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[4830-01-p]

DEPARTMENT OF TREASURY

Internal Revenue Service

26 CFR Part I

[REG-120186-18]

RIN 1545-BP04

Investing in Qualified Opportunity Funds

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking; partial withdrawal of a notice of proposed rulemaking.

**SUMMARY:** This document contains proposed regulations that provide guidance under new section 1400Z-2 of the Internal Revenue Code (Code) relating to gains that may be deferred as a result of a taxpayer's investment in a qualified opportunity fund (QOF), as well as special rules for an investment in a QOF held by a taxpayer for at least 10 years. This document also contains proposed regulations that update portions of previously proposed regulations under section 1400Z-2 to address various issues, including: the definition of "substantially all" in each of the various places it appears in section 1400Z-2; the transactions that may trigger the inclusion of gain that a taxpayer has elected to defer under section 1400Z-2; the timing and amount of the deferred gain that is included; the treatment of leased property used by a qualified opportunity zone

business; the use of qualified opportunity zone business property in the qualified opportunity zone; the sourcing of gross income to the qualified opportunity zone business; and the “reasonable period” for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty. These proposed regulations will affect QOFs and taxpayers that invest in QOFs.

**DATES:** Written (including electronic) comments must be received by **[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Outlines of topics to be discussed at the public hearing scheduled for July 9, 2019, at 10 a.m. must be received by **[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. The public hearing will be held at the New Carrollton Federal Building at 5000 Ellin Road in Lanham, Maryland 20706.

**ADDRESSES:** Submit electronic submissions via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG-120186-18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:LPD:PR (REG-120186-18), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-120186-18), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224.

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, Erika C. Reigle of the Office of Associate Chief Counsel (Income Tax and Accounting), (202) 317-7006, and Kyle C. Griffin of the Office of Associate Chief Counsel (Income Tax and Accounting), (202) 317-4718; concerning the submission of comments, the hearing, or to be placed on the building access list to attend the hearing, Regina L. Johnson, (202) 317-6901 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

**Background**

This document contains proposed regulations under section 1400Z-2 of the Code that amend the Income Tax Regulations (26 CFR part 1). Section 13823 of the Tax Cuts and Jobs Act, Public Law 115-97, 131 Stat. 2054, 2184 (2017) (TCJA), amended the Code to add sections 1400Z-1 and 1400Z-2. Sections 1400Z-1 and 1400Z-2 seek to encourage economic growth and investment in designated distressed communities (qualified opportunity zones) by providing Federal income tax benefits to taxpayers who invest new capital in businesses located within qualified opportunity zones through a QOF.

Section 1400Z-1 provides the procedural rules for designating qualified opportunity zones and related definitions. Section 1400Z-2 provides two main tax incentives to encourage investment in qualified opportunity zones. First, it allows for the deferral of inclusion in gross income of certain gain to the extent that a taxpayer elects to invest a corresponding amount in a QOF. Second, it allows for the taxpayer to elect to exclude from gross income the post-acquisition gain on investments in the QOF held for at least 10 years. Additionally, with respect to the deferral of inclusion in gross

income of certain gain invested in a QOF, section 1400Z-2 permanently excludes a portion of such deferred gain if the corresponding investment in the QOF is held for five or seven years.

On October 29, 2018, the Department of the Treasury (Treasury Department) and the IRS published in the **Federal Register** (83 FR 54279) a notice of proposed rulemaking (REG-115420-18) providing guidance under section 1400Z-2 of the Code for investing in qualified opportunity funds (83 FR 54279 (October 29, 2018)). A public hearing on 83 FR 54279 (October 29, 2018) was held on February 14, 2019. The Treasury Department and the IRS continue to consider the comments received on 83 FR 54279 (October 29, 2018), including those provided at the public hearing.

As is more fully explained in the Explanation of Provisions, the proposed regulations contained in this notice of proposed rulemaking describe and clarify requirements relating to investing in QOFs not addressed in 83 FR 54279 (October 29, 2018). Specifically, and as was indicated in 83 FR 54279 (October 29, 2018), these proposed regulations address the meaning of “substantially all” in each of the various places where it appears in section 1400Z-2; the reasonable period for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty pursuant to section 1400Z-2(e)(4)(B); the transactions that may trigger the inclusion of gain that has been deferred under a section 1400Z-2(a) election; and other technical issues with regard to investing in a QOF. Because portions of 83 FR 54279 (October 29, 2018) contained certain placeholder text, included less detailed guidance in certain areas that merely cross-referenced statutory rules, or lacked sufficient detail to address these issues, this notice of proposed rulemaking withdraws paragraphs (c)(4)(i), (c)(5), (c)(6), (d)(2)(i)(A),

(d)(2)(ii), (d)(2)(iii), (d)(5)(i), and (d)(5)(ii)(B) of proposed §1.1400Z2(d)-1 of 83 FR 54279 (October 29, 2018), and proposes in their place new paragraphs (c)(4)(i), (c)(5), (c)(6), (d)(2)(i)(A), (d)(2)(ii), (d)(2)(iii), (d)(5)(i), and (d)(5)(ii)(B) of proposed §1.1400Z2(d)-1.

The Treasury Department and the IRS welcome suggestions as to other issues that should be addressed to further clarify the rules under section 1400Z-2, as well as comments on all aspects of these proposed regulations.

Within a few months of the publication of these proposed regulations, the Treasury Department and the IRS expect to address the administrative rules under section 1400Z-2(f) applicable to a QOF that fails to maintain the required 90 percent investment standard of section 1400Z-2(d)(1), as well as information-reporting requirements for an eligible taxpayer under section 1400Z-2, in separate regulations, forms, or publications.

In addition, the Treasury Department and the IRS anticipate revising the Form 8996 (OMB Control number 1545-0123) for tax years 2019 and following. As provided for under the rules set forth in 83 FR 54279 (October 29, 2018), a QOF must file a Form 8996 with its Federal income tax return for initial self-certification and for annual reporting of compliance with the 90-Percent Asset Test in section 1400Z-2(d)(1). Subject to tax administration limitations, the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)), and other requirements under law, it is expected that proposed revisions to the Form 8996 could require additional information such as (1) the employer identification number (EIN) of the qualified opportunity zone businesses owned by a QOF and (2) the amount invested by QOFs and qualified opportunity zone businesses

located in particular Census tracts designated as qualified opportunity zones. In that regard, consistent with Executive Order 13853 of December 12, 2018, *Establishing the White House Opportunity and Revitalization Council* (EO 13853), published in the **Federal Register** (83 FR 65071) on December 18, 2018, and concurrent with the publication of these proposed regulations, the Treasury Department and the IRS are publishing a request for information (RFI) under this subject in the Notices section of this edition of the **Federal Register**, with a docket for comments on [www.regulations.gov](http://www.regulations.gov) separate from that for this notice of proposed rulemaking, requesting detailed comments with respect to methodologies for assessing relevant aspects of investments held by QOFs throughout the United States and at the State, Territorial, and Tribal levels, including the composition of QOF investments by asset class, the identification of designated qualified opportunity zone Census tracts that have received QOF investments, and the impacts and outcomes of the investments in those areas on economic indicators, including job creation, poverty reduction, and new business starts. EO 13853 charges the White House Opportunity and Revitalization Council, of which the Treasury Department is a member, to determine “what data, metrics, and methodologies can be used to measure the effectiveness of public and private investments in urban and economically distressed communities, including qualified opportunity zones.” See the requests for comments in the RFI regarding these or other topics regarding methodologies for assessing the impacts of sections 1400Z-1 and 1400Z-2 on qualified opportunity zones throughout the Nation.

## **Explanation of Provisions**

### **I. Qualified Opportunity Zone Business Property**

*A. Definition of Substantially All for Purposes of Sections 1400Z-2(d)(2) and (d)(3)*

83 FR 54279 (October 29, 2018) clarified that, for purposes of section 1400Z-2(d)(3)(A)(i), for determining whether an entity is a qualified opportunity zone business, the threshold to determine whether a trade or business satisfies the substantially all test is 70 percent. See 83 FR 54279, 54294 (October 29, 2018). If at least 70 percent of the tangible property owned or leased by a trade or business is qualified opportunity zone business property (as defined in section 1400Z-2(d)(3)(A)(i)), proposed §1.1400Z2(d)-1(d)(3)(i) in 83 FR 54279 (October 29, 2018) provides that the trade or business is treated as satisfying the substantially all requirement in section 1400Z-2(d)(3)(A)(i).

The phrase substantially all is also used throughout section 1400Z-2(d)(2). The phrase appears in section 1400Z-2(d)(2)(D)(i)(III), which establishes the conditions for property to be treated as qualified opportunity zone business property (“during substantially all of the qualified opportunity fund’s holding period for such property, substantially all of the use of such property was in a qualified opportunity zone”). The phrase also appears in sections 1400Z-2(d)(2)(B)(i)(III) and 1400Z-2(d)(2)(C)(iii), which require that during substantially all of the QOF’s holding period for qualified opportunity zone stock or qualified opportunity zone partnership interests, such corporation or partnership qualified as a qualified opportunity zone business.

83 FR 54279 (October 29, 2018) reserved the proposed meaning of the phrase substantially all as used in section 1400Z-2(d)(2). The statute neither defines the meaning of substantially all for the QOF’s holding period for qualified opportunity zone stock, qualified opportunity zone partnership interests, and qualified opportunity zone

business property, nor defines it for purposes of testing the use of qualified opportunity zone business property in a qualified opportunity zone. The Treasury Department and the IRS have received numerous questions and comments on the threshold limits of substantially all for purposes of section 1400Z-2(d)(2). Many commenters suggested that a lower threshold for the use requirement of section 1400Z-2(d)(2)(D)(i)(III) would allow a variety of businesses to benefit from qualifying investments in QOFs. Other commentators suggested that too low a threshold would negatively impact the low-income communities that section 1400Z-2 is intended to benefit, because the tax-incentivized investment would not be focused sufficiently on these communities.

Consistent with 83 FR 54279 (October 29, 2018) these proposed regulations provide that, in testing the use of qualified opportunity zone business property in a qualified opportunity zone, as required in section 1400Z-2(d)(2)(D)(i)(III), the term substantially all in the context of “use” is 70 percent. With respect to owned or leased tangible property, these proposed regulations provide identical requirements for determining whether a QOF or qualified opportunity zone business has used substantially all of such tangible property within the qualified opportunity zone within the meaning of section 1400Z-2(d)(2)(D)(i)(III). Whether such tangible property is owned or leased, these proposed regulations propose that the substantially all requirement regarding “use” is satisfied if at least 70 percent of the use of such tangible property is in a qualified opportunity zone.

As discussed in the preamble to 83 FR 54279 (October 29, 2018) a compounded use of substantially all must be interpreted in a manner consistent with the intent of Congress. Consequently, the Treasury Department and the IRS have determined that a



higher threshold is necessary in the holding period context to preserve the integrity of the statute and for the purpose of focusing investment in designated qualified opportunity zones. Thus, the proposed regulations provide that the term substantially all as used in the holding period context in sections 1400Z-2(d)(2)(B)(i)(III), 1400Z-2(d)(2)(C)(iii), and 1400Z-2(d)(2)(D)(i)(III) is defined as 90 percent. Using a percentage threshold that is higher than 70-percent in the holding period context is warranted as taxpayers are more easily able to control and determine the period for which they hold property. In addition, given the lower 70-percent thresholds for testing both the use of tangible property in the qualified opportunity zone and the amount of owned and leased tangible property of a qualified opportunity zone business that must be qualified opportunity zone business property, applying a 70-percent threshold in the holding period context can result in much less than half of a qualified opportunity zone business's tangible property being used in a qualified opportunity zone. Accordingly, the Treasury Department and the IRS have determined that using a threshold lower than 90 percent in the holding period context would reduce the amount of investment in qualified opportunity zones to levels inconsistent with the purposes of section 1400Z-2.

The Treasury Department and the IRS request comments on these proposed definitions of substantially all for purposes of section 1400Z-2(d)(2).

#### *B. Original Use of Tangible Property Acquired by Purchase*

In 83 FR 54279 (October 29, 2018) the Treasury Department and the IRS specifically solicited comments on the definition of the “original use” requirement in section 1400Z-2(d)(2)(D)(i)(II) for both real property and tangible personal property and reserved a section of the proposed regulations to define the phrase original use. The

requirement that tangible property acquired by purchase have its “original use” in a qualified opportunity zone commencing with a qualified opportunity fund or qualified opportunity zone business, or be substantially improved, in order to qualify for tax benefits is also found in other sections of the Code. Under the now-repealed statutory frameworks of both section 1400B (related to the DC Zone) and section 1400F (related to Renewal Communities), qualified property for purposes of those provisions was required to have its original use in a zone or to meet the requirements of substantial improvement as defined under those provisions. The Treasury Department and the IRS have received numerous questions on the meaning of “original use.” Examples of these questions include: May tangible property be previously used property, or must it be new property? Does property previously placed in service in the qualified opportunity zone for one use, but now placed in service for a different use, qualify? May property used in the qualified opportunity zone be placed in service in the same qualified opportunity zone by an acquiring, unrelated taxpayer?

After carefully considering the comments and questions received, the proposed regulations generally provide that the “original use” of tangible property acquired by purchase by any person commences on the date when that person or a prior person first places the property in service in the qualified opportunity zone for purposes of depreciation or amortization (or first uses the property in the qualified opportunity zone in a manner that would allow depreciation or amortization if that person were the property’s owner). Thus, tangible property located in the qualified opportunity zone that is depreciated or amortized by a taxpayer other than the QOF or qualified opportunity zone business would not satisfy the original use requirement of section 1400Z-

2(d)(2)(D)(i)(II) under these proposed regulations. Conversely, tangible property (other than land) located in the qualified opportunity zone that has not yet been depreciated or amortized by a taxpayer other than the QOF or qualified opportunity zone business would satisfy the original use requirement of section 1400Z-2(d)(2)(D)(i)(II) under these proposed regulations. However, the proposed regulations clarify that used tangible property will satisfy the original use requirement with respect to a qualified opportunity zone so long as the property has not been previously used (that is, has not previously been used within that qualified opportunity zone in a manner that would have allowed it to be depreciated or amortized) by any taxpayer. (For special rules concerning the original use requirement for assets acquired in certain transactions to which section 355 or section 381 applies, see proposed §1.1400Z2(b)-1(d)(2) in this [notice of proposed rulemaking](#) .)

The Treasury Department and the IRS have also studied the extent to which usage history of vacant structures or other tangible property (other than land) purchased after 2017 but previously placed in service within the qualified opportunity zone may be disregarded for purposes of the original use requirement if the structure or other property has not been utilized or has been abandoned for some minimum period of time and received multiple public comments regarding this issue. Several commenters suggested establishing an “at least one-year” vacancy period threshold similar to that employed in §1.1394-1(h) to determine whether property meets the original use requirement within the meaning of section 1397D (defining qualified zone property) for purposes of section 1394 (relating to the issuance of enterprise zone facility bonds). Given the different operation of those provisions and the potential for owners of property

already situated in a qualified opportunity zone to intentionally cease occupying property for 12 months in order to increase its marketability to potential purchasers after 2017, other commenters proposed longer vacancy thresholds ranging to five years. The Treasury Department and the IRS are proposing that where a building or other structure has been vacant for at least five years prior to being purchased by a QOF or qualified opportunity zone business, the purchased building or structure will satisfy the original use requirement. Comments are requested on this proposed approach, including the length of the vacancy period and how such a standard might be administered and enforced.

In addition, in response to questions about a taxpayer's improvements to leased property, the proposed regulations provide that improvements made by a lessee to leased property satisfy the original use requirement and are considered purchased property for the amount of the unadjusted cost basis of such improvements as determined in accordance with section 1012.

As provided in Rev. Rul. 2018-29, 2018 I.R.B 45, and these proposed regulations, if land that is within a qualified opportunity zone is acquired by purchase in accordance with section 1400Z-2(d)(2)(D)(i)(I), the requirement under section 1400Z-2(d)(2)(D)(i)(II) that the original use of tangible property in the qualified opportunity zone commence with a QOF is not applicable to the land, whether the land is improved or unimproved. Likewise, unimproved land that is within a qualified opportunity zone and acquired by purchase in accordance with section 1400Z-2(d)(2)(D)(i)(I) is not required to be substantially improved within the meaning of section 1400Z-2(d)(2)(D)(i)(II) and (d)(2)(D)(ii). Multiple public comments were received suggesting that not requiring the

basis of land itself to be substantially improved within the meaning of section 1400Z-2(d)(2)(D)(i)(II) and (d)(2)(D)(ii) would lead to speculative land purchasing and potential abuse of section 1400Z-2.

The Treasury Department and the IRS have considered these comments. Under section 1400Z-2(d)(2)(D)(i)(II) and these proposed regulations, land can be treated as qualified opportunity zone business property for purposes of section 1400Z-2 only if it is used in a trade or business of a QOF or qualified opportunity zone business. As described in part III.D. of this Explanation of Provisions, only activities giving rise to a trade or business within the meaning of section 162 may qualify as a trade or business for purposes of section 1400Z-2; the holding of land for investment does not give rise to a trade or business and such land could not be qualified opportunity zone business property. Moreover, land is a crucial business asset for numerous types of operating trades or businesses aside from real estate development, and the degree to which it is necessary or useful for taxpayers seeking to grow their businesses to improve the land that their businesses depend on will vary greatly by region, industry, and particular business. In many cases, regulations that imposed a requirement on all types of trades or businesses to substantially improve (within the meaning of section 1400Z-2(d)(2)(D)(i)(II) and (d)(2)(D)(ii)) land that is used by them may encourage noneconomic, tax-motivated business decisions, or otherwise effectively prevent many businesses from benefitting under the opportunity zone provisions. Such rules also would inject a significant degree of additional complexity into these proposed regulations.

Nevertheless, the Treasury Department and the IRS recognize that, in certain instances, the treatment of unimproved land as qualified opportunity zone business property could lead to tax results that are inconsistent with the purposes of section 1400Z-2. For example, a QOF's acquisition of a parcel of land currently utilized entirely by a business for the production of an agricultural crop, whether active or fallow at that time, potentially could be treated as qualified opportunity zone business property without the QOF investing any new capital investment in, or increasing any economic activity or output of, that parcel. In such instances, the Treasury Department and the IRS have determined that the purposes of section 1400Z-2 would not be realized, and therefore the tax incentives otherwise provided under section 1400Z-2 should not be available. If a significant purpose for acquiring such unimproved land was to achieve that inappropriate tax result, the general anti-abuse rule set forth in proposed §1.1400Z2(f)-1(c) (and described further in part X of this Explanation of Provisions) would apply to treat the acquisition of the unimproved land as an acquisition of non-qualifying property for section 1400Z-2 purposes. The Treasury Department and the IRS request comments on whether anti-abuse rules under section 1400Z-2(e)(4)(c), in addition to the general anti-abuse rule, are needed to prevent such transactions or "land banking" by QOFs or qualified opportunity zone businesses, and on possible approaches to prevent such abuse.

Conversely, if real property, other than land, that is acquired by purchase in accordance with section 1400Z-2(d)(2)(D)(i)(I) had been placed in service in the qualified opportunity zone by a person other than the QOF or qualified opportunity zone business (or first used in a manner that would allow depreciation or amortization if that

person were the property's owner), it must be substantially improved to be considered qualified opportunity zone business property. Substantial improvement by the QOF or qualified opportunity zone business for real property, other than land, is determined by applying the requirements for substantial improvement of tangible property acquired by purchase set forth in section 1400Z-2(d)(2)(D)(ii).

The Treasury Department and the IRS request comments on these proposed rules regarding the original use requirement generally, including whether certain cases may warrant additional consideration. Comments are also requested as to whether the ability to treat such prior use as disregarded for purposes of the original use requirement should depend on whether the property has been fully depreciated for Federal income tax purposes, or whether other adjustments for any undepreciated or unamortized basis of such property would be appropriate. The Treasury Department and the IRS are also studying the circumstances under which tangible property that had not been purchased but has been overwhelmingly improved by a QOF or a qualified opportunity zone business may be considered as satisfying the original use requirement and request comment regarding possible approaches.

Under these proposed regulations, the determination of whether the substantial improvement requirement of section 1400Z-2(d)(2)(D)(ii) is satisfied for tangible property that is purchased is made on an asset-by-asset basis. The Treasury Department and the IRS have considered the possibility, however, that an asset-by-asset approach might be onerous for certain types of businesses. For example, the granular nature of an asset-by-asset approach might cause operating businesses with significant numbers of diverse assets to encounter administratively difficult asset

segregation and tracking burdens, potentially creating traps for the unwary. As an alternative, the Treasury Department and the IRS have contemplated the possibility of applying an aggregate standard for determining compliance with the substantial improvement requirement, potentially allowing tangible property to be grouped by location in the same, or contiguous, qualified opportunity zones. Given that an aggregate approach could provide additional compliance flexibility, while continuing to incentivize high-quality investments in qualified opportunity zones, the Treasury Department and the IRS request comments on the potential advantages, as well as disadvantages, of adopting an aggregate approach for substantial improvement.

Additional comments are requested regarding the application of the substantial improvement requirement with respect to tangible personal property acquired by purchase that is not capable of being substantially improved (for example, equipment that is nearly new but was previously used in the qualified opportunity zone and the cost of fully refurbishing the equipment would not result in a doubling of the basis of such property). Specifically, comments are requested regarding whether the term “property” in section 1400Z-2(d)(2)(D)(ii) should be interpreted in the aggregate to permit the purchase of items of non-original use property together with items of original use property that do not directly improve such non-original use property to satisfy the substantial improvement requirement. In that regard, comments are requested as to the extent to which such treatment may be appropriate given that such treatment could cause a conflict between the independent original use requirement of section 1400Z-2(d)(2)(D)(i)(II) and the independent substantial improvement requirement of section 1400Z-2(d)(2)(D)(i)(II) by reason of the definition of substantial improvement



under section 1400Z-2(d)(2)(D)(ii). Comments are also requested regarding the treatment of purchases of multiple items of separate tangible personal property for purposes of section 1400Z-2(d)(2)(D)(i)(II) that have the same applicable depreciation method, applicable recovery period, and applicable convention, and which are placed in service in the same year by a QOF or qualified opportunity zone business in one or more general asset accounts within the meaning of section 168(i) and §1.168(i)-1.

*C. Safe Harbor for Testing Use of Inventory in Transit*

Section 1400Z-2(d)(2)(D)(i)(III) provides that qualified opportunity zone business property means tangible property used in a trade or business of the QOF if, during substantially all of the QOF's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone. Commentators have inquired how inventory will be treated for purposes of determining whether substantially all of the tangible property is used in the qualified opportunity zone. Commentators expressed concern that inventory in transit on the last day of the taxable year of a QOF would be counted against the QOF when determining whether the QOF has met the 90-percent ownership requirement found in section 1400Z-2(d)(1) (90-percent asset test).

The proposed regulations clarify that inventory (including raw materials) of a trade or business does not fail to be used in a qualified opportunity zone solely because the inventory is in transit from a vendor to a facility of the trade or business that is in a qualified opportunity zone, or from a facility of the trade or business that is in a qualified opportunity zone to customers of the trade or business that are not located in a qualified opportunity zone. Comments are requested as to whether the location of where inventory is warehoused should be relevant and whether inventory (including raw

materials) should be excluded from both the numerator and denominator of the 70-percent test for QOZBs.

The Treasury Department and the IRS request comments on the proposed rules regarding the determination of whether inventory, as well as other property, is used in a qualified opportunity zone, including whether certain cases or types of property may warrant additional consideration.

## II. Treatment of Leased Tangible Property

As noted previously, section 1400Z-2(d)(3)(A)(i) provides that a qualified opportunity zone business is a trade or business in which, among other things, substantially all (that is, at least 70 percent) of the tangible property owned or leased by the taxpayer is “qualified opportunity zone business property” within the meaning of section 1400Z-2(d)(2)(D), determined by substituting “qualified opportunity fund” with “qualified opportunity zone business” each place that such term appears. Taking into account this substitution, section 1400Z-2(d)(2)(D)(i) provides that qualified opportunity zone business property is tangible property that meets the following requirements:

- (1) the tangible property was acquired by the trade or business by purchase (as defined in section 179(d)(2)) after December 31, 2017;
- (2) the original use of such property in the qualified opportunity zone commences with the qualified opportunity zone business, or the qualified opportunity zone business substantially improves the property; and
- (3) for substantially all of the qualified opportunity zone business’s holding period of the tangible property, substantially all of the use of such property is in the qualified opportunity zone.

Commenters have expressed concern as to whether tangible property that is leased by a qualified opportunity zone business can be treated as

satisfying these requirements. Similar questions have arisen with respect to whether tangible property leased by a QOF could be treated as satisfying the 90-percent asset test under section 1400Z-2(d)(1).

*A. Status as Qualified Opportunity Zone Business Property*

The purposes of sections 1400Z-1 and 1400Z-2 are to increase business activity and economic investment in qualified opportunity zones. As a proxy for evaluating increases in business activity and economic investment in a qualified opportunity zone, these sections of the Code generally measure increases in tangible business property used in that qualified opportunity zone. The general approach of the statute in evaluating the achievement of those purposes inform the proposed regulations' treatment of tangible property that is leased rather than owned. The Treasury Department and the IRS also recognize that not treating leased property as qualified opportunity zone business property may have an unintended consequence of excluding investments on tribal lands designated as qualified opportunity zones because tribal governments occupy Federal trust lands and these lands are, more often than not, leased for economic development purposes.

Given the purpose of sections 1400Z-1 and 1400Z-2 to facilitate increased business activity and economic investment in qualified opportunity zones, these proposed regulations would provide greater parity among diverse types of business models. If a taxpayer uses tangible property located in a qualified opportunity zone in its business, the benefits of such use on the qualified opportunity zone's economy would not generally be expected to vary greatly depending on whether the business pays cash for the property, borrows in order to purchase the property, or leases the

property. Not recognizing that benefits can accrue to a qualified opportunity zone regardless of the manner in which a QOF or qualified opportunity zone business acquires rights to use tangible property in the qualified opportunity zone could result in preferences solely based on whether businesses choose to own or lease tangible property, an anomalous result inconsistent with the purpose of sections 1400Z-1 and 1400Z-2.

Accordingly, leased tangible property meeting certain criteria may be treated as qualified opportunity zone business property for purposes of satisfying the 90-percent asset test under section 1400Z-2(d)(1) and the substantially all requirement under section 1400Z-2(d)(3)(A)(i). The following two general criteria must be satisfied. First, analogous to owned tangible property, leased tangible property must be acquired under a lease entered into after December 31, 2017. Second, as with owned tangible property, substantially all of the use of the leased tangible property must be in a qualified opportunity zone during substantially all of the period for which the business leases the property.

These proposed regulations, however, do not impose an original use requirement with respect to leased tangible property for, among others, the following reasons. Unlike owned tangible property, in most circumstances, leased tangible property held by a lessee cannot be placed in service for depreciation or amortization purposes because the lessee does not own such tangible property for Federal income tax purposes. In addition, in many instances, leased tangible property may have been previously leased to other lessees or previously used in the qualified opportunity zone. Furthermore, taxpayers generally do not have a basis in leased property that can be depreciated,

again, because they are not the owner of such property for Federal income tax purposes. Therefore, the proposed regulations do not impose a requirement for a lessee to “substantially improve” leased tangible property within the meaning of section 1400Z-2(d)(2)(D)(ii).

Unlike tangible property that is purchased by a QOF or qualified opportunity zone business, the proposed regulations do not require leased tangible property to be acquired from a lessor that is unrelated (within the meaning of section 1400Z-2(e)(2)) to the QOF or qualified opportunity zone business that is the lessee under the lease. However, in order to maintain greater parity between decisions to lease or own tangible property, while also limiting abuse, the proposed regulations provide one limitation as an alternative to imposing a related person rule or a substantial improvement rule and two further limitations that apply when the lessor and lessee are related.

First, the proposed regulations require in all cases, that the lease under which a QOF or qualified opportunity zone business acquires rights with respect to any leased tangible property must be a “market rate lease.” For this purpose, whether a lease is market rate (that is, whether the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity zone) is determined under the regulations under section 482. This limitation operates to ensure that all of the terms of the lease are market rate.

Second, if the lessor and lessee are related, the proposed regulations do not permit leased tangible property to be treated as qualified opportunity zone business property if, in connection with the lease, a QOF or qualified opportunity zone business at any time makes a prepayment to the lessor (or a person related to the lessor within

the meaning of section 1400Z-2(e)(2)) relating to a period of use of the leased tangible property that exceeds 12 months. This requirement operates to prevent inappropriate allocations of investment capital to prepayments of rent, as well as other payments exchanged for the use of the leased property.

Third, also applicable when the lessor and lessee are related, the proposed regulations do not permit leased tangible personal property to be treated as qualified opportunity zone business property unless the lessee becomes the owner of tangible property that is qualified opportunity zone business property and that has a value not less than the value of the leased personal property. This acquisition of this property must occur during a period that begins on the date that the lessee receives possession of the property under the lease and ends on the earlier of the last day of the lease or the end of the 30-month period beginning on the date that the lessee receives possession of the property under the lease. There must be substantial overlap of zone(s) in which the owner of the property so acquired uses it and the zone(s) in which that person uses the leased property.

Finally, the proposed regulations include an anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement for purchases of real property (other than unimproved land). In the case of real property (other than unimproved land) that is leased by a QOF, if, at the time the lease is entered into, there was a plan, intent, or expectation for the real property to be purchased by the QOF for an amount of consideration other than the fair market value of the real property determined at the time of the purchase without

regard to any prior lease payments, the leased real property is not qualified opportunity zone business property at any time.

The Treasury Department and the IRS request comments on all aspects of the proposed treatment of leased tangible property. In particular, a determination under section 482 of whether the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity zone takes into account the simultaneous combination of all terms of the lease, including rent, term, possibility of extension, presence of an option to purchase the leased asset, and (if there is such an option) the terms of purchase. Comments are requested on whether taxpayers and the IRS may encounter undue burden or difficulty in determining whether a lease is market rate. If so, how should the final regulations reduce that burden? For example, should the final regulations describe one or more conditions whose presence would create a presumption that a lease is (or is not) a market rate lease? Comments are also requested on whether the limitations intended to prevent abusive situations through the use of leased property are appropriate, or whether modifications are warranted.

#### *B. Valuation of Leased Tangible Property*

Based on the foregoing, these proposed regulations provide methodologies for valuing leased tangible property for purposes of satisfying the 90-percent asset test under section 1400Z-2(d)(1) and the substantially all requirement under section 1400Z-2(d)(3)(A)(i). Under these proposed regulations, on an annual basis, leased tangible property may be valued using either an applicable financial statement valuation method or an alternative valuation method, each described further below. A QOF or qualified opportunity zone business, as applicable, may select the applicable financial statement

valuation method if they actually have an applicable financial statement (within the meaning of §1.475(a)-4(h)). Once a QOF or qualified opportunity zone business selects one of those valuation methods for the taxable year, it must apply such method consistently to all leased tangible property valued with respect to the taxable year.

*Financial statement valuation method*

Under the applicable financial statement valuation method, the value of leased tangible property of a QOF or qualified opportunity zone business is the value of that property as reported on the applicable financial statement for the relevant reporting period. These proposed regulations require that a QOF or qualified opportunity zone business may select this applicable financial statement valuation only if the applicable financial statement is prepared according to U.S. generally accepted accounting principles (GAAP) and requires recognition of the lease of the tangible property.

*Alternative valuation method*

Under the alternative valuation method, the value of tangible property that is leased by a QOF or qualified opportunity zone business is determined based on a calculation of the “present value” of the leased tangible property. Specifically, the value of such leased tangible property under these proposed regulations is equal to the sum of the present values of the payments to be made under the lease for such tangible property. For purposes of calculating present value, the discount rate is the applicable Federal rate under section 1274(d)(1), determined by substituting the term “lease” for “debt instrument.”

These proposed regulations require that a QOF or qualified opportunity zone business using the alternative valuation method calculate the value of leased tangible



property under this alternative valuation method at the time the lease for such property is entered into. Once calculated, these proposed regulations require that such calculated value be used as the value for such asset for all testing dates for purposes of the “substantially all of the use” requirement and the 90-percent asset test.

The Treasury Department and the IRS request comments on these proposed rules regarding the treatment and valuation of leased tangible property, including whether other alternative valuation methods may be appropriate, or whether certain modifications to the proposed valuation methods are warranted.

### III. Qualified Opportunity Zone Businesses

#### *A. Real Property Straddling a Qualified Opportunity Zone*

Section 1400Z-2(d)(3)(A)(ii) incorporates the requirements of section 1397C(b)(2), (4), and (8) related to Empowerment Zones. The Treasury Department and the IRS have received numerous comments on the ability of a business that holds real property straddling multiple Census tracts, where not all of the tracts are designated as a qualified opportunity zone under section 1400Z-1, to satisfy the requirements under sections 1400Z-2 and 1397C(b)(2), (4), and (8). Commenters have suggested that the proposed regulations adopt a rule that is similar to the rule used for purposes of other place-based tax incentives (that is, the Empowerment Zones) enshrined in section 1397C(f). Section 1397C(f) provides that if the amount of real property based on square footage located within the qualified opportunity zone is substantial as compared to the amount of real property based on square footage outside of the zone, and the real property outside of the zone is contiguous to part or all

of the real property located inside the zone, then all of the property would be deemed to be located within a qualified zone.

These proposed regulations provide that in satisfying the requirements of section 1400Z-2(d)(3)(A)(ii), section 1397C(f) applies in the determination of whether a qualified opportunity zone is the location of services, tangible property, or business functions (substituting “qualified opportunity zone” for “empowerment zone”). Real property located within the qualified opportunity zone should be considered substantial if the unadjusted cost of the real property inside a qualified opportunity zone is greater than the unadjusted cost of real property outside of the qualified opportunity zone.

Comments are requested as to whether there exist circumstances under which the Treasury Department and the IRS could apply principles similar to those of section 1397C(f) in the case of other requirements of section 1400Z-2.

#### *B. 50 Percent of Gross Income of a Qualified Opportunity Zone Business*

Section 1397C(b)(2) provides that, in order to be a “qualified business entity” (in addition to other requirements found in section 1397C(b)) with respect to any taxable year, a corporation or partnership must derive at least 50 percent of its total gross income “from the active conduct of such business.” The phrase *such* business refers to a business mentioned in the preceding sentence, which discusses “a qualified business within an empowerment zone.” For purposes of application to section 1400Z-2, references in section 1397C to “an empowerment zone” are treated as meaning a qualified opportunity zone. Thus, the corporation or partnership must derive at least 50 percent of its total gross income from the active conduct of a business within a qualified opportunity zone.

An area of concern for commenters is how the Treasury Department and the IRS will determine whether this 50-percent gross income requirement is satisfied.

Commenters recommended that the Treasury Department and the IRS provide guidance to clarify the requirements of sections 1400Z-2(d)(3)(A)(ii) and 1397C(b)(2).

The proposed regulations provide three safe harbors and a facts and circumstances test for determining whether sufficient income is derived from a trade or business in a qualified opportunity zone for purposes of the 50-percent test in section 1397C(b)(2). Businesses only need to meet one of these safe harbors to satisfy that test. The first safe harbor in the proposed regulations requires that at least 50 percent of the services performed (based on hours) for such business by its employees and independent contractors (and employees of independent contractors) are performed within the qualified opportunity zone. This test is intended to address businesses located in a qualified opportunity zone that primarily provide services. The percentage is based on a fraction, the numerator of which is the total number of hours spent by employees and independent contractors (and employees of independent contractors) performing services in a qualified opportunity zone during the taxable year, and the denominator of which is the total number of hours spent by employees and independent contractors (and employees of independent contractors) in performing services during the taxable year.

For example, consider a startup business that develops software applications for global sale in a campus located in a qualified opportunity zone. Because the business' global consumer base purchases such applications through internet download, the business' employees and independent contractors are able to devote the majority of

their total number of hours to developing such applications on the business' qualified opportunity zone campus. As a result, this startup business would satisfy the first safe harbor, even though the business makes the vast majority of its sales to consumers located outside of the qualified opportunity zone in which its campus is located.

The second safe harbor is based upon amounts paid by the trade or business for services performed in the qualified opportunity zone by employees and independent contractors (and employees of independent contractors). Under this test, if at least 50 percent of the services performed for the business by its employees and independent contractors (and employees of independent contractors) are performed in the qualified opportunity zone, based on amounts paid for the services performed, the business meets the 50-percent gross income test found in section 1397C(b)(2). This test is determined by a fraction, the numerator of which is the total amount paid by the entity for employee and independent contractor (and employees of independent contractors) services performed in a qualified opportunity zone during the taxable year, and the denominator of which is the total amount paid by the entity for employee and independent contractor (and employees of independent contractors) services performed during the taxable year.

For illustration, assume that the startup business described above also utilizes a service center located outside of the qualified opportunity zone and that more employees and independent contractor working hours are performed at the service center than the hours worked at the business' opportunity zone campus. While the majority of the total hours spent by employees and independent contractors of the startup business occur at the service center, the business pays 50 percent of its total

compensation for software development services performed by employees and independent contractors on the business' opportunity zone campus. As a result, the startup business satisfies the second safe harbor.

The third safe harbor is a conjunctive test concerning tangible property and management or operational functions performed in a qualified opportunity zone, permitting a trade or business to use the totality of its situation to meet the requirements of sections 1400Z-2(d)(3)(A)(i) and 1397C(b)(2). The proposed regulations provide that a trade or business may satisfy the 50-percent gross income requirement if (1) the tangible property of the business that is in a qualified opportunity zone and (2) the management or operational functions performed for the business in the qualified opportunity zone are each necessary to generate 50 percent of the gross income of the trade or business. Thus, for example, if a landscaper's headquarters are in a qualified opportunity zone, its officers and employees manage the daily operations of the business (occurring within and outside the qualified opportunity zone) from its headquarters, and all of its equipment and supplies are stored within the headquarters facilities or elsewhere in the qualified opportunity zone, then the management activity and the storage of equipment and supplies in the qualified opportunity zone are each necessary to generate 50 percent of the gross income of the trade or business. Conversely, the proposed regulations provide that if a trade or business only has a PO Box or other delivery address located in the qualified opportunity zone, the presence of the PO Box or other delivery address does not constitute a factor necessary to generate gross income by such business.

Finally, taxpayers not meeting any of the other safe harbor tests may meet the 50-percent requirement based on a facts and circumstances test if, based on all the facts and circumstances, at least 50 percent of the gross income of a trade or business is derived from the active conduct of a trade or business in the qualified opportunity zone.

The Treasury Department and the IRS request comments on the proposed safe harbor rules regarding the 50-percent gross income requirement, including comments offering possible additional safe harbors, such as one based on headcount of certain types of service providers, and whether certain modifications would be warranted to prevent potential abuses.

#### *C. Use of Intangibles*

As provided in 83 FR 54279 (October 29, 2018) and section 1400Z-2(d)(3), a qualified opportunity zone trade or business must satisfy section 1397C(b)(4). Section 1397C(b)(4) requires that, with respect to any taxable year, a substantial portion of the intangible property of a qualified business entity must be used in the active conduct of a trade or business in the qualified opportunity zone, but section 1397C does not provide a definition of “substantial portion.” The IRS and the Treasury Department have received comments asking for the definition of substantial portion. Accordingly, the proposed regulations provide that, for purposes of determining whether a substantial portion of intangible property of a qualified opportunity zone is used in the active conduct of a trade or business, the term substantial portion means at least 40 percent.

#### *D. Active Conduct of a Trade or Business*

Section 1400Z-2(d)(3)(A)(ii) also incorporates requirement (2) of section 1397C(b), which requires at least 50 percent of the total gross income of a qualified business entity to be derived from the active conduct of a trade or business within a zone. The IRS has received comments asking if the active conduct of a trade or business will be defined for purposes of section 1400Z-2. Other commentators have expressed concern that the leasing of real property by a qualified opportunity zone business may not amount to the active conduct of a trade or business if the business has limited leasing activity.

Section 162(a) permits a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business. The rules under section 162 for determining the existence of a trade or business are well-established, and there is a large body of case law and administrative guidance interpreting the meaning of a trade or business for that purpose. Therefore, these proposed regulations define a trade or business for purposes of section 1400Z-2 as a trade or business within the meaning of section 162. However, these proposed regulations provide that the ownership and operation (including leasing) of real property used in a trade or business is treated as the active conduct of a trade or business for purposes of section 1400Z-2(d)(3). No inference should be drawn from the preceding sentence as to the meaning of the “active conduct of a trade or business” for purposes of other provisions of the Code, including section 355.

The Treasury Department and the IRS request comments on the proposed definition of a trade or business for purposes of section 1400Z-2(d)(3). In addition, comments are requested on whether additional rules are needed in determining if a

trade or business is actively conducted. The Treasury Department and the IRS further request comments on whether it would be appropriate or useful to extend the requirements of section 1397C applicable to qualified opportunity zone businesses to QOFs.

#### *E. Working Capital Safe Harbor*

Responding to comments received on 83 FR 54279 (October 29, 2018) the proposed regulations make two changes to the safe harbor for working capital. First, the written designation for planned use of working capital now includes the development of a trade or business in the qualified opportunity zone as well as acquisition, construction, and/or substantial improvement of tangible property. Second, exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action the application for which is completed during the 31-month period.

#### IV. Special Rule for Section 1231 Gains

In 83 FR 54279 (October 29, 2018) the proposed regulations clarified that only capital gains are eligible for deferral under section 1400Z-2(a)(1). Section 1231(a)(1) provides that, if the section 1231 gains for any taxable year exceed the section 1231 losses, such gain shall be treated as long-term capital gain. Thus, the proposed regulations provide that only this gain shall be treated as an eligible gain for purposes of section 1400Z-2.

In addition, the preamble in 83 FR 54279 (October 29, 2018) stated that some capital gains are the result of Federal tax rules deeming an amount to be a gain from the sale or exchange of a capital asset, and, in many cases, the statutory language



providing capital gain treatment does not provide a specific date for the deemed sale. Thus, 83 FR 54279 (October 29, 2018) addressed this issue by providing that, except as specifically provided in the proposed regulations, the first day of the 180-day period set forth in section 1400Z-2(a)(1)(A) and the regulations thereunder is the date on which the gain would be recognized for Federal income tax purposes, without regard to the deferral available under section 1400Z-2. Consistent with 83 FR 54279 (October 29, 2018) and because the capital gain income from section 1231 property is determinable only as of the last day of the taxable year, these proposed regulations provide that the 180-day period for investing such capital gain income from section 1231 property in a QOF begins on the last day of the taxable year.

The Treasury Department and the IRS request comments on the proposed treatment of section 1231 gains.

## V. Relief with Respect to the 90-Percent Asset Test

### A. *Relief for Newly Contributed Assets*

A new QOF's ability to delay the start of its status as a QOF (and thus the start of its 90-percent asset tests) provides the QOF the ability to prepare to deploy new capital before that capital is received and must be tested. Failure to satisfy the 90-percent asset test on a testing date does not by itself cause an entity to fail to be a QOF within the meaning of section 1400Z-2(d)(1) (this is the case even if it is the QOF's first testing date). Some commentators on 83 FR 54279 (October 29, 2018) pointed out that this start-up rule does not help an existing QOF that receives new capital from an equity investor shortly before the next semi-annual test. The proposed regulations, therefore, allow a QOF to apply the test without taking into account any investments received in

the preceding 6 months. The QOF's ability to do this, however, is dependent on those new assets being held in cash, cash equivalents, or debt instruments with term 18 months or less.

#### *B. QOF Reinvestment Rule*

Section 1400Z-2(e)(4)(B) authorizes regulations to ensure a QOF has “a reasonable period of time to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests, and to reinvest proceeds received from the sale or disposition of qualified opportunity zone property.” For example, if a QOF, shortly before a testing date, sells qualified opportunity zone property, that QOF should have a reasonable amount of time in which to bring itself into compliance with the 90-percent asset test. Many stakeholders have requested guidance not only on the length of a “reasonable period of time to reinvest,” but also on the Federal income tax treatment of any gains that the QOF reinvests during such a period.

The proposed regulations provide that proceeds received by the QOF from the sale or disposition of (1) qualified opportunity zone business property, (2) qualified opportunity zone stock, and (3) qualified opportunity zone partnership interests are treated as qualified opportunity zone property for purposes of the 90-percent investment requirement described in 1400Z-1(d)(1) and (f), so long as the QOF reinvests the proceeds received by the QOF from the distribution, sale, or disposition of such property during the 12-month period beginning on the date of such distribution, sale, or disposition. The one-year rule is intended to allow QOFs adequate time in which to reinvest proceeds from qualified opportunity zone property. Further, in order for the

reinvested proceeds to be counted as qualified opportunity zone business property, from the date of a distribution, sale, or disposition until the date proceeds are invested in other qualified opportunity zone property, the proceeds must be continuously held in cash, cash equivalents, and debt instruments with a term of 18 months or less. Finally, a QOF may reinvest proceeds from the sale of an investment into another type of qualifying investment. For example, a QOF may reinvest proceeds from a sale of an investment in qualified opportunity stock into qualified opportunity zone business property. Analogous to the flexibility in the safe harbor for working capital, the proposed regulations extend QOF reinvestment relief from application of the 90-percent asset test if failure to meet the 12-month deadline is attributable to delay in government action the application for which is complete.

The Treasury Department and the IRS request comments on whether an analogous rule for QOF subsidiaries to reinvest proceeds from the disposition of qualified opportunity zone property would be beneficial.

Additionally, commenters have requested that the grant of authority in section 1400Z-2(e)(4)(B) be used to exempt QOFs and investors in QOFs from the Federal income tax consequences of dispositions of qualified opportunity zone property by QOFs or qualified opportunity zone businesses if the proceeds from such dispositions are reinvested within a reasonable timeframe. The Treasury Department and the IRS believe that the grant of this regulatory authority permits QOFs a reasonable time to reinvest such proceeds without the QOF being harmed (that is, without the QOF incurring the penalty set forth in section 1400Z-2(f) because the proceeds would not be qualified opportunity zone property). However, the statutory language granting this

regulatory authority does not specifically authorize the Secretary to prescribe rules for QOFs departing from the otherwise operative recognition provisions of sections 1001(c) and 61(a)(3).

Regarding the tax benefits provided to investors in QOFs under section 1400Z-2(b) and (c), as stated earlier, sections 1400Z-1 and 1400Z-2 seek to encourage economic growth and investment in designated distressed communities (qualified opportunity zones) by providing Federal income tax benefits to taxpayers who invest in businesses located within these zones through a QOF. Congress tied these tax incentives to the longevity of an investor's stake in a QOF, not to a QOF's stake in any specific portfolio investment. Further, Congress expressly recognized that many QOFs would experience investment "churn" over the lifespan of the QOF and anticipated this by providing the Secretary the regulatory latitude for permitting QOFs a reasonable time to reinvest capital. Consistent with this regulatory authority, the Treasury Department and the IRS clarify that sales or dispositions of assets by a QOF do not impact in any way investors' holding periods in their qualifying investments or trigger the inclusion of any deferred gain reflected in such qualifying investments so long as they do not sell or otherwise dispose of their qualifying investment for purposes of section 1400Z-2(b). However, the Treasury Department and the IRS are not able to find precedent for the grant of authority in section 1400Z-2(e)(4)(B) to permit QOFs a reasonable time to reinvest capital and allow the Secretary to prescribe regulations permitting QOFs or their investors to avoid recognizing gain on the sale or disposition of assets under sections 1001(c) and 61(a)(3), and notes that examples of provisions in subtitle A of the Code that provide for nonrecognition treatment or exclusion from income can be found

in sections 351(a), 354(a), 402(c), 501(a), 721(a), 1031(a), 1032(a), and 1036(a), among others, some of which are applied in the proposed rules and described as selected examples in this preamble. In this regard, the Treasury Department and the IRS are requesting commenters to provide prior examples of tax regulations that exempt realized gain from being recognized under sections 1001(c) or 61(a)(3) by a taxpayer (either a QOF or qualified opportunity zone business, or in the case of QOF partnerships or QOF S corporations, the investors that own qualifying investments in such QOFs) without an operative provision of subtitle A of the Code expressly providing for nonrecognition treatment; as well as to provide any comments on the possible burdens imposed if these organizations are required to reset the holding period for reinvested realized gains, including administrative burdens and the potential chilling effect on investment incentives that may result from these possible burdens, and whether specific organizational forms could be disproportionately burdened by this proposed policy.

#### VI. Amount of an Investment for Purposes of Making a Deferral Election

A taxpayer may make an investment for purposes of an election under section 1400Z-2(a) by transferring cash or other property to a QOF, regardless of whether the transfer is taxable to the transferor (such as where the transferor is not in control of the transferee corporation), provided the transfer is not re-characterized as a transaction other than an investment in the QOF (as would be the case where a purported contribution to a partnership is treated as a disguised sale). These proposed regulations provide special rules for determining the amount of an investment for purposes of this election if a taxpayer transfers property other than cash to a QOF in a

carryover basis transaction. In that case, the amount of the investment equals the lesser of the taxpayer's adjusted basis in the equity received in the transaction (determined without regard to section 1400Z-2(b)(2)(B)) or the fair market value of the equity received in the transaction (both as determined immediately after the transaction). In the case of a contribution to a partnership that is a QOF (QOF partnership), the basis in the equity to which section 1400Z-2(b)(2)(B)(i) applies is calculated without regard to any liability that is allocated to the contributor under section 752(a). These rules apply separately to each item of property contributed to a QOF, but the total amount of the investment for purposes of the election is limited to the amount of the gain described in section 1400Z-2(a)(1).

The proposed regulations set forth two special rules that treat a taxpayer as having created a mixed-funds investment (within the meaning of proposed §1.1400Z2(b)-1(a)(2)(v)). First, a mixed-funds investment will result if a taxpayer contributes to a QOF, in a nonrecognition transaction, property that has a fair market value in excess of the property's adjusted basis. Second, a mixed-funds investment will result if the amount of the investment that might otherwise support an election exceeds the amount of the taxpayer's eligible gain described in section 1400Z-2(a)(1). In each instance, that excess (that is, the excess of fair market value over adjusted basis, or the excess of the investment amount over eligible gain, as appropriate) is treated as an investment described in section 1400Z-2(e)(1)(A)(ii) (that is, the portion of the contribution to which a deferral election does not apply).

If a taxpayer acquires a direct investment in a QOF from a direct owner of the QOF, these proposed regulations also provide that, for purposes of making an election

under section 1400Z-2(a), the taxpayer is treated as making an investment in an amount equal to the amount paid for the eligible interest.

The Treasury Department and the IRS request comments on the proposed rules regarding the amount with respect to which a taxpayer may make a deferral election under section 1400Z-2(a).

## VII. Events That Cause Inclusion of Deferred Gain (Inclusion Events)

### *A. In General*

Section 1400Z-2(b)(1) provides that the amount of gain that is deferred if a taxpayer makes an equity investment in a QOF described in section 1400Z-2(e)(1)(A)(i) (qualifying investment) will be included in the taxpayer's income in the taxable year that includes the earlier of (A) the date on which the qualifying investment is sold or exchanged, or (B) December 31, 2026. By using the terms "sold or exchanged," section 1400Z-2(b)(1) does not directly address non-sale or exchange dispositions, such as gifts, bequests, devises, charitable contributions, and abandonments of qualifying investments. However, the Conference Report to accompany H.R. 1, Report 115-466 (Dec. 15, 2017) provides that, under section 1400Z-2(b)(1), the "deferred gain is recognized on the earlier of the date on which the [qualifying] investment is disposed of or December 31, 2026." See Conference Report at 539.

The proposed regulations track the disposition language set forth in the Conference Report and clarify that, subject to enumerated exceptions, an inclusion event results from a transfer of a qualifying investment in a transaction to the extent the transfer reduces the taxpayer's equity interest in the qualifying investment for Federal income tax purposes. Notwithstanding that general principle, and except as otherwise

provided in the proposed regulations, a transaction that does not reduce a taxpayer's equity interest in the taxpayer's qualifying investment is also an inclusion event under the proposed regulations to the extent the taxpayer receives property from a QOF in a transaction treated as a distribution for Federal income tax purposes. For this purpose, property generally is defined as money, securities, or any other property, other than stock (or rights to acquire stock) in the corporation that is a QOF (QOF corporation) that is making the distribution. The Treasury Department and the IRS have determined that it is necessary to treat such transactions as inclusion events to prevent taxpayers from "cashing out" a qualifying investment in a QOF without including in gross income any amount of their deferred gain.

Based upon the guidance set forth in the Conference Report and the principles underlying the "inclusion event" concept described in the preceding paragraphs, the proposed regulations provide taxpayers with a nonexclusive list of inclusion events, which include:

- (1) A taxable disposition (for example, a sale) of all or a part of a qualifying investment (qualifying QOF partnership interest) in a QOF partnership or of a qualifying investment (qualifying QOF stock) in a QOF corporation;
- (2) A taxable disposition (for example, a sale) of interests in an S corporation which itself is the direct investor in a QOF corporation or QOF partnership if, immediately after the disposition, the aggregate percentage of the S corporation interests owned by the S corporation shareholders at the time of its deferral election has changed by more than 25 percent. When the threshold is exceeded, any deferred gains recognized would be reported



under the provisions of subchapter S of chapter 1 of subtitle A of the Code (subchapter S);

- (3) In certain cases, a transfer by a partner of an interest in a partnership that itself directly or indirectly holds a qualifying investment;
- (4) A transfer by gift of a qualifying investment;
- (5) The distribution to a partner of a QOF partnership of property that has a value in excess of basis of the partner's qualifying QOF partnership interest;
- (6) A distribution of property with respect to qualifying QOF stock under section 301 to the extent it is treated as gain from the sale or exchange of property under section 301(c)(3);
- (7) A distribution of property with respect to qualifying QOF stock under section 1368 to the extent it is treated as gain from the sale or exchange of property under section 1368(b)(2) and (c);
- (8) A redemption of qualifying QOF stock that is treated as an exchange of property for the redeemed qualifying QOF stock under section 302;
- (9) A disposition of qualifying QOF stock in a transaction to which section 304 applies;
- (10) A liquidation of a QOF corporation in a transaction to which section 331 applies; and
- (11) Certain nonrecognition transactions, including:
  - a. A liquidation of a QOF corporation in a transaction to which section 332 applies;

- b. A transfer of all or part of a taxpayer's qualifying QOF stock in a transaction to which section 351 applies;
- c. A stock-for-stock exchange of qualifying QOF stock in a transaction to which section 368(a)(1)(B) applies;
- d. A triangular reorganization of a QOF corporation within the meaning of §1.358-6(b)(2);
- e. An acquisitive asset reorganization in which a QOF corporation transfers its assets to its shareholder and terminates (or is deemed to terminate) for Federal income tax purposes;
- f. An acquisitive asset reorganization in which a corporate taxpayer that made the qualifying investment in the QOF corporation (QOF shareholder) transfers its assets to the QOF corporation and terminates (or is deemed to terminate) for Federal income tax purposes;
- g. An acquisitive asset reorganization in which a QOF corporation transfers its assets to an acquiring corporation that is not a QOF corporation within a prescribed period after the transaction;
- h. A recapitalization of a QOF corporation, or a contribution by a QOF shareholder of a portion of its qualifying QOF stock to the QOF corporation, if the transaction has the result of reducing the taxpayer's equity interest in the QOF corporation;
- i. A distribution by a QOF shareholder of its qualifying QOF stock to its shareholders in a transaction to which section 355 applies;

- j. A transfer by a QOF corporation of subsidiary stock to QOF shareholders in a transaction to which section 355 applies if, after a prescribed period following the transaction, either the distributing corporation or the controlled corporation is not a QOF; and
- k. A transfer to, or an acquisitive asset reorganization of, an S corporation which itself is the direct investor in a QOF corporation or QOF partnership if, immediately after the transfer or reorganization, the percentage of the S corporation interests owned by the S corporation shareholders at the time of its deferral election has decreased by more than 25 percent.

Each of the previously described transactions would be an inclusion event because each would reduce or terminate the QOF investor's direct (or, in the case of partnerships, indirect) qualifying investment for Federal income tax purposes or (in the case of distributions) would constitute a "cashing out" of the QOF investor's qualifying investment. As a result, the QOF investor would recognize all, or a corresponding portion, of its deferred gain under section 1400Z-2(a)(1)(B) and (b).

The Treasury Department and the IRS request comments on the proposed rules regarding the inclusion events that would result in a QOF investor recognizing an amount of deferred gain under section 1400Z-2(a)(1)(B) and (b), including the pledging of qualifying investments as collateral for nonrecourse loans.

#### *B. Timing of Basis Adjustments*

Under section 1400Z-2(b)(2)(B)(i), an electing taxpayer's initial basis in a qualifying investment is zero. Under section 1400Z-2(b)(2)(B)(iii) and (iv), a taxpayer's basis in its qualifying investment is increased automatically after the investment has

been held for five years by an amount equal to 10 percent of the amount of deferred gain, and then again after the investment has been held for seven years by an amount equal to an additional five percent of the amount of deferred gain. The proposed regulations clarify that such basis is basis for all purposes and, for example, losses suspended under section 704(d) would be available to the extent of the basis step-up.

The proposed regulations also clarify that basis adjustments under section 1400Z-2(b)(2)(B)(ii), which reflect the recognition of deferred gain upon the earlier of December 31, 2026, or an inclusion event, are made immediately after the amount of deferred capital gain is taken into income. If a basis adjustment is made under section 1400Z-2(b)(2)(B)(ii) as a result of a reduction in direct tax ownership of a qualifying investment, a redemption, a distribution treated as gain from the sale or exchange of property under section 301(c)(3) or section 1368(b)(2) and (c), or a distribution to a partner of property with a value in excess of the partner's basis in the qualifying QOF partnership interest, the basis adjustment is made before determining the tax consequences of the inclusion event with respect to the qualifying investment (for example, before determining the recovery of basis under section 301(c)(2) or the amount of gain the taxpayer must take into account under section 301, section 1368, or the provisions of subchapter K of chapter 1 of subtitle A of the Code (subchapter K), as applicable). For a discussion of distributions as inclusion events, see part VII.G of this Explanation of Provisions.

The proposed regulations further clarify that, if the taxpayer makes an election under section 1400Z-2(c), the basis adjustment under section 1400Z-2(c) is made immediately before the taxpayer disposes of its QOF investment. For dispositions of

qualifying QOF partnership interests, the bases of the QOF partnership's assets are also adjusted with respect to the transferred qualifying QOF partnership interest, with such adjustments calculated in a manner similar to the adjustments that would have been made to the partnership's assets if the partner had purchased the interest for cash immediately prior to the transaction and the partnership had a valid section 754 election in effect. This will permit basis adjustments to the QOF partnership's assets, including its inventory and unrealized receivables, and avoid the creation of capital losses and ordinary income on the sale. See part VII.D.4 of this Explanation of Provisions for a special election for direct investors in QOF partnerships and S corporations that are QOFs (QOF S corporations) for the application of section 1400Z-2(c) to certain sales of assets of a QOF partnership or QOF S corporation. With respect to that special election, the Treasury Department and the IRS intend to implement targeted anti-abuse provisions (for example, provisions addressing straddles). The Treasury Department and IRS request comments on whether one or more such provisions are appropriate to carry out the purposes of section 1400Z-2.

More generally, the Treasury Department and the IRS request comments on the proposed rules regarding the timing of basis adjustments under section 1400Z-2(b) and (c).

### *C. Amount Includible*

In general, other than with respect to partnerships, if a taxpayer has an inclusion event with regard to its qualifying investment in a QOF, the taxpayer includes in gross income the lesser of two amounts, less the taxpayer's basis. The first amount is the fair market value of the portion of the qualifying investment that is disposed of in the

inclusion event. For purposes of this section, the fair market value of that portion is determined by multiplying the fair market value of the taxpayer's entire qualifying investment in the QOF, valued as of the date of the inclusion event, by the percentage of the taxpayer's qualifying investment that is represented by the portion disposed of in the inclusion event. The second amount is the amount that bears the same ratio to the remaining deferred gain as the first amount bears to the total fair market value of the qualifying investment in the QOF immediately before the transaction.

For inclusion events involving partnerships, the amount includible is equal to the percentage of the qualifying QOF partnership interest disposed of, multiplied by the lesser of: (1) the remaining deferred gain less any basis adjustments pursuant to section 1400Z-2(b)(2)(B)(iii) and (iv) or (2) the gain that would be recognized by the partner if the interest were sold in a fully taxable transaction for its then fair market value.

For inclusion events involving a QOF shareholder that is an S corporation, if the S corporation undergoes an aggregate change in ownership of more than 25 percent, there is an inclusion event with respect to all of the S corporation's remaining deferred gain (see part VII.D.3 of this Explanation of Provisions).

A special "dollar-for-dollar" rule applies in certain circumstances if a QOF owner receives property from a QOF that gives rise to an inclusion event. These circumstances include actual distributions with respect to qualifying QOF stock that do not reduce a taxpayer's direct interest in qualifying QOF stock, stock redemptions to which section 302(d) applies, and the receipt of boot in certain corporate reorganizations, as well as actual or deemed distributions with respect to qualifying

QOF partnership interests. This dollar-for-dollar rule would be simpler to administer than a rule that would require taxpayers to undertake valuations of QOF investments each time a QOF owner received a distribution with respect to the qualifying investment or received boot in a corporate reorganization. If this dollar-for-dollar rule applies, the taxpayer includes in gross income an amount of the taxpayer's remaining deferred gain equal to the lesser of (1) the remaining deferred gain, or (2) the amount that gave rise to the inclusion event. The Treasury Department and the IRS request comments on the dollar-for-dollar rule and the circumstances in which this rule would apply under these proposed regulations.

#### *D. Partnership and S Corporation Provisions*

##### 1. Partnership Provisions in General

With respect to property contributed to a QOF partnership in exchange for a qualifying investment, the partner's basis in the qualifying interest is zero under section 1400Z-2(b)(2)(B)(i), increased by the partner's share of liabilities under section 752(a). However, the carryover basis rules of section 723 apply in determining the basis to the partnership of property contributed. The Treasury Department and the IRS are aware that, where inside-outside basis disparities exist in a partnership, taxpayers could manipulate the rules of subchapter K to create non-economic gains and losses. Accordingly, the Treasury Department and the IRS request comments on rules that would limit abusive transactions that could be undertaken as a result of these disparities.

The proposed regulations provide that the transfer by a partner of all or a portion of its interest in a QOF partnership or in a partnership that directly or indirectly holds a

qualifying investment generally will be an inclusion event. However, a transfer in a transaction governed by section 721 (partnership contributions) or section 708(b)(2)(A) (partnership mergers) is generally not an inclusion event, provided there is no reduction in the amount of the remaining deferred gain that would be recognized under section 1400Z-2 by the transferring partners on a later inclusion event. Similar rules apply in the case of tiered partnerships. However, the resulting partnership or new partnership becomes subject to section 1400Z-2 to the same extent as the original taxpayer that made the qualifying investment in the QOF.

Partnership distributions in the ordinary course of partnership operations may, in certain instances, also be considered inclusion events. Under the proposed regulations, the actual or deemed distribution of cash or other property with a fair market value in excess of the partner's basis in its qualifying QOF partnership interest is also an inclusion event.

## 2. Partnership Mixed-Funds Investments

Rules specific to section 1400Z-2 are needed for mixed-funds investments where a partner contributes to a QOF property with a value in excess of its basis, or cash in excess of the partner's eligible section 1400Z-2 gain, or where a partner receives a partnership interest in exchange for services (for example, a carried interest). Section 1400Z-2(e)(1) provides that only the portion of the investment in a QOF to which an election under section 1400Z-2(a) is in effect is treated as a qualifying investment. Under this rule, the share of gain attributable to the excess investment and/or the service component of the interest in the QOF partnership is not eligible for the various benefits afforded qualifying investments under section 1400Z-2 and is not subject to the



inclusion rules of section 1400Z-2. This is the case with respect to a carried interest, despite the fact that all of the partnership's investments might be qualifying investments.

The Treasury Department and the IRS considered various approaches to accounting for a partner holding a mixed-funds investment in a QOF partnership and request comments on the approach adopted by the proposed regulations. For example, a partner could be considered to own two separate investments and separately track the basis and value of the investments, similar to a shareholder tracking two separate blocks of stock. However, that approach is inconsistent with the subchapter K principle that a partner has a unitary basis and capital account in its partnership interest. Thus, the proposed regulations adopt the approach that a partner holding a mixed-funds investment will be treated as holding a single partnership interest with a single basis and capital account for all purposes of subchapter K, but not for purposes of section 1400Z-2. Under the proposed regulations, solely for purposes of section 1400Z-2, the mixed-funds partner will be treated as holding two interests, and all partnership items, such as income and debt allocations and property distributions, would affect qualifying and non-qualifying investments proportionately, based on the relative allocation percentages of each interest. Allocation percentages would generally be based on relative capital contributions for qualifying investments and other investments. However, section 704(c) principles apply to partnership allocations attributable to property with value-basis disparities to prevent inappropriate shifts of built-in gains or losses between qualifying investments and non-qualifying investments. Additionally, special rules apply in calculating the allocation percentages in the case of a partner who receives a profits interest for services, with the percent attributable to the profits interest

being treated as a non-qualifying investment to the extent of the highest percentage interest in residual profits attributable to the interest.

In the event of an additional contribution of qualifying or non-qualifying amounts, a revaluation of the relative partnership investments is required immediately before the contribution in order to adequately account for the two components.

Consistent with the unitary basis rules of subchapter K, a distribution of money would not give rise to section 731 gain unless the distribution exceeded the partner's total outside basis. For example, if a partner contributed \$200 to a QOF partnership, half of which related to deferred section 1400Z-2 gain, and \$20 of partnership debt was allocated to the partner, the partner's outside basis would be \$120 (zero for the qualifying investment contribution, plus \$100 for the non-qualifying investment contribution, plus \$20 under section 752(a)), and only a distribution of money in excess of that amount would trigger gain under subchapter K. However, for purposes of calculating the section 1400Z-2 gain, the qualifying investment portion of the interest would have a basis of \$10, with the remaining \$110 attributable to the non-qualifying investment. A distribution of \$40 would be divided between the two investments and would not result in gain under section 731; however, the distribution would constitute an inclusion event under section 1400Z-2, and the partner would be required to recognize gain in the amount of \$10 (the excess of the \$20 distribution attributable to the qualifying investment over the \$10 basis in the interest).

The Treasury Department and the IRS are concerned with the potential complexity associated with this approach and request comments on alternative ways to account for distributions in the case of a mixed-funds investment in a QOF partnership.

The Treasury Department and the IRS also request comments on whether an ordering rule treating the distribution as attributable to the qualifying or non-qualifying investment portion first is appropriate, and how any alternative approach would simplify the calculations.

### 3. Application to S Corporations

Under section 1371(a), and for purposes of these proposed regulations, the rules of subchapter C of chapter 1 of subtitle A of the Code (subchapter C) applicable to C corporations and their shareholders apply to S corporations and their shareholders, except to the extent inconsistent with the provisions of subchapter S. In such instances, S corporations and their shareholders are subject to the specific rules of subchapter S. For example, similar to rules applicable to QOF partnerships, a distribution of property to which section 1368 applies by a QOF S corporation is an inclusion event to the extent that the distributed property has a fair market value in excess of the shareholder's basis, including any basis adjustments under section 1400Z-2(b)(2)(B)(iii) and (iv). In addition, the rules set forth in these proposed regulations regarding liquidations and reorganizations of QOF C corporations and QOF C corporation shareholders apply equally to QOF S corporations and QOF S corporation shareholders.

However, flow-through principles under subchapter S apply to S corporations when the application of subchapter C would be inconsistent with subchapter S. For example, if an inclusion event were to occur with respect to deferred gain of an S corporation that is an investor in a QOF, the shareholders of such S corporation would include such gain pro rata in their respective taxable incomes. Consequently, those S corporation shareholders would increase their bases in their S corporation stock

at the end of the taxable year during which the inclusion event occurred. Pursuant to the S corporation distribution rules set forth in section 1368, the S corporation shareholders would receive future distributions from the S corporation tax-free to the extent of the deferred tax amount included in income and included in stock basis.

In addition, these proposed regulations set forth specific rules for S corporations to provide certainty to taxpayers regarding the application of particular provisions under section 1400Z-2. Regarding section 1400Z-2(b)(1)(A), these proposed regulations clarify that a conversion of an S corporation that holds a qualifying investment in a QOF to a C corporation (or a C corporation to an S corporation) is not an inclusion event because the interests held by each shareholder of the C corporation or S corporation, as appropriate, would remain unchanged with respect to the corporation's qualifying investment in a QOF. With regard to mixed-funds investments in a QOF S corporation described in section 1400Z-2(e)(1), if different blocks of stock are created for otherwise qualifying investments to track basis in these qualifying investments, the proposed regulations make clear that the separate blocks will not be treated as different classes of stock for purposes of S corporation eligibility under section 1361(b)(1).

The proposed regulations also provide that, if an S corporation is an investor in a QOF, the S corporation must adjust the basis of its qualifying investment in the manner set forth for C corporations in proposed §1.1400Z2(b)-1(g), except as otherwise provided in these rules. This rule does not affect adjustments to the basis of any other asset of the S corporation. The S corporation shareholder's pro-rata share of any recognized deferred capital gain at the S corporation level will be separately stated under section 1366 and will adjust the shareholders' stock basis under section 1367. In

addition, the proposed regulations make clear that any adjustment made to the basis of an S corporation's qualifying investment under section 1400Z-2(b)(2)(B)(iii) or (iv) or section 1400Z-2(c) will not (1) be separately stated under section 1366, and (2) until the date on which an inclusion event with respect to the S corporation's qualifying investment occurs, adjust the shareholders' stock basis under section 1367. If a basis adjustment under section 1400Z-2(b)(2)(B)(ii) is made as a result of an inclusion event, then the basis adjustment will be made before determining the other tax consequences of the inclusion event.

Finally, under these proposed regulations, special rules would apply in the case of certain ownership shifts in S corporations that are QOF owners. Under these rules, solely for purposes of section 1400Z-2, the S corporation's qualifying investment in the QOF would be treated as disposed of if there is a greater-than-25 percent change in ownership of the S corporation (aggregate change in ownership). If an aggregate change in ownership has occurred, the S corporation would have an inclusion event with respect to all of the S corporation's remaining deferred gain, and neither section 1400Z-2(b)(2)(B)(iii) or (iv), nor section 1400Z-2(c), would apply to the S corporation's qualifying investment after that date. This proposed rule attempts to balance the status of the S corporation as the owner of the qualifying investment with the desire to preserve the incidence of the capital gain inclusion and income exclusion benefits under section 1400Z-2. The Treasury Department and the IRS request comments on the proposed rules regarding ownership changes in S corporations that are QOF owners.

#### 4. Special Election for Direct Investors in QOF Partnerships and QOF S Corporations

For purposes of section 1400Z-2(c), which applies to investments held for at least 10-years, a taxpayer that is the holder of a direct qualifying QOF partnership interest or qualifying QOF stock of a QOF S corporation may make an election to exclude from gross income some or all of the capital gain from the disposition of qualified opportunity zone property reported on Schedule K-1 of such entity, provided the disposition occurs after the taxpayer's 10-year holding period. To the extent that such Schedule K-1 separately states capital gains arising from the sale or exchange of any particular capital asset, the taxpayer may make an election under section 1400Z-2(c) with respect to such separately stated item. To be valid, the taxpayer must make such election for the taxable year in which the capital gain from the sale or exchange of QOF property recognized by the QOF partnership or QOF S corporation would be included in the taxpayer's gross income, in accordance with applicable forms and instructions. If a taxpayer makes this election with respect to some or all of the capital gain reported on such Schedule K-1, the amount of such capital gain that the taxpayer elects to exclude from gross income is excluded from income for purposes of the Internal Revenue Code and the regulations thereunder. For basis purposes, such excluded amount is treated as an item of income described in sections 705(a)(1) or 1366 thereby increasing the partners or shareholders' bases by their shares of such amount. These proposed regulations provide no similar election to holders of qualifying QOF stock of a QOF C corporation that is not a QOF REIT.

The Treasury Department and the IRS request comments on the eligibility for, and the operational mechanics of, the proposed rules regarding this special election.

5. Ability of QOF REITs to pay tax-free capital gain dividends to 10-plus-year investors

The proposed rules authorize QOF real estate investment trusts (QOF REITs) to designate special capital gain dividends, not to exceed the QOF REIT's long-term gains on sales of Qualified Opportunity Zone property. If some QOF REIT shares are qualified investments in the hands of some shareholders, those special capital gain dividends are tax free to shareholders who could have elected a basis increase in case of a sale of the QOF REIT shares. The Treasury Department and the IRS request comments on the eligibility for, and the operational mechanics of, the proposed rules regarding this special treatment.

*E. Transfers of Property by Gift or by Reason of Death*

For purposes of sections 1400Z-2(b) and (c), any disposition of the owner's qualifying investment is an inclusion event for purposes of section 1400Z-2(b)(1) and proposed §1.1400Z2(b)-1(a), except as provided in these proposed regulations. Generally, transfers of property by gift, in part or in whole, either will reduce or terminate the owner's qualifying investment. Accordingly, except as provided in these proposed regulations, transfers by gift will be inclusion events for purposes of section 1400Z-2(b)(1) and proposed §1.1400Z2(b)-1(c).

For example, a transfer of a qualifying investment by gift from the donor, in this case the owner, to the donee either will reduce or will terminate the owner's qualifying investment, depending upon whether the owner transfers part or all of the owner's qualifying investment. A charitable contribution, as defined in section 170(c), of a qualifying interest is also an inclusion event because, again, the owner's qualifying investment is terminated upon the transfer. However, a transfer of a qualifying investment by gift by the taxpayer to a trust that is treated as a grantor trust of which the

taxpayer is the deemed owner is not an inclusion event. The rationale for this exception is that, for Federal income tax purposes, the owner of the grantor trust is treated as the owner of the property in the trust until such time that the owner releases certain powers that cause the trust to be treated as a grantor trust. Accordingly, the owner's qualifying investment is not reduced or eliminated for Federal income tax purposes upon the transfer to such a grantor trust. However, any change in the grantor trust status of the trust (except by reason of the grantor's death) is an inclusion event because the owner of the trust property for Federal income tax purposes is changing.

Most transfers by reason of death will terminate the owner's qualifying investment. For example, the qualifying investment may be distributed to a beneficiary of the owner's estate or may pass by operation of law to a named beneficiary. In each case, the owner's qualifying investment is terminated. Nevertheless, in part because of the statutory direction that amounts recognized that were not properly includible in the gross income of the deceased owner are to be includible in gross income as provided in section 691, the Treasury Department and the IRS have concluded that the distribution of the qualifying investment to the beneficiary by the estate or by operation of law is not an inclusion event for purposes of section 1400Z-2(b). Thus, the proposed regulations would provide that neither a transfer of the qualifying investment to the deceased owner's estate nor the distribution by the estate to the decedent's legatee or heir is an inclusion event for purposes of section 1400Z-2(b). Similarly, neither the termination of grantor trust status by reason of the grantor's death nor the distribution by that trust to a trust beneficiary by reason of the grantor's death is an inclusion event for purposes of section 1400Z-2(b). In each case, the recipient of the qualifying investment has the



obligation, as under section 691, to include the deferred gain in gross income in the event of any subsequent inclusion event, including for example, any further disposition by that recipient.

*F. Exceptions for Disregarded Transfers and Certain Types of Nonrecognition Transactions*

1. In general

Proposed §1.1400Z2(b)-1(c) describes certain transfers that are not inclusion events with regard to a taxpayer's qualifying investment for purposes of section 1400Z-2(b)(1). For example, a taxpayer's transfer of its qualifying investment to an entity that is disregarded as separate from the taxpayer for Federal income tax purposes is not an inclusion event because the transfer is disregarded for Federal income tax purposes. The same rationale applies here as in the case of a taxpayer's transfer of its qualifying investment to a grantor trust of which the taxpayer is the deemed owner. However, a change in the entity's status as disregarded would be an inclusion event.

Additionally, a transfer of a QOF's assets in an acquisitive asset reorganization described in section 381(a)(2) (qualifying section 381 transaction) generally is not an inclusion event if the acquiring corporation is a QOF within a prescribed period of time after the transaction. Following such a qualifying section 381 transaction, the taxpayer retains a direct qualifying investment in a QOF with an exchanged basis. However, the proposed regulations provide that a qualifying section 381 transaction generally is an inclusion event, even if the acquiring corporation qualifies as a QOF within the prescribed post-transaction period, to the extent the taxpayer receives boot in the reorganization (other than boot that is treated as a dividend under section 356(a)(2))

because, in those situations, the taxpayer reduces its direct qualifying investment in the QOF (see part VII.F.2 of this Explanation of Provisions).

A transfer of a QOF shareholder's assets in a qualifying section 381 transaction also is not an inclusion event, except to the extent the QOF shareholder transfers less than all of its qualifying investment in the transaction, because the successor to the QOF shareholder will retain a direct qualifying investment in the QOF. Similar reasoning extends to a transfer of a QOF shareholder's assets in a liquidation to which section 332 applies, to the extent that no gain or loss is recognized by the QOF shareholder on the distribution of the QOF interest to the 80-percent distributee, pursuant to section 337(a). This rule does not apply if the QOF shareholder is an S corporation and if the qualifying section 381 transaction causes the S corporation to have an aggregate ownership change of more than 25 percent (as discussed in part VII.D.2 of this Explanation of Provisions).

Moreover, the distribution by a QOF of a subsidiary in a transaction to which section 355 (or so much of section 356 as relates to section 355) applies is not an inclusion event if both the distributing corporation and the controlled corporation qualify as QOFs immediately after the distribution (qualifying section 355 transaction), except to the extent the taxpayer receives boot. The Treasury Department and the IRS have determined that continued deferral under section 1400Z-2(a)(1)(A) is appropriate in the case of a qualifying section 355 transaction because the QOF shareholder continues its original direct qualifying investment, albeit reflected in investments in two QOF corporations.

Finally, a recapitalization (within the meaning of section 368(a)(1)(E)) of a QOF is not an inclusion event, as long as the QOF shareholder does not receive boot in the transaction and the transaction does not reduce the QOF shareholder's proportionate interest in the QOF corporation. Similar rules apply to a transaction described in section 1036.

## 2. Boot in a reorganization

An inclusion event generally will occur if a QOF shareholder receives boot in a qualifying section 381 transaction in which a QOF's assets are acquired by another QOF corporation. Under proposed §1.1400Z2(b)-1(c), if the taxpayer realizes a gain on the transaction, the amount that gives rise to the inclusion event is the amount of gain under section 356 that is not treated as a dividend (see section 356(a)(2)). A similar rule applies to boot received by a QOF shareholder in a qualifying section 355 transaction to which section 356(a) applies. If the taxpayer in a qualifying section 381 transaction realizes a loss on the transaction, the amount that gives rise to the inclusion event is an amount equal to the fair market value of the boot received.

However, if both the target QOF and the acquiring corporation are wholly and directly owned by a single shareholder (or by members of the same consolidated group), and if the shareholder receives (or the group members receive) boot with respect to a qualifying investment, proposed §1.1400Z2(b)-1(c)(8) (applicable to distributions by QOF corporations) applies to the boot as if it were distributed in a separate transaction to which section 301 applies.

Similarly, the corporate distribution rules of proposed §1.1400Z2(b)-1(c)(8) would apply to a QOF shareholder's receipt of boot in a qualifying section 355 transaction to

which section 356(b) applies. By its terms, section 356(b) states that the corporate distribution rules of section 301 apply if a distributing corporation distributes both stock of its controlled corporation and boot. As a result, under these proposed regulations, there would be an inclusion event to the extent section 301(c)(3) would apply to the distribution. The Treasury Department and the IRS request comments on the proposed treatment of the receipt of boot as an inclusion event.

If the qualifying section 381 transaction is an intercompany transaction, the rules in §1.1502-13(f)(3) regarding boot in a reorganization apply to treat the boot as received in a separate distribution. These rules do not apply in cases in which either party to the distribution becomes a member or nonmember as part of the same plan or arrangement. However, as noted in part VIII of this Explanation of Provisions, a qualifying section 355 transaction cannot be an intercompany transaction.

#### *G. Distributions and Contributions*

Under the proposed regulations, and subject to certain exceptions, distributions made with respect to qualifying QOF stock (including redemptions of qualifying QOF stock that are treated as distributions to which section 301 applies) and certain distributions with respect to direct or indirect investments in a QOF partnership are treated as inclusion events. In the case of a QOF corporation, an actual distribution with respect to a qualifying investment results in inclusion only to the extent it is treated as gain from a sale or exchange under section 301(c)(3). A distribution to which section 301(c)(3) applies results in inclusion because that portion of the distribution is treated as gain from the sale or exchange of property. Actual distributions treated as dividends under section 301(c)(1) are not inclusion events because such distributions neither

reduce a QOF shareholder's direct equity investment in the QOF nor constitute a "cashing out" of the QOF shareholder's equity investment in the QOF. In turn, actual distributions to which section 301(c)(2) applies are not inclusion events because the reduction of basis under that statutory provision is not treated as gain from the sale or exchange of property.

For these purposes, a distribution of property also includes a distribution of stock by a QOF that is treated as a distribution of property to which section 301 applies under section 305(b). The Treasury Department and the IRS have determined that this type of distribution should be an inclusion event, even though it does not reduce the recipient's interest in the QOF, because it results in an increase in the basis of QOF stock. The Treasury Department and the IRS request comments on the proposed treatment of distributions to which section 305(b) applies.

In the case of a redemption that is treated as a distribution to which section 301 applies, the Treasury Department and the IRS have determined that the full amount of the redemption generally should be an inclusion event, regardless of whether a portion of the redemption proceeds are characterized as a dividend under section 301(c)(1) or as the recovery of basis under section 301(c)(2). Otherwise, such a redemption could reduce a shareholder's direct equity investment without triggering an inclusion event (if the full amount of the redemption proceeds is characterized as either a dividend or as the recovery of basis). However, there are circumstances in which the shareholder's interest in the QOF is not reduced by a redemption (for example, if the shareholder wholly owns the distributing corporation). Thus, if a QOF redeems stock wholly and directly held by its sole QOF shareholder (or by members of the same consolidated

group), the proposed regulations do not treat the redemption as an inclusion event to the extent the proceeds are characterized as a dividend under section 301(c)(1) or as a recovery of basis under section 301(c)(2). The Treasury Department and the IRS request comments on the proposed treatment of redemptions that are treated as distributions to which section 301 applies.

In the case of a QOF partnership, interests in which are directly or indirectly held by one or more partnerships, a distribution by one of the partnerships (including the QOF partnership) of property with a value in excess of the basis of the distributee's partnership interest is also an inclusion event. In the absence of this rule, a direct or indirect partner in a QOF partnership could dilute the value of its qualifying investment and thereby reduce the amount of deferred gain that would be recognized in a subsequent transaction.

The transfer by a QOF owner of its qualifying QOF stock or qualifying QOF partnership interest in a section 351 exchange generally would be an inclusion event under the proposed regulations, because the contribution would reduce the QOF owner's direct interest in the QOF. However, the contribution by a QOF shareholder of a portion (but not all) of its qualifying QOF stock to the QOF itself in a section 351 exchange would not be so treated, as long as the contribution does not reduce the taxpayer's equity interest in the qualifying investment (for example, if the QOF shareholders made pro rata contributions of qualifying QOF stock).

The Treasury Department and the IRS request comments on the proposed rules governing inclusion events, including whether additional rules are needed to prevent abuse.

## VIII. Consolidated Return Provisions

### A. *QOF Stock is Not Stock for Purposes of Affiliation*

The framework of section 1400Z-2 and the consolidated return regulations are incompatible in many respects. If a QOF corporation could be a subsidiary member of a consolidated group, extensive rules altering the application of many consolidated return provisions would be necessary to carry out simultaneously the policy objectives of section 1400Z-2 and the consolidated return regulations. For example, special rules would be required to take into account the interaction of section 1400Z-2 with §§1.1502-13 (relating to intercompany transactions), 1.1502-32 (relating to the consolidated return investment adjustment regime), and 1.1502-19 (relating to excess loss accounts).

Section 1400Z-2 is inconsistent with the intercompany transaction regulations under §1.1502-13. The stated purpose of the regulations under §1.1502-13 is to ensure that the existence of an intercompany transaction (a transaction between two members of a consolidated group) does not result in the creation, prevention, acceleration, or deferral of consolidated taxable income or tax liability. In other words, the existence of the intercompany transaction must not affect the consolidated taxable income or tax liability of the group as a whole. Therefore, §1.1502-13 generally determines the tax treatment of items resulting from intercompany transactions by treating members of the consolidated group as divisions of a single corporation (single-entity treatment).

The deferral of gain permitted under section 1400Z-2 would conflict with the purposes of §1.1502-13 if the QOF shareholder and QOF corporation were members of the same consolidated group. Under section 1400Z-2, a qualifying investment in a QOF results in the deferral of the recognition of gain that would otherwise be recognized.

However, allowing a transfer by a member investor to a member QOF to result in the deferral of gain recognition directly contradicts the express purpose of the intercompany transaction regulations. Therefore, consolidation of a QOF corporation with a corporation that otherwise would be a QOF shareholder not only would violate a basic tenet of single-entity treatment, but also would necessitate the creation of an elaborate system of additional consolidated return rules to establish the proper tax treatment of intercompany transactions involving a group member that is a QOF (QOF member). For the same reasons, special rules would be necessary to address the consequences under section 1400Z-2 of distributions from QOF members to other group members. In addition, special rules would be required to determine if and how §1.1502-13 would apply for purposes of testing whether a member of the group (tested member) met the requirements of section 1400Z-2(d) to continue to be treated as a QOF following an intercompany transaction. For example, such rules would need to address whether satisfaction of the requirements should be tested by taking into account not only property held by the tested member, but also property held by other members that have been counterparties in an intercompany transaction.

Section 1400Z-2 is also inconsistent with the consolidated return investment adjustment regime. Section 1.1502-32 requires unique adjustments to the basis of member stock to reflect income, gain, deduction, and loss items of group members. These rules apply only to members of consolidated groups, and they cause stock basis in subsidiary members of consolidated groups to be drastically different from the stock basis that would exist outside of a group. These investment adjustment rules would affect the timing and amount of inclusion of the deferred capital gain under section



1400Z-2, because the governing rules under section 1400Z-2 depend on the observance of very particular stock basis adjustments. Therefore, significant modifications to the application of the investment adjustment rules under §1.1502-32 would be required to implement section 1400Z-2 if the QOF shareholder and QOF corporation were members of the same group. Further, the rules of §1.1502-32 are integral to the application of the consolidated return system, and it would be virtually impossible to accurately anticipate all of the instances in which the special basis rules should be applied to the QOF member, as well as to any includible corporations owned by the QOF member (such corporations also would be included in the group).

As a final example, special rules would also be needed to harmonize the excess loss account (ELA) concept established by the rules in §1.1502-19 with the operation of section 1400Z-2. The consolidated return regulations provide for downward stock basis adjustments that take into account distributions by lower-tier members to higher-tier members and the absorption of member losses by other members of the group. As a result of these adjustments, a member of a group may have negative basis (that is, an ELA) in its stock in another member. The existence of negative stock basis is not contemplated under section 1400Z-2, and it is unique to the consolidated return regulations. Harmonizing rules would be required to ensure the special QOF basis election under section 1400Z-2(c) would not eliminate an ELA in the stock of the QOF member and provide a benefit beyond what was intended by section 1400Z-2. In other words, the basis adjustment under section 1400Z-2(c) should exclude from income no more than the appreciation in the QOF investment.

In summary, section 1400Z-2 and the consolidated return system are based on incompatible principles and rules. To enable the two systems to interact in a manner that effectuates the purposes of each, complicated additional regulations would be required. However, it is not possible to anticipate all possible points of conflict. Therefore, rather than trying to forcibly harmonize the two frameworks, these proposed regulations treat QOF stock as not stock for purposes of section 1504, which sets forth the requirements for corporate affiliation. Consequently, a QOF C corporation can be the common parent of a consolidated group, but it cannot be a subsidiary member of a consolidated group. In other words, a QOF C corporation owned by members of a consolidated group is not a member of that consolidated group. These proposed regulations treat QOF stock as not stock for the broad purpose of section 1504 affiliation.

The Treasury Department and the IRS request comments on whether this rule should be limited to treat QOF stock as not stock only for the purposes of consolidation, as well as whether the burden of potentially applying two different sets of consolidated return rules would be outweighed by benefits of permitting QOF C corporations to be subsidiary members of consolidated groups.

*B. Separate Entity Treatment for Members of a Consolidated Group Qualifying for Deferral under Section 1400Z-2*

The proposed regulations clarify that section 1400Z-2 applies separately to each member of a consolidated group. Accordingly, to qualify for gain deferral, the same member of the consolidated group must: (i) Sell a capital asset to an unrelated person,

the gain of which the member elects to be deferred under section 1400Z-2; and (ii) invest an amount of such deferred gain from the original sale into a QOF.

*C. Basis Increases in Qualifying Investment “Tier Up” the Consolidated Group*

Sections 1400Z-2(b)(2)(B)(iii) and (iv) and 1400Z-2(c) provide special basis adjustments applicable to qualifying investments held for five years, seven years, and at least 10 years. If the QOF owner is a member of a consolidated group, proposed §1.1400Z2(g)-1(c) would treat these basis adjustments to the qualifying investment as meeting the requirements of §1.1502-32(b)(3)(ii)(D), and thus as tax-exempt income to the QOF owner. Consequently, upper-tier members that own stock in the QOF owner would increase their basis in the stock of the QOF owner by the amount of the resulting tax-exempt income. The basis increase under section 1400Z-2(c) would be treated as tax-exempt income only if the qualifying investment were sold or exchanged and the QOF owner elected to apply the special rule in section 1400Z-2(c). Treating these special basis adjustments under section 1400Z-2 as tax-exempt income to the QOF owner is necessary to ensure that the amounts at issue remain tax-free at all levels within the consolidated group. For example, this treatment would prevent an unintended income inclusion upon a member’s sale of the QOF owner’s stock.

*D. The Attribute Reduction Rule in §1.1502-36(d)*

These proposed regulations clarify how a member’s basis in a qualifying investment is taken into account for purposes of applying the attribute reduction rule in §1.1502-36(d). When a member (M) transfers a loss share of subsidiary (S) stock, the rules in §1.1502-36 apply. If the transferred S share is a loss share after the application of §1.1502-36(b) and (c), the attribute reduction rule in §1.1502-36(d) applies to prevent

duplication of a single economic loss. In simple terms, §1.1502-36(d) compares M's basis in the loss S share to the amount of S's tax attributes that are allocable to the loss share. If loss duplication exists on the transfer of the S share (as determined under the mechanics of §1.1502-36(d)), S must reduce its tax attributes by its attribute reduction amount (ARA). In certain cases, M instead may elect to reduce its basis in the loss S share. To ensure that the purposes of both section 1400Z-2 and §1.1502-36(d) are effectuated, the proposed regulations provide special rules regarding the application of §1.1502-36(d) when S owns a qualifying investment.

In applying the anti-loss duplication rule discussed in the preceding paragraph, S includes its basis in a qualifying investment in determining whether there is loss duplication and, if so, the amount of the duplicated loss. However, if loss duplication exists, S cannot cure the loss duplication by reducing its basis in the qualifying investment under §1.1502-36(d). Because of the special QOF basis election available under section 1400Z-2(c), reducing S's basis in the qualifying investment would not achieve the anti-loss duplication purpose of §1.1502-36(d) if the special QOF basis election were made at a later date. This is because any basis reduced under §1.1502-36(d) would be restored on the sale of the qualifying investment. Therefore, S must reduce its other attributes. If S's attribute reduction amount exceeds S's attributes available for reduction, then the parent of the group is deemed to elect under §1.1502-36(d)(6) to reduce M's basis in S to the extent of S's basis in the qualifying investment. The reduction of M's basis in S is limited to the remaining ARA.

#### IX. Holding Periods and Other Tacking Rules

Under section 1400Z-2(b)(2)(B) and (c), increases in basis in a qualifying investment held by an investor in a QOF are, in part, dependent upon the QOF investor's holding period for that qualifying investment. The proposed regulations generally provide that, for purposes of section 1400Z-2(b)(2)(B) and (c), a QOF investor's holding period for its qualifying investment does not include the period during which the QOF investor held property that was transferred to the QOF in exchange for the qualifying investment. For example, if an investor transfers a building that it has owned for 10 years to a QOF corporation in exchange for qualifying QOF stock, the investor's holding period for the qualifying QOF stock for purposes of section 1400Z-2 begins on the date of the transfer, not the date the investor acquired the building.

Similarly, if an investor disposes of its entire qualifying investment in QOF 1 and reinvests in QOF 2 within 180 days, the investor's holding period for its qualifying investment in QOF 2 begins on the date of its qualifying investment in QOF 2, not on the date of its qualifying investment in QOF 1.

However, a QOF shareholder's holding period for qualifying QOF stock received in a qualifying section 381 transaction in which the acquiring corporation is a QOF immediately thereafter, or received in a recapitalization of a QOF, includes the holding period of the QOF shareholder's qualifying QOF stock exchanged therefor. Similar rules apply to QOF stock received in a qualifying section 355 transaction. The Treasury Department and the IRS have determined that, in these situations, a QOF shareholder should be permitted to tack its holding period for its initial qualifying investment because the investor's direct equity investment in a QOF continues. In the case of a qualifying section 381 transaction in which the acquiring corporation is a QOF immediately

thereafter, the investor's continuing direct equity investment in a QOF is further reflected in the investor's exchanged basis in the stock of the acquiring corporation. Tacked holding period rules apply in the same manner with respect to a QOF partner's interest in a QOF partnership, for example, in the case of a partnership merger where the QOF partner's resulting investment in the QOF partnership continues. Finally, the recipient of a qualifying investment by gift that is not an inclusion event, or by reason of the death of the owner, may tack the donor's or decedent's holding period, respectively.

Similar rules apply for purposes of determining whether the "original use" requirement in section 1400Z-2(d)(2)(D) commences with the acquiring corporation (after a qualifying section 381 transaction in which the acquiring corporation is a QOF immediately thereafter) or the controlled corporation (after a qualifying section 355 transaction). In each case, the acquiring corporation or the controlled corporation satisfies the original use requirement if the target corporation or the distributing corporation, respectively, did so before the transaction. Thus, the acquiring corporation and the controlled corporation may continue to treat the historic qualified opportunity zone business property received from the target corporation and the distributing corporation, respectively, as qualified opportunity zone business property.

#### X. General Anti-Abuse Rule

Proposed §1.1400Z2(f)-1(c) provides a general anti-abuse rule pursuant to section 1400Z-2(e)(4)(C), which provides that "the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including \* \* \* rules to prevent abuse." The Treasury Department and the IRS expect that most taxpayers will apply the rules in section 1400Z-2 and §§1.1400Z2(a)-1

through 1.1400Z2(g)-1 in a manner consistent with the purposes of section 1400Z-2. However, to prevent abuse, proposed §1.1400Z2(f)-1(c) provides that if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of section 1400Z-2, the Commissioner can recast a transaction (or series of transactions) for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 1400Z-2. Whether a tax result is inconsistent with the purposes of section 1400Z-2 must be determined based on all the facts and circumstances. For example, this general anti-abuse rule could apply to a treat a purchase of agricultural land that otherwise would be qualified opportunity zone business property as a purchase of non-qualified opportunity zone business property if a significant purpose for that purchase were to achieve a tax result inconsistent with the purposes of section 1400Z-2 (see part I.B of this Explanation of Provisions).

The Treasury Department and the IRS request comments on this proposed anti-abuse rule, including whether additional details regarding what tax results are inconsistent with the purposes of section 1400Z-2 is required or whether examples of particular types of abusive transactions would be helpful.

#### XI. Entities Organized under a Statute of a Federally Recognized Indian Tribe and Issues Particular to Tribally Leased Property

Commenters have asked whether Indian tribal governments, like state and territorial governments, can charter a partnership or corporation that is eligible to be a QOF. Proposed §1.1400Z2(d)-1(e)(1) provides that, if an entity is not organized in one of the 50 states, the District of Columbia, or the U.S. possessions, it is ineligible to be a QOF. Similarly, proposed §1.1400Z2(d)-1(e)(2) provides that, if an entity is not

organized in one of the 50 states, the District of Columbia, or the U.S. possessions, an equity interest in the entity is neither qualified opportunity zone stock nor a qualified opportunity zone partnership interest. The Treasury Department and the IRS have determined that, for purposes of both proposed §1.1400Z2(d)-1(e)(1) and (2), an entity “organized in” one of the 50 states includes an entity organized under the law of a Federally recognized Indian tribe if the entity’s domicile is located in one of the 50 states. Such entity satisfies the requirement in section 1400Z-2(d)(2)(B)(i) and (C) that qualified opportunity zone stock is stock in a domestic corporation and a qualified opportunity zone partnership interest is an interest in a domestic partnership. See section 7701(a)(4). The Treasury Department and the IRS, while acknowledging the sovereignty of Federally recognized Indian tribes, note that an entity that is eligible to be a QOF will be subject to Federal income tax under the Code, regardless of the laws under which it is established or organized.

Commenters also noted that Indian tribal governments occupy Federal trust lands, and that these lands are often leased for economic development purposes. According to these commenters, the right to use Indian tribal government reservation land managed by the Secretary of the Interior can raise unique issues with respect to lease valuations. As discussed in part II of this Explanation of Provisions, these proposed regulations address the treatment of leased tangible property in general.

In order to obtain tribal input in accordance with Executive Order 13175, “Consultation and Coordination with Indian Tribal Governments,” and consistent with Treasury’s Tribal Consultation Policy (80 FR 57434, September 23, 2015), the Treasury Department and the IRS will schedule Tribal Consultation with Tribal Officials before



finalizing these regulations to obtain additional input, within the meaning of the Tribal Consultation Policy, on QOF entities organized under the law of a Federally recognized Indian tribe and whether any additional guidance may be needed regarding QOFs leasing tribal government Federal trust lands or regarding leased real property located on such lands, as well as other Tribal implications of the proposed regulations. Such Tribal Consultation will also seek input on questions regarding the tax status of certain tribally chartered corporations other than QOFs.

### **Proposed Effective/Applicability Dates**

Section 7805(b)(1)(A) and (B) of the Code generally provides that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) The date on which such regulation is filed with the **Federal Register**; or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the **Federal Register**. However, section 7805(b)(2) provides that regulations filed or issued within 18 months of the date of the enactment of the statutory provision to which they relate are not prohibited from applying to taxable periods prior to those described in section 7805(b)(1). Furthermore, section 7805(b)(3) provides that the Secretary may provide that any regulation may take effect or apply retroactively to prevent abuse.

Consistent with authority provided by section 7805(b)(1)(A), the rules of proposed §§1.1400Z2(a)-1, 1.1400Z2(b)-1, 1.1400Z2(c)-1, 1.1400Z2(d)-1, 1.1400Z2(e)-1, 1.1400Z2(f)-1, and 1.1400Z2(g)-1 generally apply to taxable years ending after **[INSERT DATE OF PUBLICATION IN FEDERAL REGISTER]**. However, taxpayers may generally rely on the rules of proposed §§1.1400Z2(a)-1, 1.1400Z2(b)-1,

1.1400Z2(d)-1, 1.1400Z2(e)-1, 1.1400Z2(f)-1, and 1.1400Z2(g)-1 set forth in this notice of proposed rulemaking for periods prior to the finalization of those sections if they apply these proposed rules consistently and in their entirety. This pre-finalization reliance does not apply to the rules of proposed §1.1400Z2(c)-1 set forth in this notice of proposed rulemaking as these rules do not apply until January 1, 2028.

## **Special Analyses**

### **I. Regulatory Planning and Review**

Executive Orders 13771, 13563, and 12866 direct agencies to assess the costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility.

These proposed regulations have been designated by the Office of Management and Budget's Office of Information and Regulatory Affairs (OIRA) as economically significant under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding the review of tax regulations. Accordingly, the proposed regulations have been reviewed by the Office of Management and Budget. In addition, the Treasury Department and the IRS expect the proposed regulations, when final, to be an Executive Order 13771 deregulatory action and request comment on this designation.

#### *A. Background and Overview*

Congress enacted section 1400Z-2, in conjunction with section 1400Z-1, as a temporary provision to encourage private sector investment in certain lower-income communities designated as qualified opportunity zones (see Senate Committee on Finance, Explanation of the Bill, at 313 (November 22, 2017)). Taxpayers may elect to defer the recognition of capital gain to the extent of amounts invested in a QOF, provided that such amounts are invested during the 180-day period beginning on the date such capital gain would have been recognized by the taxpayer. Inclusion of the deferred capital gain in income occurs on the date the investment in the QOF is sold or exchanged or on December 31, 2026, whichever comes first. For investments in a QOF held longer than five years, taxpayers may exclude 10 percent of the deferred gain from inclusion in income, and for investments held longer than seven years, taxpayers may exclude a total of 15 percent of the deferred gain from inclusion in income. In addition, for investments held longer than 10 years, the post-acquisition gain on the qualifying investment in the QOF also may be excluded from income through a step-up in basis in the qualifying investment. In turn, a QOF must hold at least 90 percent of its assets in qualified opportunity zone property, as measured by the average percentage of assets held on the last day of the first 6-month period of the taxable year of the fund and on the last day of the taxable year. The statute requires a QOF that fails this 90-percent test to pay a penalty for each month it fails to satisfy this requirement.

The proposed regulations clarify several terms used in the statute, such as what constitutes “substantially all” in each of the different places that phrase is used in section 1400Z-2, the use of qualified opportunity zone business property (including leased property) in a qualified opportunity zone, the sourcing of income to a qualified

opportunity zone business, the “reasonable period” for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty, and what transactions comprise an inclusion event that would lead to the inclusion of deferred gain in gross income. In part, the proposed regulations amend portions of previously proposed regulations related to section 1400Z-2.

### *B. Need for the Proposed Regulations*

The Treasury Department and the IRS are aware of concerns raised by commenters that investors have been reticent to make substantial investments in QOFs without first having additional clarity on which investments in a QOF would qualify to receive the preferential tax treatment specified by the TCJA. This uncertainty could reduce the amount of investment flowing into lower-income communities designated as qualified opportunity zones. The lack of additional clarity could also lead to different taxpayers interpreting, and therefore applying, the same statute differently, which could distort the allocation of investment across the qualified opportunity zones.

### *C. Economic Analysis*

#### 1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations.

#### 2. Economic Effects of the Proposed Regulation

##### a. Summary of Economic Effects

The proposed regulations provide certainty and clarity to taxpayers regarding utilization of the tax preference for capital gains provided in section 1400Z-2 by defining

terms, calculations, and acceptable forms of documentation. The Treasury Department and the IRS project that this added clarity generally will encourage taxpayers to invest in QOFs and will increase the amount of investment located in qualified opportunity zones. The Treasury Department and the IRS have not made quantitative estimates of these effects.

The benefits and costs of major, specific provisions of these proposed regulations relative to the no-action baseline and alternatives to these proposed rules considered by the Treasury Department and the IRS are discussed in further detail below.

b. Qualified Opportunity Zone Business Property and Definition of Substantially All

The proposed regulations establish the threshold for satisfying the substantially all requirements for four out of the five uses of the term in section 1400Z-2. The other substantially all test in section 1400Z-2(d)(3)(A)(i) already had been set at 70 percent by prior proposed regulations (83 FR 54279, October 29, 2018). The proposed regulations provide that the term substantially all means at least 90 percent with regard to the three holding period requirements in section 1400Z-2(d)(2). The other substantially all term in section 1400Z-2(d)(2)(D)(i)(III) in the context of “use” is set to 70 percent, the same as the threshold established under the prior proposed rulemaking. The clarity provided in the proposed regulations reduces uncertainty for prospective investors regarding which investments would satisfy the requirements of section 1400Z-2. This clarity likely would lead to a greater level of investment in QOFs.

In choosing what values to assign to the substantially all terms, the Treasury Department and the IRS considered the costs and benefits of setting the threshold

higher or lower. Setting the threshold higher would limit the type of businesses and investments that would be able to meet the proposed requirements and possibly distort the industry concentration within some opportunity zones. Setting the threshold lower would allow investors in certain QOFs to receive capital gains tax relief while placing a relatively small portion of its investment within a qualified opportunity zone. A lower threshold would increase the likelihood that a taxpayer may receive the benefit of the preferential treatment on capital gains without placing in service more tangible property within a qualified opportunity zone than would have occurred in the absence of section 1400Z-2. This latter concern is magnified by the way the different requirements in section 1400Z-2 interact.

For example, these regulations imply that a QOF could satisfy the substantially all standards with as little as 40 percent of the tangible property effectively owned by the fund being used within a qualified opportunity zone. This could occur if 90 percent of QOF assets are invested in a qualified opportunity zone business, in which 70 percent of the tangible assets of that business are qualified opportunity zone business property; and if, in addition, the qualified opportunity zone business property is only 70 percent in use within a qualified opportunity zone, and for 90 percent of the holding period for such property. Multiplying these shares together ( $0.9 \times 0.7 \times 0.7 \times 0.9 = 0.4$ ) generates the result that a QOF could satisfy the requirements of section 1400Z-2 under the proposed regulations with just 40 percent of its assets effectively in use within a qualified opportunity zone.

The Treasury Department and the IRS recognize that the operations of certain types of businesses may extend beyond the Census tract boundaries that define

qualified opportunity zones. The substantially all thresholds provided in the proposed regulations are set at levels so as to limit the ability of investors in QOFs to receive preferential capital gains treatment, unless a consequential amount of tangible property used in the underlying business is located within a qualified opportunity zone, while also allowing flexibility to business operations so as not to significantly distort the types of businesses that can qualify for opportunity zone funds.

#### c. Valuation of Leased Property

The proposed regulations provide two methods for determining the asset values for purposes of the 90-percent asset test in section 1400Z-2(d)(1) for QOFs or the value of tangible property for the substantially all test in section 1400Z-2(d)(3)(A)(i) for qualified opportunity zone businesses. Under the first method, a taxpayer may value owned or leased property as reported on its applicable financial statement for the reporting period. Alternatively, the taxpayer may set the value of owned property equal to the unadjusted cost basis of the property under section 1012. The value of leased property under the alternative method equals the present value of total lease payments at the beginning of the lease. The value of the property under the alternative method for the 90-percent asset test and substantially all test does not change over time as long as the taxpayer continues to own or lease the property.

The two methods should provide similar values for leased property at the time that the lease begins, as beginning in 2019, generally accepted accounting principles (GAAP) require public companies to calculate the present value of lease payments in order to recognize the value of leased assets on the balance sheet. However, there are differences. On financial statements, the value of the leased property declines over the

term of the lease. Under the alternative method, the value of the leased asset is calculated once at the beginning of the lease term and remains constant while the term of the lease is still in effect. This difference in valuation of property over time between using financial statements and the alternative method also exist in the case of owned property. In addition, the two approaches would generally apply different discount rates, thus leading to some difference in the calculated present value under the two methods.

The Treasury Department and the IRS provide the alternative method to allow for taxpayers that either do not have applicable financial statements or do not have them available in time for the asset test. In addition, the alternative method is simpler, thus reducing compliance costs, and would provide greater certainty in projecting future compliance with the 90-percent asset and substantially all tests. Thus, some taxpayers with applicable financial statements may elect to use the alternative method. The drawback to the alternative method is that it does not account for depreciation, and, over time, the values used for the sake of the 90-percent asset test and the substantially all test may diverge from the actual value of the property.

The Treasury Department and the IRS have determined that the value of leased property should be included in both the numerator and the denominator of the 90-percent asset test and the substantially all test, as this would be less distortive to business decisions compared to other available options. Leasing is a common business practice, and treating leased property differently than owned property could lead to economic distortions. If the value of leased property were not included in the tests at all, then it would be relatively easy for taxpayers to choose where to locate



owned and leased property so as to technically meet the standards of the test, while maintaining substantial business operations outside of a qualified opportunity zone.

The Treasury Department and the IRS considered a third option for how leased property should be included in the 90-percent asset and substantially all tests. Under this option, leased property of the taxpayer would be included only in the denominator of the fraction. The reason for this is that leased property generally would not satisfy the purchase and original use requirements of section 1400Z-2(d)(2)(D)(i) and thus would not be deemed as qualified opportunity zone business property. However, not allowing leased property located within a qualified opportunity zone to be treated as qualified opportunity zone business property could distort business decisions of taxpayers and also could make it difficult for some businesses to satisfy the substantially all test in section 1400Z-2(d)(3)(A)(i), despite bringing new economic activity to a qualified opportunity zone.

For example, a start-up business that rented office space within a qualified opportunity zone and owned tangible property in the form of computers and other office equipment likely would fail the substantially all test if leased property only were included in the denominator of the substantially all fraction, despite all of its operations being located within a qualified opportunity zone. This may lead businesses to take on extra debt in order to purchase property located within a qualified opportunity zone, thus increasing the risk of financial distress, including bankruptcy.

One potential disadvantage of including leased property in both the numerator and denominator of the substantially all test is that it may weaken the incentive to construct new real property or renovate existing real property within a qualified

opportunity zone, as taxpayers would be able to lease existing real property in a zone without improving it and become a qualified opportunity zone business. However, allowing the leasing of existing real property within a zone may encourage fuller utilization and improvement of such property and limit the abandonment or destruction of existing productive property within a qualified opportunity zone when new tax-favored real property becomes available.

Hence, including leased property in both the numerator and the denominator of the 90-percent asset test and substantially all test encourages economic activity within qualified opportunity zones while reducing the potential distortions between owned and leased property that may occur under other options.

#### d. Qualified Opportunity Zone Business

Section 1400Z-2(d)(3)(A)(ii) incorporates the requirement of section 1397C(b)(2) that a qualified business entity must derive at least 50 percent of its total gross income during a taxable year from the active conduct of a qualified business in a zone. The proposed regulations provide multiple safe harbors for determining whether this standard has been satisfied.

Two of these safe harbors provide different methods for measuring the labor input of the entity. The labor input can be measured in terms of hours or compensation paid. The proposed regulations provide that if at least 50 percent of the labor input of the entity is located within a zone (as measured by one of the two provided approaches), then the section 1397C(b)(2) requirement is satisfied.

In addition, a third safe harbor provides that the 50 percent gross income requirement is met if the tangible property of the trade or business located in a qualified

opportunity zone and the management or operational functions performed in the qualified opportunity zone are each necessary for the generation of at least 50 percent of the gross income of the trade or business.

The determination of the location of income for businesses that operate in multiple jurisdictions can be complex, and the rules promulgated by taxing authorities to determine the location of income are often burdensome and may distort economic activity. The provision of alternative safe harbors in these proposed regulations should reduce the compliance and administrative burdens associated with determining whether this statutory requirement has been met. In the absence of such safe harbors, some taxpayers may interpret the 50 percent of gross income standard to require that a majority of the sales of the entity must be located within a zone. The Treasury Department and the IRS have determined that a standard based strictly on sales would discriminate against some types of businesses (for example, manufacturing) in which the location of sales is often different from the location of the production, and thus would preclude such businesses from benefitting from the incentives provided in section 1400Z-2. Furthermore, the potential distortions introduced by the provided safe harbors would increase incentives to locate labor inputs within a qualified opportunity zone. To the extent that such distortions exist, they further the statutory goal of encouraging economic activity within qualified opportunity zones. Given the flexibility provided to taxpayers in choosing a safe harbor, other distortions, such as to business organizational structuring, are likely to be minimal.

e. QOF Reinvestment Rule

The proposed regulations provide that a QOF has 12 months from the time of the sale or disposition of qualified opportunity zone property or the return of capital from investments in qualified opportunity zone stock or qualified opportunity zone partnership interests to reinvest the proceeds in other qualified opportunity zone property before the proceeds would not be considered qualified opportunity zone property with regards to the 90-percent asset test. This proposed rule provides clarity and gives substantial flexibility to taxpayers in satisfying the 90-percent asset test, which should encourage greater investment within QOFs compared to the baseline.

#### f. Other Topics

The proposed regulations clarify several other areas where there is uncertainty in how to apply the statute in practice. For example, the proposed regulations clarify what events cause the inclusion of deferred gain, that a QOF may not be a subsidiary member of a consolidated group, and how to determine the length of holding periods in a qualifying investment. These proposed regulations provide greater certainty to taxpayers regarding how to structure investments so as to comply with the statutory requirements of the opportunity zone incentive. This should reduce administration and compliance costs and encourage greater investment in QOFs.

#### D. *Paperwork Reduction Act*

The proposed regulation establishes a new collection of information in §1.1400Z2(b)-1(h). In proposed §1.1400Z2(b)-1(h)(1), the collection of information requires (i) a partnership that makes a deferral election to notify all of its partners of the deferral election, and (ii) a partner that makes a deferral election to notify the partnership in writing of its deferral election, including the amount of the eligible gain

deferred. Similar requirements are set forth in proposed §1.1400Z2(b)-1(h)(4) regarding S corporations and S corporation shareholders. The collection of information in proposed §1.1400Z2(b)-1(h)(2) requires direct and indirect owners of a QOF partnership to provide the QOF partnership with a written statement containing information requested by the QOF partnership that is necessary to determine the direct and indirect owners' shares of deferred gain. Lastly, the collection of information in proposed §1.1400Z2(b)-1(h)(3) requires a QOF partner to notify the QOF partnership of an election under section 1400Z-2(c) to adjust the basis of the qualifying QOF partnership interest that is disposed of in a taxable transaction. Similar requirements again are set forth in proposed §1.1400Z2(b)-1(h)(4) regarding QOF S corporations and QOF S corporation shareholders. The collection of information contained in this proposed regulation will not be conducted using a new or existing IRS form.

The likely respondents are partnerships and partners, and S corporations and S corporation shareholders.

Estimated total annual reporting burden: 8,500 hours.

Estimated average annual burden per respondent: 1 hour.

Estimated number of respondents: 8,500.

Estimated frequency of responses: 8,500.

The collections of information contained in this notice of proposed rulemaking will be submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs,

Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by **INSERT DATE 60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER**. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

## II. Regulatory Flexibility Act

Under the Regulatory Flexibility Act (RFA) (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations, if adopted, would not have a significant

economic impact on a substantial number of small entities that are directly affected by the proposed regulations.

As discussed elsewhere in this preamble, the proposed regulations would provide certainty and clarity to taxpayers regarding utilization of the tax preference for capital gains provided in section 1400Z-2 by defining terms, calculations, and acceptable forms of documentation. The Treasury Department and the IRS anticipate that this added clarity generally will encourage taxpayers to invest in QOFs and will increase the amount of investment located in qualified opportunity zones. Investment in QOFs is entirely voluntary, and the certainty that would be provided in the proposed regulations is anticipated to minimize any compliance or administrative costs, such as the estimated average annual burden (1 hour) under the Paperwork Reduction Act. For example, the proposed regulations provide multiple safe harbors for purpose of determining whether the 50-percent gross income test has been met as required by section 1400Z-2(d)(3)(A)(ii) for a qualified opportunity zone business.

Taxpayers affected by these proposed regulations include QOFs, investors in QOFs, and qualified opportunity zone businesses in which a QOF holds an ownership interest. The proposed regulations will not directly affect the taxable incomes and liabilities of qualified opportunity zone businesses; they will affect only the taxable incomes and tax liabilities of QOFs (and owners of QOFs) that invest in such businesses. Although there is a lack of available data regarding the extent to which small entities invest in QOFs, will certify as QOFs, or receive equity investments from QOFs, the Treasury Department and the IRS project that most of the investment flowing into QOFs will come from large corporations and wealthy individuals, though some of

these funds would likely flow through an intermediary investment partnership. It is expected that some QOFs and qualified opportunity zone businesses would be classified as small entities; however, the number of small entities significantly affected is not likely to be substantial.

Accordingly, it is hereby certified that this rule would not have a significant economic impact on a substantial number of small entities. The Treasury Department and the IRS specifically invite comments from any party, particularly affected small entities, on the accuracy of this certification.

Pursuant to section 7805(f), this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### III. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of \$100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately \$150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

### IV. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes



substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

### **Statement of Availability of IRS Documents**

IRS Revenue Procedures, Revenue Rulings, and Notices cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS web site at <http://www.irs.gov>.

### **Comments**

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic and written comments that are submitted timely to the IRS as prescribed in this preamble under the “**ADDRESSES**” heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at <http://www.regulations.gov> or upon request.

### **Drafting Information**

The principal authors of these proposed regulations are Erika C. Reigle and Kyle Griffin, Office of the Associate Chief Counsel (Income Tax & Accounting); Jeremy Aron-Dine and Sarah Hoyt, Office of the Associate Chief Counsel (Corporate); and Marla Borkson and Sonia Kothari, Office of the Associate Chief Counsel (Passthroughs and

Special Industries). Other personnel from the Treasury Department and the IRS participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income Taxes, Reporting and recordkeeping requirements.

### **Partial Withdrawal of a Notice of Proposed Rulemaking**

Accordingly, under the authority of 26 U.S.C. 1400Z-2(e)(4) and 7805, §1.1400Z2(d)-1(c)(4)(i), (c)(5), (c)(6), (c)(7), (d)(2)(i)(A), (d)(2)(ii), (d)(2)(iii), (d)(5)(i), and (d)(5)(ii)(B) of the notice of proposed rulemaking (REG-115420-18) published in the **Federal Register** on October 29, 2018 (83 FR 54279) are withdrawn.

### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR Part 1 is proposed to be amended as follows:

#### **Part 1--INCOME TAX**

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805\*\*\*

Section 1.1400Z2(a)-1 also issued under 26 U.S.C. 1400Z-2(e)(4).

Section 1.1400Z2(b)-1 also issued under 26 U.S.C. 1400Z-2(e)(4).

Section 1.1400Z2(c)-1 also issued under 26 U.S.C. 1400Z-2(e)(4) and 857(g)(2).

Section 1.1400Z2(d)-1 also issued under 26 U.S.C. 1400Z-2(e)(4).

Section 1.1400Z2(f)-1 also issued under 26 U.S.C. 1400Z-2(e)(4).

Section 1.1400Z2(g)-1(a), (c), (d), (e), (f), and (g)(1) also issued under 26 U.S.C. 1400Z-2(e)(4) and 1502.

Section 1.1400Z2(g)-1(b) and (g)(2) also issued under 26 U.S.C. 1400Z-2(e)(4) and 1504(a)(5).

Par. 2. Section 1.1400Z2(a)-1, as proposed to be added by 83 FR 54279, October 29, 2018 is amended by:

1. Redesignating (b)(2)(iii) and (iv) as (v) and (vi) respectively.
2. Adding paragraphs (b)(2)(iii), and (vi); and (b)(9) and (b)(10).

The revisions and additions read as follows:

§1.1400Z2(a)-1 Deferring tax on capital gains by investing in opportunity zones.

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

\* \* \* \* \*

(iii) Gains from section 1231 property. 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.

\* \* \* \* \*

(vi) No deferral for gain realized upon the acquisition of an eligible interest. Gain is not eligible for deferral under section 1400Z-2(a)(1) if such gain is realized upon the sale or other transfer of property to a QOF in exchange for an eligible interest (see paragraph (b)(10)(i)(C) of this section) or the transfer of property to an eligible taxpayer in exchange for an eligible interest (see paragraph (b)(10)(iii) of this section).

\* \* \* \* \*

(9) Making an investment for purposes of an election under section 1400Z-2(a)--

(i) Transfer of cash or other property to a QOF. A taxpayer makes an investment for purposes of an election under section 1400Z-2(a)(1)(A) (section 1400Z-2(a)(1)(A) investment) by transferring cash or other property to a QOF in exchange for eligible interests in the QOF, regardless of whether the transfer is one in which the transferor would recognize gain or loss on the property transferred.

(ii) Furnishing services. Services rendered to a QOF are not considered the making of a section 1400Z-2(a)(1)(A) investment. Thus, if a taxpayer receives an eligible interest in a QOF for services rendered to the QOF or to a person in which the QOF holds any direct or indirect equity interest, then the interest in the QOF that the taxpayer receives is not a section 1400Z-2(a)(1)(A) investment but is an investment to which section 1400Z-2(e)(1)(A)(ii) applies.

(iii) Acquisition of eligible interest from person other than QOF. A taxpayer may make a section 1400Z-2(a)(1)(A) investment by acquiring an eligible interest in a QOF from a person other than the QOF.

(10) Amount invested for purposes of section 1400Z-2(a)(1)(A). In the case of any investments described in this paragraph (b)(10), the amount of a taxpayer's section 1400Z-2(a)(1)(A) investment cannot exceed the amount of gain to be deferred under the election. If the amount of the taxpayer's investment as determined under this paragraph (b)(10) exceeds the amount of gain to be deferred under the section 1400Z-2(a) election, the amount of the excess is treated as an investment to which

section 1400Z-2(e)(1)(A)(ii) applies. See paragraph (b)(10)(ii) of this section for special rules applicable to transfers to QOF partnerships.

(i) Transfers to a QOF--(A) Cash. If a taxpayer makes a section 1400Z-2(a)(1)(A) investment by transferring cash to a QOF, the amount of the taxpayer's section 1400Z-2(a)(1)(A) investment is that amount of cash.

(B) Property other than cash--Nonrecognition transactions. This paragraph (b)(10)(i)(B) applies if a taxpayer makes a section 1400Z-2(a)(1)(A) investment by transferring property other than cash to a QOF and if, but for the application of section 1400Z-2(b)(2)(B), the taxpayer's basis in the resulting investment in the QOF would be determined, in whole or in part, by reference to the taxpayer's basis in the transferred property.

(1) Amount of section 1400Z-2(a)(1)(A) investment. If paragraph (b)(10)(i)(B) of this section applies, the amount of the taxpayer's section 1400Z-2(a)(1)(A) investment is the lesser of the taxpayer's adjusted basis in the eligible interest received in the transaction, without regard to section 1400Z-2(b)(2)(B), or the fair market value of the eligible interest received in the transaction, both as determined immediately after the contribution. Paragraph (b)(10)(i)(B) of this section applies separately to each item of property contributed to a QOF.

(2) Fair market value of the eligible interest received exceeds its adjusted basis. If paragraph (b)(10)(i)(B) of this section applies, and if the fair market value of the eligible interest received is in excess of the taxpayer's adjusted basis in the eligible interest received, without regard to section 1400Z-2(b)(2)(B), then the taxpayer's investment is an investment with mixed funds to which section 1400Z-2(e)(1) applies.

Paragraph (b)(10)(i)(B)(1) of this section determines the amount of the taxpayer's investment to which section 1400Z-2(e)(1)(A)(i) applies. Section 1400Z-2(e)(1)(A)(ii) applies to the excess of the fair market value of the investment to which section 1400Z-2(e)(1)(A)(i) applies over the taxpayer's adjusted basis therein, determined without regard to section 1400Z-2(b)(2)(B).

(3) Transfer of built-in loss property and section 362(e)(2). If paragraph (b)(10)(i)(B) of this section and section 362(e)(2) both apply to a transaction, the taxpayer is deemed to have made an election under section 362(e)(2)(C).

(C) Property other than cash--Taxable transactions. This paragraph (b)(10)(i)(C) applies if a taxpayer makes a section 1400Z-2(a)(1)(A) investment by transferring property other than cash to a QOF and if, without regard to section 1400Z-2(b)(2)(B), the taxpayer's basis in the eligible interest received would not be determined, in whole or in part, by reference to the taxpayer's basis in the transferred property. If this paragraph (b)(10)(i)(C) applies, the amount of the taxpayer's section 1400Z-2(a)(1)(A) investment is the fair market value of the transferred property, as determined immediately before the transfer. This paragraph (b)(10)(i)(C) applies separately to each item of property transferred to a QOF.

(D) Basis in an investment with mixed funds. If a taxpayer's investment in a QOF is an investment with mixed funds to which section 1400Z-2(e)(1) applies, the taxpayer's basis in the investment to which section 1400Z-2(e)(1)(A)(ii) applies is equal to the taxpayer's basis in all of the QOF interests received, determined without regard to section 1400Z-2(b)(2)(B), and reduced by the basis of the taxpayer's

investment to which section 1400Z2-2(e)(1)(A)(i) applies, determined without regard to section 1400Z-2(b)(2)(B).

(ii) Special rules for transfers to QOF partnerships. In the case of an investment in a QOF partnership, the following rules apply:

(A) Amounts not treated as an investment--(1) Non-contributions in general. To the extent the transfer of property to a QOF partnership is characterized other than as a contribution (for example, as a sale for purposes of section 707), the transfer is not a section 1400Z-2(a)(1)(A) investment.

(2) Reductions in investments otherwise treated as contributions. To the extent any transfer of cash or other property to a partnership is not disregarded under paragraph (b)(10)(ii)(A)(1) of this section (for example, it is not treated as a disguised sale of the property transferred to the partnership under section 707), the transfer to the partnership will not be treated as a section 1400Z-2(a)(1)(A) investment to the extent the partnership makes a distribution to the partner and the transfer to the partnership and the distribution would be recharacterized as a disguised sale under section 707 if (i) any cash contributed were non-cash property, and (ii) in the case of a distribution by the partnership to which §1.707-5(b) (relating to debt-financed distributions) applies, the partner's share of liabilities is zero.

(B) Amount invested in a QOF partnership--(1) Calculation of amount of qualifying and non-qualifying investments. To the extent paragraph (b)(10)(ii)(A) of this section does not apply, the amount of the taxpayer's qualifying investment in a QOF partnership is the lesser of the taxpayer's net basis in the property contributed to the QOF partnership, or the net value of the property contributed by the taxpayer to the

QOF partnership. The amount of the taxpayer's non-qualifying investment in the partnership is the excess, if any, of the net value of the contribution over the amount treated as a qualifying investment.

(2) Net basis. For purposes of paragraph (b)(10)(ii)(B) of this section, net basis is the excess, if any, of –

(I) the adjusted basis of the property contributed to the partnership, over

(II) the amount of any debt to which the property is subject or that is assumed by the partnership in the transaction.

(3) Net value. For purposes of paragraph (b)(10)(ii)(B) of this section, net value is the excess of –

(I) the gross fair market value of the property contributed, over

(II) the amount of the debt described in paragraph (b)(10)(ii)(B)(2)(II) of this section.

(4) Basis of qualifying and non-qualifying investments. The basis of a qualifying investment is the net basis of the property contributed, determined without regard to section 1400Z-2(b)(2)(B) or any share of debt under section 752(a). The basis of a non-qualifying investment (before any section 752 debt allocation) is the remaining net basis. The bases of qualifying and non-qualifying investments are increased by any debt allocated to such investments under the rules of §1.1400Z2(b)-1(c)(6)(iv)(B).

(5) Rules applicable to mixed-funds investments. If one portion of an investment in a QOF partnership is a qualifying investment and another portion is a non-qualifying investment, see §1.1400Z2(b)-1(c)(6)(iv) for the rules that apply.



(iii) Acquisitions from another person. If a taxpayer makes a section 1400Z-2(a)(1)(A) investment by acquiring an eligible interest in a QOF from a person other than the QOF, then the amount of the taxpayer's section 1400Z-2(a)(1)(A) investment is the amount of the cash, or the fair market value of the other property, as determined immediately before the exchange, that the taxpayer exchanged for the eligible interest in the QOF.

(iv) Examples. The following examples illustrate the rules of paragraph (b)(10) of this section. For purposes of these examples, B is an individual and Q is a QOF corporation.

(A) Example 1. Transfer of built-in gain property with basis less than gain to be deferred. B realizes \$100 of eligible gain within the meaning of paragraph (b)(2) of this section. B transfers unencumbered property with a fair market value of \$100 and an adjusted basis of \$60 to Q in a transaction that is described in section 351(a). Paragraph (b)(10)(i)(B) of this section applies because B transferred property other than cash to Q and, but for the application of section 1400Z-2(b)(2)(B), B's basis in the eligible interests in Q would be determined, in whole or in part, by reference to B's basis in the transferred property. The fair market value of the eligible interest B received is \$100, and, without regard to section 1400Z-2(b)(2)(B), B's basis in the eligible interest received would be \$60. Thus, pursuant to paragraph (b)(10)(i)(B)(2) of this section, B's investment is an investment with mixed funds to which section 1400Z-2(e)(1) applies. Pursuant to paragraphs (b)(10)(i)(B)(1) and (2) of this section, B's section 1400Z-2(a)(1)(A) investment is \$60 (the lesser of the taxpayer's adjusted basis in the eligible interest, without regard to section 1400Z-2(b)(2)(B), of \$60 and the \$100 fair market value of the eligible interest received). Pursuant to section 1400Z-2(b)(2)(B)(i), B's basis in the section 1400Z-2(a)(1)(A) investment is \$0. Additionally, B's other investment is \$40 (the excess of the fair market value of the eligible interest received (\$100) over the taxpayer's adjusted basis in the eligible interest, without regard to section 1400Z-2(b)(2)(B) (\$60)). B's basis in the other investment is \$0 (B's \$60 basis in its investment determined without regard to section 1400Z-2(b)(2)(B), reduced by the \$60 of adjusted basis allocated to the investment to which section 1400Z-2(e)(1)(A)(i) applies, determined without regard to section 1400Z-2(b)(2)(B)). See paragraph (b)(10)(i)(D) of this section. Pursuant to section 362, Q's basis in the transferred property is \$60.

(B) Example 2. Transfer of built-in gain property with basis in excess of eligible gain to be deferred. The facts are the same as Example 1 in paragraph (b)(10)(iv)(A) of this section, except that B realizes \$50 of eligible gain within the meaning of

paragraph (b)(2) of this section. Pursuant to paragraph (b)(10) of this section, B's section 1400Z-2(a)(1)(A) investment cannot exceed the amount of eligible gain to be deferred (that is, the \$50 of eligible gain) under the section 1400Z-2(a) election. Therefore, pursuant to paragraph (b)(10)(i)(B)(1) of this section, B's section 1400Z-2(a)(1)(A) investment is \$50 (the lesser of the taxpayer's adjusted basis in the eligible interest received, without regard to section 1400Z-2(b)(2)(B), of \$60 and the \$100 fair market value of the eligible interest, limited by the amount of eligible gain to be deferred under the section 1400Z-2(a) election). B's section 1400Z-2(a)(1)(A) investment has an adjusted basis of \$0, as provided in section 1400Z-2(b)(2)(B)(i). Additionally, B's other investment is \$50 (the excess of the fair market value of the eligible interest received (\$100) over the amount (\$50) of B's section 1400Z-2(a)(1)(A) investment). B's basis in the other investment is \$10 (B's \$60 basis in its investment determined without regard to section 1400Z-2(b)(2)(B), reduced by the \$50 of adjusted basis allocated to B's section 1400Z-2(a)(1)(A) investment, determined without regard to section 1400Z-2(b)(2)(B)).

(C) Example 3. Transfers to QOF partnerships. (i) Facts. A and B each realized \$100 of eligible gain and each transfers \$100 of cash to a QOF partnership. At a later date, the partnership borrows \$120 from an unrelated lender and distributes the cash of \$120 equally to A and B.

(ii) Analysis. If the contributions had been of property other than cash, the contributions and distributions would have been tested under the disguised sale rules of §1.707-5(b) by, among other things, determining the timing of the distribution and amount of the debt allocated to each partner. Under paragraph (b)(10)(ii)(A)(2) of this section, the cash of \$200 (\$100 from A and \$100 from B) is treated as property that could be sold in a disguised sale transaction and each partner's share of the debt is zero for purposes of determining the amount of the investment. To the extent there would have been a disguised sale applying the rule of paragraph (b)(10)(ii)(A)(2) of this section, the amount of the investment would be reduced by the amount of the contribution so recharacterized.

(iii) Property contributed has built-in gain. The facts are the same as in paragraph (i) of this Example 3, except that the property contributed by A had a value of \$100 and basis of \$20 and the partnership did not borrow money or make a distribution. Under paragraph (b)(10)(ii)(B)(1) of this section, the amount of A's qualifying investment is \$20 (the lesser of the net value or the net basis of the property that A contributed), and the excess of the \$100 contribution over the \$20 qualifying investment constitutes a non-qualifying investment. Under paragraph (b)(10)(ii)(B)(2) of this section, A's basis in the qualifying investment (determined without regard to section 1400Z-2(b)(2)(B) or section 752(a)) is \$20. After the application of section 1400Z-2(b)(2)(B) but before the application of section 752(a), A's basis in the qualifying investment is zero. A's basis in the non-qualifying investment is zero without regard to the application of section 752(a).

(iv) Property contributed has built-in gain and is subject to debt. The facts are the same as in paragraph (iii) of this Example 3, except that the property contributed by

A has a gross value of \$130 and is subject to debt of \$30. Under paragraph (b)(10)(ii)(B)(1) of this section, the amount of A's qualifying investment is zero, the lesser of the property's \$100 net value (\$130 minus \$30) or zero net basis (\$20 minus \$30, but limited to zero). The entire contribution constitutes a non-qualifying investment.

(v) Property contributed has built-in loss and is subject to debt. The facts are the same as in paragraph (iv) of this Example 3, except that the property contributed by A has a basis of \$150. Under paragraph (b)(10)(ii)(B)(1) of this section, the amount of A's qualifying investment is \$100, the lesser of the property's \$100 net value (\$130 minus \$30) or \$120 net basis (\$150 minus \$30). The non-qualifying investment is \$0, the excess of the qualifying investment (\$100) over the net value (\$100). A's basis in the qualifying investment (determined without regard to section 1400Z-2(b)(2)(B) and section 752(a)) is \$120, the net basis. After the application of section 1400Z-2(b)(2)(B), A's basis in the qualifying investment is zero, plus its share of partnership debt under section 752(a).

\* \* \* \* \*

Par. 3. Section 1.1400Z2(b)-1 is added to read as follows:

§1.1400Z2(b)-1 Inclusion of gains that have been deferred under section 1400Z-2(a).

(a) Scope and definitions--(1) Scope. This section provides rules under section 1400Z-2(b) of the Internal Revenue Code regarding the inclusion in income of gain deferred under section 1400Z-2(a)(1)(A). This section applies to a QOF owner only until all of such owner's gain deferred pursuant to section 1400Z-2(a)(1)(A) has been included in income, subject to the limitations described in paragraph (e)(5) of this section. Paragraph (a)(2) of this section provides additional definitions used in this section and §§1.1400Z2(c)-1 through 1.1400Z2(g)-1. Paragraph (b) of this section provides general rules under section 1400Z-2(b)(1) regarding the timing of the inclusion in income of the deferred gain. Paragraph (c) of this section provides rules regarding the determination of the extent to which an event triggers the inclusion in income of all, or a portion, of the deferred gain. Paragraph (d) of this section provides rules regarding holding periods for qualifying investments. Paragraph (e) of this section provides rules

regarding the amount of deferred gain included in gross income under section 1400Z-2(a)(1)(B) and (b), including special rules for QOF partnerships and QOF S corporations. Paragraph (f) of this section provides examples illustrating the rules of paragraphs (c), (d), and (e) of this section. Paragraph (g) of this section provides rules regarding basis adjustments under section 1400Z-2(b)(2)(B). Paragraph (h) of this section provides special reporting rules applicable to partners, partnerships, and direct or indirect owners of QOF partnerships. Paragraph (i) of this section provides dates of applicability.

(2) Definitions. The following definitions apply for purposes of this section and §§1.1400Z2(c)-1 and 1.1400Z2(g)-1:

(i) Boot. The term boot means money or other property that section 354 or 355 does not permit to be received without the recognition of gain.

(ii) Consolidated group. The term consolidated group has the meaning provided in §1.1502-1(h).

(iii) Deferral election. The term deferral election means an election under section 1400Z-2(a) made before January 1, 2027, with respect to an eligible interest.

(iv) Inclusion event. The term inclusion event means an event described in paragraph (c) of this section.

(v) Mixed-funds investment. The term mixed-funds investment means an investment a portion of which is a qualifying investment and a portion of which is a non-qualifying investment.

(vi) Non-qualifying investment. The term non-qualifying investment means an investment in a QOF described in section 1400Z-2(e)(1)(A)(ii).

(vii) Property--(A) In general. The term property means money, securities, or any other property.

(B) Inclusion events regarding QOF corporation distributions. For purposes of paragraph (c) of this section, in the context in which a QOF corporation makes a distribution, the term property does not include stock (or rights to acquire stock) in the QOF corporation that makes the distribution.

(viii) QOF. The term QOF means a qualified opportunity fund, as defined in section 1400Z-2(d)(1) and associated regulations.

(ix) QOF C corporation. The term QOF C corporation means a QOF corporation other than a QOF S corporation.

(x) QOF corporation. The term QOF corporation means a QOF that is classified as a corporation for Federal income tax purposes.

(xi) QOF owner. The term QOF owner means a QOF shareholder or a QOF partner.

(xii) QOF partner. The term QOF partner means a person that directly owns a qualifying investment in a QOF partnership or a person that owns such a qualifying investment through equity interests solely in one or more partnerships.

(xiii) QOF partnership. The term QOF partnership means a QOF that is classified as a partnership for Federal income tax purposes.

(xiv) QOF S corporation. The term QOF S corporation means a QOF corporation that has elected under section 1362 to be an S corporation.

(xv) QOF shareholder. The term QOF shareholder means a person that directly owns a qualifying investment in a QOF corporation.

(xvi) Qualifying investment. The term qualifying investment means an eligible interest (as defined in §1.1400Z2(a)-1(b)(3)), or portion thereof, in a QOF to the extent that a deferral election applies with respect to such eligible interest or portion thereof.

(xvii) Qualifying QOF partnership interest. The term qualifying QOF partnership interest means a direct or indirect interest in a QOF partnership that is a qualifying investment.

(xviii) Qualifying QOF stock. The term qualifying QOF stock means stock in a QOF corporation that is a qualifying investment.

(xix) Qualifying section 355 transaction. The term qualifying section 355 transaction means a distribution described in paragraph (c)(11)(i)(B) of this section.

(xx) Qualifying section 381 transaction. The term qualifying section 381 transaction means a transaction described in section 381(a)(2), except the following transactions:

(A) An acquisition of assets of a QOF by a QOF shareholder that holds a qualifying investment in the QOF;

(B) An acquisition of assets of a QOF by a tax-exempt entity as defined in §1.337(d)-4(c)(2);

(C) An acquisition of assets of a QOF by an entity operating on a cooperative basis within the meaning of section 1381;

(D) An acquisition by a QOF of assets of a QOF shareholder that holds a qualifying investment in the QOF;

(E) A reorganization of a QOF in a transaction that qualifies under section 368(a)(1)(G);

(F) A transaction, immediately after which one QOF owns an investment in another QOF; and

(G) A triangular reorganization of a QOF within the meaning of §1.358-6(b)(2)(i), (ii), or (iii).

(xxi) Remaining deferred gain. The term remaining deferred gain means the full amount of gain that was deferred under section 1400Z-2(a)(1)(A), reduced by the amount of gain previously included under paragraph (b) of this section.

(b) General inclusion rule. The gain to which a deferral election applies is included in gross income, to the extent provided in paragraph (e) of this section, in the taxable year that includes the earlier of:

(1) The date of an inclusion event, or

(2) December 31, 2026.

(c) Inclusion events--(1) General rule. Except as otherwise provided in this paragraph (c), the following events are inclusion events (which result in the inclusion of gain under paragraph (b) of this section) if, and to the extent that--

(i) Reduction of interest in QOF. A taxpayer's transfer of a qualifying investment reduces the taxpayer's equity interest in the qualifying investment;

(ii) Distribution of property regardless of whether the taxpayer's direct interest in the QOF is reduced. A taxpayer receives property in a transaction that is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the taxpayer's ownership of the QOF; or

(iii) Claim of worthlessness. A taxpayer claims a loss for worthless stock under section 165(g) or otherwise claims a worthlessness deduction with respect to its qualifying investment.

(2) Termination or liquidation of QOF or QOF owner--(i) Termination or liquidation of QOF. Except as otherwise provided in this paragraph (c), a taxpayer has an inclusion event with respect to all of its qualifying investment if the QOF ceases to exist for Federal income tax purposes.

(ii) Liquidation of QOF owner--(A) Portion of distribution treated as sale. A distribution of a qualifying investment in a complete liquidation of a QOF owner is an inclusion event to the extent that section 336(a) treats the distribution as if the qualifying investment were sold to the distributee at its fair market value, without regard to section 336(d).

(B) Distribution to 80-percent distributee. A distribution of a qualifying investment in a complete liquidation of a QOF owner is not an inclusion event to the extent section 337(a) applies to the distribution.

(3) Transfer of an investment in a QOF by gift. A taxpayer's transfer of a qualifying investment by gift, whether outright or in trust, is an inclusion event, regardless of whether that transfer is a completed gift for Federal gift tax purposes, and regardless of the taxable or tax-exempt status of the donee of the gift.

(4) Transfer of an investment in a QOF by reason of the taxpayer's death--(i) In general. Except as provided in paragraph (c)(4)(ii) of this section, a transfer of a qualifying investment by reason of the taxpayer's death is not an inclusion event.

Transfers by reason of death include, for example:



- (A) A transfer by reason of death to the deceased owner's estate;
- (B) A distribution of a qualifying investment by the deceased owner's estate;
- (C) A distribution of a qualifying investment by the deceased owner's trust that is made by reason of the deceased owner's death;
- (D) The passing of a jointly owned qualifying investment to the surviving co-owner by operation of law; and
- (E) Any other transfer of a qualifying investment at death by operation of law.

(ii) Exceptions. The following transfers are not included as a transfer by reason of the taxpayer's death, and thus are inclusion events, and the amount recognized is includible in the gross income of the transferor as provided in section 691:

- (A) A sale, exchange, or other disposition by the deceased taxpayer's estate or trust, other than a distribution described in paragraph (c)(4)(i) of this section;
- (B) Any disposition by the legatee, heir, or beneficiary who received the qualifying investment by reason of the taxpayer's death; and
- (C) Any disposition by the surviving joint owner or other recipient who received the qualifying investment by operation of law on the taxpayer's death.

(5) Grantor trusts--(i) Contributions to grantor trusts. If the owner of a qualifying investment contributes it to a trust and, under the grantor trust rules, the owner of the investment is the deemed owner of the trust, the contribution is not an inclusion event.

(ii) Changes in grantor trust status. In general, a change in the status of a grantor trust, whether the termination of grantor trust status or the creation of grantor trust status, is an inclusion event. Notwithstanding the previous sentence, the termination of grantor trust status as the result of the death of the owner of a qualifying

investment is not an inclusion event, but the provisions of paragraph (c)(4) of this section apply to distributions or dispositions by the trust.

(6) Special rules for partners and partnerships--(i) Scope. Except as otherwise provided in this paragraph (c)(6), in the case of a partnership that is a QOF or, directly or indirectly solely through one or more partnerships, owns an interest in a QOF, the inclusion rules of this paragraph (c) apply to transactions involving any direct or indirect partner of the QOF to the extent of such partner's share of any eligible gain of the QOF.

(ii) Transactions that are not inclusion events--(A) In general. Notwithstanding paragraph (c)(1), (2), and, (c)(6)(iii) of this section, and except as otherwise provided in paragraph (c)(6) of this section, no transaction described in paragraph (c)(6)(ii) of this section is an inclusion event.

(B) Section 721 contributions. Subject to paragraph (c)(6)(v) of this section, a contribution by a QOF owner, including any contribution by a partner of a partnership that, solely through one or more upper-tier partnerships, owns an interest in a QOF (contributing partner), of its direct or indirect partnership interest in a qualifying investment to a partnership (transferee partnership) in a transaction governed all or in part by section 721(a) is not an inclusion event, provided the interest transfer does not cause a partnership termination of a QOF partnership, or the direct or indirect owner of a QOF, under section 708(b)(1). See paragraph (c)(6)(ii)(C) of this section for transactions governed by section 708(b)(2)(A). Notwithstanding the rules in this paragraph (c)(6)(ii)(B), the inclusion rules in paragraph (c) of this section apply to any part of the transaction to which section 721(a) does not apply. The transferee partnership becomes subject to section 1400Z-2 and the regulations thereunder with

respect to the eligible gain associated with the contributed qualifying investment. The transferee partnership must allocate and report the gain that is associated with the contributed qualifying investment to the contributing partner to the same extent that the gain would have been allocated and reported to the contributing partner in the absence of the contribution.

(C) Section 708(b)(2)(A) mergers or consolidations. Subject to paragraph (c)(6)(v) of this section, a merger or consolidation of a partnership holding a qualifying investment, or of a partnership that holds an interest in such partnership solely through one or more partnerships, with another partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event. The resulting partnership or new partnership, as determined under §1.708-1(c)(1), becomes subject to section 1400Z-2, and regulations thereunder, to the same extent that the original partnership was so subject prior to the transaction, and must allocate and report any eligible gain to the same extent and to the same partners that the original partnership allocated and reported such items prior to the transaction. Notwithstanding the rules in this paragraph (c)(6)(ii)(C), the general inclusion rules of paragraph (c) of this section apply to the portion of the transaction that is otherwise treated as a sale or exchange under paragraph (c) of this section.

(iii) Partnership distributions. Notwithstanding paragraph (c)(6)(i) of this section, and subject to paragraph (c)(6)(v), and except as provided in paragraph (c)(6)(ii)(C) of this section, an actual or deemed distribution of property (including cash) by a QOF partnership to a partner with respect to its qualifying investment is an inclusion event only to the extent that the distributed property has a fair market value in excess of the

partner's basis in its qualifying investment. Similar rules apply to distributions involving tiered partnerships. See paragraph (c)(6)(iv) of this section for special rules relating to mixed-funds investments.

(iv) Special rules for mixed-funds investments--(A) General rule. The rules of paragraph (c)(6)(iv) of this section apply solely for purposes of section 1400Z-2. A partner that holds a mixed-funds investment in a QOF partnership (a mixed-funds partner) shall be treated as holding two separate interests in the QOF partnership, one a qualifying investment and the other a non-qualifying investment (the separate interests). The basis of each separate interest is determined under the rules described in paragraphs (c)(6)(iv)(B) and (g) of this section as if each interest were held by different taxpayers.

(B) Allocations and distributions. All section 704(b) allocations of income, gain, loss, and deduction, all section 752 allocations of debt, and all distributions made to a mixed-funds partner shall be treated as made to the separate interests based on the allocation percentages of such interests as defined in paragraph (c)(6)(iv)(D) of this section. For purposes of this paragraph (c)(6)(iv)(B), in allocating income, gain, loss, or deduction between these separate interests, section 704(c) principles shall apply to account for any value-basis disparities attributable to the qualifying investment or non-qualifying investment. Any distribution (whether actual or deemed) to the holder of a qualifying investment is subject to the rules of paragraphs (c)(6)(iii) and (v) of this section, without regard to the presence or absence of gain under other provisions of subchapter K of chapter 1 of subtitle A of the Code.

(C) Subsequent contributions. In the event of an increase in a partner's qualifying or non-qualifying investment (for example, as in the case of an additional contribution for a qualifying investment or for an interest that is a non-qualifying investment or a change in allocations for services rendered), the partner's interest in the separate interests shall be valued immediately prior to such event and the allocation percentages shall be adjusted to reflect the relative values of these separate interests and the additional contribution, if any.

(D) Allocation percentages. The allocation percentages of the separate interests shall be determined based on the relative capital contributions attributable to the qualifying investment and the non-qualifying investment. In the event a partner receives a profits interest in the partnership for services rendered to or for the benefit of the partnership, the allocation percentages with respect to such partner shall be calculated based on (i) with respect to the profits interest received, the highest share of residual profits the mixed-funds partner would receive with respect to that interest, and (ii) with respect to the remaining interest, the percentage interests for the capital interests described in the immediately preceding sentence.

(v) Remaining deferred gain reduction rule. An inclusion event occurs when and to the extent that a transaction has the effect of reducing –

(A) the amount of remaining deferred gain of one or more direct or indirect partners, or

(B) the amount of gain that would be recognized by such partner or partners under paragraph (e)(4)(ii) of this section to the extent that such amount would reduce such gain to an amount that is less than the remaining deferred gain.

(7) Special rule for S corporations--(i) In general. Except as provided in paragraph (c)(7)(ii), (iii), and (iv) of this section, none of the following is an inclusion event:

(A) An election, revocation, or termination of a corporation's status as an S corporation under section 1362;

(B) A conversion of a qualified subchapter S trust (as defined in section 1361(d)(3)) to an electing small business trust (as defined in section 1361(e)(1));

(C) A conversion of an electing small business trust to a qualified subchapter S trust;

(D) A valid modification of a trust agreement of an S-corporation shareholder whether by an amendment, a decanting, a judicial reformation, or a material modification;

(E) A 25 percent or less aggregate change in ownership pursuant to paragraph (c)(7)(iii) of this section in the equity investment in an S corporation that directly holds a qualifying investment; and

(F) A disposition of assets by a QOF S corporation.

(ii) Distributions by QOF S corporation--(A) General rule. An actual or constructive distribution of property by a QOF S corporation to a shareholder with respect to its qualifying investment is an inclusion event to the extent that the distribution is treated as gain from the sale or exchange of property under section 1368(b)(2) and (c).

(B) Spill-over rule. For purposes of applying paragraph (c)(7)(ii) of this section to the adjusted basis of a qualifying investment, or non-qualifying investment, as appropriate, in a QOF S corporation, the second sentence of §1.1367-1(c)(3) applies--

(1) With regard to multiple qualifying investments, solely to the respective bases of such qualifying investments, and does not take into account the basis of any non-qualifying investment; and

(2) With regard to multiple non-qualifying investments, solely to the respective bases of such non-qualifying investments, and does not take into account the basis of any qualifying investment.

(iii) Aggregate change in ownership of an S corporation that is a QOF owner--

(A) General rule. Solely for purposes of section 1400Z-2, an inclusion event occurs when there is an aggregate change in ownership, within the meaning of paragraph (c)(7)(iii)(B) of this section, of an S corporation that directly holds a qualifying investment in a QOF. The S corporation is treated as having disposed of its entire qualifying investment in the QOF, and neither section 1400Z-2(b)(2)(B)(iii) or (iv) nor section 1400Z-2(c) applies to the S corporation's qualifying investment after that date. The disposition under this paragraph (c)(7)(iii)(A) is treated as occurring on the date the requirements of paragraph (c)(7)(iii)(B) of this section are satisfied.

(B) Aggregate ownership change threshold. For purposes of paragraph (c)(7)(iii)(A) of this section, there is an aggregate change in ownership of an S corporation if, immediately after any change in ownership of the S corporation, the percentage of the stock of the S corporation owned directly by the shareholders who owned the S corporation at the time of its deferral election has decreased by more than

25 percent. The ownership percentage of each shareholder referred to in this paragraph (c)(7)(iii)(B) is measured separately from the ownership percentage of all other shareholders. Any decrease in ownership is determined with regard to the percentage held by the relevant shareholder at the time of the election under section 1400Z-2(a), and all decreases are then aggregated. Decreases in ownership may result from, for example, the sale of shares, the redemption of shares, the issuance of new shares, or the occurrence of section 381(a) transactions. The aggregate change in ownership is measured separately for each qualifying investment of the S corporation.

(iv) Conversion from S corporation to partnership or disregarded entity--

(A) General rule. Notwithstanding paragraph (c)(7)(i) of this section, and except as provided in paragraph (c)(7)(iv)(B) of this section, a conversion of an S corporation to a partnership or an entity disregarded as separate from its owner under §301.7701-3(b)(1)(ii) of this chapter is an inclusion event.

(B) Exception for qualifying section 381 transaction. A conversion described in paragraph (c)(7)(iv)(A) of this section is not an inclusion event if the conversion comprises a step in a series of related transactions that together qualify as a qualifying section 381 transaction.

(v) Treatment of separate blocks of stock in mixed-funds investments. With regard to a mixed-funds investment in a QOF S corporation, if different blocks of stock are created for otherwise qualifying investments to track basis in such qualifying investments, the separate blocks are not treated as different classes of stock for purposes of S corporation eligibility under section 1361(b)(1).



(vi) Applicability. Paragraph (c)(7)) of this section applies regardless of whether the S corporation is a QOF or a QOF shareholder.

(8) Distributions by a QOF C corporation. A distribution of property by a QOF C corporation with respect to a qualifying investment is not an inclusion event except to the extent section 301(c)(3) applies to the distribution. For purposes of this paragraph (c)(8), a distribution of property also includes a distribution of stock by a QOF C corporation that is treated as a distribution of property to which section 301 applies pursuant to section 305(b).

(9) Dividend-equivalent redemptions--(i) General rule. Except as provided in paragraph (c)(9)(ii) or (iii) of this section, a transaction described in section 302(d) is an inclusion event with respect to the full amount of the distribution.

(ii) Redemption of stock of wholly owned QOF. If all stock in a QOF is held directly by a single shareholder, or directly by members of the same consolidated group, and if shares are redeemed in a transaction to which section 302(d) applies, see paragraph (c)(8) of this section (applicable to distributions by QOF corporations).

(iii) S corporations. S corporation section 302(d) transactions are an inclusion event to the extent the distribution exceeds basis in the QOF as adjusted under paragraph (c)(7)(ii) of this section.

(10) Qualifying section 381 transactions--(i) Assets of a QOF are acquired--(A) In general. Except to the extent provided in paragraph (c)(10)(i)(C) of this section, if the assets of a QOF corporation are acquired in a qualifying section 381 transaction, and if the acquiring corporation is a QOF immediately after the acquisition, then the transaction is not an inclusion event.

(B) Determination of acquiring corporation's status as a QOF. For purposes of paragraph (c)(10)(i)(A) of this section, the acquiring corporation is treated as a QOF immediately after the qualifying section 381 transaction if the acquiring corporation satisfies the certification requirements in §1.1400Z2(d)-1 immediately after the transaction and holds at least 90 percent of its assets in qualified opportunity zone property on the first testing date after the transaction (see section 1400Z-2(d)(1) and §1.1400Z2(d)-1).

(C) Receipt of boot by QOF shareholder in qualifying section 381 transaction--(1)  
General rule. Except as provided in paragraph (c)(10)(i)(C)(2) of this section, if assets of a QOF corporation are acquired in a qualifying section 381 transaction and a taxpayer that is a QOF shareholder receives boot with respect to its qualifying investment, the taxpayer has an inclusion event. If the taxpayer realizes a gain on the transaction, the amount that gives rise to the inclusion event is the amount of gain under section 356 that is not treated as a dividend under section 356(a)(2). If the taxpayer realizes a loss on the transaction, the amount that gives rise to the inclusion event is an amount equal to the fair market value of the boot received.

(2) Receipt of boot from wholly owned QOF. If all stock in both a QOF and the corporation that acquires the QOF's assets in a qualifying section 381 transaction are held directly by a single shareholder, or directly by members of the same consolidated group, and if the shareholder receives (or group members receive) boot with respect to the qualifying investment in the qualifying section 381 transaction, paragraph (c)(8) of this section (applicable to distributions by QOF corporations) applies to the boot as if it

were distributed from the QOF to the shareholder(s) in a separate transaction to which section 301 applied.

(ii) Assets of a QOF shareholder are acquired--(A) In general. Except to the extent provided in paragraph (c)(10)(ii)(B) of this section, a qualifying section 381 transaction in which the assets of a QOF shareholder are acquired is not an inclusion event with respect to the qualifying investment. However, if the qualifying section 381 transaction causes a QOF shareholder that is an S corporation to have an aggregate change in ownership within the meaning of paragraph (c)(7)(iii)(B) of this section, see paragraph (c)(7)(iii)(A) of this section.

(B) Qualifying section 381 transaction in which QOF shareholder's qualifying investment is not completely acquired. If the assets of a QOF shareholder are acquired in a qualifying section 381 transaction in which the acquiring corporation does not acquire all of the QOF shareholder's qualifying investment, there is an inclusion event to the extent that the QOF shareholder's qualifying investment is not transferred to the acquiring corporation.

(11) Section 355 transactions--(i) Distribution by a QOF--(A) In general. Except as provided in paragraph (c)(11)(i)(B) of this section, if a QOF corporation distributes stock or securities of a controlled corporation to a taxpayer in a transaction to which section 355, or so much of section 356 as relates to section 355, applies, the taxpayer has an inclusion event with respect to its qualifying investment. The amount that gives rise to such inclusion event is equal to the fair market value of the shares of the controlled corporation and the boot received by the taxpayer in the distribution with respect to its qualifying investment.

(B) Controlled corporation becomes a QOF--(1) In general. Except as provided in paragraph (c)(11)(i)(B)(3) of this section, if a QOF corporation distributes stock or securities of a controlled corporation in a transaction to which section 355, or so much of section 356 as relates to section 355, applies, and if both the distributing corporation and the controlled corporation are QOFs immediately after the final distribution (qualifying section 355 transaction), then the distribution is not an inclusion event with respect to the taxpayer's qualifying investment in the distributing QOF corporation or the controlled QOF corporation. This paragraph (c)(11)(i)(B) does not apply unless the distributing corporation distributes all of the stock and securities in the controlled corporation held by it immediately before the distribution within a 30-day period. For purposes of this paragraph (c)(11)(i)(B), the term final distribution means the last distribution that satisfies the preceding sentence.

(2) Determination of distributing corporation's and controlled corporation's status as QOFs. For purposes of paragraph (c)(11)(i)(B)(1) of this section, each of the distributing corporation and the controlled corporation is treated as a QOF immediately after the final distribution if the corporation satisfies the certification requirements in §1.1400Z2(d)-1 immediately after the final distribution and holds at least 90 percent of its assets in qualified opportunity zone property on the first testing date after the final distribution (see section 1400Z-2(d)(1) and §1.1400Z2(d)-1)).

(3) Receipt of boot. If a taxpayer receives boot in a qualifying section 355 transaction with respect to its qualifying investment, and if section 356(a) applies to the transaction, the taxpayer has an inclusion event, and the amount that gives rise to the inclusion event is the amount of gain under section 356 that is not treated as a dividend

under section 356(a)(2). If a taxpayer receives boot in a qualifying section 355 transaction with respect to its qualifying investment, and if section 356(b) applies to the transaction, see paragraph (c)(8) of this section (applicable to distributions by QOF corporations).

(4) Treatment of controlled corporation stock as qualified opportunity zone stock.

If stock or securities of a controlled corporation are distributed in a qualifying section 355 transaction, and if the distributing corporation retains a portion of the controlled corporation stock after the initial distribution, the retained stock will not cease to qualify as qualified opportunity zone stock in the hands of the distributing corporation solely as a result of the qualifying section 355 transaction. This paragraph (c)(11)(i)(B)(4) does not apply unless the distributing corporation distributes all of the stock and securities in the controlled corporation held by it immediately before the distribution within a 30-day period.

(ii) Distribution by a QOF shareholder. If a QOF shareholder distributes stock or securities of a controlled QOF corporation in a transaction to which section 355 applies, then for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section, the taxpayer has an inclusion event to the extent the distribution reduces the taxpayer's direct tax ownership of its qualifying QOF stock. For distributions by a QOF shareholder that is an S corporation, see also paragraph (c)(7)(iii) of this section.

(12) Recapitalizations and section 1036 transactions--(i) No reduction in proportionate interest in qualifying QOF stock--(A) In general. Except as otherwise provided in paragraph (c)(8) (relating to distributions subject to section 305(b)) or paragraph (c)(12)(i)(B) of this section, if a QOF corporation engages in a transaction

that qualifies as a reorganization described in section 368(a)(1)(E), or if a QOF shareholder engages in a transaction that is described in section 1036, and if the transaction does not have the result of decreasing the taxpayer's proportionate interest in the QOF corporation, the transaction is not an inclusion event.

(B) Receipt of property or boot by QOF shareholder. If the taxpayer receives property or boot in a transaction described in paragraph (c)(12)(i)(A) of this section and section 368(a)(1)(E), then the property or boot is treated as property or boot to which section 301 or section 356 applies, as determined under general tax principles. If the taxpayer receives property that is not permitted to be received without the recognition of gain in a transaction described in paragraph (c)(12)(i)(A) of this section and section 1036, then, for purposes of this section, the property is treated in a similar manner as boot in a transaction described in section 368(a)(1)(E). For the treatment of property to which section 301 applies, see paragraph (c)(8) of this section. For the treatment of boot to which section 356 applies (including in situations in which the QOF is wholly and directly owned by a single shareholder or by members of the same consolidated group), see paragraph (c)(10) of this section.

(ii) Reduction in proportionate interest in the QOF corporation. If a QOF engages in a transaction that qualifies as a reorganization described in section 368(a)(1)(E), or if a QOF shareholder engages in a transaction that is described in section 1036, and if the transaction has the result of decreasing the taxpayer's proportionate qualifying interest in the QOF corporation, then the taxpayer has an inclusion event in an amount equal to the amount of the reduction in the fair market value of the taxpayer's qualifying QOF stock.

(13) Section 304 transactions. A transfer of a qualifying investment in a transaction described in section 304(a) is an inclusion event with respect to the full amount of the consideration.

(14) Deduction for worthlessness. If a taxpayer claims a loss for worthless stock under section 165(g) or otherwise claims a worthlessness deduction with respect to all or a portion of its qualifying investment, then for purposes of section 1400Z-2 and the regulations thereunder, the taxpayer is treated as having disposed of that portion of its qualifying investment on the date it became worthless. Thus, the taxpayer has an inclusion event with respect to that portion of its qualifying investment, and neither section 1400Z-2(b)(2)(B)(iii) or (iv) nor section 1400Z-2(c) applies to that portion of the taxpayer's qualifying investment after the date it became worthless.

(15) Other inclusion and non-inclusion events. Notwithstanding any other provision of this paragraph (c), the Commissioner may determine by published guidance that a type of transaction is or is not an inclusion event.

(d) Holding periods--(1) Holding period for QOF investment--(i) General rule. Solely for purposes of sections 1400Z-2(b)(2)(B) and 1400Z-2(c), and except as otherwise provided in this paragraph (d)(1), the length of time a qualifying investment has been held is determined without regard to the period for which the taxpayer had held property exchanged for such investment.

(ii) Holding period for QOF investment received in a qualifying section 381 transaction, a reorganization described in section 368(a)(1)(E), or a section 1036 exchange. For purposes of section 1400Z-2(b)(2)(B) and 1400Z-2(c), the holding period for QOF stock received by a taxpayer in a qualifying section 381 transaction in

which the target corporation was a QOF immediately before the acquisition and the acquiring corporation is a QOF immediately after the acquisition, in a reorganization described in section 368(a)(1)(E), or in a section 1036 exchange, is determined by applying the principles of section 1223(1).

(iii) Holding period for controlled corporation stock. For purposes of section 1400Z-2(b)(2)(B) and 1400Z-2(c), the holding period of a qualifying investment in a controlled corporation received by a taxpayer on its qualifying investment in the distributing corporation in a qualifying section 355 transaction is determined by applying the principles of section 1223(1).

(iv) Tacking with donor or deceased owner. For purposes of section 1400Z-2(b)(2)(B) and 1400Z-2(c), the holding period of a qualifying investment held by a taxpayer who received that qualifying investment as a gift that was not an inclusion event, or by reason of the prior owner's death, includes the time during which that qualifying investment was held by the donor or the deceased owner, respectively.

(2) Determination of original use of QOF assets--(i) Assets acquired in a section 381 transaction. For purposes of section 1400Z-2(d), including for purposes of determining whether the original use of qualified opportunity zone business property commences with the acquiring corporation, any qualified opportunity zone property transferred by the transferor QOF to the acquiring corporation in connection with a qualifying section 381 transaction does not lose its status as qualified opportunity zone property solely as a result of its transfer to the acquiring corporation.

(ii) Assets contributed to a controlled corporation. For purposes of section 1400Z-2(d), including for purposes of determining whether the original use of qualified



opportunity zone business property commences with the controlled corporation, any qualified opportunity zone property contributed by the distributing corporation to the controlled corporation in connection with a qualifying section 355 transaction does not lose its status as qualified opportunity zone property solely as a result of its contribution to the controlled corporation.

(3) Application to partnerships. The principles of paragraphs (d)(1) and (2) of this section apply to qualifying QOF partnership interests with regard to non-inclusion transactions described in paragraph (c)(6)(ii) of this section.

(e) Amount includible. Except as provided in §1.1400Z2(a)-1(b)(4), the amount of gain included in gross income under section 1400Z-2(a)(1)(B) on a date described in paragraph (b) of this section is determined under this paragraph (e).

(1) In general. Except as provided in paragraphs (e)(2) and (e)(4) of this section, and subject to paragraph (e)(5) of this section, in the case of an inclusion event, the amount of gain included in gross income is equal to the excess of the amount described in paragraph (e)(1)(i) of this section over the amount described in paragraph (e)(1)(ii) of this section.

(i) The amount described in this paragraph (e)(1)(i) is equal to the lesser of:

(A) An amount which bears the same proportion to the remaining deferred gain,  
as

(1) The fair market value of the portion of the qualifying investment that is disposed of in the inclusion event, as determined as of the date of the inclusion event, bears to

(2) The fair market value of the total qualifying investment immediately before the inclusion event, or

(B) The amount described in paragraph (e)(1)(i)(A)(1) of this section.

(ii) The amount described in this paragraph (e)(1)(ii) is the taxpayer's basis in the portion of the qualifying investment that is disposed of in the inclusion event.

(iii) For purposes of paragraph (e)(1)(i)(A)(1) of this section, the fair market value of that portion is determined by multiplying the fair market value of the taxpayer's entire qualifying investment in the QOF, valued as of the date of the inclusion event, by the percentage of the taxpayer's qualifying investment that is represented by the portion disposed of in the inclusion event.

(2) Property received from a QOF in certain transactions. In the case of an inclusion event described in paragraphs (c)(6)(iii), (v), paragraphs (c)(8),(9), (10), (11), or paragraph (c)(12) of this section, the amount of gain included in gross income is equal to the lesser of:

(i) The remaining deferred gain, or

(ii) The amount that gave rise to the inclusion event. See paragraph (c) of this section for rules regarding the amount that gave rise to the inclusion event, and see paragraph (g) of this section for applicable ordering rules.

(3) Gain recognized on December 31, 2026. The amount of gain included in gross income on December 31, 2026 is equal to the excess of--

(i) The lesser of--

(A) The remaining deferred gain; and

(B) The fair market value of the qualifying investment held on December 31, 2026; over

(ii) The taxpayer's basis in the qualifying investment as of December 31, 2026, taking into account only section 1400Z-2(b)(2)(B).

(4) Special amount includible rule for partnerships and S corporations. For purposes of paragraphs (e)(1) and (3) of this section, in the case of an inclusion event involving a qualifying investment in a QOF partnership or S corporation, or in the case of a qualifying investment in a QOF partnership or S corporation held on December 31, 2026, the amount of gain included in gross income is equal to the lesser of:

(i) The product of:

(A) The percentage of the qualifying investment that gave rise to the inclusion event, and

(B) The remaining deferred gain, less any basis adjustments pursuant to section 1400Z-2(b)(2)(B)(iii) and (iv), or

(ii) The gain that would be recognized on a fully taxable disposition of the qualifying investment that gave rise to the inclusion event.

(5) Limitation on amount of gain included after statutory five- and seven-year basis increases. The total amount of gain included in gross income under this paragraph (e) is limited to the amount deferred under section 1400Z-2(a)(1), reduced by any increase in the basis of the qualifying investment made pursuant to section 1400Z-2(b)(2)(B)(iii) or (iv). See paragraph (g)(2) of this section for limitations on the amount of basis adjustments under section 1400Z-2(b)(2)(B)(iii) and (iv).

(f) Examples. The following examples illustrate the rules of paragraphs (c), (d) and (e) of this section. For purposes of these examples: A, B, C, W, X, Y, and Z are C corporations that do not file a consolidated Federal income tax return; Q is a QOF corporation or a QOF partnership, as specified in each example; and each divisive corporate transaction satisfies the requirements of section 355.

(1) Example 1. Determination of basis, holding period, and qualifying investment--(i) Facts. A wholly and directly owns Q, a QOF corporation. On May 31, 2019, A sells a capital asset to an unrelated party and realizes \$500 of capital gain. On October 31, 2019, A transfers unencumbered asset N to Q in exchange for a qualifying investment. Asset N, which A has held for 10 years, has a basis of \$500 and a fair market value of \$500. A elects to defer the inclusion of \$500 in gross income under section 1400Z-2(a) and §1.1400Z2(a)-1.

(ii) Analysis. Under §1.1400Z2(a)-1(b)(10)(i)(B)(1), A made a qualifying investment of \$500. Under section 1400Z-2(b)(2)(B)(i), A's basis in its qualifying investment in Q is \$0. For purposes of sections 1400Z-2(b)(2)(B) and 1400Z-2(c), A's holding period in its new investment in Q begins on October 31, 2019. See paragraph (d)(1)(i) of this section. Other than for purposes of applying section 1400Z-2, A has a 10-year holding period in its new Q investment as of October 31, 2019.

(iii) Transfer of built-in gain property. The facts are the same as in paragraph (i) of this Example 1, but A's basis in transferred asset N is \$200. Under §1.1400Z2(a)-1(b)(10)(i)(B)(1), A made a qualifying investment of \$200 and a non-qualifying investment of \$300.

(2) Example 2. Transfer of qualifying investment--(i) Facts. On May 31, 2019, A sells a capital asset to an unrelated party and realizes \$500 of capital gain. On October 31, 2019, A transfers \$500 to newly formed Q, a QOF corporation, in exchange for a qualifying investment. On February 29, 2020, A transfers 25 percent of its qualifying investment in Q to newly formed Y in exchange for 100 percent of Y's stock in a transfer to which section 351 applies (the Transfer), at a time when the fair market value of A's qualifying investment in Q is \$800.

(ii) Analysis. Under §1.1400Z2(a)-1(b)(10)(i)(A), A made a qualifying investment of \$500 on October 31, 2019. In the Transfer, A exchanged 25 percent of its qualifying investment for Federal income tax purposes, which reduced A's direct qualifying investment. Under paragraph (c)(1)(i) of this section, the Transfer is an inclusion event to the extent of the reduction in A's direct qualifying investment. Under paragraph (e)(1) of this section, A therefore includes in income an amount equal to the excess of the amount described in paragraph (e)(1)(i) over A's basis in the portion of the qualifying investment that was disposed of, which in this case is \$0. The amount described in

paragraph (e)(1)(i) is the lesser of (A) \$125 ( $\$500 \times (\$200 / \$800)$ ), or (B) \$200. As a result, A must include \$125 of its deferred capital gain in income in 2020. After the Transfer, the Q stock is not qualifying Q stock in Y's hands.

(iii) Disregarded transfer. The facts are the same as in paragraph (i) of this Example 2, except that Y elects to be treated as an entity that is disregarded as an entity separate from its owner for Federal income tax purposes effective prior to the Contribution. Since the Transfer would be disregarded for Federal income tax purposes, A's transfer of its qualifying investment in Q would not be treated as a reduction in direct tax ownership for Federal income tax purposes, and the Transfer would not be an inclusion event with respect to A's qualifying investment in Q for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. Thus, A would not be required to include in income any portion of its deferred capital gain.

(iv) Election to be treated as a corporation. The facts are the same as in paragraph (iii) of this Example 2, except that Y (a disregarded entity) subsequently elects to be treated as a corporation for Federal income tax purposes. A's deemed transfer of its qualifying investment in Q to Y under §301.7701-3(g)(1)(iv) of this chapter is an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section.

(3) Example 3. Part sale of qualifying QOF partnership interest in Year 6 when value of the QOF interest has increased--(i) Facts. In October 2018, A and B each realize \$200 of eligible gain, and C realizes \$600 of eligible gain. On January 1, 2019, A, B, and C form Q, a QOF partnership. A contributes \$200 of cash, B contributes \$200 of cash, and C contributes \$600 of cash to Q in exchange for qualifying QOF partnership interests in Q. A, B, and C hold 20 percent, 20 percent, and 60 percent interests in Q, respectively. On January 30, 2019, Q obtains a nonrecourse loan from a bank for \$1,000. Under section 752, the loan is allocated \$200 to A, \$200 to B, and \$600 to C. On February 1, 2019, Q purchases qualified opportunity zone business property for \$2,000. On July 31, 2024, A sells 50 percent of its qualifying QOF partnership interest in Q to B for \$400 cash. Prior to the sale, there were no inclusion events, distributions, partner changes, income or loss allocations, or changes in the amount or allocation of debt outstanding. At the time of the sale, the fair market value of Q's qualified opportunity zone business property is \$5,000.

(ii) Analysis. Because A held its qualifying QOF partnership interest for at least five years, A's basis in its partnership interest at the time of the sale is \$220 (the original zero basis with respect to the contribution, plus the \$200 debt allocation, plus the 10% increase for interests held for five years). The sale of 50 percent of A's qualifying QOF partnership interest to B requires A to recognize \$90 of eligible gain, the lesser of 50 percent of the remaining \$180 deferred gain (\$90) or the gain that would be recognized on a taxable sale of 50 percent of the interest (\$390). A also recognizes \$300 of gain relating to the appreciation of its interest in Q.

(4) Example 4. Sale of qualifying QOF partnership interest when value of the QOF interest has decreased--(i) Facts. The facts are the same as in Example 3 of this

paragraph (f), except that A sells 50 percent of its qualifying QOF partnership interest in Q to B for cash of \$50, and at the time of the sale, the fair market value of Q's qualified opportunity zone business property is \$1,500.

(ii) Analysis. Because A held its qualifying QOF partnership interest for at least five years, A's basis at the time of the sale is \$220. Under section 1400Z-2(b)(2)(A), the sale of 50 percent of A's qualifying QOF partnership interest to B requires A to recognize \$40 of eligible gain, the lesser of \$90 (50 percent of A's remaining deferred gain of \$180) or \$40 (the gain that would be recognized by A on a sale of 50 percent of its QOF interest). A's remaining basis in its qualifying QOF partnership interest is \$110.

(5) Example 5. Amount includible on December 31, 2026--(i) Facts. The facts are the same as in Example 3 of this paragraph (f), except that no sale of QOF interests takes place in 2024. Prior to December 31, 2026, there were no inclusion events, distributions, partner changes, income or loss allocations, or changes in the amount or allocation of debt outstanding.

(ii) Analysis. For purposes of calculating the amount includible on December 31, 2026, each of A's basis and B's basis is increased by \$30 to \$230, and C's basis is increased by \$90 to \$690 because they held their qualifying QOF partnership interests for at least seven years. Each of A and B is required to recognize \$170 of eligible gain, and C is required to recognize \$510 of eligible gain.

(iii) Sale of qualifying QOF partnership interests. The facts are the same as in paragraph (i) of this Example 5, except that, on March 2, 2030, C sells its entire qualifying QOF partnership interest in Q to an unrelated buyer for cash of \$4,200. Assuming an election under section 1400Z-2(c) is made, the basis of C's Q interest is increased to its fair market value immediately before the sale by C. C is treated as purchasing the interest immediately before the sale and the bases of the partnership's assets are increased in the manner they would be if the partnership had an election under section 754 in effect.

(6) Example 6. Mixed-funds investment--(i) Facts. On January 1, 2019, A and B form Q, a QOF partnership. A contributes \$200 to Q, \$100 of which is a qualifying investment, and B contributes \$200 to Q in exchange for a qualifying investment. All the cash is used to purchase qualified opportunity zone property. Q has no liabilities. On March 30, 2023, when the values and bases of the qualifying investments remain unchanged, Q distributes \$50 to A.

(ii) Analysis. Under paragraph (c)(6)(iv) of this section, A is a mixed-funds partner holding two separate interests, a qualifying investment and a non-qualifying investment. One half of the \$50 distribution is treated under that provision as being made with respect to A's qualifying investment. For the \$25 distribution made with respect to the qualifying investment, A is required to recognize \$25 of eligible gain.

(iii) Basis adjustments. Under paragraph (g)(1)(ii)(B) of this section, prior to determining the tax consequences of the distribution, A increases its basis in its

qualifying QOF partnership interest by \$25 under section 1400Z-2(b)(2)(B)(ii). The distribution of \$25 results in no gain under section 731. After the distribution, A's basis in its qualifying QOF partnership interest is \$0 (\$25-\$25).

(7) Example 7. Qualifying section 381 transaction of a QOF corporation--(i) Facts. X wholly and directly owns Q, a QOF corporation. On May 31, 2019, X sells a capital asset to an unrelated party and realizes \$500 of capital gain. On October 31, 2019, X contributes \$500 to Q in exchange for a qualifying investment. In 2020, Q merges with and into unrelated Y (with Y surviving) in a transaction that qualifies as a reorganization under section 368(a)(1)(A) (the Merger). X does not receive any boot in the Merger with respect to its qualifying investment in Q. Immediately after the Merger, Y satisfies the requirements for QOF status under section 1400Z-2(d)(1) (see paragraph (c)(10)(i)(B) of this section).

(ii) Analysis. The Merger is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. See paragraph (c)(10)(i)(A) of this section. Accordingly, X is not required to include in income in 2020 its \$500 of deferred capital gain as a result of the Merger. For purposes of section 1400Z-2(b)(2)(B) and 1400Z-2(c), X's holding period for its investment in Y is treated as beginning on October 31, 2019. For purposes of section 1400Z-2(d), Y's holding period in its assets includes Q's holding period in its assets, and Q's qualified opportunity zone business property continues to qualify as such. See paragraph (d)(2)(i) of this section.

(iii) Merger of QOF shareholder. The facts are the same as in paragraph (i) of this Example 7, except that, in 2020, X (rather than Q) merges with and into Y in a section 381 transaction in which Y acquires all of X's qualifying interest in Q, and Y does not qualify as a QOF immediately after the merger. The merger transaction is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. See paragraph (c)(10)(ii) of this section.

(iv) Receipt of boot. The facts are the same as in paragraph (i) of this Example 7, except that the value of X's qualifying investment immediately before the Merger is \$1,000, X receives \$100 of cash in addition to Y stock in the Merger in exchange for its qualifying investment, and neither Q nor Y has any earnings and profits. X realizes \$1,000 of gain in the Merger. Under paragraphs (c)(10)(i)(C)(1) and (e)(2) of this section, X is required to include \$100 of its deferred capital gain in income in 2020.

(v) Realization of loss. The facts are the same as in paragraph (iv) of this Example 7, except that the Merger occurs in 2025, the value of X's qualifying investment immediately before the Merger is \$25, and X receives \$10 of boot in the Merger. X realizes \$25 of loss in the Merger. Under paragraphs (c)(10)(i)(C)(1) and (e)(2) of this section, X is required to include \$10 of its deferred capital gain in income in 2020.

(8) Example 8. Section 355 distribution by a QOF--(i) Facts. A wholly and directly owns Q, a QOF corporation, which wholly and directly owns Y, a corporation

that is a qualified opportunity zone business. On May 31, 2019, A sells a capital asset to an unrelated party and realizes \$500 of capital gain. On October 31, 2019, A contributes \$500 to Q in exchange for a qualifying investment. On June 26, 2025, Q distributes all of the stock of Y to A in a transaction in which no gain or loss is recognized under section 355 (the Distribution). Immediately after the Distribution, each of Q and Y satisfies the requirements for QOF status (see paragraph (c)(11)(i)(B)(2) of this section).

(ii) Analysis. Because each of Q (the distributing corporation) and Y (the controlled corporation) is a QOF immediately after the Distribution, the Distribution is a qualifying section 355 transaction. Thus, the Distribution is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section.. See paragraph (c)(11)(i)(B) of this section. Accordingly, A is not required to include in income in 2025 any of its \$500 of deferred capital gain as a result of the Distribution. For purposes of section 1400Z-2(b)(2)(B) and 1400Z-2(c), A's holding period for its qualifying investment in Y is treated as beginning on October 31, 2019. See paragraph (d)(2)(i) of this section.

(iii) Section 355 distribution by a QOF shareholder. The facts are the same as in paragraph (i) of this Example 8, except that A distributes 80 percent of the stock of Q (all of which is a qualifying investment in the hands of A) to A's shareholders in a transaction in which no gain or loss is recognized under section 355. The distribution is an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section, and A is required to include in income \$400 (80 percent of its \$500 of deferred capital gain) as a result of the distribution. See paragraphs (c)(1) and (c)(11)(ii) of this section.

(iv) Distribution of boot. The facts are the same as in paragraph (i) of this Example 8, except that A receives boot in the Distribution. Under paragraphs (c)(8) and (c)(11)(i)(B)(3) of this section, the receipt of boot in the Distribution is an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section to the extent of gain recognized pursuant to section 301(c)(3).

(v) Section 355 split-off. The facts are the same as in paragraph (i) of this Example 8, except that Q stock is directly owned by both A and B (each of which has made a qualifying investment in Q), and Q distributes all of the Y stock to B in exchange for B's Q stock in a transaction in which no gain or loss is recognized under section 355. The distribution is a qualifying section 355 transaction and is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. Neither A nor B is required to include its deferred capital gain in income in 2025 as a result of the distribution.

(vi) Section 355 split-up. The facts are the same as in paragraph (v) of this Example 8, except that Q wholly and directly owns both Y and Z; Q distributes all of the Y stock to A in exchange for A's Q stock and distributes all of the Z stock to B in exchange for B's Q stock in a transaction in which no gain or loss is recognized under



section 355; Q then liquidates; and immediately after the Distribution, each of Y and Z satisfies the requirements for QOF status. The distribution is a qualifying section 355 transaction and is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. Neither A nor B is required to include its deferred capital gain in income in 2025 as a result of the transaction.

(vii) Section 355 split-off with boot. The facts are the same as in paragraph (v) of this Example 8, except that B also receives boot. Under paragraph (c)(11)(i)(B)(3) of this section, B has an inclusion event, and the amount that gives rise to the inclusion event is the amount of gain under section 356 that is not treated as a dividend under section 356(a)(2).

(9) Example 9. Recapitalization--(i) Facts. On May 31, 2019, each of A and B sells a capital asset to an unrelated party and realizes \$500 of capital gain. On October 31, 2019, A contributes \$500 to newly formed Q in exchange for 50 shares of Q non-voting stock (A's qualifying investment) and B contributes \$500 to Q in exchange for 50 shares of Q voting stock (B's qualifying investment). A and B are the sole shareholders of Q. In 2020, when A's qualifying investment is worth \$600, A exchanges all of its Q non-voting stock for \$120 and 40 shares of Q voting stock in a transaction that qualifies as a reorganization under section 368(a)(1)(E).

(ii) Analysis. Because A's proportionate interest in Q has decreased in this transaction, the recapitalization is an inclusion event under paragraph (c)(12)(ii) of this section. Thus, A is treated as having reduced its direct tax ownership of its investment in Q to the extent of the reduction in the fair market value of its qualifying QOF stock. The \$120 that A received in the reorganization represents the difference in fair market value between its qualifying investment before and after the reorganization. Under paragraph (c)(12)(i)(B) and paragraph (e)(2) of this section, A is required to include \$120 of its deferred capital gain in income in 2020. Because B's proportionate interest in Q has not decreased, and because B did not receive any property in the recapitalization, B does not have an inclusion event with respect to its qualifying investment in Q. See paragraph (c)(12)(i) of this section. Therefore, B is not required to include any of its deferred gain in income as a result of this transaction.

(10) Example 10. Debt financed distribution--(i) Facts. On January 1, 2019, A and B form Q, a QOF partnership, each contributing \$200 that is deferred under the section 1400Z-2(a) election to Q in exchange for a qualifying investment. On November 18, 2022, Q obtains a nonrecourse loan from a bank for \$300. Under section 752, the loan is allocated \$150 to A and \$150 to B. On November 30, 2022, when the values and bases of the investments remain unchanged, Q distributes \$50 to A.

(ii) Analysis. A is not required to recognize gain under §1.1400Z2(b)-1(c) because A's basis in its qualifying investment is \$150 (the original zero basis with respect to the contribution, plus the \$150 debt allocation). The distribution reduces A's basis to \$100.

(11) Example 11. Debt financed distribution in excess of basis--(i) Facts. The facts are the same as in Example 10 of this paragraph (f), except that the loan is entirely allocated to B under section 752. On November 30, 2024, when the values of the investments remain unchanged, Q distributes \$50 to A.

(ii) Analysis. Under §1.1400Z2(b)-1(c)(6)(iii), A is required to recognize \$30 of eligible gain under section §1.1400Z2(b)-1(c) because the \$50 distributed to A exceeds A's \$20 basis in its qualifying investment (the original zero basis with respect to its contribution, plus \$20 with regard to section 1400Z-2(b)(2)(B)(iii)).

(12) Example 12. Aggregate ownership change threshold--(i) Facts. On May 31, 2019, B, an S corporation, sells a capital asset to an unrelated party for cash and realizes \$500 of capital gain. On July 15, 2019, B makes a deferral election and transfers the \$500 to Q, a QOF partnership in exchange for a qualifying investment. On that date, B has outstanding 100 shares, of which each of individuals D, E, F, and G owns 25 shares. On September 30, 2019, D sells 10 shares of its B stock. On September 30, 2020, E sells 16 shares of its B stock.

(ii) Analysis. Under paragraph (c)(7)(iii)(A) of this section, the sales of stock by D and E caused an aggregate change in ownership of B because, the percentage of the stock of B owned directly by D, E, F, and G at the time of B's deferral election decreased by more than 25 percent. Solely for purposes of section 1400Z-2, B's qualifying investment in Q would be treated as disposed of. Consequently, B would have an inclusion event with respect to all of B's remaining deferred gain of \$500, and neither section 1400Z-2(b)(2)(B)(iii) or (iv), nor section 1400Z-2(c), would apply to B's qualifying investment after that date.

(g) Basis adjustments--(1) Timing of section 1400Z-2(b)(2)(B)(ii) adjustments--(i) In general. Except as provided in paragraph (g)(1)(ii) of this section, basis adjustments under section 1400Z-2(b)(2)(B)(ii) are made immediately after the amount of gain determined under section 1400Z-2(b)(2)(A) is included in income under section 1400Z-2(b)(1). If the basis adjustment under section 1400Z-2(b)(2)(B)(ii) is being made as a result of an inclusion event, then the basis adjustment is made before determining the other tax consequences of the inclusion event.

(ii) Specific application to section 301(c)(3) gain, S corporation shareholder gain, or partner gain--(A) General rule. This paragraph (g)(1)(ii) applies if a QOF makes a distribution to its owner, and if, without regard to any basis adjustment under section

1400Z-2(b)(2)(B)(ii), at least a portion of the distribution would be characterized as gain under section 301(c)(3) or paragraph (c)(6)(iii) and paragraph (c)(7)(ii) of this section with respect to its qualifying investment.

(B) Ordering rule. If paragraph (g)(1)(ii) of this section applies, the taxpayer is treated as having an inclusion event to the extent provided in paragraph (c)(6)(iii), paragraph (c)(7), paragraph (c)(8), paragraph (c)(9), paragraph (c)(10), paragraph (c)(11), or paragraph (c)(12) of this section, as applicable. Then, the taxpayer increases its basis under section 1400Z-2(b)(2)(B)(ii), before determining the tax consequences of the distribution.

(C) Example. The following example illustrates the rules of this paragraph (g)(1)(ii).

(1). Example 1--(i) Facts. On May 31, 2019, A sells a capital asset to an unrelated party and realizes \$500 of capital gain. On October 31, 2019, A contributes \$500 to Q, a newly formed QOF corporation, in exchange for all of the outstanding Q common stock and elects to defer the recognition of \$500 of capital gain under section 1400Z-2(a) and §1.1400Z2(a)-1. In 2020, when Q has \$40 of earnings and profits, Q distributes \$100 to A (the Distribution).

(ii) Recognition of gain. Under paragraph (g)(1)(ii)(A) of this section, the Distribution is first evaluated without regard to any basis adjustment under section 1400Z-2(b)(2)(B)(ii). Of the \$100 distribution, \$40 is treated as a dividend and \$60 is treated as gain from the sale or exchange of property under section 301(c)(3), because A's basis in its Q stock is \$0 under section 1400Z-2(b)(2)(B)(i). Under paragraphs (c)(8) and (e)(2) of this section, \$60 of A's gain that was deferred under section 1400Z-2(a) and §1.1400Z2(a)-1 is recognized in 2020.

(iii) Basis adjustments. Under paragraph (g)(1)(ii)(B) of this section, prior to determining the further tax consequences of the Distribution, A increases its basis in its Q stock by \$60 in accordance with section 1400Z-2(b)(2)(B)(ii). As a result, the Distribution is characterized as a dividend of \$40 under section 301(c)(1) and a return of basis of \$60 under section 301(c)(2). Therefore, after the section 301 distribution, A's basis in Q is \$0 (\$60 - \$60).

(2) Amount of basis adjustment. The increases in basis under section 1400Z-2(b)(2)(B)(iii) and (iv) only apply to that portion of the qualifying investment that has not been subject to previous gain inclusion under section 1400Z-2(b)(2)(A).

(3) Special partnership rules--(i) General rule. The initial basis under section 1400Z-2(b)(2)(B)(i) of a qualifying investment in a QOF partnership is zero, as adjusted to take into account the contributing partner's share of partnership debt under section 752.

(ii) Tiered arrangements. Any basis adjustment described in section 1400Z-2(b)(2)(B)(iii) and (iv) and section 1400Z-2(c) (the basis adjustment rules) shall be treated as an item of income described in section 705(a)(1) and shall be reported in accordance with the applicable forms and instructions. Any amount to which the basis adjustment rules or to which section 1400Z-2(b)(1) applies shall be allocated to the owners of the QOF, and to the owners of any partnership that directly or indirectly (solely through one or more partnerships) owns such QOF interest, and shall track to such owners' interests, based on their shares of the remaining deferred gain to which such amounts relate.

(4) Basis adjustments in S corporation stock--(i) S corporation investor in QOF—

(A) S corporation. If an S corporation is an investor in a QOF, the S corporation must adjust the basis of its qualifying investment as set forth in this paragraph (g). This rule does not affect adjustments to the basis of any other asset of the S corporation.

(B) S corporation shareholder--(1) In general. The S corporation shareholder's pro-rata share of any recognized capital gain that has been deferred at the

S corporation level will be separately stated under section 1366 and will adjust the shareholders' stock basis under section 1367.

(2) Basis adjustments to qualifying investments. Any adjustment made to the basis of an S corporation's qualifying investment under section 1400Z-2(b)(2)(B)(iii) or (iv), or section 1400Z-2(c), will not (1) be separately stated under section 1366, or (2) until the date on which an inclusion event with respect to the S corporation's qualifying investment occurs, adjust the shareholders' stock basis under section 1367.

(3) Basis adjustments resulting from inclusion events. If the basis adjustment under section 1400Z-2(b)(2)(B)(ii) is being made as a result of an inclusion event, then the basis adjustment is made before determining the other tax consequences of the inclusion event.

(ii) QOF S corporation--

(A) Transferred basis of assets received. If a QOF S corporation receives an asset in exchange for a qualifying investment, the basis of the asset shall be the same as it would be in the hands of the transferor, increased by the amount of the gain recognized by the transferor on such transfer.

(B) Basis adjustments resulting from inclusion events. If the basis adjustment under section 1400Z-2(b)(2)(B)(ii) for the shareholder of the QOF S corporation is being made as a result of an inclusion event, then the basis adjustment is made before determining the other tax consequences of the inclusion event.

(h) Notifications by partners and partnerships, and shareholders and S corporations--(1) Notification of deferral election. A partnership that makes a deferral election must notify all of its partners of the deferral election and state each partner's

distributive share of the eligible gain in accordance with applicable forms and instructions. A partner that makes a deferral election must notify the partnership in writing of its deferral election, including the amount of the eligible gain deferred.

(2) Notification of deferred gain recognition by indirect QOF owner. If an indirect owner of a QOF partnership or QOF S corporation sells a portion of its partnership interest or S corporation shares in a transaction to which §1.1400Z2(b)-1(c)(6)(iv) applies, or which is subject to §1.1400Z2(b)-1(c)(7)(iii), such indirect owner must provide to the QOF owner notification and information sufficient to enable the QOF owner, in a timely manner, to recognize an appropriate amount of deferred gain.

(3) Notification of section 1400Z-2(c) election by QOF partner or QOF partnership. A QOF partner must notify the QOF partnership of an election under section 1400Z-2(c) to adjust the basis of the qualifying QOF partnership interest that is disposed of in a taxable transaction. Notification of the section 1400Z-2(c) election, and the adjustments to the basis of the qualifying QOF partnership interest(s) disposed of or to the QOF partnership asset(s) disposed of, is to be made in accordance with applicable forms and instructions.

(4) S corporations. Similar rules to those in paragraphs (h)(1) and (h)(3) of this section apply to S corporations as appropriate.

(i) Applicability dates. This section applies for taxable years that begin on or after the date of publication in the **Federal Register** of a Treasury decision adopting these proposed rules as final regulations. However, a taxpayer may rely on the proposed rules in this section with respect to taxable years that begin before that date, but only if the taxpayer applies the rules in their entirety and in a consistent manner.

Par. 4. Section 1.1400Z2(c)-1, as proposed to be added by 83 FR 54279 October 29, 2018, is amended by:

1. Revising paragraph (a).
2. Redesignating paragraphs (b), (c), and (d) as paragraphs (c), (d), and (f) respectively.
3. Adding new paragraph (b).
4. In redesignated paragraph (d):
  - a. Revising the first sentence of paragraph (d).
  - b. In paragraph (d)(1)(ii), replace the language “paragraph (b) of this section” with “paragraph (c) of this section” and replace the language “paragraph (a) of this section” with “paragraphs (a) and (b) of this section”.
  - c. Revising paragraph (d)(2).
5. Adding paragraph (e).
6. Revising redesignated paragraph (f).

§1.1400Z2(c)-1 Investments held for at least 10 years.

(a) Scope and definitions--(1) Scope. This section provides rules under section 1400Z-2(c) of the Internal Revenue Code regarding the election to adjust the basis in a qualifying investment in a QOF or certain eligible property held by the QOF. See §1.1400Z2(b)-1(d) for purposes of determining the holding period of a qualifying investment for purposes of this section.

(2) Definitions. The definitions provided in §1.1400Z2(b)-1(a)(2) apply for purposes of this section.

(b) Investment to which an election can be made--(1) In general--(i) Election by taxpayer. If the taxpayer sells or exchanges a qualifying investment that it has held for at least 10 years, then the taxpayer can make an election described in section 1400Z-2(c) on the sale or exchange of the qualifying investment.

(ii) Limitation on the 10-year rule. As required by section 1400Z-2(e)(1)(B) (treatment of investments with mixed funds), section 1400Z-2(c) applies only to the portion of an investment in a QOF with respect to which a proper election to defer gain under section 1400Z-2(a)(1) is in effect. For rules governing the application of section 1400Z-2(c) to the portion of an investment in a QOF for which a loss has been claimed under section 165(g), see §1.1400Z2(b)-1(c)(14). See also §1.1400Z2(b)-1(c)(7)(iii) for rules governing the application of section 1400Z-2(c) to the portion of an investment in a QOF held by an S corporation QOF owner that has an aggregate change in ownership within the meaning of §1.1400Z2(b)-1(c)(7)(iii)(B).

(2) Special election rules for QOF Partnerships and QOF S Corporations--(i) Dispositions of qualifying QOF partnership interests. If a QOF partner's basis in a qualifying QOF partnership interest is adjusted under section 1400Z-2(c), then the basis of the partnership interest is adjusted to an amount equal to the fair market value of the interest, including debt, and immediately prior to the sale or exchange, the basis of the QOF partnership assets are also adjusted, such adjustment is calculated in a manner similar to a section 743(b) adjustment had the transferor partner purchased its interest in the QOF partnership for cash equal to fair market value immediately prior to the sale or exchange assuming that a valid section 754 election had been in place. This



paragraph (b)(2)(i) applies without regard to the amount of deferred gain that was included under section 1400Z-2(b)(1), or the timing of that inclusion.

(ii) Dispositions of QOF property by QOF partnerships or QOF S corporations--

(A) Taxpayer election--(1) In general. For purposes of section 1400Z-2(c), if a taxpayer has held a qualifying investment (as determined under §1.1400Z2(b)-1(c)(6)(iv)) in a QOF partnership or QOF S corporation for at least 10 years, and the QOF partnership or QOF S corporation disposes of qualified opportunity zone property after such 10 year holding period, the taxpayer may make an election to exclude from gross income some or all of the capital gain arising from such disposition reported on Schedule K-1 of the QOF partnership or QOF S corporation and attributable to the qualifying investment. To the extent that the Schedule K-1 of a QOF partnership or QOF S corporation separately states capital gains arising from the sale or exchange of any particular qualified opportunity zone property, the taxpayer may make an election with respect to such separately stated item.

(2) Section 1231 gains. An election described in paragraph (b)(2)(ii)(A)(1) of this section may be made only with respect to capital gain net income from section 1231 property for a taxable year to the extent of net gains determined under section 1231(a) reported on Schedule K-1 of a QOF partnership or QOF S corporation.

(B) Validity of election. To be valid, the taxpayer must make an election described in paragraph (b)(2)(ii)(A)(1) of this section for the taxable year in which the capital gain from the sale or exchange of QOF property recognized by the QOF partnership or QOF S corporation would be included in the taxpayer's gross

income (without regard to the election set forth in this paragraph (b)(2)(ii)), in accordance with applicable forms and instructions.

(C) Consequences of election. If a taxpayer makes a valid election under this paragraph (b)(2)(ii) with respect to some or all of the capital gain reported on Schedule K-1 of a QOF partnership or QOF S corporation, the amount of such capital gain that the taxpayer elects to exclude from gross income is excluded from the taxpayer's income for purposes of the Internal Revenue Code and the regulations thereunder. Such excluded amount is treated as an item of income under sections 705(a)(1) or 1366.

\* \* \* \* \*

(d) \* \* \* The following examples illustrate the principles of paragraphs (a) through (c) of this section. \* \* \*

(2) Example 2. (i) Facts. In 2019, A and B each contribute \$100 to a QOF partnership for qualifying QOF partnership interests.

(ii) Sale of qualifying QOF partnership interest. In 2030 when the QOF assets have a value of \$260 and a bases of \$200, A sells its partnership interest, recognizing \$30 of gain, \$15 of which is attributable to assets described in section 751(c) and (d), and for which sale A makes an election under section 1400Z-2(c) and paragraph (b)(2)(i) of this section. Because A's election under paragraph (b)(2)(i) of this section is in effect, with regard to the sale, the bases of the assets are treated as adjusted to fair market value immediately before A's sale and there is no gain recognized by A.

(iii) Sale of QOF property. The facts are the same as in paragraph (i) of this Example 2, except that the partnership sells qualified opportunity zone property with a value of \$120 and a basis of \$100, recognizing \$20 of gain, allocable \$10 to each partner and A makes an election under section 1400Z-2(c) and paragraph (b)(2)(ii) of this section for the year in which A's allocable share of the partnership's recognized gain would be included in A's gross income. Because A's election under paragraph (b)(2)(ii) of this section is in effect, A will exclude the \$10 allocable share of the partnership's \$20 of recognized gain.

(e) Capital gain dividends paid by a QOF REIT that some shareholders may be able to elect to receive tax free under section 1400Z-2(c)--(1) Eligibility. For purposes of paragraph (b) of this section, if a shareholder of a QOF REIT receives a capital gain dividend identified with a date, as defined in paragraph (e)(2) of this section, then, to the extent that the shareholder's shares in the QOF REIT paying the capital gain dividend are a qualifying investment in the QOF REIT--

(i) The shareholder may treat the capital gain dividend, or part thereof, as gain from the sale or exchange of a qualifying investment on the date that the QOF REIT identified with the dividend; and

(ii) If, on the date identified, the shareholder had held that qualifying investment in the QOF REIT for at least 10 years, then the shareholder may apply a zero percent tax rate to that capital gain dividend, or part thereof.

(2) Definition of capital gain dividend identified with a date. A capital gain dividend identified with a date means an amount of a capital gain dividend, as defined in section 857(b)(3)(B), or part thereof, and a date that the QOF REIT designates in a notice provided to the shareholder not later than one week after the QOF REIT designates the capital gain dividend pursuant to section 857(b)(3)(B). The notice must be mailed to the shareholder unless the shareholder has provided the QOF REIT with an email address to be used for this purpose. In the manner and at the time determined by the Commissioner, the QOF REIT must provide the Commissioner all data that the Commissioner specifies with respect to the amounts of capital gain dividends and the dates designated by the QOF REIT for each shareholder.

(3) General limitations on the amounts of capital gain with which a date may be identified--(i) No identification in the absence of any capital gains with respect to qualified opportunity zone property. If, during its taxable year, the QOF REIT did not realize long-term capital gain on any sale or exchange of qualified opportunity zone property, then no date may be identified with any capital gain dividends, or parts thereof, with respect to that year.

(ii) Proportionality. Under section 857(g)(2), designations of capital gain dividends identified with a date must be proportional for all dividends paid with respect to the taxable year. Greater than *de minimis* violation of proportionality invalidates all of the purported identifications for a taxable year.

(iii) Undistributed capital gains. If section 857(b)(3)(C)(i) requires a shareholder of a QOF REIT to include a designated amount in the shareholder's long-term capital gain for a taxable year, then inclusion of this amount in this manner is treated as receipt of a capital gain for purposes of this paragraph (e) and may be identified with a date.

(iv) Gross gains. The amount determined under paragraph (e)(4) of this section is determined without regard to any losses that may have been realized on other sales or exchanges of qualified opportunity zone property. The losses do, however, limit the total amount of capital gain dividends that may be designated under section 857(b)(3).

(4) Determination of the amount of capital gain with which a date may be identified. A QOF REIT may choose to identify the date for an amount of capital gain in one of the following manners:

(i) Simplified determination. If, during its taxable year, the QOF REIT realizes long-term capital gain on one or more sales or exchanges of qualified opportunity zone

property, then the QOF REIT may identify the first day of that taxable year as the date identified with each designated amount with respect to the capital gain dividends for that taxable year. A designated identification is invalid in its entirety if the amount of gains that the QOF REIT identifies with that date exceeds the aggregate long-term capital gains realized on those sales or exchanges for that taxable year.

(ii) Sale date determination--(A) In general. If, during its taxable year, the QOF REIT realizes long-term capital gain on one or more sales or exchanges of qualified opportunity zone property, then the QOF REIT may identify capital gain dividends, or a part thereof, with the latest date on which there was such a realization. The amount of capital gain dividends so identified must not exceed the aggregate long-term capital gains realized on that date from sales or exchanges of qualified opportunity zone property. A designated identification is invalid in its entirety if the amount of gains that the QOF REIT identifies with that date violates the preceding sentence.

(B) Iterative application. The process described in paragraph (e)(4)(ii) of this section is applied iteratively to increasingly earlier transaction dates (from latest to earliest) until all capital gain dividends are identified with dates or there are no earlier dates in the taxable year on which the QOF REIT realized long-term capital gains with respect to a sale or exchange of qualified opportunity zone property, whichever comes first.

(f) Applicability date. This section applies to taxable years of a taxpayer, QOF Partnership, QOF S corporation, or QOF REIT, as appropriate, that end on or after the date of publication in the **Federal Register** of a Treasury decision adopting these proposed rules as final regulations.

Par. 5. Section 1.1400Z2(d)-1, as proposed to be added by 83 FR 54279, October 29, 2018, is amended by:

1. Revising paragraphs (b) and (c)(4), (5), (6), and (7).
2. Revising the heading in paragraph (c)(8).
3. In paragraph (c)(8)(i), changing “(c)(4)(ii)” to “(c)(8)(i)”.
4. Revising paragraph (c)(8)(ii)(B).
5. Adding new paragraph (c)(9).
6. Redesignating paragraphs (d)(2)(ii) as (d)(2)(iii), adding new paragraph (d)(2)(ii) and revising redesignated paragraph (d)(2)(iii).
7. Revising paragraphs (d)(2)(i)(A), (B), (C) and adding paragraphs (d)(2)(i)(D) and (E).
8. Redesignating paragraph (d)(2)(iii) as (d)(2)(iv), and revising redesignated paragraph (d)(2)(iv).
9. Revising paragraphs (d)(3)(ii)(A) through (d)(3)(ii)(C), and (d)(4)(ii).
10. Revising paragraphs (d)(5)(i), (d)(5)(ii), and (d)(5)(iv)(A) and (C) and adding paragraphs (d)(5)(iv)(D) and (E).
11. Redesignating paragraph (d)(5)(viii) as (d)(5)(ix) and adding a new paragraph (d)(5)(vii).
12. Adding a new sentence at the end of paragraph (f).

§1.1400Z2(d)-1 Qualified Opportunity Funds.

\* \* \* \* \*

(b) Valuation of assets for purposes of the 90-percent asset test--(1) In general.

For purposes of the 90-percent asset test in section 1400Z-2(d)(1), on an annual basis,

a QOF may value its assets using the applicable financial statement valuation method set forth in paragraph (b)(2) of this section, if the QOF has an applicable financial statement within the meaning of §1.475(a)-4(h), or the alternative valuation method set forth in paragraph (b)(3) of this section. During each taxable year, a QOF must apply consistently the valuation method that it selects under this paragraph (b)(1) to all assets valued with respect to the taxable year.

(2) Applicable financial statement valuation method--(i) In general. Under the applicable financial statement valuation method set forth in this paragraph (b)(2), the value of each asset that is owned or leased by the QOF is the value of that asset as reported on the QOF's applicable financial statement for the relevant reporting period.

(ii) Requirement for selection of method. A QOF may select the applicable financial statement valuation method set forth in this paragraph (b)(2) to value an asset leased by the QOF only if the applicable financial statement of the QOF is prepared according to U.S. generally accepted accounting principles (GAAP) and requires an assignment of value to the lease of the asset.

(3) Alternative valuation method--(i) In general. Under the alternative valuation method set forth in this paragraph (b)(3), the value of the assets owned by a QOF is calculated under paragraph (b)(3)(ii) of this section, and the value of the assets leased by a QOF is calculated under paragraph (b)(3)(iii) of this section.

(ii) Assets that are owned by a QOF. The value of each asset that is owned by a QOF is the QOF's unadjusted cost basis of the asset under section 1012.

(iii) Assets that are leased by a QOF--(A) In general. The value of each asset that is leased by a QOF is equal to the present value of the leased asset as defined in paragraph (b)(3)(iii)(C) of this section.

(B) Discount rate. For purposes of calculating present value under paragraph (b)(3)(iii) of this section, the discount rate is the applicable Federal rate under section 1274(d)(1), determined by substituting the term “lease” for “debt instrument.”

(C) Present value. For purposes of paragraph (b)(3)(iii) of this section, present value of a leased asset--

(1) Is equal to the sum of the present values of each payment under the lease for the asset;

(2) Is calculated at the time the QOF enters into the lease for the asset; and

(3) Once calculated, is used as the value for the asset by the QOF for all testing dates for purposes of the 90-percent asset test.

(D) Term of a lease. For purposes of paragraph (b)(3)(iii) of this section, the term of a lease includes periods during which the lessee may extend the lease at a pre-defined rent.

(4) Option to disregard recently contributed property. A QOF may choose to determine compliance with the 90-percent asset test by excluding from both the numerator and denominator of the test any property that satisfies all the criteria in paragraph (b)(4)(A) through (C) of this section. A QOF need not be consistent from one semi-annual test to another in whether it avails itself of this option.



(A) As the case may be, the amount of the property was received by the QOF partnership as a contribution or by the QOF corporation solely in exchange for stock of the corporation,

(B) This contribution or exchange occurred not more than 6 months before the test from which it is being excluded; and

(C) Between the date of that contribution or exchange and the date of the asset test, the amount was held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less.

(c) \* \* \*

(4) Qualified opportunity zone business property of a QOF--(i) In general.

Tangible property used in a trade or business of a QOF is qualified opportunity zone business property for purposes of paragraph (c)(1)(iii) of this section if the requirements of paragraph (c)(4)(i)(A) through (E), as applicable, are satisfied.

(A) In the case of property that the QOF owns, the property was acquired by the QOF after December 31, 2017, by purchase as defined by section 179(d)(2) from a person that is not a related person within the meaning of section 1400Z-2(e)(2).

(B) In the case of property that the QOF leases--

(1) Qualifying acquisition of possession. The property was acquired by the QOF under a lease entered into after December 31, 2017;

(2) Arms-length terms. The terms of the lease were market rate (that is, the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity zone as determined under section 482 and the regulations thereunder) at the time that the lease was entered into; and

(3) Additional requirements for leases from a related person. If the lessee and the lessor are related parties, paragraph (c)(4)(i)(B)(4) and (5) of this section must be satisfied.

(4) Prepayments of not more than one year. The lessee at no time makes any prepayment in connection with the lease relating to a period of use of the property that exceeds 12 months.

(5) Purchase of other QOZBP. If the original use of leased tangible personal property in a qualified opportunity zone (within the meaning of in paragraph (c)(4)(i)(B)(6) of this section) does not commence with the lessee, the property is not qualified opportunity zone business property unless, during the relevant testing period (as defined in paragraph (c)(4)(i)(B)(7) of this section), the lessee becomes the owner of tangible property that is qualified opportunity zone business property having a value not less than the value of that leased tangible personal property. There must be substantial overlap of the zone(s) in which the owner of the property so acquired uses it and the zone(s) in which that person uses the leased property.

(6) Original use of leased tangible property. For purposes of paragraph (c)(4)(i)(B)(5) of this section, the original use of leased tangible property in a qualified opportunity zone commences on the date any person first places the property in service in the qualified opportunity zone for purposes of depreciation (or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner). For purposes of this paragraph (c)(4)(i)(B)(6), if property has been unused or vacant for an uninterrupted period of at least 5 years, original use in the zone commences on the date after that period when any person first uses or places the

property in service in the qualified opportunity zone within the meaning of the preceding sentence. Used tangible property satisfies the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone.

(7) Relevant testing period. For purposes of paragraph (c)(4)(i)(B)(5) of this section, the relevant testing period is the period that begins on the date that the lessee receives possession under the lease of the leased tangible personal property and ends on the earlier of—the date 30-months after the date the lessee receives possession of the property under the lease; or the last day of the term of the lease (within the meaning of paragraph (b)(3)(iii)(D) of this section).

(8) For purposes of paragraph (c)(4)(i)(B)(5) of this section, the value of owned or leased property is required to be determined in accordance with the valuation methodologies provided in paragraph (b) of this section, and such value in the case of leased tangible personal property is to be determined on the date the lessee receives possession of the property under the lease.

(C) In the case of tangible property owned by the QOF, the original use of the owned tangible property in the qualified opportunity zone, within the meaning of paragraph (c)(7) of this section, commences with the QOF, or the QOF substantially improves the owned tangible property within the meaning of paragraph (c)(8) of this section (which defines substantial improvement in this context).

(D) In the case of tangible property that is owned or leased by the QOF, during substantially all of the QOF's holding period for the tangible property, substantially all of the use of the tangible property was in a qualified opportunity zone.

(E) In the case of real property (other than unimproved land) that is leased by a QOF, if, at the time the lease is entered into, there was a plan, intent, or expectation for the real property to be purchased by the QOF for an amount of consideration other than the fair market value of the real property determined at the time of the purchase without regard to any prior lease payments, the leased real property is not qualified opportunity zone business property at any time.

(ii) Trade or business of a QOF. The term trade or business means a trade or business within the meaning of section 162.

(iii) Safe harbor for inventory in transit. In determining whether tangible property is used in a qualified opportunity zone for purposes of section 1400Z-2(d)(2)(D)(i)(III), and of paragraphs (c)(4)(i)(D), (c)(6), (d)(2)(i)(D), and (d)(2)(iv) of this section, inventory (including raw materials) of a trade or business does not fail to be used in a qualified opportunity zone solely because the inventory is in transit--

(A) From a vendor to a facility of the trade or business that is in a qualified opportunity zone, or

(B) From a facility of the trade or business that is in a qualified opportunity zone to customers of the trade or business that are not located in a qualified opportunity zone.

(5) Substantially all of a QOF's holding period for property described in paragraphs (c)(2), (3), and (c)(4)(i)(D) of this section. For purposes of determining whether the holding period requirements in paragraphs (c)(2), (3), and (c)(4)(i)(D) of this section are satisfied, the term substantially all means at least 90 percent.

(6) Substantially all of the usage of tangible property by a QOF in a qualified opportunity zone. A trade or business of an entity is treated as satisfying the substantially all requirement of paragraph (c)(4)(i)(D) of this section if at least 70 percent of the use of the tangible property is in a qualified opportunity zone.

(7) Original use of tangible property acquired by purchase--(i) In general. For purposes of paragraph (c)(4)(i)(C) of this section, the original use of tangible property in a qualified opportunity zone commences on the date any person first places the property in service in the qualified opportunity zone for purposes of depreciation or amortization (or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner). For purposes of this paragraph (c)(7), if property has been unused or vacant for an uninterrupted period of at least 5 years, original use in the qualified opportunity zone commences on the date after that period when any person first so uses or places the property in service in the qualified opportunity zone. Used tangible property satisfies the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone. If the tangible property had been so used or placed in service in the qualified opportunity zone before it is acquired by purchase, it must be substantially improved in order to satisfy the requirements of section 1400Z-2(d)(2)(D)(i)(II).

(ii) Lessee improvements to leased property. Improvements made by a lessee to leased property satisfy the original use requirement in section 1400Z-2(d)(2)(D)(i)(II) as purchased property for the amount of the unadjusted cost basis under section 1012 of such improvements.

(8) Substantial improvement of tangible property acquired by purchase-- \* \* \*

(ii) \* \* \*

(B) Unimproved land. Unimproved land that is within a qualified opportunity zone and acquired by purchase in accordance with section 1400Z-2(d)(2)(D)(i)(I) is not required to be substantially improved within the meaning of section 1400Z-2(d)(2)(D)(i)(II) and (d)(2)(D)(ii).

(9) Substantially all of tangible property owned or leased by a QOF--(i) Tangible property owned by a QOF. Whether a QOF has satisfied the “substantially all” threshold set forth in paragraph (c)(6) of this section is to be determined by a fraction--

(A) The numerator of which is the total value of all qualified opportunity zone business property owned or leased by the QOF that meets the requirements in paragraph (c)(4)(i) of this section, and

(B) The denominator of which is the total value of all tangible property owned or leased by the QOF, whether located inside or outside of a qualified opportunity zone.

(d) \* \* \*

(2) \* \* \*

(i) \* \* \*

(A) In the case of tangible property that the entity owns, the tangible property was acquired by the entity after December 31, 2017, by purchase as defined by section 179(d)(2) from a person who is not a related person within the meaning of section 1400Z-2(e)(2).

(B) In the case of tangible property that the entity leases--

(1) Qualifying acquisition of possession. The property was acquired by the entity under a lease entered into after December 31, 2017;

(2) Arms-length terms. The terms of the lease are market rate (that is, the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity zone as determined under section 482 and the regulations thereunder) at the time that the lease was entered into; and

(3) Additional requirements for leases from a related person. If the lessee and the lessor are related parties, paragraph (d)(2)(i)(B)(4) and (5) of this section must be satisfied.

(4) Prepayments of not more than one year. The lessee at no time makes any prepayment in connection with the lease relating to a period of use of the property that exceeds 12 months.

(5) Purchase of other QOZBP. If the original use of leased tangible personal property in a qualified opportunity zone (within the meaning of in paragraph (d)(2)(i)(B)(6) of this section) does not commence with the lessee, the property is not qualified opportunity zone business property unless, during the relevant testing period (as defined in paragraph (d)(2)(i)(B)(7) of this section), the lessee becomes the owner of tangible property that is qualified opportunity zone business property having a value not less than the value of that leased tangible personal property. There must be substantial overlap of the zone(s) in which the owner of the property so acquired uses it and the zone(s) in which that person uses the leased property.

(6) Original use of leased tangible property. For purposes of paragraph (d)(2)(i)(B)(5) of this section, the original use of leased tangible property in a qualified opportunity zone commences on the date any person first places the property in service in the qualified opportunity zone for purposes of depreciation (or first uses it in

a manner that would allow depreciation or amortization if that person were the property's owner). For purposes of this paragraph (d)(2)(i)(B)(6), if property has been unused or vacant for an uninterrupted period of at least 5 years, original use in the qualified opportunity zone commences on the date after that period when any person first uses or places the property in service in the qualified opportunity zone within the meaning of the preceding sentence. Used tangible property satisfies the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone.

(7) Relevant testing period. For purposes of paragraph (d)(2)(i)(B)(5) of this section, the relevant testing period is the period that begins on the date that the lessee receives possession under the lease of the leased tangible personal property and ends on the earlier of—the date 30-months after the date the lessee receives possession of the property under the lease; or the last day of the term of the lease (within the meaning of paragraph (b)(3)(iii)(D) of this section).

(8) For purposes of paragraph (d)(2)(i)(B)(5) of this section, the value of owned or leased property is required to be determined in accordance with the valuation methodologies provided in paragraph (b) of this section, and such value in the case of leased tangible personal property is to be determined on the date the lessee receives possession of the property under the lease.

(C) In the case of tangible property owned by the entity, the original use of the owned tangible property in the qualified opportunity zone, within the meaning of paragraph (c)(7) of this section, commences with the entity, or the entity substantially



improves the owned tangible property within the meaning of paragraph (d)(4) of this section (which defines substantial improvement in this context).

(D) In the case of tangible property that is owned or leased by the entity, during substantially all of the entity's holding period for the tangible property, substantially all of the use of the tangible property was in a qualified opportunity zone.

(E) In the case of real property (other than unimproved land) that is leased by the entity, if, at the time the lease is entered into, there was a plan, intent, or expectation for the real property to be purchased by the entity for an amount of consideration other than the fair market value of the real property determined at the time of the purchase without regard to any prior lease payments, the leased real property is not qualified opportunity zone business property at any time.

(ii) Trade or business of an entity. The term trade or business means a trade or business within the meaning of section 162.

(iii) Substantially all of a qualified opportunity zone business's holding period for property described in paragraph (d)(2)(i)(D) of this section. For purposes of the holding period requirement in paragraph (d)(2)(i)(D) of this section, the term substantially all means at least 90 percent.

(iv) Substantially all of the use of tangible property by a qualified opportunity zone business in a qualified opportunity zone. The substantially all of the use requirement of paragraph (d)(2)(i)(D) of this section is satisfied if at least 70 percent of the use of the tangible property is in a qualified opportunity zone.

(3) \* \* \*

(ii) \* \* \* (A) In general. Whether a trade or business of the entity satisfies the 70-percent “substantially all” threshold set forth in paragraph (d)(3)(i) of this section is to be determined by a fraction--

(1) The numerator of which is the total value of all qualified opportunity zone business property owned or leased by the qualified opportunity zone business that meets the requirements in paragraph (d)(2)(i) of this section, and

(2) The denominator of which is the total value of all tangible property owned or leased by the qualified opportunity zone business, whether located inside or outside of a qualified opportunity zone.

(B) Value of tangible property owned or leased by a qualified opportunity zone business--(1) In general. For purposes of the fraction set forth in paragraph (d)(3)(ii)(A) of this section, on an annual basis, the owned or leased tangible property of a qualified opportunity zone business may be valued using the applicable financial statement valuation method set forth in paragraph (d)(3)(ii)(B)(2) of this section, if the qualified opportunity zone business has an applicable financial statement within the meaning of §1.475(a)-4(h), or the alternative valuation method set forth in paragraph (d)(3)(ii)(B)(3) of this section. During each taxable year, the valuation method selected under this paragraph (d)(3)(ii)(B)(1) must be applied consistently to all tangible property valued with respect to the taxable year.

(2) Applicable financial statement valuation method--(i) In general. Under the applicable financial statement valuation method set forth in this paragraph (d)(3)(ii)(B)(2), the value of tangible property of the qualified opportunity zone business, whether owned or leased, is the value of that property as reported, or as otherwise

would be reported, on the qualified opportunity zone business's applicable financial statement for the relevant reporting period.

(ii) Requirement for selection of method. A qualified opportunity zone business may select the applicable financial statement valuation method set forth in this paragraph (d)(3)(ii)(B)(2) to value tangible property leased by the qualified opportunity zone business only if the applicable financial statement of the qualified opportunity zone business requires, or would otherwise require, an assignment of value to the lease of the tangible property.

(3) Alternative valuation method--(i) In general. Under the alternative valuation method set forth in this paragraph (d)(3)(ii)(B)(3), the value of tangible property that is owned by the qualified opportunity zone business is calculated under paragraph (d)(3)(ii)(B)(3)(ii), and the value of tangible property that is leased by the qualified opportunity zone business is calculated under paragraph (d)(3)(ii)(B)(3)(iii).

(ii) Tangible property owned by a qualified opportunity zone business. The value of tangible property that is owned by the qualified opportunity zone business is the unadjusted cost basis of the property under section 1012 in the hands of the qualified opportunity zone business for each testing date of a QOF during the year.

(iii) Tangible property leased by a qualified opportunity zone business--(A) In general. The value of tangible property that is leased by the qualified opportunity zone business is equal to the present value of the leased tangible property as defined in paragraph (d)(3)(ii)(B)(3)(iii)(C) of this section.

(B) Discount rate. For purposes of calculating present value under paragraph (d)(3)(ii)(B)(3)(iii) of this section, the discount rate is the applicable Federal rate under section 1274(d)(1), determined by substituting the term “lease” for “debt instrument.”

(C) Present value. For purposes of paragraph (d)(3)(ii)(B)(3)(iii), present value of leased tangible property

(1) Is equal to the sum of the present values of each payment under the lease for such tangible property;

(2) Is calculated at the time the qualified opportunity zone business enters into the lease for such leased tangible property; and

(3) Once calculated, is used as the value for such asset by the qualified opportunity zone business for all testing dates for purposes of the 90-percent asset test.

(D) Term of a lease. For purposes of paragraph (d)(3)(ii)(B)(3)(iii) of this section, the term of a lease includes periods during which the lessee may extend the lease at a pre-defined rent.

(C) Five-Percent Zone Taxpayer. If a taxpayer both holds an equity interest in the entity and has self-certified as a QOF, then that taxpayer may value the entity’s assets using the same methodology under paragraph (b) of this section that the taxpayer uses for determining its own compliance with the 90-percent asset requirement of section 1400Z-2(d)(1) (Compliance Methodology), provided that no other equity holder in the entity is a Five-Percent Zone Taxpayer. If two or more taxpayers that have self-certified as QOFs hold equity interests in the entity and at least one of them is a Five-Percent Zone Taxpayer, then the values of the entity’s assets may be calculated

using the Compliance Methodology that both is used by a Five-Percent Zone Taxpayer and that produces the highest percentage of qualified opportunity zone business property for the entity. A Five-Percent Zone Taxpayer is a taxpayer that has self-certified as a QOF and that holds stock in the entity (if it is a corporation) representing at least 5 percent in voting rights and value or holds an interest of at least 5 percent in the profits and capital of the entity (if it is a partnership).

(4) \* \* \*

(ii) Special rules for land and improvements on land--(A) Buildings located in the qualified opportunity zone. If a qualified opportunity zone business purchases a building located on land wholly within a QOZ, under section 1400Z-2(d)(2)(D)(ii) a substantial improvement to the purchased tangible property is measured in relation to the qualified opportunity zone business's additions to the adjusted basis of the building. Under section 1400Z-2(d), measuring a substantial improvement to the building by additions to the qualified opportunity zone business's adjusted basis of the building does not require the qualified opportunity zone business to separately substantially improve the land upon which the building is located. \* \* \*

(B) Unimproved land. Unimproved land that is within a qualified opportunity zone and acquired by purchase in accordance with section 1400Z-2(d)(2)(D)(i)(I) is not required to be substantially improved within the meaning of section 1400Z-2(d)(2)(D)(i)(II) and (d)(2)(D)(ii).

(5) Operation of section 1397C requirements incorporated by reference

(i) Gross income requirement. \* \* \* A trade or business meets the 50-percent gross income requirement in the preceding sentence if the trade or business satisfies

any one of the four criteria described in paragraph (d)(5)(i)(A), (B), (C), or (D), of this section, or any criteria identified in published guidance issued by the IRS under §601.601(d)(2).

(A) Services performed in qualified opportunity zone based on hours. At least 50 percent of the services performed for the trade or business are performed in the qualified opportunity zone, determined by a fraction--

(1) The numerator of which is the total number of hours performed by employees and independent contractors, and employees of independent contractors, for services performed in a qualified opportunity zone during the taxable year, and

(2) The denominator of which is the total number of hours performed by employees and independent contractors, and employees of independent contractors, for services performed during the taxable year.

(B) Services performed in qualified opportunity zone based on amounts paid for services. At least 50 percent of the services performed for the trade or business are performed in the qualified opportunity zone, determined by a fraction--

(1) The numerator of which is the total amount paid by the entity for services performed in a qualified opportunity zone during the taxable year, whether by employees, independent contractors, or employees of independent contractors, and

(2) The denominator of which is the total amount paid by the entity for services performed during the taxable year, whether by employees, independent contractors, or employees of independent contractors.

(C) Necessary tangible property and business functions. The tangible property of the trade or business located in a qualified opportunity zone and the management or

operational functions performed in the qualified opportunity zone are each necessary for the generation of at least 50 percent of the gross income of the trade or business.

(D) Facts and circumstances. Based on all the facts and circumstances, at least 50 percent of the gross income of a qualified opportunity zone business is derived from the active conduct of a trade or business in the qualified opportunity zone.

(E) Examples. The following examples illustrate the principles of paragraph (d)(5)(i)(C) and (d)(5)(i)(D) of this section.

(1) Example 1. A landscaping business has its headquarters in a qualified opportunity zone, its officers and employees manage the daily operations of the business (within and without the qualified opportunity zone) from its headquarters, and all its equipment and supplies are stored in the headquarters facilities. The activities occurring and the storage of equipment and supplies in the qualified opportunity zone are, taken together, a material factor in the generation of the income of the business.

(2) Example 2. A trade or business is formed or organized under the laws of the jurisdiction within which a qualified opportunity zone is located, and the business has a PO Box located in the qualified opportunity zone. The mail received at that PO Box is fundamental to the income of the trade or business, but there is no other basis for concluding that the income of the trade or business is derived from activities in the qualified opportunity zone. The mere location of the PO Box is not a material factor in the generation of gross income by the trade or business.

(3) Example 3. In 2019, Taxpayer X realized \$w million of capital gains and within the 180-day period invested \$w million in QOF Y, a qualified opportunity fund. QOF Y immediately acquired from partnership P a partnership interest in P, solely in exchange for \$w million of cash. P is a real estate developer that has written plans to acquire land in a qualified opportunity zone on which it plans to construct a commercial building for lease to other trades or businesses. In 2023, P's commercial building is placed in service and is fully leased up to other trades or businesses. For the 2023 taxable year, because at least 50 percent of P's gross income is derived from P's rental of its tangible property in the qualified opportunity zone. Thus, under P's facts and circumstances, P satisfies the gross income test under section 1397C(b)(2).

(ii) Use of intangible property requirement--(A) \* \* \* For purposes of section 1400Z-2(d)(3)(ii) and the preceding sentence, the term substantial portion means at least 40 percent.

(B) Active conduct of a trade or business--(1) In general. [Reserved]

(2) Operating real property. Solely for the purposes of section 1400Z-2(d)(3)(A), the ownership and operation (including leasing) of real property is the active conduct of a trade or business. However, merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business by such taxpayer.

(3) Trade or business defined. The term trade or business means a trade or business within the meaning of section 162.

\* \* \* \* \*

(iv) Safe harbor for reasonable amount of working capital. Solely for purposes of applying section 1397C(e)(1) to the definition of a qualified opportunity zone business under section 1400Z-2(d)(3), working capital assets are treated as reasonable in amount for purposes of sections 1397C(b)(2) and 1400Z-2(d)(3)(A)(ii), if all of the requirements in paragraph (d)(5)(iv)(A) through (C) of this section are satisfied.

(A) Designated in writing. These amounts are designated in writing for the development of a trade or business in a qualified opportunity zone (as defined in section 1400Z-1(a)), including when appropriate the acquisition, construction, and/or substantial improvement of tangible property in such a zone.

\* \* \* \* \*

(C) Property consumption consistent. The working capital assets are actually used in a manner that is substantially consistent with paragraph (d)(5)(iv)(A) and (B) of this section. If consumption of the working capital assets is delayed by waiting for governmental action the application for which is complete, that delay does not cause a failure of this paragraph (d)(5)(iv)(C).



(D) Ability of a single business to benefit from more than a single application of the safe harbor. A business may benefit from multiple overlapping or sequential applications of the working capital safe harbor, provided that each application independently satisfies all of the requirements in paragraph (d)(5)(iv)(A) through (C) of this section.

(E) Examples. The following examples illustrate the rules of paragraph (d)(5)(iv) of this section.

(1) Example 1. General application of working capital safe harbor--(i) Facts. QOF F creates a business entity E to open a fast-food restaurant and acquires almost all of the equity of E in exchange for cash. E has a written plan and a 20-month schedule for the use of this cash to establish the restaurant. Among the planned uses for the cash are identification of favorable locations in the qualified opportunity zone, leasing a building suitable for such a restaurant, outfitting the building with appropriate equipment and furniture (both owned and leased), necessary security deposits, obtaining a franchise and local permits, and the hiring and training of kitchen and wait staff. Not-yet-disbursed amounts were held in assets described in section 1397C(e)(1), and these assets were eventually expended in a manner consistent with the plan and schedule.

(ii) Analysis. E's use of the cash qualifies for the working capital safe harbor described in paragraph (d)(5)(iv) of this section.

(2) Example 2. Multiple applications of working capital safe harbor--(i) Facts. QOF G creates a business entity H to start a new technology company and acquires equity of H in exchange for cash on Date 1. In addition to H's rapid deployment of capital received from other equity investors, H writes a plan with a 30-month schedule for the use of the Date 1 cash. The plan describes use of the cash to research and develop a new technology (Technology), including paying salaries for engineers and other scientists to conduct the research, purchasing, and leasing equipment to be used in research and furnishing office and laboratory space. Approximately a year-and-a-half after Date 1, on Date 2, G acquires additional equity in H for cash, and H writes a second plan. This new plan has a 25-month schedule for the development of a new application of existing software (Application), to be marketed to government agencies. Among the planned uses for the cash received on Date 2 are paying development costs, including salaries for software engineers, other employees, and third-party consultants to assist in developing and marketing the new application to the anticipated customers. Not-yet-disbursed amounts that were scheduled for development of the Technology and the Application were held in assets described in section 1397C(e)(1), and these assets were eventually expended in a manner substantially consistent with the plans and schedules for both the Technology and the Application.

(ii) Analysis. H's use of both the cash received on Date 1 and the cash received on Date 2 qualifies for the working capital safe harbor described in paragraph (d)(5)(iv) of this section.

\* \* \* \* \*

(viii) Real property straddling a qualified opportunity zone. For purposes of satisfying the requirements in this paragraph (d)(5), when it is necessary to determine whether a qualified opportunity zone is the location of services, tangible property, or business functions, section 1397C(f) applies (substituting "qualified opportunity zone" for "empowerment zone"). If the amount of real property based on square footage located within the qualified opportunity zone is substantial as compared to the amount of real property based on square footage outside of the qualified opportunity zone, and the real property outside of the qualified opportunity zone is contiguous to part or all of the real property located inside the qualified opportunity zone, then all of the property is deemed to be located within a qualified opportunity zone.

\* \* \* \* \*

(f) \*\*\* Notwithstanding the preceding sentence, a QOF may not rely on the proposed rules in paragraphs (c)(8)(ii)(B) and (d)(4)(ii)(B) of this section (which concern the qualification of land as QOZBP) if the land is unimproved or minimally improved and the QOF or the QOZB purchases the land with an expectation, an intention, or a view not to improve the land by more than an insubstantial amount within 30 months after the date of purchase.

Par. 6. Section 1.1400Z2(f)-1 is added to read as follows:

§1.1400Z2(f)-1 Failure of qualified opportunity fund to maintain investment standard.

(a) In general. Except as provided by §1.1400Z2(d)-1(a)(2)(ii) with respect to a taxpayer's first taxable year as a QOF, if a QOF fails to satisfy the 90-percent asset test

in section 1400Z-2(d)(1), then the fund must pay the statutory penalty set forth in section 1400Z-2(f) for each month it fails meet the 90-percent asset test.

(b) Time period for a QOF to reinvest certain proceeds. If a QOF receives proceeds from the return of capital or the sale or disposition of some or all of its qualified opportunity zone property within the meaning of section 1400Z-2(d)(2)(A), and if the QOF reinvests some or all of the proceeds in qualified opportunity zone property by the last day of the 12-month period beginning on the date of the distribution, sale, or disposition, then the proceeds, to the extent that they are so reinvested, are treated as qualified opportunity zone property for purposes of the 90-percent asset test in section 1400Z-2(d)(1), but only to the extent that prior to the reinvestment in qualified opportunity zone property the proceeds are continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less. If reinvestment of the proceeds is delayed by waiting for governmental action the application for which is complete, that delay does not cause a failure of the 12-month requirement in this paragraph (b).

(c) Anti-abuse rule--(1) In general. Pursuant to section 1400Z-2(e)(4)(C), the rules of section 1400Z-2 and §§1.1400Z2(a)-1 through 1.1400Z2(g)-1 must be applied in a manner consistent with the purposes of section 1400Z-2. Accordingly, if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of section 1400Z-2, the Commissioner can recast a transaction (or series of transactions) for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 1400Z-2. Whether a tax result is inconsistent with the purposes of section 1400Z-2 must be determined based on all the facts and circumstances.

(2) [Reserved].

(d) Applicability date. This section applies to taxable years of a QOF that end on or after the date of publication in the **Federal Register** of a Treasury decision adopting these proposed rules as final regulations. However, an eligible taxpayer may rely on the proposed rules in this section (other than paragraph (c) of this section) with respect to taxable years before the date of applicability of this section, but only if the eligible taxpayer applies the rules in their entirety and in a consistent manner. An eligible taxpayer may rely on the proposed rules in paragraph (c) of this section with respect to taxable years before the date of applicability of this section, but only if the eligible taxpayer applies the rules of section 1400Z-2 and §§1.1400Z2(a)-1 through 1.1400Z2(g)-1, as applicable, in their entirety and in a consistent manner.

Par. 7. Section 1.1400Z2(g)-1 is added to read as follows:

§1.1400Z2(g)-1 Application of opportunity zone rules to members of a consolidated group.

(a) Scope and Definitions--(1) Scope. This section provides rules regarding the Federal income tax treatment of QOFs owned by members of consolidated groups.

(2) Definitions. The definitions provided in §1.1400Z2(b)-1(a)(2) apply for purposes of this section.

(b) QOF stock not stock for purposes of affiliation--(1) In general. Stock in a QOF corporation (whether qualifying QOF stock or otherwise) is not treated as stock for purposes of determining whether the issuer is a member of an affiliated group within the meaning of section 1504. Therefore, a QOF corporation can be the common parent of

a consolidated group, but a QOF corporation cannot be a subsidiary member of a consolidated group.

(2) Example. The following example illustrates the rules of this paragraph (b).

(i) Facts. Corporation P wholly owns corporation S, which wholly owns corporation Q. P, S, and Q are members of a U.S. consolidated group (P group). In 2018, S sells an asset to an unrelated party and realizes \$500 of capital gain. S contributes \$500 to Q and properly elects to defer recognition of the gain under section 1400Z-2. At such time, Q qualifies and elects to be treated as a QOF.

(ii) Analysis. Under paragraph (b) of this section, stock of a QOF (qualifying or otherwise) is not treated as stock for purposes of affiliation under section 1504. Thus, once Q becomes a QOF, Q ceases to be affiliated with the P group members under section 1504(a), and it deconsolidates from the P group.

(c) Qualifying investments by members of a consolidated group. Except as otherwise provided in this section or in §1.1400Z2(b)-1, section 1400Z-2 applies separately to each member of a consolidated group. Therefore, for example, the same member of the group must both engage in the sale of a capital asset giving rise to gain and timely invest an amount equal to some or all of such gain in a QOF (as provided in section 1400Z-2(a)(1)) in order to qualify for deferral of such gain under section 1400Z-2.

(d) Tiering up of investment adjustments provided by section 1400Z-2. Basis increases in a qualifying investment in a QOF under sections 1400Z-2(b)(2)(B)(iii), 1400Z-2(b)(2)(B)(iv), and 1400Z-2(c) are treated as satisfying the requirements of §1.1502-32(b)(3)(ii)(A), and thus qualify as tax-exempt income to the QOF owner. Therefore, if the QOF owner is a member of a consolidated group and is owned by other members of the same group (upper-tier members), the group members increase their bases in the shares of the QOF owner under §1.1502-32(b)(2)(ii). However, there is no basis increase under §1.1502-32(b)(2)(ii) in shares of upper-tier members with

regard to basis increases under section 1400Z-2(c) and the regulations thereunder unless and until the basis of the qualifying investment is increased to its fair market value, as provided in section 1400Z-2(c) and the regulations thereunder.

(e) Application of §1.1502-36(d). This paragraph (e) clarifies how §1.1502-36(d) applies if a member (M) transfers a loss share of another member (S) and S is a QOF owner that owns a qualifying investment in a QOF. To determine S's attribute reduction amount under §1.1502-36(d)(3), S's basis in its qualifying investment is included in S's net inside attribute amount to compute S's aggregate inside loss under §1.1502-36(d)(3)(iii)(A). However, S's basis in the qualifying investment is not included in S's category D attributes available for attribute reduction under §1.1502-36(d)(4). Thus, S's basis in the qualifying investment cannot be reduced under §1.1502-36(d). If S's attribute reduction amount exceeds S's attributes available for reduction, then to the extent of S's basis in the qualifying investment (limited by the remaining attribute reduction amount), the common parent is treated as making the election under §1.1502-36(d)(6) to reduce M's basis in the transferred loss S shares.

(f) Examples. The following examples illustrate the rules of this section.

(1) Example 1. Basis adjustment when member owns qualifying QOF stock--(i) Facts. Corporation P is the common parent of a consolidated group (P group), and P wholly owns Corporation S, a member of the P group. In 2018, S sells an asset to an unrelated party and realizes \$500 of capital gain. S contributes \$500 to Q (a QOF corporation) and properly elects to defer the gain under section 1400Z-2(a) and §1.1400Z2(a)-1. S does not otherwise own stock in Q. In 2029, when S still owns its qualifying investment in Q, P sells all of the stock of S to an unrelated party.

(ii) Analysis--(A) 5-year and 7-year basis increase and §1.1502-32 tier-up. In 2023, when S has held the stock of Q for five years, under section 1400Z-2(b)(2)(B)(iii), S increases its basis in its Q stock by \$50 (10 percent of \$500, the amount of gain deferred by reason of section 1400Z-2(a)(1)(A)). The 10-percent basis increase qualifies as tax-exempt income to S under paragraph (d) of this section. Thus, P (an upper-tier member) increases its basis in S's stock by \$50 under §1.1502-32(b)(2)(ii). Similarly, in 2025, when S has held the stock of Q for seven years, under section

1400Z-2(b)(2)(B)(iv), S increases its basis in its Q stock by an additional \$25 (5 percent of \$500). The 5 percent basis increase also qualifies as tax-exempt income to S under paragraph (d) of this section, and P increases its basis in S's stock by an additional \$25 under §1.1502-32(b)(2)(ii).

(B) S's recognition of deferred capital gain in 2026. S did not dispose of its Q stock prior to December 31, 2026. Therefore, under section 1400Z-2(b)(1)(B) and §1.1400Z-2(b)-1(b)(2), S's deferred capital gain is included in S's income on December 31, 2026. The amount of gain included under section 1400Z-2(b)(2)(A) is \$425 (\$500 of deferred gain less S's \$75 basis in Q). S's basis in Q is increased by \$425 to \$500, and P's basis in S also is increased by \$425.

(C) P's disposition of S. P's sale of S stock in 2029 results in the deconsolidation of S. Q remains a non-consolidated subsidiary of S, and S is not treated as selling or exchanging its Q stock for purposes of section 1400Z-2(c). Therefore, no basis adjustments under section 1400Z-2 are made as a result of P's sale of S stock.

(iii) S sells the stock of Q after 10 years. The facts are the same as in paragraph (i) of this Example 1, except that in 2029, instead of P selling all of the stock of S, S sells all of the stock of Q to an unrelated party for its fair market value of \$800. At the time of the sale, S has owned the Q stock for over 10 years, and S elects under section 1400Z-2(c) to increase its stock basis in Q from \$500 (see the analysis in paragraph (ii)(B) of this Example 1) to the fair market value of Q on the date of the sale, \$800. As a result of the election, S's basis in Q is \$800 and S has no gain on the sale of Q stock. Additionally, the \$300 basis increase in Q is treated as tax-exempt income to S pursuant to paragraph (d) of this section. Thus, P increases its basis in P's S stock by \$300 under §1.1502-32(b)(2)(ii).

(2) Example 2. Computation and application of the attribute reduction amount under §1.1502-36(d) when S owns a QOF--(i) Facts. Corporation P (the common parent of a consolidated group) wholly owns corporation M, which wholly owns corporation S, which wholly owns Q (a QOF corporation). In 2018, S sells an asset to an unrelated party and realizes \$5,000 of capital gain. S contributes \$5,000 to Q and properly elects to defer the gain under section 1400Z-2. In 2024, M sells all of its S stock to an unrelated party for fair market value of \$100, and M's basis in the stock of S is \$300. At the time of sale, S owns the stock of Q with a basis of \$500 (S's basis in Q was increased under section 1400Z-2(b)(2)(B)(iii) to \$500 in 2023), and S has a net operating loss carryover of \$50. M's transfer of the S shares is a transfer of loss shares under §1.1502-36. Assume that no basis redetermination is required under §1.1502-36(b) and no basis reduction is required under §1.1502-36(c).

(ii) Attribute reduction under §1.1502-36(d). Under §1.1502-36(d), S's attributes are reduced by S's attribute reduction amount. Section 1.1502-36(d)(3) provides that S's attribute reduction amount is the lesser of the net stock loss and S's aggregate inside loss. The net stock loss is the excess of the \$300 aggregate basis of the transferred S shares over the \$100 aggregate value of those shares, or \$200. S's aggregate inside loss, which includes the basis of the stock of Q as provided by

paragraph (e) of this section, is the excess of S's net inside attribute amount over the value of the S share. S's net inside attribute amount is \$550, computed as the sum of S's \$50 loss carryover and its \$500 basis in Q. S's aggregate inside loss is therefore \$450 (\$550 net inside attribute amount over the \$100 value of the S share).

Accordingly, S's attribute reduction amount is the lesser of the \$200 net stock loss and the \$450 aggregate inside loss, or \$200. Under §1.1502-36(d)(4), S's \$200 attribute reduction is first allocated and applied to reduce S's \$50 loss carryover to \$0. Under §1.1502-36(d)(4)(i)(D), S generally would be able to reduce the basis of its category D assets (including stock in other corporations) by the remaining attribute reduction amount (\$150). However, paragraph (e) of this section provides that S's basis in the QOF (Q) shares is not included in S's category D attributes that are available for reduction under §1.1502-36(d)(4), and the remaining \$150 of attribute reduction amount cannot be used to reduce the basis of Q shares under §1.1502-36(d). Rather, under paragraph (e) of this section, P is treated as making the election under §1.1502-36(d)(6) to reduce M's basis in the transferred loss S shares by \$150. As a result, P's basis in its M stock will also be reduced by \$150.



(g) Applicability date. Except as otherwise provided in this paragraph (g), this section applies for taxable years that begin on or after the date of publication in the **Federal Register** of a Treasury decision adopting these proposed rules as final regulations. However, a QOF may rely on the proposed rules in this section with respect to taxable years that begin before the applicability date of this section, but only if the QOF applies the rules in their entirety and in a consistent manner.

Deputy Commissioner for Services and Enforcement.