NEW YORK STATE BAR ASSOCIATION
One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

Report No. 1418
July 1, 2019

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1418 – Report on Proposed Qualified Opportunity Zone Regulations under Section 1400Z-2*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1418 commenting on the second set of proposed regulations issued by the Department of the Treasury and Internal Revenue Service under Section 1400Z-2. The proposed regulations implement the "qualified opportunity zone" provisions of the Internal Revenue Code, in particular, relating to gains that may be deferred and investments held for at least ten years. Our Report focuses on issues we believe are most in need of clarification. We commend the Department of the Treasury and the Internal Revenue Service on the thoughtful approach of the proposed regulations.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

Cc:

Krishna Vallabhaneni
Tax Legislative Counsel
Department of the Treasury

Michael Novey
Associate Tax Legislative Counsel
Department of the Treasury

Scott Dinwiddie
Associate Chief Counsel (Income Tax & Accounting)
Internal Revenue Service

Holly Porter
Associate Chief Counsel (Passthroughs & Special Industries)
Internal Revenue Service

Robert Wellen
Associate Chief Counsel (Corporate)
Internal Revenue Service

Lisa Fuller
Deputy Associate Chief Counsel (Corporate)
Internal Revenue Service

John P. Moriarty
Deputy Associate Chief Counsel (Income Tax & Accounting)
Internal Revenue Service

Julie Hanlon-Bolton
Special Counsel to the Associate Chief Counsel (Income Tax & Accounting)
Internal Revenue Service

Clifford Warren
Senior Level Counsel to the Associate Chief Counsel (Passthroughs & Special Industries)
Internal Revenue Service

Report No. 1418

New York State Bar Association Tax Section

REPORT ON PROPOSED QUALIFIED OPPORTUNITY ZONE REGULATIONS UNDER SECTION 1400Z-2

July 1, 2019

TABLE OF CONTENTS

Page

I. Introduction

This Report[1] comments on the second set of proposed regulations (the "**April Proposed Regulations**")[2] issued by the Department of the Treasury and Internal Revenue Service ("**IRS**") (together, "**Treasury**") under Section 1400Z-2.[3] This report follows our earlier Report No. 1407, submitted to Treasury on January 10, 2019, commenting on the proposed regulations ("**October Proposed Regulations**," and together with the April Proposed Regulations, "**Proposed Regulations**") and Rev. Rul. 2019-29, each issued on October 19, 2018.[4]

The April Proposed Regulations were issued further to implement the "qualified opportunity zone" ("**QOZ**") provisions added to the Code by the legislation informally known as the Tax Cuts and Jobs Act of 2017 (the "**Act**"). In particular, the April Proposed Regulations provide guidance on Section 1400Z-2 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 investments in a QOF held by a taxpayer for at least ten years. The April Proposed Regulations also would update certain portions of the October Proposed Regulations.

This Report does not address all aspects of the QOZ regime or the April Proposed Regulations, but rather focuses on issues that we believe are most in need of clarification.[5] The policies expressed in the statute are, to an extent, unclear. The aim is generally to incentivize investment in QOZs, especially "new" investment in tangible property to be used in an active business. At the same time, Congress has imposed significant limitations on the type of investments that can be made (*e.g.*, limitations on nonqualifying financial property, and the need for an active business), and on the source of qualifying investments (recent capital gains on disposition of assets to unrelated persons), but without articulating in the legislative history what particular policies are intended to be advanced by those limitations. Accordingly, as a general matter, we have focused our suggestions in the direction of creating clarity and operative practicality and have tried to identify the issues raised by the April Proposed Regulations without

---

1 The principal authors of this Report are Jason Factor and Elliot Pisem. Significant contributions to the drafting of this Report were provided by William Alexander, Robert Cassanos, James Coss, Aaron Gaynor, JinSol Lee, Deborah Paul, Brian Peabody, Jane Song and Karen Sowell. Helpful comments were received from Daniel Altman, Orla O'Connor, Stephen Land, Michael Schler, Jonathan Talansky and Joseph Toce. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

2 Investing in Qualified Opportunity Funds, REG-120186-18, 84 Fed. Reg. 18652 (proposed May 1, 2019) (to be codified at 26 C.F.R. pt. 1).

3 Except as otherwise noted, all "Section" references in this Report are to Sections of the Internal Revenue Code of 1986, as amended (the "**Code**").

4 Investing in Qualified Opportunity Funds, REG-11540-18, 83 Fed. Reg. 54279 (proposed Oct. 29, 2018) (to be codified at 26 C.F.R. pt. 1); Rev. Rul. 2019-29, 2018-45 I.R.B. 765.

5 For example, this Report does not address the treatment of gains under Section 1256 contracts and straddles, and issues generally on capital gains derived from a disposition to a related party or transactions involving offsetting positions. Also, this report does not address items discussed in our Report No. 1407 (*e.g.*, the interpretation of the 180-day period in the case of a contribution of capital gains in the context of flow-through entities). We would be pleased to make supplemental suggestions on these or other points. Please see Report No. 1407 regarding our previous recommendations.

taking a view on how policy aims should be promoted. To incentivize investment, regulations ought to be flexible. By contrast, a goal of policing limitations on investment might require more specific rules or broader anti-abuse rules. A goal of incentivizing investment might suggest that the pool of capital available for qualifying investments should be broad. The limiting rules in the Code suggest, however, that Congress may have had a narrower purpose of trying to "unlock" (and, thereby, to tax in 2026) "built-in" capital gains that taxpayers, in order to avoid the burden of current taxation, would otherwise refrain from currently realizing or recognizing.

II. Summary of Recommendations

1. "Substantially All"

- The 90% holding period test for a QOZB (as defined below) should generally be applied solely on a retrospective basis. However, if an issuer of a QOF interest is a QOZB at the time of issuance of the QOF interest or is a "new" entity organized for purposes of being a QOZB, then such entity should be deemed to meet the 90% holding period test (in the case of a "new" entity, only during the start-up period of 31 months).

- If a QOZB qualifies on the relevant testing date, the entity should be treated as qualifying for the period starting from the day after the previous testing date through the current testing date. If an entity does not qualify as a QOZB on the testing date, it should not be considered a QOZB for the period starting on the day after the immediately previous testing date through the current testing date.

- The asset test in relation to QOZB qualification should be tested on discrete dates during the QOZB's taxable year, and if met, the QOZB's trade or business should be considered, from the perspective of any QOF owning an interest therein, to be a QOZB on each of that QOF's own testing dates that occur during the QOZB's taxable year.

- Treasury should provide clarity on how the 90% holding period test interacts with the 70% substantial use test. Treasury should provide guidance on how to measure the holding period component of the QOZBP (as defined below) use test; further, Treasury should remove the "(c)(9) mechanism" (as defined below) and adopt a new mechanism that applies to QOZBP of both QOFs and QOZBs.

2. QOF Qualification and Penalties

- The final regulations should make explicit that the asset test will be applied to each year of a QOF's existence. Further, the final regulations should make clear that the asset test is satisfied for a particular year, and no penalty is imposed, if the QOF has the appropriate mix of assets on the two annual testing dates, with no further inquiry during any other dates.

- Additional guidance should be given regarding how the penalty works, and whether there is any possibility of a subsequent loss of QOF benefits, beyond payment of the penalty, in the case of an entity failing to meet QOF requirements for an extended period of time.

Consideration should also be given to permitting or even requiring disqualification in extreme cases if some standard (even if short of 90%) is not met with respect to the 90% asset test within a specified period of time. A QOF should be permitted to compute the amount of penalty for failing to qualify as a QOF on a "look-through" basis with respect to assets owned by a putative QOZB so long as other requirements have been satisfied (other than compliance with the QOZB-level asset test), and consideration should be given regarding computation of the penalty when a QOF owns a certain threshold of the assets of another business entity. Additionally, leniency from the penalty should be considered (*e.g.*, a safe harbor) with respect to a QOF that acquires property shortly after that property is "originally used" in a QOZ.

- The final regulations should allow for the termination of QOF status, and specifically permit entities to revoke their election as an elective QOF after December 31, 2026, or earlier, if 100% of the deferred gains invested therein have been triggered.

3. <u>Original Use and Substantial Improvement</u>

- The final regulations should confirm whether tangible property located in a QOZ for which depreciation was available but not actually claimed is eligible to be treated as original use by a QOF. The final regulations should further clarify how the original use rule should work in the case of purchased property.

- The final regulations should confirm that inventory is not required to meet the "original use requirement" (as defined below) or the "SI requirement" (as defined below).

- In the context of the original use requirement, it may be useful for the final regulations to confirm the treatment of tangible personal property that is not inventory or real property and is purchased from an unrelated dealer in the ordinary course of such dealer's trade or business.

- Treasury should confirm that the length or manner of transit does not affect eligibility for the safe harbor for inventory in transit, and further, that the safe harbor covers cases where the inventory in transit is warehoused briefly at some location outside the QOZ.

- There should be a clear approach on how vacancy is measured for purposes of the vacancy period for the original use requirement, such as looking to revenue generated during the past five years and requiring certain certifications from transferees of such property, but such standard should also allow for some flexibility so that a relatively *de minimis* amount of revenue does not disqualify the property.

- This vacancy period exception should also apply to clearly delineated portions of structures if such portion has been vacant for five years even though the rest of the structure has not, and when use of the remainder of the structure has not affected the vacancy of the delineated portion in question.

- The SI requirement should permit assets that are substantially contiguous geographically in the same QOZ and are acquired in a single transaction (or related series of transactions) to be evaluated on an aggregate basis by election. If assets are not purchased in a single transaction, then consideration should be given to whether the 30-month clock should be presumed to start from the date the first property was purchased.

4. Qualified Opportunity Zone Business Property

- For purposes of the QOZBP asset tests, Treasury should consider a method of valuation that treats a lease at fair market rental as having a value of zero, regardless of whether the taxpayer has an applicable financial statement, or valuing a lease at its unadjusted basis (*i.e.*, in the same manner as acquired property). Treasury should also clarify how the rules relating to valuation of leases apply to leases that are acquired by a QOF or QOZB.

- For leases between unrelated parties, there should either be a complete elimination of the market rate requirement or a presumption that such leases are market rate.

- For leases between related parties, there should be a presumption that a lease is market rate if an individual meeting certain requirements provides an appraisal or report concluding that the lease is market rate.

- With respect to the limitation on leases of real property (other than unimproved land) relating to a "plan, intent, or expectation" for the lessee to purchase the property for an amount other than fair market value at the time of purchase, Treasury should consider modifying the limitation to permit a fixed purchase price option that is consistent with general income tax principles governing the distinction between a lease and a sale and has a strike price that is no less than a specified amount of fair market value at the time the option is entered into.

- Proposed Regulations Section 1400Z2(d)-1(f) in respect of land purchased 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" should also refer to land ***leased*** by the QOF or the QOZB (or alternatively, require that a tenant of real property "substantially improve" the property).

- Treasury should consider whether a lease that is transferred after December 31, 2017 should be considered a new lease for purposes of the QOZBP rules.

5. Safe Harbors

- It would be helpful for final regulations to confirm whether there are other acceptable excuses for failure to comply with the 31-month period for the working capital safe harbor besides delays in government action.

- Final regulations should confirm how the exception for delays in government action tolls the 31-month period for the working capital safe harbor.

- Final regulations should clarify that, if the working capital safe harbor is met, then for all relevant purposes under Section 1400Z-2, the QOZB is treated as having had a "trade or business" for the duration of the working capital safe harbor period.

- Final regulations should confirm that successive "stringing" of the working capital safe harbor can occur for the same QOZBP (for different amounts of cash). The working capital safe harbor should also allow for a particular phase of a project that takes more than 31 months to complete.

- Treasury should adopt a separate safe harbor for work in process, which would provide that assets held for work in progress be treated as good QOZBP (and the QOF or QOZB be treated as engaged in a trade or business) during the entirety of the construction period, if certain specified criteria are met.

6. Qualified Opportunity Zone Businesses – Other Issues

- For purposes of the rules regarding real property straddling a QOZ, to the extent the property straddling the QOZ line was acquired as a single tract, there should be a rebuttable presumption that the unadjusted cost basis is divided on the basis of area (looking to square footage for a building).

- Final regulations should provide clear guidelines on how the 40% threshold for "substantial portion" of intangible property used in the active conduct of trade of business should be applied and measured in the context of Section 1396C(b)(4), and how the location of intangible assets should be determined. Treasury should consider adopting a rule or a rebuttable presumption that ties the situs of intangible property to the portion of tangible property within a QOZ.

- Final regulations should define "triple net lease" and explain why merely entering into such a lease would not constitute active conduct of a trade or business. Treasury should consider whether entering a triple net lease generally could be considered as actively conducting a trade or business if the taxpayer meaningfully participates in the management or operations of such trade or business.

- Treasury should consider whether the definition of nonqualified financial property should have exceptions for certain items that are commonplace in the real estate sector, such as front-loaded rent treated in part as loans, or prepaid expenses.

7. Relief with Respect to the 90% Asset Test

- With respect to the "option to disregard" property recently contributed to a QOF, Treasury should make explicit that a QOF will not fail the asset test solely because the total amount of the QOF's assets may be zero by operation of this rule.

- Final regulations should adopt a rule for "QOF subsidiaries" to reinvest proceeds from the disposition of QOZP (as defined below) that is analogous to the rule that allows reinvestment by QOFs.

- After the expiration of a QOZ designation, investments in such previously designated QOZ should continue to be treated as QOZP for purposes of the 90% asset test (as defined below) and the QOZB test, and final regulations should permit recycling of gain as well as additional investment within such former QOZ in a QOZB active business, including an expansion of the business, so long as the investment occurs within the same former QOZ.

8. Section 1231 Gains

- The full (gross) amount of a taxpayer's Section 1231 gains should be eligible for deferral under Section 1400Z-2. However, gains and losses that are treated as long-term capital gains and losses under Section 1231(a)(1) (determined without regard to the deferral of all or a portion of the gains under Section 1400Z-2) should retain that character, regardless of the amount of gain that is deferred.

- The proper time for commencement of the 180-day period with respect to a Section 1231 gain should be the date of sale, but it may be appropriate to allow a taxpayer an additional, alternative 180-day period beginning on the last day of the taxable year. Also, if by reason of subsequent Section 1231 losses during a year, a taxpayer's Section 1231 gain is ultimately determined to be ordinary gain rather than long-term capital gain, such taxpayer should be treated like any other taxpayer that makes QOF investments in excess of the taxpayer's eligible gain.

- The final regulations should permit a partnership to defer Section 1231 gain (and also exclude Section 1231 gain under the "ten year rule" (as defined below)) up to the amount of such gains that would qualify under Section 1400Z-2 for deferral were it invested at the partner level.

- If Treasury retains the proposed rule relating to Section 1231 gains, it should consider refraining from using the term "capital gain net income," as that term is used with a different meaning under Section 1222(9).

9. Inclusion Events

- Final regulations should provide clear guidance on whether and to what extent an Inclusion Event (as defined below) causes a QOF interest to cease being eligible for the ten-year basis step-up benefit.

- The specified rules relating to Inclusion Events should apply throughout the holding period of the QOF interest, even if the Inclusion Event occurs after 2026 and all deferred capital gains have already been recognized.

- Subject to the other recommendations listed below, Inclusion Events relating to a transfer of a QOF interest, whether or not such transfer would otherwise be treated as a tax-free transaction, should generally cause the transferred QOF interest to be treated as a non-qualifying interest going forward.

- Contraction-type Inclusion Events should not cause the retained QOF interest to lose its eligibility for basis step-up after ten years.

- In the context of tiered partnerships, transfers should cause the proportionate amount to be non-qualifying, while distributions generally should not count adversely for purposes of the ten-year holding period.

- Treasury should consider eliminating the general rule on Inclusion Events and instead provide only a list of specific transactions that would create Inclusion Events.

- Final regulations should expressly provide that an acquiring corporation in a qualifying Section 381 transaction in which assets of a QOF shareholder are acquired could "tack" the holding period of a qualifying investment acquired in such a transaction.

- Final regulations should provide that Inclusion Event principles for Section 381 transactions are applicable to mergers of QOF partnerships and a merger of a partnership that own qualifying investments.

- Final regulations should provide that Inclusion Event principles for Section 355 transactions involving a QOF are applicable to "assets-over" divisions of QOF partnerships.

- Final regulations should provide that mergers of a QOZB corporation with another QOZB or mergers of a QOZB partnership with another QOZB causes the original use requirement or SI requirement status to transfer over and that the QOF's interest in the successor is considered to have been acquired "solely in exchange for cash."

- Final regulations should clarify that pre-arranged drop-downs of QOF interests are allowed so long as they qualify under Section 721 and should clarify the scope of feeder fund arrangements that are authorized under the QOZ rules. Further, the holding period for purposes of the ten year rule should be tacked when a QOF interest is contributed to a partnership feeder fund in a Section 721 transaction.

- Final regulations should clarify that ***<u>direct and indirect</u>*** Section 721 contributions of QOF interests are also not Inclusion Events.

- With respect to contribution of a QOF interest to an upper-tier partnership or the acquisition of an upper-tier partnership by another person, final regulations should provide for the application of Section 704(c) and reverse Section 704(c) principles to ensure that deferred gains (or any built-in gains on the QOF interest) are allocable to the proper taxpayers and the relevant basis adjustments are made. This rule should apply on an aggregate, "look through" basis for purposes of determining the holding periods in respect of the five- or seven-year deferral rules or the ten year rule, as well as allocating benefits of the QOZ regime.

- Treasury should clarify the treatment of Section 731 distributions of a QOF interest by an upper-tier partnership.

- Treasury should provide guidance on the treatment (including treatment as an Inclusion Event and the application of Section 704(c) and reverse Section 704(c) principles) of partnership distributions of cash or property to a partner with a fair market value in excess of basis in the context of tiered partnerships.

- Final regulations should clarify how Section 1400Z-2(e)(1) relating to bifurcation between qualifying and non-qualifying investments applies for Inclusion Event purposes in the QOF C corporation context.

- In respect of QOF C corporation distributions, Treasury should consider more closely aligning the treatment of recapitalizations with the treatment of Section 301 distributions, redemptions and reorganizations generally, rather than having a special regime for recapitalizations.

10. Carried Interest Issues

- Instead of apportioning between qualifying and non-qualifying QOF interests on the basis of "highest residual" profit, the distinction between qualifying and non-qualifying QOF interests should be based on comparing the profits received by the service provider with those derived by another significant partner that does not provide services to the QOF.

11. Sale of QOF Partnership Interest versus Sale of QOZP

- The treatment of gains from the sale of QOZBP by a QOZB should be harmonized with the sale of equity in a QOZB entity. Consideration should be given to aligning the QOF partnership's inside basis in the disposed assets and the QOF investor's outside basis in the QOF in order to eliminate differences between the sale of QOF partnership interests and the QOF's sale of assets, with the result that after ten years all gains from disposition of QOF assets would be excluded.

12. Corporate Issues (Consolidation and E&P)

- Treasury should provide guidance on the E&P effects of the QOZ provisions.

- Any increase to E&P as a result of gain deferred under the QOZ rules should be deferred until such gain is included in income. Basis adjustments that are made as a result of the five, seven or ten-year rules should be treated as tax-exempt income causing a corresponding increase to E&P under Treasury Regulations Section 1.312-6(b).

- For the specific purpose of making QOF investments in the context of a consolidated group, Treasury should consider adopting a single-entity approach.

- Final regulations should provide a transition rule for taxpayers who operated under the belief that the regulations would permit a corporate QOF to be a group member.

13. Guidance on Tax Exempt and Foreign Investors in QOFs

- Final regulations should permit non-U.S. investors and U.S. tax-exempt investors to roll over capital gains that otherwise would have been subject to tax as ECI (as defined below) to non-U.S. investors and UBTI (as defined below) to U.S. tax-exempt investors. However, the benefits of the QOZ regime should not be extended to non-U.S. investors and U.S. tax-exempt investors for capital gains that are not ECI or UBTI.

- Treasury should consider whether non-U.S. taxpayers with a qualifying investment in a QOF should be required to file U.S. federal income tax returns for the duration of their investment in a QOF, including the initial year of deferred ECI. Also, to ensure that non-U.S. investors have paid tax on their deferred ECI (in a context where withholding tax under Section 1445 or Section 1446 will not apply), consideration should be given to providing that non-U.S. taxpayers are not entitled to tax benefits under Section 1400Z-2(c) after a ten-year holding period unless they establish that they have properly paid tax on their deferred ECI.

- Treasury should consider how the ECI rollover mechanic should interact with the Foreign Investment Real Property Tax Act of 1980 ("**FIRPTA**") rules.

14. Anti-Abuse Rules

- Final regulations should provide guidance describing the "purpose" of the QOZ rules in a manner detailed enough to be prescriptive and/or a series of examples of situations that would run afoul of anti-abuse rules.

- Final regulations should provide specific examples of land uses that fall within or outside the anti-abuse parameters, as well as bright-line policy reasons.

- Final regulations should define the meaning of "insubstantially improve" in respect to the anti-abuse rule that unimproved or minimally improved land does not qualify as a QOZBP if it is purchased with an expectation, intention or view not to be improved or only insubstantially improved within 30 months after the date of purchase, and define land banking in a way that ties in with this 30-month anti-abuse rule. The anti-abuse rule on land banking should apply not only to years after the final regulations have been issued, but to all years as a substantive rule.

- Treasury should consider whether the alternative valuation method is appropriate for partnership interests that have a tax basis not based on cost. A valuation presumption should be adopted to the effect that a partnership interest is treated as having a valuation no less than the amount of net income allocated in respect of the interest during a taxable year (without regard to whether the interest has a lower value during relevant valuation days because distributions were made in the interim).

- Treasury should consider whether the holding period for QOF interests should ever be tolled, including by reason of having a put right that limits a taxpayer's risk of loss.

- Treasury should consider whether "self-warehousing" should be permitted under the rule that permits a qualifying investment to be a secondary acquisition of a QOF interest.

- Treasury should consider whether "sun & sin" businesses should also be prohibited at the level of the QOF, not only at the QOZB level.

- Treasury should consider whether there are any circumstances in which transactions undertaken to qualify around the testing date (*e.g.*, stuffing transactions) should be disregarded.

15. <u>Transitional Rules and Reliance</u>

- Treasury should provide transitional guidance in the event that the final guidelines are stricter than the Proposed Regulations.

III. Summary of April Proposed Regulations

1. Proposed Regulations Section 1.1400Z2(a)-1

Proposed Regulations Section 1.1400Z2(a)-1 provides definitions and operating rules for applying Section 1400Z-2, including rules governing gains from Section 1231 property. Proposed Regulations Section 1.1400Z2(a)-1(b)(2)(iii) provides that, in the case of Section 1231 property, only net capital gain income as determined at the end of a taxable year, is eligible for deferral under Section 1400Z-2(a)(1). Under Proposed Regulations Section 1.1400Z2(a)-1(b)(2)(vi), gain is not eligible for deferral if such gain is realized upon the sale or other transfer of property to a QOZ in exchange for an eligible interest. Any investment in a QOF via a transfer of cash or other property (but not services[6]), whether otherwise resulting in a gain or loss, is considered to be a Section 1400Z-2(a)(1)(A) investment.[7] The amount invested for purposes of Section 1400Z-2(a)(1)(A) in the case of property transferred directly to a QOF cannot exceed the amount of gain to be deferred under election.[8] Proposed Regulations Section 1.1400Z2(a)-1 also provides special rules for determining the amount invested in the case of transfers to QOF partnerships[9] and in the case of an interest acquired from a person other than a QOF.[10]

2. Proposed Regulations Section 1.1400Z2(b)-1

Proposed Regulations Section 1.1400Z2(b)-1 provides rules relating to the inclusion of gain deferred under Section 1400Z-2, and applies to a QOF owner until all such deferred gain has been included in income. Proposed Regulations Section 1.1400Z2(b)-1(a) provides definitions

6 Proposed Regulations Section 1.1400Z2(a)-1(b)(9)(ii).

7 Proposed Regulations Section 1.1400Z2(a)-1(b)(9)(i).

8 Proposed Regulations Section 1.1400Z2(a)-1(b)(10).

9 Proposed Regulations Section 1.1400Z2(a)-1(b)(10)(ii).

10 Proposed Regulations Section 1.1400Z2(a)-1(b)(10)(iii).

and scope. Notably, a mixed-funds investment is defined as an investment in which only a portion is a qualifying investment. Proposed Regulations Section 1.1400Z2(b)-1(b) provides the general rule regarding timing. In general, deferred gain is included in gross income in the taxable year that includes the earlier of either December 31, 2026 or an "inclusion event."

Proposed Regulations Section 1.1400Z2(b)-1(c) provides details on what qualifies as an inclusion event ("**Inclusion Event**"). Inclusion Events include, but are not limited to: transfers of a qualifying investment that reduce a taxpayer's equity interest in a QOF, distributions of property (regardless of whether the taxpayer's direct interest in the QOF is reduced), a taxpayer's claim of worthlessness, a QOF ceasing to exist for federal income tax purposes,[11] transfers of an investment in a QOF by gift (outright or in trust), certain changes in grantor trust status, partnership distributions exceeding fair market value of a partner's basis in the qualifying investment, dividend-equivalent redemptions, certain transactions to which Section 355 applies and Section 304 transactions. Events that do not constitute Inclusion Events include: transfers by reason of a taxpayer's death (with some exceptions),[12] contributions to grantor trusts, Section 721 contributions, Section 708(b)(2)(A) mergers or consolidations, certain transactions in respect to S corporations,[13] distributions by a QOF C corporation (except to the extent Section 301(c)(3) applies), qualifying Section 381 transactions[14] as well as certain recapitalizations and Section 1036 transactions.[15]

Proposed Regulations Section 1.1400Z2(b)-1(d) provides guidance on determining holding periods for qualified investments, including investments held by partnerships. In general, the holding period is determined without regard to the period for which the taxpayer has held the property exchanged for the qualified investment.[16] If the taxpayer received the qualifying investment as a gift that was not an Inclusion Event, or by reason of the prior owner's death, the holding period includes the time during which the donor or deceased owner held the interest.[17]

Proposed Regulations Section 1.1400Z2(b)-1(e) provides general rules for determining the amount of deferred gain included in gross income, including special rules for QOF partnerships and S corporations. Gain recognized on December 31, 2026 that is included in gross income is equal to the excess of the lesser of the remaining deferred gain and the fair market value of the

---

[11] There are special rules for distribution of a qualifying investment in a complete liquidation of a QOF owner to the extent Section 337(a) applies.

[12] Proposed Regulations Section 1.1400Z2(b)-1(c)(4)(ii).

[13] Proposed Regulations Section 1.1400Z2(b)-1(c)(7).

[14] Proposed Regulations Section 1.1400Z2(b)-1(c)(10)

[15] Proposed Regulations Section 1.1400Z2(b)-1(c)(12)

[16] For purposes of Sections 1400Z-2(b)(2)(B) and 1400Z-2(c), the principles of Section 1223(1) are applied to determine 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.

[17] For the purposes of Section 1400Z-2(d), any QOZP contributed by the distributing corporation to the controlled corporation in connection with a Section 355 transaction retains its status as a QOZP.

qualifying investment held on that date, over the taxpayer's basis in the qualifying investment taking into account only Section 1400Z-2(b)(2)(B).[18]

Proposed Regulations Section 1.1400Z2(b)-1(g) provides guidance on basis adjustments under Section 1400Z-2(b)(2)(B). In general, basis adjustments are made immediately after any gain is included in income and before determining any other tax consequences of an Inclusion Event.[19]

Proposed Regulations Section 1.1400Z2(b)-1(h) provides special reporting rules for partners and partnerships, and as well for direct or indirect owners of QOF partnerships and QOF S corporations.

3. Proposed Regulations Section 1.1400Z2(c)-1

Proposed Regulations Section 1.1400Z2(c)-1 provides guidelines on the election to adjust basis in qualifying investments held for at least ten years (the "**ten year rule**"). Special rules are provided for investments in a QOF for which a loss has been claimed, as well as for QOF partnerships and S corporations.

Proposed Regulations Section 1.1400Z2(c)-1(e) addresses capital gain dividends paid by a QOF REIT that some shareholders can elect to receive tax free. A QOF REIT shareholder whose shares represent a qualifying investment and who receives a capital gain dividend may treat that dividend as a qualifying gain on the date the QOF REIT identified with the dividend and, if on such date, the shareholder had held the qualifying investment for at least ten years, apply a zero percent tax rate.[20] Proposed Regulations Section 1.1400Z2(c)-1(e)(4) provides two methods by which a QOF REIT can identify the date for an amount of capital gain.[21]

4. Proposed Regulations Section 1.1400Z2(d)-1

Proposed Regulations Section 1.1400Z2(d)-1 provides rules governing QOFs. Proposed Regulations Section 1.1400Z2(d)-1(b) provides additional guidance on valuing assets for purposes of the requirement in Section 1400Z-2(d)(1) that a QOF holds 90% of its assets in QOZP ("**90% asset test**"). In general, a QOF may value its assets using the applicable financial statement

---

[18] The total amount of gain included in gross income under this subsection is limited to the amount deferred under Section 1400Z-2(a)(1) reduced by any increase in the basis made pursuant to Section 1400Z-2(b)(2)(B)(iii) or (iv).

[19] Proposed Regulations Section 1.1400Z2(b)-1(g)(1)(ii) provides specific rules for Section 301(c)(3) gain, gains of S corporation shareholders, and gains of partners. Further rules are provided concerning basis adjustments.

[20] The dividend must be identified with a date that the QOF REIT designates in a notice to the shareholder no later than one week after designation of the dividend. 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.

[21] Option one outlines a "simplified determination" in which the QOF REIT may utilize the first day of the taxable year in which it realizes long-term capital gain on QOZP. Option two outlines a "sale date determination" in which the QOF REIT may utilize the latest date on which there was a realization of long-term capital gain on QOZP.

valuation method or the alternative valuation method.[22] A QOF must consistently apply the valuation method it selects to all assets in respect to a taxable year. A QOF may choose to disregard property contributed within the last six months in complying with the 90% asset test. Details are also provided to determine if tangible property of a QOF is qualified opportunity zone business property ("**QOZBP**") within the meaning of the 90% asset test.[23]

Proposed Regulations Sections 1.1400Z2(d)-1(c)(4) and (5) clarify that "substantially all" means 90% for the purpose of determining whether the holding period requirements are met, and 70% with respect to the use of tangible property by a QOF in a QOZ. The interaction of the 90% and 70% thresholds is less clear. Proposed Regulations Section 1.1400Z2(d)-1(c)(7) provides that, in general, original use of a property acquired by purchase commences on the date the taxpayer first places the property in service in a QOZ for the purpose of depreciation or amortization ("**original use requirement**"). Used tangible property satisfies the original use requirement if the property has not been previously so used in a QOZ. Property that has already been used must satisfy the substantial improvement requirement to be QOZBP ("**SI requirement**").

Proposed Regulations Section 1.1400Z2(d)-1(c)(4)(iii) provides a safe harbor for inventory in transit. Proposed Regulations Section 1.1400Z2(d)-1(d)(5)(iv) provides a safe harbor for working capital ("**working capital safe harbor**"). Generally, working capital assets must be used in a manner consistent with this purpose, but a business may benefit from more than a single application of this safe harbor so long as each application independently satisfies the requirements.

5. Proposed Regulations Section 1.1400Z2(f)-1

Proposed Regulations Section 1.1400Z2(f)-1 generally provides that failure to satisfy the 90% asset test results in a monthly statutory penalty.[24] If a QOF, upon receipt of proceeds (held in cash, cash equivalents, or debt instruments with at most an 18-month term) from sale or disposition of qualified opportunity zone property ("**QOZP**"), reinvests some or all of those proceeds in QOZP within 12 months, those reinvested proceeds qualify as QOZP for purposes of the 90% asset test. The Proposed Regulations also provide an anti-abuse rule that authorizes the Commissioner to recast transactions made with a significant purpose to achieve tax results inconsistent with Section 1400Z-2.

6. Proposed Regulations Section 1.1400Z2(g)-1

Proposed Regulations Section 1.1400Z2(g)-1 provides rules regarding QOZs owned by members of a consolidated group. Since stock in a QOF corporation is not treated as stock for purposes of determining affiliated group membership within the meaning of Section 1504, a QOZ

---

[22] The alternative valuation method is provided in Proposed Regulations Section 1.1400Z2(d)-1(b)(3) if the QOF does not have an applicable financial statement.

[23] Proposed Regulations Section 1.1400Z2(d)-1(c)(4).

[24] Proposed Regulations Section 1.1400Z2(f)-1(c)(1).

corporation can be the common parent, but not a subsidiary member of a consolidated group. Section 1400Z-2 applies separately to each member of a consolidated group.[25]

IV. Detailed Discussion of Recommendations

A. "Substantially All"

1. Measurement of "Substantially All" and Related Timing Issues

Section 1400Z-2 uses the phrase "substantially all" five times (emphasis added in each):

(1) Twice, to describe a portion of the holding period for stock or a partnership interest, during which portion certain requirements must be satisfied in order for that stock or partnership interest to qualify as QOZ stock or a QOZ partnership interest (collectively, the "**QOZB holding period test**"):

(a) With respect to QOZ stock, "during *substantially all* of the qualified opportunity fund's holding period for such stock, such corporation qualified as a qualified opportunity zone business."[26]

(b) With respect to a QOZ partnership interest, "during *substantially all* of the qualified opportunity fund's holding period for such interest, such partnership qualified as a qualified opportunity zone business."[27]

The Proposed Regulations define "substantially all" in each of these contexts as **90%**.[28]

[25] Proposed Regulations Section 1.1400Z2(g)-1(d) also provides rules for tiering-up of investment adjustments.

[26] Section 1400Z-2(d)(2)(B)(i)(III).

[27] Section 1400Z-2(d)(2)(C)(iii).

[28] Proposed Regulations Section 1.1400Z2(d)-1(c)(5).

(2) Twice, in the definition of QOZBP,[29] once to describe a portion of the holding period for property and once to describe a portion of the use of property:

(a) "during *substantially all* of the qualified opportunity fund's holding period for such property" (the "**holding period component of the QOZBP use test**"),[30]

(b) "*substantially all* of the use of such property was in a qualified opportunity zone" (the "**amount of use component of the QOZBP use test**").[31]

The April Proposed Regulations define "substantially all" for purposes of the holding period component of the QOZBP use test as **<u>90%</u>**,[32] and for purposes of the amount of use component of the QOZBP use test as **<u>70%</u>**.[33]

(3) Once in the definition of a qualified opportunity zone business ("**QOZB**"),[34] to describe an amount of property: "[t]he term 'qualified opportunity zone business' means a trade or business . . . in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property" (the "**QOZB owned or leased test**").[35] The Proposed Regulations define "substantially all" in this context as **<u>70%</u>**.[36]

2. Numerical Thresholds

With respect to the uses of "substantially all" in the Code, the October Proposed Regulations set a numerical threshold only for the QOZB owned or leased test.[37] The April Proposed Regulations set numerical thresholds with respect to the other uses of "substantially all." The preamble to the April Proposed Regulations does not address whether Treasury considered testing "substantially all" by reference to qualitative "facts and circumstances" measures or applying numerical thresholds merely as safe harbors.

---

29 Section 1400Z-2(d)(2)(D)(i)(III).

30 *Id.*

31 *Id.*

32 Proposed Regulations Sections 1.1400Z2(d)-1(c)(5) and 1.1400Z2(d)-1(d)(2)(iii).

33 Proposed Regulations Sections 1.1400Z2(d)-1(c)(6) and (d)(2)(iv).

34 Section 1400Z-2(d)(3)(A).

35 Section 1400Z-2(d)(3)(A)(i).

36 Proposed Regulations Section 1.1400Z2(d)-1(d)(3)(i).

37 *Id.*

We acknowledge the usefulness of a "bright line" numerical threshold for "substantially all" and agree with the approach. Although an approach involving a qualitative standard coupled with a quantitative safe harbor could be considered the "best of both worlds," we believe that such an approach would put too much electivity in the hands of the taxpayer. Further, despite the advantages of flexibility, the many "substantially all" tests would cause a problem of compounding subjective standards, making it hard for taxpayers to know whether or not they had met each such standard.

As to the numerical thresholds themselves, the preamble to the April Proposed Regulations explains that the thresholds, if set too high, "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," but, if set too low, "would allow investors in certain QOF's to receive capital gains tax relief while placing a relatively small portion of its investment within a qualified opportunity zone."[38] We agree that the numerical thresholds (in particular, the 90% thresholds) could not be set much higher without limiting investment in QOZs. Businesses that will be located inside of a QOZ, but that will service customers outside of the QOZ, may have challenges meeting these tests even at the current thresholds. However, setting the 70% thresholds, in particular, much lower would permit, for example, a QOZB to hold material tangible assets outside of a QOZ, undermining the policy goals of the regime. In view of this tension between setting the numerical thresholds too high and setting them too low, we believe that the numerical thresholds set with respect to the uses of "substantially all" are generally appropriate.

3. *QOZB Holding Period Test and Definition of "New" Corporation or Partnership*

The Code provides specific testing dates upon each of which one must determine whether at least 90% of a QOF's assets are QOZP. Thus, one must know whether stock and a partnership interest held by a QOF on the relevant testing date is QOZ stock or a QOZ partnership interest. In turn, under the QOZB holding period test, one of the requirements for QOZ stock or a QOZ partnership interest is that the issuer of the stock or partnership interest must qualify as a QOZB for "substantially all" of the QOF's holding period of such stock or interest. Although the Proposed Regulations define "substantially all" as 90% for this purpose, neither the Proposed Regulations nor the preambles answer other fundamental questions, such as whether the test is applied solely "retrospectively," by reference to circumstances occurring prior to and on the particular testing date, or whether "prospective" circumstances, anticipated to occur in the future, should also be relevant.[39]

The prospective approach better aligns with the notion of a start-up period, during which, although the "new" entity does not currently meet the numerical threshold tests for QOZB status, a "new" corporation or partnership organized to be a QOZB may qualify as such. Conversely, a retrospective approach (without other relief) might cause a failure of the QOZB holding period

---

[38] *See* 84 Fed. Reg. 18652, 18653-54 (May 1, 2019).

[39] Taking into account anticipated future circumstances could either facilitate or eliminate the ability of stock or of a partnership interest to meet the test on a particular date.

test during such a start-up period. However, we believe that, as a matter of administration, a prospective test is impractical.

As an example, if a putative QOZB failed to qualify as such in the first year of a QOF's holding period, then qualified for the next eight years, and then failed to qualify again in the tenth year, the QOF would fail to meet the QOZB holding period test. However, such failure would not be known until the end of the tenth year. If that QOF's only asset is (and had only ever been) an interest in the putative QOZB, the QOF would have had no good assets for the duration of its life. Subject to statutes of limitation, a material penalty would be incurred. Moreover, if it is possible for a QOF to become disqualified (or to fail to initially qualify) due to a 90% asset test failure, then, at that point, relevant statutes of limitation would also have run on gain that was deferred by way of an investment in the QOF in the first year. Additionally, it would seem inequitable for a QOF investor to find out ten years into its investment that its investment no longer qualifies (and, in fact, never qualified) for the election under Section 1400Z-2(c) to "step up" that investor's basis in the QOF to fair market value after a ten-year hold. For these reasons of administrability and certainty, we suggest that the final regulations clarify that the QOZB holding period test be applied solely on a retrospective basis, subject to a special rule, discussed below, for new corporations or partnerships organized to be QOZBs.

In addition, we suggest that (i) if the issuer of the stock or partnership interest is a QOZB on a testing date,[40] the issuer be considered to be a QOZB for the entire period starting from the day after the QOF's immediately previous testing date through the current testing date, or (ii) if the issuer is not a QOZB on the testing date, the issuer be considered not to be a QOZB for the entire period starting on the day after the QOF's immediately previous testing date through the current testing date. This simplification would ease the administrative and compliance burdens of testing an issuer's status as a QOZB on a continuous basis.

> **Example 1**: QOF A is organized and capitalized on January 1, 2019. On the same day, QOF A organizes Corp. X, in which QOF A acquires stock solely in exchange for a contribution of cash. On each of the first four testing dates for QOF A (June 30, 2019; December 31, 2019; June 30, 2020; and December 31, 2020), Corp. X qualifies as a QOZB. Under the rule proposed above, Corp. X will be considered to have been a QOZB from January 1, 2019, through December 31, 2020, meaning that Corp. X was a QOZB for 100% of QOF A's holding period in Corp. X, satisfying the QOZB holding period test. However, if Corp. X failed to be a QOZB on the fifth testing date (June 30, 2021), QOF A's stock in Corp. X would fail the QOZB holding period test, as Corp. X would have been a QOZB for only approximately 80% of QOF A's holding period in the stock (the quotient of (i) the duration of the period from January 1, 2019, through December 31, 2020, divided by (ii) the duration of the period from January 1, 2019, through June 20, 2021).

As indicated above, special consideration should be given under the QOZB holding period test to new corporations and new partnerships that were organized to be QOZBs. Sections 1400Z-

40 The matter of whether the issuer is a QOZB on the QOF's testing date is discussed below. Specifically, if our recommendation below is adopted, a putative QOZB's qualification as a QOZB on a particular testing date of its parent QOF will depend on whether that putative QOZB is a QOZB with respect to that QOZB's entire taxable year in which the parent QOF's testing date falls.

2(d)(2)(B)(i)(II) and (C)(ii) (and Proposed Regulations Sections 1.1400Z(d)-1(c)(2)(i)(B) and (3)(ii)) provide that the issuer of QOF stock or a QOF partnership interest must be a QOZB at the time of issuance of the stock or partnership interest to a QOF *unless* the issuer is a "new" corporation or partnership "organized for purposes of being a qualified opportunity zone business."[41] This "QOZB at acquisition or as a new business entity" requirement is stated in the Code to be in addition to the QOZB holding period test, but we believe that the QOZB holding period test must be read in light of this requirement in order to reach sensible results. Take, for example, a partnership that is organized on December 30, 2019, for the purpose of being a QOZB and that, within the first few weeks of 2020 satisfies all of the requirements for QOZB status. If a QOF with a December 31, 2019, testing date acquired an interest in that partnership on December 30, 2019, it seems clear to us that the interest would satisfy the "new business entity" prong of the "QOZB at acquisition or as a new business entity" requirement. Yet, on a hyper-literal reading of the Code, and if our recommended retrospective reading of the QOZB holding period test were adopted, the partnership interest would still fail that test on December 31, 2019. Accordingly, the new business entity rule and the QOZB holding period test use test must be harmonized.

We believe that the most evenhanded way to effect such harmonization is to treat a stock or a partnership interest as satisfying the QOZB holding period test for so long as the new business entity prong of the QOZB at acquisition or new business entity requirement is satisfied. Once a business entity ceases to be "new," the period during which it was "new" should be ignored completely in applying the QOZB holding period test.[42] We suggest that, for purposes of the "QOZB at acquisition or new business entity" requirement, a corporation or partnership be considered "new" for 31 months, the duration of the period covered by the working capital safe harbor, which we understand to be meant to coincide with a "start-up" period.

---

41 In order for an entity to elect QOF status, on Form 8996, the entity must certify "that by the end of the [entity's] first qualified opportunity fund year, the [entity's] organizing documents include a statement of the entity's purpose of investing in qualified opportunity zone property and the description of the qualified opportunity zone business" (the "**magic words requirement**"). Thus, an entity that holds no QOZP, but that satisfies the magic words requirement, may apparently elect QOF status, but an entity 100% of the assets of which are QOZP may not elect QOF status if it footfaults on the magic words requirement. Although the Code requires a QOF to be organized for the appropriate purpose, nowhere in the Code or the Proposed Regulations is the magic words requirement stated.

42 For example, on January 1, 2019, a QOF acquires an interest in a newly formed partnership that intends to qualify as a QOZB. Assume that the partnership is considered "new" for these purposes throughout 2019, that the partnership does not qualify as a QOZB at any time during 2019, and that the partnership does qualify as a QOZB on January 1, 2020, and continues to qualify as a QOZB through the end of 2027. Assume that the QOF holds no assets other than the interest in the partnership. If the partnership ceases to qualify as a QOZB commencing on January 1, 2028, the QOF will pass the QOZB holding period test with respect to that interest on the testing date of June 30, 2028 (as the partnership was a QOZB for eight out of eight-and-a-half years, *i.e.*, more than 90% of the relevant holding period), but will fail the QOZB holding period test on the testing date of December 31, 2028 (as the partnership was a QOZB for only eight out of nine years, *i.e.*, less than 90% of the relevant holding period). As the interest in the partnership is the sole asset of the QOF, the QOF will have 100% of its assets as QOZP on the first testing date, but 0% of its assets as QOZP on the second testing date. As the 90% asset test is as measured by averaging the proportion of assets that are QOZP on the two relevant testing dates, the QOF will fail the 90% asset test, as it will have only 50% (*i.e.*, the average of 0% and 100%) QOZP.

4. Testing Dates for QOZB Qualification

Neither the Code nor the Proposed Regulations provide dates upon which to apply the requirements of Section 1400Z-2(d)(3) for purposes of determining whether a corporation or partnership is a QOZB. While it may be tempting to believe that a trade or business's status as a QOZB should be tested on the same semi-annual dates as those on which its shareholder- or partner-QOF is tested, this approach would fit poorly with the annual testing requirements in Sections 1397C(b)(2), (4) and (8) that are incorporated by reference in Section 1400Z-2(d)(3)(A)(ii). Moreover, an approach of matching testing dates for the putative QOZB with testing dates for the shareholder- or partner-QOF would be problematic in the case of a QOZB that is owned by two or more QOFs with different taxable years (and testing dates) from one another or a QOZB with a taxable year different from that of some or all of the QOFs that own stock or partnership interests in that QOZB.[43]

For these reasons, we recommend that a trade or business's satisfaction of the "asset test" for QOZB qualification be measured on a discrete number of dates[44] during the QOZB's taxable year. If the trade or business meets that test on those dates and satisfies the Sections 1400Z-2(d)(3)(A)(ii) and (iii) requirements for the trade or business's entire taxable year, the trade or business should be considered, from the perspective of any QOF owning stock or a partnership interest therein, to be a QOZB on each of that QOF's own testing dates under Section 1400Z-2(d)(1) that occur during the trade or business's taxable year. In the majority of cases – in which the QOZB and all QOF's that own stock or partnership interests therein use the calendar year – this will make testing straightforward. In other cases, this rule at least provides clarity.

5. Amount of Use Component of the QOZBP Use Test and QOZB Owned and Leased Test

In order for property to qualify as QOZBP "during substantially all [90%] of the qualified opportunity fund's holding period for such property, substantially all [70%] of the use of such property [has to be] in a qualified opportunity zone" ("**QOZBP use test**").

Neither the Code nor the Proposed Regulations provides any further explanation as to how to measure whether the *holding period component* of the QOZBP use test has been met, and the Treasury should provide guidance on this point. Treasury should provide clarity on how the 90% holding period test interacts with the 70% substantial use test.

Proposed Regulations Section 1.1400Z2(d)-1(c)(9) purports to give a mechanism (the "**(c)(9) mechanism**") by which to measure whether an item of putative QOZBP has met the *amount of use component* of the QOZBP use test. The (c)(9) mechanism is substantially identical

---

43 Proposed Regulations Sections 1.1400Z2(d)-1(b)(1) and 1.1400Z2(d)-1(d)(3)(B)(1) refer to valuing assets of a QOF or a QOZB on an "annual basis," if valued based on the "applicable financial statement" method.

Proposed Regulations Section 1.1400Z2(d)-1(d)(3)(iii), Example, indicates that, in the case of a QOZB that has two shareholders with different accounting methods, the QOZB must select one accounting method (that is, it does not use a different accounting method for each partner). This implies, perhaps, that a QOZB should have a single set of testing dates, rather than separate testing dates for each QOF parent.

44 Probably two dates, determined by analogy to the principles of Section 1400Z-2(d)(1).

to the mechanism for the QOZB owned or leased test set forth in Proposed Regulations Section 1.1400Z2(d)-1(d)(3)(ii)(A) and thus tests all putative QOZBP in the aggregate (rather than testing a specific item of putative QOZBP). But this approach does not comport with the amount of use component of the QOZBP use test, as that component is meant to test a particular item of putative QOZBP.

Furthermore, the (c)(9) mechanism, which measures the amount of use component of the QOZBP use test, creates a circularity: Proposed Regulations Section 1.1400Z2(d)-1(c)(9)(A) provides that "[t]he numerator of [the (c)(9) mechanism] 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." Paragraph (c)(4)(i) sets forth requirements for property to constitute QOZBP, including the amount of use component of the QOZBP use test. Thus, in order to utilize the (c)(9) mechanism, which is meant to determine whether property meets the amount of use component of the QOZBP use test, a QOF must already know whether that property meets the amount of use component of the QOZBP use test (as that test is one requirement for property to qualify as QOZBP).

For these reasons, we believe that the (c)(9) mechanism may have been a drafting error or oversight, or an incomplete thought to adapt the mechanism for the QOZB owned or leased test to the amount of use component of the QOZBP use test. In the final regulations, the provision should be deleted in its entirety and replaced with an appropriate mechanism (discussed below) that applies to putative QOZBP of both a QOF and a QOZB. (The (c)(9) mechanism on its face applied only to putative QOZBP of a QOF, but not of a QOZB.)

The best way to understand the QOZBP use test may be through an illustration:

A QOZB in the photography business owns a putative item of QOZBP: a camera. During the first 99 days of its holding period of the camera, the QOZB uses the camera to take one picture per day outside of a QOZ (and no other pictures). On the 100th day of its holding period, the QOZB uses the camera to take 208 pictures inside a QOZ (and no other pictures).

If the proper way to compute the QOZBP use test is to determine the amount of use on each particular day, the camera would fail the QOZBP use test. This is because for only 1 day out of the QOZB's 100-day holding period (which is to say, for less than 90% of its holding period), all (which is to say more than 70%) of the use of the putative QOZBP was in a QOZ.

However, if the proper way to compute the QOZBP use test is to look at overall use on the 100th day and 89 other days (for 90 days total, or 90% of the holding period), one would find the amount of use component of the QOZBP use test is met as the quotient of (i) 208 qualifying pictures divided by (ii) 297 pictures (which is the sum of (w) 208 qualifying pictures and (x) 89 non-qualifying pictures) is slightly more than 70%.

We would also note that using 307 pictures (the sum of (y) 208 qualifying pictures and (z) 99 non-qualifying pictures) as the denominator misapplies the test, as it would look to use on all 100 days, rather than only 90 of the 100 days. To require the QOZB to look at its use on all 100 days would ignore the holding period component of the QOZBP use test: the QOZB needs to meet the use component of the QOZBP use test only during 90% of the QOZB's holding period of the property (which would be 90 days in this illustration).

B. QOF Qualification and Penalties

Section 1400Z-2(d)(1) defines the term "qualified opportunity fund." Included among the elements of the statutory definition is the phrase:

> that holds at least 90% of its assets in qualified opportunity zone property, determined by the average of the percentage of qualified opportunity zone property held in the fund as measured
>
> > (A) on the last day of the first 6-month period of the taxable year of the fund, and
> > (B) on the last day of the taxable year of the fund.[45]

1. Periods during which Penalty is Applicable

The Code does not specify whether this test must be met annually or only with respect to one or more specific taxable years of a QOF, nor does it specify – except as discussed below – what the consequences are of failing to satisfy this test. In contrast, other provisions of the Code containing analogous "asset tests" are more explicit about such issues. For example, Section 856(c)(4) provides that an entity shall not be considered a REIT "for any taxable year," unless, "at the close of each quarter of the taxable year," certain asset tests are satisfied, and it is well accepted that an entity that does not satisfy those tests ceases to be entitled to the benefit of any of the REIT provisions of the Code, unless the relief provision of Section 856(c)(7) applies.[46]

The Proposed Regulations hint at an answer to the question of whether the 90% asset test applies annually by saying, in Proposed Regulations Section 1.1400Z2(d)-1(a)(2)(i), "[f]or purposes of Section 1400Z-2(d)(1)(A) and (B) in the first year of the QOF's existence, the phrase *first 6-month period of the taxable year of the fund* means . . . ." (emphasis added). This language suggests that the 90% asset test is intended to apply during each year of the QOF's existence, although the way that the test is applied during the first year is different, to the extent provided in Proposed Regulations Section 1.1400Z2(d)-1(a)(2)(i), from the way it is applied in subsequent years. We concur in this result, and we suggest that it be stated explicitly in the final regulations.

Further, we suggest that the final regulations make explicit that the 90% asset test will be considered to have been fully satisfied for any year, and that no penalty will be imposed under Section 1400Z-2(f) with respect to that year, so long as the QOF has the appropriate asset mix on each of the two annual testing dates, with no further inquiry as to its assets on any other date. (This is potentially subject to any anti-abuse rules that may apply to "stuffing" or other similar

---

45 Section 1400Z-2(d)(1).

46 For another example, *see* Section 860D(a)(4) (one qualification for being a REIMIC is that substantially all of the assets of the entity must consist of qualified mortgages and permitted investments "at all times" after the third month beginning after the startup date), Section 860D(b)(2)(B) (entity that ceases to be a REMIC at any time during a taxable year shall not be treated as a REMIC for such year or any succeeding year).

transactions. *See* Part IV.N for our recommendations on anti-abuse rules.) Only if the 90% asset test is failed on one or both of the testing dates does the monthly penalty come into play.

2. *Consequences of Failure to Satisfy the 90% Asset Test*

With respect to a QOF's failure to satisfy the 90% asset test, Section 1400Z-2(f) provides that, if a QOF fails to meet the 90% requirement of Section 1400Z-2(d)(1),[47] the QOF shall pay a penalty for each month. Proposed Regulations Section 1.1400Z2(f)-1(a) does little more than restate the statutory language and add an exception for "Section 1.1400Z2(d)-1(a)(2)(ii) [relating to months during a taxable year before the first month in which an eligible entity is a QOF] with respect to a taxpayer's first taxable year as a QOF."

Neither the Code nor the Proposed Regulations addresses explicitly whether, on the one hand, becoming liable for the monthly penalty is the sole consequence of failure to satisfy the 90% asset test or, on the other hand, there is a potential "disqualification" consequence to such failure, whether in the first year of purported QOF qualification, in the year of any particular taxpayer's making of an investment in the QOF, or in any subsequent year. However, the preamble to the April Proposed Regulations states that "[f]ailure 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)."[48]

The Proposed Regulations properly recognize that treating an entity as not a QOF, with all of the adverse consequences that can follow from that determination, is often too onerous a penalty for what may be innocent shortcomings caused by unanticipated business exigencies, particularly during a start-up period.[49] Moreover, the imposition of the Section 1400Z-2(f) penalty may be the appropriate sanction in many cases in which such shortcomings cannot be shown to be "due to reasonable cause."

However, we find it incongruous that a taxpayer may be able to enjoy the benefit of deferring gain by investing in an entity that does not meet and, indeed, does not even intend to meet, the statutory 90% asset test during the period the investor is holding its interest in the QOF.[50] Assuming that result is not intended, we suggest that consideration be given to permitting or even requiring disqualification in extreme cases if some standard (even if short of 90%) is not met with respect to the 90% asset test within a specified period of time. If desired such a standard could be a presumption which could be rebutted by a showing of reasonable cause (as defined); conversely, certain types of specified conduct could also be viewed as inconsistent with reasonable cause. An example of blatant lack of "reasonable efforts" to comply with the 90% asset test may include running a Section 144(c)(6)(B) business in a QOZB.

If such an approach is pursued we believe that due account should be taken of the following

---

47 The Code contains a typographical error here and refers, incorrectly, to "subsection (c)(1)."

48 *See* 84 Fed. Reg. 18652, 18659 (May 1, 2019); *compare supra* note 41 on the magic words requirement.

49 *Cf.* the "reasonably expects" test of Treasury Regulations Section 1.45D-1(d)(4)(iv).

50 The penalty might not safeguard against this intent: in many cases, the Section 1400Z-2(f) penalty may be far less than the interest that would have been payable by the taxpayer on an underpayment equal to the tax putatively saved by investment in the failed QOF.

factors:

- in the case of a marketed fund, the "sting" of disqualification will be felt by investors, not by sponsors, and the two may be different and unrelated to each other. This would typically be the case with a marketed or true "fund" as opposed to a joint venture which was established by the sponsor to invest its own eligible gains;

- noncompliance may be caused by external factors beyond the investors' or sponsors' control, including the inability to entitle property, failure to raise funds in a timely manner, and changes in law;[51] and

- the appropriateness of such an approach may depend on whether the recommendations suggested below are adopted, in particular, applying the 90% asset test for QOZB assets on a "look through" basis.

Moreover, regardless of the numerical threshold for qualification under the 90% asset test, we believe that a "look through" rule (like the one proposed below with respect to penalties) should apply, so that a QOF of which the only asset is an interest in a QOZB is not treated as having 0% of its assets invested in QOZP solely because the QOZB has, for example, only 69% qualifying assets under the QOZB owned or leased test. Additionally, as is suggested below in the context of measuring the penalty, we believe that leniency should be given with respect to a QOF that acquires property shortly after that property is "originally used" in a QOZ.

Additionally, guidance should be given regarding how the penalty works, and whether an entity failing to meet QOF requirements for an extended period of time (*e.g.*, if a QOF meets the working capital safe harbor but then fails to satisfy the requisite requirements for years five through eight of its existence) can subsequently lose QOF benefits, beyond the payment of the penalty.

3. Determination of Amount of the Penalty

In many cases the primary asset of an entity that wishes to qualify as a QOF will be a partnership interest or stock in an entity that is intended to be a QOZB. This circumstance can lead to anomalies (some unduly harsh, and some unduly favorable to the taxpayer) in the determination of the penalty.

Assume that a QOF's sole asset is a partnership interest in a putative QOZB, and that the putative QOZB satisfies the requirements of Section 1400Z-2(d)(3)(A), except that only 69% of the tangible property owned or leased by the QOZB is QOZBP. Assume further that the putative QOZB has no material intangible property and has not incurred any material liabilities in connection with its operations or the acquisition of its assets. Reading the Code to look to interests in the putative QOZB entity as the QOZP, and not to the underlying assets, could lead to the conclusion that none of the QOF's assets constitute QOZP, with the effect that the penalty would

51 For example, a sponsor might not succeed in meeting its fundraising goals and have to terminate the QOF after receiving some investments but before acquiring any QOZP. Investors should have a chance to salvage their deferral when they are redeemed out of the QOF for cash (an Inclusion Event), giving rise to a new 180-day period to invest. This circumstance appears to be expressly contemplated in Proposed Regulations Section 1400Z2(a)-1(b)(4)(ii), Example 4.

be determined by reference to the full value of the interest in the putative QOZB owned by the QOF, even though an increase of only one percentage point in the amount of QOZBP owned by the putative QOZB would have eliminated entirely the application of the penalty, and even though, had the QOF owned the same assets directly, the penalty would have been determined by reference to only 21% (equal to 90% minus 69%) of their value.

On the other hand, if a putative QOZB acquires assets on a leveraged basis, a determination of the penalty under such a reading of the Code could lead to the penalty's failing to apply in circumstances evidencing what would be, in substance, a serious failure to comply with the QOF-level 90% asset test. For example, assume that a QOF owns, directly, $89 of QOZBP and also owns a 50% interest in a partnership that, in turn, owns $100 of property that is not QOZBP and has $80 of liabilities, with the effect that the QOF's interest in such partnership has a fair market value of $10. Assume further that the "value" of such partnership interest under the applicable method in Proposed Regulations Section 1.1400Z2(d)-1(b) is $10. It may be overly generous to permit this QOF to determine the penalty on the basis that its total assets are $99, of which $89, or 89.9%, are qualifying.

These examples illustrate that sensible results under the penalty provision can in many cases be reached only by determining the penalty on a look-through basis.[52]

Accordingly, we recommend that a QOF be permitted to determine the penalty on a "look-through" basis with respect to assets owned by a putative QOZB, at least so long as all requirements for QOZB stock or QOZ partnership interest status have been satisfied, other than compliance with the QOZB-level 90% asset test. Consideration should also be given to requiring determination of the penalty on a look-through basis when a QOF owns some threshold (perhaps 20% or 50%) of the stock or other interests in another business entity.[53]

Similarly, a harsh penalty would seem inequitable in the case of temporal (rather than valuation) "footfaults." For example, a single-asset QOF might acquire a rental apartment building one day after the certificate of occupancy was (or could have been) issued, meaning that the QOF does not meet the original use requirement with respect to the building. We suggest a safe harbor permitting a QOF or QOZB to be considered to meet the original use requirement if the QOF or QOZB believed in good faith that property acquired had not yet been placed in service, and the property was not, in fact, placed in service more than 90 days prior to the acquisition.

4. *Termination of Status as a QOF*

The Code contains no explicit provision relating to termination of a QOF's status as such. However, application of the penalty on an ongoing basis indefinitely into the future may be an unduly harsh consequence where underlying business or economic circumstances have changed, and it no longer makes sense for an entity to continue to refrain from operations outside of QOZs. To that end, we recommend that an entity be permitted to revoke its election as a QOF at any time

---

52 This is likely to be the case even when the QOF owns interests in corporations, and not merely in partnerships.

53 If a look-through general rule is utilized, we believe that intangible property used in the active conduct of a trade or business within a QOZ should be treated as a "good" asset for purposes of calculating the penalty. *See* our recommendations relating to intangible property in Part IV.F.2.

after December 31, 2026 (or even before that date, if the QOF can demonstrate that 100% of the deferred gains that have been invested therein (other than those eliminated by operation of Section 1400Z-2(b)(2)(B)(iii) and (iv)) have been triggered by sale or exchange of the investors' interests or by the occurrence of other Inclusion Events). If the revocation is effective on or before December 31, 2047, consideration should be given to permitting the making of Section 1400Z-2(c) elections by otherwise qualifying investors to adjust their bases in their interests in the QOF to fair market value on the effective date of the revocation. We also suggest permitting revocation at any time on or before December 31, 2026, but, if such revocation is permitted, it should be considered an Inclusion Event as to all investors in the year of termination. Without explicit guidance to that effect, the IRS could treat the termination event as a failed deferral and impose tax on the gain in the year of realization with interest. In a similar vein, guidance may need to distinguish between loss of status due to termination or revocation, on the one hand, and failed qualification, on the other hand. If taxpayers treat an arrangement as a QOF, but it never meets the QOF requirements, then arguably gain should be recognized in the original year of realization.[54]

C. Original Use and Substantial Improvement

The April Proposed Regulations provided guidance on the definitions of "original use" and "substantial improvement." As described below, we generally agree with the approach to the measurement of original use based on depreciation or amortization and believe an aggregate approach to the SI requirement would be beneficial. We also propose suggestions for additional clarifications that we believe would be helpful for implementation of these rules.

1. Original Use, Generally

Proposed Regulations Section 1.1400Z2(d)-1(c)(4)(iii)(B)(*7*) clarify that original use for tangible property acquired by purchase commences on the date on which the purchaser or a prior person first places the property in service in a QOZ for purposes of depreciation or amortization (or first uses the property in a QOZ in a manner that would allow depreciation or amortization if that person were the property owner).[55] The Proposed Regulations also provide that tangible personal property that was already in the QOZ but not depreciated or amortized by another taxpayer would satisfy the original use requirement. Accordingly, acquired tangible property previously located in the QOZ that was already depreciated or amortized by another taxpayer would not qualify for the original use requirement.[56] It is not entirely clear under the Proposed Regulations whether, in a scenario where a developer constructs a building and puts it up for a lease (which would allow for depreciation), but then immediately sells it to a third party QOF (prior to actually claiming depreciation), the building would be eligible to be treated as original use by the QOF, and the final regulations should confirm this point. It appears that the building would not be so eligible, but this effect does not seem to be intentional. At the same time, if some measurable time has passed since the property was completed (and placed in service), then the QOF would be buying property that would fail the original use test. It would be helpful to further

[54] *Cf.* Section 50(d)(4) (referencing the rules in Section 48(b)).

[55] *See* 84 Fed. Reg. 18652, 18655 (May 1, 2019).

[56] 84 Fed. Reg. 18652, 18655 (May 1, 2019).

clarify in the final regulations how the original use rule should work with purchased property. One practical way to deal with this issue may be to treat the property as satisfying the original use test if it is acquired within 90 days after it was placed in service by the seller.[57]

The Proposed Regulations also suggest that property not placed in service but sold directly to a QOF would satisfy the original use requirement even if the QOF does not put additional capital to work.[58] Given that Section 1400Z-2(d)(2)(D) is clear that the original use requirement is about putting property *in service* within a QOZ (whether or not the property was developed or constructed elsewhere), we believe that this is a reasonable approach for the application of the original use rule. The SI requirement, by contrast, focuses on improvement of tangible property within a QOZ.

We believe that the general rule in the Proposed Regulations requiring depreciation or amortization is well suited for real property owned by the QOF or the QOZB. The Proposed Regulations seem to assume that inventory does not require original use or substantial improvement, but a clarification on this point would be helpful. Additionally, with respect to tangible personal property that is not inventory or real property, it may be useful for the final regulations to provide that such property purchased from an unrelated dealer in the ordinary course of such dealer's trade or business is not treated as having been eligible to be depreciated or amortized by the dealer (or a prior owner in the case of used property purchased from a dealer). This would be consistent with the aim of identifying tangible property first placed in use in an active business (as contrasted to tangible property sold as inventory of a business).

2. *Inventory in Transit*

The Proposed Regulations in Section 1.1400Z2(d)-1(c)(4)(iii) provide that inventory (including raw materials) of a trade of business does not fail to be used in a QOZ solely because the inventory is used in transit.[59] The Proposed Regulations further list two scenarios covered by the safe harbor: inventory traveling (1) from a vendor to a facility of the trade or business located in a QOZ and (2) from a facility of the trade or business in a QOZ to customers of the trade or business located outside the QOZ. We generally agree with the approach taken by Treasury in this safe harbor, and believe it will reduce administrative and compliance burdens for QOFs and QOZBs. However, we recommend that the final regulations confirm that the length of the transit or the manner of transit (*e.g.*, rolling stock versus flight cargo) does not affect the safe harbor and that the safe harbor covers cases where the inventory in transit is warehoused briefly (*e.g.,* less than 30 days) at a location outside the QOZ en route.

3. *Vacancy Period for the Original Use Requirement*

As noted in Report No. 1407, we believe the "vacancy period" for real property (other than land) in the context of the original use requirement should be at least five years to prevent abuse. There should be a clear approach on how vacancy is measured for this purpose. We recommend

---

[57] *See* Section 50(d)(4) (referencing the rules in Section 48(b)).

[58] Proposed Regulations Section 1.400Z2(d)-1(c)(4)(i)(B)(*6*).

[59] For purposes of Sections 1400Z-2(d)(2)(D)(i)(III), and Proposed Regulations paragraphs (c)(4)(i)(D), (c)(6), (d)(2)(i)(D) and (d)(2)(iv).

that vacancy be evaluated by looking at the revenue generated in connection with a property over a five-year period (so, for example, the fact that the owner had been willing to rent the property – and would have treated such rental, had it occurred, as a trade or business – does not mean that the building would not qualify as vacant if it had not in fact been rented for five years). We do believe, however, that the standard should allow for some flexibility so that a relatively *de minimis* amount of revenue does not disqualify the property. Such revenue could be measured by a percentage of the value of property; so long as any gross income generated by any portion of the property does not exceed a small amount (*e.g.*, one percent of the value of the entire property on an annual basis for each year during the five-year vacancy period), the property could be considered to have been vacant for the entirety of the five-year period.[60] For example, if a warehouse ceases to be used in an active trade or business as a warehouse for five years, but has been rented out for one-time events occasionally during that five-year period, the gross income generated from such events should not disqualify the property so long as the *de minimis* percentage is met. For purposes of calculating the *de minimis* percentage, the value of the property for each of the five years should be fair market value measured at the time the real property is acquired by the QOF, prior to any improvements. We recognize that establishing fair market value at the end of the five-year period may inflate the value of the property, but we believe that establishing fair market value for prior years may be difficult for taxpayers. Thus, we believe that a more administrable rule would be to require a sufficiently small *de minimis* percentage to ensure that the vacancy exception is provided only with respect to structures that have been entirely or almost entirely vacant for at least a five-year period, rather than requiring historic valuations.

In terms of determining and proving vacancy over the five-year period, we recommend that the person transferring or selling the property to the QOZB be permitted to certify under penalties of perjury, similar to the types of certifications required under Sections 1445 or 1446(f), that the property has not been previously used in the QOZ in an active trade or business for the past five years, and that the *de minimis* exception has been met. The transferor should be required to provide any accompanying records reasonably available to the transferor supporting the certification. The rules should provide that the QOF or QOZB transferee can rely on such certifications, unless the transferee otherwise knows or has reason to know that the certifications received are incorrect.[61] In that case, the QOF or QOZB should rely on its knowledge or reasonable understanding.

Finally, we recommend that the vacancy exception also apply to portions of structures that are clearly delineated but are part of a larger structure (such as an annex to a building with a separate entrance), if such portion has been vacant for five years even though the rest of the structure has not been vacant, and when use of the remainder of the structure has not affected the vacancy of the delineated portion in question. The certification and reliance rules described above could be tailored for portions of a larger structure.

60 *Cf.* Treasury Regulations Section 1.469-1T(e)(3)(vi)(B)(2).

61 *Cf., e.g.*, requirements for presumptions and knowledge of withholding agents under Section 1471; rules on the "actual knowledge" of a loss corporation regarding its stock ownership under Treasury Regulations Section 1.382-2T(k)(2).

4. Substantial Improvement – Aggregate Approach

Under Proposed Regulations Section 1.400Z2(d)-1(c)(8)(i), the SI requirement is met if, during any 30-month period beginning after the acquisition of tangible property (other than land) by a QOF, additions to basis with respect to such property in the hands of the QOF exceed an amount equal to the adjusted basis of such property at the beginning of the 30-month period. We agree that the general rule should be to evaluate assets on an individual basis; however, we believe that assets acquired in a single transaction (or related series of transactions) should have the option to be aggregated, with a requirement that the assets be substantially contiguous geographically in the same QOZ. [62] We do not see a theoretical basis for aggregating assets for purposes of the SI requirement beyond temporal and geographical closeness. The aggregate treatment that we recommend should be available by election. If assets are not purchased in a single transaction but are to be evaluated together, consideration should be given to whether the 30-month clock should start from the date the first property was purchased, for purposes of evaluating the aggregate basis of the assets that are to be grouped together.[63] If an asset purchased at a later time in a related transaction cannot be substantially improved in a manner that meets the SI requirement for such aggregated group of assets, then the 30-month clock should run separately for such asset that cannot be grouped. We believe this rule would be necessary to avoid tolling or extension of the 30-month period.

There are several advantages to an aggregate approach. The aggregate approach would eliminate the practical difficulties of an asset by asset evaluation in cases where all assets are acquired in a single transaction or are otherwise intertwined, and where relevant would avoid difficult issues of determining whether a given "asset" represents a single asset or multiple assets for this purpose. Allowing taxpayers to elect into aggregate analysis may also help alleviate concerns relating to application of the SI requirement in respect to acquired tangible personal properties that are not capable of being substantially improved individually but work together in the QOZB. For example, a real estate project may involve multiple buildings on one complex to be delivered together, and some of the buildings might require substantial renovations while others may not. Spreading aggregate improvement costs over the aggregate basis of all the buildings could allow the SI requirement to be met, while a building-by-building analysis could result in some buildings failing to satisfy the test. Further, we believe that the aggregate approach would allow for a more well-rounded distribution of capital for a QOZB or within a QOZ, as the asset-by-asset approach may create an incentive to make excessive improvements to repurpose a tangible property even though such improvements might not be necessary and capital could be better utilized across multiple properties. We believe that this approach would be more helpful for encouraging continuing, substantive investment in QOZs rather than focusing on singular and more discrete investments.

---

[62] On a related note, the Proposed Regulations seem to assume that land and improvements on the land are separate properties, but it would be helpful to clarify this. If land was acquired before 2018, but improvements were made on the land and placed in service after 2018, such improvements should be treated as good QOZBP (while the land is not).

[63] However, it may be helpful to have exceptions in certain cases, such as where a QOF's subsequent closings are delayed by reasons beyond the control of the QOZB, such that the QOZB is not able to acquire additional related property within a close window of time.

While we acknowledge that an election, rather than a mandatory rule, could allow some QOF projects to qualify that otherwise might not qualify, on balance we believe an election is appropriate as it simplifies compliance with the SI requirement. The additions to basis reflect, we believe, a policy of incentivizing investment in an QOZ, and the precise assets for which the investment is made do not appear to be relevant to that objective. In addition, generally the investment will be made over an extended period of time, up to 30 months, a time frame that would appear to limit opportunities for gamesmanship.

D. Qualified Opportunity Zone Business Property

The QOF-level 90% asset test requires that a QOF "hold[] . . . at least 90 percent of its assets in qualified opportunity zone property," which includes QOZBP.[64] The statutory definition of QOZBP includes the requirement that such property be "acquired . . . by purchase (as defined in Section 179(d)(2))."[65] That Section, in turn, defines "purchase" as any "acquisition of property" that meets certain requirements, including that the property not be "acquired from" a related person and that the basis of the property in the hands of the person acquiring it not be determined by reference to the adjusted basis of the property in the hands of the person from whom acquired.

The definition of qualified opportunity zone business also requires that substantially all of the tangible property owned or leased by the taxpayer be QOZBP that meets the "acquired . . . by purchase" test.[66]

The April Proposed Regulations permit certain property leased by a QOF or a QOZB from another person to be treated as QOZBP. The preamble to the April Proposed Regulations[67] justifies this approach by reference to concerns about economic distortions that could be caused by disparate treatment of owned and leased property.

1. Definitional Issue

In the case of a QOZB, the 90% asset test prescribed by Section 1400Z-2(d)(3) applies to assets "owned or leased by the taxpayer." Were leased property necessarily to fail to constitute QOZBP, a trade or business that leased a material amount of tangible property could not qualify as a QOZB. The statutory reference to "tangible property owned or leased by the taxpayer" does seems instead intended to permit qualification to be based on leased property. Accordingly, we concur with the Proposed Regulations' approach that leased property may constitute QOZBP in the hands of a QOZB, notwithstanding the arguable absence of "acquisition" of such property, and notwithstanding that a lessee of property typically has no basis in the leased property itself (although the lessee may have a basis in the lessee's leasehold interest or in improvements made by the lessee to the leased property).

---

64 84 Fed. Reg. 18651, 18670 (May 1, 2019).

65 Section 1400Z-2(d)(2)(D)(i)(I).

66 Section 1400Z-2(d)(3)(A)(i).

67 84 Fed. Reg. 18652, 18671 (May 1, 2019).

Since the statutory definition of QOZBP does not distinguish between property leased to a QOZB and property leased to a QOF, and since a prohibition on leased property of a QOF constituting QOZBP would create arbitrary structural requirements, we also concur with extending the possibility of QOZBP treatment to property leased to a QOF. (However, see the discussion below regarding valuation.)

2. Valuation for Asset Test Purposes

Proposed Regulations Sections 1.1400Z2(d)-1(b)(2), (3)(iii) and -1(d)(3)(ii)(B) provide methods for valuing leased property for purposes of the QOF-level and QOZB-level asset tests. Generally, a QOF or QOZB may value a lease in accordance with an "applicable financial statement" (certain GAAP statements), if the QOF or QOZB has such a statement, or may use the "alternative valuation method," under which the lease is valued at its present value at the time that it is entered into.

Economically, the debt-financed acquisition of a wasting asset is not so different from the lease of an asset for its useful life. Generally, in both cases, the acquirer or lessee makes periodic payments for the use of the asset. However, the income tax laws have historically distinguished these two arrangements. Specifically, the acquirer of an asset (whether leveraged or unleveraged) will have a basis in that asset, whereas a lessee of an asset will not have a basis in that asset (other than transactional costs).

In light of this distinction, it is novel that a fair-market-value lease is valued at anything other than $0 (or, alternatively, its unadjusted basis) for purposes of the asset tests and QOZB owned or leased test. Assigning value to the lease allows the QOZB to obtain qualifying QOZBP without any current expenditure of funds and permits the seemingly incongruous result of permitting the lessor or lessee to take the same property into account at the same time. This novelty and incongruity exist regardless of whether the QOZB values the leasehold interest under the "applicable financial statement valuation method" to the extent it accords a positive value to the lease in excess of capitalized cost, or under the "alternative valuation method." Accordingly, we suggest that while leased property should qualify as "good" QOZBP, consideration should be given to requiring either a method of valuation that treats a lease at fair market rental as having a value of zero, regardless of whether the taxpayer has an applicable financial statement, or valuing a lease at its unadjusted basis (*i.e.*, in the same manner as acquired property).[68] Whatever valuation rules apply to property of which a business becomes a lessee after 2017 should apply as well to pre-2018 leases to the extent relevant to the determination of the qualification of the business as a QOZB.[69]

---

68 For a lease with arm's length rent, the economic fair market value of the lease at inception of the lease is zero.

If Treasury has concerns about the valuation of leases affecting the relative proportion of assets inside and outside of QOZs for purposes of the asset tests (*e.g.*, due to concerns about taxpayers purchasing properties within QOZs but leasing larger (or more) properties outside of QOZs), then such consideration should be taken into account for the final regulations.

69 Further, a transitional rule should provide that a business that leases property under a binding contract entered into prior to finalization of the regulations, the ongoing qualification of which business as a QOZB is dependent on using one of the valuation methods set out in the Proposed Regulations, is permitted to continue

If the valuation regime contained in the Proposed Regulations is retained, it is not clear how to apply the rules to a lease that is acquired by a QOF or QOZB after the lease's commencement, as illustrated in the example below. Treasury should clarify how the rules should be applied.

> **Example 2**: X is the fee owner of certain property located in a QOZ. On January 1, 2009, X leased the property to Y for a term of 99 years for a rent of $1.0 million a year, payable in advance. At the time the lease was entered into, the present value of the payments to be made under the lease was $34.7 million.[70] On January 1, 2019, the present value of the remaining payments to be made on the lease was $34.0 million. On that date, Z, a QOZB, acquired from Y, Y's entire leasehold interest in the property for $6.0 million. (Implicitly, the value of the use of the property for 89 years was $40.0 million, the sum of the present value of the remaining payments to be made plus the $6.0 million premium Z paid to Y.) Under the alternative valuation method, there are four possible values of the lease for QOZB owned and leased test purposes: (1) $34.7 million, the present value of the payments to be made, determined at the beginning of the lease term (this seems to be the result if the Proposed Regulations are read literally); (2) $6.0 million, the amount that Z paid to Y (and which amount will be capitalized by Z and recovered by Z over the remaining term of the lease); (3) $34.0 million, the present value of the payments to be made, determined at the time Z acquired the lease; or (4) $40.0 million, the sum of (a) the $34.0 million present value of the payments to be made, determined at the time that Z acquired the lease, plus (b) $6.0 million, the amount Z paid to Y.

3. Requirements for a Lease to Qualify as QOZBP

Proposed Regulations Sections 1.1400Z(d)-1(c)(4)(i)(B) and -1(d)(2)(i)(B) contain requirements that a lease must meet in order for the leased property to qualify as QOZBP. These rules are in many ways analogous to the rules for owned QOZBP (including that the lease must be entered into after December 31, 2017, the leased property must satisfy the QOZBP holding period test and QOZBP use test, etc.). However, there are some important differences, which we ascribe to the impossibility of applying the "purchase" requirement in a meaningful way to leased property and the concomitant need to create other safeguards against abusive transactions.

First, in order for leased property to qualify as QOZBP, "[t]he terms of the lease [must be] 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."

The preamble to the April Proposed Regulations acknowledges that this requirement may cause "undue burden or difficulty in determining whether a lease is market rate" to taxpayers and the IRS, but also expresses concern that the requirement may be needed to "prevent abusive

use of that method. *See also* Part IV.O for our recommendations on transitional rules.

[70] All values in this example are computed using the June 2019 long-term annual applicable federal rate of 2.76% and are rounded to the nearest hundred thousand dollars.

situations."[71] We believe that, in the case of leases between unrelated parties, the potential for abuse is small, given that the parties will in fact negotiate at arm's length.[72] With respect to leases between *unrelated* parties, we propose either the complete elimination of the market rate requirement, or, at least, the creation of a presumption that such leases are at market rate.[73]

With respect to *related* parties, discussed further below, we agree that the market rate standard is an appropriate benchmark for determining whether or not the leased property constitutes QOZBP. However, given the difficulty inherent in determining whether or not a lease is market rate, and the potentially onerous consequences that would follow if the rent were either too high or too low, we propose creating a presumption that a lease is market rate if an individual meeting requirements similar to those of a "qualified appraiser" for purposes of Section 170(f)(11)(E)(ii) and the Regulations thereunder, provides an "appraisal" or "report" concluding that the lease is market rate.[74]

The Proposed Regulations provide that leased property need not have its original use in a QOZ or be substantially improved in order to constitute QOZBP in the hands of the lessee. The preamble to the April Proposed Regulations explains this divergence on the basis that, generally, leased property cannot be placed in service by the lessee, and the lessee has no basis in leased property.[75] This argument creates a potentially arbitrary practical distinction between acquiring property (including debt-financed property) and leasing it. Assume, for example, that an apartment building within a QOZ was constructed and placed in service by its current owner during 2016. If that current owner were to sell the apartment building to an entity that wished to qualify as a QOF or a QOZB, the apartment building would not constitute QOZBP under the statute, because no new investment is being made within the QOZ. The rule for leasing would allow a different result, however, if the current owner "master leased" the apartment building, subject to the existing residential tenancies, to the putative QOF or QOZB. Similarly, leasing tangible property owned by a person related to the QOF would be acceptable while purchasing it would not be. We do not take a view on whether these more lenient rules for leasing are appropriate; to the extent the aim is to allow for flexibility in organizing an active business for a QOF, these rules for leased property are welcome. They do have the potential, however, to allow for a work-around against otherwise applicable limitations under the statute and Proposed Regulations.

The April Proposed Regulations place one additional limitation on leases of *real* property (other than unimproved land): they prohibit a "plan, intent, or expectation" for the lessee to

---

71 84 Fed. Reg. 18652, 18671 (May 1, 2019).

72 Moreover, elimination of the "market rate" requirement will make clear that "concessionary leases," at what might be below-market rents when viewed in isolation, but which really reflect "fair values" under the circumstances, in view of the lessee's commitment to develop the leased property and/or to create public infrastructure or amenities, qualify, so long as the lessor and lessee are not "related parties." If the market rate requirement is generally retained, we believe a special exception should apply to concessionary leases granted by governmental entities, non-profits or other similar institutions.

73 For this purpose, perhaps parties should be considered "related" if they are described either in Section 1400Z-2(e)(2) or in Treasury Regulations Section 1.482-1(i)(5).

74 Substantive and reporting requirements and safeguards derived from the Section 170 Regulations could be incorporated here as appropriate.

75 84 Fed. Reg. 18652, 18656 (May 1, 2019).

purchase the property for an amount other than fair market value at the time of purchase, without regard to prior lease payments.[76] We note that this construct of the Proposed Regulations puts pressure on determining whether a transaction is a lease or a sale (and sometimes the line is blurred), and whether there is a "plan, intent or expectation" to purchase.

This limitation may have a "chilling effect" on certain leasing transactions because (in effect) the value created by the tenant inures to the benefit of the landlord as a result of the "at the time of purchase" requirement. For example, if Blackacre is raw land worth $100, granting an option to the tenant at an initial strike price of $125 and indexed to inflation would appear unlikely to cause the transaction to be recast as a current sale under general income tax principles. However, even if Blackacre is improved (apparently to any extent) by the tenant, the strike price of the option must remain the fair market value at the time of exercise, which means that the tenant cannot benefit from the increase in value that it has created. We suggest modifying the limitation to permit a fixed purchase price option that is consistent with general income tax principles governing the distinction between a lease and a sale and has a strike price that is no less than a specified amount (such as 110%) of fair market value at the time the option is entered into.

The Proposed Regulations permit property leased by the taxpayer from a related person to constitute QOZBP in the taxpayer's hands, notwithstanding that buying the same property from a related person would not constitute a qualifying "purchase." Although the preamble to the April Proposed Regulations gives no reason for this departure,[77] the Proposed Regulations impose, in addition to the requirements that apply to all leased tangible property, two additional requirements with respect to tangible property leased from a related party.[78] First, the lessee may not make any payments of rent for use of the property for a term more than 12 months in advance.[79] Second, with respect to used leased tangible *personal* property, the lessee must, in 30 months, acquire additional tangible personal property with "a value not less than the value of that leased tangible personal property,"[80] a rule analogous to the SI requirement set forth in Section 1400Z-2(d)(2)(D)(i)(II). This requirement seems to be a guardrail to prevent a taxpayer from leasing tangible personal property to an affiliate QOF or QOZB and having the QOF or QOZB take no further action to qualify the property as QOZBP (*i.e.*, not undertake economic development activities). We believe that the additional requirements in the related-party context are appropriate. In the context of land, Proposed Regulations Section 1.1400Z2(d)-1(f) seems intended to address the concern: "a QOF may not rely on the proposed rules . . . [that] concern the qualification of land as QOZBP [] if the land is unimproved or minimally improved and the QOF or the QOZB

---

[76] Proposed Regulations Section 1.1400Z2(d)-1(c)(8)(E).

[77] If, as stated in the preamble to the April Proposed Regulations, the justification for permitting property leased by a QOF or a QOZB from another person to be treated as QOZBP is concern about economic distortions that could be caused by disparate treatment of owned and leased property, the relatively lenient treatment of property leased from a related person as compared to property purchased from a related person is hard to justify. It cannot be easier, for example, to determine whether a related party lease is on market terms than it would be to determine whether a related party sale was effected at fair market value. Accordingly, we would not object if a stricter rule barring related party leases were adopted, but subject to appropriate "grandfather" relief for taxpayers who entered into related party leases prior to issuance of final regulations.

[78] Proposed Regulations Section 1.400Z2(d)-1(d)(2)(i)(A)(*3*).

[79] Proposed Regulations Section 1.400Z2(d)-1(d)(2)(i)(A)(*4*).

[80] Proposed Regulations Section 1.400Z2(d)-1(d)(2)(i)(A)(*5*).

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."[81] Since QOZBP can be purchased or leased, it appears that Proposed Regulations Section 1400Z2(d)-1(f) should instead refer to unimproved or immaterially improved land purchased or ***leased*** by the QOF or the QOZB. The final regulations should make this correction, so that the anti-abuse rule is applied consistently, in the context of a lease (including a lease from a related party) or a purchase.

Alternatively, the final regulations could require the tenant of real property "substantially to improve" the property, determined by reference to the value of the leased property (using the current valuation metric for leased property discussed above). This would be analogous to the SI requirement in the context of the purchase of real property and ensure that QOFs and QOZBs that are tenants make material investments in a QOZ.

Finally, in order to be a qualifying lease under the QOZBP rules, the lease has to be entered into after December 31, 2017. Accordingly, a lease entered into before 2018 cannot constitute a QOZBP, while a lease executed after 2017 could qualify. It also appears that, if a lessee of a pre-2018 lease subleases the property to a new lessor under a new lease (assuming that the sub-lessor retains sufficient leasehold interests for the sublease to be respected as a separate new lease), or if the original pre-2018 lease is terminated and a new lease is executed by a new lessee with the landlord, such sublease or new lease may qualify as a QOZBP. However, in many situations, it would not be efficient to enter into a new sublease, or the landlord may request a termination fee for entering a new lease with the new lessee. In those situations, the original lessee might simply wish to transfer the leasehold interests to a new lessee, perhaps a related party – but because the lease was not technically terminated (and the original lease began pre-2018), such transferred lease may not qualify as QOZBP. Treasury should therefore consider whether final regulations should provide that transfer of a lease to a new lessee after December 31, 2017 allows for such transferred lease to qualify as a "new lease" for purposes of the QOZBP rules (including whether the degree of electivity provided by such a rule would be appropriate).

E. Safe Harbors

1. Working Capital Safe Harbor

The October Proposed Regulations had proposed a 31-month working capital safe harbor for QOF investments in QOZBs that acquire, construct or rehabilitate tangible business property in a QOZ.[82] The April Proposed Regulations clarified that this also included development of an active business.[83] The safe harbor, supplemented by the April Proposed Regulations, allows a QOF, in determining whether an entity in which it has invested is a QOZB, to treat the entity's cash, cash equivalents and short-term debt instruments as a "reasonable" amount of working capital so that the entity is not disqualified from being a QOZB due to it being cash rich, so long as: (1) the amounts are designated in writing for the development of a trade or business in a QOZ,

---

81 This rule is set forth as part of an effective date rule; if retained, it should be moved into the body of the operative provisions.

82 Proposed Regulations Section 1.1400Z2(d)-1(d)(5)(iv)(B).

83 *See* Proposed Regulations Section 1.1400Z2(d)-1(d)(5)(iv)(E)(*2*).

including the acquisition, construction and/or substantial improvement of tangible property in such a QOZ, (2) there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets, and under such schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets and (3) the working capital assets are actually used in a manner that is substantially consistent with the first two requirements.[84]

The April Proposed Regulations are helpful in clarifying that a QOZB that ultimately needs more than 31 months to comply with the written plan does not lose the benefit of the safe harbor if the delay is attributable to waiting for government action the application for which is completed during the 31-month period.[85] Final regulations should confirm whether this rule means that the government action must be pending at the end of the 31-month period or that a waiting period for government action at any time "stops the clock" on the 31-month period (and the waiting period gets added at the end of the 31-month period). We note that it is not clear whether any government action waiting period should toll the 31-month period, as some government action may come through predictably within a relatively short period of time (*e.g.*, six months), and an automatic tolling rule may be overly generous. Further, because this provision does not explicitly state that delays in government action are the only acceptable basis for failure to comply with a 31-month plan, it would be helpful if the final regulations could confirm whether relief is available in situations where that period is exceeded due to other circumstances outside of the QOZB's control (such as *force majeure* events). Treasury may have intended for such situations to already have been covered by the working capital safe harbor, since prong (3) only requires that the working capital assets are used in a manner that is "substantially consistent" with the business plan and schedule, although the preamble to the April Proposed Regulations does not provide more color on the intent.

Proposed Regulation Section 1.1400Z2(d)-1(d)(5)(i)(E), Example 3, implies that during a period in which a QOZB is within the working capital safe harbor, it is considered to be in a trade or business. Generally, under Section 162(a), a taxpayer is not treated as carrying on a trade or business until the business has begun to function as a going concern and to perform those activities for which it was organized. However, this limitation does not seem appropriate during the start-up period. We believe that the final regulations should clarify that, if the working capital safe harbor is met, then for all relevant purposes under Section 1400Z-2, the QOZB is treated as having had a "trade or business" for the duration of the working capital safe harbor.[86]

---

84 Proposed Regulations Section 1.1400Z2(d)-1(d)(5)(iv).

85 Proposed Regulation Section 1.1400Z2(f)-1(b).

86 An alternative might be, by reference to the treatment of start-up expenses under Section 195, to provide that the active trade or business requirement is satisfied during the working capital safe harbor period if the QOZB is actively engaged in the creation of an active trade or business in anticipation of conducting activities for profit and the production of income, even though it is not yet profitable or in a trade or business within the meaning of Section 162. *See* Section 195(c)(1)(A) ("Start-up expenditures" mean any amount paid or incurred with (1) investigating the creation or acquisition of an active trade or business, (2) creating an active trade or business, or (3) engaging in any activity for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activities becoming an active trade or business). However, see also our recommendation for a new safe harbor on construction, below, which incorporates a retroactive look-back concept.

Additionally, the April Proposed Regulations provide that a single QOZB can utilize multiple overlapping or sequential 31-month safe harbor periods, provided that for each such period, the QOZB satisfies all of the requirements that would apply if such period were the only one utilized by the QOZB.[87] This clarification provides certainty to QOFs pursuing certain multi-phase real estate development projects that may have been concerned that each QOZB could utilize only one 31-month safe harbor period during the term of such QOZB's existence.

While this rule is helpful, we believe that the working capital safe harbor should confirm that successive "stringing" of the safe harbor can occur for the same QOZBP (for different amounts of cash). Further, the working capital safe harbor should allow for a particular phase of a project that takes more than 31 months to complete. We believe that permitting longer-term projects that take more than 31 months to complete facilitates the purposes of the QOZ rules to encourage investments in the QOZ – it would seem that bigger construction projects would have a greater impact on the community than smaller projects that take less time to build.

2. New Safe Harbor for Construction

We recommend a new safe harbor for work in progress, applicable both to QOZBs and QOFs, unrelated to the working capital safe harbor discussed above. A construction project may be completed within a 31-month period, but using borrowed money exclusively after the working capital reserve has been expanded for developing and improving the property. Some construction projects do not need working capital at all. Cash is expensive, so some projects do not call capital nor draw on construction loans unless they immediately need to use the cash. Thus, projects without working capital would fail to qualify as QOZBs during the construction period. Given the availability of the working capital safe harbor in the Proposed Regulations, we do not believe that Congress would have intended for these QOFs or QOZBs to fail to qualify. We propose that assets held for work in progress be treated as good QOZBP (and the QOF or QOZB be treated as engaged in a trade or business) during the construction period, if certain criteria are met. The criteria might include that the QOF or QOZB increase its basis in the QOZBP by a certain multiple within the 31-month start-up period (for example, two times the original basis in the land or personal property that had been acquired and were improved during the construction), and that the QOF or the QOZB continue construction diligently until the project is completed and the building is placed in service (even if the completion takes longer than 31 months). Treasury could consider periodic certification requirements during the duration of the construction period. Once the building is completed and placed in service, then the work in progress would retroactively be treated as good QOZBP and the QOF or QOZB would be treated as engaged in a trade or business from the first day of the investment of the QOF in the QOZB and during the entire construction period. We believe that this new construction safe harbor should also apply in the case of QOZBs that comply with the working capital safe harbor for a period of time but then switch over to the construction safe harbor to complete the project with borrowed funding.

Additionally, if land does not qualify as good QOZBP (*e.g.*, because it was acquired before 2018), but the constructed building on top of the land qualifies as good QOZBP under this new safe harbor, it would be helpful if Treasury also clarified that the QOF or the QOZB met the 70% "substantially all" threshold for the QOZB owned or lease test (and relatedly, the 90% QOZB

[87] Proposed Regulations Sections 1.1400Z2(d)-1(d)(5)(iv)(D).

holding period test) retroactively since the beginning of the construction period even though during the early parts of the construction, the cost of the land (as compared to the cost of the work in progress) caused the QOF or the QOZB to fail the relevant thresholds (because at the beginning the land was the only major asset of the QOF or the QOZB and the construction was only at its beginning stages).

F. Qualified Opportunity Zone Businesses - Other Issues

1. Real Property Straddling a QOZ

The Proposed Regulations look to the Empowerment Zones rules under Section 1397C with respect to businesses that hold real property straddling multiple census tracts in circumstances where not all of the tracts are designated as a QOZ.[88] The Proposed Regulations provide that, if the amount of real property, based on square footage, located within the QOZ is substantial as compared to the amount of real property based on square footage outside of the QOZ, and the real property outside of the QOZ is contiguous to part or all of the real property located inside the QOZ, then all of the property is deemed to be located within a QOZ.[89] We agree with the approach suggested in the preamble to the April Proposed Regulations that real property located within the QOZ should be considered substantial if the unadjusted cost of the real property inside the QOZ is greater than the unadjusted cost of real property outside of the QOZ. We believe that this is a reasonable approach and should provide the necessary flexibility to taxpayers planning the parameters of their QOZB. To the extent the property straddling the QOZ line was acquired as a single tract, we believe it would be desirable to have a presumption that the unadjusted cost basis is divided on the basis of area (looking to square footage for a building), which could be rebutted (either by the IRS or the relevant taxpayer or QOZB).

2. Intangible Property

Under Section 1400Z-2(d)(3) and Section 1397C(b)(4), 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 QOZ. The Proposed Regulations provide that, for this purpose, "substantial portion" means 40%.[90]

In terms of the percentage, we agree that 40% is a reasonable threshold, as this would allow a business that sells or licenses its intellectual property to others to qualify so long as it substantially uses the intellectual property itself.

We believe that the final regulations should clarify, however, how the amount of use (40%) should be measured, and where the intellectual property is located for this purpose. It could be challenging for an operating business to determine where its intangible property is used. Lack of certainty in this respect discourage the business from developing or using intellectual property, advertising itself, or generating sales outside of the QOZ. A number of factors might be viewed as relevant, including where a QOZB provides services or has customers, where its tangible assets

[88] Proposed Regulations Section 1.1400Z2(d)-1(d)(5).

[89] Proposed Regulations Section 1.1400Z2(d)-1(d)(5)(viii).

[90] Proposed Regulations Section 1.1400Z2(d)-1(d)(5)(ii)(A).

are located, how and where the business is marketed and the geographic scope of the legal rights to use the intellectual property.

Apart from the desire to have clear rules, we have no view on what the rules ought to be. In general, in terms of use, we believe that a determination based on gross revenue would be appropriate – for example, based on the portion of gross income generated by the commercial use of the intangible property for the QOZB over the total gross income of the QOZB from the use of all of its intangible property. For an active business that licenses its intellectual property or otherwise obtains passive revenues from it, and also uses its intellectual property in an active business, we suggest that a clear set of rules be described to measure the revenues attributable to use of the intellectual property in the active business. This could be as simple as looking to *all* of the revenues from the active business, or could be based on an analogous measure of revenues (*e.g.*, if the passive licensing is based on gross sales, then the same percentage of gross sales of the active business could be used). For an active business with locations both within the QOZ and outside the QOZ, using intellectual property, we believe that comparing gross revenues derived within and without the QOZ would be appropriate.

Further, we believe that the final regulations should provide clarifications on how to determine the situs of an intangible property. Given the potential complications and uncertainty, and Congressional intent to promote investments and economic development within QOZs, we believe that Treasury might consider adopting a rule, or a rebuttable presumption, that ties the situs of the intangible property to the portion of tangible property within a QOZ. In such construct, the portion of tangible property that is being used for a QOZB's active trade or business within the QOZ would correspond to the portion of intangible property that is deemed to be used within the QOZ. We believe that this approach is consistent with the spirit of the QOZB requirements that emphasize tangible QOZBP, and should allow taxpayers to apply the intangible property rule in a consistent and predictable manner, although we acknowledge that providing that the situs of intangible property depends on the location of tangible property could undercut the requirement for substantial use of intangible property in the QOZ.[91]

3. *Triple Net Lease*

The April Proposed Regulations under 1.1400Z2(d)-1(d)(5)(ii)(B)(2) provide that 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. The final regulations should define what a "triple net lease" means, and explain why merely entering into such lease would not constitute an active conduct of a trade or business. A triple net lease should be defined as a lease where the tenant pays its proportionate share of the taxes, insurance and maintenance for the property, in addition to rent.[92] We expect that Treasury may have included the reference to triple net lease since simply entering into a triple net lease for a property, without other meaningful efforts to develop the property, does not indicate that an active trade or business is actually conducted on such property. The rules for qualified Gulf Opportunity Zone ("**GO Zone**") property under former Section 1400N provide a useful point of reference. Those rules similarly required that substantially all of the use

---

91 *C.f.* Proposed Regulations Section 1.1400Z2(d)-1(d)(5)(vi).

92 *See, e.g.*, the definition used in PLR 9603012 (Jan.19, 1996). *See also* Rev. Proc. 2019-11 (Jan.18, 2019).

of the property be in the GO Zone and in the active conduct of a trade of business by the taxpayer in the GO Zone.[93] In the context of the GO Zone, Treasury determined that a taxpayer in a triple net lease generally is considered to actively conduct a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business.[94] We believe that the standard for an active trade or business should be based on activities conducted. In the case of lease of a mixed-use building, a portion of which is leased on a triple net basis while a portion of which is not, the property owner taxpayer that actually participates in the management or operations of the leasing business for the building should be treated as engaged in one overall trade or business.

4. Nonqualified Financial Property

By applying Section 1397C(b)(8), Section 1400Z-2(d)(3) limits in each taxable year the average of the aggregate unadjusted bases of the property of a QOZB that may be attributed to nonqualified financial property ("**NQFP**") to 5%. The term NQFP includes debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities and other similar properties, but excludes reasonable amounts of working capital held in cash, cash equivalents or debt instruments with a term of 18 months or less.[95]

We believe that this definition may create a trap for the unwary and may prevent many normal-course transactions in the real estate market. For example, leases with prepaid or front-loaded rent treated in part as loans from the lessee to the lessor[96] may be treated as NQFP. Prepaid expenses such as prepaid development fees likewise may be treated as NQFP, or options to acquire property.

As to lower-tier partnerships owned by the QOZB, it may be helpful for Treasury to provide that, for purposes of the 5% NQFP test, the liabilities of a lower-tier partnership allocated to the QOZB under Section 752 are not treated as increasing NQFP even though they increase the tax basis that the QOZB has in the partnership interests in such lower-tier entity.

We do not believe that the 5% NQFP test was intended to prevent the QOZB from engaging in the type of transactions mentioned above, and do not see a policy reason against allowing these types of transactions. Treasury should consider whether the definition of NQFP should contain exceptions for such items that are commonplace in the real estate sector.

G. Relief with Respect to 90% Asset Test

1. Option to Disregard Recently Contributed Property

For purposes of applying the QOF-level 90% asset test on a particular testing date, Proposed Regulations Section 1.1400Z2(d)-1(b)(4) generally gives a QOF the option to disregard

---

93 *See* Section 1400N before repeal by Section 401(d)(6)(A), Pub. L. No. 115-141, (Mar. 23, 2018) (former Section 1400N(d)(2)(A)(ii)).

94 *See* Notice 2006-77, Sec. 3.02(2), 2006-40 I.R.B. 590 (superseding Notice 2006-67, 2006-33 I.R.B. 248).

95 Section 1397C(e)(1).

96 *See* Treasury Regulations Section 1.467-4.

amounts contributed in exchange for stock or a partnership interest in the QOF not more than six months before that testing date, so long as those amounts were "held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less."

The preamble to the April Proposed Regulations states that the reason for this rule was to assist an "existing QOF that receives new capital from an equity investor shortly before the next semi-annual test."[97] The preamble to the April Proposed Regulations also notes that "[a] new QOF's ability to delay the start of its status as a QOF (and thus the start of its 90% asset tests) provides the QOF the ability to prepare to deploy new capital before that capital is received and must be tested."[98]

This "option to disregard" and the "ability to delay," like other provisions in the Proposed Regulations, aim to give relief to QOFs and QOZBs during various "start-up" periods. However, in our experience, a new QOF may often be unable to delay the start of its status as a QOF, as prospective investors in that QOF must make their "qualified investments" within the 180-day period set forth in Section 1400Z-2(a)(1). Therefore, under the proposed rule, a QOF would still need to acquire at least a dollar of good QOZBP by its first testing date. Accordingly, we suggest that Treasury make explicit that a QOF will not fail the 90% asset test solely because the total amount of the QOF's assets may be zero by operation of this "option to disregard" rule.

2. Recycling of Assets

Section 1400Z-2(e)(4) provides that, "[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this Section, including . . . rules to ensure a qualified opportunity fund 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." Pursuant to such grant of authority, Proposed Regulations Section 1.1400Z2(f)-1(b) generally provides that "proceeds from the return of capital or the sale or disposition of some or all" of its QOZP may be treated as QOZP for purpose of the QOF-level 90% asset test for a 12-month period "beginning on the date of the distribution, sale, or disposition," so long as those "proceeds are continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less."

The phrasing in the April Proposed Regulations, which seems to apply the relief rule to all proceeds from a QOF's sale or other disposition of QOZP, whether or not in excess of the QOF's basis in that QOZP, is arguably broader than the underlying statutory language, which refers specifically to "return of capital." A coherent argument can be made that a QOF should not be permitted to retain and to reinvest *gains* from the disposition of QOZP and thereby further to increase the amount of basis step-up to which investors in the QOF may ultimately become entitled under Section 1400Z-2(c). However, the QOF-level 90% asset test is a crude instrument with which to attempt to prevent such an arguable abuse, as the test would not police to any extent sales

---

[97] 84 Fed. Reg. 18652, 18659 (May 1, 2019).

[98] *Id*.

of property and reinvestments of proceeds within a QOZ that did not happen to cross over a testing date. Accordingly, we concur with the rule in the Proposed Regulations.

The preamble to the April Proposed Regulations requests comments on whether an analogous rule for "QOF subsidiaries" to reinvest proceeds for the disposition of QOZP would be beneficial.[99] Such a rule would be beneficial to any QOZB, regardless of whether that QOZB is a "subsidiary" of any particular QOF, and we suggest that it should be adopted.

We believe that the final regulations should not prescribe rules for QOFs that depart from the otherwise operative recognition provisions of the Code and have not found precedents creating new non-recognition events.

3. Expiration of QOZ Designation

Section 1400Z-1 generally provides that QOZs were to be designated within a period of several months following the date of enactment of the Act, and that a designation of a census tract as a QOZ remains in effect for ten years. Section 1400Z-2(d)(3)(B) permits QOZBP to maintain its character as such for up to five years after it would otherwise no longer qualify. Section 1.400Z2(c)-1(b) provides that an election under Section 1400Z-2(c) can be made for dispositions occurring as late as December 31, 2047, even though eligible gains for Section 1400Z-2 purposes include only those that would have been recognized before January 1, 2027.

In those cases in which a QOF or QOZB acquires property within a QOZ prior to expiration of the QOZ's designation as such, taxpayers and their advisors have become comfortable that the QOZ's ceasing to be such – and the arguable cessation of the QOZBP's status as QOZBP that follows therefrom – do not cause the QOF to become subject to the Section 1400Z-2(f) penalty.[100] However, the Proposed Regulations do not address the consequences of the acquisition of new assets that occurs after the expiration of a QOZ's designation.[101] We recommend that the final regulations allow for such investment, but within the same QOZ, so as to support continuing development and investment within the former QOZ, but not "overextend" the benefits of the QOZ regime beyond the boundaries of such former QOZ. While such a rule could permit only "recycled" amounts to be reinvested (*i.e.*, amounts equal to the proceeds received on disposition of QOZP or QOZBP assets), we believe it would be preferable for the final regulations to permit additional investments to be made even after the expiration of the QOZ designation (whether from recycled proceeds or debt or equity financing) in an active QOZB, including an expansion of the business, so long as the investment occurs within the same QOZ. (This would not mean that new equity investment would be a qualifying QOF investment, simply that the new investment by the QOF is not treated as giving rise to "bad" assets in the QOF that negatively affect the qualification of a

---

99 84 Fed. Reg. 18652, 18660 (May 1, 2019).

100 Indeed, if this were not the case, the penalty would apply to all of such QOF's investors that intended to take advantage of the Section 1400Z-2(c) election, which would depart from the statute's extension of QOZBP status under Section 1400Z-2(d)(3).

101 A similar issue could arise with respect to capital improvements made after expiration of a QOZ designation, even if those capital improvements are made to real property located within the QOZ that was acquired prior to expiration of the designation and that, accordingly, clearly does constitute QOZBP.

QOF or QOZB). Otherwise there would be a disincentive to continue investing in or expanding QOZB businesses, which we do not believe is consistent with the general policy of the OZ statute.

H. Section 1231 Gains

Proposed Regulations Section 1.1400Z2(a)-1(b)(2)(i) provides that an amount of gain is eligible for deferral under Section 1400Z-2(a) if the gain is treated as a capital gain for U.S. federal income tax purposes and satisfies certain other requirements.

Section 1231(a)(1) provides that, if Section 1231 gains for any taxable year exceed the Section 1231 losses for such taxable year, such gains and losses shall be treated as long-term capital gains or long-term capital losses, as the case may be. When Section 1231(a)(1) applies, the words of the Code make clear that the entire amount of each Section 1231 gain or loss is treated as long-term capital gain or loss, and that the application of Section 1231(a)(1) is not restricted to the excess of the Section 1231 gains for the taxable year over the Section 1231 losses for the taxable year.[102]

Proposed Regulations Section 1.1400Z2(a)-1(b)(2)(iii) provides that the "only gain arising from Section 1231 property that is eligible for deferral under Section 1400Z-2(a)(1) is capital gain net income for a taxable year." The Proposed Regulations Section continues, "[t]his 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 Proposed Regulations Section concludes with a special rule, discussed in "*—180-Day Period*," below, relating to when the 180-day period described in Proposed Regulations Section 1.1400Z2(a)-1(b)(4) begins with respect to any "capital gain net income from Section 1231 property for a taxable year."

1. Amount of Section 1231 Gains Eligible for Deferral

The Proposed Regulations create a more restrictive rule for Section 1231 gains and losses that are treated as capital gains and losses under Section 1231(a)(1) than the rule that applies to gains and losses from the sale of capital assets, as defined in Section 1221(a). In the latter case, gains are not reduced by losses, and a taxpayer may defer the full gross amount of the taxpayer's gains, while still preserving losses for allowance against ordinary income to the extent permitted by Section 1211(b), carryover to future years under Sections 1212(a)(1)(B) and (C) (in the case of corporations) and Section 1212(b)(1) (in the case of individuals), and carryback to prior years under Section 1212(a)(1)(A) (in the case of corporations).[103]

The preamble to the April Proposed Regulations attempts to justify the more restrictive approach for Section 1231 gains and losses by stating:

> 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

---

102 *See also* Treasury Regulations Section 1.1231-1(b).

103 *See Instructions for Form 8949 on Sales and Other Dispositions of Capital Assets*, INTERNAL REVENUE SERVICE (2018), https://www.irs.gov/pub/irs-pdf/i8949.pdf.

proposed regulations provide that only this gain shall be treated as an eligible gain for purposes of Section 1400Z-2.[104] (Emphasis added.)

In contrast with the interpretation set forth in the preamble to the April Proposed Regulations, Section 1231(a)(1) mandates that "such gains and losses," *i.e.*, all such gains and losses, including all of the losses and including the portion of the gains that does not exceed the losses, shall be treated as capital gains and losses.[105] In the absence of any textual justification or policy reason for treating gains that attain capital gain status through operation of Section 1231(a)(1) less favorably than gains that arise on the sale or exchange of capital assets,[106] as defined in Section 1221(a)(1), we believe that the final regulations should not contain such a distinction, and that the full (gross) amount of a taxpayer's Section 1231 gains should be eligible for deferral under Section 1400Z-2.[107] However, in order to prevent abuse, and in order to resolve a potential circularity described in the footnote to this sentence, gains and losses that are treated as long-term capital gains and losses under Section 1231(a)(1), determined without regard to the deferral of all or a portion of the gains under Section 1400Z-2, should retain that character, regardless of the amount of gain that is deferred.[108]

---

[104] 84 Fed. Reg. 18652, 18659 (May 1, 2019).

[105] Other deferral provisions, such as Sections 453, 1031, and 1033 do not treat Section 1231 gain differently from other gain: each of those provisions permits the deferral of gross items of Section 1231 gain. The purpose of Section 1400Z-2 does not appear to justify treating Section 1231 gain differently from its treatment under those other deferral provisions.

[106] The exclusion of what are now "Section 1231 assets" from the definition of capital assets, even before the enactment of the predecessor to Section 1231, was intended to be a "benefit" in the "great majority of cases," H.R. Rep. No. 1860, 75th Cong., 3d Sess. (1938), *reprinted in* 1939-1 (part 2) C.B. 728, 732, and it would be incongruous now to turn that benefit into a detriment.

[107] This recommendation would ease administration by eliminating the need for a special 180-day period for reinvestment of Section 1231 gains, as described in the succeeding paragraphs of this report, and by facilitating our recommendation below that Treasury confirm that partnerships are permitted to defer their own Section 1231 gains, rather than requiring that investment of such gains in QOFs be effected only at the partner level.

[108] Assume that a taxpayer had both Section 1231 gains and Section 1231 losses for a taxable year, and the taxpayer elected to defer under Section 1400Z-2 an amount of Section 1231 gains greater than the excess of the gains over the losses. (For example, the taxpayer had $100 of Section 1231 gains and $80 of Section 1231 losses, and the taxpayer elected to defer $30 of Section 1231 gains.) One could perhaps argue that, upon the making of the deferral election, the taxpayer's recognized Section 1231 losses for the taxable year now exceeded the Section 1231 gains (on the view that the losses are $80 and the gains only $70), with the effect that Section 1231(a)(1) no longer applied, and Section 1231 gains ceased to be capital gains eligible for deferral under Section 1400Z-2. However, on that view, the nonrecognition treatment afforded to the gains would no longer be applicable, because they would be ordinary, and thus Section 1231 gains would exceed Section 1231 losses, and the gains would again become eligible for deferral.

We accordingly recommend that gains and losses that are treated as long-term capital gains and losses under Section 1231(a)(1), determined without regard to the deferral of all or a portion of the gains under Section 1400Z-2, should retain that character, regardless of the amount of gain that is deferred. This approach would also prevent taxpayers from taking the position that, if a net Section 1231 loss remained after deferral of some or all of the taxpayer's Section 1231 gains, the gains and losses comprising that net loss should be considered ordinary under Section 1231(a)(2). As further support for our approach, Section 1231 does not contemplate that a portion of the taxpayer's Section 1231 gains for a year be treated differently from the remainder of

2. *180-Day Period*

The final sentence of Proposed Regulations Section 1.1400Z2(a)-1(b)(2)(iii) states, "[t]he 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." The preamble to the April Proposed Regulations explains the thinking behind this rule:

> Thus, the [prior notice of proposed rulemaking published at] 83 FR 54279 (October 29, 2018) addressed this issue [of statutory language that provides capital gain treatment, but does not provide a specific date for the deemed sale] 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 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.[109]

The conclusion in the second sentence quoted above, relating to the date on which the 180-day period begins with respect to Section 1231 gains, does not follow from the sentence that precedes it. In the case of Section 1231 gains, we are dealing with gains that are in fact recognized on a particular day of the taxable year, and the timing of the inclusion of such gains in the taxpayer's gross income is not affected by the fact that the character of the gain may not be determinable on the date of recognition. Thus, the words of the final clause of the first sentence quoted above lead to the conclusion that the 180-day period should start on the date of sale, and not on the last day of the taxable year.

Moreover, the "determinability" principle that the second sentence quoted above asserts should govern the treatment of Section 1231 gains is not followed in a consistent manner in other portions of the Proposed Regulations. Thus, Proposed Regulations Section 1.1400Z2(a)-1(b)(4)(ii)(B), Example 2, provides, "[i]f an individual RIC or REIT shareholder receives a capital gain dividend (as described in Section 852(b)(3) or Section 857(b)(3)), the shareholder's 180-day period with respect to that gain begins on the day on which the dividend is paid," notwithstanding that the amount that may be designated as a capital gain dividend is limited by the net capital gain of the payor for the taxable year,[110] and that the net capital gain of the payor

---

such gains (except in the limited circumstance governed by the special rule of Section 1231(c)).

We acknowledge that our proposal can lead to a "cliff" effect, in that, in the example set out in the first paragraph of this footnote, the taxpayer would be permitted to defer $100 of Section 1231 gains if the taxpayer has up to $99.99 of Section 1231 losses, but would be permitted to defer no Section 1231 gains if the taxpayer has $100 or more of Section 1231 losses. This is an artifact of the statutory scheme of Section 1231.

109 84 Fed. Reg. 18652, 18659 (May 1, 2019).

110 Sections 852(b)(3)(C)(ii)-(iv) and 857(b)(3)(B).

may be reduced by capital losses (including in appropriate cases Section 1231 losses) recognized after the date of payment of the dividend.[111]

The proposed rule also creates a significant hardship for taxpayers who recognize Section 1231 gains during 2019. Section 1400Z-2(b)(1) provides that gain deferred under Section 1400Z-2 is included in income no later than December 31, 2026. However, under Section 1400Z-2(b)(2)(B)(iv), a taxpayer may increase its basis by 5% of the gain deferred, in the case of any investment held by the taxpayer for at least seven years, on December 31, 2026, thereby reducing the gain inclusion. As December 31, 2026 occurs exactly seven years after December 31, 2019, and as gain recognized prior to December 22, 2017, the effective date of Section 1400Z-2, is not eligible for deferral, the benefit provided by Section 1400Z-2(b)(2)(B)(iv) is available, by its terms, only for investments in QOFs that defer gain recognized during a period of two years (or very slightly longer), from January 1, 2018, through December 31, 2019.[112]

In the case of Section 1231 gain recognized during 2018, the proposed rule, were it effective with respect to such gain, would allow the taxpayer a full 180-day period, commencing on December 31, 2018, to make an eligible investment in a QOF, and thereby to defer the gain and to qualify for the 5% basis increase allowed by Section 1400Z-2(b)(2)(B)(iv). However, in the case of Section 1231 gains recognized during 2019, the proposed rule would require that the eligible investment in a QOF be made on one specific day, December 31, 2019, if the taxpayer is to qualify for that basis increase. We believe that such a stringent requirement may make it extremely difficult to qualify for the full benefit of Section 1400Z-2 with respect to Section 1231 gains realized in 2019 and thus should be changed.

We believe that the proper time for commencement of the 180-day period with respect to a Section 1231 gain is on the date of recognition of that gain. However, we believe it also may be appropriate to allow a taxpayer an additional, alternative 180-day period, by analogy to the treatment of partners under Proposed Regulations Section 1.1400Z2(a)-1(c)(2)(iii)). Starting the 180-day period for investment upon the date of recognition is consistent with the idea that a taxpayer should be able to invest gross items of Section 1231 gain. Further, commencing the 180-day period on the date of recognition allows taxpayers to invest their gain sooner. On the other hand, commencing the 180-day period on that date forces taxpayers to "gamble" on the chance that they are ineligible for QOZ benefits either because they have no net Section 1231 gain for the year (if our suggestion that gross Section 1231 gains be eligible) or that their net Section 1231 gain

---

111 Treatment as a capital gain dividend also depends on designation by the payor, which will normally occur after the end of the taxable year, and the amount of the dividend that will qualify depends on facts that are likely not to be known at the time of receipt to many recipients of the dividend. Accordingly,, our prior report recommended that the 180-day period for making an eligible investment with respect to a capital gain dividend should begin on the last day of the taxable year, rather than at the time of receipt. However, from a conceptual perspective, the Proposed Regulations' treatment of capital gain dividends, notwithstanding the possibility of reduction of the amount of the payor's net capital gain by subsequently recognized losses, provides a precise analogy to the treatment of a taxpayer's own Section 1231 gains in Proposed Regulations Section 1.1400Z2(a)-1(b)(3).

112 It is not clear whether a taxpayer could have made a qualifying investment in a QOF during the 10-day period that commenced on December 22, 2017, had a QOZ been designated in time to make such an investment. (The instructions to the 2017 Form 8949 did not provide a mechanism for a taxpayer to defer gain by way of an investment in a QOF.)

is lower than expected (if only net Section 1231 gain is eligible). Providing for an alternative 180-day period that commences at the end of the year would address that concern.

To mitigate the effects of the "cliff" that occurs if a taxpayer makes a QOF investment with respect to a Section 1231 gain, and by reason of subsequent Section 1231 losses during the year that Section 1231 gain is ultimately determined to be an ordinary gain, rather than a long-term capital gain, we suggest that such a taxpayer should be treated like any other taxpayer who makes QOF investments in excess of the taxpayer's eligible gain.

We acknowledge and appreciate the administrative grace that Treasury exercised in recently updated "Opportunity Zone Frequently Asked Questions"[113] permitting investments of 2018 net Section 1231 gain in a QOF during a period other than the 180-day period beginning on December 31, 2018.

3. Partnership Issues

Section 702(a)(3) and Treasury Regulations Section 1.702-1(a)(3) provide that, in determining a partner's income tax, the partner shall take into account separately the partner's distributive share of the partnership's gains and losses from sales or exchanges of property described in Section 1231, "as part of his gains and losses from sales or exchanges of property described in Section 1231." In other words, the netting of Section 1231 gains and losses occurs at the partner level, and one partner's distributive share of a partnership's Section 1231 gain may constitute long-term capital gain, while another partner's distributive share of the same gain may constitute ordinary income.

The interaction of these rules of partnership taxation with Section 1400Z-2 has given rise to uncertainty regarding whether, as a conceptual or theoretical matter, a partnership's Section 1231 gain can ever be viewed as giving rise to capital gain at the partnership level and thus to questions regarding whether a partnership may defer Section 1231 gain, by its making an eligible investment in a QOF, or whether such deferral can be effected solely at the partner level. This uncertainty is compounded by the complex allocation issues that could arise in some circumstances if a partnership were permitted to defer such gain.

However, other considerations militate in favor of allowing a partnership to defer that portion of its Section 1231 gain that is characterized as long-term capital gain after application of Section 1231(a) at the partner level. In our experience, Section 1231 assets are frequently held at the partnership level, and, when a Section 1231 asset has been sold by a partnership, a pool of capital and an existing management structure are in place at the partnership level to effect investment in a QOF. It would work a significant hardship, and effectively preclude the use of Section 1400Z-2 in many cases in which the statute is intended to apply, to allow eligible investments to be made only by individual (or C corporation) taxpayers, who may be separated by many tiers of intermediate entities from the partnership actually recognizing the Section 1231 gain and who may not have the necessary capital or financial know-how to make the QOF

113 *See* Opportunity Zones Frequently Asked Questions, IRS.gov (Jun. 26, 2019), https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions.

reinvestment.[114] We also note that, if each partner were to make a separate eligible investment, Proposed Regulations Section 1.1400Z2(b)-1(c)(6)(ii)(B) would permit those partners to contribute those investments to a transferee partnership, including the partnership originally recognizing the gain, and it seems excessively formalistic to permit such a transaction while prohibiting investment by the original partnership itself.

We appreciate the difficulty in formulating rules in the partnership area to deal with Section 1231 gains that reach fair and sensible results, and that are also simultaneously easy to comprehend and readily administrable. The appeal of a rule that permits a qualifying investment at only the partner level is understandable, as it would avoid difficult tracing issues that would occur if an investment was made at the partnership level. However, that approach would require partners who wish to invest in a QOF to forego participation in the pooling of capital and management expertise discussed above. Accordingly, an awkward compromise must be reached, but we believe that the Proposed Regulations, which we understand to prohibit deferral of any and all Section 1231 gains at the partnership level, do not weigh the competing factors properly. In light of the foregoing, we recommend that the final regulations be clarified specifically to permit a partnership to defer Section 1231 gain under Section 1400Z-2 up to the amount of such gain that would qualify under Section 1400Z-2 for deferral, were it invested at the partner level. If Treasury is inclined to accept this recommendation, we would be pleased to assist in formulating principles for appropriate application of Section 704 and the other provisions of Subchapter K in this context. On the other hand, if Treasury really does intend to prohibit the deferral of Section 1231 gains at the partnership level, that conclusion should be made explicit in the final regulations. Treasury should also recognize the ambiguity present under the Proposed Regulations by explicitly providing relief for partnerships that recognize Section 1231 gain before the date of publication of final regulations and make eligible investments with respect thereto.[115]

Similar issues arise in the case of a partnership that is a direct investor in a QOF, where the QOF recognizes Section 1231 gain from the sale of QOZP after the investor has held its interest for at least ten years. Proposed Regulation Section 1.1400Z2(c)-1(b)(2)(ii)(A)(2) provides that an election to exclude such gain "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" (emphasis added). In addition to the issues raised with respect to a partnership's qualifying investment with respect to Section 1231 gain, this rule raises the question about exactly who qualifies to make the election to exclude gain: the partnership is not the taxpayer that computes the character of Section 1231 gains and losses, but a partner in that partnership is not the taxpayer that made a qualifying investment

---

114 In some cases, the partnership recognizing the gain may not have sales proceeds available for distribution to the partners to enable them to make their own eligible investments (for example, if a material portion of the recognized gain arises from an excess of liabilities over basis). In other cases, the partnership may choose, for valid business reasons, not to distribute some or all of the proceeds, or the amounts distributed to some or all of the partners may be too small to allow, as a practical matter, the making of partner-by-partner investments in QOFs.

115 *See also* Part IV.O for our recommendations on transitional rules. We acknowledge that the character issues surrounding Section 1231 gain only add complexity to the already complicated "tracking" of deferral and exclusion of gain with respect to a partnership that admits a new partner after that partnership has made a qualifying investment. As we offer in the text above with respect to Subchapter K issues generally, we would be pleased to assist in formulating appropriate principles to deal with these issues.

that is reported on a Schedule K-1. For these reasons, and for the reasons described in the previous paragraph, we recommend that the final regulations be clarified specifically to permit a partnership to exclude Section 1231 gain under Section 1400Z-2 for purposes of the ten year rule, up to the amount of such gains that would qualify for benefits under Section 1400Z-2, were it invested at the partner level. If Treasury is inclined to accept this recommendation, we would be pleased to assist in formulating principles for appropriate application of Section 704 and the other provisions of Subchapter K in this context. On the other hand, if Treasury does intend to prohibit the election to exclude Section 1231 gains at the partnership level, that conclusion should be made explicit in the final regulations.

4. Technical Issue

The April Proposed Regulations use the term "capital gain net income" to mean, in this context, the excess of Section 1231 gains for a taxable year over the Section 1231 losses for the taxable year. However, the term "capital gain net income" is already defined in Section 1222(9) as the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges. Section 1231 gains and losses that are treated as long-term capital gains or losses under Section 1231(a)(1) are included in this computation of capital gain net income,[116] but all of a taxpayer's other capital gains and losses also enter into the computation. Moreover, capital gain net income under Section 1222(9) for any particular year [apparently] is computed without reference to gains that are deferred under Section 1400Z-2. In order to avoid confusion, the final regulations, if they retain the proposed rule relating to Section 1231 gains, should not use the term "capital gain net income" in a way that varies from that term's meaning under Section 1222(9).

I. Inclusion Events

Proposed Regulations Section 1.1400Z2(b)-1 provides extensive rules regarding Inclusion Events, *i.e.*, transactions that cause the recognition of some or all of the deferred gains of a direct or indirect interest holder in a QOF. Inclusion Events can be divided into: (i) transactions related to the QOF itself (*e.g.*, merger, division, distributions, recapitalization, liquidation); (ii) transfers of QOF interests (*e.g.*, sales, gifts, transfers at death, contributions, distributions, acquisition in tax-free mergers); and (iii) indirect transactions related to QOF interests (*e.g.*, indirect sales, dilutive transactions in upper-tier entities, acquisitive transactions in upper tier entities). We set forth comments on certain of these events below.

1. Inclusion Events and the Ten Year Rule

We note first a general point regarding Inclusion Events and their interaction with the ten year rule. The tax benefits available in respect of a QOF investment include, of course, not only deferral of capital gains (potentially until the end of 2026) and potential reduction (10% or 15%) of some amount of the deferred gain, but also the potential to avoid all gains attributable to a

[116] *See* Treasury Regulations Section 1.1222-1(f) (generally referencing Section 1231 with respect to "the determination of whether or not gains and losses . . . from the sale, exchange, or involuntary conversion of certain property used in the trade or business shall be treated as gains and losses from the sale or exchange of capital assets").

qualifying QOF investment assuming a ten-year holding period for the QOF interest.[117] We believe that this latter benefit is likely to be of most interest to potential investors, as it is not solely a timing benefit (like the deferral) and is not capped in amount (as is the 10% or 15% basis step-up). As we get closer to 2026, that focus will become only more important. The rules relating to Inclusion Events generally do not say how the Inclusion Events affect, or do not affect, a taxpayer's basis adjustment under Section 1400Z-2(c).[118] The examples in the Proposed Regulations[119] provide for the tacking of a holding period for this purpose in the case of transactions that are not Inclusion Events, implying that events that are Inclusion Events would cause the QOF interest to cease to be a qualifying QOF investment for purposes of the ten-year basis step-up benefit. We suggest that the final regulations provide clear guidance on whether and to what extent an Inclusion Event causes a QOF interest to cease to be eligible for the ten-year basis step-up benefit. Relatedly, we believe that these rules should apply throughout the holding period of the QOF interest, even if the event occurs after 2026 and all deferred capital gains have already been recognized. So, for example, if a taxpayer owns a QOF interest and contributes the interest to a transferee corporation in a Section 351 transaction, that clearly would be an Inclusion Event if it occurs prior to 2027 and the taxpayer's deferred gains have not previously been recognized. If the general rule is that after this sort of Inclusion Event the transferee corporation is not eligible for the basis step-up under Section 1400Z-2(c), we believe this also ought to be the case if the Section 351 transaction occurs in 2028 or afterwards, after the taxpayer's deferred gains have already been recognized, and before or after the ten-year holding period has been met. The fact that there were no deferred gains remaining to be recognized should not, as a conceptual matter, make the transferee eligible to step into the shoes of the taxpayer for purposes of avoiding gain after a ten-year holding period.

We believe that, in general, Inclusion Events relating to the transfer of a QOF interest (*e.g.*, gifts, sales and other non-qualifying transfers), whether or not such transfer would otherwise be treated as a tax-free transaction, should cause the transferred QOF interest to be treated as a non-qualifying interest going forward. For example, to the extent a QOF interest is contributed to a transferee corporation in a Section 351 transaction, that would be an Inclusion Event, and we do not believe the transferee corporation should be entitled to obtain a basis step-up under Section 1400Z-2(c), whether or not it holds the QOF interest for ten years, either on a tacked holding period basis or on its own. Similar results should apply to Inclusion Events related to transfers by gift, transfers of QOF interests in a Section 381 transaction or transfers in liquidation of a QOF shareholder.

It is less clear to us whether Inclusion Events that involve distributions to the QOF interest holder (including for this purpose redemptions, boot in reorganizations, other recapitalizations or Section 1036 transactions that reduce a QOF shareholder's proportionate interest) should be treated as causing the QOF interest to be no longer eligible for the Section 1400Z-2(c) basis step-up.

117 Section 1400Z-2(c).

118 In the case of a claim of worthlessness of a QOF investment, the Proposed Regulations provide that neither the basis step-ups at years 5 and 7 nor the basis step up at disposition after 10 years applies to the QOF investment. Proposed Regulations Section 1.1400Z2(b)-1(c)(1)(iii).

119 Proposed Regulations Sections 1.1400Z2(b)-1(f), Example 7 and Example 8.

On the one hand, unlike the transfers noted above, there is no other party that is acquiring the interest, and so there is no potential transfer of the QOF tax benefits to another party. (See the discussion below regarding tiered partnerships.) In substance, the transaction is more of a contraction in the assets of the QOF, and to the extent the QOF's net assets are reduced, there are fewer net assets to generate the gains that ultimately may be excluded.

On the other hand, to the extent the purpose of the QOZ rules is to incentivize investment in QOZs, it might be viewed as inconsistent with that purpose to allow a taxpayer's net investment in the QOF to be reduced, while permitting the taxpayer to obtain the benefits of a basis step-up on her continuing investment. For example, assume that a taxpayer makes a qualifying investment of $100 in a corporate QOF in 2022. On December 30, 2026, the investment is worth $300. The taxpayer has one-half of her investment redeemed for $150 (thereby returning the full investment originally made, plus $50). It is clear that the taxpayer should (and will) recognize her deferred gain amount of $100,[120] and will recognize gain on the appreciation (gain of $100, representing $150 of redemption proceeds on a one-half interest that has a basis of $50 after adjustment for the acceleration of deferred gain). The same aggregate amount of gain would be recognized if the redemption occurred on January 2, 2027, after the mandatory recognition of deferred gain.

Should the taxpayer be entitled to benefits under Section 1400Z-2(c) with respect to the remaining one-half of her investment? That answer depends, we believe, on whether the policy of Section 1400Z-2 is best served by looking at the taxpayer's original investment, or looking at the remaining investment. After the redemption, looking at the original cash outlay, the taxpayer has no net capital investment ($100 in and $150 out), as reflected by the fact that all of the deferred gains have been recognized. On the other hand, because of the appreciation in the investment, the QOF continues to have $150 of assets to be invested in its business and the taxpayer has paid tax on only half of the appreciation (as well as all of the deferred gains).

We suggest that final regulations provide that contraction-type Inclusion Events do not cause the retained QOF interest to lose its eligibility for basis step-up after ten years. (As discussed above we believe it should not matter whether the redemption or other contraction event occurs before or after December 31, 2026). A contrary rule would lead to arbitrary distinctions between dividends (from a corporate QOF) or debt-financed distributions (from a partnership QOF), on the one hand, and distribution-related Inclusion Events, on the other hand, even though in each case there is a potential reduction in the net invested capital of the QOF taxpayer.

Inclusion Events related to tiered partnerships (whether such partnerships were the electing taxpayers that made a qualifying QOF investment or were transferees in a Section 721 transaction) include both transfer-type events (transfers of upper-tier partnership interests in a taxable or a non-qualifying tax-free transaction) and distributions (distributions of cash or property to an upper-tier partnership with a fair market value in excess of the outside basis in the partnership interest). We believe that transfers should cause the proportionate amount to be non-qualifying.

---

120 Proposed Regulations Section 1.1400Z2(b)-1(c)(9). The Proposed Regulations do not specifically provide whether a redemption of QOF partnership interests (that is not treated as a disguised sale) would constitute an Inclusion Event, but such transactions (to the extent the proceeds do not exceed basis (inclusive of liabilities under Section 752)) generally are not treated as sales or exchanges to any extent.

By contrast, distributions generally should not count adversely for purposes of the ten-year holding period. *See also* discussions below under "*—Indirect Transactions Relating to QOF Interests*."

2. Inclusion Events and Transactions

In general, under the Proposed Regulations, an Inclusion Event occurs if the taxpayer transfers an interest and reduces its equity investment in the qualifying QOF investment, the taxpayer receives a distribution (whether or not its equity interest is reduced) from a QOF, or the taxpayer claims a worthlessness deduction in respect of the qualifying QOF investment.[121] The Proposed Regulations also contain an extensive list of specific rules relating to transfers (taxable and non-taxable), contributions and distributions.[122] The specific rules appear to cover all potentially relevant transactions. Thus, it is not clear what purpose the general rule serves. We suggest adding to the list of specific transactions any that might not have been covered and eliminating the general rule that appears to have no clear effect. The remainder of this section discusses our comments on corporate and partnership transactions treated as Inclusion Events under the Proposed Regulations.

a. Mergers of Corporate QOFs and of Corporations that are Shareholders of QOFs

Proposed Regulations Section 1.1400Z2(b)-1(c)(10)(i) and Proposed Regulations Sections 1.1400Z2(b)-1(d)(1) and (2) contain rules for qualifying Section 381 transactions in which assets of a QOF are acquired. Under those rules:

- 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, the transaction is not an Inclusion Event.[123]

- 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 is determined by applying the principles of Section 1223(1) (generally a "tacked" holding period).[124] This overrides the general rule of Proposed Regulations Section 1.1400Z2(b)-1(d)(1)(i) to the effect that, solely for purposes of Sections 1400Z-2(b)(2)(B) and 1400Z-2(c), the length of time a qualifying investment has been held is determined without regard to the period for which the taxpayer held property exchanged for such investment.

- For purposes of determining whether the original use of QOZBP commences with the acquiring corporation, any QOZBP transferred by the QOF to the acquiring corporation in

[121] *See* Proposed Regulations Section 1.1400Z2(b)-1(c)(ii) and (iii).

[122] *See* Proposed Regulations Section 1.1400Z2(b)-1(c).

[123] Proposed Regulations Section 1.1400Z2(b)-1(c)(10)(i)(A).

[124] Proposed Regulations Section 1.1400Z2(b)-1(d)(1)(ii).

connection with a qualifying Section 381 transaction does not lose its status as QOZBP solely as a result of its transfer to the acquiring corporation.[125]

Proposed Regulations Section 1.1400Z2(b)-1(c)(10)(ii) provides that a qualifying Section 381 transaction in which the assets of a QOF shareholder are acquired is generally not an Inclusion Event with respect to the qualifying investment. However, Proposed Regulations Section 1.1400Z2(d)(1)(i) contains no rule that directly addresses the holding period of a qualifying investment acquired by an acquiring corporation from a QOF shareholder in a qualifying Section 381 transaction, and Proposed Regulations Section 1.1400Z2(b)-1(f), Example 7(iii), the only example in the Proposed Regulations that touches on such transactions, does not address the holding period issue.

In the absence of a rule akin to that of Proposed Regulations Section 1.1400Z2(b)-1(d)(1)(ii), concern arises that an acquiring corporation in a qualifying Section 381 transaction in which assets of a QOF shareholder are acquired must begin a new holding period for a qualifying investment acquired in such a transaction. Although it could be argued that the rule of Proposed Regulations Section 1.1400Z2(b)-1(d)(1)(ii) is itself necessitated only by the Proposed Regulations' inclusion of a contrary general rule in Proposed Regulations Section 1.1400Z2(b)-1(d)(1)(i), and that, in the absence of such a general rule, Section 1223(2) would apply to permit the acquiring corporation to use a "tacked" holding period for Section 1400Z-2 purposes, we recommend that the matter be clarified and that a "tacked" holding period be expressly provided for a QOF shareholder's qualifying investment in this case.

b. Partnership Mergers

Proposed Regulations Section 1.1400Z2(b)-1(d)(3) provides, "[t]he principles of paragraphs (d)(1) and (d)(2) of this Section apply to QOF partnership interests with regard to non-inclusion transactions described in paragraph (c)(6)(ii) of this Section." The non-inclusion transactions described in the cited paragraph are contributions of an interest in a qualifying investment to a partnership in a transaction governed by Section 721(a) and a merger or consolidation of a partnership holding a qualifying investment with another partnership in a transaction to which Section 708(b)(2)(A) applies. The Section 721(a) transaction described in paragraph (c)(6)(ii) appears analogous to the type of transactions in which the assets of a QOF shareholder are acquired (*i.e.*, a Section 351 transaction), and merger of partnerships seem analogous to qualifying Section 381 transactions in which the assets of a corporate QOF are acquired. It is not entirely clear how the principles of paragraphs (d)(1) and (d)(2), which relate to the latter category of Section 381 transactions relating to acquisition of corporate QOF assets, would be applied in respect of partnership transactions described in paragraph (c)(6)(ii).

Moreover, there appears to be no provision of the Proposed Regulations that explicitly provides that a merger of a partnership QOF into another partnership in a transaction to which

125 Proposed Regulations Section 1.1400Z2(b)-1(d)(2)(i).

Section 708(b)(2)(A) applies will not be an Inclusion Event, even if the acquiring partnership is a QOF immediately after the merger.[126]

We recommend that the principles of Proposed Regulations Sections 1.1400Z2(b)-1(c)(10)(i)(A), 1.1400Z2(b)-1(d)(1)(ii) and 1.1400Z2(b)-1(d)(2)(i) be made applicable to mergers of QOF partnerships,[127] and that the principles of Proposed Regulations Section 1.1400Z2(b)-1(c)(10)(ii) be made applicable to a merger of a partnership that owns a qualifying investment.

c. Partnership Divisions

Proposed Regulations Section 1.1400Z2(b)-1(c)(11) and Proposed Regulations Sections 1.1400Z2(b)-1(d)(1) and (2) contain rules for Section 355 transactions involving a QOF. Under those rules:

- If a QOF corporation distributes stock of a controlled corporation in a transaction to which Section 355 applies, and if both the distributing corporation and the controlled corporation are QOFs immediately after the "final distribution," 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.[128]

- The holding period of a qualifying investment in a controlled corporation received by a taxpayer in a distribution on its qualifying investment in the distributing corporation in a qualifying Section 355 transaction is determined by applying the principles of Section 1223(1) (generally a "tacked" holding period).[129]

- For purposes of determining whether the original use of QOZBP commences with the controlled corporation, any QOZBP contributed by the distributing corporation to the controlled corporation in connection with a qualifying Section 355 transaction does not lose its status as QOZBP solely as a result of its contribution to the controlled corporation.[130]

The Proposed Regulations are silent regarding the extent to which similar rules apply to partnership divisions governed by Section 708(b)(2)(B). We recommend that the principles of

126 Although Proposed Regulations Section 1.1400Z2(b)-1(c)(6)(iii) might reach that result in particular circumstances, it is easy to imagine situations in which that provision would not apply to prevent the occurrence of an Inclusion Event.

127 The principles of the first two of the cited Sections should apply only if the acquiring partnership is a QOF immediately after the merger.

128 Proposed Regulations Section 1.1400Z2(b)-1(c)(11)(i)(B)(1).

129 Proposed Regulations Section 1.1400Z2(b)-1(d)(1)(iii).

130 Proposed Regulations Section 1.1400Z2(b)-1(d)(2)(ii).

Proposed Regulations Sections 1.1400Z2(b)-1(c)(11)(i)(B)(1), 1.1400Z2(b)-1(d)(1)(iii) and 1.1400Z2(b)-1(d)(2)(ii) be made applicable to "assets-over" divisions of QOF partnerships.[131]

d. QOZB Mergers

No provision of the Proposed Regulations deals expressly with a merger of a QOZB corporation with another QOZB or a merger of a QOZB partnership with another QOZB.[132] In such cases, questions could arise regarding whether the original use of property of the transferor QOZB would be considered to commence with the successor, whether the successor would be considered to have substantially improved property acquired from the transferor, and whether the QOF's stock or partnership interest in the successor would be considered to have been acquired "solely in exchange for cash." We recommend that the final regulations provide explicitly that each of these issues would be resolved favorably.[133]

3. Transfers of QOF Interests

The Proposed Regulations under Section 1.1400Z2(b)-1(c)(1)(i) generally provide that an Inclusion Event includes a transfer of a qualifying investment that reduces a taxpayer's equity interest in a QOF. Proposed Regulations Section 1.1400Z2(b)-1(c)(3) provides that a transfer of a taxpayer's interest in a QOF by gift generally will constitute an Inclusion Event, thereby requiring such person to include its deferred gain in income, unless the interest is gifted to a trust that is treated as a grantor trust of which the taxpayer is the owner for U.S. federal income tax purposes. The April Proposed Regulations clarify that a bequest of a QOF interest upon death is not treated as an Inclusion Event,[134] and the holding period tacks for purposes of the QOZ rules.[135] However, the recipient of such a QOF interest is required to include the deferred gain in its income upon a subsequent Inclusion Event.[136] We generally agree with the construct of these rules, which

---

131 The principles of the first two of the cited Sections should apply only to the extent that (i) the "recipient" partnership(s) are considered to be newly formed, (ii) the interests in the recipient partnerships are considered, under Treasury Regulations Section 1.708-1(d), to be distributed to the partners of the "divided" partnership, and (iii) the recipient partnerships are QOF's immediately after the division. The applicability of these rules to an "assets up" division (*i.e.*, where the divided partnership distributes assets to its partners, and those partners immediately thereafter contribute the assets to (a) new recipient partnership(s)) would introduce significant complexity, and we would accordingly not object to restricting them to "assets over" transactions (*i.e.*, where the divided partnership is considered to contribute assets to (a) newly formed recipient partnership(s), and immediately thereafter distribute the interests in the newly formed recipient partnership(s) to the partners of the divided partnership).

132 Proposed Regulations Section 1.1400Z2(b)-1(c)(11)(i)(B)(4) contains a narrow rule that applies to certain Section 355 transactions involving QOZ stock.

133 Of course, the entire asset pool and operations of the successor would have to be considered in determining whether the successor qualified as a QOZB after the merger, just as they would be if a corporation in which a QOF owned QOZ stock or a partnership in which a QOF owned a QOZ partnership interest acquired a new business.

134 Proposed Regulations Sections 1.1400Z2(b)-1(c)(4)(i).

135 Proposed Regulations Section 1.1400Z2(b)-1(d)(1)(iv)

136 Proposed Regulations Section 1.1400Z2(b)-1(c)(4)(ii).

appear consistent with the policy of encouraging long-term holdings in QOFs and which avoid the possibility of transferring (in effect) tax benefits to another person.

4. *Indirect Transactions Relating to QOF Interests*

a. Generally

The Proposed Regulations provide that the rules on Inclusion Events 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.[137] The Proposed Regulations specifically provide that Section 721 contributions are not Inclusion Events, so long as the contribution of a QOF interest does not cause a termination of a QOF partnership under Section 708(b)(1).[138] A merger or a consolidation of a partnership holding a qualifying investment (or an upper-tier partnership) in a Section 708(b)(2)(A) transaction is not an Inclusion Event.[139] In respect of partnership distributions, 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 to the extent that the distributed property has a fair market value in excess of the partner's basis in its qualifying investment.[140] This would, however, not trigger an inclusion to the extent the basis in the QOF partnership interest had been increased as a result of an allocation of debt under Section 752.

As a general point, we agree with the approach specified in the Proposed Regulations that Section 721 contributions should not be Inclusion Events (although, as discussed below, we believe there do need to be rules preventing the use of partnerships to directly or indirectly transfer the tax benefits of QOF investments to persons who did not themselves make qualifying investments). While the explicit carve-out of Section 721 contributions implies that taxpayers may hold their QOF interests through an intermediate entity such as a feeder fund, we suggest a statement in the final regulations, or an example, to further clarify that pre-arranged drop-downs of QOF partnership interests in Section 721 transactions, *i.e.*, contributions to a feeder fund or an aggregator, should not be recharacterized (under the step transaction doctrine or otherwise) as if the taxpayer had made its investment into the feeder fund, rather than directly into the QOF with a subsequent transfer of the QOF interest. As noted in our Report No. 1407, feeder or aggregator vehicles may facilitate a more streamlined onboarding process for QOFs and eliminate the need for direct privity between taxpayers with eligible gains and the QOFs themselves.[141] We do not see a statutory or policy reason why drop-downs of QOF interests into a partnership should be disfavored, unlike in the context of Section 1031, which requires that the transferred property be of a "like kind" and held for use in a trade or business or for investment. Accordingly, the final regulations should clarify the scope of feeder fund arrangements that are authorized under the QOZ

---

137 Proposed Regulations Section 1.1400Z2(b)-1(c)(6).

138 Proposed Regulations Section 1.1400Z2(b)-1(c)(6)(ii)(B).

139 Proposed Regulations Section 1.1400Z2(b)-1(c)(6)(ii)(C).

140 Proposed Regulations Section 1.1400Z2(b)-1(c)(6)(iii).

141 NYSBA Report No. 1407, at 17. Further, feeder funds may open up additional capital from investors that routinely make investments through "funds of funds."

rules. We believe that the holding period for purposes of the ten year rule should be tacked when a QOF interest is contributed to a partnership feeder fund in a Section 721 transaction.

b. Technical 721 Issue regarding Upper-Tier Contributions

Proposed Regulations Section 1.1400Z2(b)-1(c)(6)(ii)(B) provides, in part:

> [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 . . . .
>
> A "qualifying investment" is defined in Proposed Regulations Section 1.1400Z2(b)-1(a)(2)(xvi) as "an eligible interest . . . in a QOF . . . ."

Each of the following transactions appears to be covered by Proposed Regulations Section 1.1400Z2(b)-1(c)(6)(ii)(B) and therefore appears not to constitute an Inclusion Event:

- Individual owns an interest directly in QOF. Individual transfers Individual's interest in QOF to Transferee Partnership in a Section 721 transaction.

- Individual owns an interest in Partnership X. Partnership X owns an interest in Lower-Tier Partnership. Lower-Tier Partnership owns an interest directly in QOF. Individual transfers Individual's interest in Partnership X to Transferee Partnership in a Section 721 transaction.

However, under a literal reading of Proposed Regulations Section 1.1400Z2(b)-1(c)(6)(ii)(B) the following transaction does not appear to be covered:

- Individual owns an interest in Partnership X. Partnership X owns an interest directly in QOF. Individual transfers Individual's interest in Partnership X to Transferee Partnership in a Section 721 transaction.

We perceive no basis for this distinction, and we recommend that Proposed Regulations Section 1.1400Z2(b)-1(c)(6)(ii)(B) be revised to apply to a contribution by "a QOF owner, including any contribution by a partner of a partnership that ***<u>directly or</u>*** through one or more upper-tier partnerships, owns an interest in a QOF."

c. Indirect Transfers of QOF Interests

A number of issues arise in the context of QOF interests held by taxpayers through partnerships, because indirect economic ownership of the QOF interest can shift among partners in numerous ways: the QOF interest can be contributed to a partnership in a Section 721 contribution (as discussed above), QOF interests can be distributed to partners in a Section 731 distribution, partnership interests can be sold or otherwise transferred in a taxable or tax-free transaction, partnership interests can be issued for cash, property or services, a partner's interest in the partnership can be redeemed for cash or property other than the QOF interest (increasing the ownership of other partners), partners' indirect ownership in partnership assets can shift as a result of partnership allocations (*e.g.*, preferential allocations of gain or loss or special allocations of particular items), and these allocations can change over time. For each of these transactions, the following results should be clarified (through explicit rules or examples in the final regulations): (i) does the transaction constitute an Inclusion Event for taxpayers that had, either directly or indirectly, deferred capital gains; (ii) does the transaction affect that taxpayer's eligibility to benefit after ten years under Section 1400Z-2(c); and (iii) to what extent, if any, are other partners entitled to benefit from the basis step-ups or exclusion of certain allocated gains after ten years under the QOZ regime? As a related matter, of course, the final regulations should clarify the technical details of how allocations and basis adjustments are applied to obtain these results.[142]

In discussing these questions, we start from the following basic premises: *first*, to the extent a taxpayer directly or indirectly has qualifying capital gains that have properly been rolled over into a QOF investment, it should not matter whether that taxpayer holds the QOF interest directly, or holds indirectly through a partnership, and *second*, taxpayers who did not have such qualifying capital gains should not be entitled to benefit from the QOZ regime, and should not be able to acquire interests that permit them to do so. These premises provide flexibility in structuring investments and preserve consistency in treatment between taxpayers that directly make QOF investments and those that indirectly make them (*i.e.*, scenarios in which a partnership has qualifying capital gains and elects to make a qualifying QOF investment). At the same time, since the transferees of QOF interests in direct transfer transactions cannot benefit from the QOZ tax benefits, it should not be possible to obtain better results through a partnership. In order to achieve both basic premises, the rules adopted in the final regulations will need to adopt aggregate treatment of partnerships, except to the extent Section 704(c)-type principles can apply to ensure that QOZ benefits go only to the appropriate partners.

The principles discussed above are perhaps most easily seen in the context of a Section 721 contribution of a QOF interest. A taxpayer's contribution of a QOF interest to a partnership allows that taxpayer (now partner) to share the economic returns of the QOF investment with other partners and share in the returns of other partnership assets "in exchange" (economically) for the contributed QOF interest. Subchapter K generally permits the contribution of assets with built-in gains to a partnership in reliance on Section 704(c) allocations and related provisions (*e.g.*, Sections 704(c)(1)(B) and 737) to ensure that income attributable to built-in gains is allocated to the contributing partner.[143] As noted above, we agree with the proposal that a Section 721 contribution should not be an Inclusion Event. But this is predicated on the assumption that

---

142 Proposed Regulations Section 1.1400Z2(b)-1(g)(3)(ii) provides that, for tiered arrangements, "[a]ny 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." The Proposed Regulations do not provide additional color on the implications or the details of this rule. Our discussion below provides recommendations on how an indirect owner's interest in a QOF should be "tracked" for purposes of the QOF rules.

143 An alternative would be to measure decreases in the individual indirect ownership in the QOF, in a manner similar to that proposed for S corporations. We do not think this is necessary in the case of partnerships, however, as Section 704(c) allows built-in gain to be allocated to particular partners in a way that the pro rata S corporation allocation rules do not. Furthermore, measuring the decrease in interest would be significantly more difficult in the context of non-pro rata allocations that occur in the case of partnerships.

Section 704(c) would apply to cause the built-in gain on the QOF interest, when recognized, to be allocated to the contributing partner.[144]

> **Example 3:** Partnership ABC has three partners, A, B and C. Each of them holds a partnership interest with a value and outside basis of 300, and Partnership ABC owns various assets with an aggregate value and basis of 900. Partner D contributes a qualifying QOF interest with a value of 100 and a basis of 0 to Partnership ABC for a 10% interest.
>
> Assuming the contribution qualifies under Section 721, the transaction is not an Inclusion Event. This is the case even though D has decreased her interest in the QOF interest from 100% to 10%.[145] This is appropriate only because the built-in gain in the QOF interest should in all events be allocable to D as a contributing partner under Section 704(c). The recognized gain may be 100 (if the five-year holding period has not been met), 90 (if the five-year holding period has been met but the seven-year holding period has not been), or 85 (if a seven-year holding period has been met), and will in all events be recognized by the end of 2026. There can be no tax loss on the QOF interest, and so if there is an economic (book) loss allocable to Partners A, B and C, the ceiling rule will apply.[146]

Similar results should apply if a partnership owns a QOF interest (*e.g.*, the partnership has qualifying capital gains that it has elected to roll over into a QOF interest), and it subsequently issues partnership interests for cash, property or services. The built-in gains on the QOF interest in the hands of the partnership should be allocable to the original partners under reverse Section 704(c) principles.

> **Example 4:** Partnership AB has two partners, A and B, each with a one-half interest. Partnership AB recognizes a qualifying capital gain of 100 and invests 100 in a qualifying investment in a QOF. Partner D contributes cash or property to Partnership AB for a 10% interest. When the 100 (or 90 or 85) of deferred gains are recognized, they should be allocated equally to Partners A and B under reverse Section 704(c) principles.

In concept, the "built-in gain" amount for this purpose should be attributed to the partners that would have been allocated the qualifying capital gains, had the partnership not made an election to invest in a QOF. This should occur, in fact, whether or not there have been any

---

144 While in principal a similar rule for S corporations would be desirable (allocating built-in gains to the original shareholders), we agree with the provision in the Proposed Regulations that applies a 25% ownership change threshold to an S corporation owning a QOF interest. *See* Proposed Regulations Section 1.1400Z2(b)-1(c)(7)(E). This approach limits the ability of shareholders in the S corporation to dispose indirectly of a substantial amount of their ownership in the QOF, while not requiring extensive changes to otherwise applicable S corporation rules which mandate pro rata allocations among shareholders.

145 Proposed Regulations Section 1.1400Z2(b)-1(c)(1)(i) would treat as an Inclusion Event any transaction that reduces the taxpayer's equity investment in the qualifying investment. Section 721 contributions are, however, excluded from this general rule by reason of Proposed Regulations Section 1.1400Z2(b)-1(c)(6)(ii)(B).

146 If the remedial method were elected, Partner D might be allocated notional gains to offset notional losses allocated to the other partners. Assuming no specific rule is adopted for purposes of the QOZ regime, Section 1400Z-2(b)(2)(B)(iii) and (iv) would not reduce the amount of any notional gain allocated under Section 704(c) even if the five- or seven-year holding period had been met.

subsequent issuances of partnership interests to which reverse Section 704(c) would generally apply. We suggest that the final regulations clarify this result. To the extent the partnership has potentially qualifying capital gains in excess of the amounts rolled over into QOF investments, the partnership should identify and allocate among its partners the amount of deferred gains that were realized but not recognized, and identify the QOF interests into which the gains were rolled. The amounts a partner is eligible to defer indirectly should be limited to the gain on which the partner otherwise would have been subject. (For clarity, we believe this should apply without regard to whether there was, as a technical matter, a book-up of the partnership's assets.)

> **Example 5a**: Same as Example 4 above. Partner A had acquired her interest through a contribution of Blackacre, a piece of real property with a value of 100 and a basis of zero at the time of contribution. Partner B had acquired her interest for cash or services previously. The qualifying capital gains of 100 used by Partnership AB for its QOF investment would have been allocated to Partner A under Section 704(c) because she was the contributing partner. Partner D acquires her 10% interest for cash or property after the QOF investment has been made. When the 100 (or 90 or 85) of deferred gains are recognized, they should be allocated entirely to Partner A (under reverse Section 704(c) principles, from Partner D's perspective, and under Section 704(c), from Partner B's perspective).

> **Example 5b**: Same as Example 5a above, but Partner D never invests. The deferred gains should all be allocated to Partner A, even though no issuance of a new partnership interest occurred. To do otherwise would create an arbitrary distinction in treatment between Partner B (who invested cash *before* the QOF investment) and Partner D (who invested after the QOF investment), when the relevant point is that the qualifying capital gains invested in the QOF were entirely attributable to built-in gain property that had been held by Partner A.

> **Example 5c**: Same as Example 5b above, but Blackacre appreciates in value to 200. The appreciation above the 100 value of Blackacre at the time of contribution is allocable 50/50 to Partner A and Partner B. Blackacre is sold for 200; 100 of the proceeds are invested in stocks, and 100 in a QOF. Although 100 was invested in a QOF, there were actually 200 of qualifying capital gains that *could* have been invested (150 allocated to Partner A, and 50 allocated to Partner B). The partnership should be able to identify which gain amounts (up to 100) were deferred and which partners were allocated the deferred gain amounts (0 to 50 for Partner B, and 50 to 100 for Partner A), and should be able to report the allocation on its tax return and Schedule K-1s. Partner A and Partner B will recognize and pay tax on gains allocated to them that are not deferred.[147] Going forward, they should be allocated and taxed on their appropriate share of deferred gains when they are recognized. To the extent deferred gains that had been allocated to both partners are *partially* recognized (*e.g.*, in a distribution in excess of basis by a partnership QOF), the final regulations should specify whether the partners recognize those gains pro rata or whether the partnership can elect to specially allocate them.

---

[147] Proposed Regulations Section 1.1400Z2(b)-1(e).

Example 5d: Same as Example 5c above, but after Blackacre has appreciated to 200 (and no other changes to asset value have occurred, so the remaining assets are worth 100), Partner C acquires half of Partner A's partnership interest (25% of the partnership) for 75. Partnership AB has a Section 754 election in place, so Partner C has a basis in Blackacre that is adjusted under section 743 to 50 (reflecting Partner C's 25% share of the 100 of built-in appreciation). When Blackacre is sold and an investment made in a QOF, the partnership (looking to its original basis) would recognize gain of 100, but Partner C would not recognize any gain after taking into account her adjusted basis. We do not believe Partner C in this case should be treated as having an indirect qualifying investment in the QOF, notwithstanding the fact that the partnership itself has qualifying gain and that Partner C is allocated a portion of such gain before taking into account her personal basis adjustment.

The converse ought also to be true. Assume Partner C had acquired an interest in the partnership when Blackacre had a value of less than 100, and Partner C had a basis adjustment under Section 743 (either discretionary or mandatory) to take into account the built-in loss at the time of her purchase. If Blackacre subsequently appreciates and is sold, Partner C will recognize gain (or greater gain) on the sale, even if Partner A would have a loss or less gain. Partner C should be entitled to defer that gain and elect to roll it into a QOF. Consideration should be given to providing, in such a case, that such an investment could be made directly by the partnership (a simpler approach, structurally), but in any event the final regulations should provide rules for the investment of qualifying capital gains that were affected by a Section 743 or Section 734 adjustment.

Example 5e: Partnership AB owns a capital asset with 100 of built-in gain and a number of other income-generating assets. Partner A is allocated all income and gain up to a threshold (determined annually) and Partner B shares in profits and gains above the threshold. The capital asset is sold, but the allocations of qualifying capital gain to Partner A and Partner B will not be determined until the end of the year. Partnership AB, or the partners, should be able to make a qualifying investment in a QOF. The partners' ability to do so will depend on the amount of qualifying capital gain they ultimately are allocated.

The question of which partners are treated as deferring qualifying capital gains and making an investment in a QOF is relevant not only to determining which partners are taxed on the deferred gains when they are recognized, but also (and perhaps more importantly) to which partners are entitled to the benefit of a basis step-up, or an exclusion of allocated gains, after a ten-year holding period. We believe that the policy of the OZ regime is that only taxpayers that have deferred gains and invested them in a QOF should be entitled to the tax benefits of the OZ regime. As discussed above, we believe that the treatment of transferees should be governed by this principle (*e.g.*, on sale, Section 721 contribution, gift, etc.). By the same token, the final regulations should clarify that this principle also applies on an indirect basis. Even if a partnership has made a qualifying investment in a QOF, the basis step-up or gain exclusion after year ten should apply only to those partners who were (notionally) allocated the deferred gain. In effect they should be treated as indirectly holding a qualifying investment in the QOF by reference to their proportionate share of deferred gain, not by reference to their share of capital or profits in the partnership that invests in the QOF. Similarly, when an interest in a partnership that has invested in a QOF is acquired by another person (whether by secondary purchase of an interest in the partnership, contribution, allocations, grant of interests for services, or any other reason), we believe it would not be appropriate for that person to obtain a benefit with respect to that QOF investment after year ten.[148] We suggest that final regulations provide that the basis step up provided for under Section 1400Z-2(c) is for the benefit of the original indirect partner only. Such a basis step-up that is "personal" to existing partners could be implemented by application of a rule similar to Section 704(c)(1)(C), where non-contributing partners are treated as if contributed property had a basis equal to fair market value at the time of contribution, rather than the tax basis taken into account by the contributing partner. This same rule ought to apply on a "look through" basis to the extent the partnership has held the QOF interest for at least ten years and the QOF has allocated gain in respect of QOZP.

We believe that a QOF interest (and the related deferred gain amount) should be treated as akin to a Section 704(c) asset with built-in gain for purposes of determining to what extent a partner is entitled to tax benefits after a ten-year holding period. So long as, and to the extent that, the QOF interest remains held directly or indirectly by the original partner that deferred capital gains, the benefits after ten years ought to be available to that partner. Partners that did not defer capital gains with respect to that QOF interest should never be entitled to those tax benefits.

> **Example 6**: Returning to the facts of Example 5b, all of the qualifying capital gains were allocable to Partner A (who had contributed Blackacre with 100 of built-in gain), and Partners A and B own Partnership AB equally (and Partner D never invested). In 2026, all of the deferred gains were recognized and allocated to Partner A, and Partnership AB adjusted its basis in the QOF to 100. Sometime after the ten-year holding period was reached, Partnership AB sells the QOF interest for 400 of cash. The economic gain of 300 is split between Partner A and Partner B. Partnership AB adjusts its basis in the QOF immediately prior to the disposition – but this adjustment should only apply indirectly to Partner A. Partner A should recognize no gain from the indirect sale of the QOF, and Partner B should recognize 150 of gain. In addition, Partner A's basis in its interest in Partnership AB should be adjusted at that time to reflect the gain allocable to Partner A that was exempted by way of the basis step-up at the partner level, such that there is no inside-outside basis differential created on account of this transaction or the investment in the QOF.
>
> **Example 7**: Returning to the facts of Example 3, Partnership ABC has three partners, A, B and C. Each of them holds a partnership interest with a value and outside basis of 300, and Partnership ABC owns various assets with an aggregate value and basis of 900. Partner D contributes a qualifying QOF interest with a value of 100 and a basis of 0 to Partnership ABC for a 10% interest. In the next year (without any changes in value) each of Partners A, B, C and D sell an interest worth $50 (an aggregate 20% interest) to Partner E.
>
> Partner D has sold one-half of her interest in the QOF (50 out of 100), so this presumably is an Inclusion Event as to one-half of her deferred gain. This appears appropriate to the extent the relevant measure is the degree to which Partner D has "cashed out" – exchanged an interest in her (now indirect) QOF interest for cash. However, economically, in terms

148 We believe that a purchaser of a partnership interest should not be eligible for benefits under the QOZ regime whether or not the partnership has a Section 754 election in place.

of indirect percentage ownership, the initial contribution already reduced her interest in the QOF from 100% to 10%, and the subsequent sale only reduced her indirect interest to 5%. As noted above, we believe the conceptual rationale for having the sale be an Inclusion Event, while the initial contribution was not, is that the purchaser will step into Partner D's shoes for purposes of Section 704(c) to the extent of her 50% purchase.[149] This distinction could be relevant if, for example, the facts were more complicated and Partner E acquired an interest with special allocations, or preferred allocations, which affected the amount of QOF interest that she indirectly purchased.

Presumably Partner D should be treated as recognizing 50 of gain upon the sale to Partner E and holding a remaining 5% interest in Partnership ABC with a basis of zero. In order for that result to occur, the basis step-up from the Inclusion Event (the recognition of half of the deferred gain) must be attributable entirely to the interest sold to Partner E. Otherwise Partner D would take an outside basis of 50, and in the sale to Partner E would recover only 25 of that basis and would recognize another 25 of gain. We suggest that Proposed Regulations Section 1.1400Z2(b)-1(f)(3), Example 3 be clarified to illustrate how the relevant basis adjustments for the Inclusion Event should be made.

Example 8: Same facts as Example 3. After some number of years, Partnership ABC makes an in-kind distribution of the QOF interest previously contributed by Partner D in a transaction governed by Section 731. Partner D receives 10% of the distribution.

It is not entirely clear whether this transaction is intended to be an Inclusion Event, although it appears likely. Section 731 distributions are not, in any event, included on the list of transactions that are excluded from treatment as Inclusion Events. We believe this is an appropriate result, to the extent the distribution is made to partners that did not themselves defer the capital gains rolled into the QOF. We believe, however, that it would be reasonable for an exception to be made to the extent the distribution is made to Partner D, who had made the initial qualifying investment in the QOF. The same should be true for a partner that *indirectly* made the qualifying investment in the QOF, as reported by an electing partnership that made the direct investment. Relatedly, we believe it would be inappropriate for any partner other than Partner D to obtain OZ benefits after a ten-year holding period. The final regulations should clarify the treatment of Section 731 distributions of a QOF interest.

d. Partnership Distributions

The April Proposed Regulations provide that there is an Inclusion Event if a QOF partnership distributes cash or property to a partner with a fair market value in excess of basis.[150] While we do not disagree with this result – to do otherwise would require a separate calculation of outside basis under Subchapter K – the result may be viewed as arbitrary in allowing a debt financed distribution to be made without accelerating deferred gain (even though net investment in the QOF by the taxpayer has been reduced) while other distributions do accelerate gain.

---

149 Treasury Regulations Section 1.704-3(a)(7).

150 Proposed Regulations Section 1.1400Z2(b)-1(c)(6)(iii).

The Proposed Regulations further provide that, in respect of distributions involving tiered partnerships, "similar rules" apply.[151] It is not clear how this principle should be applied. If the rule is intended to apply to a distribution by an upper-tier partnership to a partner that is an indirect holder of a QOF interest whenever the distribution is of cash or property with a fair market value in excess of the outside basis in the upper-tier partnership, then the final regulations should so clarify. We do not, however, believe that this approach will give rise to an appropriate result in all circumstances. The distribution of cash or property to a partner may give rise to arbitrarily different results, depending on how much basis the partner has in the upper-tier partnership interest, which could be higher as a result of assets other than the indirect QOF interest, or as a result of debt, or relate to the timing of unrelated income or losses. The distribution in excess of basis is therefore an imperfect measure of whether and how much the partner has "cashed out" of an interest in the QOF; depending on allocations, the distribution in excess of basis may reflect instead a reduced interest in other assets. In addition, per our suggestions above, the built-in gain on the QOF interest will remain available to be allocated under Section 704(c) or reverse Section 704(c), so as a conceptual matter it does not seem necessary to treat such a distribution as an Inclusion Event. We suggest that, to the extent the partner in the upper-tier partnership will ultimately be allocated that gain (including, as necessary, through an election), it should not be an Inclusion Event.

5. *Inclusion Events for QOF Corporation Distributions and Analogous Transactions*

A QOF can be a corporation (of various tax categorizations) or a partnership. Although the general rules for corporate and partnership taxation are different, the underlying policies behind deferral for qualifying investments are the same, so that it is desirable for the inclusion regime for QOF corporations to produce similar results to that for QOF partnerships to the extent possible.

Partnerships and S corporations flow through their earnings each year with a corresponding increase in their owners' outside bases. Thus, generally allowing distributions without inclusion of deferred gain to the extent of outside basis enables the distribution of current earnings of a partnership or S corporation. The owners of C corporations are not taxed on current earnings until distribution. Thus, allowing the distribution by a C corporation of dividends out of earnings and profits without inclusion of deferred gain, as proposed in the Proposed Regulations,[152] provides analogous treatment for a QOF C corporation.

Under the Proposed Regulations, it is clear that, notwithstanding the unitary basis principle of Subchapter K, bifurcation between qualifying and non-qualifying investments occurs for Inclusion Event purposes with respect to distributions by a QOF partnership, effectively causing the distribution of the equity capital of a qualifying investment – tracing proportionately to qualifying and non-qualifying – to trigger inclusion.[153]

---

151 *Id*.

152 Proposed Regulations Section 1.1400Z2(b)-1(g)(1)(ii)(C)(1).

153 Proposed Regulations Section 1.1400Z2(b)-1(c)(6).

Although the same Code rule, Section 1400Z-2(e)(1), applies to all QOFs, the mechanics under the Proposed Regulations are less clear in the context of qualifying and non-qualifying investments in a QOF corporation. For example, assume that, in year 1, A acquires all of the stock of QOF C (a C corporation) as a qualifying investment for $500. In year 2, A contributes an additional non-qualifying $100 to C as a contribution to capital, taking back no additional shares. If the rule for QOF corporations worked like the rule for partnerships, there would be an implicit block of stock that had a basis of zero, in the case of a QOF C corporation, or the appropriate share of previously taxed retained earnings, in the case of a QOF S corporation, and an Inclusion Event would produce results comparable to the partnership case (with distributions and redemptions being apportioned between qualifying and non-qualifying blocks of equity, and deferred gains attributable to the qualifying investment being recognized), even though basis recovery under Section 301(c)(2) is not itself an Inclusion Event. It is not clear, however, that this is the result under the Proposed Regulations. Under general tax principles, each share has an identical basis under these facts. The proposed rules for QOF S corporations allow particular shares to be qualifying or non-qualifying without causing a second class of stock, but do not suggest what to do if, under general tax principles, a particular share would be sourced to mixed funds. In any event, shareholders of a QOF S corporation should be allowed to extract previously taxed income from the QOF without accelerating their deferred gains.

Dividend-equivalent redemptions raise certain anomalies. The Section 302 regulations contain two well-known examples concerning dividend-equivalent redemptions from a corporation owned by a husband and wife.[154] In one case, all of the husband's shares are redeemed and the husband's basis jumps over to the wife's shares. In the other case, most of the husband's shares are redeemed and the husband's basis is all loaded onto his remaining shares. It is understandable that the government might want to cause acceleration when the husband owns no further shares, at least if a gift of shares from the husband to the wife would also cause acceleration, as the government has proposed. (Query, however, whether that is the right family-friendly rule.) It is less understandable why the government proposes to cause acceleration if the husband still owns some shares. If the husband owned all of the shares of the corporation, only the amount treated as gain under Section 301(c)(3) would trigger inclusion under the Proposed Regulations, notwithstanding the distribution of a greater amount of cash. This suggests that the government's concern cannot be with extracting cash from the QOF or loading basis onto fewer shares. The fisc would appear to be protected as long as it was clear that the entire amount of deferred gain remained with the partially redeemed shareholder (although such a rule would then have the effect of very different results being dependent on whether the husband in the example has *any* remaining equity investment no matter how small).

The Proposed Regulations introduce further differences in treatment when the transaction is an acquisitive reorganization.[155] Assume that the husband and wife own two QOF C corporations, C1 and C2, both 50-50, and that C1 and C2 have a lot of earnings and profits. If C1 merges into C2 and husband receives only cash and notes and wife receives all stock, husband's treatment is governed by Section 302 and will be as described in the previous paragraph: husband's deferral on the qualifying investment in C1 ends, notwithstanding the treatment of the cash and

---

[154] Treasury Regulations Section 1.302-2(c).

[155] Proposed Regulations Sections 1.1400Z2(b)-1(c)(10) and (11).

notes as a dividend. If husband receives one share of C2 stock in addition to cash and notes, husband's treatment is governed by Section 356. The boot will still be a dividend, but under the Proposed Regulations, the transaction is only an Inclusion Event to the extent husband's gain is not treated as a dividend.[156] This is a better deal than offered in the redemption context, where dividend-equivalent boot triggers inclusion except in wholly-owned situations.

The Proposed Regulations also provide disparate treatment for boot in reorganizations depending on whether gain or loss is realized.[157] In the loss case, even though the loss is not recognized, the full amount of the boot accelerates deferred gain. In the gain case, the acceleration is limited to the amount of the gain not treated as a dividend. In Example 7(v), involving realization of loss, the shareholder has $50 of stock basis as the result of earning out its first tranche of "free basis," its QOF stock is now worth $25 (less than the basis), and the shareholder pockets $10, which accelerates $10 of the original deferred gain. Were the stock worth $51 instead of $25, the shareholder could pocket the same $10 while accelerating no more than $1 of deferred gain. It is hard to justify this timing difference.

Finally, the Proposed Regulations provide a special rule for recapitalizations that appears to introduce an additional and unnecessary concern.[158] A recapitalization becomes an Inclusion Event if the shareholder's proportionate interest decreases. In this case, the Inclusion Event is in an amount equal to the reduction in the value of the shareholder's qualifying stock.[159] A shareholder's proportionate interest could decrease either because it receives non-stock consideration or because a new investor comes in for additional stock, or both. Dilution, absent more, however, should not reduce the value of the shares, whereas non-stock consideration would. Even though there already are proposed rules for redemptions, for boot in reorganizations, and even for boot in recapitalizations, this proposed rule in effect augments the Inclusion Event to the full amount of the non-stock consideration in all cases except the wholly-owned case or a pro rata distribution. We note that acquisitive reorganizations normally result in the dilution of the shareholders' interests and nevertheless appear to enjoy more favorable treatment under the Proposed Regulations. We would recommend having more closely aligned rules for Section 301 distributions, redemptions and reorganizations generally, rather than a special regime for recapitalizations, which appears to be largely (perhaps wholly) unnecessary.

J. Carried Interest Issues

The Proposed Regulations provide that QOF interests granted in exchange for services are not eligible for the benefits of the QOZ rules.[160] This appears to be the case even if all of the partnership's investments are qualifying investments, or if capital interests in a QOF are acquired in exchange for services. Under Section 1400Z-2(e), an investor that holds a "mixed-funds" investment in a QOF is treated as holding two separate interests in the QOF, one portion as a qualifying investment and another as a non-qualifying investment. Accordingly, the Proposed

---

[156] Proposed Regulations Section 1.1400Z2(b)-1(c)(11)(i)(B).

[157] Proposed Regulations Sections 1.1400Z2(b)-1(c)(10)(i)(C).

[158] Proposed Regulations Sections 1.1400Z2(b)-1(c)(12).

[159] Proposed Regulations Sections 1.1400Z2(b)-1(c)(12)(ii).

[160] Proposed Regulations Section 1.1400Z2(a)-1(b)(9)(ii).

Regulations provide that a partner holding a mixed-funds investment is 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.[161] Solely for purposes of Section 1400Z-2, the mixed-funds partner is treated as holding two interests, and all partnership items affect qualifying and non-qualifying investments proportionately, based on the relative allocation percentages of each interest. The Proposed Regulations provide that the allocation percentage of the profits interest is based on the highest share of residual profits the partner would receive with respect to such interest.[162]

We believe that the mixed-funds rule is extremely helpful in order to keep track of differing interests in a QOF partnership, and we agree that partnership interests issued in respect of services should not be eligible for the benefits of a qualifying QOF investment. We do not believe, however, that a rule that apportions between qualifying and non-qualifying QOF interests on the basis of "highest residual" profit is appropriate. For example, assume that a partner that provides services invests qualifying capital gains for a 5% interest in a QOF, and obtains an interest in QOF (partnership) profits of 10%, after capital partners have received an 8% IRR. The proposed rule appears to provide that two-thirds of the partner's interest should be treated as non-qualifying (10% out of 15%), even though the partner assuredly will receive less than a 15% interest in total profits (due to the IRR threshold). Further, as a matter of policy the partner should be eligible for the 10% or 15% basis bump in respect of its deferred gain amount. We therefore suggest that a different rule be adopted to distinguish the QOF interest received for services and QOF interest received for qualifying capital. We recognize that this is a complicated, nuanced question, for which it has proven difficult in other contexts to provide a workable rule (particularly if all or most of the partners in the QOF partnership provide services in return for their interests). We believe, however, that final regulations should provide that a service-providing partner's capital interests in a QOF treated as a qualifying investment should be determined by comparing the profits received by the service provider with those derived by another significant partner that does not provide services to the QOF. Such partner's provision of services to a QOF partnership, alone, should not impact the treatment of its QOF capital interest as a qualifying investment. It would be helpful if such rule would be accompanied by specific examples involving a partner that provides services to a QOF.

K. Sale of QOF Partnership Interest Versus Sale of QOZP

While the Proposed Regulations helpfully provide that a taxpayer can exclude from income capital gain arising from a QOF partnership disposing of QOZP,[163] discrepancies remain as between a sale of QOF partnership interests and the QOF's sale of assets. Upon an investor's disposition of its qualifying interest after ten years, its basis in its qualifying investment in the QOF is adjusted to equal the fair market value of the qualifying interest (plus the investor's share of the QOF partnership's liabilities under Section 752), and the bases of the QOF partnership's assets are adjusted to reduce the discrepancy between the outside and inside bases.[164] In effect,

161 Proposed Regulations Section 1.1400Z2(a)-1(b)(10)(i)(D).

162 Proposed Regulations Section 1.1400Z2(b)-1(c)(6)(iv)(D).

163 Proposed Regulations Section 1.1400Z2(c)-1(b)(1)(ii)(A)(*1*).

164 This is the case regardless of whether the QOF is a partnership, an S corporation, or a REIT.

these adjustments avoid any offsetting capital losses and ordinary income items that may be generated under the technical partnership rules (*e.g.*, depreciation recapture). However, under the Proposed Regulations, there would be disparate tax results if the QOF partnership had itself sold the assets.[165] Investors would enjoy the QOF tax exemption only with respect to capital gains recognized by the QOF in respect of QOZP, not gains characterized as ordinary income or gains from the sale of non-QOZP assets (such as intangibles and securities other than equity interests in a QOZB). Also, the exclusion does not appear to apply to gains recognized by a QOZB on the sale of its assets, whether or not such assets constitute QOZP.

As a result of this discrepancy in treatment, the Proposed Regulations favor QOFs that hold only a single investment, such that the QOF interests can be sold. This type of structuring is inefficient. If the intention behind excluding allocated gains after a ten-year holding period is to prevent tax considerations from driving structuring, it would be necessary to equalize the results for an investor whether the QOF interest, an item of QOZP, or an asset of a QOZB is sold. Accordingly, if the policy to be achieved is to avoid creating structural impediments to the organization of QOFs, we believe final regulations should seek to align the QOF partnership's inside basis in the disposed assets and the QOF investor's outside basis in the QOF, with the result that after ten years *all* gains from disposition of QOF assets would be excluded. At a minimum it would be desirable, if Treasury believes it has the authority to do so, to equalize the treatment of gains from sale of QOZBP by a QOZB (rather than requiring the sale of equity in a QOZB entity). This approach would depressurize the current view that, from a practical perspective, the ten year rule generally seems to lend itself to a structure with separate QOF partnerships for each QOZ investment. The requested rules would seek to level the playing field for dispositions at the level of the QOF or below.

L. Corporate Issues (Consolidation and E&P)

1. Timing of E&P Increases

We recommend that Treasury provide guidance on the E&P[166] effects of the QOZ provisions.

In general, E&P is intended to measure the economic income of a corporation available for distribution to its shareholders.[167] Consistent with this, under Treasury Regulations Section 1.312-6, all items includible in gross income under Section 61 enter into the computation of E&P, and E&P is computed using the same method of accounting used to compute taxable income unless there is a specific provision authorizing a different method for E&P purposes. Accordingly, absent an express rule to the contrary, statutory provisions that affect the timing of income have a corresponding effect on the timing for increasing E&P.

[165] Proposed Regulations Sections 1.1400Z2(c)-1(b)(1) and (2).

[166] "E&P" refers to earnings and profits of a corporation within the meaning of Section 312.

[167] Conf. Rep. on the Tax Reform Act of 1984, H.R. Rep. No. 861, 98th Cong., 2d Sess. 835 (1984).

With respect to nonrecognition transactions, this principle is codified in Section 312(f)(1),[168] which provides that gain or loss increases or decreases E&P only to the extent the realized gain or loss was recognized in computing taxable income under the law applicable to the year in which the sale or disposition is made. Thus, in a nonrecognition transaction such as a like-kind exchange under Section 1031 or a stock exchange under Section 354, any increase to E&P is deferred alongside gain that is deferred under the applicable nonrecognition provision.[169]

E&P is relevant for, among other purposes, analyzing the tax consequences of actual and deemed distributions, allocating E&P in a spin-off, or qualifying as a REIT. Thus, we recommend that Treasury address the E&P consequences of the QOZ provisions. Specifically, we recommend that any increase to E&P as a result of gain deferred under Section 1400Z-2 should be deferred until such gain is included in income upon either (i) an Inclusion Event or (ii) December 31, 2026.[170] Furthermore, to the extent that basis adjustments are made as a result of the operation of Sections 1400Z-2(b)(2)(B)(iii) or (iv) (*i.e.*, after the investment is held for five or seven years, respectively) or under Section 1400Z-2(c) (*i.e.*, after the investment is held for ten years), such amount should be treated as tax-exempt income that causes a corresponding increase to E&P under Treasury Regulations Section 1.312-6(b).

As in the case of a Section 1031 exchange, Section 1400Z-2 is contingent upon the corporation making a qualifying investment in a QOF. A taxpayer may include an amount in income on December 31, 2026 even though the taxpayer continues to hold an investment in a QOF. One could argue that an increase in E&P at that time should not be made as the income inclusion does not correspond to an increase in dividend paying capacity.[171] Nonetheless, it seems that Congress made an intentional choice to require recognition of deferred gains in income at this juncture, and, on balance, there does not appear to be a compelling policy reason to depart from the general principle that E&P increases generally occur at the same time as the corresponding income inclusion. The approach of aligning E&P adjustments with income inclusions is also used for deferred losses under Section 267(f).

---

[168] *Comm'rv. Wheeler*, 324 US 542 (1945), *reh'g denied*, 325 U.S. 892 (1945) (holding that Congress had merely codified existing law on this issue).

[169] *See, e.g., Dynamo Holdings Ltd. P'ship*, TC Memo 2018-61 (2018) (corporation's E&P not increased where gain is not recognized).

[170] We acknowledge that this rule would mean that a corporation that recognizes a qualifying capital gain may not know for up to 180 days – potentially in the next taxable year – whether that gain gave rise to E&P. In general, we do not believe that this sort of retroactive determination should be problematic, or is unique to QOF investments (*e.g.*, similar results may apply in Section 1031 exchanges, which occur or do not occur after the initial sale).

[171] *See* GLAM 2015-001 (Feb. 13, 2015). We note that there is no inclusion event with respect to the basis adjustments under Sec. 1400Z2(b)(2)(B)(iii) or (iv) (*i.e.*, after the investment is held for 5 or 7 years, respectively); nonetheless, since there is an increase to basis at this point a corresponding increase to E&P seems appropriate.

2. Consolidated Issues

a. Proposed Regulations

Under the Proposed Regulations, stock in a QOF corporation 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.[172] Therefore, a QOF corporation can be the *common parent*, but not a *subsidiary member*, of a consolidated group.[173] Further, the Proposed Regulations generally provide that Section 1400Z-2 applies separately to each member of a consolidated group (*i.e.*, a consolidated group is not specifically treated as a single entity).[174] Finally, the Proposed Regulations provide special rules for applying Treasury Regulation Sections 1.1502-32 and 1.1502-36 with respect to the stock of group members owning stock in a QOF corporation.[175]

b. Proposals

i. Single-Entity Approach to Investing in a QOF

In light of various non-tax impediments that a consolidated group might face with respect to making a qualifying QOF investment, we recommend that Treasury consider adopting a single-entity approach, only for the specific purpose of making QOF investments by a consolidated group, so that one group entity S can generate the capital gain for another group entity B to make the QOF investment. The group member that has capital gain to generate may be different from the group member that has the ability to make a QOF investment (*e.g.*, certain regulated entities may not be able to have both the gain assets and own a QOF). If Treasury adopts this recommendation, the final regulations should also provide that any recognition of the deferred gain in 2026 (or upon an Inclusion Event) be treated as belonging to group entity S that originally realized the gain – otherwise, corporations within the consolidated group would be able to shift gain among themselves. If group entity S leaves the group when group entity B still holds its interest in the QOF investment, we believe that group entity S should be treated as having disposed of the QOF interest and recognizing the relevant gain, ending group entity B's tax deferral.

ii. Corporate QOF Permitted as a Subsidiary Member of the Group

Our understanding is that Treasury did not adopt a single-entity model in the Proposed Regulations in light of concerns with respect to consolidated return mechanics and not any Section 1400Z principles. In light of the fact that the Proposed Regulations permit a corporate QOF to be the common parent of the group,[176] it appears that Treasury is not concerned with a corporate QOF participating in ordinary intercompany transactions under Treasury Regulations Section 1.1502-13 or in having its E&P determined under Treasury Regulations Section 1.1502-33. This would suggest that the primary concern is with respect to corporate QOF stock basis considerations or

---

172 Proposed Regulations Section 1.1400Z2(g)-1(b)(1).

173 *Id.*

174 Proposed Regulations Section 1.1400Z2(g)-1(c).

175 *See* Proposed Regulations Section 1.1400Z2(g)-1(d) and (e).

176 *See* Proposed Regulations Section 1.400Z2(g)-1(b)(1).

the impact under Treasury Regulations Section 1.1502-13 of transferring the proceeds from the capital gain transaction to a corporate QOF in an intercompany transaction.[177] If this is the case, we would be pleased to provide additional comments, including considerations with respect to conforming the treatment of a corporate QOF with that of a partnership QOF owned by group members.

At a minimum, we recommend that Treasury provides a transition rule for taxpayers that operated under the belief that the regulations would permit a corporate QOF to be a group member. Because the statute was enacted 18 months prior to the Proposed Regulations and taxpayers have only 180 days to make their investment, group members in fact may have made investments believing this was allowed by the statute (with no reason to believe otherwise). Presumably, any such transition rule would need to address in some fashion concerns similar to those underlying the initial decision to exclude corporate QOFs from a group.[178]

c. Additional Issues Raised by the Proposed Regulations

i. Capital Gains Generated in Intercompany Transactions

If group entity S sells a capital asset at a gain to group entity B, and group entity B subsequently transfers such asset to an unrelated person such that Treasury Regulations Section 1.1502-13 triggers group entity S's gain, does group entity S's gain satisfy the "eligible gain" requirement? Considerations with respect to this question include the requirement that the asset gain purchaser be unrelated to the seller, the requirement of investing in the QOF within 180 days of recognizing the gain, whether group entity S possesses any special status to which Treasury Regulations Section 1.1502-13(c)(5) would apply, and the impact (if any) of asset depreciation in group entity B's hands prior to its disposition of the asset to an unrelated person.

ii. Intercompany Sale of QOF Interest

Where group entity S sells a QOF interest to group entity B, are the results the same as if group entity S continued to hold the QOF interest (*i.e.*, Treasury Regulations Section 1.1502-13 mechanics would compensate for the ownership change)? We recommend additional guidance under the Commissioner's discretionary rule of Treasury Regulations Section 1.1502-13(c)(6)(ii)(D) in order to provide group entity S the benefit of its 10% and 5% basis adjustments.

iii. Corporate QOF as Common Parent and Group Continuance

If Treasury retains the rule that a corporate QOF may be the common parent of a group, but not a subsidiary member thereof, clarification will be needed as to whether the mechanical results of group structure changes under Treasury Regulations Section 1.1502-75(d)(2) and (3) yield the correct policy result.

---

177 Concerning the latter point, we note that a QOF investment may be made by purchasing an interest in the QOF from an unrelated party, in which case there would be no transaction to which Treasury Regulations Section 1.1502-13 applies.

178 *See also* Part IV.O for our other recommendations on transitional rules.

M. Guidance on Tax-Exempt and Foreign Investors in QOFs

1. Generally

Final regulations should clarify how the QOZ rules apply in respect of non-U.S. investors and U.S. tax-exempt investors, both in terms of whether such investors are able to utilize the QOZ rules to roll over capital gains into a QOF, as well as the consequences upon their investment in a QOF.

By "non-U.S. investors," we refer to investors that are not U.S. persons within the meaning of Section 7701(a)(30). By "U.S. tax-exempt investors," we refer to investors that are generally exempt from U.S. federal income taxation under Section 501(a). The QOZ rules on their face do not appear to prohibit non-U.S. or U.S. tax exempt investors from benefiting from the QOZ rules, but a recent interim Internal Revenue Manual Procedural Update provides that "Exempt Organizations are not eligible to defer capital gains through an investment in a [QOF]" and "are not eligible to invest in a [QOF]."[179]

Subject to the discussion below, we do not see a statutory or policy reason why U.S. tax-exempt investors (or non-U.S. investors) should be wholly barred from obtaining tax benefits for qualifying investments in QOFs. If exclusion of such investors from the program is intended, then final regulations should clearly specify this result and provide an explanation as to the reason. Additionally, to the extent U.S. tax-exempt investors or non-U.S. taxpayers are ineligible for such tax benefits, final regulations should specify the results if a qualifying investment in a QOF becomes owned by an ineligible person (*e.g.*, a transfer at death to a non-U.S. person, or an expatriation).

We believe non-U.S. investors and U.S. tax-exempt investors should be able to roll over capital gains that otherwise would have been subject to tax – e.g., capital gains that would be treated as income that is "effectively connected with a U.S. trade or business" ("**ECI**") to non-U.S. investors and unrelated business taxable income ("**UBTI**") to U.S. tax-exempt investors. The process for such investors' making gain deferral elections should also be specified; for example, a U.S. tax-exempt investor should either be permitted to use IRS Form 8949 or IRS Form 990 to elect deferral and the instructions to such forms should be amended to specify the relevant procedures.

Regarding whether non-U.S. investors and U.S. tax-exempt investors should be permitted to roll over untaxed capital gains (*i.e.*, capital gains that are not subject to U.S. tax pursuant to U.S. sourcing rules[180] or Section 512(b)), while the statute does not explicitly address this point, we do not believe that the statute should be interpreted to extend the benefits of the QOZ regime to

[179] *See* IRM Procedural Update No. wi-21-1218-1564 (December 19, 2018), regarding IRM Section 21.7.4.4.18.

[180] Generally, for non-U.S. investors, capital gain from the sale of personal property is non-U.S. source income, unless the property is a U.S. real property interest or the sale is otherwise effectively connected with a U.S. trade or business. *See* Sections 861(a), 897(a)(1).

persons with untaxed capital gains.[181] The general construct of the QOZ program appears to be premised on the assumption that a person with eligible capital gains would be able to defer taxation on such capital gain if it meets the relevant requirements under the QOZ rules. It seems inappropriate to extend the benefits of the QOZ rules (including the ten year rule) to non-U.S. investors and U.S. tax-exempt investors for capital gains that are not (as relevant) ECI or UBTI.[182]

2. *Special Considerations for Non-U.S. Investors*

Proposed Regulations Section 1.1400Z2(a)-1(b)(5) generally provides that, when a taxpayer is required to include deferred gain in income under the QOZ rules, it retains its attributes "under any applicable provisions of the Code" as if such attributes had never been deferred. Accordingly, if non-U.S. investors and U.S. tax-exempt investors are able to elect to defer their qualifying capital gain that is ECI or UBTI and roll it into a QOF interest, then the "attributes" of the capital gain should remain and the investors should be required to recognize such original ECI or UBTI upon the expiration of the deferral (regardless of whether the investor becomes eligible for additional relief, such as treaty benefits for ECI, during the period of deferral). In order to ensure that the deferred gains are recognized at the correct time, we suggest that non-U.S. taxpayers with a qualifying investment in a QOF should be required to file U.S. federal income tax returns for the duration of their investment in a QOF.[183] While it would be possible to simply require a non-U.S. person to file a U.S. federal income tax return only for the year(s) in which its deferral has terminated in whole or in part (on an Inclusion Event, or 2026), in the absence of a tax return requirement it may be difficult to police whether a non-U.S. investor has had an Inclusion Event that requires recognition of deferred ECI. For example, because Section 1446 would not apply in respect of a Section 351 contribution of a QOF interest by a non-U.S. investor, such non-U.S. investor would not be obligated to report such Inclusion Event if it is not required to file a Section 351 statement with its tax return under Treasury Regulations Section 1.351-3(a). Because there is no reason for the QOZ rules to give non-U.S. investors an advantage over U.S. investors, we recommend that the final regulations explicitly provide that a non-U.S. investor investing in a QOF by contributing deferred ECI is required to file U.S. federal income tax returns for each year it holds an investment in such QOF, including the initial year of deferred ECI. In addition, as a means of ensuring that non-U.S. investors have paid tax on their deferred ECI (in a context where withholding tax under Section 1445 or Section 1446 will not apply), consideration should be given to providing that non-U.S. taxpayers are not entitled to tax benefits under Section 1400Z-2(c) after a ten-year holding period unless they establish that they have properly paid tax on their deferred ECI.

Treasury should also consider how the ECI rollover mechanic should interact with the FIRPTA rules under Sections 897 and 1445. If a non-U.S. investor were to contribute to a QOF

---

[181] The QOZ rules aim to "attract an influx of capital to designated low income communities," but such purpose should be read in context of the construct of the QOZ rules more generally. See October Proposed Regulations, 83 Fed. Reg. 54279, 54283 (Oct. 29, 2018), citing H.R. Rept. 115-466, 537.

[182] Assuming our proposals are adopted to treat upper tier partnerships as, in effect, aggregates of their partners, no special rules should be necessary to avoid tax-exempt and non-U.S. investors benefiting under the QOZ regime through partnerships.

[183] It might be workable for the non-U.S. investor to file a "short-form" tax return for such election year by attaching a IRS Form 8949 that indicates that the capital gain was ECI.

capital gains from its sale of U.S. real estate, then its capital gains would also be subject to FIRPTA and be withheld upon by the transferee. We agree with the existing construct which generally continues to require FIRPTA withholding upon the disposition of a real estate asset giving rise to the qualifying capital gain (rather than, for example, treating the withholding obligation as an "attribute" that is also deferred until the eventual recognition of the capital gain); the result is not dissimilar to any disposition of U.S. real property in which there is no gain recognized, or in which the gain recognition may be deferred (*e.g.*, in a Section 1031 exchange). In addition, notwithstanding the fact that the attributes of the prior gain carry over when the deferred gains are recognized, if a non-U.S. investor has invested in a corporate QOF that is not itself a U.S. real property holding corporation within the meaning of Section 897(c)(2), a transferee of the QOF interest would have no way to know that withholding under FIRPTA might be required. (A similar question may arise when a QOF interest is disposed of, in a transaction that would generally require FIRPTA withholding but which gives rise to no gain under the ten year rule.) Practically speaking, the structure of the current FIRPTA regime means that a portion of the initial capital gain reflected in the withheld cash would not be accessible by the non-U.S. investor unless it has other available cash on hand, and this may discourage non-U.S. investors from making investments in QOFs. To the extent this is viewed as a problem to be solved, potential mitigants could include developing a new certification rule that does not require FIRPTA withholding if the non-U.S. investor certifies that the FIRPTA gain will be contributed to a QOF and that a tax return will be filed by such investor for the year of sale, or creating a new refund mechanism under Section 1445 that would allow a non-U.S. investor to apply for a refund at the time of its capital gains rollover into a QOF (instead of waiting until a tax returned is filed for the year of the FIPRTA gain). Such a mechanism would need to take into account the 180-day rule, and given the timing sensitivities, it may not be very helpful to non-U.S. investors unless the refunds are paid out relatively expeditiously. Regardless of whether additional FIRPTA rules are developed, we believe that the existing FIRPTA regime may still be workable in the context of the QOZ rules, although it may dampen non-U.S. investors' enthusiasm for the rollover process.

N. Anti-Abuse Rules

1. Anti-Abuse Rules, Generally

Proposed Regulations Section 1.1400Z2(f)-1(c) provides that the Commissioner can recast a transaction (or series of transactions) as appropriate to achieve tax results that are consistent with the purposes of Section 1400Z-2. Comments were requested whether additional details regarding what tax results are inconsistent with the purposes of Section 1400Z-2, or whether examples of particular types of abusive transactions would be useful to taxpayers.[184] The Proposed Regulations and preambles provide little context for how the anti-abuse rule ought to apply, and provide only a single example (related to agricultural land) without detailed discussion of what makes the example inconsistent with the purpose of the legislation.[185] We believe that an anti-abuse rule that looks to the "purpose" of the legislation, with no details about what that relevant purpose is or how particular QOZBs might or might not be consistent with it (and no legislative history to guide the determination), will be ineffective. It will suffer the risk of being interpreted too broadly (with the

---

184 84 Fed. Reg. 18652, 18669 (May 1, 2019).

185 *Id*.

result that potentially qualifying investments might not be made) and, at the same time, may be difficult for the IRS to apply on audit and so in practice may not appropriately police transactions that go beyond appropriate limitations of the statutory scheme.

We believe that in order to have an anti-abuse rule that can effectively and appropriately be applied by both the IRS and taxpayers, guidance should be issued that describes the "purpose" of the statute in a manner that is detailed enough to be prescriptive, or provides a series of examples of situations that would run afoul of the anti-abuse rule. It is not clear to us what (apart from a "land banking" transaction which is intended to avoid gain on land appreciation functionally unrelated to an opportunity zone business conducted on it) might potentially be viewed as contrary to the purpose of the legislation. We have listed below certain issues that may be viewed as potentially abusive with respect to which we would appreciate clarifications or examples.

2. Use of Land

Proposed Regulations Section 1.1400Z2(d)-1(d)(4)(ii)(B) provides that the original use and SI requirement are not applicable to land as long as the land is used in a trade or business within the meaning of Section 162 in the QOZB, and we generally agree with this approach. The April Proposed Regulations also contain an anti-abuse rule in Section 1.1400Z2(d)-1(f), to the effect that, despite the general rule, land does not qualify as QOZBP if land that is unimproved or minimally improved is purchased with an expectation, intention or view not to be improved or only insubstantially improved within 30 months after the date of purchase. The preamble to the April Proposed Regulations states that, in certain instances, the treatment of unimproved land as QOZBP could lead to tax results that are inconsistent with the purposes of the QOZ rules.[186] The preamble to the April Proposed Regulations provide an example of such result: a QOF's acquisition of a parcel of land currently utilized entirely by a business for the production of an agricultural crop that could be treated as QOZBP without the QOF investing any new capital investment in, or increasing any economic activity or output of, that parcel.[187]

In order to have an effective application of anti-abuse rules relating to land, the final regulations should provide bright-line policy reasons for why the above example or land banking is inconsistent with the purposes of the QOZ rules. To the extent the anti-abuse rule is to have its scope limited to land banking (generally), or land banking in the context of agricultural land without significant new investment, an explicit statement to that effect would be desirable. The April Proposed Regulations do not include general directions on the types of uses of land that are encouraged or disfavored by the QOZ rules (other than certain enumerated types of QOZBs listed under Section 1400Z-2(d)(3)). QOZ rules are intended to facilitate increased business activity and economic investment in QOZs,[188] but it is unclear how that general purpose is intended to be applied to the diverse types of businesses that may be formed inside QOZs. Accordingly, the final regulations should provide specific examples of land uses that fall within or outside the anti-abuse parameters. Such examples should allow taxpayers to have a better grasp on how the anti-abuse

---

186 84 Fed. Reg. 18652, 18654 (May 1, 2019).

187 84 Fed. Reg. 18652, 18655 (May 1, 2019).

188 *See* Staff of J. Comm. on Taxation, 115th Cong., *General Explanation Of Public Law 115*-97, JCS-1-18 (Dec. 20, 2018) at 316; April Proposed Regulations, page 19.

rules interact with actual uses of land, including passive uses that generate income and uses that do not align with the principal trade or business of the QOZB, as well as the potential appreciation of the value of land.

Further, in respect of the anti-abuse rule to the effect that unimproved or minimally improved land does not qualify as a QOZBP if it is purchased with an expectation, intention or view not to be improved or only insubstantially improved within 30 months after the date of purchase, there should be clarifications on what “insubstantially improved” means. For example, although a QOZB or QOF may plan to build physical structures on a piece of land down the road, its overall development plans or financial constraints may only feasibly allow for construction of roads or installation of water or sewer facilities within the 30 month period. We believe that the expectation for such improvement should satisfy the anti-abuse rule and request examples or other clarifications to this effect. We also request that the final regulations include a definition of land banking that ties in with this 30 month anti-abuse rule, and suggest that “land banking” be defined as purchasing unimproved or minimally improved land in a QOZ with an expectation, intention or view not to be improved or only insubstantially improved within 30 months after the date of purchase, and engaging of passive or minimal active business activities on such land. Additionally, there should be a clarification that this anti-abuse rule applies not only to years after the final regulations have been issued, but applies to all years as a substantive rule.

3. Valuation Rule

The Proposed Regulations provide that a QOF or QOZB that does not prepare GAAP books would be required to use an alternative valuation method under which the value of each asset owned by the QOF is the QOF’s unadjusted cost basis in the asset under Section 1012.[189] This rule generally seems appropriate for property that has been acquired by purchase. Is it consistent with the purpose of the statute to have this apply as well to partnership interests, which have a tax basis not based on cost? For example, is the basis attributable to debt (under Section 752) taken into account for this purpose? It would seem appropriate to take into account basis attributable to debt under Section 752; if not, otherwise non-qualifying property could be held through a partnership with leverage and a different result obtained than if the property had been acquired directly. Is a profits interest received for services (and treated as received in a non-taxable transaction pursuant to Revenue Procedure 93-27[190]) treated as having a basis of zero? If so, a QOF or QOZB could hold such an interest, and derive profits from the underlying assets, without limit.[191] Treasury should consider whether the alternative valuation method is appropriate for partnership interests that have a tax basis not based on cost. We suggest that a valuation presumption should be adopted to the effect that a partnership interest is treated as having a valuation no less than the amount of net income allocated in respect of the interest during a taxable year (without regard to whether the interest has a lower value during relevant valuation days because distributions were made in the interim).

---

189 Proposed Regulations Section 1.1400Z2(d)-1(b)(3)(ii).

190 Rev. Proc. 93-27, 1993-2 C.B. 343 (June 9, 1993).

191 Lee Sheppard, *Can Investment Funds Use Opportunity Zones*?, 163 Tax Notes 959 (May 13, 2019).

4. *Holding Period of QOF Interests (Tolling)*

The QOZ rules provide for significant tax benefits depending on the holding period for the QOF interest (five, seven or ten years). Treasury should consider whether the holding period for QOF interests should ever be tolled. For example, should there be tolling by reason of having a put right which limits a taxpayer's risk of loss? Relatedly, should the holding period be tolled to the extent the OZ fund interest secures non-recourse financing?

5. *Self-Warehousing*

The QOZ rules provide that a qualifying investment in an OZ fund must be made within 180 days of recognizing a capital gain, and the capital gain must be derived from a sale to an unrelated person. The Proposed Regulations provide that a qualifying investment need not be a primary investment into a QOF, but may instead be a secondary acquisition of a QOF interest from another person. No limitations are described. In the absence of limitations, it appears permissible that the interest acquired by purchase may have been initially acquired by the seller of the QOF interest through a non-qualifying investment into the QOF, and that the seller and purchaser may be related persons. This would appear to allow a person to make a non-qualifying investment in a QOF, hold the interest (perhaps under an obligation to sell it), and then sell it to a related person when the purchaser has capital gains available. This might be appropriate – there would be no qualifying investment at all unless capital gains had been recognized within the requisite 180 days, and the holding period would not start until the acquisition – but it may be viewed as an improper work-around of the investment requirements. Treasury should consider whether "self-warehousing" should be permitted under the rule that permits a qualifying investment to be a secondary acquisition of a QOF interest.

6. *Sun & Sin Businesses*

Pursuant to Section 1400Z-2(d)(3)(A)(iii), a QOZB cannot be engaged in certain "sun & sin" businesses – a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. There is no similar prohibition on a QOF itself engaging in such businesses. Is it contrary to the purposes of the statute to have a QOF engaged in such business, even though not directly prohibited by the statute? Can a QOZB engage in the business of leasing property used in such a business, whether the lease is made to the QOF or to a third party? Treasury should consider whether "sun & sin" businesses should also be prohibited at the level of the QOF. It does not seem logically consistent to prohibit such sun & sin businesses at the level of the QOZB but not the QOF.

7. *Timing Rules*

The Proposed Regulations provide specific rules regarding when to determine whether property is qualifying QOZP (apart from first and last years, at six-month intervals). Treasury should consider whether there are any circumstances in which transactions undertaken to qualify around the testing date (*e.g.*, stuffing transactions) would be disregarded.

O. Transitional Rules and Reliance

We believe that there should be appropriate transitional rules in the event that the final regulations are in any ways stricter than the Proposed Regulations, including in response to our recommendations. For example, property acquired before the issuance of final regulations, which would have been QOZBP under the Proposed Regulations should be treated as QOZBP indefinitely into the future.

Additionally, the Proposed Regulations provide that pre-finalization reliance does not apply to the ten year rule in Proposed Regulations Section 1.1400Z2(c)-1, as the rules do not apply until January 1, 2028. The ten year rule is currently being considered by taxpayers as they structure and plan transactions pursuant to the QOZ rules. Therefore, even though there may be technical adjustments to the ten year rule in the future, we note that the current Proposed Regulations would be of limited utility if the taxpayers cannot rely on them up front when setting up structures.