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IRS Releases Second Round of Proposed Regulations on Qualified Opportunity Funds

New Proposed Regulations Resolve Many Issues Left Open by Initial Proposed Regulations

SUMMARY

On April 17th, the Internal Revenue Service (the "IRS") and the Treasury Department released the second set of proposed regulations (the "New Proposed Regulations") to provide guidance on investing in qualified opportunity zones ("QOZs") through qualified opportunity funds ("QOFs") under the tax incentive program created by the Tax Cuts and Jobs Act. Investors that make qualifying investments in QOFs can defer, and in some cases, exclude, the invested capital gains, as well as gains attributable to qualifying investments in a QOF.

The New Proposed Regulations would clarify a number of issues left open by the statute and the first set of proposed regulations, released on October 19th of last year (the "October Proposed Regulations"), and provide additional guidance on a variety of key issues for investors seeking to make investments in a QOF. These issues include:

- Whether "section 1231" gains are eligible for deferral.
- Whether taxpayers can invest in QOFs by purchasing interests in a QOF in the secondary market.
- Whether taxpayers can acquire interests in a QOF in exchange for contributing non-cash property.
- The application of the 90% Asset Test (defined below) to newly contributed assets.
- The treatment of interests in a QOF received in exchange for services (e.g., carried interest).
- Under what circumstances leased property is QOZ Business Property (defined below).
- The definition of "original use."

- The application of the "substantial improvement" requirement (including with respect to unimproved land).
- Additional clarification of the "substantially all" tests regarding the use of tangible property and the length of the required holding period for QOFs and QOZBs (defined below).
- How inventory in transit is treated.
- The treatment of real property that straddles a QOZ.
- The rules for determining when a qualified opportunity zone business (a "QOZB") derives at least 50% of its total gross income from the active conduct of a trade or business within a QOZ (the "50% Gross Income Test").
- The definition of "trade or business."
- Requirements with respect to intangible property held by QOZBs.
- Additional clarification of the safe harbor for reasonable amounts of working capital.
- Circumstances in which an investor in a QOF is required to recognize deferred gain ("Inclusion Events"), and related operational rules.
- How the election to step up the basis in an interest in a QOF to fair market value upon disposition after 10 years (the "FMV Basis Election") applies with respect to liabilities allocated to a partner in a QOF partnership and with respect to depreciation recapture rules.
- Whether the FMV Basis Election can apply to the disposition of assets of a QOF that is a partnership, S corporation or REIT, so that an exit can be structured as an asset sale rather than a sale of interests in a QOF.

BACKGROUND

The QOZ tax incentive program, enacted as part of the Tax Cuts and Jobs Act of 2017,[1] is intended to encourage investment in low-income communities. A QOF is an investment vehicle organized as a corporation or partnership (including a limited liability company treated as a corporation or partnership for federal income tax purposes) and created to invest in a QOZ.

The statute offers three potential benefits to taxpayers who invest in QOFs. First, taxpayers can defer tax on eligible capital gains if those gains are properly invested within 180 days from when triggered (certain aspects of the 180-day rule are discussed below), until the earlier of the date on which the taxpayer disposes (or is deemed to dispose) of its investment in the QOF, or December 31, 2026. Second, taxpayers may exclude from gross income 10% of such deferred gains if they hold their QOF investments for at least 5 years (and the investment is made prior to December 31, 2021) and an additional 5% if held for at least 7 years (and the investment is made prior to December 31, 2019). Lastly, taxpayers who hold their QOF investments for at least 10 years may exclude any appreciation in the value of the QOF itself by electing to step up the basis in their QOF investment to the fair market value on the date the taxpayer disposes of its investment in the QOF.

[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.

In order for an entity to qualify as a QOF, at least 90% of the entity's assets must consist of eligible investments in QOZs made after 2017 (the "90% Asset Test"). Good assets for this test generally include tangible property used in a trade or business within a QOZ ("QOZ Business Property"). In addition, equity interests in subsidiary corporations or partnerships that invest in QOZs and meet certain requirements are also good assets for the purposes of this test (i.e., QOZBs).

While the program's attractive tax benefits and flexibility have garnered significant interest, the statute left open a number of key issues, and the October Proposed Regulations did not resolve many of those issues.[2] The New Proposed Regulations would provide clarity on many of these unanswered questions.

DISCUSSION

This memorandum discusses certain provisions of the New Proposed Regulations and highlights other issues that remain unresolved.

A. ELIGIBLE GAINS AND QUALIFYING INVESTMENTS

Taxpayers may defer eligible gains if such gains are invested in a QOF within 180 days. However, significant questions were raised about exactly which gains are eligible, and when the 180-day period begins in certain contexts. The October Proposed Regulations answered some uncertainties (e.g., gains realized through partnerships) but certain questions remained. The New Proposed Regulations prescribe additional guidance in this area.

1. Section 1231 gains

The October Proposed Regulations clarified that only capital gains are eligible for deferral, but ambiguities remained with respect to so-called "section 1231 gains" (i.e., gains from the sale of business-use property). As capital gains, section 1231 gains are eligible for deferral under the QOZ program. However, section 1231 gains are calculated at the end of the taxable year, and only net gains (i.e., gains from the sale of business-use property that exceed losses from the sale of business-use property) are treated as section 1231 gains.

The New Proposed Regulations would clarify that only net section 1231 gains are treated as eligible gains under the QOF rules.[3] Moreover, because the amount of net section 1231 gains is not known until year end, the New Proposed Regulations provide that the 180-day period with respect to section 1231 gains begins on the last day of the taxable year.

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2 *See* S&C publication of October 23, 2018, *IRS Issues Proposed Regulations on Qualified Opportunity Funds* for a discussion of the October Proposed Regulations.

3 *See* Prop. Treas. Regs. § 1.1400Z2(a)-1(b)(2)(iii).

2. Interests in a QOF purchased in the secondary market

The statute is ambiguous as to whether a taxpayer purchasing an interest in a QOF in a secondary transaction (i.e., a purchase from an existing holder of an interest in a QOF) would be eligible for the benefits of investing in a QOF. The New Proposed Regulations provide that a taxpayer may be eligible for QOF benefits if the taxpayer purchases an eligible interest in a QOF from an existing holder.[4] The amount deemed invested in the QOF (and therefore eligible for deferral) would be equal to the amount the taxpayer pays for the eligible interest.

3. The "substantially all" requirements

The statute contains several "substantially all" tests in the operative requirements for a QOF. First, a QOZB must have "substantially all" of its tangible property qualify as QOZ Business Property. The October Proposed Regulations clarified that "substantially all" with respect to *amount of tangible property* means 70% of a QOZB's tangible property.

Second, in order for tangible property to constitute QOZ Business Property, "substantially all" of such property must be used in the QOF's or QOZB's trade or business in a QOZ. The New Proposed Regulations would clarify that "substantially all" with respect to *use in a QOZ* means 70% of the use.[5]

Third, in order for tangible property to constitute QOZ Business Property, the QOF or QOZB, as applicable, must use (as determined under the "substantially all" standard above) the property in a QOZ during "substantially all" of the QOF's or QOZB's holding period for the property. The New Proposed Regulations would clarify that "substantially all" with respect to *holding period for QOZ Business Property* means that during 90% of the QOF's or QOZB's holding period, the property must have been used in a QOZ.[6]

Finally, if a QOF holds an interest in a corporation or partnership, in order for such entity to be a QOZB, it must meet the qualification of a QOZB for "substantially all" of the QOF's holding period in such entity. The New Proposed Regulations would clarify that "substantially all" with respect to *holding period for a QOZB* means that during 90% of the QOF's holding period, the entity must qualify as a QOZB.

4. Contribution of non-cash property

The New Proposed Regulations would provide that a taxpayer may defer gains by contributing property other than cash to a QOF.[7] This is the case regardless of whether gain is recognized on the transfer of property exchanged for the interest in the QOF (provided that the transfer is not recharacterized as a

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4 *See* Prop. Treas. Regs. § 1.1400Z2(a)-1(b)(9)(iii).

5 *See* Prop. Treas. Regs. §§ 1.1400Z2(d)-1(d)(2)(iv), (c)(4)(iii)(6).

6 *See* Prop. Treas. Regs. §§ 1.1400Z2(d)-1(c)(4)(iii)(5), (d)(2)(iii).

7 *See* Prop. Treas. Regs. § 1.1400Z2(a)-1(b)(9)(i). Gain recognized on a taxable contribution of property would not be an eligible gain that can be deferred.

transaction other than an investment in the QOF). However, because QOZ Business Property must be acquired "by purchase," contribution of non-cash property to a QOF may give rise to non-qualifying property if the property is ultimately used in a QOF's or QOZB's trade or business. Moreover, if a QOF further contributes the property received to a QOZB in exchange for interests in the QOZB, such interests will not count as qualifying property for the QOF because of the statutory requirement that the QOF must acquire interests in its QOZB "solely in exchange for cash."

Where a taxpayer transfers an item of non-cash property to a QOF in a non-recognition transaction, the amount of the taxpayer's qualifying investment (i.e., the amount of the investment eligible for QOF benefits) would generally equal the lesser of the taxpayer's adjusted basis in the interest in the QOF received (determined without applying the QOF rules), or the fair market value of that interest in the QOF.[8]

Moreover, in the case of a contribution to a QOF partnership in a non-recognition transaction, the amount of the taxpayer's qualifying investment in the QOF partnership is the lesser of the taxpayer's "net" basis in the property contributed (i.e., net of debt to which the property is subject or debt otherwise assumed by the QOF) or the "net" fair market value of the property contributed.[9]

Where a taxpayer transfers non-cash property in a taxable transaction, the amount of the taxpayer's qualifying investment in the QOF is the fair market value of the transferred property, as determined immediately before the transfer.[10]

5. Interests in a QOF received in exchange for services

The New Proposed Regulations would provide that interests in a QOF received in exchange for services (e.g., carried interests) would not be qualifying investments eligible for the QOF benefits.[11] Where a taxpayer contributes both cash and services in exchange for an interest in a QOF, the interest in the QOF would be considered a "mixed funds" investment for purposes of the QOF rules, and any gain attributable to the portion of such interest that is received for services would be ineligible for the benefits discussed above.

B. QUALIFYING AS A QOF OR A QOZB

A QOF must satisfy the 90% Asset Test. This requires that the fund holds at least 90% of its assets in qualified opportunity zone property ("QOZ Property"). The definition of QOZ Property includes ownership interest in a QOZB or QOZ Business Property.

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[8] *See* Prop. Treas. Regs. § 1.1400Z2(a)-1(b)(10).

[9] *See* Prop. Treas. Regs. § 1.1400Z2(a)-1(b)(10)(ii)(B).

[10] *See* Prop. Treas. Regs. § 1.1400Z2(a)-1(b)(10)(ii)(C).

[11] *See* Prop. Treas. Regs. § 1.1400Z2(a)-1(b)(9)(iii).

1. The 90% Asset Test with respect to recently contributed property

The New Proposed Regulations would allow a QOF to apply the 90% Asset Test without taking into account property contributed to the QOF in the preceding six months, provided (1) the property is contributed to the QOF in exchange for an interest in the QOF and (2) the property is held continuously in the form of cash, cash equivalents or debt instruments with a term of 18 months or less.[12]

2. Twelve-month window for reinvesting returns of capital or proceeds from sale of QOZ Property

The New Proposed Regulations would also establish a 12-month period for a QOF to reinvest the proceeds from returns of capital or a sale of QOZ Property into other QOZ Property, including an additional interest in a QOZB.[13] Accordingly, if a QOF reinvests such proceeds within 12 months, during the time in which the proceeds are held at the QOF, they would be good assets for purposes of the 90% Asset Test, provided that, before reinvestment, the QOF held the proceeds continuously in the form of cash, cash equivalents or debt instruments with a term of 18 months or less. If the reinvestment of the proceeds is delayed by waiting for governmental action the application for which is complete, such delay would not be taken into account for the purposes of the 12-month requirement. Note, however, that any gains generated by a QOF (other than those gains excludable pursuant to the FMV Basis Election described below) would be recognized by the QOF or its members.

3. Leased property as QOZ Business Property

The statutory definition of QOZ Business Property refers to tangible property "acquired by purchase." Accordingly, questions arose as to whether property which a QOF leases (instead of owns) could constitute QOZ Business Property. The October Proposed Regulations provided that a QOZB could lease property, but it was not clear how leased property could meet the requirements of qualifying property for a QOZB.

The New Proposed Regulations would clarify that leased property can constitute QOZ Business Property if (1) the lease is entered into after December 31, 2017, (2) the terms of the lease are "arms-length" at the time the lease was entered into, and (3) at least 70% of the leased property is used within a QOZ during at least 90% of the period for which the QOZB leases the property.[14] Two further requirements apply if the lessee and the lessor are related parties: (1) the lessee must not make prepayments of rent more than 12 months in advance and (2) if the original use of the leased tangible personal property does not commence with the lessee, the lessee must become the owner of other tangible property that is QOZ Business Property having a value at least equal to the value of that leased tangible property, and there must be "substantial overlap of the zone(s) in which the owner of the property so acquired uses it and the

[12] *See* Prop. Treas. Regs. §§ 1.1400Z2(d)-1(b)(4)(A) – (C).

[13] *See* Prop. Treas. Regs. § 1.1400Z2(f)-1(b).

[14] *See* Prop. Treas. Regs. § 1.1400Z2(d)-1(c)(4)(i)(B).

zone(s) in which that person uses the leased property." The New Proposed Regulations would not impose an original use or substantial improvement requirement with respect to leased property.

The New Proposed Regulations would provide that leased tangible property may be valued using either an applicable financial statement valuation method or an alternative valuation method, provided the selected method is applied consistently with respect to all property valued with respect to the taxable year.[15] Under the applicable financial statement valuation method, the value of the property for purposes of the QOF requirements equals the value of that property as reported on the QOF's applicable financial statement. Under the alternative method, the value of leased property for purposes of the QOF requirements is the sum of the present values of all payments under the lease (discounted at the applicable Federal rate), calculated at the time the QOF enters the lease.

The New Proposed Regulations would also apply a specific anti-abuse rule in the case of leased real property. Leased real property would not be a good asset if, at the time the lease was entered into, there was a plan, intent or expectation that the leased property would be purchased by the QOF for an amount other than its fair market value (determined at the time of the purchase without regard to any prior lease payments).

4. Original use

The definition of QOZ Business Property requires either that the "original use" of such property in the QOZ commences with the QOF (or QOZB) or that the QOF (or QOZB) "substantially improves" the property. The New Proposed Regulations would clarify that, for this purpose, "original use" commences when the property is placed into service in the QOZ for purposes of depreciation or amortization.[16]

Accordingly, tangible property satisfies the "original use" requirement when any person first places the property in service in the QOZ for purposes of deprecation or amortization, or uses the property in a manner that would allow depreciation or amortization if that person were the property's owner.

Furthermore, the New Proposed Regulations would provide that improvements made by a lessee to leased property would satisfy the "original use" requirement as property acquired by purchase for the amount of the unadjusted cost basis of such improvements.[17]

The statute and the October Proposed Regulations left open the question of whether previously used property can be considered to meet the "original use" requirement after a significant period of disuse, for example, in situations involving vacant buildings. The New Proposed Regulations would provide that a

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[15] *See* Prop. Treas. Regs. §§ 1.1400Z2(d)-1(b)(1) – (3).

[16] *See* Prop. Treas. Regs. §§ 1.1400Z2(d)-1(c)(4)(i)(B)(6), (c)(7), (d)(2)(i)(B)(6).

[17] *See* Prop. Treas. Regs. § 1.1400Z(d)-1(b)(3)(ii).

vacant building or other vacant structure would satisfy the "original use" requirement if that building or structure has been vacant for at least 5 years prior to being purchased by a QOF or QOZB.[18]

5. Asset-by-asset application of the substantial improvement requirement

The New Proposed Regulations would provide that the determination of whether the substantial improvement requirement is satisfied for purchased tangible property is made on an asset-by-asset basis. Acknowledging, however, that this approach might be onerous for certain types of businesses, such as multi-asset QOFs or QOZBs, the IRS and the Treasury Department have considered, and are requesting comments on, adopting an aggregate standard that would potentially allow certain tangible assets to be grouped together for purposes of the substantial improvement requirement.

6. Substantial improvement of land

As discussed, QOZ Business Property need not satisfy the "original use" test if the QOF or QOZB "substantially improves" the property. "Substantial improvement" requires doubling the basis in the property within a 30-month period.

Along with the October Proposed Regulations, the IRS released a revenue ruling stating that, in the case where a QOF purchases a building and the land on which the building sits in a single transaction, the basis attributable to the land is not taken into account in determining whether the conveyed property (i.e., the building and the land) has been substantially improved.[19] Treatment of land acquired in situations other than the one addressed directly in the revenue ruling remained unclear. For example, the revenue ruling does not explain whether or not land must be substantially improved when land is acquired without any structures on it.

The New Proposed Regulations would provide that the substantial improvement requirement is inapplicable to unimproved land within a QOZ that is acquired by purchase.[20] Accordingly, unimproved land would be a good asset for purposes of the QOF requirements so long as it is used in the trade or business of the QOF or QOZB. However, a general anti-abuse rule included in the New Proposed Regulations would treat unimproved land as an acquisition of non-qualifying property if a significant purpose for acquiring such land was to achieve, for example, qualification as QOZ Business Property without the QOF investing any new capital investment in, or increasing any economic activity or output of, the land.

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[18] *See* Prop. Treas. Regs. § 1.1400Z2(d)-1(c)(4)(iii)(7).

[19] *See* Rev. Rul. 2018-29, I.R.B. 2018-45 (Oct. 19, 2018).

[20] *See* Prop. Treas. Regs. §§ 1.1400Z2(d)-1(c)(4)(iii)(8)(ii)(B), (d)(4)(ii).

7. Safe harbor for inventory in transit

For purposes of when property is treated as being used within a QOZ, the New Proposed Regulations would clarify that inventory (including raw materials) may be considered used in a QOZ, notwithstanding that the inventory is in transit to or from a location inside the QOZ.[21]

8. Safe harbors for the 50% Gross Income Test

A QOZB must derive at least 50% of its total gross income in the active conduct of its business in a QOZ. This requirement raised questions about when income would be considered to be resulting from the active conduct of a business within a QOZ.

The New Proposed Regulations would create three safe harbors, any of which would fulfill the 50% Gross Income Test if met, as well as an overall facts-and-circumstances test that could be satisfied if a QOZB could not qualify for any of the safe harbors.[22]

The first safe harbor is based on the portion of time spent by a business's employees and independent contractors inside a QOZ during the taxable year. This safe harbor is met if at least 50% of the services performed, based on hours, by a business's employees and independent contractors (and employees of independent contractors) are performed inside the QOZ.

The second safe harbor is similar, but is based instead on amounts paid by a business to its employees and independent contractors during the taxable year. This safe harbor is met if at least 50% of the services performed, based on amounts paid, by a business's employees and independent contractors (and employees of independent contractors) are performed inside the QOZ.

The third safe harbor is met if both (1) the tangible property of the business that is in a QOZ and (2) the management or operational functions performed for the business in a QOZ are each necessary to generate 50% of the gross income of the business. While the Preamble to the New Proposed Regulations identifies this as a "safe harbor," there are no bright lines provided in the New Proposed Regulations as to when this test is satisfied. However, the New Proposed Regulations would provide an example in which officers and employees of a landscaping business manage the daily operations of the business from headquarters located in the QOZ. Moreover, in the example, the business's equipment and supplies are stored in the headquarter facilities located in the QOZ. The example states that the activities of the officers and employees, and the storage of the equipment and supplies, are a "material factor" in the generation of the business's gross income. In another example, the New Proposed Regulations would clarify that merely receiving business mail at a PO box located in a QOZ is not sufficient because the location of the PO box inside a QOZ is not a "material factor" in the generation of gross income.

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[21] *See* Prop. Treas. Regs. § 1.1400Z2(d)-1(c)(4)(iii).

[22] *See* Prop. Treas. Regs. §§ 1.1400Z2(d)-1(d)(5)(i)(A) – (D).

Finally, the New Proposed Regulations would establish a facts-and-circumstances test for determining whether 50% of a business's income is derived from the active conduct of a trade or business in a QOZ. Thus, businesses which do not meet any of the described safe harbors may avail themselves of the facts-and-circumstances analysis. An example in the New Proposed Regulations provides that the facts-and-circumstances test is satisfied in a situation where a partnership develops and leases a commercial building located within a QOZ.

9. Definition of "trade or business"

The New Proposed Regulations would clarify that a "trade or business" for purposes of the QOF rules has the same definition as a "trade or business" under the general rules for determining whether an expense is a trade or business expense.[23]

Moreover, under the New Proposed Regulations, owning and operating real property (including leasing) would constitute the active conduct of a trade or business.[24] However, the New Proposed Regulations would provide that merely entering into a triple net lease does not constitute the active conduct of a trade or business.

10. QOZB requirements with respect to intangible property

One requirement of a QOZB is that it must use a "substantial portion" of its intangible property in the active conduct of a trade or business in a QOZ. The New Proposed Regulations would clarify that a "substantial portion" means 40% in this context.[25]

11. Working Capital Safe Harbor

Less than 5% of the adjusted basis of a QOZB's property may be attributable to nonqualified financial property (e.g., cash, debt, stock, partnership interests, options and other similar property). The October Proposed Regulations established a safe harbor allowing a business to hold reasonable amounts of working capital without violating the 5% threshold (the "Working Capital Safe Harbor"). In addition, any gross income derived from working capital qualifying for the safe harbor would count toward satisfying the 50% Gross Income Test. The safe harbor described in the October Proposed Regulations requires (1) a written plan identifying the working capital as property held for the acquisition, construction or substantial improvement of tangible property in a QOZ, (2) a written schedule consistent with ordinary operations for using the working capital within 31 months, and (3) that the business substantially comply with the written schedule.

The New Proposed Regulations would clarify two aspects of the Working Capital Safe Harbor.[26] First, the written designation for the planned use of working capital would now include the development of a trade

[23] *See* Prop. Treas. Regs. §§ 1.1400Z2(d)-1(c)(4)(ii), (d)(2)(ii), (d)(5)(ii)(B)(3).

[24] *See* Prop. Treas. Regs. § 1.1400Z2(d)-1(d)(5)(ii)(B)(2).

[25] *See* Prop. Treas. Regs. § 1.1400Z2(d)-1(d)(5)(ii)(A).

or business in the QOZ, in addition to the acquisition, construction, and/or substantial improvement of tangible property. Second, a business would not violate the safe harbor by exceeding the 31-month period due to delays in government action, the application for which is completed during the 31-month period.

12. QOZB requirements with respect to real property which straddles a QOZ

The New Proposed Regulations would provide that for purposes of the 50% Gross Income Test, the 5% threshold regarding nonqualified financial property and the requirement for use of intangible property (each discussed above), a contiguous parcel of real property would be considered "located within" a QOZ if the amount of real property used within the QOZ is "substantial" compared to the amount outside the QOZ (in each case based on square footage), and the real property outside the QOZ is contiguous to all or a part of the real property in the QOZ.[27] The Preamble to the New Proposed Regulations explains that real property located inside the QOZ should be considered "substantial" if the unadjusted cost of the real property inside the QOZ is greater than the unadjusted cost of the real property outside the QOZ. Where the property straddling a QOZ was acquired in a single transaction, presumably taxpayers would need to allocate their cost of acquiring the property to the portions inside and outside the QOZ.

13. QOFs as members of consolidated groups

The New Proposed Regulations would clarify that a QOF corporation cannot be a subsidiary member of a consolidated group.[28] The Preamble to the New Proposed Regulations explains that the QOZ incentive program and the consolidated return system are based on incompatible principles and rules. Therefore, the New Proposed Regulations would treat QOF stock as not stock for purposes of the consolidated return rules. As a result, a QOF organized as a corporation could not be a subsidiary member of a consolidated group. However, a QOF corporation could be the common parent of a consolidated group.

Moreover, the New Proposed Regulations would provide that the QOF rules apply separately to each member of a consolidated group. Therefore, the same member of the group must both engage in the sale of the capital asset giving rise to the gain, and invest an amount of that gain in a QOF.

C. OPERATIONAL RULES

1. Inclusion Events

The deferral of tax on capital gain invested in a QOF ends on the earlier of (1) the date on which the investment in the QOF is "sold or exchanged" and (2) December 31, 2026. However, notwithstanding the statutory reference to a "sale or exchange," the New Proposed Regulations would include a broader range of "inclusion events" that trigger the recognition of deferred gains.

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[26] *See* Prop. Treas. Regs. § 1.1400Z2(d)-1(d)(5)(iv)(C).

[27] *See* Prop. Treas. Regs. § 1.1400Z2(d)-1(d)(5)(viii).

[28] *See* Prop. Treas. Regs. § 1.1400Z2(g)-1.

Subject to certain exceptions, an Inclusion Event would generally result if, and to the extent that, a taxpayer's transfer of its interest in a QOF reduces the taxpayer's equity interest in the QOF.[29] The New Proposed Regulations also state that a transaction treated as a distribution in which a taxpayer receives property from a QOF is generally an Inclusion Event[30] (but the exceptions narrow this type of Inclusion Event considerably). In addition, an Inclusion Event would result from a taxpayer claiming a worthlessness deduction on the taxpayer's investment in a QOF.[31] The New Proposed Regulations would also identify specific types of transactions as generally being Inclusion Events, including:

- A termination or liquidation of a QOF.[32]
- A taxable liquidation of a corporate owner of a QOF.[33]
- A transfer of interests in a QOF by gift (whether outright or in trust).[34]
- A termination of grantor trust status during the lifetime of the grantor.[35]
- A greater than 25% ownership change of an S corporation that directly holds an interest in a QOF.[36]
- A redemption by a QOF corporation that is treated as a dividend distribution, unless the QOF is wholly owned.[37]
- A tax-free distribution under Section 355 (e.g., a spin-off) of the stock of a QOF corporation.[38]
- A transfer (or deemed transfer) of an interest in a QOF to a controlled corporation (e.g., Section 351 or Section 304 transactions).[39]
- In certain cases, a transfer by a partner of an interest in a partnership that itself directly or indirectly holds an interest in a QOF.[40]

Conversely, the New Proposed Regulations would also enumerate specific types of transactions that are generally not considered Inclusion Events, including:

- A tax-free liquidation of a corporate owner of a QOF.[41]

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[29] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(1)(i).

[30] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(1)(ii).

[31] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(1)(iii).

[32] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(2)(i).

[33] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(2)(ii)(A).

[34] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(3).

[35] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(5)(ii).

[36] *See* Prop. Treas. Regs. §§ 1.1400Z2(b)-1(c)(7)(i)(E), (iii).

[37] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(9)(i).

[38] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(11)(ii).

[39] *See* Preamble, p. 42.

[40] *See* Preamble, p. 41; Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(13).

[41] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(2)(ii)(B).

- A transfer of an interest in a QOF upon the taxpayer's death.[42]
- A termination of grantor trust status resulting from the owner's death.[43]
- A contribution of an interest in a QOF to a partnership.[44]
- A merger or consolidation of a partnership that holds an interest in a QOF with another partnership.[45]
- A distribution by a QOF partnership to its partners, unless the distributed property's fair market value exceeds the partner's basis in the QOF.[46]
- A distribution by a QOF S corporation, unless treated as a sale or exchange under the S corporation rules.[47]
- A distribution by a QOF C corporation, unless treated as a sale or exchange.[48]
- An election, revocation or termination of a corporation's S corporation status (whether the QOF or the owner of a QOF).[49]
- A tax-free asset reorganization in which assets of a QOF corporation are acquired by another QOF corporation, unless boot is received by the shareholder.[50]
- A tax-free asset reorganization in which assets of a shareholder of a QOF are acquired, unless the acquiring corporation fails to acquire all of the shareholder's interests in a QOF.[51]
- A tax-free spin-off by a QOF corporation of another QOF corporation, unless boot is received by the shareholder.[52]
- A tax-free recapitalization of a QOF corporation that does not reduce the shareholder's proportionate interest in the QOF corporation, unless boot is received by the shareholder.[53]

The New Proposed Regulations would also provide that the IRS may further determine by published guidance whether a specific type of a transaction is or is not an Inclusion Event.[54]

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[42] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(4)(i).

[43] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(5)(ii).

[44] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(6)(ii)(B).

[45] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(6)(ii)(C).

[46] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(6)(iii).

[47] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(7)(ii)(A).

[48] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(8).

[49] *See* Prop. Treas. Regs. §§ 1.1400Z2(b)-1(c)(7)(i)(A), (vi).

[50] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(10)(i).

[51] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(10)(ii).

[52] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(11)(i)(B).

[53] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(12).

[54] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(c)(15).

2. Amount of deferred gain triggered upon an Inclusion Event

The New Proposed Regulations would also detail certain rules for determining the amount of deferred gain that is triggered upon an Inclusion Event.

Under the statute, the amount of gain recognized is equal to the excess of (1) the lesser of the amount of deferred gain or the fair market value of the taxpayer's interest in the QOF on the date of the Inclusion Event, over (2) the taxpayer's basis in the interest in the QOF.[55]

The New Proposed Regulations would provide that, if less than all of a taxpayer's interest in a QOF is disposed of in an Inclusion Event, the amount of deferred gain triggered is generally determined proportionately based on the percentage of the disposed interest in the QOF.[56] For example, suppose an investor invests $500 of cash in a QOF and defers tax on $500 of capital gains that the investor otherwise would have recognized. Less than 5 years after the initial investment, when the investor has no basis in its interests in the QOF, the investor sells 25% of its interests in the QOF to a third party, and the fair market value of the investor's entire interest in the QOF is $800 at the time of the sale. The amount of deferred gain that the investor must include in its income is $125, which is the lesser (1) of 25% of the investor's $500 of deferred gain ($125) or (2) the fair market value of the 25% interest in the QOF sold ($200).[57]

However, a special "dollar-for-dollar" rule would apply in certain circumstances if a QOF owner receives property from a QOF in an Inclusion Event, such as distributions treated as a sale or receipt of boot in certain corporate reorganizations. If this rule applies, the amount of deferred gain triggered would equal the lesser of (1) the amount of deferred gain or (2) the amount that gave rise to the Inclusion Event.[58]

For Inclusion Events involving QOF partnerships and QOF S corporations, the amount of deferred gain triggered would equal the product of (1) the percentage of the investor's interest in the QOF disposed of, and (2) the lesser of (A) the amount of deferred gain minus any basis adjustments under the QOF rules or (B) the gain that would be recognized if the qualifying investment were sold for fair market value.[59]

Finally, with respect to a QOF partnership in which a partner holds both qualifying and non-qualifying interests (e.g., because the amount the partner invested in the QOF exceeded the amount of the partner's gains eligible for deferral), the New Proposed Regulations would specifically provide that distributions to the partner will generally be apportioned ratably between the qualifying and non-qualifying

[55] Code Section 1400Z-2(b)(2)(A).

[56] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(e)(1).

[57] *See, e.g.,* Prop. Treas. Regs. § 1.1400Z2(b)-1(f)(2).

[58] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(e)(2).

[59] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(e)(4).

investments based on the respective amount of each investment.[60] The amount of distributions apportioned to the qualifying investment would then determine the extent of an Inclusion Event and the amount of deferred gain triggered. For example, if a partner contributes $200 to a QOF partnership, only $100 of which is treated as a qualifying investment, and later receives a distribution of $50 from the QOF when the partner's basis in the qualifying investment is still zero, $25 of the distribution would be apportioned to the qualifying investment and trigger $25 of gain originally deferred by the partner.[61]

3. Basis adjustment rules

A taxpayer's basis in its interest in the QOF is increased by the amount of deferred gain recognized upon an Inclusion Event.[62] The New Proposed Regulations would clarify that such basis adjustment generally occurs immediately after the recognition of deferred gain and before determining any other tax consequences of the Inclusion Event, subject to certain special rules related to distributions by QOF corporations and partnerships.[63]

4. Partnership liabilities and distributions

The New Proposed Regulations would clarify that the basis in an investor's interest in a QOF organized as a partnership is increased by the investor's share of partnership debt.[64] Moreover, as discussed above, a distribution by a QOF partnership to its partners would generally not be an Inclusion Event, unless the amount of distribution exceeds the partner's basis in the QOF. Accordingly, debt-financed distributions by a QOF partnership should not result in an Inclusion Event to the extent the distributed amount does not exceed the partner's basis in its interest in the QOF (taking into account any basis attributable to the partner's allocable share of the debt).[65]

However, the New Proposed Regulations would also incorporate concepts from partnership "disguised sale" rules in determining the eligibility of qualifying investments. An initial investment in a QOF partnership will not be treated as a qualifying investment to the extent the partnership makes a distribution to the partner and the initial investment and the distribution would together be recharacterized as a sale. The New Proposed Regulations would treat even cash investments as investments of non-cash property in applying the partnership disguised sale rules for this purpose.[66] Under the partnership

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60 *See* Prop. Treas. Regs. §§ 1.1400Z2(b)-1(c)(6)(iv)(B), (D).

61 *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(f)(6).

62 Code Section 1400Z-2(b)(2)(B)(ii).

63 *See* Prop. Treas. Regs. §§ 1.1400Z2(b)-1(g)(1), (2).

64 *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(g)(3).

65 *See* Prop. Treas. Regs. §§ 1.1400Z2(b)-1(f)(10), (11).

66 *See* Prop. Treas. Regs. §§ 1.1400Z2(a)-1(b)(10)(ii)(A)(1)&(2).

disguised sale rules, transfers made within two years are generally presumed to constitute a disguised sale.[67]

Accordingly, cash distributions made within two years of investing in a QOF (including cash contributions) could presumptively disqualify initial investments in the QOF from being qualifying investments, unless the cash distribution is not taken into account under the disguised sale rules.

5. Holding period

The New Proposed Regulations would clarify that, solely for the purposes of the QOF rules (i.e., in determining eligibility for QOF benefits), the holding period in a taxpayer's investment in a QOF is determined without tacking on the holding period of the property exchanged therefor.[68] For example, if an investor invests in a QOF by contributing a tangible property to the QOF, the investor's holding period in its interest in the QOF begins at zero for the purposes of the QOF rules, regardless of how long the investor held the contributed property. However, the New Proposed Regulations would allow tacking-on of holding periods for interests in QOFs acquired in certain qualifying tax-free transactions involving corporations or partnerships or acquired through certain gifts or the previous owners' death.[69]

6. Certain notice requirements

The New Proposed Regulations would impose certain new notification requirements regarding investments in QOFs, to be made in accordance with applicable forms and instructions (which have not yet been issued). First, a partnership that makes a deferral election with respect to its gains must notify all of the partners of such election and state each partner's distributive share of the eligible gain invested in a QOF. A partner that makes its own deferral election must also notify the partnership of the election and the amount of deferred gain.[70] Second, if an indirect owner of a QOF partnership sells a portion of its partnership interest that is only partially treated as a qualifying investment, the indirect QOF owner must notify the direct QOF owner with information sufficient for the direct QOF owner to recognize an appropriate amount of deferred gain.[71] Finally, a partner of a QOF partnership must notify the QOF if the partner makes a FMV Basis Election discussed below.[72] Similar rules apply with respect to S corporations.[73]

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[67] *See* Treas. Regs. § 1.707-3(c).

[68] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(d)(1)(i).

[69] *See* Prop. Treas. Regs. §§ 1.1400Z2(b)-1(d)(1)(ii)-(iv), (d)(3).

[70] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(h)(1).

[71] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(h)(2).

[72] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(h)(3).

[73] *See* Prop. Treas. Regs. § 1.1400Z2(b)-1(h)(4).

D. GAIN EXCLUSION ELECTION AFTER 10 YEARS

As discussed above, if an investor holds qualifying investment in a QOF for at least 10 years, the investor may elect to increase the basis in such investment to the investment's fair market value on the date of the disposition, thereby excluding from tax any new gain from the investment in the QOF (but not the deferred gain). The statute suggests that this election is only available in respect of an investor's interest in a QOF, meaning that an exit from a QOF investment would need to be structured as a sale of interests in the QOF in order to take advantage of this benefit. In addition to the practical complexities of structuring an exit as a sale of interests in a QOF, this restriction made structuring multi-asset QOFs considerably complex. The New Proposed Regulations would provide a number of provisions and clarifications regarding the FMV Basis Election.

1. Fair market value for partnerships with debt

Prior to the New Proposed Regulations, it was unclear how the FMV Basis Election would be applied to disposition of interests in a QOF partnership with liabilities. For example, suppose an investor holds qualifying investment in a QOF partnership for 10 years, the investor's share of the partnership's liabilities is $50 and the investor sells its partnership interest for $100. If the fair market value only refers to the "net" fair market value of the investor's equity interest in the QOF (i.e., net of debt), the investor's basis would be stepped up to $100 pursuant to the FMV Basis Election. Yet, the investor's amount realized would equal $150 because the amount realized would also include relief from the investor's share of partnership liabilities. So despite the FMV Basis Election, the investor would recognize a gain of $50 under such interpretation.

However, the New Proposed Regulations would provide that fair market value for the purpose of the FMV Basis Election includes the value of debt—i.e., a "gross" fair market value.[74] Accordingly, under the New Proposed Regulations, the investor's basis in the example above should be increased to $150 pursuant to the FMV Basis Election, and the investor should not recognize any gain upon the sale of the investor's partnership interest.

2. Depreciation recapture

Prior to the New Proposed Regulations, it was also unclear if any gain from sale of interests in a QOF partnership that would have been recharacterized pursuant to the depreciation recapture rules should still be fully excluded pursuant to the FMV Basis Election. The New Proposed Regulations would provide that, upon a partner's FMV Basis Election, the QOF's bases in its assets are also generally adjusted to equal the assets' fair market values with respect to the selling partner.[75] Accordingly, depreciation recapture would not apply to the underlying assets because the assets will not be treated as having any gain, and an example from the New Proposed Regulations would confirm that the FMV Basis Election

[74] *See* Prop. Treas. Regs. § 1.1400Z2(c)-1(b)(2)(i).

[75] *See* Prop. Treas. Regs. § 1.1400Z2(c)-1(b)(2)(i).

would preclude recognition of gains that would have been subject to depreciation recapture in the absence of the election.[76]

3. Election to exclude gain from sale of property by QOF partnerships

The New Proposed Regulations would provide that if an investor holds a qualifying investment in a QOF partnership for at least 10 years, and the QOF partnership disposes of QOZ Property after such 10-year holding period, the investor may elect not to be taxed on the capital gain arising from such disposition, as reported on the investor's Schedule K-1 and attributable to the qualifying investment ("QOF Gain Exclusion Election").[77] Moreover, to the extent that the Schedule K-1 separately states capital gains arising from dispositions of separate QOZ Properties, the investor can make the QOF Gain Exclusion Election with respect to each separately stated item.[78] This benefit appears to refer only to the investor's holding period in the QOF and seems to be available regardless of the QOF's holding period in its assets. Moreover, gain excluded pursuant to this election nonetheless increases the investor's basis in the QOF.[79]

A similar election would also be available with respect to capital gains arising from the sale of QOZ Properties by QOF S corporations.

As discussed above, the statute seemed to require that, to benefit from the FMV Basis Election, investors could only exit their QOF investments through a sale of their interests in the QOF. The availability of the QOF Gain Exclusion Election should help sponsors form multi-asset QOFs more easily. However, at least as currently drafted, it is unclear whether an analogous provision for sale of properties by a subsidiary entity of the QOF partnership would apply. Accordingly, a multi-asset QOF partnership may need to be structured to hold interests in multiple subsidiary partnerships that would each qualify as a QOZB and hold a single investment, at least until further guidance is issued.

Moreover, because the New Proposed Regulations specifically refer to exclusion of capital gains in the context of the QOF Gain Exclusion Election, it is unclear whether gains subject to depreciation recapture may still be excluded under the QOF Gain Exclusion Election. If not, such treatment could be inconsistent with the result discussed above when a partner makes a FMV Basis Election with respect to a sale of interests in the QOF.

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76 *See* Prop. Treas. Regs. § 1.1400Z2(c)-1(d)(2).

77 *See* Prop. Treas. Regs. § 1.1400Z2(c)-1(b)(2)(ii)(A)(1).

78 However, special rules apply with respect to section 1231 gains of the QOF. *See* Prop. Treas. Regs. § 1.1400Z2(c)-1(b)(2)(ii)(A)(2).

79 *See* Prop. Treas. Regs. § 1.1400Z2(c)-1(b)(2)(ii)(C); Preamble, p. 54.

4. Election to receive REIT capital gain dividends tax-free

Finally, the New Proposed Regulations would provide a favorable treatment for capital gain dividends distributed by a QOF real estate investment trust. With respect to qualifying investments held for at least 10 years, if a shareholder of such QOF receives capital gain dividends that (1) are identified with a date and (2) correspond to long-term capital gains realized by the QOF from disposition of QOZ Properties, the shareholder may generally apply a zero percent tax rate to the capital gain dividends.[80] To qualify for this benefit, the QOF must comply with certain procedural requirements.[81]

E. GENERAL ANTI-ABUSE RULE

The New Proposed Regulations would establish a general anti-abuse rule. Under this broad anti-abuse rule (determined based on all the facts and circumstances), if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of the QOZ incentive program, the IRS can recast a transaction (or series of transactions) to rectify such result.[82] The Treasury Department and the IRS have requested comments on whether additional details are required regarding what tax results are inconsistent with the purposes of the QOZ incentive program or whether examples of particular types of abusive transactions would be helpful.[83]

F. EFFECTIVE DATE AND COMMENT PERIOD

If finalized, the New Proposed Regulations would generally apply to taxable years ending after the date the New Proposed Regulations are finalized. However, taxpayers may generally rely on the New Proposed Regulations prior to the date the New Proposed Regulations are finalized, provided that taxpayers apply the New Proposed Regulations in their entirety and in a consistent manner.[84] However, the provisions related to the FMV Basis Election discussed above may not be relied on prior to the finalization of those provisions.

Written comments to the New Proposed Regulations must be received by the IRS by the date 60 days after the date of publication of the New Proposed Regulations in the Federal Register.[85]

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[80] *See* Prop. Treas. Regs. § 1.1400Z2(c)-1(e)(1).

[81] *See* Prop. Treas. Regs. § 1.1400Z2(c)-1(e)(2).

[82] *See* Prop. Treas. Regs. § 1.1400Z2(f)-1(c).

[83] *See* Preamble, p. 71.

[84] *See* Preamble, pp. 73 – 74.

[85] The New 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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