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: Treasury Department's Hearing on Second Set of Qualified Opportunity Zone Regulations

Dear Secretary Mnuchin and Commissioner Rettig:

Accompanying this letter you will find a copy of our written testimony submitted on behalf of the Institute for Portfolio Alternatives (IPA) in connection with the Treasury Department's hearing scheduled to occur on July 9, 2019 regarding the second set of proposed and pending Qualified Opportunity Zone regulations.

With Kind Regards,

Daniel F. Cullen, Esq.
Partner
Baker & McKenzie LLP

Darryl Steinhause, Esq.
Partner
DLA Piper LLP

Encl. Exhibit - Written Testimony of Daniel F. Cullen, Esq. and Darryl Steinhause, Esq. for the Treasury Department's Hearing on the Second Set of Qualified Opportunity Zone Regulations, Submitted on Behalf of the IPA.

<u>Exhibit</u>

Written Testimony of Daniel F. Cullen, Esq. and Darryl Steinhause, Esq. for the Treasury Department's Hearing on the Second Set of Qualified Opportunity Zone Regulations Submitted on Behalf of the IPA

Opening Remarks

Good morning. My name is Dan Cullen, and I'm a partner at Baker & McKenzie LLP in Chicago, and a Director at the Institute for Portfolio Alternatives, or the IPA. And, my name is Darryl Steinhause, a partner at DLA Piper LLP in San Diego. Today we're speaking on behalf of the IPA, which represents approximately 200 member companies and over 1,500 individual members involved in all aspects of the nation's portfolio diversifying investments industry. The IPA brings together the investment managers, broker-dealers, investment advisers and industry service professionals who are dedicated to driving transparency and innovation in the marketplace.

On behalf of the IPA, we appreciate the time and effort that the Treasury Department and the IRS have devoted to developing the QOZ proposed regulations, as well as the opportunity to speak to you today with respect to the second set of the proposed and pending QOZ regulations. Our testimony today highlights some of the key issues from our comment letter.

The Key Issues

First, we ask for clarification that sales of QOF interests and sales of assets, held by QOFs directly and indirectly, 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.

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.

Second, we seek clarification that "substantial improvement" is measured on an aggregate rather than an asset-by-asset basis, and that 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.

Third, we seek clarification relating 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.

Finally, we ask for 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, in a tax-deferred transaction, 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.

Closing Remarks

Thank you, again, for the opportunity to present this testimony today on behalf of the IPA. The IPA looks forward to continuing to work with the Treasury and the IRS as you move forward to finalize the proposed regulations, and we will be happy to answer any questions you may have.