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The Honorable Steven T. Mnuchin
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Re: REG-115420-18—Notice of proposed rulemaking re: Investing In Qualified Opportunity Funds

Dear Secretary Mnuchin, Deputy Assistant Secretary Kautter, Ms. Reigle, and Mr. Griffin,

K&L Gates, LLP ("K&L Gates" or "we"),[1] submits the following comments in response to the notice of proposed rulemaking issued by the Internal Revenue Service ("IRS") and the

[1] K&L Gates is a fully integrated global law firm counting among its clients numerous small, medium and large U.S.-owned businesses and corporations, all stakeholders that stand to be impacted by the Notice's proposed regulatory framework.

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Department of the Treasury ("Treasury") in the Federal Register on October 29, 2018 entitled "Investing In Qualified Opportunity Funds" (the "Notice").[2] The Notice sets out proposed regulations to implement Section 1400Z-2 of the Internal Revenue Code ("Code"),[3] as added by the Tax Cut and Jobs Act ("TCJA").[4]

Section 1400Z-2 seeks to encourage economic growth and investment in designated distressed communities (qualified opportunity zones) by providing U.S. federal income tax benefits to taxpayers who invest in businesses located within these zones through a qualified opportunity fund ("QOF"). In enacting Section 1400Z-2, Congress sought to make investments in qualified opportunity zones attractive to potential investors. Conscious of this intent, K&L Gates requests that a clarification be reflected in the final regulations that would allow QOFs additional flexibility in how they structure the dispositions of their investments.

Specifically, K&L Gates requests clarification that the benefits of the basis step-up election under Section 1400Z-2(c) (the "Step-Up Election") are available where the relevant disposition of the investment is structured as a sale of assets by the QOF.[5] Where a QOF is structured as a partnership for U.S. federal income tax purposes, K&L Gates believes that the best way to address this issue is to allow, at the time a QOF disposes of an asset, any QOF investors that are eligible to make the Step-Up Election with respect to their QOF interests at such time ("Qualified Investors") to elect to receive both (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. K&L Gates believes Qualified Investors should be allowed to use this mechanic multiple times where a QOF disposes of its assets on an incremental basis. This clarification would increase the attractiveness of qualified opportunity zone investments by providing a QOF with flexibility in determining how to structure the sale of an investment and, in the case of a QOF which holds multiple investments, flexibility in timing the sale of each investment. It would also encourage longer term investment in QOFs, providing greater economic stability in disadvantaged areas consistent with the policy intent of the Opportunity Zone incentive.

I. Background

a. TCJA: Statutory Text and the Notice

Pursuant to Section 1400Z-2, added by Section 13823 of the TCJA,[6] in the case of a taxpayer that recognizes gain from the sale or exchange of property with an unrelated person, the taxpayer may elect to exclude from its gross income the amount of such gain as does not

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[2] 83 Fed. Reg. 54279 (October 29, 2018).
[3] Unless otherwise noted, all "Section" references are to the Internal Revenue Code, 26 U.S.C.
[4] Pub. L. No. 115-97.
[5] Similar considerations would apply in the case of the direct disposition of an investment by a qualified opportunity zone business ("QOZB").
[6] Section 13823 of P.L. 115-97, "Opportunity Zones."

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exceed the amount invested by the taxpayer in a QOF during the 180-day period beginning on the date of the sale or exchange. Such gain will be included in income by the taxpayer in the taxable year which includes the earlier of the date on which the taxpayer disposes of its investment in the QOF, or December 31, 2026. Furthermore, pursuant to Section 1400Z-2(c), in the case of an investor that holds its QOF interest for at least ten years and makes the Step-Up Election, the taxpayer's basis in its investment is stepped-up to its fair market on the date that it is sold or exchanged. Thus, the Step-Up Election allows any post-acquisition gains from eligible investments in a QOF to be excluded from gross income.

The statutory language of Section 1400Z-2(c) does not clarify with certainty whether the benefits of the Step-Up Election are only available to a Qualified Investor which sells its QOF interest, or whether the Step-Up Election may also be made with respect to the Qualified Investor's share of the underlying property of the QOF. The statute provides that Step-Up Election is available "in the case of any investment held by the taxpayer for at least 10 years," with the term "investment" presumably including (but not explicitly being limited to) the taxpayer's QOF interest. The statute then provides that the effect of the Step-Up Election is to cause "the basis of such property" to be equal to its fair market value on the date it is sold or exchanged. The statutory language, in using terms ("such property" and "investment") that are more general than necessary to refer to a QOF interest, does not explicitly limit the basis step-up to the taxpayer's interest in the QOF. The Notice does not address this statutory ambiguity.[7]

b. Request that Section 1400Z-2(c) be Clarified

In light of the Congressional intent underlying Section 1400Z-2, and the difficulties that arise from interpreting Section 1400Z-2 to allow a step-up solely with respect to a QOF interest, we believe it would be inappropriate for the benefits of the Step-Up Election to be unavailable to Qualified Investors where the relevant exit event is structured as the sale of assets by the QOF. Accordingly, we request that the statutory ambiguity discussed above be resolved in favor of allowing a Qualified Investor to make the Step-Up Election with respect to its share of the inside basis of a QOF's assets whenever the QOF disposes of assets.

II. Congressional Intent Behind Opportunity Zone Provisions

A principal policy goal of Congress in enacting the TCJA was to encourage economic growth and job creation, especially in distressed communities. One of the provisions which most clearly reflects this Congressional intent is Section 1400Z-2(c), which provides certain tax benefits to taxpayers who invest in businesses located in qualified opportunity zones.[8] Congress viewed the Step-Up Election as one of the two main tax benefits in Section 1400Z-

[7] 83 Fed. Reg. 54279 (October 29, 2018). However, in light of the fact that the incentive provided by the Step-Up Election is integral to the primary purpose of Section 1400Z-2, the Notice allows the flexibility for an investor to make a Step-Up Election with respect to a QOF after the applicable qualified opportunity zone designation has expired. *Id.* at 54283.

[8] H. REP. NO. 115-466, at 537.

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2(c) (along with the ability to elect deferral of eligible gains invested in a QOF) that would incentivize taxpayers to invest in qualified opportunity zones.[9] Congress therefore believed that it was critical to the ability of Section 1400Z-2 to achieve its policy goals that the Step-Up Election sufficiently induce investors to invest in qualified opportunity zones.

As discussed above, the statute does not clearly limit the Step-Up Election to situations where a QOF interest is sold, and does not clearly indicate that a Step-Up Election may not be used when a QOF (or QOZB) directly sells an asset. However, numerous problems arise if Section 1400Z-2(c) is interpreted so that the Step-Up Election may only be made where a taxpayer sells its interests in a QOF, and not when a QOF sells its assets, and these problems threaten to undermine the ability of Section 1400Z-2 to incentivize investment in opportunity zones.

First, limiting the availability of the Step-Up Election to where QOF interests are sold would result in a QOF not being able to dispose of its qualified opportunity zone property directly without causing its Qualified Investors to recognize gain. In the case of a QOF that is classified as a partnership, if the QOF directly disposes of appreciated assets, and if the Step-Up Election is not available or otherwise does not result in the QOF increasing its basis in such property, the QOF generally will recognize gain on such sale, and a portion of this gain will be allocated to Qualified Investors. This seems contrary to Congressional intent that post-investment gain in a QOF/QOZB be free from Federal income tax to Qualified Investors. Furthermore, there is no guarantee that a Qualified Investor would be able to offset this gain with corresponding losses that may be associated with the liquidation of the QOF. The allocation of gain would cause the investor to increase its basis in its QOF interest by an equivalent amount, and as a result, when the taxpayer disposes of its interest in the QOF the taxpayer would recognize less gain or additional loss. If the Qualified Investor is an individual and disposes of its QOF interest in a tax year following the tax year in which the gain is recognized, the investor would generally not be able to carryback the loss to offset the gain allocated to it, and the investor may not be able to use the loss in a later tax year. Thus, practically speaking, the Qualified Investor in such a case would be taxed on the post-investment appreciation in the QOF investment.

The same issue will prevent a QOF from disposing of different assets at different times, because when an exit event must be structured as a sale of QOF interests the sale would generally relate to the entirety of the QOF's property absent provisions in a partnership agreement providing for special allocations (and even if such provisions existed, the purchaser would be a partner after the sale with the Qualified Investors, which may not be desirable). Both of these restrictions require a QOF to operate in a manner contrary to market practice. Generally, buyers will want to acquire a QOF's assets directly rather than acquire QOF interests, for example to avoid assuming any potential QOF-level liabilities and because it is easier to purchase an asset from a single seller than to purchase QOF interests from all of the QOF's investors. A QOF which holds several distinct investments also will generally desire, for

[9] H. REP. NO. 115-466, at 539 ("The second main tax incentive in the bill excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years").

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valid business reasons, to dispose of different investments at different times. For example, a buyer may wish to purchase only one of several investments held by the QOF. A statutory framework that requires transactions to be structured outside of standard market practice may discourage buyers from acquiring such target companies, or buyers may seek a purchase price discount in connection with such a purchase. As a result, because QOFs are prevented from disposing of investments in a manner that they would prefer and that is consistent with usual market practice, qualified opportunity zone business property will be less attractive to a buyer than similarly situated investments that are not organized through a QOF.

Investors may attempt to preserve the ability to sell assets incrementally in several ways, including by forming a separate QOF to hold each investment, so that the interests of each QOF may be sold separately, thus allowing each asset to be (indirectly) sold separately. However, this structure will require investors to incur additional administrative costs that are atypical for an investment fund. Given that an investment fund organized to acquire multiple businesses, properties or portfolio companies would ordinarily use a single partnership or investment vehicle to directly and indirectly make such investments, this structure is also inconsistent with market practice; and furthermore, as described below, this multiple QOF structure suffers from additional defects.

As an example, the multiple QOF structure discourages sponsored QOF projects where investors may be admitted at different times. The sponsor of an investment fund ordinarily will admit the initial investors in the first closing once a target amount of committed capital has been obtained and then will admit additional investors at one or more subsequent closings when the fund desires additional committed capital. When an investment fund makes one or more portfolio investments before admitting additional investors, investors admitted at subsequent closings typically proportionately participate in earlier acquired investments, and earlier investors will proportionately participate in later acquired investments, even though the earlier and later investments may have been funded by capital contributions from the earlier and later investors, respectively. If each investment is held through a separate chain of vehicles, the investment vehicle which holds early investments will be required to take additional capital in order to give later investors a proportionate interest and return capital to earlier investors, which will then be required to reinvest the returned funds at a later date to fund additional portfolio investments (i.e., the returned capital would typically be re-called). If a QOF is required to return capital attributable to eligible gains to an early investor that may be re-called to invest in a separate QOF once the sponsor identifies an additional investment opportunity, the 180-day window to invest eligible gains may have closed or it may be after December 31, 2026, and the investor may no longer be eligible for deferral with respect to such previously invested capital gains. Additionally, reinvestment in another QOF would appear to trigger a new holding period which could affect the investor's ability to meet the 10 year holding period. On the other hand, if a single QOF holds multiple investments, the QOF could effect such rebalancing without returning capital to earlier investors, preserving the qualified status of the early investors' investments.

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As noted above, there are many reasons why it may be desirable from a commercial perspective for the QOF to directly dispose of its assets instead of having the exit event be structured as the sale of QOF interests. The increased complexity of structuring sales as dispositions of QOF interests, the potential unwillingness of buyers to purchase QOF interests as opposed to a direct purchase of assets, and the problems associated with organizing multiple QOFs to make investments in multiple assets all likely will discourage investors from making long-term investments in qualified opportunity zones. This result is contrary to the policy of Section 1400Z-2, which is to promote long term investment and sustained economic growth in such areas.

III. Requested Clarification: The Benefits of the Step-Up Election Are Available Where a QOF Directly Disposes of an Investment, and the Step-Up Election May Be Made Separately With Respect to Each Asset Sold by a QOF

In order to ensure that investing in QOFs is sufficiently desirable, we recommend that the benefits of the Step-Up Election be available where the QOF directly disposes of the relevant asset. In the case of a QOF classified as a partnership, we believe this result would be best and most easily be achieved by allowing a Qualified Investor to make the Step-Up Election with respect to each disposition of assets by the QOF, which election would result in both an "inside basis" step-up in the Qualified Investor's share of the QOF's assets and an "outside basis" step-up in the Qualified Investor's QOF interest. The inside basis step-up would occur immediately prior to the asset being sold, and the amount of the inside basis step-up would equal the amount of gain from the sale that (absent the Step-Up Election) would be allocated to Qualified Investors under the QOF's operating agreement. Any gain recognized by the QOF on the sale after the basis step-up would be allocated to non-Qualified Investor(s) to ensure that only the Qualified Investor(s) received the benefit of the Step-Up Election. Qualified Investors would also receive an outside basis step-up in order to ensure that sales proceeds distributed to them did not trigger gain under Section 731. The outside basis step up would equal the amount of gain which would (absent the Step-Up Election) be allocated to the Qualified Investor. Therefore, the total inside basis step up should equal the total outside basis step up. The mechanism described above would allow Qualified Investors to make the Step-Up Election (as described above) multiple times, with each election corresponding to the separate disposition of an investment by a QOF.

As an example, suppose that investors A and B each contribute $100 in eligible gains to a qualified opportunity fund ("Fund") on Jan. 1 2019, and investors C and D each contribute $100 of eligible gains to Fund on Jan. 1, 2020. Following these contributions, A, B, C, and D each own a 25% interest in Fund. In Feb. 2020, Fund purchases opportunity zone asset X for $100 and by Dec. 2020 has paid $300 to substantially improve asset X such that Fund's basis in asset X is (and remains until sale) $400. Fund sells asset X in Feb. 2029 for $800, and would (but for the effect of the Step-Up Election) recognize $400 of capital gains. At the date of the

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sale, A and B have properly certified to Fund (i) that they are Qualified Investors and A and B and (ii) that they wish to make the Step-Up Election with respect to Fund's sale of Asset X.

As a result of A and B making the Step-Up Election, Fund is entitled to receive a basis step-up in asset X immediately prior to its sale. The amount of the basis step-up is $200, which is the amount of capital gain from the sale that would be allocated to Qualified Investors ($100 to each of A and B). Therefore, Fund's basis in asset X is increased from $400 to $600 immediately prior to sale, and Fund will recognize $200 of capital gain on the sale ($800 - $600). This $200 of gain will be specially allocated to QOF's non-Qualified Investors (C and D), and the amount of gain recognized by C and D will be unaffected by the Step-Up Election. Immediately prior to the sale, A and B will each receive a step up of $100 in their interests in Fund, matching the inside basis step up of $100 with respect to each of A and B.

In connection with adopting this step-up mechanism, we believe the IRS should promulgate safe harbor rules under which a QOF will be able to determine what portion of its investors are Qualified Investors on the date of the asset sale. A certification from an investor that its entire investment in the QOF is attributable to qualified gains, together with the QOF's knowledge of the date on which the investor was admitted, should be adequate for this purpose. We also would expect that a QOF will be required to report to each electing Qualified Investor any inside basis step up attributable to a Step-Up Election by the Qualified Investor, which will affect the Qualified Investor's basis in its QOF interest. In addition, we believe the IRS should promulgate streamlined procedures for Qualified Investors to notify the QOF that they are making a Step-Up Election with respect to an asset sale. For example, we believe a Qualified Investor should be allowed to notify a QOF in advance that it opts to make the Step-Up Election for any asset sale for which it is eligible.

IV. Policy Considerations Weigh in Favor of K&L Gates' Requested Clarifications

Our recommendation for the Step-Up Election to be permitted where a QOF directly disposes of its assets would increase the commercial appeal of making investments in QOFs and eliminate expenses which investors may incur in structuring around potential pitfalls of the uncertain language in Section 1400Z-2(c), likely making investments in QOFs more attractive to investors. The clarifications therefore align with Congress' overarching goal in enacting the TCJA to jumpstart the economy and increase the rate of GDP growth. As House Ways and Means Committee Chairman Kevin Brady (R-TX) said regarding the TCJA's passage, "it will revitalize our economy so American businesses can once again compete and win..."[10] Incentivizing investors to invest in QOFs which hold multiple assets aligns with the goal of increasing investments in qualified opportunity zones.

[10] Press Release, House Ways and Means Committee, SIGNED INTO LAW: First Overhaul of Nation's Tax Code in 31 Years (Dec. 22, 2017) (available at https://waysandmeans.house.gov/signed-law-first-overhaul-nations-tax-code-31-years/).

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V. Conclusion

The TCJA added Section 1400Z-2 to provide certain tax benefits for investments in qualified opportunity zones. The Step-Up Election of Section 1400Z-2(c) is one of the two primary tax benefits for investing in opportunity zones, allowing a Qualified Investor to elect to step-up the basis in its investment to fair market value on the date that the investment is sold or exchanged. Unfortunately, due to a lack of clarity in the statutory text, it is uncertain whether the benefits of the Step-Up Election are available where a QOF directly disposes of its assets. This uncertainty also prevents QOFs from disposing of assets at different times. Failing to allow a Step-Up Election to be made where QOF directly disposes of its assets would cause Qualified Investors to recognize gain in those situations when a QOF deems it necessary or desirable to directly sell its assets, or to sell assets at different times, which diminishes the tax benefits of the Step-Up Election, reduces the advantage of the tax benefits provided by Section 1400Z-2, and thereby makes investing in QOFs less attractive. Accordingly, K&L Gates respectfully requests that the Notice's proposed regulations be clarified as described herein.

Thank you for the opportunity to provide these comments. Please contact Mary Burke Baker at mary.baker@klgates.com, Adam Tejeda at adam.tejeda@klgates.com, or Jay Buchman at jay.buchman@klgates.com with any questions or to discuss these comments in more detail.

Very truly yours,

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