



February 8, 2019

The Honorable Steven Mnuchin  
Secretary of the Treasury  
U.S. Department of the Treasury  
1500 Pennsylvania Avenue, N.W.  
Washington, D.C. 20220

The Honorable Charles P. Rettig  
Commissioner  
Internal Revenue Service  
1111 Constitution, Avenue, N.W.  
Washington, D.C. 20224

**RE: Guidance Regarding Investing in Qualified Opportunity Funds (REG-115420-18)**

Dear Secretary Mnuchin and Commissioner Rettig:

On behalf of the members of the Institute for Portfolio Alternatives (the “*IPA*”), we write to highlight certain critical issues regarding the proposed regulations for investments in qualified opportunity funds (“*QOFs*”) under Section<sup>1</sup> 1400Z-2 of the Internal Revenue Code. The IPA is an organization that provides national leadership for the portfolio diversifying investments industry by bringing together the investment managers, broker-dealers, investment advisers and industry service professionals who are dedicated to driving transparency and innovation in the marketplace.

Section 1400Z-2 is designed to encourage economic growth and investment in designated distressed communities (known as “qualified opportunity zones,” or “*QOZs*”) by providing certain U.S. federal income tax benefits to taxpayers who invest in businesses located within a QOZ through a QOF. We believe the Treasury should preserve the purpose and Congressional intent behind Section 1400Z-2 by addressing the following issues in pending regulatory guidance or via a new Revenue Ruling, as appropriate, for each issue:

- (i) providing clarification that investors in a QOF making the basis step-up election in their QOF interest after 10 years may receive the benefit of such basis increase when a QOF sells assets in connection with a desired exit strategy as part of an overall plan of liquidation and redemption of the QOF interests (in full or in part);
- (ii) providing clarification that normal partnership tax rules apply with respect to the use of debt financing proceeds by a QOF and lower-tier entities, as well as clarification as to special QOF restrictions, if any;
- (iii) providing clarification relating to the impact, if any, of certain tax-deferred transactions on the fair market value basis step-up election available under Section 1400Z-2(c); and

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<sup>1</sup> Unless noted otherwise, all section references provided for herein refer to the Internal Revenue Code of 1986, as amended (the “*Code*”), and the Treasury Regulations promulgated thereunder.



- (iv) providing clarification relating to a QOF or its lower-tier entities' ability to sell assets and roll into new QOZ property with the ability to tack the holding period incurred on the relinquished property, while maintaining the long-term tax benefits under Section 1400Z-2.

## **1. Form of Disposition**

***Provide clarification that investors in a QOF making the basis step-up election in their QOF interest after 10 years may receive the benefit of such basis increase when a QOF sells assets in connection with a desired exit strategy as part of an overall plan of liquidation and redemption of the QOF interests (in full or in part).***

The benefit of the fair market value basis step-up election under Section 1400Z-2(c) should be available where the relevant disposition of the investment is structured as a sale of assets by the QOF (or its lower-tier entities) in connection with a plan of liquidation that includes a partial or full redemption of the investors' QOF interest as part of the overall transaction.

When a QOF, structured as a partnership for U.S. federal income tax purposes, disposes of an asset in connection with a plan of liquidation that includes a partial or full redemption of the investors' QOF interest, the investors should be allowed to elect to receive (i) a step-up in their share of the QOF's basis in an asset immediately before the asset is sold, as well as (ii) a corresponding basis step-up in the basis of their QOF interests. The qualified investors should be allowed to use this mechanic multiple times where a QOF disposes of its assets on an incremental basis in connection with a plan of liquidation, as long as it includes a partial or full redemption of the investors' QOF interest. Failure to provide this clarification may cause QOFs to structure their ultimate exits as only QOF interest sales. In such cases, history has shown that prospective buyers will demand a discounted purchase price to account for concerns over latent liabilities that may or may not exist in the QOF. This result will create an economic penalty to the investors unintended by Congress. In contrast, an asset sale would not create such an unintended economic penalty and, as long as the plan of liquidation includes a redemption feature, the statutory requirements would be fully satisfied.

## **2. Permitted Use of Debt Financing Proceeds**

***Provide clarification that normal partnership tax rules apply with respect to the use of debt financing proceeds by a QOF and lower-tier entities, as well as clarification as to special QOF restrictions, if any.***

Clarification is needed with regard to the permitted use of debt financing proceeds by a QOF. For example, 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). 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.

We recommend including examples in the final regulations clarifying the permitted use of debt financing proceeds by a QOF. The regulations should illustrate how 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. The Treasury has already provided similar clarifying statements in Proposed Regulations 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.

Further, in order for QOFs to attract the capital needed to spur economic growth in low-income communities, investors need assurance that the funds will not be subject to overly restrictive limits on traditional and customary refinancing transactions. Debt distribution rules that result in gain recognition, loss of QOF status, loss of the five-year and seven-year basis step-ups, or loss of the 10-year basis step-up, would negatively impact capital formation and the success of the QOZ program.

The final regulations should clarify that QOFs can refinance QOZ assets and distribute proceeds without triggering recognition of the deferred gain, provided the refinancing does not reduce the fair value of equity in the QOF interest below the level of the original deferred capital gain. The rules should permit refinancing on the increase in value of the deferred gain contribution (with an administrative safe harbor for growth supported by a third-party appraisal). A distribution, however, would be subject to the general rules of Subchapters C and K, as the case may be. A partnership should be permitted to revalue its capital accounts under Treasury Regulations Section 1.704-1(b)(2)(iv)(f) to properly reflect the economics of such a refinancing and distribution. A rule that requires QOFs to retain equity value equal to the initial deferred amount would represent a balanced approach, ensuring the program leads to long-term, patient investment in low-income communities while also allowing opportunity funds to compete for capital with traditional real estate funds that are not subject to debt distribution restrictions.

### **3. Impact of Tax-Deferred Transactions on Step-Up in Basis**

***Provide clarification relating to the impact, if any, of certain tax-deferred transactions on the fair market value basis step-up election available under Section 1400Z-2(c).***

Both the statute and the proposed regulations are unclear about the impact of certain tax-deferred transactions (e.g., stock-for-stock mergers or a Section 721 transaction, like an UPREIT transactions) on the 10-year basis step-up available under Section 1400Z-2(c).

We recommend including examples in the final regulations clarifying the permitted use of certain tax-deferred (basis carryover) transactions by a QOF. The regulations should illustrate how a QOF can utilize such transactions in the same manner as any other entity without impacting the qualification of the QOF, and clarify that the transaction will simply be governed by existing rules under the Code and general tax principles.



**4. Flexible Gain Reinvestment, Roll-over, and Holding Period Rules**

*Provide clarification relating to a QOF or its lower-tier entities' ability to sell assets and roll into new QOZ property with the ability to tack the holding period incurred on the relinquished property, while maintaining the long-term tax benefits under Section 1400Z-2.*

The final regulations should clarify that if a QOF (or its lower-tier entity) sells an asset and reinvests in another QOZ asset within 12 months of the sale, the QOF is allowed to tack on the holding period of the old investment for purposes of the five, seven, and 10-year rules for the new investment. Here, the key point is that the investor's capital remains committed to QOZ investment. This is consistent with the proposed rule deferring gain recognition when an investor sells a QOF interest and reinvests in another QOF.

These flexible reinvestment rules will contribute to a more efficient market, with capital flowing to its best use, and they will encourage investors and funds to remain committed and invested in the designated communities.

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Thank you for your consideration of these comments. We look forward to the opportunity to discuss these issues further during the public hearing scheduled for February 14, 2019.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Anthony Chereso", is written over a horizontal line.

Anthony Chereso  
President and Chief Executive Officer  
Institute of Portfolio Alternatives

cc: David J. Kautter, Assistant Secretary, Office of Tax Policy, U.S. Department of the Treasury  
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