Forum on Affordable Housing & Community Development Law
MS 18.2
321 N. Clark Street
Chicago, Illinois 60654
Phone (312) 988-5660
www.americanbar.org/groups/affordable_housing

July 1, 2019

CC:PA:LPD:PR (REG-115420-18) Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044
Attention: Erika C. Reigle of the Office of Associate Chief Counsel (Income Tax and Accounting), Kyle C. Griffin of the Office of Associate Chief Counsel (Income Tax and Accounting)

Michael Novey, U.S. Department of the Treasury,
Michael.Novey@Treasury.gov

and uploaded to the Federal Rulemaking Portal at
https://www.regulations.gov/document?D=IRS-2019-0022-0001

Re: Guidance Regarding Investing in Qualified Opportunity Funds (Reg-120186-18)

Dear Ms. Reigle, Mr. Griffin and Mr. Novey:

Enclosed please find comments with respect to the proposed regulations regarding investments in qualified opportunity funds under Section 1400Z-2. These comments are submitted on behalf of the Forum of Affordable Housing and Community Development Law and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly should not be construed as representing the position of the Association.

The Forum would be pleased to discuss these comments with you or your staff.

Sincerely,

George Weidenfeller
Chair, Forum of Affordable Housing and Community Development Law
Washington, DC

Enclosure

COMMENTS TO SECOND TRANCHE OF QUALIFIED OPPORTUNITY ZONE REGULATIONS[1]

I. OVERVIEW

II. QUALIFIED OPPORTUNITY ZONE BUSINESS

A. Clarification Regarding Grace Period to Qualify and Expected Working Capital

III. QUALIFIED OPPORTUNITY ZONE BUSINESS PROPERTY

A. Satisfaction of the Original Use Test for LIHTC Projects
B. Election to Aggregate Assets for Satisfying the Substantial Improvement Test
C. Treatment of Improvements as Separate Property for Qualification as QOZBP
D. Self-constructed Property and Treatment of Related Party Fees

IV. RECOGNITION OF GAIN IN 2026

A. Measurement of Gain Recognized in 2026 Under Special Partnership/Sub S Rule

V. 10-YEAR FAIR MARKET VALUE BASIS ELECTION

A. Treatment of Debt in Basis Step-up
B. Inclusion Event Does Not Preclude Basis Step-up
C. Consistency for Sales of QOF/Qualified Partnership Interest/Project

VI. ELIGIBLE CAPITAL GAINS

A. Section 1231 Gains
B. QOF Investments by Consolidated Groups

---

[1] We have used various acronyms in this letter for technical terms defined in Sections 1400Z-1 and 1400Z-2. To ensure clarity, we include a glossary of these terms:
QOF refers to a "qualified opportunity fund" as defined in Section 1400Z-2(d)(1).
QOZB refers to "qualified opportunity zone business" as defined in Section 1400Z-2(d)(3).
QOZP refers to "qualified opportunity zone property" as defined in Section 1400Z-2(d)(2)(A).
QOZBP refers to "qualified opportunity zone business property" as defined in Section 1400Z-2(d)(2)(D).
Opportunity Zone or ***OZ*** refers to a "qualified opportunity zone" as defined in Section 1400Z-1(a).

I. OVERVIEW

These comments (the "Comments") are submitted on behalf of the American Bar Association Forum on Affordable Housing and Community Development Law (the "Forum") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association. The Comments were prepared by Forum's Tax Credit and Equity Financing Committee and the primary authors were Glenn Graff, Forrest Milder, and Brad Tomtishen. The Comments were reviewed by B. Susan Wilson and the following Forum Governing Committee members and liaisons: Schuyler Armstrong, Althea J.K. Broughton, Patience Crowder, Jill Goldstein, Michael Hopkins, Hilary Jaffe, Tim Iglesias, Margaret Jung, Kelly Rushin Lewis, Amy McClain, Sarah Molseed, Sarah Perez, Dan Rosen, and George Weidenfeller.

As practitioners focused on affordable housing and community development, we observe a number of difficulties in combining Opportunity Zone incentives and existing tax incentives in a synergistic way to increase affordable housing and community development. There is an opportunity to reduce those difficulties through the proposals set forth in this letter, but there is also a risk that without an increased focus on coordination of tax incentives, the OZ incentives may have a net negative effect on low-income residents and their existing communities.

Socially motivated projects intended to benefit the low-income people that live in existing Opportunity Zones often have limited or no long-term upside. For example, projects that employ low-income housing tax credits ("LIHTC") generally require occupancy by persons having incomes below 60% of the area median income and rents that are 30% of such income levels and that such restrictions last for 30 years or more. Income and rent restrictions can also encumber many other community development focused projects using HUD and other federal and state programs. As a result, such projects have very little potential for appreciation after a 10-year investment or may actually lose value. Thus, one of the major benefits of the OZ regime – the ability to increase basis to fair market value after a 10-year holding period – does not provide a significant benefit for most LIHTC investments.

Moreover, that incentive is important to economic investments, such as market rate apartments and hotels, and has resulted in increases in land costs in Opportunity Zones. LIHTC investments are particularly hurt by increases in land costs because affordable housing investors give up the potential economic gains in exchange for tax benefits. In addition, there are no tax benefits associated with land. Land costs cannot be depreciated and are not eligible for tax credits. Thus, increases in land costs are deadweight costs in determining the viability of a LIHTC project.

As discussed herein, other factors are inherent in affordable housing transactions that may not be as important for other transactions. We discuss these issues in detail herein, but a few examples follow.

i. One of the tax benefits to investments in Opportunity Zones is the potential reduction in tax due in 2026 on deferred capital gains. The statute provides that the deferred gain to be recognized can be reduced to the extent the fair market value of the QOF investment is less than the deferred gain. This would seem to be a key incentive for LIHTC investments as the value of these investments may decrease over time as tax benefits are realized and are not offset by appreciation due to requirements to maintain affordable rents. However, the special rule created in the Proposed Regulations for investments in partnerships and S corporations largely eliminates the potential benefit for LIHTC investments, which are typically structured through partnerships. **We propose an alternative rule.**

ii. Housing is a long-term investment, but one that needs periodic rehabilitation. That means there are important questions relating to "original use" and "substantial improvement" that more regularly occur. Transactions involving property owned prior to 2018 and transfers between potentially related parties are common and do not implicate any of the tax policy concerns that inspire limits on "churning" transactions. **We request clarification on several of these questions.**

iii. Another issue is that a majority of investors in affordable housing projects are banks. Banks face regulatory restrictions on investments for their own account and capital gain transactions are not recurring events. Moreover, banks often invest in affordable housing and community development through community development subsidiaries and those entities may not be the entities that realize capital gains**. We propose rules for determining which entity can undertake the investment of capital gain realized by a consolidated group that we believe make sense overall, but are especially important to affordable housing.**

We ask that you consider these issues that are unique, or at least more critical, to affordable housing in finalizing the regulations. We believe that they are critical to the goal of the Opportunity Zone incentives to improve low-income communities for the benefit of existing low-income residents.

II. QUALIFIED OPPORTUNITY ZONE BUSINESS

A. Clarification Regarding Grace Period to Qualify

and Expected Working Capital

Section 1400Z-2(d)(3) provides that a QOZB means a trade or business in which substantially all of the tangible property owned and leased by the taxpayer is QOZBP. The Proposed Regulations provide that substantially all means 70% of tangible property.

However, we recommend that there be some grace period in which a business can meet the substantially all test and the active conduct of a trade or business test. Section 1400Z-2(d)(2)(B)(i)(III) and (C)(ii) provide that to qualify as QOZP, the stock or a partnership interest must be in a corporation or partnership that is a QOZB at the time of acquisition or "such (corporation or partnership) was being organized for purposes of being a qualified opportunity zone business". Whether an existing business is expanding or a new business is constructing assets in preparation for beginning a new business, there will be an initial period in which the requirements for a QOZB are not met.

The Proposed Regulations provide a safe harbor for the use of working capital within a 31-month period and Proposed Regulation Section 1.1400Z-2(d)-1(d)(5)(vii) provides that the tangible property being constructed with such working capital will not fail to be QOZBP because the expenditure of the working capital is not yet complete. We request clarification that the tangible property to be constructed during the 31-month period can be counted toward the 70% test.

The second tranche of the Proposed Regulations expand the working capital safe harbor to address successive 31-month periods. We would similarly request that the property to be constructed can continue be counted during serial or overlapping 31-month periods and that the active conduct of a trade or business requirement would also be satisfied.

Finally, we also request clarification, that in the above 70% computations, one looks to the cost of the building to be constructed or the business to be started and that the interim 70% computations are not limited to the amount of working capital actually received. For example, assume that a QOZB purchases land from a related party for $3,000,000 and pursuant to a written plan, expects to expend an additional $7,000,000 to construct an apartment building within 31 months. Assume that the QOZB received an initial capital contribution from a QOF for $6,000,000 and reasonably expects to receive a bank loan or additional equity in 18 months for an additional $4,000,000 when the initial equity has been consumed by construction costs. The QOZB designates the entire $10,000,000 as working capital. For purposes of any 70% QOZB substantially all computations during the 31-month period, the QOZB should be treated as owning the $7,000,000 building and thus has $10,000,000 of assets of which $7,000,000 are QOZB. As a result, the 70% test would be satisfied during each testing date during the 31-month period.

III. QUALIFIED OPPORTUNITY ZONE BUSINESS PROPERTY

A. Satisfaction of the Original Use Test for LIHTC Projects

One of the most important objectives of the legislation is to create affordable housing opportunities for residents in Opportunity Zones. However, the Opportunity Zone requirement that an existing property must be substantially improved can frustrate this type of investment.

Section 1400Z-2 requires that the original use of QOZBP must commence with the QOF/QOZB or, in the case of an existing property, that the QOF/QOZB undertake a "substantial improvement" of the property. For this purpose, a property is substantially improved if the improvement costs incurred within a 30-month period after acquisition exceed the adjusted basis of the property at the time of acquisition.

In the case of affordable housing, Section 42 of the Code has provided a lower percentage of basis rehabilitation requirement since 1989. In 2008, the standard was set at the greater of 20 percent of basis, or $6,000 per unit, adjusted for inflation, over a 24-month period. This standard was set at an appropriate level to encourage the rehabilitation of existing buildings to provide affordable housing. In comparison, the QOZ requirement is so much higher than the Section 42 requirement that there is very little potential for pairing of QOF and Section 42 tax credit investment in the case of existing buildings. Thus, the QOZ incentive is not serving one of its most important functions.

Treasury could address this problem by providing that if a property qualifies for the Section 42 low income housing tax credit, that use will be considered the "original use" of the property, so that the Section 1400Z-2 substantial improvement test will not apply. We note that there is already precedent for this interpretation; the proposed regulations provide a similar definition for property that has been vacant for five years, even though it is plainly "used" in the common meaning of the word. If the IRS applied the original use definition to Section 42 property, then rehabilitation would still be required, but the Section 42 requirement (20%, or $6,000 per unit, adjusted for inflation) would apply, keeping the required expenditures to the levels thought appropriate for affordable housing. This would significantly and appropriately enable the two incentives to work together to produce a very desirable outcome.

B. Election to Aggregate Assets for Satisfying the Substantial Improvement Test

The Proposed Regulations test the substantial improvement requirement for used property on an asset-by-asset basis. They do not permit aggregation of related assets in order to meet the test. This hinders the ability to claim OZ benefits in various circumstances. We note that this does not seem consistent with the statutory language; it calls for expenditures "with respect to" the used property, which we believe is consistent with a broader range of eligible expenditures.

For example, a single owner may own used buildings and land on the same parcel in the same Opportunity Zone, and have a plan to rehabilitate the buildings to be suitable residential property, while also repaving parking lots and sidewalks and building a new playground and a new community building. These new additions seem to be "with respect to" the existing buildings and, in the case of a LIHTC project, would be includible in the eligible basis of the buildings in determining the amount of tax credit with respect to each building. However, the rule for the Opportunity Zone in the current version of the Proposed Regulations would require that the rehabilitation of each building meet the substantial improvement requirement on an individual basis, significantly impairing the availability of funds for the overall project. This would frustrate what would otherwise be a beneficial application of the Opportunity Zone legislation and deter its use.

Meeting the substantial improvement requirement for some businesses may be cumbersome as well. Where a business has multiple assets, and some do not require substantial rehabilitation, but others do, it is difficult to know how the substantial improvement test will be applied. Businesses should be able to couple major improvements on some assets, with little or no improvement to others.

Moreover, applying the substantial improvement requirement on an asset-by-asset basis may raise difficult questions of proof that would require burdensome record keeping. For example, a taxpayer that acquires a residential rental project that it intends to rehabilitate likely does not obtain a building-by-building appraisal or construction contract. Even in a multiple building project where buildings were built within the same timeframe, there will be differences in the condition of buildings.

Example: Example, a partnership which desires to meet the requirements to be a QOZB acquires land and an operating apartment building for $10,000,000 and acquires the adjacent lot for $500,000. The partnership plans to spend $3,000,000 on improving the apartment building and spend another $7,000,000 on the adjacent lot where the following will be constructed: a smaller apartment building with a coffee shop, a playground, and a building that will include new laundry facilities and a community center.

We recommend that the IRS adopt a regulation that would consider the substantial improvement test to be passed where the owner had (i) a written development plan which met the substantial improvement requirement on an aggregate basis (including both rehabilitation of the used buildings and the cost of new construction); (ii) the expenditures were for contiguous properties that include the used properties; and (iii) the written plan was approved by a local government agency responsible for authorizing development activities.

C. Treatment of Improvements as Separate Property for Qualification as QOZBP

Section 1400Z-2(d)(2)(D) provides several requirements that must be met for property to be QOZBP, including that (i) the property must be acquired after December 31, 2017, by purchase (as defined in Section 179(d)(2)), and (ii) the original use of the property must commence with the QOF or the QOF must substantially improve the property.

We request that Treasury clarify that improvements to existing property are separately tested as QOZBP so that an improvement to existing property could be QOZBP even though the existing property was acquired prior to 2018, or was acquired from a related party.

Example: A building is acquired from a related party for $300,000 and rehabilitated at a cost of $700,000. The acquired building cannot be QOZBP, but the $700,000 improvement is a separate property that can qualify as QOZBP.

D. Self-constructed Property and the Treatment of Related Party Fees

As noted above, Section 1400Z-2(d)(2)(D) provides a requirement that QOZBP must be acquired by purchase (as defined in Section 179(d)(2)). We believe it is clearly the intent of the statute that self-constructed property satisfy this requirement, but a clarification that self-constructed property is deemed as acquired by purchase would be helpful.

Further, under the requirements of Section 179(d)(2), property acquired is not acquired by purchase if it is acquired from a related party. Section 1400Z-2(d)(2)(D)(iii) modifies the related party test of Section 179(d)(2) by substituting 20% for 50% in each place it occurs.

It is common in the case of self-constructed property that related parties perform services and receive fees for activities such as development services, construction management, or even architectural services. Such fees are then capitalized into the basis of the assets being constructed.

We request that Treasury clarify that reasonable fees for services paid to a related party that are capitalized into the basis of tangible property do not constitute an acquisition of any portion of that tangible property from a related party and do not cause that property to fail to qualify as QOZBP.

This clarification is particularly important for LIHTC transactions, as each project includes a significant fee for development services that is limited to a reasonable amount by each state allocating agency. The development services are typically performed by an affiliate of the general partner or manager of the entity that owns the LIHTC project, which may perform additional services with respect to construction. Treatment of such payments as disqualifying even a portion of the LIHTC project from treatment as QOZBP would preclude QOFs from investing in many, if not most, LIHTC projects.

IV. RECOGNITION OF GAIN IN 2026

B. Measurement of Gain Recognized in 2026 Under Special Partnership/Sub S Rule

While focusing primarily on investments that appreciate in value, Section 1400Z-2 also was crafted with an eye towards the fact that investments in distressed communities come with higher risk. The general rule is to have gain recognition on December 31, 2026, for capital gains income that was deferred when an investment is made in a QOF, less the taxpayer's basis in the investment.[2] However, Section 1400Z-2(b)(2)(A) provides a rule that where a QOF investment has lost value, then the gain recognized would be the lower of the deferred capital gain or the fair market value of the QOF interest, less the taxpayer's basis in the investment. The rule drafted by Congress inherently says that for the risky QOZ investments, when some investments do not appreciate, the taxpayer will not be hit twice in 2026: once with taxes owed on the deferred gain and a second time on loss in economic value. Instead, the recognition of deferred capital gain will be lowered to reflect any reduction in fair market value of the QOF investment.

In drafting the Proposed Regulations, we understand Treasury's concern that an untoward result could occur if a partnership/S-corporation QOF (or its subsidiary QOZB) borrowed funds and distributed those funds to its member taxpayers. The concern is the taxpayers would then claim a reduced QOF value on December 31, 2026 due to the debt and recognize less of the deferred capital gain. As a result, Proposed Regulation Section 1.1400Z-2(b)-1(e)(4) removes the statutory reference to fair market value and instead provides that for partnership or S-corporation QOFs gain recognition based on the lesser of (1) the deferred capital gain less the 10% or 15% basis increases, or (2) the gain that would be recognized on a fully taxable disposition of the qualifying investment.[3]

We believe that the special rule in the Proposed Regulations has an inadvertent negative effect on investments in affordable housing and that an

---

[2] Proposed Regulation Section 1.1400Z-2(b)-1(e)(3) clarifies that such basis is only the 10% and 5% basis increases allowed under Section 1400Z-2(b)(2)(B).

[3] The Proposed Regulation also include special percentage rules that would apply to pre-December 31, 2026 partial dispositions of a QOF interest. Such percentage rules do not impact the change being recommended.

alternative rule that more closely tracks the statute will address the concern raised by Treasury while eliminating the adverse effect.

The impact of the special rule is that gain recognized can be higher if there is debt involved at the QOF/QOZB level. Because debt is a common funding source for real estate projects, and even operating businesses, this approach creates a higher tax on business that may have prudently borrowed funds to increase the investment in the Opportunity Zone, but experienced a reduction in the economic value of that investment. This is an especially onerous result for socially motivated investments in Opportunity Zones where the appreciation possibilities are much lower and the possibility of lost capital is higher.

This can be illustrated by investments in LIHTC transactions. Because of statutorily required 30-year limits on rents that can be charged, such projects have limited prospects for appreciation and often may have lost value in the early years. An investment in a LIHTC project in 2019 may have lost value by the end 2026.

***Example*:** A LIHTC project cost $20 million to build and was funded with a $6 million investment from the QOF on January 1, 2022, and $14 million of nonrecourse debt requiring interest only payments. Through 2026, $3.333 million in losses were allocated to the QOF and, at the end of 2026, an investor would pay $3 million in cash for the interest in the partnership held by the QOF. Under the special rule in the Proposed Regulations, the investor in the QOF would pay taxes based on the lesser of the deferred gain of $6 million or the gain on the sale of its interest in the QOF, which is $3.33 million ($3 million of value plus $14 million share of debt less basis of $14 million).

Effectively, in determining the amount of deferred gain subject to tax in 2026, the investor must take the market value of its QOF interest and add back the losses it had taken through 2026, even though those losses matched a true decrease in the value of its investment. This is the exact result that would follow if the investor had instead received $3.333 million of cash distribution from the proceeds of a loan.[4] However, in the latter case, the diminution of value is caused by value being distributed up to owners of the QOF, whereas in the example, the loss is caused by real economic loss in value from the project the QOF invested in.

The current Proposed Regulation approach which bases deferred gain recognition based on the tax result from a disposition of the QOF interest rather than the fair market value of the QOF removes much of the benefit of the Opportunity Zone from investments, like LIHTC projects, where there is likely to be a true reduction in the economic value of the investment.

[4] We note that such a result would not be an inclusion event because the owners of the QOF would have had basis from the debt in a sufficient amount to allow the distribution.

We recommend that the Proposed Regulations be modified to provide that gain recognized in 2026 is (i) the lesser of (A) the deferred gain, or (B) the fair market value of the interest in the QOF, which will be equal to its market value at the end of 2026, increased by any distributions to members of the QOF made over the term of the investment, less (ii) in either case, any 10% or 5% basis increases that may apply. This approach will address the issue where the QOF investment has a lower value at the end of 2026 because the investors have received distributions in respect of their interest, but will not penalize investors that have realized a true economic loss in the value of their QOF investment. We also believe it is more in keeping with the language of the statute than the special rule in the Proposed Regulations, which substitutes and entirely separate calculation of gain for the statutory formula.

V. 10-YEAR FAIR MARKET VALUE BASIS ELECTION

A. Treatment of Debt in Basis Step-up

Proposed Regulation §1.1400Z-2-d(1)(b)(2) provides the following:

> (2) Special election rules for QOF Partnerships and QOF S Corporations—
>
> (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), 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.

Gross Value Computation. Unfortunately, there may be an interpretation that the election to step-up is to the value net of debt and not the gross unencumbered value of the property. For example, assume a QOF owns a property with a $100 gross value, subject to $70 of debt, and a $40 basis. The taxpayer now sells the QOF interest for $100, consisting of $30 of cash and $70 of debt taken subject to. If the step-up is to gross value, then the taxpayer has $100 of proceeds, and a $100 basis, and no tax is owed. If the step-up is to just $30 (i.e., $100 gross value, less $70 of debt), then the taxpayer will not even make the election, since the “actual” basis ($40) is more than the Section 1400Z¬2 stepped-up basis ($30), and the taxpayer will recognize $60 of gain (i.e., $100 of proceeds less $40 of basis). The net result is plainly contrary to the intention of the statute, and to everything that has been written and said about the tax consequences of a QOF investment that is disposed of after ten or more years. In fact, the Proposed Regulations confirm that debt is “included” in the valuation of the QOF interest, which prevents a negative capital account from being "recaptured."

We know that Treasury and IRS representatives confirmed that the gross treatment is the proper treatment at a meeting of the American Bar Association in May 2019. **However, to assure that there is no confusion, we urge the IRS to include an example in the regulations like the one above to show application of the gross value computation.**

Nonrecourse Debt in Excess of Value. We also note an additional situation that occurs in some cases, where the value of an underlying asset may be below the amount of nonrecourse debt encumbering the property. This is not uncommon for certain LIHTC transactions, particularly those financed with tax-exempt bonds. As noted above, LIHTC projects often have limited economic or market value, principally due to the required 30-year (or longer) low-income restrictions on the property. However, investors may have exit tax liability because nonrecourse debt exceeds tax basis. To avoid an unfortunate tax result for projects that lose value, in such a situation the basis step-up should be up to the amount of the nonrecourse indebtedness. This would be consistent with Section 7701(g) which provides that when property is sold, its fair market value is no less than the nonrecourse debt encumbering the property. This could be exemplified by using the above example, but assuming that there is $120 of debt on the property. In a transfer by an LIHTC Investor of its interest in a QOF, the transferee (likely the lender) would pay $0 in cash and assume the $120 of debt. The LIHTC investor’s amount received would be the $120 of debt assumed. If the LIHTC investor’s basis in the QOF were stepped up to the $120 of debt, then there is no gain on the transaction. Without the requested clarification, the result would be the LIHTC investor owing tax upon exiting even though it received no sales proceeds. It would seem an undesirable consequence if investors in profitable QOFs avoided tax after a 10-year period, but investors in unprofitable QOFs had to pay taxes when ending their investments after the same period.

Example – Debt Exceeds FMV

- In 2019 Investors A and B invested a total of $600K for all the interests in QOF Partnership

- QOF invested $600K for a 99% interest in QOZB Partnership in 2019
- QOZB borrowed $1.5M and bought land and built a building for $2.1M
- Assume FMV of QOZB asset is $1M in 2029.
- Assume there is $1.5M of Nonrecourse Debt in 2029
- Neg. $500K Value of QOF ($1M FMV Assets - $1.5M debt)

Analysis **-** Ignoring any lack of marketability and control discounts, upon election, the QOF must be adjusted to $1.5M (the amount of nonrecourse debt taken subject to) even though such amount exceeds the unencumbered value of the QOZB asset. This is the result necessary to be consistent with Section 7701(g).

Result – With a stepped-up basis of $1.5M, if the QOF interest is disposed of for $0 of cash, the investor would be deemed to have proceeds equal to the $1.5M of the debt the investor is relieved of. **$1.5M deemed proceeds - $1.5M basis = $0 gain.** The result achieves the Congressional intent of no tax being due upon a sale after 10 years.

B. Inclusion Event Does Not Preclude Basis Step-up

Proposed Regulation Section 1.1400Z-2(c)-1 provides that the 10-year basis step-up is available "without regard to the amount of deferred gain that was included under Section 1400Z-2(b)(1), or the timing of that inclusion." We request clarification of the interaction of this rule with the inclusion event provisions of Proposed Regulation 1.1400Z-2(b)-1.

Proposed Regulation 1.1400Z-2(b)-1 defines a number of inclusion events that will trigger deferred gain prior to December 31, 2026. The types of inclusions events are varies, some related to distributions in excess of basis, some are related to transfers of the QOF interest as well as other situations.

We are specifically concerned with situations where a partnership QOF (either directly or through a subsidiary partnership QOZB) may have positive cash flow, but due to depreciation it may not have any taxable income. The QOF or QOZB will often need to distribute such cash flow in order to not violate the 5% Non-Qualified Financial Property requirements or the rule that 90% of a QOF's assets must be QOZP. While such distributions may trigger an inclusion event, we believe that the investor in a QOF should continue to be allowed to step-up the basis of its interest to fair market value after 10 years.

We believe that there are other situations where it is also important to clarify that an inclusion event will not prevent a 10-year step-up. **We suggest the regulations clarify this point in general.**

C. Consistency for Sales of QOF/Qualified Partnership Interest/Project

Pursuant to the Proposed Regulation, once an investor has held a QOF Partnership interest for 10 years or more, if the QOF sells QOZP and the sale generates capital gain, the taxpayer can elect to exclude the capital gain that shows up on the K-1 the investor gets from the QOF. Allowing the QOF to sell QOZP tax free after the ten-year period has elapsed greatly furthers a goal of the OZ incentive by substantially facilitating liquidity.

However, the current regulations create disparate tax results depending on how QOF investments are ended. If the QOF interest is outright sold, then all taxes are avoided. If the QOF sells its assets and liquidates, an election can be made to avoid capital gains, but not ordinary income like depreciation recapture. Furthermore, if a QOZB sells an asset and distributes the funds up to the QOF and then the QOF distributes funds to its members, the members will still incur taxable income from the sale of the QOZB's assets, whether that gain is capital or ordinary.

There are legitimate reasons why the sale of a QOF interest may not be the best economic choice. For QOFs that own multiple assets, whether such assets are interest in subsidiary QOZBs or tangible property themselves, they may have different buyers for different assets. Buyers may not want all the assets or may not want the potential liability that comes from buying a QOF interest rather than buying real estate or business assets owned by a QOF or QOZB.

We recommend that an election be available to avoid tax on a K-1 for sales of assets by either a QOF or QOZB, whether such income is capital or ordinary in nature. Such election would not be available for sales that generate ordinary income from the sale of property in the ordinary course of a trade or business. An alternative option could be to adopt the foregoing rule, but only in the case where there is plan to liquidate the QOF within three years from the end of the tax year in which the first such sale occurs.

VII. ELIGIBLE CAPITAL GAINS

We discuss below two issues related to determination of eligible capital gains that are likely important for many investors, but are critical to finding investors that can benefit both from the OZ benefits and other tax incentives available in affordable housing and community development.

A. Section 1231 Gains

The proposed regulations provide that Section 1231 gains can be invested in a QOF if, and to the extent that, an investor has net gains from the disposition of Section 1231 property at the end of the tax year. Accordingly, losses from the sale of other Section 1231 property, if any, reduce the net amount of gain eligible for favorable treatment.

By not allowing an investor to invest the gross amount of particular gains, this netting rule treats Section 1231 items less favorably than other capital gains and losses. As a result of the netting requirement, investors may now be persuaded to consider alternative investment strategies — such as utilizing Section 1031 treatment for Section 1231 realized gains while claiming ordinary deductions for the losses. This would result in an unfortunate redirection of gain proceeds away from Opportunity Zone investments.

In addition, the proposed regulations further provide that, if an investor has Section 1231 net gains, they then have 180 days from the end of the year to invest the net gain. By delaying the start of the 180-day period until the end of the tax year, this rule will artificially stall investments for most investors even if no Section 1231 losses are expected.

We recognize the difficulty that arises from the usual computation of Section 1231 gains because the net result may not be known until the end of the tax year, when the investor can look back and determine what other Section 1231 transactions (if any) have occurred. Indeed, the taxpayer may have an ordinary loss rather than a capital gain, depending on other Section 1231 transactions. This difficulty would be eliminated if the netting rule were abandoned. Essentially, a gain deferred pursuant to Section 1400Z-2 would not be included in the year end computation of Section 1231 gain or loss.

In practice, requiring the 180-day period to commence on December 31 will not facilitate Opportunity Zone investment. Once a taxpayer sells trade or business assets, it can be very discouraging to tell them to wait for what might be several months before they can reinvest. Moreover, waiting to reinvest on a 2019 transaction may result in the investor losing the benefit of the 7-year hold step-up, since December 31, 2019, would be the <u>only</u> day that an investor with net 1231 gains in 2019 could invest and still obtain the 5% tax avoidance allowed for investments held for 7 years as of December 31, 2026.

We recommend that the investment eligible for favorable treatment be based on the gross gain arising from each Section 1231 transaction, so as to afford Section 1231 gains the same access to Opportunity Zone investments as other capital gains.

If netting is retained, we recommend that the 180-day period can be elected to commence with the day of sale, with the investor responsible for the lookback, to determine if later Section 1231 transactions caused the investor's investment to exceed its Section 1231 gains for the year. Such a rule would be similar to the grandfathering that the IRS recently provided in the FAQs for taxpayers who had 2018 Section 1231 gains. In addition, any recapture of Section 1231 gains as ordinary income from the 5-year lookback should be recognized when the original deferred gain is recognized.

Finally, we request that confirmation of the treatment of flow-through entities which have Section 1231 gains be included in the final regulations. We prefer that the netting rule be abandoned, but, if netting applies, the treatment of flow-through entities is uncertain because the netting that determines whether there has been a Section 1231 gain is ordinarily done at the individual (or other investor) taxpayer level. We note that the first round of regulations provides pass-through entities and their partners a choice in investment periods, while the second round of regulations provides the special rule for Section 1231 property. Much of the gains that we might see in pass-through entities are likely to be from the sale of assets used in a trade or business, so that Section 1231 would otherwise apply to these sales, but pass-through entities are not taxpayers who can compute net Section 1231 gains. This issue affects many real estate partnerships as well as S corporations and their shareholders, and it does not appear to be specifically addressed by the new regulations. Conflicting information from Treasury officials has been reported on this issue as well.

B. QOF Investments by Consolidated Groups

Proposed Regulation Section 1.1400Z-2(g)-1(c) requires that for entities that file a consolidated return, the corporate entity that has a capital gain has to be the same entity that invests in the QOF. While not intended to impact the affordable housing industry, this rule is having a significant impact on traditional LIHTC investors that also want to use the OZ incentive and make more projects viable in Opportunity Zones.

The largest investors in LIHTC transactions tend to be banks. Many banks organize there LIHTC investments in a single corporate subsidiary which is a community development corporation ("CDC"). See https://www.occ.gov/topics/community-affairs/publications/fact-sheets/pub-fact-sheet-bank-owned-cdcs-sep-2011.pdf for a discussion of the use of CDCs. However, bank capital gains generally come from other areas of the bank. For a bank that has such a capital gain, the Proposed Regulation prevents the bank from deferring the capital gain in a non-CDC corporate affiliate by having the CDC arm of the bank make the investment in the QOF. This then removes the incentive for banks to have their CDCs invested in Opportunity Zones.

We recommend that the rules allow consolidated groups to have one affiliate invest in a QOF and defer the recognition of capital gains for a different

consolidated affiliate. This in consistent with the Congressional desire to incentivize entities with capital gains to invest in Opportunity Zones. The fact that a corporate group chooses to optimize its corporate structure through the use of subsidiaries and CDCs should not result in consolidated groups being unable to access OZ benefits.

This is also consistent with the general treatment of capital gains within a consolidated group. See, for example, Treasury Regulation § 1.1502-22, Consolidated Capital Gain and Loss, which provides that "[t]he determinations under Section 1222 . . . are not made separately. Instead, consolidated amounts are determined for the group as a whole."

We note that this position in no way implicates the decision in the Proposed Regulations to prohibit consolidation of a QOF into a consolidated group. We are not asking that the QOF be considered part of the consolidated group, but that one member of the consolidated group, such as a CDC, be able to invest a capital gain realized by another member of the consolidated group in a QOF.

We do not envision that this change would create administrative burdens, because, as noted above, consolidated groups generally make capital gain determinations on a group wide basis. However, if there are difficulties that we do not foresee, then we would suggest at least creating an exception for investments made by CDC subsidiaries of consolidated groups.