January 24, 2019

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

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

RE: Proposed Regulations on Investing in Qualified Opportunity Zones (REG-115420-18)

Dear Ms. Reigle and Mr. Griffin:

The American Institute of CPAs (AICPA) appreciates the opportunity to provide the following comments and recommendations related to the proposed regulations on Investing in Qualified Opportunity Zones (REG-115420-18) issued by the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS). The proposed regulations and accompanying Revenue Ruling 2018-29 provide guidance on the deferral of gains resulting from a taxpayer's investment in a Qualified Opportunity Fund. Sections 1400Z-1[1] and 1400Z-2 allow this deferral as a means of offering an incentive for investment aimed at encouraging economic growth in designated low-income communities.[2]

Specifically, we recommend that Treasury and the IRS provide guidance on the following issues:

1. Disposition of an Interest in a Pass-Through Entity that Elected to Defer Gain
2. 180-Day Period for a Partner Electing Deferral
3. Deferral Election on an Amended Tax Return
4. Extension of 10-Year Basis Step-Up Election Until December 31, 2047
5. Effect of Section 179 and Bonus Depreciation Under Section 168 on "Substantial Improvement" of the Tangible Property Requirement
6. Guidance Stating that Rental Real Estate is a Trade or Business for Purposes of Section 1400Z-2
7. Guidance Stating that the Definition of Corporation for all Purposes of Section 1400Z-2 Includes Subchapter S Corporations
8. Other Issues Requiring Guidance or Clarification Related to Section 1400Z-2

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[1] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.
[2] Joint Explanatory Statement of the Committee of the Conference for the Tax Cuts and Jobs Act, Page 537.

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. Please feel free to contact Michael Greenwald, Chair, AICPA Partnership Taxation Technical Resource Panel, at (212) 842-7513 or MGreenwald@friedmanllp.com; Jonathan Horn, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9204 or Jonathan.Horn@aicpa-cima.com; or me at (408) 924-3508 or Annette.Nellen@sjsu.edu.

Respectfully submitted,

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

cc: The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
Mr. William M. Paul, Acting Chief Counsel, Internal Revenue Service
Mr. Scott Dinwiddie, Associate Chief Counsel (Income Tax & Accounting), Internal Revenue Service

AMERICAN INSTITUTE OF CPAS

Proposed Regulations on Investing in Qualified Opportunity Zones (REG-115420-18)

January 24, 2019

1. Disposition of an Interest in a Pass-Through Entity that Elected to Defer Gain

Overview

Proposed Reg. § 1.1400Z-2(a)-1(c)(1)[3] provides that if a partnership makes an election to defer recognition of an eligible capital gain, the deferred gain is not included in the distributive shares of the partners under section 702 and is not subject to section 705(a)(1). Absent any additional deferral, any amount of the deferred gain that the partnership subsequently must include in income under sections 1400Z-2(a)(1)(B) and (b) is recognized by the partnership at the time of inclusion and is subject to sections 702 and 705(a)(1) in a manner consistent with recognition at that time.

Recommendation

The American Institute of CPAs (AICPA) recommends that the Department of the Treasury ("Treasury") and Internal Revenue Service (IRS) provide assurance that a partner's disposition of its interest in a partnership that elected to defer gain under section 1400Z-2(a)(2) will not trigger recognition of the partner's distributive share of the deferred gain.

Analysis

Neither the Preamble nor the proposed regulations provide that an eligible gain deferred by a partnership is personal as to a partner. Therefore, the sale or exchange of a partnership interest should not trigger inclusion of the deferred gain by the selling partner. Accordingly, a partner who acquires the interest of a person who was a partner at the time of the partnership deferral election is generally allocated the gain when recognized at some future date by the partnership.

2. 180-Day Period for a Partner Electing Deferral

Overview

Under section 1400Z-2(a)(1)(A), a taxpayer must generally invest any eligible gains in a Qualified Opportunity Fund (QOF) during the 180-day period beginning on the date of the sale or exchange giving rise to the gain.

Proposed Reg. § 1.1400Z-2(a)-1(c)(2)(iii)(A) provides a general rule that if a partner's distributive share includes an eligible gain, the 180-day period with respect to the eligible gain begins on the last day of the partnership taxable year in which the partner's allocable share of the partnership's eligible gain is taken into account under section 706(a).

[3] Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to Treasury Regulations promulgated thereunder.

Proposed Reg. § 1.1400Z-2(a)-1(c)(2)(iii)(B) provides an alternative rule where a partner may instead choose to begin the 180-day period with respect to their distributive share of gain on the same date as the partnership's 180-day period (the date of the actual sale or exchange) when the partnership does not invest the gain itself into a QOF and elect deferral under section 1400Z-2.

Recommendation

The AICPA recommends that Treasury and the IRS provide that the 180-day period under Prop. Reg. § 1.1400Z-2(a)-1(c)(2)(iii)(A) begins on the due date (including extensions) of the partnership's tax return for the year in which the partner's allocable share of the partnership's eligible gain is taken into account under section 706(a).

Analysis

The proposed regulations provide that a partner's 180-day period for gains not deferred by the partnership generally begins on the last day of the partnership's taxable year, since that is the day on which the partner would have recognized the gain. Partnerships generally have calendar-year ends, therefore partners would generally have until June 29 of the following year to make an eligible investment in a QOF. However, partnerships are provided a maximum six-month extension to September 15th for calendar-year partnerships to file the partnership tax return and provide their partners with a Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.* As a result, many partners will not receive the Schedule K-1 reporting their share of eligible gain available for investment and deferral until after the 180-day period to make an eligible investment in a QOF has passed.

Consistent with the intent of the legislation to encourage investment in designated distressed communities, the 180-day period for a partner to reinvest its distributive share of eligible gain into a QOF should begin on the due date (including extensions) of the partnership's tax return to provide a partner the adequate time to identify and make the qualifying investment.

3. Deferral Election on an Amended Tax Return

Overview

Proposed Reg. § 1.1400Z-2(a)-1(d) prescribes that deferral elections are made at the time and in the manner provided by the Commissioner. Published guidance indicates that such election to defer tax on an eligible gain invested in a QOF is made on Form 8949,[4] *Sales and Other Dispositions of Capital Assets,* which is attached to a taxpayer's federal income tax return.

Recommendation

The AICPA recommends that Treasury and the IRS provide assurance that any taxpayer (including a partnership) may elect to defer tax on an eligible gain with respect to a previously filed return by filing an amended federal income tax return or administrative adjustment request, as appropriate.

[4] See draft instructions as of November 14, 2018 for Form 8949.

Analysis

If a taxpayer has filed their tax return for a prior tax year and failed to properly elect deferral of an eligible gain that was invested within the required 180-day period, the taxpayer should have the ability to file an amended return and make the deferral election. This recommendation is consistent with the specific guidance issued for taxpayers who filed a 2017 tax return reporting an eligible gain prior to issuance of the proposed regulations.[5]

4. Extension of 10-Year Basis Step-Up Election Until December 31, 2047

Overview

Proposed Reg. § 1.1400Z-2(c)-1(b) provides for the ability to make the basis step-up election under section 1400Z-2(c) after the designation of one or more Qualified Opportunity Zones (QOZ) expires. The ability to make such election is preserved under the proposed regulations for dispositions occurring on or before December 31, 2047. The Preamble to the proposed regulations requests comments with respect to this fixed date, as well as alternatively allowing for a basis step-up without a disposition, and how such QOF investment is valued at the time of the deemed step-up.

Recommendation

The AICPA recommends that Treasury and the IRS issue guidance permitting taxpayers the ability to elect a step-up in basis of their investment in a QOF to the fair market value of such investment as of December 31, 2047 in lieu of a disposition of their QOF investment.

Analysis

As noted in the Preamble to the proposed regulations, one of the main tax incentives under section 1400Z-2 is the ability to exclude from gross income the post-acquisition capital gains on investments in QOFs that are held for at least ten years. Thus, in keeping with the purpose of this incentive, the proposed regulations permit a taxpayer to dispose of their investment in a QOF until December 31, 2047 and receive the associated basis step-up benefit as provided by section 1400Z-2(c).

Unless regulations provide for a deemed step-up election as of December 31, 2047, taxpayers are forced to dispose of their investment in a QOF or QOZ business solely to meet an arbitrary deadline with potentially negative economic implications for the underlying investment's continued viability. Existing guidance with respect to valuing interests in businesses such as under Treas. Reg. § 20.2031-3 provide a basis for properly valuing such QOF investments at the time of the deemed step-up.

[5] Opportunity Zones Frequently Asked Questions, as of November 5, 2018.

5. Effect of Section 179 and Bonus Depreciation Under Section 168 on "Substantial Improvement" of the Tangible Property Requirement

Overview

Proposed Regs. § 1.1400Z-2(d)-1(c)(8)(i) and § 1.1400Z-2(d)-1(d)(4)(i) provide that tangible property (other than land) is treated as substantially improved by a QOF or QOZ business only if, during any 30-month period beginning after the date of acquisition of such tangible property, additions to basis with respect to such tangible property in the hands of the QOF or QOZ business exceed an amount equal to the *adjusted basis* of such tangible property at the beginning of such 30-month period in the hands of the QOF or QOZ business (emphasis added).

Recommendation

The AICPA recommends that Treasury and the IRS provide guidance clarifying that the term "adjusted basis" as used in regard to the substantial improvement requirement is defined as the cost of such tangible property as determined under section 1012.

Analysis

The term "adjusted basis" is defined under section 1011(a) for purposes of determining gain or loss as "the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016." However, allowing the reduction to zero of the basis of certain assets under the bonus depreciation rules would produce meaningless results in this context, such that just $0.01 of capital improvements to those assets would qualify as substantial improvement under the proposed regulations.

The term "adjusted basis" for purposes of the substantial improvement requirement under section 1400Z-2 and proposed regulations thereunder should mean its cost under section 1012, without regard to any adjustments under sections 1016 or 179. Such a definition is similar to the definition provided in Prop. Reg. § 1.199A-2(c)(3).

6. Guidance Stating that Rental Real Estate is a Trade or Business for Purposes of Section 1400Z-2

Overview

The phrase "trade or business" appears twice in section 1400Z-2. The initial mention of this phrase is in section 1400Z-2(d)(2)(D)(i) where the term "qualified opportunity zone business *property*" is defined as "tangible property used in a trade or business of the QOF if…" (emphasis added). The next time the phrase is mentioned is in section 1400Z-2(d)(3)(A) where the term "qualified opportunity zone *business*" means a "trade or business in which…" (emphasis added). Neither the statute nor the proposed regulations define the phrase "trade or business." In addition, Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(ii)(B) reserves on the meaning of "active conduct of a trade or business."

Recommendation

The AICPA recommends that Treasury and the IRS provide guidance stating that rental real estate activities, including residential rental property and triple net leasing of real estate, are generally treated as a trade or business for purposes of section 1400Z-2.

Furthermore, we recommend that Treasury and the IRS provide a definition of "active conduct of a trade or business" similar to that under Treas. Reg. § 1.45D-1(d)(4)(iv) and confirm that no other corollary provisions of section 1397C (such as the disallowance of residential rental property under section 1397C(d)(2)(A)) other than paragraphs (2), (4), and (8) of section 1397C(b) would apply.

We suggest that the guidance include examples identifying any specific circumstances where Treasury and the IRS believe rental real estate activities would not qualify for the opportunity zone benefits under section 1400Z-2.

Analysis

1. Qualification of rental real estate as a trade or business.

The definition of a "trade or business" generally is provided for under section 162(a). The issue of whether the rental of real property rises to the level of a section 162 trade or business was most recently considered by Treasury and the IRS in the context of the proposed and final regulations for section 199A.[6] Specifically, Treas. Reg. § 1.199A-1(b)(14) provides that a trade or business is defined as a section 162 trade or business other than the trade or business of performing services as an employee. According to the Preamble of the proposed regulations under section 199A, "the definition of trade or business under section 162 is derived from a large body of existing case law and administrative guidance interpreting the meaning of trade or business in the context of a broad range of industries."

Contemporaneous with the issuance of the proposed regulations under section 1400Z-2, Revenue Ruling 2018-29 was issued. The ruling addresses the "original use" requirement for land purchased after 2017 in QOZs. It is unclear whether the fact pattern described in the ruling was meant to suggest that residential rental property owned by a QOF is always considered an eligible trade or business for purposes of section 1400Z-2.

Since the primary intent of the legislation is to encourage economic growth and investment in the designated QOZs, Treasury and the IRS should provide for an expansive view of the meaning of "trade or business" as it relates to the rental of real property for purposes of section 1400Z-2.

2. Active conduct of a trade or business.

Section 1400Z-2 imports an "active conduct of a trade or business" requirement through its cross-reference to section 1397C(b)(2) under section 1400Z-2(d)(3)(A)(ii). Proposed Reg. § 1.1400Z-2(d)-1(d)(5)(ii)(B) reserves on the definition of "active conduct of a trade or business." Given the similar objectives and statutory language of section 45D(d)(2)(A)(i), we recommend that the

[6] REG-107892-18 and final regulations released by the IRS on Jan. 18, 2019 (no TD number yet assigned)

meaning of "active conduct of a trade or business" is interpreted in a manner similar to that under Treas. Reg. § 1.45D-1(d)(4)(iv) which in relevant part provides that an entity is treated as engaged in the active conduct of a trade or business if, at the time the qualified community development entity (CDE) makes an investment in the entity, the CDE reasonably expects that the entity will generate revenues within three years after the date of the investment.

7. Guidance Stating that the Definition of Corporation for all Purposes of Section 1400Z-2 Includes Subchapter S Corporations

Overview

Section 1400Z-2(d)(1) and Prop. Reg. § 1.1400Z-2(d)-1(a)(1) provide that an entity treated as a *corporation* or partnership for federal tax purposes is eligible for treatment as a QOF (emphasis added). Additionally, section 1400Z-2(d)(2)(B) and Prop. Reg. § 1.1400Z-2(d)-1(c)(2) define the term "qualified opportunity zone stock" to mean any stock in a *corporation* for federal tax purposes (emphasis added).

Recommendation

The AICPA recommends that Treasury and the IRS clarify that the term "corporation" as used throughout section 1400Z-2 and the proposed regulations thereunder includes subchapter S corporations.

Analysis

Proposed Reg. § 1.1400Z-2(a)-1(b)(1) expressly provides that an S corporation qualifies as an eligible investor in a QOF, but the statute and proposed regulations are silent on whether an S corporation can qualify as a QOF and whether QOZ stock includes stock of an S corporation.

The general definitions of "corporation" under section 7701(a)(3) and Treas. Reg. 301.7701-2(b) suggest that the term corporation as used throughout section 1400Z-2 and the proposed regulations thereunder includes S corporations. Additionally, the draft instructions for Form 8996, *Qualified Opportunity Fund* under the "Who Must File" section, includes corporations required to file Form 1120S, *U.S. Income Tax Return for an S Corporation*.

8. Other Issues Requiring Guidance or Clarification Related to Section 1400Z-2

A. Guidance is needed in relation to what types of transactions trigger the inclusion of gain previously deferred under section 1400Z-2(a), including whether debt-financed distributions to a QOF partner investor is treated as a sale or exchange of the QOF investment under section 1400Z-2(b)(1)(A), and the impact of a QOF investor's death or gifting of a QOF investment under section 1400Z-2.

B. With respect to the initial self-certification of an entity as a QOF and for the annual reporting compliance requirements, the Preamble to the proposed regulations states that Form 8996 is attached to the taxpayer's federal income tax returns for the *relevant tax years* (emphasis added). Clarification is needed whether that period shall end no later than

December 31, 2026 (date of last eligible gain subject to deferral) or December 31, 2047 (last date for the section 1400Z-2(c) basis step-up election), and whether filing of a Form 8996 is required in a year that a federal income tax return is otherwise not required.

C. Clarification is needed as to whether the contribution of assets other than cash, such as unimproved land or other property, is permitted as an investment into a QOF for which a deferral election is available. Sections 1400Z-2(d)(2)(B)(i)(I) and 1400Z-2(d)(2)(C)(i) and the proposed regulations thereunder expressly require the exchange for cash with respect to the acquisition of QOZ stock or partnership interests. However, the statute and proposed regulations are otherwise silent with respect to assets eligible for investment in a QOF.

D. Clarification is needed with respect to the various basis issues associated with QOFs, such as whether a taxpayer's initial outside basis in its investment in a QOF partnership is zero (subject to five and seven-year basis increases) for all purposes or solely with respect to calculating the taxpayer's original capital gain that is deferred under section 1400Z-2(b).

   For example, an individual invests $100x in a QOF partnership and begins with a zero basis in the partnership interest. After 5 years, the individual increases the basis in the QOF partnership by $10x. The proposed regulations are unclear on whether the $10x is available to offset current losses from the business or is only available when the deferred capital gain is taxed.

   Other associated QOF basis issues needing clarification include the following:

   - Whether the QOF's inside basis of its assets of such investment equals cost;
   - Whether a sale of an interest in a QOF taxed as a partnership which has a section 754 election in place is eligible for an increase in the inside basis of the QOF's assets under section 743(b); and
   - Whether a partnership level QOF investment gain deferral would take into account a section 734(b) or 743(b) adjustment.

E. Clarification is needed to address whether the restrictions imposed on a "qualified opportunity zone business" under sections 1400Z-2(d)(3)(A)(ii) and (iii) apply to a QOF that directly holds QOZ business property under section 1400Z-2(d)(2)(D).

F. Proposed Reg. § 1.1400Z-2(e)-1(a)(2) provides where a QOF partnership borrows money, the section 752(a) basis increase is not taken into account for purposes of the mixed investment bifurcation rules under section 1400Z-2(e)(1)(A). Proposed Reg. § 1.1400Z-2(e)-1(a)(3) provides an example illustrating the rule. Clarification is needed as to whether there are any restrictions or limitations on a QOF, or a partnership or corporate subsidiary of a QOF that borrows to help fund a project. In addition, clarification is also needed on whether any such permitted borrowing would affect the amount of deferred or excluded gain under sections 1400Z-2(b) or (c) of an investor in a leveraged QOF.

   For example, A has $10x of capital gain. A invests $1X in each of ten QOZ partnerships that are limited liability companies. Each partnership business is leveraged and A shares in an average of $5X liabilities per business. Confirmation is needed that all ten

investments qualify under section 1400Z-2 and are not subject to mixed investment rules under section 1400Z-2(e).

G. Proposed Reg. § 1.1400Z-2(a)-1(b)(3)(i) provides that for purposes of section 1400Z-2, an eligible interest in a QOF is an equity interest issued by the QOF, including a partnership interest with special allocations. An example of this type of equity interest is an energy credit flip deal where the developer/sponsor interest in the partnership flips from 1% to 95% as provided under Rev. Proc. 2007-65. Clarification is needed as to whether the gain eligible for the basis step-up is the full 95% interest or the original 1% interest if there is a sale of the developer/sponsor interest after ten years. Stated differently, clarification is needed that the portion of the partnership interest eligible for the 10-year step-up is determined by profit share and not the capital share used in section 1045.

H. Where a partnership elects to defer recognition of some or all of its eligible gains under section 1400Z-2(a)(2), clarification is needed with respect to the interaction between section 704(c) provisions and the allocation of the subsequent recognition of the deferred gain by the partnership.

For example, suppose a 50/50 partnership between A and B has capital gain of $100x and elects to defer the recognition of the gain at the partnership level. If the partnership elected to not defer the gain, Partner A would have received a distributive share of $80x of the gain under section 704(c) and $10x of the remaining $20x gain. It is unclear whether the proposed regulations require treating the partnership as an entity and ignore how the gain is allocated if it was treated as a distributive share to the partners. In such a case, the result would treat A and B as each having 50% of the QOF investment and each would receive an allocation of $50x of the deferred gain when recognized by the partnership.

I. Regulations should clarify whether a partnership is permitted to distribute some portion of the QOF investment to current owners of the business. The qualifying business partnership or the entity improving the property often want to distribute some of the QOF money to pay down debt of the business. The regulations should clarify that the reduction of debt is equivalent to an investment in the business that qualifies. Sometimes, the distribution is made to equity holders to reduce or eliminate a preferred interest that is similar to debt. Technically, the equity distribution may result in disguised sales of partnership interests. The guidance should address whether these distributions cause a reduction in the qualifying investment. With regard to common equity reductions that are normal business practice in some industries, allowance of the distribution to some extent seems reasonable.

J. Clarification is needed as to whether a QOF that is set up with a profits interest or a carried interest for services by a partner provides any tax benefit to the recipient partner. Additionally, where a QOF partnership makes a qualified investment and receives a carry or profits interest, the regulations should clarify the treatment of the carry/profits interest.

K. Under Prop. Reg. § 1.1400Z-2(c)-1, a taxpayer can receive an increase in basis to fair market value of a QOF investment on the date the investment is sold or exchanged. Clarification is needed as to what events are considered a sale or exchange. Further, the following questions require clarification related to the application of this provision:

i. If the QOF closes after the ten-year period and the partners do not individually sell, is the fund closure considered a sale or exchange?

ii. If the QOF sells an asset after ten years, does the taxpayer take a basis increase related to the sale of the individual asset if they have also held the QOF investment for ten years?

iii. If the QOF sells an asset before ten years but the taxpayer has held an investment in the QOF for ten years, is the taxpayer entitled to any basis step-up?

iv. Are holding periods of the assets in the QOF independent of the holding period of the partner for the basis step-up?

L. Additional guidance is needed as to whether investors in QOF funds that flip assets are still entitled to the basis step-up. A fund that sells assets frequently may have the ability to continue to defer the gain with each sale. Guidance is needed on whether all appreciation related to the initial gain deferral is eligible for the basis step-up or whether these intermediate sales result in additional deferred gain that the partnership will eventually realize.

M. Clarification is needed as to whether the reasonable amount of working capital safe harbor under Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(iv) applies to both the direct ownership of property by a QOF and indirect ownership of property through a subsidiary; whether revenues received by the QOZ business during the 31-month period are included in the working capital definition; and whether working capital is considered QOZ business property under the proposed regulations.

N. Clarification is needed in relation to whether any sponsorship arrangement from the sponsor (QOF investor) is included in the related person definition under section 1400Z-2(e)(2).

O. Where a taxpayer timely re-invests a previously deferred gain through a new investment in a QOF,[7] clarification is needed whether the 5, 7, and 10-year basis step-up holding periods would track from the date of the original QOF investment or restart from the date of the rolled over QOF investment.

P. Guidance should clarify that gain previously deferred under section 1031, if otherwise treated as eligible gain under Prop. Reg. § 1.1400Z-2(a)-1(b)(2), is not precluded from investment into a QOF under section 1400Z-2.

Q. Clarification is needed as to whether a taxpayer must invest directly in a QOF or may invest in such QOF indirectly through another intermediary entity to qualify for the benefits under section 1400Z-2.

[7] Prop. Reg. § 1.1400Z-2(a)-1(b)(4)(ii)(Ex. 4).