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July 1, 2019

Via: www.regulations.gov (IRS and REG-120186-18)

CC: PA:LPD:PR (REG–120186–18)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: May 1, 2019 Proposed Qualified Opportunity Zone (QOZ) Regulations (the 2019 Proposed QOZ Regulations)

Dear Sir or Madam:

Nareit appreciates the opportunity to offer comments regarding the 2019 Proposed QOZ Regulations.[1]

Nareit[2] is the worldwide representative voice for real estate investment trusts (REITs) 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). On Oct. 29, 2018, the Treasury Department and IRS issued the first set of regulations under these provisions (2018 Proposed QOZ Regulations).[5] Nareit submitted comments on Dec. 26, 2018 with respect to the 2018 Proposed QOZ Regulations. In those comments, Nareit commended the efforts of the Treasury Department and Internal Revenue Service (IRS) regarding the 2018 Proposed QOZ Regulations and recommended, among other things, that the final regulations should: 1) 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)); and, 2) begin the 180-

[1] Investing in Qualified Opportunity Funds, 84 Fed. Reg. 18652 (May 1, 2019), date corrected, 84 Fed. Reg. 22987 (May 18, 2019).

[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).

[5] Investing in Qualified Opportunity Funds, 83 Fed. Reg. 54279 (Oct. 29, 2018).

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

While the 2019 Proposed QOZ Regulations confirm that section 1231 gains are eligible for deferral under the qualified opportunity zone rules, they do so only to the extent that such gains exceed section 1231 losses. Further, the 180-day deferral period for such section 1231 gains only begins at the end of the taxable year. Nareit appreciates that the Treasury Department and IRS have requested comments on the treatment of section 1231 gain, and again recommends that, to maximize the important economic potential of the QOZ rules, the final regulations permit the deferral of Section 1231 gain, without a Section 1231 loss offset, and begin the 180-day deferral period on that date that the relevant section 1231 property is sold or exchanged.[6] Even if this recommendation is not accepted, Nareit again recommends that the IRS and Treasury Department provide clear guidance that partnerships can defer gain from section 1231 property and further recommends that the relevant IRS forms for deferral of both gains from capital assets and gains from section 1231 property be amended to conform to the final regulations.

In addition, Nareit requests that the final regulations confirm that: 1) the 180-day deferral period for shareholders receiving capital gain dividends from a REIT begin at the date that is 30 days after the end of the REIT's tax year; 2) section 291 does not apply to recharacterize as ordinary income unrecaptured section 1250 gain in the year of the sale or exchange to the extent that gain is deferred with a qualified opportunity fund investment; 3) section 1400Z-2(b)(2)(B)(iii), (iv), and 2(c)'s basis step up rules apply equally for taxable income and REIT earnings and profits (E&P) purposes; and, 4) the 0% tax rate applicable to certain capital gain dividends received by shareholders of qualified opportunity fund REITs (a QOF REIT) also applies to shareholders of upper-tier REIT shareholders in QOF REITs.

[6] Comments expected to be submitted by The Real Estate Roundtable with respect to the 2019 Proposed Regulations make a similar recommendation. If there is concern regarding the potential separation of section 1231 gains from section 1231 losses (thus potentially treating those losses as ordinary deductions) a possible response of extending section 1231(c)'s loss recapture provision to the longer of the statutory five years or December 31, 2026 could be considered. With that said, Nareit understands that there may be other reasonable approaches to address this concern as well.

Recommendations

Clarify Certain Qualified Opportunity Zone Rules Applicable to Gains from Section 1231 Property, Including Gains Recognized by Partnerships

Consider treating gain from disposition of section 1231 property similarly to gain from disposition of capital assets

By way of 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." In Nareit's Dec. 26, 2018 letter to the IRS and Treasury Department with respect to the Oct. 29, 2018 proposed qualified opportunity zone regulations, Nareit requested confirmation that gain eligible for deferral include section 1231 gain. In addition, Nareit's 2018 letter noted that real estate partnerships historically have recognized, and are likely to continue to recognize, a significant amount of section 1231 gains. Nareit recommended that the IRS and Treasury Department consider 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)).

Nareit appreciates that the 2019 Proposed QOZ Regulations specifically do confirm that gains from section 1231 property are eligible for deferral under the QOZ rules, by providing that:

> the only gain arising from section 1231 property that is eligible for deferral under section 1400Z–2(a)(1) is capital gain net income for a taxable year. This net amount is determined by taking into account the capital gains and losses for a taxable year on all of the *taxpayer's* section 1231 property. The 180-day period described in paragraph (b)(4) of this section with respect to any capital gain net income from section 1231 property for a taxable year begins on the last day of the taxable year.

Prop. Treas. Reg. § 1.1400Z2(a)–1(b)(2)(iii) (emphasis added).

The Preamble to the 2019 Proposed QOZ Regulations specifically requests comments on the proposed treatment of section 1231 gains. While Nareit appreciates the 2019 Proposed QOZ Regulations' clarification that gains from section 1231 property are eligible for deferral, Nareit again recommends that the Treasury Department and IRS consider permitting the deferral of Section 1231 gains without an offset of Section 1231 losses (whether through use of a definition similar to that used in former section 1400B or otherwise). Doing so would be consistent with the statutory language of section 1400Z-2(a)(1) refers to “gain” from the sale or exchange of property, and section 1400Z-2(a)(1)(A) provides that “gross income for the taxable year shall not include so much of such gain as does not exceed the aggregate amount invested by the taxpayer in a qualified opportunity fund *during the 180-day period beginning* ***on the date of such sale or exchange***.” (Emphasis added).

Because the statute contemplates that the deferral period for “gain” from the sale or exchange of property begins on the date of such sale or exchange, waiting until the end of the taxable year in order to determine whether section 1231 gains in fact exceed section 1231 losses adds a requirement to the statute that does not exist in the statutory language and also may limit the potential benefit of the qualified opportunity zone provisions in encouraging investment in distressed communities.[7] Furthermore, a taxpayer’s sale of its business could result in gain that is both attributable to section 1231 property (such as depreciable or real property used in a trade or business, including acquired goodwill) and/or gain attributable to capital assets (such as self-created goodwill, which is not depreciable under section 197 and therefore not section 1231 property). Any requirement to bifurcate eligible gain between the capital gain realized from the sale of self-created goodwill (immediately eligible for deferral) and the net section 1231 gains (not eligible for deferral until the end of the year) may create unwarranted confusion that could limit the benefits of the QOZ provisions to distressed communities. Another potential area of confusion could relate to whether a taxpayer’s gain is from depreciable and/or real property held for more than one year and used in a “trade or business” (section 1231 property) or depreciable and/or real property not used in a “trade or business” (capital gain).

Confirm that partnerships can defer gains from section 1231 property

Assuming that the final regulations retain the requirement that only capital gains and net section 1231 gains are eligible for deferral, advisors have expressed uncertainty regarding whether a partnership can defer gains from section 1231 property.

Nareit is aware that several government representatives have made unofficial statements at various public speaking engagements that confirm that partnerships can defer section 1231 gains. Reportedly, officials also have said that the Treasury Department is still thinking about how to handle situations when the partnership has section 1231 gains, but the partners have section 1231 losses. It would provide greater certainty to the investing community and assist in spurring investment in opportunity zones if the IRS and Treasury Department could provide greater clarity with respect to partnership deferral of gain from section 1231 property.

Clarity could be provided by including examples in the final regulations showing examples when a partnership is eligible, and is not eligible, to defer its capital gain net income arising from section 1231

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[7] Another potential solution would be to allow an election to begin the 180-day deferral period with respect to gain from disposition of section 1231 property either at the time of property disposition or at the end of the taxpayer’s taxable year.

property. Additionally, the final regulations should confirm that that section 1231(c) recapture does not affect the eligible gain in the year of the sale or exchange that can be deferred with a QOF investment, and instead the recapture applies only in the year of gain recognition in 2026 (or earlier). The application of section 1231(c) recapture can be particularly problematic for partnership-level gain, since recapture is normally done at the partner level. This clarity also could be provided by amending Form 4797 (Sales of Business Property) and/or its instructions as well as Form 8949 (Sales and Other Dispositions of Capital Assets) and its instructions to align with the rules final Regulations.

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

Nareit again recommends that the 180-deferral period for REIT capital gain dividends begin 30 days after the close of the REIT's taxable year, rather than on the date of the distribution. A REIT can only designate a capital gain dividend as such with certainty after the close of its taxable year; as a result, a shareholder cannot know on the date of a particular distribution whether that distribution is a capital gain dividend.

Confirm that section 291's recapture rule does not apply to unrecaptured section 1250 gain in the year of the sale or exchange to the extent that gain is deferred with a QOF investment

Section 291(a) generally provides that if a corporation recognizes unrecaptured section 1250 gain, 20% of that gain is treated as ordinary income.

Section 291(d) generally provides that the amount of a REIT's unrecaptured section 1250 gain that is treated as ordinary income is reduced to the extent the gain is distributed as a capital gain dividend to the REIT's shareholders.

Section 291 was originally enacted in 1982 to cut back on some of the benefits of the preferential corporate tax rate for capital gains, which were taxed at 28% at the time compared to a tax rate of 46% for a corporation's ordinary income. When the Tax Reform Act of 1986 eliminated the preferential corporate tax rate for capital gains, section 291 lost its reason for being, and it now serves mainly as a trap for the unwary.

One such trap exists for a REIT that is seeking to invest unrecaptured section 1250 gain into a QOF. The final regulations should confirm that section 291 does not apply to unrecaptured section 1250 gain in the year of the sale or exchange to the extent that gain is deferred with a QOF investment. Instead, the recapture rule in section 291 should apply when the gain is included in gross income in 2026 (or earlier if there is an inclusion event).

For example, assume that a REIT recognized $100 of unrecaptured section 1250 gain in 2019. If the REIT does not make a QOF investment and makes no capital gain dividend distribution, $20 of that gain is treated as ordinary income and $80 of the gain is unrecaptured section 1250 gain, both taxed at the REIT level. The final regulations should confirm that the REIT has $100 of eligible capital gain in 2019 that can be deferred with a QOF investment, without regard to section 291's application in 2019. When the REIT recognizes some or all of the deferred unrecaptured section 1250 gain in 2026 (or earlier), section 291 would apply at that time.

In contrast, if section 291 applies to a REIT's unrecaptured section 1250 gain in the year of the sale or exchange, the REIT would have only $80 of eligible gain in 2019 that can be deferred with a QOF investment, and the REIT would have $20 of undistributed ordinary income that is subject to tax at the REIT level and may cause the REIT to fail the distribution requirement in section 857(a)(1). Further, if the REIT distributes $20 of ordinary income, there is a potential circular effect that could require the REIT to distribute all of the gain to avoid tax at the REIT level and meet the REIT distribution requirement, in which case the REIT cannot make any QOF investment with its unrecaptured section 1250 gain. For example, if the REIT distributes $20 of ordinary income, its remaining $80 of unrecaptured section 1250 gain could be recharacterized as 20% ordinary income ($16), and so on until all of the gain is recharacterized as ordinary income and distributed to the shareholders.

Clarify REIT Earnings and Profits Rules so that a REIT and its Shareholders are Treated Consistently under the QOZ Rules

The QOZ rules provide for a step-up in basis of the QOF interest after five years in section 1400Z-2(b)(2)(B)(iii), after seven years in section 1400Z-2(b)(2)(B)(iv), and after 10 years in section 1400Z-2(c). The intent of those step-ups is to allow taxpayers to permanently defer recognition of certain income. However, when a REIT holds a QOF interest, the rules do not achieve that objective if the basis step-ups do not also apply for purposes of computing a REIT's earnings and profits (E&P). If the basis step-up rule does not also apply for E&P purposes, then a REIT's distribution of gain from the disposition of a QOF interest may actually result in ordinary income to its shareholders from the REIT's distribution of such gain, rather than even capital gain.

For example, assume a REIT recognized $100 of capital gain in 2022, which the REIT deferred with a $100 QOF investment in 2022. The REIT recognizes all $100 of its deferred gain in 2026. The REIT sells its QOF investment in 2033 for $300, with a basis step-up under section 1400Z-2(c) from $100 to $300 immediately before the sale. The final regulations should confirm that the section 1400Z-2(c) basis step-up applies for E&P purposes and that the REIT does not have $200 of E&P from the 2033 disposition.

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In contrast, if the REIT has $200 of E&P in 2033, then $200 of the REIT's distributions to its shareholders would be a taxable dividend. The dividend would be an ordinary dividend because the REIT has no taxable capital gain that allows the REIT to make a capital gain dividend designation. The taxation of the REIT's distributions attributable to 10-year appreciation of the QOF interest in the hands of the REIT, at full ordinary income rates, is contrary to the purposes of the QOZ rules and greatly discourages REIT investments in QOFs.

The same E&P issue applies to a REIT that makes a QOF investment before 2022, as to whether its 10% basis step-up after five years and its additional 5% basis step-up after seven years also apply for E&P purposes.

Given the intent of the QOZ rules to allow taxpayers not to recognize income associated with the step ups, Nareit believes that treating the basis step-ups as similar to tax-exempt income, which causes a corresponding increase to E&P under Treas. Reg. § 1.312-6(b), is not within the intention of the provision as the step up could ultimately become taxable to a REIT shareholder if the REIT distributes amounts greater than taxable income. Assuming a REIT satisfies the REIT requirements and in fact distributes 100% of its REIT taxable income, the REIT shareholders bear the tax liability associated with the income earned by the REIT, and it would be inconsistent with the policy behind the QOZ rules for the REIT to defer gain permanently at the same time that its shareholders must recognize gain on the same income.

As an alternative, the final regulations should consider providing REITs with the ability to make tax-exempt capital gain dividends to the REIT shareholders, to the extent attributable to the REIT's gain with respect to its investments in a QOF (whether a partnership or a corporation). The tax-exempt capital gain dividends (of a REIT that is not itself a QOF REIT, but has realized gain from its investment in a QOF) can be handled similar to the 0% tax rate for a QOF REIT's capital gain dividends in Prop. Treas. Reg. § 1.1400Z2(c)-1(e)(1)(ii). This regulatory relief is necessary because there is no pass-through of the REIT's basis step-ups in its QOF investments to the REIT's shareholders. In other words, absent such a rule, REIT shareholders would recognize gain on a QOF investment made by the REIT notwithstanding that the REIT itself would not recognize such gain.

Using the same example as above, a REIT distributes $200 of cash to its shareholders in 2033. If the REIT has no other taxable income in 2033 and there is no regulatory relief, the $200 distribution is a return of capital distribution that reduces the shareholders' REIT stock tax basis under section 301(c)(2) and may give rise to up to $200 of capital gain for the REIT shareholders under section 301(c)(3). The shareholders' $200 of capital gain is contrary to the purpose of the QOF regime and its intent to provide tax-exempt gain for investments in QOFs and inconsistent with the capital gain dividend rules applicable to REITs that are themselves QOFs under the 2019 Proposed QOZ Regulations.

Confirm that QOZ Tax Treatment Applies to Shareholders who Invest in QOF REITs Through Upper-Tier REITs

Prop. Treas. Reg. § 1.1400Z2(c)-1(e) allows capital gain dividends paid by a QOF REIT (a REIT that is itself a QOF) to be received by shareholders in a tax-free manner. Specifically, when a QOF REIT shareholder holds shares representing a qualifying investment and receives a capital gain dividend, it may treat that dividend as a qualifying gain subject to a 0% tax rate if, on the date the QOF REIT identified with the dividend, the shareholder has held the qualifying investment for at least 10 years. Prop. Treas. Reg. § 1.1400Z2(c)-1(e)(4) provides two methods by which a QOF REIT can identify the date for an amount of capital gain.

As described above, a REIT that is an equity holder in a QOF that is **not** a REIT may realize tax-exempt gain under section 1400Z-2(c) when it disposes of the qualifying investment after a ten-year holding period. In the absence of a clarification, this benefit will not extend to the REIT's shareholders, since a subsequent distribution of the tax-exempt proceeds by the REIT will either result in ordinary REIT dividend pick-up to the shareholders, or alternatively a capital gain (or reduction in either basis or capital loss) in the event of a liquidating distribution by the REIT or a stock sale by the shareholder. Accordingly, we recommend that the section 1400Z-2(c) basis step-up be applied for E&P purposes and that the REIT not have an increase to E&P because of the qualifying disposition. We also recommend that a REIT that makes a qualifying QOF investment should be able to make tax-exempt capital gain dividends to its shareholders, to the extent attributable to the REIT's tax-exempt gain with respect to such investments.

The final regulations should implement this flexibility in a manner that is sufficiently broad to capture situations when the REIT's tax-exempt gain is itself attributable to the 0% tax rate on capital gain dividends from QOF REITs pursuant to Prop. Treas. Reg. § 1.1400Z2(c)-1(e)(1)(ii). This approach would effectively permit 0% capital gain dividends to "tier up" through one or more REITs, and would ensure that an upper-tier REIT does not increase its E&P as a result of the 0% capital gain dividend received from a QOF REIT. As the capital gain dividend is tiered up, it would be identified (at each level) with the date designated by the QOF REIT at the "bottom" of the tiered structure. Any shareholder that received the capital gain dividend through these tiers would be able to apply a 0% rate to the cap gain dividend to the extent that shareholder has held its interest in the "top tier" REIT for at least 10 years. The 0% tax rate would also apply for purposes of the section 1411 net investment income tax. That shareholder's interest in the upper-tier REIT would not itself be required to constitute a qualifying investment under the QOF rules.

For example, assume that an upper-tier REIT (Upper REIT) recognized $100 of capital gain in 2020, which it deferred with a timely $100 investment into a lower-tier REIT (Lower REIT, a QOF). Upper REIT recognizes all $100 of its deferred gain in 2026. In 2033, Lower REIT pays a capital gain dividend to Upper REIT that is properly identified by "Lower REIT" (under Prop. Treas. Reg. § 1.1400Z2(c)-1(e)(2) and (3)) with a date that would satisfy Upper REIT's requisite 10-year holding period with respect to its

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QOF investment. Accordingly, Upper REIT may apply a 0% rate to that capital gain dividend. Consistent with our recommendations herein, Upper REIT would not have an increase in E&P as a result of this dividend, and would then be able to make a tax-exempt capital gain dividend to its qualifying shareholders (to the extent attributable to the 0% capital gain dividend received from Lower REIT). That is, any shareholder of Upper REIT that has held its stock for at least 10 years (as of the date identified with the dividend) should be able to apply a 0% rate to this dividend for both regular income tax as well as section 1411 net investment income tax purposes.

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 Executive Vice President & General Counsel, at (202) 739-9422, or cbarre@nareit.com; or Dara Bernstein, Nareit's Senior Vice President & Tax Counsel, at (202) 739-9446 or dbernstein@nareit.com.

Respectfully submitted,

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