Boston University School of Law
Graduate Tax Program

765 Commonwealth Avenue
Suite 1005
Boston, Massachusetts 02215

BOSTON UNIVERSITY

July 1, 2019

Erika C. Reigle and Kyle C. Griffin
Office of Associate Chief Counsel (Income Tax and Accounting)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Recent Guidance from the Department of Treasury ("Treasury") and Internal Revenue Service ("IRS") Regarding Opportunity Zones

Dear Ms. Reigle and Mr. Griffin:

The Treasury and the IRS issued in April 2019 a second set of proposed regulations (the "Second Guidance")[1] under Code[2] Sections 1400Z-1 and -2[3] that built on an earlier set of proposed regulations (the "First Guidance")[4] and that thoughtfully addressed many of the crucial issues raised by the Opportunity Zone tax incentives. As you know, these include many issues that need to be addressed successfully in order to achieve a full and successful implementation of the new law. The Treasury and IRS have requested comments and suggestions from the public on many key aspects of the Second Guidance.

This letter is being submitted by the students and faculty instructors at the Boston University School of Law's Graduate Tax Program, who are collectively participating in a full semester course[5] on the Opportunity Zone tax incentives that we believe may be the first graduate-level tax course in the country to address exclusively these important new tax incentives. The entire class has participated in the preparation and submission of this letter. The following are our comments and recommended suggestions on how the Second Guidance can be best implemented in order to achieve the important policy objectives of the Opportunity Zone tax incentives.

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[1] The Second Guidance was informally published on April 17, 2019 and formally published in the Federal Register on May 1, 2019, 84 Fed. Reg. 18652.

[2] All references herein to "Code" mean the Internal Revenue Code of 1986, as amended.

[3] Sections 1400Z-1 and -2 are sometimes collectively referred to herein as the "OZ Act", or as "Subchapter Z" or as the "Opportunity Zone tax incentives."

[4] The First Guidance was informally published on October 29, 2018 and formally published in the Federal Register at 83 Fed. Reg. 54279.

[5] The Course is TX 970, entitled "No Gain, No Pain: Opportunity Zones, Like-Kind Exchanges and Qualified Small Business Stock." It addresses Subchapter Z (Sections 1400Z-1 and -2) and also covers the interaction of these new tax incentives with Like-Kind Exchanges under Section 1031 and sales of Qualified Small Business Stock under Sections 1202 and 1045.

I. RESPONSE TO TREASURY AND IRS REQUEST IN THE SECOND SET OF PROPOSED REGULATIONS UNDER SECTION 1400Z-2[6] FOR COMMENTS ON THE PROPOSED TREATMENT OF SECTION 1231 GAINS.

This Section I addresses the request by Treasury and IRS for comments on the proposed treatment of "Section 1231 gain" and, in particular, the proposal that Section 1231 gain be treated as eligible "gain" for purposes of enjoying the tax benefits pursuant to Sections 1400Z-2(b) and (c), but that the 180-day investment period under Section 1400Z-2(a) runs only from the last day of the taxpayer's taxable year and only after netting all Section 1231 gains against 1231 losses.

A. Background.

1. Definition of eligible "gain' prior to Issuance of Second Set of Proposed Regulations

Under Section 1400Z-2(a)(1), a taxpayer is allowed to elect to exclude "gain from the sale to, or exchange with, an unrelated party of any property held by the taxpayer…" Under Section 1400Z-2(a)(1)(A), this exclusion of gain is permitted only to the extent that "such gain" does not exceed "the aggregate amount invested by the taxpayer in a qualified opportunity fund during the 180-day period beginning on the date of such sale or exchange" (the "180-Day Period").

In the first set of Proposed Regulations issued by Treasury under Section 1400Z-2 (the "First Guidance"),[7] the Treasury clarified that only capital gains are eligible for deferral under Section 1400Z-2(a)(1). The First Guidance went on to state:

> *The proposed regulations provide that a gain is eligible for deferral if it is treated as a capital gain for Federal income tax purposes. Eligible gains, therefore, generally include capital gain from an actual, or deemed, sale or exchange, or any other gain that is required to be included in a taxpayer's computation of capital gain.*

The First Guidance also provided that the "taxpayers eligible to elect deferral under Section 1400Z-2 are those that recognize capital gain for Federal income tax purposes. These taxpayers include individuals, C corporations (including regulated investment companies (RICs) and real estate investment trusts (REITs)), partnerships, and certain other pass-through entities …"

In the case of a partner in a partnership that recognizes capital gain, the First Guidance provided a very flexible reinvestment approach that allowed partnership to elect deferral under Section 1400Z-2, but, to the extent that the partnership did not elect deferral, provided additional rules that allowed a partner to do so. This alternative rule was described as follows:

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[6] Issued on April 17, 2019, and published at 84 Federal Register 18652 (May 1, 2019)

[7] Issued October 29, 2018, and published at 83 Federal Register 54279-54296.

> *Proposed §1.1400Z-2(a)-1(c)(2) provides that, to the extent that a partnership does not elect to defer capital gain, the capital gain is included in the distributive shares of the partners under Section 702 and is subject to Section 705(a)(1). If all or any portion of a partner's distributive share satisfies all of the rules for eligibility under Section 1400Z-2(a)(1) (including not arising from a sale or exchange with a person that is related either to the partnership or to the partner), then the partner generally may elect its own deferral with respect to the partner's distributive share. The partner's deferral is potentially available to the extent that the partner makes an eligible investment in a QOF.*
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> *Consistent with the general rule for the beginning of the 180-day period, the partner's 180-day period generally begins on the last day of the partnership's taxable year, because that is the day on which the partner would be required to recognize the gain if the gain is not deferred. The proposed regulations, however, provide an alternative for situations in which the partner knows (or receives information) regarding both the date of the partnership's gain and the partnership's decision not to elect deferral under Section 1400Z-2. In that case, the partner may choose to begin its own 180-day period on the same date as the start of the partnership's 180-day period.*

Capital gain (or loss) is generally recognized from the sale or exchange of a "capital asset"[8] and such gain is divided into short-term capital gain[9] and long-term capital gain,[10] depending on whether the capital asset is held for more than one year. Capital gains are netted against capital losses, and if the taxpayer has net capital gain for any year, the taxpayer is taxed on such net gain at the favorable tax rates applicable to various categories of capital gains under Section 1(h).

Capital gain can also be recognized for federal income tax purposes on the sale of certain other types of assets, most notably "property used in the trade or business" as defined in Section 1231(b) (herein "1231 Property"). The requirements of 1231 Property are that it is property used in the trade or business, of a character which is subject to the allowance for depreciation provided in Section 167, and held for more than one year, and which is not property described in paragraphs (1), (3) or (5) of Section 1221(a). The treatment of net Section 1231 gain for purposes of investment under Section 1400Z-2 was not addressed in the First Guidance.

Gains and losses from the sale or exchange 1231 Property – like gains and losses from the sale of a capital asset – are subject to netting on the federal income tax return of the taxpayer for the taxable year. If the Section 1231 gains exceed the Section 1231 losses, the net amount is considered long-term capital gain.[11] If the Section 1231 gains do not exceed the Section 1231

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[8] The term "capital asset" is defined in Section 1221, and is comprised of all property held by the taxpayer except for eight classes of excluded assets, The three most prominent excluded categories are inventory (1221(a)(1)), property used in a trade or business and subject to the allowance for depreciation (1221(a)(2)) and certain categories of self-created intangible assets (1221(a)(3)(A)).

[9] Section 1222(1)

[10] Section 1222(3)

[11] Section 1231(a)(1).

losses, the net amount is treated as an ordinary loss (i.e., not from the sale or exchange of a capital asset). Partners in a partnership that recognizes Section 1231 gains and/or losses receive in the partnership Form K-1 a separately reported distributive share of the partnership's next Section 1231 gain or loss.[12]

Since net Section 1231 gain for a tax year is eligible for favorable long-term capital gain treatment, while net Section 1231 loss for a tax year is eligible for favorable ordinary loss treatment, there exists a potential incentive for a taxpayer to separate the recognition of Section 1231 gains and Section 1231 losses into two separate tax years, thereby maximizing long-term capital gain and ordinary loss. Congress recognized and dealt with this issue back in 1984[13] by adopting an anti-abuse provision contained in Section 1231(c), which provides for the "recapture" of net Section 1231 losses by recharacterizing net Section 1231 gain for any taxable year as ordinary income to the extent of prior non-recaptured net Section 1231 losses. This recapture rule applies to the extent aggregate prior net Section 1231 losses over the prior five years exceed the amount recaptured under this provision over that period. Thus, for example, if a taxpayer recognizes (deliberately or otherwise) $100,000 of net Section 1231 loss in Year 1, any net Section 1231 gain recognized in the next five years (up to a maximum of $100,000) will be recharacterized as ordinary income rather than as long-term capital gain.

2. <u>Proposed Treatment of Section 1231 Gain in the Second Set of Proposed Regulations</u>

Proposed Regulation Section 1.1400Z2(a)-1(b)(2)(iii) provides the following rule with respect to the amount of Section 1231 gain that is considered eligible gain for purposes of Section 1400Z-2(a) (the "Net Gain Rule"), and also a specific rule for the commencement of the 180-day investment period (the "Year-End Rule"):

> The only gain arising from Section 1231 property that is eligible for deferral under Section 1400Z-2(a)(1) is capital gain net income for a taxable year. This net amount is determined by taking into account the capital gains and losses for a taxable year on all of the taxpayer's Section 1231 property. The 180-day period described in [Proposed Regulation Section 1.1400Z2(a)-1(b)(4)] with respect to any capital gain net income from Section 1231 property for a taxable year begins on the last day of the taxable year.[14]

The Preamble to the Second Set of Proposed Regulations, in addressing and explaining these provisions, states as follows:

> In addition, the preamble [to the First Guidance] stated that some capital gains are the result of Federal tax rules deeming an amount to be a gain from the sale or exchange of a capital asset, and, in many cases, the statutory language providing capital gain treatment does not provide a specific date for the deemed sale. Thus, [the First Guidance] addressed this issue by providing that, except as specifically

[12] Section 702(a)(3).

[13] Deficit Reduction Act of 1984 (P.L. 98-369), Section 176a), added subSection (c) to Section 1231.

[14] Prop. Reg. § 1.1400Z2(a)–1(b)(2)(iii), 84 Fed. Reg. 18652, 18673 (May 1, 2019).

> provided in the proposed regulations, the first day of the 180-day period set forth in Section 1400Z–2(a)(1)(A) and the regulations thereunder is the date on which the gain would be recognized for Federal income tax purposes, without regard to the deferral available under Section 1400Z–2. Consistent with [the October Proposed Regulations] and because the capital gain income from Section 1231 property is determinable only as of the last day of the taxable year, these proposed regulations provide that the 180-day period for investing such capital gain income from Section 1231 property in a QOF begins on the last day of the taxable year.[15]

B. Recommendations

1. We recommend that Section 1231 gain, like capital gain, be treated as recognized for purposes of Section 1400Z-2, as a discrete tax item at the time the applicable 1231 Property is sold or exchanged, and that the Net Gain Rule not be adopted.

2. We recommend that the amount of gain recognized on a sale of 1231 Property be eligible for investment as a separate and discrete amount for a 180-day investment period commencing on the date the 1231 Property is sold or exchanged, and that the Year End Rule not be adopted as the sole mechanism for investment of Section 1231 gain.

3. We recommend that, with respect to Section 1231 gain recognized by a partnership, that the 180-day investment period rules be conformed with the rules applicable to partnerships that recognize capital gain from a sale or exchange of capital assets, such that (a) the partnership may elect to invest Section 1231 gain within 180 days after a discrete sale or exchange transaction that generates recognition of Section 1231 gain, (b) if the partnership chooses not to reinvest all or any portion of such Section 1231 gain, then the partners can reinvest their respective distributive shares of such Section 1231 gain, and, further, can elect to commence the 180-day investment period using either (i) the Section 1231 gain amount distributed to each such partner under Section 702 commencing on the last day of the partnership's taxable year or (ii) alternatively, if the partner knows (or receives information) regarding both the date of the partnership's gain, and the partnership's decision not to elect deferral under Section 1400Z-2, each partner may choose to begin its own 180-day period on the same date as the start of the partnership's 180-day period.

4. We recommend that, if Treasury remains troubled about the ability of taxpayers to separate and exclude Section 1231 gains currently and thereby create net Section 1231 losses that can be claimed as ordinary deductions, then the most obvious response would be to allow taxpayers to elect to treat Section 1231 gain in the same manner as capital gains, but in doing to also agree that the 1231 loss recapture rule under Section 1231(c) is extended to the longer of the statutory five years or December 31, 2026, so that any unrecaptured 1231 losses can be offset by the deferred recognition of 1231 gain on that date.

5. Alternatively, if the Treasury does not adopt the foregoing recommendations and retains the Net Gain Rule and/or the Year End Rule, we recommend that a "grandfathering" provision be adopted whereby a taxpayer that has invested Section 1231 gain in a taxable year

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[15] *See* Preamble to REG-120186-18, 84 Fed. Reg. 18652, 18659 (May 1, 2019) (emphasis added).

ending on or before December 31, 2019 in a manner that would qualify if such gain were capital gain be treated as making an eligible investment (i.e., adopt our recommendations above for a transaction period for tax years ending on or before December 31, 2019).

C. Explanation

1. The Same Investment Rules Should Apply Both to Section 1231 Gain and to Capital Gain Recognized from a Discrete Sale or Exchange Transaction

Section 1400Z-2 states a taxpayer is allowed to elect to exclude "gain from the sale to, or exchange with, an unrelated party of any property held by the taxpayer…" and further provides that the investment of "such gain" shall occur "during the 180-day period beginning on the date of such sale or exchange."

The Treasury, in the First Guidance, interpreted and restricted this provision to the recognition of "capital gain," based on legislative history and on the specific reference to "capital gain" in the title to Section 1400Z-2. However, even if one can impute an intention of Congress to limit this provision to "capital gain" there seems little doubt everyone – including Treasury and the IRS – believe that Congress intended this provision to apply to gain from the sale of 1231 Property as well as from the sale of capital assets.

It is further clear that by providing a 180-day investment period "beginning on the date of such sale or exchange" that Congress intended for gain to be measured on an asset by asset basis without regard to the otherwise applicable rules under the Code that call for the "netting" of gains and losses for each tax year. In fact, the "netting" rules for capital gains set forth in Section 1222 (11) and for 1231 Property set forth in Section 1231(a) are for all intents and purposes substantively and procedurally the same: net long-term capital gain for the taxable year over the net ordinary loss for such year. They key issue is that Treasury and the IRS already recognize that a taxpayer with capital gain from a single transaction can invest the gain as a separate tax item even though the taxpayer may have other capital losses in the same tax year that would otherwise offset and reduce (or even entirely eliminate) the single discrete item of capital gain being reinvested by the taxpayer under Section 1400Z-2(a).

For exactly the same reason, a separate transaction generating Section 1231 gain should be put on equal footing with a separate transaction generating capital gain. If Treasury concedes that Section 1231 gain is the type of "gain" to which Section 1400Z-2 applies, then the standard applied to capital assets should be applied by analogy to 1231 property, and there is no logical reason to apply an entirely different rule to Section 1231 gains – especially an interpretation that, in fact, is dramatically at odds with the clear language of the statute. Congress clearly wants gain to be redeployed into eligible investments in QOFs within a relatively short time period, 180 days, after the gain is recognized from "the date of such sale or exchange."

If Congress wanted taxpayers to wait until year end for a netting of capital gains, or for a netting of Section 1231 gains, that intention would have no doubt been expressed in language profoundly different that the actual statutory language. The rule requiring investment of "such gain" within 180 days of the "sale or exchange" is perhaps one of the very clearest statutory

pronouncements in this often ambiguous provision, and there is simply no justification to adopt a contrary position – and especially two radically different positions, one for capital gain that follows the statutory language, and a second for Section 1231 gain that does not.

The Treasury may have been swayed by the fact that, if the netting of Section 1231 gains and losses produces an overall net loss, such loss is treated as ordinary in character. But the larger point being overlooked is that net losses do not matter for purposes of Section 1400Z-2: a taxpayer can only invest gains, not losses, and if Treasury and IRS concede that gains from 1231 Property are eligible for investment, then the netting rules are statutorily irrelevant.

A taxpayer with capital gain on a sale of a capital asset is allowed under Treasury guidance to invest that gain within 180 days of the sale, and that is true even if the taxpayer has other offsetting capital losses that, if netted at the end of the tax year, would result in a loss and this literally zero net gain for the applicable tax year. Likewise, it should make no difference whether a taxpayer has any net Section 1231 losses in a given tax year that might otherwise offset Section 1231 gain from a specific sale or exchange.

Netting capital gains and losses at year end and netting Section 1231 gains and losses at year end has *exactly* the same consequence for purposes of Section 1400Z-2. Under a netting rule, capital gain from a specific transaction could be offset by other capital losses recognized during the same tax year. If the netting produced a net capital gain, but less than the gain from the specific transaction being reinvested, then the net eligible gain would be reduced to the net year-end gain. This is the same rule that Treasury proposes for Section 1231 gain. If the net capital gain were zero or negative, then under a netting rule the taxpayer would have zero eligible gain to invest. That is likewise the exact same outcome as under Treasury's proposed rule for Section 1231 gain.

The point is that whether an aggregate net loss is a capital loss (under 1222) or an ordinary loss (under 1231(a)) has zero impact on Section 1400Z-2, because a net loss would not allow any investment of gain whether the loss is capital or ordinary. For this reason the huge distinction between treating each sale or exchange of a capital asset as a discrete and separate tax item eligible for immediate investment (and requiring investment no later than 180 days from the sale or exchange date) and a sale or exchange of 1231 Property as not eligible for immediate investment (and requiring investment no earlier than the end of the taxpayer's tax year, which means that 180-day investment period could start as much as 364 days after the sale or exchange date) is both logically and substantively indefensible.

The only logical and consistent conclusion is that both capital gains and Section 1231 gains should have the same rule apply, and we strongly recommend that that rule be the set of gain measurement and timing rules that Treasury has already set forth with respect to capital gains.

2. Policy Reasons that Further Support the Foregoing Recommendation

The policy reasons for adopting rules with consistent treatment for capital gain and Section 1231 gain become glaringly obvious in the case of a taxpayer that sells its business assets on April 1, 2019 and recognizes both capital gain and Section 1231 gain on the transaction.

Assume the taxpayer in this example recognized $1 million of capital gain from the sale of self-created intangible assets such as goodwill and going concern value and/or trademarks (these will generate capital gain and generally not be excluded from capital asset treatment by Section 1221(a)(3)) and $1 million of Section 1231 gain attributable to appreciation of depreciable assets, such as depreciable real estate used in the trade or business or, for that matter, purchased patents and purchased goodwill.

The capital gain must be invested within 180 days of April 1, 2019, which would be no later than September 28, 2019. The Section 1231 gain, meanwhile, could not be invested until December 31, 2019 at the earliest. Given that the general policy objectives of Section 1400Z-2 (heavily encouraged by the various time limitations such as the five-year and seven-year rules for the step-up in tax basis under Section 1400Z-2(b)) clearly suggest an urgency on the part of Congress in driving investments into Qualified Opportunity Zones, this netting policy – which could be described as a "wait and see" policy or, even worse, as a "wait a long time and see" policy, is clearly inconsistent with the goals, objectives and intentions of the statute.

A second important consideration – that should be weighed heavily – is that taxpayers, and even many tax professionals who advise taxpayers, do not have a clear grasp of the often high-nuanced distinctions between capital assets and 1231 Property. For example, self-created goodwill and going concern value of a trade or business is a capital asset,[16] but goodwill purchased in the acquisition of a trade or business and later resold is 1231 Property.

A copyright in the hands of an individual whose personal efforts created the property is excluded from capital asset treatment and will generate ordinary income,[17] but a copyright created by employees of a corporation will generate capital gains on sale.[18]

A patent acquired by purchase in connection with the acquisition of a business will be an amortizable Section 197 intangible and thus 1231 Property. But in the hands of a person whose personal efforts created the patent (i.e., the inventor), the patent will be excluded from capital asset treatment and will be an ordinary asset – unless the investor sells all rights in the patent, in which case the sale will generate long-term capital gain under Section 1235.

The point is that distinctions between capital assets (or sales of assets generating capital gain) versus sales of assets generating Section 1231 gain are both highly technical and strikingly idiosyncratic, and so applying dramatically different investment rules to capital gain versus Section 1231 gain is best described as an intentional and pervasive trap for the unwary – and even a trap for the wary – that is guaranteed to confuse and trap taxpayers and, in the long run, severely undermine the goal of having taxpayers sell assets that generate (or potentially generate) capital gain and then timely invest those recognized gains into Qualified Opportunity Zones.

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[16] As a self-created intangible, goodwill is excluded from the category of an "amortizable Section 197 intangible" by Section 197(c)(2), and thus is not amortizable or depreciable under any provision of the Code (see Section 197(b) and 197(f)(7)) and thus cannot be 1231 Property. Likewise, it is not one of the specific categories of intangible property specifically excluded from the definition of "capital asset by Section 1221(a)(3).

[17] See Section 1221(a)(3)(A); see D.D. Levy, TC Memo. 1992-471, 64 TCM 534 (1992).

[18] Desilu Prods. Inc., TC Memo. 1965-307, 24 TCM 1695 (1965); Chronicle Publishing Co., 97 TC 4445 (1991), recons. denied 63 TCM 1899(1992).

3. Section 1231(c) Contains an Appropriate Anti-Abuse Provision that Protects Treasury Against the Timing Effects of Allowing Prompt Investment of Discrete Section 1231 Gains.

As noted above, there has always been an opportunity for taxpayers to control the timing of sales of 1231 Property so that the taxpayer avoids the "netting" under Section 1231(a), which is done on an annual basis. For example a taxpayer might want to sell all 1231 Property that will generate ordinary losses on December 31 of a calendar tax year, and sell all the 1231 Property that will generate long-term capital gains on January 1 of the next year.

Section 1231(c) was adopted 35 years ago to address this manipulation of timing transactions by requiring that if Section 1231 loss is recognized in a tax year, then for the next five years any Section 1231 gain (up to the amount of the unrecaptured 1231 loss) will be recharacterized as ordinary gain rather than capital gain. This rule has been in place for decades before the enactment of Section 1400Z-2, and provides a more-than-adequate adjustment in situations that Treasury seems to deeply fear, namely, a taxpayer separates Section 1231 gain from a discrete property sale and invests the gain into a QOF, while the "naked" Section 1231 loss now produces an ordinary loss.

Let's be candid: That may well be the consequence in a small minority of situations, but this will be, at most, a small tail that should not wag the larger objective of driving investment and business gains into timely investments in QOFs under rules that are both relatively clear and overwhelmingly fair in the large majority of practical, real-world transactions. Taxpayers who "strip" Section 1231 gain through reinvestment and leave a residual net 1231 loss would get an ordinary loss deductible in the year the otherwise off-setting gain is recognized. But this would, in turn, create an unrecaptured 1231 loss that would carry-forward under Section 1231(c) for each of the next five tax years. We note that if the QOF investment is sold or disposed of in an inclusion transaction over the next five years, the gain recognized will be 1231 gain and will be subject to the recharacterization rules. If the taxpayer has other 1231 gain, it will likewise be recharacterized as ordinary gain rather than capital gain.

We believe strongly that this possible miss-matching of excluded gain and current ordinary loss under Section 1231 is very unlikely to rise to a material level in the aggregate, especially given the recapture rule under Section 1231(c). But if Treasury is determined to let this seemingly small and relatively tangible issue drive policy in this critically important area, then we suggest the following rule: Any taxpayer can elect to reinvest Section 1231 gain within 180 days of the sale or exchange generating such gain, and, as part of that election, can automatically extend the recapture period under Section 1231(c) through December 31, 2026. This assures that if the taxpayer gets a "break" with the mismatching of 1231 gains and 1231 losses, it is at most a timing issue – and that is exactly what Congress offered to taxpayers as the first of the three tax incentives set forth in Section 1400Z-2. This rule would be far more consistent with the statutory scheme enacted by Congress, and would also properly implement

and effectuate the general policy that gains recognized on December 31, 2026 will be of the same character as the original gains being deferred.[19]

4. Partnership Tax Provisions Further Support the Proposals Set Forth Above.

Under Sections 702 and 703, partnerships determine their overall Section 1231 gain by netting the gains and losses and then reporting the net amount as a separately stated item on the Form K-1 issued to each partner.[20] However, partnerships also determine their overall capital gains by netting the gains and losses and then reporting separately stated items, although because of the different tax rates the capital gains are broken down into net long-term capital gains and net short-term capital gains.[21] The Proposed Regulations clearly allow partnerships to invest capital gain from a discrete sale or exchange transaction within 180 days, and to adjust correspondingly the amount of net capital gain treated as distributed to its partners on the Form K-1, and there is no evident reason why partnerships and their partners should be subject to dramatically different investment rules for capital gains and losses versus 1231 gains and losses.

In particular, if the presence of separately stated items suggests that a partner should wait until the end of its taxable year to net those items, there is no logical reason why Treasury would not apply the same logic and principles to capital gains. Fortunately, Treasury correctly identified that the plan language of the statute calls for the investment of "such gain" within 180-day period "beginning on the date of such sale or exchange." We believe Treasury's proposals set forth in the First Guidance on capital gain recognized at the partnership level were both entirely consistent with the language of the statute and completely consonant with the policies and objectives expressed by Congress in enacting Section 1400Z-2, and we think the same policies and logic should and indeed must apply to Section 1231 gain as well if the Congressional intent is going to be implemented in a clear, logical and coherent manner.

5. Alternative Proposal if Treasury Declines to Adopt the Proposals Set Forth Above.

For the reasons set forth above, we strongly recommend that Treasury put Section 1231 gain on an exactly equal footing with capital gain, by allowing Section 1231 gain recognized in a discrete sale or exchange transaction to be invested within 180 days of such sale or exchange, and by adopting identical or substantially identical rules with respect to partnerships. While this is a somewhat technical tax distinction, the amount of 1231 gain that can be invested in opportunity zones is quite large, the delay in investing Section 1231 gain that would be engendered by Treasury's initial proposal would be a major drag on the success and effectiveness of the entire Qualified Opportunity Zone

[19] Prop. Reg. §1.1400Z-2(a)-1(b)(5) from First Guidance, which states, "If Section 1400Z-2(a)(1)(B) and (b) require a taxpayer to include in income some or all of a previously deferred gain, the gain so included has the same attributes in the taxable year of inclusion that it would have had if tax on the gain had not been deferred. These attributes include those taken into account by Sections 1(h), 1222, 1256, and any other applicable provisions of the Code."

[20] I.R.C. § 702(a)(3).

[21] I.R.C. § 702(a)(1), (2).

program, and the combination of dramatically different investment periods arising from a single sale of a business, described above, and the predictable certainty that many taxpayers will make mistakes because of the complexity of distinguishing Section 1231 gain from capital gain, all make it clear that providing congruent rules for Section 1231 gain and capital gain is not just a good idea, but a practical necessity for the program to succeed as envisioned.

Nevertheless, if Treasury does not agree with this strong recommendation, we propose that Treasury adopt the proposed rules, as a matter of fairness, through a date certain that will not penalize taxpayers who in good faith invested Section 1231 gains in the belief that such gains would qualify as capital gain and would be subject to the corresponding rules.

II. TREASURY'S REQUEST FOR COMMENTS ON THE LENGTH OF THE VACANCY PERIOD OF 5 YEARS WITH RESPECT TO BUILDINGS OR OTHER STRUCTURES, AND HOW SUCH STANDARD MIGHT BE ADMINISTERED OR ENFORCED.

This Section II addresses the Treasury's request for comments on the proposed length of the vacancy period of five (5) years and the enforcement of such a standard.

A. Background

1. Uncertain Issues Prior to Issuance of Second Set of Regulations

Prior to the Second Guidance there was uncertainty about whether vacant or abandoned property could meet the "original use" requirement under Section 1400Z-2. The First Guidance provided that land could never be "original use" property, and that when improved real estate was purchased the portion of the purchase price allocated to land was disregarded and only the purchase price allocated to improvements located on the land was taken into account for purposes of the "substantial improvement" test.[22]

Unanswered was whether vacant or abandoned real property could possibly qualify as "original use," and, if so, what period of vacancy would cause such property to qualify.

2. Second Guidance on Vacant or Abandoned Properties

In response to comments received, Treasury and IRS in the second set of Proposed Regulations provided that vacant structures or other tangible property, other than land, will satisfy the "original use" requirement under Section 1400Z-2 if the properties have been vacant or abandoned for at least five years.

The Treasury Department and the IRS have also studied the extent to which usage history of vacant structures or other tangible property (other than land) purchased after 2017 but previously placed in service within the qualified opportunity zone may be

[22] Rev. Rul. 2018-29.

disregarded for purposes of the original use requirement if the structure or other property has not been utilized or has been abandoned for some minimum period of time and received multiple public comments regarding this issue. Several commenters suggested establishing an "at least one-year" vacancy period threshold similar to that employed in §1.1394-1(h) to determine whether property meets the original use requirement within the meaning of Section 1397D (defining qualified zone property) for purposes of Section 1394 (relating to the issuance of enterprise zone facility bonds). Given the different operation of those provisions and the potential for owners of property already situated in a qualified opportunity zone to intentionally cease occupying property for 12 months in order to increase its marketability to potential purchasers after 2017, other commenters proposed longer vacancy thresholds ranging to five years. The Treasury Department and the IRS are proposing that where a building or other structure has been vacant for at least five years prior to being purchased by a QOF or qualified opportunity zone business, the purchased building or structure will satisfy the original use requirement.[23]

3. Treasury Request for Comments

Comments are requested on this proposed approach, including the length of the vacancy period and how such a standard might be administered and enforced.[24]

B. Recommendations

1. We agree with the proposal in the Second Guidance that land under a building or other structure need not be "substantially improved" in order to satisfy the "original use" requirement.[25]

2. We also agree that some quantifiable minimum period of vacancy is necessary to prevent potential abuse of this favorable guidance allowing vacant property to qualify as "original use" property.

3. We recommend that for property that was unused or vacant at the time the applicable census tract was designated as a qualified opportunity zone ("QOZ") that a period of at least one year should apply, and that, for properties that become unused or vacant after the designation date, that a period of two years should apply.

4. We recommend that Treasury rely on local municipal governments and their property tax assessment and delinquency records to administer and enforce the adopted vacancy or abandonment standards.

C. Explanation.

[23] 84 Fed. Reg. 18652, 18663-18664.

[24] 84 Fed. Reg. 18652, 18664.

[25] See Section III, below, for our recommendations regarding unimproved land and the potential abuse of "land banking."

Treasury's primary concern with a length of time shorter than five years is the potential for abuse by property owners who might have an incentive to vacate their properties to purposefully increase marketability. However, cities and towns across the United States have recognized the negative impacts of vacant and abandoned properties, including increases in crime and vandalism, decreases in surrounding property values, increased risk to health and welfare, and escalating municipal government costs.[26] Multiple research studies in varying localities have found that while foreclosures have a relatively minimal effect on the aforementioned negative impacts, the actual vacancy and abandonment of properties has a much more pronounced effect.[27] Studies have also found a correlation between the length of vacancy and increased crime (incidents of crime increase immediately after vacancy began and plateaus 12-18 months later), decreased property values (affects a much wider radius of surrounding properties after 3 years of vacancy), and higher municipal government costs (compounding through reduction in property tax revenue and increased public expense maintaining properties).[28] Local government officials, community organizations, and residents across the country recognize the value in putting vacant and abandoned properties back into productive use as quickly as possible.

It is extremely doubtful that property owners who held vacant properties prior to designation of QOZs in early 2018 intentionally arranged a vacancy with any future tax incentive in mind. We therefore recommend that Treasury adopt a standard similar to that applicable to Enterprise Zones and found in Treas. Reg. §1.1394-1(h), which in relevant part states that "if property is vacant for at least a one-year period including the date of zone designation, use prior to that period is disregarded for purposes of determining original use." This regulation makes it clear that the property had to be vacant on the date that the zone was designated in order to enjoy the favorable one-year qualification period. This one-year rule would help give every QOZ with property that was vacant or abandoned prior to zone designation the immediate opportunity to reverse the deleterious impact of such property by making it immediately eligible for "original use" status (since today's date is already more than one year from the designation date). In light of the studies cited above, the urgency of this favorable classification should not be underestimated.

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[26] John Accordino and Gary T. Johnson. 2000. "Addressing the Vacant and Abandoned Property Problem," Journal of Urban Affairs 22:3, 302-3.

[27] https://www.huduser.gov/portal/periodicals/em/winter14/highlight1.html: referencing two studies (1) a 2008 study in Columbus, Ohio conducted by the Federal Reserve Bank of Cleveland, and (2) a 2012 study in Cleveland, Ohio also conducted by the Federal Reserve Bank of Cleveland; John Accordino and Gary T. Johnson. 2000. "Addressing the Vacant and Abandoned Property Problem," Journal of Urban Affairs 22:3, 302-3.

[28] Lin Clu. 2010. "Foreclosure, Vacancy, and Crime," Department of Economics, University of Pittsburg, 23: found that once foreclosed properties became vacant, crime within 250 feet of the foreclosed property increased, and plateaued between 12-18 months later. The researchers also found that once the properties were reoccupied, the crime rates dropped; https://www.huduser.gov/portal/periodicals/em/winter14/highlight1.html: referencing a study in Baltimore, MD finding that properties within 250 feet of a vacant or abandoned property experience a decrease in value in the first 3 years of vacancy, but that after 3 years, the decrease in property values can be experienced up to 1,500 feet away from the vacant or abandoned property.

For property that was not vacant or abandoned on the designation date of the applicable QOZ, but becomes so afterwards, we believe a two-year period is appropriate. Treasury's concern about potentially advantageous vacancy strategies is not misplaced, but we do believe it is exaggerated. We anticipate that few if any property owners intentionally sought to make their otherwise productive properties vacant in 2018 or early 2019 in expectation of favorable "vacancy" rules under Subchapter Z -- and this is especially true in light of the proposed five-year rule put forth by Treasury in the Second Guidance. To the extent that a prospective two-year rule provides an incentive to abandon property, it will be mitigated by the reduction in tax benefits for anyone waiting at least two years from the issuance of final regulations to act on a vacancy "strategy." There is a trade-off in policy objectives in this case, and we favor a policy the helps rescue vacant buildings to the greatest extent possible.

In its request for comments, Treasury astutely recognized the daunting challenge of administering and enforcing this vacancy or abandoned property standard in order to prevent abuse among property owners looking to capitalize on this newly increased marketability. A broad list of characteristics could be used to define vacancy or abandonment, including, but not limited to, physical condition of the structure, length of time the structure has been in that condition, use of public utilities, landscape maintenance, mail delivery, etc.[29] Alternatively, in the enterprise zone regulations, "de minimis incidental uses of property, such as renting the side of a building for a billboard" do not strip a property of its vacant status and allow the property to satisfy the original use requirement.[30] Here again we recommend hat Treasury adopt a standard similar to that found in Treas. Reg. §1.1394-1(h), disregarding any de minimis incidental uses of property for purposes of determining vacancy.

III. TREASURY AND IRS REQUEST FOR COMMENTS ON VARIOUS ASPECTS OF THE PROPOSED TREATMENT OF UNIMPROVED LAND.

This Section III addresses the Treasury and IRS request for comments on whether anti-abuse rules under Section 1400Z-2(e)(4)(c), in addition to the general anti-abuse rule, are needed to prevent such transactions or "land banking" by QOFs or qualified opportunity zone businesses, and on possible approaches to prevent such abuse.

A. Background

1. Uncertain Issues Prior to Issuance of Second Guidance

In the First Guidance, Treasury included Revenue Ruling 2018-29 that addressed how the "substantial improvement" test would apply to purchases of existing real property that included both land and improvements. Treasury ruled that the "substantial improvement" test would not take into account the portion of the purchase price allocated to land, and that "substantial improvement" meant increasing the tax basis of the building/improvements by more than the tax basis allocated to the building at the time of purchase. However, the revenue ruling was silent on the issue of unimproved land being purchased by itself, and also whether a valuable parcel of

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[29]Legal League 100, December 2017. "A Complicated Web: Vacant and Abandoned Property Law," 4.
[30]Section 1.1394-1(h)

land with a small "shack" on it could qualify through improvement to the shack that technically met the "substantial improvement" standard but were relatively minimal compared to the value of the land.

2. Second Guidance on Unimproved Land

The Second Guidance provides that unimproved land automatically qualifies as "original use" property and need not be substantially improved, provided that the land is incorporated into an active "trade or business" as defined under Section 162. Commentators have suggested an example of the application of this rule where a hotel purchases land adjacent to its property to be used as walking trails or other outdoor activities[31] or perhaps to use an acquisition of adjacent land as a parking lot for an active business when additional parking was required by local zoning or parking regulations.

At the same time, Treasury expressed concerns and misgivings with respect to this proposed rule on unimproved land, particularly the fear that this could lead investors to purchase and hold land in anticipation of future appreciation (so called "land banking"). The requirement that land must be used in a trade or business was designed to prevent this type of abuse --. Land held for future appreciation and not held for use in the trade or business would not qualify for favorable treatment.

Additionally, Treasury provides that if a significant purpose for acquiring such unimproved land was to achieve an inappropriate tax result, the general anti-abuse rule set forth in Proposed Regulations §1.1400Z2(f)-1(c) would apply to treat the acquisition of unimproved land as an acquisition of non-qualifying property for Section 1400Z-2 purposes. An example provided to illustrate this situation is a QOF's acquisition of a parcel of land currently utilized entirely by a business for the production of an agricultural crop, whether active or fallow at that time, that might otherwise be treated as qualified opportunity zone business property without the QOF investing any new capital investment in, or increasing any economic activity or output of, that parcel. Treasury does not provide any comment on the minimum amount of new capital, or the amount of increased economic activity, that might avoid the application of the anti-abuse rule.

3. Treasury Request for Comments

The Treasury Department and the IRS requested comments on whether anti-abuse rules under Section 1400Z-2(e)(4)(c), in addition to the general anti-abuse rule, are needed to prevent such transactions or "land banking" by QOFs or qualified opportunity zone businesses, and on possible approaches to prevent such abuse.

B. Recommendations

[31] See Holland and Knight *New Guidance on Opportunity Zones: Highlights for Real Estate Owners and Developers* May 9, 2019, available at https://www.hklaw.com/en/insights/publications/2019/05/new-guidance-on-opportunity-zones-highlights-for-real-estate

1. We agree with Treasury's general policy position that an acquisition of unimproved land by a QOF or QOZB should not be subject to the "original use" or substantial improvement requirements, and instead should qualify as eligible QOZBP so long as certain safe-guards and standards are applied to prevent mere "land banking.'

2. We recommend that Treasury adopt a two-part test: 1) that the land must be used as a material income-producing factor in the Section 162 trade or business conducted by the applicable purchaser and 2) that the use of the land by the purchaser is either a) in a different trade or business than the use in the hands of the seller, or b) that the purchaser makes 'more than insubstantial" improvements to the property. For this purpose we believe that "more than insubstantial" improvements would be a facts and circumstances test, but should include a safe harbor that applies if aggregate expenditures on improvements are at least equal to 20% of the total purchase price of the land and are incurred within 30 months following the land purchase.

C. <u>Explanation</u>

Treasury correctly observed in the Second Guidance that unimproved land has a distinct status that requires separate and distinct rules, which Treasury described as follows:

> *"Moreover, land is a crucial business asset for numerous types of operating trades or businesses aside from real estate development, and the degree to which it is necessary or useful for taxpayers seeking to grow their businesses to improve the land that their businesses depend on will vary greatly by region, industry, and particular business. In many cases, regulations that imposed a requirement on all types of trades or businesses to substantially improve (within the meaning of Section 1400Z-2(d)(2)(D)(i)(II) and (d)(2)(D)(ii)) land that is used by them may encourage noneconomic, tax-motivated business decisions, or otherwise effectively prevent many businesses from benefitting under the opportunity zone provisions. Such rules also would inject a significant degree of additional complexity into these proposed regulations."*

Treasury is also correct to be concerned that its fair and flexible proposed rules on the treatment of unimproved land as QOZP could lead to tax results that are inconsistent with the purposes of Section 1400Z-2.

We believe that the Section 162 test is the correct starting point, by making sure that property is not held for investment and instead is used in a trade or business of the purchaser. But that is not the end of the inquiry. This use of unimproved land in a business must not be tangential or immaterial to the taxpayer's business, but rather, should be a "material" income-producing factor in the business. This standard would weigh both the necessity and the contribution of the unimproved land to the business as a whole -- in effect, a back-stop to demonstrate that the land is really a business asset and not merely an investment asset.

A second step is necessary to demonstrate that the land is not merely being purchased for the same exact use as in the hands of the seller and without any incremental improvement. If the

use in the hands of the purchaser is different than the use in the hands of the seller, this (together with the material income producing factor requirement) should be sufficient to establish a bona fide use of the unimproved land. On the other hand, if the land use is essentially the same by the purchaser as by the seller, we concur that some element of enhancement or improvement is a reasonable requirement. For the reasons noted by Treasury, and quoted above, unimproved land raises a different category of issues and considerations than improved property, and so a standard of improvement described as being "more than in insubstantial amount" seems entirely appropriate. However, we would add a safe harbor expenditure level, such that the safe harbor is satisfied if the aggregate amount spent on improvements is at least equal to 20% of the purchase price of the land and is expended within 30 months after the purchase date of the land.

IV. TREASURY REQUEST FOR COMMENTS ON ALL ASPECTS OF THE PROPOSED TREATMENT OF LEASED TANGIBLE PROPERTY.

This Section IV addresses the Treasury's broad request for comments on all aspects of the proposed treatment of leased tangible property.

A. Background

1. Uncertain Issues Prior to Issuance of Second Set of Regulations

Prior to Treasury's issuance of its Second Guidance on April 17, 2019, there was considerable uncertainty about how leased tangible property would be treated under Section 1400Z-2. First, the definition of "qualified opportunity zone business property" (herein "QOZBP") stipulated, among other elements, that QOZBP was tangible property "acquired by the qualified opportunity fund *by purchase* (as defined in Section 179(d)(2)) after December 31, 2017…"[32] The cross-reference to Section 179(d)(2) further indicated that the purchased property must not be acquired from "a person whose relationship to the person acquiring it would result in the disallowance of losses under Section 267 or 707(b)."[33] Meanwhile, Section 1400Z-2(e)(2) provides that, for purposes of that Section 1400Z-2, "related person" has the definition set forth in Sections 267(b) and 707(b)(1) but substitutes "20 percent" in place of "50 percent" each place it occurs in Section 267(b) or Section 707(b)(1).

Although there were drafting glitches in the statute that made the exact application of the related party rules to Section 179(d)(2) somewhat uncertain, the concern was that tangible property would be QOZBP only if it was purchased from an unrelated party as determined by substituting 20% for 50% in Sections 267(b) and 707(b)(1)).

An even greater concern was that leased tangible property appeared to potentially be a "bad asset" for purposes of the 90-percent asset test under Section 1400Z-2(d)(1) (the "90-Percent Asset Test") and for purposes of the "substantially all" requirement under Section

[32] I.R.C. § 1400Z-2(d)(2)(D)(i) (emphasis added)

[33] I.R.C. § 179(d)(2)(A).

1400Z-2(d)(3)(A)(i)[34] (the "70-Percent Test") (the 90-Percent Asset Test and the 70-Percent Test are sometimes referred to herein collectively as the "Two Tests"). The term "substantially all" for purposes of the latter test was defined in the First Guidance as meaning 70% or more, but the First Guidance left unanswered two key issues: 1) whether leased tangible property was included only in the denominator of the percentage calculations (the numerator appeared to be limited to QOZBP, which, by definition, seemed to require tangible property acquired by "purchase" rather than by lease), and 2) how leased tangible property should be valued for purposes of implementing these percentage calculations under the Two Tests.

2. Treasury's Second Guidance on Leased Tangible Property

Treasury in the second set of Proposed Regulations provided a number of favorable rules and interpretations with respect to the treatment of leased tangible property under Section 1400Z-2. The Treasury, in turn, has asked for broad comments on all aspects of its treatment of leased tangible property. In order to accurately recapitulate the proposals we quote the entirety of Treasury's comments on this subject:

> *The purposes of Sections 1400Z-1 and 1400Z-2 are to increase business activity and economic investment in qualified opportunity zones. As a proxy for evaluating increases in business activity and economic investment in a qualified opportunity zone, these Sections of the Code generally measure increases in tangible business property used in that qualified opportunity zone. The general approach of the statute in evaluating the achievement of those purposes inform the proposed regulations' treatment of tangible property that is leased rather than owned. The Treasury Department and the IRS also recognize that not treating leased property as qualified opportunity zone business property may have an unintended consequence of excluding investments on tribal lands designated as qualified opportunity zones because tribal governments occupy Federal trust lands and these lands are, more often than not, leased for economic development purposes.*
>
> *Given the purpose of Sections 1400Z-1 and 1400Z-2 to facilitate increased business activity and economic investment in qualified opportunity zones, these proposed regulations would provide greater parity among diverse types of business models. If a taxpayer uses tangible property located in a qualified opportunity zone in its business, the benefits of such use on the qualified opportunity zone's economy would not generally be expected to vary greatly depending on whether the business pays cash for the property, borrows in order to purchase the property, or leases the property. Not recognizing that benefits can accrue to a qualified opportunity zone regardless of the manner in which a QOF or qualified opportunity zone business acquires rights to use tangible property in the qualified opportunity zone could result in preferences solely*

[34] This latter provision requires that, in order for a trade or business to qualify as a "qualified opportunity zone business," such business must (among other elements) be one in which "substantially all" of the tangible property owned or leased by the taxpayer is QOZBP.

based on whether businesses choose to own or lease tangible property, an anomalous result inconsistent with the purpose of Sections 1400Z-1 and 1400Z-2.

Accordingly, leased tangible property meeting certain criteria may be treated as qualified opportunity zone business property for purposes of satisfying the 90-percent asset test under Section 1400Z-2(d)(1) and the substantially all requirement under Section 1400Z-2(d)(3)(A)(i). The following two general criteria must be satisfied. First, analogous to owned tangible property, leased tangible property must be acquired under a lease entered into after December 31, 2017. Second, as with owned tangible property, substantially all of the use of the leased tangible property must be in a qualified opportunity zone during substantially all of the period for which the business leases the property.

These proposed regulations, however, do not impose an original use requirement with respect to leased tangible property for, among others, the following reasons. Unlike owned tangible property, in most circumstances, leased tangible property held by a lessee cannot be placed in service for depreciation or amortization purposes because the lessee does not own such tangible property for Federal income tax purposes. In addition, in many instances, leased tangible property may have been previously leased to other lessees or previously used in the qualified opportunity zone. Furthermore, taxpayers generally do not have a basis in leased property that can be depreciated, again, because they are not the owner of such property for Federal income tax purposes. Therefore, the proposed regulations do not impose a requirement for a lessee to "substantially improve" leased tangible property within the meaning of Section 1400Z-2(d)(2)(D)(ii).

Unlike tangible property that is purchased by a QOF or qualified opportunity zone business, the proposed regulations do not require leased tangible property to be acquired from a lessor that is unrelated (within the meaning of Section 1400Z-2(e)(2)) to the QOF or qualified opportunity zone business that is the lessee under the lease. However, in order to maintain greater parity between decisions to lease or own tangible property, while also limiting abuse, the proposed regulations provide one limitation as an alternative to imposing a related person rule or a substantial improvement rule and two further limitations that apply when the lessor and lessee are related.

First, the proposed regulations require in all cases, that the lease under which a QOF or qualified opportunity zone business acquires rights with respect to any leased tangible property must be a "market rate lease." For this purpose, whether a lease is market rate (that is, whether the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity zone) is determined under the regulations under Section 482. This limitation operates to ensure that all of the terms of the lease are market rate.

Second, if the lessor and lessee are related, the proposed regulations do not permit leased tangible property to be treated as qualified opportunity zone business property if, in connection with the lease, a QOF or qualified opportunity zone business at any time

makes a prepayment to the lessor (or a person related to the lessor within the meaning of Section 1400Z-2(e)(2)) relating to a period of use of the leased tangible property that exceeds 12 months. This requirement operates to prevent inappropriate allocations of investment capital to prepayments of rent, as well as other payments exchanged for the use of the leased property.

Third, also applicable when the lessor and lessee are related, the proposed regulations do not permit leased tangible personal property to be treated as qualified opportunity zone business property unless the lessee becomes the owner of tangible property that is qualified opportunity zone business property and that has a value not less than the value of the leased personal property. This acquisition of this property must occur during a period that begins on the date that the lessee receives possession of the property under the lease and ends on the earlier of the last day of the lease or the end of the 30-month period beginning on the date that the lessee receives possession of the property under the lease. There must be substantial overlap of zone(s) in which the owner of the property so acquired uses it and the zone(s) in which that person uses the leased property.

Finally, the proposed regulations include an anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement for purchases of real property (other than unimproved land). In the case of real property (other than unimproved land) that is leased by a QOF, if, at the time the lease is entered into, there was a plan, intent, or expectation for the real property to be purchased by the QOF for an amount of consideration other than the fair market value of the real property determined at the time of the purchase without regard to any prior lease payments, the leased real property is not qualified opportunity zone business property at any time.[35]

3. <u>Treasury Request for Comments</u>

The Treasury Department and the IRS request comments on all aspects of the proposed treatment of leased tangible property. In particular, a determination under Section 482 of whether the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity zone takes into account the simultaneous combination of all terms of the lease, including rent, term, possibility of extension, presence of an option to purchase the leased asset, and (if there is such an option) the terms of purchase. Comments are requested on whether taxpayers and the IRS may encounter undue burden or difficulty in determining whether a lease is market rate. If so, how should the final regulations reduce that burden? For example, should the final regulations describe one or more conditions whose presence would create a presumption that a lease is (or is not) a market rate lease? Comments are also requested on whether the limitations intended to prevent abusive situations through the use of leased property are appropriate, or whether modifications are warranted.[36]

[35] 84 Fed. Reg. 18652, 18656-57.

[36] Id. at 18657.

B. Recommendations

1. We strongly agree with and endorse Treasury's general interpretation that leased tangible property meeting certain criteria should be treated as QOZBP for purposes of satisfying the 90-Percent Asset Test under Section 1400Z-2(d)(1) and the "substantially all" requirement under Section 1400Z-2(d)(3)(A)(i).

2. We also strongly agree with and endorse Treasury's conclusion that leases of tangible property between related parties may be treated as QOZBP so long as certain additional standards and safe guards are met.

3. We recommend that Treasury adopt its proposed position that leases between related parties be evaluated under the arms-length standards of Section 482.

4. We believe that the two additional requirements proposed by Treasury with respect to related party leases – that prepayment of rent may not exceed 12 months and that, in the case of tangible personal property, the lessee must purchase within 30 months an amount of tangible personal property equal to the value of the leased tangible property for use in the applicable QOZ – are both reasonable and beneficial in promoting the objectives of the legislation.

5. However, we further recommend that, in the case of leases of tangible property between unrelated parties (using the 20% standard for testing related party status under Section 1400Z-2(e)(2)), such leases should not be tested under Section 482 standards, and instead should be given a presumption of meeting the standard of "market rate lease" unless either there is clear evidence that the lease structure is intentionally abusive in its structure or there is evidence that the parties, though unrelated, do not have adverse interests or otherwise are not negotiating in good faith to protect and pursue their respective interests.

6. We also agree with and endorse the Treasury's decision to provide two alternative methodologies for valuing leased tangible property for purposes of the Two Tests.

C. Explanation.

We agree with the important determination made by Treasury that leased tangible property can qualify as QOZBP provided that certain requirements are met, including 1) the lease is entered into after December 31, 2017, 2) the leased tangible property is used in a trade or business of the QOF, 3) during substantially all the QOF's holding period for the tangible property, substantially all of the use of the tangible property is in a QOZ, and 4) the lease must be a "market rate" lease. Additional requirements are imposed if the lease of tangible property is between related parties.

We strongly endorse this overall scheme proposed by Treasury, including Treasury's determination not to impose an "original use" requirement for leased tangible property. We specifically endorse the determination to apply the rules to all leases entered into after December 31, 2017, and to apply the "substantially all/substantially all" requirement to the use of leased tangible property.

We also endorse the general concept of a "market rate lease," requirement, but with the following further observations and suggestions. Proposed Regulation Section 1.1400Z2(d)-1(c)(4)(i)(B)(2) provides that, with respect to all leases of tangible property to a QOF (whether such lease is between related or unrelated parties), in order for such leased tangible property to meet the definition of QOZBP, the lease must, inter alia, meet the following requirement:

> "(2) Arms-length terms. The terms of the lease were market rate (that is, the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity zone as determined under Section 482 and the regulations thereunder) at the time that the lease was entered into…"

We note at the outset that Section 482 by its terms applies to transactions between related parties[37] and we think that if a lease of tangible property is entered into between a QOF and an unrelated party[38] that in fact no further "arms length" analysis is required – and certainly not under Section 482. The terms of a lease (or other business transaction) between truly unrelated parties does not need to be tested any further as to whether it is arms length, because Section 482 itself inherently assumes, in the very definition of the "arms-length" standard, that the self-interest of each respective party to a transaction will result in an appropriate financial arrangement.[39]

The Treasury in fact has no obvious reason to impose a special "arms length" standard on the financial terms and conditions of a lease transaction between unrelated parties[40] with respect to tangible property, because the parties themselves have self-interest as an incentive to arrive at economically appropriate terms. True "arms length" lease terms may well vary from "standard"

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[37] The first sentence of Section 482, which applies to tangible property, reads as follows:

"In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

The second sentence of Section 482 addresses intangible property and is not relevant to the provisions of the Proposed Regulation, which specifically address leases of tangible property.

[38] We assume that "related person" test should be within the meaning of Section 1400Z-2(e)(2).

[39] Regulation Section 1.482-1(a)(1) states in relevant part: "The purpose of Section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer."

Regulation Section 1.482-1(b)(1) states in relevant part: "In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)."

[40] We believe that for purposes of distinguishing "related" and "unrelated" persons, the Treasury may decide that any application of Section 482 under these regulations should be based on a 20% rather than a 50% test.

or "average" market terms and conditions, because markets are famously varied and diverse, and it seems likely to be more discouraging to flexible market business arrangements if the IRS seeks to impose any specific set or combination of "standard" terms and conditions on the market place for this important purpose. As the Treasury recognized in the context of acquisitions of undeveloped land, there are a myriad of arrangements that can and do have bona fide purposes, and imposing overly detailed and stringent regulations would be counter-productive.[41]

Rather, we propose that the Treasury treat lease transactions between "unrelated" parties (using the relatively stringent standard of 20% for determining whether parties are related) as having a presumption that such relationship are market rate leases, subject to rebuttal if either there is clear evidence that the lease structure is intentionally abusive (including if it structured solely for tax-motivated reasons) or there is evidence that the parties, though unrelated, do not have adverse interests or otherwise are not negotiating in good faith to protect and pursue their respective interests. Section 482 itself recognizes that unrelated parties have every incentive to engage is "arms length" transactions, and therefore the Treasury should not try to "second guess" market forces unless there is a strong and compelling reason to do so.

On the other hand, we recognize and concur that careful scrutiny should be given to a lease of tangible property between related parties in the context of treating such property as QOZBP. However, the standards that determine whether a lease transaction is a bona fide lease should be addressed by the voluminous tax authority[42] applicable to determining whether a lease is a capital lease (i.e., the financing of a sale of property) versus a true lease, and should not analyzed for this purpose solely (or even predominantly) under Section 482.

On the other hand, determining whether the lease transaction should characterized as a lease or a sale can be critical in determining whether the tangible property should be treated as QOZBP.[43] We further recognize a legitimate concern that related parties could structure a lease to be unreasonably favorable to a QOF or QOZB, with the intention of transferring "extra" value from the lessor to the lessee (or vice versa). This type of non-market arrangement goes to the

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[41] The Preamble to the Second Guidance, in addressing unimproved land, states as follows:

> "Moreover, land is a crucial business asset for numerous types of operating trades or businesses aside from real estate development, and the degree to which it is necessary or useful for taxpayers seeking to grow their businesses to improve the land that their businesses depend on will vary greatly by region, industry, and particular business. In many cases, regulations that imposed a requirement on all types of trades or businesses to substantially improve (within the meaning of Section 1400Z-2(d)(2)(D)(i)(II) and (d)(2)(D)(ii)) land that is used by them may encourage noneconomic, tax-motivated business decisions, or otherwise effectively prevent many businesses from benefitting under the opportunity zone provisions. Such rules also would inject a significant degree of additional complexity into these proposed regulations."

[42] For example, Rev. Proc. 2001-28, 2001-1 C.B. 1156, 5/07/2001, provides detailed guidance on the IRS's ruling position on whether a transaction should be characterized as a lease or a sale for federal income tax purposes

[43] We note that so long as the lease transaction is entered into after December 31, 2017, and the other criteria are met, it will not matter whether a transaction between unrelated parties is a lease of tangible property or a sale of tangible property.

very heart and purpose of Section 482, and seems to be an appropriate area in which to apply its principles. In the context of leasing, contract terms that might (or might not) be subject to abuse could include below-market or above-market rents, unusual rent holidays, tenant build-out allowances, reversion of tenant improvements to a related landlord under Section 109, and similar arrangements. In general, related-party leases should be treated in the same manner as all related-party transactions – namely, subject to scrutiny by the Treasury and IRS under the broad and well-defined principles of Section 482. We do not believe the Regulations need to provide any further restrictions or guidance than simply affirming the applicability of Section 482 to related-party leasing arrangements.

We note that Treasury does impose two additional requirements for related party leases. First, there is a prohibition on a substantial pre-payment or rent (more than 12 months or rent paid in advance) and this is identified as being for the purpose of assuring that capital contributed to a QOF or QOZB (and generally subject to the 31-month safe-harbor on working capital) should be used for capital expenditures rather than mere pre-payment of operating expenses. We recognize this as an appropriate rationale for this proposed policy. The second limitation is that where tangible personal property is leased from a related party, then the lessee must also purchase and place in service within 30 months an amount of tangible personal property that equals the value of the lease property. This mimics in some respects the requirements that apply with respect to "substantial improvement" to purchased tangible property, and again comes within the policy prerogatives of Treasury to encourage the purchase and use of new tangible property in QOZs. We do not think either of these two requirements will place undue burdens on the implementation of projects in QOZs.

Although Section 482 is appropriate to test certain economic terms of leases, we note that there is also other authority providing highly developed standards to determine whether a leasing transaction is a "lease" or a "sale," including both case law and detailed IRS guidance.[44] Persons active in the real estate industry or the equipment leasing industry are intimately familiar with the tax rules and limitations applicable to leasing arrangements, and it does not seem necessary – or beneficial – to add significant additional complexity to an area that already has a long-established framework for understanding and analyzing transactions.

For these reasons, we recommend that Treasury modify its Proposed Regulations to make it clear that Section 482 will apply to related party leases for the traditional purpose of assuring that such transaction will "clearly reflect income." The scope of Section 482 is well understood, and parties can take appropriate steps – including seeking valuation and other opinions – to document that lease terms are consistent with a market rate lease.

On the other hand, we recommend that Section 482 should not apply to leases between unrelated parties (using a 20% standard for related party status, consistent with Section 1400Z-2(e)(2), and instead the Proposed Regulations should be modified such that unrelated party leases are given a presumption of being market rate leases unless there is clear evidence that the lease structure is intentionally abusive (including if it structured solely for tax-motivated reasons) or there is

[44] See footnote 28, above.

evidence that the parties, though unrelated, do not have adverse interests or otherwise are not negotiating in good faith to protect and pursue their respective interests.

Finally, the Treasury should expressly note and recognize that traditional guidance applicable to leasing transactions should also be incorporated into determining the federal tax consequences of a leasing structure within the context of Section 1400Z-2. In particular, the guidance provided by Revenue Procedure 2001-28 and the extensive case law interpreting economic substance and bona fide leasing arrangements will provide a more-than-adequate framework for determining whether leasing relationships should be respected.

V. COMMENTS ON PROPOSED RULES REGARDING THE TREATMENT AND VALUATION OF LEASED TANGIBLE PROPERTY

A. Background

1. Uncertain Issues Prior to Issuance of Second Guidance

See the discussion at Section III.A.1, above, addressing the uncertainty surrounding the treatment of leased tangible property prior to the Second Guidance.

2. Second Guidance the Treatment and Valuation of Leased Tangible Property

See the discussion at Section III.A.2, above, providing Treasury's full comments on the treatment and valuation of leased tangible property contained in the Second Guidance.

3. Treasury Request for Comments

The Treasury Department and the IRS request comments on these proposed rules regarding the treatment and valuation of leased tangible property, including whether other alternative valuation methods may be appropriate, or whether certain modifications to the proposed valuation methods are warranted.

B. Recommendations

1. As noted above, we agree with the Treasury's proposed treatment of leased tangible property as generally eligible to be treated as QOZBP so long as certain criteria discussed above are met.

2. The two alternative valuation methodologies proposed in the Second Guidance are fair and should be sufficient. We do not recommend adding to or modifying the proposed valuation methodologies.

C. Explanation.

The proposed regulations provide two alternative methods for valuing leased of tangible property for purposes of the Two Tests, and this choice seems both appropriate and adequate for general implementation of the legislation.

Looking first at the alternative valuation method, it recognizes that the value or total economic cost of leased property is generally the same as purchased property, particularly if the property in question is purchased with outside financing. Therefore, present value calculations for lease payment using the formula $PV=Sum[P/(1+r)^n + [RV/(1+r)^n]$[45] will provide a present value of the leasehold interest that is very close to the purchase cost of the property based on comparable interest rates and loan amortizations.

The Second Guidance proposes to use the applicable federal rate (AFR) as the discount rate for this purpose, and that rate would be generally favorable to taxpayers, since the AFR reflects the general credit rating of the United States government and will be better than the credit rating of taxpayers generally. However, the Code has used the AFR as the general minimum required interest rate since 1984, and uses it in a variety of Code provisions and circumstances,[46] and so this is clearly the appropriate rate for this purpose.

Taxpayers with applicable financial statements can select to use the value reported on such statement, provided that such valuation method applies to all assets for the taxable year. This flexibility seems likewise designed to provide the maximum opportunity for taxpayers to meet the Two Tests, since the appropriate valuation alternative can be selected for each tax year.

VI. COMMENTS ON THE DEFINITION OF TRADE OR BUSINESS AND RELATED ISSUES.

A. Background

1. Uncertain Issues Prior to Issuance of Second Set of Regulations.

There are two distinct standards implicated in Subchapter Z for the term "trade or business." That term "trade or business" will apply to a business conducted through a QOF – although, because of the awkwardness of the QOF operating requirements generally, it is unlikely that many businesses will chose to operate at the QOF level.

At the QOZB level, meanwhile, it is easier to meet various thresholds and operating requirements – the 70-Percent Test instead of the 90 Percent Test, the availability of the working capital safe harbor, and so forth – but a QOZB is clearly subject to the seemingly higher standard of caring on the "active conduct of a trade or business."

One very large issue was the treatment of so-called "triple net leasing" or NNN leasing, where the lessor leases the property to the lessee and takes a very limited role in the active management of the property. Triple-net leasing is a very common relationship in the real estate work between the lessor and lessee, but there was deep concern whether triple-net leasing met

[45]PV=present value, P=annual lease payments, r=interest rate, n=number of payments, RV=Residual Value.

[46] The applicable federal rate is used as the relevant interest rate for debt instruments (Section 1272), installment sales (Sections 1274 and 483), below-market loans to related parties (Section 7872) and to value certain interests in trusts (Section 7520), among other uses.

either the "trade or business" standards applicable to a QOF, and especially the "active business" requirement that seems to apply to a QOZB.

2. Treasury's Second Guidance on the Definition of Trade or Business

The Second Guidance provides that "trade or business" has the same meaning as under Section 162. Then the Guidance becomes interesting. On the one hand, the Second Guidance states in the preamble the following:

> *"[T]he ownership and operation (including leasing) of real property used in a trade or business is treated as the active conduct of a trade or business for purposes of Section 1400Z-2(d)(3). No inference should be drawn from the preceding sentence as to the meaning of the "active conduct of a trade or business" for purposes of other provisions of the Code, including Section 355."*

The foregoing, especially the second sentence, seems to suggest that Treasury feels it has reduced the differences, between a Section 162 "trade or business" and an "active conduct of a trade or business," for purposes of Subchapter Z.

However, the actual language of the Proposed Regulations provides the following information: 1) there is no actual definition of "active conduct" (the topic is identified as "RESERVED"), and 2) the Proposed Regulations state that **"***merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business by such taxpayer."*[47]

3. Treasury Request for Comments.

1. Comment on the proposed definition of a trade or business for the purposes of Section 1400Z-2(d)(3).
2. Comment on whether additional rules needed for determining whether a trade or business is actively conducted?
3. Comment on whether it would be appropriate or useful to extend the requirements of Section 1397C applicable to Qualified Opportunity Zones.

B. Recommendations

1. We recommend that the Proposed Regulations should use the same definition both for "trade or business" and for "active conduct of a trade or business." This will help avoid the uncertainty and challenges that arise from multiple definitions under Subchapter Z applies to essentially the same core activities and conduct.

2. We recommend that this unified definition of "trade or business" should be based on the favorable definition of "active conduct of a trade or business" used in the New Markets Tax Credit area, namely, that the taxpayer reasonably expects that the entity will generate revenues within three (3) years after the date the investment is made. Alternatively, the

[47] Prop. Reg. Section 1400Z-1(d)(5) (ii}(B)(2)

definition should be based the definition of" trade or business" under Section 162 and this standard should be applicable to "active conduct of a trade or business" as well .

3. We recommend that the Proposed Regulations should explicitly address and allow triple net leasing of real estate located in a QOZ to qualify as a "trade or business" of the lessor, and this recommendation is particularly strong if the real estate in question is meets the "original use" test of the "substantial improvement" test in the hands of the lessor.

4. We recommend that Section 1397C be applied in a manner that is informed by the goals and purposes of Subchapter Z. Thus, its scope should not be expanded, and indeed should be reduced to the extent that it (we believe) erroneously introduced "active conduct" standards into Subchapter Z.

C. Explanation.

1. Overview

The proposed regulations currently seem to perpetuate a fundamental dichotomy in the meaning of "trade or business" for purposes of Subchapter Z, and this dichotomy will have an adverse impact on the ability (or willingness) of taxpayers to take advantage of the Opportunity Zone tax incentive.

For general purposes, the proposed regulations adopt the definition of "trade or business within the meaning of Section 162. However, the phrase "active conduct of trade or business" remains undefined. As a result, we are left with two distinct standards in the OZ Act for the term "trade or business".

The uncertainty engendered by multiple definitions for "trade or business" will discourage investment in QOZs, and for this reason a sensible and appropriate common definition is strongly recommended.

Qualified Opportunity Fund ("QOF")

A QOF must hold at least 90% of its assets in qualified opportunity zone property.[48] There are three kinds of qualified opportunity zone property: 1) qualified opportunity zone stock; 2) qualified opportunity zone partnership interest; and 3) qualified opportunity zone business

[48] *See* Section 1400Z-2(d)(1). Treasury and the IRS have issued two sets of proposed regulations pertaining to qualified opportunity zones. Both are effective when they are adopted as final regulations, but, subject to several exceptions, taxpayers may rely on them so long as they apply the rules in their entirety. *See* REG-115420-18, 83 Fed. Reg. 54,279 (Oct. 29, 2018); REG-120186-18, 84 Fed. Reg. 18,652 (May 1, 2019). For a practical explanation of the proposed regulations and discussion of the questions not answered by them, see Starczewski, *The Eagerly Awaited Opportunity Zone Regulations: What Do They Tell Us and What Do We Still Need to Figure Out*, 34 T.M. Real Estate Journal 214 (Nov. 7, 2018), and Starczewski, *The Second Set of Proposed Opportunity Zone Regulations: Where Are We Now?*, 60 Tax Management Memorandum, No. 9, 143 (April 29, 2019).

property (QOZBP).[49] Each of these require ownership in or operation of a "qualified opportunity zone business" (QOZB) or, in the case of QOZBP, ownership of property for use in such a business.[50]

When determining what is a "trade of business" for determining whether a QOF uses property in a trade or business the answer now seems straight forward: the activity will be a trade or business for the purposes of a QOF if it would be considered a trade or business under Section 162.

Qualified Opportunity Zone Business ("QOZB")

A second and distinct "active conduct" standard seems to apply to QOZBs. Specifically, a QOZB is a trade or business in which substantially all of the tangible property owned or leased by the business is QOZBP.[51] In addition:[52]

- at least 50% of the business's total gross income must be derived from the *active conduct* of a qualified business within a qualified opportunity zone;[53]
- a substantial portion (at least 40%) of the business's intangible property must be used in the *active conduct* of a qualified business within a qualified opportunity zone;[54]
- less than 5% of the average of the aggregate unadjusted bases of the business's property must be attributable to nonqualified financial property;[55] and
- the business cannot be a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store

[49] *See* Section 1400Z-2(d)(2)(A), added by the 2017 tax act, Pub. L. No. 115-97, Section 13823(b), effective on the date of enactment (December 22, 2017); Prop. Reg. Section 1.1400Z2(d)-1(c).

[50] *See* Section 1400Z-2(d)(2).

[51] *See* Section 1400Z-2(d)(3)(A)(i) (reference to §1400Z-2(d)(2)(D)); Prop. Reg. Section 1.1400Z2(d)-1(d)(1).

[52] *See* Section 1400Z-2(d)(3)(A)(ii) (reference to §1397C(b)); Prop. Reg. Section 1.1400Z2(d)-1(d)(1). Section 1400Z-2(d)(3) provides that a QOZB must satisfy certain requirements set forth in Section 1397C(b), which defines an enterprise zone business located in enterprise zones.

[53] *See* Section 1400Z-2(d)(3)(A)(ii) (reference to Section 1397C(b)(2)); Prop. Reg. Section 1.1400Z2(d)-1(d)(5)(i).

[54] *See* Section 1400Z-2(d)(3)(A)(ii) (reference to Section 1397C(b)(4)); Prop. Reg. Section 1.1400Z2(d)-1(d)(5)(ii).

[55] *See* Section 1400Z-2(d)(3)(A)(ii) (reference to Section 1397C(b)(8)); Prop. Reg. Section 1.1400Z2(d)-1(d)(5)(iii). Section 1397C(e)(1) 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 (working capital assets).

whose principal business is the sale of alcoholic beverages for consumption off premises.[56]

The Various Meanings of "Trade or Business"

As an initial observation, Subchapter Z itself refers to the phrase "trade or business" twice[57] and does not require an "active" trade or business either time the phrase is mentioned in the OZ Act. The word "active" is brought in – if at all – through the cross reference to Section 1397C(b)(2). Therefore, it is fair to ask whether the correct test applicable to a QOZB should be "active conduct of a trade or business" or merely "conduct of a trade or business"?[58]

A fair amount turns on that distinction, because, under the curious history of a series of US Tax Court cases dating back to Leland Hazard,[59] the US Tax Court may, to this day, take the position that the "general rule" is that a lease of a single parcel of real estate constitutes a "trade of business."[60]

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[56] *See* Section 1400Z-2(d)(3)(A)(iii) (reference to Section 144(c)(6)(B)); Prop. Reg. Section 1.1400Z2(d)-1(d)(6).

[57] The first time is in the definition of "Qualified Opportunity Zone Business Property," which is defined as "tangible property used in a trade or business of the qualified opportunity fund if…[three criteria are met]." The three criteria are (i) the property is acquired by purchase from an unrelated person after December 31, 2017, (ii) the property is either original use property or substantially improved property, and (iii) substantially all the use of the property by the fund is in the opportunity zone.

The second use is in the definition of "qualified opportunity zone business" and means "a trade or business" that meets three criteria, including the statutory requirements imported from Section 1397C(b).

[58] See Warren R. Miller, Sr., 51 T.C. 755 (1968) (the incorporation of one statute into another by cross-reference calls for practical and sensible interpretation in fitting the provisions of the adopted statute into the scheme of the adopting one).

[59] 7 T.C. 372 (1946). In the Hazard case, the issue was whether the rental of a single family residential property constituted a trade or business, and thus resulted in an ordinary loss (rather than a capital loss) on sale. The court opinion in Hazard does not discuss or identify any services provided by the lessor to the lessee, nor does it discuss the lease terms.

The IRS acquiesced to the Hazard case. See 1946-2 C.B. 3. At a much later point in time (1981) a request was made by the IRS National Office Audit Division to reverse the acquiescence in Hazard. This request was rejected by the IRS General Counsel. GCM 38779, 7-27-81. That GCM is quoted in detail in the next footnote.

Therefore, Hazard to this day has acquiescence from the IRS. The Hazard case continues to represent the Tax Court's continuing position in every jurisdiction in the U.S. except the 2nd Circuit, where the Court of Appeals in Grier v. U.S., 218 F.2d 603 (2nd Cir. 1955) affirmed a decision, 120 F. Supp. 395, that declined to follow Hazard and held that more "activity" was needed in order for a rental of real estate to constitute a trade or business.

Hazard was reaffirmed (more or less) in Balsamo v. Comm'r., T.C. Memo 1987-477, in which the Tax Court stated as follows: "Our historical position that rental of one property constitutes a trade or business establishes a general not an absolute rule. See Fegan v. Commissioner, 71 T.C. 791, 814 (1979), affd. without published opinion (10th Cir. 1981), wherein we referred to "our longstanding definition of 'trade or business' as including under appropriate circumstances the rental of one property" (emphasis added)." In Balsamo, the taxpayer was ultimately denied an ordinary loss, not because of the trade or business analysis of a bona fide lease of one property, but because the taxpayer in that case did not actually rent the property to anyone.

[60] See "'ACTIVE CONDUCT' DISTINGUISHED FROM 'CONDUCT' OF A RENTAL REAL ESTATE BUSINESS", by John W. Lee, Tax Lawyer Vol. 25, No. 2, 1972; see also Comment, "The Single Rental as a 'Trade or Business' under

The language of GCM 38779 provides a basis optimism that taxpayers could potentially prevail on this issue, even if the "management" activities associated with leasing a single property are relatively minimal.[61]

2. Provide a Convergent Definition of Trade or Business Based on the New Markets Tax Credit, or Alternative converge on Section 162.

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the Internal Revenue Code," 23 U. CHI. L. Rev. 111 (1955); see also Balsamo, supra, that seems to confirm and reiterate (more or less) this standard as the continuing standard of the US Tax Court in all federal circuits except the Second Circuit, where the Grier case mandates a facts and circumstances analysis of the actual management exercised by the taxpayer-lessor.

[61] GCM 38779 states as follows:

> Although Grier appears to support a stricter test for determining when the rental of property will constitute a trade or business, its analysis is much the same as that of the other cases that have followed Hazard. In the recent case of Curphey v. Commissioner, 73 T.C. 766 (1980), the Tax Court noted that the rental of a single piece of real property has repeatedly been recognized as the conduct of a trade or business. The court stated, however, that the ownership and rental of real property does not, as a matter of law, constitute a trade or business. After citing Grier, the court concluded: "In the final analysis, the issue is ultimately one of fact in which the scope of the ownership and management activities may be an important consideration."
>
> We read the majority of cases that have been decided since Hazard as turning upon a factual finding that a particular taxpayer was engaged in a trade or business. In the typical case, the taxpayer has offered evidence of the various activities involved in managing the rental property and the court has accepted this evidence as indicating that the taxpayer was engaged in a trade or business. Even in a case such as that described in your recent technical advice memorandum, the taxpayer undoubtedly could offer evidence of various efforts to collect unpaid rents and other activities with respect to the property. Based upon the decided cases, there is substantial doubt that the Service would prevail if such a case were litigated.
>
> For these reasons, we question whether a change in Service position in this area is advisable. The problem that you raise is not with the legal standard applied by the courts, *but with the relatively small amount of activity that the courts have found to be indicative of a trade or business*. [Emphasis supplied.] In view of the number of cases that have been decided on this issue, only some of which have been cited above, *it is unlikely that the Service could now persuade the courts to take a more restrictive approach with respect to the amount of activity required to find that a taxpayer's rental activity constituted a trade or business.* [Emphasis supplied.]
>
> Finally, we would note that the Service's acquiescence in Hazard has little bearing on this issue. The acquiescence merely represents the Service's acceptance of the court's decision on what was admittedly a factual question. Moreover, although Hazard has been cited frequently in subsequent cases, the courts have not viewed the acquiescence as indicating Service position to be that every rental of real property is a trade or business. At most, it has been cited for the fact that rental of even a single piece of property may be a trade or business, a proposition with which we do not disagree. Thus, we believe that withdrawal of the Hazard acquiescence would have little effect on future cases.

Obviously, having two materially different "trade or business" standards makes little sense, and the convergence of these definitions is, at a minimum, a step in the direction of certainty. However, beyond the benefits from such a convergence, we further recommend that Treasury reconsider adopting a definition for "active conduct of a trade or business for businesses in a QOZ

similar to the definition in the New Markets Tax Credit area, which states in relevant part as follows:

> *For purposes of paragraph (d)(4)(i) of this Section, an entity will be treated as engaged in the active conduct of a trade or business if, at the time the CDE makes a capital or equity investment in, or loan to, the entity, the CDE reasonably expects that the entity will generate revenues (or, in the case of a nonprofit corporation, engage in an activity that furthers its purpose as a nonprofit corporation) within three (3) years after the date the investment or loan is made.*[62]

If such a reconsideration is not possible at this junction, then in the alternative we recommend that "active conduct of a trade or business" be give the same meaning as "trade or business," and that both be given the meaning under Section 162.

3. Triple Net Leasing (TNL) Should Be Explicitly Permitted, Especially for Real Property that Meets the Definition of QOZBP in the Hands of the Lessor

Generally, under Section 162 standards, a lease of a single property, accompanied by relatively minor additional administrative activities, can potentially rise to the level of trade or business.[63] At the present time, the Proposed Regulations signal a reluctance to permit TNL to qualify as a trade or business, stating:

> *Solely for the purposes of Section 1400Z-2(d)(3)(A), the ownership and operation (including leasing) of real property is the active conduct of a trade or business. However, merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business by such taxpayer.*[64]

If the word "merely" is intended to invoke the standards under Section 162 described by the Hazard case and GCM 28799, then we recommend that this be clarified as consistent with the current authority, so that taxpayers can make sound structuring decisions. The reality is that TNL is widely used in standing commercial real estate transactions precisely because the lessor and lessee agree that the lessee is in the best position to control and maintain property, and because the lessee's maintenance covenants are not appreciably different than those that a lessor might enter into with a property manager or other agent.

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[62] Treasury Regulation Section 1.45D-1(d)(4)(iv).

[63] See the detailed discussion of the *Leland Hazard* case under footnote 45.

[64] *Prop. Reg. Section 1.1400Z2-1(d)(5)(ii)(B)(2).*

We further note that taxpayers who place real property into service in a QOZ either through original use or as a result of substantial improvement are performing the crucially important function in improving the real estate stock in a QOZ, and the leasing of real property that meets the definition of QOZBP should be given appropriately favorable consideration under these rules. In connection with leases of tangible property, the Second Guidance observes:

> *Given the purpose of Sections 1400Z-1 and 1400Z-2 to facilitate increased business activity and economic investment in qualified opportunity zones, these proposed regulations would provide greater parity among diverse types of business models. If a taxpayer uses tangible property located in a qualified opportunity zone in its business, the benefits of such use on the qualified opportunity zone's economy would not generally be expected to vary greatly depending on whether the business pays cash for the property, borrows in order to purchase the property, or leases the property. Not recognizing that benefits can accrue to a qualified opportunity zone regardless of the manner in which a QOF or qualified opportunity zone business acquires rights to use tangible property in the qualified opportunity zone could result in preferences solely based on whether businesses choose to own or lease tangible property, an anomalous result inconsistent with the purpose of Sections 1400Z-1 and 1400Z-2.*

We believe that, for the same reasons the Treasury concluded that leased tangible property should be considered QOZBP for the lessee, it should also be considered QOZBP for the lessor, and that this conclusion should not turn on what GCM 38799 calls "the relatively small amount of activity that the courts have found to be indicative of a trade or business."

Alternatively, if the standards described in GCM 38799 are the applicable standard, then taxpayer should be made aware of this position so that they can structure important business transactions with appropriate certainty and clarity as to the result.

4. Section 1397C

Section 1397C is imported into Subchapter Z by cross-reference to three generic business qualifications set forth in Section 1397C(b)(2), (4) and (8), respectively.

First, we note that the mechanical requirements of those three provisions could be read as applicable to Section 1400Z-2 without necessarily importing the "active conduct" language. See Warren R. Miller, Sr., 51 T.C. 755 (1968) (the incorporation of one statute into another by cross-reference calls for practical and sensible interpretation in fitting the provisions of the adopted statute into the scheme of the adopting one). Since Section 1400Z-2 does not use "active conduct of a trade or business" at any point, it raises strongly the question of whether the two provisions should be construed in a manner that sharply distinguishes their very different origins, purposes and intentions.

Second, the cross references to Section 1397C are very specific, and were pulled into the statute specifically for the requirements of a QOZB. A QOF has completely different rules in

almost every respect – it has a 90-Percent Asset, does not have a working capital safe harbor, is subject to an explicit penalty provision if funds are not invested timely into QOZP, and so forth. There is nothing about the very strong distinctions within Section 1400Z-2 between a QOF and a QOZB that suggests conflating the two and importing the (generally restrictive) requirements from Section 1397C. We therefore recommend against any such interpretation.

VII. COMMENTS REGARDING WHETHER A RULE ANALOGOUS TO THE QOF REINVESTMENT RULE SHOULD APPLY TO QOF SUBSIDIARIES THAT REINVEST PROCEEDS FROM THE DISPOSITION OF QUALIFIED OPPORTUNITY ZONE BUSINESS PROPERTY

A. Background

1. Reinvestment of Gain Prior to Second Guidance

A QOF is subject to the 90-Percent Asset Test, which requires that the QOF hold at least 90% of its assets in qualified opportunity zone property with such percentage being calculated as the average of the applicable percentage on the last day of the first six-month period of the taxable year of the QOF and on the last day of the taxable year of the QOF.[65] Section 1400Z-2(e)(4)(B) authorizes regulations to ensure a QOF has "a reasonable period of time to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests, and to reinvest proceeds received from the sale or disposition of qualified opportunity zone property."

Treasury received numerous requests for further guidance, not only on the length of a "reasonable period of time to reinvest," but also on the Federal income tax treatment of any gains that the QOF reinvests during such a period.

2. Second Guidance

The Second Guidance provides that proceeds received by the QOF from the sale or disposition of (1) qualified opportunity zone business property, (2) qualified opportunity zone stock, and (3) qualified opportunity zone partnership interests are treated as qualified opportunity zone property for purposes of the 90-percent investment requirement described in 1400Z-1(d)(1) and (f), so long as the QOF reinvests the proceeds received by the QOF from the distribution, sale, or disposition of such property during the 12-month period beginning on the date of such distribution, sale, or disposition, and further provided that, from the date of a distribution, sale, or disposition until the date proceeds are invested in other qualified opportunity zone property, the proceeds must be continuously held in cash, cash equivalents, and debt instruments with a term of 18 months or less.

3. Request for Comments with Respect to QOF Subsidiaries

[65] I.R.C. § 1400Z-2(d)(1).

The Treasury Department and the IRS request comments on whether an analogous rule for QOF subsidiaries to reinvest proceeds from the disposition of qualified opportunity zone property would be beneficial.

B. Recommendations

We recommend that an analogous rule for QOF subsidiaries to reinvest proceeds from disposition of qualified opportunity zone property should be adopted.

C. Explanation

Allowing for QOF subsidiaries (meaning QOZBs) to reinvest proceeds from the disposition of assets at the QOZB level would fall in line with the Second Guidance's view of relief for newly contributed assets, as well as the clear intent of 1400Z-2(e)(4)(B).

The Second Guidance makes it clear that for purposes of the 90-percent Asset Test described in 1400Z-1(d)(1) and (f), a QOF may reinvest its proceeds received by the QOF from distribution, sale, or disposition of such property during the 12-month period beginning on the date of such distribution, sale, or distribution. Allowing QOF subsidiaries to make such investments directly, instead of distributing money out and receiving contributions back, is consistent with the specific authorization set forth in the statute.

In particular, if a QOZB disposes of property generating gain, and the QOF intends to reinvest such gain into the QOZB, treating such funds (at the election of the QOF) as immediately reinvested, and further treating such funds as QOZBP of the QOZB during a 12-month investment period, is consistent with the obvious invention of the statute to allow a 12-month grace period during which eligible capital gains could be reinvested without disqualifying the QOF (which necessarily also means not disqualifying the QOZB) on technicalities that would otherwise be triggered by the very nature of a gain recognition event.

Treasury has sensibly adopted a 31-month safe harbor for contributions of cash from a QOF to a QOZB, and a corresponding 12-month safe harbor for cash generated by sales of property at the QOZB level seems completely reasonable, and also necessary, to effectuate the statutory scheme.

VIII. TREASURY REQUEST FOR COMMENTS ON TIMING OF BASIS ADJUSTMENTS

A. Background

1. Status Prior to Issuance of Second Set of Regulations

Under Section 1400Z-2(b)(2)(B)(i), an electing taxpayer's initial basis in a qualifying investment is zero. Under Section 1400Z-2(b)(2)(B)(iii) and (iv), a taxpayer's basis in its qualifying investment is increased automatically after the investment has been held for five years by an amount equal to 10 percent of the amount of deferred gain, and then again after the

investment has been held for seven years by an amount equal to an additional five percent of the amount of deferred gain.

Under Section 1400Z-2(c), a taxpayer that holds a QOF investment for at least ten years may elect to increase the basis of the investment to the fair market value of the investment on the date that the investment is sold or exchanged.

2. Second Guidance.

The proposed regulations clarify that such increased tax basis is basis for all purposes and, for example, losses suspended under Section 704(d) would be available to the extent of the basis step-up.

The proposed regulations also clarify that basis adjustments under Section 1400Z-2(b)(2)(B)(ii), which reflect the recognition of deferred gain upon the earlier of December 31, 2026, or an inclusion event, are made immediately after the amount of deferred capital gain is taken into income.

The proposed regulations further clarify that, if the taxpayer makes an election under Section 1400Z-2(c), the basis adjustment under Section 1400Z-2(c) is made immediately before the taxpayer disposes of its QOF investment. For dispositions of qualifying QOF partnership interests, the bases of the QOF partnership's assets are also adjusted with respect to the transferred qualifying QOF partnership interest, with such adjustments calculated in a manner similar to the adjustments that would have been made to the partnership's assets if the partner had purchased the interest for cash immediately prior to the transaction and the partnership had a valid Section 754 election in effect. This will permit basis adjustments to the QOF partnership's assets, including its inventory and unrealized receivables, and avoid the creation of capital losses and ordinary income on the sale..

3. Request for Comments.

With respect to that special election, the Treasury Department and the IRS intend to implement targeted anti-abuse provisions (for example, provisions addressing straddles). The Treasury Department and IRS request comments on whether one or more such provisions are appropriate to carry out the purposes of Section 1400Z-2.

More generally, the Treasury Department and the IRS request comments on the proposed rules regarding the timing of basis adjustments under Section 1400Z-2(b) and (c).

B. Recommendations

1. We agree with the approach in the Proposed Regulations providing that the basis adjustment s under Section 1400Z-2(b)(2)(B)(ii) are made immediately after the previously deferred gain is included in the investor's income.

2. We also agree with the language in the Proposed Regulations that characterizes the step-up in outside tax basis pursuant to an event described in Section 1400Z-2(c) by reference to the adjustments that would have been made to the partnership's assets if the partner had purchased the interest for cash immediately prior to the transaction and the partnership had a valid Section 754 election in effect. However, we further suggest that this adjustment have two corollary implementation rules. First, is should not be treated as an actual 754 election, and instead the partnership (assuming it is a sale of a partnership interest) should make (or not make) a Section 754 election with respect to the sale and transfer. Second, the 754 election should be deemed to occur and adjust property tax basis on the occurrence of a "liquidation" event, which includes not only the sale of a QOF interest, but also a QOZP interest and, if applicable, a sale of substantially all the assets of a QOZB in contemplation of liquidation.

C. **Explanations**

Mechanically, the recognition of gain either on sale or from the occurrence of the date December 31, 2026, followed immediately by the adjustment to outside tax basis, seems to reasonably track the interaction of Section 1400Z-2(b)(2)(B)(ii) with other Code provisions. This increase in outside basis can then be used to provide appropriate related adjustments, such as for suspended losses due to lack of outside tax basis under Section 704(d), distributions of money under Section 731(a)(1), and similar provisions.

In the Second Guidance, the IRS provided that, upon a disposition of a qualifying QOF partnership interest after it has been held for at least 10 years (and an election by the taxpayer under Section 1400Z-2(c)), there is a basis adjustment in the outside tax basis in the QOF partnership interest to fair market value, and also an "inside" adjustment in the QOF partnership's assets. The Treasury commentary provides that "such adjustments [are] calculated in a manner similar to the adjustments that would have been made to the partnership's assets if the partner had purchased the interest for cash immediately prior to the transaction and the partnership had a valid Section 754 election in effect. This will permit basis adjustments to the QOF partnership's assets, including its inventory and unrealized receivables, and avoid the creation of capital losses and ordinary income on the sale."

Treasury is clearly making a major effort to implement the intent and spirit of Section 1400Z-2(c) by having the sale of the QOF partnership interest produce "zero" gain on sale. Treasury apparently recognizes that a mere upward adjustment to outside tax basis, without more, does not overcome the tax consequences of the interaction of Section 741 and 751. In particular, absent any special further rules for a QOF partnership, if a sale of a partnership interest results in gain under Section 751(a) (i.e., ordinary gain), and if the outside basis in the partnership interest equals the purchase price, then, to the extent the partnership holds "hot assets," the tax result on sale of the partnership interest would be (1) ordinary income in an amount equal to the gain on hot assets recognized under Section 751(a) and (2) an equal and corresponding capital loss under Section 741. See Reg. Section 1.751-1(a)(2).

Treasury's proposal is to treat the seller as making a hypothetical sale to itself immediately before the transaction and assumes a valid Section 754 election is in effect, all for the purpose of avoiding the unintended consequence of making a sale of the QOF partnership

interest bifurcate (under Section 741 and 751(a)) into offsetting amounts of ordinary income and capital loss. However, there is a potential disconnect in having a deemed 754 election be made by a selling partner in a sale of a partnership interest. A more logical rule would be simply to determine that upon an election under Section 1400Z-1(c), the sale of a QOF interest held for more than ten years – including a sale of a QOF partnership interest -- generates zero gain to the selling taxpayer.

On the buyer side, the partnership can choose -- and should be able to choose -- whether the partnership wants to make a Section 754 election. If a 754 election is made, then the buyer can enjoy the corresponding adjustments under 743(b). Many partnerships make a 754 election, but others intentionally choose not to make the election, because the adjustment to tax basis is not made with respect to the partnership assets, but rather is special depreciation adjustment that is reported on the K-1 for each separate partner. Each partner can have his own special, unique depreciation schedule, and there are plenty of partnerships that choose not to maintain separate depreciation accounts at that level and intentionally decide, and inform its partners, that the partnership will not make a 754 election. Having an "automatic" 754 election made by the seller of the QOF would be a truly strange and anomalous result, and would go in the wrong direction of trying to integrate the Subchapter with Subchapter K. We respectfully submit that it does not make sense to adopt a rule that is completely inconsistent with the principles of subchapter K.

Rather, we suggest that the "fix" in this case is simply to clarify that the deemed purchase 754 election applies ***solely*** for purposes of determining that tax liabilities of the partner selling the QOF partnership interest, and that the partnership retains the right determine whether to make a 754 election with respect to the purchaser of that partnership interest. We think that is consistent with both the language and the intention of Section 1400Z-2(c).

We further believe that Section 1400Z-2(c) can be used to justify an equivalent deemed 754 election not only on sale of the QOF interest, but on a liquidation of the QOF interest, including a sale of either underlying QOZP or even sale of assets held in a QOZB. For example, the adoption of a plan of liquidation of a QOF partnership can be construed as a hypothetical Section 754 election immediately before such liquidation and would produce a step up in basis to the QOF, to an underlying QOZB partnership, and to the assets in the QOZB partnership, e.g., appreciated real estate that is the principal asset of the QOZB.

The current Proposed Regulations provide that if a taxpayer sells the QOF interest after ten years (and make the applicable election) there is no income or gain of any kind; if the taxpayer sells the QOZB interest (assuming it is Qualified Opportunity Zone Property, which it presumably should be), the taxpayer can exclude capital gain, but not ordinary income/gain (e.g., ordinary income under Section 751); and if the taxpayer sells the underlying assets of the QOZB partnership, the taxpayer will seemingly recognize all income/gain recognized at the QOZB level and will not enjoy any gain exclusion whatsoever.

Obviously, it is a peculiar tax policy that produces three separate gain recognition regimes arising out of the same exact investment structure, and suggest that Treasury and the IRS reconsider this drastically different set of outcomes. The "solution" would be to treat a partner in

a QOF partnership as making a "deemed purchase" and a 754 election immediately before engaging in any of the three alternative disposition transactions, so long as the partnership adopts a plan of liquidation and such subsequent transactions are pursuant to such liquidation plan.

IX. 10-YEAR GAIN EXCLUSION PROVISION FOR PARTNERSHIPS AND S-CORPS

A. Background.

1. Status Prior to Issuance of Second Guidance.

Before the Second Guidance was issued, it was assumed that the only mechanism for enjoying the exclusion from gain under Section 1400Z-2(c) was through the sale of a QOF interest.

2. Second Guidance.

The Second Guidance provides that a taxpayer that is the holder of a direct qualifying QOF partnership interest or qualifying QOF stock of a QOF S corporation may make an election to exclude from gross income some or all of the capital gain from the disposition of qualified opportunity zone property reported on Schedule K-1 of such entity, provided the disposition occurs after the taxpayer's 10-year holding period. To the extent that such Schedule K-1 separately states capital gains arising from the sale or exchange of any particular capital asset, the taxpayer may make an election under Section 1400Z-2(c) with respect to such separately stated item. To be valid, the taxpayer must make such election for the taxable year in which the capital gain from the sale or exchange of QOF property recognized by the QOF partnership or QOF S corporation would be included in the taxpayer's gross income, in accordance with applicable forms and instructions. If a taxpayer makes this election with respect to some or all of the capital gain reported on such Schedule K-1, the amount of such capital gain that the taxpayer elects to exclude from gross income is excluded from income for purposes of the Internal Revenue Code and the regulations thereunder. For basis purposes, such excluded amount is treated as an item of income described in Sections 705(a)(1) or 1366 thereby increasing the partners or shareholders' bases by their shares of such amount. These proposed regulations provide no similar election to holders of qualifying QOF stock of a QOF C corporation that is not a QOF REIT.

3. Request for Comments.

The Treasury Department and the IRS request comments on the eligibility for, and the operational mechanics of, the proposed rules regarding this special election.

B. Recommendations.

1. As discussed and addressed elsewhere this Letter, we believe that a taxpayer that meets the ten-year holding requirements of a QOF under Section 1400Z-2(c) should be able to make a deemed 754 election with respect to a liquidation of the QOF, whether structured as the

sale of a QOZB that is QOZP, and whether structured as a sale of QOZB assets followed by a liquidation of the QOZB.

2. We believe the language stepping up tax basis to exclude gain under Section 1400Z-2(c) was clearly intended to exclude all gain on the liquidation of a QOF investment held for ten or more years, and, as Treasury and the IRS as concluded with respect to the timing issues under Section 1400Z-2(c), this tax result is most appropriately achieved by treating the selling taxpayer as if the taxpayer has made a deemed 754 election immediately before the disposition of the QOF interest.

3. For an S corporation, the same result would be appropriately achieved by treating the S shareholders as making a deemed 336(e) election immediately before the sale of the S corporation or the liquidation of the S corporation.

C. Explanation.

The proposed regulations seek to promote the intent of the QOZ legislation by allowing an investor in a QOF partnership to elect to exclude from gross income its share of capital gain from the sale of QOZP.[66] However, our concern is that this election is inferior to the deemed Section 754 election that occurs on a sale of a QOF interest and thus falls short of effectuating Congressional intent to reward investors who hold QOF interests for a full ten years. Whereas the deemed Section 754 election on the sale of a QOF interest permits exclusion of both capital gains and ordinary income, [67] the asset sale election only permits the exclusion of separately stated capital gains and net Section 1231 gain reported on a K-1 to the investor.[68]

We believe it is appropriate for the final regulations to allow an election under Section 1400Z-2(c) at the time of a liquidation invent that, through a deemed Section 754 election for a partnership and a deemed Section 336(e) election for an S corporation, results in a step-up in tax basis in QOZP (including a QOZB) owned by the QOF, so long as the QOF has held for at least 10 years. The plain language of the statute is that "any investment" of the "taxpayer" is eligible for the step-up election.[69] It should be noted that the clear purpose of the legislation is to promote investments in QOZ Property as the primary investment priority, whereas the QOF investment is simply a facilitative shell. Though investments in QOZ Property, including QOZBs, are underlying investments of a QOF, these critical investments cannot and should not be ignored simply because they are a part of a multi-level investment structure. Therefore, the final regulations should clarify that the basis of the QOZ Property, including QOZ Businesses, are also eligible for the election to step-up tax basis at the time the QOF investment is liquidated..

The next item to be addressed is the treatment of asset sales by underlying QOZ Businesses. We note that, under the currently proposed regulations, substantively identical sales will have markedly different tax results depending on whether the entity selling the asset is a QOF or a

[66] *See* Prop. Reg. § 1400Z2(c)-1(b)(2)(ii).
[67] *See* Prop. Reg. § 1400Z2(c)-1(b)(2)(i) .
[68] *See* Prop. Reg. § 1400Z2(c)-1(b)(2)(ii)(A).
[69] *See* 26 IRC 1400Z-2(C).

QOZ Business. Maintaining and ensuring this economically artificial distinction will discourage investment in QOZ Businesses, contrary to the intent of the legislation. We recommend that if a QOF a held for 10 years, and the path to liquidation of the QOF investment is a liquidation of the underling QOF assets, then the election to step-up as basis should be available to the taxpayer as this is just another means of selling the "investment" held by the "taxpayer" under Section 1400Z-2(c).

Alternatively, since the proposed regulations already give the taxpayer the ability to elect or exclude capital gain and sales of QOZP by a QOF, we believe a similar an election should be available to the taxpayer to exclude capital gain recognized on the sale of assets by an underlying QOZ Business.[70] In a multi-tier investment structure consisting of pass-through entities, the logic of such a proposed election mirrors the deemed Section 754 election provided for in the proposed regulations on a sale of a QOF interest, and would certainly be equally consistent with the legislative intent.

X. THE AMOUNT OF AN INVESTMENT ELIGIBLE FOR A DEFERRAL ELECTION

This Comment X addresses debt-financed distributions ("DFDs"), disguised sales, and the amount with respect to which a taxpayer may make a deferral election under Section 1400Z-2(a).

A. Background

1. Status Prior to Issuance of Second Guidance.

The Opportunity Zone Act ("Act")[71] and the first set of regulations produced by the Treasury did not address whether partners of a real estate partnership located in a QOZ (or partners of any qualified opportunity fund partnership) could receive a DFD without triggering gain and/or triggering other adverse tax consequences. The application of the disguised sale rules was likewise not addressed and thus neither was whether the application of such rules would disqualify the partners' original investments in the partnership from receiving beneficial treatment under the Act.

In general, real estate partnerships typically enhance the value real estate by constructing or substantially improving the building(s) or other property improvements. In the typical real estate partnership, once the building becomes sustainable (and worth a lot more than it was originally), the partnership will either take out a loan (or refinance an existing loan) and in turn their share of the refinanced debt increases the partners' bases in their partnership interest since any increase in a partner's share of liabilities is treated as a contribution of cash.[72] The partnership then typically distributes out the borrowed funds to the partners (this is known as a DFD), which distribution decreases the partner's outside tax basis in their respective interests. This distribution is tax-free to the extent it does not exceed each partner's adjusted tax basis in the partnership.

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[70] *See* Prop. Reg. § 1400Z2(c)-1(b)(2)(ii)

[71] Section 13823 of the Tax Cuts and Jobs Act of 2017 (Pub. L. No. 115-97, 131 Stat. 2054 (2017)), as amended, including Sections 1400Z-1 and 1400Z-2 of the Code.

[72] *Section* 752(a).

2. Second Guidance.

The Second Guidance clarified that partners get an increase in their outside tax basis for debt allocated to them under the normal partnership rules of Subchapter K of the Code and that DFDs may be made to the partners tax-free to the extent of their adjusted tax basis in the partnership. If the partners start with zero tax basis, [73] this means that the partners can be distributed an amount of money equal to the amount of debt that was allocated to them.

However, the Second Guidance goes on to provide that '[t]o the extent the transfer of property to a QOF partnership is characterized other than as a contribution (for example, as a sale for purposes of Section 707), the transfer is not a Section 1400Z-2(a)(1)(A) investment." These "disguised sale rules" seem to rely on the regulations under Regulations Section 1.707-3 (so that a DFD within the initial two-year period following the investment (the so-called "presumption period") may be treated as a disguised sale), but there remains some ambiguity in this area that needs further clarification. Specifically, confirmation is needed that the disguised sale rules will in fact apply within the initial two-year period of the investment, or presumption period, and that such application will disqualify the investment from receiving beneficial treatment under the Act. Likewise, we recommend greater clarity and guidance on DFDs after the initial two-year presumption period. Additionally, there should be appropriate exceptions or modifications to these rules for when a DFD will not be treated as a disguised sale, regardless of the time frame.

B. Recommendations

1. The apparent reliance in the Second Guidance on the disguised sale rules of Section 707 of the Code, it is clear that the disguised sale rules can apply to DFDs (and other types of distributions), and thus the two-year presumption period contained in Reg. Section 1.707-3 likely also applies.

2. We recommend that Treasury and the IRS adopt a two-year period for DFDs that provides a bright line rule that is easy to follow and apply, not to mention the fact that such a rule would be in line with the partnership rules already in existence.

3. Explanations

The typical real estate project probably take a minimum of about two years from initial investment to completion, and on average may run anywhere from two to five years from initial funding to issuance of a certificate of occupancy. Thus, the two-year presumption period under the disguised sale rules would probably not be unduly burdensome in the context of real estate partnerships formed to be QOFs.

If the two-year presumption period applies, it should be clarified that if a distribution is in fact treated as a disguised sale, then this will change the nature of the investment so that the amount does not qualify as an investment eligible for beneficial treatment under the Act. It should not matter whether the partner contributed cash or non-cash property to the partnership,

[73] *See* Section 1400Z-2(b)(2)(B) of the Code.

or whether the partnership distributes cash or non-cash property to the partner; under the second set of proposed regulations, the partner will be treated as having contributed non-cash property and thus the investment will be re-characterized under the disguised sale rules.

We note the following two examples in the Proposed Regulations:

> Example 3. Transfers to QOF partnerships. (i) Facts. A and B each realized $100 of eligible gain and each transfers $100 of cash to a QOF partnership. At a later date, the partnership borrows $120 from an unrelated lender and distributes the cash of $120 equally to A and B.
>
> Analysis. If the contributions had been of property other than cash, the contributions and distributions would have been tested under the disguised sale rules of §1.707-5(b) by, among other things, determining the timing of the distribution and amount of the debt allocated to each partner. Under paragraph (b)(10)(ii)(A)(2) of this Section, the cash of $200 ($100 from A and $100 from B) is treated as property that could be sold in a disguised sale transaction and each partner's share of the debt is zero for purposes of determining the amount of the investment. To the extent there would have been a disguised sale applying the rule of paragraph (b)(10)(ii)(A)(2)) of this Section, the amount of the investment would be reduced by the amount of the contribution so recharacterized.
>
> Example 10. Debt financed distribution--(i) Facts. On January 1, 2019, A and B form Q, a QOF partnership, each contributing $200 that is deferred under the Section 1400Z-2(a) election to Q in exchange for a qualifying investment. On November 18, 2022, Q obtains a nonrecourse loan from a bank for $300. Under Section 752, the loan is allocated $150 to A and $150 to B. On November 30, 2022, when the values and bases of the investments remain unchanged, Q distributes $50 to A.
>
> Analysis. A is not required to recognize gain under §1.1400Z2(b)-1(c) because A's basis in its qualifying investment is $150 (the original zero basis with respect to the contribution, plus the $150 debt allocation). The distribution reduces A's basis to $100.

The implication of Example 3 is that debt financed distributions must be tested under the disguised sale rules, although the Example does not reach a specific conclusion on this issue. Meanwhile, Example 10, with a gap of more than three years and ten months between the contribution of capital and the debt financed distribution, does not even raise the disguised sale rule – even to note that the presumption against a disguised sale applies. Better and clearer guidance would be strongly urged in this very important area.

After the two-year presumption period, it is unlikely that a DFD (or any distribution) will be treated as a disguised sale and thus will not re-characterize a partner's investment; the only remaining effect after this time will be when a distribution exceeds the partner's adjusted basis in the partnership. However, it should be noted that there is still uncertainty as to whether certain facts and circumstances exist that may nonetheless give rise to the presumption of a disguised

sale even after the two-year presumption period (for example, if it was determined with certainty from the initial investment that a distribution would be made to the partner). The Treasury should clarify and delineate what facts and circumstances will treat a DFD or other distribution as a disguised sale after the two-year presumption period has passed. It seems sensible to apply the body of law that already exists under the disguised sale rules and Subchapter K in general in this context and that is what the Treasury should follow in specifying these facts and circumstances.

As mentioned, the Treasury should also promulgate some exceptions or modifications to the disguised sale rules, regardless of the two-year presumption period. For example, the Second Guidance does not address whether DFDs provided as reimbursements for pre-formation/startup and operating expenses, as well as for reasonable preferred returns and guaranteed payments, may be treated as a disguised sale and thus disqualify the investment. Though it appears reasonable to assume that such DFDs will not be treated as a disguised sale under the rebuttable presumption rules, the Treasury should confirm this fact. Otherwise, these very common real estate partnership structures may be discouraged and investment in QOFs deterred.

XI. TREASURY REQUEST FOR COMMENTS ON IMPACT ON INCLUSION EVENT ON TAXPAYER'S RIGHT TO MAKE CERTAIN TAX ELECTIONS

This Section XI addresses the Treasury's broad request for comments on the impact of the enumeration of "inclusion events," as defined in Prop. Reg. 1.1400Z2(b)-1(c), on the taxpayer's right to make the elections set forth in Section 1400Z-2(c), Prop. Reg. 1.1400Z2(c)-1(b)(2)(i), and Prop. Reg. 1.1400Z2(c)-1(b)(2)(ii), and related issues.

A. Background

1. Status Prior to Issuance of Second Guidance

The three primary tax benefits available to a taxpayer under Section 1400Z-2 are the following:

1 Section 1400Z-2(b)(1): The exclusion of qualifying gain until the taxable year that includes the earlier of (A) the date on which such investment is ***sold or exchanged***, or (B) December 31, 2026 (herein, the "**Deferral Benefit"**);
2 Section 1400Z-2(b)(2): The amount of gain includible under Section 1400Z-2(a)(1)(B) is equal to the excess of (i) the lesser of either (a) the amount of qualifying gain excluded as a result of investment in a QOF or (b) the fair market value of the QOF investment over (ii) the taxpayer's tax basis in the QOF investment, where such tax basis may be increased by 10 percent or 15 percent of the qualifying gain if the QOF investment is held for 5 and 7 years, respectively (herein, the "**Basis Benefit**"). A taxpayer's eligibility to enjoy the Basis Benefit is determined by whether a qualifying QOF investment has been held by the taxpayer for 5 (or 7) years at the time gain is measured under the Deferral Benefit test of Section 1400Z-2(b)(1), i.e., the earlier of (A) the date on which such investment is ***sold or exchanged***, or (B) December 31, 2026.
3 Section 1400Z-2(c): In the case of any investment held by the taxpayer for at least 10 years and with respect to which the taxpayer makes an election under this clause, the basis of such

property shall be equal to the fair market value of such investment on the date that the investment is ***sold or exchanged*** (herein, the "**Outside Basis Election**").

Accordingly, whether a taxpayer can avail itself of these tax benefits is driven in part by when the qualifying investment is ***sold or exchanged***. Prior to the Second Guidance, it was unclear how to interpret the phrase "sold or exchanged." In fact, it would be natural that many investments held by QOFs would be aggregated, traded, and consolidated by investment advisors as a matter of ordinary practice, provided such transactions stayed within the overall framework of Section 1400Z-2.

Understanding what such advisors can and cannot do in maintaining an investment portfolio of QOFs, without risking forfeiture of the tax benefits of Section 1400Z-2, is critical to the successful administration of these investments.

2. Second Guidance

Events That Cause Inclusion of Deferred Gain (Inclusion Events)

In the Second Guidance, Treasury defined the date on which such investment is treated as sold or exchanged for purposes of determining eligibility for the Deferral Benefit and the Basis Benefit as an "inclusion event" and proceeded to list a number of transactions deemed to be inclusion events and a number of transactions deemed not to be inclusion events. While the inclusion events listed are subject to ongoing discussions, the Proposed Regulations affirmatively identified the transactions that Treasury considers to fall under the ***sold or exchanged*** language for purposes of the Deferral Benefit and the Basis Benefit, but remained largely silent on how to interpret ***sold or exchanged*** for purposes of the Outside Basis Election.

The following is the Treasury comment on events that cause inclusion of deferred gain:

> *Section 1400Z-2(b)(1) provides that the amount of gain that is deferred if a taxpayer makes an equity investment in a QOF described in Section 1400Z-2(e)(1)(A)(i) (qualifying investment) will be included in the taxpayer's income in the taxable year that includes the earlier of (A) the date on which the qualifying investment is sold or exchanged, or (B) December 31, 2026. By using the terms "sold or exchanged," Section 1400Z-2(b)(1) does not directly address non-sale or exchange dispositions, such as gifts, bequests, devises, charitable contributions, and abandonments of qualifying investments. However, the Conference Report to accompany H.R. 1, Report 115-466 (Dec. 15, 2017) provides that, under Section 1400Z-2(b)(1), the "deferred gain is recognized on the earlier of the date on which the [qualifying] investment is disposed of or December 31, 2026." See Conference Report at 539.*
>
> *The proposed regulations track the disposition language set forth in the Conference Report and clarify that, subject to enumerated exceptions, an inclusion event results from a transfer of a qualifying investment in a transaction to the extent the transfer reduces the taxpayer's equity interest in the qualifying investment for Federal*

income tax purposes. Notwithstanding that general principle, and except as otherwise provided in the proposed regulations, a transaction that does not reduce a taxpayer's equity interest in the taxpayer's qualifying investment is also an inclusion event under the proposed regulations to the extent the taxpayer receives property from a QOF in a transaction treated as a distribution for Federal income tax purposes. For this purpose, property generally is defined as money, securities, or any other property, other than stock (or rights to acquire stock) in the corporation that is a QOF (QOF corporation) that is making the distribution. The Treasury Department and the IRS have determined that it is necessary to treat such transactions as inclusion events to prevent taxpayers from "cashing out" a qualifying investment in a QOF without including in gross income any amount of their deferred gain.

Based upon the guidance set forth in the Conference Report and the principles underlying the "inclusion event" concept described in the preceding paragraphs, the proposed regulations provide taxpayers with a nonexclusive list of inclusion events, which include:

[List set forth in Proposed Regulations excluded in this Comment.]

Each of the previously described transactions would be an inclusion event because each would reduce or terminate the QOF investor's direct (or, in the case of partnerships, indirect) qualifying investment for Federal income tax purposes or (in the case of distributions) would constitute a "cashing out" of the QOF investor's qualifying investment. As a result, the QOF investor would recognize all, or a corresponding portion, of its deferred gain under Section 1400Z-2(a)(1)(B) and (b).

1. Treasury Request for Comments.

Treasury and IRS request comments on the proposed rules regarding the inclusion events that would result in a QOF investor recognizing an amount of deferred gain under Section 1400Z-2(a)(1)(B) and (b), including the pledging of qualifying investments as collateral for nonrecourse loans.

B. Recommendations

1. We agree generally with Treasury's identification and enumeration of inclusion events as a means to provide clarity on which transactions undertaken by the taxpayer could potentially be treated as a **sale *or exchange*** under Section 1400Z-2(a)(2)(B) and thus risk loss of the Deferral Benefit or the Basis Benefit.

2. We recommend that Treasury confirm in final regulations that, under Prop. Reg. Section 1.1400Z2(c)-1(b)(2)(i), the right to enjoy a step-up in outside tax basis under 1400Z-2(c) after the end of a ten-year holding period for a QOF applies without regard to the amount of deferred gain that was included under Section 1400Z-2(b)(1) or the timing of that inclusion, and thereby confirm that an inclusion event that terminates the Deferral Benefit and the Basis Benefit does not terminate the Outside Basis Election.

C. Explanation

In elaborating on its definition of inclusion events, the Treasury indicated that the Proposed Regulations are intended to "track the ***disposition*** language set forth in the Conference Report and clarify that, subject to enumerated exceptions, an inclusion event results from a taxpayer of a qualifying investment in a transaction to the extent the transfer reduces the taxpayer's equity interest in the qualifying investment for Federal income tax purposes." The Conference Report's use of ***disposition*** language tracks to its discussion of the Deferral Benefit and the Basis Benefit, however the subsequent discussion of the Outside Basis Election, and use of ***sale or exchange*** (as opposed to ***disposition***), suggests and supports an intention on the part of Congress to distinguish how the benefits of Section 1400Z-2 should be impacted differently depending on whether the transaction undertaken by the taxpayer is in the nature of a disposition versus a sale or exchange.[74]

We note that many of the inclusion events fall outside the conventional definition of transactions that qualify as ***sold or exchanged*** (*e.g.*, transfer of an investment in a QOF by gift under Prop. Reg. 1.1400Z2(b)-1(c)(3) or distribution by a QOF partnership to a partner under Prop. Reg. 1.1400Z2(b)-1(c)(6)(iii)).

Proposed Regulations Section 1.1400Z2(c)-1(b)(2)(i) states as follows:

> (i) Dispositions of qualifying QOF partnership interests. If a QOF partner's basis in a qualifying QOF partnership interest is adjusted under Section 1400Z-2(c),

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[74] H.R. 1, Report 115-466 (Dec. 15, 2017) in relevant point is provided below:

If the investment in the qualified opportunity zone fund is held by the taxpayer for at least five years, the basis on the original gain is increased by 10 percent of the original gain. If the opportunity zone asset or investment is held by the taxpayer for at least seven years, the basis on the original gain is increased by an additional 5 percent of the original gain. The deferred gain is recognized on the earlier of the date on which the qualified opportunity zone investment ***is disposed of or December 31, 2026***. Only taxpayers who rollover capital gains of non-zone assets before December 31, 2026, will be able to take advantage of the special treatment of capital gains for non-zone and zone realizations under the provision.

The basis of an investment in a qualified opportunity zone fund immediately after its acquisition is zero. If the investment is held by the taxpayer for at least five years, the basis on the investment is increased by 10 percent of the deferred gain. If the investment is held by the taxpayer for at least seven years, the basis on the investment is increased by an additional five percent of the deferred gain. If the investment is held by the taxpayer until at least December 31, 2026, the basis in the investment increases by the remaining 85 percent of the deferred gain.

The second main tax incentive in the bill excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years. Specifically, ***in the case of the sale or exchange*** of an investment in a qualified opportunity zone fund held for more than 10 years, at the election of the taxpayer the basis of such investment in the hands of the taxpayer shall be the fair market value of the investment at the date ***of such sale or exchange***. Taxpayers can continue to recognize losses associated with investments in qualified opportunity zone funds as under current law.

See Conference Report at 539 (emphasis added).

then the basis of the partnership interest is adjusted to an amount equal to the fair market value of the interest, including debt, and immediately prior to the sale or exchange, the basis of the QOF partnership assets are also adjusted, such adjustment is calculated in a manner similar to a Section 743(b) adjustment had the transferor partner purchased its interest in the QOF partnership for cash equal to fair market value immediately prior to the sale or exchange assuming that a valid Section 754 election had been in place. *This paragraph (b)(2)(i) applies without regard to the amount of deferred gain that was included under Section 1400Z-2(b)(1), or the timing of that inclusion.*

We understand that the italicized language above reflects the distinctions expressed in the legislative history set forth in footnote 74, and confirms that an inclusion event is considered a disposition that terminates the Deferral Benefit and the Basis Benefit, but does not constitute a sale or exchange that would terminate a taxpayer's right to enjoy the Outside Basis Election.

We again thank the Department of Treasury and the Internal Revenue Service for the excellent overall guidance provided in the second set of Proposed Regulations under Section 1400Z-2, and we hope these comments can be helpful in formulating and publishing final regulations.

Yours very truly,

Professor Joseph B. Darby III
Boston University School of Law
Graduate Tax Program
Direct Dial: (617) 338-2985
jbdarby@sullivanlaw.com

Professor Susan A. Atlas
Boston University School of Law
Graduate Tax Program
Direct Dial: (978) 244-9292
satlas@susanatlaslaw.com