



September 10, 2019

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Re: Proposed Regs. on Investing in Qualified Opportunity Funds [[REG-120186-18](#)]

Dear Ms. Reigle and Mr. Griffin:

The American Institute of CPAs (AICPA) is pleased to submit recommendations on the proposed regulations related to investing in Qualified Opportunity Funds (QOF) on the following areas:

- I. 180-Day Period for a Partner Electing Deferral and Certain Partnership Transactions;
- II. Gains from Section 1231¹ Property;
- III. Dispositions of QOF Property with Respect to Investments Held for at Least 10 Years;
- IV. Pre-Finalization Reliance on Prop. Reg. § 1.1400Z2(c)-1;
- V. Distributions in the Case of a Mixed-Funds Investment in a QOF Partnership;
- VI. Disguised Sale Rules and Mixed-Funds Investments;
- VII. Step-up to Fair Market Value of the Underlying Investment in a QOF at the Death of the QOF Investor;
- VIII. Rollover of Gain by Either Grantor or Trustee of a Grantor Trust; and
- IX. Other Issues Requiring Guidance or Clarification Related to Section 1400Z-2.

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¹ Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

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We appreciate your consideration of our recommendations and welcome the opportunity to further discuss our comments. If you have any questions, please contact Sarah E. Allen-Anthony, Chair, AICPA Partnership Taxation Resource Panel, at (574) 235-6818, or Sarah.Allen-Anthony@crowe.com; or Melanie Lauridsen, Senior Manager – AICPA Tax Policy & Advocacy, at 202-434-9235, or Melanie.Lauridsen@aicpa-cima.com; or me at (612) 397-3071, or Chris.Hesse@CLAconnect.com.

Sincerely,

A handwritten signature in blue ink that reads "Christopher W. Hesse". The signature is fluid and cursive, with a stylized flourish at the end.

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable David J. Kautter, Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
The Honorable Michael J. Desmond, Chief Counsel, Internal Revenue Service

AMERICAN INSTITUTE OF CPAs

Proposed Regulations on Investing in Qualified Opportunity Funds [[REG-120186-18](#)]

September 10, 2019

I. 180-Day Period for a Partner Electing Deferral and Certain Partnership Transactions

Overview

Section 1400Z-2(a)(1)(A) generally provides that a taxpayer invest any eligible gain 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. § 1.1400Z2(a)-1(c)(2)(iii)(A) provides that if a partner's distributive share includes an eligible gain, the 180-day period with respect to the partner's eligible gain generally 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).²

Recommendations

The AICPA recommends that the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) issue final regulations providing that the 180-day period under Prop. Reg. § 1.1400Z2(a)-1(c)(2)(iii)(A) begins on the earlier of the date filed or 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).

In addition, we recommend that the final regulations apply this same period to eligible gains arising in the case of a sale or exchange of a partnership interest or a distribution by a partnership to a partner.

Analysis

As partnerships generally have calendar year ends, partners would have until June 29 (June 28 if the period includes February 29) of the following year to invest their allocable share of the partnership's eligible gain in a QOF. In most cases, partners will not know if any of their allocable share of the partnership's eligible gain is investable in a QOF until they receive their Schedules K-1, *Partner's Share of Income, Deductions, Credits, etc.* and the original due date of calendar year partnership tax returns is not until March 15.³ Additionally, partnerships may request an automatic extension of time to file for six months.⁴ As a result, most partners will not receive their Schedules K-1 reporting their share of eligible gain available for investment and deferral until 75 days after

² For additional information, see AICPA letter "[Proposed Regulations on Investing in Qualified Opportunity Zones \(REG-115420-18\)](#)," January 24, 2019.

³ Section 6072(b) and Temp. Reg. § 1.6031(a)-1T(e)(2).

⁴ Temporary Reg. § 1.6081-2T(a)(1) and Treas. Reg. § 1.6081-2.

the partnership's taxable year ends, and in many cases, after the 180-day period to make an eligible investment has expired.

Beginning the 180-day period to invest eligible gains at the "end of the partnership's taxable year" is too soon for a partner to identify the amount of the gains and find an investment. The 180-day period for a partner to reinvest its distributive share of eligible gain into a QOF should begin on the earlier of the date filed or the due date (including extensions) of the partnership's tax return.

Additionally, in order for a partner to determine the amount of eligible gain under sections 731(a)(1) or 741, a partner must calculate the adjusted basis in its partnership interest under section 705(a), which generally can only occur when the partner receives its Schedule K-1. Thus, the 180-day period recommended above should also apply to eligible gains arising in the case of a sale or exchange of an interest in a partnership or a distribution by a partnership to a partner.

II. Gains from Section 1231 Property

Overview

Section 1231(a)(1) provides that if "(A) the section 1231 gains for any taxable year, exceed (B) the section 1231 losses for such taxable year, such gains and losses shall be treated as long-term capital gains or long-term capital losses."

Proposed Reg. § 1.1400Z2(a)-1(b)(2)(iii) generally provides that the only gain arising from section 1231 property that is eligible for deferral under section 1400Z-2(a)(1) is capital gain net income. Moreover, the net amount is determined by taking into account the capital gains and losses for a taxable year on all of the taxpayer's section 1231 property. In addition, the 180-day period with respect to any capital gain net income from section 1231 property for a taxable year begins on the last day of the taxable year.

Additionally, the IRS's [Opportunity Zone Frequently Asked Questions](#) (FAQs) respond to only net gains for 2018. The FAQs do not address net section 1231 gains for tax years ending after December 31, 2018.

Recommendations

The AICPA recommends that Treasury and the IRS issue final regulations providing that if a taxpayer has net section 1231 gains for a taxable year, then all such gross capital gains are eligible gains for deferral under section 1400Z-2(a)(1).

Furthermore, we recommend that final regulations provide taxpayers an elective rule, similar to Prop. Reg. § 1.1400Z2(a)-1(c)(2)(iii)(B), to elect to begin the 180-day period upon the date of sale of such section 1231 property.

Additionally, clarity is needed as to how the general rules of Prop. Reg. § 1.1400Z2(a)-1(c) apply when a partnership has a net section 1231 gain.

Analysis

If a taxpayer has a net section 1231 gain, the statute provides that all such gains and losses are treated as long-term capital gains and losses. It is unclear why the proposed regulations limit the gain eligible for deferral under section 1400Z-2(a)(1) to capital gain net income. Based on the statute, gross capital gains should qualify as eligible gains.

With respect to the 180-day period, the preamble to the proposed regulations (the “Preamble”) states that because capital gain income from section 1231 property is determinable only as of the last day of the taxable year, the proposed regulations provide that the 180-day period for investing such capital gain income from section 1231 property in a QOF begins on the last day of the taxable year. The requirement that the 180-day period begin on the last day of the taxable year delays the ability of the taxpayer who realizes a section 1231 gain to invest in an Opportunity Zone, and causes investment capital to sit idle until the end of the year. This delay is counter to the purpose of section 1400Z-2, which is to encourage investments in economically distressed communities. The IRS, in its Opportunity Zone FAQs, allowed the section 1231 gain deferral period as the 180-day period from the transaction date for section 1231 gains that were realized in 2018. Allowing a taxpayer to invest funds generated in a transaction within the 180-day period after the transaction, instead of requiring holding funds until the end of the year, furthers the government’s purpose of encouraging investments in Opportunity Zones and allows taxpayers to make investment timing decisions based upon economics. If at the end of any taxable year section 1231 gains do not exceed section 1231 losses, treating such investment as a mixed-funds investment is appropriate.

Lastly, the final regulations should clarify how the general rules of Prop. Reg. § 1.1400Z2(a)-1(c) apply to gross eligible capital gains if a partnership has a net section 1231 gain.

III. Dispositions of QOF Property with Respect to Investments Held for at Least 10 Years

Overview

Section 1400Z-2(c) provides that if a taxpayer holds any investment for at least 10 years and makes an election, “the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged.”

Proposed Reg. § 1.1400Z2(c)-1(b)(2)(i) further provides that when a QOF partnership interest is adjusted under section 1400Z-2(c), the basis of the QOF partnership assets are also adjusted immediately prior to the sale of the partnership interest. The adjustment is calculated in a manner similar to a section 743(b) basis adjustment. The Preamble states that these basis adjustments to the QOF partnership assets, including its inventory and unrealized receivables, should avoid the creation of capital losses and ordinary income on the sale. The specifics of this rule appear in one example in the proposed regulations.⁵

Additionally, Prop. Reg. § 1.1400Z2(c)-1(b)(2)(ii) generally provides that for purposes of section 1400Z-2(c), if a taxpayer has held a qualifying investment in a QOF partnership for at least 10 years, and the QOF partnership disposes of Qualified Opportunity Zone Property (QOZP) after the

⁵ Proposed Reg. § 1.1400Z2(c)-1(d)(2), Example 2(ii).

10-year holding period, the taxpayer may elect to exclude from gross income some or all of the capital gain (including section 1231 capital gain net income) arising from the disposition reported on Schedule K-1 of the QOF partnership and attributable to the qualifying investment. The language implies that this exclusion only applies to capital gain income and not ordinary gain income. It also appears that this election applies only to property disposed of by a QOF partnership and not to property disposed of by a Qualified Opportunity Zone Business (QOZB) subsidiary.

Recommendations

The AICPA recommends that Treasury and the IRS issue final regulations with respect to certain investments held for at least 10 years generally conforming: (1) the tax treatment of the sale of QOZP by a QOF partnership to the sale of a qualifying QOF partnership interest; and (2) the rules for the sale of property by a QOZB subsidiary to the rules for the sale of property by a QOF partnership.

We also recommend that the final regulations extend the benefits when the QOF partnership or QOZB subsidiary sells substantially all (e.g., defined as either 90% or 70% referenced generally in the proposed regulations) of its qualifying trade or business assets in one or a series of related transactions. The key concept is the withdrawal from the qualifying trade or business, either by the QOF partnership, or the QOZB subsidiary.

Analysis

1. *Generally conforming the tax treatment of the sale of QOZP by a QOF partnership to the sale of a qualifying QOF partnership interest after holding it for 10 years.*

The proposed regulations appear to provide a better tax result on a sale of an equity interest in a QOF partnership versus a sale of a QOF partnership's assets. In particular, if an investor has held a qualifying investment in a QOF partnership for at least 10 years and sells it, the investor can eliminate all capital and ordinary gain income from the sale. However, if instead the QOF partnership sells a QOZP after the 10-year holding period, an investor can only eliminate capital gain income from the sale. Whether investors exit their Opportunity Zone investments through the sale of their interests in the QOF partnership itself, or indirectly through the sale of a QOF partnership's assets, the economics of both transactions are similar and thus should have a similar tax result, with no bias towards an equity sale. Consequently, whether a QOF partnership interest or a QOF partnership's QOZP is sold, investors should generally have the ability to eliminate all gain upon exit after a 10-year holding period.

2. *Generally conforming the rules for the sale of property by a QOZB subsidiary to the rules for the sale of property by a QOF partnership.*

The capital gain exclusion election under Prop. Reg. § 1.1400Z2(c)-1(b)(2)(ii) is generally available only to QOF partnerships that dispose of QOZP and not to gains that a QOZB subsidiary recognizes upon a disposition of any of its Qualified Opportunity Zone Business Property (QOZBP). While some QOFs may directly own their business assets, many will organize in a two-tier structure in which the QOZB subsidiary will own the QOZBP. In those cases, it appears that

gain arising from the sale of property owned by the QOZB subsidiary will not qualify for the capital gain exclusion election.

The capital gain exclusion election available to QOF partnerships should expand to QOZB subsidiaries. There are many business reasons for QOFs to own their real estate or other business assets through a QOZB subsidiary. Consistent with the intent of sections 1400Z-1 and 1400Z-2 to facilitate economic investment and business activity in qualified opportunity zones, the tax benefits for investors under Prop. Reg. § 1.1400Z2(c)-1(b)(2)(ii) should not differ based on whether the QOF partnership sells its business assets, or the QOZB subsidiary sells its business assets. Furthermore, not providing the same benefits based solely on which entity holds and divests its business assets could lead to QOF partnership structures inconsistent with otherwise sound business practices.

These recommendations provide greater flexibility to investors and increased tax parity among similar economic QOF transactions. Also, these recommendations would fund structures that generally do not differ based merely on the nature of the divestiture from the qualifying business, either by the QOF investor, the QOF partnership, or the QOZB subsidiary. Expressed differently, the tax benefits afforded certain investments held for at least ten years should generally apply equally to any sale in termination of an interest in a QOF partnership or the underlying business.

We also understand there is a concern that allowing a QOF investor to exclude its allocable share of gain when either the QOF partnership or the QOZB subsidiary sells its qualifying property could result in unintended benefits (e.g., either the QOF partnership or the QOZB subsidiary sells its inventory in the ordinary course of business). To address this concern, the final regulations should extend the benefits when the QOF partnership or QOZB subsidiary sells substantially all of its qualifying trade or business assets in one or a series of related transactions while allowing the investor the benefits of the 10-year holding period irrespective of the sale structure (e.g., sale of an interest in the QOF partnership or sale of the business).

IV. Pre-Finalization Reliance on Prop. Reg. § 1.1400Z2(c)-1

Overview

The Preamble states that taxpayers may generally rely on the rules of the proposed regulations for periods prior to the finalization of each section if they apply those proposed rules consistently and in their entirety. However, the pre-finalization reliance does not apply to the rules related to investments held for at least 10 years. Specifically, Prop. Reg. § 1.1400Z2(c)-1(f) provides that taxpayers may not rely on the rules in Prop. Reg. § 1.1400Z2(c)-1 until the proposed regulations are finalized.

Recommendation

The AICPA recommends that Treasury and the IRS issue immediate guidance stating that taxpayers may rely on the rules of Prop. Reg. § 1.1400Z2(c)-1 prior to finalization if they apply the proposed rules consistently and in their entirety.

Analysis

The Preamble explains that the pre-finalization reliance does not apply to the rules of Prop. Reg. § 1.1400Z2(c)-1 as these rules do not apply until January 1, 2028. Due to the uncertainties with respect to the 10-year provisions, the inability to rely on these rules currently will affect QOF investors and sponsors. Both parties generally want to plan now with respect to exiting their investments and structuring their funds accordingly. Therefore, Treasury and the IRS should issue guidance permitting taxpayers to rely on the proposed regulations prior to finalization if applied consistently and in their entirety.

V. Distributions in the Case of a Mixed-Funds Investment in a QOF Partnership

Overview

Section 1400Z-2(e)(1) generally provides that in the case of any investment in a QOF when only a portion consists of investments of gain to which a deferral election is in effect, such investment shall be treated as two separate investments. The two investments would consist of one that only includes amounts to which the deferral election applies, and a separate investment consisting of other amounts (the portion of the investment to which a deferral election does not apply).

The Preamble state that rules specific to section 1400Z-2 are needed for partnership mixed-funds investments,⁶ including where a partner contributes cash to a QOF partnership in excess of the partner's eligible section 1400Z-2 gain. Under these rules, the share of gain attributable to the excess investment in the QOF partnership is not eligible for the various benefits afforded qualifying investments under section 1400Z-2 and is not subject to the inclusion rules of section 1400Z-2.

The Preamble notes that Treasury and the IRS considered various approaches to accounting for a partner holding a mixed-funds investment in a QOF partnership. The proposed regulations adopt the approach that a partner holding a mixed-funds investment is treated as holding a single partnership interest with a single basis for all purposes of subchapter K. However, solely for purposes of section 1400Z-2, the partner holding a mixed-funds investment is treated as holding two separate interests in the QOF partnership. The two interests consist of a qualifying investment and the other a non-qualifying investment. Under the rules of Prop. Reg. § 1.1400Z2(b)-1(c)(6)(iv)(B), all partnership items, including distributions, affect qualifying and non-qualifying investments proportionately. Consequently, division of a distribution between the two investments would occur and could, in part, give rise to an inclusion event under section 1400Z-2 and not result in section 731 gain. The proposed regulations include an example illustrating this rule.⁷

The Preamble states that Treasury and the IRS request comments on alternative ways to account for a distribution in the case of a mixed-funds investment, and whether an ordering rule treating the distribution as attributable to the qualifying or non-qualifying investment portion first is appropriate.

⁶ Defined in Prop. Reg. § 1.1400Z2(b)-1(a)(2)(v) as an investment a portion of which is a qualifying investment and a portion of which is a non-qualifying investment.

⁷ Proposed Reg. § 1.1400Z2(b)-1(f)(6), Example 6.

Recommendations

The AICPA recommends that Treasury and the IRS issue final regulations providing that in the case of a mixed-funds investment in a QOF partnership, distributions are first attributable to the non-qualifying investment and then to the qualifying investment for purposes of section 1400Z-2.

Furthermore, we recommend that Treasury and the IRS provide a two-year window in which a non-qualifying investment in a QOF partnership can be completely returned to the investor without the complexity of a disguised sale. Limiting this rule to a certain dollar value (such as, \$500,000) is an option.

Analysis

Proposed Reg. § 1.1400Z2(b)-1(c)(6)(iii) generally provides that distributions by a QOF partnership to a partner with respect to its qualifying investment will not accelerate gain deferral if the partner has basis in its qualifying investment at least equal to the amount of the distribution. As eluded to in the Preamble, a complicating factor exists where a partner has a mixed-funds investment in a QOF partnership. Therefore, the partner must separately track basis in each investment to determine whether a distribution is in excess of basis in the qualifying investment and thus accelerate gain deferral.

A simpler approach is to avoid mixed-funds investments in a QOF partnership by making the non-qualifying investment through a separate entity. Nonetheless, the statutory language of section 1400Z-2(e)(1) allows for such mixed-funds investments. To achieve simplicity and the purpose of sections 1400Z-1 and 1400Z-2, the final regulations should provide for maximum gain deferral of QOF partnership investments by treating QOF partnership distributions as first attributable to the non-qualifying investment and then to the qualifying investment.

This recommendation will minimize the result of the mixed-funds investment complexity. However, it may still trigger the disguised sale rule under Prop. Reg. § 1.1400Z2(a)-1(b)(10)(ii)(A)(2) that applies to even a contribution of money. Many taxpayers will stumble into a mixed-funds investment; we further recommend a two-year window in which the non-qualifying investment can be completely returned to the investor without the complexity of a disguised sale.

We recognize that some investors could attempt to increase the return on investment by intentionally making a mixed-funds investment where a return of the non-qualifying investment is preplanned. The anti-abuse rule should cover such situations.

VI. Disguised Sale Rules and Mixed-Funds Investments

Overview

Proposed Reg. § 1.1400Z2(a)-1(b)(10)(ii)(A)(2) generally provides that to the extent any transfer of cash or other property to a partnership is not otherwise disregarded as a contribution (e.g., treated as a disguised sale for purposes of section 707), the transfer to the partnership will not be treated as a qualifying investment under section 1400Z-2(a)(1)(A) to the extent (i) the partnership

makes a distribution to the partner; and (ii) the transfer to the partnership and the distribution is otherwise recharacterized as a disguised sale under section 707(a)(2)(B) if (i) any cash contributed were non-cash property; and (ii) in the case of a debt-financed distribution by the partnership (to which Treas. Reg. § 1.707-5(b) applies), the partner's share of the liability is zero.

Recommendations

In the event that Treasury and the IRS disagree with our recommendation in Section V, Distributions in the Case of a Mixed-Funds Investment in a QOF Partnership, the AICPA recommends that final regulations provide that distributions of excess investments are not treated as disguised sales that would result in the remaining contributions under Prop. Reg. § 1.1400Z2(a)-1(b)(10)(ii)(A)(2) being treated as a mixed-funds investment.

In addition, we suggest that the investor withdrawing a portion of its investment is allowed to amend its return (for the year in which the investment was made) and include any gain originally deferred (on the originally filed return) equal to the investment returned.

Analysis

Distributions treated as section 707 disguised sales under Prop. Reg. § 1.1400Z2(a)-1(b)(10)(ii)(A)(2) change the character of an original investment in a QOF partnership from a qualifying investment to a non-qualifying investment to the extent of the disguised sale, therefore, triggering the application of the rules for mixed-funds investments under section 1400Z-2(e) and the proposed regulations thereunder. If a taxpayer has a qualifying investment in a QOF partnership, and later the disguised sale rules apply, the taxpayer may own a mixed-funds investment although the investment did not initially start as a mixed-funds investment. Notwithstanding there is some flexibility in the rules (e.g., 90% of assets), given the short-term window in which to make the investments, there likely are situations in which a person invests more in a QOF than the QOF can ultimately invest in a QOZP. In that case, we recommend that the rules allow the QOF to distribute the excess funds to the investor(s) without causing the investor's remaining investment to be treated as mixed-funds investment.

VII. Step-up to Fair Market Value of the Underlying Investment in a QOF at the Death of the QOF Investor

Overview

Section 1400Z-2(e)(3) provides that "In the case of a decedent, amounts recognized under this section shall, if not properly includible in the gross income of the decedent, be includible in gross income as provided by section 691." Thus, the recipient of the QOF has the obligation under section 691 to include the deferred gain (i.e., income in respect of a decedent (IRD)) in gross income in the event of any subsequent inclusion event.

The section 1400Z-2(e) proposed regulations do not provide guidance on the application of section 1014 on the basis of the QOF's basis.

Section 1400Z-2(b)(2)(B) provides that the basis of the underlying QOF initially is zero. The statute also provides that the basis of the QOF is increased by the amount of the deferred gain recognized by reason of section 1400Z-2(a)(1)(B) (in the case of a decedent, the IRD). Section 1400Z-2(b)(2)(B) also provides for increases to the basis of the QOF if held for 5 and 7 years. If a QOF is held by the taxpayer at least 10 years, the basis of the investment is the fair market value of the QOF on the date that the QOF is sold or exchanged.

Recommendation

The AICPA recommends that the final regulations clarify that section 1014 is applicable to the appreciation in the underlying investment in the QOF.

Analysis

Under section 1014, the basis of property in the hands of the person acquiring the property from a decedent or to whom the property passed from a decedent is the fair market value at the decedent's death. This adjustment to basis does not apply to IRD. However, it does apply to the basis of other property. Section 1400Z-2 and the proposed QOF regulations do not override the application of section 1014, therefore, section 1014 is applicable.

VIII. Rollover of Gain by Either Grantor or Trustee of a Grantor Trust

Overview

Section 1400Z-2(a) provides that an "eligible taxpayer" may elect to defer recognition of eligible capital gains to the extent the taxpayer invests in eligible interests of a QOF. Proposed Reg. § 1.1400Z2(a)-1 provides definitional and operational rules related to the mechanics of investing in a QOF. Specifically, Prop. Reg. § 1.1400Z2(a)-1(c) provides special rules for pass-through entities, including trusts. Based on the definition of a taxpayer in the proposed regulations, the trust referred to in Prop. Reg. § 1.1400Z2(a)-1(c)(3) could apply only to non-grantor trusts. In addition, the proposed regulations do not address which taxpayer is eligible in the case of a grantor trust for purposes of identifying who could make the investment in a QOF.

Recommendations

The AICPA recommends that the final regulations clarify that the deemed owner and the trustee (on behalf of the grantor trust) are both eligible to make the investment in the QOF resulting from an eligible capital gain recognized by the grantor trust. In addition, either the deemed owner or the trustee of a grantor trust could make the investment in a QOF resulting in an eligible capital gain recognized by the deemed owner individually.

We also recommend that the final regulations confirm that the rules applicable to trusts under Prop. Reg. § 1.1400Z2(a)-1(c)(3) apply only to non-grantor trusts.

Analysis

For purposes of determining who is an eligible taxpayer for a trust under section 1400Z-2, the proposed regulations do not distinguish between grantor trusts and non-grantor trusts. Proposed Reg. § 1.1400Z2-1(b)(1) defines an eligible taxpayer as the person that may recognize gains for purposes of federal income tax accounting including, among others, individuals, various corporations, partnerships, trusts and estates. Based on the long-standing history of the grantor trust rules under sections 671 through 679 and the principles of Rev. Rul. 85-13, the deemed owner of a grantor trust owns the assets of the trust for income tax purposes. Treasury and the IRS should recognize the deemed owner of a grantor trust as the eligible taxpayer for purposes of section 1400Z-2.

Treasury and the IRS should permit the deemed owner of a grantor trust to invest in a QOF to defer an eligible capital gain that was recognized by the grantor trust. Under long-standing principles of income tax, the final regulations should make this distinction in the case of an eligible capital gain recognized by a grantor trust.

Treasury and the IRS should also make it possible for treating the trustee of a grantor trust as the eligible taxpayer able to make the QOF investment on behalf of the trust, and therefore, on behalf of the deemed owner of the trust's assets for income tax purposes.

A review of the relevant section of the proposed regulations dealing with trusts does not add clarity. Proposed Reg. § 1.1400Z2(a)-1(c)(3) provides, in relevant part, that rules similar to partnerships with eligible capital gains are applicable to trusts. Under rules applicable to partnerships, a partnership with an eligible capital gain may elect to defer the capital gain by investing in a QOF.⁸ In addition, if the partnership does not elect to invest its eligible gain in a QOF, the partners of the partnership may elect to defer the capital gain by investing in a QOF.⁹ The proposed regulations provide the same treatment for trusts as for pass-through entities. We refer to this treatment as the "pass-through equivalence." Essentially, under the current proposed regulations, a nongrantor trust with an eligible capital gain can either elect to defer capital gain by investing in a QOF, or forego such election and permit the beneficiaries of the trust to make the investment in a QOF.

We note that this pass-through equivalence could apply only to non-grantor trusts. If the trust at issue were a grantor trust, an investment in a QOF by the trustee would produce the intended tax result if no trust distributions were made. Treasury and the IRS should treat the deemed owner as the owner of the trust's assets for income tax purposes and the eligible taxpayer for purposes of section 1400Z-2. A distribution of capital gain to a beneficiary of the grantor trust¹⁰ with a corresponding investment into a QOF by the beneficiary would not produce a rollover of the eligible capital gain intended by section 1400Z-2. In such case, the deemed owner would not have made an investment in a QOF, either directly or through the trustee of the trust. Moreover, the beneficiary would also have not made an investment in a QOF because distributions to a beneficiary of a grantor are not treated as taxable to the beneficiary. The beneficiary would not

⁸ Proposed Reg. § 1.1400Z2(a)-1(c)(1)(i).

⁹ Proposed Reg. § 1.1400Z2(a)-1(c)(2)(ii)(B).

¹⁰ This scenario assumes that the trustee includes capital gains in the distributable net income of the trust under section 643.

recognize an eligible capital gain. Therefore, Treasury and the IRS should not apply the pass-through equivalence to a grantor trust, unless the trustee makes the investment in a QOF for the trust.

If the trust at issue were a non-grantor trust, the trustee could make the QOF investment on behalf of the trust or, alternatively, the trustee could distribute the eligible capital gain to a beneficiary of the trust, who in turn could make the investment in a QOF.

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

The AICPA also recommends that Treasury and the IRS provide guidance or clarification on various issues regarding section 1400Z-2.

- A. Proposed Reg. § 1.1400Z2(b)-1(c)(6)(ii)(C) generally provides that a merger or consolidation of a partnership holding a qualifying investment, or of a partnership that holds an interest in such partnership solely through one or more partnerships, with another partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event except for the portion of the transaction that is otherwise treated as a sale or exchange.

Additional guidance is needed as to whether the merger or consolidation of a QOF partnership itself is a probable inclusion event, as well as how section 708(b)(2)(B) applies to the division of a QOF partnership (including a partnership holding a qualifying investment). In addition, guidance is needed as to how such merged or divided QOF partnership is subject to section 1400Z-2 and the regulations thereunder.

- B. Clarification is needed as to whether there is a basis step-up under any circumstances (e.g., a distribution on December 1, 2047 in excess of a partner's basis that triggers section 731 gain) if there is no disposition of a QOF partnership's QOZP or a partner's qualifying investment in a QOF by December 31, 2047 under Prop. Reg. § 1.1400Z2(c)-1(b).
- C. Section 1400Z-2(c) generally provides that a taxpayer that holds a qualifying investment in a QOF for at least 10 years can elect to step-up the basis of its investment to fair market value on the date that its investment is sold or exchanged. For dispositions of qualifying QOF partnership interests, Prop. Reg. § 1.1400Z2(c)-1(b)(2)(i) provides, in part, that if a QOF partner's basis in a qualifying QOF partnership interest is adjusted under section 1400Z-2(c), "the basis of the partnership interest is adjusted to an amount equal to the fair market value of the interest, including debt." Given that taxpayers may not rely on the rules of Prop. Reg. § 1.1400Z2(c)-1 before they are finalized, confirmation is needed that the 10-year basis step-up to fair market value as provided for under the statute includes debt (e.g., the selling partner's share of partnership debt from which the partner is relieved).