NYS SOCIETY OF CPAs
NYSSCPA

January 9, 2019

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

By email: erika.c.reigle@irscounsel.treas.gov

Re: Investing in Qualified Opportunity Funds (REG-115420-18) – Proposed Regulations Under Code Section 1400Z-2

The New York State Society of Certified Public Accountants (NYSSCPA), representing more than 25,000 CPAs in public practice, business, government and education, welcomes the opportunity to comment on the above-captioned proposed regulations.

The NYSSCPA's Taxation of Individuals, Estate Planning and Trusts and Estates Administration Committees deliberated the proposed regulations and prepared the attached comments. If you would like additional discussion with us, please contact Kevin Matz, member of the Estate Planning and Trusts and Estates Administration Committees, at (212) 806-6076, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

Jan C. Herringer
President

Attachment

NEW YORK STATE SOCIETY OF

CERTIFIED PUBLIC ACCOUNTANTS

COMMENTS ON

INVESTING IN QUALIFIED OPPORTUNITY FUNDS (REG-115420-18) – PROPOSED REGULATIONS UNDER CODE SECTION 1400Z-2

January 9, 2019

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Comments on

Investing in Qualified Opportunity Funds (REG-115420-18) – Proposed Regulations Under Code Section 1400Z-2

Treasury Notice 83 Fed. Reg. 54279 (10/29/18) requested comments on proposed regulations (the "proposed regulations") issued under section 1400Z-2 of the Code concerning qualified opportunity funds ("QOFs").[1] The New York State Society of Certified Public Accountants (NYSSCPA) welcomes the opportunity to comment on the proposed regulations and commends Treasury and the IRS for their efforts in quickly drafting such a well-organized package of proposed regulations.[2]

BACKGROUND

Section 1400Z-2 contains a new tax incentive provision that is intended to promote investment in economically-distressed communities, referred to as "Opportunity Zones." Through this program, investors can achieve the following three significant tax benefits:

1. The deferral of gain on the disposition of property to an unrelated person until the earlier of the date on which the subsequent investment is sold or exchanged, or December 31, 2026, so long as the gain is reinvested in a QOF within 180 days of the disposition of the underlying property;

2. The elimination of up to 15% of the gain that has been reinvested in a QOF provided that certain holding period requirements are met;[3] and

3. The potential elimination of tax on gains associated with the appreciation in the value of a QOF, provided that the investment in the QOF is held for at least ten years.

An Opportunity Zone is an economically-distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment. Localities qualify as Opportunity Zones if they have been nominated for that designation by the state and that

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[1] Unless otherwise stated, references herein to "section(s)" or to "Code" are to the Internal Revenue Code of 1986, as amended. References herein to "§" are to relevant sections of the Treasury regulations.

[2] The proposed regulations can be found at the following link: https://www.federalregister.gov/documents/2018/10/29/2018-23382/investing-in-qualified-opportunity-funds

[3] This is accomplished through basis adjustments. Section 1400Z-2(b)(2)(B)(iii) provides that in the case of any investment in a QOF that is held for at least five years, the basis of such investment shall be increased by ten percent (10%) of the deferred gain. In addition, section 1400Z-2(b)(2)(B)(iv) provides for an additional five percent (5%) increase in the basis of the QOF investment if it is held by the taxpayer for at least seven years.

nomination has been certified by the Internal Revenue Service (IRS). All Opportunity Zones were designated as of June 14, 2018, and a list is available on the U.S. Department of Treasury website. *See* https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx

A QOF, in turn, is an investment vehicle that is established as either a domestic partnership or a domestic corporation for the purpose of investing in eligible property that is located in an Opportunity Zone and uses investor gains from prior investments as a funding mechanism.

To become a QOF, the entity self-certifies itself. The entity must meet certain requirements, in particular a general requirement that at least 90% of its assets be "qualified opportunity zone property" used within an Opportunity Zone, but no approval or action by the IRS is required. To self-certify, the entity completes Form 8996, and then attaches that form to the entity's timely-filed federal income tax return for the taxable year (taking into account extensions).[4]

On October 19, 2018, the U.S. Department of Treasury and the Internal Revenue Service announced the issuance of proposed regulations on QOFs that were published in the Federal Register on October 29, 2018. The U.S. Treasury Department has also promised further guidance in the "near future."

QOZ Investor Requirements and Benefits

An investor that would otherwise recognize taxable gain on a sale occurring between 2018 and 2026 may reinvest up to the amount of such gain (the "rollover gain") into a QOF within 180 days of the sale. The investor may thereby defer recognizing the rollover gain as income until December 31, 2026, assuming the investor continues to hold the interest in the QOF. In addition:

- If the investor holds the interest in the QOF for 5 years, the basis in the investment increases by 10% of the amount of the rollover gain.
- If the investor holds the interest in the QOF for 7 years, the basis in the investment will increase by an additional 5% for a total of 15%.[5] Such basis increases reduce the deferred gain amount ultimately subject to tax.
- An investor holding the QOF interest for 10 years or more qualifies for a special rule by which the investor may elect, on a subsequent disposition of the QOF interest,[6] not to recognize taxable gain with respect to any post-acquisition appreciation (thereby limiting the total gain recognized to the amount of the rollover gain, potentially reduced by up to 15%).

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[4] Drafts of the IRS Form 8996 and the instructions thereto are set forth at the following links: https://www.irs.gov/pub/irs-dft/f8996--dft.pdf and https://www.irs.gov/pub/irs-dft/i8996--dft.pdf

[5] Given the December 31, 2026 "sunset," rollovers after 2019 cannot receive the additional 5% basis under the 7-year rule, and rollovers after 2021 cannot receive any increase in basis under either the 5- or 7-year rule.

[6] The exit from a QOF must generally be by sale of the QOF interest in order to take advantage of the QOZ benefits.

The proposed regulations clarify that:

(1) only capital gains (and not ordinary income or certain recapture "gain") are eligible for rollover reinvestment;

(2) either a partnership (if it so elects) or a partner in such partnership (if the partnership does not elect) may rollover gains recognized through the partnership;

(3) if a partner recognizes gains through a partnership, the 180-day period in which to rollover such gains begins at the end of the partnership's taxable year (unless the partner elects to use the partnership's 180-day period beginning on the date the respective asset was sold);[7] and

(4) investors may continue to hold their QOZ investments (for purposes of the special 10-year rule above) until December 31, 2047 (and still not pay tax on any post-acquisition appreciation prior to the date of disposition).

QOF Requirements

An entity must meet certain requirements, separate from the investor-specific requirements above, to qualify as a QOF. Specifically, a QOF must meet a test (the "90% Asset Test") whereby 90% of its assets, measured every 6 months and averaged for each year, must be qualifying "QOZ Property." To meet this requirement, a QOF may (i) directly own "QOZ Business Property" or (ii) may own a QOZ Business that in turn owns QOZ Business Property. A QOF may not, however, own (as a qualifying asset) an interest in another QOF.

A QOZ Business must (i) have "substantially all" of its tangible assets invested in QOZ Business Property, (ii) meet certain requirements under section 1397C regarding permissible assets (including a general prohibition against owning more than 5% nonqualified financial assets such as cash),[8] and (iii) comport with certain "sin business" prohibitions under section 144(c)(6)(B).

QOZ Business Property means, in general, tangible property acquired by purchase from an unrelated party,[9] which property either is "originally used" in the QOZ by the QOF or QOZ Business, or is "substantially improved" by the QOF or QOZ Business (meaning, generally, improvements over a period of 30 months that result in a 100% increase to the adjusted basis of the property).

[7] The proposed regulations state that rules analogous to the partnership and partner guidance indicated above apply to other pass-through entities (including S corporations, decedents' estates, and trusts) and to their shareholders and beneficiaries.

[8] Section 1397C generally governs the rules applicable to tax credits for so-called "enterprise zone businesses." Several of these provisions – section 1397C(b)(2), (b)(4) and (b)(8) – are incorporated into the QOZ rules by reference.

[9] "Relatedness" for this purpose is generally determined by a 20% or greater common ownership test taking into account certain constructive ownership rules.

The proposed regulations provide that:

(1) a QOF may be formed as an LLC;

(2) the working capital safe harbor from section 1397C applies to the assets of QOZ Businesses for a period of up to 31 months;[10]

(3) for the "substantially all" test, only 70% of the tangible assets of a QOZ Business must constitute QOZ Business Property;[11] and

(4) if a QOF or QOZ Business purchases property consisting of land and a building, the "substantial improvement" prong of the QOZ Business Property test is met with respect to such property if the building's adjusted basis is doubled, without any need to increase the basis of the land.

Despite this guidance, many open questions remain, as discussed below.

DISCUSSION

1. The QOZ Zero-Basis Rule: How Does the Rule Interact With Other Basis Adjustments and Potential Distributions?

A major concern presented by the QOZ Rules is the extent to which a QOF may distribute cash or proceeds it receives, whether from operating income or from a refinancing, without adverse tax consequences. An investor is initially deemed to have a zero tax basis in the QOZ investment,[12] and accordingly, there is a twofold concern: first, that any amounts distributed to the investor would potentially be taxable, and second, that under certain tax rules a distribution might be treated as the constructive disposition of all or a portion of the distributee's interest in the entity – which, in the case of an interest in a QOF, would trigger the deferred gain and render the interest holder ineligible for future QOZ benefits.

This issue may be particularly complicated in the context of a QOF formed as a tax partnership. The proposed regulations provide that a partner in a QOF does not treat its share of debt under section 752 as a QOZ investment, but this provision does not address whether the partner receives basis for its share of such debt (as would normally occur, absent the special zero-basis rule under the QOZ provisions). In 2026, when the gain is included in income and the basis in the QOZ is accordingly adjusted (to equal the original rollover amount), the partner

[10] Among other requirements, this safe harbor generally requires that there be a written plan identifying the entity's financial property as property held for the acquisition, construction, or substantial improvement of qualifying QOZ Business Property.

[11] The proposed regulations specifically observe that this means the QOF itself can potentially have as little as 63% (i.e., 90% of 70%) of its assets be QOZ Business Property.

[12] Section 1400Z-2(b)(2)(B) provides that, except as otherwise provided in such section (which includes, for example, the 10% basis step up after 5 years), the taxpayer's basis in the investment shall be zero.

should be able to receive distributions against such basis without the recognition of taxable gain or the deemed disposition of the QOZ investment. However, would partners also receive basis for their share of debt incurred by the QOZ Fund over the life of the partnership, or would that amount, and thus the amount they could withdraw without immediate recognition of taxable income, be forever limited until the ultimate sale of their QOZ investment?

A technical reading of the proposed regulations implies that, as in the case of a non-QOF partnership, debt basis would be available to the holder of an interest in a QOZ Fund formed as a partnership. While the provisions state that "any basis increase resulting from a deemed section 752(a) contribution" is not taken into account in determining the portion of a partner's investment subject to section 1400Z-2(e)(1)(A)(i) or (ii), this language nevertheless appears to contemplate that such basis increase does occur,[13] and the nature of the provision generally appears to be favorable to taxpayers rather than restrictive. On the other hand, if basis is received for the debt and is not treated as a separate investment, there is the potential that small rollover investments can, through the use of debt, turn into significant projects with significant appreciation, opening the potential for the 10-year rule to provide arguably disproportionate tax benefits on the ultimate sale of such projects. Given the importance of leverage to many projects and businesses, we believe the Treasury Department should clarify these rules and provide guidance on the overall mechanics of debt basis in a QOZ project.

Another basis issue to consider is whether an investor partner in a QOF partnership would receive tax basis for taxable income allocated to that partner by the QOF partnership, such that a corresponding amount of cash may be distributed tax-free. Although an allocation of income would normally result in a basis step-up, the zero-basis provision in the QOZ Rules suggests the possibility that this rule may not apply in the QOZ context.

Conversely, suppose there is cash flow in excess of taxable income (for example, as a result of tax depreciation at the QOZ Business level). Can the QOF distribute this cash to its investors, or would this distribution jeopardize the QOZ investments as a result of the zero-basis rule? If not, what can the QOF do with the cash? Purchasing another QOZ asset is a possibility, but may be inconsistent with the economic objectives of the QOF, and may be difficult from a practical standpoint. The QOF also may not want to retain the cash, as doing so may reduce the economic returns of the investors and, if there is too much cash, jeopardize the QOF's ability to qualify under the 90% Asset Test. There has not been any guidance thus far specifically addressing these points.

Example:

X is a 20% partner in QOF Partnership A, with his contribution to Partnership A consisting solely of a rollover investment such that his basis in Partnership A is zero (per the QOZ Rules). Partnership A earns $100 of operating income in Year 1, of which X's share is $20. Assuming no offsetting losses, X will recognize $20 of taxable income which is his distributive share of the partnership's income (note that the QOZ Rules do not address such ongoing partnership dynamics).

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[13] Prop. Reg. § 1.1400Z-2(e)-1(a)(2); see also Example in -1(a)(3).

Ordinarily, X's basis in Partnership A would be increased by this $20 income amount – such that the $20 of corresponding cash could be distributed to X without incurring further tax (as he has already been taxed on this $20 through the partnership). But if the QOZ Rules operate to deny this basis increase, keeping the basis at zero, X cannot take a cash distribution without a second layer of tax (due to a distribution in excess of basis), and risking the possibility of being treated as having disposed of a portion of his QOZ investment.

Alternatively, suppose Partnership A has $100 of operating cash flow, but no taxable income as a result of depreciation.[14] X would continue to have a zero basis and accordingly could not receive a cash distribution without incurring the potential adverse consequences above.

The same potential issue arises with respect to a refinancing. If the refinancing does not create tax basis for X, a distribution of the refinancing proceeds would result in immediate tax and a potential recapture of the deferred gain.

Additionally, the issue may arise outside the partnership context. May a QOF formed as a corporation make distributions to its rollover-investor shareholders? There is no "debt basis" concept in corporate taxation, so there remains a significant concern that any such distributions would be treated as a taxable disposition of the QOZ investment and prevent further QOZ benefits.

Investors, developers and sponsors will need to know the answers to these questions, particularly as refinancing distributions are a significant part of real estate development and other investment strategies. The inability to distribute refinancing proceeds prior to (or even after) 7 years would represent either a drag on the ability of investors to put their capital back to work in the market or, more likely, a drag on the carried interest of the developer as additional IRR accrues on such capital. Conversely, the ability to receive debt basis without affecting the underlying rollover investment would be a significant boon to such strategies.

2. Working Capital Safe Harbor: Which Entity?

A significant question regarding the new working capital safe harbor is whether a QOF that owns a QOZ Business may hold such capital at the QOF level, or whether the QOF must contribute such working capital to the QOZ Business to be held at this "lower level." The latter outcome could result in a drag on investment returns at the QOZ Business level, as cash would remain stagnant in the QOZ Business entity before such cash would actually be needed – potentially a significant amount in excess of current construction expenditures.

Logically, it makes sense for the QOF to be able to hold the capital at the upper tier level until such capital is needed at the QOZ Business level – why should the QOZ Business require capital

[14] Some commentators have raised the possibility of a downward adjustment in the basis of the QOF's (or QOZ Business's) assets, similar to that in section 743(b). In this event, there would be no depreciation with respect to X's interest in the QOF, and thus this particular sub-issue would be avoided. However, the Treasury Department has not indicated whether it will follow such an approach.

significantly in excess of its needs at such an early point in time?[15]

Nevertheless, the language of the proposed regulations and the underlying examples imply that the working capital safe harbor must be applied at the QOZ Business level only – the provisions clearly specify section 1400z-2(d)(3). The rationale for this provision, despite the above policy-driven concerns, is that a QOZ Business must meet a requirement that a QOF need not: the requirement under section 1397C(b)(8) that less than 5% of the average aggregate unadjusted bases of the entity's property be attributable to nonqualified financial property. This requirement is entirely separate from the requirement that "substantially all" of the QOZ Business's tangible property be QOZ Business Property,[16] and accordingly works in tandem with the 70% threshold set forth in the proposed regulations under which the "substantially all" prong is met.

An interesting corollary, however, is that the QOF may not need to satisfy the requirements of sections 1397C(b)(2), (4) and (8); the language of the QOZ statute provides only that QOZ Businesses must meet such requirements. Accordingly, it would seem that up to 10% of the QOF's assets (i.e., all but the 90% that must be QOZ Property) could be cash or financial instruments without violating the QOZ Rules. Furthermore, the prohibition on "sin businesses" from section 144(c)(6)(B) also appears as a technical matter only to apply to QOZ Businesses and not QOFs, and thus a QOF could potentially operate such a business. It is unclear whether this result is intended, and it is possible that future clarifications (whether statutory or regulatory) would extend all of the QOZ Business provisions to QOFs generally – which could include the working capital safe harbor.

3. Multiple Asset QOFs: Will There Be Any Flexibility to Invest or Ultimately Sell Through Tiered Entities?

Two related issues that have yet to be clarified by regulations involve the structuring of QOFs where multiple assets are concerned. An investor must exit a QOF by selling its interest in the QOF in order to obtain QOZ benefits,[17] but this form of exit may be complicated and unattractive if the QOF owns multiple properties. An alternative may be to form multiple QOFs, one for each property, but (assuming each QOF owns the property through a QOZ Business, which may be a partnership with a developer involving management provisions and a carried interest waterfall) there is no way to consolidate these multiple QOFs under a single umbrella, as a QOF may not own another QOF as a qualifying asset. Accordingly, clarification is requested whether taxpayers may generally invest into a QOF through a separate entity such as a feeder or

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[15] The preamble to the proposed regulations states that the working capital safe harbor is meant to aid QOFs in meeting the 90% Asset Test, but technically, if the safe harbor were only to apply to QOZ Businesses, then it would only aid QOZ Businesses in meeting the *70%* test to qualify as a QOZ Business – which does benefit QOFs, but only indirectly. This technical nuance in the preamble's language, however, does not militate in favor of a different reading (given the strong argument in the following paragraph).

[16] Section 1400z-2(d)(3)(A)(ii) as opposed to -2(d)(3)(A)(i).

[17] This means that a QOF, as a general matter (except perhaps in certain contexts involving corporations), cannot sell its assets and liquidate (and still provide the QOZ benefits to its investors).

aggregator.[18]

4. Rollover from QOZ Investment to New QOZ Investment: Does the Holding Period Tack?

The proposed regulations provide that a taxpayer who disposes of a QOF interest prior to December 31, 2026 may reinvest the deferred gain (that would otherwise be included in income in the year of such disposition) into a new QOZ investment. What is unclear, however, is whether the new QOZ investment would tack the holding period of the old investment for purposes of the 5-year, 7-year and 10-year rules.

Absent further guidance, the technical reading of the proposed regulations would not permit a tacking of the holding period. The proposed regulations merely clarify when the 180-day period begins for investors wishing to do so, and support the general concept that the deferred gain may be rolled over again (despite the statutory language suggesting that it would be "included in income"). Accordingly, guidance is requested on this point.

5. New Provisions Regarding Land: Does Land Count as a 90% Asset Even If Not Improved? Must (Entirely) Vacant Land Be Substantially Improved?

The proposed regulations provide that for purposes of the "substantial improvement" prong of the test for qualifying QOZ Business Property, a QOF (or QOZ Business) that purchases a building located on land within a QOZ is not required to improve the land, only the building (i.e., it may effectively ignore the cost of the land for substantial improvement purposes). Revenue Ruling 2018-29, issued the same day as the proposed regulations, elaborates on this rule by, among other items, (i) noting that land, by its very nature, never has an original use in a QOZ by a QOF, and (ii) providing an example in which a QOF acquires land with a building and improves (only) the building. There are several uncertainties here, however.

First, it is unclear whether the land is treated as a qualifying asset for purposes of the 90% Asset Test. The statutory provisions do not exclude land from the 90% calculation – but they also do not exclude land from the "substantial improvement" test (which both the proposed regulations and Revenue Ruling 2018-29 do).[19] Accordingly, it is possible that the guidance to date contemplates land as automatically a qualifying asset. On the other hand, it is possible to construe the provisions of the proposed regulations and Revenue Ruling as simply ignoring land for the 90% Asset Test (i.e., treating the land at a zero value, to effectively remove it from both the numerator and the denominator) and basing such test solely on the substantial improvement of the building. It is moreover possible that the land could remain a non-qualifying asset, and only the building would qualify, although this reading would appear to vitiate the intent of the provision (and as the example in the Revenue Ruling involves 60% land, the QOF in the example would appear not to meet the 90% Asset Test if the land were a non-qualifying asset).

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[18] As noted, the proposed regulations did clarify that gain recognized through a partnership is eligible for QOZ reinvestment by the partners, but the proposed regulations did not address any tiering with respect to the reinvestment itself.

[19] Sections 1400z-2(d)(1) and -2(d)(2)(D)(ii).

The proper treatment of vacant land is also unclear under the proposed regulations and Revenue Ruling. There is no requirement, in either the proposed regulations or the Revenue Ruling (where land and a building are purchased together, as in the Revenue Ruling's example), that the building have any minimum value in order for the land to be excluded from the substantial improvement requirement. Accordingly, the implication is that the value of the building could be *de minimis* or zero. If so, then vacant land should also qualify as "substantially improved" under the proposed regulations and Revenue Ruling, even without any improvement at all. Note that if this were *not* the case, then (absent any anti-abuse restrictions), a seller could simply improve vacant land with a simple small building prior to selling it to a QOF, so that the QOF purchasing it would be able to effortlessly meet the substantial improvement requirement and thereby avoid the issue. Even if this result may follow logically, it is unclear whether it is intended or whether this result would be considered abusive. The U.S. Treasury Department should clarify the intent of the proposed regulations on this point and, if necessary, provide for a building-to-land-value ratio below which the land would have to be substantially improved regardless of any building.

6. QOZ Land Acquired by a QOZ Prior to 2018: Will There Be Any Guidance to Facilitate the Development of Such Land?

The proposed regulations do not address whether there is any ability for a taxpayer to utilize land it already owns (i.e., prior to 2018). From a public policy perspective, it would make sense for taxpayers to be able to build ground-up developments (i.e., new acquisitions of buildings and improvements) on land they already own, and many believe this should be expressly permitted. As noted previously, the proposed regulations provide that acquired land may be effectively disregarded from a substantial improvement perspective; the question is whether the U.S. Treasury Department might add a similar provision to permit a QOF to disregard land it already owned provided there will be qualifying improvements with original use on such land.

7. Guidance is Needed Concerning Investments in Businesses That Depend Heavily on Intangibles or Have Customers Who Do Not Reside in the QOZ

The statutory requirements contained in Code Section 1400Z-2(d)(3)(A), regarding what constitutes a qualified opportunity zone business conducted by a partnership or corporation (a "QOZ subsidiary") in which a QOF owns stock or partnership interests, are somewhat clarified by the proposed regulations, but significant gaps remain. The statutory provisions require that:

- at least 50% of the gross income of the QOZ business is "from" the active conduct of a trade or business "in" the QOZ,
- a "substantial" portion of the intangible property of the business is "used in the active conduct" of such trade or business "in" the QOZ,
- less than 5% of the aggregate unadjusted basis of property of the business is attributable to nonqualified financial property (such as cash, debt, swaps etc., but not including reasonable amounts of working capital), and

- substantially all of the tangible property owned or leased by the QOZ business is property purchased after 2017 that is originally used in the QOZ (or satisfies a doubling of the property's basis test).

The proposed regulations provide that the substantially all test in this last bullet means at least 70% of the tangible property owned or leased by a QOZ Subsidiary (based on the applicable financial statement of the QOZ business or if it has none, its cost). It should be noted that the statutory requirements described in the first 3 bullet points do not apply to a QOF that owns its QOZ business property directly, but then at least 90% of **all** its assets must consist of tangible property. *See* section 1400Z-2(d)(1).

It would be helpful for the IRS to provide guidance that addresses the following questions:

- When will a QOZ business be treated as engaged in the active conduct of the QOZ business? For example, if a startup is just spending money on research and development ("R&D"), is that active enough for these purposes?
- What constitutes a "substantial portion" of the intangible property of the business? We would suggest that 40% is a substantial portion, based on the use of that percentage for the new markets tax credit. *See* Treas. Reg. §1.45D-1(d).
- Is cash used for advertising, research and development or other purposes eligible for the working capital exception? We would suggest that cash used for expenses to create or buy intangible property be eligible for the same 31-month safe harbor that is provided for cash that is used by a QOZ business to acquire or construct ***tangible*** property pursuant to a written schedule.
- Under what circumstances should a business be treated as being conducted (and intangible assets be considered to be used) in the zone? For example, should this determination be made solely based on the location of employees and/or tangible assets of the business? We believe those factors should be determinative. Should the location in which property is sold or services are provided be relevant? We believe they should not be. Based on the use of 40% for purposes of the new markets tax credit, we would suggest that a business would be considered conducted in qualified opportunity zones if at least 40% of the tangible assets of the business are in one or more QOZs or at least 40% of the employees of the business are employed in QOZs.

Additional clarifications that would be helpful to all businesses include the following:

- What year or years must an entity qualify as a QOF for the investment in the QOF to be entitled to the deferral, 5-year, 7-year and 10-year benefits? *Cf.* sections 1400Z-2(d)(2)(B)(i)(III) and -2(d)(2)(C)(iii)(a QOZ business must be qualified for substantially all the QOF's holding period). Does the answer differ depending on which test the investor is seeking to qualify for? Is it affected by the activities of the QOF after December 31, 2026?

8. Clarification Should be Provided Concerning the Income Tax Consequences Resulting from the Death of a Taxpayer Who Has Deferred Gain Through a Timely Reinvestment of Gain in a QOF, And to Provide Relief for Successors-in-Interest

Section 1400Z-2(e)(3) provides that, "[i]n 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." This statutory provision raises questions concerning the appropriate treatment of the deferred gain where a person who has rolled over gain through a timely investment in a QOF dies prior to December 31, 2026 without having previously disposed of the QOF investment.

Section 691

Section 691 sets forth the rules that apply to a person's receipt of income in respect of a decedent ("IRD"). IRD refers to income earned by a decedent who was a cash basis taxpayer prior to his or her death, but that is not received by either the decedent's estate or some other person until after the decedent's death. IRD is not reportable on the decedent's final income tax return. Rather, it is reportable by the recipient of the IRD item.[20]

Since items of IRD are subject to both income and estate taxes, the recipient is allowed an income tax deduction for the proportionate share of the estate tax (and generation-skipping transfer ("GST") tax) attributable to the IRD item.[21] This deduction mitigates, to some extent, the burden of double taxation.

One very significant aspect of IRD is that section 1014(c) denies a step-up in basis at death to items of IRD.

Analogous to those rules relating to <u>income</u> in respect of a decedent is section 691(b), which addresses <u>deductions</u> and <u>credits</u> in respect of a decedent -- which are incurred prior to death but are not paid until after death.[22] Because the deductible payments would have reduced the decedent's taxable income had the decedent incurred them during life and payment would have reduced the decedent's gross estate for estate tax purposes, deductions in respect of a decedent

[20] Examples of IRD can include the following:

- income earned by an employee for services performed prior to his or her death but which is not received by the recipient until after the employee has died
- rents earned by the decedent prior to death but not paid until after his or her death
- an employee's interest in a qualified retirement plan
- a person's interest in an individual retirement account ("IRA").

[21] *See* section 691(c).

[22] Itemized under section 691(b)(1) are only the section 162 (business expenses), 163 (interest), 164 (taxes), 212 (expenses of producing income or managing or safeguarding income producing property), and 611 (percentage depletion) deductions, and the section 27 foreign tax credit.

are excepted from the section 642(g) limitation that denies an income tax deduction if an estate tax deduction is allowed for the same item postmortem.[23]

Certain transfers of the right to receive income in respect of a decedent cause an acceleration of the income represented by that right.[24] Includible in the transferor's gross income for the taxable year of the transfer is the greater of the amount of any consideration received for the transfer or the fair market value of the right at the time of the transfer. Some transfers are excepted: for example, transfers by the decedent's estate to any beneficiary to whom the right was specifically bequeathed or as part of the residue passing to a residuary beneficiary are not acceleration events[25] and distributions by a trustee in similar circumstances presumably should be accorded similar treatment (although the law is unclear on this).[26] On the other hand, certain distributions are sure to trigger acceleration: for example, distributions in satisfaction of pecuniary bequests are acceleration events,[27] and an estate beneficiary who receives the right to income in respect of the decedent in a nonaccelerating distribution will cause an acceleration by making a gift of the right to a third party.[28]

Application of Section 691 to QOFs

The application of these rules to QOFs would seem to be as follows. Suppose that D has a $2,000,000 capital gain on April 1, 2019 and timely reinvests it in QOF on July 1, 2019. D then dies four years later – on July 1, 2023. At the time of D's death, D's interest in the QOF is worth only $100,000. D's Will gives his interest in the QOF to his son, S, as part of the residue of the estate. On December 31, 2026, the interest in the QOF is worth $500,000.

Of particular application to these facts, section 1400Z-2(b)(2) contains a special rule that caps the amount of the gain so as not to exceed the fair market value of the investment as of the date that the gain is included in income. It provides as follows:

> **1400Z-2(b)(2) AMOUNT INCLUDIBLE.—**
>
> > **1400Z-2(b)(2)(A) IN GENERAL.—** The amount of gain included in gross income under subsection (a)(1)(A) shall be the excess of—

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[23] See section 642(g) (last sentence).

[24] Section 691(a)(2).

[25] Treas. Reg. §1.691(a)-4(b). *Cf.* Private Letter Ruling 200234019 (allocation in satisfaction of pick and choose fractional residuary bequest to charity was not an acceleration event).

[26] It is clear that a terminating distribution by a trust is not an acceleration event. *See* Treas. Reg. § 1.691(a)-4(b)(3). In contrast, the section 691(a)(2) exception for estate distributions that do not generate acceleration does not list trust interim transfers.

[27] Section 691(a)(2).

[28] Treas. Reg. § 1.691(a)-4(a) (penultimate sentence).

1400Z-2(b)(2)(A)(i) the lesser of the amount of gain excluded under paragraph (1) or the fair market value of the investment as determined as of the date described in paragraph (1), over

1400Z-2(b)(2)(A)(ii) the taxpayer's basis in the investment.

Taking this special rule into account, it would appear that D's disposition under his Will of his interest in the QOF to his son, S, as part of the residue of the estate should not trigger the inclusion of income. ***But what happens on December 31, 2026?*** It would appear that at that point S would pick up the income of $500,000, which is the amount of deferred gain capped at the fair market value of the investment in the QOF at that time. ***However, S may or may not have the liquidity necessary to pay the deferred tax that becomes due at that time. This could be particularly problematic to S if the fund does not contain redemption provisions, or if a secondary market for the interest in the fund has not matured.***

One possible approach to help mitigate this potentially serious liquidity concern of a beneficiary could be to give the successor-in-interest upon the taxpayer's death (including the personal representative of the decedent's estate) the ability to elect to treat the taxpayer's death as a recognition event for income tax purposes. In accordance with the principles set forth in Rev. Rul. 86-72[29] and *Estate of Frane v. Commissioner*,[30] the income would be properly reported <u>by the decedent's estate</u> on its Form 1041 fiduciary income tax return, and not on the decedent's final Form 1040 individual income tax return.[31] This solution, however, is not without its own set of potentially significant complications, as the successor-in-interest may be a fiduciary with a duty of impartiality with respect to all of the beneficiaries of the decedent's estate. In addition, the fiduciary may itself be a beneficiary of the decedent's estate, and could potentially stand to benefit from the consequences of any such election. So although there may be some appeal to providing such a solution on behalf of the successor-in-interest, it may be too problematic, all things considered.

Rather, we believe that the better approach would be to allow the successor-in-interest to be able to continue to defer the gain under section 691 (including after December 31, 2026) until such time that it disposes of its interest in the QOF. Such disposition could be governed by the principles of section 691 that are described above with respect to the disposition of IRD. By doing so, the successor-in-interest could be protected from inheriting a potentially significant tax liability without having the wherewithal to pay for it.

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[29] 1986-1 C.B. 253. In this Revenue Ruling, the IRS held that installment obligations that self-canceled upon the seller's death were treated as transfers that triggered the section 691(a)(2) income acceleration rule, and the outstanding gain was recognized by and includible in the gross income of the seller's estate.

[30] 98 T.C. 341 (1992), *aff'd in part and rev'd in part*, 998 F.2d 567 (8th Cir. 1993).

[31] In *Frane*, the United States Court of Appeals for the Eighth Circuit held that cancellation of a self-canceling installment note was an income taxable event, and further ruled that the income is properly reported <u>by the decedent's estate</u> on its Form 1041 fiduciary income tax return, and not on the decedent's final Form 1040 individual income tax return.

We further request that clarification be provided to confirm that a taxpayer's death shall not interrupt the holding period for purposes of the basis adjustments that can result from holding an interest in a QOF for five or more years, or for purposes of the potential elimination of tax on gains associated with the appreciation in the value of a QOF that has been held for at least ten years.

9. Clarification Should be Provided Concerning the Income Tax Consequences Resulting from the Gift of an Interest in a QOF Where the Donor Has Deferred Gain Through a Timely Reinvestment of Gain in a QOF

Similarly, clarification is needed concerning the income tax consequences that result from a gift of an interest in a QOF.

Section 1400Z-2(b) provides for the deferral of gain that is invested in opportunity zone property until the earlier of the date on which such investment is sold or exchanged, or December 31, 2026. A gift of an interest in a QOF is generally neither a sale nor an exchange.[32] Accordingly, we respectfully request that clarification be provided to confirm that, provided that the gift is not otherwise treated by the tax law as a taxable disposition for income tax purposes, it should not be considered a sale or exchange for purposes of section 1400Z-2(b).

We further request that clarification be provided to confirm that such a gift shall not interrupt the holding period for purposes of the basis adjustments that can result from holding an interest in a QOF for five or more years, or for purposes of the potential elimination of tax on gains associated with the appreciation in the value of a QOF that has been held for at least ten years.

10. Clarification Should be Provided Concerning Grantor Trusts, Including to Confirm That a Transaction with a Grantor Trust That is Disregarded for Income Tax Purposes Pursuant to Rev. Rul. 85-13 Should Not Be Considered a Sale or Exchange of an Interest in a QOF

In addition, clarification is requested concerning grantor trusts, including with respect to the income tax consequences that would result from a transaction between a grantor and a grantor trust where Rev. Rul. 85-13[33] would otherwise cause it to be a non-recognition event for income tax purposes.

The grantor trust rules are set forth in sections 671 through 679. These rules generally provide that if certain rights or powers are retained, the grantor (or other individual treated as the "owner" for income tax purposes) will be required to include all (or a portion) of the gains, losses, deductions and credits attributable to the trust on his or her own personal income tax return. As a result of the grantor trust rules, it should not matter whether the gain that is sought

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[32] An exception to this general rule could apply, for example, if the donor's interest in the QOF is encumbered by debt in excess of basis.

[33] *See* Rev. Rul. 85-13, 1985-1 C.B. 184.

to be deferred, or the funds that are subsequently invested in the QOF, belong to the taxpayer or to such taxpayer's grantor trust. We accordingly request clarification to this effect.

In addition, pursuant to Rev. Rul. 85-13, transactions between a grantor and such person's grantor trust are disregarded for federal income tax purposes. Accordingly, a sale or other transaction[34] involving an interest in a QOF that is between a grantor and such person's grantor trust should not be considered a sale or exchange of an interest in a QOF, and therefore should not trigger the recognition of gain. We request that this be confirmed as well.

We further request that clarification be provided to confirm that transactions between a grantor and such person's grantor trust shall not interrupt the holding period for purposes of the basis adjustments that can result from holding an interest in a QOF for five or more years, or for purposes of the potential elimination of tax on gains associated with the appreciation in the value of a QOF that has been held for at least ten years.

11. Further Relief to Extend the 180 Day Period for Rollover of Gain to a QOF Should Be Granted to Partners, S Corporation Shareholders and Beneficiaries of Estates and Trusts Because They May Not Receive a Schedule K-1 Indicating Capital Gains Until More Than 180 Days After the End of the Taxable Year

Section 1400Z-2(a)(2) provides that, to qualify for the tax benefits that can be derived through an investment in a QOF, the taxpayer's rollover of gain to the QOF must occur during the 180-day period beginning on the date of the sale or exchange that gives rise to such gain.

The proposed regulations provide some relief to the above rule in the case of certain pass-through entities, including for this purpose beneficiaries of trusts and estates.

- First, the proposed regulations include special provisions by which gain recognized by a partnership may flow through to the partners and be reinvested by the partners in a QOF (except to the extent the partnership elects to rollover the gain itself).[35]

- Second, there is the potential for partners to have an increased period during which to reinvest gain in a QOF. The partnership's 180-day period begins on the date of its sale, but if the gain flows through to the partners, the partners' 180-day period generally begins on the last day of the partnership's taxable year.[36]

The proposed regulations state that rules analogous to the partnership and partner guidance indicated above apply to other pass-through entities (including S corporations, decedents'

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[34] Such other transaction could include the exercise of a so-called "swap power" described in section 675(4)(C) to reacquire the trust corpus by substituting other property of an equivalent value, where such power is exercisable in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity.

[35] Prop. Reg. §1.1400Z-2(a)-1(c)(2).

[36] Partners may instead elect to use the partnership's 180-day period if they so desire (e.g., if the desired investment is already lined up). *See* Prop. Reg. §1.1400Z-2(a)-1(c)(2)(iii)(B).

estates, and trusts) and to their shareholders and beneficiaries.[37] In addition, the preamble to the proposed regulations request comments concerning whether taxpayers would benefit from further clarification in the context of S corporations, decedents' estates and trusts.

The chief administrative difficulty that taxpayers will have with these rules is the clear potential for an "information gap" to exist between the partnership, S corporation, executor and trustee, on the one hand, and the partner, S corporation shareholder, and beneficiary on the other hand. The Schedule K-1 is the mechanism for a partnership, S corporation, estate or trust to report tax attributes – including capital gains – not only to the Internal Revenue Service, but also to the partner, S corporation shareholder or beneficiary, as the case may be. If the tax return for the pass-through entity is placed on extension, a substantial possibility will then exist that the Schedule K-1 will not be issued until more than 180 days after the end of the tax year, at which point the opportunity to rollover gain to a QOF will have been lost.

This information gap problem can be especially pronounced in the case of certain estates and trusts. Under section 663(b), a fiduciary is permitted to elect to treat a distribution made in the first 65 days of the tax year as having occurred on the last day of the preceding tax year. Such a distribution could involve capital gains that, as a result of the section 663(b) election, may be treated by the estate or trust as having been distributed to the beneficiary on the last day of the preceding tax year. The beneficiary would not become aware of this in the ordinary course until it receives the Schedule K-1 reporting such distributed gains. As noted above, this may potentially occur more than 180 days after the end of the estate's or trust's tax year if the Form 1041 fiduciary income tax return is on extension.

Furthermore, the 180-day periods for the partnership, S corporation, executor and trustee, as the case may be, and the partner, S corporation shareholder or beneficiary, as the case may be, can overlap. If the partnership, S corporation, executor and trustee are deemed to sell property on the last day of the tax year (*e.g.*, December 31st) resulting in capital gains, the 180-day periods can coincide.

To be consistent with the objectives of the statute -- which is to promote investment in economically distressed communities with capital gains as the funding mechanism for such investment -- we believe that in the case of partners, S corporation shareholders, and beneficiaries of estates or trusts, the due date for a partner, S corporation shareholder or beneficiary to elect to defer gains by reinvesting in a QOF should instead be the later of (i) 180 days after the end of the relevant tax year (which is the current rule under the proposed regulations)[38] and (ii) 180 days after the timely filing (taking into account extensions) of the tax return for the partnership, S corporation, estate or trust that has incurred such gain.

These concerns – and our proposed solution – are illustrated by the following example.

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[37] Prop. Reg. §1.1400Z-2(a)-1(c)(3).

[38] This prong of this proposed standard would apply to a situation where a trust or estate is not required to file a tax return because its gross income is below the applicable filing threshold.

Suppose that X Estate is a calendar year estate that has $5 million of capital gains during the year ending December 31, 2018, which it distributes to Y (a beneficiary of X Estate) on February 28, 2019. The estate elects under section 663(b) to treat this distribution of capital gains as having been made by the estate on December 31, 2018 and further elects to treat this distribution as carrying out to Y distributable net income (DNI) under section 643(a). X Estate timely extends the due date for filing its Form 1041 fiduciary income tax return and eventually files its 2018 Form 1041 with the Internal Revenue Service on September 1, 2019 and mails out its Schedule K-1 to Y, who receives it on September 5, 2019. Y timely files her 2018 individual income tax return on October 1, 2019, and her tax return does not contain an election to rollover gain to a QOF.

Absent further relief, Y would not have received any formal notice (in the form of a Schedule K-1) of her eligibility to rollover this gain to a QOF until after June 29, 2019 (which is 180 days after December 31, 2018). To remedy this, we would propose that Y instead be given the opportunity to rollover her deferred gain to a QOF under these facts until February 28, 2020 – which is 180 days after the timely filing (including extensions) of X Estate's 2018 Form 1041 with the Internal Revenue Service on September 1, 2019. Y would report this election to defer gain that she has timely rolled over to a QOF on her 2018 individual income tax return, including (as may be warranted) on an amended 2018 individual income tax return that attaches Form 8949 that she subsequently files with the Internal Revenue Service within the period prescribed by section 6511.

The New York State Society of Certified Public Accountants appreciates this opportunity to have provided its comments on the proposed regulations.