June 28, 2019

The Honorable Steven Mnuchin
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution, Avenue, N.W.
Washington, D.C. 20224

RE: Guidance Regarding Investing in Qualified Opportunity Funds (REG-120186-18)

Dear Secretary Mnuchin and Commissioner Rettig:

On behalf of the members of the Institute for Portfolio Alternatives (the "***IPA***"), we write to highlight certain critical issues regarding the second set of Proposed Treasury Regulations for investments in qualified opportunity funds ("***QOFs***") under Section[1] 1400Z-2 of the Internal Revenue Code. The IPA is an organization that provides national leadership for the portfolio diversifying investments industry by bringing together the investment managers, broker-dealers, investment advisers and industry service professionals who are dedicated to driving transparency and innovation in the marketplace.

Section 1400Z-2 is designed to encourage economic growth and investment in designated distressed communities (known as "qualified opportunity zones," or "***QOZs***") by providing certain U.S. federal income tax benefits to taxpayers who invest in businesses located within a QOZ through a QOF. We believe the Treasury should preserve the purpose and Congressional intent behind Section 1400Z-2 by addressing the following issues in additional regulatory guidance or via a new Revenue Ruling, as appropriate, for each issue:

(i) providing clarification that sales of QOF interests and sales of assets held (directly and indirectly) by QOFs should receive the same treatment for purposes of Section 1400Z-2(c);

(ii) providing guidance that Section 1231 gains can be invested outside the six-month period following the end of a tax year;

(iii) providing clarification that (A) "substantial improvement" is measured on an aggregate rather than an asset-by-asset basis, and that (B) property can be replaced instead of improved for purposes of satisfying the substantial improvement requirement;

(iv) providing a mechanism, consistent with existing mechanisms under Code Sections 1031 or 1033, to allow QOFs (including investors in QOF partnerships and S corporations) to defer gain from a disposition of QOZ property so long as the proceeds of such disposition are reinvested during a "reasonable period of time" as contemplated in the statute;

(v) providing clarification relating to the potential allocation of Section 704(b) income with an artificially high residual allocation percentage;

[1] Unless noted otherwise, all section references provided for herein refer to the Internal Revenue Code of 1986, as amended (the "***Code***"), and the Treasury Regulations promulgated thereunder.

(vi) providing clarification that property contributed to a QOF as permitted under Prop. Reg. Section 1.1400Z2(a)-1(b)(9) can constitute QOZ business property under Section 1400Z-2(d)(2)(D)(i);

(vii) providing clarification relating to the disguised sale rule as it applies to a QOF's distribution within two years of the original contribution;

(viii) providing clarification that inclusion events exclude not only Section 721 partnership contributions but also transactions that are similar in nature;

(ix) providing clarification relating to the tests used for property straddling a QOZ, which are different in the Preamble (relative costs) and the text (relative square footage);

(x) providing clarification on whether the real property straddling rule applies in determining whether a property is located within a QOZ for purposes of qualifying as QOZ business property;

(xi) providing clarification on how a QOZ business can satisfy the "active conduct of a trade or business" requirement of Section 1400Z-2(d)(3)(A)(ii) with respect to start-up and net leasing activities;

(xii) providing guidance that the use of property in a QOZ that has been vacant or unused for an uninterrupted period of at least one year, including the date of designation of that QOZ, may be treated as original use;

(xiii) providing clarification relating to whether investors get "at risk" basis for their QOZ investments;

(xiv) providing clarification relating to whether personal use property may be acquired and qualify as original use even though such property is not subject to depreciation;

(xv) providing clarification relating to whether entering into a lease extension is treated as entering a new lease under the QOZ rules;

(xvi) providing clarification that gain will be automatically eliminated unless an investor elects the income to be taxable;

(xvii) providing clarification relating to when a non-qualifying QOF fails; and

(xviii) providing clarification relating to how the 90% test will be measured with respect to selling commissions and offering expenses.

1. Equal tax treatment for sales of QOF interests and sales of QOF assets: provide clarification that sales of QOF interests and sales of assets held (directly and indirectly) by QOFs should receive same treatment for purposes of Section 1400Z-2(c)

Section 1400Z-2(c) provides that, in the case of any investment held by a taxpayer for at least 10 years (and with respect to which the taxpayer makes an election under this section), the basis of the property shall be equal to the fair market value of the investment on the date of disposition. Although the statute does not require it, the Proposed Treasury Regulations create different tax treatment for the disposition of interests in QOFs that are partnerships or S corporations, and dispositions of assets held (directly and indirectly) by such QOFs, which taken together hamstring the ability of QOF investors to take advantage of the intended benefits of the QOF rules.

First, Prop. Reg. Section 1.1400Z2(c)-1(b)(2)(ii)(A)(1) provides that if an investor has held an interest in a partnership or S corporation QOF for the 10-year period required by Section 1400Z-2(c), the investor is allowed to "exclude from gross income some or all of the capital gain arising from such disposition." This is in contrast to the rule for dispositions of interests in QOF partnerships and S corporations, set forth at Prop. Reg. Section 1.1400Z2(c)-1(b)(2)(i) which clarifies that Section 1400Z-2(c) applies to all elements of income that arise in the event of a disposition that satisfies the 10-year holding period requirement of the statute. Second, Prop. Reg. Section 1.1400Z2(c)-1(b)(2)(ii)(A)(1) further complicates dispositions by applying the gain exclusion rule only to dispositions by partnership or S corporation QOFs of their "qualified opportunity zone property," *i.e.*, pursuant to Section 1400Z-2(d)(2), their interests in QOZ stock, QOZ partnership interests or directly owned QOZ business property.

We believe that Section 1400Z-2(c) should be implemented in a way that does not discriminate in its application between sales of interests in partnership or S corporation QOFs and sales of QOZ property or businesses, whether undertaken directly or indirectly by such QOFs. Finalization of the Proposed Treasury Regulations in their current form could lead to significant economic disadvantages to QOF investors. For a variety of business and tax reasons (such as management of successor liability risk, and maximizing tax benefits), buyers of real estate and other businesses commonly prefer to execute transactions through asset acquisitions as opposed to acquisitions of interests in entities that hold those assets, whether directly or indirectly. If QOF investors are provided the full benefit of Section 1400Z-2(c) only by selling interests in a QOF, those investors will commonly be subject to meaningful purchase price discounts that will have the net effect of discouraging efficient use of the QOZ program. In addition, multiple-asset QOFs will be disadvantaged because the only way to maximize the benefits will be to sell all the assets to one buyer by selling the interests in the QOF.

We recommend the following changes to the Proposed Treasury Regulations:

(a) Revise Prop. Reg. Section 1.1400Z2(c)-1(b)(2)(ii)(A)(1) to provide that the gross income exclusion applies to all elements of gross income, not just capital gain, arising from a transaction in the underlying assets of a partnership or S corporation QOF in a manner consistent with the operation of Prop. Reg. Section 1.1400Z2(c)-1(b)(2)(i) with respect to the disposition of interests in such QOFs. This could be achieved by using a deemed Section 743(b) adjustment mechanism already provided for under Prop. Reg. Section 1.1400Z2(c)-1(b)(2)(i) with respect to dispositions of interests in QOF partnerships and S corporations.

(b) Revise Prop. Reg. Section 1.1400Z2(c)-1(b)(2)(ii)(A)(1) to clarify that the exclusion applies to gross income arising from all dispositions of "qualified opportunity zone property," including dispositions of such property by entities the ownership interests in which constitute "qualified opportunity zone partnership interests" or "qualified opportunity zone stock" pursuant to Section 1400A-2(d)(2), to the extent such gross income is reported on a K-1 issued to a partnership or S corporation QOF.

2. Investment period for Section 1231 property: provide clarification that Section 1231 gains can be invested outside the six-month period following the end of a tax year

The Proposed Treasury Regulations indicate that because the amount of capital gain income from Section 1231 property can be determined only on the last day of the taxable year, the 180 day period for investing such capital gain into a QOF begins on the last day of the taxable year. We believe that this policy is too restrictive and should be re-considered. We believe that it is preferable from an investment standpoint if investors were able to invest gain from the sale of property used in a trade or business within 180 days of the sale date. Most investors have a reasonable understanding of their anticipated gains or losses for the remaining year when they sell Section 1231 property. We believe it would be preferable to allow investors to invest such gain within 180 days of the sale date and in the event the investor does not have sufficient Section 1231 gain at the end of the year, such taxpayer would just have a lower qualifying investment into the QOF. This

benefits the investors because it gives potential investors more flexibility with respect to their investments. In addition, there is no downside or any policy reason to not make this change because in the event the taxpayer does not actually have sufficient Section 1231 gain, the investor just made a non-qualifying investment into a QOF.

3. Substantial improvement: provide clarification that (A) "substantial improvement" is measured on an aggregate rather than an asset-by-asset basis, and that (B) property can be replaced instead of improved for purposes of satisfying the substantial improvement requirement

The Proposed Treasury Regulations provide that in determining whether a property is substantially improved the determination must be made on an asset-by-asset basis. Although this may be the best test with respect to certain real estate projects, it does not work well for operating businesses. Even quasi-real estate assets that are also businesses, such as hotels, will have a difficult time complying with these requirements. We suggest that this test be based on an aggregate approach.

Upon the acquisition of a business, many of the assets used in the business may not be in a position that they can be improved. For example, in a hotel acquisition it would be difficult to substantially improve the towels and the linens. Further, we believe that a substantial improvement should include the replacement of the asset. In a business acquisition, assets will typically be replaced and not improved.

4. Gain deferral for disposition and reinvestment of QOZ property: provide a mechanism, consistent with existing mechanisms under Code Sections 1031 or 1033, to allow QOFs (including investors in QOF partnerships and S corporations) to defer gain from a disposition of QOZ property so long as the proceeds of such disposition are reinvested during a "reasonable period of time" as contemplated in the statute

Section 1400Z-2(e)(4)(B) provides that "[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including … rules to ensure a qualified opportunity fund 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 reinvestment proceeds received from the sale of or disposition of qualified opportunity zone property…".

Notwithstanding this broad grant of regulatory authority, the Treasury Department interpreted its mandate narrowly and, in Prop. Reg. Section 1.1400Z-2(f)(1)(b), provided only that the status of a QOF as such, for purposes of the 90% asset test of Section 1400Z-2(d)(1), would not be negatively impacted by a disposition of qualified QOZ property so long as the proceeds from such disposition are continuously held in cash or equivalents and reinvested in other QOZ property on or before the last day of the 12-month period following such disposition. In the accompanying preamble to this Proposed Regulation, the Treasury Department specifically requested commenters to provide, among other things, "prior examples of tax regulations that exempt realized gain from being recognized under [Code] section 1001(c) or 61(a)(3) by a taxpayer … without an operative provision of subtitle A of the code expressly providing for nonrecognition treatment…".

While we appreciate the Treasury Department's restraint, and welcome the 12-month exception to the 90% asset test provided for in Prop. Reg. Section 1.1400Z2(f)-(1)(b), the fact of the matter is that failure to provide a mechanism to defer income tax in a disposition/reinvestment transaction described in Section 1400Z-2(e)(4)(B) will render the statute a dead letter. As to the Treasury Department's request for examples of tax regulations that expand the ambit of their related underlying sections of the Code, the clearest example of this is in Section 1031. Section 1031 provides no guidance regarding tax free exchanges other than those directly occurring between two taxpayers. Nevertheless, Reg. Section 1.1031(k)-1 created an entire ecosystem of qualified intermediaries and elaborate rules regarding the identification and

timing of the acquisition of replacement property, and in doing so converted Section 1031 from a limited-use tax deferral mechanism into a powerful investment tool that plays a meaningful role in the American real estate economy.

We recommend that Prop. Reg. Section 1.1400Z2(f)-(1)(b) be revised to provide, analogous to the function of exchanges under Section 1033, the income tax consequences that would otherwise arise from a disposition described therein are deferred so long as the rules currently set forth in Prop. Reg. Section 1.1400Z2(f)-(1)(b) are observed.

5. Profits interest: allocation of Section 704(b) income: provide clarification relating to the potential allocation of Section 704(b) income to profits interest with an artificially high residual allocation percentage

The final Treasury Regulations should clarify how Section 704(b) income should be allocated to a profits interest in the case of a mixed investment. The Proposed Treasury Regulations provide that income, loss, and Section 752 debt allocations are shared based on "allocation percentages" that compare the relative capital contributions between the two categories of investments, subject to Section 704(c) principles for a QOF partnership and by allocating a profits interest the highest percentage interest in residual profits attributable to the interest. Because a profits interest receives an allocation percentage equal to the highest possible residual profit share, it may receive a percentage that is higher than that to which it might economically be entitled. We recommend that this discrepancy be addressed in the final regulations.

6. Carryover basis contribution of in-kind property: provide clarification that property contributed to a QOF as permitted under Prop. Reg. Section 1.1400Z2(a)-1(b)(9) can constitute QOZ business property under Section 1400Z-2(d)(2)(D)(i)

The Proposed Treasury Regulations provided helpful guidance to investors and QOFs concerning the treatment of contributions of property to QOFs. Having established these rules, however, what remains unclear, and a source of significant uncertainty, is whether such contributed property can constitute "qualified opportunity zone business property" within the meaning of Section 1400Z-2(d)(2)(D)(i). This is due to the requirement that such property must be "acquired by purchase" as defined in Section 179(d)(2), which excludes property acquired in a carryover basis transaction. While Section 1400Z-2(d)(3) allows up to 30% of the tangible property of a QOZ business not to constitute QOZ business property, issues around the period of time that a QOZ business must qualify as such (90% of an uncertain time frame under the Proposed Treasury Regulations) as applied to the likely common use of contributed property (*e.g.*, as seed assets for development) render the uncertainty around the treatment of contributed property problematic from a QOF planning perspective.

We recommend that this issue be resolved by clarifying that tangible property contributed to a QOF as provided under the Proposed Treasury Regulations and that is used in a QOZ business (or is acquired for such purpose) be treated as QOZ business property for purposes of Section 1400Z-2(d)(2)(D)(i).

7. Disguised sale rule: provide clarification relating to the disguised sale rule as it applies to a QOF's distribution within two years of the original contribution

The final Treasury Regulations should clarify how a QOF can make distributions within two years of an original contribution without disqualifying the original eligible investment. The disguised sale rules create a rebuttable presumption that all distributions from a QOF within two years from the original contribution disqualify the original eligible investment, even if the cash is funded from a pro rata debt-financed distribution. The final regulations should provide a further safe harbor to clarify how and when distributions made within two years of an original contribution will not be treated as a disguised sale.

8. Exclusions from inclusion events: provide clarification that inclusion events exclude not only Section 721 partnership contributions but also transactions that are similar in nature

The Proposed Treasury Regulations exclude Section 721 partnership contributions from inclusion events. In expansion of the roll-over transaction, the scope of such exclusion should include other transactions that are similar in nature. For example, a fund formed as a REIT should be able to merge into another REIT without triggering an inclusion event if it is structured appropriately and continues to satisfy other QOZ requirements. We recommend that the final regulations clarify and expand the scope of the permitted transactions under the rules for inclusion events.

9. Tests for real property straddling QOZs: provide clarification relating to the tests used for property straddling a QOZ, which are different in the Preamble (relative costs) and the text (relative square footage)

The Proposed Treasury Regulations clarify that some real property straddling a QOZ may be treated as located within the QOZ for purposes of satisfying the 50% gross income requirement. However, two seemingly conflicting tests are provided. First, the text provides that the amount of *square footage* of the real property located within the outside the QOZ should be compared; on the other hand, the Preamble provides that the *unadjusted cost* of the real property inside and outside the QOZ should be compared. The Proposed Treasury Regulations must be supplemented with additional guidance clarifying which rule applies to the taxpayers, as well as whether the tests are applied before or after development (*e.g.*, whether the square footage test looks only to the square footage of the land itself or also the developed square footage of the property).

10. Real property straddling rule for QOZ business property requirement: provide clarification on whether the real property straddling rule applies in determining whether a property is located within a QOZ for purposes of qualifying as QOZ business property

The Proposed Treasury Regulations provide rules for real property straddling a QOZ, but such rules apply specifically to the 50% gross income requirement. The Proposed Treasury Regulations should be supplemented with further guidance on whether the same rule applies to real property straddling a QOZ for purposes of qualifying as QOZ business property.

11. Active conduct of a trade or business for start-up and net leasing activities: provide clarification on how a QOZ business can satisfy the "active conduct of a trade or business" requirement of Section 1400Z-2(d)(3)(A)(ii) with respect to start-up and net leasing activities

Section 1400Z-2(d)(3)(A)(ii) requires, by reference to Section 1397C(b), that a QOZ business must involve the active conduct of a trade or business in a QOZ. While the Proposed Treasury Regulations have provided helpful guidance, particularly with respect to operating businesses, two areas in particular merit further amplification.

First, given that the majority of QOZ businesses will be start-up businesses involved in an intense early period of pre-operational capital investment (a fact acknowledged by the Treasury Department in its 31-month grace period for the deployment working capital pursuant to a written plan), clarification would be welcome that the active conduct of a trade or business requirement is deemed satisfied during the period covered by any written plan for the deployment of working capital satisfying the requirements of the Proposed Treasury Regulations.

Second, we note that the Proposed Treasury Regulations provide that a "trade or business" is defined by reference to Section 162, but also state, with respect to the operation of real estate, that "merely entering into a triple-net-lease with respect to real property owned by the taxpayer is not the active contact of a trade or business by such taxpayer." While this guidance parallels guidance published by the Treasury Department with respect to the pass-through deduction under

Section 199A, it is difficult for taxpayers to deploy in real-world leasing activity. Clarification would be welcome that a taxpayer who retains contractual responsibility for meaningful capital obligations (*e.g.*, the obligation to maintain building roof, structure and/or operating systems) or meaningful operating obligations (*e.g.*, the obligation to provide cleaning, groundskeeping or similar services) has not entered into a triple-net lease within the meaning of the Proposed Treasury Regulations.

12. Vacancy period requirement for original use: provide clarification that the use of property in a QOZ that has been vacant or unused for an uninterrupted period of at least one year, including the date of designation of that QOZ, may be treated as original use

The final regulations should impose a one-year vacancy requirement for purposes of meeting the original use test. The final regulations for Enterprise Zone Facility Bonds issued by state and local governments imposed a one-year vacancy requirement: "if real 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."

The Treasury and IRS may be concerned that real property owners may leave an asset vacant on purpose if a shorter vacancy requirement is in place, but they are not likely to let a building remain vacant because of the substantial cost (*e.g.*, foregone rents). As such, only the properties not generating significant revenue are likely to be left vacant. If the final regulations impose a one-year vacancy period for the original test, such properties may become viable QOZ investments.

We recommend that the final regulations modify the rule so that the five-year (or shorter) vacancy period becomes a safe harbor and a one-year vacancy period becomes the requirement for original use. If the buildings are vacant for less than the safe harbor period but at least one year, then the taxpayers would have to demonstrate that the buildings were vacant for a reason other than to qualify the building for QOZ benefits (*e.g.*, changes in zoning laws, market conditions, structural defects, natural disasters, etc.).

13. "At-risk" basis: provide clarification relating to whether investors get "at risk" basis for their QOF investments

The Proposed Treasury Regulations provide that investors who make qualified investments will have a zero basis in their investments. The Proposed Treasury Regulations also indicate that the basis is determined without regard to any liability allocated under Section 752. There is uncertainty under the Proposed Treasury Regulations as to whether investors will be considered "at risk" under Section 469 with respect to their capital contributions. We believe the Proposed Treasury Regulations should clarify that as a result of the fact that investors are making a true economic investment into the QOFs, the "at risk" rules should treat these capital contributions as qualifying investments under the "at risk" rules.

14. Original use of property used for non-business purposes: provide clarification relating to whether personal use property may be acquired and qualify as original use even though such property is not subject to depreciation

The Proposed Treasury Regulations provide that the "original use" of property acquired by purchase begins when the property is first placed in service in a QOZ for purposes of depreciation or amortization. The Proposed Treasury Regulations should make it clear that property used for non-business purposes, such as property use for personal purposes as opposed to business purposes, will also be treated as property whose original use began in the QOZ if acquired.

15. Lease extension as new lease: provide clarification relating to whether entering into a lease extension is treated as entering a new lease under the QOZ rules

The Proposed Treasury Regulations indicate that entering into a lease will qualified as the acquisition of tangible property for purposes of the QOF provisions. It is unclear under the Proposed Treasury Regulations whether entering into a renewal of a lease would be considered as qualifying under the QOF provisions. We believe that entering into a lease renewal where the renewal is at fair market value should be treated the same as entering into a new lease. It should be indifferent if a QOF cancels an existing lease and enters into a new lease or just renews an existing lease.

16. Automatic elimination of gain without election: provide clarification that gain will be automatically eliminated unless an investor elects the income to be taxable

Under the Proposed Treasury Regulations an investor that has made an election to invest qualified capital gain into a QOF can make an election to exclude the gain recognized upon a sale of the QOF investment. In addition, if a QOF sells a QOZ property after the ten-year holding period a taxpayer can make an election to exclude the gain upon such sale. These provisions should be adjusted so that the income is automatically excluded unless a taxpayer elects to include the income. This is just a tax trap for the uneducated.

17. Non-qualifying QOF: provide clarification relating to when a non-qualifying QOF fails

The Proposed Treasury Regulations provide for a statutory penalty in the event that a QOF fails to qualify under the applicable QOF provisions. However, there is no provision which indicates when a QOF actually fails under the rules. Are QOFs allowed to just pay the penalty and not qualify for the entire 10 year period? There should be guidance as to when a QOF would permanently fail. We would suggest that a QOF that fails to meet the requirements for a 3-year period would no longer be eligible for the QOF benefits.

18. 90% test for selling commission and offering expenses: provide clarification relating to how the 90% test will be measured with respect to selling commissions and offering expenses

A QOF must hold at least 90% of its assets in QOZ Property. The value of each asset must be determined under Section 1012 of the Code unless the Financial Statement Valuation Method applies. It is uncertain under the Proposed Treasury Regulation how the 90% test will be measured with respect to selling commissions and offering expenses. In some broker-dealer transactions the selling commissions and organization and offering expenses could be as high as between 10 and 12%. Thus, if the payment of these commissions and offering expenses would be included as an asset in determining the 90% test, most of the QOFs that are syndicated through broker-dealers would fail to qualify. We suggest that the Treasury Regulations make it clear that in determining the 90% test sales commissions and offering expenses paid on the sale of interests in the QOF will be excluded from the numerator and the denominator for purposes of the 90% test.

* * *

Thank you for your consideration of these comments. We look forward to the opportunity to discuss these issues further during the public hearing scheduled for July 9, 2019.

Respectfully submitted,

Anthony Chereso
President and Chief Executive Officer
Institute for Portfolio Alternatives

cc: David J. Kautter, Assistant Secretary, Office of Tax Policy, U.S. Department of the Treasury
Erika C. Reigle, Attorney (Income Tax and Accounting), Internal Revenue Service
Kyle C. Griffin, Attorney (Income Tax and Accounting), Internal Revenue Service
Daniel F. Cullen, Esq., Partner, Baker & McKenzie LLP
Catherine Lyons, Manager of Policy and Coalitions, Economic Innovation Group
Steven Meier, Esq., Partner, Seyfarth Shaw LLP
Darryl Steinhause, Esq., Partner, DLA Piper LLP