SULLIVAN & CROMWELL LLP

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IRS Issues Proposed Regulations on Qualified Opportunity Funds

Proposed Regulations Would Clarify a Number of Threshold Issues But Also Leave Many Other Issues to be Resolved by Future Guidance

SUMMARY

On October 19, the Internal Revenue Service (the "IRS") and the Treasury Department released the first set of proposed regulations (the "Proposed Regulations") to provide guidance on investing in qualified opportunity zones ("QOZs") through qualified opportunity funds ("QOFs") under a new tax incentive program created by last year's federal tax reform legislation. The IRS also contemporaneously released Revenue Ruling 2018-29 and drafts of the QOF self-certification form (IRS Form 8996) and form instructions for additional guidance. Investors who make qualifying investments in QOFs can defer (and in some cases, exclude) capital gains from any source and can avoid tax altogether on gains attributable to the QOF investment.

Together with the revenue ruling and the draft form and instructions, the Proposed Regulations would clarify a number of threshold issues left open by the statutory text, including:

- What types of gains are eligible for deferral.
- Which taxpayers are eligible to make the deferral election, particularly in the context of partnerships.
- QOF certification process.
- What valuation methodology must be used in complying with the 90% Asset Test.
- How the "original use" and "substantial improvement" requirements apply to real estate.
- How an operating subsidiary of a QOF can hold "substantially all" of its assets as qualifying investments.

- Safe-harbor for working capital of a QOF operating subsidiary.
- Various clarifications on how the 10-Year Gain Exclusion Benefit (as defined below) applies.

However, the Proposed Regulations also defer to future guidance to resolve many other outstanding questions and invite taxpayer comments, both on the Proposed Regulations and on issues reserved for future guidance. The IRS and the Treasury Department are currently drafting a second set of proposed regulations, which are expected to be released later this year.

BACKGROUND

As part of last year's comprehensive tax reform legislation,[1] Congress enacted the opportunity zone tax incentive program designed to encourage investment in low income communities.

Under the program, states can nominate a limited number of existing low income community census tracts for designation as QOZs to be certified by the Treasury Department and the IRS.[2] The Treasury Department and the IRS completed designating all QOZs in June 2018.[3]

A QOF is an investment vehicle organized as a corporation or partnership (including, under the Proposed Regulations, a limited liability company treated as a corporation or partnership for federal income tax purposes) to invest in QOZs.[4] Taxpayers can potentially obtain three different benefits by investing in QOFs. First, taxpayers can defer capital gains from any source if those gains are invested in a QOF within 180 days after the gain is triggered.[5] The deferred gain would be recognized on the earlier of the date on which the taxpayer disposes of its investment in the QOF or December 31, 2026.[6] Second, if the taxpayer holds the investment in the QOF for at least five years, 10% of the deferred gain is excluded from taxation through basis step-up, and if held for at least seven years, another 5% is excluded, for a total of 15% exclusion.[7] Finally, if the taxpayer holds the investment in the QOF for at least ten years, any appreciation in the value of the investment in the QOF (not the deferred gain) is excluded from taxation if

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1 *See* S&C publication of December 20, 2017, *U.S. Tax Reform*, for a description of the key provisions included in the enacted legislation.

2 *See* Section 1400Z-1.

3 The full list of designated QOZs is available at *Opportunity Zones Resources,* https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

4 *See* Section 1400Z-2(d); Prop. Treas. Regs. § 1.1400Z-2(d)-1(a)(1).

5 *See* Section 1400Z-2(a)(1)&(b). Gain must also be triggered from a transaction with an unrelated person.

6 *See* Section 1400Z-2(b)(1).

7 *See* Section 1400Z-2(b)(2)(B)(iii)&(iv).

the taxpayer elects to step up the basis in its investment in the QOF to the fair market value on the date the taxpayer disposes of the investment in the QOF.[8]

In order for an entity to qualify as a QOF, at least 90% of the QOF's assets must consist of eligible investments in QOZs made after 2017 ("90% Asset Test"), as determined by averaging the applicable percentage as measured at mid-year and year-end.[9] Generally speaking, eligible investments include tangible assets that are substantially used in QOZs.[10] In addition, equity interests in subsidiary corporations or partnerships that make substantial investments in QOZs (such operating subsidiaries, "QOZ Subsidiaries") are also eligible assets for the purposes of the 90% Asset Test.[11] As described in detail below, the Proposed Regulations would provide greater flexibility for QOFs operating through subsidiaries in satisfying the 90% Asset Test. If a QOF fails to satisfy the 90% Asset Test, the QOF must pay a penalty for each month that the QOF fails to satisfy the test, unless the QOF can show reasonable cause for the failure.[12]

Unlike some other tax incentive programs, the opportunity zone program generally allows a QOF to invest in any business in a QOZ other than a "sin" business (e.g., golf course, massage parlor, racetrack or liquor store), including multi-family residential and commercial real estate.[13] Such flexibility and attractive tax benefits have generated significant taxpayer interest in the program. However, the statutory text leaves open a number of key issues, and such uncertainty has so far discouraged actual investment under the program.

DISCUSSION

The Proposed Regulations are the first set of guidance to clarify some of the major ambiguities in the statute. This memorandum discusses some of the most important provisions of the Proposed Regulations and highlights other key issues that remain unresolved.

A. ELIGIBLE GAINS

1. Only capital gains are eligible for deferral.

The statutory text is silent on whether both ordinary and capital gains may be invested in QOFs for deferral. However, the Proposed Regulations would clarify that only gains treated as capital gain for

[8] *See* Section 1400Z-2(c).

[9] *See* Section 1400Z-2(d)(1). Different rules may apply for a QOF's first year of inception.

[10] *See* Section 1400Z-2(d)(2)(A)&(D).

[11] *See* Section 1400Z-2(d)(2)(A)-(C).

[12] *See* Section 1400Z-2(f).

[13] *See* Section 1400Z-2(d)(3); Section 144(c)(6)(B).

federal income tax purposes are eligible for deferral.[14] Accordingly, gains recaptured as ordinary income would not be eligible to be deferred.

The Proposed Regulations would allow both short-term and long-term capital gains to be deferred.[15] The preamble to the Proposed Regulations further clarifies that eligible gains would include capital gains from deemed dispositions of property, as well as any other gain required to be included in a taxpayer's computation of capital gain.[16] Moreover, the Proposed Regulations would allow a taxpayer to invest in QOFs portions of capital gain from a single asset disposition in multiple increments, so long as each investment is made within 180 days of triggering the gain.[17]

If the deferred capital gain is subsequently triggered by a disposition of the taxpayer's investment in the QOF, the Proposed Regulations would allow the taxpayer to continue deferring the gain by reinvesting the gain in a QOF within 180 days.[18] When the deferral ultimately ends, the gain would be taxed based on the gain's tax attributes at the time the gain was initially triggered.[19]

2. Capital gains from "marked-to-market" contracts.

Under the Internal Revenue Code (the "Code"), certain financial instruments are taxed by being "marked to market" at the end of the taxable year (so-called "1256 Contracts").[20] 60% of any resulting gain is treated as long-term capital gain and 40% as short-term capital gain.[21] For the purposes of the opportunity zone program, the Proposed Regulations would allow deferral for the aggregate net capital gain from all of the taxpayer's 1256 Contracts for the year, rather than allowing gain to be deferred on a per-instrument basis.[22] Moreover, the Proposed Regulations would prohibit deferral of any gain from 1256 Contracts if any one of the taxpayer's 1256 Contracts is, at any point during the taxable year, part of an "offsetting-positions transaction" (as described below) in which any of the other positions is not a 1256 Contract.[23]

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[14] *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(b)(2)(i)(A).

[15] *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(b)(8), Example 1.

[16] Preamble to the Proposed Regulations, pp. 6-7.

[17] *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(b)(2)(ii).

[18] *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(b)(4)(ii), Example 4. However, this result would be permitted only if the taxpayer disposes of its entire initial investment in the QOF attributable to the deferred gain. *See* Preamble to the Proposed Regulations, p. 9.

[19] *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(b)(5).

[20] *See* Section 1256.

[21] *See* Section 1256(a)(3).

[22] *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(b)(2)(iii)(A).

[23] *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(b)(2)(iii)(B).

3. Capital gains from "offsetting-positions transaction."

The Proposed Regulations would prohibit deferral of any capital gain from a position that has been a part of an "offsetting-positions transaction,"[24] except for offsetting-positions transactions in which all of the positions are 1256 Contracts.[25] The Proposed Regulations would broadly define an offsetting-positions transaction as any transaction in which a taxpayer substantially diminishes its risk of loss from holding one position by holding other positions, whether or not of the same kind.[26] In addition, the Proposed Regulations would further stipulate that this definition applies regardless of whether either position is with respect to actively traded property.[27] Accordingly, offsetting-positions transactions would include transactions that would not be subject to the Code's straddle rules, such as positions involving non-traded property or substantially offsetting derivatives.[28] As a result, for example, a taxpayer that seeks to "lock in" the value of appreciated stock by entering into offsetting positions may not be able to defer the locked-in gain once that gain is realized.

B. OPERATIONAL RULES

1. Eligible taxpayers.

The statutory text is unclear on which taxpayers can elect to defer capital gains by investing in QOFs. Especially in the context of pass-through entities such as partnerships and S corporations, taxpayers lacked clarity on whether the entity itself or the entity's investors would make the election.

The Proposed Regulations would clarify that any taxpayer that recognizes capital gain is eligible to elect deferral.[29] For partnerships, the Proposed Regulations would provide flexibility by allowing both a partnership and its partners to make the deferral election.[30] A partnership may elect to defer some or all of its capital gains by investing in a QOF,[31] and gains deferred by the partnership would not be included in the partners' taxable income for the year.[32] If the partnership does not elect to defer some or all of its capital gain, the non-deferred gain is included in the partners' taxable income under the normal

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24 *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(b)(2)(iv).

25 Preamble to the Proposed Regulations, pp. 13-14.

26 *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(b)(2)(iv).

27 *See id.*

28 *See id*.

29 *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(b)(1).

30 *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(c).

31 *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(c)(1).

32 *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(c)(1)(i).

partnership tax rules.[33] Each partner can then make its own deferral election with respect to the gain by investing the gain into a QOF.[34]

For partners electing deferral, the Proposed Regulations would generally provide that the 180-day period for investing in a QOF begins on the last day of the partnership's taxable year.[35] However, the Proposed Regulations would also provide an alternative rule: if the partner knows or receives information regarding both the date of when the partnership triggered the gain and the partnership's decision to forgo deferral, the partner may choose to begin the partner's 180-day period on the date that the partnership triggered the gain.[36] This alternative rule would allow partners to invest in QOFs using other funds available during the taxable year and treat such investment as investment of gain triggered by the partnership.[37]

The Proposed Regulations would provide that analogous election rules would apply to other pass-through entities such as S corporations and trusts.[38]

2. Eligible Interests.

The Proposed Regulations would provide that capital gains must be invested as equity interests in a QOF to be eligible for deferral.[39] Eligible equity interests include preferred stock or preferred partnership interests, and the Proposed Regulations do not contain any prohibition on special allocations of income within a QOF taxed as a partnership.[40] Debt investments in QOFs would not be eligible for deferral.[41] However, the Proposed Regulations would allow taxpayers to use equity interests in a QOF as collateral for a loan.[42]

3. QOF Certification.

The Proposed Regulations would generally permit any entity that is treated as a corporation or partnership for federal income tax purposes to self-certify as a QOF, provided other conditions for

33 *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(c)(2)(ii)(A).

34 *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(c)(2)(ii)(B).

35 *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(c)(2)(iii)(A).

36 *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(c)(2)(iii)(B).

37 *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(c)(2)(iii)(C).

38 *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(c)(3).

39 *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(b)(3)(i).

40 *See id.*

41 *See id.*

42 *See* Prop. Treas. Regs. § 1.1400Z-2(a)-1(b)(3)(ii).

qualification are properly met.[43] Accordingly, an entity organized as a limited liability company for corporate law purposes would be eligible to be a QOF, resolving an ambiguity in the statutory language.[44]

Under the Proposed Regulations, an entity would self-certify as a QOF by filing a self-certification form (Form 8996) with the IRS, a draft of which was also released.[45] It is expected that entities will use Form 8996 to self-certify as a QOF, as well as to annually report compliance with the 90% Asset Test. As currently drafted, Form 8996 and the instructions would require the QOF's organizing documents to include a statement of the entity's purpose of investing in qualified opportunity zone properties and the descriptions of the qualified opportunity zone businesses that the entity expects to engage in.

C. 90% ASSET TEST

1. Valuation methodology.

As described above, a QOF must hold at least 90% of its assets as eligible investments. However, the statute is silent on how assets must be valued in computing such percentage. The Proposed Regulations would provide two alternative rules for asset valuation methodology. If the QOF prepares, in accordance with U.S. GAAP, (i) a financial statement that is filed with the Securities and Exchange Commission or any federal agency other than the IRS or (ii) a certified audited financial statement for significant business use ("Applicable Financial Statement"), the Proposed Regulations would require the QOF to use the value of assets as reported in the Applicable Financial Statement.[46] In all other cases, the Proposed Regulations would require QOFs to use the cost bases of the assets.[47]

2. Substantial improvement and original use of real estate.

A tangible asset situated entirely within a QOZ can qualify as an eligible investment even if the original use of the asset does not commence with the QOF, as long as the QOF "substantially improves" the asset by at least doubling the asset's adjusted basis within 30-months of acquisition.[48] Prior to the Proposed Regulations, it was unclear how to apply this "substantial improvement" test to real estate, particularly if a taxpayer acquires both an existing building and the land on which the building sits in a single transaction. The Proposed Regulations would provide that, in such a situation, the basis

43 *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(a)(1). The Proposed Regulations also clarify that there is no prohibition against using a pre-existing entity as a QOF or as an operating subsidiary, provided that the pre-existing entity otherwise satisfies the necessary requirements. *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(a)(3); Preamble to the Proposed Regulations, p. 22.

44 *See also Opportunity Zones Frequently Asked Questions*, https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions.

45 *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(a)(1)(i).

46 *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(b)(1).

47 *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(b)(2).

48 *See* Section 1400Z-2(d)(2)(D).

attributable to land is disregarded in satisfying this substantial improvement test.[49] Accordingly, only the portion of the basis attributable to the building would need to be doubled to meet the "substantial improvement" requirement.[50] Revenue Ruling 2018-29 further clarifies that the land associated with the building need not be substantially improved and the land's original use need not commence with the QOF for the land to qualify as an eligible investment, so long as the building associated with the land is substantially improved.

3. 70% asset test for operating subsidiaries' QOZ investments.

A QOZ Subsidiary must, among other conditions, hold "substantially all" of its tangible assets as eligible investments in a QOZ.[51] Solely for the purposes of this particular requirement, the Proposed Regulations would define "substantially all" as requiring a QOZ Subsidiary to hold at least 70% of its tangible assets as eligible investments ("70% Asset Test").[52]

The preamble to the Proposed Regulations acknowledges that a QOF that makes investments through operating subsidiaries, rather than directly owning tangible assets, may have more flexibility in satisfying the QOF's 90% Asset Test.[53] The preamble contains the following example. If a QOF with \$10 million invests directly in assets, at least \$9 million (90%) of those assets must be qualifying investments in a QOZ. However, the QOF can also satisfy the 90% Asset Test by investing \$9 million in an operating subsidiary that would hold 70% of its assets as qualifying investments in a QOZ. In the latter scenario, the QOF only needs to hold \$6.3 million (63%) of its total assets as qualifying QOZ assets to comply with the 90% Asset Test.[54]

As for the valuation methodology to be used in applying the 70% Asset Test, rules similar to the rules for the 90% Asset Test would apply.[55] First, if the QOZ Subsidiary itself maintains an Applicable Financial Statement, value of assets as reported on the Applicable Financial Statement must be used.[56] If the QOZ Subsidiary does not maintain an Applicable Financial Statement and if there is no QOF that holds more than a 5% equity interest in the subsidiary ("5% QOF"), each QOF may use the valuation methodology that the QOF itself uses for complying with the 90% Asset Test ("Compliance Methodology") in determining the QOZ Subsidiary's compliance with the 70% Asset Test.[57] If there is at least one 5% QOF

49 *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(c)(8)(ii).

50 *See id*.

51 *See* Section 1400Z-2(d)(3)(A)(i).

52 *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(d)(3)(i).

53 *See* Preamble to the Proposed Regulations, pp. 41-42.

54 *See id*.

55 *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(d)(3)(ii).

56 *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(d)(3)(ii)(A).

57 *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(d)(3)(ii)(B)&(C).

with respect to the QOZ Subsidiary, then the Compliance Methodology used by a 5% QOF that would yield the highest percentage of eligible properties for the QOZ Subsidiary may be used.[58]

4. Safe-harbor for working capital of a QOZ Subsidiary.

In addition to the 70% Asset Test, an operating subsidiary must also comply with various other requirements to qualify as a QOZ Subsidiary. Namely, the entity must: (i) derive at least 50% of the entity's total gross income from active conduct of the entity's business ("50% Gross Income Test"); (ii) use a "substantial portion" of its intangible assets in the active conduct of the entity's business ("Intangibles Use Test"); and (iii) hold less than 5% of its property as "nonqualified financial property" (such as debt, stock, partnership interests or other financial instruments) ("Nonqualified Financial Property Test").[59] Moreover, a QOF may need to comply with the 90% Asset Test as early as within the first six months of the QOF's inception.[60] Commentators have noted the practical difficulty of meeting all the requirements in the context of many real estate and other development projects, which may take much longer than six months to complete.

To alleviate such concerns, the Proposed Regulations would provide a safe harbor for a QOZ Subsidiary's working capital for acquiring, constructing or substantially improving a tangible property in a QOZ. Working capital includes cash, cash equivalents or debt instruments with a term of 18 months or less,[61] and working capital would be within the safe harbor (i.e., be deemed as "reasonable working capital") if:

- there is a written plan identifying the working capital as property held for the acquisition, construction or substantial improvement of tangible property in a QOZ;
- there is a written schedule consistent with ordinary business operations for using the working capital within 31 months; and
- the QOZ Subsidiary substantially complies with the schedule.[62]

If working capital is treated as "reasonable working capital" under the test described above:

- Working capital would not count as disqualifying property for the purposes of the Nonqualified Financial Property Test.[63]
- Any gross income derived from working capital would count toward satisfying the 50% Gross Income Test.[64]

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58 *See id*.

59 *See* Section 1400Z-2(d)(3)(A)(ii); Section 1397C(b)(2),(4)&(8).

60 *See* Section 1400Z-2(d)(1); Prop. Treas. Regs. § 1.1400Z-2(d)-1(a)(2)(i).

61 *See* Section 1397C(e)(1).

62 *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(d)(5)(iv).

63 *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(d)(5)(iii).

64 *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(d)(5)(v).

- The Intangibles Use Test would be deemed satisfied during any period in which the business proceeds in compliance with the written schedule.[65]
- If the tangible property for which the working capital is reserved is otherwise expected to satisfy the requirements to qualify as an eligible investment, the tangible property would not be treated as failing to satisfy such requirements solely because the scheduled expenditure of the working capital is incomplete.[66]

It is unclear what the consequences would be if a QOZ Subsidiary fails to comply with its working capital schedule or if the working capital fails to qualify as "reasonable" for any other reason.

D. GAIN EXCLUSION ELECTION AFTER 10 YEARS

As described above, in addition to the deferral benefit, if a taxpayer holds the investment in the QOF for at least ten years, any new gain from the investment in the QOF (not the deferred gain) is excluded from taxation when the taxpayer subsequently disposes of its investment in the QOF ("10-Year Gain Exclusion Benefit"). The Proposed Regulations would clarify a number of issues regarding the 10-Year Gain Exclusion Benefit.

First, although the statute allows a taxpayer to invest in a QOF partially with funds for which deferral election is made and partially with funds without such election, the statute requires the taxpayer to treat a "mixed-funds" investment as essentially two separate investments. Accordingly, the Proposed Regulation would provide that the 10-Year Gain Exclusion Benefit is available only with respect to the investment in QOF attributable to the deferred gain.[67]

Under current partnership tax rules, an increase in a partner's share of a partnership's liability is treated as a contribution of additional money to the partnership.[68] Prior to the Proposed Regulations, commentators questioned whether a deemed contribution as a result of borrowing by a QOF partnership should be treated as an additional separate investment in the QOF. The Proposed Regulations would resolve the issue by clarifying that borrowing by a QOF partnership does not create a bifurcated partnership interest in the QOF for the purposes of the 10-Year Gain Exclusion Benefit.[69] By contrast, if a partner borrows funds and contributes the proceeds to a partnership QOF, such investment in the QOF attributable to borrowed funds would not qualify for the 10-Year Gain Exclusion Benefit.

Finally, because the statute provides that QOZ designations expire in 2028, there was uncertainty as to whether the 10-Year Gain Exclusion Benefit would apply for investments in QOFs made after 2019 and subsequently disposed after the QOZ designations expire. The Proposed Regulations would provide

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65 *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(d)(5)(vi).

66 *See* Prop. Treas. Regs. § 1.1400Z-2(d)-1(d)(5)(vii).

67 *See* Prop. Treas. Regs. § 1.1400Z-2(c)-1(a).

68 *See* Section 752(a).

69 *See* Prop. Treas. Regs. § 1.1400Z-2(e)-1(a)(2); Preamble to the Proposed Regulations, p. 29.

reassurance to taxpayers by clarifying that the 10-Year Gain Exclusion Benefit would be available for interests in QOFs disposed after QOZ designations expire but prior to 2048.[70]

E. FORTHCOMING REGULATIONS

Although the Proposed Regulations provide helpful guidance on a number of important threshold issues, the IRS and the Treasury Department noted that many other issues are reserved to be addressed in future guidance, to be published in the near future,[71] including:

- Further guidance on applying the "substantially all" standard in various other places the term appears in the statutory requirements other than the 70% Asset Test.
- Transactions other than disposition of investments in QOFs that may trigger the inclusion of deferred gain.
- Further guidance on how a QOF can reinvest proceeds generated by its eligible investments without failing the 90% Asset Test.
- Administrative rules when a QOF fails to satisfy the 90% Asset Test.
- Information-reporting requirements under the opportunity zone program.

F. REQUESTED COMMENTS AND OPEN ISSUES

In the preamble to the Proposed Regulations, the IRS and the Treasury Department also invited taxpayer comments on a variety of issues, whether addressed in the Proposed Regulations or reserved for future guidance, including:

- Aspects of determining a tangible property's "original use" in a QOZ for the purposes of determining whether the tangible property qualifies as an eligible investment, especially as applied to real property and other tangible property such as movable property. For example, whether a period of abandonment or underutilization followed by a subsequent productive use of the property should qualify as "original use."
- Whether additional rules regarding the definition of "substantial improvement" would be useful.
- The suitability of the 70% Asset Test as a "substantially all" standard in that particular context, as well as how "substantially all" standard should be defined for all other instances in which the statute relies on the term.
  - For example, further clarification would be necessary for determining how "substantially all" of the use of a movable tangible asset (e.g., vehicle used in a trade or business) is considered to be in a QOZ.
- Whether there should be further guidance regarding deferral elections by partnerships and partners or by other pass-through entities.

  We note that the Proposed Regulations do not seem to fully address all relevant scenarios. For example:

  - If a partnership elected to defer its gains triggered in a given year, what would occur if a partner subsequently exits the partnership by selling the partnership interests to a new

70 *See* Prop. Treas. Regs. § 1.1400Z-2(c)-1(b).

71 *See* Preamble to the Proposed Regulations, pp. 5-6.

partner? If the partnership's deferred gain is subsequently recognized by the partnership, should the new partner be taxed or the old partner?

- What would occur if a partnership distributes its interests in a QOF to the partners after the partnership makes the deferral election?

Moreover, many partnerships do not provide their partners with Schedule K-1 until well after the end of the partnership's taxable year. This could be problematic for a partner electing deferral if, under the general rule in the Proposed Regulations, the partner's 180-day period for investing in a QOF begins on the last day of the partnership's taxable year.

We also note that clarifications would be helpful on how corporations within a consolidated group can make the deferral election.

- Whether there is statutory basis for providing additional flexibility for the requirement that a tangible asset must be purchased after 2017 to qualify as an eligible investment, so as to facilitate more pre-existing entities to qualify as QOFs or QOZ Subsidiaries.
- Whether another valuation methodology, such as using adjusted tax basis, would be more appropriate for the 90% Asset Test and the 70% Asset Test.
- Whether the working-capital safe harbor for QOZ Subsidiaries is adequate, and whether additional safe harbors or other reliefs would be appropriate.
- Whether not treating deemed contributions under Section 752(a) as separate QOF investments could lead to abusive practices or other problems, and whether a similar rule should be provided for other types of pass-through entities.

G. EFFECTIVE DATE AND COMMENT PERIOD

If finalized, the Proposed Regulations would generally apply to transactions that occur on or after the date the Proposed Regulations are finalized. However, taxpayers may rely on the Proposed Regulations prior to the date the Proposed Regulations are finalized, provided that taxpayers apply the Proposed Regulations in their entirety and in a consistent manner.[72]

Written comments to the Proposed Regulations must be received by the IRS by the date 60 days after the date of publication of the Proposed Regulations in the Federal Register.[73]

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[72] *See* Preamble to Proposed Regulations, pp. 29-30.

[73] The Proposed Regulations have been submitted to the Office of the Federal Register for publication but have not been officially published in the Federal Register yet as of the date of this memorandum.

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