or exchange of qualifying investment after a 10-year holding period, regardless of whether the investor has used net losses allocated by the QOF partnership and whether the investor has received substantial leveraged distributions for the QOF. These rules also avoid the creation of offsetting capital losses and ordinary income items under any technical partnership tax rules.

In contrast, Proposed Regulations section 1.1400Z2(c)-1(b)(2)(ii)(1) states that, provided the 10-year holding period is met, when a taxpayer owns an interest in an QOF and that QOF owns an QOF Subsidiary, that taxpayer may elect to exclude from that taxpayer's gross income (for the pertinent year of sale) any capital gain (including unrecaptured items under Section 1250), but not Section 1245 recapture income, separately stated on the Schedule K-1 issued by the QOF that is derived from the sale of QOF's qualified opportunity zone property (which by definition could

include a QOF Subsidiary or qualified opportunity zone business property directly owned by the QOF), but not qualified opportunity zone business property directly owned by a QOF Subsidiary.

While Proposed Regulations section 1.1400Z2(c)-1(b)(2)(ii)(1) allows multi-asset QOFs to sell separate assets on different occasions and still achieve capital gain savings without forcing an investor to sell his or her entire interest in the QOF, using this election may be less advantageous than the investor selling his or her interest in the QOF since selling interest in the QOF allows the investor to avoid being taxed on any depreciation recapture taxable as ordinary income.

This result incentivizes well advised taxpayers to form unduly complicated "parallel QOF" structures to hold any investments that might be sold separately, even if such investments could more naturally be held in a single QOF, so that each asset may be exited through sale of QOF interests. Further, this result may not be consistent with the statute because Proposed Regulations section 1.1400Z2(c)-1(b)(2)(ii)(1) does not exclude the full amount realized upon the sale of qualified opportunity zone business property by a QOF or QOF Subsidiary. Specifically, the exclusion does not apply to any portion of the amount realized, such as depreciation recapture, which is taxed as ordinary income. Given that the language of Code Section 1400Z-2(c) operates through an increase of the tax basis of an investment to fair market value, excluding this ordinary income portion of the amount realized from the election available under Proposed Regulations section 1.1400Z2(c)-1(b)(2)(ii)(1) appears to be unduly restrictive because it fails to provide, in practical effect, a "basis increase" that accounts for the full fair market value of the sold investment. We respectfully request that the language of Proposed Regulations section 1.1400Z2(c)-1(b)(2)(ii)(1) be revised to operate similarly to Proposed Regulations section 1.1400Z2(c)-1(b)(2)(i).

We appreciate the opportunity to provide these comments and suggestions on the Proposed Regulations. Thank you for your consideration.