December 28, 2018

CC:PA:LPD:PR (REG-115420-18), Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station,
Washington, DC 20044

**Re: REG-115420-18 – Investing in Qualified Opportunity Funds**

Dear Sir or Madam:

Plante Moran is pleased to submit comments as requested by the Department of Treasury ("Treasury") and the Internal Revenue Service ("IRS") in REG-115420-18 implementing the opportunity zone program pursuant to section 1400Z-2. Our comments are focused on a number of areas where we believe that changes or additions to the guidance could provide more certainty for investors in qualified opportunity funds (QOFs). Because Treasury's interpretation of the opportunity zone statute could dramatically affect an investor's after tax rate of return from an investment in a QOF, investors are looking for more certainty from these rules than they may look for from other tax rules. Without this certainty, many investors may be unwilling to participate in the program, limiting the amount of investment that Congress intended by enacting this program.

As described more fully below, Plante Moran recommends that Treasury and the IRS make the following changes to the proposed regulations:

- Ensure that QOFs have time to raise, deploy, and redeploy capital
- Clarify that qualified opportunity zone business property (QOZBP) can include improvements to property that is not QOZBP
- Clarify how vacant land should be treated in applying the QOF and qualified opportunity zone business (QOZB) tangible property tests
- Clarify the calculation of outside basis for investors in a QOF
- Clarify that QOF investors can exclude gain from a sale of assets by the QOF or QOZB by making an election under section 1400Z-2(c) when the QOF investors exchange their QOF investments in a related transaction

**Overview**

Public Law No. 115-97 enacted a new community development financing tool pursuant to sections 1400Z-1 and 1400Z-2. The opportunity zone program encourages investment into low-income census tracts selected by each state's governor. Tax deferrals and exclusions are available to taxpayers to the extent that they invest capital gains in QOF's in accordance with the program requirements.

The opportunity zone program has attracted a significant amount of attention. However, program participants have been hesitant to utilize the program in the absence of guidance clarifying ambiguities in the statute. REG-115420-18 provides a considerable amount of guidance that is immediately helpful to program participants. In particular, we commend Treasury for defining "substantially all" as 70 percent for purposes of applying the tangible property test for QOZBs. We encourage Treasury to retain this 70 percent definition in the final regulations to help facilitate QOF investments into operating businesses. However, as outlined below, we feel that certain other aspects of the proposed regulations could be changed or clarified to provide certainty to the many investors who are looking for a higher level of certainty before they would be willing to invest in a QOF. As noted below, some of our comments echo recommendations included in the comment letter submitted by the Economic Innovation Group's Opportunity Zones Coalition ("EIG"), of which Plante Moran is a member.

**Ensure QOFs have time to raise, deploy, and redeploy capital**

Section 1400Z-2(d) defines a QOF as an investment vehicle that holds at least 90 percent of its assets in qualified opportunity zone property (QOZP). Section 1400Z-2(d)(1) measures the asset test by taking the average of the QOF's percentage of QOZP on the last day of the first six month period of the tax year and the last day of the tax year. Unless due to reasonable cause, failure by the QOF to meet the 90 percent asset test results in application of a penalty.

Proposed regulation section 1.1400Z-2(d)-1(d)(5)(iv) provides a working capital safe harbor for QOZBs that acquire, construct, or rehabilitate tangible business property. Such safe harbor allows a QOZB 31 months to make investments into QOZBP. However, the proposed regulations do not extend such safe harbor to QOFs and they do not provide any grace period to allow QOFs additional time to make investments in QOZP.

EIG's comment letter made several points to support the need and justification for a QOF level grace period, including:

- Congress gave the Treasury Department broad regulatory authority to craft "such regulations as may be necessary or appropriate to carry out the purposes of [section 1400Z-2]," including "rules to ensure that a qualified opportunity fund has a reasonable period of time to reinvest" cash returns.
- QOFs will have less than six months – perhaps only a few days – to initially deploy funds. Under this rule, QOFs will effectively be unable to accept contributions of deferred capital gains in the weeks before a testing date if there is not sufficient time to ensure that QOZP investments can be made. The lack of a QOF working capital safe harbor will be disruptive to the timing of the flow of capital and may prevent some willing participants from utilizing the program if QOFs are not in a position to utilize capital at the specific time of an investment based on testing dates.
- It was clear to Congress that investments in opportunity zone operating businesses and projects cannot be instantaneously completed; prudent investment takes time. For this reason Section 1400Z-2(e)(4)(B) directs Treasury to issue regulatory guidance providing a reasonable time to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests, and to reinvest proceeds received from the sale or disposition of qualified opportunity zone property. It is clear, from the structure of the incentive to the specific mention of investment timing, that Congress intended for this incentive to draw capital to QOFs and for QOFs to invest in a portfolio of QOZBs. In order to carry out this directive in a responsible manner QOFs require a reasonable time to deploy contributed capital. Treasury has authority to carry out the

statute's purposes in this regard by clearly providing in final regulations a reasonable time to invest the funds that QOFs receive at the outset as well.
- Although the New Markets Tax Credit (NMTC) statute has no grace period for a Community Development Entity's (CDE's) investment (or reinvestment) of cash proceeds from a sale, Treasury provided in Regulation Section 1.45D-1(c)(5)(iv) and (d)(2) that cash held by a CDE may be treated as invested in a qualifying investment to the extent it is actually appropriately invested within 12 months of the day it was received.

EIG's comment letter also provided several recommendations as to how Treasury could address concerns regarding the time period in which QOFs are required to invest their assets in QOZP. We fully support EIG's recommendations, which are summarized as follows:

- The proposed regulations helpfully provide up to 31 months for QOZBs to make investments or improvements in QOZBP. A similar start-up grace period could be given to QOFs that have a written plan for the deployment of capital and that do, in fact, deploy the capital in qualifying investments within the 31-month time frame, while still acknowledging that a QOF will generally need to meet the 90 percent asset test semi-annually.
- At the very least, similar to the NMTC regulations referenced above, final regulations should provide that for 12 months after receipt of any cash (from new investment, from returns on investments, or from the sale of QOZBP), such cash will be deemed to be QOZP for purposes of the 90 percent asset test if it is invested in qualifying investments by the end of the 12-month period.
- The final regulations could also provide a QOF with an initial grace period of 12-18 months from the time the QOF is formed before it must participate in its first semi-annual asset testing date. A 12-to 18-month grace period, together with more general flexibility to take a year to deploy any cash coming in, would provide newly formed QOFs the additional time needed to invest in a full portfolio of QOZBs.
- Finally, Treasury could provide relief to QOFs by describing circumstances when a failure to meet the 90 percent asset test is due to reasonable cause. Section 1400Z-2(f)(3) provides a reasonable cause exception to the asset test penalty, but does not describe such circumstances. Section 1400Z-2(e)(4)(A) further provides Treasury with regulatory authority regarding the certification of QOFs. Regulations could provide that the failure of a QOF to meet the test during the first 31 months of its existence is due to reasonable cause, to the extent the failure is due to holding excess cash, and provided that it is using reasonable efforts to invest such cash in QOZBs. At a minimum, the failure of a QOF to meet the 90 percent test due to excess cash that is ultimately invested within one year of receipt should be considered a reasonable cause exception.

**Clarify that QOZBP can include improvements to property that is not QOZBP**

Tangible property must satisfy both a purchase and original use requirement to be considered QOZBP as defined by section 1400Z-2(d)(2)(D). To meet the purchase requirement, tangible property must be acquired after December 31, 2017 via purchase as defined by section 179(d)(2). To meet the original use requirement, the original use of the property must commence with the QOF in the opportunity zone or the QOF or QOZB must substantially improve the property in accordance with section 1400Z-2(d)(2)(D)(ii) and proposed regulation sections 1.1400Z-2(d)-1(c)(8) and 1.1400Z-2(d)-1(d)(4). There are numerous common situations where a QOF or QOZB may have acquired tangible property that does not satisfy the purchase or the original use requirement, including the following situations:

1. Acquired prior to December 31, 2017
2. Acquired via capital contribution
3. Acquired from a related party
4. Not substantially improved in accordance with section 1400Z-2(d)(2)(D)(ii)

It is unclear whether improvements to such ineligible property can be considered QOZBP. To eliminate such ambiguities, proposed regulation sections 1.1400Z-2(d)-1(c)(4) and 1.1400Z-2(d)-1(d)(2) should be revised to clarify that improvements to property can be QOZBP regardless of whether the underlying property meets the QOZBP applicable requirements, as long as the improvements otherwise meet the applicable requirements. In other words, the regulations should clarify that improvements to a building should be treated as separate property from the underlying building in applying the definition of QOZBP. Such clarification should apply to all of the situations listed above. This clarification would be consistent with other similar provisions within tax law. For example, regulation section 1.168(k)-1(b)(3)(i) provides that "additional capital expenditures incurred by a taxpayer to recondition or rebuild property acquired or owned by the taxpayer satisfies the original use requirement" when interpreting the original use requirement for previous versions of the bonus depreciation rules. We believe that a similar interpretation is appropriate for this purpose as well.

Absent clarification that improvements can be QOZBP without the underlying property meeting the QOZBP applicable requirements, most QOFs and QOZBs with property that does not satisfy the purchase or original use test would be at risk of failing the 90 or 70 percent tangible property test. Investors considering the opportunity zone program are generally looking for certainty in the qualification of a QOF given the significant tax consequences of failing to satisfy the QOF requirements. As a result, we believe that this clarification would be important to ensure that the program operates smoothly and that QOFs and QOZBs holding property that does not satisfy the purchase or original use test (including all entities that owned buildings in a qualified opportunity zone (QOZ) on December 31, 2017) will be able to raise equity to improve such property.

**Clarify how vacant land should be treated in applying the QOF and QOZB tangible property tests**

As discussed above, tangible property must satisfy both a purchase and original use requirement to be considered QOZBP as defined by section 1400Z-2(d)(2)(D) and the original use requirement is met if the property is substantially improved. Proposed regulation sections 1.1400Z-2(d)-1(c)(8)(ii)(A) and 1.1400Z-2(d)-1(d)(4)(ii)(A) provide that the basis attributable to the land on which a building sits may be excluded for purposes of determining whether the building meets the substantial improvement test. In addition, such provisions state that measuring a substantial improvement to the building by additions to the QOF's adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located. Revenue Ruling 2018-29, released contemporaneously with these proposed regulations, mirrors regulation sections 1.1400Z-2(d)-1(c)(8)(ii)(A) and 1.1400Z-2(d)-1(d)(4)(ii)(A) and also holds that the original use requirement is not applicable to the land on which the building is located.

The preamble to the proposed regulations notes that these provisions were in response to commenters concerns regarding the treatment of vacant or unutilized land. However, the proposed regulations do not clarify whether vacant land (including land acquired with a building that is later demolished) is treated the same as land acquired with a building that is subsequently substantially improved. Consequently, it would be helpful if Treasury can clarify that vacant land is not required to be separately substantially improved to be considered QOZBP and that the original use test is not applicable to vacant land. If Treasury determines that vacant land is

required to be substantially improved to be treated as QOZBP then Treasury should provide guidance as to when vacant land will be considered substantially improved.

**Clarify the calculation of outside basis for investors in a QOF**

Section 1400Z-2(b)(2)(B) includes several provisions related to the calculation of a taxpayer's basis in its QOF investment. In particular, section 1400Z-2(b)(2)(B)(i) provides that a "taxpayer's basis in the investment shall be zero." This could be interpreted as requiring a taxpayer to always maintain a zero basis in the investment (other than with respect to basis adjustments under sections 1400Z-2(b)(2)(B) and 1400Z-2(c)) regardless of any later activities for which basis would ordinarily be adjusted under general income tax principles (e.g., contributions, distributions, allocated income or loss from flow-through QOFs, etc.). If this were the case, it would cause substantial complications for coordinating the opportunity zone rules with other existing tax rules. In addition, resulting tax inefficiencies would deter potential QOF investors. Such tax inefficiencies could include deferral and potential permanent loss of the tax benefits related to otherwise deductible tax losses and taxation of otherwise nontaxable operating cash flow distributions. For example, if a QOF investor's basis is not increased by its share of the QOF's taxable income or liabilities, the investor's share of operating distributions may be taxable and it may never have basis to deduct its share of the QOF's taxable losses.

The original conference committee report provided that "[t]he basis of an investment in a qualified opportunity zone fund *immediately after its acquisition* is zero" (emphasis added).[1] The joint committee report provides that "investor-partners in a fund organized as a partnership would recognize income and increase their basis with respect to their distributive share of the fund's taxable income."[2] These statements seem to make clear that Congress intended the initial basis in an investment in a QOF to be zero while all other basis adjustments under general principles of tax law would still apply from that moment forward. Proposed regulation section 1.1400Z-2(e)-1(a)(2) also seems to take this view by excepting deemed contributions under section 752(a) from creating a mixed fund investment under section 1400Z-2(e)(1).

In order to provide certainty to investors in QOFs, we believe that it would be helpful for regulations to more clearly limit the zero basis provision as applying only with respect to the initial investment of deferred capital gains and not with respect to any other basis adjustments provided under general principles of tax law.

Further, it is likely that many QOFs will be investing in real estate. It is not uncommon for real estate partnerships to make debt-financed distributions from debt proceeds obtained after the development is completed, the property's operations have stabilized, and the value of the property has appreciated. Debt-financed distributions are generally not taxable to a partner unless the distribution exceeds the partner's adjusted tax basis in its partnership interest (which has been increased by the partner's share of the debt funding such a distribution). Similar to the discussion above, investors in QOFs are looking for a high level of clarity in the mechanics of how general tax principles apply to their investment in QOFs and an understanding that certain ordinary transactions will not be viewed as abusive, particularly for those QOFs structured as partnerships. As a result, we recommend including an example in the proposed regulations clarifying that a QOF can make a debt-financed distribution in the same manner as any other partnership without impacting the qualification of the QOF and that the treatment of the distribution will simply follow general tax principles. Treasury has already provided similar clarifying statements in proposed

[1] H. Rep. No. 115-466, at 539 (2017).
[2] General Explanation of Public Law 115-97, 320 (Jt. Comm. Print 2018).

regulation section 1.1400Z-2(a)-1(b)(3)(ii) with respect to QOF investors that use their QOF interest as collateral for a loan by indicating that this would not disqualify the gain deferral election.

**Clarify that QOF investors can exclude gain from a sale of assets by the QOF or QOZB by making an election under section 1400Z-2(c) when the QOF investors exchange their interests in a related transaction**

Section 1400Z-2(c) provides that a taxpayer can exclude gain from the sale or exchange of an investment in a QOF by making an election to increase the basis of any investment held for at least 10 years to equal the fair market value of the investment at the time of the sale or exchange. When exiting a QOF investment it is possible either for the QOF investors to directly sell their interests or for the QOF or QOZB to dispose of assets and distribute proceeds to the QOF investors in exchange for such interests. Without additional guidance, the applicability of such exclusion when a QOF or QOZB sells its assets and QOF investors exchange their interests for sale proceeds could depend upon whether the QOF is a C Corporation or a pass-through entity.

Section 331(a) provides that amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock. Consequently, the shareholder will recognize gain or loss equal to the difference between the fair market value of the assets received and the adjusted basis of the stock surrendered. Since an S Corporation shareholder increases its basis in the corporation by its share of the corporation's taxable income, a shareholder in an S corporation will generally not recognize gain or loss upon liquidation of the corporation because such shareholder's basis is increased by its share of the taxable gain from the sale of the corporation's assets. Similarly, a partner in a partnership is subject to tax on its share of the gain associated with the sale of the partnership's assets, but such partner will generally not recognize gain or loss upon liquidation of the partnership because its basis in the partnership is increased by its share of taxable gain on the sale of the partnership's assets. However, a shareholder in a C corporation will recognize a gain or loss on the liquidation of the corporation because such shareholder's basis is not increased in connection with the taxable gain recognized by the corporation on the sale of its assets.

If a taxpayer were able to only step-up its outside basis in an investment in a QOF, as illustrated above, there would generally be no basis step-up for a QOF or QOZB partnership that sold its underlying assets because such QOF partner will have already increased its basis by the amount of its share of the gain under general tax principles. Section 1400Z-2(c) incentivizes investors to hold investments in QOFs for more than 10 years by enabling them to make an election to step-up basis to exclude gain upon the sale or exchange of such investment. However, investors may not be motivated to make investments into a QOF or to hold such an investment for more than 10 years if it is not clear that they will be entitled to actually exclude gain on the disposal of their investment if such disposal is accomplished via a sale by the QOF or the QOZB followed by a liquidation of the QOF.

However, we feel that the proper reading of the statute would provide for a basis step-up in the underlying assets of the QOF or QOZB at the time of the disposition of those assets in addition to stepping-up the outside basis in the QOF itself. Section 1400Z-2(c) states that "In the case of any investment held by the taxpayer for at least 10 years and with respect to which the taxpayer makes an election under this clause, the basis of such *property* shall be equal to the fair market value of such investment on the date the investment is sold or exchanged" (emphasis added). The term "property" is different from the term "investment" used in the beginning of that sentence. This implies that the basis step-up is meant to be broader than merely stepping up the basis in the investment in the QOF itself. That is, this could be interpreted to represent a step-up in the

investor's share of the property of the QOF. Such interpretation would create consistency in that the exclusion would be available to all owners of QOFs that dispose of their investment after at least 10 years regardless of (1) whether the QOF's owners sell their investment to a third party or the QOF sells its assets and QOF investors exchange their interest for sale proceeds and (2) whether the QOF is structured as a pass-through entity or a C Corporation.

Alternatively, if Treasury determines that it does not have authority to apply a basis step-up concept to a QOF or QOZB classified as a C or S Corporation, Treasury should not hesitate to promulgate regulations applying such a basis step-up concept to QOFs and QOZB's classified as partnerships consistent with the aggregate theory of partnership taxation. The general principle of law underlying aggregate or entity treatment of a partnership is set forth in the 1954 Conference Report on Section 707: H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954), which states the general proposition that aggregate or entity principles are applied as appropriate under the circumstances: "No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions." Numerous rulings and court cases have applied the aggregate vs. entity theory to resolve various technical issues. In doing so, the IRS and the courts generally rely upon the aggregate vs. entity theory to resolve issues consistent with the intent of Congress. With respect to the issue at hand, Congress clearly intended QOF investors who hold their investments for at least 10 years to exclude gains from the disposal of such investment. As discussed above, Congressional intent will not be served consistently if the availability of such exclusion depends upon the structure of the disposition (redemption of the QOF interest following an asset sale vs. sale of an ownership interest in the QOF). Consequently, at a minimum, the regulations should apply the aggregate theory consistent with Congressional intent to allow QOFs and QOZBs classified as partnerships that sell their assets and use the proceeds to redeem QOF investors to step-up the basis of property sold to the extent necessary to exclude gain allocable to partners that make a valid election under section 1400Z-2(c). Such basis adjustment should function similar to a section 743(b) basis adjustment in that it should benefit the owner(s) of the QOF that make a valid section 1400Z-2(c) election to enable such owner(s) of the QOF to exclude their share of the partnership's gain on the sale of its assets.

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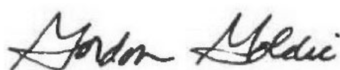
We appreciate your consideration of our comments on the proposed regulations for the opportunity zone program under section 1400Z-2. We welcome a further discussion of these issues and our comments. We are available to meet with government officials in this regard. Please feel free to contact Gordon Goldie at (248) 375-7430 or gordon.goldie@plantemoran.com; Valerie Grunduski at (313) 496-7420 or valerie.grunduski@plantemoran.com; or Stephen Eckert at (312) 602-3653 or stephen.eckert@plantemoran.com.

Respectfully submitted,



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