Proposed Regulations Likely to Stimulate Investment in Qualified Opportunity Zones

July 2, 2019

The Tax Cuts and Jobs Act of 2017 included tax incentives for investment in low-income communities designated as "qualified opportunity zones" ("**QOZs**")—tracts located in over 8,700 communities, spanning all fifty states, the District of Columbia, and five U.S. territories, comprising about 12% of the land and 10 percent of the population in the United States.

The tax incentives allow investors in "qualified opportunity funds" (or "**QOFs**") organized to invest in properties or business entities located in QOZs (1) to defer and partly eliminate tax on capital gains from unrelated investments if equal amounts are invested in QOFs and (2) to permanently eliminate tax on any appreciation in the QOF investment if the QOF interest is held for at least 10 years.[1] However, the legislation left open questions and appeared to impose restrictions that dampened investor appetite, even after proposed regulations were issued in October 2018.

On April 17, 2019, the Treasury Department and the IRS released a second set of proposed regulations that we expect will spur further QOZ investments. Under the new proposed regulations:

- Investors can buy QOF investments in the secondary market and still claim the tax benefits;[2]
- QOFs are not required to maintain investments in the same QOZ property for 10 years: QOFs can sell an investment in one QOZ property or business entity and replace it with investments in different QOZ properties or business entities before investors have held the QOF investment for 10 years without causing investors to lose the QOZ tax benefits (although gain or loss will be recognized by the QOFs);[3]
- Investors who have held their QOF interests for at least 10 years need not sell the QOF investment to realize the benefit of tax-free appreciation: if the QOF is a partnership, S corporation, or REIT, and it sells the QOZ property or business entity, the investor can elect to eliminate the capital gain income that would otherwise flow through the QOF to the investor;[4]
- QOFs and QOZBs can lease, rather than purchase, property and qualify for the QOZ tax benefits without needing to satisfy the "original use" or "substantial improvement" requirements, but if the property is not real property and is leased from a related party and the original use of the property does not commence with the lessee, the lessee must acquire ownership of QOZ property of equal value to the leased property;[5]

[1] See Internal Revenue Code Sections 1400Z-1 and 1400Z-2.

[2] See discussion at Part 2.a below.

[3] See discussion at Part 1.a below.

[4] See discussion at Part 3.c below.

[5] See discussion at Part 3.a below.

- QOFs can borrow and distribute the loan proceeds to investors (up to the amount of the investors' tax basis in the QOF interest including tax basis attributable to the investors' share of partnership liabilities) without causing investors to lose the QOZ tax benefits;[6] and
- Businesses based in QOZs with operations outside of the QOZ can nevertheless qualify for the QOZ tax benefits.[7]

Taxpayers are generally entitled to rely on the proposed regulations before the proposed regulations are finalized if they apply the rules consistently and in their entirety, except that taxpayers may not rely on the section of the proposed regulations addressing the permanent exclusion of tax on appreciation on QOF investments held for at least 10 years before the regulations are finalized.

A few points of note:

- Investors seeking to defer tax on capital gains must make direct purchases of QOF interests—the deferral benefits are not available through investments in upper-tier feeder funds;[8]
- Profits interests received in exchange for services do not qualify for the tax benefits, and partners with both capital and profits interests will be required to bifurcate their interests;[9]
- A QOF or a QOF's lower-tier QOZ business entity can lease its properties to third-party operators but must be engaged in a "trade or business," so triple-net leases raise special questions; and
- The rules appear to preclude QOZ business entities from entering into joint ventures: they encourage investments through a two-tier structure, in which the QOF holds interests in lower-tier QOZ business entities, but preclude third-tier partnership or corporate investments, so third-tier entities will qualify only if they are wholly-owned "disregarded entities."[10]

The new proposed regulations also offer guidance and clarity on a number of other questions discussed below. We have prepared a version of the proposed regulations that consolidates the April 2019 proposed regulations with the first set of proposed regulations issued in October 2018, as described in our **Client Memorandum dated October 25, 2018**. Our consolidated version of the proposed regulations can be accessed **here.**

Key Takeaways

This memorandum first describes the basic rules and then addresses investor and fund-level considerations in light of the new proposed regulations.

1. The Basics

a. Potential investor tax benefits

- ***Defer (and partly eliminate) tax on unrelated capital gains*:** Taxpayers who realize capital gain income (for example, from selling stock portfolio investments) may elect to defer

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[6] See discussion at Part 2.b below.

[7] See discussion at Part 3.b below.

[8] See discussion at Part 2.a below.

[9] See discussion at Part 2.a below.

[10] See discussion at Part 3 below.

recognizing the gain for federal income tax purposes to the extent they invest an amount (whether or not from proceeds generated by the capital gain realization event) equal to the amount of the gain in equity interests in QOFs within 180 days of realizing the gain.[11] The taxpayer's initial tax basis in the QOF investment is zero, but the basis is stepped up to 10% of the deferred gain if the QOF interest is held for five years, and again by an additional 5% of the deferred gain if the investment is held for seven years, in each case before December 31, 2026. Recognition of the gain is deferred until the earliest of (i) the year the QOF interest is sold, (ii) the year in which an "inclusion event" under the new proposed regulations occurs,[12] and (iii) December 31, 2026. The amount then recognized is the excess of (x) the lesser of the deferred gain and the then-current value of the QOF interest over (y) the basis of the QOF investment.

- ***Permanently exclude tax on appreciation on QOF investments*****:** Taxpayers who hold QOF investments for at least 10 years and then sell their QOF interests may elect to eliminate tax on all appreciation on the investment by stepping up the basis in the QOF investment to fair market value immediately before sale. Under the new proposed regulations, this 10-year requirement does not preclude the QOF from selling its assets and reinvesting in different QOZ businesses or properties so long as the QOF reinvests the proceeds within 12 months and the investor retains the QOF interest for at least 10 years.[13] In addition, taxpayers who have held QOF investments for at least 10 years may elect to eliminate tax on capital gain recognized by QOFs that are partnerships, S corporations or REITs when the QOFs sell investments in QOZ properties or QOZBs.

b. Overview of fund-level requirements

A QOF can be any legal entity that is classified for U.S. tax purposes as a partnership or corporation. It must be organized under the laws of a U.S. state, the District of Columbia, or a U.S. possession. (Special rules apply to QOFs organized under the laws of U.S. possessions.)

A QOF must maintain investment of 90% of its assets in "QOZ property," measured as the average value of the QOF's assets generally as of the middle and end of its tax year. "QOZ property" is "QOZ business property" or a partnership interest or stock in a "QOZ business."

- ***QOZ business property*** is tangible property either owned or leased by the QOF. If the property is owned by the QOF, the QOF must acquire the property by "purchase" from an unrelated party after December 31, 2017 and either the "original use" of the property must commence with the QOF or the QOF must "substantially improve" the property by expenditures that more than double the adjusted tax basis of the property within any 30-month period. The new proposed regulations provide different rules in the case of property leased by the QOF.[14] Also, during "substantially all" (defined in the new proposed regulations as 90%) of the QOF's holding period, "substantially all" (defined in the new proposed regulations as 70%) use of the property must be within a QOZ.

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[11] As discussed at Part 2.a below, the 180-day period commences on December 31 in the case of (1) gains allocated to partners through partnerships on Schedules K-1 and (2) net Section 1231 gain.

[12] See discussion at Part 2.b below.

[13] See discussion at Part 3.c below.

[14] See discussion at Part 3.a below.

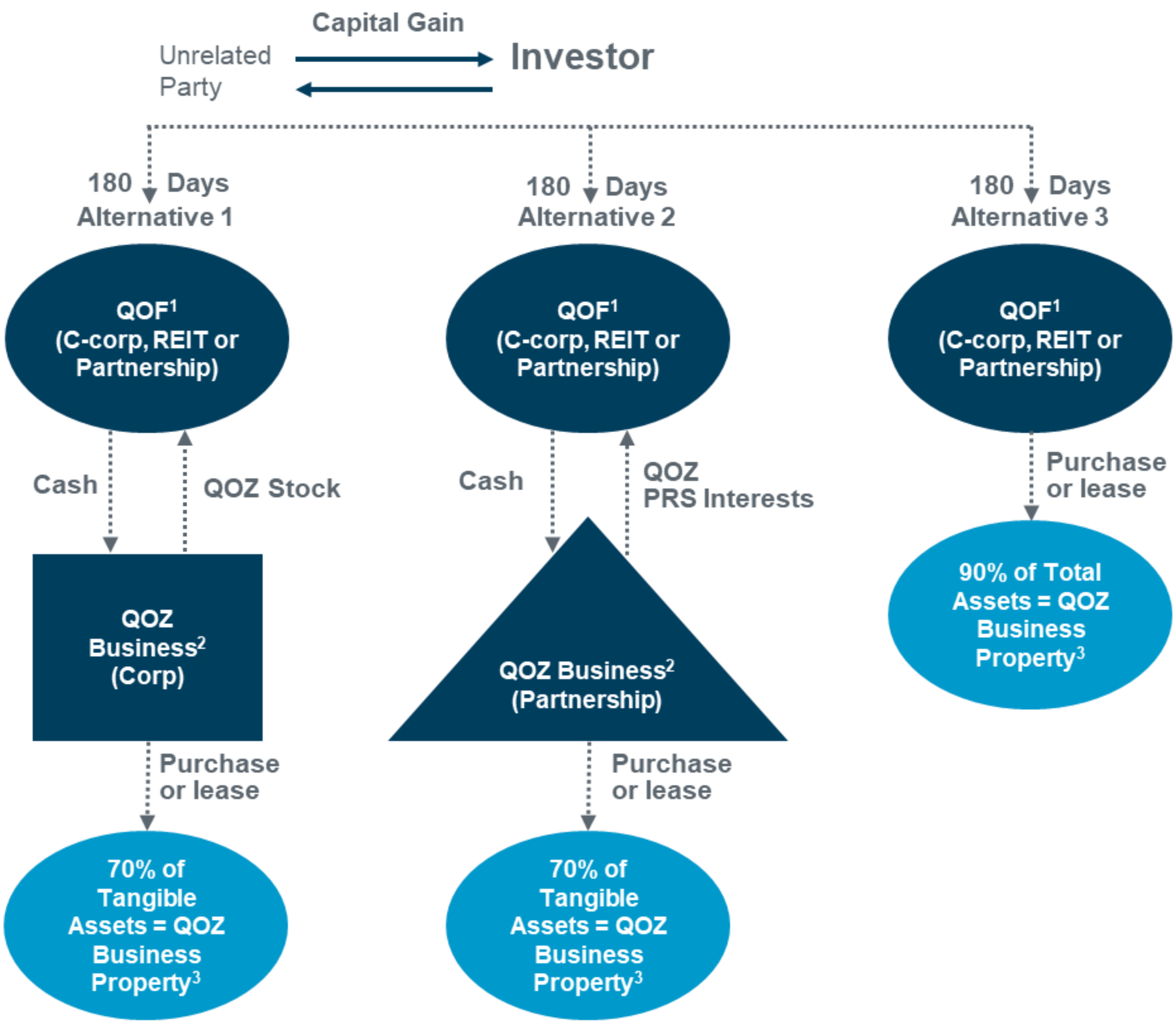
- ***QOZ businesses (or "QOZBs")*** must be (i) trades or businesses; (ii) "substantially all" (defined in the October proposed regulations as 70%) of the tangible assets of which are QOZ business property; (iii) at least 50% of the gross income of which is considered to be derived in the QOZ; (iv) a "substantial portion" (defined in the new proposed regulations as 40%) of the intangible properties of which are used in the active conduct of the business in the QOZ; (v) less than 5% of the unadjusted basis of assets of which are held in "nonqualified financial property"; and (vi) which are not engaged in certain excluded businesses (e.g., a golf course, country club, gambling facility, liquor store or massage parlor). Stock or partnership interests in QOZBs must be acquired solely for cash directly from a partnership or from a corporation at original issue.

c. Example

Assume that Investor A holds portfolio stock investments with a value of $100 and a tax basis of $10. If A sells the stock in 2019 and invests $90 in an equity interest in a QOF within 180 days beginning on the date of sale, A can defer recognizing its gain on the stock sale until 2026 and the gain it recognizes then will be equal to the excess of (x) the lesser of the deferred gain and the value of the QOF investment in 2026 over (y) A's basis in the QOF investment. A's basis in the QOF investment would initially be zero, but would be stepped up to $13.50 (15% of 90) by 2026 because A will have held its QOF investment for seven years as of 2026. A will thus recognize no more than $76.50 (85% of the $90 deferred gain) in 2026. Now assume that A sells the QOF investment in 2030 for $500. A's basis in the QOF investment will be stepped up to $500 immediately before the 2030 sale, and A will recognize no gain on its sale of the QOF investment. Under the new proposed regulations, these tax consequences to Investor A would not change even if, while Investor A held the QOF equity interest, the QOF sold its interest in its initial QOZ investment and purchased a new QOZ investment within 12 months of the sale.

Tax consequences arising at the QOF level would need to be considered separately. If the QOF is treated as a partnership for tax purposes, income and deductions will flow through to investors as in the case of any partnership investment, and the new 20% pass-through deduction may be available to investors if the requirements of those rules are satisfied. If the QOF is treated as a C corporation for tax purposes, the QOF will be subject to tax at the new 21% corporate tax rate, and distributions of earnings to investors will be taxable as dividend income, as in the case of any regular corporate investment. A corporation that elects to be treated as a REIT may also qualify as a QOF and ordinary dividends distributed by a REIT will also be eligible for the 20% pass-through deduction.

As discussed below, the new proposed regulations clarify important aspects of these rules. The diagram on the following page depicts the main QOF structural alternatives and related requirements.



[1]A **Qualified Opportunity Fund** ("QOF") is a corporation or partnership that is organized to invest in (and holds at least 90% of its assets in) QOZ Business Property or stock or partnership interests in a QOZ Business.

[2]A **Qualified Opportunity Zone Business** ("QOZ Business") generally is a trade or business that meets the following requirements:
- at least 70% of its tangible property (owned or leased) is QOZ Business Property;
- at least 40% of its intangible property is used in an active business in a qualified opportunity zone;
- at least 50% of its gross income is derived from the active conduct of such business in the qualified opportunity zone;
- less than 5% of the unadjusted basis of its assets are held in "nonqualified financial property" (excluding reasonable amounts of working capital); and
- it is not an excluded business (e.g., a golf course, country club, gambling facility, liquor store or massage parlor).

[3]**QOZ Business Property** means tangible property that meets the following requirements:
- it is used in a trade or business;
- it is acquired by "purchase" from an unrelated party or leased (with special rules applying to leased property) after 2017;
- in the case of property that is acquired by purchase, the original use of the property in a qualified opportunity zone commences with the QOF or QOZ Business or the QOF or QOZ Business substantially improves the property by more than doubling its adjusted tax basis over any 30-month period; and
- during 90% of the QOF's or QOZ Business's holding period, 70% of the use of the property is in a qualified opportunity zone.

Illustrative Timeline for an Investment of Capital Gain Recognized on December 31, 2018 in a Two-Tier QOF Structure

- **Dec. 31, 2018** Investor Recognizes Capital Gain
- **Jun. 28, 2019** Investor Invests Capital Gain in QOF
- **Oct. 15, 2019** Investor Makes Deferral Election on Return[1]
- **Nov. 30, 2019** First QOF Testing Date[2]
- **Dec. 31, 2019** Second QOF Testing Date[3]
- **Jul. 31, 2022** Working Capital Safe Harbor Expires[4]
- **Jun. 28, 2024** +10% Basis Step-Up[5]
- **Jun. 28, 2026** +5% Basis Step-Up[6]
- **Dec. 31, 2026** Investor Recognizes Deferred Eligible Gain[7]
- **Jun. 28, 2029 – Dec. 31, 2047** Investor May Make Election to Step Up Basis or Exclude Gain

[1] Assumes that Investor is an individual filing U.S. federal income tax return by the extended due date.
[2] Investor's cash may remain in the QOF as of the first QOF testing date.
[3] By the second QOF testing date, QOF must have invested at least 90% of Investor's cash into a QOZB; QOZB has 31 months to deploy the cash under a working capital plan.
[4] Investor's cash must be used to acquire property or make improvements by this date (unless due to government action) or it will constitute nonqualified financial property.
[5] Investor's basis in the QOF interest is increased by 10% of the originally deferred eligible gain.
[6] Investor's basis in the QOF interest is increased by an additional 5% of the originally deferred eligible gain.
[7] Gain recognized is (A) the lesser of originally deferred eligible gain or FMV of the investment over (B) Investor's basis (including the 15% step-up).

2. Investor Considerations

The discussion below addresses key investor considerations during three phases: when making QOF investments, while holding QOF investments, and when selling QOF investments.

a. Investor considerations: making QOF investments

- **Election**. Taxpayers can elect to defer "eligible gain" (as described below) that is reinvested in an "eligible interest" in a QOF within 180 days beginning on the date on which the eligible gain would otherwise be recognized. An eligible interest is an equity interest in a QOF, including preferred stock and a partnership interest with preferred or special allocations. The election is made on a Form 8949 that is attached to the taxpayer's tax return. Any taxpayer that recognizes gain for U.S. federal tax purposes may elect to defer eligible gain.
  - *No tracing*. Only an amount that coincides with the amount of the eligible gain is required to be reinvested, unlike Section[15] 1031 exchanges which require reinvestment of the actual sales proceeds and are subject to tracing rules.
  - *Gain only; not gross sales proceeds.* The required investment is limited to gain recognized, unlike Section 1031 exchanges which require reinvestment of gross sales proceeds.
  - *Qualifying investment.* Qualifying investments in a QOF can be received in exchange for contributions of cash or property, *but not services*, to the QOF. Only the amount that coincides with the eligible gain can be a qualifying investment eligible for the tax benefits offered by the QOZ regime. Additional rules apply when the amount invested exceeds the amount of eligible gain. See "—Mixed-funds investments" below.
  - *No disguised sales to partnership.* A contribution of property to a QOF must be characterized as an "investment" in the QOF. Thus, a contribution of property to a partnership that is treated as a "disguised sale" of the property to the partnership under Section 707 (or would be so treated if the rules under Section 707 were applied with certain modifications, as discussed under "—b. Investor considerations: holding QOF investments—Leveraged distributions by QOF partnerships—Modified disguised sale test") is not a qualifying investment.
  - *Secondary acquisitions permitted*. Under the new proposed regulations, a taxpayer may now make a qualifying investment by acquiring an eligible interest from a person other than the QOF rather than by contributing funds directly to a QOF.
  - *No indirect investment*. A taxpayer can elect to defer "eligible gain" only if it makes a direct purchase of a QOF interest. If a taxpayer makes an indirect purchase of a QOF interest by investing into an upper-tier feeder fund or other vehicle which then purchases the QOF interest, the taxpayer will not be able to elect to defer its "eligible gain" in respect of the indirectly purchased QOF interest. However, it is noteworthy that the new proposed regulations generally permit taxpayers to contribute a previously purchased QOF interest to a partnership in a Section 721 contribution without triggering an inclusion of the deferred gain. Thus, a taxpayer may elect to defer "eligible gain" by making a direct purchase of a QOF interest and may then contribute the QOF interest to a holding partnership even though the holding partnership could not itself acquire the QOF interest for the taxpayer.
  - *Partial or staggered deferral election*. A deferral election may be made with respect to some or all of the amount of eligible gain, and if an election is made with respect to only a

[15] "Section" references are to the Code unless otherwise indicated.

portion of eligible gain, a subsequent election may be made for other portions of eligible gain, provided the investment is made within the 180-day window.

- **Eligible gain**. Only "eligible gain" qualifies for the deferral election and exclusion benefits under the QOF rules. Eligible gain is capital gain that does not arise from a sale or exchange with a related person (defined as a person who has certain familial relationships or a 20% ownership relationship with an investor),
  - *Only net Section 1231 gain is eligible gain*. Gain from the sale of Section 1231 property to the extent it exceeds Section 1231 losses in a taxable year is eligible to be reinvested in a QOF.
  - *Gain realized upon the acquisition of a QOF interest is not eligible gain*. Taxpayers are not entitled to elect to defer gain realized upon the transfer of property to a QOF in exchange for an eligible interest.
  - *Depreciation recapture is not eligible gain*. Depreciation recapture on Section 1245 property (e.g., equipment) is treated as ordinary income and thus is not eligible gain for purposes of the QOF regime.
    - *Observation*. However, with respect to real property, unrecaptured Section 1250 gain (i.e., gain attributable to the straight-line depreciation of real property, which is subject to a special 25% tax rate) should qualify for the deferral election.
  - *Limitations on Section 1256 contracts and offsetting positions transactions*. Deferral of gain from Section 1256 contracts is limited to the net capital gain from all Section 1256 contracts for the tax year. Gain from a position that is or has been part of an "offsetting positions transaction" where risk of loss is substantially diminished is not eligible for deferral.
- **180-day period for investing eligible gain**. The 180-day period begins on the date that gain otherwise would have been required to be recognized by the taxpayer.
  - *Partnerships.* If gain is recognized by a partnership, the partnership itself may elect to defer eligible gain or may pass through the gain to its partners, which the partners can then elect to reinvest and defer. If the partnership does not elect deferral, a partner may make the election within 180 days beginning on the last day of the partnership's taxable year or, at the partner's election, 180 days from the recognition of the gain by the partnership. Partners in non-electing partnerships thus will often have significantly more than 180 days from the date of the partnership's recognition of the gain to reinvest gain recognized by the partnership. An analogous rule applies to S corporations.
  - *Section 1231 gain*. Because the net Section 1231 gain generally cannot be determined until the end of a taxable year, such net gain can be reinvested within a 180-day period beginning on the last day of the taxable year.
  - *RICs and REITS.* Capital gain dividends paid by a regulated investment company ("**RIC**") or real estate investment trust ("**REIT**") are includible when paid and the 180-day period begins on the date of payment. For undistributed capital gain retained by a RIC or REIT that is required to be included in income by the shareholders of the RIC or REIT, the 180-day period starts from the last day of the taxable year of the RIC or REIT.
- **No restrictions on using QOF investments as loan collateral**. The status of a QOF interest as a qualifying investment is generally not impaired by using the QOF interest as collateral for a loan, whether as part of a purchase-money borrowing or otherwise.
- **Tax basis in the QOF investment**. The taxpayer's initial tax basis in a QOF qualifying investment is zero (the "**zero basis rule**"). If the QOF is a partnership, the taxpayer's initial

zero basis in the QOF qualifying investment would be increased by its share of the liabilities of the QOF attributable to the qualifying investment.

- **Mixed-funds investments**. If a taxpayer invests an amount in excess of its eligible gain, including by contributing in a non-recognition transaction property that has a fair market value in excess of the property's adjusted basis, then the taxpayer is treated as having created a "mixed-funds investment," consisting of two separate investments: a qualifying investment and a nonqualifying investment. The nonqualifying investment is not eligible for any of the tax benefits offered by the QOZ regime.
  - *Contributed property*. When a taxpayer invests by contributing property to a QOF in a non-recognition transaction in exchange for an eligible interest, only the lesser of its adjusted basis in the QOF interest received (determined without regard to the zero-basis rule) and the fair market value of the QOF interest received is considered a qualifying investment in the QOF and any remainder is considered a nonqualifying investment. Special rules apply for purposes of determining tax basis in the case of contributed property as discussed immediately below.
  - *Basis in mixed-funds investment.* If a taxpayer is treated as holding a mixed-funds investment, the taxpayer's tax basis in the qualifying investment is equal to zero under the zero-basis rule, and its tax basis in the nonqualifying investment is equal to its tax basis in the mixed-funds investment as a whole reduced by the tax basis in the qualifying investment (determined without regard to the zero-basis rule). If the QOF is a partnership, the tax basis of each qualifying and nonqualifying investment is further increased by the share of the liabilities of the QOF attributable to such investment. The new proposed regulations provide special clarifications with respect to mixed-funds investments received in exchange for properties contributed to QOF partnerships. In that event, the tax basis in each of the qualifying investment and the nonqualifying investment is determined in the following manner: the net basis of the contributed property is first allocated to tax basis in the qualifying investment to the extent of the qualifying investment (which is in turn treated as zero) and the tax basis in the nonqualifying investment is the remaining net basis, if any, of the contributed property; the tax basis of each qualifying and nonqualifying investment is then increased by allocable partnership liabilities.
    - For example, if a taxpayer recognizes $100x of eligible gain and contributes property to a QOF that has a fair market value of $100x and a basis of $60x, the amount of the qualifying investment would be $60x and the amount of the nonqualifying investment would be $40x. The taxpayer's basis in its qualifying investment would be $60x absent the application of the zero-basis rule. Accordingly, the taxpayer's basis in its nonqualifying investment would be $0 ($60x basis in the contributed property, minus the $60x basis allocated to the qualifying investment before application of the zero-basis rule).
    - In the above example, if instead the taxpayer recognizes only $50x of eligible gain, the taxpayer would have $50x of qualifying investment with a basis of $50x (reduced to $0 by application of the zero-basis rule) and the taxpayer's basis in its nonqualifying investment of $50x would be $10.
  - *Allocation percentages*. If a taxpayer holds a mixed-funds investment consisting of a qualifying investment and a nonqualifying investment in a QOF that is a partnership, all allocations of income, gain, loss and deduction, all allocations of Section 752 liabilities, and all distributions made to the taxpayer are generally treated as made to the separate interests based on the "allocation percentages." With respect to capital interests in a

partnership, the allocation percentages are determined based on relative capital contributions.

- *Profits interest*. A partner who receives a QOF interest in exchange for rendering services will be treated as receiving a nonqualifying investment. If the partner also holds a capital interest in the partnership that is a qualifying investment, the allocation percentages with respect to the partner are based on (i) the highest share of residual profits the partner would receive with respect to the profits interest and (ii) with respect to the remaining interest, the relative capital contributions. The manner in which this rule will apply in practice is somewhat unclear.

    - For example, assume that each of Partner A and Partner B contributes $50x to a QOF partnership in exchange for a 50% percentage interest that is a qualifying investment. B is also an investment professional who renders investment management services to the QOF partnership. A and B will each receive an annual 10% preferred return on its capital contributions. To compensate B for the investment management services rendered to the QOF partnership, B will receive 20% of the profits of the QOF partnership after the preferred returns (including a "catch-up" provision), and A and B will each receive 50% of the remaining 80% of profits of the QOF partnership in respect of their capital contributions. B's profits interest is a nonqualifying investment and the highest share of residual profits with respect to the profits interest is 20%. Assume that the QOF partnership has $10x of income in year one and allocates $5x to each of A and B. Is the entire $5x allocated to B allocable to B's qualifying investment? Or is $1.67x allocable to B's nonqualifying investment (= $5x * 20% / (20%+40%)) and the remaining $3.33x is allocable to B's qualifying investment? The new proposed regulations do not seem to provide a clear answer.

- **Secondary acquisition of QOF interests**. Under the new proposed regulations, a taxpayer may make a qualifying investment in a QOF by acquiring an eligible interest in the QOF from a person other than the QOF. In that case, the amount of the taxpayer's qualifying investment is the amount of the cash, or the fair market value of the other property as determined immediately before the exchange, that the taxpayer exchanged for the eligible interest in the QOF. This rule will increase the liquidity of QOF investments. In addition, because this rule allows a QOF sponsor or investor to sell its interest in the QOF (whether or not such interest is a qualifying investment) before 2027 to investors with eligible gain, the QOF will have more flexibility with respect to timing of investor fundraising.

    - For example, assume that a sponsor A organizes a QOF with a plan to invest $100x in a QOZ property in 2019. However, in 2019, A has found investors with an aggregate eligible gain of only $50x. A does not have any eligible gain to invest. Nonetheless, A could make a $50x investment itself in the QOF to permit for the QOF to begin its operations and make the $100x investment in QOZ property in a timely manner. A's $50x investment could come from a variety of sources, including debt financing secured by a pledge of A's QOF interest. Assume that, in 2021, the QOZ property held by the QOF has appreciated to an estimated value of $500x so that the estimated value of A's QOF interest is $250x. Meanwhile, A finds B, an investor with $300x of eligible gain that is looking for long-term exposure to the QOZ property, and negotiates a sale of its QOF interest to B for $250x. B may elect to defer $250x of its gain because its QOF interest acquired from A is a qualifying investment in its hands.

b. Investor considerations: holding QOF investments

- **Tax basis in the QOF investment before disposition**. The taxpayer's initial tax basis in its QOF qualifying investment is zero.[16] The basis is stepped up by an amount equal to 10% of the deferred gain if the QOF qualifying investment is held for five years, and by an additional 5% if the QOF qualifying investment is held for seven years, before December 31, 2026.
  - *Multi-tier arrangements*. If a partnership or S corporation holds a QOF interest and has made a gain-deferral election, the 10% and 5% QOF basis adjustments are treated as tax-exempt income to the partnership or S corporation, which in turn increases their owners' tax bases in their interests in the partnership or S corporation. These adjustments will tier up with respect to any upper-tier pass-through entities.
- **Recognition of deferred gain at earlier of "inclusion event" or 2026**. A taxpayer's deferred gain initially invested in a QOF is generally recognized upon the earlier of an "inclusion event" and December 31, 2026, but the amount recognized is limited to the excess of (x) the lesser of the deferred gain and the then-current value of the QOF interest over (y) the taxpayer's basis in the QOF interest. The taxpayer's basis in the QOF interest is then increased by any amount so recognized.
  - *Inclusion events (acceleration of deferred gain)*. The new proposed regulations provide extensive guidance covering a wide range of transactions that could be considered "inclusion events" resulting in the recognition of deferred gain. Generally, an inclusion event occurs upon (i) a transfer of a qualifying investment (including a redemption) that reduces the taxpayer's equity interest in the qualifying investment, (ii) a transaction in which the taxpayer receives a distribution of property from a QOF in excess of the taxpayer's basis in the QOF interest (including basis attributable to its share of liabilities if the QOF is a partnership) and (iii) a claim by the taxpayer of a worthlessness deduction with respect to the qualifying investment. Other inclusion events include a transfer by gift of a qualifying investment, a dissolution of the QOF, an upper-tier transfer of an interest in a partnership that directly or indirectly holds a qualifying investment, a transfer resulting in an aggregate change in ownership of more than 25% of an S corporation that is the direct owner of a QOF interest, certain dividend-equivalent redemptions by QOFs that are corporations and certain non-recognition transactions involving corporations. There are also a number of important exceptions to inclusion events. For example, Section 721 contributions are generally not inclusion events, which may permit a taxpayer to consolidate its holdings of QOF investments under one umbrella partnership.
    - Assume that each of taxpayers A and B invests $50x of eligible gain in a QOF organized as a partnership in exchange for a qualifying investment. The QOF has no debt. Each of A and B has an initial basis of zero in its QOF interest. In the first year, the QOF has $10x of income (received in cash) and $10x of depreciation deductions, so the net income allocable to each of A and B is zero, and the basis of each of A and B in its QOF interest remains at zero before any distribution. The fair market value of the QOF's assets remains the same. At the end of the first year, the QOF distributes its cash: $5x to A and $5x to B. Because the cash distribution to each of A and B exceeds the partner's basis in its QOF interest, the distribution results in an inclusion event and each of A and B is required to recognize $5x of

[16] As noted above, the taxpayer's basis in a QOF partnership interest would be increased by allocable partnership liabilities.

deferred gain. Note that the recognition of deferred gain here is entirely caused by distributions of operating cash rather than a true reduction in the equity investment in the QOF.

- *Observation*. An inclusion event, by itself, does not create a mixed-funds investment, so an inclusion event should not preclude an investor from making a 10-year step-up election (discussed below) to exclude gain attributable to appreciation of a qualifying investment in a QOF.

– *Amount of deferred gain includible in income.* The amount of deferred gain required to be recognized on December 31, 2026 is (i) the lesser of (a) the amount of the deferred gain remaining as of such date and (b) the fair market value of the qualifying investment held on December 31, 2026 over (ii) the taxpayer's basis in the qualifying investment. Analogous rules apply for determining the amount of deferred gain included in gross income upon an inclusion event. Therefore, for example, if the value of the qualifying investment decreases as compared to the original investment, the amount of deferred gain required to be recognized on December 31, 2026 or upon an inclusion event is generally reduced as well. However, special rules apply in the case of certain types of inclusion events, which are primarily applicable to transactions involving QOFs that are corporations.

- For example, if a taxpayer invests $100x of eligible gain in 2019 in a QOF in exchange for a qualifying investment and there is no inclusion event with respect to the taxpayer prior to December 31, 2026, the taxpayer's tax basis in the qualifying investment will be $15x on December 31, 2026. If the fair market value of the qualifying investment is only $50x on December 31, 2026, the taxpayer will recognize only $35x of the original $100x deferred gain and the taxpayer's basis in the qualifying investment will increase to $50x. The amount of deferred gain not included in gross income as of December 31, 2026 will no longer be required to be recognized.

– *Attributes of original gain preserved*. Deferred gain retains its tax attributes when it is later included in income. Accordingly, for example, gain that was short-term capital gain with respect to which a QOF deferral election was made will be treated as short-term capital gain upon its later inclusion in income.

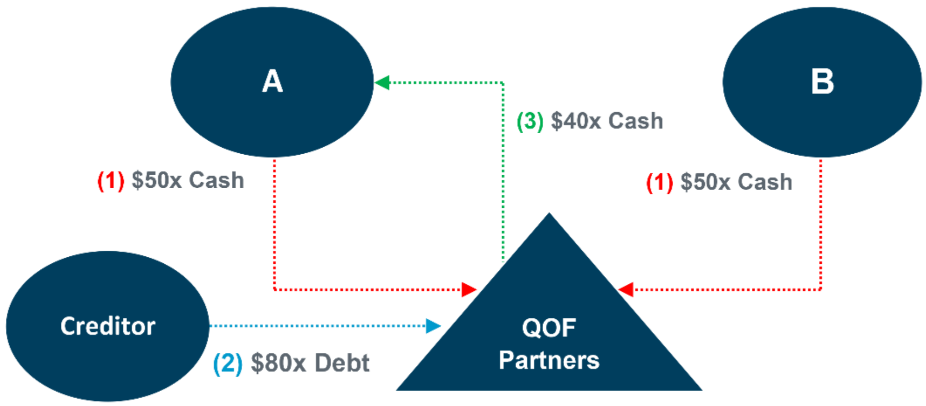
- **Rollover into another QOF**. If a taxpayer sells its entire investment in a QOF in, for example, 2025, and an amount coinciding with the amount of capital gain realized on the sale of the first QOF is invested within 180 days in a second QOF, the taxpayer may make another deferral election with respect to the capital gain realized on the sale of the first QOF and treat the newly acquired interest in the second QOF as a qualifying investment. Capital gain from the sale of a QOF investment is eligible for deferral only if the taxpayer's entire investment in the QOF is sold. The taxpayer's holding period for its qualifying investment in the second QOF begins on the date of its acquisition of the qualifying investment in the second QOF, and not on the date of its acquisition of the qualifying investment in the first QOF.

- **Dispositions of assets by a QOF**. Sales or dispositions of assets by a QOF have no impact on a QOF investor's holding period in its qualifying investment and on their own do not trigger the acceleration of deferred gain with respect to the QOF investment. However, if the QOF is a pass-through entity, the investor will be required to include in income its share of income or gain from a sale or other disposition of assets by the QOF if the investor has not held its qualifying investment in the QOF for at least 10 years at the time of the sale or disposition.

- **Leveraged distributions by QOF partnerships**. The new proposed regulations provide two important rules, as set forth below, governing leveraged distributions by QOF partnerships. The effect of these rules is such that, on the one hand, a leveraged distribution to a partner made in close proximity (e.g., within two years) of the partner's investment in the QOF partnership will likely disqualify all or a portion of the partner's QOF investment. On the other hand, to the extent a distribution occurs later (e.g., after two years) and is considered to be dependent on the entrepreneurial risk of the QOF partnership, a partner may receive the distribution (whether or not debt-financed) to the extent of the partner's outside basis (including debt) and not suffer adverse U.S. federal income tax consequences.
  - *Modified disguised sale test*. First, if a partner makes a contribution to a QOF partnership and the partnership makes a distribution to the partner, then the contribution and distribution are tested under a modified version of the disguised sale rules of Treasury Regulations Section 1.707-5(b) by treating any cash contributed as non-cash property that could potentially be subject to the disguised sale rules and treating the partner's share of liabilities of the QOF partnership as zero. To the extent the distribution would cause all or a portion of the initial contribution to be treated as a disguised sale, the amount of the partner's qualifying investment acquired in connection with the initial contribution will be reduced by the amount of the initial contribution so recharacterized.
  - *Distributions not exceeding outside basis (including debt)*. Second, if a distribution falls outside of the modified disguised sale test described above (e.g., generally outside the two-year window), such distribution would not reduce the qualifying investment or give rise to gain or other adverse U.S. federal income tax consequences to the partner unless the distribution exceeds the partner's outside basis in the QOF partnership interest, determined by including the partner's share of liabilities of the QOF partnership under Section 752(a). These rules are illustrated by the following examples.
    - *"Disguised sale" example*. Assume that each of two taxpayers, A and B, contributes $50x of eligible gain to a QOF partnership. After one year, pursuant to a prearranged plan, the partnership borrows $80x and distributes $40x to A. There are no items of income, gain, loss or deduction at the QOF partnership during the relevant period. The contribution and the distribution are tested under the disguised sale rules of Treasury Regulations Section 1.707-5(b) by treating the cash contributed as non-cash property and treating A's share of the liabilities as zero. A's qualified investment will be reduced by $40x (the portion of A's contribution recharacterized as a non-contribution under the modified disguised sale test), with the result that A's qualifying investment will be $10x and A will be able to defer only $10x of the $50x eligible gain in connection with the initial contribution.
    - *"No disguised sale" example*. Assume that the facts are the same as described above except that the distribution of $40x to A occurs more than two years after A made the initial contribution, and that there was no plan or circumstance suggesting that A would be entitled to such a distribution from the QOF partnership when A made the initial contribution. Because the distribution occurs more than two years after the contribution, the contribution is presumed not to be a disguised sale. Assuming that this presumption is not rebutted, A's qualifying investment in the QOF partnership will not be reduced by reason of the distribution so long as the distribution does not exceed A's basis in the qualifying investment. Assume that, under Section 752, the QOF partnership debt is allocated $40x to A and $40x to B. Thus, A's basis in its qualifying investment is $40x immediately before the distribution (the original zero basis with respect to the contribution, plus the $40x debt allocation). Because the distribution of $40x does not exceed A's basis of $40x, A can receive

$40x without triggering current U.S. federal income tax. A's qualifying investment in the QOF remains $50x and its basis in the QOF is zero after the distribution.

- The examples above are illustrated in the diagram below:



	Disguised sale	No disguised sale
A's net equity investment before distribution	$50x	$50x
A's net equity investment after distribution	$10x	$10x
A's qualified investment	$10x	$50x
A's recognized income or gain	$40x	$0

- **Consolidated return provisions**. The new proposed regulations provide that QOF stock is not treated as stock for purposes of Section 1504. Therefore, a QOF that is organized as a C corporation cannot be a subsidiary member of a consolidated group although it can be the common parent of a consolidated group for U.S. federal income tax purposes. In addition, the QOF tax incentives apply separately to each member of a consolidated group that invests in a QOF (e.g., the same entity must realize eligible gain and elect to defer the gain by investing in a QOF). Finally, the special basis adjustments applicable to qualifying investments held for five years, seven years, and at least 10 years (upon election at disposition) are treated as tax-exempt income to the QOF owner for which the consolidated return investment adjustment rules apply with respect to upper-tier members of the same consolidated group.

c. Investor considerations: exiting QOF investments

- **10-year step-up election available until December 31, 2047**. If a taxpayer holds a qualifying investment in a QOF for at least 10 years, the taxpayer can elect to step up the basis in the qualifying investment to its fair market value on the date the qualifying investment is sold or disposed of (a "**step-up election**"). If the qualifying investment is an interest in a QOF partnership, the new proposed regulations appear to clarify that the fair market value of the qualifying investment is the "gross" fair market value (i.e., including taxpayer's share of partnership debt allocable to the qualifying investment). The proposed regulations also provide that sales of qualifying investments in QOFs through the end of 2047 will be eligible for the step-up election regardless of whether the designation of qualified opportunity zone (expiring at the end of 2028) has expired at the time of the sale or disposition. It should be noted, however, that even though the proposed regulations generally permit pre-finalization reliance by taxpayers they do not permit such reliance in the case of the provisions relating to the 10-year step-up election.

- *Special rule for sale or disposition of partnership interests*. The new proposed regulations contain a favorable special rule applicable to a step-up election with respect to the sale or disposition of a QOF partnership interest that is intended to prevent a selling partner from recognizing ordinary income attributable to inventory or unrealized receivables of the QOF partnership pursuant to Section 751 and a corresponding capital loss. The mechanism to achieve this favorable result is such that, upon an election by the selling partner to step up its basis in the QOF partnership interest, the selling partner's share of the bases of the QOF partnership's assets, including inventory and unrealized receivables, are adjusted in a manner similar to a Section 743(b) adjustment that would be made if the selling partner had purchased its interest in the QOF partnership for cash equal to the fair market value of the interest immediately prior to the sale or exchange and a valid Section 754 election had been in effect.
- *Multi-tier arrangements*. With respect to a holder of a QOF interest that is itself a partnership or S corporation, the amount of basis adjustment pursuant to a step-up election is treated as tax-exempt income to the holder, which in turn increases the bases in the interests of such entity for its owners, and such adjustments tier up with respect to any upper-tier pass-through entities.

- **Dispositions of QOZ properties by QOFs that are partnerships, S corporations or REITs**. If a taxpayer has held a qualifying investment in a QOF partnership, QOF S corporation or QOF REIT for at least 10 years at the time of a disposition by the QOF of QOZ properties, the taxpayer may elect to exclude from income, or if the QOF interest is REIT stock, apply a 0% tax rate with respect to, any capital gain arising from such disposition. See below "3. Fund-Level Considerations—c. Fund-level considerations: disposition by a QOF of QOZ properties—Gain exclusion election for holders of QOF partnerships or QOF S corporations" and "3. Fund-Level Considerations—c. Fund-level considerations: disposition by a QOF of QOZ properties—Election for capital gain dividends from QOF REITs."
- **Mixed-funds investments and the 10-year step-up election**. The step-up election and the gain exclusion election may be made only with respect to QOF investments (or portions thereof) that are qualifying investments (i.e., investments as to which initial gain deferral elections were made and that are not subsequently disqualified). If a taxpayer holds a mixed-funds investment (because, for example, the taxpayer invested additional amounts in excess of eligible gain in QOF interests or received a profits interest in a QOF partnership for services rendered), the portion of the investment that is not a qualifying investment will not be eligible for the step-up election or the gain exclusion election.
- **Accounting for staggered sales of QOF interests**. If an investor holds identical interests in a QOF that were acquired at different times and then sells some but not all of these interests, a first-in, first-out method applies for determining which interests were sold for purposes of counting the holding period and for the character of gain to be included. If all of the interests an investor holds were purchased on the same day and they have different gain characteristics, then the determination is made on a pro-rata basis.

3. Fund-Level Considerations

The discussion below addresses key fund-level considerations at three phases: upon formation; during fund operations; and when the fund is exiting QOZ investments.

a. Fund-level considerations: QOF and QOZB formation

- **Organization**. A QOF can be any legal entity (newly formed or existing) classified for U.S. federal income tax purposes as a partnership or a corporation (including a REIT), whether or not it is a partnership or corporation in legal form. The QOF must be organized under the laws of a U.S. state, the District of Columbia, or a U.S. possession.[17]
  - *Self-certification*. An entity (newly formed or existing) aspiring to be a QOF must be organized for the purpose of investing in QOZ property and must self-certify as a QOF by filing IRS Form 8996[18] with its tax return for each taxable year. For its first QOF year, the entity can specify any month within the taxable year as the first month during which the entity became a QOF. A deferral election cannot be made with respect to an investment of eligible gain in an entity before the first QOF month designated by the entity in its self-certification.
    - *Observation*. Choosing the first month to specify has strategic timing implications because it starts the clock on satisfaction of the QOF requirements, including the 90% asset test and the substantial improvement test.
- **The 90% asset test**. A QOF is required to hold at least 90% of its assets in "QOZ property" (described below), determined by the average of the percentage of QOZ property held by the QOZ on (1) the last day of the first six-month period of the taxable year and (2) the last day of the taxable year (the "**90% Asset Test**").
  - *First QOF year*. For its first QOF year, the first testing date is the earlier of (i) the last day of the sixth month beginning with and including its first month as a QOF and (ii) the last day of the year. For example, if a calendar-year entity that was created in February chooses June as its first month as a QOF, then the 90% Asset Test testing dates for the QOF are November 30 and December 31. If the calendar-year QOF chooses a month after June as its first month as a QOF, then the first and only testing date for the taxable year is December 31.
  - *Six-month period to disregard recently contributed property*. In order to allow a QOF time to deploy newly contributed capital, the new proposed regulations provide that a QOF may elect to disregard for purposes of the 90% Asset Test any contributions of cash or property received in the six-month period preceding a testing day, as long as the contributed amount is held in cash, cash equivalents or debt instruments with a term of 18 months or less.
    - *Observation*. The potential benefits of this rule can vary greatly. If a contribution occurs on the day *before* a semi-annual testing date, then the QOF gets the benefit of the exclusion only for purposes of the next testing date, which is the day after the contribution. In this scenario, the QOF has six months and one day to use the contributed amounts in a manner that ensures its qualification under the 90% Asset Test. If instead the contribution occurs the day *after* a semi-annual testing date, the benefit of the exclusion stretches to the full six months because the QOF is permitted

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[17] Special rules apply in the case of QOFs organized under the laws of U.S. possessions.

[18] The Treasury Department has stated that it anticipates that possible revisions to the Form 8996 could be proposed for tax years 2019 and following. U.S. Department of the Treasury, "Request for Information on Data Collection and Tracking for Qualified Opportunity Zones," 84 FR 18648, Document Number 2019-08076, May 1, 2019, **https://www.federalregister.gov/documents/2019/05/01/2019-08076/request-for-information-on-data-collection-and-tracking-for-qualified-opportunity-zones**.

to disregard the contributed amounts for purposes of the next testing date. Thus, depending on the timing of contributions, the QOF may have from just over six months to close to an entire year from the date of the contribution to deploy the contributed amounts in a manner that ensures its qualification under the 90% Asset Test.

– *Failure to meet requirement*. For each month in which a QOF fails to satisfy the 90% Asset Test, the QOF is required to pay a penalty equal to the underpayment rate under the Code multiplied by the QOF's shortfall in the amount of qualifying assets needed to meet the 90% Asset Test.[19] A "reasonable cause" exception may be available to avoid imposition of this penalty.

- **QOZ property**. QOZ property includes "QOZ business property," "QOZ stock" and "QOZ partnership interests." QOZ stock and QOZ partnership interests are stock or partnership interests acquired by the QOF for cash from a corporation at original issue or from the issuing partnership, as the case may be, provided that such corporation or partnership is a QOZB at the time of such acquisition (or, in the case of a new entity, was organized for purposes of becoming a QOZB) and remains a QOZB for substantially all (defined in the new proposed regulations to mean at least 90%) of the QOF's holding period.

- **QOZB qualification**. A QOZB is a trade or business in which "substantially all," defined in the proposed regulations to mean at least 70%, of the tangible property owned or leased by the trade or business is "QOZ business property" (the "**70% Tangible Asset Test**") and certain other conditions are satisfied. Among the additional requirements for the trade or business are the following: (1) at least 50% of its gross income must be derived from the active conduct of a trade or business in a QOZ (the "**QOZB Gross Income Test**"), (2) a substantial portion of its intangible property (defined in the new proposed regulations to mean at least 40%) must be used in the active conduct of a trade or business in the QOZ (the "**QOZB Intangibles Requirement**") and (3) less than 5% of the aggregate unadjusted bases of its property must be attributable to nonqualified financial property (the "**QOZB Nonqualified Property Test**"). In addition, a QOZB cannot operate certain excluded businesses (e.g., a golf course, country club, gambling facility, liquor store or massage parlor). The QOZB qualification rules are discussed in more detail below under "—b. Fund-level considerations: Operating QOFs and QOZBs."

- **QOZ business property**. In general, QOZ business property is tangible property used in a trade or business that is acquired by a QOF or QOZB from an unrelated party by purchase after December 31, 2017, the original use of which commences with the QOF or QOZB ("**original use property**") or which is "substantially improved" by the QOF or QOZB ("**substantially improved property**"). In addition, during substantially all (defined in the new proposed regulations as 90%) of the QOF's or QOZB's holding period for the property, substantially all (defined in the new proposed regulations as 70%) of the use of such property must be considered to occur within a QOZ. New special rules relating to leased properties are discussed below. In this context, a related party with respect to a person includes certain family members of that person, any entity more than 20% of which is directly or indirectly owned by that person, and any entity that shares more than 20% common ownership with that person.

[19] The current IRS Form 8996 provides that the penalty is prorated for each month within a tax year.

– *Trade or business*. Trade or business for these purposes is defined by reference to Section 162. The new proposed regulations also provide a special rule clarifying that the ownership and operation (including leasing) of real property constitutes the active conduct of a trade or business for a QOZB. However, the new proposed regulations 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 precise scope of this rule is unclear.

  - *Observation*. The new proposed regulations do not define the term "triple-net lease" and describe the exception for triple-net leases rather narrowly ("merely entering into" "a" triple-net lease). Thus, the rule may not preclude an entity that enters into triple-net leases regularly from meeting the active trade or business test.

– *Original use*. The original use of property commences with a QOF or QOZB on the date on which the property is first placed in service in the QOZ in a manner that would allow depreciation or amortization deductions to be taken by its owner. Property previously used outside of a QOZ may qualify as original use property in the QOZ when first placed in service in the QOZ. Property previously used in a QOZ but that has been unused or abandoned for an uninterrupted period of five years may qualify as original use property in the same QOZ when placed in service again by a QOF or QOZB.

– *Substantial improvement*. Property is considered to be substantially improved if, during any 30-month period, the QOF or QOZB improves the property by more than doubling the adjusted basis of the property at the beginning of the 30-month period in the hands of the QOF or QOZB.

– *Asset-by-asset determination*. Under the proposed regulations, the original use and substantial improvement requirements are evaluated on an asset-by-asset basis. The Treasury Department and the IRS have requested comments regarding whether an aggregate approach may be more appropriate to provide desired flexibility and ease of administration.

– *Unimproved land*. Unimproved land cannot be original use property in the hands of a QOF or QOZB due to its permanent nature. The new proposed regulations provide, however, that unimproved land is not required to be substantially improved. Therefore, in order for unimproved land in a QOZ to qualify as QOZ business property, it is only required that the land be used in a trade or business, subject to a broad anti-abuse rule.

  - For example, if a QOZB purchases land with a preexisting used building located within a QOZ, substantial improvement to the property purchased by the QOZB is measured by the QOZB's additions to the portion of the adjusted basis that is allocable to the building. The QOZB does not need to separately substantially improve the land on which the building is located.

– *Leases and leased property*. The new proposed regulations provide much needed guidance regarding the treatment of leases and leased property under the QOZ regime. In general, leased tangible property taken into account for purposes of the asset tests is ***not*** required to be acquired by purchase by, or to be original use property or substantially improved property in the hands of, a QOF or QOZB, but certain alternative requirements discussed below may apply. Moreover, as noted above, a lessor of real property under a triple-net lease will need to evaluate whether it can satisfy the trade or business requirement.

  - *Requirements applicable to all leases*. In general, if a QOF or QOZB leases tangible property from an unrelated party and uses it in a trade or business in a QOZ, the leased tangible property will be considered qualifying property if (a) it is acquired under a lease entered into after December 31, 2017, (b) the lease reflects arms-length terms, and (c) in the case of real property, the lease does not provide a purchase option at, and that there is no plan, intent or expectation that the property will be acquired by the lessee at, a price other than the fair market value of the real property at the time of purchase.

- *Additional requirements applicable to related party leases*. If a QOF or QOZB leases tangible property from *a related party*, in addition to the requirements described above, (d) the lease may not provide for more than 12 months of prepaid rent and (e) if the leased tangible property is *personal* property (as opposed to real property) and the original use of the property does not commence with the lessee (determined by treating the lessee as if it were the owner), the lessee must become the owner of other QOZ business property used in substantially overlapping QOZ(s) of a value that is not less than the value of leased tangible personal property within 30 months (or, if shorter, the term of the lease) of acquiring possession of the leased property. The latter requirement is analogous to the "substantial improvement" requirement applicable to owned property.
- *Observations*.
  - Property located within a QOZ cannot be qualifying property to a QOF or QOZB if the QOF or QOZB ***acquires ownership*** of the property from a related party. However, it is generally possible for a QOF or QOZB to lease property from such a related party and satisfy the requirements for treating the leased property as qualifying property. Moreover, if the leased property is real (as opposed to personal) property, a related-party lessee is not required to make the additional investments described in clause (e) immediately above.
  - In addition, with respect to personal property previously used in a QOZ for which substantial improvement would be difficult or inefficient (such as previously used manufacturing equipment), it would not make sense for a QOF or QOZB to acquire and own such used personal property because owned property needs to be either original use property or substantially improved property in order to qualify. In such a scenario, leasing the used personal property would solve the dilemma because property acquired under a lease is not required to be original use property or substantially improved property. Even when the lease is entered into with a related party, the lessee could qualify used personal property by acquiring other qualifying property of more than equal value, which may be much easier to do than more than doubling the adjusted basis of such used personal property.

b. Fund-level considerations: Operating QOFs and QOZBs

- **Ongoing certification**. As described above, an eligible entity must meet the semi-annual 90% Asset Test in order to qualify for treatment as a QOF.
- **QOZB qualification**. As described above, in addition to the 70% Tangible Asset Test, for each taxable year, a QOZB must satisfy (1) the QOZB Gross Income Test, (2) the QOZB Intangibles Requirement and (3) the QOZB Nonqualified Property Test.

– *QOZB Gross Income Test*. Because the QOZB Gross Income Test requires that 50% of a QOZB's gross income be derived from the active conduct of a trade or business ***in*** the *QOZ*, the source and location of the income requirement of this test would present a challenge to many QOZBs without a bright-line rule. The new proposed regulations provide three favorable safe harbors and a facts and circumstances test to determine whether a QOZB satisfies the QOZB Gross Income Test. Notably, because in many circumstances the determination of the location of income can be complex and burdensome, none of the safe harbors is based on the location of sales of a QOZB's products or services. Instead, the safe harbors focus on measuring the location of labor and tangible property in an effort to reduce the compliance and administrative burden of demonstrating satisfaction of the requirement.

- *Employee hours*. If at least 50% of the services performed (based on hours) by the employees and independent contractors of the QOZB are performed within the QOZ, the QOZB will satisfy the QOZB Gross Income Test.
- *Compensation*. If at least 50% of the amounts paid by a QOZB for services performed by its employees and independent contractors (and employees of independent contractors) are for services performed in the QOZ, the QOZB will satisfy the QOZB Gross Income Test.
- *Property and management*. If (1) the tangible property of the business that is in a QOZ and (2) the management or operational functions performed for the QOZB in the QOZ are necessary to generate 50% of the gross income of the business, the QOZB will satisfy the Gross Income Test.
- *Observation*. The safe harbors provide much-needed clarity to intellectual property-focused businesses that aspire to qualify as QOZBs. Ultimately, if a business establishes its headquarters and maintains meaningful core assets and/or a campus with adequate employees in a QOZ, regardless of where its sales or users are located, it can satisfy the QOZB Gross Income Test.

– *QOZB Intangibles Requirement*. Under the new proposed regulations, a QOZB will satisfy the QOZB Intangibles Requirement if at least 40% of the QOZB's intangible property is "used" in the active conduct of a trade or business in the QOZ.

  - *Observation*. The new proposed regulations do not offer clear guidance as to where intangible property is considered to be "used."

– *QOZB Nonqualified Property Test*. A QOZB needs to hold less than 5% of the unadjusted basis of its assets in nonqualified financial property. Nonqualified financial property includes debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities and other similar property, but does not include reasonable amounts of working capital held in cash, cash equivalents or debt instruments with a term of 18 months or less.

  - *Working capital safe harbor*. The proposed regulations treat working capital assets as "reasonable" for this purpose if (i) there is a written plan that identifies the assets as held for the development of a trade or business, including the acquisition, construction or substantial improvement of tangible property in the QOZ, (ii) there is a written schedule, consistent with the ordinary business operations of the QOZB, providing for use of the working capital assets within 31 months of receipt, and (iii) the working capital assets are actually used in a manner that is substantially consistent with the schedule.
  - *Delay due to government action*. The working capital safe harbor is not violated if a delay in deploying the working capital assets within the 31-month period is

attributable to waiting for government action the application for which is completed during the 31-month period.

- *Restriction on QOZB holding interests in other entities*. Because nonqualified financial property includes stock and partnership interests and there is no look-through rule in respect of stock or partnership interests, the rules appear to preclude QOZBs from owning interests in lower-tier partnerships or corporations and to permit QOZBs to own interests only in wholly-owned entities that are treated as disregarded entities for U.S. federal income tax purposes.

- **Valuation**. The new proposed regulations provide that the value of each asset for purposes of the 90% Asset Test at the QOF level and for purposes of the 70% Tangible Asset Test at the QOZB level is the value that is reported on the relevant entity's "applicable financial statement," if there is one available, for the relevant reporting period or, alternatively, the value determined under a prescribed alternative valuation method. The value is measured on an annual basis, and the QOF or QOZB must apply the valuation method it selects consistently to all assets valued with respect to the taxable year.

  – *Annual valuation*. Even though not explicit in the new proposed regulations, it appears that a QOF or QOZB that is eligible to use both valuation methods in a taxable year may select a valuation method regardless of the valuation method it used in a prior year so long as it applies the chosen valuation method consistently to all assets for that taxable year.

  – *Applicable financial statement*. An applicable financial statement is generally the financial statement filed publicly with the Securities and Exchange Commission or with another federal agency other than the IRS or, in the case of a privately held entity that does not file with any federal agency, a certified audited financial statement that is prepared in accordance with U.S. generally accepted accounting principles ("**GAAP**") and that is provided to creditors for purposes of making lending decisions, provided to equity holders for purposes of evaluating their investment, or provided for other substantial non-tax purposes. With respect to a QOF or QOZB that leases tangible property, an applicable financial statement must assign value to the lease of the tangible property.

  – *Alternative valuation method*. Under the alternative valuation method, the value of property is generally the unadjusted cost basis of the property. With respect to tangible property leased by a QOZB, the value is equal to the sum of the present value of each payment under the lease for such tangible property discounted at the applicable federal rate for debt instruments of a similar term. This present value is calculated at the time the QOZB enters into the lease and does not change over the term of the lease when used for any testing date subsequent to the inception of the lease.

    - *Observation*. Because the applicable financial statement method looks at the value of property for the relevant reporting period, the value of any property that is depreciated or amortized under GAAP rules will decline over time. By contrast, the value of property under the alternative valuation method may remain constant for purposes of the 90% Asset Test and the 70% Tangible Asset Test. The alternative valuation method could be simpler and easier to monitor in this respect and provide a QOF or a QOZB greater certainty with respect to its qualification under the applicable asset test. In the case of leases, the discount rate used to calculate the present value of the leased asset (i.e., the applicable federal rate) is likely different from the discount rate used for GAAP purposes, which would result in a different initial valuation of the leased asset.

c. Fund-level considerations: disposition by a QOF of QOZ properties

- **Sales of QOZ properties; 12-month reinvesting period**. QOFs are permitted to dispose of QOZ property without affecting QOF investors' eligibility for tax benefits or their holding period in the QOF investment, but such dispositions are fully taxable to the QOF or, if the QOF is a pass-through entity, to its investors. Congress contemplated that a QOF would have a reasonable period of time to reinvest the proceeds from a sale of a QOZ property, and because of concern that a QOF could fail the semi-annual 90% Asset Test on a testing date by reason of sales or dispositions of QOZ property, the new proposed regulations establish a bright-line 12-month period in which a QOF can reinvest proceeds into other QOZ property without implicating its QOF qualification. Proceeds from the return of capital, or the sale or disposition, of QOZ property are treated as QOZ property for purposes of the 90% Asset Test so long as the QOF reinvests such proceeds during the 12-month period following the date of the relevant transaction, but only to the extent that the proceeds are held in cash, cash equivalents or debt instruments with a life of 18 months or less until they are reinvested.
  - *Income recognition*. Although commenters requested that Treasury exempt QOFs (and owners of pass-through QOFs) from income tax on the sale or disposition of QOZ property itself if the proceeds were reinvested into other QOZ property, Treasury determined that such an exemption was beyond its authority under the statute. However, if at the time of the sale or disposition of QOZ property by a QOF organized as a partnership, S corporation or REIT, the QOF investor has held its QOF investment for at least 10 years, the QOF investor may be able to exclude from gross income capital gain attributable to such sale or disposition as described further below.
    - *Delay due to government action*. The new proposed regulations provide relief to QOFs that fail to satisfy the 90% Asset Test because of a delay in reinvesting proceeds from the sale of QOZ property within the 12-month period if the delay is attributable to government action the application for which was complete during the relevant period.
- **Gain exclusion election for holders of QOF partnerships or QOF S corporations**. If a taxpayer has held a qualifying investment in a QOF partnership or QOF S corporation for at least 10 years, the taxpayer may make an election (a "**gain exclusion election**") to exclude from gross income some or all of the capital gain reported to the taxpayer on Schedule K-1 to the extent the capital gain (i) arises from a sale or disposition of QOZ property by the QOF partnership or QOF S corporation after the taxpayer has satisfied the 10-year holding period requirement for its interest in the QOF (regardless of the QOF's holding period in the QOZ property sold or disposed of) and (ii) is attributable to the taxpayer's qualifying investment. As noted above, however, even though the proposed regulations generally permit pre-finalization reliance by taxpayers, they do not permit such reliance in respect of the gain exclusion election described above.
  - *Election procedures*. The taxpayer must make the election for the taxable year in which the capital gain recognized by the QOF partnership or QOF S corporation would be included in the taxpayer's gross income. The proposed regulations do not specify the applicable form or procedures for making this election or whether there is any consistency requirement across different QOF investments of the same taxpayer within the same taxable year or across different taxable years of the same taxpayer with respect to the same QOF investment.
  - *Exclusion of capital gain*. To the extent that the Schedule K-1 of the QOF partnership or QOF S corporation separately states the capital gain arising from the sale or disposition of *any particular* QOZ property, the taxpayer may make the gain exclusion election with

respect such separately stated item of capital gain. This rule seems to suggest that the taxpayer may be able to exclude capital gain attributable to a particular QOZ property so long as the capital gain is separately stated, even if the QOF recognized capital losses from other QOZ property or non-QOZ property in the same taxable year. However, if the QOZ property is Section 1231 trade or business property, the gain exclusion election applies only to the extent of the net Section 1231 gain reported on Schedule K-1 of the QOF partnership or QOF S corporation.

– *Mixed-funds investments*. If the taxpayer has a mixed-funds investment in a QOF, only the allocation percentage of such capital gain attributable to the qualifying investment would be eligible for exclusion. See discussion above under "2. Investor Considerations—a. Investor considerations: making QOF investments—Mixed-Funds Investment."

– *Multi-tier arrangements*. With respect to a holder of a QOF partnership interest or QOF S corporation stock that is itself a partnership or S corporation, any excluded amount of capital gain is treated as tax-exempt income to the holder that increases the bases in the interests of such entity for its owners, and such adjustments tier up with respect to any upper-tier pass-through entities.

– *Observations*.

  - Because of the gain exclusion election, an investor that has held a qualifying investment in a QOF partnership or QOF S corporation for at least 10 years is not required to dispose of its QOF partnership interest or QOF S corporation stock in order to get the benefit of the 10-year exclusion from U.S. federal income taxation of post-investment appreciation gain. Thus, the gain exclusion election provides flexibility to investors regarding exit options and therefore makes it practicable for a QOF that is organized as a partnership or S corporation to hold more than a single QOZ investment project.

  - However, the gain exclusion election does not provide complete flexibility with respect to asset sales by the QOF because, while the election applies to a disposition of QOZ property by a QOF treated as either a partnership or an S corporation, it does not appear to apply to a disposition of QOZ business property by a lower-tier QOZB partnership or S corporation. Therefore, it may be advisable for a QOF partnership or QOF S corporation to organize its lower-tier QOZBs as, or invest in, single-investment QOZBs so that the QOF can dispose of its investments one QOZB at a time in order for the owners of the QOF to make the gain exclusion elections.

  - In addition, the gain exclusion election is not a perfect substitute for the step-up election in connection with a sale or disposition because it applies only to capital gain recognized by the QOF partnership or QOF S corporation and not to any ordinary income recognized by the entity (e.g., from sales of inventory, unrealized receivables or from depreciation recapture). In contrast, as discussed above, upon a step-up election in connection with a sale of a QOF partnership interest, the basis of the QOF partnership interest is stepped up to its gross fair market value and the basis of the QOF partnership's assets (including inventory, unrealized receivables and depreciated equipment) is also treated as stepped up to fair market value immediately before the sale so that the election will eliminate the transferor partner's entire income or gain attributable to its interest in the QOF partnership, including its indirect interest in the QOF partnership's ordinary-income-generating assets.

  - For example, assume that taxpayer A invested eligible gain in QOF partnership P in exchange for a qualifying investment in 2019. At the end of 2030, A's investment in the QOF partnership interest has an outside basis of $100x and corresponds to a share of the QOF partnership's QOZ properties consisting of assets with a fair market value of $200x and inside basis of $100x, the sale of which would give rise to capital gain, and other assets with a fair market value of $100x and inside basis of $0, the sale of which would give rise to ordinary income. Assume further that P has no outstanding indebtedness. If P sells an undivided 50% interest in all of its assets, it will allocate $50x of capital gain and $50x of ordinary income to A. In that case, A will be able to make an election to exclude $50x of capital gain but will be required to recognize $50x of ordinary income. However, if A sells half of its qualifying investment in P for $150x and makes the step-up election, A will recognize no gain or income from the sale.

- **Election for capital gain dividends from QOF REITs**. If a shareholder of a QOF REIT receives a capital gain dividend from the QOF REIT that the REIT identifies with a date, as described below, then the shareholder may treat the capital gain dividend as gain from the sale or exchange of a qualifying investment in the QOF REIT on the identified date, and, if on such date the shareholder has held a qualifying investment in the QOF REIT for at least 10 years, the shareholder may apply a 0% tax rate to the capital gain dividend. The total amount a QOF REIT may designate as a capital gain dividend for any taxable year is determined under the normal REIT rules and may therefore not exceed the QOF REIT's net capital gain (i.e., the excess of net long-term capital gains over net short-term capital losses) for the taxable year as determined under the REIT rules. However, even though the proposed regulations generally permit pre-finalization reliance by taxpayers, taxpayers are not entitled to rely on the proposed regulations relating to QOF REIT capital gain dividends described above.
  - *Identify the date*. A QOF REIT cannot identify any date for any capital gain dividend for the purpose of applying the 0% tax rate if the QOF REIT realized no *long-term* capital gain on any sale or exchange of *QOZ property* during the taxable year. If a QOF REIT realized long-term capital gain on one or more sales or exchanges of QOZ property, then the QOF REIT may apply a simplified determination and identify the first day of the taxable year as the date identified with respect to all capital gain dividends for that taxable year. The QOF REIT may also identify one or more actual disposition dates of QOZ property, but the amount of capital gain dividends associated with an actual disposition date must not exceed the aggregate long-term capital gain realized on that date from sales or exchanges of QOZ property.
  - *Retained capital gains*. Capital gains retained by the QOF REIT that a shareholder of the QOF REIT is required to include in income as long-term capital gain under the normal REIT rules are treated as capital gain dividends received by the shareholder for this purpose and may be identified by the QOF REIT with a date for purposes of these rules.
  - *Observations*.
    - Because there is no requirement that the capital gain designated by the QOF REIT be derived from a sale or exchange of QOZ property held directly by the QOF REIT, the 0% tax rate may apply to capital gain realized indirectly by the QOF REIT (e.g., from a partnership that is a QOZB of the QOF REIT) and properly designated as a capital gain dividend identified with a date.
    - In contrast with capital gains allocated from a QOF partnership or QOF S corporation and capital gain dividends paid by a QOF REIT, the new proposed regulations do not contain a similar gain exclusion election or 0% tax rate treatment with respect to

capital gains realized (or distributions attributable thereto) by a QOF C corporation that is not a REIT.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Po Sit	**212 450 4571**	**po.sit@davispolk.com**
Mary Conway	**212 450 4959**	**mary.conway@davispolk.com**
David Schnabel	**212 450 4910**	**david.schnabel@davispolk.com**
Patrick Sigmon	**212 450 4814**	**patrick.sigmon@davispolk.com**
Rachel D. Kleinberg	**650 752 2054**	**rachel.kleinberg@davispolk.com**
Leslie Altus	**212 450 4008**	**leslie.altus@davispolk.com**
Dao Fu	**212 450 4079**	**dao.fu@davispolk.com**
Elina Khodorkovsky	**212 450 3267**	**elina.khodorkovsky@davispolk.com**
Liang Zhang	**212 450 3431**	**liang.zhang@davispolk.com**
Joseph M. Gerstel	**212 450 3504**	**joseph.gerstel@davispolk.com**