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Dec. 26, 2018

Via www.regulations.gov (REG–115420–18)

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: Proposed Qualified Opportunity Zone Regulations (the Proposed QOZ Regulations)
CC:PA:LPD:PR (REG–115420–18)

Dear Secretary Mnuchin and Commissioner Rettig:

Nareit appreciates the opportunity to offer comments regarding the Proposed QOZ Regulations.[1] Nareit is the worldwide representative voice for real estate investment trusts (REITs) [2] and publicly traded real estate companies with an interest in U.S. real estate and capital markets. Nareit advocates for REIT-based real estate investment with policymakers and the global investment community.

Executive Summary

Last year's tax reform legislation known as the Tax Cuts and Jobs Act[3] added sections[4] 1400Z-1 and -2 to the Internal Revenue Code in order to encourage investment in low-income communities (qualified opportunity zones). Nareit commends the efforts of the Treasury Department and Internal Revenue Service (IRS) regarding the Proposed QOZ Regulations and makes the following two recommendations.

First, Nareit recommends that the final regulations clearly define gain eligible for deferral as including any items of gross gain from the sale or exchange of property used in a trade or business (as defined in section 1231(b)). However, if the final regulations only permit the deferral of net section 1231 gains (which are only determined at the end of the taxable year and take into account that year's section 1231 gross losses and the previous five years' unrecaptured section 1231 losses), the 180–day deferral period should begin on the last day of the taxpayer's taxable year. Second, Nareit recommends that the 180-

[1] Investing in Qualified Opportunity Funds, 83. Fed Reg. 54279 (Oct. 29, 2018).
[2] REITs are real estate working for you. Through the properties they own, finance and operate, REITs help provide the essential real estate we need to live, work and play. All U.S. REITs own approximately $3 trillion in gross assets, public U.S. REITs account for $2 trillion in gross assets, and stock-exchange listed REITs have an equity market capitalization of over $1 trillion. In addition, more than 80 million Americans invest in REIT stocks through their 401(k) and other investment funds.
[3] Pub. L. No. 115-97.
[4] Unless otherwise provided, all references to a "section" shall be to a section of the Internal Revenue Code of 1986, as amended (the Code).

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day deferral period for capital gain dividends of REIT shareholders begin 30 days after the close of the REIT's taxable year.[5]

Discussion

Final regulations should clarify that "eligible gain" includes section 1231 gain

Background

Section 1400Z-2 allows for the deferral of "gain" if the gain is invested in a qualified opportunity fund (QOF). In addition, section 1400Z-2(e)(4) grants broad regulatory authority to the Treasury Department to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

The Proposed QOZ Regulations[6] with respect to section 1400Z-2 provide that "gain" is eligible for deferral if it would be recognized for Federal income tax purposes absent deferral under the QOZ rules and if is treated as a capital gain for Federal income tax purposes, explaining that:

> [t]he statutory text is silent as to whether Congress intended both ordinary and capital gains to be eligible for deferral under section 1400Z-2. (Sections 1221 and 1222 define these two kinds of gains.) However, the statute's legislative history explicitly identifies "capital gains" as the gains that are eligible for deferral. The Treasury Department and the IRS believe, based on the legislative history as well as the text and structure of the statute, that section 1400Z-2 is best interpreted as making deferral available only for capital gains. The proposed regulations provide that a gain is eligible for deferral if it is treated as a capital gain for Federal income tax purposes. Eligible gains, therefore, generally include capital gain from an actual, or deemed, sale or exchange, or any other gain that is required to be included in a taxpayer's computation of capital gain. [7]

Presumably, a REIT's section 1374 gain (built-in gain) is eligible for deferral under section 1400Z-2, and it would be helpful if this were confirmed either by the final regulations or the Preamble to the final regulations.[8]

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[5] Nareit supports the comments on the Proposed QOZ Regulations submitted on behalf of the U.S. Chamber of Commerce and The Real Estate Roundtable.
[6] *See* Prop. Reg. § 1.1400Z2(a)-1(b)(2)(A).
[7] 83 Fed. Reg. at 54280. We also note that the statutory provision, as enacted, is entitled "Special Rules for Capital Gains Invested in Opportunity Zones."
[8] Under the Proposed QOZ Regulations, the gain would retain its character as section 1374 gain.

As relevant to this discussion, two Code provisions provide for the treatment of gain as capital gain for Federal income tax purposes: section 1222 and section 1231. Section 1222 provides general rules regarding the treatment of gain from the sale or exchange of a "capital asset" as either short or long-term capital gain or loss. Included in section 1221's definition of "capital asset" is generally property held by the taxpayer other than inventory or depreciable or real property used in the taxpayer's trade or business.

Section 1231 provides the Federal income tax treatment for gains and losses on the sale or exchange of, among other things, non-inventory depreciable property and real property used in a trade or business and held for more than one year. Under section 1231(a)(1), if section 1231 gains for the taxable year exceed section 1231 losses for the taxable year, such net gains are treated as long-term capital gains, subject to the special section 1231 recapture rule described below. If, however, section 1231 losses exceed section 1231 gains for such year, the net loss is treated as an ordinary loss. Section 1231(c) provides an exception to treating section 1231 gains as capital gain by treating net section 1231 gain in a taxable year as ordinary income up to the amount of non-recaptured net section 1231 losses from the previous five taxable years.

As relevant in the real estate context, section 1231 gains and losses are those gains or losses from the sale or exchange of property described in section 1231(b). Section 1231(b) property includes non-inventory depreciable and real property used in a trade or business and held for more than one year. It also includes timber to which section 631 applies.

The IRS' Statistics of Income Division recently released partnership tax return data for 2015. Table 5 of that data ("All Partnerships: Income (or Loss) Allocated to Partners, by Industrial Sector, Tax Year 2015") indicates that partnerships across all industry sectors recognized net section 1231 gains. Real estate and rental and leasing accounted for 49.7% of all partnerships and allocated to partners almost 75% of the approximately $208 billion in partnership net section 1231 gains. In addition, Table 3 of the data ("All Partnerships: Balance Sheets by Selected Industrial Group, Tax Year 2015") indicates that real estate partnerships held approximately $4.9 trillion of depreciable assets and land. Presumably, a sizable portion of the gain attributable to disposition of such property would constitute section 1231 gain. Assuming similar patterns going forward, partnerships of all industries, and, in particular, real estate partnerships, have the potential of realizing significant amounts of section 1231 gains that could be invested in QOFs. Section 1231 gains are also routinely realized by individual taxpayers as well.

Deferral of gain from the disposition of section 1231(b) property is consistent with the statute and would encourage additional QOF investments

The Proposed QOZ Regulations appear to contemplate significant investment in QOFs from partnerships, as evidenced from the preamble, which states that "[p]artnerships are expected to be a

significant source of funds invested in [QOFs] . . . Without these proposed rules clarifying how partnerships and partners may satisfy the requirements for the preferential treatment of capital gains, partners may be less willing to invest in a QOF."[9] Real estate partnerships comprise almost half of all partnerships and could deploy significant capital in QOFs. There is some uncertainty, however, regarding whether a partnership with section 1231 gain can defer that gain through a QOF investment because the partnership does not itself calculate whether such gain is treated as capital gain for Federal income tax purposes. Specifically, section 702(a)(3) applies to partnerships and provides that the determination of whether section 1231 gains are treated as capital gains is made at the partner level, rather than partnership level.

Thus, the section 1231 gain becomes capital gain or ordinary income at the individual or corporate partner level, generally depending on the partner's section 1231 losses from other sources (including other partnerships and through tiered partnerships) and from unrecaptured net section 1231 losses from prior years. As a result, partnerships with section 1231 gain may face significant complexity in making gain deferral elections, contrary to legislative intent.

Moreover, a unique issue exists for REITs in the umbrella partnership REIT (UPREIT) structure.[10] This structure, in which a REIT owns only a majority interest in an operating partnership (OP) that owns and operates (through flow-through entities) all of the business' properties, is used by the majority of listed REITs. Investors acquire limited partnership units in the OP in exchange for contributions of property or partnership interests, and such units ultimately may be redeemed in a taxable transaction in exchange for cash or REIT stock (at the REIT's option). These partners generally are entitled to distributions from the OP on parity with REIT shareholders. To maintain this parity, the REIT partner may not invest outside of the OP. Any outside investments are required to be contributed to the OP. [11]

The Proposed QOZ Regulations also retain the character of any deferred gain when ultimately recognized.[12] Without clarification, this issue creates uncertainty (and therefore may hinder QOF investments) for many taxpayers, including, but not limited to, real estate partnerships and potentially all UPREITs.

[9] 83 Fed. Reg. at 54287.
[10] Treas. Reg § 1.701-2(d), Example 4 generally describes an UPREIT structure and concludes that it will not constitute an abusive transaction under section 701.
[11] REITs may reinvest gains in QOFs, and in an UPREIT structure, there is some uncertainty regarding whether the REIT can then contribute the QOF interests to the OP without triggering deferred gain. Although this is a distinct issue from the section 1231 question, we would welcome guidance on the ability to transfer QOF interests in nonrecognition transactions.
[12] In this respect, the tax treatment of gain recognition under the QOZ rules resembles that under the installment sale rules of section 453.

To eliminate this uncertainty, and to encourage investment of section 1231 gains in QOFs, we recommend using a definition of eligible gain under Section 1400Z-2(a) similar to the definition of "qualified capital gain" under a similar provision meant to encourage investment, former section 1400B(e)(1): gain from the sale or exchange of a capital asset or property used in the trade or business (as defined in section 1231(b)).

The IRS and Treasury Department have broad regulatory authority to define "gain" in section 1400Z-2(a) necessary or appropriate to carry out its purposes – namely, to encourage investment in distressed areas through the deferral of gain on the sale or exchange of property. The statutory language uses the term "gain," rather than "capital gain." Thus, allowing deferral of gains from disposition of section 1231(b) property would not be inconsistent with the statutory language. Although the legislative history may have referred to capital gain, there is no indication that the drafters intended to exclude section 1231 gains (which, absent any section 1231 losses in excess of the section 1231 gains, are treated as long-term capital gain) from deferral.

The 180-day period applicable to net section 1231 gains should begin on last day of taxable year

Prop. Reg. § 1.1400Z2(a)-1(b)(4) provides that the first day of the 180-day period described in section 1400Z-2(a)(1)(A) "begins on the day on which the gain would be recognized for Federal income tax purposes if the taxpayer did not elect under section 1400Z-2 to defer recognition of that gain." Because of the complex section 1231 calculation described above, a taxpayer may not know within 180 days from the date that the gain is recognized whether a section 1231 gain will, at the end of the taxable year, in fact be treated as capital gain for Federal income tax purposes.

As noted above, at the partner or individual taxpayer level, the determination of whether section 1231 gain is treated as capital gain for Federal income tax purposes can only be determined once all section 1231 losses are aggregated, to measure whether they equal or exceed the aggregate section 1231 gains. For partners or individuals in multiple partnerships, that means waiting until the receipt of all Schedules K-1, which could be received as late as September 15 of (or 258 days into) the subsequent tax year.

If the final regulations only permit the deferral of section 1231 gains to the extent that they are treated as capital gains for Federal income tax purposes (*i.e.*, if they exceed that year's section 1231 losses and the previous five year's non-recaptured section 1231 losses), the 180–day deferral period should begin on the last day of the taxpayer's taxable year in order for the taxpayer to undertake the calculations required by section 1231. This rule would be consistent with the Proposed QOZ Regulations' treatment of capital gains realized through a non-electing partnership. If, however, taxpayers were permitted to elect to defer gross section 1231 gains, the 180-day period could begin on the date the gain is realized (or from the

last day of a partnership's taxable year in the case of non-electing partnership), because section 1231 losses and unrecaptured 1231 losses would not be taken into account.

For REIT capital gain dividends, the 180-day deferral period should begin 30 days after the close of the REIT's taxable year

Background

A similar issue in connection with the 180-day deferral period arises in the context of capital gain dividends distributed by REITs and regulated investment companies (RICs). Specifically, Example 2 of that Prop. Reg. § 1.1400Z2(a)-1(b)(4) specifies if an individual RIC or REIT shareholder receives a capital gain dividend, the shareholder's 180-day period with respect to that gain begins on the day that the dividend is paid.

Starting the 180-day deferral period for REIT capital gain dividends 30 days after the end of the REIT's year would ensure that all designated capital gain dividends will be eligible for deferral without the administrative burden of knowing the precise designation date

As a practical matter, beginning a REIT or RIC shareholder's 180-day period on the day that the dividend is paid makes it virtually impossible for recipients of capital gain dividends to be able to effectively participate in the opportunity zone program. REIT capital gain dividends can only be declared on the net capital gain of the REIT.[13] Therefore, there is no way for a REIT to determine if a dividend will even be eligible for capital gain until the taxable year has ended when the REIT can aggregate all of its capital gains and losses, as well as section 1231 gains and losses, for the taxable year.

Of greater import, even if the taxable year has ended and a REIT dividend is eligible to be treated as a capital gain dividend, it cannot be treated as a capital gain dividend unless the dividend is designated as a capital gain dividend by the REIT.[14] The REIT capital gain dividend rules recognize that a REIT cannot determine its capital gain dividend at the time the dividend is paid. Therefore, the Internal Revenue Code provides that a REIT generally can designate a dividend paid as a capital gain dividend at any time before the expiration of 30 days after the close of the REIT's tax year.[15] Note that, even if a dividend is eligible to be treated as a capital gain dividend, if a REIT does not properly designate it as such, the dividend would not be a capital gain dividend. Therefore, a dividend does not become a capital gain dividend until the time that the dividend is designated as such, such as on Jan. 30 of the following year.

[13] Section 857(b)(3)(B).
[14] *Id.*
[15] *Id.*

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Again, to eliminate uncertainty and encourage investment in QOFs, we recommend that the 180-day period for deferral and reinvestment of a REIT capital gain dividend begin at the date that is 30 days after the end of the REIT's tax year.

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We would be pleased to discuss these comments if you believe it would be helpful. Please feel free to contact me at (202) 739-9408, or tedwards@nareit.com; Cathy Barré, Nareit's Senior Vice President, Policy & Politics, at (202) 739-9422, or cbarre@nareit.com; or Dara Bernstein, Nareit's Senior Vice President and Tax Counsel, at (202) 739-9446 or dbernstein@nareit.com.

Respectfully submitted,

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