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T.D. 9889

Investing in Qualified Opportunity Funds

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations governing the extent to which taxpayers may elect the Federal income tax benefits provided by section 1400Z-2 of the Internal Revenue Code (Code) with respect to certain equity interests in a qualified opportunity fund (QOF). The final regulations address the comments received in response to the two notices of proposed rulemaking issued under section 1400Z-2 and provide additional guidance for taxpayers eligible to elect to temporarily defer the inclusion in gross income of certain gains if corresponding amounts are invested in certain equity interests in QOFs, as well as guidance on the ability of such taxpayers to exclude from gross income additional gain recognized after holding those equity interests for at least 10 years. The final regulations also address various requirements that must be met for an entity to qualify as a QOF, including requirements that must be met for an entity to qualify as a qualified opportunity zone business. The final regulations affect entities that self-certify as QOFs and eligible taxpayers that make investments, whether qualifying or non-qualifying, in such entities.

DATES:

Effective date: The final regulations contained in this document are effective on March 13, 2020.

Applicability dates: See SUPPLEMENTARY INFORMATION.

FOR FURTHER INFORMATION CONTACT: Concerning section 1400Z-2 and these regulations generally, Alfred H. Bae, (202) 317-7006, or Kyle C. Griffin, (202) 317-4718, of the Office of Associate Chief Counsel (Income Tax and Accounting); concerning issues related to C corporations and consolidated groups, Jeremy Aron-Dine, (202) 317-6848, or Sarah Hoyt, (202) 317-5024, of the Office of Associate Chief Counsel (Corporate); concerning issues related to gains from financial contracts, REITs, or RICs, Andrea Hoffenson or Pamela Lew, (202) 317-7053, of the Office of Associate Chief Counsel (Financial Institutions and Products); concerning issues related to investments by foreign persons, Eric Florenz, (202) 317-6941, or Milton Cahn (202) 317-6937, of the Office of Associate Chief Counsel (International); concerning issues related to partnerships, S corporations or trusts, Marla Borkson, Sonia Kothari, or Vishal Amin, at (202) 317-6850, and concerning issues related to estates and gifts, Leslie Finlow or Lorraine Gardner, at (202) 317-6859, of the Office of Associate Chief Counsel (Passthroughs and Special Industries). These numbers are not toll-free numbers.

SUPPLEMENTARY INFORMATION:

Background

This document amends the Income Tax Regulations (26 CFR part 1) by adding final regulations under section 1400Z-2 of the Code. Section 13823 of Public Law 115-97, 131 Stat. 2054 (December 22, 2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA), added sections 1400Z-1 and 1400Z-2 to the Code. Section 1400Z-1 addresses the designation of population census tracts located in the 50 states, U.S. territories, and the District of Columbia as qualified opportunity zones (QOZs). See Notice 2018-48, 2018-28 I.R.B. 9, and Notice 2019-42, 2019-29 I.R.B. 352, for the list of population census tracts designated as QOZs (each, a QOZ designation notice).

Section 1400Z-2 provides two main Federal income tax benefits to eligible taxpayers that make longer-term investments of new capital in one or more designated QOZs through QOFs and qualified opportunity zone businesses. The first main Federal income tax benefit provided by section 1400Z-2 is the ability of an eligible taxpayer, upon the making of a valid election, to defer until as late as December 31, 2026, the inclusion in gross income of certain gains that would otherwise be recognized in a taxable year if the taxpayer invests a corresponding amount of such gain in a qualifying investment in a QOF within a 180-day statutory period. The eligible taxpayer may potentially exclude 10 percent of such deferred gain from gross income if the eligible taxpayer holds the qualifying investment in the QOF for at least five years. See section 1400Z-2(b)(2)(B)(iii). An additional five percent of such gain may potentially be excluded from gross income if the eligible taxpayer holds that qualifying investment for at least seven years. See section 1400Z-2(b)(2)(B)(iv). The second main Federal income tax benefit provided by section 1400Z-2 is the ability for the eligible taxpayer, upon the making of a separate valid election, to exclude from gross income any appreciation on the eligible taxpayer's qualifying investment in the QOF if the eligible taxpayer holds the qualifying investment for at least 10 years. See section 1400Z-2(c).

On October 29, 2018, the Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking (REG-115420-18) in the Federal Register (83 FR 54279) containing a first set of proposed regulations under section 1400Z-2 (October 2018 proposed regulations). The October 2018 proposed regulations addressed the type of gain that is eligible for deferral by eligible taxpayers, the timing by which eligible taxpayers must invest amounts in QOFs corresponding to the gains to be deferred, and the manner in which eligible taxpayers could make deferral elections of any gains. The October 2018 proposed regulations also provided rules for the self-certification of QOFs, valuation of QOF assets, and general guidance on the requirements for a corporation or partnership to be a qualified opportunity zone business, including providing that the term "substantially all" as used in section 1400Z-2(d)(3)(A)(i) means at least 70 percent. The Treasury Department and the IRS received 180 written and electronic comments responding to the October 2018 proposed regulations. A public hearing on the October 2018 proposed regulations was held on February 14, 2019.

A second notice of proposed rulemaking (REG-120186-18) was published in the Federal Register (84 FR 18652) on May 1, 2019, containing additional proposed regulations under section 1400Z-2 (May 2019 proposed regulations). The May 2019 proposed regulations updated

portions of the October 2018 proposed regulations to address various issues, including: The definition of the term "substantially all" in each of the various places the term appears in section 1400Z-2; transactions resulting in the inclusion under section 1400Z-2(a)(1)(B) and (b) of eligible gain that an eligible taxpayer elected to defer under section 1400Z-2(a); the treatment of leased property used by a QOF or qualified opportunity zone business; the use of qualified opportunity zone business property in the QOZ; the sourcing of gross income to the qualified opportunity zone business; and the "reasonable period" for a QOF to reinvest proceeds from the sale of qualifying assets without paying the penalty imposed by section 1400Z-2(f)(1). The Treasury Department and the IRS received 127 written and electronic comments responding to the May 2019 proposed regulations. A public hearing on the May 2019 proposed regulations was held on July 9, 2019.

The October 2018 proposed regulations and the May 2019 proposed regulations are collectively referred to in this Treasury decision as the "proposed regulations." All comments received on the proposed regulations are available at www.regulations.gov or upon request.

The preamble to the May 2019 proposed regulations stated that the Treasury Department and the IRS would schedule tribal consultation with officials of governments of Federally recognized Indian tribes (Indian tribal governments) before finalizing the proposed regulations to obtain additional input, within the meaning of the Treasury Department's Tribal Consultation Policy (80 FR 57434, September 23, 2015), in accordance with Executive Order 13175, "Consultation and Coordination with Indian tribal governments" (65 FR 67249, November 6, 2000), on the ability of entities organized under the law of an Indian tribe to be QOFs or qualified opportunity zone businesses, whether any additional guidance may be needed regarding the ability of QOFs or qualified opportunity zone businesses to lease tribal government Federal trust lands or leased real property located on such lands, and any other tribal implications of the proposed regulations. This tribal consultation took place via telephone on October 21, 2019 (Consultation) (see part VI. of the Special Analyses for additional discussion).

After full consideration of all comments received on the proposed regulations, including comments received from the Consultation, and the testimony heard at both public hearings, this Treasury decision adopts the proposed regulations with modifications in response to such comments and testimony, as described in the Summary of Comments and Explanation of Revisions following this Background.

For dates of applicability, see §§ 1.1400Z2(a)-1, 1.1400Z2(b)-1, 1.1400Z2(c)-1, 1.1400Z2(d)-1, 1.1400Z2(d)-2, 1.1400Z2(f)-1, 1.1502-14Z, and 1.1504-3 set forth in this document, which provide that the final regulations set forth in §§ 1.1400Z2(a)-1 through 1.1400Z2(d)-2, 1.1400Z2(f)-1, 1.1502-14Z, and 1.1504-3 are generally applicable for taxable years beginning after March 13, 2020. With respect to the portion of a taxpayer's first taxable year ending after December 21, 2017 that began on December 22, 2017, and for taxable years beginning after December 21, 2017, and on or before March 13, 2020, taxpayers may choose either (1) to apply the final regulations set forth in §§ 1.1400Z2(a)-1 through 1.1400Z2(d)-2, 1.1400Z2(f)-1, 1.1502-14Z, and 1.1504-3 contained in this document, if applied in a consistent manner for all such taxable years, or (2) to rely on each section of proposed §§ 1.1400Z2(a)-1 through 1.1400Z2(g)-1, except for proposed § 1.1400Z2(c)-1, contained in the notice of proposed rulemaking documents published on October 29, 2018, and on May 1, 2019, in the Federal Register (83 FR 54279; 84 FR 18652), but only if relied upon in a consistent manner for all such

taxable years. Taxpayers relying on each section of proposed §§ 1.1400Z2(a)-1 through 1.1400Z2(g)-1, except for proposed § 1.1400Z2(c)-1, contained in the notice of proposed rulemaking documents published on October 29, 2018, and on May 1, 2019, in the Federal Register (83 FR 54279; 84 FR 18652), must apply § 1.1400Z2(c)-1 of the final regulations contained in this document with respect to any elections made under section 1400Z-2(c).

Summary of Comments and Explanation of Revisions

I. Overview

The final regulations set forth in §§ 1.1400Z2(a)-1 through 1.1400Z2(f)-1, 1.1502-14Z, and 1.1504-3 (section 1400Z-2 regulations) retain the basic approach and structure of the proposed regulations, with certain revisions. The Treasury Department and the IRS have refined and clarified certain aspects of the proposed regulations in these final regulations to make the rules easier to follow and understand. Specifically, proposed § 1.1400Z2(d)-1 has been split into two separate sections: §§ 1.1400Z2(d)-1 and 1.1400Z2(d)-2. Further, the Treasury Department and the IRS have combined duplicative rules regarding QOFs and qualified opportunity zone businesses, and have added defined terms to allow the reader to more intuitively grasp the meaning of the numerous provisions cross-referenced in the final regulations.

This Summary of Comments and Explanation of Revisions discusses those revisions as well as comments received in response to each of §§ 1.1400Z2(a)-1 through 1.1400Z2(g)-1 of the proposed regulations (proposed §§ 1.1400Z2(a)-1 through 1.1400Z2(g)-1). The rules proposed in the October 2018 proposed regulations and the May 2019 proposed regulations are explained in greater detail in the Explanation of Provisions sections of the preambles to each set of proposed regulations.

II. Comments on and Changes to Proposed § 1.1400Z2(a)-1

Proposed § 1.1400Z2(a)-1 prescribed rules regarding the election to defer gains under section 1400Z-2(a)(1), including rules regarding which taxpayers are eligible to make the election, which gains are eligible for deferral, and the method by which eligible taxpayers may make deferral elections. This part II describes the revisions made to proposed § 1.1400Z2(a)-1 based on the comments received on those proposed rules, including revisions to the definition of eligible gain and revisions to the rules applying the statutory 180-period and other requirements with regard to the making of a qualifying investment in a QOF.

A. Definitions and Related Operating Rules

1. Eligible Gain

Proposed § 1.1400Z2(a)-1(b)(2) generally provided that an amount of gain would be eligible for deferral under section 1400Z-2(a) if the gain (i) is treated as a capital gain for Federal income tax purposes that would be recognized for Federal income tax purposes before January 1, 2027, if section 1400Z-2(a)(1) did not apply to defer recognition of the gain; and (ii) did not arise from a sale or exchange with a related person within the meaning of section 1400Z-2(e)(2) (eligible

gain). This part II.A.1. describes the comments received on various aspects of the proposed definition of eligible gain and explains the revisions, based on those comments, adopted by § 1.1400Z2(a)-1(b)(11) of the final regulations.

a. Gains From Section 1231 Property

Proposed § 1.1400Z2(a)-1(b)(2)(iii) of the May 2019 proposed regulations provided that the only gain arising from property used in the taxpayer's trade or business (section 1231 property) eligible for deferral under section 1400Z-2(a)(1) was "capital gain net income" for a taxable year, which was defined as the amount by which the capital gains arising from all of a taxpayer's section 1231 property exceeded all of the taxpayer's losses from section 1231 property for a taxable year. The Treasury Department and the IRS have reconsidered this approach based on the numerous comments received on this aspect of the May 2019 proposed regulations.

i. Section 1231 Generally

Section 1231 governs the character of a taxpayer's gains or losses with respect to section 1231 property not otherwise characterized by section 1245 or 1250. Section 1231(b) defines "section 1231 property" generally as depreciable or real property that is used in the taxpayer's trade or business and held for more than one year, subject to enumerated exceptions (for example, property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business).

Under section 1231(a)(1), if a taxpayer's aggregate gains from each sale and exchange (each gain, a section 1231 gain) during the taxable year exceed the taxpayer's aggregate losses from each sale and exchange (each loss, a section 1231 loss), the taxpayer's section 1231 gains and section 1231 losses are treated as long-term capital gains and long-term capital losses, respectively. However, if the aggregate section 1231 gains do not exceed the aggregate section 1231 losses (that is, the aggregate amount of section 1231 gains equals or is less than the aggregate amount of section 1231 losses), those gains and losses are not treated as gains and losses from sales or exchanges of capital assets (that is, they are treated as ordinary income and ordinary losses). See sections 64, 1221, 1222, and 1231(a)(2) of the Code.

Several provisions of the Code may apply to limit the long-term capital treatment otherwise potentially provided under section 1231(a)(1). For example, prior to the aggregation of section 1231 gains and losses under section 1231(a), the recapture rules of sections 1245 and 1250 must be applied on an asset-by-asset basis. Section 1245, which applies to sales, exchanges, or dispositions of depreciable tangible and intangible property, characterizes any gain recognized as ordinary income (as defined in section 64) to the extent depreciation or amortization has been allowed or allowable with respect to that property. Section 1250 provides a similar "pre-aggregation" recapture rule with regard to sales, exchanges, or dispositions of depreciable real property that is not section 1245 property, and it characterizes as ordinary income (as defined in section 64) any gain recognized in excess of straight line depreciation.

Section 1231(c), on the other hand, sets forth a "post-aggregation" recapture provision, requiring the net section 1231 gain for any taxable year to be treated as ordinary income to the

extent that such gain does not exceed the non-recaptured net section 1231 losses. Non-recaptured net section 1231 losses are net section 1231 losses for the five most recent preceding taxable years of the taxpayer that have not yet been recaptured. However, section 1231(c)(5), provides that the principles of section 1231(a)(4) apply for purposes of section 1231(c). Under section 1231(a)(4), to determine whether gains exceed losses for the section 1231(a) character determination, section 1231 gains are included only if and to the extent that they are taken into account in computing gross income, and section 1231 losses are included only if and to the extent that they are taken into account in computing taxable income.

Essentially, the operation of the "pre-aggregation" recapture rules under sections 1245 and 1250, as well as the "post-aggregation" recapture rule under section 1231(c), requires a gain recognized with respect to section 1231 property potentially to be treated as ordinary income, even if that gain otherwise would have been characterized differently under section 1231(a) in the absence of such recapture rules.

Section 64 defines the term "ordinary income" for purposes of subtitle A of the Code (subtitle A), which includes sections 1231, 1245, 1250, and 1400Z-2, to include "any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b)," and provides further that "[a]ny gain from the sale or exchange of property which is treated or considered, under other provisions of this subtitle, as 'ordinary income' shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b)." See for example, sections 1231(c), 1245, and 1250; see also §§ 1.1245-1(a)(1), 1.1245-1(b)(2), 1.1250-1(a)(1), 1.1250-1(b)(1), and 1.1250-1(c)(1).

ii. Comments on Treatment of Section 1231 Property

Commenters suggested that the gross amount of section 1231 gain realized from sales or exchanges of section 1231 property should be eligible gain, provided that such gain is determined to be capital gain at the end of the taxable year by taking into account all section 1231 gains and section 1231 losses. Some commenters also recommended that the 180-day period for investment begin on the date of the sale or exchange that gives rise to a section 1231 gain instead of at the end of the taxable year. Many of the commenters recognized that, because section 1231(a)(1) requires a netting process to determine whether section 1231 gains and losses are capital in character, investors might not be certain if any of the section 1231 gain invested from sales or exchanges before the end of the taxable year is capital in character. Therefore, several commenters suggested that gross section 1231 gains be eligible for investment on the date of the sale or exchange, contingent on such gains being capital in character as determined by the netting process at the end of the taxable year. Under this approach, if the section 1231 gains invested in a QOF during a taxable year are determined not to be capital in character because section 1231 gains for the year do not exceed section 1231 losses, the section 1231 gains invested that year would constitute an investment that does not qualify for deferral under section 1400Z-2(a)(1) (a non-qualifying investment).

In the alternative, many commenters recommended an election to permit a taxpayer to begin the 180-day period for section 1231 gains on the last day of the taxable year. This election would accommodate the needs of taxpayers who are unable to determine whether section 1231 gains will be capital in character until all transactions involving section 1231 property have been

completed for a taxable year. As a model for this elective approach, commenters referred to proposed § 1.1400Z2(a)-1(c)(2)(iii)(B), which permits a partner to elect to align its 180-day period with that of the partnership, that is, the date of the sale or exchange giving rise to such gain.

Commenters observed that because gain that is deferred under section 1400Z-2 would not be taken into account in computing gross income until recognized, pursuant to section 1231(a)(4), any deferred gains would be excluded from the section 1231(a) character determination. As a result, taxpayers could ensure that section 1231 gains do not exceed section 1231 losses for a taxable year under section 1231(a) by investing the excess of gains realized from the sale or exchange of section 1231 property over the losses from those sales, thus, rendering all section 1231 losses, that otherwise would be capital in character, ordinary in character. However, commenters noted that section 1231(a)(4) gives rise to a circularity issue if applied in this manner. If the only section 1231 gains that are eligible for deferral under section 1400Z-2 are capital character section 1231 gains, then, if a taxpayer invests an amount of section 1231 gains in a QOF such that the character determination under section 1231(a) produces ordinary character gains and losses for a taxable year, then all section 1231 gains in that taxable year would not be eligible gains. Therefore, in light of the application of section 1231(a)(4), a taxpayer could only defer an amount of section 1231 gains such that even after subtracting deferred gains, the remaining non-deferred section 1231 gains for the taxable year would still exceed section 1231 losses. In many cases, this excess amount would be substantially less than the gross amount of section 1231 gains realized from the sale or exchange section 1231 property for the taxable year. To resolve both the issue of shifting the character of otherwise capital character section 1231 losses to ordinary character section 1231 losses and the circularity issue described previously, a commenter suggested treating section 1231 gains deferred under section 1400Z-2 as if they were "taken into account in computing gross income" for purposes of section 1231(a)(4). Under such a rule, even if the full amount of section 1231 gains that are capital in character were deferred under section 1400Z-2, section 1231 gains would still exceed section 1231 losses and both section 1231 gains and losses would retain their capital character after the application of section 1231(a).

Several commenters also requested additional rules with respect to the application of the rules of section 1231(c) (described earlier) to deferred section 1231 gain. Commenters suggested a rule providing that deferred section 1231 gain to the extent of non-recaptured net section 1231 losses be treated as ordinary income when those gains are recognized rather than in the year of gain deferral. In some instances, this approach may require a taxpayer to account for its non-recaptured net section 1231 losses for a period longer than the five most recent taxable years section 1231(c) requires. A commenter suggested that the extension of the recapture period be accomplished by means of an election by the taxpayer at the time any section 1231 gain is deferred under section 1400Z-2. In electing to defer section 1231 gain, a taxpayer also would elect to extend the section 1231(c) recapture period to the longer of the statutory five-year period or the taxable year that includes December 31, 2026. Alternatively, some commenters asked that section 1231(c) not apply at all to deferred section 1231 gains.

One commenter also noted that the term "capital gain net income" already is defined in section 1222(9), and that its separate definition and use in the section 1400Z-2 regulations might lead to confusion.

In response to these comments, the final regulations provide that eligible gains that may be deferred pursuant to section 1400Z-2(a)(1)(A) and the section 1400Z-2 regulations include gains from the sale or exchange of property described in section 1231(b) not required to be characterized as ordinary income by sections 1245 or 1250 (qualified section 1231 gains), regardless of whether section 1231(a) (without regard to section 1231(a)(4)) would determine those gains to be capital or ordinary in character. As noted earlier, section 64 provides that gains from the sale or exchange of section 1231 property generally are not considered ordinary income for purposes of subtitle A, although recaptured income under section 1245 or 1250 would be ordinary income under section 64.

However, the final regulations do not set forth a special rule to address the application of section 1231(a)(4) for purposes of applying section 1400Z-2 and the section 1400Z-2 regulations. Thus, section 1231(a)(4) applies to eligible section 1231 gains deferred pursuant to section 1400Z-2(a)(1)(A) as it would under similar deferral provisions, such as sections 453 and 1031. That is, unless a section 1231 gain (as defined in section 1231(a)(3)(A)) is taken into account in computing gross income in a taxable year, section 1231(a)(4) does not include that gain in calculating whether section 1231 gains exceed section 1231 losses under section 1231(a)(1) for the taxable year.

Additionally, these final regulations do not alter the statutory application of the section 1231(c) recapture of net ordinary loss. Therefore, if a deferral election with respect to an eligible section 1231 gain is made in year 1, any non-recaptured net section 1231 losses from the five most recent taxable years that precede year 1 apply to recapture as ordinary income in year 1 any net section 1231 gain that has not been deferred in year 1. In other words, the section 1231(c) amount that would have applied to the eligible section 1231 gain absent a deferral election and corresponding investment in a QOF is not an attribute associated with the deferred eligible section 1231 gain that is taken into account in applying section 1231 in the ultimate year in which the deferred gain is included in income under section 1400Z-2(b) and the section 1400Z-2 regulations. Instead, when deferred eligible section 1231 gain is subsequently included in income on December 31, 2026, or on an earlier date as a result of an inclusion event, section 1231(c) will recapture net section 1231 gain in the year of inclusion by taking into account non-recaptured section 1231 losses only from the five most recent taxable years preceding the taxable year of inclusion.

Unlike the net approach of the proposed regulations, the final regulations adopt a gross approach to eligible section 1231 gains without regard to any section 1231 losses. In addition, under the final regulations, the character of eligible section 1231 gains, other than as gains arising from the sale or exchange of section 1231 property, is not determined until the taxable year such gains are taken into account in computing gross income pursuant to section 1231(a)(4). Accordingly, the term "capital gain net income" used in the proposed regulations is no longer applicable when referring to the amount of any gain from the sale or exchange of section 1231 property that is eligible for deferral under section 1400Z-2(a)(1)(A) and the section 1400Z-2 regulations.

The Treasury Department and the IRS have determined that a gross approach that does not apply section 1231(a) and (c) (gross approach) to determine eligible gain from the sale or exchange of section 1231 property is consistent with the long-standing rules of section 64, and is appropriate due to the complexity of applying section 1231 to deferred gains generally. Moreover, limiting eligible gain from the sale or exchange of section 1231 property to an amount less than the net

section 1231 gains for a taxable year would impose a significant administrative burden on persons that are required to report the recognition of such gains during the taxable year under Federal income tax accounting principles (eligible taxpayers). Similarly, a gross approach to determine eligible section 1231 gains eliminates complexity and uncertainty in determining eligible gain for partnerships and S corporations that are eligible taxpayers.

As discussed in part II.A.3.a. of this Summary of Comments and Explanation of Revisions, because eligible gains include the gross amount of eligible section 1231 gains unreduced by section 1231 losses regardless of character, it is not necessary for an investor to wait until the end of the taxable year to determine whether any eligible section 1231 gains are eligible gains. As a consequence, the final regulations provide that the 180-day period for investing an amount with respect to an eligible section 1231 gain for which a deferral election is to be made begins on the date of the sale or exchange that gives rise to the eligible section 1231 gain.

b. Character of Eligible Gain

Section 1400Z-2(a)(1)(A) provides that if a taxpayer has "gain from the sale to, or exchange with, an unrelated person of any property held by the taxpayer," the taxpayer may elect to exclude from gross income for the taxable year the aggregate amount of such gain invested by the taxpayer in a QOF during the 180-day period beginning on the date of such sale or exchange. The Treasury Department and the IRS considered whether "gain" eligible for deferral under section 1400Z-2 should include both gain from the disposition of a capital asset as well as gain treated as ordinary income under subtitle A.

As noted in part II.A.1.a, section 64 of the Code provides generally that for purposes of subtitle A, the term "ordinary income" includes any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b). Any gain from the sale or exchange of property which is treated or considered, under other provisions of subtitle A, as "ordinary income" shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b). Thus, for purposes of subtitle A, including section 1400Z-2, section 64 defines gains treated as ordinary income as categorically different from gains from the sale or exchange of capital assets or section 1231 property.

In this regard, proposed § 1.1400Z2(a)-1(b)(2)(i) as contained in the October 2018 proposed regulations provided that an amount of gain is an "eligible gain," and thus is eligible for deferral under section 1400Z-2(a), if the gain is treated as a capital gain for Federal income tax purposes. In addition, the May 2019 proposed regulations provided that the only gain arising from section 1231 property eligible for deferral under section 1400Z-2(a)(1) was "capital gain net income" for a taxable year, which was defined as the amount by which the capital gains arising from all of a taxpayer's section 1231 property exceeded all of the taxpayer's losses from section 1231 property for a taxable year.

Based on the statutory text of section 1400Z-2(a)(1)(A), several commenters requested that the final regulations permit taxpayers to treat both capital gains and ordinary gains (that is, gains treated as ordinary income) as eligible gains. For example, commenters requested that gain from property used in a trade or business required to be characterized as ordinary income, such as

recapture income under section 1231(c) or 1245(a), should be permitted to be invested in a QOF.

After consideration of the language, structure and purpose of section 1400Z-2 as a whole, the Treasury Department and the IRS have determined that it would be inconsistent with section 64 and the statutory framework of section 1400Z-2 to extend the meaning of the term "gain" in section 1400Z-2(a)(1) to gain required to be treated as ordinary income under subtitle A, including section 1245 gain. The interpretation of the Treasury Department and the IRS of the text and structure of the statute is confirmed by the legislative history, which explicitly identifies "capital gains" as the gains that are eligible for deferral. See H.R. Rep. No. 115-466, at 537-540 (Dec. 15, 2017) (Conference Report).

Accordingly, the Treasury Department and the IRS have retained in the final regulations the general rule set forth in the proposed regulations that limits eligible gains to gains treated as capital gains for Federal income tax purposes. For purposes of section 1400Z-2(a)(1), eligible gains generally include gains from the disposition of capital assets as defined in section 1221(a), gains from the disposition of property described in section 1231(b), and income treated as capital gain under any provision of the Code, such as capital gain dividends distributed by certain corporations. For this purpose, both long-term capital gain and short-term capital gain may be determined to be eligible gain under the section 1400Z-2 regulations. However, consistent with section 64, any gain required to be treated as ordinary income under subtitle A, such as section 1245 recapture income, is not eligible gain.

In that regard, one commenter suggested that, unlike other investors in QOFs, existing residents of a QOZ should be provided a special accommodation not available to other eligible taxpayers—such residents should be permitted to invest any gain, regardless of character, in QOFs and elect to defer the corresponding amounts in accordance with section 1400Z-2. The Treasury Department and the IRS have determined that neither the statutory language nor legislative history of section 1400Z-2 supports different treatment for residents of QOZs regarding the deferral of eligible gains. Section 1400Z-2 references the term "taxpayer," which section 7701(a)(14) defines as "any person subject to any internal revenue tax." In turn, section 7701(a)(1) defines the term "person" to include "an individual, a trust, estate, partnership, association, company or corporation."

The Treasury Department and the IRS have determined that construction of the term "taxpayer" in accordance with section 7701(a)(14) would be consistent with the language and purpose of section 1400Z-2 as a whole, and therefore would give effect to the intent of Congress. Moreover, disparate treatment of eligible taxpayers residing in QOZs and those who do not is not warranted given that the statute equally incents investment in QOZs by any taxpayer, including those that have historically invested in businesses operated within QOZs and those that have not. Accordingly, the section 1400Z-2 regulations do not adopt the comment recommending special treatment for residents of QOZs to invest ordinary income, including gain required to be treated as ordinary income under subtitle A, in QOFs.

c. Gain From Sales of Capital Assets, Unreduced by Any Losses

One commenter also requested clarification that the deferral election under section 1400Z-2(a)(1) applies to the gross amount of gain treated as capital gain unreduced by losses. The proposed regulations generally provided that in the case of gain from the sale of a capital asset as defined under section 1221, the full amount of capital gain from that sale or exchange, unreduced by any losses, is eligible gain that generally may be invested during the 180-day period beginning on the date of the sale or exchange of the property giving rise to the gain.

The section 1400Z-2 regulations retain the general rule of the proposed regulations providing that the full amount of gain that would be recognized from the sale or exchange of a capital asset as defined under section 1221, unreduced by any losses, is eligible gain and therefore eligible taxpayers do not have to net a gain from a section 1221 capital asset against the sum of the taxpayer's losses from section 1221 capital assets. Thus, if a capital gain is realized by an eligible taxpayer during a taxable year, section 1400Z-2 and the section 1400Z-2 regulations generally do not require that any losses reduce the amount of the gain that may be an eligible gain.

However, gain that otherwise may qualify as a capital gain may be required to be recharacterized or redetermined by other provisions of the Code. For example, sections 1245 and 1250 may require gain that potentially could be characterized as capital in nature to instead be treated as ordinary income "notwithstanding any other provision of this subtitle," referring to subtitle A, which includes section 1400Z-2. Consistent with section 64, if a provision of the Code requires the character of a potential capital gain to be recharacterized, redetermined, or treated as ordinary income for purposes of subtitle A, such gain cannot be, and is not, treated as other than ordinary income under the Code, and therefore is not eligible gain for purposes of section 1400Z-2 and the section 1400Z-2 regulations. See §§ 1.1245-1(a)(1), 1.1245-1(b)(2), 1.1250-1(a)(1), 1.1250-1(b)(1), and 1.1250-1(c)(1).

d. Gains From Sales to, or Exchanges of Property With, a QOF or Qualified Opportunity Zone Business

The October 2018 proposed regulations provided that eligible gain does not include gain from the sale to, or the exchange of property with, a person that is related to the taxpayer within the meaning of section 1400Z-2(e)(2). Section 1400Z-2(d)(2)(D) and the May 2019 proposed regulations provided that qualified opportunity zone business property that a QOF owns must be acquired by the QOF by purchase from an unrelated party. As a result, property that is purchased by a QOF from a related party, as well as property that is contributed to a QOF in a transfer to which section 351 or section 721(a) applies, is not qualified opportunity zone business property.

Commenters have requested confirmation that eligible gain includes gain arising from the sale to, or the exchange of property with, a QOF if the amount of the gain is later invested in that QOF. Commenters similarly have requested confirmation that gain from the sale to, or the exchange of property with, a qualified opportunity zone business is eligible for investment into the QOF that owns the qualified opportunity zone business. Relatedly, commenters have requested that the final regulations provide that a sale to, or an exchange of property with, a QOF or qualified opportunity zone business, followed by an investment of the amount of the sales proceeds into the QOF, would not be characterized as a purchase from a related party for purposes of section 1400Z-2(d)(2)(D).

One commenter expressed concern that, if a taxpayer sold property to an unrelated QOF and then invested the amount of the sales proceeds in the same QOF, that sequence of transactions could be characterized under circular cash flow principles as if the taxpayer contributed the property directly to the QOF (and each transfer of the amount of the sales proceeds would be disregarded for Federal income tax purposes). If this construct applied, the acquired property would not qualify as qualified opportunity zone business property.

The Treasury Department and the IRS agree that generally applicable Federal income tax principles would require this result if, under the facts and circumstances, the consideration paid by the QOF or by a qualified opportunity zone business returns to its initial source as part of the overall plan. See Rev. Rul. 83-142, 1983-2 C.B. 68; Rev. Rul. 78-397, 1978-2 C.B. 150. Under the step transaction doctrine and circular cash flow principles, the circular movement of the consideration in such a transaction would be disregarded for Federal income tax purposes, including for purposes of section 1400Z-2 and the section 1400Z-2 regulations. Thus, the transaction would be treated for Federal income tax purposes as a transfer of property to the purchasing QOF for an interest therein or, if applicable, as a transfer of property to a QOF for an interest therein followed by a transfer of such property by the QOF to the purchasing qualified opportunity zone business.

Accordingly, an eligible taxpayer's gain from a sale to or an exchange of property with an unrelated QOF (acquiring QOF), as part of a plan that includes the investment of the consideration received by the eligible taxpayer back into the acquiring QOF, is not eligible gain to the eligible taxpayer because the transaction would not be characterized as a sale or exchange to an unrelated person for Federal income tax purposes. Similarly, an eligible taxpayer's gain from a sale to or an exchange of property with an unrelated qualified opportunity zone business (acquiring qualified opportunity zone business) is not eligible gain to the eligible taxpayer if the sale occurs as part of a plan that includes (i) the investment of the consideration received by the eligible taxpayer back into the QOF that owns the acquiring qualified opportunity zone business, followed by (ii) the contribution by the QOF of that consideration to the qualified opportunity zone business. Furthermore, because the transaction is not treated as a "purchase" of tangible property by the qualified opportunity zone business from an unrelated party, the newly acquired property will not qualify as qualified opportunity zone business property under section 1400Z-2(d)(2)(D).

The Treasury Department and the IRS also note that, if an eligible taxpayer sells property to, or exchanges property with, an unrelated qualified opportunity zone business as part of a plan that includes the investment of the consideration by the taxpayer back into the QOF that owns the acquiring qualified opportunity zone business, the transaction potentially may be recast or recharacterized as a non-qualifying investment even if the QOF retains the consideration (rather than transferring the consideration to the qualified opportunity zone business). See § 1.1400Z2(f)-1(c)(1). See also part II. D (discussing the transfer of property for a qualifying investment) and part VI. A (discussing the applicability of the step transaction doctrine) of this Summary of Comments and Explanation of Revisions.

e. Gain Not Subject to Federal Income Tax

The Treasury Department and the IRS received comments regarding the scope of the term "eligible gain" with respect to gains realized by persons that generally are not subject to Federal income tax with respect to those gains, such as persons that are not United States persons under section 7701(a)(30) (foreign persons) or that are entities generally exempt from tax under the Code. Some commenters suggested that an eligible gain should include all realized capital gains, including gains that are not subject to Federal income tax. However, other commenters stated that permitting deferral elections with respect to gains that are not subject to Federal income tax would be inappropriate because section 1400Z-2 is premised on the assumption that a person could make qualified investments in a QOF only with respect to amounts of capital gains for which taxation is deferred.

The Treasury Department and the IRS have determined that eligible taxpayers generally should be able to make an election under section 1400Z-2(a)(1) and the section 1400Z-2 regulations only for capital gains that would be subject to tax under subtitle A before January 1, 2027 (subject to Federal income tax) but for the making of a valid deferral election under section 1400Z-2(a)(1) and the section 1400Z-2 regulations. Section 1400Z-2 defers the time when eligible gains are included in income, and there would not be any taxable income to defer for a gain that is not subject to Federal income tax. This approach ensures that both United States persons and foreign persons may be eligible for the Federal income tax benefits of section 1400Z-2 under the same conditions. Moreover, particularly with respect to foreign persons, the lack of any requirement that a gain be subject to Federal income tax would make it difficult for the IRS to verify the extent to which the amount being invested in a QOF was, in fact, with respect to a capital gain.

Accordingly, the final regulations clarify that deferral of a gain under section 1400Z-2(a)(1) and the section 1400Z-2 regulations generally is available only for capital gain that would be subject to Federal income tax but for the making of a valid deferral election under section 1400Z-2(a)(1) and the section 1400Z-2 regulations. Thus, for example, a deferral election may generally be made by nonresident alien individuals and foreign corporations with respect to an item of capital gain that is effectively connected with a U.S. trade or business. Further, individual bona fide residents of U.S. territories who are United States persons may generally make a deferral election with respect to an item of capital gain that is derived from sources outside their territory of residence. Similarly, an organization that is subject to the unrelated business income tax imposed by section 511 may generally make a deferral election with respect to an item of capital gain to the extent the item would be included in computing the organization's unrelated business taxable income (such as under the unrelated debt-financed income rules).

In contrast, an eligible taxpayer who is not a United States person within the meaning of section 7701(a)(30), or who is treated as a resident of another country for purposes of an applicable income tax treaty (foreign eligible taxpayer), should not be able to elect to defer an item of capital gain if, in the taxable year in which such gain is includible, the item is treated as exempt from Federal income tax under a provision of an applicable income tax treaty (for example, capital gain that is effectively connected with a U.S. trade or business but is not attributable to a permanent establishment of the taxpayer within the United States). To prevent foreign eligible taxpayers from taking inconsistent positions with respect to treaty benefits in the taxable year of deferral and the taxable year of inclusion, the final regulations provide that a foreign eligible taxpayer cannot make a deferral election under section 1400Z-2(a) and the section 1400Z-2 regulations with respect to an eligible gain unless the foreign eligible taxpayer irrevocably

waives, in accordance with forms and instructions, any treaty benefits that would exempt that gain from Federal income tax at the time of inclusion pursuant to an applicable U.S. income tax convention.

In the event that forms and instructions have not yet been published incorporating the treaty waiver requirement for a foreign eligible taxpayer for the taxable year that the deferral election applies to, the final regulations require the attachment of a written statement to waive such treaty benefits. Eligible taxpayers other than foreign eligible taxpayers will only be required to make this treaty waiver if and to the extent required in forms and publications.

The Treasury Department and the IRS have determined that it would be unduly burdensome to require a partnership to determine the extent to which a capital gain would be, but for a deferral election by the partnership under section 1400Z-2(a) and the section 1400Z-2 regulations, subject to Federal income tax by its direct or indirect partners because partnerships do not generally have sufficient information about the tax treatment and positions of their partners to perform this analysis. Thus, in the case of partnerships, the final regulations provide an exception to the general requirement that gain be subject to Federal income tax in order to constitute eligible gain.

The Treasury Department and the IRS are aware that foreign persons who are not subject to Federal income tax may plan to enter into transactions including, but not limited to, the use of partnerships formed or availed of to circumvent the rule generally requiring eligible gains to be subject to Federal income tax. Therefore, under an anti-abuse rule added in § 1.1400Z2(f)-1(c)(2), a partnership formed or availed of with a significant purpose of avoiding of avoiding the requirement in § 1.1400Z2(a)-1(b)(11)(i)(B) that eligible gains be subject to Federal income tax will be disregarded, in whole or in part to prevent the creation of a qualifying investment by the partnership with respect to any partner that would not otherwise satisfy the requirement of that paragraph. The anti-abuse rule may apply even if some of the partners in the partnership are subject to Federal income tax. See § 1.1400Z2(f)-1(c)(3)(i) and (ii), Examples 1 and 2.

Finally, in response to comments expressing uncertainty as to whether persons who do not or cannot make a valid deferral election for eligible gains nevertheless may invest in QOFs, the Treasury Department and the IRS note that nothing in section 1400Z-2 or the section 1400Z-2 regulations prevents persons who do not have eligible gains from investing in QOFs. Thus, Indian tribal governments, and tax-exempt organizations that invest amounts other than items of capital gain that would be included in computing their unrelated business taxable income, may invest in a QOF to the extent otherwise permitted by law or regulation. However, those investments will not qualify for the Federal income tax benefits under section 1400Z-2 or the section 1400Z-2 regulations. That is, those investments are not qualifying investments described in section 1400Z-2(e)(1)(A)(i).

f. Measuring Gain From Sales or Exchanges of Virtual Currency

Section 1400Z-2 and the proposed regulations clearly provide that eligible gain is gain that has been realized pursuant to a sale or exchange. One commenter identified a potential obstacle in calculating the eligible gain from sales or exchanges of certain types of digital assets, including virtual currency. The commenter expressed concern that the vast majority of digital assets could

not directly be exchanged for traditional types of money. The commenter explained that these digital assets first must be converted into other digital assets in taxable transactions before ultimately being sold for the type of currency that would be invested in a QOF. The commenter expressed concern that gain or loss from these intermediate transactions in which a digital asset is exchanged for another digital asset may not necessarily be tracked in detail. Thus, the commenter requested a separate rule for these digital assets under which eligible gain would be calculated by reference to the basis of the original digital asset and to the actual proceeds received in the ultimate transaction that converts an intermediate digital asset to money or property that would be invested in a QOF.

Notice 2014-21, 2014-16 I.R.B. 938 provides that convertible virtual currency is property for Federal income tax purposes, and that general Federal income tax principles applicable to property transactions apply to transactions involving convertible virtual currency. Section 1400Z-2(a) applies to gain that, absent a deferral election, would be included in the taxpayer's gross income. To determine the amount of such gain, the taxpayer must know the basis of the property, regardless of the type of such property. If the amount invested in a QOF exceeds the amount of eligible gain, then the taxpayer will have a non-qualifying investment for the amount of gain invested in excess of eligible gain invested in the QOF and a qualifying investment for the amount of eligible gain invested in the QOF (mixed-funds investment). Taxpayers selling digital assets are not prevented from investing eligible gain generated from the sale into a QOF simply because one digital asset must be converted into another type of asset before the taxpayer can convert its assets into U.S. dollars. Therefore, the Treasury Department and the IRS decline to adopt the commenter's request for a special rule for digital assets.

g. Gain From a Section 1256 Contract or a Position Part of an Offsetting-Positions Transaction

The preamble to the October 2018 proposed regulations explained that the Treasury Department and the IRS considered allowing deferral under section 1400Z-2(a)(1) for a net amount of capital gain related to a straddle (as defined in section 1092(c)(1)) after the disposition of all positions in the straddle, but concluded that such a rule would pose significant administrative burdens. Proposed § 1.1400Z2(a)-1(b)(2)(iv) provided that, if a capital gain is from a position that is or has been part of an offsetting-positions transaction, the gain is not eligible for deferral under section 1400Z-2(a)(1). For this purpose, an offsetting-positions transaction generally is a transaction in which a taxpayer has substantially diminished the taxpayer's risk of loss from holding one position with respect to personal property by holding one or more other positions with respect to personal property (whether or not of the same kind) and includes positions with respect to personal property that is not actively traded.

Proposed § 1.1400Z2(a)-1(b)(2)(iii)(A) provided that the only gain arising from section 1256 contracts that is eligible for deferral under section 1400Z-2(a)(1) is capital gain net income from all of a taxpayer's section 1256 contracts for a taxable year. Additionally, proposed § 1.1400Z2(a)-1(b)(2)(iii)(B) provided that, if at any time during the taxable year, any of the taxpayer's section 1256 contracts were part of an offsetting-positions transaction and any other position in that transaction was not a section 1256 contract, then no gain from any section 1256 contract is an eligible gain with respect to that taxpayer in that taxable year.

Two commenters expressed concern about the application of the offsetting-positions transaction rule in the October 2018 proposed regulations to positions that are not part of a straddle under section 1092. One commenter stated that the IRS did not adequately describe its policy concerns when extending the offsetting-positions transaction rule beyond the scope of section 1092. The second commenter argued that a taxpayer is permitted to recognize losses while deferring gains by continuing to hold an asset that is not actively traded, and that allowing deferral under section 1400Z-2(a)(1) would be no different than having the taxpayer continue to hold its gain position. The Treasury Department and the IRS appreciate the concerns expressed regarding the extension of the proposed offsetting-positions transaction rule to transactions that are not straddles under section 1092 and the final regulations do not include the provisions that applied to transactions that are not straddles under section 1092.

Two commenters expressed concern that the proposed offsetting-positions transaction rule excluded gains from a position that, at any time, had been part of an offsetting-positions transaction, including offsetting-positions transactions that occurred many years ago. The commenters recommended either deleting the phrase "or has been" or limiting application of that phrase to permit deferral of capital gain from an offsetting-positions transaction if there is no offsetting position on or after the enactment of the TCJA. The Treasury Department and the IRS have concluded that the rule should not exclude gains that have, at any time, been part of an offsetting position but should instead exclude gains based on whether an offsetting position was in existence during a limited time period. Limiting the application of the straddle rules to situations in which there was an offsetting position on or after the date of the enactment of the TCJA would, in future years, require taxpayers and the IRS to look back over an extended period of time. This requirement could result in significant administrative burdens without serving a significant tax policy purpose. As a result, the Treasury Department and the IRS have revised the limitation on the use of gains from a straddle to net gain from a position that was either part of a straddle during the taxable year or part of a straddle in a prior taxable year if a loss from that straddle is carried over under section 1092(a)(1)(B) to the taxable year.

One commenter suggested that, in the context of a straddle, the deferral under section 1400Z-2(a)(1) of gain from the disposition of a position in a straddle would not permit the current recognition of an otherwise suspended loss from an offsetting position in the straddle. The commenter also recognized, however, that it might be overly generous for a taxpayer investing in a QOF to eliminate 15 percent of the taxpayer's deferred gain (assuming that the taxpayer holds that QOF interest for seven years by December 31, 2026), if the taxpayer was also permitted ultimately to recognize all of its suspended loss from the offsetting straddle position. The commenter suggested a rule eliminating any suspended loss in the same proportion as any elimination of gain in one or more offsetting positions.

The Treasury Department and the IRS have determined that there would be significant administrative burdens for taxpayers and the IRS in tracking specific gains deferred under section 1400Z-2(a)(1) for the purpose of determining whether and when some or all of a deferred straddle loss might ultimately become deductible. In addition, the Treasury Department and the IRS have determined that the tracking of deferred losses for multiple taxable years after the positions in the straddle have been disposed of and a potential proportional elimination of a suspended loss, years after the suspension, would create additional complexity and administrative burdens for both taxpayers and the IRS. The final regulations therefore provide a general rule that net gain from positions that are or, as described previously, in certain

circumstances have recently been part of a straddle, are not eligible for deferral under section 1400Z-2(a)(1).

Another commenter suggested that, absent a clearly articulated policy concern with permitting deferral of net gain from a straddle, the Treasury Department and the IRS should consider eliminating or minimizing the scope of capital gains subject to the prohibition in the proposed regulations. The Treasury Department and the IRS have concluded that, in certain circumstances, deferral of net gain from a straddle does not present significant policy concerns or unreasonable administrative burdens for taxpayers and the IRS. Under the final regulations, if during the taxable year: (i) A position was covered by an identification under section 1092 or 1256(d), (ii) no gain or loss with respect to any position that was part of the identified straddle remains unrecognized at the end of the taxable year (other than gain that would be recognized but for deferral under section 1400Z-2(a)(1)), (iii) none of the positions in the identified straddle were part of any other straddle during the taxable year, and (iv) none of the positions in the identified straddle were part of a straddle in a previous taxable year from which a loss was carried over to the taxable year under section 1092(a)(1)(B), then the net gain during the taxable year from positions that were part of the identified straddle is not prevented from being an eligible gain. Net gain from an identified straddle during the taxable year is equal to the excess of the capital gains recognized for Federal income tax purposes in the taxable year, determined without regard to section 1400Z-2(a)(1), over the sum of the capital losses and net ordinary losses from all positions that were part of the straddle, including capital gains and losses from section 1256 contracts and other positions marked to market on the last business day of the taxable year or upon transfer or termination and annual account net gain from positions in a mixed straddle account.

The final regulations clarify that, if a taxpayer identifies a straddle under section 1092(a)(2), the taxpayer must adjust basis in accordance with section 1092(a)(2)(A)(ii) and (iii) when determining the net gain during the taxable year from positions that were part of the straddle. The net gain realized during the taxable year that is deferred under section 1400Z-2(a)(1) is not treated as unrecognized gain for purposes of determining whether a loss from a position in the straddle is deferred under section 1092(a)(3)(A)(ii).

A commenter suggested that the provision in the October 2018 proposed regulations disqualifying all gains from section 1256 contracts if at any time during the taxable year, any of the taxpayer's section 1256 contracts were part of an offsetting-positions transaction and any other position in that transaction was not a section 1256 contract be revised to limit the disqualification to the specific type of offsetting-positions transaction identified by the Treasury Department and the IRS. In response to this comment, under the final regulations net gain during the taxable year from section 1256 contracts that were not part of a straddle is not prevented from being eligible gain.

The final regulations also provide that additional exceptions to the general rule may be provided in guidance published in the Internal Revenue Bulletin. The Treasury Department and the IRS request comments on whether there are other situations that might warrant an exception from the general rule that net gain from a position that was either part of a straddle during the taxable year or part of a straddle in a prior year if a loss from that straddle is carried over under section 1092(a)(1)(B) to the taxable year is not eligible gain.

2. Eligible Interests

Proposed § 1.1400Z2(a)-1(b)(3) provided that an eligible interest in a QOF must be an equity interest issued by a QOF, and that eligible interests do not include debt instruments as defined in section 1275(a)(1) and § 1.1275-1(d). One commenter requested clarification with respect to debt instruments issued by a QOF or a potential investor. The commenter set forth a fact pattern in which an eligible taxpayer lends money to a QOF prior to the sale of property that generates eligible gain. After the sale of the property, the taxpayer essentially transfers its creditor position in the loan to the QOF. The commenter requested confirmation that such an arrangement would result in a qualifying investment in a QOF. Determination of the tax treatment of the arrangement described previously would require a debt-equity analysis based on a careful examination of all relevant facts and circumstances and Federal income tax principles apart from those found in section 1400Z-2 and these regulations. Accordingly, such an analysis would exceed the scope of these regulations.

The commenter also described a second fact pattern in which an eligible taxpayer issues a promissory note to the QOF in exchange for an interest in the QOF. The commenter requested clarification as to whether such an exchange would give rise to an amount invested in the QOF. A taxpayer can make an investment in a QOF by contributing cash or property. The contribution of a promissory note, however, is inconsistent with the policy of the section 1400Z-2 statute to incentivize investments in QOZs, and is beyond the scope of these regulations. The Treasury Department and the IRS have determined that a taxpayer should not receive the benefits under section 1400Z-2 merely by promising to pay, and thereby invest in a QOZ, in the future. As such, the Treasury Department and the IRS decline to adopt this comment.

3. 180-Day Investment Requirement

a. Section 1231 Gains

As discussed in part II.A.1.a. of this Summary of Comments and Explanation of Revisions, proposed § 1.1400Z2(a)-1(b)(2)(iii) of the May 2019 proposed regulations provided that the 180-day period for investment with respect to capital gain net income from section 1231 property for a taxable year began on the last day of the taxable year without regard to the date of any particular disposition of section 1231 property.

The Treasury Department and the IRS have received numerous comments regarding the "capital gain net income" approach of the May 2019 proposed regulations. In response to the May 2019 proposed regulations, taxpayers and practitioners consistently have emphasized that the year-long character testing period under section 1231 often can frustrate a taxpayer's ability to defer gains resulting from sales or exchanges of section 1231 property. Unlike typical transactions that result in ordinary or capital gain upon their completion, taxpayers generally lack the ability to determine whether section 1231 gain from a sale or exchange of section 1231 property will be capital in character until the completion of all sales or exchanges of section 1231 property during a taxable year. See generally section 1231(a), (c) (describing taxable-year-based determination). However, to defer recognition under section 1400Z-2(a), taxpayers must invest eligible gain within a 180-day period that begins on the date on which the taxpayer otherwise would have recognized that gain (180-day investment requirement). See section 1400Z-

2(a)(1)(A) (setting forth the 180-day investment requirement). Accordingly, commenters have recommended a wide spectrum of approaches to integrate the rules of section 1231 with section 1400Z-2, including approaches that would (i) modify the timing of the section 1231 calculation (including recapture), the start of the 180-day period, or both; or (ii) allow for immediate investment of gross section 1231 gains to be treated as eligible gains if those gains are determined to be capital at the end of the taxable year.

As described in part II.A.1.a. of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have determined that a "gross approach" solely with regard to eligible section 1231 gains (without regard to any section 1231 losses) would eliminate unnecessary barriers to potential QOF investors. Specifically, the final regulations provide that eligible gains include gains from the sale or exchange of property described in section 1231(b) not required to be characterized as ordinary income by section 1245 or 1250 (eligible section 1231 gains), regardless of whether section 1231(a) (without regard to section 1231(a)(4)) would determine those gains to be capital or ordinary in character. This approach will eliminate significant complexity, as well as uncertainty in determining eligible gain for partnerships and S corporations that are eligible taxpayers. Importantly, although the determination under section 1231(a) of the character of an eligible section 1231 gain would ordinarily occur at the end of a taxable year, that section 1231(a) determination is not necessary to determine whether that gain is eligible for deferral under section 1400Z-2 and the section 1400Z-2 regulations. Because status as an eligible gain relies on facts that are known at the time of a sale or exchange, the 180-day period for an eligible taxpayer to invest an amount with respect to an eligible section 1231 gain begins on the date of the sale or exchange giving rise to the gain rather than at the end of the taxable year. Therefore, an investor can invest an amount with respect to an eligible section 1231 gain from a sale or exchange of section 1231 property and have certainty as to the amount of the qualifying investment on the date the investment is made. Finally, allowing the 180-day period to begin on the date of the sale, exchange, or other disposition that gives rise to the eligible section 1231 gain accelerates both capital infusion into a QOZ and allows an investor to invest eligible proceeds from dispositions of section 1231 property as soon as any such funds are available to invest.

b. RIC and REIT Capital Gain Dividends

Several commenters noted that the application of the 180-day investment requirement to real estate investment trust (REIT) capital gain dividends may preclude some shareholders from making qualifying investments in QOFs because REIT capital gain dividends are based on the net capital gain of the REIT during the relevant taxable year of the REIT. In other words, REITs determine that a dividend, or part thereof, is eligible for capital gain dividend status after the REIT's taxable year has ended, when the REIT can compute net capital gain for the year. Thus, a shareholder may receive a dividend during the year but may not receive the designation that the dividend is a capital gain dividend until after the REIT's taxable year has ended. To facilitate investment in QOZs, commenters requested that the 180-day investment requirement apply beginning on the last day of the REIT's taxable year, rather than the date on which the shareholder receives a dividend, thereby providing a 180-day period after the shareholder has notice of the dividend's capital gain designation. In the alternative, some commenters proposed beginning the 180-day period for investment of REIT capital gain dividends on the date that is 30 days after the close of the REIT's taxable year. Commenters also noted that the same concerns

apply to regulated investment company (RIC) capital gain dividends and maintained that the 180-day period should be the same for both RIC and REIT capital gain dividends.

The Treasury Department and the IRS seek to facilitate the ability of RIC and REIT shareholders to make qualifying investments in QOFs that result from capital gain dividends received during a taxable year. However, because shareholders may not have the same taxable year as the RIC or REIT in which they are invested, these final regulations provide that the 180-day period for RIC or REIT capital gain dividends generally begins at the close of the shareholder's taxable year in which the capital gain dividend would otherwise be recognized by the shareholder. To ensure that RIC and REIT shareholders do not have to wait until the close of their taxable year to invest capital gain dividends received during the taxable year, these final regulations provide that shareholders may elect to begin the 180-day period on the day each capital gain dividend is paid. The 180-day period for undistributed capital gain dividends, however, begins on either the last day of the shareholder's taxable year in which the dividend would otherwise be recognized or the last day of the RIC or REIT's taxable year, at the shareholder's election. Regardless of the 180-day period applicable to its capital gain dividends, the aggregate amount of a shareholder's eligible gain with respect to capital gain dividends received from a RIC or a REIT in a taxable year cannot exceed the aggregate amount of capital gain dividends that the shareholder receives as reported or designated by that RIC or that REIT for the shareholder's taxable year. Any excess investments will be treated under the final regulations as non-qualifying investments.

c. Installment Sales

Commenters requested clarification regarding the application of the 180-day investment requirement to gains recognized in an installment sale pursuant to the installment method under section 453. See section 453(c) (defining the term "installment method"). Section 453(a) provides generally that income from an installment sale must be taken into account for purposes of the Code under the installment method. In general, the installment method allows taxpayers to report gain from a sale of property in the taxable year or years during which payments are received rather than in the year of the sale. Commenters expressed concern that, for taxpayers who are considering investing the gain from an installment sale in a QOF, it is not clear whether (i) there is a single 180-day period for all income from the installment sale that begins on the date and year of the sale (for example, March 15, 2020), or (ii) there are multiple 180-day periods, each beginning in the year during which a payment is received and income is recognized under the installment method.

To provide flexibility to these types of potential investors in QOZs, the Treasury Department and the IRS have included in these final regulations a rule that accommodates both of the potential options described by the commenters previously. Specifically, the final regulations allow an eligible taxpayer to elect to choose the 180-day period to begin on either (i) the date a payment under the installment sale is received for that taxable year, or (ii) the last day of the taxable year the eligible gain under the installment method would be recognized but for deferral under section 1400Z-2. As a result, if the taxpayer defers gain from multiple payments under an installment sale, there might be multiple 180-day periods, or a single 180-day period at the end of the taxpayer's taxable year, depending upon taxpayer's election.

One commenter also requested confirmation that only capital gain realized with respect to an installment sale that occurred after the effective date of section 1400Z-2 (that is, December 22, 2017) should be eligible gain. The Treasury Department and the IRS have determined that it would be inconsistent with the general rule for eligible gains in the final regulations, as well as installment sale case law, to exclude from the definition of eligible gains any capital gains recognized by an eligible taxpayer under the installment method, regardless of whether the installment sale occurred before the effective date of section 1400Z-2. Accordingly, the Treasury Department and the IRS decline to adopt this comment.

d. Special 180-Day Period for Partners, S Corporation Shareholders, and Trust Beneficiaries

The May 2019 proposed regulations provided that, for purposes of the 180-Day Investment Requirement, the period during which a partner must invest an amount equal to the partner's eligible gains in the partner's distributive share generally begins on the last day of the partnership taxable year in which the partner's allocable share of the partnership's eligible gain is taken into account under section 706(a). However, if a partnership does not elect to defer all of its eligible gain, the partner may elect to treat the partner's own 180-day period regarding the partner's distributive share of that gain as being the same as the partnership's 180-day period.

Several commenters requested an additional special rule for application of the 180-day investment requirement with regard to partners in a partnership, shareholders in an S corporation, and beneficiaries of a trust. These commenters highlighted that owners of flow-through entities experience information delays regarding the Federal income tax consequences of transactions taken by such entities due to the ordinary course timing of Schedule K-1 issuances. As a result of this delay in receiving information necessary to determine the existence of eligible gain, commenters contended that partners in a partnership, shareholders in an S corporation, and beneficiaries of a trust should have an additional option to commence the 180-day period upon the due date of the entity's tax return.

The Treasury Department and the IRS agree with the commenters' suggestions. As a result, the final regulations provide partners of a partnership, shareholders of an S corporation, and beneficiaries of decedents' estates and non-grantor trusts with the option to treat the 180-Day period as commencing upon the due date of the entity's tax return, not including any extensions. However, the Treasury Department and the IRS have determined that similar rules for a grantor trust are not necessary because the grantor is treated as the owner of the grantor trust's property for Federal income tax purposes. Therefore, the final regulations set forth different rules applicable to the grantor.

4. Additional Deferral of Previously Invested Gains

Section 1400Z-2(a)(2)(A) provides that no deferral election under section 1400Z-2(a)(1) may be made with respect to a sale or exchange if an election previously made with respect to the sale or exchange is in effect. In proposed § 1.1400Z2(a)-1(b)(4)(ii)(D), Example 4 (Proposed Example 4), a taxpayer disposed of its entire qualifying investment in a QOF in 2025 in a transaction that constituted an event described in proposed § 1.1400Z(b)-1(c) (inclusion event) and recognized gain as a result. In the example, the taxpayer wanted to defer the amount of gain from the inclusion transaction by making another qualifying investment. The example concluded

that the gain recognized due to the inclusion event may be invested in either the original QOF or a different QOF within 180 days of the inclusion event in order to make a new deferral election under section 1400Z-2. The preamble to the May 2019 proposed regulations explained that, upon disposition of that QOF interest, deferring an inclusion otherwise mandated by section 1400Z-2(a)(1)(B) is permitted only if the taxpayer has disposed of the entire initial investment because section 1400Z-2(a)(2)(A) expressly prohibits the making of a deferral election under section 1400Z-2(a)(1) with respect to a sale or exchange if an election previously made with respect to the same sale or exchange remains in effect.

A commenter requested that gain from an inclusion event in which a taxpayer disposes of less than its entire investment in a QOF be eligible for the deferral election under section 1400Z-2(a)(1). The commenter asserted that gain arising from an inclusion event, whether representing all or part of the initially deferred gain, represents new gain that should be eligible for deferral under section 1400Z-2(a).

The Treasury Department and the IRS agree with the commenter. The final regulations adopt the position that gain arising from an inclusion event is eligible for deferral under section 1400Z-2(a) even though the taxpayer retains a portion of its qualifying investment after the inclusion event. Although such gain relates in part to gain from a sale or exchange for which there was a prior election in effect, it is no longer subject to that prior election within the meaning of section 1400Z-2(a)(2)(A) as soon as the inclusion event triggers an income inclusion. Therefore, if an inclusion event relates only to a portion of a taxpayer's qualifying investment in the QOF, (i) the deferred gain that otherwise would be required to be included in income (inclusion gain amount) may be invested in a different QOF, and (ii) the taxpayer may make a deferral election under section 1400Z-2(a) with respect to the inclusion gain amount, so long as taxpayer satisfies all requirements for a deferral election on the inclusion gain amount. To satisfy the requirements under section 1400Z-2(a) and § 1.1400Z2(a)-1(b)(11)(iv), the eligible taxpayer must treat the inclusion gain amount to be deferred as if it were originally realized as a result of the inclusion event. In addition, the eligible taxpayer must meet all other requirements to defer gain under section 1400Z-2. See section 1400Z-2(a)(1) and § 1.1400Z2(a)-1(b)(11)(i)(C) (gain that arises from a sale or exchange of property with a related person is not eligible gain); section 1400Z-2(a)(2)(B) (election may not be made for gain arising after December 31, 2026). Consistent with Proposed Example 4, included in these regulations as § 1.1400Z2(a)-1(b)(7)(iv)(D), the 180-day period for the inclusion gain amount begins on the date of the inclusion event, and the holding period for the second QOF investment begins on the date that an amount corresponding to the inclusion gain amount is invested in the second QOF. See § 1.1400Z2(a)-1(b)(7)(iv), Example 4.

A commenter also requested clarification as to whether additional gain deferral under section 1400Z-2(a)(1)(A), as in Proposed Example 4, is permitted for gain included due to the operation of section 1400Z-2(b)(1)(B), which requires the full amount of gain that was deferred under section 1400Z-2(a)(1)(A), reduced by the amount of gain previously included under proposed § 1.1400Z2(b)-1(b) (remaining deferred gain) to be included in income in the taxable year of the eligible taxpayer that includes December 31, 2026. The commenter explained that the ability to reinvest gains required to be included in income under section 1400Z-2(b) would facilitate liquidity and capital mobility for investors. Moreover, in the event that additional gain deferral is permitted after a taxable year that includes December 31, 2026, the commenter requested clarification regarding the effect of such an additional gain deferral election on items including

the proper amount includible as well as the amount of deferred gain that may be reinvested for the benefits of the election under section 1400Z-2(c).

Proposed Example 4 only illustrated that a taxpayer may invest gain that otherwise would be included pursuant to section 1400Z-2(b)(1)(A) upon the complete disposition of a QOF interest prior to December 31, 2026 (that is, an inclusion event), where the amount of that gain is reinvested in any QOF during the 180-day period beginning on the date of the inclusion event. No inferences should be drawn regarding gains from dispositions after December 31, 2026, because deferral of any gain from such dispositions is expressly prohibited by section 1400Z-2(a)(2)(B). Section 1400Z-2(b)(1) provides that all gain to which section 1400Z-2(a)(1)(A) deferral applies must be included in income in the taxable year that includes the earlier of the date on which a QOF investment is sold or exchanged or December 31, 2026. Further, section 1400Z-2(a)(2)(B) provides that no deferral election may be made under section 1400Z-2(a)(1) with respect to any sale or exchange after December 31, 2026. Accordingly, the statutory language of section 1400Z-2 clearly states, and therefore the section 1400Z-2 regulations provide, that (i) the ability to defer eligible gains pursuant to section 1400Z-2(a)(1)(A) is not permitted with respect to a gain arising after December 31, 2026, and (ii) no additional deferral of any gain is permitted if such gain is required to be included in gross income under section 1400Z-2(b)(1)(B).

5. Qualifying Investment

Section 1400Z-2 provides Federal income tax benefits to an eligible taxpayer that makes an equity investment in a QOF described in section 1400Z-2(e)(1)(A)(i) (that is, a qualifying investment) if the qualifying investment is held for the various statutorily prescribed holding periods. For example, in the case of an eligible taxpayer that maintains a qualifying investment for seven years, the eligible taxpayer's basis in the qualifying investment will be increased by a total amount equal to 15 percent of the amount of the taxpayer's deferred gain. See section 1400Z-2(b)(2)(B)(iii) and (iv) (providing for basis increases of 10 and five percent, respectively). With respect to a qualifying investment that is sold or exchanged after being held by the eligible taxpayer for at least 10 years, if the eligible taxpayer makes an election under section 1400Z-2(c), the basis of the qualifying investment will be increased to an amount equal to the fair market value of that investment on the date on which it is sold or exchanged. See section 1400Z-2(c).

In the May 2019 proposed regulations, the Treasury Department and the IRS specified transactions that would cause the inclusion in gross income of an eligible taxpayer's gain that had been deferred under section 1400Z-2(a)(1)(B) and (b). Defined as an "inclusion event," each of these transactions "would reduce or terminate the QOF investor's direct (or, in the case of partnerships, indirect) qualifying investment for Federal income tax purposes or (in the case of distributions) would constitute 'cashing out' of the QOF investor's qualifying investment.... It is necessary to treat such [distributive] transactions as inclusion events to prevent taxpayers from 'cashing out' a qualifying investment in a QOF without including in gross income any amount of their deferred gain." See May 2019 proposed regulations, Explanation of Provisions, part VII.A.

As indicated in the first sentence of part VII.E. (Transfers of Property by Gift or by Reason of Death) and elsewhere in the Explanation of Provisions in the May 2019 proposed regulations, the

termination of a direct interest in a qualifying investment that resulted in an inclusion event terminated the status of an investment in a QOF as a qualifying investment " [f]or purposes of sections 1400Z-2(b) and (c)." This is because the statutory text of each of section 1400Z-2(a), (b), (c), and (e)(1) focuses on one holding period of "the taxpayer" tested at various points during a period of at least 10 years.

The May 2019 proposed regulations excepted certain enumerated dispositions of qualifying investments from treatment as inclusion events to provide for business flexibility for QOFs or qualified opportunity zone businesses. However, those exceptions were premised upon the requirement that the same eligible taxpayer generally be treated as continuing to hold the same interest in the QOF, and thereby continue to bear the Federal income tax liability associated with holding the interest, such as by reason of section 381 or section 704(c). This degree of identity of taxpayer is fundamentally different (and more demanding) than a mere "step in the shoes" concept based on whether the transferee of the interest can tack the holding period and basis of the transferor. Accordingly, the May 2019 proposed regulations treated, among other transactions, gifts and section 351 exchanges as inclusion events because, in each instance, (i) the initial eligible taxpayer had severed the direct investment interest in the QOF and (ii) the transferee taxpayer was not treated for Federal income tax purposes either as the same taxpayer as the initial eligible taxpayer or as a successor taxpayer. This is true even though in each such case, the acquiring taxpayer's basis and holding period for purposes of determining gain or loss may be identical to that of the taxpayer that made the initial investment in the QOF. See *id.*, parts VII. E (regarding gifts) and VII. G (regarding section 351 exchanges).

Commenters have requested clarification of the treatment of investments in QOFs under section 1400Z-2(c) that have been disposed of by gift, in section 351 exchanges, and in other transactions treated as inclusion events. For the foregoing reasons, the final regulations clarify that transactions described as inclusion events result in a reduction or termination of a qualifying investment's status as a qualifying investment to the extent of the reduction or termination, except as otherwise provided in § 1.1400Z2(b)-1(c) or other provisions of the section 1400Z-2 regulations. See part IV. C of this Summary of Comments and Explanation of Revisions. Moreover, the reduction or termination of that status applies for purposes of section 1400Z-2(c) as well as section 1400Z-2(a)(1)(B) and (b). An inclusion event is a transaction that reduces or terminates the QOF investor's direct (or, in the case of partnerships, indirect) qualifying investment for Federal income tax purposes or, in the case of distributions, constitutes a "cashing out" of the eligible taxpayer's qualifying investment in the QOF. For that reason and to that extent, the taxpayer holding the reduced investment in the QOF after the inclusion event no longer possesses a qualifying investment. Thus, the benefits provided under section 1400Z-2(c) generally are available only to a taxpayer that not only makes an equity investment in a QOF described in section 1400Z-2(e)(1)(A)(i) (that is, a qualifying investment), but also then continuously maintains that qualifying investment throughout statutorily prescribed holding periods.

However, consistent with that rationale, the May 2019 proposed regulations did not treat as an inclusion event a gift by the taxpayer to a grantor trust of which the taxpayer is the deemed owner because, for Federal income tax purposes, the owner of the grantor trust is treated as the owner of the trust's property and thus of the qualifying investment in its QOF. See *id.*, part VII.E. See also *id.*, part VII.F.1 (providing a similar exception regarding section 381 transactions based

on a statutory successor taxpayer concept). Accordingly, eligibility for benefits under section 1400Z-2 in these limited instances would be maintained.

The Treasury Department and the IRS have received several comments requesting clarification that qualifying investments include interests received in a transfer by reason of death that is not an inclusion event. In the case of a decedent, section 1400Z-2(e)(3) provides a special rule requiring amounts recognized under section 1400Z-2, if not properly includible in the gross income of the decedent, to be includible in gross income as provided by section 691. In that specific case, the beneficiary that receives the qualifying investment has the obligation to include the deferred gain in gross income in the event of any subsequent inclusion event, including for example, any further disposition by that recipient. See *id.*, part VII.E. In other words, unlike an inclusion event contemplated by the general rules of section 1400Z-2(b), the obligation to include the original taxpayer investor's deferred gain in income travels with that taxpayer's qualifying investment to the beneficiary. Accordingly, the May 2019 proposed regulations excepted transfers of a qualifying investment to the deceased owner's estate, as well as distributions by the estate, from the definition of "inclusion event." See *id.*, part VII.E.

As indicated in part VII.E. of the Explanation of Provisions of the May 2019 proposed regulations, the Treasury Department and the IRS have determined that interests received in a transfer by reason of death continue to be a qualifying investment in the hands of the beneficiary for purposes of section 1400Z-2(c). As described earlier, sections 691 and 1400Z-2(e)(2) require such a transfer to not give rise to an inclusion event because the beneficiary is treated as a successor to the original eligible taxpayer that made the qualifying investment (that is, the beneficiary "steps into the shoes" of the original taxpayer investor with regard to both the benefits of the qualifying investment and the obligation to ultimately include the original taxpayer's deferred gain into the beneficiary's income). As a result, the Treasury Department and the IRS have determined that a qualifying investment received by a beneficiary in a transfer by reason of death should continue to be a qualifying investment in the hands of the beneficiary for purposes of section 1400Z-2(b) and (c).

The Treasury Department and the IRS have also received a comment suggesting that the final regulations should permit QOFs to make loans to qualified opportunity zone businesses and treat as qualifying investments the debt instruments arising from such loans. Confirmation of the tax treatment of such debt instruments as qualifying investments (that is, equity investments in a QOF) would require a debt-equity analysis based on a careful examination of all relevant facts and circumstances and Federal income tax principles apart from those found in section 1400Z-2 and the section 1400Z-2 regulations. Such an analysis would exceed the scope of these regulations. As a result, the final regulations do not adopt the commenter's suggestion.

B. Making an Investment for Purposes of an Election Under Section 1400Z-2(a)

1. Acquisition of an Eligible Interest From a Person Other Than a QOF

Proposed § 1.1400Z2(a)-1(b)(9)(iii) permitted a taxpayer to make a deferral election under section 1400Z-2(a)(1)(A) for an eligible interest acquired from a person other than a QOF. Commenters asked whether the transferor of that eligible interest needed to have made an election under section 1400Z-2(a) prior to the taxpayer's acquisition. Commenters also asked

whether the acquirer must have realized eligible gain within the 180-day period prior to the acquisition of the eligible interest in order for acquisition of that interest to support a deferral election under section 1400Z-2(a)(1)(A) with respect to the eligible gain. Additionally, commenters requested confirmation regarding whether shares or partnership interests in a pre-existing entity that becomes a QOF pursuant to proposed § 1.1400Z2(d)-1(a)(3) become eligible interests when the pre-existing corporation or partnership becomes a QOF.

The final regulations do not require the transferor to have made a prior election under section 1400Z-2(a) for the acquirer of an eligible interest to make such an election. Further, for interests in entities that existed before the enactment of section 1400Z-2, if such entities become QOFs pursuant to § 1.1400Z2(d)-1(a)(3), then the interests in those entities, even though not qualifying investments in the hands of a transferor, are eligible interests that may (i) be acquired by an investor and (ii) result in a qualifying investment of the acquirer if the acquirer has eligible gain and the acquisition was during the 180-day period with respect to that gain.

2. Eligibility of Built-In Gain for Deferral

One commenter requested confirmation that the built-in gain of a REIT, a RIC, or an S corporation potentially subject to corporate-level tax under section 1374 or § 1.337(d)-7 is eligible for deferral under section 1400Z-2. To the extent the built-in gain is an eligible gain, an election under section 1400Z-2 may be made for such gain of a REIT, a RIC, or an S corporation. If such election is made, the amount of such gain will not be included in the calculation of the entity's net recognized built-in gain (as defined in section 1374(d)(2)) in the year of deferral. Similarly, if a deferral election is made with respect to an eligible gain that, absent the deferral election, would constitute a recognized built-in gain (RBIG) within the meaning of section 382(h)(2)(A) or section 1374(d)(3), the amount of such eligible gain deferred as a result of a qualifying investment in a QOF is not taken into account as RBIG in the year of deferral.

3. Grantor Trusts

A commenter pointed out that the rule in proposed § 1.1400Z2(a)-1(c)(3) does not achieve the proper result for grantor trusts that do not make the deferral election but distribute the deferred gain to a trust beneficiary other than the deemed owner of the trust. The commenter pointed out that the proposed rule should not apply to grantor trusts because the deemed owner of the trust is liable for the Federal income tax on the gain regardless of whether that gain is distributed currently to a trust beneficiary other than the deemed owner. The commenter also requested clarification that either the grantor trust recognizing the gain or the deemed owner of that trust is eligible to both make the deferral election and make a qualifying investment, regardless of whether the grantor trust distributes the gain to the deemed owner or to any other person. The Treasury Department and the IRS agree with the commenter and have made the requested adjustments in the final regulations.

C. Identification of Disposed Interests in a QOF

Under the May 2019 proposed regulations, if a taxpayer held interests in a QOF with identical rights (for example, equivalent shares of stock in a QOF corporation) that were acquired on different days, and if the taxpayer disposed of less than all of those interests on a single day, the taxpayer was required to use the first-in-first-out (FIFO) method to identify which interests were disposed of for certain specified purposes, such as determining the character and other attributes of the deferred gain that is included as a result of the disposition. In circumstances in which the FIFO method did not provide a complete answer, taxpayers were required to use a pro-rata method. In requesting comments as to whether methods other than the FIFO method and the pro-rata method should be used, the Treasury Department and the IRS stipulated that any such methods must both provide certainty as to which fungible interest a taxpayer disposes of and allow taxpayers to comply easily with the requirements of section 1400Z-2(a)(1)(B) and (b) that certain dispositions of an interest in a QOF cause deferred gain be included in a taxpayer's income.

In response, commenters requested that taxpayers be permitted to specifically identify the QOF interests that are sold or otherwise disposed of, and they recommended that the final regulations adopt rules similar to those in § 1.1012-1(c). Under such rules, a taxpayer would be required to use the FIFO method only if the taxpayer fails to adequately identify which shares were disposed of.

The Treasury Department and the IRS agree that specific identification should be permitted for dispositions of interests in QOF corporations. Thus, the final regulations permit taxpayers to employ the rules and principles of § 1.1012-1(c) to specifically identify the QOF stock that is sold or otherwise disposed. If a taxpayer fails to adequately identify which QOF shares are disposed of, then the FIFO identification method applies. If, after application of the FIFO method, a taxpayer is treated as having disposed of less than all of its investment interests that the taxpayer acquired on one day and the investments vary in its characteristics, then the pro-rata method will apply to the remainder.

However, the final regulations do not extend this specific identification methodology to the disposition of interests in a QOF partnership because, under Federal income tax law, a partnership interest represents an undivided, unitary interest in all of the partnership assets and liabilities. Other than in the case of a mixed-funds investment in a QOF partnership, where the section 1400Z-2 statute mandates a division of partnership interests, the final regulations do not adopt the commenters' recommendation because it would broaden the complexities associated with dividing partnership interests into separate components with associated assets and liabilities.

In addition, the final regulations make it clear that if a taxpayer is required to include in income some or all of a previously deferred gain, the gain so included has the same attributes that the gain would have had if the recognition of gain had not been deferred under section 1400Z-2. The final regulations generally provide that forms, instructions, and other administrative guidance control in determining which deferred gains are associated with particular interests in QOFs. However, the final regulations also provide that, to the extent that such guidance does not clearly associate an investment in a QOF with an amount of deferred gain, an ordering rule applies that permits taxpayers to determine how to associate investments in QOFs with particular deferred gains.

D. Property Transferred in Exchange for a Qualifying Investment Is Not Qualified Opportunity Zone Business Property

The May 2019 proposed regulations clarify that taxpayers may transfer property other than cash to a QOF in exchange for a qualifying investment. A commenter asked whether property that is purchased in a QOZ and contributed to a QOF could be qualified opportunity zone business property, or whether such property would be excluded automatically because it is not purchased by the QOF. The commenter further asked why taxpayers are permitted to contribute property to a QOF in exchange for a qualifying investment if the property cannot be qualified opportunity zone business property.

Taxpayers are permitted to transfer property to a QOF in exchange for a qualifying investment because the statute does not preclude taxpayers from investing in a QOF in this manner and because permitting such transfers is not inconsistent with the policies underlying section 1400Z-2. As the commenter noted, property that is contributed to a QOF cannot be qualified opportunity zone business property because qualified opportunity zone business property must be purchased by a QOF. See section 1400Z-2(d)(2)(D)(i)(I). The QOF may retain the contributed property among its assets that are not qualified opportunity zone property, or it may sell the property and use the proceeds to acquire qualified opportunity zone property in accordance with section 1400Z-2(d) and the section 1400Z-2 regulations.

E. Amount Invested in a QOF Partnership for Purposes of Section 1400Z-2(a)(1)(A)

The May 2019 proposed regulations contained two rules that, if either were applicable, would reduce the amount of a taxpayer's qualifying investment.

First, proposed § 1.1400Z2(a)-1(b)(11)(ii)(A)(1) provided that, to the extent the transfer of property to a QOF partnership is characterized other than as a contribution (for example, a transfer that is characterized as a disguised sale under section 707), the transfer is not an investment within the meaning of section 1400Z-2(a)(1)(A) (section 1400Z-2(a)(1)(A) investment). The Treasury Department and the IRS confirm that the reference to the disguised sale regulations under section 707 is intended to provide an existing analytical framework and rules applicable to transfers of property to a QOF partnership to determine whether the transfer is a contribution for purposes of making a qualifying investment. All guidance under section 707 that otherwise would be applicable, including any exception, applies. In particular, § 1.707-4(b)(2) (relating to operating cash flow distributions) applies to transfers to and distributions from a QOF partnership. Therefore, to the extent a transfer of property is characterized as a sale under the existing section 707 framework, there is no contribution and section 1400Z-2 would not apply to the transfer. These final regulations do not modify section 707 or the regulations in this part under section 707.

Second, proposed § 1.1400Z2(a)-1(b)(11)(ii)(A)(2) provided that, to the extent proposed § 1.1400Z2(a)-1(b)(11)(ii)(A)(1) did not apply, the transfer to the partnership would not be treated as a section 1400Z-2(a)(1)(A) investment to the extent the partnership makes a distribution to the partner and the transfer to the partnership and the distribution would be recharacterized as a disguised sale under section 707 if (i) any cash contributed were non-cash property, and (ii) in the case of a distribution by the partnership to which § 1.707-5(b) (relating to debt-financed

distributions) applies, the partner's share of liabilities is zero. The Treasury Department and the IRS received comments asking for clarification of the application of proposed § 1.1400Z2(a)-1(b)(11)(ii)(A)(2) and confirmation that the regulations under section 707, including the exceptions to the disguised sale rules, apply in determining whether a contribution, in whole or part, is treated as part of a disguised sale. In particular, commenters asked how debt-financed distributions should be treated and requested confirmation that operating cash flow distributions would not be presumed to be a part of a disguised sale.

The Treasury Department and the IRS note that, even if a contribution were not recharacterized as a disguised sale under section 707 and the regulations in this part under section 707, the amount of the qualifying investment is reduced under the modified application of the section 707 disguised sale rules in § 1.1400Z2(a)-1(c)(6)(iii)(A)(2). This provision adopts the rule contained in the May 2019 proposed regulations without change. However, in making the qualifying investment determination under this rule, the other exceptions to the disguised sale rules still would apply. For example, a distribution by the partnership would not reduce the amount of the qualifying investment to the extent the operating cash flow distribution exception of § 1.707-4(b) applied.

Commenters also requested clarification regarding the Federal income tax consequences of distributions by an "overfunded" QOF partnership carried out to eliminate the amount of excess cash invested therein. Commenters explained that, in this situation, an eligible taxpayer would contribute a cash amount in excess of the amount that the QOF partnership desires to invest and, within the same year, the QOF partnership distributes the excess cash back to the eligible taxpayer. The final regulations provide an example clarifying and illustrating the application of the rules. The later distribution by the QOF partnership would be tested under the normal distribution rules for purposes of determining whether there is an inclusion event. For QOF partnerships, there would be an inclusion event to the extent the distribution exceeds the partner's outside basis in its qualifying investment. Although the basis in the qualifying investment is initially zero, that basis may be increased by the partner's share of debt and net income.

F. At-Risk Basis

One commenter requested clarification that investors get at-risk basis for their qualifying investments. The May 2019 proposed regulations did not address whether a taxpayer has at-risk basis in its qualifying investment. Thus, the commenter stated that there is uncertainty under the May 2019 proposed regulations as to whether investors' capital contributions will give rise to at-risk basis under section 465 even though taxpayers must take zero basis in their qualifying investments.

Section 465 generally provides that a taxpayer shall be considered "at risk" for an activity with respect to amounts including the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity. The Treasury Department and the IRS note that a taxpayer's amount at risk generally is determined by reference to the amount of money and the basis of property contributed, not to the basis of the interest received in exchange for the property. Additionally, section 465 and the regulations in this part under section 465 provide the necessary guidance for this determination. As a result, the Treasury Department and the IRS

have determined that the commenter's requested clarification exceeds the scope of the section 1400Z-2 regulations.

G. Withholding Tax and FIRPTA

The Treasury Department and the IRS received comments regarding the application of withholding tax regimes within the context of section 1400Z-2(a). For example, a commenter requested that a foreign taxpayer engaging in a sale subject to withholding under section 1445(a) (imposing a 15 percent withholding tax as part of the Foreign Investment in Real Property Tax Act (FIRPTA)) be able to provide a certificate or other form of documentation to avoid withholding on the basis of the taxpayer's intention to invest the resulting gain in a QOF pursuant to a deferral election under section 1400Z-2(a)(1). Another commenter requested an exemption from withholding when a person enters into an agreement with the IRS to pay the tax when the deferred gain is included under section 1400Z-2(a)(1)(B) and (b), similar to when a gain recognition agreement is "triggered" under section 367 and the regulations in this part under section 367. The Treasury Department and the IRS continue to consider this comment and other matters related to the mechanics of applying section 1400Z-2 in the context of a sale subject to withholding tax.

The final regulations clarify that section 1400Z-2 is not a "nonrecognition provision" for purposes of section 897(e) and § 1.897-6T. See § 1.1400Z2(a)-1(e). A non-recognition provision is defined in section 897(e)(3) as any provision of the Code for "not recognizing gain or loss." Similarly, § 1.897-6T(a)(2) defines a non-recognition provision as any Code provision "which provides that gain or loss shall not be recognized." Pursuant to section 897(e)(1) and § 1.897-6T(a)(1), nonrecognition provisions generally do not apply upon the exchange of a U.S. real property interest in a transaction subject to FIRPTA unless the asset received in exchange is also a U.S. real property interest. The Treasury Department and the IRS have determined that section 1400Z-2 is not a nonrecognition provision for purposes of section 897(e) and § 1.897-6T because an election under that provision generally defers, rather than prevents altogether, the recognition of gain. By deferring gain recognition, section 1400Z-2 is fundamentally different from the provisions identified as nonrecognition provisions in § 1.897-6T(a)(2), such as sections 332, 351, 721, and 1031.

III. Comments on and Changes to Proposed § 1.1400Z2(b)-1

Proposed § 1.1400Z2(b)-1 provided rules regarding the inclusion in income of gain deferred under section 1400Z-2(a)(1)(A), including rules regarding which events trigger the inclusion of deferred gain, how much gain is included, and the effects of these events on the investor's basis and holding period in its qualifying investment.

A. General Rule Regarding Inclusion Events

Proposed § 1.1400Z2(b)-1(c)(1) generally provided that, except as otherwise provided in proposed § 1.1400Z2(b)-1(c), certain events (that is, inclusion events) result in the inclusion of gain under proposed § 1.1400Z2(b)-1(b) if and to the extent that: (i) A taxpayer's transfer of a qualifying investment reduces the taxpayer's equity interest in the qualifying investment; (ii) a

taxpayer receives property in a transaction treated as a distribution for Federal income tax purposes, regardless of whether the receipt reduces the taxpayer's ownership of the QOF; or (iii) a taxpayer claims a worthlessness deduction with respect to its qualifying investment. Proposed § 1.1400Z2(b)-1(c)(2) through (15) then provided specific rules for certain types of transactions that are or are not treated as inclusion events.

The Treasury Department and the IRS received several comments and questions regarding the general rule set forth in proposed § 1.1400Z2(b)-1(c)(1). For example, one commenter asked whether the phrase "the following events" refers to the items in proposed § 1.1400Z2(b)-1(c)(2) through (15) or whether the phrase instead refers to the items in proposed § 1.1400Z2(b)-1(c)(1)(i) through (iii). Another commenter stated that the general rule in proposed § 1.1400Z2(b)-1(c)(1)(i) could be read to suggest that there is no inclusion event so long as a taxpayer retains an equity interest, whether direct or indirect, in a qualifying investment after a transfer, even though the preamble to the May 2019 proposed regulations indicated that any reduction in a taxpayer's direct interest in a qualifying investment is an inclusion event, other than in the case of partnerships. Yet another commenter asserted that the specific rules in proposed § 1.1400Z2(b)-1(c)(2) through (15) appear to cover all potentially relevant transactions and therefore the purpose of the general rule seems unclear. As a result, commenters recommended that the Treasury Department and the IRS clarify or eliminate the general rule.

As explained in the preamble to the May 2019 proposed regulations, proposed § 1.1400Z2(b)-1(c) reflected the general principle that, except as otherwise provided, an inclusion event results from: A transfer of a qualifying investment, to the extent the transfer reduces the taxpayer's direct equity interest; the receipt of a distribution on or with respect to a qualifying investment, which constitutes an impermissible "cashing out" of the taxpayer's qualifying investment; or the claim of a worthlessness deduction (under section 165(g) or otherwise) in respect of a qualifying investment. Proposed § 1.1400Z2(b)-1(c)(1) set forth these principles as a general rule, and proposed § 1.1400Z2(b)-1(c)(2) through (15) provided elaborations of, and exceptions to, the general rule. The Treasury Department and the IRS did not intend the general rule to suggest that a taxpayer may avoid an inclusion event by retaining an indirect interest in a QOF, and the specific rules clearly indicated that a transfer that reduces a taxpayer's direct interest is an inclusion event except as otherwise provided.

These final regulations retain the general rule in proposed § 1.1400Z2(b)-1(c)(1). However, this general rule has been clarified in response to the foregoing comments. In addition to the changes described in this part III, the specific rules in § 1.1400Z2(b)-1(c)(2) through (c)(15) have been clarified as necessary.

These final regulations also clarify that if a QOF is decertified, either through the QOF's voluntary self-decertification or an involuntary decertification, such decertification is an inclusion event that terminates the qualifying investment status of the taxpayer's interest in the QOF.

A commenter also requested clarification as to whether an inclusion event terminates the application of section 1400Z-2 to an interest in a QOF. In some cases, an inclusion event may be the result of a transfer of the qualifying investment that reduces or terminates the owner's interest in the QOF, but in other cases it may not (for example, a distribution from a QOF C corporation

subject to section 301(c)(3)). Thus, the commenter argued that the occurrence of an inclusion event is not the appropriate test for determining whether an interest in a QOF ceases to be a qualifying investment eligible for the basis adjustments under section 1400Z-2(b).

As discussed in part II.A.5 of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have determined that an inclusion event generally results in a reduction or termination of a qualifying investment's status as a qualifying investment to the extent of the reduction or termination for purposes of section 1400Z-2(a)(1)(B), (b), and (c). However, the Treasury Department and the IRS agree that certain types of inclusion events (namely, certain distributions) do not terminate a taxpayer's qualifying investment. See part IV. C of this Summary of Comments and Explanation of Revisions.

The Treasury Department and the IRS also recognize that the language in proposed § 1.1400Z2(b)-1(g)(2), which provided that "[t]he increases in basis under section 1400Z-2(b)(2)(B)(iii) and (iv) only apply to that portion of the qualifying investment that has not been subject to previous gain inclusion under section 1400Z-2(b)(2)(A)," could be read to suggest that all inclusion events cause interests in a QOF to cease to be qualifying investments. In other words, by restricting the five-year and seven-year basis increases to qualifying investments that have "not been subject to previous gain inclusion," proposed § 1.1400Z2(b)-1(g)(2) appeared to exclude any qualifying investment that has been subject to any inclusion event, even if substantial amounts of deferred gain remain.

The Treasury Department and the IRS have determined that qualifying investments that have been subject to inclusion events should continue to be eligible for the five-year and seven-year basis increases to the extent deferred gain has not yet been recognized at the time of these basis increases. For example, if a taxpayer invests \$100x of eligible gain in a QOF corporation and the corporation subsequently makes a section 301(c)(3) distribution of \$20x with respect to the taxpayer's qualifying investment, the taxpayer still should be eligible to receive a five-year basis increase of \$8x (10 percent of its remaining deferred gain of \$80x) and a seven-year basis increase of \$4x (five percent of its remaining deferred gain of \$80x). Section 1.1400Z2(b)-1(g)(2) of the final regulations has been modified accordingly.

B. Transactions Treated as Distributions for Federal Income Tax Purposes

1. Overview

Proposed § 1.1400Z2(b)-1(c)(1)(ii) generally provided that, except as otherwise provided in proposed § 1.1400Z2(b)-1(c), an inclusion event occurs if and to the extent a taxpayer receives property in a transaction that is treated as a distribution for Federal income tax purposes, regardless of whether the receipt reduces the taxpayer's ownership of the QOF. Proposed § 1.1400Z2(b)-1(c)(8) modified this general rule by providing that a distribution of property by a QOF C corporation with respect to a qualifying investment, including a distribution of stock that is treated as a distribution of property to which section 301 applies under section 305(b), is an inclusion event only to the extent section 301(c)(3) applies to the distribution. In the preamble to the May 2019 proposed regulations, the Treasury Department and the IRS requested comments on the proposed treatment of distributions to which section 305(b) applies.

In turn, proposed § 1.1400Z2(b)-1(c)(9) generally provided that a redemption described in section 302(d) by a QOF C corporation is an inclusion event with respect to the full amount of the distribution. However, if the QOF C corporation is wholly and directly owned by a single shareholder (or by members of a single consolidated group), the section 302(d) redemption is an inclusion event only to the extent section 301(c)(3) applies.

2. Section 302(d) Redemptions

Commenters made several recommendations with respect to the foregoing rules. For example, commenters questioned the treatment of dividend-equivalent redemptions in the May 2019 proposed regulations. One commenter acknowledged that a section 302(d) redemption reduces a taxpayer's direct equity interest, but the commenter recommended treating such redemptions in the same manner as section 301 distributions for purposes of section 1400Z-2 because section 302 treats such redemptions as distributions rather than as sales or exchanges. The commenter further recommended that section 302(d) redemptions in which each shareholder surrenders a pro rata percentage of its shares not be treated as inclusion events. Another commenter recognized that requiring an inclusion event only upon a complete redemption of a shareholder's qualifying investment would enable taxpayers to avoid taxation by retaining even a small amount of qualifying QOF stock, but the commenter still questioned why a partial redemption should cause acceleration. Both commenters recommended that section 302(d) redemptions and section 301 distributions be treated similarly for purposes of section 1400Z-2, with the exception of complete redemptions, which would be an inclusion event to the extent of the full amount of the distribution.

As noted in the foregoing comments, a redemption transaction reduces a taxpayer's direct qualifying investment in a QOF, regardless of whether such transaction is treated as a dividend for Federal income tax purposes. The Treasury Department and the IRS have determined that the general treatment of section 302(d) redemptions as section 301 distributions for Federal income tax purposes should not override the general requirement that QOF shareholders must retain their direct qualifying investment in a QOF corporation in order to retain the benefits of section 1400Z-2. See section 1400Z-2(b)(1)(A) ("Gain to which subsection (a)(1)(B) applies shall be included in income in the taxable year which includes... the date on which such investment is sold or exchanged..."). As a result, the Treasury Department and the IRS have determined that it would be inappropriate to treat such redemptions in the same manner as section 301 distributions for purposes of section 1400Z-2.

However, in certain circumstances, a reduction in a taxpayer's qualifying investment by virtue of a section 302(d) redemption is meaningless. For example, if a wholly owned QOF C corporation partially redeems its sole shareholder, the shareholder will continue to wholly own the QOF C corporation after the redemption. Similarly, if a QOF C corporation redeems its single outstanding class of stock from all shareholders on a pro rata basis, each QOF shareholder will retain the same proportionate interest in the QOF after the partial redemption.

As a result, the final regulations generally continue to treat dividend-equivalent redemptions by QOF C corporations as inclusion events with respect to the full amount of the distribution, with an exception for redemptions by wholly owned QOF C corporations, which are inclusion events only to the extent section 301(c)(3) applies. The Treasury Department and the IRS agree with

the commenter that an additional exception should be created for pro rata section 302(d) redemptions, so long as the QOF C corporation has only one class of stock outstanding. The final regulations have been modified to treat such redemptions in the same manner as redemptions by wholly owned QOF C corporations. In other words, an inclusion event occurs only to the extent section 301(c)(3) applies. Similarly, with respect to QOF S corporations, the final regulations continue to treat dividend-equivalent redemptions as inclusion events to the extent that the distributed property has a fair market value in excess of the shareholder's basis, including any basis adjustments under section 1400Z-2(b)(2)(B)(iii) and (iv). See part III.E.2.a of this Summary of Comments and Explanation of Revisions.

3. Section 305 Distributions and Section 306 Redemptions

A commenter agreed with the treatment of section 305(b) distributions in the May 2019 proposed regulations—namely, that such distributions should be included as distributions subject to the rule in proposed § 1.1400Z2(b)-1(c)(8). However, the commenter further recommended that the final regulations address the treatment of stock received in a section 305(a) distribution with respect to qualifying QOF stock. When a corporation distributes its own stock to its shareholders, section 305(a) provides that the shareholders do not include the distribution in gross income. The basis of the new stock received and of the stock with respect to which the distribution is made (old stock) is determined by allocating the basis of the old stock between the old stock and the new stock in proportion to the respective fair market values of the old stock and the new stock on the date on which the new stock is distributed, and the holding period for the new stock is the same as the holding period for the old stock. See § 1.307-1(a) (regarding allocation of basis) and section 1223(4) (regarding determination of holding period). The commenter requested clarification that the new stock received in a section 305(a) distribution with respect to qualifying QOF stock is also qualifying QOF stock, with the remaining deferred gain being allocated pro rata between the old stock and the new stock, and with the holding period for the new stock being the same as the holding period for the old stock. The Treasury Department and the IRS agree with the commenter's recommendation, and the final regulations have been modified accordingly.

The commenter also requested clarification regarding the treatment of redemptions of section 306 stock. Section 306 stock generally includes stock, other than common stock, that was received tax-free in certain transactions by the shareholder disposing of such stock, including a stock dividend under section 305(a), a corporate reorganization described in section 368(a), or a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applied. See section 306(c). Section 306(a)(2) provides that, if a shareholder disposes of its section 306 stock in a redemption, the amount realized is treated as a distribution of property to which section 301 applies. The commenter recommended that such a redemption be subject to the rules for section 301 distributions in proposed § 1.1400Z2(b)-1(c)(8).

The Treasury Department and the IRS agree that the final regulations should address the treatment of section 306(a)(2) redemptions. For the reasons discussed in part III.B.2 of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have determined that section 306(a)(2) redemptions should be treated in the same manner as dividend-equivalent redemptions for purposes of section 1400Z-2. The final regulations have been modified accordingly.

4. Distributions Subject to Section 1059

A commenter recommended that qualifying investments in QOF C corporations be excluded from the application of section 1059. Alternatively, the commenter requested confirmation that (1) the recognition of gain under section 1059(a)(2) would result in an inclusion event to the extent of that gain, and (2) the ordering rule in proposed § 1.1400Z2(b)-1(g)(1)(ii), which applied to basis increases under section 1400Z-2(b)(2)(B)(ii), also would apply to such inclusion event.

The commenter contended that, in many instances, the policy concerns underlying section 1059, as described by the commenter, would not be applicable to distributions made by a QOF C corporation. However, an example in the commenter's analysis illustrated that the concerns underlying section 1059 are present any time a QOF corporation has earnings and profits (E&P) predating the date on which a qualifying investment is made. The Treasury Department and the IRS have determined that, to the extent consistent with the application of section 1400Z-2, and unless provided otherwise by the section 1400Z-2 regulations, the rules of subchapter C apply with respect to a QOF C corporation. The commenter's analysis did not set forth any statutory authority under section 1400Z-2 or subchapter C for not applying section 1059 to distributions from a QOF C corporation. As a result, the Treasury Department and the IRS have determined that section 1059 should apply to a QOF C corporation, and the final regulations do not adopt the commenter's primary recommendation.

However, the Treasury Department and the IRS agree with the commenter's alternative recommendation that the recognition of gain under section 1059(a)(2) should result in an inclusion event to the extent of that gain, and that the ordering rule in proposed § 1.1400Z2(b)-1(g)(1)(ii) should apply to such inclusion event. The final regulations have been modified accordingly.

C. Reorganizations of QOF Corporations

1. Overview

Proposed § 1.1400Z2(b)-1(c)(10) generally provided that, if the assets of a QOF corporation are acquired in a qualifying section 381 transaction, and if the acquiring corporation is a QOF within a prescribed period of time after the acquisition, the transaction would not be an inclusion event. The proposed regulations included this rule because, after the transaction, the taxpayer would have retained a direct qualifying investment in an acquiring QOF that is a successor to the transferor QOF under section 381. The proposed regulations defined the term "qualifying section 381 transaction" to mean an acquisitive asset reorganization described in section 381(a)(2), with certain enumerated exceptions. See proposed § 1.1400Z2(b)-1(a)(2)(xx).

However, if a QOF shareholder received boot in a qualifying section 381 transaction with respect to the shareholder's qualifying investment, the taxpayer would have an inclusion event because the taxpayer would have reduced its direct qualifying investment in the QOF or cashed out part of its investment. For this purpose, the term "boot" means money or other property that section 354 or 355 does not permit to be received without the recognition of gain. Under the

May 2019 proposed regulations, if the taxpayer realizes a gain on the transaction, the amount that gives rise to the inclusion event is the amount of gain under section 356 that is not treated as a dividend under section 356(a)(2). If the taxpayer realizes a loss on the transaction, the amount that gives rise to the inclusion event is an amount equal to the fair market value of the boot received. If a single taxpayer or members of a single consolidated group wholly own both the target QOF and the acquiring QOF, the boot is treated as if it were distributed from the QOF in a separate section 301 transaction and is only taxable to the extent section 301(c)(3) applies.

In turn, proposed § 1.1400Z2(b)-1(c)(12) generally provided that, if a QOF corporation engages in a recapitalization transaction described in section 368(a)(1)(E) (recapitalization), or if a QOF shareholder engages in a stock-for-stock exchange described in section 1036 (section 1036 exchange), and if the transaction does not have the result of decreasing the shareholder's proportionate interest in the QOF corporation, the transaction is not an inclusion event. However, any property or boot received by the shareholder in the transaction is treated as property or boot to which section 301 or section 356 applies, as determined under general Federal income tax principles. Proposed § 1.1400Z2(b)-1(c)(8) or (10), respectively, then determined the extent to which the receipt of such property or boot triggers an inclusion event. Moreover, if the transaction decreases the shareholder's proportionate qualifying investment in the QOF corporation, the shareholder has an inclusion event equal to the amount of the reduction in fair market value of the shareholder's qualifying QOF stock.

2. Proposed Treatment of Recapitalizations and Section 1036 Exchanges

Several commenters recommended that a single inclusion event rule be applied to qualifying section 381 transactions, recapitalizations, and section 1036 exchanges. One commenter argued that, if a taxpayer's proportionate interest were reduced in a recapitalization or in a section 1036 exchange, the taxpayer either would have received actual consideration (that is, boot) in the transaction or would be deemed to have received boot in the transaction under general Federal income tax principles. See, for example, Rev. Rul. 74-269, 1974-1 C.B. 87. Another commenter argued that a reduction in a shareholder's proportionate interest by virtue of the QOF's issuance of new stock to a new investor should not be treated as an inclusion event, and that a reduction in the shareholder's interest by virtue of the shareholder's receipt of non-stock consideration should be covered by the boot rules for reorganizations. Thus, the commenters argued that recapitalizations and section 1036 exchanges should be governed by the same rules that govern qualifying section 381 transactions.

The Treasury Department and the IRS agree with many of the foregoing comments. For example, the Treasury Department and the IRS agree that the reduction of a shareholder's proportionate interest in a QOF through a recapitalization should not be treated as an inclusion event unless the shareholder receives, or is deemed to receive, boot in the transaction. Thus, a shareholder should not have an inclusion event by virtue of the QOF's issuance of qualifying QOF stock to a new investor. The Treasury Department and the IRS also agree that the rules for recapitalizations and section 1036 exchanges should be modified to mirror more closely the rules for qualifying section 381 transactions. The final regulations reflect these determinations. However, the final regulations retain separately numbered rules for reorganizations, and for recapitalizations and section 1036 exchanges.

3. Receipt of Boot

Commenters also recommended simplifying the proposed rules regarding boot. For example, one commenter recommended eliminating the special rule for the receipt of boot from a wholly owned QOF in proposed § 1.1400Z2(b)-1(c)(10)(i)(C)(2) and subjecting qualifying section 381 transactions, recapitalizations, and section 1036 exchanges to a single rule similar to proposed § 1.1400Z2(b)-1(c)(10)(i)(C)(1) (the general rule regarding the receipt of boot by QOF shareholder in a qualifying section 381 transaction). Another commenter questioned the disparate treatment of boot in reorganizations depending on whether gain or loss is realized.

The Treasury Department and the IRS agree with commenters that the proposed rules regarding the receipt of boot should be simplified. Accordingly, the final regulations adopt a single rule for the receipt of boot in a qualifying section 381 transaction. Under this rule, a taxpayer is treated as disposing of a portion of its qualifying investment equal to the portion of total consideration received in the transaction with respect to the taxpayer's qualifying investment that consists of boot. For example, if a QOF engages in a merger that is a qualifying section 381 transaction, and if 10 percent of the consideration received by a QOF shareholder, as measured by fair market value, consists of boot, the QOF shareholder is treated as having disposed of 10 percent of its qualifying investment. This rule applies regardless of whether the QOF shareholder recognizes gain or loss on the transaction, and regardless of whether the QOF is wholly owned.

For property or boot received in recapitalizations or section 1036 exchanges, the final regulations provide that the property or boot is treated as property or boot to which section 301 or section 356(a) or (c) applies, as determined under general Federal income tax principles. The receipt of property to which section 301 applies is an inclusion event only to the extent section 301(c)(3) applies. The receipt of boot to which section 356(a) or (c) applies is subject to the single rule for the receipt of boot in a qualifying section 381 transaction.

If a taxpayer receives boot with respect to its qualifying investment in a qualifying section 355 transaction, as defined in proposed § 1.1400Z2(b)-1(a)(2)(xix), and if section 356(a) applies to the transaction, the receipt of boot also is subject to the single rule for the receipt of boot in a qualifying section 381 transaction. In turn, if a taxpayer receives boot with respect to its qualifying investment in a qualifying section 355 transaction, and if section 356(b) applies to the transaction, the receipt of boot is an inclusion event only to the extent section 301(c)(3) applies.

4. Treatment of the Surviving or Acquiring Corporation as a QOF

A commenter also requested clarification that, in the event of mergers, consolidations, share exchanges, asset acquisitions, and conversions in which the acquiring or surviving enterprise is a QOF, such acquiring or surviving enterprise continues to be a QOF.

Whether the surviving or acquiring corporation after a merger, consolidation, share exchange, or asset acquisition continues to be a QOF depends on whether the surviving or acquiring corporation satisfies the requirements of section 1400Z-2(d) and the section 1400Z-2 regulations. Therefore, the final regulations do not adopt the commenter's recommended

clarification. For a discussion of conversions of QOF partnerships to QOF corporations, see part III.E.1 of this Summary of Comments and Explanation of Revisions.

D. Reorganizations of QOF Shareholders

Proposed § 1.1400Z2(b)-1(c)(10)(ii) generally provided that a transfer of a QOF shareholder's assets in a qualifying section 381 transaction (qualifying owner reorganization) is not an inclusion event, except to the extent the QOF shareholder transfers less than all of its qualifying investment in the transaction, because the section 381 successor to the QOF shareholder retains a direct qualifying investment in the QOF. In other words, the section 381 successor is treated as the historic QOF shareholder and therefore no disposition of the direct qualifying investment in the QOF has occurred. Based on the same rationale, proposed § 1.1400Z2(b)-1(c)(2)(ii)(B) provided that the transfer of a QOF shareholder's qualifying investment in a complete liquidation under section 332 is not an inclusion event to the extent section 337(a) applies (qualifying owner liquidation). Special rules applied to S corporations that are shareholders of a QOF, and generally tracked the rules of subchapter C described previously, to the extent consistent with the rules of subchapter S. See proposed § 1.1400Z2(b)-1(c)(7).

Proposed § 1.1400Z2(b)-1(d)(1) and (2) contained special rules for qualifying section 381 transactions in which the target corporation was a QOF immediately before the acquisition and the acquiring corporation is a QOF immediately after the acquisition. For purposes of section 1400Z-2(b)(2)(B) and 1400Z-2(c), the May 2019 proposed regulations provided that the holding period for the QOF stock relinquished by a taxpayer is "tacked" onto the holding period of the QOF stock received in the transaction, and any qualified opportunity zone property transferred by the transferor QOF to the acquiring QOF in connection with the transaction does not lose its status as qualified opportunity zone property solely as a result of the transfer. However, the May 2019 proposed regulations did not provide similar rules for qualifying owner reorganizations or liquidations. As a result, one commenter requested that a "tacked" holding period be expressly provided for a QOF shareholder's qualifying investment in such transactions. Another commenter requested a rule for qualifying owner liquidations and reorganizations similar to proposed § 1.1400Z2(b)-1(c)(6)(ii)(C), which generally provided that the resulting partnership after certain partnership mergers or consolidations is subject to section 1400Z-2 and the section 1400Z-2 regulations to the same extent as the original partnership before the transaction.

The Treasury Department and the IRS agree that a "tacking" rule should apply to stock of a QOF shareholder after a qualifying owner reorganization or liquidation. Section 1.1400Z2(b)-1(d)(1)(ii) of the final regulations has been modified accordingly.

E. Partnerships, S Corporations, and Trusts

1. Inclusion Events for QOF Partnerships

Proposed § 1.1400Z2(b)-1(c)(6)(i) provided inclusion rules for QOF partnerships and partnerships that directly or indirectly own interests in QOFs. These rules applied to transactions involving any direct or indirect partner of a QOF to the extent of the partner's share of any eligible gain. Proposed § 1.1400Z2(b)-1(c)(6)(ii)(B) provided that a contribution by a QOF

owner of its direct or indirect partnership interest in a qualifying investment to a partnership is not an inclusion event to the extent the transaction is governed by section 721(a), provided the transfer does not cause a termination of a QOF partnership, or of the direct or indirect owner of a QOF, under section 708(b)(1).

The Treasury Department and the IRS received several comments on whether certain transactions involving QOF partnerships should be considered inclusion events. One commenter requested clarification of proposed § 1.1400Z2(b)-1(c)(6)(iii), which provided that a distribution of property by a QOF partnership to a partner is an inclusion event if the distributed property has a fair market value in excess of the partner's basis in its qualifying investment, and that similar rules apply to distributions involving tiered partnerships. The final regulations provide that, for amounts relating to a partner's qualifying investment, a distribution by a QOF partnership to a partner is an inclusion event to the extent the distribution is of cash or property with a fair market value in excess of the partner's outside basis in the QOF partnership. However, with respect to distributions by a partnership that owns a QOF, such distribution will only be an inclusion event for the indirect QOF owner if the distribution is a liquidating distribution.

The commenter suggested that such a distribution should not be an inclusion event to the extent the partner in the QOF ultimately would be allocated the gain recognized upon the distribution. The commenter also requested an exception from inclusion event treatment for section 731 distributions of a QOF interest by an upper-tier partnership to the extent the distribution is to the partner that made the initial qualifying investment in the QOF. The Treasury Department and the IRS decline to adopt these recommendations. Under the rules in subchapter K of chapter 1 of subtitle A (subchapter K), a distribution of property with a fair market value in excess of basis reduces a partner's equity interest in the partnership. Such a reduction is an inclusion event and is economically the same as an investor cashing out its investment or reducing its equity investment in the QOF.

One commenter also requested that a contribution of an interest in a partnership that holds a direct interest in a QOF partnership to another partnership not be considered an inclusion event. This transaction was addressed by proposed § 1.1400Z2(b)-1(c)(6)(ii)(B), which applied to contributions under section 721(a) by a QOF owner, including a QOF partner. See proposed § 1.1400Z2(b)-1(a)(2)(xii), which defined a QOF partner as a person that directly owns a qualifying investment in a QOF partnership or a person that owns such a qualifying investment through equity interests solely in one or more partnerships. The final regulations clarify that the rule in proposed § 1.1400Z2(b)-1(c)(6)(ii)(B) applies to any QOF owner that contributes its qualifying QOF stock or direct or indirect partnership interest in a qualifying investment to a partnership in a transaction governed by section 721(a).

Another commenter requested that the list of inclusion events exclude not only section 721 contributions, but also the merger of a fund formed as a REIT into another REIT. The commenter recommended that the final regulations clarify and expand the scope of the permitted transactions under the rules for inclusion. The Treasury Department and the IRS decline to adopt this suggestion but note that the exceptions to inclusion event treatment applicable to QOF C corporations, such as the exception for qualifying section 381 transactions, also apply to RICs and REITs.

Proposed § 1.1400Z2(b)-1(c)(6)(ii)(C) provided that a merger or consolidation of a partnership holding a qualifying investment, or of a partnership holding an interest in such partnership solely through one or more partnerships, with another partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event. A commenter noted that the May 2019 proposed regulations did not explicitly provide that a merger of a QOF partnership into another partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event, even if the acquiring partnership is a QOF immediately after the merger.

The Treasury Department and the IRS adopt the comment in part. The Treasury Department and the IRS have determined that the rule in § 1.1400Z2(b)-1(c)(6)(iii) of the May 2019 proposed regulations, which provided that a QOF partnership distribution with a fair market value in excess of the distributee partner's basis is an inclusion event, should be modified in the case of certain mergers or consolidations under section 708(b)(2)(A).

The final regulations provide that, in the case of an assets-over merger or consolidation of a QOF partnership with another QOF partnership in a transaction to which section 708(b)(2)(A) applies, the fair market value of property distributed in the merger or consolidation is reduced by the fair market value of the partnership interest received in the merger or consolidation for purposes of determining whether there has been an inclusion event. Therefore, the transaction will not be an inclusion event to a partner that receives only a partnership interest in the resulting partnership. However, there will be an inclusion event to the extent that a partner receives other property that exceeds that partner's basis in the partnership.

Additionally, the final regulations provide that a merger or consolidation of a QOF partnership with another QOF partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event under § 1.1400Z2(b)-1(c)(2)(i), which provides that there is an inclusion event if a QOF ceases to exist for Federal income tax purposes. The resulting partnership becomes subject to section 1400Z-2 and the section 1400Z-2 regulations to the same extent that the terminated partnership was so subject prior to the transaction, and must allocate and report any gain inclusion under section 1400Z-2(b) to the same extent and to the same partners that the terminated partnership would have been required to allocate and report those items prior to the transaction.

A commenter also requested clarification that any partnership distribution of property pursuant to a division governed by § 1.708-1(d) is not an inclusion event, provided the taxpayer's beneficial interest in a QOF has not changed and all deferred gain still would be recognized by the same taxpayer. Several other commenters requested that pro-rata divisions of QOF partnerships into two or more QOF partnerships pursuant to section 708 not be treated as inclusion events, provided the amount of a taxpayer's equity interest in its qualifying investment remains the same.

The Treasury Department and the IRS decline to adopt a general rule excluding divisions as inclusion events because divisions may result in deemed distributions arising from debt shifts, as well as distributions in excess of basis, which may result in gain recognition under the subchapter K rules. Additionally, as described in part IV.E.4 of this Summary of Comments and Explanation of Revisions, the final regulations expand the rule of proposed § 1.1400Z2(c)-1(b)(2)(ii) to provide that, with the exception of gain from the sale of inventory in the ordinary course of business, all gain from the sale of property by a QOF partnership or by a qualified

opportunity zone business that is a partnership is eligible for exclusion as long as the qualifying investment in the QOF has been held for at least 10 years. This change to proposed § 1.1400Z2(c)-1(b)(2)(ii) may minimize the need for divisions of QOF partnerships as a way to dispose of certain assets.

One commenter also asked that a distribution by a QOF partnership of its net cash flow, measured on an annual basis by reference to taxable income, plus depreciation deductions, not constitute an inclusion event. The Treasury Department and the IRS decline to adopt this recommendation because allowing such distributions in excess of the QOF partner's basis would add significant complexity, requiring the tracing of distributions of net cash flow proceeds versus cash from other sources.

One commenter asked why proposed § 1.1400Z2(b)-1(c)(6) used the phrase "eligible gain." Proposed § 1.1400Z2(b)-1(c)(6) stated, in relevant part, that "the inclusion rules of this paragraph (c) apply to transactions involving any direct or indirect partner of the QOF to the extent of such partner's share of eligible gain of the QOF." The commenter further noted that proposed § 1.1400Z2(b)-1(c)(6) used this phrase three times, and the inclusion of that phrase seemed inappropriate.

The Treasury Department and the IRS confirm that "eligible gain" was the intended term in proposed § 1.1400Z2(b)-1(c)(6). Eligible gain is a defined term in proposed § 1.1400Z2(a)-1(b)(2), and generally refers to gain that is eligible to be deferred under section 1400Z-2(a). The term is further defined in § 1.1400Z2(a)-1(b)(11) of the final regulations. In addition, proposed § 1.1400Z2(b)-1(c)(6) provided special rules relating to inclusion events for partners and partnerships, and used the defined term "eligible gain" to reference the amount of gain deferred under section 1400Z-2(a) that is required to be included in income upon the occurrence of certain inclusion events.

Proposed § 1.1400Z2(b)-1(c)(7)(iv) provided special rules regarding inclusion events for conversions of S corporations to partnerships or disregarded entities. Otherwise, the May 2019 proposed regulations did not expressly address whether a QOF's change in classification, such as from a partnership to a corporation, is an inclusion event. A commenter recommended that the conversion of a QOF from a partnership to a corporation for Federal tax purposes be treated as neither an inclusion event nor a disposition of a qualifying investment for purposes of the election in section 1400Z-2(c).

The Treasury Department and the IRS note that, if a partnership elects under § 301.7701-3(c)(1)(i) to be classified as an association, under § 301.7701-3(g)(1)(i) the partnership is deemed to contribute all of its assets and liabilities to the association in exchange for stock and to liquidate immediately thereafter. See also Rev. Rul. 2004-59, 2004-1 C.B. 1050 (applying the same treatment to a partnership that converts to a corporation under a state law formless conversion statute). As provided in proposed § 1.1400Z2(b)-1(c)(2)(i), a taxpayer generally has an inclusion event for all of its qualifying investment if the QOF ceases to exist for Federal income tax purposes, and no specific rule in proposed § 1.1400Z2(b)-1(c) provides an exception for liquidations of QOF partnerships. Thus, the conversion of a partnership to a corporation would be an inclusion event. No change has been made to the final regulations with respect to this comment.

2. Inclusion Events for QOF S Corporations

a. General Principle of Section 1371(a)

The May 2019 proposed regulations relied upon the principle set forth in section 1371(a), which provides that the rules of subchapter C of chapter 1 of subtitle A (subchapter C) applicable to C corporations and their shareholders apply to S corporations and their shareholders, except to the extent inconsistent with the provisions of subchapter S. In such instances, S corporations and their shareholders are subject to the specific rules of subchapter S. For example, similar to rules applicable to QOF partnerships, a distribution of property to which section 1368 applies by a QOF S corporation is an inclusion event to the extent that the distributed property has a fair market value in excess of the shareholder's basis, including any basis adjustments under section 1400Z-2(b)(2)(B)(iii) and (iv). In addition, the rules set forth in the May 2019 proposed regulations regarding redemptions, liquidations, and reorganizations of QOF C corporations and QOF C corporation shareholders apply equally to QOF S corporations and QOF S corporation shareholders to the extent consistent with the rules of subchapter S. For example, because the stock of an S corporation cannot be held by a C corporation, no exception is provided for a liquidation or upstream asset reorganization of an S corporation investor in a QOF.

However, the May 2019 proposed regulations also reflect that flow-through principles under subchapter S apply to S corporations when the application of subchapter C would be inconsistent with subchapter S. For example, under the May 2019 proposed regulations, if an inclusion event were to occur with respect to deferred gain of an S corporation that is an investor in a QOF, the shareholders of the S corporation would include the gain pro rata in their respective taxable incomes. See section 1366(a)(1)(A). Consequently, those S corporation shareholders would increase their bases in their S corporation stock at the end of the taxable year during which the inclusion event occurred. See section 1367(a)(1)(A). Pursuant to the S corporation distribution rules set forth in section 1368, the S corporation shareholders would receive future distributions from the S corporation tax-free to the extent of the deferred gain amount included in income and included in stock basis. If the S corporation has accumulated E&P, the S corporation's accumulated adjustments account would be increased by the same amount as the increase in stock basis to ensure the shareholders' tax-free treatment of the future distributions. See section 1368(c), (e)(1).

b. Specific Inclusion Event Rules for S Corporations

The May 2019 proposed regulations also set forth specific rules for S corporations to provide certainty to taxpayers regarding the application of particular provisions under section 1400Z-2. Regarding section 1400Z-2(b)(1)(A), the May 2019 proposed regulations clarified that a conversion of an S corporation that holds a qualifying investment in a QOF to a C corporation (or a conversion of a C corporation to an S corporation) is not an inclusion event because the interests held by each shareholder of the C corporation or S corporation, as appropriate, would remain unchanged with respect to the corporation's qualifying investment in a QOF. For mixed-funds investments in a QOF S corporation described in section 1400Z-2(e)(1), if different blocks of stock are created for otherwise qualifying investments to track basis in these qualifying investments, the May 2019 proposed regulations made clear that the separate blocks would not

be treated as different classes of stock for purposes of S corporation eligibility under section 1361(b)(1).

The Treasury Department and the IRS received favorable comments regarding the reliance of the May 2019 proposed regulations upon the principle set forth in section 1371(a). In addition, commenters provided favorable comments regarding the foregoing rules, which the Treasury Department and the IRS drafted in accordance with that principle. As a result, the final regulations adopt those rules without modification.

c. Elimination of 25-Percent Aggregate Ownership Change Rule

The May 2019 proposed regulations set forth a special rule that, solely for purposes of section 1400Z-2, an S corporation's qualifying investment in a QOF would be treated as disposed of if there is a greater-than-25 percent aggregate change in ownership of the S corporation (25-percent aggregate ownership change rule). Under that rule, upon a greater-than-25 percent aggregate change in ownership, the S corporation would have an inclusion event for all of the S corporation's remaining deferred gain, and neither section 1400Z-2(b)(2)(B)(iii) or (iv), nor section 1400Z-2(c), would apply to the S corporation's qualifying investment after that date. In proposing the 25-percent aggregate ownership change rule, the Treasury Department and the IRS attempted to "balance the status of the S corporation as the owner of the qualifying investment with the desire to preserve the incidence of the capital gain inclusion and income exclusion benefits under section 1400Z-2." Section VII.D.3 of the preamble to the May 2019 proposed regulations.

The Treasury Department and the IRS have received comments from the taxpayer and practitioner communities critical of the 25-percent aggregate ownership change rule. In particular, commenters have emphasized that the proposed rule conflicts with the stated purpose of inclusion events under section 1400Z-2, which is to "prevent taxpayers from 'cashing out' a qualifying investment in a QOF without including in gross income any amount of their deferred gain." Section VII. A of the preamble to the May 2019 proposed regulations. In addition, commenters have noted that subchapter S of the Code already contains provisions, such as section 1377, that achieve more effectively the "balance" intended through the proposed 25-percent aggregate ownership change rule.

As previously stated, for purposes of the Code, including section 1400Z-2, the rules of subchapter C apply to an S corporation and its shareholders unless inconsistent with subchapter S. See section 1371(a). For example, if an S corporation investor in a QOF were to have an inclusion event regarding the S corporation's qualifying investment, the rules of subchapter S would apply to ensure that the shareholders of the S corporation would include the resulting gain pro rata in their respective taxable incomes and increase their bases in their S corporation stock at the end of the taxable year during which the inclusion event occurred. See generally section 1366. However, neither subchapter S nor section 1400Z-2 provides that the disposition of any stock held by a shareholder of an S corporation should cause an inclusion event under section 1400Z-2 for a qualifying investment held by the S corporation in a QOF (that is, should be treated as a disposition by the S corporation). Rather, the rules of subchapter S indicate the opposite, as evidenced by the ability for S corporation shareholders to dispose of their stock without affecting the S corporation's tax-free treatment resulting from a like-kind exchange of

one of its assets. See generally section 1031. The Treasury Department and the IRS have determined that, like a C corporation investor in a QOF C corporation, an S corporation investor should not have an inclusion event for its qualifying investment solely as the result of a disposition of shares by one of its shareholders, regardless of the disposition's magnitude.

Furthermore, the Treasury Department and the IRS have determined that the proposed 25-percent aggregate ownership change rule does not achieve its stated purpose of balancing the status of the S corporation as the owner of the qualifying investment while directing capital gain inclusion to the proposed rule's intended parties (that is, the S corporation's shareholders, upon an inclusion event). See section VII.D.3 of the May 2019 proposed regulations. Indeed, the Treasury Department and the IRS note that the proposed rule conflicts with section 1377, the longstanding provision in subchapter S that governs the allocation of items of income among S corporation shareholders.

Under section 1377(a)(1), each shareholder's pro rata share of any item for any tax year generally equals the sum of the amounts determined for the shareholder by (1) assigning an equal portion of the item to each day of the tax year, and then (2) dividing that portion pro rata among the shares outstanding on that day, per share, per day. As an exception for terminations of a shareholder's interest, section 1377(a)(2) permits an S corporation and the affected shareholders (that is, the remaining shareholders of the S corporation at the time of the termination) to agree to a "closing of the books" of the S corporation and allocate the S corporation's items of income among those shareholders based on their ownership before and after the termination (that is, treat the taxable year as two taxable years, the first of which ends on the date of the termination). As highlighted by one commenter, in the absence of a "closing of the books" election, the inclusion of capital gain resulting from an inclusion event will be allocated pro rata among all of the S corporation's shareholders as of the end of the S corporation's taxable year, rather than to those shareholders who were shareholders at the time the S corporation invested its deferred capital gain in its QOF. In other words, the allocation rules of section 1377 do not operate to match S corporation items to specific shareholders. For these reasons, the Treasury Department and the IRS agree with the comments received and have removed the proposed 25-percent aggregate ownership change rule from the final regulations.

d. Contributions of QOF Investments to a Partnership

With respect to the contribution of a qualifying investment to an upper-tier partnership or the acquisition of an interest in an upper-tier partnership by another person, one commenter requested that forward section 704(c) and reverse section 704(c) principles apply to ensure that deferred gains, or any built-in gains on the QOF interest, are allocable to the proper taxpayers and that appropriate basis adjustments are made. The Treasury Department and the IRS agree that forward section 704(c) and reverse section 704(c) principles, which otherwise would apply, also apply in this context.

In addition, several commenters requested that the final regulations provide greater flexibility in the structuring of investments in QOF partnerships by allowing investors to use master-feeder structures and similar structures such as aggregator funds. The commenters noted that proposed § 1.1400Z2(b)-1(c)(6)(ii)(B) permitted a QOF owner to contribute its direct or indirect interest in a QOF partnership to another partnership under certain circumstances in a transaction governed by

section 721(a) without the transfer being treated as an inclusion event. The final regulations decline to incorporate that comment because it is inconsistent with the statute. Specifically, section 1400Z-2(a)(1)(A) requires an eligible taxpayer to make an investment in a QOF within 180 days of the sale or exchange that gave rise to the eligible gain in order for the taxpayer to have made a qualifying investment.

The final regulations clarify that, when a QOF partner contributes its qualifying investment to a transferee partnership in a section 721 transaction, the transferee partnership is the party that recognizes the deferred gain and is eligible for the five- and seven-year basis adjustments. However, the transferee partnership must allocate all such amounts to the contributing partner, applying the principles of section 704(c). The contributing partner no longer will be eligible to make the elections under section 1400Z-2(c) and § 1.1400Z2(c)-1(b)(2). Instead, the transferee partnership will be the sole person eligible to make these elections, and the elections will apply to all partners in the transferee partnership for that tax year.

e. Mixed-Funds Investments in QOF Partnerships

Proposed § 1.1400Z2(b)-1(c)(6)(iv) provided that a partner that holds a mixed-funds investment in a QOF partnership (mixed-funds partner) is treated as holding separate interests in the QOF partnership—a qualifying investment and a non-qualifying investment—solely for purposes of section 1400Z-2. Under proposed § 1.1400Z2(b)-1(c)(6)(iv)(B), all section 704(b) allocations of income, gain, loss, and deduction, all section 752 allocations of debt, and all distributions made to a mixed-funds partner were treated as made to the separate interests based on the allocation percentages of the interests, which generally were determined based on the relative capital contributions attributable to the qualifying investment and the non-qualifying investment. However, if a partner received a profits interest in the partnership in exchange for services, the May 2019 proposed regulations provided that the profits interest was a non-qualifying investment and that the allocation percentage for the profits interest was based on the highest share of residual profits the mixed-funds partner would receive with respect to that interest.

The Treasury Department and the IRS received a number of comments advocating different methods of allocating section 704(b) items, debt, and distributions between qualifying and non-qualifying investments in a mixed-funds investment. For example, one commenter requested that taxpayers be allowed to treat partnership distributions as made disproportionately to non-qualifying investments to minimize the likelihood that a distribution will cause a qualifying investment to be considered sold or exchanged. Another commenter requested that all debt be allocated to the non-qualifying investment. One commenter also recommended that gain on the sale of property by a QOF partnership be treated as attributable to the non-qualifying investment and qualifying investment based on each investment's share of section 704(b) gain with respect to the property.

The Treasury Department and the IRS decline to adopt these comments because the recommended changes would (i) increase the complexities in determining the items attributable to qualifying and non-qualifying investments comprising a mixed-funds investment, and (ii) be significantly more difficult to administer for both taxpayers and the IRS. The Treasury Department and the IRS have determined that the approach in the May 2019 proposed regulations is the most straightforward option, and the option that minimizes administrable

burden, for determining allocation percentages for qualifying and non-qualifying investments. Therefore, the final regulations retain the rule in the May 2019 proposed regulations and continue to determine allocation percentages based on relative capital contributions.

Commenters generally agreed with the rule in proposed § 1.1400Z2(a)-1(b)(9)(ii) that profits interests received for services should not be treated as qualifying investments. However, a number of commenters requested changes to the rule for calculating allocation percentages in the case of a profits interest received for services. One commenter highlighted that the proposed rule could result in a profits interest holder receiving an allocation percentage that is higher than its actual share of residual profits. Another commenter recommended that the allocation percentage for a profits interest 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 partnership. Yet another commenter requested that the final regulations incorporate the definition of "applicable partnership interest" under section 1061. This commenter recommended that the final regulations provide that the highest share of residual profits that a partner holding the mixed-funds investment would receive with respect to an "applicable partnership interest" would be determined by the highest share of residual profits less a reasonable return on the partner's capital interest, based on consideration of all facts and circumstances at the time of the receipt of the interest.

The Treasury Department and the IRS decline to adopt any of these comments because the approach in proposed § 1.1400Z2(b)-1(c)(6)(iv) is simpler and more administrable. The final regulations require a partner who receives a profits interest for services as part of a mixed-funds investment in a QOF partnership to determine the allocation percentage of the profits interest based on the share of residual profits that the mixed-funds partner would receive from the partnership. In addition, the final regulations provide that, if the residual share provided in the partnership agreement is not reasonably likely to apply, then that share will be disregarded in determining allocation percentages, and the allocation percentage for the profits interest will be the final share of profits provided in the partnership agreement that is likely to apply.

f. QSST and ESBT Conversions

A commenter requested clarification as to whether a conversion from a qualified subchapter S trust (QSST) to an electing small business trust (ESBT), and vice versa, falls within the exceptions to an inclusion event. The final regulations confirm that neither type of conversion is an inclusion event if the person who is both the deemed owner of the portion of the ESBT holding the qualifying investment and the QSST beneficiary is the person taxable on the income from the qualifying investment both before and after the conversion. For this purpose, § 1.1361-1(j)(8) is deemed not to apply because the conversion of a QSST to an ESBT differs from a disposition of the QSST asset where there is recognition of gain on the asset. However, there will be an inclusion event upon conversion if the qualifying investment is in the grantor portion of the ESBT and the ESBT's deemed owner is a nonresident alien.

g. Holding Periods

One commenter suggested clarifying how the principles of proposed § 1.1400Z2(b)-1(d)(1) and (2), which provided rules for holding periods for QOF investments, would be applied to

partnership transactions described in proposed § 1.1400Z2(b)-1(c)(6)(ii), such as section 721(a) contributions and section 708(b)(2)(A) mergers or consolidations.

Proposed § 1.1400Z2(b)-1(d)(3) allowed the holding period of qualifying investments transferred in non-inclusion events listed in proposed § 1.1400Z2(b)-1(c)(6)(ii) to tack onto the holding period of the transferor under section 1223(1). The final regulations retain this provision. Under § 1.1400Z2(b)-1(d)(1), the holding period of the transferee partnership will include the holding period of the contributing partner.

h. Special Amount Includible Rule for Partnerships and S Corporations

Proposed § 1.1400Z2(b)-1(e)(4) provided that, for inclusion events involving partnerships and S corporations, the amount includible is equal to the percentage of the qualifying QOF partnership or QOF S corporation interest disposed of, multiplied by the lesser of (1) the remaining deferred gain less the five-year and seven-year basis adjustments; or (2) the gain that would be recognized by the partner or shareholder if the interest were sold in a fully taxable transaction for its then fair market value.

Section 1400Z-2(b)(2)(A) provides that the amount of gain included in gross income under section 1400Z-2(a)(1)(A) is the excess of (i) the lesser of the amount of gain excluded under paragraph (1) of that section or the fair market value of the investment as determined as of the date described in paragraph (1), over (ii) the taxpayer's basis in the investment.

Several commenters requested that the special amount includible rule for partnerships and S corporations be changed to follow the statutory language in section 1400Z-2(b)(2)(A). Commenters acknowledged that the special amount includible rule was intended to prevent taxpayers from avoiding the recognition of deferred gain upon an inclusion event when the fair market value of their qualifying investment has diminished due to debt-financed deductions or distributions. However, these commenters emphasized that the special amount includible rule creates inequitable results for debt-financed losses attributable to periods before December 31, 2026, as compared to debt-financed losses incurred after this date. Certain commenters also suggested that this rule has adversely affected the ability to develop low-income housing tax credit projects and other community development properties in QOZs.

The Treasury Department and the IRS have determined that the proposed special amount includible rule for partnerships and S corporations conforms to the underlying intent of the capital gain deferral allowed under section 1400Z-2. Thus, the Treasury Department and the IRS decline to adopt this request, and the final regulations retain the special amount includible rule for partnerships and S corporations found in proposed § 1.1400Z2(b)-1(e)(4). Further, although the final regulations do not limit the combining (commonly referred to as "twinning") of other tax incentives with the benefits provided by section 1400Z-2, the creation of special rules in this regard exceeds the scope of section 1400Z-2 and the section 1400Z-2 regulations.

3. Grantor Trusts

Proposed § 1.1400Z2(b)-1(c)(5)(i) provided that a taxpayer's transfer of its qualifying investment in a QOF to a grantor trust of which the taxpayer is the deemed owner was not an inclusion event for purposes of section 1400Z-2(b)(1) and proposed § 1.1400Z2(b)-1(c). One commenter asked whether a gift to a "defective grantor trust" would be an inclusion event. The Treasury Department and the IRS note that a defective grantor trust is a grantor trust for Federal income tax purposes, so its funding does not change the conclusion that the transfer is not an inclusion event under section 1400Z-2. In each situation, the deemed owner of the grantor trust's property for Federal income tax purposes (that is, the taxpayer) would be treated as maintaining a direct qualifying investment in the QOF for Federal income tax purposes. See part II.A.5 of this Summary of Comments and Explanation of Revisions (describing rationale for not treating such transfers as inclusion events).

Another commenter stated that proposed § 1.1400Z2(b)-1(c)(5)(ii), which addressed inclusion events related to grantor trusts, was too broad because the proposed rule applied to "a change in the status of a grantor trust." The commenter noted that this language could be read to apply to a taxpayer that owned a QOF investment and was the deemed owner of a grantor trust, regardless of whether the grantor trust itself held a QOF investment. The Treasury Department and the IRS agree with this comment. Accordingly, the final regulations clarify that the provision applies to a change in the status of a grantor trust owning a qualifying investment in a QOF.

A commenter also requested clarification that non-gift transactions between a grantor trust and its deemed owner that are not recognition events for Federal income tax purposes are not inclusion events, and that such transactions do not start a new holding period for purposes of section 1400Z. In such transactions, the deemed owner of the trust continues, for Federal income tax purposes, to be the taxpayer liable for the Federal income tax on the qualifying investment. Thus, the Treasury Department and the IRS have determined that, like transfers by the deemed owner to the grantor trust, these transactions (including transfers from the grantor trust to its deemed owner) are not inclusion events.

F. Transfers of Property by Gift or by Reason of Death, or Incident to Divorce

1. Gifts

The May 2019 proposed regulations provided that a transfer by gift of a qualifying investment in a QOF is an inclusion event for purposes of section 1400Z-2(b)(1) and proposed § 1.1400Z2(b)-1(c). One commenter asserted that a donor's gift of a qualifying investment in a QOF should not be considered a sale or exchange for purposes of section 1400Z-2, provided that the gift otherwise is not treated as a taxable disposition for Federal income tax purposes.

As noted in the preamble to the May 2019 proposed regulations, section 1400Z-2(b)(1) does not directly address non-sale or exchange dispositions, such as gifts and bequests. However, the Conference Report provides that, under section 1400Z-2(b)(1), the "deferred gain is recognized on the earlier of the date on which the [qualifying] investment is disposed of or December 31, 2026." See Conference Report at 539 (indicating that continued gain recognition deferral requires the taxpayer to maintain directly the taxpayer's qualifying investment).

Section 1400Z-2 requires the deferred Federal income tax on capital gains to be paid by the taxpayer who incurred that gain and reinvested an amount up to the amount of the net proceeds from the sale into the qualifying investment in the QOF. The only exception is the recognition under section 691 of a decedent's deferred gain that is not properly includible in the decedent's gross income. The Treasury Department and the IRS have concluded that (i) no authority exists to impose the donor's deferred capital gains tax liability on the donee of the qualifying investment, and therefore (ii) the Federal income tax on the deferred gain must be collected from the donor at the time of the gift of the qualifying investment. Accordingly, the final regulations continue to provide that a gift of the qualifying investment in a QOF is an inclusion event. In addition, consistent with the discussion in part VII.E. of the Explanation of Provisions to the May 2019 proposed regulations, the final regulations provide that the interest received by the donee is no longer a qualifying investment in a QOF as a result of the inclusion event, and thus the donee is not eligible to make an election under section 1400Z-2(c) to adjust the basis of the interest in the QOF to fair market value.

2. Death

The May 2019 proposed regulations generally provided that a transfer of a qualifying investment by reason of the taxpayer's death is not an inclusion event. See proposed § 1.1400Z2(b)-1(c)(4)(ii) (enumerating the sole exceptions to that general rule). One commenter noted that the recipient of a deceased owner's qualifying investment may not have the liquidity to pay the deferred tax on the gain the decedent invested in the QOF upon an inclusion event as of December 31, 2026. The commenter requested that the final regulations permit an election to treat death as an inclusion event, thereby making the decedent's estate liable for the payment of the deferred tax, or grant the recipient a further deferral until the recipient's disposition of the qualifying investment.

The Treasury Department and the IRS note that, if a decedent who dies after 2026 had not disposed of the qualifying investment prior to December 31, 2026, it is possible that even the decedent could have faced such a liquidity problem. In light of the statute's clear direction that the deferral be terminated no later than December 31, 2026, the final regulations provide no election to a decedent's estate to treat death as an inclusion event or provide further deferral to a person inheriting the qualifying investment as a result of the deceased owner's death.

One commenter also requested clarification regarding the application of section 691 to the recipient of the qualifying investment by reason of the death of the owner. In response, the final regulations provide that the tax on the decedent's deferred gain is the liability of the person in receipt of that interest from the decedent at the time of an inclusion event.

3. Transactions Between Spouses or Incident to Divorce

A commenter requested that transfers between spouses or incident to divorce, as described in section 1041, be excepted from the definition of an inclusion event. Although those transactions are nonrecognition events for Federal income tax purposes, a transfer of the qualifying investment in such a transaction constitutes a disposition of that interest for purposes of section 1400Z-2(a)(1)(B) and (b). Therefore, the final regulations in § 1.1400Z2(b)-1(c)(3)(ii) clarify that a transfer described in section 1041 is an inclusion event. Accordingly, the transferor's

deferred gain is recognized, and the transferee's interest in the QOF no longer is a qualifying investment.

G. Basis Adjustments

1. Adjustments to Basis of Qualifying QOF Stock

Under section 1400Z-2(b)(2)(B)(ii) and proposed § 1.1400Z2(b)-1(g), a taxpayer's basis in its qualifying investment is increased by the amount of gain recognized upon an inclusion event or on December 31, 2026. Proposed § 1.1400Z2(b)-1(g) also provided additional rules regarding the timing and amount of basis adjustments under section 1400Z-2(b)(2)(B)(ii).

Commenters requested clarification as to how the section 1400Z-2(b)(2)(B)(ii) basis adjustments should be made if a taxpayer disposes of less than all of its qualifying QOF stock or if less than all of its qualifying QOF stock is redeemed by the QOF corporation. If an investor has a qualifying investment with \$0 basis and a corresponding \$100 of deferred gain, and if the investor were to sell its entire qualifying investment for \$100, the investor would recognize \$100 of deferred gain, increase its basis in the qualifying investment by \$100, and then recognize \$0 of gain under section 1001 on the sale of the qualifying investment. If the investor were to sell half of its investment for \$50 instead, the investor would recognize \$50 of deferred gain under proposed § 1.1400Z2(b)-1(e)(1) and then increase its basis in its qualifying investment by \$50. However, it is unclear under the May 2019 proposed regulations whether the \$50 basis increase should be applied to the shares that were sold, to the shares that were retained, or to both the sold and the retained shares proportionally.

A commenter recommended that the section 1400Z-2(b)(2)(B)(ii) basis increase be made only to those specific shares that trigger the inclusion event. In the foregoing example, if the \$50 basis adjustment were made solely to the sold shares, the investor would recognize \$50 of the deferred gain on the disposition of such shares and \$0 of gain under section 1001, and the investor would continue to have \$50 of deferred gain and \$0 of basis in the retained shares. In contrast, if all or a proportionate amount of the section 1400Z-2(b)(2)(B)(ii) basis increase were made to the retained shares, the investor would recognize \$50 of deferred gain plus an additional \$50 or \$25 of gain, respectively, under section 1001. Thus, the investor would recognize more gain than the amount realized in the transaction. Moreover, the retained portion of the investment still would be associated with \$50 of deferred gain. Although the taxpayer would have a basis of either \$50 or \$25 in its retained stock, the taxpayer could end up recognizing gain in excess of the amount of deferred gain if the qualifying investment appreciates sufficiently—an outcome that is contrary to the express language of the statute. See section 1400Z-2(b)(2)(A).

Similarly, commenters recommended that, in the case of a dividend-equivalent redemption of qualifying QOF stock owned by a sole shareholder of a QOF corporation, the section 1400Z-2(b)(2)(B)(ii) basis increase for any section 301(c)(3) gain or 1059(a)(2) gain be made only to the redeemed shares.

The Treasury Department and the IRS agree with the commenters that, if a shareholder of a QOF corporation sells less than all of its qualifying QOF stock, the section 1400Z-2(b)(2)(B)(ii) basis

increase should be made only to those specific shares that are sold. The final regulations have been revised accordingly. Otherwise, issues relating relating to the treatment of basis upon a redemption are beyond the scope of the final regulations. The Treasury Department and the IRS continue to study such issues. See REG-143686-07, 84 FR 11686 (March 28, 2019).

2. Basis Adjustments to QOF Partnership Interests and QOF S Corporation Stock

a. General Application of Five-Year and Seven-Year Basis Increases

A commenter noted that the May 2019 proposed regulations, unlike the preamble, did not specifically provide that the five-year and seven-year basis increases to a qualifying investment are basis for all purposes of the Code, and recommended that the final regulations confirm this result. The Treasury Department and the IRS agree with this comment. Accordingly, the final regulations in § 1.1400Z2(b)-1(g)(4)(ii) and (g)(5)(i) specifically provide that five-year and seven-year basis adjustments to a qualifying investment in a partnership or S corporation described in section 1400Z-2(b)(2)(B)(iii) and (iv) and section 1400Z-2(c) are basis for all purposes of the Code, including for purposes of suspended losses under sections 704(d) and 1366(d).

b. Specific Stock Basis Rules for S Corporations

The May 2019 proposed regulations provided that, if an S corporation is an investor in a QOF, the S corporation must adjust the basis of its qualifying investment in the manner set forth for C corporations in proposed § 1.1400Z2(b)-1(g), except as otherwise provided in those proposed regulations. This rule does not affect adjustments to the basis of any other asset of the S corporation. The S corporation shareholder's pro-rata share of any recognized deferred capital gain at the S corporation level will be separately stated under section 1366 and will adjust the shareholders' stock basis under section 1367. In addition, the May 2019 proposed regulations made clear that any adjustment to the basis of an S corporation's qualifying investment under section 1400Z-2(b)(2)(B)(iii) or (iv) or section 1400Z-2(c) will not (1) be separately stated under section 1366, and (2) adjust the shareholders' stock basis under section 1367 until the date on which an inclusion event with respect to the S corporation's qualifying investment occurs. If a basis adjustment under section 1400Z-2(b)(2)(B)(ii) is made as a result of an inclusion event, then the basis adjustment will be made before determining the other tax consequences of the inclusion event.

The Treasury Department and the IRS received favorable comments regarding the foregoing rules, which the Treasury Department and the IRS drafted in accordance with the principle of section 1371(a), as discussed in part III.E.2.a of this Summary of Comments and Explanation of Revisions. As a result, the final regulations adopt these rules without modification.

3. Basis Adjustments by Reason of Death

Several commenters requested clarification regarding the basis of a qualifying investment in the hands of a deceased owner's heir, legatee, or beneficiary. More specifically, commenters

requested clarification as to whether the basis adjustment under section 1014 would apply less the amount of unrecognized gain.

If the decedent's investment in a QOF exceeded the gain the decedent elected to defer under section 1400Z-2(a), the investment is a mixed-funds investment that is treated as two separate investments—a qualifying investment subject to section 1400Z-2, and a non-qualifying investment to which section 1400Z-2 is inapplicable. See section 1400Z-2(e)(1). Proposed § 1.1400Z2(a)-1(b)(11)(i)(D) identified the basis of the non-qualifying investment as the taxpayer's total basis in the QOF less the basis of the qualifying investment, in each case determined without the zero-basis rule and without any other basis adjustment provided for in section 1400Z-2(b)(2)(B). In general, this amount equals the taxpayer's total investment in the QOF less the amount of gain invested on which the capital gains tax was deferred.

Because section 1400Z-2 is inapplicable to the non-qualifying investment, the recipient's basis in the non-qualifying investment on the death of the owner is governed by section 1014. As with other income in respect of a decedent, the estate tax value is not reduced by the liability for the deferred income tax.

However, section 1400Z-2(b)(2)(B) applies with regard to the recipient's basis in the qualifying investment. This section provides that the basis of the qualifying investment is zero, with specified increases for gain recognized at the time of an inclusion event and for qualifying investments held for at least five or seven years. This provision governs without regard to section 1014. Because a taxpayer's basis in its qualifying investment is zero except as otherwise provided in section 1400Z-2(b)(2)(B) and section 1400Z-2(c) (which concerns qualifying investments held for at least 10 years), the Treasury Department and the IRS have determined that section 1014 does not apply to adjust the basis of an inherited qualifying investment to its fair market value as of the deceased owner's death.

H. Earnings and Profits

A commenter requested guidance regarding the E&P consequences of section 1400Z-2 and the section 1400Z-2 regulations. Specifically, the commenter recommended that any increase to E&P as a result of gain deferred under section 1400Z-2 be deferred until such gain is included in income upon either an inclusion event or December 31, 2026.

As noted by the commenter, section 312(f)(1) provides that gain or loss realized on the sale or other disposition of property by a corporation increases or decreases the E&P of such corporation, but only to the extent the realized gain or loss was recognized in computing taxable income under the law applicable to the year in which such sale or disposition was made. Section 1400Z-2 and the section 1400Z-2 regulations enable a taxpayer to defer recognition of an eligible gain in the year the eligible gain was realized. As a result, the amount of gain so deferred does not increase the taxpayer's E&P in the year of realization. See section 312(f)(1). When the gain eventually is included in income upon an inclusion event or on December 31, 2026, the taxpayer's E&P will be increased. See § 1.312-6(b). The Treasury Department and the IRS have determined that section 312 and the regulations in this part under section 312 provide this result in their current form, and therefore no additional rules are necessary. However, the examples set

forth in § 1.1400Z2(b)-1(g)(3) have been revised to illustrate the application of the existing E&P rules within the context of section 1400Z-2.

The commenter also recommended that the amount of basis adjustments resulting from the application of section 1400Z-2(b)(2)(B)(iii) and (iv) and section 1400Z-2(c) should be treated as tax-exempt income that causes an increase to E&P under § 1.312-6(b). Section 1.312-6(b) provides that, among other items, income exempted from Federal income tax by statute is entered into the computation of E&P for a particular period. The basis increases under section 1400Z-2(b)(2)(B)(iii) and (iv) exempt from tax under subtitle A those gains that are deferred under section 1400Z-2(a). Similarly, the election under section 1400Z-2(c) potentially exempts from tax under subtitle A those gains that are attributable to the appreciation of QOF investments. Therefore, these basis increases are tax-exempt income for purposes of computing E&P and will increase the E&P of the taxpayer at the time such increases are made. As noted previously, the Treasury Department and the IRS have determined that section 312 and the regulations in this part under section 312 provide this result in their current form and that no additional rules are necessary.

One commenter further asserted that § 1.312-6(b) should not apply to income that is exempt from tax as a result of the basis increases under section 1400Z-2 in order to facilitate passing the benefits of a REIT's qualifying investments to the REIT's shareholders. See part IX. B of this Summary of Comments and Explanation of Revisions. However, the Treasury Department and the IRS have determined that section 312 and § 1.312-6(b) appropriately apply to income that is exempt from tax under subtitle A as a result of these basis increases. Thus, the final regulations have not been revised in response to this comment.

I. Voluntary Inclusion; Applicable Tax Rate

A commenter requested that a QOF investor be permitted to voluntarily recognize the full amount of deferred gain in a taxable year of the investor's choosing prior to the statutorily required year of inclusion under section 1400Z-2(b)(1), and at the Federal income tax rate applicable to the chosen recognition year. The investor would remain fully invested in the QOF, and therefore the basis increases at the five-year mark and seven-year mark, as well as the basis adjustment to fair market value after 10 years, still would be available with regard to the taxpayer's qualifying investment. If the investor meets the requirements for one or more of these basis adjustments, the investor could request a refund of the tax paid on the appropriate amount of the gain in a prior year.

According to the commenter, voluntary gain recognition prior to the statutorily provided year of inclusion would accomplish two purposes. First, the investor could eliminate the risk that the tax rate under subtitle A in the statutorily required year of inclusion would be significantly higher than in the year of voluntary inclusion. Second, the investor would possess the flexibility to pay a tax liability in a year during which the investor is certain to have available the necessary amount of funds.

The Treasury Department and the IRS do not adopt the commenter's recommendation. Section 1400Z-2(b) specifies two events upon which an investor's deferred gain under section 1400Z-2(a)(1) may be included in income. First, deferred gain is included in income upon the

occurrence of an inclusion event as explained further in these regulations in § 1.1400Z2(b)-1. Second, deferred gain is included on December 31, 2026. It is not contemplated under the statute or legislative history that a taxpayer may choose to include deferred gain in income at another time and continue to remain invested in a QOF. Accordingly, if a taxpayer wishes to include deferred gain in income, it may cause the occurrence of an inclusion event, with the effect that the investor's ownership of the QOF would terminate for all purposes, including the basis adjustment to fair market value under section 1400Z-2(c).

Another commenter inquired whether the proper Federal income tax rate to apply to the gain recognized pursuant to section 1400Z-2(b)(1) is the Federal income tax rate at the time of the investment and deferral election, or the Federal income tax rate in the taxable year of inclusion. The May 2019 proposed regulations provided that, if section 1400Z-2(a)(1)(B) and (b) require a taxpayer to include in income some or all of a previously deferred gain, the gain so included has the same attributes in the taxable year of inclusion that it would have had if tax had not been deferred. Thus, if the Federal income tax rate were considered an "attribute" of the gain, the rate applicable in the year of deferral arguably would apply to gain recognized under section 1400Z-2(b)(1).

Although the May 2019 proposed regulations provided rules for the tax attributes of the amount deferred in the year of inclusion, the May 2019 proposed regulations did not discuss the Federal income tax rates for the year of inclusion. The final regulations clarify that gain recognized pursuant to section 1400Z-2(b)(1) and the section 1400Z-2 regulations is subject to taxation at the applicable Federal income tax rates for the year of inclusion, not of the year of deferral.

J. Availability of Basis Adjustments Under Section 1400Z-2(b)(2)(B)(iii) and (iv)

Section 1400Z-2(b) provides that gain deferred under section 1400Z-2(a)(1)(A) is included in income in the taxable year that includes the earlier of the date on which the QOF investment was sold or exchanged or December 31, 2026. Therefore, in order to be eligible for both the five-year and seven-year basis increases under section 1400Z-2(b)(2)(B)(iii) and (iv), respectively, a taxpayer must invest eligible gain in a qualifying investment no later than December 31, 2019. Eligibility solely for the five-year basis increase requires an investment of eligible gain no later than December 31, 2021. Commenters requested that the statutory inclusion date be postponed to December 31, 2027 or December 31, 2028 to provide investors additional time to consider investing in a QOF, and still receive the benefit of the five- and seven-year basis increases with the benefit of final regulatory guidance.

The Treasury Department and the IRS note that the December 31, 2026, date is mandated by statute, and that there is no indication that Congress intended a later inclusion date. Therefore, the final regulations do not adopt this recommendation.

Another commenter requested confirmation that the inclusion dates in section 1400Z-2(b)(1) do not apply to the five-year and seven-year basis increases under section 1400Z-2(b)(2)(B)(iii) and (iv). As a consequence, a qualifying investment would be eligible for these basis increases regardless of whether the full amount of deferred gain has been recognized, and regardless of when the qualifying investment is made.

As discussed in parts III. A and III. I of this Summary of Comments and Explanation of Revisions, the basis adjustments provided by section 1400Z-2(b)(2)(B)(iii) and (iv) are based on an eligible taxpayer's remaining deferred gain. Moreover, section 1400Z-2(b)(1) clearly requires all deferred gain to be taken into account no later than December 31, 2026. After that date, there will be no remaining deferred gain to be excluded from Federal income tax as a result of the five- or seven-year basis adjustments. As a consequence of the commenter's recommendation, the five- and seven-year basis increases would operate not only to exclude a portion of the deferred gain from Federal income tax, but also to exclude a portion of subsequent appreciation in the value of a qualifying investment from Federal income tax. The Treasury Department and the IRS have determined that the statutory text of section 1400Z-2 does not adequately support the commenter's recommendation, and have clarified the final regulations.

In addition, a commenter requested that the five-year and seven-year basis increases under section 1400Z-2(b)(2)(B) be elective rather than automatic, based on the commenter's position that an investor should be allowed to choose to recognize deferred gain that otherwise would be eliminated due to those basis increases. The statute and legislative history do not indicate that the basis increases under section 1400Z-2(b)(2)(B) operate at the taxpayer's option once the requisite five- and seven-year holding periods have been met. Accordingly, the Treasury Department and the IRS decline to adopt this recommendation.

K. Commencement of the Holding Period for a QOF Investment

In Examples 1 and 7 in proposed § 1.1400Z2(b)-1(f), the holding period for a qualifying investment in a QOF begins on the date on which the qualifying investment is acquired rather than on the day after the date of its acquisition. One commenter noted that, under Rev. Rul. 70-598, 1970-2 C.B. 168, and general Federal income tax principles, the holding period for a capital asset begins on the day after the acquisition of the asset.

The Treasury Department and the IRS acknowledge the divergence between (i) the day on which the holding period of a qualifying investment begins, and (ii) the day on which the holding period for a capital asset ordinarily would begin. However, the Treasury Department and the IRS have determined that no provision of the Code, nor any Federal income tax principle, requires conformity in this context. As a result, the final regulations do not modify the date on which the holding period for a qualifying investment commences.

L. QOF Exit and Reinvestment

Commenters requested that the final regulations provide a rule that would permit an investor to dispose of its entire interest in a qualifying investment and reinvest the resulting proceeds in another QOF within a short period of time, such as 180 days. Under this rule, the investor would be permitted to tack the holding period of the disposed qualifying investment onto the new qualifying investment for purposes of the five-year, seven-year, and ten-year basis adjustments under section 1400Z-2(a)(2)(B)(iii) and (iv) and section 1400Z-2(c), respectively. This rule would allow an investor to disinvest in a particular QOF as long as the investor remains invested in QOFs, in the aggregate, for the requisite holding periods. One commenter indicated that such a rule would expose investors to a lower risk of loss, which would facilitate investments in professionally managed QOFs from a wider variety of consumer-type investors.

The Treasury Department and the IRS acknowledge the additional investment flexibility that would be provided through adoption of the commenters' recommendation. However, the Treasury Department and the IRS have found no support for this recommendation in the statutory text of section 1400Z-2 or its underlying legislative history. As a result, the final regulations do not incorporate the commenters' recommendation. With regard to the effect of specific transactions on the holding period of a qualifying investment for purposes of the basis adjustments under sections 1400Z-2(a)(2)(B)(iii) and (iv) and 1400Z-2(c), the final regulations provide taxpayers with provisions that address specific inclusion events.

IV. Comments on and Changes to Proposed § 1.1400Z2(c)-1

Section 1400Z-2(c) provides that in the case of any investment held by the taxpayer for at least 10 years and with respect to which the taxpayer makes an election under section 1400Z-2(c), the basis of such property will be equal to the fair market value of such investment on the date that the investment is sold or exchanged. Proposed § 1.1400Z2(c)-1 set forth proposed rules concerning the election under section 1400Z-2(c), including special rules for QOF partnerships and QOF S corporations.

A. Gain Exclusion for Asset Sales by QOFs and Qualified Opportunity Zone Businesses

Proposed § 1.1400Z2(c)-1(b)(2)(ii)(A)(1) provided that an investor in a QOF partnership or a QOF S corporation may elect to exclude some, or all, of the capital gain arising from the QOF's sale of qualified opportunity zone business property upon satisfaction of the 10-year holding period in section 1400Z-2(c). A commenter requested guidance regarding a fact pattern in which a QOF that has been held for the requisite 10-year holding period owns multiple qualified opportunity zone businesses. Specifically, the commenter requested confirmation that the gain from each separate disposition of interests in qualified opportunity zone businesses, after a 10-year holding period of a qualifying investment, qualifies for the basis adjustment and potential gain exclusion under section 1400Z-2(c).

The Treasury Department and the IRS agree that, in the case of a QOF partnership or QOF S corporation, the disposition of QOF assets, including interests in qualified opportunity zone businesses, may qualify for the election under section 1400Z-2(c) if the qualifying investment in the QOF partnership or QOF S corporation meets the 10-year holding period of section 1400Z-2(c), notwithstanding the disposal of interests in qualified opportunity zone businesses at different times. A rule that requires a single disposition of all QOF assets in order to qualify for the benefits under section 1400Z-2(c) would provide an incentive for QOFs and their investors to dispose of a qualified opportunity zone business at a time when, in the absence of section 1400Z-2(c), such a disposition would not be made for reasons unrelated to section 1400Z-2. The final regulations permit interests in qualified opportunity zone businesses to be disposed of at different times. This rule provides taxpayers flexibility consistent with the principle that the economic success of the QOF and the qualified opportunity zone businesses should be the overriding concern when an investor decides whether to dispose of an interest in a qualified opportunity zone business.

One commenter also requested clarification regarding the application of section 1400Z-2(c) to a disposition of assets at less than fair market value, including situations in which the property sold

is government-owned or low-income housing. If an investment is held for at least 10 years by a QOF and a taxpayer makes an election under section 1400Z-2(c), then the basis of the investment is equal to fair market value on the date that the investment is sold or exchanged. Proposed § 1.1400Z2(c)-1(b)(2)(ii)(A)(1) applied the basis adjustment rule in section 1400Z-2(c) to the disposition of assets by a QOF partnership. Under general Federal income tax principles, the fair market value of property will generally be equal to the actual sales price of such property when a buyer and seller are unrelated. Fair market value under section 1400Z-2(c) is consistent with these principles. Therefore, in a disposition of assets of a QOF to an unrelated party where the taxpayer makes a valid election under section 1400Z-2(c), the relevant fair market value of the assets generally would be the sale price. In a disposition of assets to a related party, the fair market value for purposes of section 1400Z-2(c) would be determined with consideration of the principles of section 482.

B. Application of Section 1400Z-2(c) Election to Certain Gain

Commenters asked whether taxpayers may make an election under section 1400Z-2(c) with respect to section 301(c)(3) gain or section 731 gain on a qualifying investment. The Treasury Department and the IRS have determined that an election under section 1400Z-2(c) should be available for gain resulting from section 301(c)(3), section 731(a), section 1059(a)(2), or section 1368(b)(2) or (c)(3) on a qualifying investment because such gain is treated as gain from the sale or exchange of property for Federal income tax purposes.

C. Inclusion Events

As discussed in part III of this Summary of Comments and Explanation of Revisions, proposed § 1.1400Z2(b)-1(c) provided rules regarding various events that trigger the inclusion of deferred gain under section 1400Z-2(b) and proposed § 1.1400Z2(b)-1(b). Commenters requested guidance as to whether, and to what extent, such inclusion events, as well as events that occur after December 31, 2026, also would cause a qualifying investment to lose eligibility for the election under section 1400Z-2(c) and proposed § 1.1400Z2(c)-1. Specifically, commenters asked whether an inclusion event with respect to gain under section 301(c)(3) would preclude an election under section 1400Z-2(c). See proposed § 1.1400Z2(b)-1(c)(8) and related provisions in proposed § 1.1400Z2(b)-1(c)(9) through (12).

As discussed in part II.A.5 of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have determined that an inclusion event generally would cause a qualifying investment to lose eligibility for the election under section 1400Z-2(c) and § 1.1400Z2(c)-1. However, the Treasury Department and the IRS have determined that gain resulting from section 301(c)(3), section 731(a), section 1059(a)(2), or section 1368(b)(2) or (c)(3) should not preclude a taxpayer from making a subsequent election under section 1400Z-2(c) for its qualifying investment. Therefore, a QOF C corporation shareholder or QOF S corporation shareholder is eligible to make an election under section 1400Z-2(c) for a qualifying investment regardless of the extent to which the shareholder has received distributions subject to section 301(c)(3), section 1059(a)(2), or section 1368(b)(2) or (c)(3) with respect to such investment. Similarly, in the case of inclusion events under § 1.1400Z2(b)-1(c)(6)(iii) (partnership distributions) and § 1.1400Z2(b)-1(c)(7)(ii) (distributions by QOF S corporation), the section 1400Z-2(c) election continues to be available to a partner or S corporation

shareholder, respectively, as long as the QOF owner continues to hold a qualifying investment in the QOF partnership or QOF S corporation, despite the distribution that caused an inclusion event. The final regulations have been modified accordingly.

Commenters also recommended that an ordering rule similar to proposed § 1.1400Z2(b)-1(g)(1)(ii) be applied to the election under section 1400Z-2(c), so that such a basis increase would occur immediately before determining the results under section 301(c) and section 1059(a). The final regulations adopt such a rule.

D. QOF REIT Capital Gain Dividends Identified With a Date

Proposed § 1.1400Z2(c)-1(e) provided rules for QOF REITs to identify capital gain dividends with a date so that some shareholders could elect to receive the amount of such dividends tax-free under section 1400Z-2(c). One commenter recommended that the term "QOF RIC" be added throughout the final regulations alongside all references to QOF REITs to ensure that the regulations apply equally to QOF RICs and QOF REITs.

The Treasury Department and the IRS understand that a Business Development Company (BDC) that is a RIC may qualify as a QOF. The Treasury Department and the IRS have determined that, if a RIC meets the qualifications for, and elects to be, a QOF RIC, that entity and its shareholders should receive the same treatment under these regulations as a QOF REIT and its shareholders. This change is reflected in the final regulations. The proportionality rule for QOF REITs identifying a capital gain dividend with a date in the May 2019 proposed regulations was proposed under the authority granted to the Secretary under section 857(g)(2). The Treasury Department and the IRS apply a similar proportionality requirement to RICs (see Rev. Rul. 89-81, 1989-1 C.B. 226), and thus have maintained the proportionality rule for both QOF RICs and QOF REITs identifying capital gain dividends with a date.

E. Special Rules for QOF Partnerships and QOF S Corporations

1. Section 1400Z-2(c) Election by Transferee Partnership

The transferee partnership of a qualifying investment in a QOF partnership, following a section 721(a) contribution (including those resulting from a merger of QOF partnerships), provided there is no inclusion event, is eligible to make the section 1400Z-2(c) election to exclude from gross income gains and losses from the disposition of property held by a QOF (other than gains and losses from the sale of inventory in the ordinary course of a business), so long as the 10-year holding period requirement is satisfied. See § 1.1400Z2(b)-1(d)(1)(ii) (transferee partnership has a tacked holding period). The final regulations clarify this rule and provide reporting requirements for the transferee partnership in making the section 1400Z-2(c) election.

2. Basis Adjustment Amount on the Sale of a Qualifying Investment

Proposed § 1.1400Z2(c)-1(b)(2)(i) provided that, if a taxpayer sells or exchanges a qualifying investment in a QOF partnership that has been held for at least 10 years, and the taxpayer makes the election described in section 1400Z-2(c), the basis of the partnership interest is adjusted to

an amount equal to the fair market value of the interest, including debt. The Treasury Department and the IRS received comments asking for clarification of the phrase "including debt" in the proposed rule. Specifically, commenters requested a rule that more clearly states that the basis of the partnership interest is adjusted to an amount equal to the net fair market value of the QOF partnership interest plus the partner's share of debt. One commenter suggested that a "gross fair market value" rule would encourage QOF partnerships to borrow money and distribute the proceeds, which could increase debt within QOZs while reducing cash amounts held by QOF partnerships, potentially exacerbating the plight of the economically distressed communities. In addition, several commenters asked for clarification that the fair market value of the QOF partnership interest cannot be less than the partner's allocable share of non-recourse debt, consistent with section 7701(g).

The Treasury Department and the IRS agree with the commenters that clarification is needed. Accordingly, the final regulations clarify that the basis of the partnership interest is adjusted to an amount equal to its net fair market value, plus the partner's share of partnership debt relating to that interest, so that the partner would recognize no gain or loss on a sale or exchange of the qualifying QOF partnership interest after at least 10 years. The final regulations also state that the fair market value cannot be less than the partner's allocable share of non-recourse debt. In addition, the final regulations note that, in the case of a sale or exchange of qualifying S corporation shares, the basis is adjusted to an amount equal to the fair market value of the shares immediately prior to the sale or exchange.

3. Adjustment to Basis of QOF Partnership Assets on Sale of a Qualifying Investment

Proposed § 1.1400Z2(c)-1(b)(2)(i) provided that, if a taxpayer's basis is adjusted under section 1400Z-2(c), the bases of the QOF partnership assets also are adjusted immediately prior to the sale or exchange. The adjustment is calculated in a manner similar to a section 743(b) adjustment as if the transferor partner had purchased its interest in the QOF partnership for an amount of cash equal to the fair market value of the partnership interest immediately prior to the sale or exchange, assuming that a valid section 754 election had been in place. The Treasury Department and the IRS received comments asking for clarification that (i) the assets of lower-tier partnerships also should be adjusted pursuant to this rule, (ii) no actual section 754 election is required, and (iii) generally applicable guidance issued pursuant to sections 743(b) and 754 applies in this context.

The Treasury Department and the IRS agree with the commenters that clarification is needed. Accordingly, the final regulations clarify that the adjustment applies to any partnerships directly or indirectly owned, solely through one or more partnerships (tiered partnerships), by the QOF partnership, whether or not an actual section 754 election is in place for any of the partnerships. Guidance issued pursuant to sections 743(b) and 754 applies as it would outside of the context of section 1400Z-2. Further, because section 1400Z-2(c) is designed to result in no gain or loss to the transferor QOF partner, the final regulations provide that, to the extent the existing rules of sections 743(b) and 755 operate in a manner that results in recognition of gain or loss on the transaction, the basis adjustments are to be made to the extent necessary to eliminate any such gain or loss.

4. Sales or Exchanges of Property by QOF Partnerships and QOF S Corporations

The May 2019 proposed regulations provided that, if a QOF partnership or QOF S corporation disposes of qualified opportunity zone property after a taxpayer is treated as holding its qualifying investment in the QOF partnership or QOF S corporation for 10 years, the taxpayer may make an election to exclude from gross income some or all of the capital gain arising from the disposition. The Treasury Department and the IRS received comments requesting that, in addition to capital gain from the sales of qualified opportunity zone property by a QOF, capital gain from the sales of property by a qualified opportunity zone business that is held in partnership form should be eligible for exclusion as long as the qualifying investment in the QOF has been held for 10 years. The final regulations adopt this recommendation for QOF partnerships and QOF S corporations.

Commenters also requested that all types of gains and losses, including gains and losses from the sales of inventory, section 1231 gains and losses, and depreciation recapture, be eligible for exclusion under this special election for QOF partnerships and QOF S corporations. Other commenters suggested that the exclusion election should apply to all gains and losses of QOF partnerships or QOF S corporations other than gains and losses from the sales of inventory in the ordinary course of business. The final regulations adopt the recommendation to exclude ordinary course inventory sales from the exclusion election.

The final regulations set forth two requirements for the QOF partnership or QOF S corporation and the taxpayer when the taxpayer wishes to make an election to exclude gains and losses upon sales of assets other than inventory sold in the ordinary course of a trade or business by the QOF. First, the taxpayer must make the election for each taxable year in which it wishes to exclude the QOF's gains and losses from all sales and exchanges of assets. This election may be made regardless of whether the taxpayer has made an election for any prior taxable year. The election will apply to all gains and losses, other than gains and losses from sales of inventory in the ordinary course of business, of the QOF partnership or QOF S corporation for that taxable year, including any gains and losses from a lower-tier partnership. The election must be made by the taxpayer on the applicable form filed with its Federal tax return for the year in which the sale or exchange occurs.

The second requirement is designed to eliminate future section 1400Z-2 benefits attributable to the reinvestment of proceeds from asset sales for which gain and loss is not recognized under section 1400Z-2. Under this provision, and solely for purposes of determining the amount of a QOF owner's qualifying investment and non-qualifying investment, the QOF is treated as distributing to each electing QOF owner its share of net proceeds from the asset sales on the last day of the QOF's tax year. For a QOF S corporation, such deemed distributions and recontributions will have no Federal income tax consequence other than the adjustment of the respective values of qualifying and non-qualifying investments in a QOF S corporation. For example, such deemed distributions will have no impact on an accumulated adjustments account of a QOF S corporation, and will not be treated as a disproportionate distribution of a QOF S corporation.

For a QOF partner that holds a mixed-funds investment, any distribution will be allocated to the separate interests of the QOF partner pursuant to § 1.1400Z2(b)-1(c)(6)(iv)(B). This rule provides that any distribution will be allocated proportionately between the qualifying and non-qualifying investments of the partner. Immediately after the deemed distribution, the distributee

QOF owner is treated as recontributing the amount received in exchange for a non-qualifying investment.

In determining the post-contribution qualifying investment and non-qualifying investment of a QOF partnership, the QOF partnership is required to value each interest based on the underlying value of the partnership's assets, determined in accordance with the principles of § 1.704-1(b)(2)(iv) at the end of its taxable year. For this purpose, the amount of the net proceeds from an asset sale is equal to the amount realized from the sale, less any indebtedness included in the amount realized that would constitute a qualified liability under § 1.707-5(a)(6) if property subject to the debt had been contributed to a lower-tier partnership. An actual distribution of sales proceeds within 90 days of that asset sale will reduce the amount of the deemed distribution and deemed recontribution.

In determining the post-contribution qualifying investment and non-qualifying investment of a QOF S corporation, the QOF S corporation is required to value each interest based on the underlying value of the QOF S corporation's assets. For this purpose, the amount of the net proceeds from an asset sale is equal to the amount realized from the sale, less any indebtedness included in the amount realized that would constitute a qualified liability under the principles of § 1.707-5(a)(6). An actual distribution of sales proceeds within 90 days of that asset sale will reduce the amount of the deemed distribution and deemed recontribution.

F. Controlled Foreign Corporations

A commenter requested that a United States shareholder investor in a QOF that is a controlled foreign corporation (CFC) organized in a U.S. territory be permitted to make section 1400Z-2(c) elections with respect to assets sold by the CFC, thereby eliminating any subpart F income or tested income resulting from these transactions. The commenter analogized this treatment to rules in proposed § 1.1400Z2(c)-1(b)(2)(ii) providing that, in certain cases, the owners of a QOF partnership or QOF S corporation can make a section 1400Z-2(c) election with respect to their distributive or pro rata shares of capital gain from the QOF's disposition of assets.

However, the rules for income inclusions with respect to CFCs are not analogous to those for partnerships or S corporations. Unlike partnerships and S corporations, CFCs are not treated as flow-through entities for purposes of the Code. Additionally, in contrast with partnerships and S corporations, only certain U.S. taxpayer owners of CFCs (United States shareholders) are required to have current income inclusions with respect to CFCs, and these United States shareholders are required to currently include in gross income only certain income earned by a CFC (for example, subpart F income). These rules effectuate the policies underlying the subpart F and global intangible low-taxed income under section 951A(a) (GILTI) regimes-to prevent United States shareholders from deferring or eliminating U.S. tax on certain income by earning such income through CFCs. Such policies generally are not applicable to partnerships and S corporations, which generally are treated as flow-through entities for purposes of the Code. See H.R. Rep. No. 1447 at 57-58 (1962); S. Rep. No. 1881 at 78-80 (1962); S. Comm. on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Print No. 115-20, at 370 (2017).

As opaque entities, CFCs are more analogous to domestic C corporations than to partnerships or S corporations because the income of CFCs and domestic C corporations may be subject to U.S. taxation when earned (at the United States shareholder-level in the case of a CFC) and also when distributed as a dividend to U.S. taxpayer shareholders. This result with respect to domestic C corporations is not changed by section 1400Z-2, which does not permit a shareholder of a domestic QOF C corporation to make a section 1400Z-2(c) election with respect to either the QOF C corporation's capital gains from sales of assets or dividends distributed to such shareholder, unless section 1059(a)(2) applies to such dividends. Allowing this benefit for United States shareholders of QOFs that are CFCs organized in a U.S. territory would thus provide an unwarranted advantage to shareholders of QOF C corporations organized under the laws of U.S. territories compared to shareholders of QOF C corporations organized under the laws of the 50 states or the District of Columbia. The Treasury Department and the IRS have determined that there is no statutory or policy basis for such disparate treatment. Accordingly, the comment is not adopted. A comment with respect to QOFs that are passive foreign investment companies (within the meaning of section 1297(a)) is rejected for similar reasons.

G. Permitting Elections Through December 31, 2047

The October 2018 proposed regulations preserved the ability of taxpayers to make an election under section 1400Z-2(c) until December 31, 2047. The Treasury Department and the IRS requested comments on whether some other period would better align with taxpayers' economic interests and the purposes of the statute, and whether alternative approaches would be appropriate. For example, the preamble to the October 2018 proposed regulations noted the possibility of allowing for an automatic basis step-up immediately before the end of 2047. The Treasury Department and the IRS will continue to consider the appropriateness of such an approach, including ways to address how best to value investments in QOFs absent a sale or exchange between unrelated persons by December 31, 2047.

V. Comments on and Changes To Proposed § 1.1400Z2(d)-1

Section 1400Z-2(d) sets forth requirements that an entity classified for Federal income tax purposes as a partnership or corporation must satisfy to qualify as a QOF or as a qualified opportunity zone business that is owned, in whole or in part, by one or more QOFs.

Section 1400Z-2(d)(1) defines a QOF as a partnership or corporation that (i) is organized for the purpose of investing in "qualified opportunity zone property" (other than another qualified opportunity fund), and (ii) must hold at least 90 percent of its assets in qualified opportunity zone property, determined by the average of the percentage of qualified opportunity zone property held in the entity as measured on two semiannual testing dates (90-percent investment standard). Section 1400Z-2(d)(2) defines the term "qualified opportunity zone property" to mean property directly held by a QOF that consists of (i) stock in a corporation that is qualified opportunity zone stock, (ii) partnership interests that are qualified opportunity zone partnership interests, or (iii) tangible property that is qualified opportunity zone business property.

A QOF's directly held interest in a partnership or corporation will be treated as a qualified opportunity zone partnership interest or qualified opportunity zone stock, and thus qualified opportunity zone property, for purposes of the 90-percent investment standard if the interest or

stock satisfies the requirements set forth in section 1400Z-2(d)(2)(B) or (C), as applicable. First, the QOF must have acquired the interest or stock from the partnership or corporation, respectively, solely in exchange for cash after December 31, 2017. Second, at the time of issuance of the interest or stock, as well as during substantially all of the QOF's holding period for such interest or stock, the entity must qualify as a "qualified opportunity zone business" (or, if newly formed, must have been organized for such purpose).

Section 1400Z-2(d)(2)(D) provides that tangible property will be treated as qualified opportunity zone business property if the tangible property is used in a trade or business of the QOF and satisfies three general requirements. First, the QOF must have acquired the tangible property after December 31, 2017 (post-2017 acquired tangible property) from a person that is not related (as defined in section 179(d)(2), and modified by section 1400Z-2(e)(2)) and not a member of the same controlled group (as defined in section 179(d)(2)(B) and (d)(7)) in a transaction resulting in the QOF holding the tangible property with other than a transferred basis (within the meaning of section 7701(a)(43)) or with a section 1014 basis (post-2017 acquisition requirement). Second, the original use of the post-2017 acquired tangible property in the QOZ must begin with the QOF (original use requirement), or the QOF must substantially improve the post-2017 acquired tangible property (substantial improvement requirement). Third, during substantially all of the QOF's holding period for such post-2017 acquired tangible property, substantially all of the use of post-2017 acquired tangible property has been in a QOZ. Under section 1400Z-2(d)(2)(D)(ii), the substantial improvement requirement is met only if, during any 30-month period beginning after the date of acquisition of the post-2017 acquired tangible property, there are "additions to basis with respect to such property" held by the QOF that, in the aggregate, exceed the adjusted basis of the post-2017 acquired tangible property held by the QOF as of the beginning of that 30-month period.

Section 1400Z-2(d)(3)(A) defines the term "qualified opportunity zone business" as a trade or business (other than an enumerated "sin business" under section 144(c)(6)(B)) that meets each of the following two requirements. First, substantially all of the tangible property owned or leased in connection with the trade or business must be qualified opportunity zone business property. See section 1400Z-2(d)(3)(A)(i). Second, the trade or business must satisfy the following requirements provided in paragraphs (2), (4), and (8) of section 1397C(b): (i) At least 50 percent of the total gross income of such entity must be derived from the active conduct of the trade or business in the QOZ (50-percent gross income requirement); (ii) a substantial portion of the intangible property of such entity must be used in the active conduct of the trade or business in the QOZ; and (iii) less than five percent of the average of the aggregate unadjusted bases of the property of such entity must be attributable to nonqualified financial property (NQFP and five-percent NQFP limitation, respectively). See section 1400Z-2(d)(3)(A)(ii).

Proposed § 1.1400Z2(d)-1, introduced in the October 2018 proposed regulations and expanded in the May 2019 proposed regulations, provided guidance for applying each of the provisions of section 1400Z-2(d). In general, the proposed regulations addressed (i) QOF self-certification procedures, (ii) valuation methods for determining satisfaction of the 90-percent investment standard, (iii) how various types of property can qualify as qualified opportunity zone property, including qualified opportunity zone business property, and (iv) how trades or businesses can satisfy the requirements for qualifying as qualified opportunity zone businesses. The Treasury Department and the IRS have received numerous comments regarding the proposed rules set forth in proposed § 1.1400Z2(d)-1. The remainder of this part V discusses those comments in the

order of the rules set forth in proposed § 1.1400Z2(d)-1 and describes the changes in the final regulations in response to those comments.

A. Certification of an Entity as a QOF

1. Consideration of Revisions to QOF Self-Certification Requirements

Section 1400Z-2(e)(4)(A) directs the Treasury Department and the IRS to prescribe regulations for the certification of QOFs for purposes of section 1400Z-2. In order to facilitate the certification process and minimize the information collection burden placed on taxpayers, proposed § 1.1400Z2(d)-1(a)(1) generally permits any taxpayer that is a corporation or partnership for Federal income tax purposes to self-certify as a QOF, provided that the entity is eligible to self-certify. Proposed § 1.1400Z2(d)-1(a)(1)(i) permits the Commissioner of Internal Revenue (Commissioner) to determine the time, form, and manner of the self-certification in IRS forms and instructions or guidance published in the Internal Revenue Bulletin.

In this regard, the Commissioner has determined that self-certification must be reported annually on a timely filed Form 8996. Form 8996 requires the taxpayer to certify that, for the first period during which an entity will certify as a QOF, the QOF must include in its organizing documents (1) a statement of the purpose of investing in qualified opportunity zone property (as required by section 1400Z-2(d)(1)) by the end of the first QOF year, and (2) a description of the qualified opportunity zone business that a QOF expects to engage in, either directly or indirectly through a lower-tier operating entity.

The Treasury Department and the IRS received several comments regarding the certification process outlined in the proposed regulations. Several commenters requested that the requirements set forth in Form 8996 be incorporated into the final regulations. Other commenters recommended that the final regulations require individuals who manage the QOFs (fund managers) to certify that they have not been indicted or convicted of fraud, embezzlement, or theft, similar to requirements under section 45D of the Code for the New Markets Tax Credit program. One commenter recommended the use of licensing procedures for fund managers similar to those used in the Small Business Investment Company (SBIC) licensure program administered by the Small Business Administration. Other commenters recommended that QOF certification require the QOF to receive a letter of support from the local government of the QOZ in which the QOF will operate.

Several commenters also recommended that the final regulations require a taxpayer to identify, at the time of QOF certification, the QOF's intended community development outcomes and objectives. For example, one commenter requested that, as part of the QOF certification process, a QOF must certify that the QOF will create quality jobs for low-income individuals, develop affordable housing, and achieve other beneficial community outcomes. To facilitate the ability of a QOF to make such certification, one commenter suggested that the final regulations provide a safe harbor for certification for a QOF that undergoes an independent, third-party verification (similar to the SBIC's annual third-party impact assessment) to establish that the QOF meets the needs of the community, fund managers, and investors.

The Treasury Department and the IRS appreciate the commenters' recommendations regarding QOF certification. In developing the proposed regulations, as well as Form 8996, the Treasury Department and the IRS intended to strike a balance between providing taxpayers with a flexible and efficient process for organizing QOFs, while ensuring that investments in such vehicles will be properly directed toward the economic development of low-income communities. The suggested recommendations, while potentially helpful for directing such investment and limiting abuse, likely would present numerous obstacles for potential QOF investors and ultimately reduce, rather than increase, the total amount of investment in low-income communities. As a result, the final regulations do not adopt the commenters' recommendations. However, the Treasury Department and the IRS will consider these comments in the event that additional guidance on QOF certification is warranted.

2. Consideration of Indian Tribal Governments and Corporations as Eligible Entities To Certify as QOFs

Several commenters requested that Indian tribal governments and corporations organized under Indian tribal laws should be included in the definition of entities eligible to be a QOF. Proposed § 1.1400Z2(d)-1(e)(1) provided that, if an entity is not organized in one of the 50 states, the District of Columbia, or the U.S. territories, it is ineligible to be a QOF. Similarly, proposed § 1.1400Z2(d)-1(e)(2) provided that, if an entity is not organized in one of the 50 states, the District of Columbia, or the U.S. territories, an equity interest in the entity is neither qualified opportunity zone stock nor a qualified opportunity zone partnership interest. The Treasury Department and the IRS have determined that, for purposes of both proposed § 1.1400Z2(d)-1(e)(1) and (2), an entity "organized in" one of the 50 states includes an entity organized under the law of a Federally recognized Indian tribe if the entity's domicile is located in one of the 50 states or the District of Columbia. Such entity satisfies the requirement in section 1400Z-2(d)(2)(B)(i) and (C) that qualified opportunity zone stock be stock in a domestic corporation, and a qualified opportunity zone partnership interest be an interest in a domestic partnership. See section 7701(a)(4) (defining the term "domestic").

The Treasury Department and the IRS appreciate the sovereignty of Indian tribal governments. However, an entity eligible to be a QOF must be subject to Federal income tax, including the penalty imposed by section 1400Z-2(f)(1) where a QOF fails to meet the 90-percent investment standard, regardless of the laws under which the entity is established or organized. No individual who participated in the Consultation disagreed with the position that an entity organized under the law of an Indian tribal government is eligible to be a QOF, if the entity's domicile is located in one of the 50 states or the District of Columbia, but that such entity would be subject to Federal income tax. Accordingly, the Treasury Department and IRS affirm these positions and incorporate a reference to entities organized under the law of an Indian tribal government in the definition of the term "eligible entity."

3. QOF Decertification Rules and Federal Income Tax Consequences

In the October 2018 proposed regulations, the Treasury Department and the IRS announced an intention to publish additional guidance regarding QOF decertification. See 83 FR 54283 (September 29, 2018). Comments were received on this topic, including comments requesting a mechanism to permit a QOF to self-decertify, as well as comments requesting guidance on the

ability of the IRS to decertify a QOF. The Treasury Department and the IRS have included in the final regulations a provision to allow a QOF to self-decertify. This rule specifies that self-decertification becomes effective at the beginning of the month following the month specified by the taxpayer. The month specified by the taxpayer must not be earlier than the month in which the taxpayer files its self-decertification. For example, if a QOF wishes to decertify on May, the earliest date that the QOF could be decertified would be June 1st, provided that all applicable procedures were followed.

The Treasury Department and the IRS are developing additional instructions regarding QOF self-decertification including instructions regarding the time, form, and manner of QOF self-decertification. Additionally, the Treasury Department and the IRS continue to consider the circumstances under which involuntary decertification of a QOF would be warranted, and intend to propose guidance regarding those circumstances. As noted in part III.A. of this Summary of Comments and Explanation of Revisions, the final regulations include a rule providing that the decertification of a QOF, whether voluntary or involuntary, is an inclusion event for eligible taxpayers that hold a qualifying investment in that QOF. See § 1.1400Z2(b)-1(c)(15).

4. Entities That Are Not QOFs During the First Month of Their Taxable Year

Under proposed § 1.1400Z2(d)-1(a)(2), an entity may become a QOF during a month that is not the first month of the QOF's taxable year. Several commenters suggested that the Treasury Department and the IRS provide additional detail and clarification regarding this proposed rule. One commenter suggested that the final regulations permit QOFs to select as the QOF's first six-month period testing date either (i) the corresponding day of the month that is six months after the date of certification, or (ii) the last day of a month that is not more than six months after that certification date. Another commenter requested confirmation that the term "month" means a period of time between the same dates in successive calendar months in order to provide a consistent measuring period. A commenter also asserted that the first six-month period testing date should fall on the last day of that first six-month period, even if that period ends later than the end of the taxable year. The Treasury Department and the IRS will consider adding clarifying language to the Instructions to the Form 8996, "Qualified Opportunity Fund," to address these comments.

5. Qualification of Existing Entities as QOFs or Qualified Opportunity Zone Businesses

Section 1400Z-2(d)(1) provides, in relevant part, that a QOF is "any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property." Accordingly, the statute does not indicate whether such partnership or corporation must be newly formed or could be a preexisting entity. Likewise, neither the definition of the term "qualified opportunity zone partnership interest" nor the definition of the term "qualified opportunity zone stock" explicitly states that the partnership or corporation may be a preexisting entity. See section 1400Z-2(d)(2)(B)(i), (C). Several commenters have requested confirmation as to whether existing entities could qualify as QOFs or qualified opportunity zone businesses. In addition, one commenter inquired as to whether preexisting entities could use an adjusted tax basis for valuing assets purchased before 2018 to improve the ability for such entities to qualify as QOFs.

The Treasury Department and the IRS have addressed these comments in the final regulations. The final regulations confirm that preexisting entities are not barred from qualifying as QOFs or qualified opportunity zone businesses. Like newly formed partnerships and corporations, however, the final regulations require preexisting entities to satisfy all requirements applicable to QOFs under section 1400Z-2 and the section 1400Z-2 regulations.

To value assets acquired prior to 2018, the final regulations provide that preexisting entities must use either (i) the applicable financial statement valuation method set forth in § 1.1400Z2(d)-1(b)(3) of the final regulations, if the QOF has an applicable financial statement within the meaning of § 1.475(a)-4(h) (AFS), or (ii) the alternative valuation method set forth in § 1.1400Z2(d)-1(b)(4) of the final regulations. Under the applicable financial statement valuation method, the value of each asset that is owned or leased by a QOF is the value of that asset as reported on the QOF's AFS for the relevant reporting period (rather than the adjusted tax basis of the asset). Under the alternative valuation method for purchased assets, a QOF must use the QOF's unadjusted cost basis of the asset under section 1012, section 1013 (with regards to inventory), or its fair market value. See part V. B of this Summary of Comments and Explanation of Revisions (providing additional discussion regarding the valuation of assets for purposes of the 90-percent investment standard).

6. Clarification Regarding Entities That May Appraise Property

A commenter requested clarification regarding which entities may appraise property required to be valued for purposes of section 1400Z-2(d), including for purposes of determining compliance with the 90-percent investment standard. The Treasury Department and the IRS decline to provide additional guidance on appraisals in the final regulations. However, the Treasury Department and the IRS note that entities that may appraise property for valuation purposes under section 1400Z-2 and the section 1400Z-2 regulations are the same entities that may appraise property for AFS purposes.

B. Valuation of Assets for Purposes of the 90-Percent Investment Standard

1. Comments Regarding Determination Dates, Includable Assets, and Safe Harbors

Section 1400Z-2(d)(1) provides that a QOF must maintain an average of 90 percent of its assets in qualified opportunity zone property, measured on both the last day of the first six-month period and on the last day of the taxable year (that is, the 90-percent investment standard). Section 1400Z-2(f)(1) provides that, if a QOF fails to maintain the 90-percent investment standard, the QOF must pay a penalty for each month that the QOF fails to meet that standard. Proposed § 1.1400Z2(d)-1(b) provided that, to meet the requirements of the 90-percent investment standard, a QOF may value its assets on a semiannual basis using (i) the AFS valuation method, if the QOF has an AFS, or (ii) the alternative valuation method.

The Treasury Department and the IRS received several comments regarding the application of the 90-percent investment standard. For example, a commenter requested confirmation that the 90-percent investment standard is determined for each year of the QOF's existence. Another commenter suggested that the final regulations make explicit that the 90-percent investment

standard will be considered to have been fully satisfied for any year if the QOF meets the 90-percent investment standard on at least two semiannual testing dates. The Treasury Department and the IRS agree with the commenters that the proposed rules should be clarified. As a result, the final regulations make clear that a QOF may determine whether the 90-percent investment standard is satisfied by valuing its assets on the semiannual testing dates as provided by section 1400Z-2(d)(1).

Several commenters also suggested that the final regulations provide greater clarity regarding the assets of a QOF taken into account for determining whether the 90-percent investment standard is satisfied. Commenters inquired as to whether selling commissions, offering expenses, deferred gain, investments in intangible property, and financial accounting depreciation are included or excluded in that valuation calculation. The Treasury Department and the IRS confirm that all of a QOF's assets cognizable for Federal income tax purposes are required to be valued on each semiannual testing date in determining whether the 90-percent investment standard is satisfied. However, mere expenses arising from organizing a QOF or day-to-day operations with regard thereto (such as selling commissions, organization expenses, offering expenses, and similar expenses) do not result in any QOF asset cognizable for Federal income tax purposes and therefore are not taken into account to any extent in determining satisfaction of the 90-percent investment standard.

Two commenters suggested that the Treasury Department and the IRS should include in the final regulations a grace period for the QOF's first year to meet the 90-percent investment standard. The Treasury Department and the IRS have determined that the statutory text of section 1400Z-2 does not permit adoption of the commenters' suggestion, but rather requires that the 90-percent investment standard be met for each taxable year of the QOF's existence. As a result, the final regulations do not incorporate this suggestion.

In addition, a commenter recommended that, if a qualified opportunity zone business qualifies on each relevant testing date, then that entity should be treated also as qualifying during the periods between each relevant testing date. The Treasury Department and the IRS agree that if an entity satisfies all of the requirements of a qualified opportunity zone business determined as of the end of the entity's taxable year, the entity qualifies as a qualified opportunity zone business for the entire taxable year of the entity. However, a QOF and an entity whose equity the QOF owns may have different taxable years, making it difficult to determine whether the entity qualifies as a qualified opportunity zone business of the QOF on a semiannual basis based on the QOF's taxable year pursuant to section 1400Z-2(d)(1). Accordingly, the Treasury Department and the IRS have provided a safe harbor rule for determining on the two semiannual testing dates of a QOF whether an entity is a qualified opportunity zone business for at least 90 percent of the cumulative holding period beginning on the first date the QOF's self-certification is effective and the end of the entity's most recent taxable year ending on or before a semiannual testing date of the QOF for purposes of the 90-percent investment standard.

Finally, the Treasury Department and the IRS note that, if a QOF operates a business through an entity that is transparent for Federal income tax purposes, the transparent entity is not treated as a qualified opportunity zone business in which the QOF has invested. Such transparent entities include a qualified subchapter S subsidiary (as defined in section 1361(b)(3)(B)), a grantor trust, or an entity disregarded as separate from the QOF under § 301.7701-3. For Federal income tax purposes, the assets of the transparent entity are treated as assets of the QOF, and therefore are

taken into account for determining whether the QOF satisfies the 90-percent investment standard. The 70-percent tangible property standard for qualified opportunity zone businesses set forth in § 1.1400Z2(d)-1(d)(1)(i) (70-percent tangible property standard) is not relevant with respect to the assets directly held by a transparent entity owned by a QOF.

2. Ability of a QOF With an AFS To Use the Alternative Valuation Method

Proposed § 1.1400Z2(d)-1(b)(2) provided that a QOF may utilize the AFS valuation method to value each asset owned or leased by the QOF for purposes of determining compliance with the 90-percent investment standard. Under the AFS valuation method, the value of each asset owned or leased by the QOF equals the value of that asset as reported on the QOF's AFS for the relevant reporting period. Proposed § 1.1400Z2(d)-1(b)(2)(ii) clarified that a QOF may select the AFS valuation to value an asset leased by the QOF only if the AFS of the QOF (1) is prepared according to U.S. generally accepted accounting principles (GAAP) and (2) requires an assignment of value to the lease of the asset.

A commenter recommended that the final regulations allow a QOF to elect to use unadjusted cost basis to value tangible assets (that is, the alternative valuation method), regardless of whether the QOF has an AFS. The Treasury Department and the IRS note that the proposed regulations would accommodate the commenter's request without change. Specifically, under the proposed regulations and these final regulations, a QOF with an AFS may use the alternative valuation method.

3. Alternative Valuation Method

a. Valuation of Intangible Assets With a Tax Basis Not Based on Cost

Under the alternative valuation method set forth in proposed § 1.1400Z2(d)-1(b)(3), the value of each asset that is owned by a QOF is the QOF's unadjusted cost basis of the asset under section 1012 or section 1013 (with regard to inventory). One commenter considered the application of the alternative valuation method to partnership interests with a tax basis not based on cost. The commenter agreed that the alternative valuation method generally provided an appropriate valuation methodology with regard to property that has been acquired by purchase, but questioned whether that method provided an appropriate means to value a partnership interest.

The Treasury Department and the IRS agree that applying the alternative valuation method to partnership interests, as well as other intangible assets with a tax basis not based on cost, would be inconsistent with the intent and purpose of the statute. As a result, the final regulations reflect the commenter's observation and provide that the alternative valuation method may be used to value only assets owned by a QOF that are acquired by purchase or constructed for fair market value. In such instances, the QOF's unadjusted cost basis of the asset is determined under section 1012 or section 1013 (with regard to inventory). The final regulations also provide that the value of each asset owned by a QOF that is not purchased or constructed for fair market value equals the asset's fair market value. A QOF determines that fair market value on the last day of the first six-month period of the taxable year and on the last day of the taxable year.

b. Valuation of Assets Leased by a QOF

Proposed § 1.1400Z2(d)-1(b)(3)(iii)(A) provided that the value of each asset that is leased by a QOF is equal to the present value of the leased asset. The "present value" of such leased asset is (i) equal to the sum of the present values of each payment under the lease for the asset, and (ii) calculated at the time at which the QOF enters into the lease for the asset. See proposed § 1.1400Z2(d)-1(b)(3)(iii)(C)(1), (2). Once calculated, that present value is used as the value for the asset by the QOF for all testing dates for purposes of the 90-percent investment standard. See proposed § 1.1400Z2(d)-1(b)(3)(iii)(C)(3). To determine the present value of the lease payments, the proposed regulations provided that the discount rate is the applicable Federal rate (AFR) under section 1274(d)(1). See proposed § 1.1400Z2(d)-1(b)(3)(iii)(B) (present value determined under section 1274(d)(1) by substituting the term "lease" for "debt instrument"). The final regulations clarify the rules to be used to determine the AFR for a particular lease, and provide that the short-term AFR must be used. The Treasury Department and the IRS have determined that use of the short-term AFR will provide a simple and objective rule for taxpayers and practitioners.

Prior to the publication of the May 2019 proposed regulations, the Treasury Department and the IRS received comments requesting that the final regulations provide flexibility regarding the valuation of leases. For example, one commenter requested that the final regulations permit QOFs to use a type of basis other than the basis used for GAAP (for example, cost basis under section 1012). This comment was particularly relevant to Indian tribal governments, which typically rely upon leases. Another commenter had suggested that QOFs and qualified opportunity zone businesses should be able to elect to use Federal income tax basis to determine the value of assets for these purposes. The commenter reasoned that the value of the operating lease, as a non-qualifying asset, would be \$0 and would not affect the 90-percent investment standard.

The Treasury Department and the IRS have determined that the alternative valuation method for leased assets, as set forth in proposed § 1.1400Z2(d)-1(b)(3), addresses the concerns raised by these commenters. In addition, the Treasury Department and the IRS note that no participant of the Consultation requested additional guidance regarding these issues. Therefore, proposed § 1.1400Z2(d)-1(b)(3) has not been modified as a result of those comments.

With regard to the 90-percent investment standard, a commenter suggested that the Treasury Department and the IRS consider a valuation method for leases that are negotiated at arms-length under section 482. This valuation method would value the lease (i) as having a value of \$0 regardless of whether the QOF has an AFS, or (ii) at the unadjusted cost basis of the lease, similar to purchased property. Another commenter requested that the value of leased property be excluded from the numerator and denominator of the fraction-based test underlying the 90-percent investment standard, while the value of substantial improvements to leased property should be included. Another commenter suggested that leased property should be valued at the lease's fair market value.

The Treasury Department and the IRS have determined that the proposed regulations provided a comprehensive method to value leased property to satisfy the 90-percent investment standard. While the commenters' recommended rules would provide value in certain instances, the

Treasury Department and the IRS have concluded that such rules would inject significant complexity into the final regulations that would outweigh any potential resulting benefits. As a result, the final regulations retain the method provided in the proposed regulations with some clarifications. For example, the term of a lease that is being valued for purposes of the 90-percent investment standard includes periods during which the lessee may extend the lease at a pre-defined rent. The terms of a pre-defined market rate rent must follow the criteria set forth under section 482 with a rebuttable presumption that terms of a lease between unrelated parties is market rate.

4. Option To Disregard Recently Contributed Property to a QOF for Purposes of the 90-Percent Investment Standard

Under proposed § 1.1400Z2(d)-1(b)(4), a QOF may choose to determine compliance with the 90-percent investment standard by excluding certain eligible property from both the numerator and denominator of the fraction-based test underlying that standard. Such excluded amount of property must satisfy each of the following criteria: (1) The amount of contributed property was received by the QOF partnership or the QOF corporation solely in exchange for an interest in the partnership or stock in the corporation; (2) that contribution or exchange occurred not more than six months before the date of the test from which the amount of property is excluded; and (3) between the date of that contribution or exchange and the date of the underlying asset test, the amount of property was held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less. Finally, proposed § 1.1400Z2(d)-1(b)(4) provided that a QOF need not be consistent from one semiannual test to another in whether it avails itself of this option.

While commenters largely agreed with the approach set forth in proposed § 1.1400Z2(d)-1(b)(4), many commenters suggested significant revisions. For instance, commenters suggested that the permitted six-month period (that is, the period between the date of contribution or exchange and the testing date) should be extended to a 12-month period, starting on the date of the contribution or exchange, to facilitate increased investments into beneficial qualified opportunity zone property. Another commenter recommended that the final regulations provide QOFs with a 31-month period to deploy capital into a qualified opportunity zone property, and thereby provide QOFs with a rule similar to the 31-month working capital safe harbor (as defined in part V. O of this Summary of Comments and Explanation of Revisions) for qualified opportunity zone businesses.

The Treasury Department and the IRS have considered each of these recommendations and have concluded that their adoption would achieve results inconsistent with the purposes of section 1400Z-2. In particular, the Treasury Department and the IRS have determined that the commenters' recommended rules would permit the holding of capital for extended periods of time without deployment into qualifying investments, and ultimately into QOZs. A delay of such capital investment would reduce, rather than increase, investments in QOZs and thereby delay the type of economic growth for which section 1400Z-2 was enacted to achieve.

One commenter suggested that a QOF should control, by election, the decision to disregard recently contributed property. Under the commenter's approach, a QOF could either disregard the recently contributed property, or upon an election, include the property in both the numerator and the denominator of the fraction-based test underlying the 90-percent investment standard.

However, if the QOF elects to disregard the property, the commenter argued that both the numerator and the denominator of the fraction-based test would be zero, resulting in an undefined mathematical result. In the alternative, the commenter suggested that the Treasury Department and the IRS should treat recently contributed property as qualified opportunity zone property only if, and to the extent that, such property is invested in qualified opportunity zone property before the next QOF testing date following that contribution.

The Treasury Department and the IRS have determined that the option to disregard recently contributed property provides a sufficiently expansive rule set to address the concerns raised by the commenter, namely that by excluding recently contributed property from both the numerator and denominator, the resulting fraction may be undefined. The commenter's solution to allow a QOF to elect to disregard property, although potentially helpful to taxpayers in certain cases, would significantly increase the complexity of the mechanics for determining compliance with the 90-percent investment standard. Moreover, the commenter presumes that a QOF would have no other property to include in the denominator, which would allow a mathematically correct result. Further, the alternative suggested by the commenter is similar to the proposed rule and would result in the same outcome. Accordingly, the final regulations do not incorporate the commenter's suggestions. Because several commenters requested flexibility in timing of investments, the final regulations provide that a QOF has until the fifth business day after the contribution of the property to exchange such property into cash, cash equivalents, or debt instruments with a term of 18 months or less.

In addition, one commenter suggested that, with regard to periods during which the previously described contributed property is disregarded, the Treasury Department and the IRS should require that the capital be held in mission-driven institutions such as Community Development Financial Institutions (CDFIs), low-income credit unions, or minority-owned depository institutions. While the Treasury Department and the IRS appreciate the policy objectives underlying this recommendation, section 1400Z-2 does not provide sufficient authority to incorporate this recommendation into the final regulations.

5. Wind-Down Period Safe Harbor for Applying 90-Percent Investment Standard to Dissolving QOFs

For purposes of applying the 90-percent investment standard, two commenters requested that the final regulations provide a wind-down safe harbor period that would precede the start of the QOF's dissolution phase. The commenters reasoned that during a QOF wind-down period which the commenters suggested could last for up to two years, QOFs would hold larger amounts of non-qualifying property because the dissolving QOF typically would dispose of business assets (that is, qualified opportunity zone business property) in exchange for cash or other non-qualifying property. The commenter contended that the policy rationale for a wind-down period safe harbor for QOF dissolutions would parallel the policy rationale for proposed safe harbor provisions that facilitate the development and operation by QOFs of start-up businesses.

The Treasury Department and the IRS acknowledge the policy arguments set forth by the commenter. However, the final regulations do not adopt the commenter's recommendation. In particular, the Treasury Department and the IRS note that section 1400Z-2 was enacted to encourage the development of operating businesses in QOZs and thereby increase the economic

development of the communities located in those designated census tracts. Safe harbors provided by the proposed and final regulations to facilitate the success of start-up businesses in QOZs advances the achievement of those purposes. A QOF wind-down safe harbor for purposes of the 90-percent investment standard, however, potentially would encourage the opposite effect—that is, QOF dissolutions and disinvestment from QOZs.

C. Consideration of Synthetic Equity as Qualified Opportunity Zone Stock or Partnership Interest

Under proposed § 1.1400Z2(d)-1(c), qualified opportunity zone stock and a qualified opportunity zone partnership interest generally must satisfy three requirements. First, such stock or partnership interest must be stock in a corporation or an interest in a partnership that is acquired by a QOF after December 31, 2017 from the corporation or the partnership solely in exchange for cash. See proposed § 1.1400Z2(d)-1(c)(2)(i)(A) (regarding qualified opportunity zone stock), (c)(3)(i) (regarding qualified opportunity zone partnership interests). Second, at the time of acquisition, the corporation whose stock was acquired, or the partnership whose interest was acquired, must either be a qualified opportunity zone business, or in the process of becoming a qualified opportunity zone business. See proposed § 1.1400Z2(d)-1(c)(2)(i)(B) (regarding qualified opportunity zone stock), (c)(3)(ii) (regarding qualified opportunity zone partnership interests). Third, during substantially all of the QOF's holding period for the stock or partnership interest, the corporation or partnership must qualify as a qualified opportunity zone business. See proposed § 1.1400Z2(d)-1(c)(2)(i)(C) (regarding qualified opportunity zone stock), (c)(3)(iii) (regarding qualified opportunity zone partnership interests).

The Treasury Department and the IRS received comments recommending that the final regulations include in the definition of the term "qualified opportunity zone stock" any interest constituting synthetic equity under section 409(p)(6)(C) or an employee stock option plan. The synthetic equity definitions recommended by the commenters include an expansive range of interests, some of which would require potentially complex rules to ensure their proper application in the section 1400Z-2 regulations. The Treasury Department and the IRS continue to consider synthetic equity for purposes of the definitions of "qualified opportunity zone stock" and "qualified opportunity zone partnership interest," but have determined that specific rules to address synthetic equity would add inappropriate complexity to the final regulations. As a result, the final regulations do not incorporate the commenters' recommendation.

D. Qualified Opportunity Zone Business Property Purchased by QOF or Qualified Opportunity Zone Business

Under proposed § 1.1400Z2(d)-1(c)(4)(i)(A) and (d)(2)(i)(A), property that is purchased (as defined in section 179(d)(2)) by a QOF or a qualified opportunity zone business from an unrelated party (as defined in section 1400Z-2(e)(2)) qualifies as "qualified opportunity zone business property," provided that the property satisfies all other requirements under section 1400Z-2(d)(2)(D)(i).

1. Qualification of Property Constructed by an Eligible Entity

The Treasury Department and the IRS received several comments requesting that the final regulations expand the definition of the term "qualified opportunity zone business property" to include an eligible entity's self-constructed property. One commenter recommended that the final regulations treat construction costs of such self-constructed property as part of the property's purchase price. To determine the acquisition date for each testing period, one commenter suggested that the final regulations utilize the approach provided under former section 168(k)(2) and § 1.168(k)-1(b)(4)(iii). Former section 168(k)(2)E(i) and § 1.168(k)-1(b)(4)(iii) provided that if a taxpayer manufactures, constructs or produces property for use in its trade or business (or for its production of income), the property will be treated as acquired when the taxpayer begins manufacturing, constructing or producing the property. Under § 1.168(k)-1(b)(4)(iii), manufacturing, construction or production of the property begins when physical work of a significant nature begins. Another commenter suggested that, if an eligible entity's self-constructed property is not to be included as purchased property, (i) the incorporation of non-qualifying property into new construction should not taint the new property, and (ii) that new property should be treated as a separate asset under section 1400Z-2(d)(2)(D)(i)(III).

The Treasury Department and the IRS have determined that tangible property is not disqualified from constituting qualified opportunity zone business property solely because the property is manufactured, constructed, or produced, rather than purchased, by the eligible entity. However, to qualify as qualified opportunity zone business property, such tangible property must be manufactured, constructed, or produced by the eligible entity with the intent to use the property in the trade or business of the eligible entity in a QOZ. In addition, the materials and supplies used for the construction of the qualified opportunity zone business property must be qualified opportunity zone business property. Self-constructed property must otherwise meet the requirements of section 1400Z-2(d)(2)(D)(i).

For purposes of the 90-percent investment standard and the 70-percent tangible property standard, an eligible entity must determine the date on which such self-constructed property will be treated as acquired. The Treasury Department and the IRS agree with the prior commenter that applying a standard similar to former section 168 and the regulations thereunder make logical sense. Thus, the final regulations provide that, for purposes of the 90-percent investment standard and the 70-percent tangible property standard, self-constructed property will be treated as acquired on the date physical work of a significant nature begins. Physical work of a significant nature does not include preliminary activities such as planning or designing, securing financing, exploring or researching, and will depend on a facts and circumstances analysis. The final regulations also provide a safe harbor to determine when physical work of a significant nature begins. An eligible entity may choose the date on which the eligible entity paid or incurs more than 10 percent of the total cost of the property, excluding the cost of any land and preliminary activities such as planning and designing, securing financing, exploring or researching.

2. Qualification of Property Contributed to a QOF

Several commenters suggested that property contributed to a QOF, and used in the QOF's trade or business, should be treated as qualified opportunity zone business property. Under section 1400Z-2(d)(2)(D)(i)(I), to qualify as qualified opportunity zone business property, the property must be purchased from an unrelated party. Property contributed by an entity to a QOF, while potentially used in the QOF's trade or business, will not be considered qualified opportunity zone

business property because the QOF has not purchased, leased, or self-constructed the contributed property. Because the commenters' suggestion would not be consistent with the text of section 1400Z-2(d)(2)(D)(i)(I), the final regulations do not adopt it.

3. Qualification of Property Purchased Before Statutory Deadline

A commenter asserted that, by requiring the purchase of property to have occurred after December 31, 2017, the proposed regulations will irrationally exclude owners of property purchased on or before that date from the benefits of section 1400Z-2. Another commenter raised similar concerns, and requested that the final regulations treat as qualified opportunity zone business property otherwise qualifying property acquired by a QOF or qualified opportunity zone business prior to the publication date of the October 2018 proposed regulations. While the Treasury Department and the IRS are sympathetic to the concerns expressed by these commenters, the text of section 1400Z-2(d) does not provide authority to allow property purchased on or before December 31, 2017, to be treated as qualified opportunity zone business property.

One commenter requested confirmation that contractual rights to real property (including easements, land leases, timber deeds, agricultural leases, and water rights) qualify as an acquisition by purchase, and therefore could qualify as qualified opportunity zone business property. The Treasury Department and the IRS acknowledge the common usage of these types of arrangements, particularly in rural industries. While the text of section 1400Z-2 requires qualified opportunity zone business property to be purchased or leased, the Treasury Department and the IRS note that contractual rights may qualify as leases under the rules discussed in part V. E of this Summary of Comments and Explanation of Revisions. If such contractual rights do not meet the requirements of either purchased or leased property, however, the final regulations provide that the contractual rights will not qualify as qualified opportunity zone property.

4. Qualification of Property Based on Factors Not Consistent With Section 1400Z-2

For purposes of determining whether property qualifies as qualified opportunity zone business property, the text of section 1400Z-2(d)(2)(D)(i) sets forth requirements regarding the property's acquisition, location, and use. The Treasury Department and the IRS have received comments requesting that the final regulations provide exceptions to those statutory requirements. For example, a commenter requested that the final regulations provide rules that focus on the use of the subject property at the time the property is acquired, but exclude any consideration regarding the location of the property. Similarly, another commenter suggested that the final regulations should provide an exception to allow residents of a QOZ to treat previously purchased property as qualified opportunity zone business property. Commenters also have suggested that property owned by residents of a QOZ, as well as land, should be treated as completely exempt from the post-2017 acquisition requirement.

The Treasury Department and the IRS appreciate the commenters' recommendations. However, each of these suggested rules would conflict with the statutorily imposed acquisition, location, and use requirements set forth in section 1400Z-2(d)(2)(D)(i). As a result, the final regulations do not adopt the commenters' recommendations.

5. Qualification of Property Purchased From Related Persons

Section 1400Z-2(d)(2)(D)(iii) limits the purchase of qualified opportunity zone property to purchases from parties who are not related parties, as that term is defined in section 1400Z-2(e)(2). Proposed § 1.1400Z2(d)-1(c)(4)(i)(A) and (d)(2)(i)(A) provide that property must be acquired by a QOF or qualified opportunity zone business from a person that is not related under section 1400Z-2(e)(2). Under that statutory provision, persons are related to each other for purposes of section 1400Z-2 if such persons are described in section 267(b) or 707(b)(1), determined by substituting "20 percent" for "50 percent" each place the phrase "50 percent" occurs in those sections. See section 1400Z-2(e)(2).

The Treasury Department and the IRS received numerous comments requesting that the final regulations treat property purchased from a related person (under section 1400Z-2(e)(2)) as qualified opportunity zone business property. To prevent potential abuse that could arise from such related-party transactions, one commenter suggested that the final regulations should require purchases between related parties to be negotiated at arm's length. Other commenters recommended that the final regulations allow otherwise qualifying purchases by a QOF or qualified opportunity zone business to be carried out with (i) businesses or partnerships that owned property located in a QOZ prior to the QOZ's designation, and (ii) residents of a QOZ prior to such time. The Treasury Department and the IRS note that the text of section 1400Z-2, as described above, does not permit property purchased from a related party to qualify as qualified opportunity zone property, and therefore decline to adopt these comments.

Another commenter requested that the final regulations provide clarification as to whether any sponsorship arrangement with a sponsor, who is a QOF investor, would establish relatedness included in the definition of "related person" under section 1400Z-2(e)(2). The Treasury Department and the IRS have determined that (i) specific rules to address sponsorship agreements would introduce significant, additional complexity into the final regulations, and (ii) the proposed regulations provide adequate guidance to address the commenter's request. As a result, the final regulations do not incorporate specific rules to address sponsorship agreements.

The final regulations, however, have added rules to address the qualification of property purchased in certain "sponsor-like" arrangements as qualified opportunity zone business property. With regard to these arrangements, the final regulations provide that, in the case of real property that is purchased by a QOF or qualified opportunity zone business, if at the time of the purchase there was a plan, intent, or expectation for the real property to be repurchased by the seller of the real property for an amount of consideration other than the fair market value of the real property, the purchased real property is not qualified opportunity zone business property. Under this rule, the "fair market value of the real property" refers to the fair market value of that property at the time of the repurchase by the seller.

E. Qualified Opportunity Zone Business Property Leased by QOF or Qualified Opportunity Zone Business

Proposed § 1.1400Z2(d)-1(c)(4)(i)(B) and (d)(2)(i)(B) provided that a QOF or qualified opportunity zone business may treat leased tangible property as qualified opportunity zone business property for purposes of satisfying the 90-percent investment standard and the 70-

percent tangible property standard. To qualify, the leased tangible property must satisfy the following two general requirements: First, analogous to owned tangible property, leased tangible property must be acquired under a lease entered into after December 31, 2017. Second, and also similar to owned tangible property, substantially all of the use of the leased tangible property must be located within a QOZ during substantially all of the period for which the business leases the property.

1. General Comments Requesting Additional Rules and Clarifications

The Treasury Department and the IRS received several comments agreeing with the rules addressing leased tangible property set forth in the May 2019 proposed regulations. However, many commenters requested that the Treasury Department and the IRS further clarify whether certain types of leased property qualify as qualified opportunity zone business property. Similarly, other commenters recommended that the final regulations provide additional detailed rules and examples, and include definitions for leases, lease-like arrangements, and licenses for purposes of determining whether such instruments qualify as qualified opportunity zone property.

As described further in this part V. E of the Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS have provided additional details and examples in the final regulations to respond to the commenters' concerns and recommendations. For example, the final regulations exempt State and local governments, as well as Indian tribal governments, from the market-rate requirement for leased tangible property that otherwise must be satisfied to qualify as qualified opportunity zone business property. In addition, the final regulations provide rules that permit certain short-term leased property to lessors located outside of a QOZ to be counted as qualified opportunity zone business property for purposes of satisfying the 70-percent use test. The final regulations also contain additional examples to clarify the application of the rules regarding leased tangible property.

2. Qualification of Tangible Property Subject to an Existing Lease

Section 1400Z-2(d)(2)(D)(i)(I) requires tangible property to be purchased after December 31, 2017, which the May 2019 proposed regulations followed in requiring that leased tangible property be acquired under a lease entered into after December 31, 2017. One commenter requested that the final regulations treat an existing lease of property the same as a new lease of property for purposes of determining whether the property subject to the existing lease is qualified opportunity zone business property. The Treasury Department and the IRS note that the leased tangible property rules were included in the May 2019 proposed regulations to provide parity among diverse business models (for example, parity between business models that utilize purchased tangible property and those that utilize leased tangible property). To achieve that parity, the Treasury Department and the IRS have determined that in general acquisitions of tangible property by purchase or lease should be treated consistently. In addition, the Treasury Department and the IRS note that section 1400Z-2 requires the acquisition of such property to occur after December 31, 2017. Therefore, the final regulations confirm that property subject to an existing lease will not constitute qualified opportunity zone business property unless the lease was entered into on or after December 31, 2017.

3. Requirement That the Terms of Lease Must Be Market Rate Between Parties

Proposed § 1.1400Z2(d)-1(c)(4)(i)(B)(2) and (d)(2)(i)(B)(2) provided that, to qualify as qualified opportunity zone business property, the terms of a lease must be market rate at the time at which the lease was entered into (market-rate lease requirement). For this purpose, whether a lease is market rate (that is, whether the terms of the lease reflect common, arms-length market pricing in the locale that includes the QOZ) is determined in accordance with the regulations under section 482. This limitation operates to ensure that all of the terms of the lease are market rate. The proposed regulations applied the market-rate lease requirement to leases between unrelated parties and related parties.

The Treasury Department and the IRS received multiple comments regarding the market-rate lease requirement. For example, many commenters requested that the final regulations not apply the market-rate lease requirement to leases between unrelated parties. Rather, these commenters recommended that the final regulations provide a presumption that such unrelated-party leases are arms-length. The Treasury Department and the IRS agree with the commenters' recommendation. Accordingly, the final regulations provide that there will be a rebuttable presumption that, with regard to leases between unrelated parties, the terms of the lease were market rate (that is, the lease satisfies the market-rate lease requirement).

In addition, the Treasury Department and the IRS received several comments requesting that the final regulations exempt from the market-rate lease requirement leases between an unrelated party and a state or local government. Commenters explained that such leases are subject to numerous requirements and other special rules. The Treasury Department and the IRS agree with the commenters, and have determined that, based on the same rationale, Indian tribal governments likewise should be exempt from the market-rate lease requirement. As a result, the final regulations provide that, for purposes of satisfying the market-rate lease requirement, tangible property acquired by lease from a state or local government, or an Indian tribal government, is not considered tangible property acquired by lease from a related party.

Another commenter suggested that the final regulations replace the market-rate lease requirement with a requirement that a subject lease must have reasonable terms. This commenter, however, acknowledged that a "reasonableness" standard likely would inject additional uncertainty into the final regulations. The Treasury Department and the IRS appreciate the commenter's suggestion and agree that a "reasonableness" standard would pose additional uncertainty for taxpayers in determining whether the terms of a subject lease are reasonable. Moreover, the Treasury Department and the IRS believe that such a standard would be too complex to administer. As a result, the final regulations do not adopt the commenter's suggestion.

4. Plan, Intent, or Expectation of QOF or Qualified Opportunity Zone Business To Purchase Leased Real Property

Proposed § 1.1400Z2(d)-1(c)(4)(i)(E) and (d)(2)(i)(E) provided an anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement for purchases by QOFs or qualified opportunity zone businesses of real property (other than unimproved land). If, at the time a QOF or qualified opportunity zone business enters into a lease for real property (other

than unimproved land), there was a plan, intent, or expectation for the QOF or qualified opportunity zone business to purchase the real property for an amount of consideration other than the fair market value of the land (as determined at the time of the purchase without regard to any prior lease payments) the leased real property does not qualify as qualified opportunity zone business property at any time.

A commenter suggested that the Treasury Department and the IRS should consider eliminating from this anti-abuse rule the reference to a plan, intent, or expectation to purchase the leased property. Rather, the commenter asserted that, even if the QOF or qualified opportunity zone business had such "plan, intent, or expectation," the anti-abuse rule should not be applied if there were a fixed purchase price option, consistent with general Federal income tax principles governing the distinction between a lease and a sale, with a strike price not less than a specified amount of the fair market value at the time the option is entered into.

The Treasury Department and the IRS have considered the commenter's suggestion and have determined that such a rule might enable QOFs and qualified opportunity zone businesses to circumvent the substantial improvement requirement because leased property from an unrelated party is not required to be substantially improved. Thus, the final regulations do not reflect this suggestion.

F. Treatment of Inventory for Purposes of Determining Substantial Use in QOZ

Under section 1400Z-2(d)(2)(D)(i)(III), the term "qualified opportunity zone business property" refers to tangible property used in a trade or business of a QOF or qualified opportunity zone business if, during substantially all of the holding period of the QOF or qualified opportunity zone business for such property, substantially all of the use of such property was in a QOZ. Prior to the publication of the May 2019 proposed regulations, commenters inquired how inventory would be treated for purposes of determining whether substantially all of the tangible property is used in the QOZ. To address those questions, the May 2019 proposed regulations provided a safe harbor that inventory would not fail to qualify as qualified opportunity zone business property simply because the inventory is in transit outside the QOZ due to transport (i) from a vendor to a facility of the trade or business that is in a QOZ, or (ii) from a facility of the trade or business that is in a QOZ to customers outside the QOZ (inventory transit safe harbor). See proposed § 1.1400Z2(d)-1(c)(4)(iii) (setting forth the inventory transit safe harbor).

1. Inventory as Qualified Opportunity Zone Business Property and Application of 90-Percent Investment Standard and 70-Percent Tangible Property Standard

As part of the May 2019 proposed regulations, the Treasury Department and the IRS requested comments as to whether inventory, including raw materials, should be excluded from both the numerator and denominator of the fraction used to determine compliance with the 90-percent investment standard and the 70-percent tangible property standard. In response, some commenters recommended that the final regulations exclude inventory from the 90-percent investment standard and the 70-percent tangible property standard. These commenters based that recommendation upon their conclusion that inventory should never be treated as qualified opportunity zone business property because such inventory (i) is a transitory asset, (ii) does not add value to the QOZ, and (iii) does not meet the requirements for either the original use or

substantial improvement requirement. Other commenters agreed that inventory should be excluded from the 70-percent tangible property standard, emphasizing that any requirement that taxpayers measure inventory would be significantly burdensome.

Several additional commenters, however, recommended that the final regulations treat inventory, in a limited manner, as qualified opportunity zone business property. These commenters suggested that taxpayers should be allowed to elect on an annual basis whether to exclude inventory from the numerator and denominator for purposes of the 90-percent investment standard and the 70-percent tangible property standard. Another commenter contended that inventory should be limited to a certain percentage of total qualified opportunity zone property, suggesting that 15 or 20 percent of such total property would provide a reasonable maximum.

The Treasury Department and the IRS also received numerous requests that the final regulations provide additional detail and clarity regarding the general application of section 1400Z-2 to inventory. Like the commenters described previously, these commenters noted that the proposed regulations did not specify whether inventory is properly includable in the numerator of the 70-percent tangible property standard or the 90-percent investment standard. These commenters also highlighted that the proposed regulations did not clarify whether inventory must be original use property or substantially improved property.

The Treasury Department and the IRS acknowledge the concerns raised by these commenters and agree that additional rules regarding the treatment of inventory would be appropriate. As a result, the final regulations provide that, for purposes of determining compliance with the 90-percent investment standard and the 70-percent tangible property standard, a QOF or qualified opportunity zone business may choose to (i) include inventory in both the numerator and the denominator, or (ii) exclude inventory entirely from both the numerator and the denominator. The final regulations also provide that, once a QOF or qualified opportunity zone business makes such choice, the QOF or qualified opportunity zone business must apply that choice consistently with respect to all semiannual tests during the holding period in which the QOF, or the qualified opportunity zone business of the QOF, holds the inventory. The Treasury Department and the IRS have determined that these rules will provide appropriate flexibility for QOFs and qualified opportunity zone businesses, as well as certainty regarding the application of the 90-percent investment standard and the 70-percent tangible property standard.

2. Comments Regarding Application of 90-Percent Investment Standard to Inventory in Transit

Commenters also expressed concern that inventory in transit on the last day of the taxable year of a QOF would be counted against the QOF when determining whether the QOF has met the 90-percent investment standard. Several commenters recommended that inventory in transit, either from the vendor or to the ultimate customer, be excluded from the numerator and denominator for purposes of the 90-percent investment standard, but should qualify for the 70-percent use test. Another commenter suggested that the location of inventory in transit should be taken into account in determining whether the inventory is qualified opportunity zone business property. One commenter generally agreed with the approach of the May 2019 proposed regulations with regard to inventory in transit, but requested clarification that (i) the distance traveled during the course of the transit, or (ii) the manner of the transit, does not affect application of the inventory transit safe harbor. The commenter also requested clarification as to whether the inventory transit

safe harbor covers instances in which the inventory is warehoused briefly (that is, for less than 30 days) in a location outside of the QOZ while in the process of transit.

The Treasury Department and the IRS appreciate the commenters' concerns regarding the manner by which transported inventory is treated for purposes of applying the 90-percent investment standard. To provide certainty for QOFs as well as qualified opportunity zone businesses on this matter, the final regulations set forth a rule that provides that (i) the distance traveled in the course of the transit, and (ii) the fact that the inventory is briefly warehoused while in transit, does not affect the application of the inventory transit safe harbor. The Treasury Department and the IRS intend for these provisions to complement the inventory transit safe harbor, which the final regulations adopt in full.

G. Definition of "Substantially All" for Purposes of Qualified Opportunity Zone Property and Qualified Opportunity Zone Business Determinations

The definitions of the terms "qualified opportunity zone property" and "qualified opportunity zone business" incorporate several "substantially all" requirements. For example, with regard to (1) qualified opportunity zone stock, (2) qualified opportunity zone partnership interests, and (3) qualified opportunity zone business property, to qualify as qualified opportunity zone property, the corporation or partnership must have qualified as a qualified opportunity zone business, and the qualified opportunity zone business property must have been used in a QOZ, during "substantially all" of the QOF's holding period of such stock, interest, or business, as appropriate. See section 1400Z-2(d)(2)(B)(i)(III) (regarding qualified opportunity zone stock); section 1400Z-2(d)(2)(C)(iii) (regarding qualified opportunity zone partnership interests); section 1400Z-2(d)(2)(D)(i)(III) (regarding qualified opportunity zone businesses). In this holding period context, the May 2019 proposed regulations defined "substantially all" of a QOF's holding period as 90 percent of the total holding period of the QOF. See proposed § 1.1400Z2(d)-1(c)(5).

In addition to QOF holding period requirements, the term "substantially all" appears in a "use" context. Specifically, tangible property used in a trade or business of a QOF or in a qualified opportunity zone business will not qualify as qualified opportunity zone business property unless "substantially all" of the use of such tangible property was within the geographic boundaries of a QOZ. See section 1400Z-2(d)(2)(D)(i)(III), (3)(A)(i). In this "use" context, the May 2019 proposed regulations defined "substantially all" of the use of tangible property in a QOZ by a trade or business of a QOF, or by a qualified opportunity zone business, as 70 percent of the total use of such tangible property. See proposed § 1.1400Z2(d)-1(c)(6), (d)(2)(iv).

Lastly, the term "substantially all" appears in the context of the portion of a business's tangible property that must be qualified opportunity zone business property in order for the business to qualify as a qualified opportunity zone business. Specifically, a trade or business qualifies as a qualified opportunity zone business only if (among the satisfaction of other requirements) "substantially all" of the tangible property owned or leased by the taxpayer for the trade or business is qualified opportunity zone business property. See section 1400Z-2(d)(3)(A)(i). For this determination of whether the trade or business owns or leases a sufficient amount of qualified opportunity zone business property, the October 2018 proposed regulations defined "substantially all" as an amount equal to 70 percent of the total amount of tangible property

owned or leased by the trade or business (70-percent tangible property standard). See proposed § 1.1400Z2(d)-1(d)(3).

As discussed in the respective preambles to the October 2018 and May 2019 proposed regulations, the Treasury Department and the IRS provided a higher threshold in the holding period context to preserve the integrity of the statute and ensure that investors focus their investments within the geographic borders of QOZs. Therefore, the term "substantially all," as used in the holding period context, was defined in the proposed regulations as 90 percent of the QOF's total holding period. The Treasury Department and the IRS determined that a percentage threshold higher than, for example 70 percent, was warranted because taxpayers can more easily control and determine the period for which they hold property. In addition, given the lower 70-percent thresholds for testing both the use of tangible property in the QOZ and the amount of owned and leased tangible property of a qualified opportunity zone business that must be qualified opportunity zone business property, applying a 70-percent threshold in the holding period context could result in an unacceptably low percentage of a qualified opportunity zone business's tangible property being used in a QOZ.

The Treasury Department and the IRS, however, recognized that the operations of certain types of businesses may extend beyond the census tract boundaries that define QOZs. Accordingly, the "substantially all" thresholds provided by the proposed regulations with regard to required amounts and use of tangible property owned or leased by a trade or business were set to a 70-percent standard. The Treasury Department and the IRS determined that a 70-percent standard would appropriately tie the ability of investors in QOFs to receive preferential capital gains treatment to a consequential amount of tangible property being used by the underlying business within a QOZ. Importantly, the Treasury Department and the IRS also determined that a 70-percent standard would provide businesses with an appropriate degree of flexibility to conduct their day-to-day operations, and therefore avoid significantly distorting or otherwise limiting the introduction of new businesses and investment in QOZs.

1. Consideration of Uniform 90-Percent "Substantially All" Standard

Commenters have suggested that the term "substantially all" should be interpreted as requiring a 90-percent standard with regard to each instance in which the term is used in section 1400Z-2. As described previously, the Treasury Department and the IRS have determined that the policy considerations underlying each use of the term "substantially all" are not uniform, and therefore a uniform standard would fail to effectuate such policies in all cases. For example, the Treasury Department and the IRS established the 70-percent tangible property standard and 70-percent use test to provide "substantially all" requirements for qualified opportunity zone businesses that, while substantial, would ensure that a diverse spectrum of businesses would be able to operate in QOZs. However, the Treasury Department and the IRS selected a higher 90-percent threshold regarding holding periods of QOFs (under the 90-percent investment standard) to encourage long-term direct or indirect investments in those qualified opportunity zone businesses. In addition, due to the compound application of the 90-percent threshold, the 70-percent tangible property standard, and the 70-percent use test, the Treasury Department and the IRS sought to ensure that each percentage requirement, when taken together, would remain significant.

Another commenter that advocated for a uniform 90-percent standard specifically contended that the 70-percent use test presented an inappropriately low threshold to ensure that acceptable amounts of new economic activity are introduced in QOZs. The Treasury Department and the IRS appreciate the commenter's perspective, but have determined that a 70-percent standard achieves an appropriate balance between providing proper flexibility to potential investors in QOZs and limiting the potential for abuse. A 90-percent use threshold would pose a much stricter standard than the proposed 70-percent standard, and potentially would discourage investment in QOZs. As a result, the final regulations retain the 70-percent use test.

Several commenters recommended that, solely with regard to real estate businesses, the final regulations should adopt a threshold of 90 percent for the substantially all use test. The Treasury Department and the IRS have determined that such industry-specific rules would (i) not be consistent with section 1400Z-2 or its underlying policy, and (ii) present administratively burdensome tracking requirements under which taxpayers, as well as the IRS, would need to apply different rules for different types of businesses. As a result, the final regulations do not adopt this recommendation.

2. Clarification Regarding the Measurement of "Use" for the 70-Percent Use Test

Several commenters requested clarification regarding the scope of the term "use" under section 1400Z-2(d)(2)(D)(i)(III). Similarly, other commenters requested that the final regulations clarify the meaning of the term "use" with regard to qualified opportunity zone property located both inside, and outside the geographic borders of a QOZ. Taken together, commenters generally requested easily applicable metrics for determining compliance with the 70-percent use test that are responsive to the practical realities of businesses that utilize a range of tangible property in addition to real estate.

The Treasury Department and the IRS agree with the commenters that guidance regarding the meaning and application of the term "use" would be significantly helpful to taxpayers. As a result, the final regulations provide that tangible property of a trade or business is counted for purposes of satisfying the 70-percent use test (qualified tangible property) to the extent the tangible property is (1) located within the geographic borders of a QOZ, and (2) in connection with the ordinary conduct of the trade or business, utilized in the QOZ in the performance of an activity of the trade or business that contributes to the generation of gross income for the trade or business. The final regulations explicitly provide that this determination is based upon the amount of time during which the use of the subject tangible property meets those two requirements.

3. Application of 70-Percent Use Test to Mobile Tangible Property

The Treasury Department and the IRS received several comments regarding the application of the 70-percent use test to mobile tangible property that a trade or business might utilize both inside and outside a QOZ or in multiple QOZs. Commenters noted that many trades or businesses rely on delivery vehicles, construction equipment, service trucks and other types of mobile tangible property to generate gross income. Ordinarily, such trades or businesses will deploy mobile tangible property without regard to QOZ boundaries, at times utilizing the property inside a QOZ, while at other times utilizing the property outside of a QOZ. As a result,

these commenters requested that the final regulations articulate standards or safe harbors for determining whether a mobile tangible property satisfies the 70-percent use test to qualify as qualified opportunity zone business property.

The Treasury Department and the IRS appreciate the concerns raised by these commenters. To provide standards that more effectively respond to the day-to-day customary operation of trades or businesses, the final regulations set forth specific rules clarifying the application of the 70-percent use test to mobile tangible property. The Treasury Department and the IRS have drafted these rules to strike an appropriate balance between allowing flexibility for business development and ensuring that such business development primarily benefits low-income communities comprising QOZs.

For example, the final regulations provide a safe harbor for tangible property utilized in rendering services both inside and outside the geographic borders of a QOZ. Under this safe harbor, a limited amount of such tangible property may be excluded from the general time of use calculation underlying the 70-percent use test. Specifically, the safe harbor permits up to 20 percent of the tangible property of a trade or business to be treated as satisfying the 70-percent tangible property standard if the tangible property is utilized in activities both inside and outside of the geographic borders of a QOZ, and if (i) the trade or business has an office or other fixed location located within a qualified opportunity zone (QOZ office), and (ii) the tangible property is operated by employees of the trade or business who regularly use a QOZ office of the trade or business in the course of carrying out their duties, and are managed directly, actively, and substantially on a day-to-day basis by one or more employees of the trade or business at a QOZ office. In addition, in order to qualify for the safe harbor, the tangible property must not be operated exclusively outside of the geographic borders of a qualified opportunity zone for a period longer than 14 consecutive days for the generation of gross income for the trade or business.

In addition, the final regulations provide a similar safe harbor for short-term leased tangible property. Under this rule, tangible property leased by a trade or business located within the geographic borders of a QOZ to a lessee that utilizes the tangible property at a location outside of a QOZ is qualified tangible property if the following two requirements are satisfied. First, consistent with the normal, usual, or customary conduct of the trade or business, the tangible property must be parked or otherwise stored at a location within a QOZ when the tangible property is not subject to a lease to a customer of the trade or business. Second, the lease duration of the tangible property (including any extensions) must not exceed 30 consecutive days. This special leased tangible property rule, however, is not subject to a limitation similar to the 20-percent limitation with regard to non-leased mobile tangible property due to the highly mobile nature of tangible property typically leased to customers by leasing businesses.

4. Use of Tangible Property in Multiple QOZs Aggregated for the 70-Percent Use Test

The Treasury Department and the IRS have received comments recommending that the final regulations clarify the manner in which use of tangible property is measured if such use occurs in multiple QOZs. To respond to these comments, the final regulations specifically provide that, if tangible property is used in one or more QOZs, satisfaction of the 70-percent use test is determined by aggregating the number of days the tangible property in each QOZ is utilized. The

Treasury Department the IRS have determined that the policy underlying the 70-percent use test would be effectuated through the introduction of new economic activity into any low-income community designated as a QOZ, regardless of specific designation.

A commenter highlighted potential confusion caused by circular language in proposed § 1.1400Z2(d)-1(c)(9)(i)(A). In general, proposed § 1.1400Z2(d)-1(c)(9) described the fraction by which the 70-percent use test is calculated. Proposed § 1.1400Z2(d)-1(c)(9)(i)(A) referred to the value of qualified opportunity zone business property that meets the requirements of § 1.1400Z2(d)-1(c)(4)(i)(A)-(C), (E), and (F). The commenter noted that this reference results in a circular analysis because qualified opportunity zone business property is the item calculated by the previously described fraction, and proposed § 1.1400Z2(d)-1(c)(4)(i)(D) sets forth the "substantially all" test for use in a QOZ. In other words, the 70-percent use fraction must be calculated before one can determine whether property qualifies as qualified opportunity zone business property.

The Treasury Department and the IRS appreciate the commenter's point. The final regulations set forth a significantly revised calculation for determining satisfaction of the 70-percent use test that does not implicate the issue raised by the commenter. In addition, the final regulations clarify that the use of tangible property in a QOZ is determined on an asset-by-asset basis. See part V.G. of this Summary of Comments and Explanation of Revisions.

5. Application of Holding Period Requirements Under Section 1400Z-2

The Treasury Department and the IRS received numerous requests for clarification regarding the manner by which QOFs can meet the holding period requirements under section 1400Z-2(d)(2)(B)(i)(III) and (d)(2)(C)(iii) (90-percent qualified opportunity zone property holding period) and QOFs and qualified opportunity zone businesses can meet the holding period requirement under section 1400Z-2(d)(2)(D)(i)(III) (90-percent qualified opportunity zone business property holding period). For example, several commenters suggested that QOFs and qualified opportunity zone businesses should test for satisfaction of the two 90-percent holding period requirements only at the end of their holding period for the property. One commenter recommended that the final regulations provide QOFs with an election to test for satisfaction of the 90-percent holding period requirement based on either (i) the taxpayer's actual holding period as of a testing date, or (ii) the taxpayer's projected holding period. See V.B.1. of this Summary of Comments and Explanation of Revisions.

The Treasury Department and the IRS agree that the rules for determining satisfaction of the 90-percent qualified opportunity zone property holding period requirement and 90-percent qualified opportunity zone business property holding period requirement should be clarified. Accordingly, the final regulations provide that the determination of whether the two 90-percent holding period requirements are satisfied is made on a semiannual basis, based on the cumulative amount of time the QOF or qualified opportunity zone business has held the property.

Stock or partnership interests will satisfy the 90-percent qualified opportunity zone property holding period requirement if during 90-percent of the QOF's holding period for the stock or partnership interest, beginning on the date that it's self-certification as a QOF is effective and ending on the relevant semiannual testing date, the corporation or partnership qualified as a

qualified opportunity zone business. Similarly, tangible property will satisfy the 90-percent qualified opportunity zone business property holding period requirement only if the tangible property satisfied the 70-percent use test for at least 90 percent of the period during which the QOF or qualified opportunity zone business has held such property. As noted in part V.B.1. of this Summary of Comments and Explanation of Revisions, the determination of whether an eligible entity engaged in a trade or business qualified as a qualified opportunity zone business is determined at the end of the entity's taxable year but a QOF has semiannual testing dates on which it must determine if the entity was a qualified opportunity zone business for 90 percent of the QOF's holding period of the equity of the entity. Because status as a qualified opportunity zone business is defined with respect to an entity's taxable year, taxpayers may encounter difficulties when a QOF's semiannual testing date falls before the end of the entity's taxable year. The final regulations therefore provide a safe harbor for purposes of complying with the 90-percent holding period test. Under the safe harbor, the QOF may limit the period tested to the period that starts with the beginning of the QOF's status as a QOF and lasts until the last day of the entity's latest taxable year and ends on or before the relevant testing date.

To determine whether qualified opportunity zone business property meets the statutory holding period requirements, a QOF or qualified opportunity zone business must measure the use of the property on a semiannual basis, on the same testing dates as the 90-percent investment standard. (If QOFs with diverse taxable years invest in the same qualified opportunity zone business, the business may have to measure use of the property semiannually for each investing QOF). The purposes of section 1400Z-2 and the section 1400Z-2 regulations are to provide specified tax benefits to owners of QOFs to encourage the making of longer-term investments of new capital, through QOFs and qualified opportunity zone businesses, into one or more QOZs and to increase the economic growth therein. The Treasury Department and the IRS have determined that, if the final regulations were to permit QOFs or qualified opportunity zone businesses to use a projected holding period, or to measure the holding period only at the end of their holding period in the property, the previously described policy goals of section 1400Z-2 would be compromised. In addition, such approaches would pose administrative difficulties for the IRS in administering holding period requirements in instances in which a period of ownership extends beyond the statute of limitations for assessing the QOF.

6. Consideration of Cure Periods and Other Relief Regarding Application of 90-Percent Investment Standard

Commenters noted that, under the proposed regulations, no relief was available to a QOF that discovered that the entity in which it invested failed to qualify as a qualified opportunity zone business. Several commenters emphasized that the 90-percent investment standard posed a high threshold with severe consequences for a trade or business that failed to qualify as a qualified opportunity zone business for a testing date. As an example, one commenter described a scenario in which an entity qualified as a qualified opportunity zone business during one year, but failed to satisfy the 90-percent qualified opportunity zone property holding period during the next year, and therefore lost any potential to satisfy the 90-percent qualified opportunity zone property holding period for that stock or partnership interest in later years-regardless of whether the otherwise compliant trade or business permanently cured the defect that led to the second-year failure. As a result, commenters recommended various "grace periods" during which an entity would be treated as a qualified opportunity zone business even if the entity failed one or more requirements under section 1400Z-2.

The Treasury Department and the IRS agree that entities should be afforded appropriate relief to cure a defect that prevents qualification as a qualified opportunity zone business for purposes of the 90-percent qualified opportunity zone property holding period, without penalty to the investing QOF under section 1400Z-2(f). Accordingly, the final regulations provide a six-month period for an entity in which a QOF has invested to cure a defect that caused the entity to fail to qualify as a qualified opportunity zone business. The six-month cure period corresponds to both the testing periods for both the qualified opportunity zone business and the QOF as required in sections 1400Z-2(d)(1) and (3). The final regulations provide that during that six-month cure period, the QOF can treat the interest held in the entity as qualified opportunity zone property. Upon the conclusion of the six-month cure period, if the entity again fails to qualify as a qualified opportunity zone business, the QOF must determine if the QOF meets the 90-percent investment standard, taking into account its ownership in the non-qualifying entity. If the QOF fails to meet the 90-percent investment standard, the final regulations provide that the QOF must determine the penalty applicable to each month in which the QOF failed to meet the 90-percent investment standard, including each month during and prior to the six-month cure period. The final regulations specify that a qualified opportunity zone business can utilize a six-month cure period only once.

The Treasury Department and the IRS note that, in addition to this six-month cure period, a QOF can assert a defense of reasonable cause under section 1400Z-2(f)(3) if the QOF becomes subject to a penalty for failure to satisfy the 90-percent investment standard. Specifically, section 1400Z-2(f)(3) provides that no penalty may be imposed for failure to meet the 90-percent investment standard "if it is shown that such failure is due to reasonable cause." The Treasury Department and the IRS view this relief under the statute, as well as the six-month cure period provided by the final regulations, as sufficient relief to address the commenters' concerns.

One commenter suggested that the Treasury Department and the IRS consider whether the 90-percent qualified opportunity zone property holding period should be tolled due to circumstances beyond the control of the QOF or qualified opportunity zone business. The Treasury Department and the IRS note that section 1400Z-2(f)(3) provides that a QOF can assert a defense of reasonable cause if the QOF becomes subject to the penalty for failure to maintain the 90-percent investment standard. Based on the existence of this statutory relief, the Treasury Department and the IRS have determined that a QOF possesses appropriate recourse (that is, a reasonable cause defense) with regard to circumstances beyond the QOF's control.

H. Original Use of Tangible Property Acquired by Purchase

Section 1400Z-2(d)(2)(D) requires either that the original use of qualified opportunity zone business property in the QOZ commences with the QOF or qualified opportunity zone business or that the QOF or qualified opportunity zone business substantially improve the property. Similar requirements are also found in other sections of the Code. Under the now-repealed statutory frameworks of both section 1400B (related to the DC Zone) and section 1400F (related to Renewal Communities), qualified property for purposes of those provisions was required to have its original use in a zone or to meet the requirements of substantial improvement as defined under those provisions. Following the publication of the October 2018 proposed regulations, the Treasury Department and the IRS received numerous questions and comments on the meaning of "original use." Several commenters requested confirmation as to whether (i) tangible property could be previously used property, rather than solely new property; (ii)

property previously placed in service in the QOZ for one use, but subsequently placed in service for a different use by an acquirer, could qualify as original use; and (iii) property previously used in the QOZ could be placed in service in the same QOZ by an acquiring, unrelated taxpayer.

After carefully considering the comments and questions received regarding the October 2018 proposed regulations, the May 2019 proposed regulations generally provided that the "original use" of tangible property acquired by purchase by any person commences on the date on which that person or a prior person (i) first places the property in service in the QOZ for purposes of depreciation or amortization, or (ii) first uses the property in the QOZ in a manner that would allow depreciation or amortization if that person were the property's owner. Therefore, tangible property located in the QOZ that has been depreciated or amortized by a taxpayer other than the QOF or qualified opportunity zone business would not satisfy the original use requirement of section 1400Z-2(d)(2)(D)(i)(II) under the May 2019 proposed regulations. Conversely, tangible property, other than land, located in the QOZ that has not yet been depreciated or amortized by a taxpayer other than the QOF or qualified opportunity zone business would satisfy the original use requirement of section 1400Z-2(d)(2)(D)(i)(II) under those proposed regulations. The May 2019 proposed regulations also clarified that used tangible property will satisfy the original use requirement for a QOZ so long as the property has not been previously used in the QOZ (that is, has not previously been used within that QOZ in a manner that would have allowed it to be depreciated or amortized, by any taxpayer).

1. Reliance on Certificate of Occupancy for "Original Use" Determination

Several commenters of the May 2019 proposed regulations recommended that the final regulations permit taxpayers to rely on certificates of occupancy for determining whether a property satisfies the original use requirement. For example, commenters suggested that, if a certificate of occupancy has not been received for property consisting of a structure, the property has not been used prior to the issuance of the certificate and therefore potentially could satisfy the original use requirement. Another commenter requested that the final regulations treat real property as meeting the original use requirement if the property receives a certificate of occupancy following a certain number of years without a certificate. Another commenter suggested that, similar to the rules under §§ 1.46-3(d)(2), 1.150-2(c), and 1.179-4(e), the final regulations permit QOFs and qualified opportunity zone businesses to elect to have "original use" measured from the date on which (i) the property is placed into service, or (ii) the certificate of occupancy is granted under local law.

The Treasury Department and the IRS appreciate the commenters' objective to increase certainty regarding "original use" determinations. However, the Treasury Department and the IRS note that standards applicable to certificates of occupancy vary by jurisdiction and therefore fail to provide a uniform standard. In addition, the processes for obtaining a certificate of occupancy vary significantly based on jurisdiction and likely would introduce additional complexity and uncertainty. As a result, the final regulations do not adopt the commenters' recommendation.

2. Consideration of Treating Acquired Non-Business Property or Newly Rezoned Property as "Original Use" Property

Several commenters recommended that the final regulations clarify that property previously used for non-business purposes may be treated as "original use" property in a QOZ upon its acquisition. For support, these commenters emphasized that such property would not have been depreciated or amortized. Similarly, one commenter requested that the final regulations provide a special rule that real property located in an area newly rezoned pursuant to a local government's master plan be treated as "original use property" because the local government's rezoning would fundamentally change the real property's use. Other commenters contended that no previously used property in a QOZ should qualify as satisfying the original use requirement regardless of whether, for example, the property had been depreciated or amortized.

The Treasury Department and the IRS have considered each of the arguments set forth by the commenters and have concluded that acquired property previously used in a QOZ does not satisfy the original use requirement. A rule treating historically used property in a QOZ as "original use" property because such property's prior use was nonbusiness in nature or classified differently under a local government's master plan would fail to sufficiently encourage the introduction of new capital investments into QOZs. Accordingly, the final regulations retain the rules set forth in the proposed regulations that a property's "original use" commences on the date on which the property is first (i) placed into service in the QOZ and is depreciated or amortized, or (ii) used in a manner that would allow depreciation or amortization.

3. Consideration of Safe Harbor Based on Belief That Property Was Not Placed Into Service

One commenter requested that the Treasury Department and the IRS provide a safe harbor to treat property acquired by a taxpayer as satisfying the original use requirement if the taxpayer believed that the property had not yet been placed into service. The commenter contended that, if such taxpayer held that belief, the acquired property should be treated as "original use" property even if the taxpayer subsequently discovers that the property actually had been placed in service shortly before its acquisition. The Treasury Department and the IRS decline to adopt this comment because the purposes of section 1400Z-2 and the section 1400Z-2 regulations are to provide specified tax benefits to owners of QOFs to encourage the making of longer-term investments, through QOFs and qualified opportunity zone businesses, of new capital in one or more QOZs and to increase the economic growth of such QOZs. The Treasury Department and the IRS have determined that the commenter's recommended safe harbor would not help achieve those goals.

4. Consideration of Newly Constructed Buildings Acquired Prior To Being Placed Into Service

A commenter requested clarification regarding whether a building that is newly constructed and sold to a purchaser meets the original use requirement with respect to the purchaser. The commenter noted that potential QOF investors intend to invest in QOZs by acquiring newly constructed buildings for their trades or businesses that, prior to acquisition, have not been placed into service for purposes of depreciation. In such circumstances, the commenter noted that potential QOF investors have expressed uncertainty regarding the application of the original use requirement.

The Treasury Department and the IRS appreciate the commenter's concern and have determined that such newly constructed buildings satisfy the original use requirement. The construction of

new buildings in economically disadvantaged communities, which are acquired for the purpose of introducing new businesses into such communities, clearly achieves the policy goals underlying section 1400Z-2 and should be encouraged. Accordingly, the final regulations provide an example that provides certainty with regard to the acquisition of such newly constructed buildings.

5. Qualification of Demolished Property, Overwhelmingly Improved Property, and Property Improvements as "Original Use" Property

One commenter requested that the final regulations provide that an improvement made to non-qualified property used in a QOZ satisfies the original use requirement. The commenter reasoned that such treatment would be appropriate because, under the May 2019 proposed regulations, improvements made by a lessee to leased property are treated as separate property for purposes of section 1400Z-2(d)(2)(D)(i) and therefore as satisfying the original use requirement. The Treasury Department and the IRS appreciate the argument raised by the commenter, but have determined that the administrative burdens that would arise for taxpayers and the IRS from tracking improvements made to such non-qualified property would significantly exceed those arising from the tracking of lessee improvements. As a result, the final regulations do not adopt the commenter's recommendation.

A commenter also requested that the final regulations treat tangible property that has not been purchased, but has been overwhelmingly improved, as "original use" property. Section 1400Z-2(d)(2)(D)(i)(I) requires that property must be acquired after December 31, 2017 to qualify as qualified opportunity zone business property. While a QOZ would benefit from the overwhelming improvement of currently owned property located within the QOZ, such improvement does not satisfy the statutory requirement set forth in section 1400Z-2(d)(2)(D)(i)(I). Therefore, the final regulations do not incorporate the commenter's recommendation.

Another commenter requested that the Treasury Department and the IRS confirm that newly constructed real property, or substantially improved property, that otherwise meets the requirements of section 1400Z-2(d)(2)(D), will not fail to qualify as qualified opportunity zone business property solely because the property is constructed upon leased land. The Treasury Department and the IRS note that land, including leased land, does not need to be substantially improved within the meaning of section 1400Z-2(d)(2)(D)(i)(II) and 1400Z-2(d)(2)(D)(ii). Cf. § 1400Z2(d)-1(c)(7)(iv)(B) and (d)(4)(iv)(B). Accordingly, if property otherwise qualifies as qualified opportunity zone business property, the fact that the property is constructed on leased land will not disqualify the property from being treated as qualified opportunity zone business property.

6. Treatment of Property That Qualifies for Certain Low-Income Housing Credits

A commenter requested that the final regulations address the application of credits provided under section 42(a) of the Code for investment in certain low-income housing buildings (section 42 credits). Specifically, the commenter requested that the final regulations provide that a property that qualifies for section 42 credits be treated as satisfying the original use requirement. The Treasury Department and the IRS continue to consider the combining of other tax incentives

(including credits) with the benefits provided by section 1400Z-2. As a result, the final regulations do not incorporate the commenter's request.

7. Application of Original Use Requirement to Leased Tangible Property

A commenter recommended that the final regulations require that leased tangible property located in a QOZ be (i) originally used in the QOZ, and (ii) substantially improved. The Treasury Department and the IRS note that, under the proposed regulations, improvements made by a lessee to leased property satisfy the original use requirement and are considered purchased property to the extent of the unadjusted cost basis of those improvements (as under section 1012). However, the proposed regulations do not set forth any requirement that leased property be substantially improved. After considering the commenter's analysis, the Treasury Department and the IRS have determined that a rule requiring both original use and substantial improvement with regard to leased tangible property would be inconsistent with section 1400Z-2 and unnecessary.

8. Vacancy Period for Original Use Requirement

In the May 2019 proposed regulations, the Treasury Department and the IRS proposed that, where a building or other structure has been vacant for at least five years prior to being purchased by a QOF or qualified opportunity zone business, the purchased building or structure will satisfy the original use requirement. Specifically, the May 2019 proposed regulations provided that, if property has been unused or vacant for an uninterrupted period of at least five years, original use in the QOZ commences on the date after that period when any person first so uses or places the property in service in the QOZ. See proposed § 1.1400Z2(d)-1(c)(4)(i)(B)(6), (c)(7)(i), (d)(2)(i)(B)(6). The Treasury Department and the IRS requested comments regarding that proposed approach, including the length of the vacancy period and how such a standard might be administered and enforced.

a. Duration of Vacancy Period Required To Satisfy Original Use Requirement

The Treasury Department and the IRS received several comments regarding the five-year vacancy requirement set forth in the May 2019 proposed regulations. While some commenters expressed approval, others contended that a five-year vacancy period would be inappropriately long. Commenters also recommended vacancy periods in excess of five years, contending that any shorter vacancy period would increase the number of vacant properties exempt from the substantial improvement requirement, and therefore decrease the overall magnitude of property development in QOZs. One commenter requested that the final regulations include, in addition to a five-year vacancy requirement, safeguards to reduce the incentive for taxpayers to vacate buildings for tax benefits.

In particular, several commenters suggested that the final regulations provide a vacancy period threshold similar to the threshold provided in § 1.1394-1(h), which requires a vacancy period of "at least one-year." See § 1.1394-1(h) (setting forth an original use requirement for purposes of qualified zone property under section 1397D, with regard to the issuance of enterprise zone facility bonds under section 1394). However, numerous commenters disagreed with that

approach, contending that the vacancy period required under § 1.1394-1(h) responds to a different policy objective than the section 1400Z-2 policy objective of increasing new economic development in QOZs. These commenters also contended that a one-year vacancy period would constitute an unacceptably weak standard that potentially would encourage owners of property in QOZs to attempt to artificially satisfy the vacancy requirement by ceasing occupation of a property for one year.

Commenters also recommended rules consisting of multiple vacancy periods to accommodate different types of situations involving vacant buildings. For example, a commenter recommended that the final regulations require (i) a vacancy period spanning not less than two years, or (ii) a five-year vacancy period, if less than 25 percent of the rentable square footage of the subject property is rented or occupied. Another commenter, while expressing general approval regarding the five-year vacancy period requirement, suggested that properties already vacant for at least one year at the time of QOZ designation should qualify as vacant.

The Treasury Department and the IRS appreciate the commenters' suggestions and recommendations, and have modified the proposed five-year vacancy requirement to better effectuate the policy of section 1400Z-2. Accordingly, the final regulations provide a special one-year vacancy requirement for property that was vacant prior to and on the date of publication of the QOZ designation notice that listed the designation of the QOZ in which the property is located, and through the date on which the property was purchased by an eligible entity. The Treasury Department and the IRS have determined that a shorter vacancy period for property vacant at the time of their QOZ designation is appropriate because (i) such buildings do not present the same potential for abuse (for example, causing a building to be vacant for one year to convert the building to "original use" property), and (ii) the infusion of capital investments into vacant property that contributed to the QOZ's designation would achieve a core policy objective of section 1400Z-2.

With respect to property not vacant as of the time of such QOZ designation notice but that later become vacant, the final regulations require the property to be vacant continuously for at least three years. The Treasury Department and the IRS agree that a one-year vacancy requirement similar to that imposed under § 1.1394-1(h) would spur capital investment into needed areas. However, a three-year vacancy period for property that was not vacant at the time of QOZ designation will more effectively facilitate such investment while alleviating concerns that QOFs and qualified opportunity zone businesses would intentionally cease occupying property to convert otherwise used property into "original use" property.

b. Buildings Located on Brownfield Sites Qualify as "Original Use" Property

The Department of the Treasury and the IRS have received several comments regarding the application of section 1400Z-2 and the section 1400Z-2 regulations to brownfield site redevelopment. A "brownfield site" comprises "real property, the expansion, redevelopment, or reuse of which may be complicated by the presence or potential presence of a hazardous substance, pollutant, or contaminant." Comprehensive Environmental Response, Compensation and Liability Act of 1980, section 101(39) (42 U.S.C. 9601(39)). The Environmental Protection Agency has defined these sites as "abandoned, idled or under-used industrial and commercial facilities where expansion or redevelopment is complicated by real or perceived environmental

contamination." 60 FR 49276 (September 22, 1995). Cleaning up and reinvesting in these properties increases local tax bases, facilitates job growth, utilizes existing infrastructure, takes development pressures off of undeveloped, open land, and both improves and protects the environment.

Commenters have recommended that the final regulations contain rules to facilitate brownfield redevelopment, particularly rules to provide that the real property composing the brownfield site be treated as "original" use property under section 1400Z-2(d)(2)(D)(i)(II). One commenter contended that, because of the degree of contamination present in brownfield sites, remediation and construction periods for these properties generally extend beyond 30 months. The Treasury Department and the IRS agree with this observation, and have included rules in the final regulations to adopt the commenters' recommendation. Specifically, the final regulations provide that all real property composing a brownfield site, including land and structures located thereon, will be treated as satisfying the original use requirement of section 1400Z-2(d)(2)(D)(i)(II). To alleviate concerns that the property purchased will not be remediated, the final regulations also provide that the eligible entity must make investments in the brownfield site to ensure that the site meets basic safety standards for human health and the environment. The final regulations also make clear that remediation of contaminated land is taken into account for determining if the land has been more than minimally improved, and that the QOF or qualified opportunity zone business must make investments into the brownfield site to improve its safety and environmental standards.

c. Clarification of the Term "Vacant" for Purposes of Applying the Vacant Property Rules

The Treasury Department and the IRS received multiple suggestions to clarify the meaning of the term "vacant". One commenter suggested that the definition of the term should be modified to add the phrase "substantially unused or substantially vacant." For this purpose, the commenter recommended that the term "substantially vacant" be defined to require that greater than 70 percent of the square footage of the subject building be unoccupied.

In addition, commenters suggested that the final regulations define the term "vacant" in a manner similar to the term under § 1.1394-1(h). Accordingly, these commenters requested that the final regulations include a provision disregarding de minimis, incidental uses of property. See § 1.1394-1(h) (providing that "de minimis incidental uses of property, such as renting the side of a building for a billboard, are disregarded"). Another commenter suggested that the definition of "vacant" be revised to allow for clearly delineated portions of a larger property to be treated as vacant after five years of uninterrupted vacancy, even if the rest of the larger property had not been unoccupied.

One commenter also suggested that property that had involuntarily transferred to local government control be included in the definition of the term "vacant." This commenter emphasized that local governments often acquire brownfield sites and other blighted properties through tax delinquency, abandonment, bankruptcy, and other similar events. As a result, many local governments hold large inventories of vacant properties with varying histories of use. The commenter contended that a bright-line treatment of such properties as "vacant" for purposes of the original use requirement will eliminate burdens regarding the determination of historical use and, importantly, expedite capital investment in properties located in distressed communities.

Several commenters suggested that the final regulations set forth a vacancy definition that relies upon vacant property determinations carried out by Federal, state, and local governmental authorities (including, for example, a local government waiver process to demonstrate vacancy). Commenters also suggested that a vacancy definition similarly could rely upon vacant property determinations by public utilities. In addition, some commenters contended that a vacancy definition should take into account a spectrum of factors, including the structure of the subject property and the length of time during which the property's structure had been significantly damaged or otherwise decrepit.

The Treasury Department and the IRS agree that the final regulations should provide a definition for the term "vacant" for purposes of § 1.1400Z2(d)-1. Under the final regulations, real property, including land and buildings, is considered to be in a state of vacancy if the property is "significantly unused." A building or land will be considered to be "significantly unused" under the final regulations if more than 80 percent of the building or land, as measured by the square footage of useable space, is not being used.

In addition, the Treasury Department and the IRS appreciate that a bright-line test for "vacancy" would facilitate the ability for local governments to increase capital investment in underused property and increase economic activity in their respective communities. As a result, the final regulations provide that an eligible entity that purchases real property from a local government that the local government holds as the result of an involuntary transfer (including through abandonment, bankruptcy, foreclosure, or receivership) may treat all property composing the real property (including the land and structures thereon) as satisfying the original use requirement of section 1400Z-2(d)(2)(D)(i)(II).

d. Requests To Require All Vacant Buildings To Be Substantially Improved

Multiple commenters recommended that the final regulations provide that no building, regardless of occupancy, be treated as satisfying the original use requirement. One commenter also suggested that the final regulations (i) require all vacant buildings to be substantially improved, and (ii) not permit such buildings to be treated as originally used in a QOZ by a QOF or qualified opportunity zone business. The Treasury Department and the IRS appreciate the commenters' recommendations and suggestions, and agree that the improvement of all buildings acquired by a QOF or qualified opportunity zone businesses would significantly benefit the QOZs in which such buildings are located. However, the Treasury Department and the IRS have determined that, by permitting certain buildings to satisfy the original use requirement, the final regulations will encourage a larger aggregate amount of long-term investments in economically distressed communities nationwide.

I. Substantial Improvement of Qualified Opportunity Zone Business Property

1. Consideration of Asset-by-Asset Approach and Alternative Approaches

In the May 2019 proposed regulations, the Treasury Department and the IRS requested comments regarding the relative strengths and weakness of determining "substantial improvement" based on an asset-by-asset approach, as compared to asset aggregation and similar

approaches. See 84 FR 18655 (May 1, 2019). Taxpayers and practitioners have provided numerous responses, several of which articulated examples of difficulty in applying an asset-by-asset approach-particularly within the context of building renovation.

Many of these commenters requested that the final regulations adopt an aggregate approach to determining "substantial improvement," or otherwise permit taxpayers to elect such an approach. Similarly, other commenters requested that the final regulations permit asset aggregation based on (i) asset location within a QOZ, or (ii) whether the assets were acquired as part of the same transaction or business decision. In contrast, a commenter suggested that the final regulations adopt an approach similar to the "integrated unit approach" of § 1.1250-1(a)(2)(ii). See § 1.1250-1(a)(2)(ii) (providing for example that, "if two or more buildings or structures on a single tract or parcel (or contiguous tracts or parcels) of land are operated as an integrated unit (as evidenced by their actual operation, management, financing, and accounting), they may be treated as a single item of section 1250 property").

The Treasury Department and the IRS also received several recommendations to retain the asset-by-asset approach set forth in the May 2019 proposed regulations. Commenters that made these suggestions generally argued that "substantially all" determinations based on an asset aggregation approach would encourage businesses to target investments narrowly in rigidly defined areas, thereby preventing a broader disbursement of capital investment. Such commenters also emphasized that, by requiring the basis of each discrete asset to be doubled in value, the proposed regulations will ensure a minimum level of investment for each qualified asset. Because the asset-by-asset approach of the May 2019 proposed regulations prohibits a taxpayer from using any excess capital investment in a qualified asset to satisfy the "doubling of basis" requirement for a different asset, commenters noted that the total capital investments by a taxpayer often will exceed a doubling of the aggregate basis of all of the taxpayer's qualified assets.

Based on the strengths and weaknesses of each of these various approaches, the Treasury Department and the IRS have concluded that permitting asset aggregation to a limited extent is appropriate for carrying out "substantial improvement" determinations. Accordingly, for example, the final regulations set forth an asset aggregation approach for determining whether a non-original use asset (such as a preexisting building) has been substantially improved. Under the approach adopted by the final regulations, QOFs and qualified opportunity zone businesses can take into account purchased original use assets that otherwise would qualify as qualified opportunity zone business property if the purchased assets (i) are used in the same trade or business in the QOZ (or a contiguous QOZ) for which the non-original use asset is used, and (ii) improve the functionality of the non-original use assets in the same QOZ (or a contiguous QOZ). In the case of purchased non-original use real property, the final regulations require that the purchased property must be improved by more than an insubstantial amount. Finally, if an eligible entity chooses to use this approach, the purchased property will not be treated as original use property, and instead, the basis of that purchased property will be taken into account in determining whether the additions to the basis of the non-original use property satisfy the requirements of sections 1400Z-2(d)(2)(D)(i)(II) and 1400Z-2(d)(2)(D)(ii).

For example, if a QOF purchases and intends to substantially improve a hotel, the QOF may include "original use" purchased assets in the basis of the purchased hotel to meet the substantial improvement requirement if those purchased assets are integrally linked to the functionality of

the hotel business. These "original use" purchased assets could include mattresses, linens, furniture, electronic equipment, or any other tangible property. However, for purposes of the substantial improvement requirement, the QOF may not include in the basis of that hotel an apartment building purchased by the QOF that is operated in a trade or business separate from the hotel business.

2. Aggregation of Certain Buildings To Be Treated as Single Property

The final regulations also provide that, for purposes of applying the substantial improvement requirement, certain buildings can be aggregated and treated as a single item of property, as that term is used in section 1400Z-2(d)(2)(D)(ii) (single property). Specifically, with respect to two or more buildings located within a QOZ or a single series of contiguous QOZs (eligible building group) that are treated as a single property, the amount of basis required to be added to those buildings will equal the total amount of basis calculated by adding the basis of each such building comprising the single property and additions to the basis of each building comprising the single property are aggregated to determine satisfaction of the substantial improvement requirement.

To clarify which buildings may be treated as a single property, the final regulations address eligible building groups located entirely within a parcel of land described in a single deed, as well as groups spanning contiguous parcels of land described in separate deeds. First, a QOF or QOZ business may treat all buildings that compose an eligible building group and that are located entirely within the geographic borders of a parcel of land described in a single deed as a single property. In addition, a QOF or QOZ business may treat all buildings composing an eligible building group that are located entirely within the geographic borders of contiguous parcels of land described in separate deeds as a single property to the extent each building is operated as part of one or more trades or businesses that meet the following three requirements:

(1) The buildings must be operated exclusively by the QOF or by the qualified opportunity zone business;

(2) the buildings must share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; and

(3) the buildings must be operated in coordination with, or reliance upon, one or more of the trades or businesses (for example, supply chain interdependencies or mixed-use facilities).

3. Inclusion of Substantial Improvement Requirement on Form 8996

A commenter recommended that the Form 8996 be revised to incorporate the substantial improvement requirement. The Treasury Department and the IRS appreciate the commenter's suggestion and will consider this recommendation during the annual review of Form 8996.

4. Items Includable in Basis of Property for Substantial Improvement Requirement

The Treasury Department and the IRS received multiple comments requesting that the final regulations clarify what items are includable in a property's basis for purposes of the substantial improvement requirement. These commenters emphasized that, while section 1400Z-2(d)(2)(D)(ii) requires a QOF or a qualified opportunity zone business to make additions to the basis of a subject property that exceed an amount equal to the initial adjusted basis of that property within a 30-month period, the statute does not specify what items are properly includable in that basis. Several of the commenters recommended safe harbors and other simplifying rules to limit complexity and increase taxpayer certainty regarding the application of the substantial improvement requirement.

a. Consideration of Safe Harbor for "Value Add" Real Estate Projects

One commenter recommended that the final regulations include a safe harbor for "value-add" real estate projects, which ordinarily entail significant renovation or redevelopment of a real property to significantly increase the price-point of the property. The commenter asserted that a property renovated through a value-add project should be treated as automatically satisfying the substantial improvement requirement due to the significant magnitude of the project. The commenter reasoned that, because a value-add project results in a transformative modification to the QOZ property, the QOF or qualified opportunity zone business should be relieved from undertaking a granular analysis and confirmation of project costs for purposes of satisfying the substantial improvement requirement. The commenter also requested that the final regulations express a general policy that the IRS will not challenge a decision by a QOF or qualified opportunity zone business to capitalize expenses into basis.

The Treasury Department and the IRS acknowledge that the commenter's recommendation would facilitate the conduct of value-add projects in QOZs. However, the Treasury Department and the IRS have concluded that value-add projects are similar to other types of property renovation projects for which no special safe harbor is provided. As a result, the Treasury Department and the IRS have determined that no special safe harbor is warranted for value-add projects in QOZs, and the final regulations do not incorporate the commenter's recommendation.

b. Clarification Regarding Property Previously Placed in Service

A commenter requested that the final regulations confirm that additions to basis of property for purposes of the substantial improvement requirement do not include property previously placed in service. Under section 1400Z-2, and as reflected in the proposed regulations, property already placed in service can meet the substantial improvement requirement if the property was not placed in service by the QOF. Therefore, the final regulations do not adopt the commenter's request.

c. Calculation of Basis by Reference to Pre-Depreciation Adjusted Cost Basis

A commenter requested that, for purposes of the substantial improvement requirement, the final regulations permit a QOF or qualified opportunity zone business to calculate the basis of the

subject property by reference to the property's pre-depreciation adjusted cost basis. Similarly, another commenter suggested that the term "adjusted basis" be defined as cost under section 1012. In addition, a commenter requested that the final regulations confirm that depreciation is not taken into account in determining if a property satisfies the substantial improvement requirement.

The Treasury Department and the IRS disagree with the suggestion that, for determining compliance with the substantial improvement requirement, taxpayers must use section 1012 cost basis for determining the adjusted basis of the property. Section 1400Z-2(d)(2)(D)(ii) provides that adjusted basis, not cost basis under section 1012, is the appropriate standard to determine if property has been substantially improved during the 30-month substantial improvement period. Therefore, the final regulations provide that, property has been substantially improved when the additions to basis of the property in the hands of the QOF exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month substantial improvement period in the hands of the QOF. The basis, and any additions thereto, are measured on the testing dates set forth in section 1400Z-2(d)(1). See part V.O.1.d of this Summary of Comments and Explanation of Revisions.

d. Effect of Certain Improvements on Requirements for Qualified Opportunity Zone Business Property

The Treasury Department and the IRS received comments regarding the effect of certain improvements on the qualification of tangible property as qualified opportunity zone business property. For example, a commenter suggested that QOFs and qualified opportunity zone businesses should be permitted to treat tangible property purchased before December 31, 2017 as qualified opportunity zone business property if the QOF or qualified opportunity zone business substantially improves the tangible property after that date. In addition, several commenters requested that the final regulations provide that costs resulting from the creation of intangibles, as well as other research and development costs, count for purposes of satisfying the Substantial Improvement Requirement.

The Treasury Department and the IRS have determined that the text of section 1400Z-2 does not permit adoption of these suggestions. First, section 1400Z-2(d)(2)(D)(i)(I) requires that tangible property be acquired after December 31, 2017 to qualify as qualified opportunity zone business property. In addition, section 1400Z-2(d)(2)(D)(i)(II) requires that substantially improved property must be tangible property based on the reference in that provision to section 1400Z-2(d)(2)(D)(i). Accordingly, the final regulations do not incorporate the commenters' recommendations.

5. Clarification of Activities and Expenses That Count as Substantial Improvements

The Treasury Department and the IRS have received several comments requesting clarification as to whether certain activities and expenses count as substantial improvements for purposes of the substantial improvement requirement. In particular, commenters requested clarification as to whether "substantial improvements" to property include (i) equipment installed in a building and used in a trade or business, (ii) demolition costs, (iii) reasonable capitalized fees for development, (iv) required permits, (v) necessary infrastructure, (vi) brownfield site assessment

and remediation, (vii) professional fees, and (viii) necessary site preparation costs (including remediation and utility upgrades). These commenters also requested that the final regulations provide additional rules to address the applicability of these items with regard to the substantial improvement requirement.

The Treasury Department and the IRS note that the text of section 1400Z-2(d)(2)(D)(ii) provides that any cost added to the basis of a property improved during the 30-month improvement period will be included in determining satisfaction of the substantial improvement requirement. As a result, each activity or expense described by the commenter will be included in such determination if the cost adds to the basis of the subject property. In addition, the Treasury Department and the IRS agree that certain expenses with regard to tangible property (such as "betterment" expenses under § 1.263(a)-3(j)(1)(i)) are included in the calculation of basis of that property for purposes of the substantial improvement requirement, even if those expenses are properly chargeable under the Code to the basis of the land on which the property is located (which does not need to be doubled). As a result, the final regulations permit all capitalized costs with respect to the cost of residential rental property to be taken into account for determining satisfaction of the substantial improvement requirement.

6. Requests for Extensions and Safe Harbors Regarding 30-Month Substantial Improvement Period

The Treasury Department and the IRS have received several comments regarding the 30-month substantial improvement period set forth in section 1400Z-2(d)(2)(D)(ii), which provides the period during which a QOF or qualified opportunity zone business can improve acquired tangible property to satisfy the substantial improvement requirement. In particular, many commenters recommended that the final regulations extend this period to a period not exceeding 60 months in the event that (i) the QOF or qualified opportunity zone business encounters a delay not within the entity's control, (ii) the land on which the property rests requires significant preparation or remediation, or (iii) the scale of the project appropriately requires such extended period. Another commenter suggested that the final regulations provide a phase-based safe harbor, similar to that set forth in § 1.148-7(e)(1), that would allow a taxpayer to satisfy the substantial improvement requirement if the QOF or qualified opportunity zone business expended (i) at least 10 percent of the total invested funds within 8 months, (ii) at least 50 percent of the total funds within 16 months, (iii) at least 75 percent of the total funds within 24 months, and (iv) 100 percent of the total funds within 30 months.

The Treasury Department and the IRS note that the commenters' suggestions conflict with the statutory text of section 1400Z-2(d)(2)(D)(ii). That provision explicitly requires that (i) improvements be made to tangible property during the 30-month period beginning after the date of acquisition of such property, and (ii) the measurement for "substantial improvement" be based on additions to the basis of the subject tangible property, rather than the percentage of expended funds. As a result, the final regulations do not adopt the commenters' recommended extensions or safe harbors.

7. Safe Harbor for 90-Percent Investment Standard During 30-Month Substantial Improvement Period

One commenter suggested that a QOF or qualified opportunity zone business should be deemed to have met the 90-percent investment standard throughout the 30-month substantial improvement period. The Treasury Department and the IRS appreciate the commenter's recommendation and have revised the final regulations to address, in large part, the commenter's concern. The final regulations provide that, during the 30-month substantial improvement period, eligible tangible property in the process of being improved but not yet placed into service or used in the trade or business of the QOF or qualified opportunity zone business is treated as satisfying the original use requirement and substantial improvement requirement. For property to be eligible for this safe harbor, there must be a reasonable expectation that, not later than the conclusion of the 30-month substantial improvement period, the property will be used in a QOZ as part of the trade or business of the QOF or qualified opportunity zone business, as appropriate. The Treasury Department and the IRS, however, note that a QOF's satisfaction of the 90-percent investment standard will be measured with regard to all of the QOF's qualified opportunity zone property, not just the property being substantially improved.

8. Clarification Regarding Interaction With Substantial Rehabilitation Rules

The Treasury Department and the IRS received a request that the final regulations clarify the interaction between the substantial improvement requirement and the substantial rehabilitation rules under section 42. See section 42(e)(3) (setting forth a minimum expenditure threshold that must be satisfied for rehabilitation expenditures to be considered sufficient to constitute a rehabilitation project eligible for a section 42 credit). The commenter recommended that, with regard to projects carried out in conjunction with section 42 credits, the 30-month substantial improvement period should be subject to the rules for substantial rehabilitation under section 42(e). The Treasury Department and the IRS continue to consider the interaction of rules governing other tax incentives (including credits) with section 1400Z-2 and the regulations under section 1400Z-2. As a result, the final regulations do not incorporate the commenter's request.

9. Qualification of Land Used for Agriculture or Renewable Energy

The Treasury Department and the IRS received multiple comments regarding the qualification of land used for agriculture or renewable energy as qualified opportunity zone business property. To ease difficulties in determining qualification, one commenter suggested that the final regulations include an option to permit the use of specific metrics to calculate the increase of economic activity on unimproved land used for agriculture (for example, specific metrics to calculate increased economic activity that arises from a conversion of agricultural property from pasture to row crops). The commenter stated that such clarification would be useful for farmers. Another commenter recommended that the final regulations treat land used in agricultural activities the same as other tangible business property. Similarly, a commenter requested that the final regulations provide a safe harbor to alleviate difficulties in determining satisfaction of the substantial improvement requirement with regard to farming and biofuel businesses.

The Treasury Department and the IRS acknowledge that complex and fact-specific questions can arise when applying qualified opportunity zone business requirements to agricultural and renewable energy businesses. However, such complexities result in large part from the flexibility that the Treasury Department and the IRS intended to instill in those requirements to facilitate

the inclusion of diverse ranges of businesses in QOZs. To preserve that flexibility, and reduce additional complexity that would result from business-specific rules and exceptions, the final regulations do not incorporate the commenters' suggestions.

10. Application of Substantial Improvement Requirement to Land and Buildings Located Thereon

As provided in Rev. Rul. 2018-29, 2018 I.R. B 45, and the May 2019 proposed regulations, if land that is within a QOZ is acquired by purchase in accordance with section 1400Z-2(d)(2)(D)(i)(I), the requirement under section 1400Z-2(d)(2)(D)(i)(II) that the original use of tangible property in the QOZ commence with a QOF is not applicable to the land, whether the land is improved or unimproved. See proposed § 1.1400Z2(d)-1(c)(8)(ii)(B), (d)(4)(ii)(B).

Likewise, unimproved land located within a QOZ and acquired by purchase in accordance with section 1400Z-2(d)(2)(D)(i)(I) is not required to be substantially improved within the meaning of section 1400Z-2(d)(2)(D)(i)(II) and (d)(2)(D)(ii). The May 2019 proposed regulations, however, provided that a QOF or qualified opportunity zone business may not rely on these rules if the land is unimproved or minimally improved and the QOF or the qualified opportunity zone business 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 (insubstantial improvement exception). See proposed § 1.1400Z2(d)-1(f).

a. General Applicability of Substantial Improvement Requirement to Land

The Treasury Department and the IRS received numerous comments regarding the proposed application of the substantial improvement requirement to land. While commenters expressed general approval regarding this proposed approach, several commenters disagreed or otherwise suggested revisions or clarifications. For example, multiple commenters requested that the final regulations clarify that unimproved land is treated as qualified opportunity zone business property. Another commenter requested clarification as to whether land held in conjunction with substantially improved property could be treated as qualified opportunity zone business property even if the land was not acquired through a capital contribution or substantially improved. With regard to these requests for clarification, the Treasury Department and the IRS note that land does not need to meet the original use requirement or the substantial improvement requirement to be treated as qualified opportunity zone business property. However, land must meet all other relevant requirements under section 1400Z-2(d)(2)(D) and the section 1400Z-2 regulations.

In addition, commenters recommended that the final regulations subject unimproved land to the substantial improvement requirement to ensure that the land will be used productively to encourage economic growth in the QOZ in which it is located. The Treasury Department and the IRS acknowledge the commenters' recommendations and agree that an integral policy of section 1400Z-2 is to encourage the making of longer-term investments of new capital into QOZs to enhance economic growth and development. However, the Treasury Department and the IRS continue to appreciate that "land is a crucial business asset for numerous types of operating trades or businesses aside from real estate development, and the degree to which it is necessary or useful for taxpayers seeking to grow their businesses to improve the land that their businesses depend on will vary greatly by region, industry, and particular business." 84 FR 18652, 18655 (May 1, 2019). Therefore, the Treasury Department and the IRS have concluded that the

imposition of a substantial improvement requirement on all types of trades or businesses for land used in such trades or businesses "may encourage noneconomic, tax-motivated business decisions, or otherwise effectively prevent many businesses from benefitting under the opportunity zone provisions" and "would inject a significant degree of additional complexity" into the final regulations. Id.

b. Eligibility of Naturally Occurring Structures for Substantial Improvement

A commenter requested that the final regulations clarify that naturally occurring structures are eligible for substantial improvement (including any preservation expenses incurred). The commenter contended that the substantial improvement requirement should be determined based on the aggregate expenditure made to improve such natural structures. In addition, the commenter requested that, with regard to trades or businesses in which the value of the land substantially exceeds any building thereon, the rationale of Rev. Rul. 2018-29 should apply without regard to the value of buildings constructed on the land relative to the value of the land (i) provided that the buildings were substantially improved, and (ii) taking into account improvements to natural structures on the land. The commenter also noted that "naturally occurring structures" should include vegetation (including trees and other plants) and water sources (including ponds and wetlands).

The Treasury Department and the IRS appreciate the commenter's request for clarity, but note that the proposed regulations did not subject land to the substantial improvement requirement. As provided in the October 2018 proposed regulations, the Treasury Department and the IRS have determined that "an absence of a requirement to increase the basis of land itself would address many of the comments that taxpayers have made regarding the need to facilitate repurposing vacant or otherwise unutilized land." 83 FR 54279 (October 29, 2018). However, the Treasury Department and the IRS agree with the commenter that expenditures to improve land and any naturally occurring structures located thereon can be taken into account for purposes of the requirement that land be improved by more than an insubstantial amount under the final regulations.

c. Application of Substantial Improvement Requirement to Land Expected To Be Only Insubstantially Improved

As described previously, proposed § 1.1400Z2(d)-1(f) prohibits a QOF or qualified opportunity zone business, in certain instances, from relying on rules that except land from the substantial improvement requirement. Specifically, such exception does not apply if (i) the subject land is unimproved or minimally improved, and (ii) the QOF or qualified opportunity zone business purchased the land with an expectation not to improve the land by more than an insubstantial amount (insubstantial improvement exception). See proposed § 1.1400Z2(d)-1(f). This rule helps ensure that the QOZ in which such land is located receives an appropriate amount of capital investment from QOF investors.

The Treasury Department and the IRS received several comments and recommendations regarding the proposed insubstantial improvement exception. For example, one commenter recommended that the final regulations adopt a two-part test, which would require that (i) the subject land be used as a material income-producing factor in the section 162 trade or business

conducted by the purchaser, and (ii) the use of the land be in a different trade or business than the use in the hands of the seller, or the purchaser make more than insubstantial improvements to the land. Another commenter requested clarification that the insubstantial improvement exception be revised to permit improvements to be completed after the 30-month substantial improvement period. In addition, a commenter requested that the final regulations provide that capital investments of at least 20 percent of the total cost basis of the subject land made within a 30-month period beginning on the acquisition date be deemed to have improved the land by more than an insubstantial amount.

The Treasury Department and the IRS acknowledge that the commenters' recommendations would provide additional flexibility for investors that acquire unimproved land located within a QOZ. However, the Treasury Department and the IRS have determined that the commenters' suggested rules likely would reduce overall capital investments in low-income communities by either (i) introducing significant additional complexity into the final regulations, or (ii) relaxing the timing requirements for capital investment for an inappropriate duration. As a result, the final regulations do not adopt the commenters' recommendations.

Commenters also recommended that the final regulations limit the application of the insubstantial improvement exception solely to land the value of which is small in relation to the value of the structures on the land. One commenter argued that, with regard to a circumstance in which the value of the subject land on which a structure is located significantly exceeds the value of the structure, substantially improving only the structure should not be considered a genuine economic investment in the real property as an aggregate. Similarly, multiple commenters requested that the final regulations provide additional detail for determining the amount of capital improvement necessary to exceed an "insubstantial amount", including percentage thresholds that would provide a clear amount that needs to be improved. Such threshold amounts ranged from 20 percent to 33 percent.

The Treasury Department and the IRS appreciate the logic of comparing the value of the land to the value of any structures on the land when considering the proposed insubstantial improvement exception for land. However, a rule that makes a distinction between high-value land and low-value land properties would disadvantage investors who planned to make investments in QOZs with higher land value relative to the existing structures on that land. A disproportionate relationship between land value and structure value may exist for a variety of reasons, many of which do not warrant separate treatment. Moreover, a rule that includes the basis of land in the substantial improvement calculation could make development prohibitively expensive for some QOFs and qualified opportunity zone businesses. Accordingly, the final regulations do not distinguish between real property with high or low value land in relation to the structures built upon that land in the application of the exception to substantial improvement.

The Treasury Department and the IRS agree with the commenters that QOFs and qualified opportunity zone businesses should improve land by more than an insubstantial amount. The Treasury Department and the IRS, however, decline to assign a specific percentage threshold to the concept of insubstantial improvement because an appropriate amount of improvement for a particular parcel of land is a highly fact dependent inquiry. Instead, the Treasury Department and the IRS will regard improvements to the land, such as an irrigation system for a farming business or grading of the land with a sufficient nexus to a trade or business of the QOF or qualified opportunity zone business, as more than an insubstantial amount of improvement. Further, the

Treasury Department and the IRS view this requirement that land be more than insubstantially improved as clarifying the overall requirement that land be qualified opportunity zone business property. Thus, the proposed rule concerning the qualification of land as qualified opportunity zone business property is moved from § 1.1400Z2(d)-1(f) to the special rules concerning land and improvements on land in § 1.1400Z2(d)-2(b)(4)(iv)(C).

d. Severability of Land From Buildings for Purposes of Applying the Substantial Improvement Requirement

A commenter requested that land on which an existing building is located, and which is not substantially improved, be severable from the existing building for purposes of applying the substantial improvement requirement. Specifically, the commenter recommended that such land should be treated as qualified opportunity zone business property, if (i) the QOF or the qualified opportunity zone business uses or improves the land as part of its trade or business, and (ii) the land otherwise meets the tests for being qualified opportunity zone business property.

However, as noted above, the proposed regulations did not subject land to the substantial improvement requirement. Instead, the land to which the commenter refers would qualify as qualified opportunity zone business property if all other requirements set forth in section 1400Z-2 and the section 1400Z-2 regulations are satisfied (including the insubstantial improvement exception). For these reasons, as well as the rationale for the insubstantial improvement exception described in part V.J.10.c of this Summary of Comments and Explanation of Revisions, the final regulations do not adopt the commenter's recommendation.

11. Speculative Land Purchasing

Several commenters requested that the final regulations provide more stringent rules to prevent the acquisition of land for speculative investment, as well as increased substantial improvement standards with regard to land. These commenters also requested that the final regulations clarify that land does not need to be improved more than an insubstantial amount if (i) the use of the land is integral to the business, and (ii) the land is reasonably expected to generate economic activity that was not reasonably expected prior to its purchase. Other commenters requested that land have a minimum level of improvement to be considered qualified opportunity zone business property. One commenter suggested that land should be improved by 33 percent of its basis. Another suggested that land that is not improved should not count as qualified opportunity zone business property if the value of the land does not exceed a certain threshold percentage of the QOF's assets.

The Treasury Department and the IRS appreciate the commenters' concerns regarding speculative land purchasing. However, the Treasury Department and the IRS have determined that a bright-line standard would be inappropriately restrictive because the determination of whether such land would qualify as qualified opportunity zone business property would require consideration of all relevant facts and circumstances. See additional discussion at VII. B of this Summary of Comments and Explanation of Revisions. Accordingly, the final regulations do not adopt additional rules for speculative land purchasing.

J. Transactions Between Qualified Opportunity Zone Businesses

Proposed § 1.1400Z2(b)-1(c)(10)(i)(A) generally provided that the acquisition of a QOF corporation's assets in a qualifying section 381 transaction is not an inclusion event if the acquiring corporation is a QOF within a prescribed period of time after the acquisition. See parts III. C and III. D of this Summary of Comments and Explanation of Revisions. In turn, proposed § 1.1400Z2(b)-1(d)(1) and (2) provided that the holding period for the target QOF stock is "tacked" onto the holding period of the acquiring QOF stock, and any qualified opportunity zone property transferred by the transferor QOF to the acquiring QOF in the transaction does not lose its status as qualified opportunity zone property solely as a result of the transfer. In addition, proposed § 1.1400Z2(b)-1(c)(6)(ii)(C) provided that a merger or consolidation of a partnership holding a qualifying investment, or of a partnership that holds an interest in such partnership solely through one or more partnerships, with another partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event, to the extent section 721 applies. See part III.E.1.b of this Summary of Comments and Explanation of Revisions.

As one commenter observed, however, the proposed regulations did not expressly address the merger of a qualified opportunity zone business corporation with another qualified opportunity zone business corporation, or the merger of a qualified opportunity zone business partnership with another qualified opportunity zone business partnership. Thus, it is unclear whether the successor business would be treated as succeeding to the target business's original use of, and substantial improvements to, qualified opportunity zone business property for purposes of section 1400Z-2(d)(2)(D), and whether the QOF's stock or partnership interest in the successor business would be treated as acquired "solely in exchange for cash" for purposes of section 1400Z-2(d)(2)(B) and (C). The commenter recommended that, after a merger of qualified opportunity zone businesses, the original use and substantial improvement status of the target's property should continue, and the QOF's interest in the successor business should be considered to have been acquired solely in exchange for cash. Another commenter recommended more generally that, when QOFs or qualified opportunity zone businesses transact in qualified assets among themselves, those assets should retain their status as qualified assets, and the transferee QOF or qualified opportunity zone business should be afforded a new working capital safe harbor of up to 31 months to the extent the transferee intends to inject additional capital with respect to the transferred property.

The Treasury Department and the IRS agree that, if a qualified opportunity zone business that is a corporation engages in a transaction described in section 381(a)(2) with another qualified opportunity zone business, or if a qualified opportunity zone business that is a partnership engages in a transaction described in section 708(b)(2)(A) with another qualified opportunity zone business, the original use and substantial improvement status of the transferor business's property should continue, and the QOF's interest in the successor business should be considered to have been acquired solely in exchange for cash. The final regulations have been modified accordingly. See §§ 1.1502-14Z and 1.1504-3 for special rules applicable to consolidated groups.

However, the Treasury Department and the IRS do not agree that a successor qualified opportunity zone business or a successor QOF should be afforded a new 31-month working capital safe harbor because such a rule would be patently inconsistent with treating the entity as a "successor" for other purposes, such as original use. The Treasury Department and the IRS also do not agree that a qualified asset should retain its status as such if it is transferred from one

QOF or qualified opportunity zone business to another QOF or qualified opportunity zone business in a transaction not described in section 381(a)(2) or section 708(b)(2)(A) because the transferee in such transactions is not a "successor" to the transferor.

K. Operation of Section 1397C Requirements Incorporated by Reference

1. 50-Percent Gross Income Requirement

Section 1397C(b) sets forth eight requirements that a corporation or partnership must satisfy to qualify as a "qualified business entity" and therefore an "enterprise zone business." Section 1400Z-2(d)(3)(A), which describes the requirements that a trade or business must satisfy to qualify as a "qualified opportunity zone business," incorporates paragraphs (2), (4), and (8) of section 1397C(b)(2). See section 1400Z-2(d)(3)(A)(ii). With regard to gross income, section 1397C(b)(2) requires that "at least 50 percent of the total gross income of such entity is derived from the active conduct of such business."

The Treasury Department and the IRS interpret section 1400Z-2(d)(3)(A)(ii)'s incorporation of section 1397C(b)(2) to require that a corporation or partnership, in order to qualify as a qualified opportunity zone business, must derive at least 50 percent of its total gross income from the active conduct of a trade or business within "a" QOZ (50-percent gross income requirement). In response to commenters' requests for clarification, the May 2019 proposed regulations provided three safe harbors and a facts-and-circumstances test for determining whether a trade or business in a QOZ has generated sufficient income to satisfy the 50-percent gross income requirement. The Treasury Department and the IRS requested comments regarding those proposed safe harbors, including suggestions for additional safe harbors and revisions to the proposed rules to prevent abuse."

a. Satisfaction of 50-Percent Gross Income Requirement Through Activities in Multiple QOZs

The Treasury Department and the IRS have received comments requesting clarification that a trade or business can satisfy the 50-percent gross income requirement by aggregating activities carried out by the trade or business in multiple QOZs. Specifically, commenters emphasized that the proposed regulations, in numerous instances, referenced a trade or business "within the QOZ" rather than "within a QOZ." These commenters asserted that the use of the word "the" could be interpreted as requiring that 50 percent of the total gross income from a trade or business (as well as a startup business relying on an applicable safe harbor) be derived from activities carried out solely within a single QOZ.

The Treasury Department and the IRS did not interpret the 50-percent gross income requirement as requiring a trade or business to carry out all activities necessary to satisfy the requirement in only one QOZ. Give the purpose of section 1400Z-2 to encourage economic growth in all QOZs, the Treasury Department and the IRS intended taxpayers and practitioners to apply the 50-percent gross income requirement by aggregating all activities of a trade or business carried out among all QOZs in which the trade or business operates. As a result, the final regulations have been revised to clarify that intended interpretation.

b. Requirement That Activities of Trade or Business Be Carried Out in a QOZ

The Treasury Department and the IRS also received comments suggesting that the 50-percent gross income requirement does not require a qualified opportunity zone business to generate 50 percent of its total gross income from the active conduct of its business "in a qualified opportunity zone." As stated in the preamble of the May 2019 proposed regulations, the phrase "such business" in section 1397C(b)(2) refers to a business mentioned in the preceding sentence, which discusses "a qualified business within an empowerment zone." See 84 FR 18652, 18658 (May 1, 2019). In applying section 1397C to section 1400Z-2, references in section 1397C to "an empowerment zone" are treated as referring to a QOZ. See *id.* Therefore, the final regulations do not adopt this comment, but rather provide that the corporation or partnership must derive at least 50 percent of its total gross income from the active conduct of a business within a QOZ.

2. Services Performed in a QOZ Based on Hours and Amounts Paid for Services

The May 2019 proposed regulations provided that, if at least 50 percent of the services performed for the trade or business are performed in a QOZ, based on (i) total number of hours performed by employees and independent contractors and employees of independent contractors in a QOZ (hours performed test), or (ii) amounts paid to employees and independent contractors and employees of independent contractors in a QOZ (amounts paid test), then the trade or business is deemed to satisfy the 50-percent gross income requirement. See proposed § 1.1400Z2(b)-1(d)(5)(i)(A) (setting forth the hours performed test), (d)(5)(i)(B) (setting forth the amounts paid test). As provided in the preamble to the May 2019 proposed regulations, the hours performed test is intended to address businesses located in a QOZ that primarily provide services. See 84 FR 18652, 18658 (May 1, 2019). In addition, the preamble explained that the amounts paid test is based upon amounts paid by the trade or business for services performed in the QOZ during the taxable year by employees and independent contractors, and employees of independent contractors. See *id.*

a. Calculations and Recordkeeping for Hours Performed and Amounts Paid Tests

The Treasury Department and the IRS received comments requesting clarification on how to calculate and track "hours worked" and "amounts paid" for purposes of the hours performed test and the amounts paid test. For example, some commenters highlighted difficulties in distinguishing employees from independent contractors. In particular, a commenter asked whether a trade or business is required to include hours worked by, or payments made to, third-party accountants, lawyers, or investment bankers in determining whether those safe harbors have been met. Commenters also criticized the inclusion of independent contractors and employees of independent contractors, as unreasonable for the hours performed test and amounts paid test because newer businesses, which may be unable to hire full time employees, might not be able to require independent contractors to work primarily in QOZs.

The Treasury Department and the IRS appreciate the commenters' requests and suggestions. With regard to determining satisfaction of the hours performed test and amounts paid test, a majority of the services performed (measured by hours worked or amounts paid) must be provided by employees and independent contractors, and employees of independent contractors,

in a QOZ for the trade or business. These calculations do not take into account hours worked by, or amounts paid to, independent contractors and their employees for services that are not performed for the qualified opportunity zone business.

With regard to recordkeeping, the Treasury Department and the IRS have determined that taxpayers and practitioners should be afforded flexibility rather than be encumbered by rigid tracking requirements. However, the Treasury Department and the IRS expect qualified opportunity zone businesses to maintain adequate records and implement sound processes to track hours worked by and amounts paid to employees, independent contractors, and employees of independent contractors for purposes of the hours performed and amounts paid tests. Further, the classification of an employee as opposed to an independent contractor must be determined based upon all relevant facts and circumstances under the applicable common law standard and all relevant provisions of the Code and general principles of tax law.

b. Clarification Regarding Services Provided by Partners in a Partnership

Commenters requested that the final regulations clarify that hours worked by, and amounts paid to, partners in a partnership that provide services to the partnership's trade or business count towards satisfying the hours performed test and amounts paid test. In particular, these commenters emphasized that such partners constitute neither employees nor independent contractors of the subject trade or business. As a result, the commenters noted that such hours worked, and amounts paid, were not specifically covered by either safe harbor.

The Treasury Department and the IRS agree that hours worked by, and amounts paid to, partners in a partnership for services provided to the partnership's trade or business should be taken in account for the hours performed and amounts paid tests. Therefore, the final regulations adopt the commenter's suggestion. In order to ensure that amounts paid to partners are for services provided to the trade or business of the partnership, the final regulations provide that guaranteed payments for services (within the meaning of section 707(c)) to a partner are the only amounts that will be taken into account for the amounts paid test.

c. Clarification Regarding Services Provided by Partners in a Partnership

Some commenters criticized the hours performed test and amounts paid test based on the commenters' view that neither test is sufficiently stringent. These commenters encouraged the Treasury Department and the IRS to combine all three safe harbors into one conjunctive, three-prong approach to provide a better measure of overall business activity occurring within a QOZ. Commenters also requested that the operative threshold be raised from 50 percent of hours worked and amounts paid to 75 percent to ensure that the residents of the QOZ sufficiently benefit from the economic activity created by the QOF investments.

The Treasury Department and the IRS appreciate the policy concerns underlying the commenters' recommendations. However, the Treasury Department and the IRS have determined that the hours performed test and amounts paid test strike an appropriate balance between (i) ensuring economic activity is created in a QOZ (that is, by requiring that at least half of the services performed, determined by hours or amounts paid, be performed in a QOZ), and (ii)

providing operating businesses with appropriate flexibility to expand and provide services outside of a QOZ. Therefore, the final regulations do not adopt these comments.

3. Clarification Regarding the Application of the Business Functions Test

In addition to the hours performed test and the amounts paid test, the May 2019 proposed regulations provided a "business functions test." Under that test, a trade or business satisfies the 50-percent gross income requirement if each of (i) the tangible property of the trade or business located in a QOZ, and (ii) the management or operational functions performed in the QOZ, are necessary for the generation of at least 50 percent of the gross income of the trade or business (business functions test). See proposed § 1.1400Z2(b)-1(d)(5)(i)(C) (setting forth the business functions test). The May 2019 proposed regulations requested comments on the business functions test. See 84 FR 18652, 18659 (May 1, 2019).

In response, the Treasury Department and the IRS received several comments requesting that the final regulations clarify the application of the business functions test. Many commenters emphasized that the business functions test fails to provide clearly the manner by which to determine when an asset generates income, as well as which managerial and operational staff are necessary for the generation of income. Commenters requested that the final regulations clarify (i) the meaning of the term "operational functions," and (ii) the method for tracing income generated from tangible property and managerial or operational functions in the QOZ. Also, a commenter highlighted that administrative "back office" functions are necessary functions for the generation of income, although administrative tasks may not be as intrinsically related to the operation of the trade or business.

In addition, a commenter requested that the final regulations provide additional guidance regarding mobile workforces and portable assets. The commenter noted that the May 2019 proposed regulations set forth an example involving a business with a mobile workforce and portable assets that returned to the business' headquarters on a daily basis, but the example does not address a situation in which the tangible assets of the business are almost entirely located in a QOZ at all times, but the business is operated by a workforce which may be remote, mobile, or shared with other businesses. See proposed § 1.1400Z2(b)-1(d)(5)(i)(E)(1), 84 FR 18652, 18659 (May 1, 2019). The commenter noted that the example does not clearly indicate whether an employee's activities outside of a QOZ, even while performing key operational roles inside of a QOZ, would cause their work not to be treated as an "operational function" that is "necessary" for the generation of the business' gross income. The commenter requested that the final regulations describe what is meant by management or operational functions and whether management functions, operational functions, and the location of tangible property are similarly weighted when applying the business functions test.

Commenters also noted that the business functions test could encourage businesses to bring high-skilled, high-income workers into a QOZ, but may not encourage businesses to create jobs for lower-skilled residents of the QOZ. Commenters requested additional examples describing what may or may not meet the business functions test, particularly within the context of fixed assets that are managed or operated by service providers, some of which are physically located outside of a QOZ.

The Treasury Department and the IRS appreciate the commenters' request for clarity regarding the application of the business functions test. Based on comments received, the Treasury Department and the IRS have determined that the business functions test would present an achievable and readily applicable safe harbor for businesses that are headquartered in a QOZ and for which the bulk of business activity occurs in a QOZ. However, the Treasury Department and the IRS acknowledge that businesses with unconventional management and operational structures, as well as tangible property located both inside and outside of a QOZ, would benefit from additional guidance. For those difficult cases, the Treasury Department and the IRS continue to study the commenters' request for clarification regarding the business functions test and may consider providing additional rules and examples through guidance published in the Internal Revenue Bulletin.

L. Requirement To Use Substantial Portion of Intangible Property in a Trade or Business

Section 1400Z-2(d)(3) provides that a qualified opportunity zone trade or business must satisfy the intangible property requirement set forth in section 1397C(b)(4). Section 1400Z-2(d)(3)'s incorporation of section 1397C(b)(4) requires that, with respect to any taxable year, a substantial portion of the intangible property of a qualified opportunity zone business must be used in the active conduct of a trade or business within the QOZ (intangible property use test). However, section 1397C does not provide a definition for the term "substantial portion." To provide additional certainty for determinations regarding whether a substantial portion of intangible property is used in the active conduct of a trade or business within a QOZ, the May 2019 proposed regulations provided that the term "substantial portion" means at least 40 percent of the intangible property of the qualified opportunity zone business. See proposed § 1.1400Z2(b)-1(d)(5)(ii), 84 FR 18652, 18659 (May 1, 2019)."

1. Clarification Regarding Determinations of Location and "Use" of Intangible Property

The Treasury Department and the IRS received comments requesting that the final regulations clarify the methods for determining the location and "use" of intangible property. Commenters contended that any uncertainty with regard to those determinations could discourage qualified opportunity zone businesses from developing and using intangible property. These commenters suggested that the Treasury Department and the IRS should consider a number of relevant factors for determining the location and use of intangible property, including (i) where a business provides services or has customers, (ii) where the business' tangible assets are located, (iii) how and where the business is marketed, and (iv) the geographic scope of the legal rights to use the intangible property.

One commenter suggested that, with regard to "use," a determination based on both gross revenue and the location in which such revenue is earned would be appropriate. For example, the commenter contended that an active trade or business that uses intangible property both inside and outside a QOZ should undertake a comparison of gross revenues derived inside the QOZ as well as outside the QOZ. Some commenters suggested that the final regulations adopt a rule similar to the safe harbors used for the 50-percent gross income test which would be based on the location of a business' employees or tangible property located within a QOZ. A commenter noted that a rule that ties "use" to tangible property or employees would help prevent abusive situations and ensure that economic activity occurs within a QOZ.

Commenters also suggested methods for determining the situs of intangible property. Commenters noted that, for state property law purposes, the location of intangible property generally is treated as the location at which the owner of that property is located. These commenters asserted that such a determination might be difficult in situations in which a business owner has locations both inside and outside of a QOZ. For example, if a business has a management and operations headquarters in a QOZ, and a technology research and development facility located outside of a QOZ, commenters expressed uncertainty regarding how to determine or measure the location of the business' intangible property. Another commenter suggested that the final regulations provide a rule or rebuttable presumption that connects the situs of an intangible property to a tangible property located within a QOZ if the portion of tangible property that is used for a trade or business inside the QOZ corresponds to the portion of intangible property deemed to be used inside the QOZ. This commenter also noted that a rule providing that an intangible property's location depends upon a tangible property's location could undercut the requirement for substantial use of intangible property in the QOZ.

The Treasury Department and the IRS appreciate the commenters' concerns regarding determinations of location and "use" of intangible property for purposes of applying the intangible property use test. To increase certainty in making such determinations, the final regulations provide that intangible property of a qualified opportunity zone business is used in the active conduct of a trade or business in a QOZ if the following two requirements are satisfied. First, the use of the intangible property must be normal, usual, or customary in the conduct of the trade or business. In addition, the intangible property must be used in the QOZ in the performance of an activity of the trade or business that contributes to the generation of gross income for the trade or business.

2. Consideration of 40-Percent Threshold for Use of Intangible Property

Commenters generally agreed with the 40-percent threshold for defining the minimum level of use necessary to satisfy the section 1397C(b)(4) requirement that a substantial portion of intangible property be used in a QOZ. However, some commenters asserted that the threshold percentage should be increased to more effectively prevent abuse. Commenters highlighted the potential for abusive transactions involving intangible property, noting that intangible property is highly mobile, may appreciate significantly in value, and is not subject to the same restrictions that apply to tangible property under section 1400Z-2(d)(2)(D) (regarding qualified opportunity zone business property). These commenters suggested that the final regulations apply anti-abuse rules similar to those set forth in section 1400Z-2(d)(2)(D) to the use by a trade or businesses of intangible property.

The final regulations adopt the 40-percent threshold for determining whether a "substantial portion" of the intangible property of a qualified opportunity zone business is used in the trade or business in a QOZ. After considering the concerns of commenters regarding potential abuses involving intangible property, the Treasury Department and the IRS have determined that the 40-percent threshold requires an appropriately substantial amount of intangible property to be used in a QOZ. In addition, the Treasury Department and the IRS have determined that a 40-percent

threshold will provide appropriate flexibility for trades and businesses to expand and operate outside of a QOZ.

3. Clarification Regarding Reference to "Such Business" in Section 1397C(b)(4)

A commenter requested clarification regarding whether an intellectual property holding company can be a qualified opportunity zone business in light of section 1397C(d)(4), which excludes any trade or business the activities of which consist predominantly of developing or holding intangibles for sale or license. This commenter noted that section 1397C(b)(4) provides the following condition: "a substantial portion of the intangible property of such entity is used in the active conduct of any such business." The commenter requested that the final regulations confirm whether the use of "such business" in section 1397(b)(4) incorporates the qualified business definition set forth in section 1397C(d).

As provided in the preamble to the May 2019 proposed regulations, the Treasury Department and the IRS addressed a similar question with regard to section 1397C(b)(2), which provides that, in order to be a "qualified business entity" (in addition to other requirements found in section 1397C(b)) with respect to any taxable year, a corporation or partnership must derive at least 50 percent of its total gross income "from the active conduct of such business." See 84 FR 18652, 18658 (May 1, 2019). As noted in that preamble, the phrase "such business" refers to a business mentioned in the preceding sentence, referring to section 1397C(b)(1), which discusses "a qualified business within an empowerment zone." See *id.* The preamble goes on to state that for purposes of applying section 1400Z-2, references in section 1397C to "an empowerment zone" are treated as meaning a qualified opportunity zone. Therefore, section 1400Z-2 does not incorporate the concept of "qualified business" within an empowerment zone under section 1397C(d), but instead reads "such business" in section 1397C(b)(2) and (4) to refer to "a business within a qualified opportunity zone." As a result, the Treasury Department and the IRS have concluded that the exception set forth in section 1397C(d)(4) has no application with respect to the qualification of an intellectual property holding company as a qualified opportunity zone business.

M. Limitation on Nonqualified Financial Property of Qualified Opportunity Zone Business

Section 1400Z-2(d)(3) incorporates section 1397C(b)(8), which limits the portion of the qualified opportunity zone business' assets that may be held in nonqualified financial property (NQFP) to less than five percent of the average of the aggregate unadjusted bases of the property of the entity in a taxable year (five-percent NQFP limitation). Section 1397C(e) defines the term "nonqualified financial property" as debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar properties. However, section 1397C(e) excludes from that definition reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less.

1. Consideration of Industry-Specific Revisions to Five-Percent NQFP Limitation

The Treasury Department and the IRS received several recommendations that the final regulations tailor the five-percent NQFP limitation to provide flexibility for certain industries.

For example, several commenters expressed a general concern that ordinary-course transactions in the real estate sector may be prohibited by the definition of NQFP. One commenter noted that the definition of NQFP may cover commonplace items such as leases with prepaid or front-loaded rent that are treated in part as loans, prepaid expenses, prepaid development fees, and options to acquire property. The commenter requested that (i) the definition of NQFP provide exceptions for the aforementioned items, and (ii) the five-percent NQFP limitation be revised to exclude commonplace real estate transactions. For support, the commenter asserted that the definition of NQFP creates a trap for the unwary and that the five-percent NQFP limitation was not intended to prevent qualified opportunity zone businesses from engaging in the ordinary-course real estate transactions that develop QOZs.

The Treasury Department and the IRS also received comments requesting similar revisions to the five-percent NQFP limitation to accommodate other industries. For example, a commenter requested that insurance company general account assets be excluded from the definition of NQFP. The commenter emphasized that insurance companies are required to invest a significant portion of their assets in financial property to satisfy obligations to policy holders. By not excluding insurance companies from the five-percent NQFP limitation, the commenter reasoned that the section 1400Z-2 regulations would prevent insurance companies from being qualified opportunity zone businesses.

The Treasury Department and the IRS acknowledge the concerns raised by the commenters. However, sections 1400Z-2(d)(3)(A)(ii) and 1397C(b)(8) provide a clear statutory definition of NQFP and an equally clear limitation on the percentage of NQFP that a qualified opportunity zone business may own. As a result, the final regulations do not adopt the commenters' recommended revisions to the five-percent NQFP limitation.

2. Consideration of Special Rules To Facilitate the Use of Tax-Exempt Municipal Bonds

Several commenters stressed the importance of adequate infrastructure for the economic development of a QOZ, and the critical role of tax-exempt municipal bonds in the financing of infrastructure projects. These commenters recommended that the final regulations provide favorable treatment for municipal bonds used to finance new or improve existing infrastructure projects located within a QOZ. In particular, these commenters recommended that the final regulations treat municipal bonds essentially as qualified opportunity zone property in which a QOF would be eligible to invest. Further, these commenters recommended that the final regulations treat municipal bonds as property that would not be treated as NQFP in the hands of an entity seeking to qualify as a qualified opportunity zone business. In support of these recommendations, a commenter highlighted that two-thirds of all domestic infrastructure projects are financed by municipal bonds. This commenter reasoned that, if the final regulations were not to remove municipal bonds from the definition of NQFP, infrastructure developments that might otherwise occur would not be financed.

The Treasury Department and the IRS recognize the significant need for additional investment in public infrastructure in QOZs, and that expanded debt and equity tax incentives could facilitate such increased investment. In addition, the Treasury Department and the IRS acknowledge that municipal bonds provide an important source of financing for infrastructure projects. However, section 1400Z-2(d) does not contemplate direct investments in municipal bonds as qualifying

property for QOFs. Municipal bonds, which are intangible debt instruments, cannot qualify under the statutory categories of qualified opportunity zone property because municipal bonds are neither (i) equity in a qualified opportunity zone business nor (ii) a tangible asset that is qualified opportunity zone business property. A QOF could make a direct equity investment in tangible property that meets the definition of qualified opportunity zone business property, and the property also may have municipal bond financing (for example, a private water facility financed with tax-exempt private activity bonds under section 142 of the Code). Further, if held by a qualified opportunity zone business, municipal bonds generally constitute NQFP and can qualify for the reasonable working capital safe harbor only in limited circumstances in which the bonds have a term of 18 months or less. For the foregoing reasons, the Treasury Department and the IRS decline to adopt the recommendations of these commenters regarding municipal bond investments.

3. Consideration of Special Rules To Facilitate Tiered Entity Structures

The Treasury Department and the IRS have received several comments regarding the application of sections 1400Z-2(d)(3)(A)(ii) and 1397C(b)(4) to groups of related corporations and partnerships structured to conduct integrated qualified opportunity zone businesses. In particular, several commenters expressed concern that the text of section 1397C(e) prohibits qualified opportunity zone businesses from owning operating subsidiaries due to the inclusion of stock and partnership interests in the statutory definition of NQFP. However, one commenter contended that Congress clearly intended the statute only to prevent qualified opportunity zone businesses from owning publicly traded securities that are passive investments, rather than prevent the ownership of operating subsidiaries. Accordingly, the commenter recommended that the definition of NQFP be clarified to prohibit actively traded personal property for purposes of § 1.1092(d)-1, but not equity interests in operating subsidiaries.

Similarly, other commenters requested that all requirements for a qualified opportunity zone business under section 1400Z-2(d)(3) (including the five-percent NQFP limitation) be applied to an entire group that conducts an integrated business. These commenters asserted that an entity-by-entity test would not be appropriate because such integrated businesses often are organized by entity-specific functions that, in the view of the commenters, would distort the intended application of the five-percent NQFP limitation. For example, an integrated business carried out by a holding corporation that owns all of the equity interests in an operating subsidiary and a treasury subsidiary might comply with the five-percent NQFP limitation if tested in the aggregate, even though the treasury subsidiary, tested on its own, would exceed that limitation.

The Treasury Department and the IRS agree that section 1400Z-2(d)(3) should be applied in a manner that permits flexibility to taxpayers in structuring and conducting qualified opportunity zone businesses. However, with regard to the five-percent NQFP limitation, sections 1397C(b)(8) and 1397C(e) clearly provide that (i) less than five percent of the average of the aggregate unadjusted bases of the property of the subject entity, rather than any group of related entities, must be attributable to NQFP, and (ii) the definition of the term "nonqualified financial property" includes stock and partnership interests. As a result, the final regulations do not adopt a group-based test for purposes of the five-percent NQFP limitation.

In addition, the final regulations do not adopt a group-based approach for testing the remaining requirements for a qualified opportunity zone business under section 1400Z-2(d)(3). The Treasury Department and the IRS have determined that an inconsistent application of the requirements for qualified opportunity zone business qualification would significantly increase the complexity of the final regulations and create potential traps for unwary taxpayers. In addition, the Treasury Department and the IRS note that these section 1400Z-2(d)(3) requirements (including the five-percent NQFP limitation) can be applied on a group basis with regard to a qualified opportunity zone business that owns interests in function-specific entities disregarded as separate from their owner for Federal income tax purposes.

N. Trade or Business of a Qualified Opportunity Zone Business

1. Significance of Trade or Business Concept in Section 1400Z-2

Section 1400Z-2(d)(2)(D)(i) and (d)(3)(A)(i) require that qualified opportunity zone business property be tangible property used in the trade or business of a QOF or qualified opportunity zone business. Under section 1400Z-2(d), both QOFs and qualified opportunity zone businesses must meet "substantially all" property requirements. For QOFs, at least 90 percent of the qualified entity's property must be qualified opportunity zone property, which includes qualified opportunity zone stock and qualified opportunity zone partnership interests (that is, the 90-percent investment standard). For qualified opportunity zone businesses, at least 70 percent of the qualified entity's property must be qualified opportunity zone business property (that is, the 70-percent tangible property standard). In addition, section 1400Z-2(d)(3)(A)(ii) imposes an additional requirement on qualified opportunity zone businesses but not on QOFs. Under this requirement, at least 50 percent of the total gross income of a qualified entity must be derived from the active conduct of a trade or business within a QOZ (that is, the 50-percent gross income requirement).

2. Proposed Definition Based on a "Trade or Business" Under Section 162

The October 2018 proposed regulations contained the term "active conduct of a trade or business" in several provisions. See proposed § 1.1400Z2(d)-1(d)(5). Following the publication of that proposal, the Treasury Department and the IRS received comments asking whether future guidance would define the phrase "active conduct of a trade or business" for purposes of section 1400Z-2. Commenters also expressed concern that the leasing of real property by a qualified opportunity zone business may not amount to the active conduct of a trade or business if the business has limited leasing activity.

With regard to the term "trade or business," the May 2019 proposed regulations set forth a definition for QOFs and qualified opportunity zone businesses that referenced section 162 of the Code. See 84 FR 18652, 18659 (May 1, 2019). See also § 1.1400Z2(d)-1(c)(4)(ii) (regarding QOFs); § 1.1400Z2(d)-1(d)(2)(ii) (regarding qualified opportunity zone businesses). Section 162(a) permits a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business. Because neither the Code nor the regulations define the meaning of a "trade or business" under section 162, courts have established requirements to determine the existence of a trade or business. The Supreme Court has set forth a two-pronged test, providing that, "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and

regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit." Commissioner v. Groetzinger, 480 U.S. 23, 35 [59 AFTR 2d 87-532] (1987). With respect to the requirement that the activity must be engaged for income or profit, the Court has expressly provided that section 162 qualification "requires only an intent to earn an economic profit." Portland Golf Club v. Commissioner, 497 U.S. 154, 164, 169 [65 AFTR 2d 90-1162] (1990) (citing Commissioner v. Groetzinger for the Court's observation that it "has ruled that a taxpayer's activities fall within the scope of [section] 162 only if an intent to profit has been shown").

3. Application of Section 162 Trade or Business Standard to Start-Up Businesses

While commenters agreed that section 162 provides an appropriate standard for trade or business qualification under section 1400Z-2(d)(2)(D)(i) and (d)(3)(A)(i), many noted significant uncertainties in applying the section 162 standard to a trade or business of a QOF or qualified opportunity zone business that does not expect to generate profits immediately. In general, these commenters have noted that QOF property used in a start-up business cannot qualify as qualified opportunity zone property unless the start-up business that utilizes such property qualifies as a section 162 trade or business. With regard to QOFs that hold an equity interest in a newly formed partnership or corporation organized for the purpose of being a qualified opportunity zone business, commenters have questioned how section 162 would apply if the partnership or corporation experiences a start-up phase of significant duration. See section 1400Z-2(d)(2)(B)(i)(II) and (d)(2)(C)(ii). With regard to qualified opportunity zone businesses, commenters similarly have expressed uncertainty regarding the qualification of a start-up business as a qualified opportunity zone business if the start-up business has not yet matured to a trade or business under section 162.

a. Comments Suggesting Safe Harbors for Start-Up Businesses

To provide certainty to current and potential investors of start-up businesses in QOZs, commenters suggested a variety of safe harbors. These suggestions included (1) a grace period for a QOF to use tangible property in a trade or business to satisfy the 90-percent investment standard, as well as (2) a provision similar to that under § 1.45D-1(d)(4)(iv) in the New Markets Tax Credit regulations that treats an entity as engaged in the active conduct of a trade or business if, at the time an investment is made, there is a reasonable belief that the entity will generate revenues during the subsequent three-year period. To support the addition of a safe harbor for start-ups, commenters correctly noted that section 1400Z-2 contemplates the start-up phase of a trade or business. Sections 1400Z-2(d)(2)(B)(i)(II) and (d)(2)(C)(ii), as discussed previously, reference newly formed partnerships and corporations organized for the purpose of being a qualified opportunity zone business. In addition, commenters highlighted section 1400Z-2(d)(2)(D)(ii), which provides QOFs 30 months to improve tangible property acquired for use in a QOF's trade or business to meet the substantial improvement requirement.

b. Comments Requesting Clarifications and Simplifying Rules for Start-Up Businesses

Commenters also requested that the final regulations provide a number of clarifications or simplifying rules. For example, commenters requested clarification on whether the conduct of a section 162 trade or business must have begun by the conclusion of a working capital safe harbor

period in situations in which the plan underlying the development of the trade or business contemplates the utilization of multiple contributions to which a working capital safe harbor would otherwise apply. Another commenter requested that the final regulations include an example to clarify that the conduct of a trade or business would be required only upon the conclusion of all working capital safe harbors carried out as components of a single integrated plan. Consistent with that request, commenters contended that many types of business ventures, to achieve qualification as a section 162 trade or business, require start-up periods in excess of a single 31-month working capital safe harbor period.

With regard to simplifying rules, a commenter suggested that the final regulations treat the development of a section 162 trade or business as a qualifying section 162 trade or business, regardless of whether the operations that constitute the trade or business have actually begun. Other commenters requested clarification that the ongoing development of real estate constitutes the active conduct of a trade or business even if rent or other revenues are not yet being collected. Similarly a commenter suggested that the final regulations treat a QOF as engaged in a trade or business under section 162 even if the subject business activity had generated no income. Another commenter suggested that the "active conduct" requirements set forth in paragraphs (2) and (4) of section 1397C(b) should not be treated as applying to section 1400Z-2(d)(3)(A)(ii).

c. Creation of New 62-Month Working Capital Safe Harbor for Start-Up Businesses

The Treasury Department and the IRS appreciate the commenters' concerns and recommendations regarding the application of the section 162 trade or business standard to start-up businesses. To provide taxpayers with straightforward and responsive rules, the Treasury Department and the IRS have created an additional 62-month safe harbor for start-up businesses (62-month working capital safe harbor). Unlike the 31-month working capital safe harbor, this start-up-focused safe harbor addresses each qualified opportunity zone business requirement, other than the "sin business" prohibition under section 1400Z-2(d)(3)(A)(iii).

As set forth in the final regulations, the 62-month working capital safe harbor provides that, during the maximum 62-month covered period, (1) NQFP in excess of the five-percent NQFP limitation will not cause a trade or business to fail to qualify as a qualified opportunity zone business, and (2) gross income earned from the trade or business will be counted towards satisfying the 50-percent gross income requirement (each of clauses (1) and (2) function in a manner similar to the 31-month working capital safe harbor). In addition, the 62-month working capital safe harbor provides that, during the maximum 62-month covered period, (i) tangible property purchased, leased, or improved by a business with cash covered by a working capital safe harbor, pursuant to the plan submitted with respect to that safe harbor, will count towards satisfaction of the 70-percent tangible property standard, and (ii) intangible property purchased or licensed with that cash, and pursuant to that plan, likewise will count towards the satisfaction of the 40-percent intangible property use test.

To qualify for a maximum 62-month safe harbor period, a start-up business must receive multiple cash infusions during its start-up phase. Specifically, under the 62-month working capital safe harbor, a start-up business can qualify for a 31-month safe harbor period with respect to the business' first cash infusion. Upon receipt of a subsequent contribution of cash (subsequent

cash infusion), the business can both (i) extend the original 31-month safe harbor period that covered the initial cash infusion, and (ii) receive safe-harbor coverage for the subsequent cash contribution for a maximum 31-month period, if the business satisfies the following two conditions. First, the subsequent cash infusion must be independently covered by an additional working capital safe harbor. Second, the working capital safe harbor plan for the subsequent cash infusion must form an integral part of the working capital safe harbor plan that covered the initial cash infusion.

To ensure the proper application of the 62-month working capital safe harbor, the final regulations also provide additional operating rules. For example, the final regulations make clear that, regardless of the number of subsequent cash infusions, the 62-month working capital safe harbor cannot extend past the 62 month-period beginning on the date of the first cash infusion covered by the safe harbor (for example, a subsequent cash infusion received 60 months after the date of the first cash infusion will be covered by the 62-month working capital safe harbor for only two months). In addition, the 62-month working capital safe harbor features a minimum investment threshold for each subsequent cash infusion to ensure that a de minimis subsequent infusion does not unlock a subsequent 31-month period for previously covered tangible and intangible property. The final regulations also provide that tangible property covered by the 62-month working capital safe harbor plan is not considered qualified opportunity zone business property for purposes of the special rule in section 1400Z-2(d)(3)(B).

4. Expansion of 30-Month Substantial Improvement Period

The October 2018 proposed regulations provided a 30-month substantial improvement period of tangible property for purposes of applying the substantial improvement requirement. Under that proposal, tangible property is treated as substantially improved by a QOF or qualified opportunity zone business only if, during any 30-month period beginning after the date of acquisition of the property, additions to the basis of the property in the hands of the QOF or qualified opportunity zone business exceed an amount equal to the adjusted basis of the property at the beginning of the 30-month period in the hands of the QOF or qualified opportunity zone business. See proposed § 1.1400Z2(d)-1(c)(8) (setting forth the requirement with regard to QOFs); proposed § 1.1400Z2(d)-1(d)(4) (setting forth the requirement with regard to qualified opportunity zone businesses). The May 2019 proposed regulations provided that the term trade or business means a trade or business within the meaning of section 162, for both QOFs and qualified opportunity zone businesses, and requested comments on whether additional clarification or guidance was needed.

Several commenters pointed out that the proposed regulations are unclear regarding the treatment of tangible property during the 30-month substantial improvement period for a QOF and a qualified opportunity zone business that is not utilizing 31-month working capital safe harbor. Commenters noted that the proposed regulations do not clarify whether non-original use tangible property undergoing a substantial improvement process will be treated as qualified opportunity zone business property during the 30-month substantial improvement period. A commenter noted that just as startup businesses have difficulty satisfying the "used in a trade or business requirement" found in section 1400Z-2(d)(2)(D)(i), a QOF or qualified opportunity zone business generally will not be able to use tangible property in a section 162 trade or business during a 30-month substantial improvement period.

Another commenter requested a new safe harbor for work in progress, applicable to both QOFs and qualified opportunity zone businesses, unrelated to the working capital safe harbor. The commenter noted that some projects do not need working capital and that, without an additional safe harbor, projects not utilizing the working capital safe harbor would fail to qualify as qualified opportunity zone business property during the 30-month substantial improvement period. The commenter requested that assets held for work in progress be treated as qualified opportunity zone business property for the 90-percent investment standard found in section 1400Z-2(d)(1) (and the property be treated as used in a trade or business) during the substantial improvement period, if certain criteria are met.

The Treasury Department and the IRS recognize that QOFs are ineligible to utilize the benefits of the working capital safe harbor since the requirements found in paragraphs (2), (4), and (8) of section 1397C(b) are not applicable to QOFs, and that not all qualified opportunity zone businesses will be able to utilize the working capital safe harbor for a variety of reasons. Therefore, the final regulations provide that for QOFs and qualified opportunity zone businesses, tangible property purchased, leased, or improved by a trade or business that is undergoing the substantial improvement process but has not been placed in service or used in a trade or business by the QOF or qualified opportunity zone business is treated as used in a trade or business and satisfies the requirements of section 1400Z-2(d)(2)(D)(i) for the 30-month substantial improvement period with respect to that property. In order to receive such treatment, the QOF or qualified opportunity zone business must reasonably expect that the property will be substantially improved, as defined in section 1400Z-2(d)(2)(D)(ii), and used in a trade or business in the QOZ by the end of the 30-month substantial improvement period.

5. Consideration of Excluding Real Estate Speculation From the Definition of "Trade or Business"

A commenter suggested that the final regulations modify the definition of the term "trade or business" to specifically exclude real estate speculation. The commenter asserted that real estate speculation on projects carried out within QOZs presents a significant potential for abuse, and reasoned that a specific exclusion of real estate speculation from the definition of "trade or business" would eliminate such potential. The Treasury Department and the IRS appreciate the concern raised by the commenter, but note that the final regulations address real estate speculation abuse by requiring that land (1) be more than insubstantially improved and (2) be used in the trade or business of a QOF or qualified opportunity zone business. Accordingly, the final regulations do not adopt the commenter's recommendation.

6. Consideration of Triple-Net-Leases for Active Conduct a Trade or Business Requirement

Proposed § 1.1400Z2(d)-1(d)(5)(ii)(B)(2) provided that, solely for the purposes of determining whether a trade or business qualified as a qualified opportunity zone business, the ownership and operation, including leasing, of real property qualifies as an active conduct of a trade or business. The proposed rule, however, provided that merely entering into a triple-net-lease with respect to real property owned by a taxpayer does not constitute an active conduct of a trade or business by such taxpayer. See proposed § 1.1400Z2(d)-1(d)(5)(ii)(B)(2) (second sentence). The Treasury Department and the IRS determined that, solely for purposes of determining qualified

opportunity zone business qualification, triple-net-leases constitute inappropriately passive activities similar to holding publicly traded stock or securities.

a. Comments Suggesting Special Definitions for "Triple-Net-Lease"

In general, commenters requested additional guidance regarding the meaning of the term "triple net lease" for purposes of applying proposed § 1.1400Z2(d)-1(d)(5)(ii)(B)(2). Several commenters suggested that the final regulations define the term "triple-net-lease" as a lease in which the tenant, in addition to rent and utilities, pays the tenant's proportionate share of the taxes, insurance, maintenance, and other fees for the property leased. Multiple commenters recommended that a triple-net-lease of a taxpayer be defined to constitute an active conduct of a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business of the lessee. Similarly, another commenter requested that the final regulations define a triple-net-lease to exclude arrangements pursuant to which a taxpayer retains contractual responsibility for meaningful capital obligations or meaningful operating obligations. The commenter indicated that an obligation to maintain certain structural or operating systems of a building would qualify as a meaningful capital obligation, while obligations to provide cleaning or grounds-keeping services would qualify as meaningful operating obligations.

b. Comments Suggesting Active Trade or Business Qualification Based on Section 162 Case Law

Another commenter recommended that the final regulations adopt a rule based on case law under section 162 to determine whether a triple-net-lease qualifies as the active conduct of a trade or business. According to the commenter, the case law under section 162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business related to a triple-net-lease if the landlord, or an employee, agent, or contractor of the landlord, performs the services related to the taxes, maintenance, insurance, and similar fees even though the landlord receives payment for these services from the tenant. Therefore, the commenter suggested that a triple-net-lease in which the landlord, or an employee, agent, or contractor of the landlord, performs these services should qualify as the active conduct of a trade or business, regardless of which party ultimately bears the cost for these services.

c. Comments Suggesting Special Rules for Active Trade or Business Qualification

Commenters also recommended that the final regulations provide special rules for determining whether a taxpayer entering into a triple-net-lease with respect to real property owned by a taxpayer constitutes an active conduct of a trade or business by such taxpayer. For example, a commenter contended that a triple-net-lease qualify as the active conduct of a trade or business if (1) the underlying property meets the test under the original use requirement or the substantial improvement requirement, and (2) assuming all other requirements are met, qualifies as qualified opportunity zone business property. For support, the commenter highlighted the May 2019 proposed regulations, which provided that leased property can qualify as qualified opportunity zone business property to a tenant that is a QOF or a qualified opportunity zone business. This commenter reasoned that, because leased property would be qualified opportunity zone business property to a tenant notwithstanding the fact that the property was subject to a triple-net-lease, it could also be qualified opportunity zone business property to the landlord. Therefore, under the

commenter's reasoning, a lessor's participation in a triple-net-lease could constitute the active conduct of a trade or business.

Commenters also recommended that lessor participation in certain arrangements that utilize the rehabilitation tax credit under section 47 of the Code should qualify as an active conduct of a trade or business. In such arrangements, a landlord owns a building that is the subject of a rehabilitation project. The landlord acquires the property, obtains permits and approvals, assembles the development team, raises the funds necessary to develop the property, and places the rehabilitated structure into service. After that initial phase, the landlord leases the building to a tenant, who may further lease the property to a subtenant. The landlord transfers the rehabilitation tax credits to the original tenant pursuant to section 50(d)(5). The commenter noted that this arrangement between the landlord and the original tenant may constitute a triple-net-lease. As a result, the commenter recommended that the final regulations adopt a rule to provide specifically that such arrangements constitute the active conduct of a trade or business.

d. Comments Suggesting Triple-Net-Leases Qualify as an Active Trade or Business

However, other commenters disagreed with the premise of proposed § 1.1400Z2(d)-1(d)(5)(ii)(B) that merely entering into a triple-net-lease for property owned by a taxpayer does not constitute the active conduct of a trade or business. Several commenters noted that triple-net-leases cause capital to enter a QOZ and provide property for use in trades or businesses within the QOZ. These commenters also emphasized that landlords and tenants often prefer triple-net-lease arrangements, as opposed to employing a separate property manager or agent of the landlord, because tenants often are better positioned to control and maintain the leased property. Accordingly, the commercial real estate industry widely employs triple-net-leasing.

e. Revisions to Proposed Triple-Net-Lease Rule for Active Trade or Business Qualification

The Treasury Department and the IRS appreciate the comments and recommendations received with respect to triple-net-leases. In general, the final regulations confirm that merely entering into a triple-net-lease with respect to real property owned by a taxpayer does not constitute the active conduct of a trade or business by such taxpayer. To illustrate the application of this rule, the final regulations set forth examples describing a triple-net-lease as a lease arrangement pursuant to which the tenant is responsible for all of the costs relating to the leased property (for example, paying all taxes, insurance, and maintenance expenses) in addition to paying rent. In an instance in which the taxpayer's sole business consists of a single triple-net-lease of a property, the final regulations confirm that the taxpayer does not carry out an active trade or business with respect to that property solely for purposes of section 1400Z-2(d)(3)(A).

The Treasury Department and the IRS agree with commenters that, in certain cases, a taxpayer that utilizes a triple-net-lease as part of the taxpayer's leasing business could be treated as conducting an active trade or business solely for purposes of section 1400Z-2(d)(3)(A). Accordingly, the final regulations provide an example in which a lessor leases a three-story mixed-use building to three tenants, each of which rents a single floor. In that example, (i) the lessor leases one floor of the building under a triple-net-lease, but leases the remaining two floors under leases that do not constitute triple-net-leases, and (ii) the employees of the lessor meaningfully participate in the management and operations of those two floors. As a result, the

example provides that the lessor is treated as carrying out an active trade or business with respect to the entire leased building solely for purposes of section 1400Z-2(d)(3)(A).

O. Safe Harbor for Reasonable Amounts of Working Capital

The October 2018 proposed regulations provided a 31-month working capital safe harbor for QOF investments in qualified opportunity zone businesses that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property used in a business operating in a QOZ (31-month working capital safe harbor). See proposed § 1.1400Z2(d)-1(d)(5)(iv); 83 FR 54279, 54284 (October 29, 2018). Solely for purposes of applying section 1397C(e)(1) to the definition of a qualified opportunity zone business under section 1400Z-2(d)(3), working capital assets held by the business are treated as reasonable in amount under sections 1397C(b)(2) and 1400Z-2(d)(3)(A)(ii) for a period of up to 31 months. See *id.* To qualify, the qualified opportunity zone business (1) must have a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the QOZ, (2) must have a written schedule consistent with the ordinary business operations of the business that the property will be used within 31 months, and (3) must substantially comply with the schedule. See *id.*

The May 2019 proposed regulations provided revisions to the 31-month working capital safe harbor in response to comments. First, the May 2019 proposal modified the rule requiring a written designation for planned use of working capital to include the development of a trade or business in the QOZ as well as acquisition, construction, and/or substantial improvement of tangible property. See proposed § 1.1400Z2(d)-1(d)(5)(iv)(A); 84 FR 18652, 18659 (May 1, 2019). Second, the May 2019 proposal provided that exceeding the 31-month period does not violate the 31-month working capital safe harbor if the delay is attributable to waiting for government action the application for which is completed during the 31-month period. See proposed § 1.1400Z2(d)-1(d)(5)(iv)(C); 84 FR 18652, 18659 (May 1, 2019). The May 2019 proposed regulations also clarified that a business may benefit from multiple overlapping or sequential applications of the working capital safe harbor, provided that each application independently satisfies all of the requirements in proposed § 1.1400Z2(d)-1(d)(5)(iv)(A) through (C) (multiple safe harbor rule). See proposed § 1.1400Z2(d)-1(d)(5)(iv)(D).

1. Additional Guidance Regarding Reasonable Delays to Toll the 31-Month Working Capital Safe Harbor

The Treasury Department and the IRS have received several comments and requests for additional guidance regarding delays relating to governmental action, as well as delays arising from a variety of other events. With regard to applying proposed § 1.1400Z2(d)-1(d)(5)(iv)(C), one commenter requested confirmation as to whether a delay attributable to governmental action, the application for which is completed during the 31-month period, means that (i) the governmental action must be pending at the end of the 31-month period or (ii) a waiting period for governmental action at any time "stops the clock" on the 31-month period (and therefore the waiting period is added at the end of the 31-month period). The commenter noted that, in certain instances, a governmental action might be completed predictably within a relatively short period of time, and therefore automatic tolling might provide an overly generous result. Another commenter, however, emphasized that the governmental permitting guidelines regarding natural

resource projects lack predictable completion timeframes because such projects often require the receipt of several state and local permits that are subject to various timelines. As a result, this commenter requested that the 31-month period be tolled to accommodate successive permits in a circumstance in which the business has received the first serious of permits that initially tolled the 31-month period.

Commenters also recommended that the final regulations provide that, in addition to delays resulting from governmental action, certain events outside of a business' control will toll the 31-month working capital safe harbor. For example, several commenters requested that events delaying the 31-month period include, among other occurrences, severe weather conditions, natural disasters, labor stoppages, financing delays, and supply shortages. Another commenter requested that trades or businesses receive an extension of the 31-month period to account for delays arising from the cleanup of a brownfield site due because the cleanup of such a site ordinarily will require other lengthy regulatory approval from states and local governments.

The Treasury Department and the IRS acknowledge the concerns raised by the commenters. In many ordinary-course instances, however, applicants can obtain governmental permits through a routine process of predictable duration. The Treasury Department and the IRS continue to expect a qualified opportunity zone business, to the maximum extent practicable, to take any actions during the governmental permitting period that are necessary for the improvement of tangible property subject to the 31-month working capital safe harbor. Therefore, with regard to instances in which governmental delay does not pose a substantial obstacle for improving such tangible property, a tolling of the 31-month period would not be appropriate.

The Treasury Department and the IRS have determined that the 31-month working capital safe harbor should be tolled in certain instances, however, and have clarified and expanded the scope of proposed § 1.1400Z2(d)-1(d)(5)(iv)(C). In general, the final regulations make clear that, if a governmental permitting delay has caused the delay of a project covered by the 31-month working capital safe harbor, and no other action could be taken to improve the tangible property or complete the project during the permitting process, then the 31-month working capital safe harbor will be tolled for a duration equal to the permitting delay. In such case, the final regulations require that the permit for the governmental action was completed during the 31-month period. The final regulations also provide that, if a project that otherwise meets the requirements of the 31-month working capital safe harbor is located within a QOZ designated as a part of a Federally declared disaster area (as defined in section 165(i)(5)(A)), the qualified opportunity zone business may receive up to an additional 24 months to consume its working capital assets, provided the project is delayed due to that disaster.

2. Clarification Regarding Overlapping or Sequential Applications of the 31-Month Working Capital Safe Harbor

The Treasury Department and the IRS received several comments and requests for clarification regarding the multiple safe harbor rule. In particular, commenters questioned whether a successive application of the 31-month working capital safe harbor can occur for the same piece of tangible property, given that multiple 31-month harbor periods can be utilized for that same piece of tangible property. These commenters contended that a successive application of the 31-month working capital safe harbor would appropriately accommodate practical realities of

improving tangible property in a trade or business (such as ordinary course-improvement projects that typically require durations in excess of 31 months).

The Treasury Department and the IRS confirm that a qualified opportunity zone business may string together subsequent or overlapping working capital safe harbors with respect to the same tangible property. Accordingly, the final regulations specifically provide that a qualified opportunity zone business may choose to apply subsequent 31-month working capital safe harbors for a maximum 62-month period (that is, a duration equal to two working capital safe harbor periods), provided that each 31-month period satisfies the requirements for applying a 31-month working capital safe harbor. To qualify for a subsequent 31-month working capital safe harbor period, (i) working capital subject to an expiring 31-month period must be expended in accordance with each requirement set forth in the section 1400Z-2 regulations, and (ii) the subsequent infusions of working capital must form an integral part of the plan covered by the initial 31-month working capital safe harbor.

3. Treatment of Tangible Property Not Used Upon Conclusion of a 31-Month Working Capital Safe Harbor

Commenters also noted that, although the May 2019 proposed regulations expanded the 31-month working capital safe harbor to include the development of a trade or business, the proposal failed to clarify the application of the safe harbor regarding situations in which the qualified opportunity zone business does not use the tangible property in the QOZ by the end of the 31-month period. For example, commenters requested that the final regulations describe circumstances in which a business that uses a contribution of working capital during a 31-month period, but does not use the tangible property in a trade or business in the QOZ by the end of the 31-month period, may continue to be covered by the 31-month working capital safe harbor. These commenters asserted that such a business should continue to receive coverage by the safe harbor if, based on a consideration of the relevant facts and circumstances, the business diligently and reasonably continues to develop the trade or business and uses the tangible property in a trade or business in the QOZ within a reasonable period of time.

Another commenter suggested that the final regulations provide a rebuttable assumption that all working capital that will be expended by the business has been expended before each testing date, including future tranches of working capital that, as part of the working capital plan, will be used to substantially improve or construct new property in a QOZ. Similarly, a commenter suggested that the final regulations provide that, if a trade or business receives serial capital contributions under a common written plan, the trade or business must use cash equal to the first capital contribution within 31 months, but is not required to use 70 percent of its tangible property in the QOZ by the end of the 31-month period associated with the first capital contribution. In addition, a commenter suggested that the 31-month working capital safe harbor be revised to provide that the 70-percent tangible property standard would not be applied until all working capital has been expended and the substantially improved (or new) property is placed in service by the business in the QOZ.

The Treasury Department and the IRS appreciate the commenters' suggestions and requests for clarification, and have included additional guidance in the final regulations. In general, the final regulations permit a qualified opportunity zone business to treat tangible property for which

working capital covered by the 31-month working capital safe harbor is expended as (i) used in the trade or business of the qualified opportunity zone business, and (ii) qualified opportunity zone business property throughout the period during which such working capital is covered by the safe harbor. The final regulations make clear that such improvements must be made pursuant to the written plan governing the expenditure of the working capital assets. In addition, the tangible property subject to such improvements must be used in a trade or business, within the meaning of section 162, of the qualified opportunity zone business by the end of the 31-month working capital safe harbor. The final regulations also clarify that unexpended amounts of working capital covered by the 31-month working capital safe harbor are not, following the conclusion of the final safe harbor period, treated as tangible property for purposes of applying the 70-percent tangible property standard.

4. Consideration of Special Debt-Financed Safe Harbor for QOFs and Qualified Opportunity Zone Businesses

A commenter requested that the final regulations provide a new safe harbor to cover debt-financed work-in-progress projects that (i) would operate in addition to the 31-month working capital safe harbor, and (ii) could be applied by QOFs and qualified opportunity zone businesses. For support, the commenter emphasized that many construction projects are debt financed and would not be covered by the 31-month working capital safe harbor during the construction period. Accordingly, the absence of a debt-financed safe harbor would complicate the ability to carry out construction projects within QOZs.

The commenter suggested that, if certain requirements were met, the final regulations should provide that (i) assets held for work-in-progress construction projects be treated as qualified opportunity zone business property during the construction period, and (ii) the QOF or qualified opportunity zone business be treated as engaged in a section 162 trade or business. Requirements suggested by the commenter for this safe harbor included (1) mandatory increases to the basis of the trade or business in the qualified opportunity zone business property by a prescribed multiple during the 31-month period, (2) periodic certification requirements during the construction period, and (3) continuous and diligent construction by the trade or business until the completion of project and the placed-in-service date of the subject building. Upon such date, the commenter suggested that the final regulations retroactively treat (i) the work-in-progress property as qualified opportunity zone business property, and (ii) the trade or business as engaged in a section 162 trade or business beginning on the first day of the investment by the QOF in the trade or business and throughout the project's construction period.

The Treasury Department and the IRS appreciate the commenter's recommendation and are sympathetic to the commenter's concern regarding the existing business practice of using debt to finance construction. However, section 1397C(e) clearly treats as NQFP any debt with a term greater than 18 months. Based on the text of section 1397C(e), the final regulations do not adopt the commenter's request to provide a special safe harbor for debt-financed construction projects.

5. Consequence of Failure To Qualify for a 31-Month Working Capital Safe Harbor

The Treasury Department and the IRS received comments requesting clarification with regard to the consequences that would result if a trade or business fails to satisfy the requirements for a 31-

month working capital safe harbor, including the imposition of penalties. In general, if a qualified opportunity zone business fails to satisfy the conditions for applying a 31-month working capital safe harbor, then the qualified opportunity zone business must satisfy the requirements of section 1400Z-2 and the 1400Z-2 regulations for qualifying as a qualified opportunity zone business in the absence of the safe harbor. Such failure could cause a QOF to fail to satisfy the 90-percent investment standard, which would result in penalties to the QOF as provided under section 1400Z-2 and the section 1400Z-2 regulations.

P. Real Property Straddling QOZ and Non-QOZ Census Tracts

To determine whether a QOZ is the location of services, tangible property, or business functions for purposes of satisfying the requirements of section 1400Z-2(d)(3)(A)(ii), proposed § 1.1400Z2(d)-1(d)(5)(viii) provided that section 1397C(f) applies, substituting the term "QOZ" for the term "empowerment zone" in each instance in which the term "empowerment zone" appears. In addressing the circumstance in which a business owns real property that is located in more than one census tract, only one of which is a QOZ, proposed § 1.1400Z2(d)-1(d)(5)(viii) provided that if (1) 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 (square footage test); and (2) 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.

1. Consideration for Eliminating Proposed Square Footage Test

Several commenters praised the Treasury Department and the IRS for allowing real property that straddles census tracts to be treated as located within a QOZ for purposes of determining whether the QOZ should be treated as the location of services, tangible property, or business functions. However, one commenter suggested that the proposed square footage test be eliminated. The commenter reasoned that only property located entirely within the geographic borders of a QOZ should be treated as within a QOZ because section 1400Z-2 was enacted to increase investment and business activity in QOZ, rather than non-QOZ census tracts. That commenter further contended that, if the proposed square footage test were to be finalized, at least 75 percent of the square footage or value of the property should be located in the QOZ, with an allocation of capital gains and profits to the property located within the QOZ.

The Treasury Department and the IRS decline to adopt the commenter's recommendations. With regard to the commenter's suggestion to eliminate the proposed square footage test, the Treasury Department and the IRS note that parcels of real property commonly extend across census tract lines, particularly in highly populated areas. As a result, the Treasury Department and the IRS have determined that guidance addressing such situations would provide flexibility for potential investors in QOZs, and therefore is consistent with the underlying policy of section 1400Z-2. Based on the same rationale for providing appropriate flexibility to QOF investors and encourage additional investment within QOZs, the Treasury Department and the IRS decline to adopt the commenter's suggestion to require that at least 75 percent of the square footage or value of the real property be located in the QOZ in order for real property to be treated as wholly located within the QOZ.

2. Clarification Regarding Applicability of the Unadjusted Cost Test

A number of commenters noted that the preamble to the May 2019 proposed regulations set forth an unadjusted cost test, rather than the square footage test, to determine whether property that straddles QOZ and non-QOZ census tracts would be treated as located within a QOZ (unadjusted cost test). See 84 FR 18652, 18658 (May 1, 2019) (setting forth the unadjusted cost test); proposed § 1.1400Z2(d)-1(d)(5)(viii) (setting forth the square footage test). These commenters highlighted the relative strengths of each of these tests, and the flexibility afforded by multiple approaches for taxpayers with land that straddles QOZ and non-QOZ census tracts. The Treasury Department and the IRS acknowledge that both tests would provide helpful guidance such taxpayers and accordingly have revised the final regulations to include both the square footage test and the unadjusted cost test.

3. Consideration of Revisions to the Square Footage Test and the Unadjusted Cost Test and Additional Safe Harbors

The Treasury Department and the IRS received numerous comments and recommendations regarding the square footage test and the unadjusted cost basis test, including rules that would govern the application of such tests in certain circumstances. For example, one commenter suggested that, with regard to real property acquired as a single parcel, the final regulations should apply the unadjusted cost test and set forth a presumption that unadjusted cost is allocated based on the area of the real property located inside, as compared to outside, the QOZ. In applying this presumption to buildings, however, the commenter suggested that the final regulations should apply the square footage test.

The Treasury Department and the IRS also received several recommendations regarding appropriate thresholds for the safe harbor tests. For instance, one commenter requested that the final regulations provide a rule to treat real property located in a QOZ as substantial, as compared to real property located outside of a QOZ, if more than 50 percent of the total square footage of real property is located inside of the QOZ. Another commenter suggested that the percentage of property located in a QOZ should be increased to at least 75 percent of the total square footage of the property. A third commenter suggested that the final regulations provide a safe harbor to treat real property located within a QOZ as substantial if more than 50 percent of the real property is located in the QOZ, as measured by square footage, unadjusted cost, fair market value, or other types of quantitative measures. The commenter indicated that such quantitative measures might reference the occurrence of business activities conducted on the portion of the real property located inside of the QOZ that are integral to the business activities conducted on the portion of real property located outside of the QOZ.

The Treasury Department and the IRS have determined that the square footage test and the unadjusted cost test provide appropriate levels of flexibility for owners of property that straddles QOZ and non-QOZ census tracts. While adoption of the commenters' recommendations would increase the degree of guidance available to owners of such parcels, the Treasury Department and the IRS have concluded that the complexity resulting from adoption of these recommendations would outweigh their intended benefits. As a result, the final regulations do not adopt the commenters' recommendations.

4. Requested Clarification for Applying the Unadjusted Cost Test to Leased Property

One commenter requested clarification in applying the unadjusted cost test to leased property. Under proposed § 1.1400Z2(d)-1(d)(3)(ii)(B)(3), to determine the value of tangible property owned by a qualified opportunity zone business for purposes of the 70-percent tangible property standard, the unadjusted cost basis of the property under section 1012 may be used. For tangible property leased by a qualified opportunity zone business to meet the requirements of section 1400Z-2(d)(3)(A)(i), a taxpayer may use the methodology in proposed § 1.1400Z2(d)-1(d)(3)(ii)(B)(4). Because the unadjusted cost of real property may be used to determine whether property located inside of a QOZ is substantial relative to property located outside of a QOZ, the commenter requested clarification on which method to use.

The Treasury Department and the IRS acknowledge that such guidance could benefit taxpayers and practitioners in applying these rules. However, because the valuation methodology in proposed § 1.1400Z2(d)-1(d)(3)(ii)(B)(4) is used to value property to meet the statutory requirements for the 70-percent tangible property standard, the Treasury Department and the IRS decline to apply these methodologies for all purposes. Accordingly, qualified opportunity zone businesses may use only the square footage test or the unadjusted cost test, to determine if the subject property is located substantially within a QOZ when property straddles QOZ and non-QOZ tracts. The method chosen must be applied consistently throughout the holding period under section 1400Z-2(d)(2)(D)(iii) for such property.

5. Requested Clarification Regarding Contiguous Requirement for Straddle Property

A number of commenters requested clarification regarding the requirement that real property located outside of a QOZ be contiguous to all or part of the real property located inside the QOZ. Some commenters requested that the contiguity requirement be relaxed in the following circumstances: (1) Two or more parcels of real property that are not contiguous because they are separated by public property, such as a road or a sidewalk; and (2) two or more parcels of real property that are not contiguous because a third-party owns a right that burdens the bordering area between the two tracts, such as an easement or other right-of-way. Similarly, commenters have recommended that the contiguity requirement be treated as satisfied in cases in which a development project that is located outside of a QOZ, but in a location either adjacent to or within a short distance from a QOZ.

The Treasury Department and the IRS appreciate the commenters' request, and agree that the final regulations should clarify and define contiguous property. As a result, the final regulations provide that parcels or tracts of land will be considered contiguous if they possess common boundaries, and would be contiguous but for the interposition of a road, street, railroad, stream or similar property. In addition, the final regulations exclude from the definition of the term "common boundaries" boundaries of parcels of land that touch only at a common corner.

6. Extension of Straddle Safe Harbor Principles for Purposes of the 70-Percent Use Test

The Treasury Department and the IRS received multiple recommendations that the final regulations extend the principles of proposed § 1.1400Z2(d)-1(d)(5)(viii) to determine whether

real property is used in a QOZ for the 70-percent use test. A portion of these commenters requested that the extension of these principles apply to QOFs as well as qualified opportunity zone businesses. These commenters contended that QOFs and qualified opportunity zone businesses should be treated similarly in this context to further the policy of introducing new capital investment into QOZs.

For purposes of determining whether real property qualifies as qualified opportunity zone business property, the Treasury Department and the IRS have determined that it would be appropriate to extend the treatment of real property that straddles QOZ and non-QOZ tracts to the 70-percent use test. The final regulations also confirm that this extension of treatment applies to both qualified opportunity zone businesses and QOFs. The extension of this concept provides flexibility for trades or businesses within QOZs, and the Treasury Department and the IRS note that the requirements for substantiality (that is, the square footage and unadjusted cost tests) and contiguity will minimize the occurrence of abusive arrangements.

7. Requested Expansion of QOZ Definition Under Section 1400Z-2

The Treasury Department and the IRS received a comment requesting that the final regulations expand the definition of a QOZ. Specifically, the commenter suggested that the definition of a QOZ be revised to include any census tract in which a development or project is located if (1) the relevant statistics of the census tract meet the criteria that were originally used to identify eligible QOZ tracts; (2) the development or project is located within one-quarter mile of an existing or proposed high-quality transit stop; or (3) the census tract is located directly adjacent to, or within a short distance from, an existing QOZ. For support, the commenter contended that the process to nominate census tracts as QOZs may have omitted other tracts with similar statistical profiles that might have qualified as QOZs if the selection process were to have had a longer duration.

Another commenter recommended that the final regulations expand the QOZ concept by treating certain projects located completely outside a QOZ as though such projects are located within a QOZ. Specifically, the commenter suggested that project components located outside of a QOZ that are connected or necessary to the project components located inside of the QOZ should be treated as if located in a QOZ. For support, the commenter provided examples of industries that rely on natural resources that might be located outside of a QOZ, and may be of limited portability due to their connection to certain geological or topographic land features.

The Treasury Department and the IRS appreciate the commenters' recommendations but decline to incorporate them in the final regulations. With regard to the commenter's request to expand the definition of a QOZ, the Treasury Department and the IRS have determined that such recommendation is not supported by the text of section 1400Z-1, which sets forth the process for QOZ designation. Moreover, the Treasury Department and the IRS note that Rev. Proc. 2018-16, 2018-9 I.R.B. 383, provided additional guidance to the Chief Executive Officers of each state regarding the manner by which certain population census tracts may be designated as QOZs. With regard to the commenter's request to expand the concept of QOZs to include certain projects located entirely outside of QOZs, the Treasury Department and the IRS have determined that the section 1400Z-2 regulations provide appropriate flexibility to facilitate the development of projects and economic activity that extend beyond the geographic boundaries of QOZs. The

commenter's recommendation, if adopted, would exceed that degree of flexibility and in certain cases potentially conflict with locational requirements of section 1400Z-2.

Q. Application of Section 1397C Requirements and Safe Harbors to QOFs

The October 2018 and May 2019 proposed regulations provided safe harbors to address requirements described in section 1397C that trades or businesses must satisfy to qualify as qualified opportunity zone businesses. These safe harbors, including the 31-month working capital safe harbor and the active trade or business safe harbors, did not specifically apply to QOFs. Several commenters requested clarification regarding whether such requirements described in section 1397C for qualified opportunity zone businesses also apply to QOFs. Many commenters suggested that, while QOFs should not be subject to statutory requirements imposed on qualified opportunity zone businesses, QOFs should be permitted to apply safe harbors that address section 1397C requirements. In addition, two commenters suggested that the 31-month working capital safe harbor should be made available to a QOF that otherwise meets the requirements for the safe harbor.

The Treasury Department and the IRS note that the text of section 1400Z-2 does not support the application of the section 1397C requirements to QOFs, but rather limits the application of those requirements to qualified opportunity zone businesses. Consequently, the Treasury Department and the IRS have concluded that any safe harbor made available under the proposed regulations to address a section 1397C requirement imposed on a qualified opportunity zone business likewise should not be extended to QOFs. As a result, the final regulations do not incorporate the commenters' recommendations.

R. Consideration of QOF Reliance Rule Regarding Satisfaction of Qualified Opportunity Zone Business Requirements

Commenters have requested that the final regulations provide a special QOF reliance rule. Such rule would provide that an entity may be treated as a qualified opportunity zone business for the duration of a QOF's ownership of the stock or partnership interest in that entity if, at the time the QOF acquires its interest in the trade or business, (i) the QOF does not have control over the trade or business and (ii) the QOF reasonably expects the entity will satisfy each requirements described in section 1400Z-2(d)(3) to qualify as a qualified opportunity zone business.

The Treasury Department and the IRS note that, for stock or a partnership interest to be treated as qualified opportunity zone property and counted toward the 90-percent investment standard, the trade or business must meet the requirements of section 1400Z-2(d)(3). A QOF is responsible for ensuring that the requirements of section 1400Z-2(d)(3) are met when reporting the value of the QOF's assets on Form 8996. Therefore, the Treasury Department and the IRS decline to accept the commenter's suggestion.

S. Certain Businesses Described in Section 144(c)(6) Not Eligible To Be Qualified Opportunity Zone Businesses

Section 1400Z-2(d)(3)(A)(iii) provides that the term "qualified opportunity zone business" means a trade or business that, in addition to satisfying other requirements described in section 1400Z-2(d)(3)(A), is not a business described in section 144(c)(6)(B) (commonly referred to as a "sin business"). Section 144(c)(6)(B) lists as a sin business any (i) private or commercial golf course, (ii) country club, (iii) massage parlor, (iv) hot tub facility, (v) suntan facility, (vi) racetrack or other facility used for gambling, or (vii) store the principal business of which is the sale of alcoholic beverages for consumption off premises. Section 1400Z-2(d)(1), which sets forth the definitional requirements for a QOF, does not prohibit QOFs from directly conducting section 144(c)(6)(B) sin businesses.

1. Consideration of General Application and Adoption of de minimis Threshold

The Treasury Department and the IRS have received several comments regarding the general application of the sin business prohibition. Many commenters have emphasized that section 1400Z-2 explicitly prohibits qualified opportunity zone businesses from being a sin business, but sets forth no such prohibition for QOFs. These commenters also have noted, however, that section 1400Z-2 does not contain any specific provision that prohibits a qualified opportunity zone business from leasing property to a sin business. In addition, commenters have contended that a de minimis use of property in any sin business should not, on its own, prevent that property from qualifying as qualified opportunity zone business property of a QOF. Similarly, commenters recommended that the final regulations provide rules prohibiting a qualified opportunity zone business from leasing more than a de minimis amount of its property to a sin business. These commenters emphasized that section 1400Z-2(d)(3)(A)(iii) clearly conveyed Congress' intent that a qualified opportunity zone business should not be a sin business, and therefore should not be permitted to circumvent the substance of the sin business prohibition simply through leasing its property to such business.

The Treasury Department and the IRS appreciate all of the comments submitted on this issue. First, the final regulations do not extend the prohibition on sin businesses to the definition of a QOF because, as highlighted by several commenters, section 1400Z-2 explicitly prohibits qualified opportunity zone businesses from operating sin businesses, but sets forth no similar prohibition for QOFs. See section 1400Z-2(d)(3)(A)(iii) (setting forth sin business prohibition for qualified opportunity zone businesses); section 1400Z-2(d)(1) (providing QOF definition). In addition, the Treasury Department and the IRS agree that section 1400Z-2 does not explicitly prohibit a qualified opportunity zone business from leasing its property to a sin business. However, the Treasury Department and the IRS have determined that the purpose of section 1400Z-2(d)(3)(A)(iii) is to prevent qualified opportunity zone businesses from operating sin businesses, which a qualified opportunity zone business nonetheless could carry out simply by leasing such property to a sin business. To ensure that the purpose of section 1400Z-2(d)(3)(A)(iii) is effectuated, the final regulations prohibit a qualified opportunity zone business from leasing more than five percent of its property to a sin business. The Treasury Department and the IRS have determined that this de minimis threshold will reduce the risk of a qualified opportunity zone business inadvertently violating the sin business prohibition.

2. Consideration of Request for Additional Detail Regarding "Sin Business" Qualification

Commenters also requested that the final regulations provide additional detail regarding the spectrum of businesses covered by the descriptions set forth in section 144(c)(6)(B). One commenter requested confirmation that the "alcoholic beverage" restriction be limited to the clear meaning of a traditional "liquor store" that sells alcoholic beverages to customers for consumption off premises, but not to restaurants, wineries, breweries, or distilleries. Another commenter requested clarification that full-service spa facilities operated in hotels and other similar properties do not constitute prohibited sin businesses.

The Treasury Department and the IRS agree with the commenters that additional detail regarding the qualification of a business as a "sin business" would be helpful in certain cases. However, the Treasury Department and the IRS have determined that the rules suggested by the commenters, as well as similar provisions, would inject significant complexity into the final regulations and likely cause additional uncertainty regarding the scope of the term "sin business" due to its inherently factual nature. As a result, the final regulations do not incorporate the commenters' recommendations.

U. Tangible Property That Ceases To Be Qualified Opportunity Zone Business Property

Section 1400Z-2(d)(3)(B) provides a special rule that permits a qualified opportunity zone business to treat tangible property that ceases to be qualified opportunity zone business property as qualified opportunity zone business property for the lesser of five years after (i) the date on which such tangible property ceases to be so qualified, or (ii) the date on which such tangible property is no longer held by the qualified opportunity zone business. The phrase "ceases to be qualified opportunity zone business property" indicates that the tangible property must have been used in a trade or business for a period of time. The Treasury Department and the IRS have determined that tangible property must have been qualified opportunity zone business property used in a trade or business for at least two years.

Therefore, the final regulations provide that a qualified opportunity zone business may apply section 1400Z-2(d)(3)(B) only if the qualified opportunity zone business property was qualified opportunity zone business property used by a qualified opportunity zone business in a QOZ for at least two years. Further, to ensure that only qualified opportunity zone business property used in a qualified opportunity zone business is eligible for the benefits of section 1400Z-2(d)(3)(B), the final regulations provide that the 31-month working capital safe harbor period and the 30-month substantial improvement period pursuant to which tangible property may be treated as qualified opportunity zone business property for purposes of the 70-percent tangible property standard, are not taken into consideration in determining whether property meets the requirements for eligibility under section 1400Z-2(d)(3)(B).

V. Exceptions Based on Location in Which an Entity Is Created, Formed or Organized

The proposed regulations clarified that a QOF must be an entity classified as a corporation or partnership for Federal tax purposes. In addition, a QOF must be created or organized in one of the 50 states, the District of Columbia, or a U.S. territory, or organized under the laws of an Indian tribal government. If an entity is organized in a U.S. territory but not in one of the 50 states or in the District of Columbia, then the entity may be a QOF only if the entity is organized

for the purpose of investing in qualified opportunity zone property that relates to a trade or business operated in the territory in which the entity is organized.

The proposed regulations further clarified that qualified opportunity zone property may include stock or a partnership interest in an entity classified as a corporation or partnership for Federal income tax purposes. In addition, that entity must be a corporation or partnership created or organized in, or under the laws of, one of the 50 states, the District of Columbia, or a U.S. territory, or organized under the laws of an Indian tribal government. If an entity is organized in a U.S. territory but not in one of the 50 states or in the District of Columbia, then an equity interest in the entity may be a qualified opportunity property only if the entity conducts a qualified opportunity zone business in the U.S. territory in which the entity is organized.

The proposed regulations defined a U.S. possession, now referred to as a U.S. territory, to mean any jurisdiction outside of the 50 states and the District of Columbia in which a designated QOZ exists under section 1400Z-1. This definition includes the following jurisdictions: (1) American Samoa, (2) Guam, (3) the Commonwealth of the Northern Mariana Islands, (4) the Commonwealth of Puerto Rico, and (5) the U.S. Virgin Islands.

Certain comments discussed the interaction between the section 1400Z-2 rules and the rules for taxation of controlled foreign corporations (as defined in section 957) (CFCs). One commenter requested the basis for the proposed rule requiring that a QOF be organized in one of the 50 states, District of Columbia, or a U.S. territory, but did not request any change. Other than for clarifying that an entity qualifying as a QOF or qualified opportunity zone business can be organized under the laws of an Indian tribal government, this rule is being finalized without change. This rule was proposed due to the difficulty of tracking whether a foreign entity continuously satisfies the requirements for QOF status. Additionally, a foreign entity may not be subject to Federal income tax; thus, imposing the penalty under section 1400Z-2(f)(1) if the entity fails to maintain the 90-percent investment standard set forth in section 1400Z-2(d)(1) could be difficult. Finally, a foreign entity is unlikely to be a QOF given the requirement that a QOF must invest almost exclusively in QOZs, which must themselves be located only in the United States and U.S. territories.

As noted previously, although a QOF cannot be an entity organized in a foreign country, it can be an entity organized in a U.S. territory. A corporation organized in a U.S. territory is treated as a CFC on a given day if the ownership requirements in section 957 are satisfied on that day. A United States shareholder (as defined in section 951(b)) of a CFC generally includes in gross income, for its taxable year in which or with which the CFC's taxable year ends, its pro rata share of the CFC's subpart F income (as defined in section 952) under section 951(a) (subpart F regime), as well as the United States shareholder's global intangible low-taxed income under section 951A(a) (GILTI regime), which is based on the tested income (as defined in section 951A(c)(2)(A)) of the CFC and other items relevant to determining the amount of the United States shareholder's inclusion in gross income under section 951A(a).

The proposed rules relating to entities organized in U.S. territories are adopted without change.

VI. Comments on and Changes to Proposed § 1.1400Z2(e)-1

Proposed § 1.1400Z2(e)-1 provided rules regarding mixed-funds investments. This part VI of this Summary of Comments and Explanation of Revisions addresses comments regarding proposed § 1.1400Z2(e)-1 as well as comments regarding provisions of section 1400Z-2(e) that were not addressed in the proposed regulations, such as the definition of "related persons" in section 1400Z-2(e)(2). For a discussion of whether certain transactions between investors and QOFs or qualified opportunity zone businesses are treated as transactions between related persons, see part II.A.1.d of this Summary of Comments and Explanation of Revisions.

A. Related Persons and the Step Transaction Doctrine

Section 1400Z-2(e)(2) provides that, for purposes of section 1400Z-2, parties are "related" if their relationship satisfies either section 267(b) or 707(b)(1), with the threshold for relatedness lowered from 50 percent to 20 percent. This definition applies to two categories of transactions. First, eligible gain must arise from a sale or exchange with an unrelated party. See section 1400Z-2(a)(1) and proposed § 1.1400Z2(a)-1(b)(2)(i)(C). Second, in order for tangible property to qualify as qualified opportunity zone business property, a QOF or qualified opportunity zone business must acquire the subject tangible property from an unrelated party. See section 1400Z-2(d)(2)(D)(i)(I) and proposed § 1.1400Z2(d)-1(c)(4)(i)(A). The proposed regulations did not further elaborate on the statutory definition of "relatedness."

One commenter recommended that a sale be considered to take place between unrelated parties for purposes of section 1400Z-2 and the section 1400Z-2 regulations if, as part of an overall plan, the seller and buyer become unrelated in a series of transactions that includes the tested sale. The commenter noted that certain other income tax regulations determine "relatedness" after the last step in a series of related transactions and advocated a similar rule in the section 1400Z-2 regulations.

The Treasury Department and the IRS have determined that all relevant provisions of the Code and general principles of tax law, including the step transaction doctrine, govern the determination whether a transaction is between unrelated parties for purposes of section 1400Z-2 and the section 1400Z-2 regulations. Accordingly, the final regulations do not include a specific step transaction rule as requested by the commenter.

B. Non-Qualifying Investment in a QOF Corporation for Which No Stock Is Received

Commenters requested clarification regarding the treatment of mixed-funds investments in QOF corporations. More specifically, commenters asked for clarification regarding situations in which a shareholder with a qualifying investment in a QOF corporation makes a non-qualifying investment in the QOF but receives no stock in exchange (that is, a meaningless-gesture contribution). One commenter requested confirmation that the shareholder in such situations has a mixed-funds investment, and that the basis in the non-qualifying investment is determined without regard to section 1400Z-2(b)(2)(B). Another commenter questioned whether the shareholder would have two implicit blocks of stock in the QOF, with separate basis determinations and with distributions and redemptions being apportioned between the qualifying and non-qualifying blocks of stock (analogous to the result under the special rules for QOF partnerships discussed in part III.E.1 of this Summary of Comments and Explanation of

Revisions), or whether each share of QOF stock would have an identical basis under general Federal income tax principles.

The final regulations confirm that a meaningless-gesture contribution results in a mixed-funds investment. However, the Treasury Department and the IRS have determined that addressing the foregoing questions regarding basis in a mixed-funds investment in a QOF corporation is beyond the scope of the final regulations. The Treasury Department and the IRS continue to study such issues. See REG-143686-07, 84 FR 11686 (March 28, 2019).

VII. Comments on and Changes to Proposed § 1.1400Z2(f)-1

Proposed § 1.1400Z2(f)-1 prescribed rules for QOFs that fail to maintain the 90-percent investment standard of section 1400Z-2(d)(1) and proposed § 1.1400Z2(d)-1. In particular, proposed § 1.1400Z2(f)-1(b) specified the time period in which proceeds must be reinvested in qualifying property, and proposed § 1.1400Z2(f)-1(c) provided a general anti-abuse rule.

A. Time Period for a QOF To Reinvest Proceeds

1. Reinvestment

Section 1400Z-2(e)(4)(B) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to ensure that a QOF has a reasonable period of time to reinvest the return of capital from investments in qualified opportunity zone property and to reinvest proceeds received from sale or disposition of qualified opportunity zone property. To this end, proposed § 1.1400Z2(f)-1(b) provided that if a QOF received proceeds from the return of capital or the sale or disposition of some or all of its qualified opportunity zone property, and if the QOF reinvested some or all of the proceeds in qualified opportunity zone property by the last day of the 12-month period beginning on the date of the distribution, sale, or disposition, then the proceeds were treated as qualified opportunity zone property in evaluating whether the QOF satisfied the 90-percent investment standard, but only to the extent the proceeds were continuously held in cash, cash equivalents or debt instruments with a term of 18-months or less. Several commenters have requested modifications to this reinvestment rule for QOFs.

In the proposed regulations, the Treasury Department and the IRS requested comments addressing whether an analogous rule for qualified opportunity zone businesses would be beneficial. Multiple commenters have requested an extension of this QOF reinvestment rule to qualified opportunity zone businesses so that certain dispositions of qualified opportunity zone business property would not adversely affect satisfaction of the 70-percent tangible property standard in section 1400Z-2(d)(3)(A)(i). The primary argument for the extension of the QOF reinvestment rule to qualified opportunity zone businesses is that like a QOF, a qualified opportunity zone business may dispose of assets and reinvest proceeds in other qualified opportunity zone business property. These commenters assert that a qualified opportunity zone business in the course of its business operations is more likely to acquire and dispose of assets than the QOF itself.

Because section 1400Z-2(e)(4)(B) specifically directs the Secretary to prescribe regulations relating to the time period for QOFs to reinvest proceeds from the sale of qualified opportunity zone property and does not explicitly refer to qualified opportunity zone businesses, the Treasury Department and the IRS decline to extend this reinvestment concept to similar dispositions by a qualified opportunity zone business. However, qualified opportunity zone businesses may avail themselves of the working capital safe harbor to enable proceeds to qualify as qualified opportunity zone business property.

Proposed § 1.1400Z2(f)-1(b) also provides that the 12-month reinvestment period is tolled while waiting on government action if the QOF has completed the application for action and is awaiting a government response. A commenter requested that the time period for waiting on government action be expanded to 24 months if a state of emergency is declared by the federal government in the jurisdiction in which the qualified opportunity zone property is located. The Treasury Department and the IRS agree that the reinvestment period should be expanded if additional delays are caused by a Federally declared natural disaster, and have modified the rules relating to the reinvestment period to allow for such expansion. However, a QOF must invest proceeds as originally planned before the disaster. For example, if a QOF is unable to invest in a certain qualified opportunity zone business property because the property is located in a Federally declared disaster area, the QOF must invest the proceeds in similar property located in that QOZ.

2. Nonrecognition Provisions and Their Application to Section 1400Z-2

In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments identifying prior examples of tax regulations that would exclude from gross income gain from the sale or disposition of assets held by a QOF or qualified opportunity zone business without an operative statutory nonrecognition provision. Other code sections that permit nonrecognition of income or gain have operative language permitting nonrecognition. In response, one commenter recommended a rule that would exclude from gross income the gain from the disposition of assets by a QOF if the gain was reinvested in "qualifying assets" within a 180-day period after the disposition. In support of this recommendation, the commenter explained that such a rule would encourage reinvestment in assets located in the areas designated as QOZs. A second commenter submitted a similar recommendation with an additional suggestion that to qualify for nonrecognition treatment on the disposition of assets, a QOF or qualified opportunity zone business must satisfy a minimum holding period for the qualified opportunity zone property or qualified opportunity zone business property. Another commenter suggested that nonrecognition treatment for the disposition of QOF or qualified opportunity zone business assets should follow the principles of sections 1031 and 1033. This commenter cited § 1.1031(k)-1 with its qualified intermediary rules as an example of a regulation that expands the scope of the underlying Code section. While the Treasury Department and the IRS understand that such a rule would provide additional benefits for QOFs and qualified opportunity zone businesses, the statutory regime permits gain deferral only at the QOF owner level; section 1400Z-2 does not contemplate nonrecognition of gain arising from transactions at any other level. Consequently, in order for a QOF or qualified opportunity zone business to receive nonrecognition treatment on the disposition of assets, the disposition must qualify for nonrecognition treatment under another provision of subtitle A. Accordingly, the Treasury Department and the IRS do not adopt this recommendation.

B. Land Banking

As provided in Rev. Rul. 2018-29, 2019 I.R.B. 45, and the proposed regulations, land that is purchased and located within a qualified opportunity zone is not subject to either the original use requirement under section 1400Z-2(d)(2)(D)(i)(II) or the substantial improvement requirement under sections 1400Z-2(d)(2)(D)(i)(II) and 1400Z-2(d)(2)(D)(ii). See additional discussion at V.H, and V.I, of this Summary of Comments and Explanation of Revisions. However, in certain circumstances, unimproved land might be held in a manner that is inconsistent with the purposes of section 1400Z-2, such as if a parcel of unimproved land does not receive new capital investment or is not the subject of increased economic activity or output. As a result, the Treasury Department and the IRS have requested and received comments related to the application of the anti-abuse rule under section 1400Z-2(e)(4)(C) to so-called "land banking" and similar arrangements in addition to the general anti-abuse rule in proposed 1.1400Z2(f)-1(c).

Some commenters objected to the use of the term "land banking" to describe the practice of holding land primarily for speculative investment and without an intention to develop a trade or business on that land and similar arrangements. These commenters noted that a commonly used second definition of the term land banking involves certain arrangements whereby a local government may acquire real property and convert the property to productive use, or hold the properties for long-term strategic purposes with the objective of community development rather than to earn a profit. The Treasury Department and the IRS recognize that the use of the term "land banking" in the final regulations may cause confusion with this second definition. In response to this comment, these final regulations do not use the term "land banking" or another alternate term and instead describe the non-qualifying arrangements as holding land for speculative investment.

Several commenters requested that the final regulations explicitly identify the policy reasons that holding land for speculative investment is inconsistent with the purposes of section 1400Z-2. Commenters also requested specific examples of land use that would be abusive under the regulations. Some commenters recommended that specific types of land use be enumerated as per se abusive including long-term holding of vacant land and speculative passive holding of vacant land. Another commenter recommended an anti-abuse rule that would prohibit arrangements that only marginally improve land while providing a significant tax benefit to investors without a clear and direct economic benefit to the community.

Other commenters requested an explicit definition for the arrangements that constitute holding land for speculative investment. Several commenters requested and recommended a standard for the use of land that would be considered abusive. Multiple commenters indicated that such an anti-abuse standard should incorporate the principles of proposed § 1.1400Z2(d)-1(f), which provides that a QOF may not rely on the proposed rules for qualified opportunity zone property in proposed § 1.1400Z2(d)-1(c)(8)(ii)(B) and (d)(4)(ii)(B) if land is unimproved or minimally improved and the QOF or qualified opportunity zone business 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. Regarding the minimal improvement or insubstantial improvement standard, commenters requested that the final regulations include either a bright-line threshold or provide examples of insubstantial improvement to land. In addition to a bright-line threshold for insubstantial improvement, one commenter suggested that

the final regulations require that QOFs or qualified opportunity zone businesses provide a timeline for the improvements to be made on the unimproved land.

One commenter provided an illustration of a potentially problematic fact pattern in which a taxpayer, a QOF or a qualified opportunity zone business, constructs a small shed for use by an attendant on a parking lot and charges customers to park on the lot which is, except for the attendant's shed, vacant land. According to the commenter, this example may represent improvements that fall in the range between insubstantial and substantial improvement and would not be captured by a rule that prohibits the practice of holding unimproved land merely for passive investment due to the profit motivated trade or business activities on the lot. By contrast, referring to a similar fact pattern, another commenter provided an analysis that the proposed regulations were sufficient to thwart speculative land investment of this type. The commenter suggested that there were two existing proposed rules that would apply to such an arrangement (1) the requirement that tangible property must be used in the trade or business of a QOF or a qualified opportunity zone business to be considered qualified opportunity zone business property; and (2) the general anti-abuse rule in proposed § 1.1400Z2(f)-1(c). Under the commenter's analysis, the parking lot fact pattern would meet the trade or business standard; however, under the general anti-abuse rule, a significant purpose of the transaction would be a speculative investment purpose, therefore, the arrangement could be recast.

The Treasury Department and the IRS have provided examples to illustrate the application of the general anti-abuse rule to two fact patterns related to the acquisition of land that multiple commenters have indicated require additional guidance. The first example involves a taxpayer that establishes a parking lot business on a land parcel in a QOZ. The second example involves a taxpayer that acquires farmland, repurposes the land for a different principal business activity, and makes a significant investment of capital and labor into that new business. In the parking lot example, notwithstanding the fact that the business has built small structures on an otherwise empty lot, because a significant purpose for the acquisition of the land is to hold the land for speculative investment, the anti-abuse rule functions to recharacterize the transaction so that the taxpayer may not receive the benefits of section 1400Z-2. By contrast, in the second example, the taxpayer's post-acquisition investment tends to show that land is being used to develop an operating business in the QOZ, rather than merely being held with a minimum level of activity to reap the benefit of appreciation on what is essentially bare land. These examples serve to reiterate the guiding principle that land held for speculative purposes does not further the purposes of section 1400Z-2 and the section 1400Z-2 regulations.

C. General Anti-Abuse Rule

A number of comments addressed the anti-abuse rule of proposed § 1.1400Z2(f)-1(c), which provides that section 1400Z-2 and the 1400Z-2 regulations must be applied in a manner consistent with the purposes of section 1400Z-2. To this end, if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of section 1400Z-2, then the proposed regulations provided that the Commissioner can recast a transaction to achieve consistency with the purposes of section 1400Z-2. The determination of whether a tax result is inconsistent with the purposes of section 1400Z-2 requires a facts and circumstances analysis.

Many commenters requested an articulation of the purposes of section 1400Z-2 to assist taxpayers in avoiding a recast of their transaction. The Treasury Department and the IRS have determined that the purposes of section 1400Z-2 and the section 1400Z-2 regulations are to provide specified tax benefits to owners of QOFs to encourage the making of longer-term investments, through QOFs and qualified opportunity zone businesses, of new capital in one or more QOZs and to increase the economic growth of such QOZs. Therefore, these purposes have been included in the text of the anti-abuse rule in the final regulations.

Another commenter requested a safe harbor from the anti-abuse rule for failure to comply with the rules, where the entity's efforts are in good faith. The Treasury Department and the IRS disagree that the purposes of section 1400Z-2 are so elusive that a good faith attempt to comply with the rules would be subject to the anti-abuse rule. As stated previously, the purposes of section 1400Z-2 and the section 1400Z-2 regulations are to provide specified tax benefits to owners of QOFs to encourage the making of longer-term investments, through QOFs and qualified opportunity zone businesses, of new capital in one or more QOZs and to increase the economic growth of such QOZs. Accordingly, the Treasury Department and the IRS decline to provide a good faith exception.

Several commenters requested enumeration of specific instances of per se abuse. Items that might be on this list include: Non-qualifying investments; a specific rule to ensure that taxpayers do not exploit the inventory safe harbor to evade the 90-percent investment standard for QOFs or the 70-percent tangible property standard; and a rule, similar to an "anti-stuffing" rule, that establishes that certain transactions undertaken to qualify property as qualified opportunity zone property, but with transitory effect, would be deemed abusive.

Other commenters suggested adding to the list of per se abuses activities that would be harmful to the community in which the QOF or qualified opportunity zone business operates, such as dramatically increased rents, a high number of tenant evictions, lack of direct or sustained community benefit, and activities not vetted by community or local government and that result in a dislocation of community residents. To this end, several commenters suggested that QOFs and qualified opportunity zone businesses identify, ex ante, one or more beneficial community outcomes that the QOF and qualified opportunity zone businesses intend to achieve. These outcomes would include creating quality jobs, developing affordable housing, and investing in community facilities that benefit low-income residents of the community. One commenter recommended a safe harbor from the anti-abuse provision for QOFs that receive third party certification demonstrating the QOF's public benefit. The commenter cited benefit corporation legislation and standards under the Small Business Administration as precedent for this approach.

The Treasury Department and the IRS are appreciative of the comments received on the anti-abuse provision. Accordingly, several examples of the operation of the general anti-abuse rule have been included in the final regulations.

VIII. Comments on and Changes to Proposed § 1.1400Z2(g)-1

Proposed § 1.1400Z2(g)-1 prescribed rules regarding the Federal income tax treatment of QOFs owned by members of consolidated groups.

A. Section 1400Z-2 and the Consolidated Return Regulations

As discussed in part II.A.1 of this Summary of Comments and Explanation of Revisions, section 1400Z-2 and the section 1400Z-2 regulations permit the deferral of eligible gain when a taxpayer makes a qualifying investment in a QOF. The deferred gain is tracked by the taxpayer's basis in its qualifying investment and is included in gross income upon an inclusion event.

Section 1501 provides that an affiliated group of corporations, as defined in section 1504, may elect to file a consolidated income tax return. The regulations under section 1502 provide rules applicable to consolidated groups. Many of the consolidated return provisions aim to treat members of a consolidated group as a single entity. For example, the investment adjustment rules under § 1.1502-32 affect the determination of members' basis in the stock of subsidiary members. The purpose of the investment adjustment rules is to treat the consolidated group as a single entity by ensuring that members' items of income, gain, deduction, and loss are taken into account by the tax system once, and only once.

As stated in the preamble to the May 2019 proposed regulations, the respective frameworks of section 1400Z-2 and the consolidated return regulations are incompatible in many respects. The preamble emphasized that special rules would be required to harmonize the policy objectives of sections 1400Z-2 and 1502; for example, special rules would be required under §§ 1.1502-13, 1.1502-19, and 1.1502-32. For this reason, among others, the Treasury Department and the IRS proposed treating stock of a QOF C corporation as not stock for purposes of section 1504. Accordingly, under the May 2019 proposed regulations, a QOF C corporation could be the common parent of a consolidated group but could not be a subsidiary member of the consolidated group. However, the Treasury Department and the IRS requested comments on whether the burden of potentially applying two different sets of consolidated return rules would be outweighed by the benefits of permitting QOF C corporations to be subsidiary members of consolidated groups.

The Treasury Department and the IRS received numerous comments regarding the consolidated return rules in the May 2019 proposed regulations. For example, as a procedural matter, commenters recommended moving these rules to the regulations under sections 1502 and 1504. The Treasury Department and the IRS agree with this recommendation and have moved the rules regarding the Federal income tax treatment of QOFs owned by members of consolidated groups from § 1.1400Z2(g)-1 to §§ 1.1502-14Z and 1.1504-3.

Part VIII.B.1 of this Summary of Comments and Explanation of Revisions sets forth summaries of the comments received with respect to the consolidated return rules in the May 2019 proposed regulations. The remainder of part VIII of this Summary of Comments and Explanation of Revisions provides the responses of the Treasury Department and the IRS and describes the revisions adopted in the final regulations.

B. QOF C Corporation as a Subsidiary Member of a Consolidated Group

1. Comments on Consolidating Subsidiary QOF C Corporations

Commenters requested generally that QOF C corporations be permitted to join in the filing of consolidated income tax returns as subsidiary members. The commenters maintained that, if consolidation of subsidiary QOF C corporations were permitted, investors would possess greater flexibility to structure and manage qualifying investments, which would result in increased investment in QOZs. Consistent with the preamble to the May 2019 proposed regulations, commenters acknowledged that, if a QOF C corporation could be a subsidiary member of a consolidated group (QOF member), special rules might be needed under § 1.1502-13 (regarding intercompany transactions), § 1.1502-19 (regarding excess loss accounts, or ELAs), and § 1.1502-32 (regarding stock basis adjustments). In particular, commenters suggested adopting rules similar to the rules in proposed § 1.1400Z2(b)-1(e)(4) for pass-through entities to resolve complications arising from the interaction of section 1400Z-2 and § 1.1502-32.

Commenters also suggested alternatives to a blanket permission for QOF corporations to be subsidiary members of a consolidated group. For example, some commenters requested that subsidiary QOF C corporations formed as members of, or acquired by, a consolidated group prior to the publication of the May 2019 proposed regulations (pre-existing QOF subs) be permitted to continue as QOF members. Commenters argued that, even if the Treasury Department and the IRS decline to generally allow the consolidation of subsidiary QOF C corporations, grandfathering these pre-existing QOF subs would be appropriate. Those commenters stressed that many taxpayers had evaluated, structured, and completed transactions prior to the issuance of the May 2019 proposed regulations based on the assumption that subsidiary QOF C corporations could join in the filing of consolidated returns. One commenter suggested that QOF members formed within a reasonable grace period after the issuance of the May 2019 proposed regulations also be grandfathered.

As a second alternative, commenters requested that taxpayers be allowed to convert their QOF members into partnerships and treat those entities as partnerships retroactive to the date of the qualifying investment. These commenters also requested that the final regulations provide rules to ensure that such restructuring would not constitute an inclusion event. Similarly, commenters requested that taxpayers be allowed to retroactively treat a QOF C corporation either as a nonmember of a consolidated group or as a member of the consolidated group that is not a QOF.

Commenters also requested rules detailing the consequences of deconsolidating pre-existing QOF subs if the Treasury Department and the IRS decline to allow pre-existing QOF subs to remain members of the consolidated group. The commenters requested that the deconsolidation event not be treated as an inclusion event and suggested multiple approaches with regard to stock basis adjustments, ELA inclusions, application of the unified loss rule, and other issues on deconsolidation.

2. Election To Consolidate a Subsidiary QOF C Corporation

As discussed in part VIII.B.1 of this Summary of Comments and Explanation of Revisions, commenters requested that subsidiary QOF C corporations be permitted to join in the filing of consolidated returns while acknowledging that additional rules may be required to harmonize the operation of section 1400Z-2 and the consolidated return regulations. In response to these comments, the final regulations permit the consolidation of subsidiary QOF C corporations, subject to certain conditions. The final regulations also include special rules to coordinate the

simultaneous application of section 1400Z-2 and the consolidated return regulations to QOF members.

a. Conditions To Consolidate a Subsidiary QOF C Corporation

These final regulations permit the consolidation of a subsidiary QOF C corporation only if certain conditions are satisfied. Specifically, except in very limited circumstances, and consistent with the general principles of section 1400Z-2, the consolidated group member that makes the qualifying investment in the QOF member (QOF investor member) must maintain a direct equity interest in the QOF member. In addition, the final regulations require all QOF investor members to be wholly owned, directly or indirectly, by the common parent of the consolidated group. The Treasury Department and the IRS have determined that these conditions will help preserve the integrity of the consolidated return regulations and ensure that taxpayers apply section 1400Z-2 and the section 1400Z-2 regulations in a manner consistent with the policies underlying section 1400Z-2 and the consolidated return regulations.

Failure to satisfy either of the foregoing conditions for consolidation will result in the deconsolidation of the QOF member. Part VIII.B.4 of this Summary of Comments and Explanation of Revisions describes the Federal income tax consequences of deconsolidation of a QOF member.

i. Direct Ownership Requirement

Section 1400Z-2 sets forth a general requirement that a QOF owner must retain its direct qualifying investment in a QOF in order to retain the benefits of that section. See § 1.1400Z2(b)-1(c) and part III. A of this Summary of Comments and Explanation of Revisions; see also the preamble to the May 2019 proposed regulations. Accordingly, to consolidate a subsidiary QOF C corporation, the investor member generally must retain direct ownership of the QOF stock of the QOF member (QOF member stock). In addition, the QOF investor member generally is subject to the same rules regarding inclusion events as an investor in a non-member QOF. However, the final regulations provide a limited exception for certain transfers of QOF member stock that are treated as intercompany transactions and are eligible for single-entity treatment. See part VIII.C.3 of this Summary of Comments and Explanation of Revisions for a discussion of this limited exception.

The direct ownership requirement is not a section 1502-specific rule, for this requirement generally applies outside of consolidation as well. The operation of the section 1400Z-2 rules requires close monitoring of a QOF owner's basis in the qualifying investment. See generally part III. G of this Summary of Comments and Explanation of Revisions. Moreover, as noted in the preamble to the May 2019 proposed regulations, application of the investment adjustment rules of § 1.1502-32 results in substantial and ongoing stock basis adjustments to QOF member stock that are unrelated to the rules and policies of section 1400Z-2 and that complicate the operation of section 1400Z-2 in the consolidated group context. In addition, the transfer of QOF member stock between consolidated group members, and across ownership chains, further increases the complexity of appropriately tracking the QOF investor member's basis in its QOF member stock. Therefore, the Treasury Department and the IRS have determined that applying the general rule in § 1.1400Z2(b)-1(c) (regarding dispositions of qualifying investments) inside

the consolidated group, by imposing the direct ownership requirement on the QOF investor member, would simplify the administration of section 1400Z-2 to QOF members. But see part VIII.C.3 of this Summary of Comments and Explanation of Revisions for a discussion of an exception to the general rule for certain intercompany sales of qualifying investments.

ii. Wholly Owned QOF Investor Member

The requirement that each QOF investor member itself be wholly owned, directly or indirectly, by the common parent of the consolidated group further serves to prevent uneconomic or other inappropriate outcomes that otherwise might be achieved through the interaction of sections 1400Z-2 and 1502.

Under the general affiliation rules, to be a member of a consolidated group, an includible corporation need not be wholly owned. Instead, only 80 percent of the vote and value of the stock of an includible corporation must be owned directly by other consolidated group members. Therefore, an includible corporation that is owned 80 percent by members of a consolidated group and 20 percent by non-members can be a member of the consolidated group (80/20 member).

The final regulations impose a stricter requirement for the ownership of QOF investor members to ensure the application of the inclusion rules of section 1400Z-2(b) conforms to the policy underlying section 1400Z-2. As emphasized in part III. G of this Summary of Comments and Explanation of Revisions, the application of key provisions under section 1400Z-2 depends upon a close monitoring of the basis of the qualifying investment in the hands of the QOF owner. If QOF investor members were not required to be wholly owned, a consolidated group effectively could alienate and monetize a substantial portion of its qualifying investment by selling shares in QOF investor members or in higher-tier members in a QOF investor member's ownership chain, but the consolidated group would continue to enjoy section 1400Z-2 benefits because direct ownership of the qualifying investment would not change hands. The requirement that each QOF investor member be wholly owned, directly or indirectly, by the common parent also limits incongruities in the application of § 1.1502-32 to an ownership chain that includes a QOF member. Both of these issues are discussed later in this part VIII.B.2.a of this Summary of Comments and Explanation of Revisions.

Under § 1.1502-76(b), a consolidated group includes in its computation of taxable income all income, gain, deduction, and loss items of a consolidated group member, regardless of the percentage of the member's stock that is directly or indirectly (economically) held by the common parent. However, under § 1.1502-32, the investment adjustments that are made to the stock of that member (and up the chain through tiers of stock ownership to the common parent) reflect only the pro rata stock ownership held at each tier. For example, assume that the common parent owns 80 percent of another member (R) (an 80/20 member), which owns 80 percent of the QOF investor member (also an 80/20 member), which wholly owns the QOF member. In that case, the consolidated group's use of a \$100 loss of the QOF member would result in an \$80 reduction of basis in the stock of the QOF investor member held by R, but only a \$64 reduction of basis in the stock of R held by the common parent. Adding a third 80/20 member to the QOF member's ownership chain would result in a 51 percent indirect interest, and adding a fourth 80/20 member would result in a 41 percent indirect interest, thereby further reducing the extent

to which the QOF member's tax items used by the consolidated group are reflected in stock basis up the chain.

The facial incongruity between the full inclusion of taxable items and the pro rata adjustment to stock basis generally does not upset the equilibrium of the consolidated return system because the rules apply to income and gain as well as deduction and loss items. In other words, even though a consolidated group may receive an overstated benefit in the case of loss and deduction items (that is, full use of a member's loss with only a pro rata decrease in the basis of the member's stock), the consolidated group also must take into account all of a member's income despite holding less than all of the member's stock (and getting only a pro rata increase in the basis of the member's stock). Over the course of years, this situation generally will remain in balance.

However, the interaction of the foregoing rules with the rules under section 1400Z-2 upsets this balance in the case of 80/20 members with outside investors. In fact, the exclusion of gain under section 1400Z-2(c) upon the sale or exchange of a qualifying investment not only ensures that there will be no balancing over the course of years, but also may offer opportunities to magnify the imbalance.

The Treasury Department and the IRS are aware that, outside of consolidation, taxpayers can monetize the value of a qualifying investment by selling an indirect interest in the QOF (that is, stock in the QOF owner). However, in that case, the QOF owner would retain all of its ownership of the qualifying investment. Because the consolidated group computes its taxable income and tax liability as a single entity (headed by the common parent), the sale of a portion of the indirect interest in the QOF member out from under the common parent is the functional equivalent of a non-consolidated QOF owner disposing of part of its qualifying investment. Therefore, these regulations require that the QOF investor member be wholly owned, directly or indirectly, by the common parent.

b. Effects of Consolidating a Subsidiary QOF C Corporation

The preamble to the May 2019 proposed regulations noted, and commenters have acknowledged, that allowing a QOF C corporation to become a subsidiary member of a consolidated group would necessitate the imposition of special rules. In addition to the requirements for consolidation of a QOF member discussed in part VIII.B.2.a of this Summary of Comments and Explanation of Revisions, these final regulations add special rules that coordinate the application of the consolidated return provisions and the rules in section 1400Z-2 by imposing restrictions on the application of the full range of consolidated return rules. The Treasury Department and the IRS have determined that this approach is preferable to the alternative-creating a complex set of parallel consolidated investment adjustment rules and intercompany transaction rules applicable to QOF member stock and transactions by QOF members.

First, as stated in the preamble to the May 2019 proposed regulations, a special rule is needed to effectuate and harmonize the ELA rules under § 1.1502-19 and the rules of section 1400Z-2. Section 1.1502-19 allows a consolidated group to use tax attributes of a member (M) in excess of the consolidated group's investment in M without recognition of gain. Instead, members owning M stock must track the negative basis (that is, the ELA) in their M shares and must include the

ELA in income upon the occurrence of specified events, including the disposal of M stock. However, upon a sale or exchange of a qualifying investment, section 1400Z-2(c) permits an investor that has held its qualifying investment for at least 10 years to elect to treat its basis in the qualifying investment as equal to fair market value. Thus, an investor may eliminate the appreciation on its qualifying investment by making the election under section 1400Z-2(c). As further noted in the preamble to the May 2019 proposed regulations, the existence of negative stock basis is unique to the consolidated return regulations and is not contemplated by section 1400Z-2. Accordingly, these final regulations include a rule under which the investor member must take its ELA into account pursuant to § 1.1502-19 before its basis in the QOF member stock is adjusted to fair market value under section 1400Z-2(c).

Second, the final regulations include a special rule to determine when a distribution by a QOF member to the QOF investor member constitutes an inclusion event. Generally, as provided in § 1.1400Z2(b)-1(c)(8), a distribution by a QOF C corporation is an inclusion event to the extent section 301(c)(3) applies to the distribution. In a consolidated group, intercompany distributions are governed by the rules in § 1.1502-13(f), and distributions in excess of the distributee's basis in the distributor do not result in income to the distributee under section 301(c)(3); rather, the excess amount creates or increases the distributee's ELA in the distributor stock. Thus, to coordinate the application of section 1400Z-2 and the consolidated return rules, these final regulations provide that a distribution by a QOF member to a QOF investor member is an inclusion event to the extent the distribution otherwise would create or increase an ELA in the QOF member stock.

Third, the final regulations include a special rule for computing the amount includible by an investor member upon the occurrence of an inclusion event. Generally, the amount includible under section 1400Z-2(b)(2) is determined by reference to the investor's basis in the qualifying investment. However, when a subsidiary QOF C corporation is a member of a consolidated group, § 1.1502-32 applies to adjust the QOF investor member's basis in the stock of the QOF member to reflect the QOF member's income, gain, deduction, or loss. The preamble to the May 2019 proposed regulations raised the issue of how to properly determine the QOF investor member's amount includible when its basis in the QOF member includes basis adjustments unrelated to section 1400Z-2.

Commenters recommended that the final regulations adopt rules similar to those for pass-through entities to compute the QOF investor member's amount includible under section 1400Z-2. The investment adjustment rules under § 1.1502-32 are similar to the partnership basis provisions of section 705, and these final regulations adopt rules similar to the special rule for pass-through entities in § 1.1400Z2(b)-1(e)(4). The Treasury Department and the IRS have determined that the adoption of this rule to compute the QOF investor member's amount includible, in conjunction with the imposition of certain conditions for consolidation (as discussed in part VIII.B.2.a of this Summary of Comments and Explanation of Revisions), will avoid many complexities in the application of the inclusion rules of section 1400Z-2 within a consolidated group.

Fourth, the final regulations include a special rule applicable to transactions between the QOF's separate affiliated group (QOF SAG) and other members of the consolidated group. A QOF SAG is, with respect to a QOF member, the affiliated group that would be determined under section 1504(a) if the QOF member were the common parent. The final regulations treat a sale or exchange of property between a QOF SAG member and a member of the consolidated group that

is not a member of such QOF SAG as a transaction that is not an intercompany transaction. Conversely, transactions between QOF SAG members, and transactions between a QOF SAG member and a member of the consolidated group that is not a member of such QOF SAG other than a sale or exchange of property, are intercompany transactions that are subject to the rules of § 1.1502-13.

This rule is necessary to effectuate the application of section 1400Z-2 in a consolidated group. As noted previously in this part VIII.B.2.b of this Summary of Comments and Explanation of Revisions, the election under section 1400Z-2(c) potentially allows taxpayers to permanently exclude their gain on a qualifying investment held for at least 10 years. The availability of this benefit places additional import on ensuring that the gain excluded as a result of the election under section 1400Z-2(c) is not inflated by bargain sales within the consolidated group. Treating property transactions between the QOF SAG and other members as currently taxable helps ensure that any such transactions are bona fide, arm's-length transactions. This treatment also is consistent with treating the QOF as a separate entity for purposes integral to the rules of section 1400Z-2 (for example, treating a contribution to a QOF member as a qualifying investment).

Fifth, the final regulations provide that a consolidated group is not treated as a single entity for purposes of determining whether a QOF member or a qualified opportunity zone business satisfies the investment standard rules in section 1400Z-2(d) and (f) and §§ 1.1400Z2(d)-1 and 1.1400Z2(f)-1. Instead, these rules generally apply separately to each consolidated group member that is a QOF or qualified opportunity zone business. For example, in measuring whether a QOF member meets the 90-percent investment standard, only property (including qualified opportunity zone stock or qualified opportunity zone partnership interests) owned by the QOF member itself is taken into account. To preserve the separate-entity treatment of the QOF, the QOF member cannot take into account property transferred to a member of the consolidated group that is not a member of the QOF member's QOF SAG in satisfying the requirements in section 1400Z-2(d). This issue was identified in the preamble to the May 2019 proposed regulations. See also the discussion of the inapplicability of the intercompany transaction regulations to property transactions between QOF members and certain other consolidated group members in this part VIII.B.2.b of this Summary of Comments and Explanation of Revisions.

c. Anti-Avoidance Rule

As discussed in parts VIII.A, VIII.B, and VIII.C.2 of this Summary of Comments and Explanation of Revisions, the interactions between the consolidated return regulations and section 1400Z-2 are novel and complex, particularly for QOF members whose consolidation is allowed under these final regulations in response to comments received on the May 2019 proposed regulations. In response to comments, these final regulations also make single-entity treatment available for purposes of section 1400Z-2 following certain transfers of qualifying investments, including deemed transactions, between members of a consolidated group. To prevent inappropriate interactions between the two sets of rules, certain consolidated return regulations have been made inapplicable in relation to QOF members and qualifying investments transferred between consolidated group members, and the application of other consolidated return rules has been modified. However, due to the novelty of the interactions between the rules, the Treasury Department and the IRS are concerned that additional, unanticipated issues may

arise from those interactions, which might be exploited to produce results that violate the purposes underlying section 1400Z-2 or the consolidated return regulations.

To be responsive to comments received but still provide the flexibility necessary to obtain an appropriate balancing of the purposes underlying section 1400Z-2 and the consolidated return rules, these final regulations include an anti-avoidance rule. This rule provides that, if a transaction is structured with a view to avoiding the application of the rules of section 1400Z-2 and the section 1400Z-2 regulations or the consolidated return regulations (including section 1.1502-14Z), appropriate adjustments will be made to carry out the purposes of section 1400Z-2 and the section 1400Z-2 regulations. For example, if a consolidated group engages in a restructuring (such as a distribution described in section 355) with a purpose to make use of stock basis adjustments under § 1.1502-32 resulting from increases in the basis of stock under section 1400Z-2(b) in a sale or exchange transaction but without disposing of any part of the consolidated group's direct ownership of the relevant qualifying interest, the transaction will be treated as an inclusion event with regard to an appropriate amount of deferred gain.

3. Transition Relief

As discussed in part VIII.B.1 of this Summary of Comments and Explanation of Revisions, commenters requested transition relief for pre-existing QOF subs. The Treasury Department and the IRS have determined that transition relief is appropriate, and these final regulations include multiple elective relief options.

Under the final regulations, a pre-existing QOF sub may elect to be reclassified as a QOF partnership, a QOF C corporation that is not a member of the consolidated group, or a member of the consolidated group that is not a QOF (reclassification election). A reclassification election is effective as of the first day the pre-existing QOF sub was acquired or formed by members of the consolidated group (day one). If a pre-existing QOF sub makes a reclassification election, appropriate adjustments (for example, with respect to basis adjustments under § 1.1502-32 and E&P under § 1.1502-33) must be made to account for the change in status of the pre-existing QOF sub. In addition, if a pre-existing QOF sub was a QOF C corporation before being acquired by a consolidated group, and if the consolidated group elects to treat the pre-existing QOF sub as a QOF partnership as of day one (that is, the date it was acquired by the consolidated group), the conversion from a QOF C corporation to a QOF partnership on day one is an inclusion event. See § 1.1400Z2(b)-1(c)(2).

In the alternative, a pre-existing QOF sub that meets certain conditions may elect to maintain its status as a QOF C corporation and remain a member of the consolidated group. See part VIII.B.2.a of this Summary of Comments and Explanation of Revisions, which describes the conditions for such an election. If a pre-existing QOF sub elects to remain a member of the consolidated group, the pre-existing QOF sub will be subject to unique rules and restrictions not typically applicable to a consolidated group member, as discussed in part VIII.B.2.b of this Summary of Comments and Explanation of Revisions. The pre-existing QOF sub will have 90 days from the date of publication of these final regulations to satisfy the conditions for consolidating as a subsidiary QOF C corporation.

Transition relief is available only to pre-existing QOF subs. QOF C corporations formed after the publication of the May 2019 proposed regulations are not eligible for transition relief, but any such QOF C corporation may elect to be treated as a subsidiary member of a consolidated group. See part VIII.B.2 of this Summary of Comments and Explanation of Revisions for a discussion of the conditions and effects of consolidating a subsidiary QOF C corporation.

4. Deconsolidation of Subsidiary QOF C Corporation

The final regulations also provide rules regarding the deconsolidation of QOF members. Deconsolidation can occur when a QOF member fails to meet the general section 1504 affiliation requirements or fails to satisfy the conditions in these final regulations to consolidate a subsidiary QOF C corporation. In addition, deconsolidation can occur when a pre-existing QOF sub fails to elect in a timely manner one of the transition relief provisions discussed in part VIII.B.3 of this Summary of Comments and Explanation of Revisions.

If a QOF member deconsolidates, the deconsolidation is treated as a disposition for purposes of applying the rule in § 1.1502-19 that requires any ELA in the QOF member's stock to be included in income, and it is treated as a transfer of all of the QOF member stock for purposes of applying the unified loss rule in § 1.1502-36. However, the deconsolidation constitutes an inclusion event only to the extent the deconsolidation event also constitutes an inclusion event as defined in § 1.1400Z2(b)-1(c). For example, if a QOF member deconsolidates because the investor member sells 25 percent of the QOF member stock to a nonmember, the QOF deconsolidates and §§ 1.1502-19 and 1.1502-36 will apply to all QOF shares owned by members, but there will be an inclusion event only for 25 percent of the shares. In addition, if the investor member has positive basis in QOF member stock because of investment adjustments under § 1.1502-32, the investor member retains such basis in the QOF member following deconsolidation, but such basis is not taken into account in computing the investor member's amount includible under section 1400Z-2(b) post-deconsolidation.

A special E&P rule applies if the QOF member deconsolidates before December 31, 2026. The special E&P rule reverses the general rule for deconsolidations in § 1.1502-33(e) to provide that the QOF member retains its E&P, and to require elimination from the consolidated group of any QOF member's E&P taken into account by other members under § 1.1502-33. This special rule will permit the QOF C corporation to make section 301(c)(1) distributions, to the extent of its E&P, following deconsolidation without triggering inclusion of the investor member's remaining deferred gain under section 1400Z-2(b).

5. Treatment of QOF Stock Under Section 1504

The May 2019 proposed regulations treated stock in a QOF C corporation as not stock for purposes of section 1504. As discussed in part VIII. A of this Summary of Comments and Explanation of Revisions, the purpose of this rule was to prevent a subsidiary QOF C corporation from being included as a member of an affiliated group filing consolidated returns. However, commenters noted that, under this proposed rule, the dividends received deduction under section 243 would be unavailable to corporate shareholders of QOF C corporations because qualification for that deduction depends on the distributing corporation and shareholder being part of the same affiliated group. Commenters recommended that, even if the final regulations preclude a

subsidiary QOF C corporation from being a member of an affiliated group for purposes of joining in the filing of a consolidated return, the final regulations should permit a QOF C corporation to be a member of an affiliated group for purposes of the dividends received deduction.

In response to the foregoing comments, these final regulations provide that QOF stock is not treated as stock only for purposes of determining eligibility to join in the filing of a consolidated return under section 1501. Therefore, this rule will not affect the availability of the dividends received deduction or any other provision that cross-references affiliation status under section 1504 other than consolidated group membership.

C. Qualifying Investments by Members of a Consolidated Group

In response to the May 2019 proposed regulations, commenters raised many questions regarding the interaction of the intercompany transaction rules of § 1.1502-13 and section 1400Z-2. For example, commenters asked about the application of § 1.1502-13 when a qualifying investment is transferred in an intercompany transaction. Many of the issues noted by commenters arise regardless of whether the QOF is a member of a consolidated group.

The stated purpose of § 1.1502-13 is to provide rules to clearly reflect the taxable income (and tax liability) of the consolidated group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income or consolidated tax liability. In other words, the existence of intercompany transactions must not affect consolidated taxable income or consolidated tax liability. Therefore, § 1.1502-13 generally determines the tax treatment of items resulting from intercompany transactions by treating members of a consolidated group as divisions of a single entity (single-entity treatment).

1. Investment in QOF Member as Qualifying Investment

As discussed in part VIII.B.1 of this Summary of Comments and Explanation of Revisions, commenters requested that subsidiary QOF C corporations be permitted to join in the filing of consolidated returns. In connection with this request, commenters also sought clarification of the application of § 1.1502-13 to the gain deferred under section 1400Z-2 when an investor member makes an otherwise qualifying investment in a QOF member.

The Treasury Department and the IRS proposed to exclude a subsidiary QOF C corporation from consolidation because, among other reasons, the Treasury Department and the IRS determined that section 1400Z-2 is inconsistent with the intercompany transaction regulations under § 1.1502-13. In particular, the Treasury Department and the IRS highlighted that the stated purpose of the regulations under § 1.1502-13 is to ensure that the existence of an intercompany transaction (a transaction between two members of a consolidated group) does not result in the creation, prevention, acceleration, or deferral of consolidated taxable income or tax liability. Based on comments from taxpayers and practitioners, the Treasury Department and the IRS have considered approaches to provide additional investment structures for potential investors in

QOZs while ensuring the compatibility of such structures with the consolidated return regulations. As a result, the final regulations provide that an investment of eligible gain by the investor member into a QOF member is not treated as an intercompany transaction for purposes of § 1.1502-13 and, thus, is a qualifying investment for purposes of section 1400Z-2.

2. Treatment of S's Intercompany Gain as Eligible Gain

These final regulations also include rules that clarify whether and when capital gain from an intercompany transaction can constitute eligible gain for purposes of section 1400Z-2.

When a member (S) sells property to another member of the consolidated group (B) and recognizes gain, the gain is an intercompany gain subject to § 1.1502-13. The matching rule of § 1.1502-13(c) may apply to redetermine the attributes of S's intercompany gain and to control the timing of the reporting of S's intercompany gain. Commenters requested clarification as to whether S's intercompany gain qualifies as an eligible gain that can be deferred under section 1400Z-2 and, if so, the time at which S is treated as having an eligible gain.

The final regulations clarify that S's gain and B's gain on the property (if any) is treated as eligible gain to the extent the gain would be an eligible gain if S and B were divisions of a single entity. Moreover, the gain is treated as an eligible gain at the time the gain would be taken into account (without regard to the potential application of section 1400Z-2) if S and B were divisions of a single entity.

3. Application of § 1.1502-13 to Intercompany Transfer of a Qualifying Investment

In discussing the complications arising from the interaction of section 1400Z-2 and § 1.1502-13, the preamble to the May 2019 proposed regulations generally focused on issues that would arise if a subsidiary QOF C corporation were a member of a consolidated group. Neither the May 2019 proposed regulations nor the preamble thereto included any language on the general application of § 1.1502-13 to the transfer of qualifying investments. Whether and how § 1.1502-13 applies to an intercompany transfer of a qualifying investment is an issue regardless of whether the QOF is a QOF C corporation or a QOF partnership, and regardless of whether the QOF C corporation is a QOF member.

Commenters detailed the technical impediments under the current intercompany transaction regulations to achieving single-entity treatment when a member of the consolidated group transfers its qualifying investment in an intercompany transaction, and they requested guidance to grant single-entity treatment to a consolidated group after such an intercompany transaction. Commenters also noted that section 1400Z-2(c) does not appear to permit an election for the basis increase to be made by any party other than the taxpayer who makes the qualifying investment.

As discussed in the preamble to the May 2019 proposed regulations, the availability of benefits and the continuation of deferral under section 1400Z-2 are determined with respect to the holder's basis in the qualifying investment. For example, a shareholder's basis in its QOF stock differs from a shareholder's basis in the stock of non-QOF C corporations. Because of the

difficulties in tracking basis for purposes of section 1400Z-2 following the transfer of QOF shares in certain nonrecognition transactions (for example, in exchanges to which section 351 applies or in reorganizations described in section 368(a)(1)(B)), the regulations generally applicable to investors in a QOF C corporation (whether or not the QOF C corporation is a QOF member) provide that the transfer of QOF shares in such nonrecognition transactions is an inclusion event under section 1400Z-2(b).

The same basis tracking issues exist within a consolidated group and are magnified by the application of § 1.1502-32, which adjusts an upper-tier member's basis in the stock of a lower-tier member to reflect items of income, gain, loss, and deduction produced by the lower-tier member. As discussed in part VIII.B.2.a.ii of this Summary of Comments and Explanation of Revisions, basis adjustments to lower-tier member stock "tier up" within a consolidated group under § 1.1502-32. In other words, economic items recognized by lower-tier members result in basis adjustments to the stock of upper-tier members, resulting in blended basis at the upper tiers. Moreover, because an upper-tier member may have economic items of its own, the basis of the upper-tier members' stock is further blended. This blended basis in the consolidated group creates additional tracking issues with regard to section 1400Z-2.

In the interest of administrability and simplicity, the Treasury Department and the IRS decline to impose complex new rules for tracing the basis in a qualifying investment through tiers of entities and across ownership chains within a consolidated group. Instead, to permit the movement of qualifying investments within consolidated groups to satisfy business needs, these final regulations allow consolidated groups to obtain single-entity treatment only on a fully taxable intercompany transfer of a qualifying investment. In a fully taxable transaction, B takes a cost basis in the qualifying investment; thus, S's basis in the qualifying investment is not replicated. As a result, in a fully taxable transaction, the gain deferred under section 1400Z-2 is not replicated in the consolidated group. All other intercompany transfers of qualifying investments are treated as not constituting intercompany transactions for purposes of § 1.1502-13.

As noted earlier in this part VIII.C.3 of this Summary of Comments and Explanation of Revisions, single-entity treatment for intercompany transfers of qualifying investments is not currently available under the consolidated return regulations. The limited application of the intercompany transaction rules in § 1.1502-13 under these final regulations provides consolidated groups with a workable option for making necessary transfers of qualifying investments within the consolidated group while preventing complications under the section 1400Z-2 rules.

To further facilitate single-entity treatment, these final regulations enable B to make an election under section 1400Z-2(c) following a transfer of a qualifying investment that is treated as an intercompany transaction. Specifically, if § 1.1502-13 applies to treat S and B as divisions of a single entity for purposes of section 1400Z-2, then B (and not S) makes the election under section 1400Z-2(c) (if eligible), as it is the member that actually owns an interest in the qualifying investment at the time of its disposition by the single entity. B is eligible to make the election under section 1400Z-2(c) only if and when, treating S and B as a single entity, the single entity would be eligible to make such an election. For example, under single-entity treatment, S and B's holding period in the qualifying investment is combined to determine whether the 10-year requirement for the election under section 1400Z-2(c) has been met.

4. Treating Investment by One Member as Qualifying Investment by Another Member

Under the May 2019 proposed regulations, the requirements in section 1400Z-2 applied separately to each member of a consolidated group. Thus, the same member of the consolidated group must both sell the capital asset giving rise to eligible gain and timely invest the proceeds in a qualifying investment. Commenters argued that this requirement is overly restrictive and may limit the ability of taxpayers to make use of section 1400Z-2 as intended by Congress. Instead, commenters recommended that the Treasury Department and the IRS adopt a single-entity approach that permits a QOF investment by one member to be treated as a qualifying investment by another member with eligible gain. One commenter also requested that this treatment be applied to investments made prior to June 1, 2019, allowing for a one-month grace period following the publication of the May 2019 proposed regulations.

In response to these comments, and to further the purposes of section 1400Z-2, the final regulations include an election to treat the investment by one member (M2) as a qualifying investment by another member (M1). The election is available when M1 has an eligible gain and M2 makes an investment in a QOF that would be a qualifying investment if M1 (rather than M2) had made the investment. If the consolidated group makes this election, for all Federal income tax purposes M1 is treated as making an investment in the QOF and immediately selling the qualifying investment to M2 for fair market value. The sale of the qualifying investment from M1 to M2 is subject to § 1.1502-13, as discussed in part VIII.C.3 of this Summary of Comments and Explanation of Revisions.

The Treasury Department and the IRS decline to adopt the recommendation to treat M2's investment as a qualifying investment by M1 retroactively because such treatment is available only by election, subject to certain conditions. However, taxpayers generally have the option to apply these final regulations in their entirety, and in a consistent manner, to taxable years beginning after December 21, 2017, or to the portion of any taxable year after December 21, 2017. If a taxpayer chooses to adopt these final regulations in their entirety for taxable years beginning after December 21, 2017, or to the portion of any taxable year after December 21, 2017, then taxpayers may elect to treat an investment by M2 as a qualifying investment by M1 as of the earlier date.

IX. Comments Not Specifically on Regulatory Text

A. Reporting

The Treasury Department and the IRS have received hundreds of comments on whether reporting of the QOF and qualified opportunity zone investments was needed, and what type of information should be reported. On May 1, 2019, the Treasury Department published a notice and request for information to seek public input on the development of public information collection and tracking related to investment in qualified opportunity funds. See 84 FR 18648. As indicated in the proposed regulations, the Treasury Department and the IRS were considering certain changes to the Form 8996 requiring QOFs to report additional information regarding the location of their investments.

Several comments suggested that no additional reporting should be required and that the amount of reporting already required was sufficient. Several other comments requested that additional reporting be allowed, but to not be onerous or prohibitive in either cost or time. Other comments suggested that the reporting should be coordinated with other government agencies, such as the Department of Housing and Urban Development (HUD) or the Treasury Department's CDFI Fund, and local and state governments.

Many commenters requested additional reporting, on items such as location of investments, job creation in the QOZ, the impact on the local economy, number of units of affordable housing built, and any reduction in poverty. These comments requested that such information be made public, including a database which the public can use to track projects nationally and the creation of a standardized set of performance metrics. One commenter asked for reporting guidelines for entities that lend capital to QOFs.

The Treasury Department and the IRS are appreciative of the comments received focused on requiring reporting of data in addition to what is useful for tax administration purposes. Comments received in this regard are not adopted in these final regulations. However, On October 30, 2019, the IRS released an early release draft of Form 8996 for public review. The early release draft includes additional reporting requirements for QOFs. The information required to be reported focuses on data useful for tax administration purposes, data that may also be instructive in measuring the impact and effectiveness of the statute.

B. REITs

Several commenters discussed passing the benefits of a REIT's qualifying investments to the REIT's shareholders. These comments include applying the 1400Z-2(c) basis adjustment rules for E&P purposes so that distributions of gain from the disposition of a qualifying investment will not result in ordinary income to the REIT's shareholders. Additionally, the commenters asked that REITs have the ability to distribute tax-exempt capital gain dividends to the extent attributable to the REIT's gain with respect to its qualifying investments. The Treasury Department and the IRS have concluded that such special rules for REITs and their shareholders would create a vehicle in which taxpayers that do not make a qualifying investment for the required period of time pursuant to section 1400Z-2 would nevertheless receive the benefits of that section. Thus, these changes were not accepted. REITs may still qualify and elect to be QOF REITs or may distribute capital gain dividends to their shareholders who in turn may invest those capital gain dividends in a QOF pursuant to section 1400Z-2.

C. Policy

In addition to comments concerning the proposed regulations, several comments were received concerning the tax benefits of the statute. For example, some commenters requested preferred treatment for various classes of individuals and entities, including veterans, healthcare practitioners, needy individuals, and residents of QOZs. Several other commenters requested that the Treasury Department and the IRS should disallow the tax benefits provided by section 1400Z-2 if entities fail to build a sufficient number of affordable housing units. Another commenter suggested that the tax benefits provided by section 1400Z-2 in general should be disallowed if a QOF or qualified opportunity zone business fails to operate solely within a QOZ.

Many commenters requested a rule requiring managers of QOFs to certify that they had not been convicted of financial crimes within the past three years, and register with the local government that they are managing a QOF. Further, many commenters suggested requiring QOF managers to demonstrate that their actions have not encouraged any additional displacement of residents in low income areas. Some commenters were concerned with the impact that QOFs and qualified opportunity zone businesses will have on existing small businesses located within QOZs.

Several commenters requested that the Treasury Department and the IRS require that QOFs and qualified opportunity zone businesses coordinate their activities with other Federal agencies, like HUD, and CDFI Fund, and state and local government and housing agencies. Several others suggested allowing local jurisdictions to add criteria that is consistent with a locality's needs and goals. Two commenters stated that the capital invested in QOFs should be invested in small and midsize businesses, rather than large corporations. Another commenter suggested additional guidance to permit housing finance agencies to layer their programs within QOZs with QOFs or qualified opportunity zone businesses. One commenter requested guidance on using QOF investments to satisfy requirements pertaining to certain depository institutions under the Community Reinvestment Act.

Several commenters requested coordination and integration with local government authorities including measures to coordinate projects within QOZs with other government funded projects and a formal process for local and regional authorities to review projects in QOZs. Another comment suggested that the Treasury Department and the IRS mandate cooperation by QOFs with local community banks to determine who needs the most assistance.

The Treasury Department and the IRS received several comments concerned that QOFs and qualified opportunity QOZ businesses would not benefit the existing residents and businesses in designated QOZs. These commenters suggested adding provisions to the final regulations aimed at the prevention of displacement of residents, and targeted incentives to aid the neediest of QOZs. Several others suggested that the Treasury Department and the IRS require that QOF investments target local businesses with established ties to the local communities and that serve the local community's needs. Another comment requested that preference should be shown to local and/or minority owned businesses, or sustainably focused companies. Finally, a commenter suggested that there should be a requirement that a minimum number of local residents be employed by a QOF or qualified opportunity zone business.

In addition to the comments noted earlier, the Treasury Department and the IRS received comments requesting that certain items, such as food inventory or business related property owned by the residents of QOZs, should qualify as qualified opportunity zone business property.

The Treasury Department and the IRS will continue to study the issues addressed in these comments. However, many of these comments are outside the scope of these final regulations. In addition the Treasury Department and the IRS are concerned with the potential complexity associated with creating rules that would interfere with the ultimate intent of the statute, which is to invest new capital in low-income communities.

D. QOZ Designations

The Treasury Department and the IRS received many comments regarding section 1400Z-1 and the process for designating QOZs. Several comments requested that the determination process be reopened, so new QOZs could be designated. One commenter requested that if no investment has occurred in a QOZ, that accommodation be provided to replace it with another QOZ. Another comment suggested that some designated QOZs either do not meet the statutory requirements or were mistakenly nominated.

The Treasury Department and the IRS are appreciative of the comments received on the designation of the QOZs. Section 1400Z-1 provides the statutory authority for one round of nominations and designations. Thus, there are no current or proposed plans to reopen consideration of additional census tracts to be designated as QOZs.

Several comments were received questioning how QOFs and qualified opportunity zone businesses would be treated after the QOZ designation expires. Another commenter asked for clarification for the treatment of QOFs and qualified opportunity zone businesses if the census tract boundaries change during the designation period. Under the October 2018 proposed regulations and § 1.1400Z2(c)-1(b) of the final regulations, although QOZ designations expire on December 31, 2028, a taxpayer who makes an election under section 1400Z-2(a) and whose holding period in the qualifying investment is at least 10 years, is eligible to make an election described in section 1400Z-2(c) on the sale or exchange of the qualifying investment. Accordingly, if a portion of the taxpayer's 10-year holding period under section 1400Z-2(c) accrues after the relevant census tract's QOZ designation expires on December 31, 2028, this fact alone should not disqualify a taxpayer's properly executed QOF investment from the benefit of section 1400Z-2(c).

E. Questions and Comments on the Penalty Under Section 1400Z-2(f)(1)

Under section 1400Z-2(f)(1), if a QOF fails to meet the 90-percent investment standard, the QOF shall pay a penalty for each month it fails to meet the requirements in an amount equal to the excess of the amount equal to 90-percent of its aggregate assets over the aggregate amount of qualified opportunity zone property held by the QOF, multiplied by the underpayment rate established under section 6621(a)(2) for such month.

Several commenters requested clarification on the mechanics of this penalty, including whether there is a possibility of the QOF, or its investors, of losing the benefits, if the QOF fails to meet the 90-percent investment standard for an extended period of time.

Two other commenters requested that, to calculate the penalty, only the assets that were the subject of the deferral election, should be included. They reason that the statute could be interpreted to assess a QOF based upon a shortfall related to its aggregate assets, regardless of the source of financing for those assets.

One commenter requested that the Treasury Department and the IRS eliminate the testing dates under section 1400Z-2(d)(2)(A) and instead adopt a penalty based on a per month penalty.

Finally, one commenter suggested that the Treasury Department and the IRS should use the anti-abuse provision to create penalties for failing to invest in entities that meet the policy objectives mentioned in a prior section.

The Treasury Department and the IRS appreciate the comments received on the penalty imposed on QOFs under section 1400Z-2(f)(1). All comments will be considered for future guidance.

F. Reasonable Cause

Under section 1400Z-2(f)(3), no penalty shall be imposed on a QOF with respect to any failure to meet the 90-percent investment standard if it is shown that the failure is due to reasonable cause.

Multiple commenters requested clarification on what would constitute reasonable cause. Several commenters requested that reasonable cause should be defined to include circumstances that are outside the QOF's control to deploy capital into qualifying investments. The Treasury Department and the IRS are cognizant that this is an area for which commenters requested relief. The final rules provide a 6 month period in which QOFs may choose to disregard recently contributed property from the 90-percent investment standard. That rule may be elected in circumstances in which a QOF is unable to deploy its capital into qualified opportunity zone property.

Another commenter requested that the final rule provide a non-exhaustive list of circumstances that would constitute reasonable cause. The final rule does not adopt these comments. The determination of whether there is reasonable cause for penalty relief in a particular case is inherently factual. The Treasury Department and the IRS have determined that the appropriate standards for determining whether the reasonable cause exception to the penalty applies in a particular case are the general standards set out in the "Penalty Handbook," which is included in Internal Revenue Manual (IRM) at section 20.1. The Treasury Department and the IRS will consider whether further guidance specific to the penalty under section 1400Z-2(f)(1) is necessary in the future.

G. Regulatory Flexibility Act

The Treasury Department and the IRS received comments on the Regulatory Flexibility Act (5 U.S.C. chapter 6) (RFA) urging that an RFA analysis on the potential significant economic effect of these final regulations on small entities be conducted by the Treasury Department and the Small Business Administration. The Treasury Department and the IRS do not agree that an analysis is required. There is a lack of data as to the extent to which small entities invest in QOFs, will certify as QOFs, or receive equity investments from QOFs. However, the Treasury Department and the IRS project that most of the investment flowing into QOFs will come from large corporations and wealthy individuals, though some of these funds would likely flow through an intermediary investment partnership. There may be some QOFs and qualified opportunity zone businesses that will be classified as small entities; however, the number of small entities significantly affected is not likely to be substantial.

Effective/Applicability Dates

Sections 1.1400Z2(a)-1 through 1.1400Z2(f)-1, 1.1502-14Z, and 1.1504-3 generally apply to taxable years beginning after March 13, 2020. However, for the portion of a taxpayer's first taxable year ending after December 22, 2017, that began on December 22, 2017, and for taxable years beginning after December 21, 2017, and on or before March 13, 2020, taxpayers may choose either (1) to apply the rules set forth in §§ 1.1400Z2(a)-1 through 1.1400Z2(f)-1, 1.1502-14Z, and 1.1504-3 contained in this document, if applied in their entirety and in a consistent manner for all such taxable years, or (2) to rely on each section of the proposed regulations under §§ 1.1400Z2(a)-1 through 1.1400Z2(g)-1, except for § 1.1400Z2(c)-1, issued on October 29, 2018, and on May 1, 2019, but only if applied in their entirety and in a consistent manner for all such taxable years. See section 7805(b)(7)

Special Analyses

I. Regulatory Planning and Review-Economic Analysis

Executive Orders 13711, 13563, and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. For purposes of Executive Order 13771, this rule is deregulatory.

The final regulations have been designated as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations. The Office of Information and Regulatory Affairs has designated these regulations as economically significant under section 1(c) of the Memorandum of Agreement. Accordingly, the OMB has reviewed these regulations.

A. Need for the Final Regulations

As a part of the Tax Cuts and Jobs Act (TCJA), Congress enacted section 1400Z, which provided tax incentives related to investment in qualified opportunity zones (QOZs). The Treasury Department and the IRS issued proposed regulations related to section 1400Z-2 on October 29, 2018 (October 2018 proposed regulations) and May 1, 2019 (May 2019 proposed regulations), together referred to as the proposed regulations. The numerous comments to the proposed regulations indicate substantial interest in the opportunity zone tax incentives provided in section 1400Z-2. The comments demonstrate a variety of opinions on how to interpret ambiguous parts of section 1400Z-2 and on how section 1400Z-2 interacts with other sections of the tax code and corresponding regulations. The Treasury Department and the IRS are aware of concerns raised by commenters that some investors have been reticent to make substantial investments in QOZs without first having additional clarity on which investments would qualify to receive the preferential tax treatment specified by the TCJA.

Based on these considerations, the final regulations are needed to bring clarity to instances where the meaning of the statute was unclear and to respond to comments received on the proposed regulations.

B. Background and Overview

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

C. Economic Analysis

1. Baseline

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

2. Summary of Economic Effects

The final regulations provide certainty and clarity to taxpayers regarding utilization of the tax preferences for capital gains provided in section 1400Z-2 by defining terms, calculations, and acceptable forms of documentation. The Treasury Department and the IRS project that this added certainty and clarity generally will encourage taxpayers to increase the amount of investment located in QOZs relative to the no-action baseline. The certainty and clarity added by the final regulations and the specific regulatory decisions they entail will further bring the volume and diversity of investment in QOZs and in non-QOZs closer to the intent and purpose of the statute, relative to the alternative regulatory approaches that were considered, including the no-action baseline.

The Treasury Department and the IRS have not attempted to quantify the economic effects of any changes in business activity stemming from these final regulations, in part because of the uncertainty regarding the patterns of investment that will materialize as a result of QOF activity and the distribution of investments across opportunity zones. The Treasury Department and the IRS do not have readily available data or models that predict with reasonable precision the decisions that taxpayers would make under the final regulations versus alternative regulatory approaches, including the no-action baseline. Nor do they have readily available data or models that would measure with reasonable precision the loss or gain in economic surplus resulting from these investment and business decisions relative to the decisions that would be made under an alternative regulatory approach. Such estimates would be necessary to quantify the economic effects of the final regulations versus alternative approaches. Subject to these limitations, the next two sections of these Special Analyses provide a qualitative assessment of the economic effects of the final regulations relative to the alternative regulatory approaches that were considered.

The Treasury Department and the IRS welcome comments on this economic analysis as well as analysis regarding how choices made in this regulation will materially affect specific types of investments that are likely to attract capital that has been invested in QOFs.

3. Number of Affected Taxpayers

Because section 1400Z-2 is a new provision and many of the entities affected by these regulations have not yet been formed, there is considerable uncertainty regarding the number of taxpayers that will eventually be affected by the final regulations. Based in part on the preliminary number of taxpayers filing Form 8996 for tax year 2018 and the assumption that a QOF will on average have 10 investors, the Treasury Department and the IRS project that between 5,500 and 12,000 QOFs, 6,000 to 15,000 qualified opportunity zone businesses, and 55,000 to 120,000 investors in QOFs will eventually be affected by the final regulations.

4. Economic Effects of Provisions Substantially Revised From the Proposed Regulations

a. Eligible Gains From Section 1231 Property

The final regulations provide that a gain is eligible for deferral under section 1400Z-2(a) if the gain is treated as a capital gain for Federal income tax purposes. There is uncertainty, however, regarding how to treat gains arising from selling section 1231 property. Section 1231 property is certain property used in a trade or business, such as depreciable property and land, and also includes capital assets subject to an involuntary conversion, such as arising from a natural disaster or theft. Under the Code, gains from the sale or exchange of section 1231 property are characterized as capital gains if the sum of all section 1231 transactions for the taxable year is positive. If the sum of all section 1231 transactions for the year is negative, then the losses are ordinary losses. ¹

The Treasury Department and the IRS considered two main options for the treatment of gains from section 1231 property. ² The primary issue is whether the amount of the gains eligible for

deferral is based on the sum of all sales over the taxable year or on an item-by-item basis. These approaches are also referred to as the net approach and gross approach, respectively.

The statute also sets a 180-day requirement for investment in a QOF beginning on the date of the sale or exchange generating the gain, to be eligible for deferral under section 1400Z-2(a). The two options for calculating eligible section 1231 gains further determine when the 180-day requirement begins. When gains are based on the sum of sales over the taxable year, the 180-day period starts at the end of the taxable year, after it is determined whether the sum is positive or negative, and how large the net positive gain is. When gains are counted item-by-item, it is possible, although not necessary, to start the 180-day period from the date of each sale.

The proposed regulations used the net approach. Under the proposed regulations, the only gain arising from section 1231 property eligible for deferral under section 1400Z-2(a) was the amount by which the gains arising from all of a taxpayer's section 1231 property exceeded all of the taxpayer's losses from section 1231 property for a taxable year. In addition, the proposed regulations provided that the 180-day period for investment with respect to capital gain net income from section 1231 property for a taxable year began on the last day of the taxable year without regard to the date of any particular disposition of section 1231 property.

The final regulations adopt the gross approach. Under the final regulations, eligible section 1231 gains are determined on an item-by-item basis and therefore positive gains are not reduced by section 1231 losses. Furthermore, the amount of the gain is known at the time of each sale so it is not necessary for the taxpayer to wait until the end of the taxable year to determine whether any positive section 1231 sales will be offset by losses. As a consequence, the final regulations further provide that the 180-day period for investing an amount with respect to an eligible section 1231 gain for which a deferral election has been made begins on the date of the sale or exchange that gives rise to the section 1231 gain. In addition, the final regulations do not determine the character of eligible section 1231 gains, other than as gains arising from the sale or exchange of section 1231 property, until the taxable year such gains are taken into account in computing gross income pursuant to section 1231(a)(4). The treatment of section 1231 property under the gross option is essentially the same treatment provided in the final regulations for gain arising from the sale of a capital asset as defined by section 1221.

To illustrate this discussion, suppose that Corporation A sells two pieces of section 1231 property during the taxable year, one for a \$100 gain early in its taxable year and the other for a \$30 loss later in its taxable year. Suppose that Corporation B also sells two pieces of section 1231 property during the taxable year, one for a \$20 gain, the other for a \$50 loss. Neither taxpayer realizes any other capital gain during the taxable year.

Under the net approach, Corporation A's net gain is \$70, which is positive. Thus, it would be able to defer up to \$70 in capital gain by investing in a QOF. Corporation B has a net loss from selling section 1231 property. This net loss would be treated as ordinary and no gains would be deferrable under section 1400Z-2(a). Furthermore, although Corporation A sells the first piece of property for a gain early in its taxable year, it would not be able to make a qualifying investment in a QOF until the last day of the taxable year, because it needs to wait until the end of the tax year to determine whether it is eligible to defer any of the gain.

Under the gross approach, only the gains need to be accounted for. Corporation A would be able to defer \$100 in gain and Corporation B would be able to defer \$20. In this case, the amount of gain eligible for deferral increases for both taxpayers. The total amount of gain eligible for deferral increases from \$70 to \$120 compared to the net approach.

Although not determinative, we note that the gross approach, as adopted under the final regulations, will generally expand the pool of gains eligible for deferral under section 1400Z-2(a) relative to the net approach specified under the proposed regulations.³ Based on recent taxpayer records, the Treasury Department and the IRS estimate that the gross option may increase the amount of eligible gains by four to eight percent compared to the net option. The increase in potentially eligible gains overstates the likely increase in investment in QOFs resulting from using the gross approach (rather than the net approach) for two different reasons. First, for many taxpayers, the amount of section 1231 gains is not likely to be a binding constraint on the amount of investment made by the taxpayer into a QOF because of the ability of the taxpayer to defer other sources of capital gains. Second, taxpayers have considerable discretion over when to realize gains, and even under the net approach taxpayers could often plan on selling section 1231 property with sufficient net gain in a taxable year to cover the amount of desired QOF investment. The Treasury Department and the IRS have not attempted to estimate the overall effect of this provision of the final regulations (relative to the proposed regulations) on either QOZ or non-QOZ investment.

An additional effect of the gross option would be to minimize the tax considerations of determining the best time to sell section 1231 property, leading to a more efficient use of resources. Under the gross option, taxpayers would be less likely to delay or rush selling section 1231 property in order to achieve the desired amount of net gain that would be eligible for deferral within a particular year. Also, under the gross option, taxpayers would have more flexibility in realizing gains eligible to be invested in a QOF in calendar year 2019.

The Treasury Department and the IRS considered several variations to these two primary options. For example, one intermediate option would have required taxpayers to wait to determine the capital gain character of section 1231 property sales until summing at the end of the taxable year, but then allow the gross amount of gains to be eligible for deferral if the net is positive. Under this intermediate option, Corporation A would be eligible to defer \$100 in gain, while Corporation B would not be able to defer any amount. The pool of eligible gains would be greater than under the net option, but less than the gross option. This intermediate option would also have the costs similar to the net option regarding the need for taxpayers to wait to until the end of the taxable year before investing in a QOF.

The number of taxpayers expected to be affected by this aspect of the final regulations ranges between 36,000 and 80,000 investors in QOFs.

b. Sales or Exchanges of Property by QOF Partnerships and QOF S Corporations

The Treasury Department and the IRS considered three options for how owners of QOF partnerships and QOF S corporations may exclude gains from tax on qualifying investments in the QOF held longer than 10 years. First, the Treasury Department and the IRS considered not providing a specialized rule for QOF partnerships and QOF S corporations. Under this option,

owners of a QOF would need to sell or exchange their QOF ownership interest to another party in order to receive the exemption from tax on the gain. For certain business structures, this would not be the most efficient way to dispose of the assets of the QOF. For example, suppose QOF A has 20 partners and QOF A owns two commercial buildings that are qualified opportunity zone business property. If another investor B would like to purchase one of the buildings, it would generally be easier for QOF A to sell the building to investor B directly, rather than investor B buying out the partnership interests of several or all of the partners of QOF A. Under this first option, the owners of QOF A would only receive tax free gain from their investment if they are able to find an investor willing to buy their partnership interests in QOF A. This option would likely lead to relatively high negotiating costs and may reduce the pool of potential buyers for QOF assets.

Second, the May 2019 proposed regulations proposed that investors in a QOF partnership or a QOF S corporation could elect to exclude capital gains arising from the QOF selling qualified opportunity zone property from gross income. This option would provide a simpler way for owners of pass-through QOFs to receive tax-free gain, but it would apply only in certain cases. It would apply only to capital gains and not ordinary gains, such as the recapture of depreciation deductions. Also, this option would apply only to QOFs selling qualified opportunity zone property, and would not apply to qualified opportunity zone business property sold by a qualified opportunity zone business that is a subsidiary of the QOF.

Third, the final regulations allow QOF owners to elect to exclude from gross income all gains and losses of a QOF partnership or QOF S corporation (except those deriving from sales of inventory in the ordinary course of business). This would allow the gains from the sale of qualified opportunity zone business property by a qualified opportunity zone business to flow through to the owners of the QOF as excluded from income. This election can be made on an annual basis, but it must apply to all gains and losses of the QOF partnership or QOF S corporation for that taxable year. In addition, when the proceeds from the asset sales are reinvested, rather than distributed as cash, then the QOF owner's share of the qualifying investment is reduced as the reinvested amount is deemed to be a non-qualifying investment.

These rules generally match the tax treatment that would exist for an owner of a QOF partnership or QOF S corporation after selling a qualifying investment in the QOF after it has been held at least 10 years, but would avoid the extra costs associated with negotiating the selling price of the interest in the QOF, rather than the underlying assets owned by the QOF or qualified opportunity zone business. The Treasury Department and the IRS project that this approach will lead to a reduction in transactions costs for taxpayers relative to alternative approaches (the no-action baseline and the proposed regulations), and will continue to treat similar taxpayers similarly. The number of taxpayers expected to be affected by this rule ranges between 5,000 and 11,500 QOFs, and 50,000 to 115,000 investors in QOFs.

c. Substantial Improvement of Qualified Opportunity Zone Business Property

Section 1400Z-2(d)(2)(D) requires that if tangible property was already used in a QOZ (non-original use asset) when purchased by a QOF or qualified opportunity zone business, then it needs to be substantially improved by the QOF or qualified opportunity zone business before it can become qualified opportunity zone business property. Substantial improvement, as defined

by section 1400Z-2(d)(2)(D)(ii), requires the QOF or qualified opportunity zone business to more than double the adjusted basis of the property within 30 months after acquiring the property. The Treasury Department and the IRS considered two options for how to measure substantial improvement.

First, the proposed regulations provided an asset-by-asset approach. This option would require each property to be substantially improved in order to become qualified opportunity zone business property. For example, if a QOF purchases an existing commercial building, a separate determination for each piece of tangible property associated with the building would be needed, such as the structure itself, and every item of furniture and equipment within the building that is not part of the building structure.

This approach would limit the ability of taxpayers to purchase property already used within a QOZ, place that property in service in the taxpayer's business with little improvement from the previous owner, and have the property be qualified opportunity zone business property. This option would also likely encourage the purchase and substantial improvement of existing property with low existing basis; that is, property where it is easier for improvement expenditures to double the existing basis. Such properties are more likely to be older and more in need of repair and upgrades.

Second, the final regulations allow taxpayers to use an asset-by-asset approach (as provided in the proposed regulations) or a more aggregative approach. The final regulations allow purchased original use property to count towards the determination of whether non-original use property has been substantially improved if such purchased original use property improves the functionality of the non-original use property along with other conditions. Also, certain betterment expenses, such as environmental remediation or utility upgrades, which are properly chargeable to the basis of the land, may be added to the basis of a building on the land that was non-original use property for the purpose of calculating substantial improvement of that building. These rules in effect expand the definition of what expenses could be considered improvements for a particular asset. In some cases, this option could reduce compliance costs for taxpayers, as it is not always clear under the Code and regulations when expenditures should be considered an improvement of an existing property, for example a building, or be considered separate depreciable property.

These rules will make it easier for purchased non-original use property to be substantially improved compared to the proposed regulations. This will help to smooth the cliff effect that occurs with the statutory requirement that improvements need to more than double the cost basis. For example, suppose a QOF purchases a non-original use building in a QOZ for \$1 million, makes \$950,000 in improvements to the building that bring that building into good condition for that local market, and purchases \$50,001 of furniture or equipment for use within the building. This building would not meet the substantial improvement test under the proposed regulations but it would meet it under the final regulations.

In addition, the final regulations allow a QOF or qualified opportunity zone business to aggregate multiple buildings into a single property for purposes of the substantial improvement test. The buildings must either be entirely located within a parcel of land described in a single

deed, or the buildings may be on contiguous parcels of land with separate deeds if certain conditions are met that indicate the buildings are related in management or use.

This rule would expand the number of existing buildings in a QOZ that could be purchased by a QOF or a qualified opportunity zone business and be deemed to have met the substantial improvement test relative to the first option. For example, one expensive renovation project would provide excess "improvement expenses" that could be applied to other buildings. This increases the likelihood that certain substantial renovation projects would be undertaken. However, the ability to aggregate improvement of non-original use property could effectively allow a QOF or qualified opportunity zone business to purchase property already fully in use in a QOZ and count it as qualified opportunity zone business property, though use by the new owner would be qualitatively similar to the previous owner.

In summary, the Treasury Department and the IRS considered two primary options for how much aggregation to allow when determining whether purchased non-original use property satisfied the substantial improvement test. The different options would likely have different effects on the amount and distribution of non-original use property purchased by QOFs and qualified opportunity zone businesses. The proposed regulations would not allow any aggregation, and instead require each of the assets purchased under this option to receive substantial improvement. This would focus improvement expenditures on properties most in need of considerable rehabilitation to remain productive.

The final regulations allow aggregation, and will likely encourage the purchase and improvement of more non-original use property compared to the proposed regulations. The final regulations will also likely lead to a broader mix of properties purchased and improved relative to the first option. However, the final regulations also increase the likelihood that some buildings will meet the substantial improvement test when the individual building receives little to moderate improvements. Overall, the rules provided in the final regulations make it easier for a non-original use property to be substantially improved relative to the proposed regulations, which will encourage more investment through QOFs.

The Treasury Department and the IRS project that the number of taxpayers expected to be affected by this rule ranges between 5,500 and 12,000 QOFs plus 6,000 to 15,000 qualified opportunity zone businesses.

d. Vacancy

Property that is eligible for opportunity zone treatment must be "original use" or substantially improved. This statutory language leaves open the question of the conditions under which vacant property that is developed and used by an opportunity zone business might count as original use. 4 The Treasury Department and the IRS considered options of one, three, or five years for how long existing property located in a QOZ must be vacant before the purchase of such property would allow it to be considered original use property. The May 2019 proposed regulations proposed that property would need to be vacant for at least five years prior to the purchase by a QOF or qualified opportunity zone business in order to satisfy the original use requirement under section 1400Z-2(d)(2)(D)(i)(II).

In selecting among these options, the Treasury Department and the IRS recognize that vacant property is an underused resource to the owner and potential users of the property, and can lower the value and use of neighboring property. The Treasury Department and the IRS further recognize that property could become vacant due to economic reasons unrelated to section 1400Z-2, but also because the owner strategically let the property become or stay vacant in expectation that the property would have a higher resale value if it were eligible to be original use property under section 1400Z-2(d)(2)(D)(i)(II).

A shorter period of required vacancy provides a greater incentive for owners of vacant property to keep it vacant for purposes of later selling it for use as original use property. This incentive may also result in owners vacating property that is currently occupied. On the other hand, a longer period of required vacancy means that on average properties would remain vacant for a longer period before being sold and put into productive use, which would increase the likelihood that such property (and possibly surrounding property) would be inefficiently used.

The final regulations provide that the required time of vacancy is three years except for property that was vacant as of the date of publication of the QOZ designation notice in which the designation of the QOZ is listed, in which case the vacancy period is one year. This one-year period for vacant property at the time of designation provides an incentive for property that was vacant for economic reasons at the time of publication of the QOZ designation notice to be quickly placed back into service through sale to a new owner, thus reducing the social costs that would occur if those properties remained unused, relative to the longer three-year period. The three-year period for property that was not initially vacant makes it costly for owners to strategically limit the use of the property in order to gain a more favorable condition for selling the property in the future, relative to a shorter period. The Treasury Department and the IRS recognize, however, that even under this three-year specification, there may be situations where a property becomes vacant for a period of time due to economic reasons and the owner of that property decides to let the property remain vacant in order to receive an expected higher price upon selling after the three-year vacancy period is met.

The number of taxpayers expected to be affected by this rule ranges between 5,500 and 12,000 QOFs plus 6,000 to 15,000 qualified opportunity zone businesses.

e. Subsidiary of a Consolidated Group

The statute is silent regarding the treatment of corporate taxpayers that file consolidated returns and seek to invest in a QOF. The Treasury Department and the IRS considered two options to address this issue. Under the proposed regulations a consolidated group could invest in a corporate QOF only if the QOF would not be treated as part of the consolidated group for tax filing purposes. That is, a QOF could not be a subsidiary of a consolidated group, because of concerns of potential conflicts between the section 1400Z-2 rules and the consolidated group rules in § 1.1502. Under this approach, the gains and losses of a corporate QOF would not be shared with the consolidated group owning the QOF when determining aggregate tax liability of the consolidated group, but rather the QOF would file its own tax return, leading to a small increase in compliance burden.

This treatment could affect the choice of QOF entity for a consolidated corporate group that wanted to own a QOF, making a partnership QOF a more likely choice as tax attributes of the partnership QOF (income, deductions, credits, etc.) would flow to the member of the consolidated corporate group that owns the QOF. Sharing those tax attributes of a partnership QOF with other members of the group is subject to certain limitations. However, if the QOF is a corporate subsidiary member of the consolidated group, there is more flexibility with how tax attributes of the QOF are shared with the rest of the consolidated group. In addition, some corporate consolidated groups are likely to favor a using a corporate form due to familiarity with the corporate rules that would lead to lower organizational costs. These additional organizational or tax compliance costs are not likely to be large, but nevertheless may discourage investment in QOFs for some consolidated groups.

Therefore, the final regulations permit corporate taxpayers filing consolidated returns to own a QOF that is a subsidiary member of the consolidated group; and, as provided in the proposed regulations, a corporate QOF may be the parent member of a consolidated group. This option will reduce the limitations on the organizational structure of QOF investments that would have occurred under the proposed regulations. The final regulations permit the consolidation of a subsidiary QOF corporation only if certain conditions are satisfied. Specifically, except in very limited circumstances, the group member making the qualifying investment in the QOF member (investor member) must maintain direct equity interest of the QOF member stock. More importantly, all investor members must be wholly owned, directly or indirectly, by the common parent of the group. The final regulations also provide special rules to govern the treatment of an investment of eligible gain in the subsidiary QOF in order not to conflict with the consolidated return rules found in § 1.1502. However, these rules are not expected to be overly burdensome, because the choice of establishing the QOF as a subsidiary member of the consolidate group are elective; taxpayers would not choose to consolidate a corporate QOF subsidiary unless the benefits to the taxpayer were greater than the costs.

One drawback to allowing QOFs to be part of subsidiary member of a consolidated group is that there would be less information available regarding taxable income and loss of the QOF and its subsidiary qualified opportunity zone businesses, as that information will be reported as part of the aggregated income and deductions of the parent on the consolidated tax return.

The number of taxpayers expected to be affected by these rules ranges between 25 and 500.

5. Economic Effects of Provisions Not Substantially Revised From the Proposed Regulations

a. Definition of Substantially All

There are five uses of the term "substantially all" in section 1400Z-2 but the statute is ambiguous regarding the precise meaning of this term. The final regulations establish thresholds for all five uses of this term. The final regulations provide that "substantially all" means at least 90 percent with regard to the three holding period requirements in section 1400Z-2(d)(2) and at least 70 percent with regard to section 1400Z-2(d)(3)(A)(i) and in the context of "use" in section 1400Z-2(d)(2)(D)(i)(III). The Treasury Department and the IRS have not attempted to assess how taxpayers would have interpreted these terms in the absence of specific guidance and

therefore have not projected whether these regulations will increase or decrease investment in QOZs or non-QOZ's relative to regulatory alternatives.

In choosing what values to assign to the substantially all terms, the Treasury Department and the IRS considered the economic consequences of setting the thresholds higher or lower. Setting the threshold higher would reduce investment in QOFs but would increase the percentage of that investment that would be located within a QOZ. One reason why a higher threshold would reduce overall investment in QOFs is that it will be more difficult for businesses with diverse operations and/or multiple locations to satisfy the threshold. Setting the threshold lower would increase investment in QOFs but reduce the percentage of that investment that is located within a QOZ.

A lower threshold would further increase the likelihood that a taxpayer may receive the benefit of the preferential treatment on capital gains without placing in service more tangible property within a QOZ than would have occurred in the absence of section 1400Z-2. This effect would be magnified by the way the different requirements in section 1400Z-2 interact. For example, these final regulations imply that, in certain limited fact patterns, a QOF could satisfy the substantially all standards with as little as 40 percent of the tangible property effectively owned by the fund being used within a QOZ. This could occur if 90 percent of QOF assets are invested in a qualified opportunity zone business, in which 70 percent of the tangible assets of that business are qualified opportunity zone business property; and if, in addition, the qualified opportunity zone business property is only 70 percent in use within a QOZ, and for 90 percent of the holding period for such property. Multiplying these shares together ($0.9 \times 0.7 \times 0.7 \times 0.9 = 0.4$) generates the result that a QOF could satisfy the requirements of section 1400Z-2 under the final regulations with just 40 percent of its assets effectively in use within a QOZ.

The Treasury Department and the IRS have not undertaken quantitative estimates of the volume of investment that would be placed in QOZs under the different thresholds for "substantially all" because we do not have data or models that can predict spatial patterns of investment with reasonable precision. The Treasury Department and the IRS further recognize that the specified thresholds may indirectly affect investment outside of QOZs; we have likewise not undertaken quantitative estimates of this investment effect.

The Treasury Department and the IRS have determined that the substantially all thresholds provided in the final regulations represent an appropriate balance between the ability of investors in QOFs to receive preferential capital gains treatment only for placing a consequential amount of tangible property (used in the underlying business) within a QOZ, and the flexibility provided to business operations so as not to significantly distort the types of businesses that can qualify for opportunity zone funds.

b. Treatment of Leased Property

The Treasury Department and the IRS have determined that leased property that is located in a QOZ may be treated as qualified opportunity zone business property under certain conditions. This determination means, effectively, that the value of leased property should be included in both in the numerator and the denominator of the 90-percent investment standard and the substantially all tests. ⁵ We project that the inclusion of leased property will enhance the

efficiency of business decisions compared to other available regulatory options because leasing is a common business practice and because business decisions would be distorted if otherwise similar property (owned versus leased) were treated differently.

This treatment of leased property is efficiency-enhancing (compared to alternative treatments) because of other features of the statute. For example, a start-up business that leased office space within a QOZ and owned tangible property in the form of computers and other office equipment would likely fail the substantially all test (if the office space is sufficiently valuable relative to the other tangible property) because the leased property is included in the denominator of the substantially all test; this failure to satisfy the substantially all test would occur despite all of this business's operations being located within a QOZ. This possibility may lead the business to purchase rather than lease its office property, a decision that significantly changes the nature of the business's risk and expenses.

The Treasury Department and the IRS recognize that the treatment of leased property as qualified opportunity zone business property may weaken the incentive for taxpayers to construct new real property or renovate existing real property within a QOZ, as taxpayers would be able to lease existing real property in a zone without improving it and thereby become a qualified opportunity zone business (assuming the other conditions of the statute were met). However, allowing the leasing of existing real property within a zone may encourage fuller utilization and improvement of such property and limit the abandonment or destruction of existing productive property within a QOZ when new tax-favored real property becomes available.

In summary, the Treasury Department and the IRS project that the inclusion of leased property in both the numerator and the denominator of the 90-percent investment standard and the substantially all test will increase economic activity within QOZs relative to alternative decisions including the no-action baseline. This provision will reduce potential distortions between owned and leased property that may occur under other options.

c. Valuation of Property

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

The Treasury Department and the IRS project that the two methods will, in the majority of cases, provide similar values for leased property at the time that the lease begins because, as beginning in 2019, generally accepted accounting principles (GAAP) require public companies to calculate

the present value of lease payments in order to recognize the value of leased assets on the balance sheet. However, there are situations in which the two methods may differ in the value they assign to leased property. On financial statements, the value of the leased property declines over the term of the lease. Under the alternative method, the value of the leased asset is calculated once at the beginning of the lease term and remains constant while the term of the lease is still in effect. This difference in valuation of property over time between using financial statements and the alternative method also exists for owned property. In addition, the two approaches would generally apply different discount rates, thus leading to some difference in the calculated present value under the two methods.

The Treasury Department and the IRS provide the alternative method to allow for taxpayers that either do not have applicable financial statements or do not have them available in time for the asset tests. In addition, the alternative method is simpler, thus reducing compliance costs, and provides greater certainty in projecting future compliance with the 90-percent investment standard and the substantially all test. Thus, even some taxpayers with applicable financial statements may choose to use the alternative method. One drawback to the alternative method is that it is less likely to provide accurate asset valuation over time because it does not account for depreciation or other items that may affect the value of assets after the time of purchase, and, over time, the values used for the sake of the 90-percent investment standard and the substantially all test may diverge from the actual value of the property.

Because this provision provides an election to taxpayers, the Treasury Department and the IRS project that this provision will slightly increase investment in QOFs, relative to not providing an election. The Treasury Department and the IRS have not estimated the proportion of taxpayers likely to use the alternative method nor the volume of increased investment in QOFs relative to not providing an election.

d. Gross Income Requirement of Section 1397C(b)(2)

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

Two of these safe harbors provide that the 50 percent of gross income standard would be satisfied if the majority of the labor input of the trade or business is located within a QOZ and provide two different methods for measuring the labor input of the trade or business. The labor input can be measured in terms of hours (hours performed test) or compensation paid (amounts paid test) of employees, independent contractors, and employees of independent contractors for the trade or business. The final regulations clarify that guaranteed payments to partners in a partnership for services provided to the trade or business are also included in the amounts paid test. The final regulations provide that if at least 50 percent of the labor input of the trade or business is located within a QOZ (as measured by one of the two provided approaches), then the section 1397C(b)(2) requirement is satisfied.

In addition, a third safe harbor (business functions test) provides that the 50-percent gross income requirement is met if the tangible property of the trade or business located in a QOZ and

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

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

e. Working Capital Safe Harbor

Section 1400Z-2 contains several rules limiting taxpayers from benefitting from the deferral and exclusion of capital gains from income offered by that section without also locating investment within a QOZ. The final regulations clarify the rules related to nonqualified financial property and what amounts can be held in cash and cash equivalents as working capital. A qualified opportunity zone business is subject to the requirements of section 1397C(b)(8), that less than 5 percent of the aggregate adjusted basis of the entity is attributable to nonqualified financial property. The final regulations establish a working capital safe harbor consistent with section 1397C(e)(1), under which a qualified opportunity zone business may hold cash or cash equivalents for a period not longer than 31 months and not violate section 1397C(b)(8). The final regulations also provide that qualified opportunity zone businesses may utilize multiple working capital safe harbors, provided that each one satisfies all of the conditions of the safe harbor provided in the final regulations. In the case where multiple working capital safe harbors applies to the same unit of tangible property, then total length of time the working capital safe harbor may last is 62 months.

The Treasury Department and the IRS expect that the establishment of the working capital safe harbors under these parameters will provide net economic benefits. Without specification of the working capital safe harbor, some taxpayers would not invest in a QOF for fear that the QOF would not be able to deploy the funds soon enough to satisfy the 90-percent asset test. Thus, this rule would generally encourage investment in QOFs by providing greater specificity to how an entity may consistently satisfy the statutory requirements for maintaining a QOF without penalty.

A longer or a shorter period could have been chosen for the working capital safe harbor. A shorter time period would minimize the ability of taxpayers to use the investment in a QOF as a way to lower taxes without actually investing in tangible assets within a QOZ, but taxpayers may

also forego legitimate investments within an opportunity zone out of concern of not being able to deploy the working capital fast enough to meet the requirements. A longer period would have the opposite effects. Taxpayers could potentially invest in a QOF and receive the benefits of the tax incentive for multiple years before the money is invested into a QOZ.

f. QOF Reinvestment Rule

The final regulations provide that a QOF has 12 months from the time of the sale or disposition of qualified opportunity zone property or the return of capital from investments in qualified opportunity zone stock or qualified opportunity zone partnership interests to reinvest the proceeds in other qualified opportunity zone property before the proceeds would not be considered qualified opportunity zone property with regards to the 90-percent investment standard. This rule provides clarity and gives substantial flexibility to taxpayers in satisfying the 90-percent investment standard. The Treasury Department and the IRS have not projected the effect of this rule on the volume of investment held by QOFs compared to a no action baseline.

g. Clarity Regarding Electing Post-10-Year Gain Exclusion if Zone Designation Expires

The final regulations specify in § 1.1400Z2(c)-1 that expiration of a zone designation would not impair the ability of a taxpayer to elect the exclusion from gains for investments held for at least 10 years, provided the disposition of the investment occurs prior to January 1, 2048. The Treasury Department and the IRS considered four alternatives regarding the interaction between the expiration of the designated zones and the election to exclude gain for investments held more than 10 years. A discussion of the economic effects of the four options follows.

(i) Remaining Silent on Electing Post-10-Year Gain Exclusion

The first alternative would be for the final regulations to remain silent on this issue. Section 1400Z-2(c) permits a taxpayer to increase the basis in the property held in a QOF longer than 10 years to be equal to the fair market value of that property on the date that the investment is sold or exchanged, thus excluding post-acquisition capital gain on the investment from tax. However, the statutory expiration of the designation of QOZs on December 31, 2028, makes it unclear to what extent investments in a QOF made after 2018 would qualify for this exclusion.

In absence of the guidance provided in the final regulations, some taxpayers may have believed that only investments in a QOF made prior to January 1, 2019, would be eligible for the exclusion from gain if held greater than 10 years. Such taxpayers may have rushed to complete transactions within 2018, while others may choose to hold off indefinitely from investing in a QOF until they received clarity on the availability of the 10-year exclusion from gain for investments made later than 2018. Other taxpayers may have planned to invest in a QOF after 2018 with the expectation that future regulations would be provided or the statute would be amended to make it clear that dispositions of assets within a QOF after 2028 would be eligible for exclusion if held longer than 10 years. The ambiguity of the statute would likely lead to uneven response by different taxpayers, dependent on the taxpayer's interpretation of the statute, which may lead to an inefficient allocation of investment across QOZs.

(ii) Providing a Clear Deadline for Electing Post-10-Year Gain Exclusion

The alternative adopted by the final regulations clarifies that as long as the investment in the QOF was made with funds subject to a proper deferral election under section 1400Z-2(a), then the 10-year gain exclusion election is allowed as long as the disposition of the investment occurs before January 1, 2048. This rule would provide certainty to taxpayers regarding the timing of investments eligible for the 10-year gain exclusion. Taxpayers would have a more uniform understanding of what transactions would be eligible for the favorable treatment on capital gains. This would help taxpayers determine which investments provide a sufficient return to compensate for the extra costs and risks of investing in a QOF. This rule would likely lead to an increase in investment within QOFs compared the final regulations remaining silent on this issue.

However, setting a fixed date for the disposition of eligible QOFs investments could introduce economic inefficiencies. Some taxpayers might dispose of their investment in a QOF by the deadline in the proposed regulation primarily in order to receive the benefit of the gain exclusion, even if that selling date is not optimal for the taxpayer in terms of the portfolio of assets that the taxpayer could have chosen to invest in were there no deadline. Setting a fixed deadline may also generate an overall decline in asset values in some QOZs if many investors in QOFs seek to sell their portion of the fund within the same time period. This decline in asset values may affect the broader level of economic activity within some QOZs or affect other investors in such zones that did not invest through a QOF. In anticipation of this fixed deadline, some taxpayers may choose to dispose of QOF assets earlier than the deadline to avoid an anticipated "rush to the exits," but this would seem to conflict with the purpose of the incentives in the statute to encourage "patient" capital investment within QOZs. While the final regulations may produce these inefficiencies, by providing a long time period for which taxpayers may dispose of their investment within a QOF and still qualify for the exclusion the final regulations will lead any such inefficiencies to be minor.

(iii) Providing No Deadline for Electing Gain Exclusion

As an alternative, the final regulations could have provided no deadline for electing the 10-year gain exclusion for investments in a QOF, while still stating that the ability to make the election is not impaired solely because the designation of one or more QOZs ceases to be in effect. While this alternative would eliminate the economic inefficiencies associated with a fixed deadline and would likely lead to greater investment in QOFs, it could introduce substantial additional administrative and compliance costs. Taxpayers would also need to maintain records and make efforts to maintain compliance with the rules of section 1400Z-2 on an indefinite basis.

(iv) Providing Fair Market Value Basis Without Disposition of Investment

Another alternative considered would allow taxpayers to elect to increase the basis in their investment in the QOF if held at least 10 years to the fair market value of the investment without disposing of the property, as long as the election was made prior to January 1, 2048. (Or, the final regulations could have provided that, at the close of business of the day on which a taxpayer first has the ability to make the 10-year gain exclusion election, the basis in the investment automatically sets to the greater of current basis or the fair market value of the investment.) This alternative would minimize the economic inefficiencies of the proposed regulations resulting

from taxpayers needing to dispose of their investment in the opportunity zone at a fixed date not related to any factor other than the lapse of time. However, this approach would require a method of valuing unsold assets that could raise administrative and compliance costs. It may also require the maintenance of records and trained compliance personnel for over two decades.

(v) Summary

As discussed in section V. B of the Explanation of Provisions of the October 2018 proposed regulations, the Treasury Department and the IRS have determined the ability to exclude gains for investment held at least 10 years in a QOF is integral to the TCJA's purpose of creating QOZs. The final regulations provide a uniform signal to all taxpayers on the availability of this tax incentive, which should encourage greater investment, and a more efficient distribution of investment, in QOFs than in the absence of the final regulations. The relative costs and benefits of the various alternatives are difficult to measure and compare. The final regulations would likely produce the lowest compliance and administrative costs among the alternatives and any associated economic inefficiencies are likely to be small.

II. Paperwork Reduction Act

The collections of information in these final regulations are in §§ 1.1400Z2(b)-1(h), 1.1502-14Z(c)(2), (f)(2)(ii), (iii), and (iv), (f)(3), and (h), and 1.1504-3(b)(2) and (c). The information in all of the collections of information provided will be used by the IRS for tax compliance purposes.

A. Partnership and S Corporation Collections of Information

The final regulations establish a new collection of information in § 1.1400Z2(b)-1(h). In § 1.1400Z2(b)-1(h)(1), the collection of information requires a partnership that takes a deferral election to notify all of its partners of the deferral election and their shares of the deferred gain. Similar requirements are set forth in § 1.1400Z2(b)-1(h)(4) regarding S corporations and S corporation shareholders.

The collection of information in § 1.1400Z2(b)-1(h)(2) requires indirect owners of a QOF partnership that sell or otherwise dispose of all or a portion of their indirect interest in the QOF partnership in a transaction that is an inclusion event to notify the QOF owner so it can recognize an appropriate amount of deferred gain. Lastly, the collection of information in § 1.1400Z2(b)-1(h)(3) requires a QOF partner to notify the QOF partnership of an election under section 1400Z-2(c) to adjust the basis of the qualifying QOF partnership interest that is disposed of in a taxable transaction. Similar requirements again are set forth in § 1.1400Z2(b)-1(h)(4) regarding QOF S corporations and QOF S corporation shareholders.

The collection of information contained in this final regulation will not be conducted using a new or existing IRS form. The notifications required by § 1.1400Z2(b)-1(h)(1) will be provided by the respective partnership to its partners in order to properly track the amount of eligible gain invested in a QOF. The notification requires a statement to be sent by the partnership electing deferral to the relevant partners.

The notifications required by § 1.1400Z2(b)-1(h)(2) will be provided by indirect owners of a QOF partnership to the QOF owner and must include information needed in order to enable the QOF owner, in a timely manner, to recognize an appropriate amount of deferred gain. The notification requires a statement to be sent from an indirect owner of a QOF partnership to the QOF owner.

The notifications required by § 1.1400Z2(b)-1(h)(3) will be provided by a QOF partner to a QOF partnership to inform the partnership that the partner made an election under section 1400Z-2(c) to adjust the basis of the qualifying QOF partnership interest disposed of in a taxable transaction. The notification requires a statement be sent by the partner electing deferral under section 1400Z-2(c) to the QOF partnership.

Similar notifications between shareholders and S Corporations are also required by § 1.1400Z2(b)-1(h)(4).

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

Estimated total annual reporting burden: 8,500 hours.

Estimated average annual burden per respondent: 1 hour.

Estimated number of respondents: 8,500.

Estimated frequency of responses: One time notification.

B. Collections of Information Under Existing Tax Forms

The collections of information imposed on consolidated groups in these regulations are contained in §§ 1.1502-14Z(c)(2), (f)(2)(ii), (iii), (iv), and (f)(3), 1.1502-14Z(h), and 1.1504-3(b)(2) and (c). The collection of information provided by these regulations has been approved by the Office of Management and Budget (OMB) under control number 1545-0123. The information is required to inform the IRS on whether, and to what extent, a taxpayer makes any of the consolidated group elections as described in these regulations. For purposes of the Paperwork Reduction Act, 44 U.S.C. 3501 et seq. (PRA), the reporting burden associated with the collection of information in Form 1065, "U.S. Return of Partnership Income," Form 1120, "U.S. Corporation Income Tax Return," Form 851, "Affiliations Schedule," and/or Form 8996 will be reflected in the Paperwork Reduction Act Submission associated with OMB control number 1545-0123.

The consolidated return rules in §§ 1.1502-14Z and 1.1504-3 provide for certain elections that are available to consolidated groups. These elections may require the consolidated group and/or the QOF to file original, amended or superseding returns and attach an election statement to such return with the required information to make the applicable election. Section 1.1504-3(b)(2) generally allows the consolidated group (subject to certain requirements and limitations) to elect

to consolidate a subsidiary QOF C corporation that was formed or acquired by the consolidated group after May 1, 2019. In order to make the § 1.1504-3(b)(2) election, the consolidated group must attach an election statement as described in § 1.1504-3(c) to its Form 1120 and include the QOF C corporation as a subsidiary member on its Form 851. Section 1.1502-14Z(c)(2) allows a consolidated group to elect to treat an investment of one member as a qualifying investment by another member. This election is available to consolidated groups after March 13, 2020. The consolidated group must attach an election statement as described in § 1.1502-14Z(h)(2) with its Form 1120.

The elections provided in § 1.1502-14Z(f) are available only to consolidated groups that formed or acquired a subsidiary QOF C corporation and included the subsidiary QOF C corporation in its consolidated group prior to May 1, 2019. These elections allow the consolidated group to treat the subsidiary QOF C corporation as (i) a QOF partnership, (ii) a non-member QOF C corporation, (iii) a non-QOF C corporation, or (iv) to continue treating the pre-existing QOF subsidiary corporation as a member of the consolidated group. In general, if the consolidated group makes an election under § 1.1502-14Z(f), the consolidated group is required to amend its Form 1120 to account for the changes resulting from the election and to attach the applicable election statement as provided in § 1.1502-14Z(h)(3). If the consolidated group makes an election to treat the QOF C corporation as a QOF partnership as described in § 1.1502-14Z(f)(2)(ii), the QOF partnership is required to file its own Form 1065 as well as a new Form 8996 for the taxable year the election is effective. If the consolidated group elects to treat the subsidiary QOF C corporation as not a member of the group (as described in § 1.1502-14Z(f)(2)(iii)), the subsidiary QOF C corporation is required to file its own Form 1120 and include its Form 8996 with the return for the taxable year the election is effective.

The following table displays the number of respondents estimated to be required to report on Form 1120, Form 851, Form 8996 and/or Form 1065, with respect to the collections of information required by these consolidated group regulations. Due to the absence of available tax data, estimates of respondents required to attach a statement to other types of tax returns, as applicable, are not available.

Number of respondents (estimated)

Transition Relief Elections-§ 1.1502-14Z(f):

Form 1120 10 to 100.

Expected Number of Consolidated C Corporations formed after May 1, 2019:

Form 1120 0 to 50.

Source: RAAS:CDW.

The numbers of respondents in the table were estimated by the Research, Applied Analytics and Statistics Division (RAAS) of the IRS from the Compliance Data Warehouse (CDW).

Data for Form 1120 represents estimates of the total number of taxpayers that may attach an election statement to their Form 1120 to make the elections in §§ 1.1502-14Z(c)(2), (f)(2)(ii), (iii), and (iv), and (f)(3), and 1.1504-3(b)(2). The lower bound estimate is based on the number of consolidated group taxpayers filing Form 1120 and Form 8996 through July 2019. The upper bound estimate is based on consolidated group taxpayer filing trends, the observed filings to date, and uncertainty about the number of future filers. Accordingly, the difference between the lower bound and upper bound estimates reflect an estimate of the possible number of respondents as a result of the changes made by TCJA and the regulations.

An agency may not conduct or sponsor and a person is not required to respond to a collection of information unless it displays a valid OMB control number.

III. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that the final regulations will not have a significant economic impact on a substantial number of small entities under section 601(6) of the Regulatory Flexibility Act (small entities).

As discussed elsewhere in this preamble, the final regulations provide certainty and clarity to taxpayers regarding the utilization of the tax preference for capital gains provided in section 1400Z-2 by defining terms, calculations, and acceptable forms of documentation. The Treasury Department and the IRS anticipate that this clarity generally will encourage taxpayers to invest in QOFs and will increase the amount of investment located in QOZs. Investment in QOFs is entirely voluntary, and the certainty that would be provided by these final regulations, will minimize any compliance or administrative costs, such as the estimated average annual burden (1 hour) under the Paperwork Reduction Act. For example, the final regulations provide multiple safe harbors for the purpose of determining whether the 50-percent gross income test has been met as required by section 1400Z-2(d)(3)(A)(ii) for a qualified opportunity zone business. Taxpayers affected by these final regulations include QOFs, investors in QOFs, and qualified opportunity zone businesses in which a QOF holds an ownership interest. The final regulations will not directly affect the taxable incomes and liabilities of qualified opportunity zone businesses; they will affect only the taxable incomes and tax liabilities of QOFs (and owners of QOFs) that invest in such businesses. Although there is a lack of available data regarding the extent to which small entities invest in QOFs, will certify as QOFs, or receive equity investments from QOFs, the Treasury Department and the IRS project that most of the investment flowing into QOFs will come from large corporations and wealthy individuals, though some of these funds would likely flow through an intermediary investment partnership. It is expected that some QOFs and qualified opportunity zone businesses would be classified as small entities; however, the number of small entities significantly affected is not likely to be substantial.

For the reasons explained previously, the Treasury Department and the IRS certify that the final regulations will not have a significant economic impact on a substantial number of small entities. Pursuant to section 7805(f), the notice of proposed rulemaking preceding these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of \$100 million in 1995 dollars, updated annually for inflation. In 2019, that threshold is approximately \$154 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law.

VI. Executive Order 13175: Consultation and Coordination With Indian Tribal Governments

Executive Order 13175 requires that Federal departments and agencies engage in consultation procedures in certain circumstances where regulations are issued which have substantial direct effects with respect to the Federal Government and Indian tribes. As noted in the Background, on October 21, 2019, the Treasury Department and the IRS held a government-to-government tribal consultation on Opportunity Zones (Consultation). Seven organizations representing tribal interests participated, with one tribal designee providing comments expressing support for the May 2019 proposed regulations. In addition, many tribes submitted written comments in response to the proposed regulations, and the presiding officer of one Indian tribe provided oral testimony at the February 14, 2019 public hearing.

Several commenters requested that Indian tribal governments and corporations organized under Indian tribal laws should be included in the definition of entities eligible to be a QOF. The final regulations provide that an entity "organized in" one of the 50 states includes an entity organized under the law of a federally recognized Indian tribe if the entity's domicile is located in one of the 50 states or the District of Columbia. Such entity satisfies the requirement in section 1400Z-2(d)(2)(B)(i) and (C) that qualified opportunity zone stock is stock in a domestic corporation, and a qualified opportunity zone partnership interest is an interest in a domestic partnership.

The Treasury Department and the IRS, while acknowledging the sovereignty of Indian tribal governments, also note that an entity eligible to be a QOF must be subject to Federal income tax, including the penalty imposed by section 1400Z-2(f)(1) where a QOF fails to meet the 90-percent investment standard, regardless of the laws under which it is established or organized. Tribal commenters at the Consultation did not disagree with the position that if an entity organized under the law of an Indian tribal government is eligible to be a QOF, and the entity's domicile is located in one of the 50 states or the District of Columbia, that such entity would be subject to Federal income tax because the QOF would include investors from outside of the tribe. Accordingly, the Treasury Department and IRS affirm these positions and incorporate a reference to entities organized under the law of an Indian tribal government in the definition of the term "eligible entity."

Several tribal commenters, commenting on the October 2018 proposed regulations (83 FR 54279), requested that leased tangible property qualify as qualified opportunity zone business property for purposes of the section 1400Z-2 although the statute only addresses the qualification of tangible property acquired by purchase, as defined in section 179(d)(2), as qualified opportunity zone business property. The commenters stated that typically long-term ground leases of land held in trust by the Federal government are used for economic development purposes because such real property is generally not transferred through a sale. As provided for in the May 2019 proposed regulations (84 FR 18652), leased tangible property may qualify as qualified opportunity zone business property held by a QOF of qualified opportunity zone business, provided the regulatory requirements are met. At the Consultation, no participant requested additional guidance on this provision, or disagreed with the position taken by the Treasury Department and the IRS.

Prior to the publication of the May 2019 proposed regulations (84 FR 18652), the Treasury Department and the IRS received a comment requesting that the final regulations provide flexibility regarding the valuation of leases. The commenter requested that the final regulations permit QOFs to use a basis for valuing property other than the basis used for GAAP purposes (for example, cost basis under section 1012). Because Indian tribal governments typically rely upon leases of land held in trust by the Federal Government for economic development and recent changes to GAAP methods require the recognition of leasehold interests valued at the present value of prospective lease payments over the lifetime of the lease, the commenter was concerned that applying GAAP methods to value long-term leasehold interests would result in eligible entities not qualifying as QOFs or qualified opportunity zone businesses. In responding to this comment, as well as other comments expressing similar concerns, the Treasury Department and the IRS determined that the alternative valuation method for leased tangible property, as set forth in the final regulations, addresses the concerns raised by these commenters. In addition, the Treasury Department and the IRS note that no participant of the Consultation requested additional guidance regarding these issues. Therefore, proposed § 1.1400Z2(d)-1(b)(3) has not been modified as a result of those comments.

Following the Consultation, one tribe submitted additional comments regarding the issue of whether leased property is qualified opportunity zone business property. First, the commenter asked for clarification on whether leasehold interests of the real property subject to a sublease can be qualified opportunity zone business property for a qualified opportunity zone business where the sublease is entered into after December 31, 2017. The Treasury Department and the IRS, while declining to clarify the rule, generally do not view tangible property acquired under a

sublease entered into after December 31, 2017, as necessarily different from tangible property acquired under a lease entered into after December 31, 2017, to the extent that the tangible property otherwise would qualify as qualified opportunity zone business property.

Second, the commenter inquired whether a leasehold interest that was assigned by a tribe to a qualified opportunity zone business would not qualify as qualified opportunity zone business property because the leasehold interest is not tangible property solely being leased or subleased to the qualified opportunity zone business. The Treasury Department and the IRS agree that assigning an existing lease, the parties to which are not related persons within the meaning of section 1400Z-2(e)(2), to another entity would not prevent the tangible property subject to the lease from qualifying as qualified opportunity zone business property. However, it should be noted that assigning an existing lease that was entered into by unrelated persons to an assignee that is related person with respect to the lessee may make the leased tangible property subject to the special rules for leases between related persons within the meaning of section 1400Z-2(e)(2).

In addition to these comments, one tribe requested a more robust reporting regime to measure the benefits of section 1400Z-2. As discussed in part IX.A. of this Summary of Comments and Explanation of Revision, the Treasury Department and the IRS have modified the Form 8996 to request additional reporting information from QOFs for tax administration purposes, which may also be helpful in measuring the impact and effectiveness of section 1400Z-2 on designated qualified opportunity zones.

VII. Congressional Review Act

The Administrator of the Office of Information and Regulatory Affairs of the Office of Management and Budget has determined that this is a major rule for purposes of the Congressional Review Act (CRA) (5 U.S.C. 801 et seq.).

Drafting Information

The principal authors of these final regulations are Alfred Bae and Kyle Griffin, Office of the Associate Chief Counsel (Income Tax & Accounting); Jeremy Aron-Dine and Sarah Hoyt, Office of the Associate Chief Counsel (Corporate); and Marla Borkson, Sonia Kothari, and Vishal Amin, Office of the Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from the Treasury Department and the IRS participated in their development.

Statement of Availability of IRS Documents

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

List of Subjects in 26 CFR Part 1

Income Taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1-INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding sectional authorities for §§ 1.1400Z2(a)-1 through 1.1400Z2(f)-1, 1.1502-14Z, and 1.1504-3 in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805

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

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

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

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

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

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

***** Section 1.1502-14Z also issued under 26 U.S.C. 1400Z-2(e)(4) and 1502.

***** Section 1.1504-3 also issued under 26 U.S.C. 1400Z-2(e)(4) and 1504(a)(5).

***** ▪ Par. 2. Section 1.1400Z2-0 is added to read as follows:

§ 1.1400Z2-0. Table of Contents.

This section lists the table of contents for §§ 1.1400Z2(a)-1 through 1.1400Z2(f)-1.

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

(a) Deferring tax on capital gains.

(1) Overview.

(2) Procedure for deferring gain.

(b) Definitions.

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(2) 70-percent tangible property standard.

(3) 70-percent use test.

(4) 90-percent investment standard.

(5) 90-percent qualified opportunity zone property holding period.

(6) 90-percent qualified opportunity zone business property holding period.

(7) 180-day period.

(8) Boot.

(9) Consolidated group.

(10) Deferral election.

(11) Eligible gain.

(12) Eligible interest.

(13) Eligible taxpayer.

(14) Inclusion event.

(15) Mixed-funds investment.

(16) Non-qualifying investment.

- (17) Property.
- (18) QOF.
- (19) QOF C corporation.
- (20) QOF corporation.
- (21) QOF RIC.
- (22) QOF REIT.
- (23) QOF owner.
- (24) QOF partner.
- (25) QOF partnership.
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- (27) QOF shareholder.
- (28) QOZ designation notice.
- (29) Qualified opportunity zone business.
- (30) Qualified opportunity zone business property.
- (31) Qualified opportunity zone partnership interest.
- (32) Qualified opportunity zone property.
- (33) Qualified opportunity zone stock.
- (34) Qualifying investment.
- (35) Qualifying QOF partnership interest.
- (36) Qualifying QOF stock.
- (37) Qualifying section 355 transaction.

- (38) Qualifying section 381 transaction.
- (39) Related persons.
- (40) Remaining deferred gain.
- (41) Section 1400Z-2 regulations.
- (c) Operational and special rules.
 - (1) Attributes of gains included in income under section 1400Z-2(a)(1)(B).
 - (2) Identification of which interest in a QOF corporation has been disposed of.
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 - (1) Taxable year of deferral election.
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- (e) Interaction of section 1400Z-2 and § 1.897-6T.
- (f) Treatment of mixed-funds investments.
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 - (2) Treatment of deemed contributions of money under section 752(a).

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(1) In general.

(2) Prior periods.

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

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(2) Status of QOF assets as qualified opportunity zone property.

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(e) Capital gain dividends paid by a QOF RIC or QOF REIT that some shareholders may be able to elect to receive tax free under section 1400Z-2(c).

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§ 1.1400Z2 (d)-1 Qualified opportunity funds and qualified opportunity zone businesses.

(a) Overview.

(1) Eligible entity.

(2) Self-certification as a QOF.

(3) Self-decertification of a QOF.

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(b) Valuation of property for purposes of the 90-percent investment standard and the 70-percent tangible property standard.

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(1) In general.

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(2) Satisfaction of 70-percent tangible property standard.

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(5) Tangible property of a qualified opportunity zone business that ceases to be qualified opportunity zone business property

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(1) In general.

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§ 1.1400Z2 (d)-2 Qualified opportunity zone business property

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(b) Tangible property owned by an eligible entity.

(1) Purchase requirement.

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(3) Original use of tangible property acquired by purchase.

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(1) Qualifying acquisition of possession.

(2) Arms-length terms.

(3) Additional requirements for tangible property leased from a related person.

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(d) Holding period and use within a qualified opportunity zone of owned or leased tangible property.

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(2) Valuation of owned and leased property.

(3) Substantially all of an eligible entity's holding period for owned or leased tangible property.

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(1) In general.

(2) Prior periods.

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§ 1.1400Z2 (f)-1 Administrative rules- penalties, anti-abuse, etc.

(a) In general.

(b) Time period for a QOF to reinvest certain proceeds.

(1) In general.

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(3) Examples.

(d) Applicability dates.

(1) In general.

(2) Prior periods.

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

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

(a) Deferring tax on capital gains-

(1) Overview. Under section 1400Z-2(a) of the Internal Revenue Code (Code) and the section 1400Z-2 regulations (as defined in paragraph (b)(41) of this section), an eligible taxpayer may elect to defer recognition of some or all of one or more eligible gains that otherwise would be recognized by the eligible taxpayer in the taxable year to the extent that the eligible taxpayer timely acquires a qualifying investment in a qualified opportunity fund (QOF) within the meaning of section 1400Z-2(d)(1) and § 1.1400Z2(d)-1. Paragraph (a)(2) of this section describes how a taxpayer elects to defer gain. Paragraph (b) of this section defines terms used in the section 1400Z-2 regulations. Paragraph (c) of this section provides operational rules for applying section 1400Z-2 and the section 1400Z-2 regulations, including special rules regarding the election to defer gain under section 1400Z-2(a) and this section when an eligible taxpayer that is a partnership, S corporation, trust, or decedent's estate recognizes an eligible gain in a taxable year. Paragraph (d) of this section provides the manner in which a deferral election under section 1400Z-2(a) must be made. Paragraph (e) of this section provides the treatment of section 1400Z-2 for purposes of § 1.897-6T. Paragraph (f) of this section provides rules for mixed-funds investments. Paragraph (g) of this section provides dates of applicability. See §§ 1.1502-14Z and 1.1504-3 for special rules applicable to consolidated groups that invest in QOFs.

(2) Procedure for deferring gain. A taxpayer defers gain, in whole or in part, by making an election on its Federal income tax return for the taxable year in which the gain would be included if not deferred. The election must be made in the manner prescribed by the Internal Revenue Service in guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§ 601.601(d)(2) and 601.602 of this chapter).

(b) Definitions. The following definitions apply for purposes of section 1400Z-2 and the section 1400Z-2 regulations:

(1) 30-month substantial improvement period. The term 30-month substantial improvement period means any 30-month period, beginning after the date of acquisition of tangible property, in which additions to the basis of the tangible property in the hands of the QOF or qualified opportunity zone business (see § 1.1400Z2(d)-2(b)(4)) exceed an amount equal to the adjusted basis of such property at the beginning of the 30-month period in the hands of the QOF or qualified opportunity zone business.

(2) 70-percent tangible property standard. The term 70-percent tangible property standard means the requirement in section 1400Z-2(d)(3)(A)(i) that a qualified opportunity zone business must satisfy with respect to qualified opportunity zone business property (see § 1.1400Z2(d)-2) that the qualified opportunity zone business holds, whether the qualified opportunity zone business property is owned by the qualified opportunity zone business or leased by the qualified opportunity zone business from another person.

(3) 70-percent use test. The term 70-percent use test means the test used to determine if a QOF or qualified opportunity zone business satisfies the requirement in sections 1400Z-2(d)(2)(D)(i)(III) and 1400Z-2(d)(3)(A)(i) that substantially all of the use of tangible property was in a qualified opportunity zone.

(4) 90-percent investment standard. The term 90-percent investment standard means the requirement provided in section 1400Z-2(d)(1) that a QOF must hold at least 90 percent of its assets in qualified opportunity zone property, as defined in section 1400Z-2(d)(2) and § 1.1400Z2(d)-1(c)(1), determined by the average of the percentage of qualified opportunity zone property held by the QOF as measured on the last day of the first six-month period and on the last day of the taxable year of the QOF.

(5) 90-percent qualified opportunity zone property holding period. The term 90-percent qualified opportunity zone property holding period means the minimum portion of a QOF's holding period in stock of a corporation or interests in a partnership, during which the corporation or partnership qualifies as a qualified opportunity zone business in order for the stock or the partnership interests to meet the substantially all requirement under section 1400Z-2(d)(2)(B)(i)(III) to be treated as qualified opportunity zone stock or the substantially all requirement under section 1400Z-2(d)(2)(C)(iii) to be treated as qualified opportunity zone partnership interests, as applicable, held by the QOF.

(6) 90-percent qualified opportunity zone business property holding period. The term 90-percent qualified opportunity zone business property holding period means the minimum portion of a QOF's or qualified opportunity zone business's holding period in tangible property during which the 70-percent use test with respect to the tangible property must be satisfied, in order for the tangible property to meet the requirement under section 1400Z-2(d)(2)(D)(i)(III) to be treated as qualified opportunity zone business property held by the QOF or qualified opportunity zone business.

(7) 180-day period-

- In general. Except as otherwise provided elsewhere in this section, the term 180-day period means the 180-day period referred to in section 1400Z-2(a)(1)(A) with respect to any eligible gain meeting the requirements of paragraph (b)(11) of this section that begins on the day on which the gain would be recognized for Federal income tax purposes if the eligible taxpayer did not elect under section 1400Z-2 and the section 1400Z-2 regulations to defer recognition of that gain.

- 180-day period for RIC and REIT capital gain dividends-

(A) General rule. Unless the shareholder of a regulated investment company (RIC) or real estate investment trust (REIT) chooses to apply paragraph (b)(7)(ii)(B) of this section, the 180-day period for a RIC or REIT capital gain dividend begins on the last day of the shareholder's taxable year in which the capital gain dividend would otherwise be recognized by the shareholder.

(B) Elective rule. Notwithstanding the general rule in paragraph (b)(7)(ii)(A) of this section, a shareholder of a RIC or REIT may choose to treat the 180-day period with respect to a capital gain dividend that the shareholder receives from the RIC or REIT as beginning on the date of the dividend distribution; provided, however, that the aggregate amount of the shareholder's eligible gain with respect to capital gain dividends from the RIC or REIT is limited to the aggregate amount of capital gain dividends reported for that shareholder by the RIC for that shareholder's taxable year or designated for that shareholder by the REIT for that shareholder's taxable year.

(C) Undistributed capital gains. If section 852(b)(3)(D) or 857(b)(3)(C) (concerning undistributed capital gains) requires the holder of shares in a RIC or REIT to include an amount in the shareholder's long-term capital gains, the rule in paragraph (b)(7)(ii)(B) of this section does not apply to that amount. The 180-day period with respect to the included undistributed capital gain begins, at the shareholder's election, on either the last day of the RIC or REIT's taxable year or the last day of the shareholder's taxable year in which the amount would otherwise be recognized as long-term capital gains by the shareholder.

- 180-day period for partners, S corporation shareholders, and owners of other passthrough entities. See paragraph (c)(8) and (9) of this section for rules relating to the determination of the

180-day period for partners, S corporation shareholders, or beneficiaries of a trust or decedent's estate in cases in which a partnership, S corporation, trust, or decedent's estate is not an eligible taxpayer with respect to an eligible gain, or does not make a deferral election with respect to an eligible gain.

- Examples. The following examples illustrate the principles of paragraph (b)(7)(i) through (iii) of this section.

(A) Example 1. Regular-way trades of stock. Individual A sells stock at a gain in a regular-way trade on an exchange (that is, in a transaction in which a trade order is placed on the trade date, and settlement of the transaction, including payment and delivery of the stock, occurs a standardized number of days after the trade date). The 180-day period with respect to A's gain on the stock begins on the trade date.

(B) Example 2. Capital gain dividends received by a REIT shareholder. REIT and Shareholder are calendar year taxpayers. REIT distributes a dividend to Shareholder on March 1, Year 1. REIT designates the March 1 dividend as a capital gain dividend before 30 days after the close of Year 1. Shareholder's 180-day period with respect to that capital gain dividend begins on December 31, Year 1. However, Shareholder may choose to begin the 180-day period on March 1, Year 1. If so, an equity interest in a QOF received by Shareholder in exchange for an investment of an amount corresponding to that capital gain dividend may be a qualifying investment to the extent that Shareholder's aggregate elected deferrals of dividends from REIT for Year 1 do not exceed Shareholder's aggregate capital gain dividends from REIT for the taxable year.

(C) Example 3. Multiple capital gain dividends received by a RIC shareholder. RIC is a calendar year taxpayer. RIC distributes a dividend of \$100 to Shareholder, a calendar year taxpayer, on March 1, Year 1 and distributes another dividend of \$50 to Shareholder on June 1, Year 1. RIC reports both the March 1 and June 1 dividends as capital gain dividends on Shareholder's Form 1099-DIV for Year 1. Shareholder's 180-day period with respect to both capital gain dividends begins on December 31, Year 1. However, Shareholder may choose to begin the 180-day period for the \$100 RIC capital gain dividend on March 1, Year 1, and may choose to begin the 180-day period for the \$50 RIC capital gain dividend on June 1, Year 1. Thus, if Shareholder makes a single investment of \$200 in a QOF in exchange for an eligible interest (as defined in paragraph (b)(12) of this section) on July 1, Year 1, absent any other eligible gain, Shareholder may treat \$150 of the eligible interest as a qualifying investment in the QOF (that is, the amount that corresponds to the aggregate amount of the RIC capital gain dividends in Year 1) and \$50 of the eligible interest as a non-qualifying investment therein.

(D) Example 4. Additional deferral of previously deferred gains-

(1) Facts. Taxpayer A invested in a QOF and properly elected to defer realized gain. On March 15, 2025, A disposes of its entire investment in the QOF in a transaction that, under sections 1400Z-2(a)(1)(B) and (b), triggers an inclusion of gain in A's gross income. Section 1400Z-2(b) determines the date and amount of the gain included in A's income. That date is March 15, 2025, the date on which A disposed of its entire interest in the QOF. A wants to make a deferral election with respect to A's gain from the disposal of the QOF investment.

(2) Analysis. Under paragraph (b)(7)(i) of this section, the 180-day period for making another investment in a QOF begins on the day on which section 1400Z-2(b) requires the prior gain to be included. As prescribed by section 1400Z-2(b)(1)(A), that is March 15, 2025, the date of the inclusion-triggering disposition. Thus, in order to make a deferral election under section 1400Z-2, A must invest the amount of the inclusion in the original QOF or in another QOF during the 180-day period beginning on March 15, 2025, the date when A disposed of its entire investment in the QOF.

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

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

(10) Deferral election. The term deferral election means an election under section 1400Z-2(a) and the section 1400Z-2 regulations made before January 1, 2027, with respect to an eligible gain.

(11) Eligible gain-

(i) In general. An amount of gain is an eligible gain, and thus is eligible for deferral under section 1400Z-2(a) and the section 1400Z-2 regulations, if the gain-

(A) Is treated as a capital gain for Federal income tax purposes or is a qualified 1231 gain within the meaning of paragraph (b)(11)(iii)(A) of this section, determined by-

(1) Not taking into account any losses unless otherwise specified in the section 1400Z-2 regulations; and

(2) Taking into account any other provision of the Code that requires the character of potential capital gain to be recharacterized or redetermined as ordinary income, as defined in section 64, for purposes of the Code;

(B) Would be recognized for Federal income tax purposes and subject to tax under subtitle A of the Code before January 1, 2027 (subject to Federal income tax), if section 1400Z-2(a)(1) did not apply to defer recognition of the gain; and

(C) Does not arise from a sale or exchange of property with a person that, within the meaning of section 1400Z-2(e)(2), is related to-

(1) The eligible taxpayer that would recognize the gain in the taxable year in which the sale or exchange occurs if section 1400Z-2(a)(1) and the section 1400Z-2 regulations did not apply to defer recognition of the gain; or

(2) Any passthrough entity or other person recognizing and allocating the gain to the eligible taxpayer described in paragraph (b)(11)(i)(C)(1) of this section.

(ii) Portion of eligible gain not already subject to a deferral election. In the case of an eligible taxpayer who has made an election under section 1400Z-2(a) and the section 1400Z-2 regulations regarding some but not all of an eligible gain, the portion of that eligible gain with respect to which no election under section 1400Z-2(a) and the section 1400Z-2 regulations has been made remains an eligible gain for which a deferral election may be made.

(iii) Qualified 1231 gains-

(A) Definition. A section 1231 gain (as defined in section 1231(a)(3)(A)) recognized on the sale or exchange of property defined in section 1231(b) (1231(b) property) is a qualified 1231 gain to the extent that it exceeds any amount with respect to the 1231(b) property that is treated as ordinary income under section 1245 or section 1250.

(B) 180-day period. For the applicable 180-day period with respect to a qualified 1231 gain, see paragraph (b)(7) of this section.

(C) Attributes of included income when deferral ends. For the Federal income tax treatment of the later inclusion of a qualified 1231 gain deferred under section 1400Z-2(a)(1) and the section 1400Z-2 regulations, see paragraph (c)(1) of this section.

(iv) Gain arising from an inclusion event-

(A) In general. Gain that is otherwise required to be included in gross income under § 1.1400Z2(b)-1(e)(1), whether from the disposition of an entire interest in a QOF or a disposition of a partial interest, may be eligible for deferral under section 1400Z-2(a)(1), provided that all of the requirements to elect to defer gain under section 1400Z-2(a)(1)(A) are met. For purposes of determining whether such gain is eligible gain under section 1400Z-2(a)(1)(A) and this paragraph (b)(11)(iv)(A), the eligible taxpayer should treat such inclusion gain as if it was

originally realized upon the occurrence of the inclusion event rather than on the sale or exchange that gave rise to the eligible gain to which the inclusion event relates.

(B) 180-day period. The 180-day period for investing gain from an inclusion event begins on the date of the inclusion event.

(C) Holding period. The holding period for a qualifying investment attributable to eligible gain arising from an inclusion event begins on the date that the gain is reinvested in a QOF.

(v) No deferral for gain realized upon the acquisition of an eligible interest. Gain is not eligible for deferral under section 1400Z-2(a)(1) and the section 1400Z-2 regulations if such gain is realized upon the contribution, exchange, or other transfer of property to a QOF in exchange for an eligible interest (see paragraph (c)(6)(ii)(C) of this section) or the transfer of property to an eligible taxpayer in exchange for an eligible interest (see paragraph (c)(6)(iv) of this section).

(vi) Gain from section 1256 contracts and from positions in a straddle-

(A) General rule. Except as otherwise explicitly provided in paragraph (b)(11)(vi)(B), (C), or (D) of this section, eligible gain for a taxable year does not include-

(1) Gain from a section 1256 contract as defined in section 1256(b);

(2) Gain from a position that was part of a straddle as defined in section 1092 (straddle) during the taxable year; or

(3) Gain from a position that was part of a straddle in a previous taxable year if, under section 1092(a)(1)(B), a loss from any position in that straddle is treated as sustained, subject to the limitations of section 1092(a)(1)(A), during the taxable year.

(B) Exception for net gain from certain section 1256 contracts. Paragraph (b)(11)(vi)(A)(1) of this section does not apply to the net gain during the taxable year from section 1256 contracts that were not part of a straddle at any time during the taxable year (qualified section 1256 contracts). For purposes of this paragraph (b)(11)(vi)(B), the net gain during the taxable year from qualified section 1256 contracts is determined by taking into account all capital gains and losses from such contracts for the taxable year that are recognized for Federal income tax purposes, determined without regard to section 1400Z-2(a)(1). The 180-day period with respect to any eligible gain described in this paragraph (b)(11)(vi)(B) begins on the last day of the taxable year, and the character of that gain when it is later included under sections 1400Z-2(a)(1)(B) and 1400Z-2(b) is determined under the general rule in paragraph

(c)(1) of this section. If, under section 1256(a)(4), section 1092 does not apply to a straddle, such straddle is not treated as a straddle for purposes of this paragraph (b)(11)(vi)(B).

(C) Exception for net gain from certain identified straddles-

(1) Paragraph (b)(11)(vi)(A) of this section does not apply to the net gain during the taxable year from positions in a straddle if-

(i) During the taxable year, the positions were part of an identified straddle under section 1092(a)(2), part of an identified mixed straddle under § 1.1092(b)-3T (and, as applicable, § 1.1092(b)-6), part of an identified straddle under section 1256(d), or included in a mixed straddle account under § 1.1092(b)-4T;

(ii) All gains and losses with respect to the positions that were part of such straddle or included in such mixed straddle account are recognized by the end of the taxable year (other than gain that would be recognized but for deferral under section 1400Z-2(a)(1));

(iii) None of the positions in such straddle or mixed straddle account were part of a straddle during the taxable year, other than a straddle described in paragraph (b)(11)(vi)(C)(1)(i) and (ii) of this section; and

(iv) None of the positions in such straddle or mixed straddle account were part of a straddle in a previous taxable year if, under section 1092(a)(1)(B), a loss from any position in such straddle is treated as sustained, subject to the limitations of section 1092(a)(1)(A), during the taxable year.

(2) For purposes of paragraph (b)(11)(vi)(C)(1) of this section, net gain during the taxable year from an identified straddle or mixed straddle account described in paragraph (b)(11)(vi)(C)(1)(i) through (iv) of this section is equal to the excess of the capital gains recognized in the taxable year for Federal income tax purposes, determined without regard to section 1400Z-2(a)(1), from all of the positions that were part of that straddle over the sum of the capital losses and net ordinary loss (if any) from all of the positions that were part of that straddle. For purposes of this paragraph (b)(11)(vi)(C)(2), capital gains and losses from an identified straddle or mixed straddle account include capital gains and losses from section 1256 contracts and other positions marked to market either upon termination or on the last business day of the taxable year, as well as annual account net gain from positions in a mixed straddle account covered by § 1.1092(b)-4T. In addition, for purposes of this paragraph (b)(11)(vi)(C)(2), net ordinary loss means the excess of ordinary losses over ordinary gains.

(3) If a straddle is an identified straddle described in section 1092(a)(2), the basis adjustment provisions described in sections 1092(a)(2)(A)(ii) and (iii) must be applied in determining the net gain during the taxable year from positions that were part of that straddle.

(4) The 180-day period with respect to any eligible gain described in paragraph (b)(11)(vi)(C)(2) of this section begins on the earlier of the date when all of the positions that

are, or have been, part of the straddle are disposed of (or otherwise terminated) or the last day of the taxable year.

(5) If net gain described in paragraph (b)(11)(vi)(C)(2) of this section is deferred under section 1400Z-2(a)(1), that gain is not treated as unrecognized gain for purposes of section 1092(a)(3)(A)(ii).

(D) Additional exceptions to the general rule. Additional exceptions to the general rule in paragraph (b)(11)(vi)(A) of this section may be prescribed in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(E) Examples. The following examples illustrate the rules described in paragraph (b)(11)(vi) of this section. All of the examples assume that Taxpayer holds the positions described as capital assets and that Taxpayer holds no offsetting positions other than those described in the examples.

(1) Example 1. Taxpayer owns 100 shares of publicly traded Company X common stock and acquires put options on 100 shares of Company X common stock during the taxable year. Taxpayer does not make any straddle identifications under section 1092. During the taxable year, Taxpayer sells all 100 shares of its Company X common stock and has a \$40 capital gain. During the taxable year, Taxpayer also closes out all of its put options on Company X common stock and has a \$30 capital loss. That \$40 of capital gain is from a position that was part of a straddle during the taxable year because the position in Company X common stock and the position in put options on Company X stock are offsetting positions as defined in section 1092(c). Under paragraph (b)(11)(vi)(A) of this section, none of Taxpayer's \$40 of capital gain is eligible gain.

(2) Example 2. Taxpayer's taxable year is the calendar year. Taxpayer owns 100 shares of publicly traded Company Y common stock and has a basis in each share of \$10.00. Taxpayer also owns put options on 100 shares of Company Y common stock. Taxpayer makes a valid and timely identification under section 1092(a)(2) of the 100 shares of Company Y common stock and the put options on the 100 shares of Company Y common stock. On January 10, Year 1, Taxpayer closes out all of the put options and has a \$30.00 capital loss. On March 10, Year 1, Taxpayer sells 40 shares of the Company Y common stock for \$11.00 per share. At the end of Year 1, the fair market value of each of the 60 remaining shares of Company Y common stock held by Taxpayer is \$10.50. Under section 1092(a)(2)(A)(ii), when the put options are closed out at a loss of \$30.00, the basis of each of Taxpayer's shares of Company Y common stock is increased by \$0.30 ($\$30.00/100$). Thus, Taxpayer has a gain of \$28.00 ($(40 * \$11.00) - (40 * \$10.30)$) on the sale of the 40 shares of Company Y common stock. Paragraph (b)(11)(vi)(A) of this section applies to all of Taxpayer's gain during the taxable year from the straddle. Because Taxpayer has unrecognized gain from the straddle at the end of the taxable year, paragraph (b)(11)(vi)(C) of this section does not shield any of Taxpayer's gain from that result. The \$28 of gain is thus not eligible gain. Taxpayer must recognize and include in taxable income for the taxable year the \$28.00 capital gain. Under section 1092(a)(2)(A)(iv), Taxpayer may not deduct the \$30.00 loss from the put options.

(3) Example 3. The facts are the same as in paragraph (b)(11)(vi)(E)(2) of this section (Example 2), except Taxpayer sells the 100 shares of Company Y common stock on March 10, Year 1, for \$11.50 per share. Under section 1092(a)(2)(A)(ii), as in paragraph (b)(11)(vi)(E)(2) of this section (Example 2), when the put options are closed out at a loss of \$30.00, the basis of each of Taxpayer's shares of Company Y common stock is increased by \$0.30 ($\$30.00/100$). Taxpayer has a gain of \$120.00 ($(100 * \$11.50) - (100 * \$10.30)$) on the sale of the 100 shares of Company Y common stock. Taxpayer has net gain during the taxable year from the identified straddle of \$120.00. Under paragraph (b)(11)(vi)(C) of this section, paragraph (b)(11)(vi)(A) of this section does not apply to prevent the \$120.00 net gain from being eligible gain. As in paragraph (b)(11)(vi)(E)(2) of this section (Example 2), under section 1092(a)(2)(A)(iv), Taxpayer may not deduct the \$30.00 loss from the put options.

(4) Example 4. Taxpayer's taxable year is the calendar year. Taxpayer owns 100 shares of publicly traded Company Z common stock and has a basis in each share of \$10. Taxpayer also owns put options on 100 shares of Company Z common stock. In Year 1, Taxpayer closes out the put options at a \$100 loss. At the end of Year 1, the fair market value of each of the shares of Company Z common stock held by Taxpayer is \$15 and, under section 1092(a)(3), Taxpayer has \$500 of unrecognized gain. Because Taxpayer's unrecognized gain on the Company Z common stock at the end of Year 1 exceeds Taxpayer's loss on the put options, Taxpayer's loss is deferred under section 1092(a)(1). During Year 2, Taxpayer sells 40 shares of Company Z common stock for \$14 per share. Taxpayer has a gain of \$160 ($(40 * \$14) - (40 * \$10)$) on the sale of the 40 shares of Company Z common stock. Under paragraph (b)(11)(vi)(A) of this section, because Taxpayer's Company Z common stock was part of a straddle in a previous taxable year and a loss from a position in that straddle was deferred under section 1092(a) at the end of Year 1, the preceding taxable year, Taxpayer's \$160 Year 2 gain on the sale of the Company Z common stock is not eligible gain. At the end of Year 2, the fair market value of each of the 60 remaining shares of Company Z common stock held by Taxpayer is \$10 and Taxpayer has no unrecognized gain on its Company Z common stock. Under section 1092(a)(1)(B), Taxpayer's \$100 loss from Year 1 is treated as sustained in Year 2. Because Taxpayer has no unrecognized gain on its Company Z common stock at the end of Year 2, Taxpayer may deduct the \$100 loss in Year 2. In Year 3, Taxpayer sells the remaining 60 shares of Company Z common stock for \$50 per share. Taxpayer has a gain of \$2,400 ($(60 * \$50) - (60 * \$10)$) on the sale of the 60 shares of Company Z common stock. Because there was no loss from the straddle deferred under section 1092(a) at the end of Year 2, paragraph (b)(11)(vi)(A) of this section does not apply to prevent the \$2,400 of Year 3 net gain from being eligible gain.

(5) Example 5. Taxpayer's taxable year is the calendar year. On October 5, Year 1, Taxpayer buys 100 shares of publicly traded Exchange Traded Fund A (ETF A) and acquires offsetting section 1256 contracts on the index that underlies the ETF A shares. Taxpayer makes a valid and timely identification of all 100 ETF A shares and the offsetting section 1256 contracts under § 1.1092(b)-3T. On December 31, Year 1, the fair market value of the ETF A shares has increased by \$500, and the fair market value of the section 1256 contracts has decreased by \$450. On December 31, Year 1, Taxpayer sells the ETF shares for a \$500 gain. In addition, under section 1256(a)(1), the section 1256 contracts are treated as sold for fair market value on December 31, Year 1, for a \$450 loss. Pursuant to § 1.1092(b)-3T(b)(4), Taxpayer has a net short term capital gain from the identified mixed straddle of \$50 ($\$500 - \450). Under paragraph (b)(11)(vi)(C) of this section, paragraph (b)(11)(vi)(A) of this section does not apply to prevent the \$50 of net short term capital gain from being eligible gain.

(vii) [Reserved]

(viii) Eligible installment sale gains-

(A) In general. The term eligible gain includes gains described in this paragraph (b)(11) that would be recognized by an eligible taxpayer under the installment method pursuant to section 453 and with §§ 1.453-1 through 1.453-12 for a taxable year, provided such gain otherwise meets the requirements of this paragraph (b)(11). This includes gains recognized under the installment method under section 453 from an installment sale that occurred before December 22, 2017.

(B) 180-day period for gain from installment sales. For gains reported on the installment method, an eligible taxpayer may treat the date the payment on the installment sale is received or the last day of the taxable year in which the eligible taxpayer would have recognized the gain under the installment method as the beginning of the 180-day period described in paragraph (b)(7) of this section. Thus, if an eligible taxpayer receives one or more payments on an installment sale and treats the date the payment on the installment sale is received as the beginning of the 180-day period, each payment will begin a new 180-day period.

(ix) Additional rules for determining if gain is subject to Federal income tax-

(A) Application of a treaty-

(1) In general. For purposes of paragraph (b)(11)(i)(B) of this section, whether gain would be subject to Federal income tax is determined after application of any treaty exemption provision that an eligible taxpayer elects to apply under any applicable U.S. income tax convention.

(2) Treaty waiver. An eligible taxpayer who is not a United States person within the meaning of section 7701(a)(30) (or an eligible taxpayer who is a United States person within the meaning of section 7701(a)(30) but who is treated as a resident of another country under an applicable U.S. income tax convention) may not make an election to defer gain pursuant to section 1400Z-2(a) after the applicability date of this section (see paragraph (g) of this section) unless such eligible taxpayer irrevocably waives, in accordance with forms and instructions (see § 601.602 of this chapter), any treaty benefits that would exempt such gain from being subject to Federal income tax at the time of inclusion pursuant to an applicable U.S. income tax convention. In the event that such forms and instructions that include such waiver have not yet been published when an election pursuant to paragraph (d)(1) of this section is required to be made, such an eligible taxpayer must attach a written statement, signed under penalties of

perjury, to any forms on which an election is made pursuant to paragraph (d)(1) of this section, which states "With respect to gain deferred pursuant to an election under section 1400Z-2(a), the below signed taxpayer irrevocably waives any treaty benefits that would exempt such gain from being subject to Federal income tax at the time of inclusion pursuant to an applicable U.S. income tax convention." If such an eligible taxpayer chooses to apply the section 1400Z-2 regulations in a consistent manner for all taxable years (see paragraph (g)(2)(i) of this section), the taxpayer must include the signed statement required under this paragraph (b)(11)(ix)(A)(2) with the first annual report described in paragraph (d)(2) of this section that is required to be filed on a date that is after March 13, 2020. An eligible taxpayer not described in the first sentence of this paragraph (b)(11)(ix)(A)(2) will only be required to make the waiver described in this paragraph (b)(11)(ix)(A)(2) if and to the extent required in forms and publications (see § 601.602 of this chapter).

(3) Non-application to certain entities. This paragraph (b)(11)(ix)(A) does not apply to an entity described in paragraph (b)(11)(ix)(B) of this section.

(B) Gain of a partnership. Subject to § 1.1400Z2(f)-1(c), with respect to a partnership, the requirement in paragraph (b)(11)(i)(B) of this section that a gain be subject to Federal income tax does not apply to an otherwise eligible gain of the partnership, provided the partnership acquires the eligible interest with respect to such gain. See § 1.1400Z2(f)-1(c)(3)(i) and (ii), Examples 1 and 2, for illustrations of the application of § 1.1400Z2(f)-1(c) (providing an anti-abuse rule) to a partnership.

(12) Eligible interest-

(i) In general. For purposes of section 1400Z-2, an eligible interest in a QOF is an equity interest issued by the QOF, including preferred stock or a partnership interest with special allocations. Thus, the term eligible interest excludes any debt instrument including those within the meaning of section 1275(a)(1) and § 1.1275-1(d). An eligible interest includes a pre-existing interest in an entity that becomes a QOF pursuant to § 1.1400Z2(d)-1(a)(1)(iii).

(ii) Use as collateral permitted. Provided that the eligible taxpayer is the owner of the equity interest in the QOF for Federal income tax purposes, status as an eligible interest is not impaired by using the interest as collateral for a loan, whether as part of a purchase-money borrowing or otherwise.

(iii) Deemed contributions not creating mixed-funds investment. See paragraph (f)(2) of this section for rules regarding deemed contributions of money to a partnership pursuant to section 752(a).

(13) Eligible taxpayer. An eligible taxpayer is a person that is required to report the recognition of gains during the taxable year under Federal income tax accounting principles. Thus, for example, eligible taxpayers include individuals; C corporations, including RICs and REITs; organizations subject to tax under section 511; and partnerships, S corporations, trusts, and decedents' estates to the extent permitted by paragraphs (c)(7) through (9) of this section.

(14) Inclusion event. The term inclusion event has the meaning provided in § 1.1400Z2(b)-1(c).

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

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

(17) Property-

(i) In general. The term property means money, securities, or any other property.

(ii) Inclusion events regarding QOF corporation distributions. For purposes of § 1.1400Z2(b)-1(c), in the context in which a QOF corporation makes a distribution, the term property does not include stock (or rights to acquire stock) in the QOF corporation that makes the distribution.

(18) QOF. The term QOF means a qualified opportunity fund, as defined in section 1400Z-2(d)(1) and § 1.1400Z2(d)-1.

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

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

(21) QOF RIC. The term QOF RIC means a QOF that elects to be taxed as a RIC for Federal income tax purposes. For purposes of section 1400Z-2 and the section 1400Z-2 regulations, a RIC is a regulated investment company within the meaning of section 851.

(22) QOF REIT. The term QOF REIT means a QOF that elects to be taxed as a REIT for Federal income tax purposes. For purposes of section 1400Z-2 and the section 1400Z-2 regulations, a REIT is a real estate investment trust within the meaning of section 856.

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

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

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

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

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

(28) QOZ designation notice. The term QOZ designation notice means a notice designating population census tracts as qualified opportunity zones (QOZs) in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(29) Qualified opportunity zone business. The term qualified opportunity zone business has the meaning provided in section 1400Z-2(d)(3) and § 1.1400Z2(d)-1(d).

(30) Qualified opportunity zone business property. The term qualified opportunity zone business property has the meaning provided in section 1400Z-2(d)(2)(D) and § 1.1400Z2(d)-2.

(31) Qualified opportunity zone partnership interest. The term qualified opportunity zone partnership interest has the meaning provided in section 1400Z-2(d)(2)(C) and § 1.1400Z2(d)-1(c)(3).

(32) Qualified opportunity zone property. The term qualified opportunity zone business property has the meaning provided in section 1400Z-2(d)(2)(A) and § 1.1400Z2(d)-1(c)(1).

(33) Qualified opportunity zone stock. The term qualified opportunity zone stock has the meaning provided in section 1400Z-2(d)(2)(B) and § 1.1400Z2(d)-1(c)(2).

(34) Qualifying investment. The term qualifying investment means an eligible interest, or portion thereof, in a QOF to the extent that a deferral election is made and applies with respect to such eligible interest or portion thereof and the IRS has been timely notified of the deferral election. An eligible interest in a QOF ceases to be a qualifying investment of the owner upon, and to the extent of, the occurrence of an inclusion event with regard to that eligible interest, or

portion thereof, except as is expressly provided otherwise in § 1.1400Z2(b)-1(c) or other provisions of the section 1400Z-2 regulations.

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

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

(37) Qualifying section 355 transaction. The term qualifying section 355 transaction means a distribution described in § 1.1400Z2(b)-1(c)(11)(i)(B).

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

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

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

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

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

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

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

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

(39) Related persons. The term related when used with regard to persons and the term related persons means that there is a relationship described in section 267(b) or 707(b)(1), determined by substituting "20 percent" for "50 percent" each place it occurs in such sections. The term unrelated when used with regard to persons means that there is no relationship described in preceding sentence.

(40) Remaining deferred gain. With respect to a qualifying investment, the term remaining deferred gain means the full amount of gain that was deferred under section 1400Z-2(a)(1)(A), reduced by the amount of gain previously included under § 1.1400Z2(b)-1(b). After December 31, 2026, an eligible taxpayer's remaining deferred gain is \$0.

(41) Section 1400Z-2 regulations. The term section 1400Z-2 regulations means the regulations in this chapter, which are prescribed in whole or in part under section 1400Z-2.

(c) Operational and special rules-

(1) Attributes of gains included in income under section 1400Z-2(a)(1)(B). If section 1400Z-2(a)(1)(B), section 1400Z-2(b), and the section 1400Z-2 regulations require a taxpayer to include in income some or all of a previously deferred gain, the rules of paragraphs (c)(1)(i) and (ii) of this section apply with respect to such gain.

(i) Deferral year attributes. The gain so included per paragraph (c)(1) of this section has the same attributes in the taxable year of inclusion that the gain would have had if recognition of the gain had not been deferred under section 1400Z-2(a)(1)(A). These attributes include those taken into account by sections 1(h), 1222, 1231(b), 1256, and any other applicable provisions of the Code.

(ii) Inclusion year treatment. The gain so included per paragraph (c)(1) of this section is subject to the same Federal income tax provisions and rates that would apply to any other gains that are realized and recognized at the same time as the included gain and that have the same attributes as the deferred gain. For example, when a deferred qualified 1231 gain, as defined in paragraph (b)(1)(iii) of this section, is required to be included in income, the included section 1231 gain is treated as if it were a section 1231 gain (within the meaning of section 1231(a)(3)(A)) that was recognized on the date of inclusion.

(iii) Rules for associating included gain with deferred gains-

(A) In general. For purposes of paragraphs (c)(1)(i) and (ii) of this section, a taxpayer determines which previously deferred gain is associated with a qualifying investment in accordance with guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§ 601.601(d)(2) and 601.602 of this chapter). The rules of paragraphs (c)(1)(iii)(B) and (C) of this section only apply only to the extent a deferred gain is not clearly associated with a particular qualifying investment under this paragraph (c)(1)(iii)(A).

(B) Only one eligible gain associated with a deferral election. If only one eligible gain could have been deferred with respect to a qualifying investment, that deferred gain is associated with that qualifying investment. For example, if an eligible taxpayer makes a deferral election with respect to an investment in a QOF and only one eligible gain of the taxpayer satisfies the 180-day period with respect to the investment in the QOF, that eligible gain is the gain deferred

with respect to the qualifying investment for purposes of paragraphs (c)(1)(i) and (ii) of this section.

(C) Multiple eligible gains associated with a deferral election-

(1) In general. If more than one eligible gain may have been deferred with respect to an investment in a QOF for which a deferral election has been made, then for purposes of paragraphs (c)(1)(i) and (ii) of this section, the eligible taxpayer is treated as making the investment in the QOF first with respect to the earliest realized eligible gain, followed by the next earliest eligible gain and any other eligible gains in order of the date of their realization.

(2) Rule for gains realized on the same day. If in the application of paragraph (c)(1)(iii)(C)(1) of this section, two eligible gains are realized on the same day, such gains are allocated to the investment in the QOF proportionately.

(2) Identification of which interest in a QOF corporation has been disposed of-

(i) Need for identification. If a taxpayer holds shares of QOF stock with identical rights (fungible interests), and if the taxpayer disposes of less than all of the fungible interests, it is necessary to identify which interest or interests were disposed of. A taxpayer may effect this identification in accordance with the rules and principles of § 1.1012-1(c). Consistent with § 1.1012-1(c), if a taxpayer does not adequately identify which of the fungible interests are disposed of, the first-in, first-out identification method (FIFO method) applies.

(ii) Consequences of identification. The identification determines-

(A) Whether an investment disposed of is a qualifying investment or a non-qualifying investment; and

(B) In the case of qualifying investments-

(1) The attributes of the gain addressed in paragraph (c)(1) of this section; and

(2) The extent, if any, of an increase under section 1400Z-2(b)(2)(B) in the basis of an investment interest that is disposed of.

(3) Pro-rata method. If, after application of the FIFO method, a taxpayer is treated as having disposed of less than all of the investment interests that the taxpayer acquired on one day,

and if the interests acquired on that day vary with respect to the characteristics described in paragraph (c)(2)(ii) of this section, then a proportionate allocation must be made to determine which interests were disposed of (pro-rata method).

(4) Examples. The following examples illustrate the rules of paragraph (c)(1) through (3) of this section.

(i) Example 1. Short-term gain. For 2018, taxpayer B properly made an election under section 1400Z-2 to defer \$100 of eligible gain that, if not deferred, would have been recognized as short-term capital gain, as defined in section 1222(1). In 2022, sections 1400Z-2(a)(1)(B) and (b) require taxpayer B to include the gain in gross income. Under paragraph (c)(1) of this section, the gain included in 2022 is short-term capital gain.

(ii) Example 2. Collectibles gain. For 2018, taxpayer C properly made an election under section 1400Z-2 to defer a gain that, if not deferred, would have been collectibles gain as defined in section 1(h)(5). In a later taxable year, section 1400Z-2(a)(1)(B) and (b) requires some or all of that deferred gain to be included in gross income. The gain included is collectibles gain.

(iii) Example 3. Net capital gain from section 1256 contracts. For 2019, taxpayer D had \$100 of net capital gain realized from section 1256 contracts that is eligible gain under paragraph (b)(1)(vi)(B) of this section. D timely invested \$100 in a QOF and properly made an election under section 1400Z-2 to defer that \$100 of gain. In 2023, section 1400Z-2(a)(1)(B) and (b) requires D to include that deferred gain in gross income. Under paragraph (c)(1) of this section, the character of the inclusion is governed by section 1256(a)(3), which requires a 40:60 split between short-term and long-term capital gain. Accordingly, \$40 of the inclusion is short-term capital gain and \$60 of the inclusion is long-term capital gain.

(iv) Example 4. FIFO method. For 2018, taxpayer E properly made an election under section 1400Z-2 to defer \$300 of short-term capital gain. For 2020, E properly made a second election under section 1400Z-2 to defer \$200 of long-term capital gain. In both cases, E properly invested in QOF corporation Q the amount of the gain to be deferred, resulting in a total investment in Q of \$500. The two investments are fungible interests and the price of the interests was the same at the time of the two investments. E did not purchase any additional interest in Q or sell any of its interest in Q until 2024, when E sold for a gain 60 percent of its interest in Q. E did not adequately identify which investment in QOF Q E sold. Under paragraph (c)(2)(i) of this section, E must apply the FIFO method to identify which investments in Q that E disposed of. 60 percent of E's total investment in Q is \$300 (60% x \$500), thus under the FIFO method, E sold its entire 2018 initial investment of \$300 in Q. Under section 1400Z-2(a)(1)(B) and (b), the sale triggered an inclusion of deferred gain. Because the inclusion has the same character as the gain that had been deferred, the inclusion is short-term capital gain.

(v) Example 5. FIFO method. In 2018, before Corporation R became a QOF, Taxpayer F invested \$100 to R in exchange for 100 R common shares. Later in 2018, after R was a QOF, F invested \$500 to R in exchange for 400 R common shares and properly elected under section 1400Z-2 to defer \$500 of realized short-term capital gain from a separate investment. Even later in 2018, on different days, F realized \$300 of short-term capital gain and \$700 of long-term capital gain. On a single day that fell during the 180-day period for both of those gains, F

invested \$1,000 in R in exchange for 800 R common shares and properly elected under section 1400Z-2 to defer the two gains. In 2020, F sold 100 R common shares. F did not adequately identify which investment in R F sold. Under paragraph (c)(2)(i) of this section, F must apply the FIFO method to identify which investments in R F disposed of. As determined by that identification, F sold the initially acquired 100 R common shares, which were not part of a deferral election under section 1400Z-2. R must recognize gain or loss on the sale of its R shares under the generally applicable Federal income tax rules, but the sale does not trigger an inclusion of any deferred gain.

(vi) Example 6. FIFO method. The facts are the same as in paragraph (c)(4)(v) of this section (Example 5), except that, in addition, during 2021 F sold an additional 400 R common shares, and, as with the other sale, F did not adequately identify which investment in QOF R F sold. Under paragraph (c)(2)(i) of this section, F must apply the FIFO method to identify which investments in R were disposed of. As determined by this identification, F sold the 400 common shares which were associated with the deferral of \$500 of short-term capital gain. Thus, the deferred gain that must be included upon sale of the 400 R common shares is short-term capital gain.

(vii) Example 7. Pro-rata method. The facts are the same as in examples 5 and 6, except that, in addition, during 2022 F sold an additional 400 R common shares. Under paragraph (c)(2)(i) of this section, F must apply the FIFO method to identify which investments in R were disposed of. In 2022, F is treated as holding only the 800 R common shares purchased on a single day, and the section 1400Z-2 deferral election associated with these shares applies to gain with different characteristics (described in paragraph (c)(2)(ii) of this section). Under paragraph (c)(3) of this section, therefore, R must use the pro-rata method to determine which of the characteristics pertain to the deferred gain required to be included as a result of the sale of the 400 R common shares. Under the pro-rata method, \$150 of the inclusion is short-term capital gain ($\$300 \times 400/800$) and \$350 is long-term capital gain ($\$700 \times 400/800$).

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

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

(ii) Furnishing services. Rendering services to a QOF is not a transfer of cash or other property to a QOF. Thus, if a taxpayer receives an eligible interest in a QOF for services rendered to the QOF or to a person in which the QOF holds any direct or indirect equity interest, then the interest in the QOF that the taxpayer receives is a non-qualifying investment.

(iii) Acquisition of eligible interest from person other than QOF. An eligible taxpayer may make an investment in a QOF by acquiring an eligible interest in a QOF from a person other than the QOF, provided that all of the requirements of section 1400Z-2(a)(1) and the section

1400Z-2 regulations for making a valid deferral election with respect to that investment are otherwise satisfied with respect to such acquisition. For example, an eligible taxpayer who acquires an eligible interest in a QOF other than from the QOF also must have an eligible gain within the 180-day period prior to the eligible taxpayer's acquisition of the eligible interest in the QOF.

(6) Amount invested for purposes of section 1400Z-2(a)(1)(A)-

(i) In general. In the case of any investments described in this paragraph (c)(6), the amount of a taxpayer's qualifying investment cannot exceed the amount of eligible gain to be deferred under the deferral election. If the amount of an otherwise qualifying investment exceeds the amount of eligible gain to be deferred under the deferral election, the amount of the excess is treated as a non-qualifying investment. See paragraph (c)(6)(iii) of this section for special rules applicable to transfers to QOF partnerships.

(ii) Transfers to a QOF-

(A) Cash. If a taxpayer makes an investment in a QOF by transferring cash to a QOF, the amount of the taxpayer's investment is that amount of cash.

(B) Property other than cash-Nonrecognition transactions. This paragraph (c)(6)(ii)(B) applies if a taxpayer makes an investment in a QOF by transferring property other than cash to a QOF and if, but for the application of section 1400Z-2(b)(2)(B) and the section 1400Z-2 regulations, the taxpayer's basis in the resulting investment in the QOF would be determined, in whole or in part, by reference to the taxpayer's basis in the transferred property. This paragraph (c)(6)(ii)(B) applies separately to each item of property transferred to a QOF.

(1) Amount of qualifying investment. If paragraph (c)(6)(ii)(B) of this section applies, the amount of the taxpayer's qualifying investment is the lesser of the taxpayer's adjusted basis in the eligible interest received in the transaction, without regard to section 1400Z-2(b)(2)(B) and the section 1400Z-2 regulations, or the fair market value of the eligible interest received in the transaction, both determined immediately after the transfer.

(2) Fair market value of the eligible interest received exceeds its adjusted basis. If paragraph (c)(6)(ii)(B) of this section applies, and if the fair market value of the eligible interest received is in excess of the eligible taxpayer's adjusted basis in the eligible interest received, without regard to section 1400Z-2(b)(2)(B) and the section 1400Z-2 regulations, then the eligible taxpayer's investment in a QOF is a mixed-funds investment to which section 1400Z-2(e)(1) applies. In such a case, an amount equal to the adjusted basis of the eligible interest in the hands of the eligible taxpayer is the eligible taxpayer's qualifying investment, and the excess is the eligible taxpayer's non-qualifying investment.

(3) Transfer of built-in loss property and section 362(e)(2). If paragraph (c)(6)(ii)(B) of this section and section 362(e)(2) both apply to a transaction, the eligible taxpayer and the QOF are deemed to have made an election under section 362(e)(2)(C).

(C) Property other than cash-Taxable transactions. This paragraph (c)(6)(ii)(C) applies if an eligible taxpayer makes an investment in a QOF by transferring property other than cash to a QOF and if, without regard to section 1400Z-2(b)(2)(B) and the section 1400Z-2 regulations, the eligible taxpayer's basis in the eligible interest received would not be determined, in whole or in part, by reference to the eligible taxpayer's basis in the transferred property. If this paragraph (c)(6)(ii)(C) applies, the amount of the eligible taxpayer's investment in a QOF is the fair market value of the transferred property, as determined immediately before the transfer. This paragraph (c)(6)(ii)(C) applies separately to each item of property transferred to a QOF.

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

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

(A) Amounts not treated as a qualifying investment-

(1) Non-contributions in general. To the extent the transfer of property to a QOF partnership is characterized other than as a contribution, such as characterization as a sale under section 707 and the regulations in this part under section 707 of the Code, the transfer is not treated as being made in exchange for a qualifying investment.

(2) Reductions in investments otherwise treated as contributions. If any transfer of cash or other property to a partnership is not treated as a contribution, in whole or in part, under paragraph (c)(6)(iii)(A)(1) of this section, the part of the transfer to the partnership that is not disregarded is not a qualifying investment to the extent the partnership makes a distribution to the partner and the transfer to the partnership and the distribution would be recharacterized as a disguised sale under section 707 and the regulations in this part under section 707 of the Code if:

(i) Any cash contributed were non-cash property; and

(ii) In the case of a distribution by the partnership to which § 1.707-5(b) (relating to debt-financed distributions) applies, the partner's share of liabilities is zero.

(B) Amount invested in a QOF partnership-

(1) Calculation of amount of qualifying and non-qualifying investments. To the extent paragraph (c)(6)(iii)(A) of this section does not apply, the amount of equity received by an eligible taxpayer in a QOF partnership in exchange for the lesser of the net basis or net value of the property contributed to the QOF partnership by the eligible taxpayer is a qualifying investment. The amount of equity received by an eligible taxpayer in a QOF partnership that is a non-qualifying investment is the excess, if any, of the total equity received by the eligible taxpayer over the amount treated as a qualifying investment.

(2) Net basis. For purposes of paragraph (c)(6)(iii)(B) of this section, net basis is the excess, if any, of-

(i) The adjusted basis of the property contributed to the partnership; over

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

(3) Net value. For purposes of paragraph (c)(6)(iii)(B) of this section, net value is the excess of-

(i) The gross fair market value of the property contributed to the partnership; over

(ii) The amount of the debt described in paragraph (c)(6)(iii)(B)(2)(ii) of this section.

(4) Basis of qualifying and non-qualifying investments. The initial basis of a qualifying investment, before application of section 1400Z-2(b)(2)(B) and the section 1400Z-2 regulations or any section 752 debt allocation, is the net basis of the property contributed. The basis of a non-qualifying investment, before any section 752 debt allocation, is the remaining net basis. The basis of the qualifying investment is adjusted as provided in section 1400Z-2(b)(2)(B) and the section 1400Z-2 regulations. The bases of qualifying and non-qualifying investments are increased by any debt allocated to those investments under the rules of § 1.1400Z2(b)-1(c)(6)(iv)(B).

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

(iv) Acquisitions from another person. An eligible taxpayer may make an investment in a QOF by acquiring in a sale or exchange to which § 1.1001-1(a) applies an eligible interest in a QOF from a person other than the QOF. The amount of the eligible taxpayer's investment in the QOF with respect to which the eligible taxpayer may make a deferral election is the amount of the cash, or the net fair market value of the other property, as determined immediately before the exchange, that the eligible taxpayer exchanged for the eligible interest in the QOF.

(v) Examples. The following examples illustrate the rules of this paragraph (c)(6).

(A) Example 1. Transfer of built-in gain property with basis less than gain to be deferred-

(1) Facts. Individual B realizes \$100 of eligible gain within the meaning of paragraph (b)(11) of this section. B transfers unencumbered property with a fair market value of \$100 and an adjusted basis of \$60 to QOF Q, a C corporation, in a transaction that is described in section 351(a).

(2) Analysis. Paragraph (c)(6)(ii)(B) of this section applies because B transferred property other than cash to Q and, but for the application of section 1400Z-2(b)(2)(B), B's basis in the eligible interests in Q would be determined, in whole or in part, by reference to B's basis in the transferred property. The fair market value of the eligible interest B received is \$100, and, without regard to section 1400Z-2(b)(2)(B), B's basis in the eligible interest received would be \$60. Thus, pursuant to paragraph (c)(6)(ii)(B)(2) of this section, B's investment is a mixed-funds investment to which section 1400Z-2(e)(1) applies. Pursuant to paragraphs (c)(6)(ii)(B)(1) and (2) of this section, B's qualifying investment is \$60 (the lesser of the taxpayer's adjusted basis in the eligible interest, without regard to section 1400Z-2(b)(2)(B), of \$60 and the \$100 fair market value of the eligible interest received). Pursuant to section 1400Z-2(b)(2)(B)(i), B's basis in the qualifying investment is \$0. Additionally, B's non-qualifying investment is \$40 (the excess of the fair market value of the eligible interest received (\$100) over the taxpayer's adjusted basis in the eligible interest, without regard to section 1400Z-2(b)(2)(B) (\$60)). B's basis in the non-qualifying investment is \$0 (B's \$60 basis in its investment determined without regard to section 1400Z-2(b)(2)(B), reduced by the \$60 of adjusted basis allocated to the investment to which section 1400Z-2(e)(1)(A)(i) applies, determined without regard to section 1400Z-2(b)(2)(B)). See paragraph (c)(6)(ii)(D) of this section. Pursuant to section 362, Q's basis in the transferred property is \$60.

(B) Example 2. Transfer of built-in gain property with basis in excess of eligible gain to be deferred. The facts are the same as in paragraph (c)(6)(v)(A)(1) of this section (Example 1), except that B realizes \$50 of eligible gain within the meaning of paragraph (b)(11) of this section. Pursuant to paragraph (c)(6)(i) of this section, B's qualifying investment cannot exceed the amount of eligible gain to be deferred (that is, the \$50 of eligible gain) under the section 1400Z-2(a) election. Therefore, pursuant to paragraph (c)(6)(ii)(B)(1) of this section, B's qualifying investment is \$50 (the lesser of the taxpayer's adjusted basis in the eligible interest received, without regard to section 1400Z-2(b)(2)(B), of \$60 and the \$100 fair market value of the eligible interest, limited by the amount of eligible gain to be deferred under the section 1400Z-2(a) election). B's qualifying investment has an adjusted basis of \$0, as provided in section 1400Z-2(b)(2)(B)(i). Additionally, B's non-qualifying investment is \$50 (the excess of the fair market value of the eligible interest received (\$100) over the amount (\$50) of B's section 1400Z-2(a)(1)(A) investment). B's basis in the non-qualifying investment is \$10 (B's \$60 basis in its investment determined without regard to section 1400Z-2(b)(2)(B)), reduced by the \$50 of adjusted basis allocated to B's qualifying investment, determined without regard to section 1400Z-2(b)(2)(B).

(C) Example 3. Transfers to QOF partnerships-

(1) Facts. A and B each realized \$100 of eligible gain and each transfers \$100 to a QOF partnership. In a subsequent year, the partnership borrows \$120 from an unrelated lender and distributes \$120 equally to A and B.

(2) Analysis. If the contributions had been of property other than cash, the contributions and distributions would have been tested under the disguised sale rules of section 707 and the regulations in this part under section 707 of the Code, determining the timing of the distribution and amount of the debt allocated to each partner. Under paragraph (c)(6)(iii)(A)(2) of this section, the cash of \$200 (\$100 from A and \$100 from B) is treated as property that could be sold in a disguised sale transaction and each partner's share of the debt is zero for purposes of determining the amount of the qualifying investment. To the extent there would have been a disguised sale applying the rule of paragraph (c)(6)(iii)(A)(2) of this section, the amount of the qualifying investment would be reduced by the amount of the contribution so recharacterized.

(D) Example 4. Return of capital by QOF partnership-

(1) Facts. A realized \$100 of eligible gain and transfers \$100 of cash to a QOF partnership. Later in the partner's tax year, the partnership distributes \$20 to A in a distribution that is not recharacterized under paragraph (c)(6)(iii)(A)(2) of this section. At the time of the distribution, no allocations of income, gain, loss, or deduction had been made to A, and A's share of the partnership's debt was zero under section 752.

(2) Analysis. Because the contribution and distribution are not recharacterized under paragraph (c)(6)(iii)(A)(2) of this section, the amount of A's qualifying investment is \$100 despite the \$20 distribution. At the time the \$20 distribution is made to A, A's basis in its

qualifying investment is zero, and thus the distribution is an inclusion event under § 1.1400Z2(b)-1(c)(6)(iii).

(E) Example 5. Property contributed has built-in gain. The facts are the same as in paragraph (c)(6)(v)(C)(1) of this section (Example 3), except that the property contributed by A had a value of \$100 and basis of \$20 and the partnership did not borrow money or make a distribution. Under paragraph (c)(6)(iii)(B)(1) of this section, the amount of A's qualifying investment is \$20 (the lesser of the net value or the net basis of the property that A contributed), and the excess of the \$100 contribution over the \$20 qualifying investment is a non-qualifying investment. Under paragraph (c)(6)(iii)(B)(4) of this section, A's basis in the qualifying investment (determined without regard to section 1400Z-2(b)(2)(B) or section 752(a)) is \$20. After the application of section 1400Z-2(b)(2)(B) but before the application of section 752(a), A's basis in the qualifying investment is zero. A's basis in the non-qualifying investment is zero without regard to the application of section 752(a).

(F) Example 6. Property contributed has built-in gain and is subject to debt. The facts are the same as in paragraph (c)(6)(v)(E) of this section (Example 5), except that the property contributed by A has a gross value of \$130 and is subject to debt of \$30. Under paragraph (c)(6)(iii)(B)(1) of this section, the amount of A's qualifying investment is zero, the lesser of the property's \$100 net value (\$130 minus \$30) or \$0 net basis (\$20 minus \$30, but limited to zero). The entire contribution constitutes a non-qualifying investment.

(G) Example 7. Property contributed has built-in loss and is subject to debt. The facts are the same as in paragraph (c)(6)(v)(F) of this section (Example 6), except that the property contributed by A has a basis of \$150. Under paragraph (c)(6)(iii)(B)(1) of this section, the amount of A's qualifying investment is \$100, the lesser of the property's \$100 net value (\$130 minus \$30) or \$120 net basis (\$150 minus \$30). The non-qualifying investment is \$0, the excess of the net value (\$100) over the qualifying investment (\$100). A's basis in the qualifying investment (determined without regard to section 1400Z-2(b)(2)(B) and section 752(a)) is \$120, the net basis. After the application of section 1400Z-2(b)(2)(B), A's basis in the qualifying investment is zero, plus its share of partnership debt under section 752(a).

(7) Eligible gains that a partnership elects to defer. A partnership generally is an eligible taxpayer under paragraph (b)(13) of this section and may elect to defer recognition of some or all of its eligible gains under section 1400Z-2(a)(2) and the section 1400Z-2 regulations.

(i) Partnership deferral election. If a partnership properly makes a deferral election, then-

(A) The partnership defers recognition of the eligible gain under the rules of section 1400Z-2 and the section 1400Z-2 regulations, that is, the partnership does not recognize gain at the time it otherwise would have in the absence of the deferral election; and

(B) The deferred eligible gain is not included in the distributive shares of the partners under section 702 and is not treated as an item described in section 705(a)(1).

(ii) Subsequent recognition. Absent any additional deferral under section 1400Z-2(a)(1)(A) and the section 1400Z-2 regulations, any amount of deferred gain that an electing partnership subsequently must include in income under sections 1400Z-2(a)(1)(B) and (b) and the section 1400Z-2 regulations is recognized by the electing partnership at the time of inclusion, is subject to section 702 and is treated as an item described in section 705(a)(1) in a manner consistent with recognition at that time.

(8) Eligible gains that the partnership does not defer-

(i) Federal income tax treatment of the partnership. If a partnership does not elect to defer some, or all, of its eligible gains, the partnership's treatment of any such amounts is unaffected by the fact that the eligible gains could have been deferred under section 1400Z-2 and the section 1400Z-2 regulations.

(ii) Federal income tax treatment by the partners. If a partnership does not elect to defer some, or all, of the eligible gains-

(A) The gains for which a deferral election are not made are included in the partners' distributive shares under section 702 and are treated as items described in section 705(a)(1);

(B) If a partner's distributive share includes one or more gains that are eligible gains with respect to the partner, the partner may elect under section 1400Z-2(a)(1)(A) and the section 1400Z-2 regulations to defer some or all of such eligible gains; and

(C) A gain in a partner's distributive share is an eligible gain with respect to the partner only if it is an eligible gain with respect to the partnership and it did not arise from a sale or exchange with a person that, within the meaning of section 1400Z-2(e)(2) and the section 1400Z-2 regulations, is related to the partner.

(iii) 180-day period for a partner electing deferral-

(A) General rule. If a partner's distributive share includes a gain that is described in paragraph (c)(8)(ii)(C) of this section (gains that are eligible gains with respect to the partner), the 180-day period with respect to the partner's eligible gains in the partner's distributive share generally begins on the last day of the partnership taxable year in which the partner's distributive share of the partnership's eligible gain is taken into account under section 706(a).

(B) Elective rule. Notwithstanding the general rule in paragraph (c)(8)(iii)(A) of this section, if a partnership does not elect to defer all of its eligible gain, the partner may elect to treat the partner's own 180-day period with respect to the partner's distributive share of that gain as being-

(1) The same as the partnership's 180-day period; or

(2) The 180-day period beginning on the due date for the partnership's tax return, without extensions, for the taxable year in which the partnership realized the gain that is described in paragraph (c)(8)(ii)(C) of this section.

(C) Example. The following example illustrates the principles of this paragraph (c)(8)(iii).

(1) Facts. Four individuals, A, B, C, and D, have equal interests in a partnership, P. P has no other partners, and P's taxable year is the calendar year. On January 17, 2019, P realizes a capital gain of \$1000x that P decides not to elect to defer.

(2) Analysis of A's election. A is aware of the capital gain realized by P, and decides to defer its distributive shares of P's eligible gain. A invests \$250x in a QOF during February 2020. Under the general rule in paragraph (c)(8)(iii)(A) of this section, this investment is within the 180-day period for A, which began on December 31, 2019, the last day of P's taxable year in which A's share of P's eligible gain is taken into account under section 706(a).

(3) Analysis of B's election. B is also aware of the capital gain realized by P, and decides to defer its distributive shares of P's eligible gain. B decides to make the election provided in paragraph (c)(8)(iii)(B)(1) of this section, and invests \$250x in a QOF during February 2019. Under the elective rule in paragraph (c)(8)(iii)(B)(1) of this section, this investment is within the 180-day period for B, which began on January 17, 2019, the same day as P's 180-day period.

(4) Analysis of C's election. On March 15, 2020, P provides all of its partners with their Schedules K-1. Upon learning that its distributive share of income from P included eligible gain, C decides to make a deferral election, and also makes the election provided in paragraph (c)(8)(iii)(B)(2) of this section. It then invests \$250x in a QOF during June 2020. Under the elective rule in paragraph (c)(8)(iii)(B)(2) of this section, this investment is within the 180-day period for C, which began on March 15, 2020, the 180-day period beginning on the due date for P's tax return without extensions, for the taxable year in which P realized eligible gain.

(9) Passthrough entities other than partnerships-

(i) S corporations, nongrantor trusts, and estates. If an S corporation, a nongrantor trust, or a decedent's estate realizes an eligible gain, then rules analogous to the rules of paragraphs (c)(7) and (8) of this section apply to that entity and to its shareholders or its beneficiaries, as the case may be, to the extent they receive or are deemed to receive an allocable share of the eligible gain.

(ii) Grantor trusts. If a grantor trust realizes an eligible gain, either the trust or the deemed owner of the trust may make the election to defer recognition of the gain and make the qualifying investment under rules analogous to the rules of paragraphs (c)(7) and (8) of this section (other than the rule in paragraph (c)(8)(iii) of this section regarding the 180-day period), whether or not the gain is distributed to the deemed owner of the trust.

(d) Elections-

(1) Taxable year of deferral election. For a deferral election with respect to any eligible gain to be valid, an eligible taxpayer must make such election in accordance with guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§ 601.601(d)(2) and 601.602 of this chapter), as to the required time, form, and manner in which an eligible taxpayer (including a partner, S corporation shareholder, or beneficiary applying the elective 180-day period provided in paragraphs (c)(8)(iii)(B) and (c)(9) of this section) may make a deferral election.

(2) Annual reporting of qualifying investments. An eligible taxpayer must report whether the gains that have been deferred remain deferred at the end of each taxable year, including the year of deferral, in accordance with guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§ 601.601(d)(2) and 601.602 of this chapter). A failure to make this report for any given taxable year will result in a rebuttable presumption that the taxpayer has had an inclusion event described in § 1.1400Z2(b)-1(c) during that year. The presumption

described in the previous sentence may be rebutted by the taxpayer making the report described in the first sentence of this paragraph (d)(2) or by the taxpayer establishing to the satisfaction of the Commissioner that an inclusion event described in § 1.1400Z2(b)-1(c) did not occur during that taxable year.

(e) Interaction of section 1400Z-2 and § 1.897-6T. Section 1400Z-2 is not a nonrecognition provision, as defined in § 1.897-6T(a)(2), for purposes of § 1.897-6T.

(f) Treatment of mixed-funds investments-

(1) Investments to which no election under section 1400Z-2(a) applies. If a taxpayer invests in a QOF and makes a deferral election with respect to less than all of that investment, the portion of the investment to which the election does not apply is a non-qualifying investment. Similarly, an investment in a QOF with respect to which no deferral election is made is a non-qualifying investment.

(2) Treatment of deemed contributions of money under section 752(a). In the case of a QOF partnership, the deemed contribution of money described in section 752(a) does not create or increase an investment in the QOF described in section 1400Z-2(e)(1)(A)(ii). Thus, any basis increase resulting from a deemed section 752(a) contribution is not taken into account in determining the portion of a partner's investment subject to section 1400Z-2(e)(1)(A)(i) or (ii). See § 1.1400Z2(b)-1(c)(6)(iv)(B) for rules relating to the application of section 752 to a mixed-funds investment.

(3) Treatment of contributions to QOF corporation in which no stock is received. If a taxpayer with a qualifying investment or a non-qualifying investment in a QOF corporation subsequently makes a non-qualifying investment or a qualifying investment, respectively, and if the taxpayer receives no additional QOF stock in exchange for the subsequent investment, the taxpayer has a mixed-funds investment.

(4) Example. The following example illustrates the rules of this paragraph (f):

(i) Facts. Taxpayer A realizes \$1 million of eligible gain and on the next day contributes \$1 million to a QOF, Partnership P, in exchange for a 50 percent interest in Partnership P. Taxpayer A makes an election under section 1400Z-2(a) with respect to \$900,000 of that eligible gain. Under section 1400Z-2(e)(1), 90 percent of A's investment is described in section 1400Z-2(e)(1)(A)(i) (an investment that only includes amounts to which the election under section 1400Z-2(a) applies), and 10 percent is described in section 1400Z-2(e)(1)(A)(ii) (a separate investment consisting of other amounts). Partnership P borrows \$8 million. Under § 1.752-3(a), taking into account the terms of the partnership agreement, \$4 million of the \$8 million liability is allocated to A.

(ii) Analysis. Under section 752(a), A is treated as contributing \$4 million to Partnership P. Under paragraph (f) of this section, A's deemed \$4 million contribution to Partnership P is

ignored for purposes of determining the percentage of A's investment in Partnership P subject to the deferral election under section 1400Z-2(a) or the portion not subject to the deferral election under section 1400Z-2(a). As a result, after A's section 752(a) deemed contribution, \$900,000, or 90 percent, of A's investment in Partnership P is described in section 1400Z-2(e)(1)(A)(i) and \$100,000, or 10 percent, is described in section 1400Z-2(e)(1)(A)(ii).

(g) Applicability dates-

(1) In general. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) Prior periods. With respect to eligible gains that would be recognized (absent the making of a deferral election) during the portion of a taxpayer's first taxable year ending after December 21, 2017 that began on December 22, 2017, and during taxable years beginning after December 21, 2017, and on or before March 13, 2020, an eligible taxpayer may choose either-

(i) To apply the section 1400Z-2 regulations, if applied in a consistent manner for all such taxable years; or

(ii) To rely on the rules in proposed § 1.1400Z2(a)-1 contained in the notice of proposed rulemaking (REG-115420-18) published on October 29, 2018, as amplified by the notice of proposed rulemaking (REG-120186-18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

▪ Par. 4. Section 1.1400Z2(b)-1 is added to read as follows:

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

(a) Scope. This section provides rules under section 1400Z-2(b) of the Internal Revenue Code and the section 1400Z-2 regulations (as defined in § 1.1400Z2(a)-1(b)(41)) regarding the inclusion in income of gain deferred by a QOF owner under section 1400Z-2(a)(1)(A) and the section 1400Z-2 regulations. This section applies to a QOF owner only until all of such owner's gain deferred pursuant to a deferral election has been included in income, subject to the limitations described in paragraph (e)(5) of this section, and except as otherwise provided in

paragraph (c) or (d) of this section. Paragraph (b) of this section provides general rules under section 1400Z-2(b)(1) regarding the timing of the inclusion in income of the deferred gain. Paragraph (c)(1) of this section provides the general rule regarding the determination of the extent to which an event triggers the inclusion in gross income of all, or a portion, of an eligible taxpayer's deferred gain, and paragraphs (c)(2) through (16) of this section provide specific rules for certain events that are or are not treated as inclusion events. Paragraph (d) of this section provides rules regarding holding periods for qualifying investments. Paragraph (e) of this section provides rules regarding the amount of deferred gain included in gross income under section 1400Z-2(a)(1)(B) and (b), including special rules for QOF partnerships and QOF S corporations. Paragraph (f) of this section provides examples illustrating the rules of paragraphs (c), (d), and (e) of this section. Paragraph (g) of this section provides rules regarding basis adjustments under section 1400Z-2(b)(2)(B). Paragraph (h) of this section provides special reporting rules applicable to partners, partnerships, and direct or indirect owners of QOF partnerships. Paragraph (i) is reserved. Paragraph (j) of this section provides dates of applicability.

(b) General inclusion rule. The gain to which a deferral election applies is included in gross income, to the extent provided in paragraph (e) of this section and in accordance with the rules of § 1.1400Z2(a)-1(c)(1), in the taxable year that includes the earlier of:

(1) The date of an inclusion event; or

(2) December 31, 2026.

(c) Inclusion events-

(1) In general. Except as otherwise provided in this paragraph (c), an event is an inclusion event, if, and to the extent that-

(i) The event reduces an eligible taxpayer's direct equity interest for Federal income tax purposes in the qualifying investment;

(ii) An eligible taxpayer receives property in the event with respect to its qualifying investment and the event is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the eligible taxpayer's ownership of the QOF;

(iii) An eligible taxpayer claims a loss for worthless stock under section 165(g) or otherwise claims a worthlessness deduction with respect to its qualifying investment; or

(iv) A QOF in which an eligible taxpayer holds a qualifying investment loses its status as a QOF.

(2) Termination or liquidation of QOF or QOF owner-

(i) Termination or liquidation of QOF. Except as otherwise provided in this paragraph (c), an eligible taxpayer has an inclusion event with respect to all of its qualifying investment if the QOF ceases to exist for Federal income tax purposes. For example, if a QOF partnership converts to a QOF C corporation, or if a QOF C corporation converts to a QOF partnership or to an entity disregarded as separate from its owner for Federal income tax purposes, all investors in the QOF have an inclusion event with respect to all of their qualifying investments in the QOF.

(ii) Liquidation of QOF owner-

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

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

(3) Transfer of an investment in a QOF by gift or incident to divorce-

(i) Transfer of an investment in a QOF by gift. Except to the extent provided in paragraph (c)(5) of this section, a taxpayer's transfer of a qualifying investment by gift, as defined for purposes of chapter 12 of subtitle B of the Code, whether outright or in trust, is an inclusion event, regardless of whether that transfer is a completed gift for Federal gift tax purposes, and regardless of the taxable or tax-exempt status of the donee of the gift.

(ii) Transfers between spouses incident to divorce. A transfer between spouses or incident to divorce or otherwise as provided in section 1041 of the Code is an inclusion event.

(4) Transfer of an investment in a QOF by reason of the taxpayer's death-

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

(A) A transfer by reason of death to the deceased owner's estate;

(B) A distribution of a qualifying investment by the deceased owner's estate;

(C) A distribution of a qualifying investment by the deceased owner's trust that is made by reason of the deceased owner's death;

(D) The passing of a jointly owned qualifying investment to the surviving co-owner by operation of law; and

(E) Any other transfer of a qualifying investment at death by operation of law.

(ii) Exceptions. The following transfers are not included as a transfer by reason of the taxpayer's death, and thus are inclusion events:

(A) A sale, exchange, or other disposition by the deceased taxpayer's estate or trust, other than a distribution described in paragraph (c)(4)(i) of this section;

(B) Any disposition by the legatee, heir, or beneficiary who received the qualifying investment by reason of the taxpayer's death; and

(C) Any disposition by the surviving joint owner or other recipient who received the qualifying investment by operation of law on the taxpayer's death.

(iii) Liability for deferred Federal income tax. If the owner of a qualifying investment in a QOF dies before an inclusion event and the deferred gain is not includable in the decedent's gross income, the gain that the decedent elected to defer under section 1400Z-2(a) and the section 1400Z-2 regulations will be includable in the gross income, for the taxable year in which occurs an inclusion event, of the person described in section 691(a)(1).

(iv) Qualifying investment in the hands of the person described in section 691(a)(1). A qualifying investment received in a transfer by reason of death listed in paragraph (c)(4)(i) of this section continues to be a qualifying investment under § 1.1400Z2(a)-1(b)(34).

(5) Grantor trusts-

(i) Contributions to grantor trusts. If the owner of a qualifying investment contributes it to a trust and, under subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code (grantor trust rules), the contributing owner of the investment is the deemed owner of the trust (grantor trust), the contribution to the grantor trust is not an inclusion event. Similarly, a transfer

of the investment by the grantor trust to the trust's deemed owner is not an inclusion event. For all purposes of the section 1400Z-2 regulations, references to the term grantor trust mean the portion of the trust that holds the qualifying investment in the QOF, and such a grantor trust, or portion of the trust, is a wholly grantor trust as to the deemed owner. Such contributions may include transfers by gift or any other type of transfer between the grantor and the grantor trust that is a nonrecognition event as a result of the application of the grantor trust rules (that is, subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code).

(ii) Changes in grantor trust status. In general, a change in the income tax status of an existing trust owning a qualifying investment in a QOF, whether the termination of grantor trust status or the creation of grantor trust status, is an inclusion event. Notwithstanding the previous sentence, the termination of grantor trust status as the result of the death of the owner of a qualifying investment is not an inclusion event, but the provisions of paragraph (c)(4) of this section apply to distributions or dispositions by the trust. If a qualifying investment is held in the grantor portion of an electing small business trust (ESBT), as defined in section 1361(e)(1), and the ESBT converts into a qualified subchapter S trust (QSST), as defined in section 1361(d)(3), the beneficiary of which is the deemed owner of the grantor portion of the ESBT, there has been no change in the grantor trust status because the deemed owner continues to be taxable under subtitle A of the Code on the income and gain from the qualifying investment.

(iii) Conversions of QSSTs and ESBTs. With regard to conversions of QSSTs and ESBTs, see paragraphs (c)(7)(i)(B) and (C) of this section. For purposes of paragraph (c)(5)(ii) of this section, if a qualifying investment is held by a QSST that converts to an ESBT, the beneficiary of the QSST is the deemed owner of the grantor portion of the ESBT that then holds the qualifying investment, and the deemed owner is not a nonresident alien for purposes of this section (and thus notwithstanding § 1.1361-1(j)(8)), there has been no change in the grantor trust status because the deemed owner continues to be taxable under subtitle A of the Code on the income and gain from the qualifying investment.

(6) Special rules for partners and partnerships-

(i) Scope. Except as otherwise provided in this paragraph (c)(6), in the case of a partnership that is a QOF or a QOF partner, the inclusion rules of this paragraph (c) apply to transactions involving any direct or indirect partner of the QOF to the extent of that partner's share of any eligible gain of the QOF.

(ii) Transactions that are not inclusion events-

(A) In general. Notwithstanding paragraphs (c)(1) and (2) of this section, and except as otherwise provided in paragraph (c)(6) of this section, no transaction described in paragraph (c)(6)(ii) of this section is an inclusion event.

(B) Section 721 contributions. Subject to paragraph (c)(6)(v) of this section, a contribution by a QOF owner (contributing partner), of its qualifying QOF stock, qualifying

QOF partnership interest, or direct or indirect partnership interest in a qualifying investment to a partnership (transferee partnership) to the extent the transaction is governed by section 721(a) is not an inclusion event, provided the interest transfer does not cause a partnership termination of a QOF partnership, or the direct or indirect owner of a QOF, under section 708(b)(1). See paragraph (c)(6)(ii)(C) of this section for transactions governed by section 708(b)(2)(A). The inclusion rules in paragraph (c) of this section apply to any part of the transaction to which section 721(a) does not apply. The transferee partnership becomes subject to section 1400Z-2 and the section 1400Z-2 regulations with respect to the eligible gain associated with the contributed qualifying investment. The transferee partnership must allocate and report the remaining deferred gain that is associated with the contributed qualifying investment to the contributing partner to the same extent that the remaining deferred gain would have been allocated and reported to the contributing partner in the absence of the contribution. Additionally, the transferee partnership must allocate the basis increases described in section 1400Z-2(b)(2)(B)(iii) and (iv) to the contributing partner. If a transferee partnership is a direct QOF owner, only the transferee partnership may make the elections under section 1400Z-2(c) and the regulations in this part under section 1400Z-2(c) of the Code with respect to the contributed qualifying investment. See § 1400Z-2(c)-1(b)(1)(ii) (election by transferee partnership).

(C) Section 708(b)(2)(A) mergers or consolidations-

(1) Merger of a partnership that is a QOF partner. Subject to paragraphs (c)(6)(iii) and (v) of this section, a merger or consolidation of a partnership that is a QOF partner (original partnership) with another partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event to the extent section 721(a) applies to the merger. To the extent the original partnership terminates in the merger, as determined under § 1.708-1(c)(1), the partnership that is a continuation of the original partnership becomes subject to section 1400Z-2 and the section 1400Z-2 regulations to the same extent that the original partnership was so subject prior to the transaction, and must allocate and report any gain under section 1400Z-2(b) to the same extent and to the same partners that the original partnership allocated and reported such items prior to the transaction. Notwithstanding the rules in this paragraph (c)(6)(ii)(C)(1), the general inclusion rules of paragraph (c) of this section apply to the portion of the transaction that is otherwise treated as a sale or exchange under paragraph (c) of this section.

(2) Merger of QOF partnerships. Subject to paragraph (c)(6)(v) of this section, a merger or consolidation of a QOF partnership with another QOF partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event under paragraph (c)(2)(i) of this section if, immediately after the merger or consolidation, the resulting partnership is a QOF. The continuing partnership, as determined under § 1.708-1(c)(1), becomes subject to section 1400Z-2 and the section 1400Z-2 regulations to the same extent that the terminated partnership was so subject prior to the transaction, and must allocate and report any gain under section 1400Z-2(b) to the same extent and to the same partners that the terminated partnership would have allocated and reported such items prior to the transaction. Notwithstanding the rules in this paragraph (c)(6)(ii)(C)(2), the general inclusion rules of paragraph (c) of this section apply to the portion of the transaction that is otherwise treated as a sale or exchange under paragraph (c) of this section.

(D) Example. The following example illustrates the rules of this paragraph (c)(6)(ii).

(1) Example-

(i) Facts. In 2019, taxpayer A contributes \$100 of eligible gain to a QOF partnership, X, in exchange for a qualifying QOF partnership interest in X, and taxpayer B contributes \$100 of eligible gain to another QOF partnership, Y, in exchange for a qualifying QOF partnership interest in Y. In 2021, in transactions governed by section 721(a), A contributes her qualifying QOF partnership interest in X, and B contributes her qualifying QOF partnership interest in Y, to a newly formed partnership, UTP. In 2024, C receives a profits interest in UTP for services that she will provide to UTP. In 2031, X sells a non-inventory asset and allocates X's distributive share of the gain to UTP. No distributions are ever made from X, Y, or UTP.

(ii) Analysis. On December 31, 2026, UTP recognizes \$170 of remaining deferred gain relating to the QOF interests. Of that gain, A is allocated the \$85 of gain relating to the \$100 of eligible gain that she invested in X, and B is allocated the \$85 of gain relating to the \$100 of eligible gain that she invested in Y. C recognizes no gain at this time. In 2031, because UTP's holding period in X includes A's holding period in X, UTP has a holding period in X that exceeds 10 years, and may make an election under § 1.1400Z2(c)-1(b)(2)(ii) to exclude the gain from X's asset sale. Even though A was the original investor in X, she may not make the election. If UTP makes the election, UTP will exclude its distributive share of gain from the sale of the X asset.

(2) [Reserved]

(iii) Partnership distributions. Subject to paragraph (c)(6)(v) of this section, an actual or deemed distribution of property, including cash, by a QOF partnership to a partner with respect to its qualifying investment is an inclusion event only to the extent that the distributed property has a fair market value in excess of the partner's basis in its qualifying investment. For purposes of this paragraph (c)(6)(iii), in the case of a merger or consolidation of a QOF partnership with another QOF partnership in a transaction to which section 708(b)(2)(A) applies, the fair market value of the distributed property is reduced by the fair market value of the QOF partnership interest received in the merger or consolidation. A distribution from a partnership that directly or indirectly owns a QOF is an inclusion event only if the distribution is a liquidating distribution. For purposes of this paragraph (c)(6)(iii), the distribution is not in complete liquidation if the partnership making the distribution is a partnership that terminates in a partnership merger or consolidation under § 1.708-1(c), the continuing partnership in the merger or consolidation continues to directly or indirectly own an interest in the QOF, and the distributee is distributed an interest in the resulting partnership as part of the merger or consolidation. See paragraph (c)(6)(iv) of this section for special rules relating to mixed-funds investments.

(iv) Special rules for mixed-funds investments-

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

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

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

(D) Allocation percentages. The allocation percentages of the separate interests will be determined based on the relative capital contributions attributable to the qualifying investment and the non-qualifying investment. In the event a partner receives a profits interest in the QOF partnership for services provided to or for the benefit of the QOF partnership, the allocation percentage with respect to the profits interest is based on the share of residual profits the mixed-funds partner would receive with respect to that interest, disregarding any allocation of residual profits for which there is not a reasonable likelihood of application.

(E) Examples. The following examples illustrate the rules of this paragraph (c)(6)(iv).

(1) Example 1. Allocation of residual profits for which there is no reasonable likelihood of application-

(i) Facts. A realizes \$100 of eligible gain and B realizes \$900 of eligible gain. A and B form Q, a QOF partnership. B contributes \$900 to Q in exchange for a qualifying QOF partnership interest (B's capital interest). A contributes \$100 to Q in exchange for a qualifying QOF partnership interest (A's capital interest and, with B's capital interest, the capital interests) and agrees to provide services to Q in exchange for a profits interest in Q (A's profits interest). Q's partnership agreement provides that Q's profits are first allocated to the capital interests until

the capital interest holders receive a 10 percent preferred return with respect to those interests. Next, Q's profits are allocated 15 percent to A with respect to A's profits interest, 10 percent to A with respect to A's capital interest, and 75 percent to B until the capital interests receive a 1,000% preferred return. Thereafter, Q's profits are allocated 1 percent to A's profits interest and 99 percent to the capital interests. There is not a reasonable likelihood that Q's profits will be sufficient to result in an allocation in the last tranche.

(ii) Analysis. Under paragraph (c)(6)(iv)(D) of this section, the allocation percentage with respect to A's profits interest is calculated based on the share of residual profits that A would receive with respect to A's profits interest, disregarding any allocation of residual profits that has no reasonable likelihood of being achieved. Under Q's partnership agreement, A's share of Q's residual profits with respect to A's profits interest is 1 percent. However, there is no reasonable likelihood that this 1 percent allocation will apply because it is unlikely that the capital interests will receive a 1,000% preferred return. Therefore, under paragraph (c)(6)(iv)(D) of this section, A's share of Q's residual profits with respect to A's profits interest is 15 percent, the final allocation of Q's profits to A's profits interest that is reasonably likely to apply. The allocation percentage for A's capital interest in Q is 10 percent under paragraph (c)(6)(iv)(D) of this section. Thus, allocations and distributions made to A are treated as made 60 percent (15/25) to A's non-qualifying profits interest and 40 percent (10/25) to A's qualifying QOF partnership interest.

(2) Example 2. Separate entity holding profits interest-

(i) Facts. The facts are the same as in paragraph (c)(6)(iv)(E)(1) of this section (Example 1), except that A is a partnership that has no eligible gain and P, a partnership that is owned by the same taxpayers who own A, realizes \$100 of eligible gain and contributes \$100 to Q for its qualifying investment.

(ii) Analysis. Under paragraph (c)(6)(iv)(D) of this section, A's profits interest is a non-qualifying investment in Q. Because P directly holds only a qualifying QOF partnership interest in Q, P is not a mixed-funds partner in Q, and 100 percent of the allocations and distributions made to P are attributable to P's qualifying QOF partnership interest.

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

(A) The amount of remaining deferred gain of one or more direct or indirect partners; or

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

(7) Special rules for S corporations-

(i) In general. Except as provided in paragraphs (c)(7)(ii), (iii), and (iv) of this section, none of the following is an inclusion event:

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

(B) A conversion of a QSST to an ESBT, but only if the QSST beneficiary is the deemed owner of the grantor portion of the ESBT that receives the qualifying investment and if the deemed owner is not a nonresident alien;

(C) A conversion of an ESBT to a QSST, where the qualifying investment is held in the grantor portion of the ESBT and the QSST beneficiary is the deemed owner of the grantor portion of the ESBT; and

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

(ii) Distributions by QOF S corporation-

(A) General rule. An actual or constructive distribution of property by a QOF S corporation to a QOF shareholder with respect to its qualifying investment is an inclusion event to the extent that the distribution is treated as gain from the sale or exchange of property under section 1368(b)(2) and (c). For the treatment of a distribution by a QOF S corporation to which section 305(a) applies, see paragraph (c)(8)(ii). For the treatment of a distribution to which section 302(d) or section 306(a)(2) applies, see paragraph (c)(9)(ii) of this section.

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

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

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

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

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

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

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

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

(8) Distributions by a QOF corporation-

(i) General rule for distributions by a QOF C corporation. If a QOF C corporation distributes property to a QOF shareholder with respect to a qualifying investment, only the amount of the distribution to which section 301(c)(3) or 1059(a)(2) applies gives rise to an inclusion event. For purposes of this paragraph (c)(8)(i), a distribution of property includes a distribution of stock in the QOF C corporation making the distribution (or rights to acquire such

stock) if the distribution is treated as a distribution of property to which section 301 applies pursuant to section 305(b).

(ii) Section 305(a) distributions. A distribution with respect to qualifying QOF stock to which section 305(a) applies is not an inclusion event. QOF stock received in such a distribution is qualifying QOF stock. The shareholder's remaining deferred gain is allocated pro rata between the new qualifying QOF stock received and the qualifying QOF stock with respect to which the distribution was made in proportion to the fair market values of each on the date of distribution. See § 1.307-1(a).

(9) Dividend-equivalent redemptions and redemptions of section 306 stock.-

(i) Redemptions by QOF C corporations-

(A) In general. Except as provided in paragraph (c)(9)(i)(B) of this section, if a QOF C corporation redeems its stock from a QOF shareholder in a transaction described in section 302(d) or section 306(a)(2), the full amount of such redemption gives rise to an inclusion event.

(B) Redemptions of stock of wholly owned QOF C corporation and pro rata redemptions. Paragraph (c)(8)(i) of this section applies to a redemption described in paragraph (c)(9)(i)(A) of this section if, at the time of such redemption-

(1) All stock in the QOF C corporation is held directly by a single shareholder, or directly by members of a single consolidated group; or

(2) The QOF C corporation has outstanding only one class of stock, as defined in section 1361 and § 1.1361-1(l), and the redemption is pro rata as to all shareholders of the redeeming QOF C corporation.

(ii) Redemptions by QOF S corporations. If a QOF S corporation redeems its stock from a QOF shareholder in a transaction described in section 302(d) or section 306(a)(2), the amount that gives rise to an inclusion event is the amount by which the distribution exceeds basis in the QOF stock as adjusted under paragraph (c)(7)(ii) of this section.

(10) Qualifying section 381 transactions-

(i) Assets of a QOF are acquired-

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

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

(C) Receipt of boot by QOF shareholder in qualifying section 381 transaction. This paragraph (c)(10)(i)(C) applies if assets of a QOF corporation are acquired in a qualifying section 381 transaction and an eligible taxpayer that is a QOF shareholder receives boot with respect to its qualifying investment. If this paragraph (c)(10)(i)(C) applies, the QOF shareholder has an inclusion event and is treated as disposing of a portion of its qualifying investment that bears the same proportion to the QOF shareholder's total qualifying investment immediately before the inclusion event as the fair market value of the boot received by the QOF shareholder with respect to its qualifying investment in the qualifying section 381 transaction bears to the fair market value of the total consideration received by the QOF shareholder with respect to its qualifying investment in the qualifying section 381 transaction.

(ii) Assets of a QOF shareholder are acquired-

(A) In general. Except to the extent provided in paragraph (c)(10)(ii)(B) of this section, a qualifying section 381 transaction in which the assets of a QOF shareholder are acquired is not an inclusion event with respect to the qualifying investment and the acquiring corporation succeeds to the target corporation's status as the QOF shareholder with respect to the qualifying investment.

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

(11) Section 355 transactions-

(i) Distribution by a QOF-

(A) In general. Except as provided in paragraph (c)(11)(i)(B) of this section, if a QOF corporation distributes stock or securities of a controlled corporation to a QOF shareholder with respect to a qualifying investment in the QOF corporation in a transaction to which section 355 (or so much of section 356 as relates to section 355) applies, the QOF shareholder has an inclusion event and is treated as disposing of a portion of its qualifying investment equal in value to the fair market value of the shares of the controlled corporation and the fair market value of any boot received by the QOF shareholder in the distribution with respect to its qualifying investment.

(B) Controlled corporation becomes a QOF-

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

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

(3) Receipt of boot. If a QOF shareholder receives boot in a qualifying section 355 transaction with respect to its qualifying investment, and if section 356(a) applies to the transaction, paragraph (c)(10)(i)(C) of this section applies. If a QOF shareholder receives boot in a qualifying section 355 transaction with respect to its qualifying investment, and if section 356(b) applies to the transaction, paragraph (c)(8)(i) of this section applies.

(4) Treatment of controlled corporation stock as qualified opportunity zone stock. If stock or securities of a controlled corporation are distributed in a qualifying section 355 transaction, and if the distributing corporation retains a portion of the controlled corporation stock after the initial distribution, the retained stock will not cease to qualify as qualified opportunity zone stock in the hands of the distributing corporation solely as a result of the qualifying section 355

transaction. This paragraph (c)(11)(i)(B)(4) does not apply unless the distributing corporation distributes all of the stock and securities in the controlled corporation held by it immediately before the distribution within a 30-day period.

(ii) Distribution by a QOF shareholder. If a QOF shareholder distributes stock or securities of a controlled QOF corporation in a transaction to which section 355 applies, then for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section, the QOF shareholder has an inclusion event and is treated as disposing of the portion of its qualifying QOF stock over which it no longer has direct Federal income tax ownership.

(12) Recapitalizations and section 1036 transactions-

(i) In general. Except as otherwise provided in paragraph (c)(12)(ii) of this section, if a QOF corporation engages in a transaction that qualifies as a reorganization described in section 368(a)(1)(E) (a recapitalization), or if a QOF shareholder engages in a transaction that is described in section 1036 (a section 1036 exchange), the transaction is not an inclusion event.

(ii) Receipt of property or boot by QOF shareholder. If a QOF shareholder receives property or boot, or is treated as having received property or boot, with respect to its qualifying investment in a recapitalization, then the property or boot is treated as property or boot to which section 301 or section 356(a) or (c) applies, as determined under general Federal income tax principles. If, in a section 1036 exchange, a QOF shareholder receives property with respect to its qualifying investment that is not permitted to be received without the recognition of gain, then, for purposes of this section, the receipt of the property is treated in a similar manner as the receipt of such property or boot in a recapitalization. Paragraph (c)(8)(i) of this section applies to property to which section 301 applies. Paragraph (c)(10)(i)(C) of this section applies to boot to which section 356(a) or (c) applies.

(13) Section 304 transactions. If a QOF shareholder transfers its qualifying investment in a transaction described in section 304(a), the full amount of the consideration gives rise to an inclusion event.

(14) Deduction for worthlessness. If an eligible taxpayer claims a loss for worthless stock under section 165(g) or otherwise claims a worthlessness deduction with respect to all or a portion of its qualifying investment, then for purposes of section 1400Z-2 and the section 1400Z-2 regulations, the eligible taxpayer has an inclusion event and is treated as having disposed of that portion of its qualifying investment on the date it became worthless. Thus,

neither section 1400Z-2(b)(2)(B)(iii) or (iv) nor section 1400Z-2(c) applies to that portion of the eligible taxpayer's qualifying investment after the date it became worthless.

(15) Decertification of a QOF. The decertification of a QOF, whether a self-decertification pursuant to § 1.1400Z2(d)-1(a)(3) or an involuntary decertification pursuant to § 1.1400Z2(d)-1(a)(4), is an inclusion event.

(16) Other inclusion and non-inclusion events. Notwithstanding any other provision of this paragraph (c), the Commissioner may determine in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) that a type of transaction is or is not an inclusion event.

(d) Holding periods-

(1) Holding period for qualifying investment-

(i) In general. Solely for purposes of section 1400Z-2(b)(2)(B), section 1400Z-2(c), and the section 1400Z-2 regulations, and except as otherwise provided in this paragraph (d)(1), the length of time a qualifying investment has been held is determined without regard to the period for which the eligible taxpayer had held property exchanged for such investment (even if such period would be relevant for determining the length of time for other Federal income tax purposes).

(ii) Holding period for qualifying investment received in certain transactions with respect to QOFs. For purposes of section 1400Z-2(b)(2)(B), section 1400Z-2(c), and the section 1400Z-2 regulations, the principles of section 1223(1) or (4) apply to determine the holding period for a qualifying investment received by a QOF owner in-

(A) A distribution described in paragraph (c)(2)(ii)(B) of this section;

(B) A distribution to which section 305(a) applies;

(C) A qualifying section 381 transaction described in paragraph (c)(10)(i) or (ii) of this section;

(D) A qualifying section 355 transaction described in paragraph (c)(11)(i)(B) of this section;

(E) A recapitalization or a section 1036 exchange described in paragraph (c)(12) of this section;

(F) A contribution of a QOF interest to a partnership to the extent section 721(a) applies to the transfer; or

(G) A distribution of a QOF interest to the extent the interest was received in a merger of two or more QOF partnerships in a transaction described in section 708(b)(2)(A).

(iii) Tacking with deceased owner or deemed owner of a grantor trust. For purposes of section 1400Z-2(b)(2)(B), section 1400Z-2(c), and the section 1400Z-2 regulations, the holding period of a qualifying investment held by an eligible taxpayer who received that qualifying investment by reason of the prior owner's death includes the time during which that qualifying investment was held by the deceased owner. The rule in the preceding sentence also applies to allow a grantor trust to tack the holding period of the deemed owner if the grantor trust acquires the qualifying investment from the deemed owner in a transaction that is not an inclusion event.

(2) Status of QOF assets as qualified opportunity zone property. For purposes of section 1400Z-2(d) and the section 1400Z-2 regulations, including for purposes of determining whether the original use of qualified opportunity zone business property commences with the acquiring corporation or partnership, qualified opportunity zone property does not lose its status as qualified opportunity zone property solely as a result of-

(i) Its transfer by the transferor corporation to the acquiring corporation in a qualifying section 381 transaction described in paragraph (c)(10)(i) of this section;

(ii) Its transfer by the distributing corporation to the controlled corporation in a qualifying section 355 transaction described in paragraph (c)(11)(i)(B) of this section; or

(iii) Its transfer by the transferor partnership to the acquiring partnership in a transaction to which section 708(b)(2)(A) applies, but only to the extent section 721(a) applies to the transaction.

(e) Amount includible. Except as provided in §§ 1.1400Z2(a)-1(b)(7) and 1.1400Z2(f)-1(b), the amount of gain included in gross income under section 1400Z-2(a)(1)(B) and this section on a date described in paragraph (b) of this section is determined under this paragraph (e).

(1) In general. Except as provided in paragraphs (e)(2) and (4) of this section, and subject to paragraph (e)(5) of this section, in the case of an inclusion event, the amount of gain included in gross income is equal to the excess of the amount described in paragraph (e)(1)(i) of this section over the eligible taxpayer's basis in the portion of the qualifying investment that is disposed of in the inclusion event. See paragraph (c) of this section for rules regarding the amount that gave rise to the inclusion event, and see paragraph (g) of this section for applicable ordering rules.

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

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

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

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

(B) The fair market value of the portion of the qualifying investment that is disposed of in the inclusion event.

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

(2) Property received from a QOF in certain transactions. In the case of an inclusion event described in paragraph (c)(6)(iii) or (v), (c)(7)(ii), (c)(8)(i), or (c)(9) or (13) of this section (or in paragraph (c)(11) or (12) of this section, to the extent the rules in paragraph (c)(8)(i) of this section apply to the inclusion event), the amount of gain included in gross income is equal to the lesser of-

(i) The remaining deferred gain; or

(ii) The amount that gave rise to the inclusion event.

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

(i) The lesser of-

(A) The remaining deferred gain; and

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

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

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

(i) The product of-

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

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

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

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

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

(1) Example 1. Determination of basis, holding period, and qualifying investment-

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

(ii) Analysis. Under § 1.1400Z2(a)-1(c)(6)(ii)(B)(1), A made a qualifying investment of \$500. Under section 1400Z-2(b)(2)(B)(i), A's basis in its qualifying investment in Q is \$0. For purposes of sections 1400Z-2(b)(2)(B) and 1400Z-2(c), A's holding period in its new investment in Q begins on October 31, 2019. See paragraph (d)(1)(i) of this section. Other than for purposes of applying section 1400Z-2, A has a 10-year holding period in its new Q investment as of October 31, 2019.

(iii) Transfer of built-in gain property. The facts are the same as in paragraph (f)(1)(i) of this section (this Example 1), but A's basis in transferred asset N is \$200. Under § 1.1400Z2(a)-1(c)(6)(ii)(B)(1), A made a qualifying investment of \$200 and a non-qualifying investment of \$300.

(2)

(2) Example 2. Transfer of qualifying investment-

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

(ii) Analysis. Under § 1.1400Z2(a)-1(c)(6)(ii)(A), A made a qualifying investment of \$500 on October 31, 2019. In the Transfer, A exchanged 25 percent of its qualifying investment for Federal income tax purposes, which reduced A's direct qualifying investment. Under paragraph (c)(1)(i) of this section, the Transfer is an inclusion event to the extent of the reduction in A's direct qualifying investment. Under paragraph (e)(1) of this section, A therefore includes in income an amount equal to the excess of the amount described in paragraph (e)(1)(i) of this section over A's basis in the portion of the qualifying investment that was disposed of, which in this case is \$0. The amount described in paragraph (e)(1)(i) is the lesser of \$125 ($\$500 \times (\$200/\$800)$) or \$200. As a result, A must include \$125 of its deferred capital gain in income in 2020. After the Transfer, the Q stock is not qualifying Q stock in Y's hands.

(iii) Disregarded transfer. The facts are the same as in paragraph (f)(2)(i) of this section (this Example 2), except that Y elects to be treated as an entity that is disregarded as an entity

separate from its owner for Federal income tax purposes effective prior to the Transfer. Since the Transfer is disregarded for Federal income tax purposes, A's transfer of its qualifying investment in Q is not treated as a reduction in direct tax ownership for Federal income tax purposes, and the Transfer is not an inclusion event with respect to A's qualifying investment in Q for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. Thus, A is not required to include in income any portion of its deferred capital gain.

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

(3) Example 3. Part sale of qualifying QOF partnership interest in Year 6 when value of the QOF partnership interest has increased-

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

(ii) Analysis. Because A held its qualifying QOF partnership interest for at least five years, A's basis in its partnership interest at the time of the sale is \$220 (the original zero basis with respect to the contribution, plus the \$200 debt allocation, plus the 10% increase for interests held for five years). The sale of 50 percent of A's qualifying QOF partnership interest to B requires A to recognize \$90 of gain, the lesser of \$90, which is 50 percent of \$180 (the \$200 remaining deferred gain less the \$20 five-year basis adjustment), or \$390, which is the gain that would be recognized on a taxable sale of 50 percent of the interest. A also recognizes \$300 of gain relating to the appreciation of its interest in Q.

(4) Example 4. Sale of qualifying QOF partnership interest when value of the QOF partnership interest has decreased-

(i) Facts. The facts are the same as in paragraph (f)(3) of this section (Example 3), except that A sells 50 percent of its qualifying QOF partnership interest in Q to B for cash of \$50, and at

the time of the sale, the fair market value of Q's qualified opportunity zone business property is \$1,500.

(ii) Analysis. Because A held its qualifying QOF partnership interest for at least five years, A's basis at the time of the sale is \$220. Under section 1400Z-2(b)(2)(A), the sale of 50 percent of A's qualifying QOF partnership interest to B requires A to recognize \$40 of gain, the lesser of \$90 (50 percent of the excess of A's \$200 remaining deferred gain over A's \$20 five-year adjustment) or \$40 (the gain that would be recognized by A on a sale of 50 percent of its QOF interest). A's remaining basis in its qualifying QOF partnership interest is \$110.

(5) Example 5. Amount includible on December 31, 2026-

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

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

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

(6) Example 6. Mixed-funds investment-

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

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

qualifying investment. For the \$25 distribution made with respect to the qualifying investment, A is required to recognize \$25 of gain.

(iii) Basis adjustments. Under paragraph (g)(1)(ii)(B) of this section, prior to determining the tax consequences of the distribution, A increases its basis in its qualifying QOF partnership interest by \$25 under section 1400Z-2(b)(2)(B)(ii). The distribution of \$25 results in no gain under section 731. After the distribution, A's basis in its qualifying QOF partnership interest is \$0 (\$25-\$25).

(7) Example 7. Qualifying section 381 transaction of a QOF corporation-

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

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

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

(iv) Receipt of boot. The facts are the same as in paragraph (f)(7)(i) of this section (this Example 7), except that the value of X's qualifying investment immediately before the Merger is \$1,000, X receives \$100 of cash in addition to Y stock with a fair market value of \$900 in the Merger in exchange for its qualifying investment, and neither Q nor Y has any earnings and profits. Under paragraph (c)(10)(i)(C) of this section, X is treated as disposing of 10 percent (\$100/\$1000) of its qualifying investment. Under paragraph (e)(1) of this section, X is required to include \$50 (\$500 x (\$100/\$1000)) of its deferred capital gain in income in 2020.

(8) Example 8. Section 355 distribution by a QOF-

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

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

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

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

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

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

QOF status. The distribution is a qualifying section 355 transaction and is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. Neither A nor B is required to include its deferred capital gain in income in 2025 as a result of the transaction.

(vii) Section 355 split-off with boot. The facts are the same as in paragraph (f)(8)(v) of this section (this Example 8), except that B also receives boot. Under paragraph (c)(11)(i)(B)(3) of this section, B has an inclusion event and is treated as disposing of a portion of its qualifying investment that bears the same proportion to B's total qualifying investment immediately before the inclusion event as the fair market value of the boot bears to the fair market value of the total consideration received by B.

(9) Example 9. Recapitalization-

(i) Facts. On May 31, 2019, each of A and B sells a capital asset to an unrelated party and realizes \$500 of capital gain. On October 31, 2019, A contributes \$500 to newly formed Q in exchange for 50 shares of class A stock of Q (A's qualifying investment) and B contributes \$500 to Q in exchange for 60 shares of class B stock of Q (B's qualifying investment). A and B are the sole shareholders of Q. In 2020, B exchanges all of its class B stock of Q for 40 shares of class A stock of Q as well as other property in a transaction that qualifies as a reorganization under section 368(a)(1)(E).

(ii) Analysis. Because A did not receive any boot in the transaction, A does not have an inclusion event with respect to its qualifying investment in Q. See paragraph (c)(12)(i) of this section. Therefore, A is not required to include any of its deferred gain in income as a result of this transaction. However, under paragraph (c)(12)(ii) of this section, B has an inclusion event. If section 301 applies to the boot received by B, B has an inclusion event to the extent of its section 301(c)(3) gain. If section 356(a) or (c) applies to the boot received by B, B is treated as disposing of a portion of its qualifying investment that bears the same proportion to B's total qualifying investment immediately before the inclusion event as the fair market value of the boot bears to the fair market value of the total consideration received by B.

(10) Example 10. Debt financed distribution-

(i) Facts. On September 24, 2019, A and B form Q, a QOF partnership, each contributing \$200 that is deferred under the section 1400Z-2(a) election to Q in exchange for a qualifying investment. On November 18, 2022, Q obtains a nonrecourse loan from a bank for \$300. Under section 752, the loan is allocated \$150 to A and \$150 to B. On November 30, 2022, when the values and bases of the investments remain unchanged, Q distributes \$50 to A.

(ii) Analysis. A is not required to recognize gain under paragraph (c) of this section because A's basis in its qualifying investment is \$150 (the original zero basis with respect to the contribution, plus the \$150 debt allocation). The distribution reduces A's basis to \$100.

(11) Example 11. Debt financed distribution in excess of basis-

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

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

(g) Basis adjustments-

(1) Basis adjustments under section 1400Z-2(b)(2)(B)(ii) resulting from the inclusion of deferred gain-

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

(ii) Specific application to section 301(c)(3) gain, section 1059(a)(2) gain, S corporation shareholder gain, or partner gain-

(A) Applicability. This paragraph (g)(1)(ii) applies if a QOF makes a distribution to its owner, and if, without regard to any basis adjustment under section 1400Z-2(b)(2)(B)(ii), at least a portion of the distribution would be characterized as gain under section 301(c)(3), section 1059(a)(2), or paragraphs (c)(6)(iii) and (c)(7)(ii) of this section with respect to the owner's qualifying investment in the QOF.

(B) Ordering rule. If paragraph (g)(1)(ii) of this section applies, an eligible taxpayer is treated as having an inclusion event to the extent provided in paragraph (c)(6)(iii), (c)(7)(ii), or (c)(8), (9), (11), (12), or (13) of this section, as applicable. Then, the eligible taxpayer increases its basis under section 1400Z-2(b)(2)(B)(ii) before determining the Federal income tax consequences of the distribution.

(iii) Shares in QOF C corporations to which section 1400Z-2(b)(2)(B)(ii) adjustments are made. If a shareholder of a QOF C corporation disposes of qualifying QOF stock in an exchange subject to section 1001, basis adjustments under section 1400Z-2(b)(2)(B)(ii) are made only to the portion of the qualifying investment that is disposed of in the inclusion event.

(2) Amount of basis adjustment under section 1400Z-2(b)(2)(B)(iii) and (iv). The increases in basis under section 1400Z-2(b)(2)(B)(iii) and (iv) are limited to 10 percent and 5 percent, respectively, of the remaining deferred gain with respect to a qualifying investment as of the dates on which basis is increased under that section.

(3) Examples. The following examples illustrate the rules of paragraphs (g)(1) and (2) of this section.

(i) Example 1-

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

(B) Recognition of gain. Under paragraph (g)(1)(ii)(B) of this section, the Distribution is first evaluated without regard to any basis adjustment under section 1400Z-2(b)(2)(B)(ii). Of the \$100 distribution, \$40 is treated as a dividend and \$60 is treated as gain from the sale or exchange of property under section 301(c)(3), because A's basis in its Q stock is \$0 under section 1400Z-2(b)(2)(B)(i). Under paragraphs (c)(8)(i) and (e)(2) of this section, \$60 of A's gain that was deferred under section 1400Z-2(a) and § 1.1400Z2(a)-1 is recognized in 2020. Pursuant to § 1.312-6(b), A's earnings and profits increase by \$60.

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

(ii) Example 2-

(A) Facts. The facts are the same as in paragraph (g)(3)(i) of this section (Example 1), except that, instead of receiving a distribution, A sells half of the Q stock for \$250 in 2020. A continues to hold the remainder of its Q stock through 2024.

(B) Recognition of gain and basis adjustments in 2020. Under paragraphs (c)(1) and (e)(1) of this section, \$250 of A's gain that was deferred under section 1400Z-2(a) and § 1.1400Z2(a)-1 is recognized in 2020. Under paragraphs (g)(1)(i) and (iii) of this section, A increases its basis to \$250 in the sold shares in accordance with section 1400Z-2(b)(2)(B)(ii) immediately before the sale. Accordingly, A has no gain or loss on the sale (\$250-\$250). Pursuant to § 1.312-6(b), A's earnings and profits increase by \$250. A's basis in its remaining shares of Q stock remains \$0.

(C) Basis adjustment in 2024. Under paragraph (g)(2) of this section, A increases its basis in its remaining shares of Q stock in accordance with section 1400Z-2(b)(2)(B)(iii). Pursuant to § 1.312-6(b), A's earnings and profits are increased by the amount of the basis adjustment.

(4) Special partnership rules-

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

(ii) Treatment of basis adjustments. Any basis adjustment to a qualifying investment in a QOF partnership described in section 1400Z-2(b)(2)(B)(iii) and (iv) and section 1400Z-2(c) is basis for all purposes, including for purposes of suspended losses under section 704(d).

(iii) Tiered arrangements. Any basis adjustment described in section 1400Z-2(b)(2)(B)(iii) and (iv) and section 1400Z-2(c) (basis adjustment rules) will be treated as an item of income described in section 705(a)(1) and must be reported in accordance with the applicable forms and instructions. Any amount to which the basis adjustment rules or to which section 1400Z-2(b)(1) applies will 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 the eligible interest, and will track to the owners' interests, based on their shares of the remaining deferred gain to which such amounts relate.

(5) Basis adjustments in S corporation stock-

(i) Treatment of basis adjustments. Any basis adjustment to a qualifying investment in a QOF S corporation described in section 1400Z-2(b)(2)(B)(iii) and (iv) and section 1400Z-2(c) is basis for all purposes, including for purposes of suspended losses under section 1366(d).

(ii) S corporation investor in QOF-

(A) S corporation. If an S corporation is an investor in a QOF, the S corporation must adjust the basis of its qualifying investment as set forth in this paragraph (g). The rule in this paragraph (g)(5)(ii)(A) does not affect adjustments to the basis of any other asset of the S corporation.

(B) S corporation shareholder-

(1) In general. The S corporation shareholder's pro-rata share of any recognized capital gain that has been deferred at the S corporation level will be separately stated under section 1366 when recognized and will adjust the shareholders' stock bases under section 1367 at that time.

(2) Basis adjustments to qualifying investments. Any adjustment made to the basis of an S corporation's qualifying investment under section 1400Z-2(b)(2)(B)(iii) or (iv), or section 1400Z-2(c), will not:

(i) Be separately stated under section 1366; or

(ii) Until the date on which an inclusion event with respect to the S corporation's qualifying investment occurs, adjust the shareholders' stock bases under section 1367.

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

(iii) QOF S corporation-

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

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

(6) Basis in the hands of a taxpayer who received a qualifying investment in a QOF by reason of the prior owner's death-

(i) In general. The basis of a qualifying investment in a QOF, transferred by reason of a decedent's death in a transfer that is not an inclusion event, is zero under section 1400Z-2(b)(2)(B)(i), as adjusted for increases in basis as provided under section 1400Z-2(b)(2)(B)(ii) through (iv) and (c). See paragraph (c)(4) of this section.

(ii) Examples. The following examples illustrate the rule of this paragraph (g)(6).

(A) Example 1. Taxpayer A, an individual, contributed \$50X to a QOF in exchange for a qualifying investment in the QOF in January 2019. This \$50X was capital gain that was excluded from A's gross income under section 1400Z-2(a)(1)(A). A's basis in the qualifying investment is zero. As of January 2024, A's basis in the QOF is increased by an amount equal to 10 percent of the amount of gain deferred by reason of section 1400Z-2(a)(1)(A), so that A's adjusted basis in 2024 is \$5X. A dies in 2025 and A's heir inherits this qualifying investment in the QOF. A's death is not an inclusion event for purposes of section 1400Z-2. The heir's basis in the qualifying investment is \$5X.

(B) Example 2. The facts are the same as in paragraph (g)(6)(ii)(A) of this section (Example 1), except that A dies in November 2027, when the fair market value of the qualifying investment was \$75X. A was required to pay the tax on the excess of the deferred capital gain over A's basis as part of A's 2026 income. Therefore, at the time of A's death, A's basis in the qualifying investment is the sum of three basis adjustments: The adjustment made in January 2024 described in paragraph (g)(6)(ii)(A) (Example 1) (\$5X); an additional adjustment made as of January 2026 equal to 5 percent of the amount of gain deferred by reason of section 1400Z-2(a)(1)(A) (\$2.5X); and the adjustment as of December 31, 2026, by reason of section 1400Z-2(b)(1)(B) and (b)(2)(B)(ii) (\$42.5X). Accordingly, the basis of the qualifying investment in the hands of A's heir is \$50X.

(h) Notifications by partners and partnerships, and shareholders and S corporations-

(1) Notification of deferral election. A partnership that makes a deferral election must notify all of its partners of the deferral election and state each partner's distributive share of the deferred gain in accordance with applicable forms and instructions.

(2) Notification of deferred gain recognition by indirect QOF owner. If an indirect owner of a QOF partnership sells or otherwise disposes of all or a portion of its indirect interest in the QOF partnership in a transaction that is an inclusion event under paragraph (c) of this section, such indirect owner must provide to the QOF owner notification and information sufficient to enable the QOF owner, in a timely manner, to recognize an appropriate amount of deferred gain.

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

(i) [Reserved]

(j) Applicability dates-

(1) In general. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) Prior periods. With respect to the portion of a taxpayer's first taxable year ending after December 21, 2017, that began on December 22, 2017, and for taxable years beginning after December 21, 2017, and on or before March 13, 2020, a taxpayer may choose either-

(i) To apply section 1400Z-2 regulations, if applied in a consistent manner for all such taxable years; or

(ii) To rely on the rules in proposed § 1.1400Z2(b)-1 contained in the notice of proposed rulemaking (REG-120186-18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

- Par. 5. Section 1.1400Z2(c)-1 is added to read as follows:

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

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

(b) Investment for which an election can be made-

(1) In general-

(i) Election by taxpayer. An eligible taxpayer who makes a deferral election with respect to, or acquires by reason of a transaction that is not an inclusion event, a qualifying investment in a QOF, recognizes gain (if any) on December 31, 2026, of an amount determined under § 1.1400Z2(b)-1(e)(3) (and so much of § 1.1400Z2(b)-1(e)(4) as relates to § 1.1400Z2(b)-1(e)(3)) with respect to that qualifying investment, and whose holding period in that qualifying investment is at least ten years, is eligible to make an election described in section 1400Z-2(c) on the sale or exchange of that qualifying investment. Except as otherwise provided in this paragraph (b)(1), to the extent a taxpayer described in the preceding sentence has an inclusion event described in § 1.1400Z2(b)-1(c) with respect to any portion of a qualifying investment, that portion is no longer a qualifying investment and the taxpayer is not eligible to make an election pursuant to section 1400Z-2(c) and this section with respect to that portion. See § 1.1400Z2(c)-1(b)(2) for special election rules for QOF partnerships and QOF S corporations.

(ii) Transferee partnership to make an election under section 1400Z-2(c)-

(A) In general. This paragraph (b)(1)(ii)(A) applies if an eligible taxpayer (transferor) transfers its qualifying investment to a transferee in a transaction described in § 1.1400Z2(b)-1(c)(6)(ii) to the extent governed by section 721(a). If this paragraph (b)(1)(ii)(A) applies, and if the transferee sells or exchanges a qualifying investment that has a holding period of at least 10 years under § 1.1400Z2(b)-1(d)(1)(ii)(F), then the transferee can make an election described in section 1400Z-2(c) on the sale or exchange of the qualifying investment. See § 1.1400Z2(b)-1(c)(6)(ii)(B) (transferee partnership makes section 1400Z-2(c) election regarding contributed qualifying investment).

(B) Conditions for transferee partnership or merged partnership to make an election described in section 1400Z-2(c). A transferee referred to in paragraph (b)(1)(ii)(A) of this section is eligible to make an election described in section 1400Z-2(c) with respect to a qualifying investment only if the transferee:

(1) Files a statement, at the time and in the manner that the Commissioner of Internal Revenue may prescribe by Internal Revenue Service forms and instructions or by publication in the Internal Revenue Bulletin (see § 601.601(d)(ii)(b) of this chapter), providing the name of the transferor, the date of the transfer, and the transferor's holding period in the transferred qualifying investment immediately before the transfer; and

(2) Files form 8997, Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments, with the transferee's timely filed Federal Tax Return.

(iii) Limitation on the 10-year rule. As required by section 1400Z-2(e)(1) (treatment of investments with mixed funds), section 1400Z-2(c) applies only to the portion of an investment in a QOF that is a qualifying investment. For rules governing the application of section 1400Z-2(c) to the portion of an investment in a QOF for which a loss has been claimed under section 165(g) or otherwise, see § 1.1400Z2(b)-1(c)(14).

(iv) Transactions to which section 301(c)(3), section 1059(a)(2), or section 1368(b)(2) or (c)(3) applies. The receipt of amounts treated as gain from the sale or exchange of property under section 301(c)(3), section 1059(a)(2), or section 1368(b)(2) or (c)(3) with respect to qualifying QOF stock in a transaction treated as an inclusion event under § 1.1400Z2(b)-1(c) does not prevent the QOF shareholder from making a subsequent election described in section 1400Z-2(c) with respect to that qualifying QOF stock.

(v) Partnership distributions in excess of basis. The occurrence of an inclusion event described in § 1.1400Z2(b)-1(c)(6)(iii), which addresses a distribution of property by a QOF partnership to a QOF partner where the distributed property has a fair market value in excess of the QOF partner's basis in its qualifying investment, does not prevent the QOF partner from making a subsequent election described in section 1400Z-2(c) with respect to the QOF partner's qualifying QOF partnership interest.

(2) Special election rules for QOF partnerships and QOF S corporations-

(i) Dispositions of qualifying QOF partnership interests. If a QOF partner's basis in a qualifying QOF partnership interest is adjusted under section 1400Z-2(c) upon the disposition of a qualifying investment, then the basis of the QOF partnership interest is adjusted to an amount equal to the net fair market value of the interest, plus the QOF partner's share of QOF partnership indebtedness under section 752 with respect to that interest, and immediately prior to the sale or exchange, the bases of the assets of the QOF partnership and of any partnership owned directly or indirectly by the QOF partnership solely through one or more partnerships are also adjusted with respect to the disposed-of qualifying investment. For purposes of this paragraph (b)(2)(i), section 7701(g) will apply in determining the value of a qualifying investment in a QOF

partnership. The adjustments in this paragraph (b)(2)(i) are calculated in a manner similar to the section 743(b) adjustments that would have been made if the transferor QOF 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, assuming that valid section 754 elections had been in place with respect to the QOF partnership and any partnerships directly or indirectly owned by the QOF partnership, whether or not an actual section 754 election is in place for any of the partnerships. This paragraph (b)(2)(i) applies without regard to the amount of deferred gain that was included under section 1400Z-2(b)(1) or the timing of that inclusion.

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

(A) Election to exclude gains and losses. If a taxpayer has held a qualifying investment in a QOF partnership or QOF S corporation for at least 10 years, as determined under § 1.1400Z2(b)-1(d), and the QOF partnership or QOF S corporation or any partnership that is owned directly, or indirectly solely through one of more partnerships, by the QOF partnership or QOF S corporation sells or exchanges property, the taxpayer may make an election under this paragraph (b)(2)(ii)(A) to exclude from the taxpayer's income all gains and losses allocable to the qualifying investment that arise from all such sales or exchanges for the QOF partnership's or QOF S corporation's taxable year. In order for the election to be valid, the requirements set forth in paragraph (b)(2)(ii)(B) of this section must be satisfied. For purposes of paragraph (b)(2)(ii) of this section, gains and losses include all gains and losses other than gains or losses from the sale or exchange of any item of inventory, as defined in section 1221(a)(1), in the ordinary course of business.

(B) Deemed distribution and recontribution-

(1) In general. If any partner of a QOF partnership, or shareholder of a QOF S corporation, makes an election under paragraph (b)(2)(ii)(A) of this section, the taxpayer is treated as receiving a distribution of cash as calculated under paragraph (b)(2)(ii)(B)(2) of this section, from the QOF partnership or QOF S corporation at the end of the QOF partnership's or QOF S corporation's taxable year and immediately recontributing the cash to the QOF partnership or QOF S corporation in exchange for a non-qualifying investment in the QOF partnership or QOF S corporation. In determining the post-contribution qualifying investment and non-qualifying investment, the QOF will value each interest based on the underlying values of the QOF's assets determined at the end of its taxable year in accordance with the principles of § 1.704-1(b)(2)(iv) (in the case of a QOF partnership) or fair market value (in the case of a QOF S corporation). If the QOF partner or QOF S corporation shareholder is a mixed-funds partner or shareholder prior to the sale or exchange, the deemed distribution will be treated as made proportionately with respect to the partner's or shareholder's qualifying investment and non-qualifying investment in the QOF partnership in accordance with § 1400Z2(b)-1(c)(6)(iv)(B), or the QOF S corporation. The distribution and recontribution rule of paragraph (b)(2)(ii)(B) of this section is solely for purposes of determining the taxpayer's interests in the QOF partnership or QOF S corporation that constitute a qualifying investment and a non-qualifying investment, and has no other Federal income tax consequence (for example, the rule does not affect the accumulated adjustments account of an S corporation and cannot be treated as a disproportionate distribution by an S corporation).

(2) Amount of deemed distribution and re-contribution. The amount of cash referred to in paragraph (b)(2)(ii)(B)(1) of this section that is deemed distributed by and recontributed to the QOF partnership or QOF S corporation is equal to-

(i) The partner's or shareholder's share of net proceeds from all sales and exchanges of property described in paragraph (b)(2)(ii)(A) of this section (other than sales of inventory in the ordinary course of business) for the taxable year for which the election under paragraph (b)(2)(ii)(A) is made (calculated without regard to whether any gain or loss is recognized with regard to such property); less

(ii) All actual distributions of cash by the QOF partnership or QOF S corporation with respect to any such sale or exchange that is made within 90 days of the sale or exchange.

(3) Meaning of net proceeds-

(i) QOF partnerships. For purposes of paragraph (b)(2)(ii)(B)(2)(i) of this section, with respect to QOF partnerships, the term "net proceeds" means the amount realized from the sale of property described in paragraph (b)(2)(ii)(A) of this section less any indebtedness included in the amount realized that would constitute a qualified liability under § 1.707-5(a)(6) if the sold or exchanged property had been contributed to a lower-tier partnership subject to the debt.

(ii) QOF S corporations. For purposes of paragraph (b)(2)(ii)(B)(2)(i) of this section, with respect to QOF S corporations, the term "net proceeds" means the amount realized from the sale of property described in paragraph (b)(2)(ii)(A) of this section less any indebtedness included in the amount realized that would constitute a qualified liability under the principles of § 1.707-5(a)(6).

(C) Treatment as exempt income-

(1) General rule. With respect to the taxpayer making an election under paragraph (b)(2)(ii) of this section, the excess of any gains over losses excluded from income under paragraph (b)(2)(ii) of this section is treated as income of the partnership or S corporation that is exempt from tax under the Internal Revenue Code for purposes of section 705(a)(1)(B) or section 1367(a)(1)(A). Section 265 or any similar provisions do not apply to disallow any deductions otherwise allowable under subtitle A for amounts paid or incurred by a taxpayer that are allocable to any gain excluded from income under paragraph (b)(2)(ii) of this section.

(2) Special rule regarding accumulated adjustments account. Solely for purposes of determining whether an adjustment must be made to the accumulated adjustments account of an

S corporation, the excess amount described in paragraph (b)(2)(ii)(C)(1) of this section is not treated as tax exempt income.

(D) Time and manner of making the election to exclude gain. An election under paragraph (b)(2)(ii)(A) of this section is made by filing the applicable form with the taxpayer's timely filed income tax return, without extensions, for its taxable year that includes the taxable year end of the QOF partnership or QOF S corporation. A taxpayer must make the election under paragraph (b)(2)(ii)(A) of this section for each taxable year in which it wishes to exclude gains and losses of a QOF partnership or QOF S corporation.

(3) Basis adjustments upon sale or exchange of qualifying QOF stock-

(i) In general. Except as provided in paragraph (b)(3)(ii) of this section, if a QOF shareholder's basis in qualifying QOF stock is adjusted under section 1400Z-2(c), then the basis of the qualifying QOF stock is adjusted to an amount equal to the fair market value of the qualifying QOF stock immediately prior to the sale or exchange. This paragraph (b)(3)(i) applies without regard to the amount of deferred gain that was included under section 1400Z-2(b)(1) or the timing of that inclusion.

(ii) Specific application to transactions to which section 301(c)(3), section 1059(a)(2), or section 1368(b)(2) or (c)(3) applies-

(A) Applicability. This paragraph (b)(3)(ii) applies if a QOF corporation makes a distribution to a QOF shareholder, at least a portion of the distribution would be characterized as gain from a sale or exchange under section 301(c)(3), section 1059(a)(2), or section 1368(b)(2) or (c)(3) with respect to the QOF shareholder's qualifying QOF stock without regard to any basis adjustment under section 1400Z-2(c), and the QOF shareholder elects to adjust the basis of its qualifying QOF stock under section 1400Z-2(c).

(B) Ordering rule. If paragraph (b)(3)(ii) of this section applies with respect to a QOF corporation, the QOF shareholder increases its basis by the lesser of the amount of the distribution characterized as gain from a sale or exchange or the fair market value of the QOF shareholder's qualifying QOF stock before determining the Federal income tax consequences of the distribution.

(c) Extension of availability of the election described in section 1400Z-2(c). The ability to make an election under section 1400Z-2(c) for investments held for at least 10 years is not impaired solely because, under section 1400Z-1(f), the designation of one or more qualified opportunity zones ceases to be in effect. The preceding sentence does not apply to elections under section 1400Z-2(c) that are related to dispositions occurring after December 31, 2047.

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

(1) Example 1-

(i) Facts. In 2020, taxpayer A invests \$100 in QOF S, a QOF S corporation, in exchange for a qualifying investment and defers \$100 of gain. At the end of 2028, the qualified opportunity zone designation expires for the population census tract in which QOF S primarily conducts its trade or business. In 2031, A sells all of its QOF S shares, realizes gain, and makes an election to increase the qualifying basis in its QOF S shares to fair market value. But for the expiration of the designated zones in section 1400Z-1(f), QOF S and A's conduct is consistent with continued eligibility to make the election under section 1400Z-2(c).

(ii) Analysis. Under paragraph (c) of this section, although the designation expired on December 31, 2028, the expiration of the zone's designation does not, without more, invalidate A's ability to make an election under section 1400Z-2(c). Accordingly, pursuant to that election, A's basis in the QOF stock is increased to its fair market value and A recognizes no gain or loss on the sale.

(2) Example 2-

(i) Facts. In 2019, taxpayer A realizes \$100 of eligible gain and contributes \$100 to a QOF partnership, X, in exchange for a qualifying QOF partnership interest in X, and taxpayer B contributes \$100 of eligible gain to another QOF partnership, Y, in exchange for a qualifying QOF partnership interest in Y. In 2021, in transactions governed by section 721(a), A contributes her qualifying QOF partnership interest in X, and B contributes her qualifying QOF partnership interest in Y, to a newly formed partnership, UTP. In 2024, C receives a profits interest in UTP for services that she will provide to UTP. In 2031, X sells a non-inventory asset and allocates X's distributive share of the gain to UTP. No distributions are ever made from X, Y, or UTP.

(ii) Analysis. On December 31, 2026, UTP recognizes \$170 of remaining deferred gain relating to the QOF interests. Of that gain, A is allocated the \$85 of gain relating to the \$100 of eligible gain that she invested in X, and B is allocated the \$85 of gain relating to the \$100 of eligible gain that she invested in Y. C recognizes no gain at this time. In 2031, because UTP's holding period in X includes A's holding period in X, UTP has a holding period in X that

exceeds 10 years, and may make an election under § 1.1400Z2(c)-1(b)(2)(ii)(A) to exclude the gain from X's asset sale. Even though A was the original investor in X, she may not make the election. If UTP makes the election, UTP will exclude its distributive share of gain from the sale of the X asset.

(3) Example 3-

(i) Facts. In 2019, taxpayer B invests \$100 in P, a QOF partnership, in exchange for a qualifying investment and properly makes an election under section 1400Z-2(a) to defer \$100 of eligible gain. B's interest in the partnership is 50 percent. In 2030, when B's interest in P has a value of \$130 and a basis of \$100, B sells the interest, recognizing \$30 of gain, \$15 of which is attributable to inventory assets of P. B makes an election under section 1400Z-2(c) with respect to the sale.

(ii) Analysis. Because B's election under section 1400Z-2(c) is in effect with respect to the sale, the bases of B's interest in P and of P's assets with respect to the interest sold are adjusted to fair market value immediately before B's sale under paragraph (b)(2)(i) of this section, and B recognizes no gain or loss on the sale.

(4) Example 4-

(i) Facts. The facts are the same as in paragraph (d)(3) of this section (Example 3), except that P sells qualified opportunity zone property that is not inventory sold in the ordinary course of business and distributes all of the proceeds from the sale to partners within 90 days of the sale (the qualified opportunity zone property was the only property sold by P in the taxable year). The sold property has a value of \$60 and a basis of \$40. P recognizes \$20 of gain, \$10 of which is allocable to B, and B makes an election under paragraph (b)(2)(ii)(A) of this section for the year in which B's allocable share of the partnership's recognized gain would be included in B's gross income.

(ii) Analysis. Because B's election under paragraph (b)(2)(ii)(A) of this section is in effect, B will exclude its entire \$10 allocable share of the partnership's \$20 of recognized gain. Because \$10 of the sale proceeds were actually distributed to B within 90 days of the sale, P is not treated as making a deemed distribution and receiving a recontribution under paragraph (b)(2)(ii)(B) of this section with respect to B.

(5) Example 5-

(i) Facts. In 2019, taxpayer C invests \$100 in Q, a QOF partnership, in exchange for a qualifying investment and properly makes an election under section 1400Z-2(a) to defer \$100 of eligible gain. C's interest in Q is 50%. Q's taxable year ends on December 31. In 2025, Q purchases three qualified opportunity zone properties, X, Y, and Z. On January 22, 2031, Q sells property X for \$200, recognizing \$140 of gain. On July 31, 2031, Q sells property Y for \$80, recognizing \$20 of loss. Q makes no distributions to its partners in 2031, has no indebtedness, and has no other gain or loss other than from the sales of properties X and Y. Property Z has a value of \$280 at all times throughout 2031. C's share of Q's gain and loss is \$70 and \$10, respectively, for a net gain of \$60, and C makes an election under paragraph (b)(2)(ii)(A) of this section to exclude the gains and losses from its income.

(ii) Analysis. Because C has made an election under paragraph (b)(2)(ii)(A) of this section, under paragraph (b)(2)(ii)(B) of this section, C is treated as receiving a cash distribution of \$140 from Q, C's share of the net proceeds from the sales of properties X and Y, on December 31, 2031, and immediately recontributing \$140 to Q in exchange for a non-qualifying investment in Q. Beginning on January 1, 2032, 50 percent of A's interest in Q is a qualifying investment, and 50 percent of A's investment in Q is a non-qualifying investment. This amount is calculated as a fraction, the numerator of which is \$140, the amount deemed distributed and recontributed, and the denominator of which is \$280, the value of C's interest prior to the deemed distribution.

(6) Example 6-

(i) Facts. The facts are the same as in paragraph (d)(5) of this section (Example 5), except that Q distributes all of the proceeds from the sale of property X to its partners on March 30, 2031. Q does not make any distribution of proceeds from the sale of property Y.

(ii) Analysis. Under paragraph (b)(2)(iii)(B)(2)(ii) of this section, the actual distribution of cash to C on March 30, 2031, reduces the amount of the deemed distribution and recontribution with respect to C on December 31, 2031. Accordingly, the amount of C's deemed distribution and recontribution is \$40, which increases C's non-qualifying investment to 22 percent. This amount is calculated as a fraction, the numerator of which is \$40, the amount deemed distributed and recontributed, and the denominator of which is \$180, the value of C's interest.

(7) Example 7. Section 301(c)(3) gain-

(i) Facts. In 2020, taxpayer X makes an investment in Q, a QOF corporation, in exchange for a qualifying investment. In 2031, when X's qualifying Q stock is worth \$1000x, Q makes a distribution to X with respect to X's qualifying QOF stock, \$500x of which is treated as gain from a sale or exchange under section 301(c)(3). In 2032, X disposes of all of its qualifying QOF stock in Q.

(ii) Analysis-

(A) Section 301(c)(3) distribution. X is eligible to make an election described in section 1400Z-2(c) in 2031 with respect to its \$500x gain. Under paragraph (b)(3)(ii) of this section, the basis adjustment is \$500x, the lesser of \$500x, the amount of the distribution treated as gain from the sale or exchange of property, and \$1000x, the fair market value of the qualifying QOF stock before the distribution. As a result of the election, X increases its basis in its qualifying QOF stock in Q by \$500x immediately before the distribution; consequently, the \$500x is treated as a return of basis under section 301(c)(2).

(B) Disposition of qualifying QOF stock. X is eligible to make an election described in section 1400Z-2(c) in 2032 with respect to all of its qualifying QOF stock in Q, notwithstanding X's receipt of a section 301(c)(3) distribution in 2031. See paragraph (b)(1)(iv) of this section.

(e) Capital gain dividends paid by a QOF RIC or QOF REIT that some shareholders may be able to elect to receive tax free under section 1400Z-2(c)-

(1) Eligibility. For purposes of paragraph (b) of this section, if a shareholder of a QOF RIC or QOF REIT receives a capital gain dividend identified with a date, as defined in paragraph (e)(2) of this section, then, to the extent that the shareholder's shares in the QOF RIC or QOF REIT paying the capital gain dividend are a qualifying investment in the QOF RIC or QOF REIT-

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

(ii) If, on the date identified, the shareholder had held that qualifying investment in the QOF RIC or QOF REIT for at least 10 years, then the shareholder may exclude that capital gain dividend, or part thereof, from its taxable income for the taxable year.

(2) Definition of capital gain dividend identified with a date. A capital gain dividend identified with a date means an amount of a capital gain dividend, as defined in section 852(b)(3)(C) or 857(b)(3)(B), or part thereof, and a date that the QOF RIC reports or QOF REIT designates in a notice provided to the shareholder not later than one week after the QOF RIC reports or QOF REIT designates the capital gain dividend pursuant to section 852(b)(3)(C) or 857(b)(3)(B). The notice must be mailed to the shareholder unless the shareholder has provided

the QOF RIC or QOF REIT with an email address to be used for this purpose. In the manner and at the time determined by the Commissioner, the QOF RIC or QOF REIT must provide the Commissioner all data that the Commissioner specifies with respect to the amounts of capital gain dividends and the dates reported or designated by the QOF RIC or QOF REIT for each shareholder.

(3) General limitations on the amounts of capital gain with which a date may be identified-

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

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

(iii) Undistributed capital gains. If section 852(b)(3)(D)(i) or 857(b)(3)(C)(i) requires a shareholder of a QOF RIC or QOF REIT to include a reported or designated amount in the shareholder's long-term capital gain for a taxable year, then inclusion of this amount in this manner is treated as receipt of a capital gain for purposes of this paragraph (e) and may be identified with a date.

(iv) Gross gains. The amount determined under paragraph (e)(4) of this section is determined without regard to any losses that may have been recognized on other sales or exchanges of qualified opportunity zone property. The losses do, however, limit the total amount of capital gain dividends that may be reported or designated under section 852(b)(3) or section 857(b)(3).

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

(i) Simplified determination. If, during its taxable year, the QOF RIC or QOF REIT recognizes long-term capital gain on one or more sales or exchanges of qualified opportunity zone property, then the QOF RIC or QOF REIT may identify the first day of that taxable year as the date identified with each reported or designated amount with respect to the capital gain dividends for that taxable year. A reported or designated identification is invalid in its entirety if the amount of gains that the QOF RIC or QOF REIT identifies with that date exceeds the aggregate long-term capital gains recognized on those sales or exchanges for that taxable year.

(ii) Sale date determination-

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

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

(f) Applicability dates. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

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

§ 1.1400Z2 (d)-1 Qualified opportunity funds and qualified opportunity zone businesses.

(a) Overview. This section provides rules that an eligible entity (as defined in paragraph (a)(1) of this section) must satisfy to be a qualified opportunity fund (QOF) or a qualified opportunity zone business. Paragraphs (a)(2) through (4) of this section provide rules that eligible entities must follow to be certified as QOFs, as well as rules for the de-certification of QOFs. Paragraph (b) of this section provides rules for determining whether the property held by a QOF satisfies the 90-percent investment standard of section 1400Z-2(d)(1) or the property held by a qualified opportunity zone business satisfies the 70-percent tangible property standard of section 1400Z-2(d)(3)(A)(i). Paragraph (c) of this section provides rules regarding qualified opportunity zone property that a QOF must hold to satisfy the 90-percent investment standard. Paragraph (d) of this section provides rules that an eligible entity must satisfy to be a qualified opportunity zone business that is owned, in whole or in part, by one or more QOFs. Paragraph (e) of this section provides applicability dates for this section. See § 1.1400Z2(d)-2 for rules that

must be satisfied for tangible property of an eligible entity to be treated as qualified opportunity zone business property.

(1) Eligible entity-

(i) In general. Except as provided in paragraph (a)(1)(ii) of this section, the term eligible entity means an entity that is classified as a corporation or partnership for Federal income tax purposes. In order to be treated as a QOF, an eligible entity must self-certify on an annual basis that it satisfies the requirements of paragraphs (b) and (c) of this section, as appropriate. An eligible entity is a qualified opportunity zone business if it satisfies the requirements of paragraph (d) of this section.

(ii) Exceptions based on where an entity is created, formed, or organized-

(A) QOFs. An entity classified as a corporation or partnership for Federal income tax purposes (an entity) but that is not organized under the law of the United States or the law of one of the 50 states, a government of a federally recognized tribe (Indian tribal government), the District of Columbia, or a U.S. territory, is not an eligible entity and is ineligible to be a QOF. An entity described in the preceding sentence is also ineligible to be a qualified opportunity zone business, and therefore an equity interest in the entity is neither qualified opportunity zone stock nor a qualified opportunity zone partnership interest for purposes of section 1400Z-2(d)(2).

(B) Entities organized in a U.S. territory-

(1) In general. If an entity is organized in a U.S. territory but not in one of the 50 States or the District of Columbia, the entity may be a QOF only if the entity is organized for investing in qualified opportunity zone property that relates to a trade or business operated in the U.S. territory in which the entity is organized. If an entity is organized in a U.S. territory but not in one of the 50 States or the District of Columbia, an equity interest in the entity may be qualified opportunity zone stock or a qualified opportunity zone partnership interest, as the case may be, only if the entity conducts a qualified opportunity zone business in the U.S. territory in which the entity is organized. An entity described in the preceding sentence is treated as satisfying the requirement, as applicable, of being a domestic corporation for purposes of section 1400Z-2(d)(2)(B)(i) or of being a domestic partnership for purposes of section 1400Z-2(d)(2)(C).

(2) U.S. territory defined. For purposes of this paragraph (a)(1), the term U.S. territory means American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, the U.S. Virgin Islands, and any other territory not under the jurisdiction of one of the 50 States, an Indian tribal government, or the District of Columbia where a qualified opportunity zone has been designated under section 1400Z-1.

(iii) Pre-existing entities. There is no legal barrier to a pre-existing eligible entity qualifying as a QOF or a qualified opportunity zone business, but the pre-existing eligible entity must satisfy all of the applicable requirements of section 1400Z-2, this section, and § 1.1400Z2(d)-2.

(2) Self-certification as a QOF. The following rules apply to the required self-certification of an eligible entity as a QOF:

(i) Time, form, and manner. The self-certification must be timely-filed and effected annually in such form and manner as may be prescribed by the Commissioner of Internal Revenue (Commissioner) in the Internal Revenue Service (IRS) forms or instructions, or in publications or guidance published in the Internal Revenue Bulletin (see §§ 601.601(d)(2) and 601.602 of this chapter).

(ii) First taxable year. The self-certification must identify the first taxable year for which the self-certification takes effect.

(iii) First month. The self-certification may identify the first month (in that initial taxable year) in which the self-certification takes effect.

(A) Failure to specify first month. If the self-certification fails to specify the month in the initial taxable year that the self-certification takes effect, then the self-certification is treated as taking effect in the first month of that taxable year.

(B) Investments before entity's first month as QOF not eligible for deferral. If an investment in eligible interests of an eligible entity occurs prior to the eligible entity's first month as a QOF, any election under section 1400Z-2(a)(1) made for that investment is invalid and the investment is a non-qualifying investment.

(iv) Becoming a QOF in a month that is not the first month of the taxable year. This paragraph (a)(2)(iv) applies to an eligible entity if its self-certification as a QOF is first effective for a month that is not the first month of that entity's taxable year.

(A) For purposes of applying section 1400Z-2(d)(1)(A) and (B) in the first year of the QOF's existence, the phrase first six-month period of the taxable year of the fund means the first six months each of which is in the taxable year and in each of which the entity is a QOF. Thus, if an eligible entity becomes a QOF in the seventh or later month of a 12-month taxable year, the 90-percent investment standard in section 1400Z-2(d)(1) takes into account only the QOF's assets on the last day of the QOF's taxable year.

(B) The computation of any penalty under section 1400Z-2(f)(1) does not take into account any months before the first month in which an eligible entity is a QOF.

(3) Self-decertification of a QOF. If a QOF chooses to self-decertify as a QOF, the following rules apply:

(i) Form and manner. The self-decertification must be effected in such form and manner as may be prescribed by the Commissioner in IRS forms or instructions or in publications or guidance published in the Internal Revenue Bulletin (see §§ 601.601(d)(2) and 601.602 of this chapter).

(ii) Time. The self-decertification becomes effective at the beginning of the month following the month specified by the taxpayer, which month must not be earlier than the month in which the taxpayer files its self-decertification as provided in paragraph (a)(3)(i) of this section.

(4) [Reserved]

(b) Valuation of property for purposes of the 90-percent investment standard and the 70-percent tangible property standard-

(1) In general. An eligible entity may value its owned or leased property using the valuation methods provided in paragraphs (b)(3) and (4) of this section to determine whether-

(i) In the case of an eligible entity that has self-certified as a QOF, the assets owned or leased by the QOF satisfy the 90-percent investment standard in section 1400Z-2(d)(1); and

(ii) In the case of an eligible entity that has issued qualified opportunity zone partnership interests or qualified opportunity zone stock to a QOF, the tangible property owned or leased by the eligible entity satisfies the 70-percent tangible property standard in section 1400Z-2(d)(3)(A)(i).

(2) Special rules-

(i) QOFs-

(A) In general. To meet the 90-percent investment standard in section 1400Z-2(d)(1), on a semiannual basis, a QOF may value its assets using the applicable financial statement valuation method set forth in paragraph (b)(3) of this section, if the QOF has an applicable financial statement within the meaning of § 1.475(a)-4(h), or the alternative valuation method set forth in paragraph (b)(4) of this section. During each taxable year, a QOF must apply consistently the valuation method that it selects under paragraph (b) of this section to all assets valued with respect to the taxable year.

(B) Option for QOFs to disregard recently contributed property. A QOF may choose to determine compliance with the 90-percent investment standard by excluding from both the numerator and denominator of the test any property that satisfies all the criteria in paragraphs (b)(2)(i)(B)(1) through (3) of this section. A QOF need not be consistent from one semiannual test to another in whether it avails itself of the option in this paragraph (b)(2)(i)(B).

(1) The amount of the property was received by the QOF partnership as a contribution or by the QOF corporation solely in exchange for stock of the corporation;

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

(3) Between the date of the fifth business day after the contribution or exchange and the date of the semiannual test, the amount was held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less.

(C) Safe harbor for QOFs to determine whether equity in an entity is qualified opportunity zone property. A QOF may choose to determine compliance with the 90-percent investment standard for each semiannual testing date of the QOF by including in both the numerator and denominator of the test the equity of each entity the QOF holds on that testing date that satisfies all the criteria in paragraph (b)(2)(i)(C)(1) or (2) of this section.

(1) The entity was a qualified opportunity zone business for at least 90 percent of the QOF's cumulative holding period for that equity of the entity-

(i) Beginning on the date the QOF's self-certification as a QOF is first effective; and

(ii) Ending on the last day of the entity's most recent taxable year ending on or before the semiannual testing date of the QOF.

(2) An entity that would not be a qualified opportunity zone business as of the end of its last taxable year ending on or before a semiannual testing date of the QOF is a qualified opportunity zone business with respect to the QOF for that taxable year of the entity if-

(i) A cure is achieved for the entity under paragraph (d)(6) of this section; and

(ii) The QOF files its Federal income tax return for the taxable year of the QOF containing the testing date on a date that is timely (taking extensions into account) and that is not later than when that cure is achieved.

(ii) Qualified opportunity zone businesses-

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

(B) Five-percent zone taxpayer. If a taxpayer both has self-certified as a QOF and holds an equity interest in an eligible entity that is tested as a qualified opportunity zone business, then that taxpayer may value the eligible entity's tangible property for purposes of satisfying the 70-percent tangible property standard using the same valuation methodology under this paragraph (b) that the taxpayer uses for determining its own compliance with the 90-percent investment standard (compliance methodology), provided that no other equity holder in the eligible entity is a five-percent zone taxpayer. If two or more taxpayers that have self-certified as QOFs hold equity interests in the eligible entity and at least one of them is a five-percent zone taxpayer, then the values of the eligible entity's tangible property may be calculated using the compliance methodology that both is used by a five-percent zone taxpayer and that produces the highest percentage of qualified opportunity zone business property for the eligible entity for purposes of the 70-percent tangible property standard. A five-percent zone taxpayer is a taxpayer that has self-certified as a QOF and that holds stock in the entity (if it is a corporation) representing at least 5 percent in voting rights and value or holds an interest of at least 5 percent in the profits and capital of the entity (if it is a partnership).

(1) Example. The example in paragraph (b)(2)(ii)(B)(2) of this section illustrates the principles of paragraph (b)(2)(ii)(B) of this section.

(2) Example. Entity JH is a corporation that has issued only one class of stock and that conducts a trade or business. Taxpayer X holds 94% of the JH stock, and Taxpayer Y holds the remaining 6% of that stock. (Thus, both X and Y are five percent zone taxpayers within the meaning of paragraph (b)(2)(ii)(B) of this section.) JH does not have an applicable financial statement, and, for that reason, a determination of whether JH is conducting a qualified opportunity zone business may employ the compliance methodology of X or Y. X and Y use

different compliance methodologies permitted under paragraph (b)(2)(i)(A) of this section for purposes of satisfying the 90-percent investment standard of section 1400Z-2(d)(1). Under X's compliance methodology (which is based on X's applicable financial statement), 65% of the tangible property owned or leased by JH's trade or business is qualified opportunity zone business property. Under Y's compliance methodology (which is based on Y's cost), 73% of the tangible property owned or leased by JH's trade or business is qualified opportunity zone business property. Because Y's compliance methodology would produce the higher percentage of qualified opportunity zone business property for JH (73%), both X and Y may use Y's compliance methodology to value JH's owned or leased tangible property. If JH's trade or business satisfies all additional requirements in section 1400Z-2(d)(3), the trade or business is a qualified opportunity zone business. Thus, if all of the additional requirements in section 1400Z-2(d)(2)(B) are satisfied, stock in JH is qualified opportunity zone stock in the hands of a taxpayer that has self-certified as a QOF.

(iii) Inventory. In determining whether the 90-percent investment standard in section 1400Z-2(d)(1) or the 70-percent tangible property standard in section 1400Z-2(d)(3)(A)(i) is satisfied, an eligible entity may choose to exclude from both the numerator and denominator of the applicable test the value of all inventory (including raw materials) of the trade or business, if applied consistently within a taxable year of the eligible entity.

(3) Applicable financial statement valuation method-

(i) In general. Under the applicable financial statement valuation method set forth in this paragraph (b)(3), the value of each property that is owned or leased by an eligible entity is the value of that asset as reported on the eligible entity's applicable financial statement for the relevant reporting period.

(ii) Requirement for selection of method. An eligible entity may select the applicable financial statement valuation method set forth in this paragraph (b)(3) to value an asset leased by the eligible entity only if the applicable financial statement of the eligible entity is prepared according to U.S. generally accepted accounting principles (GAAP) and requires an assignment of value to the lease of the asset.

(4) Alternative valuation method-

(i) In general. Under the alternative valuation method set forth in this paragraph (b)(4), the value of the property owned by an eligible entity is calculated under paragraph (b)(4)(ii) of

this section, and the value of the property leased by an eligible entity is calculated under paragraph (b)(4)(iii) of this section.

(ii) Property owned by an eligible entity-

(A) Property purchased or constructed. The value of each property owned by an eligible entity that is acquired by purchase for fair market value or constructed for fair market value is the eligible entity's unadjusted cost basis of the asset under section 1012 or section 1013.

(B) Other property. The value of each item of property owned by an eligible entity that is not purchased or constructed for fair market value is the item of property's fair market value, determined on the last day of the first 6 month period of the taxable year and on the last day of the taxable year.

(iii) Property leased by an eligible entity-

(A) In general. The value of each property that is leased by an eligible entity is equal to the present value of the leased property as defined in paragraph (b)(4)(iii)(C) of this section.

(B) Discount rate. For purposes of calculating present value under paragraph (b)(4)(iii) of this section, the discount rate is the short-term applicable Federal rate under section 1274(d)(1), based on semiannual compounding, for the month in which the eligible entity enters into the lease. For purposes of the preceding sentence, the three month rule in section 1274(d)(2) does not apply to determine the applicable Federal rate.

(C) Present value. For purposes of paragraph (b)(4)(iii) of this section, present value of a leased property-

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

(2) Is calculated at the time the eligible entity enters into the lease for the property; and

(3) Once calculated, is used as the value for the property by the eligible entity for all testing dates during the term of the lease for purposes of the 90-percent investment standard or the 70-percent tangible property standard.

(D) Term of a lease. For purposes of paragraph (b)(4)(iii) of this section, the term of a lease includes periods during which the lessee may extend the lease at a pre-defined market rate rent. For nonresidential real property or residential real property, pre-defined rent does not

include the option to renew at fair market value, determined at the time of renewal. The terms of the pre-defined rent must satisfy the following criteria:

(1) General rule. The terms of the pre-defined rent are market rate (that is, the terms of the pre-defined rent reflect common, arms-length market pricing in the locale that includes the qualified opportunity zone as determined under section 482 and all section 482 regulations in this chapter) at the time the lease is entered into.

(2) Rebuttable presumption regarding leases not between related persons. There will be a rebuttable presumption that the terms of the extension of the lease are market rate for leases not between related persons (within the meaning of section 1400Z-2(e)(2)), and thus, the parties to the lease are not required to perform a section 482 analysis.

(3) Exception for state, local, and Indian tribal governments. For purposes of this paragraph (b)(4)(iii)(D), tangible property acquired by lease from a state or local government, or an Indian tribal government, is not considered tangible property acquired by lease from a related person.

(c) Qualified opportunity zone property-

(1) In general. Pursuant to section 1400Z-2(d)(2)(A), the following property is qualified opportunity zone property:

(i) Qualified opportunity zone stock as defined in paragraph (c)(2) of this section;

(ii) Qualified opportunity zone partnership interest as defined in paragraph (c)(3) of this section; and

(iii) Qualified opportunity zone business property as defined in § 1.1400Z2(d)-2.

(2) Qualified opportunity zone stock-

(i) In general. Except as provided in paragraph (c)(2)(ii) of this section, if an eligible entity is classified as a corporation for Federal income tax purposes (corporation), then an equity interest (stock) in the eligible entity is qualified opportunity zone stock if the requirements described in this paragraph (c)(2)(i) are satisfied:

(A) Date of acquisition. The stock is acquired by a QOF after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash;

(B) Qualified opportunity zone business. As of the time the stock was issued, the corporation was a qualified opportunity zone business as defined in section 1400Z-2(d)(3) and paragraph (d) of this section (or, in the case of a new corporation, the corporation was being organized for purposes of being such a qualified opportunity zone business); and

(C) 90-percent qualified opportunity zone property holding period-

(1) Cumulative holding period test. During at least 90 percent of the QOF's holding period for the corporation's stock, determined on a cumulative basis in accordance with paragraph (c)(2)(i)(C)(2) of this section, the corporation qualified as a qualified opportunity zone business.

(2) Semiannual qualified opportunity zone business test. For purposes of determining satisfaction of the cumulative 90-percent qualified opportunity zone property holding period test described in paragraph (c)(2)(i)(C)(1) of this section, the determination of whether a corporation engaged in a trade or business qualifies as a qualified opportunity zone business is made by the QOF on a semiannual basis pursuant to section 1400Z-2(d)(1). However, a QOF may choose to apply the safe harbor rule in paragraph (b)(2)(i)(C) of this section to make this determination.

(ii) Redemptions of stock. Pursuant to section 1400Z-2(d)(2)(B)(ii), the following rules apply for purposes of determining whether stock in a corporation qualifies as qualified opportunity zone stock:

(A) Redemptions from taxpayer or related person. Stock acquired by a QOF is not treated as qualified opportunity zone stock if, at any time during the 4-year period beginning on the date 2 years before the issuance of the stock, the corporation issuing the stock purchased either directly or indirectly any of its stock from the QOF or from a person related (within the meaning of section 1400Z-2(e)(2)) to the QOF. Even if the purchase occurs after the issuance, the stock was never qualified opportunity zone stock.

(B) Significant redemptions-

(1) In general. Stock issued by a corporation is not treated as qualified opportunity zone stock if, at any time during the 2-year period beginning on the date one year before the issuance of the stock, the corporation made one or more purchases of more than a de minimis amount of its stock and the purchased stock has an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of its stock as of the beginning of the 2-year period. The aggregate value is determined as of the time of the stock purchases. Even if one or more of the disqualifying purchases occurs after the issuance, the stock was never qualified opportunity zone stock.

(2) De minimis amount. For purposes of this paragraph (c)(2)(ii)(B), stock acquired from the taxpayer or a related person exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds \$10,000 and more than 2 percent of the stock held by the taxpayer and related persons (within the meaning of section 1400Z-2(e)(2)) is acquired. The rules in the following sentences of this paragraph (c)(2)(ii)(B)(2) apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

(C) Treatment of certain transactions. If any transaction is treated under section 304(a) as a distribution in redemption of the stock of any corporation, for purposes of paragraphs (c)(2)(ii)(A) and (B) of this section, that corporation is treated as purchasing an amount of its stock equal to the amount that is treated as such a distribution under section 304(a).

(D) Principles of § 1.1202-2(c) and (d). The principles of § 1.1202-2(c) and (d) apply in determining whether stock is redeemed or purchased for purposes of paragraph (c)(2)(ii) of this section.

(iii) Reorganizations of corporations otherwise qualifying as qualified opportunity zone businesses-

(A) Qualification as qualified opportunity zone stock. Stock that meets all of the requirements of paragraph (c)(2)(i) of this section except for the requirement in paragraph (c)(2)(i)(A) of this section is qualified opportunity zone stock if it is received solely in exchange for qualified opportunity zone stock in a transaction described in section 381(a)(2). The requirements in paragraphs (c)(2)(i)(B) and (C) of this section must be met with respect to both the stock held before such transaction and the stock for which it is exchanged in such transaction.

(B) Satisfaction of original use and substantial improvement tests. The requirements of § 1.1400Z2(d)-2 apply to property of a qualified opportunity zone business acquired from a qualified opportunity zone business in a transaction described in section 381(a)(2) as if the

acquiring corporation had held the property during the period in which the target corporation held the property. For example, an item of property must be substantially improved by the same date by which the target corporation was required to satisfy the substantial improvement test for such property.

(C) Reorganizations of qualified opportunity zone businesses within a consolidated group. See §§ 1.1502-14Z and 1.1504-3 for special rules applicable to consolidated groups.

(3) Qualified opportunity zone partnership interest-

(i) In general. If an eligible entity is classified as a partnership for Federal tax purposes (partnership), any capital or profits interest (partnership interest) in the eligible entity is a qualified opportunity zone partnership interest if-

(A) Date of acquisition. The partnership interest is acquired by a QOF after December 31, 2017, from the partnership solely in exchange for cash;

(B) Qualified opportunity zone business. As of the time the partnership interest was acquired, the partnership was a qualified opportunity zone business as defined in section 1400Z-2(d)(3) and paragraph (d) of this section (or, in the case of a new partnership, the partnership was being organized for purposes of being a qualified opportunity zone business); and

(C) 90-percent qualified opportunity zone property holding period-

(1) Cumulative holding period test. During at least 90-percent of the QOF's holding period for the partnership interest, determined on a cumulative basis in accordance with paragraph (c)(3)(i)(C)(2) of this section, the partnership qualified as a qualified opportunity zone business.

(2) Semiannual qualified opportunity zone business test. For purposes of determining satisfaction of the cumulative 90-percent qualified opportunity zone property holding period test described in paragraph (c)(3)(i)(C)(1) of this section, the determination of whether a partnership engaged in a trade or business qualifies as a qualified opportunity zone business is made by the QOF on a semiannual basis pursuant to section 1400Z-2(d)(1). However, a QOF may choose to apply the safe harbor rule in paragraph (b)(2)(i)(C) of this section to make this determination.

(ii) Reorganizations of partnerships otherwise qualifying as qualified opportunity zone businesses-

(A) Qualification as a qualified opportunity zone partnership interest. A partnership interest that meets all of the requirements of paragraph (c)(3)(i) of this section except for the requirement in paragraph (c)(3)(i)(A) of this section is a qualified opportunity zone partnership interest if it is received solely in exchange for a qualified opportunity zone partnership interest in a merger or consolidation transaction described in section 708(b)(2)(A). The requirements in paragraphs (c)(3)(i)(B) and (C) of this section must be met with respect to both the partnership interest held before the transaction and the partnership interest for which it is exchanged in the transaction.

(B) Satisfaction of original use and substantial improvement tests. The requirements of § 1.1400Z2(d)-2 apply to property of a qualified opportunity zone business acquired from a qualified opportunity zone business in a transaction described in section 708(b)(2)(A) as if the resulting partnership had held the property during the period in which the merging or consolidating partnership held the property. For example, an item of property must be substantially improved by the same date by which the merging or consolidating partnership was required to satisfy the substantial improvement test for such property.

(d) Qualified opportunity zone business-

(1) In general. An eligible entity engaged in a trade or business within the meaning of section 162 is a qualified opportunity zone business if the entity satisfies, as determined at the end of its taxable year, all the criteria in paragraphs (d)(1)(i) through (iii) of this section. An eligible entity's status as a qualified opportunity zone business applies for the entire taxable year of the entity.

(i) Pursuant to section 1400Z-2(d)(3)(A)(i), the eligible entity engaged in the trade or business satisfies the 70-percent tangible property standard with respect to its tangible property, as provided in paragraph (d)(2) of this section;

(ii) Pursuant to section 1400Z-2(d)(3)(A)(ii), the eligible entity engaged in the trade or business satisfies the requirements of section 1397C(b)(2), (4), and (8), as provided in paragraph (d)(3) of this section; and

(iii) Pursuant to section 1400Z-2(d)(3)(A)(iii), the eligible entity engaged in the trade or business is not described in section 144(c)(6)(B) as provided in paragraph (d)(4) of this section.

(2) Satisfaction of 70-percent tangible property standard-

(i) In general. A trade or business of an eligible entity satisfies the 70-percent tangible property standard if at least 70 percent of the tangible property owned or leased by the trade or business is qualified opportunity zone business property (as defined in § 1.1400Z2(d)-2).

(ii) Calculating percent of tangible property owned or leased in a trade or business-

(A) In general. Whether a trade or business of the eligible entity satisfies the 70-percent tangible property standard set forth in paragraph (d)(2)(i) of this section is determined by a fraction-

(1) The numerator of which is the total value of all tangible property owned or leased by the qualified opportunity zone business that is qualified opportunity zone business property; and

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

(B) Valuation. See paragraph (b)(2)(ii) of this section for rules regarding the valuation of tangible property for purposes of the 70-percent tangible property standard.

(3) Operation of section 1397C requirements adopted by reference-

(i) Gross income requirement. Section 1400Z-2(d)(3)(A)(ii) incorporates section 1397C(b)(2), requiring that for each taxable year at least 50 percent of the gross income of a qualified opportunity zone business is derived from the active conduct of a trade or business in the qualified opportunity zone (or in multiple qualified opportunity zones). A trade or business meets the 50-percent gross income requirement in the preceding sentence if the trade or business satisfies any one of the four criteria described in paragraph (d)(3)(i)(A), (B), (C), or (D) of this section, or any criteria identified in published guidance issued by the Commissioner under § 601.601(d)(2) of this chapter.

(A) Services performed in qualified opportunity zone based on hours. At least 50 percent of the services performed for the trade or business are performed in a qualified opportunity zone, determined by the fraction described in paragraphs (d)(3)(i)(A)(1) and (2) of this section.

Amounts paid to partners that provide services to the trade or business of a partnership are taken into account in the numerator and denominator set forth in paragraphs (d)(3)(i)(A)(1) and (2) of this section only to the extent the amounts paid to the partners are guaranteed payments for services provided to the partnership within the meaning of section 707(c).

(1) The numerator of the fraction is the total number of hours of services performed for the trade or business in a qualified opportunity zone during the taxable year by employees, partners that provide services to a partnership, independent contractors, and employees of independent contractors; and

(2) The denominator of the fraction is the total number of hours of services performed for the trade or business during the taxable year by employees, partners that provide services to a partnership, independent contractors, and employees of independent contractors.

(B) Services performed in qualified opportunity zone based on amounts paid for services. At least 50 percent of the services performed for the trade or business are performed in a qualified opportunity zone, determined by the fraction described in paragraphs (d)(3)(i)(B)(1) and (2) of this section. Amounts paid to partners that provide services to the trade or business of a partnership are taken into account in the numerator and denominator set forth in paragraphs (d)(3)(i)(B)(1) and (2) of this section only to the extent the amounts paid to the partners are guaranteed payments for services provided to the partnership within the meaning of section 707(c).

(1) The numerator of the fraction is the total amount paid by the entity for services performed in a qualified opportunity zone during the taxable year, whether by employees, partners that provide services to a partnership, independent contractors, or employees of independent contractors; and

(2) The denominator of the fraction is the total amount paid by the entity for services performed during the taxable year, whether by employees, partners that provide services to a partnership, independent contractors, or employees of independent contractors.

(C) Necessary tangible property and business functions. The tangible property of the trade or business located in a qualified opportunity zone and the management or operational functions performed in a qualified opportunity zone are each necessary for the generation of at least 50 percent of the gross income of the trade or business.

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

(E) Examples. The following examples illustrate the principles of paragraphs (d)(3)(i)(C) and (D) of this section.

(1) Example 1. A landscaping business has its headquarters in a qualified opportunity zone, its officers and employees manage the daily operations of the business (inside and outside the qualified opportunity zone) from its headquarters, and all its equipment and supplies are stored in the headquarters facilities. The activities occurring and the storage of equipment and supplies in the qualified opportunity zone are, taken together, necessary for the generation of the income of the business.

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

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

(ii) Use of intangible property requirement-

(A) In general. Section 1400Z-2(d)(3)(A)(ii) incorporates section 1397C(b)(4), requiring that, with respect to any taxable year, a substantial portion of the intangible property of a qualified opportunity zone business is used in the active conduct of a trade or business in a qualified opportunity zone. For purposes of section 1400Z-2(d)(3)(A)(ii) and the preceding sentence, the term substantial portion means at least 40 percent.

(B) Use of intangible property. For purposes of section 1400Z-2(d)(3)(A)(ii) and paragraph (d)(3)(ii)(A) of this section, intangible property of a qualified opportunity zone business is used in the active conduct of a trade or business in a qualified opportunity zone if-

(1) The use of the intangible property is normal, usual, or customary in the conduct of the trade or business; and

(2) The intangible property is used in the qualified opportunity zone in the performance of an activity of the trade or business that contributes to the generation of gross income for the trade or business.

(iii) Active conduct of a trade or business-

(A) Operating real property. Solely for purposes of section 1400Z-2(d)(3)(A), the ownership and operation (including leasing) of real property is the active conduct of a trade or business.

(B) Lessee is responsible for certain costs. Merely entering into a triple-net-lease with respect to real property owned by a taxpayer does not constitute the active conduct of a trade or business by such taxpayer.

(C) Examples. The following examples illustrate the rules of paragraph (d)(3)(iii) of this section.

(1) Example 1. Mere triple-net-lease not active conduct of trade or business-

(i) Facts. Company N constructs and places into service a new, three-story office building in a qualified opportunity zone and leases the entire building to tenant X, an unrelated person, which uses the building as office space for its software development firm. This building is the only property owned by Company N. The lease agreement between Company N and tenant X is a triple-net-lease under which tenant X is responsible for all of the costs relating to the office building (for example, paying all taxes, insurance, and maintenance expenses) in addition to paying rent. Company N also maintains an office in the building with staff members to address any issues that may arise with respect to the triple-net-lease.

(ii) Analysis. Solely for purposes of section 1400Z-2(d)(3)(A), Company N is treated as not engaged in the active conduct of a trade or business with respect to the leased office building. Company N leases the building to tenant X under a triple-net-lease, and therefore the employees of Company N do not meaningfully participate in the management or operations of the building. The fact that Company N maintains an office in the leased building with staff members to address any issues that may arise with respect to the triple-net-lease does not alter this result. Therefore, Company N does not conduct an active trade or business in a qualified opportunity zone.

(2) Example 2. Triple-net-lease and managerial and operational activities can constitute active conduct of trade or business-

(i) Facts. Company N constructs and places into service a new, three-story mixed-use building in a qualified opportunity zone and leases a floor to each of unrelated tenants X, Y, and Z, respectively. This building is the only property owned by Company N. The lease agreement between Company N and tenant X is a triple-net-lease under which tenant X is responsible for all of the costs relating to the third floor of the building (for example, paying all such taxes, insurance, and maintenance expenses) in addition to paying rent. The lease agreement between Company N and tenant Y is not a triple-net-lease and employees of Company N manage and operate the second floor of the building. Likewise, the lease agreement between Company N and tenant Z is not a triple-net-lease and employees of Company N manage and operate the first floor of the building. Company N maintains an office in the building, which the employees regularly use to carry out their managerial and operational duties with respect to the first and second floors, and address any other issues that may arise with respect to the three leases.

(ii) Analysis. Solely for purposes of section 1400Z-2(d)(3)(A), Company N is treated as engaged in the active conduct of a trade or business with respect to the leased mixed-use building. While Company N leases the third floor of the building to tenant X merely under a triple-net-lease, and therefore the employees of Company N do not meaningfully participate in the management or operations of that floor, the employees of Company N meaningfully participate in the management and operations of the first and second floors of the leased building. Therefore, in carrying out the overall leasing business of Company N with respect to the mixed-use building, employees of Company N conduct meaningful managerial and operational activities. As a result, Company N conducts an active trade or business in a qualified opportunity zone.

(iv) Nonqualified financial property limitation. Section 1400Z-2(d)(3)(A)(ii) incorporates section 1397C(b)(8), which requires that in each taxable year less than 5 percent of the average of the aggregate unadjusted bases of the property of a qualified opportunity zone business is attributable to nonqualified financial property. Section 1397C(e)(1), which defines the term nonqualified financial property for purposes of section 1397C(b)(8), excludes from that term reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less (working capital assets) and debt instruments described in section 1221(a)(4).

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

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

(B) Reasonable written schedule. There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets. Under the schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets.

(C) Property consumption consistent. The working capital assets are actually used in a manner that is substantially consistent with the writing and written schedule described in paragraphs (d)(3)(v)(A) and (B) of this section. If consumption of the working capital assets is delayed by waiting for governmental action the application for which is complete, that delay does not cause a failure of this paragraph (d)(3)(v)(C).

(D) Federally declared disasters. If the qualified opportunity zone business is located in a qualified opportunity zone within a federally declared disaster (as defined in section 165(i)(5)(A)), the qualified opportunity zone business may receive up to an additional 24 months to consume its working capital assets, as long as it otherwise meets the requirements of paragraph (d)(3)(v) of this section.

(E) Ability of a single business to benefit from more than a single application of the safe harbor. A business may benefit from multiple overlapping or sequential applications of the working capital safe harbor, provided that each application independently satisfies all of the requirements in paragraphs (d)(3)(v)(A) through (C) of this section.

(F) Ability of tangible property to benefit from more than a single application of the safe harbor. Tangible property may benefit for an additional 31-month period, for a total of 62 months, in the form of multiple overlapping or a sequential application of the working capital safe harbor, provided that each application independently satisfies all of the requirements in paragraphs (d)(3)(v)(A) through (C) of this section, the working capital assets from an expiring 31-month period were expended in accordance with the requirements in paragraphs (d)(3)(v)(A) through (C) of this section, and the subsequent infusions of working capital assets form an integral part of the plan covered by the initial working capital safe harbor period. An overlapping or sequential application of the working capital safe harbor must include a substantial amount of working capital assets (which may include debt instruments described in section 1221(a)(4)).

(G) Examples. The following examples illustrate the rules of paragraph (d)(3)(v) of this section.

(1) Example 1. General application of working capital safe harbor-

(i) Facts. QOF F creates a domestic C corporation E to open a fast-food restaurant and acquires almost all of the equity of E in exchange for cash. E has a written plan and a 20-month schedule for the use of this cash to establish the restaurant. Among the planned uses for the cash

are identification of favorable locations in the qualified opportunity zone, leasing a building suitable for such a restaurant, outfitting the building with appropriate equipment and furniture (both owned and leased), necessary security deposits, obtaining a franchise and local permits, and the hiring and training of kitchen and wait staff. Not-yet-disbursed amounts were held in assets described in section 1397C(e)(1), and these assets were eventually expended in a manner consistent with the plan and schedule.

(ii) Analysis. E's use of the cash qualifies for the working capital safe harbor described in paragraph (d)(3)(v) of this section.

(2) Example 2. Multiple applications of working capital safe harbor-

(i) Facts. QOF G creates a domestic C corporation H to start a new technology company and acquires equity of H in exchange for cash on Date 1. In addition to H's rapid deployment of capital received from other equity investors, H writes a plan with a 30-month schedule for the use of the Date 1 cash. The plan describes use of the cash to research and develop a new technology (Technology), including paying salaries for engineers and other scientists to conduct the research, purchasing, and leasing equipment to be used in research and furnishing office and laboratory space. Approximately 18 months after Date 1, on Date 2, G acquires additional equity in H for cash, and H writes a second plan. This new plan has a 25-month schedule for the development of a new application of existing software (Application), to be marketed to government agencies. Among the planned uses for the cash received on Date 2 are paying development costs, including salaries for software engineers, other employees, and third-party consultants to assist in developing and marketing the new application to the anticipated customers. Not-yet-disbursed amounts that were scheduled for development of the Technology and the Application were held in assets described in section 1397C(e)(1), and these assets were eventually expended in a manner substantially consistent with the plans and schedules for both the Technology and the Application.

(ii) Analysis. H's use of both the cash received on Date 1 and the cash received on Date 2 qualifies for the working capital safe harbor described in paragraph (d)(3)(v) of this section.

(3) Example 3. General application of working capital safe harbor-

(i) Facts. In 2019, Taxpayer H realized \$w million of capital gains and within the 180-day period invested \$w million in QOF T, a qualified opportunity fund. QOF T immediately acquired from partnership P a partnership interest in P, solely in exchange for \$w million of cash. P immediately placed the \$w million in working capital assets, which remained in working capital assets until used. P had written plans to acquire land in a qualified opportunity zone on which it planned to construct a commercial building. Of the \$w million, \$x million was dedicated to the land purchase, \$y million to the construction of the building, and \$z million to ancillary but necessary expenditures for the project. The written plans provided for purchase of

the land within a month of receipt of the cash from QOF T and for the remaining \$y and \$z million to be spent within the next 30 months on construction of the building and on the ancillary expenditures. All expenditures were made on schedule, consuming the \$w million. During the taxable years that overlap with the first 31-month period, P had no gross income other than that derived from the amounts held in those working capital assets. Prior to completion of the building, P's only assets were the land it purchased, the unspent amounts in the working capital assets, and P's work in process as the building was constructed.

(ii) Analysis-P met the three requirements of the safe harbor provided in paragraphs (d)(3)(v)(A) through (C) of this section. P had a written plan to spend the \$w received from QOF T for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone, as defined in section 1400Z-1(a). P had a written schedule consistent with the ordinary start-up for a business for the expenditure of the working capital assets. And, finally, P's working capital assets were actually used in a manner that was substantially consistent with its written plan and the ordinary start-up of a business. First, the \$x million, the \$y million, and the \$z million are treated as reasonable in amount for purposes of sections 1397C(b)(2) and 1400Z-2(d)(3)(A)(ii). Second, because P had no other gross income during the 31 months at issue, 100 percent of P's gross income during that time is treated as derived from an active trade or business in the qualified opportunity zone for purposes of satisfying the 50-percent test of section 1397C(b)(2). Third, for purposes of satisfying the requirement of section 1397C(b)(4), during the period of land acquisition and building construction a substantial portion of P's intangible property is treated as being used in the active conduct of a trade or business in the qualified opportunity zone. Fourth, all of the facts described are consistent with QOF T's interest in P being a qualified opportunity zone partnership interest for purposes of satisfying the 90-percent investment standard in section 1400Z-2(d)(1).

(iii) Analysis if P had purchased an existing building. The conclusions would also apply if P's plans had been to buy and substantially improve a pre-existing commercial building. In addition, the fact that P's basis in the building has not yet doubled would not cause the building to fail to satisfy section 1400Z-2(d)(2)(D)(i)(III).

(vi) Safe harbor for gross income derived from the active conduct of business. Solely for purposes of applying the 50-percent test in section 1397C(b)(2) to the definition of a qualified opportunity zone business in section 1400Z-2(d)(3), if any gross income is derived from property that paragraph (d)(3)(v) of this section treats as a reasonable amount of working capital, then that gross income is counted toward satisfaction of the 50-percent test.

(vii) Safe harbor for use of intangible property. Solely for purposes of applying the use requirement in section 1397C(b)(4) to the definition of a qualified opportunity zone business under section 1400Z-2(d)(3), intangible property purchased or licensed by the trade or business, pursuant to the reasonable written plan with a written schedule for the expenditure of the working capital, satisfies the use requirement during any period in which the business is proceeding in a manner that is substantially consistent with paragraphs (d)(3)(v)(A) through (C) of this section.

(viii) Safe harbor for property on which working capital is being expended-

(A) In general. If paragraph (d)(3)(v) of this section treats property that would otherwise be nonqualified financial property as being a reasonable amount of working capital because of compliance with the three requirements of paragraphs (d)(3)(v)(A) through (C) of this section and if the tangible property referred to in paragraph (d)(3)(v)(A) is expected to satisfy the requirements of section 1400Z-2(d)(2)(D)(i) as a result of the planned expenditure of those working capital assets, then tangible property purchased, leased, or improved by the trade or business, pursuant to the written plan for the expenditure of the working capital assets, is treated as qualified opportunity zone business property satisfying the requirements of section 1400Z-2(d)(2)(D)(i), during that and subsequent working capital periods the property is subject to, for purposes of the 70-percent tangible property standard in section 1400Z-2(d)(3).

(B) Example. Multiple applications of working capital safe harbor to tangible property-

(i) Facts. B also borrows cash and forms a domestic C corporation B to develop a large mixed-use real estate development that will consist of commercial and residential real property, owning almost all of the equity of B in exchange for cash. QOF A has a master written plan for the completion of the commercial and residential real property over a 55 month period. The plan provides that the commercial real property will be completed over a 30 month schedule and subsequently, the residential real property will be completed over a 25 month schedule. The plan further provides that a portion of the commercial real property is unable to be used in a trade or business after the completion of the commercial real property since that portion of the commercial real property will be unusable during the residential construction phase. Pursuant to B's original master plan for the completion of the real estate development, QOF A acquires additional equity in B for cash after the completion of the commercial development phase, and B commences use of those working capital assets for residential development phase.

(ii) Analysis. B's use of the cash for the commercial and residential phase qualified for the working capital safe harbor described in paragraph (d)(3)(v) of this section. In addition, all of B's commercial real property developed pursuant to B's original master plan is treated as qualified opportunity zone business property under paragraph (d)(3)(viii) of this section.

(ix) Real property straddling a qualified opportunity zone. For purposes of satisfying the requirements in this paragraph (d)(3) in the case of real property that straddles a qualified opportunity zone, a qualified opportunity zone is the location of services, tangible property, or business functions if-

(A) The trade or business uses the portion of the real property located within a qualified opportunity zone in carrying out its business activities;

(B) The trade or business uses the real property located outside of a qualified opportunity zone in carrying out its business activities;

(C) The amount of the real property located within a qualified opportunity zone is substantial compared to the amount of real property located outside of a qualified opportunity zone; and

(D) The real property located in the qualified opportunity zone is contiguous to part, or all, of the real property located outside of the qualified opportunity zone.

(E) In general, one of the two methods in paragraph (d)(3)(ix)(E)(1) and (2) of this section may be chosen to determine whether the amount of real property located in the qualified opportunity zone is substantial compared to the amount of real property located outside the qualified opportunity zone.

(1) Square footage test. If the amount of real property based on square footage located within the qualified opportunity zone is greater than the amount of real property based on square footage outside of the qualified opportunity zone, and the real property outside of the qualified opportunity zone is contiguous to part or all of the real property located inside the qualified opportunity zone, then all of the property is deemed to be located within a qualified opportunity zone. The test in this paragraph (d)(3)(ix)(E)(1) is carried out at the time at which the subject real property is acquired.

(2) Unadjusted cost test. If the unadjusted cost of the real property located inside a qualified opportunity zone is greater than the unadjusted cost of the real property outside the qualified opportunity zone, and the real property outside of the qualified opportunity zone is contiguous to all or part of the real property located inside the qualified opportunity zone, then all of the property is deemed to be located within a qualified opportunity zone. The unadjusted cost basis of property acquired as a single tract is presumed to be allocated on the basis of the square footage of the property. The test in this paragraph (d)(3)(ix)(E)(2) is carried out at the time at which the subject real property is acquired.

(F) For purposes of the two tests described in paragraph (d)(3)(ix)(E)(1) and (2) of this section, two or more tracts or parcels of land are contiguous if they share common boundaries or would share common boundaries but for the interposition of a road, street, railroad, stream or similar property. Tracts or parcels of land which touch only at a common corner are not contiguous.

(x) Example. The following example illustrates the rules of paragraph (d)(3) of this section-

(A) Facts. In 2019, Taxpayer H realized \$w million of capital gains and within the 180-day period invested \$w million in QOF T, a qualified opportunity fund. QOF T immediately acquired from partnership P a partnership interest in P, solely in exchange for \$w million of cash. P immediately placed the \$w million in working capital assets, which remained in working

capital assets until used. P had written plans to acquire land in a qualified opportunity zone on which it planned to construct a commercial building. Of the \$w million, \$x million was dedicated to the land purchase, \$y million to the construction of the building, and \$z million to ancillary but necessary expenditures for the project. The written plans provided for purchase of the land within a month of receipt of the cash from QOF T and for the remaining \$y and \$z million to be spent within the next 30 months on construction of the building and on the ancillary expenditures. All expenditures were made on schedule, consuming the \$w million. During the taxable years that overlap with the first 31-month period, P had no gross income other than that derived from the amounts held in those working capital assets. Prior to completion of the building, P's only assets were the land it purchased, the unspent amounts in the working capital assets, and P's work in process as the building was constructed.

(B) Analysis-

(1) P met the three requirements of the safe harbor provided in paragraph (d)(3)(v) of this section. P had a written plan to spend the \$w received from QOF T for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone, as defined in section 1400Z-1(a). P had a written schedule consistent with the ordinary start-up for a business for the expenditure of the working capital assets. And, finally, P's working capital assets were actually used in a manner that was substantially consistent with its written plan and the ordinary start-up of a business. Therefore, the \$x million, the \$y million, and the \$z million are treated as reasonable in amount for purposes of sections 1397C(b)(2) and 1400Z-2(d)(3)(A)(ii).

(2) Because P had no other gross income during the 31 months at issue, 100 percent of P's gross income during that time is treated as derived from an active trade or business in the qualified opportunity zone for purposes of satisfying the 50-percent test of section 1397C(b)(2).

(3) For purposes of satisfying the requirement of section 1397C(b)(4), during the period of land acquisition and building construction a substantial portion of P's intangible property is treated as being used in the active conduct of a trade or business in the qualified opportunity zone.

(4) All of the facts described are consistent with QOF T's interest in P being a qualified opportunity zone partnership interest for purposes of satisfying the 90-percent investment standard in section 1400Z-2(d)(1).

(C) Analysis if P had purchased an existing building. The conclusions in paragraph (d)(3)(x)(B) of this section would also apply if P's plans had been to buy and substantially improve a pre-existing commercial building. In addition, the fact that P's basis in the building has not yet doubled would not cause the building to fail to satisfy section 1400Z-2(d)(2)(D)(i)(III).

(4) Trade or businesses described in section 144(c)(6)(B) not eligible-

(i) Pursuant to section 1400Z-2(d)(3)(A)(iii), the following trades or businesses, and businesses leasing more than a de minimis amount of property to the following trades or businesses, cannot qualify as a qualified opportunity zone business:

(A) Any private or commercial golf course;

(B) Country club;

(C) Massage parlor;

(D) Hot tub facility;

(E) Suntan facility;

(F) Racetrack or other facility used for gambling; or

(G) Any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

(ii) De minimis amounts of gross income attributable to a business described in section 144(c)(6)(B) will not cause a trade or business to fail to be a qualified opportunity zone business.

(iii) The term de minimis amount of property, used in paragraph (d)(4)(i) of this section, means less than 5 percent of the net rentable square feet for real property and less than 5 percent of the value for all other tangible property. The term de minimis amount of gross income, used in paragraph (d)(4)(ii) of this section, means less than 5 percent of the gross income of the qualified opportunity zone business may be attributable to the types of business described in section 144(c)(6)(B).

(iv) The following examples illustrate the rules of paragraph (d)(4) of this section:

(A) Example 1. Entity A is a QOF that meets the requirements of section 1400Z-2(d)(1). Entity A owns qualified opportunity zone stock in a domestic corporation described in section 1400Z-2(d)(2)(B), which operates a hotel located in a qualified opportunity zone that qualifies as a trade or business. As part of that trade or business, the hotel operates a spa that provides massages and other therapies. Less than 5 percent of the hotel's total gross income is attributable to the spa, and less than 5 percent of the net rentable square feet for real property and less than 5 percent of the value for all other tangible property is attributable to the spa. As a result, the

operation of the spa, which is a business described in section 144(c)(6)(B), will not prevent the operation of the hotel from qualifying as a qualified opportunity zone business.

(B) Example 2-

(1) Facts. Entity B is a qualified opportunity zone business that meets the requirements of section 1400Z-2(d)(3). Entity B plans to acquire a commercial golf course that consists of land and other related buildings and equipment in a qualified opportunity zone, that will satisfy each requirement for qualified opportunity zone business property set forth in section 1400Z-2(d)(2)(D). Instead of directly managing and operating the commercial golf course business, Entity B will lease the land and other related buildings and equipment to a third party to manage and operate the commercial golf course. The leased real property represents more than 5 percent of the net rentable square feet of Entity B's real property and the leased and other tangible property represents more than 5 percent of the value for all other tangible property of Entity B.

(2) Analysis. Because a golf course is prohibited from being a qualified trade or business under section 1400Z-2(d)(3)(A)(iii), the leasing arrangement will cause Entity B to fail to be a qualified opportunity zone business regardless of the satisfaction of each requirement set forth in section 1400Z-2(d)(2)(D).

(C) Example 3-

(1) Facts. Entity B meets the explicit requirements of section 1400Z-2(d)(1) and has certified itself as a QOF. Entity B owns a commercial golf course that consists of land and other related buildings and equipment in a qualified opportunity zone, and the land and buildings satisfy all explicit requirements (in section 1400Z-2(d)(2)(D)) to be qualified opportunity zone business property. Entity B manages and operates the commercial golf course business, but does not manage or operate any other trade or business not described in section 144(c)(6)(B) (listing businesses not eligible to be a qualified opportunity zone business pursuant to section 1400Z-2(d)(3)(A)(iii)). Entity B chose to operate the commercial golf course through Entity B, rather than through a qualified opportunity zone business, in order to avoid the requirement in section 1400Z-2(d)(3)(A)(iii), which provides that a qualified opportunity zone business cannot operate a commercial golf course due to the inclusion of that trade or business in section 144(c)(6)(B).

(2) Analysis. The ownership and operation of the golf course at the QOF level will not disqualify the QOF because the prohibition on businesses described in section 144(c)(6)(B) is not applicable at the QOF level. In addition, if each requirement set forth in section 1400Z-2(d)(2)(D) is satisfied, the property used in the commercial golf course will qualify as qualified opportunity zone business property held by Entity B for purposes of section 1400Z-2(d)(2)(A).

(5) Tangible property of a qualified opportunity zone business that ceases to be qualified opportunity zone business property. For qualified opportunity zone businesses, tangible property that ceases to be qualified opportunity zone business property shall continue to be treated as qualified opportunity zone business property for the lesser of five years after the date on which such tangible property ceases to be so qualified or the date on which such tangible property is no longer held by the qualified opportunity zone business. However, tangible property is not eligible for the benefits provided in this paragraph (d)(5) unless the tangible property ceasing to qualify as qualified opportunity zone business property was qualified opportunity zone business property used by a qualified opportunity zone business in a qualified opportunity zone for two years. For purposes of this paragraph (d)(5), tangible property purchased, leased, or improved by a trade or business, that is treated as satisfying the requirements of section 1400Z-2(d)(2)(D)(i) during that working capital safe harbor period pursuant to paragraph (d)(3)(v) of this section or that 30-month substantial improvement period described in § 1.1400Z2(d)-2(b)(4), is not treated as used by a qualified opportunity zone business in a qualified opportunity zone for any portion of the two year period described in this paragraph (d)(5).

(6) Cure period for qualified opportunity zone businesses.

(i) For purposes of the 90-percent qualified opportunity zone business holding period requirements set forth in sections 1400Z-2(d)(2)(B)(i)(III), 1400Z-2(d)(2)(C)(iii), and 1400Z-2(d)(2)(D)(i)(III), if a trade or business causes the QOF to fail the 90-percent investment standard on a semiannual testing date, the QOF may treat the stock or partnership interest in that business as qualified opportunity zone property for that semiannual testing date provided the business corrects the failure within 6 months of the date on which the stock or partnership interest lost its qualification.

(ii) If the failure occurs on the last testing date of the taxable year, the six-month cure period described in paragraph (d)(6)(i) of this section is available to the QOF only if the QOF files a valid application for an extension of time to file its tax return.

(iii) Each QOF is permitted only one correction pursuant to paragraph (d)(6) of this section. If the entity, at the end of the additional six-month cure period, fails to qualify as a qualified opportunity zone business, then the QOF becomes subject to the penalty under section 1400Z-2(f)(1) for each month the entity failed to qualify as a qualified opportunity zone business beginning with the first month following the last month that the QOF met the 90-percent investment standard.

(e) Applicability dates-

(1) In general. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) Prior periods. With respect to the portion of a taxpayer's first taxable year ending after December 21, 2017, that began on December 22, 2017, and for taxable years beginning after December 21, 2017, and on or before March 13, 2020, a taxpayer may choose either-

(i) To apply the section 1400Z-2 regulations, if applied in a consistent manner for all such taxable years; or

(ii) To rely on the rules in proposed § 1.1400Z2(d)-1 contained in the notice of proposed rulemaking (REG-115420-18) published on October 29, 2018, as amplified by the notice of proposed rulemaking (REG-120186-18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

▪ Par. 7. Section 1.1400Z2(d)-2 is added to read as follows:

§ 1.1400Z2(d)-2 Qualified opportunity zone business property.

(a) Qualified opportunity zone business property-

(1) In general. This section provides rules for determining whether owned or leased tangible property held by an eligible entity (within the meaning of § 1.1400Z2(d)-1(a)(1)) is qualified opportunity zone business property within the meaning of section 1400Z-2(d)(2)(D). Paragraph (a)(2) of this section provides general requirements that tangible property must satisfy to be qualified opportunity zone business property. Paragraph (b) of this section provides rules related to owned tangible property. Paragraph (c) of this section provides rules related to leased tangible property (that is, tangible property that the eligible entity acquires by lease from a lessor). Paragraph (d) of this section provides rules related to the 90-percent qualified opportunity zone business property holding period requirement and the 70-percent use test of section 1400Z-2(d)(2)(D)(i)(III). Paragraph (e) of this section provides the dates of applicability of this section.

(2) Qualified opportunity zone business property requirements. The term qualified opportunity zone business property means tangible property owned or leased by an eligible entity (as defined in § 1.1400Z2(d)-1(a)(1)) that-

(i) Is used by the eligible entity in a trade or business within the meaning of section 162; and

(ii) Satisfies the requirements of paragraphs (b), (c), and (d) of this section, as applicable.

(b) Tangible property owned by an eligible entity-

(1) Purchase requirement-

(i) In general. In the case of tangible property that is owned by an eligible entity, the tangible property must be acquired by the eligible entity after December 31, 2017, by purchase as defined by section 179(d)(2) from a person that is not a related person within the meaning of section 1400Z-2(e)(2) (providing that persons are related to each other if such persons are described in section 267(b) or section 707(b)(1), determined by substituting "20 percent" for "50 percent" each place it appears in such sections).

(ii) Plan, intent, or expectation for seller to repurchase acquired property. In the case of real property that is purchased by an eligible entity, if, at the time of the purchase, there was a plan, intent, or expectation for the acquired real property to be repurchased by the seller of the real property for an amount of consideration other than the fair market value of the real property, determined at the time of the repurchase by the seller, the purchased real property is not qualified opportunity zone business property.

(iii) Property manufactured, constructed, or produced for use in a qualified opportunity zone-

(A) In general. In the case of tangible property manufactured, constructed, or produced by an eligible entity, if the property is manufactured, constructed, or produced for use by an eligible entity with the intent to use such property in a trade or business in a qualified opportunity zone, then such property satisfies the requirements of paragraph (b)(1)(i) of this section if the manufacture, construction, or production begins after December 31, 2017. The materials and supplies used to manufacture, construct, or produce qualified opportunity zone business property by the eligible entity must also be qualified opportunity zone business property.

(B) Time when manufacture, construction or production considered to begin. For purposes of paragraph (b)(1)(iii) of this section, the acquisition date of such property is the date on which the manufacture, construction, or production of property (as defined in paragraph (b)(1)(iii) of this section) begins. The manufacture, construction, or production of property begins when physical work of a significant nature begins. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring or

researching. The determination of when physical work of a significant nature begins depends on the facts and circumstances. For example, if a factory is to be constructed on-site, construction begins when physical work of a significant nature commences at the site; this could occur, for example, when work begins on the excavation of footings, or the pourings of pads for the factory. Preliminary work, such as clearing or testing of soil condition, does not constitute the beginning of construction.

(C) Safe harbor. For purposes of paragraph (b)(1)(iii)(B) of this section, a taxpayer may choose to determine when physical work of a significant nature begins in accordance with this paragraph (b)(1)(iii)(C). Physical work of a significant nature will not be considered to begin before the taxpayer incurs or pays more than 10 percent of the total cost of the property (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching).

(2) Original use or substantial improvement requirement-

(i) In general. In the case of tangible property owned by the eligible entity either-

(A) The original use of the owned tangible property in the qualified opportunity zone, within the meaning of paragraph (b)(3) of this section, must commence with the eligible entity; or

(B) The eligible entity must substantially improve the owned tangible property within the meaning of paragraph (b)(4) of this section (which defines substantial improvement in this context).

(ii) Inventory. Inventory (including raw materials) of a trade or business produced by an eligible entity after December 31, 2017, is deemed to satisfy the requirements set forth in paragraphs (b)(1) and (b)(2)(i) of this section.

(3) Original use of tangible property acquired by purchase-

(i) Original use-

(A) In general. For purposes of paragraph (b)(2) of this section, the original use of tangible property in a qualified opportunity zone commences on the date any person first places

the property in service in the qualified opportunity zone for purposes of depreciation or amortization, or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner.

(B) Commencement of original use of vacant property. For purposes of this paragraph (b)(3), if real property, including land and buildings, has been vacant for an uninterrupted period of at least one calendar year beginning on a date prior to the date on which the qualified opportunity zone in which the property is located is listed as a designated qualified opportunity zone in a QOZ designation notice and the property has remained vacant through the date on which the property was purchased by the eligible entity, or if the property has been vacant for an uninterrupted three calendar year period beginning on a date after the date of publication of the QOZ designation notice that lists as designated the qualified opportunity zone in which the property is located and the property has remained vacant through the date on which the property was purchased by the eligible entity, original use in the qualified opportunity zone commences on the date after that period when any person first so uses or places the property in service in the qualified opportunity zone. Such property must satisfy the definition of vacancy under paragraph (b)(3)(iii) of this section.

(C) Used tangible property. Used tangible property satisfies the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone. If the tangible property had been so used or placed in service in the qualified opportunity zone before it is acquired by purchase, it must be substantially improved in order to satisfy the requirements of section 1400Z-2(d)(2)(D)(i)(II).

(D) Example. The following example illustrates the principles of paragraph (b)(3)(i)(A) of this section.

(1) Facts. On January 1, 2019, QOF A purchases from a developer a newly constructed hotel building located in a qualified opportunity zone for \$10 million. The developer purchased a parcel of land in that qualified opportunity zone, and constructed the hotel building thereon, with the intent and expectation to sell the building to a QOF. As of the time of the purchase, the developer had not placed the hotel building in service in the qualified opportunity zone for purposes of depreciation. Other than the original use requirement, assume that the hotel building satisfies all requirements under section 1400Z-2(d)(2)(D). In addition, assume that, at the time of the purchase, the developer had no plan, intent, or expectation to repurchase the hotel building.

(2) Analysis. At the time of QOF A's purchase of the hotel building, the original use of the hotel building had not commenced because the developer had not yet placed the hotel building into service for purposes of depreciation in a qualified opportunity zone. See paragraph (b)(3)(i)(A) of this section. Therefore, the original use of the hotel building in the qualified opportunity zone in which the building is located is treated as commencing with QOF A. See paragraph (b)(3)(i)(A) of this section. As a result, the hotel building purchased by QOF A is treated as satisfying the original use requirement of section 1400Z-2(d)(2)(D)(i)(II).

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

(iii) Vacancy. Solely for purposes of meeting the requirements of section 1400Z-2, real property, including land and buildings, is considered to be in a state of vacancy if the property is significantly unused. A building or land will be considered significantly unused if more than 80 percent of the building or land, as measured by the square footage of useable space, is not currently being used.

(iv) Brownfield sites. An eligible entity that purchases a parcel of land that is a brownfield site, as defined by section 101 of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (42 U.S.C. 9601) (brownfield site), may treat all property composing the brownfield site (including the land and structures thereon) as satisfying the original use requirement of section 1400Z-2(d)(2)(D)(i)(II), if, within a reasonable period, the eligible entity makes investments in the brownfield site to ensure that all property composing the brownfield site meets basic safety standards for both human health and the environment.

(v) Property involuntarily transferred to local government. An eligible entity that purchases real property from a local government that the local government holds as the result of an involuntary transfer (including through abandonment, bankruptcy, foreclosure, or receivership) may treat all property composing the real property (including the land and structures thereon) as satisfying the original use requirement of section 1400Z-2(d)(2)(D)(i)(II).

(4) Substantial improvement of tangible property acquired by purchase-

(i) In general. Except as provided in paragraph (b)(4)(iv) of this section, for purposes of paragraph (b)(2) of this section, tangible property is treated as substantially improved by an eligible entity only if it meets the requirements of section 1400Z-2(d)(2)(D)(ii) during the 30-month substantial improvement period. The property has been substantially improved when the additions to basis of the property in the hands of the QOF exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the QOF (substantial improvement requirement).

(ii) Treatment of property in the 30-month substantial improvement period. For purposes of the 90-percent investment standard under section 1400Z-2(d)(1), tangible property purchased, leased, or improved by a trade or business that is undergoing the substantial improvement process but has not yet been placed in service by the eligible entity or used in the eligible entity's trade or business is treated as satisfying the requirements of section 1400Z-2(d)(2)(D)(i) and paragraph (b)(2) of this section for the 30-month substantial improvement period with respect to

that property provided the eligible entity reasonably expects that the property will be substantially improved as defined in paragraph (b)(4)(i) of this section and used in the eligible entity's trade or business in a qualified opportunity zone by the end of such 30-month period. Tangible property described in the preceding sentence is not considered qualified opportunity zone business property for purposes of the special rule in section 1400Z-2(d)(3)(B) unless the tangible property is qualified opportunity zone business property for at least two years without regard to this paragraph (b)(4)(ii).

(iii) Aggregation of original use property that improves the functionality of non-original use property-

(A) General rule. The cost of purchased property that would otherwise qualify as qualified opportunity zone business property may be taken into account in determining whether additions to the basis of non-original use property acquired by purchase satisfy the substantial improvement requirement under section 1400Z-2(d)(2)(D)(ii), so long as the purchased property is located in the same qualified opportunity zone (or a contiguous qualified opportunity zone) as the non-original use property, is used in the same trade or business as the non-original use property, and improves the functionality of the non-original use property.

(B) Improvement of non-original use real property. If an eligible entity chooses to apply this paragraph (b)(4)(iii) to non-original use real property, the eligible entity must improve the non-original use real property by more than an insubstantial amount within the meaning of paragraph (b)(4)(iv)(C) of this section.

(C) Effect on purchased property. If an eligible entity chooses to apply this paragraph (b)(4)(iii), the purchased property that would otherwise qualify as qualified opportunity zone business property will not be treated as original use property, and instead the basis of that purchased property will be taken into account in determining whether additions to the basis of the non-original use property satisfy the requirements under section 1400Z-2(d)(2)(D)(i)(II) and (d)(2)(D)(ii).

(D) Examples. The following examples illustrate the principles of paragraph (b)(4)(iii) of this section.

(1) Example 1-

(i) Facts. On January 1, 2019, QOF A purchases the assets of a hotel business located in a qualified opportunity zone for \$5 million. The purchased assets include land, a building, linens, furniture and other fixtures attached to the building. \$1 million of the purchase price is allocated to land and the remaining \$4 million is allocated to the building, furniture and fixtures. During the course of renovations over the 30-month substantial improvement period, the QOF spent \$1 million replacing linens, mattresses and furniture, \$500,000 on the purchase of new exercise equipment for a gym located in the hotel building, \$1 million on renovations for a restaurant (including restaurant equipment) attached to the hotel, and \$1.5 million on structural renovations to the hotel. The QOF chooses to apply paragraph (b)(4)(iii) of this section to determine whether the substantial improvement requirement in section 1400Z-2(d)(2)(D)(ii) is met.

(ii) Analysis. In order for the hotel to be considered qualified opportunity zone business property, QOF A must substantially improve the hotel as the hotel had previously been placed in service in the qualified opportunity zone. (QOF A was not required to substantially improve the land on which the hotel was located pursuant to paragraph (b)(4)(iv) of this section.) Because the amount of basis allocated to the hotel was \$4 million, QOF A must expend \$4 million to improve the hotel within the 30-month substantial improvement period provided in section 1400Z-2(d)(2)(D)(ii). The new linens, mattresses and furniture, new exercise equipment, and new restaurant equipment all qualify as original use assets under section 1400Z-2(d)(2)(D)(i)(II). QOF A also substantially improved the hotel, which was the asset that needed to be improved under section 1400Z-2(d)(2)(D)(i)(II). QOF A chose, at the start of the 30-month period, to include the costs of the newly purchased assets that improve the functionality of the hotel to the basis of the hotel. Thus, the cost of these items is eligible to be added to the hotel's basis pursuant to paragraph (b)(4)(iii) of this section. Therefore, QOF A has met the substantial improvement requirement under section 1400Z-2(d)(2)(D)(i)(II) by doubling its basis in the hotel and its fixtures within the 30-month substantial improvement period. The amounts spent replacing linens, mattresses, furniture, exercise equipment, and new restaurant equipment that were counted toward the substantial improvement requirement for the hotel are not considered original use assets for purposes of the 90-percent investment standard.

(2) Example 2-

(i) Purchase of unrelated property. The facts are the same as in paragraph (b)(4)(iii)(D)(1)(i) of this section, except that in addition to purchasing the hotel and the related land, QOF A also purchases an apartment building one block away from the hotel for \$10 million. The apartment building is located in the same qualified opportunity zone as the hotel.

(ii) Analysis. QOF A may not include any improvements made to the apartment building, including purchased property that improves the functionality of the apartment building, to the basis of the hotel. QOF A may choose, under paragraph (b)(4)(iii) of this section, to include the purchased property that improves the functionality of the apartment building in the basis of the apartment building for purposes of the substantial improvement requirement under section 1400Z-2(d)(2)(D)(i)(II).

(iv) Special rules for land and improvements on land-

(A) Buildings located in a qualified opportunity zone. In accordance with the rules set forth in this paragraph (b)(4)(iv)(A), if an eligible entity purchases a building located on a parcel of land within the geographic borders of a qualified opportunity zone, for purposes of section

1400Z-2(d)(2)(D)(ii), a substantial improvement to the building is measured by the eligible entity's additions to the basis of the building, as determined under section 1012.

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

(C) Exception for insubstantially improved land. Notwithstanding paragraph (b)(4)(iv)(B) of this section, if the land is unimproved or minimally improved and the eligible entity purchases the land with an expectation or an intention to not improve the land by more than an insubstantial amount within 30 months after the date of purchase, paragraph (b)(4)(iv)(B) of this section does not apply with respect to such land and such land is not considered qualified opportunity zone business property unless it is substantially improved within the meaning of sections 1400Z-2(d)(2)(D)(i)(II) and (d)(2)(D)(ii). In determining whether an eligible entity had an expectation or an intention to improve the land by more than an insubstantial amount, improvements to the land by the eligible entity (including grading, clearing of the land, remediation of the contaminated land, or acquisition of related qualified opportunity zone business property that facilitates the use of the land in a trade or business of the eligible entity) will be taken into account.

(D) Remediation of contaminated land. Betterments to land within the meaning of § 1.263(a)-3(j)(1)(i) may be added to the basis of the purchased land and included for purposes of section 1400Z-2(d)(2)(D)(ii) if the betterments are paid for by the eligible entity.

(E) Separate improvement to underlying land not required. In determining whether the substantial improvement test under section 1400Z-2(d)(2)(D) has been met with respect to a building, there is no requirement that the eligible entity separately substantially improve the land upon which the building is located.

(v) Aggregation of purchased buildings-

(A) Substantial improvement requirement for eligible building group. For purposes of applying the substantial improvement requirement under sections 1400Z-2(d)(2)(D)(i)(II) and 1400Z-2(d)(2)(D)(ii), an eligible entity may apply paragraph (b)(4)(v)(D) of this section with respect to two or more buildings located within a qualified opportunity zone or a single series of contiguous qualified opportunity zones, as described in paragraph (b)(4)(v)(B) or (C) of this section (eligible building group), respectively.

(B) Eligible building group located entirely within parcel of land described in single deed. All buildings comprising an eligible building group may be treated as a single property as that term is used in section 1400Z-2(d)(2)(D)(ii) (single property), if each building comprising the eligible building group is located entirely within the geographic borders of a parcel of land described in a single deed.

(C) Eligible building group spanning contiguous parcels of land described in separate deeds. An eligible entity may treat all buildings comprising an eligible building group located entirely within the geographic borders of contiguous parcels of land described in separate deeds as a single property to the extent each building is operated as part of one or more trades or businesses that-

(1) Are operated exclusively by the eligible entity;

(2) Share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; and

(3) Are operated in coordination with, or reliance upon, one or more of the trades or businesses (for example, supply chain interdependencies or mixed-use facilities).

(D) Calculation of aggregate building basis and additions to basis of single property-

(1) In general. For purposes of the substantial improvement requirement under section 1400Z-2(d)(2)(D)(ii), the amount of basis required to be added to the portion of an eligible building group treated as a single property equals the total amount of basis calculated by adding the basis of each building comprising the single property at the beginning of the 30-month period and additions to the basis of each building comprising the single property are aggregated to determine satisfaction of the substantial improvement requirement.

(2) Aggregation of original use property that improves the functionality of single property. In applying paragraph (b)(4)(v)(D)(1) of this section, purchased property that would otherwise qualify as qualified opportunity zone business property may be taken into account in determining whether additions to the basis of a single property described in paragraph (b)(4)(v)(B) or (C) of this section satisfy the substantial improvement requirement under section 1400Z-2(d)(2)(D)(ii).

(c) Tangible property leased by an eligible entity. In the case of tangible property with respect to which an eligible entity is a lessee-

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

(2) Arms-length terms-

(i) General rule. The terms of the lease must be market rate (that is, the terms of the lease reflect common, arms-length market pricing in the locale that includes the qualified opportunity zone as determined under section 482 and all section 482 regulations in this chapter) at the time that the lease was entered into.

(ii) Rebuttable presumption regarding unrelated persons. There will be a rebuttable presumption that the terms of the lease were market rate for leases between persons not related within the meaning of section 1400Z-2(e)(2) (unrelated persons), and thus, the parties to the lease are not required to perform a section 482 analysis.

(iii) Exception for state, local, and Indian tribal governments. For purposes of this paragraph (c)(2), tangible property acquired by lease from a state or local government, or an Indian tribal government, is not considered tangible property acquired by lease from a related person within the meaning of section 1400Z-2(e)(2) (related person).

(3) Additional requirements for tangible property leased from a related person. If the lessor is a related person with respect to an eligible entity that is the lessee of tangible property, the requirements of paragraphs (c)(3)(i) and (ii) of this section, as applicable, must be satisfied in order for the tangible property to be treated as qualified opportunity zone business property.

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

(ii) Purchase of other qualified opportunity zone business property. In the case of leased tangible property that is personal property, if the original use of the leased tangible personal property in a qualified opportunity zone (within the meaning of paragraph (c)(3)(iii) of this section) does not commence with the lessee, the property is not qualified opportunity zone business property unless, during the relevant testing period (as defined in paragraph (c)(3)(iv) of this section), the lessee becomes the owner of tangible property that is qualified opportunity zone business property having a value not less than the value of that leased tangible personal property. There must be substantial overlap of the qualified opportunity zone(s) in which the owner of the tangible property so acquired uses it and the qualified opportunity zone(s) in which that person uses the leased tangible personal property.

(iii) Original use of leased tangible property-

(A) In general. For purposes of paragraph (c)(3)(ii) of this section, the original use of leased tangible property in a qualified opportunity zone commences on the date any person first places the property in service in the qualified opportunity zone for purposes of depreciation (or first uses the property in the qualified opportunity zone in a manner that would allow depreciation or amortization if that person were the property's owner).

(B) Used leased tangible property. Used leased tangible personal property can satisfy the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone.

(iv) Relevant testing period. For purposes of paragraph (c)(3)(ii) of this section, the relevant testing period is the period that begins on the date that the lessee receives possession under the lease of the leased tangible personal property and ends on the earlier of-

(A) The date 30-months after the date the lessee receives possession of the leased tangible personal property under the lease; or

(B) The last day of the term of the lease (within the meaning of § 1.1400Z2(d)-1(b)(4)(iii)(D)).

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

(d) Holding period and use within a qualified opportunity zone of owned or leased tangible property-

(1) In general. In the case of tangible property that is owned or leased by an eligible entity, during substantially all of the eligible entity's holding period for the tangible property, substantially all of the use of the tangible property must be in a qualified opportunity zone.

(2) Valuation of owned and leased property. For purposes of the 70-percent use test in paragraph (d)(4) of this section, the value of owned and leased property is required to be

determined in accordance with the valuation methodologies provided in § 1.1400Z2(d)-1(b), and such value in the case of leased tangible personal property is to be determined on the date the lessee receives possession of the tangible personal property under the lease.

(3) Substantially all of an eligible entity's holding period for owned or leased tangible property-

(i) In general. For purposes of determining whether the holding period requirement in paragraph (d)(1) of this section is satisfied, the term substantially all means at least 90 percent. The holding period requirement is applied on a semiannual basis, based on the entire amount of time the eligible entity has owned or leased such property. Thus, on each semiannual testing date of the eligible entity, the tangible property satisfies the 90-percent qualified opportunity zone business property holding period requirement of section 1400Z-2(d)(2)(D)(i)(III) only if, during at least 90 percent of the period during which the QOF has owned or leased the property, the property has satisfied the 70-percent use test in paragraph (d)(4) of this section.

(ii) Semiannual qualified opportunity zone business test. For purposes of determining satisfaction of the 90-percent qualified opportunity zone business property holding period test described in paragraph (d)(3)(i) of this section in the case of a QOF, the determination of whether property satisfies the 70-percent use test is made on a semiannual basis pursuant to section 1400Z-2(d)(1) and paragraph (d)(4) of this section.

(4) Substantially all of the use of owned or leased tangible property in a qualified opportunity zone-

(i) 70-percent use test. Tangible property used in a trade or business of an eligible entity satisfies the substantially all requirement of paragraph (d)(2)(i) of this section (that is, the 70-percent use test) if and only if the tangible property is qualified tangible property. Qualified tangible property is tangible property that satisfies the requirements of paragraph (d)(4)(ii), (iii) (subject to the limitation in paragraph (d)(4)(iv) of this section), or (v) of this section.

(ii) Qualified tangible property. Tangible property held by a trade or business is qualified tangible property to the extent, based on the number of days between two consecutive semiannual testing dates, not less than 70 percent of the total utilization of the tangible property by the trade or business occurs at a location within the geographic borders of a qualified opportunity zone.

(iii) Safe harbor for tangible property utilized in rendering services inside and outside of a qualified opportunity zone. Subject to the limitation described in paragraph (d)(4)(iv) of this section, tangible property utilized by a trade or business in rendering services both inside and outside of the geographic borders of a qualified opportunity zone may be treated as qualified tangible property if-

(A) The tangible property utilized in rendering the service directly generates gross income for the trade or business both inside and outside of the geographic borders of a qualified opportunity zone;

(B) The trade or business has an office or other facility located within the geographic borders of a qualified opportunity zone (QOZ office);

(C) The tangible property is operated by employees of the trade or business who-

(1) Regularly use a QOZ office of the trade or business in the course of carrying out their duties; and

(2) Are managed directly, actively, and substantially on a day-to-day basis by one or more employees of the trade or business who carry out their duties at a QOZ office; and

(D) The tangible property is not operated exclusively outside of the geographic borders of a qualified opportunity zone for a period longer than 14 consecutive days for the generation of gross income for the trade or business.

(iv) Limitation. For purposes of the 70-percent tangible property standard, the safe harbor provided in paragraph (d)(4)(iii) of this section may not be used to treat more than 20 percent of the tangible property of the trade or business as qualified tangible property.

(v) Safe harbor for tangible property owned by leasing businesses with QOZ offices. Tangible property of a trade or business, the employees of which use a QOZ office of the trade or business to regularly lease such tangible property to customers of the trade or business, may be treated as qualified tangible property if-

(A) Consistent with the normal, usual, or customary conduct of the trade or business, when not subject to a lease to a customer of the trade or business, the tangible property is parked or otherwise stored at a QOZ office; and

(B) No lease under which a customer of the trade or business acquires possession of the tangible property is for a duration (including extensions) longer than 30 consecutive days.

(vi) Use of tangible property in one or more qualified opportunity zones. In accordance with paragraphs (d)(4)(ii) through (v) of this section, if qualified tangible property is utilized by the trade or business in one or more qualified opportunity zones, satisfaction of the 70-percent use test is determined by aggregating the number of days the tangible property is utilized by the trade or business in each qualified opportunity zone.

(vii) Real property straddling a qualified opportunity zone. For purposes of satisfying the requirements in this paragraph (d), the rules of § 1.1400Z2(d)-1(d)(3)(ix) apply to a QOF or qualified opportunity zone business for determining whether real property is situated in a qualified opportunity zone.

(viii) Safe harbor for inventory in transit-

(A) In general. In determining whether tangible property is used in a qualified opportunity zone for purposes of applying the 70-percent use test under paragraph (d)(4) of this section, inventory (including raw materials) of a trade or business does not fail to be used in a qualified opportunity zone solely because the inventory is in transit-

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

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

(B) No effect from certain events in transit. The distance traveled by the inventory while it is in transit, or the fact that the inventory is briefly warehoused while in transit, does not affect the application of the safe harbor described in paragraph (d)(4)(viii) of this section.

(e) Applicability dates-

(1) In general. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) Prior periods. With respect to the portion of a taxpayer's first taxable year ending after December 21, 2017, that began on December 22, 2017, and for taxable years beginning after December 21, 2017, and on or before March 13, 2020, a taxpayer may choose either-

(i) To apply the section 1400Z-2 regulations, if applied in a consistent manner for all such taxable years; or

(ii) To rely on the rules in proposed § 1.1400Z2(d)-1 contained in the notice of proposed rulemaking (REG-115420-18) published on October 29, 2018, as amplified by the notice of

proposed rulemaking (REG-120186-18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

§ 1.1400Z2(e)-1 [Added and Reserved]

- Par. 8. Reserved § 1.1400Z2(e)-1 is added.
- Par. 9. Section 1.1400Z2(f)-1 is added to read as follows:

§ 1.1400Z2(f)-1 Administrative rules- penalties, anti-abuse, etc.

(a) In general. Except as provided by § 1.1400Z2(d)-1(a)(2)(iv)(B) with respect to a taxpayer's first taxable year as a QOF, if a QOF fails to satisfy the 90-percent investment standard in section 1400Z-2(d)(1), then the QOF must pay the statutory penalty set forth in section 1400Z-2(f) for each month it fails to meet the 90-percent investment standard.

(b) Time period for a QOF to reinvest certain proceeds-

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

(2) Federally declared disasters. If the QOF's plan to reinvest some or all of the proceeds described in paragraph (b)(1) of this section in qualified opportunity zone property is delayed due to a federally declared disaster (as defined in section 165(i)(5)(A)), the QOF may receive up to an additional 12 months to reinvest such proceeds, provided that the QOF invests such proceeds in the manner originally intended before the disaster.

(c) Anti-abuse rules-

(1) General anti-abuse rule. Pursuant to section 1400Z-2(e)(4)(C), the rules of section 1400Z-2 and §§ 1.1400Z2(a)-1 through 1.1400Z2(d)-(2), 1.1400Z2(f)-1, 1.1502-14Z, and 1.1504-3 must be applied in a manner consistent with the purposes of section 1400Z-2 and the section 1400Z-2 regulations (as defined in § 1.1400Z2(a)-1(b)(41)). The purposes of section 1400Z-2 and the section 1400Z-2 regulations are to provide specified Federal income tax benefits to owners of QOFs to encourage the making of longer-term investments, through QOFs and qualified opportunity zone businesses, of new capital in one or more qualified opportunity zones and to increase the economic growth of such qualified opportunity zones. Accordingly, if a significant purpose of a transaction is to achieve a Federal income tax result that is inconsistent with the purposes of section 1400Z-2 and the section 1400Z-2 regulations, a transaction (or series of transactions) will be recast or recharacterized for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 1400Z-2 and the section 1400Z-2 regulations. This recasting and recharacterization may include, as appropriate, treating an investment as other than a qualifying investment. A determination of whether a Federal income tax result is inconsistent with the purposes of section 1400Z-2 and the section 1400Z-2 regulations must be based on all facts and circumstances.

(2) Special anti-abuse rule for partnerships-

(i) In general. In addition to being subject to the general anti-abuse rule of paragraph (c)(1) of this section, the application of the rules of section 1400Z-2 and §§ 1.1400Z2(a)-1 through 1.1400Z2(d)-2, 1.1400Z2(f)-1, 1.1502-14Z, and 1.1504-3 to partnerships is also subject to the special anti-abuse rule set forth in paragraph (c)(2)(ii) of this section.

(ii) Special partnership anti-abuse rule. If a partnership is formed or availed of with a significant purpose of avoiding the requirements of § 1.1400Z2(a)-1(b)(11)(i)(B) that a gain be subject to Federal income tax in order to be an eligible gain, the partnership will be disregarded in whole or in part for purposes of § 1.1400Z2(a)-1(b)(11)(i)(B) and (b)(11)(ix)(B) to prevent the creation of a qualifying investment by the partnership with respect to any partner or partners that would not otherwise satisfy such requirements.

(3) Examples. The following examples illustrate the anti-abuse rule of paragraph (c) of this section.

(i) Example 1-

(A) Facts. Two nonresident alien individuals (collectively, the individuals) plan to sell stock at a gain of \$50, to invest the amount of the resulting capital gain in a QOF, and to make a deferral election under section 1400Z-2(a). They make this election with the intent of holding the QOF investment for 10 years and then making an election to increase the qualifying basis to fair market value under section 1400Z-2(c). A gain on a sale of the stock by the individuals, however, would not be subject to Federal income tax, and so the gain would not support their

making a deferral election as a result of the requirement in § 1.1400Z2(a)-1(b)(11)(i)(B). Instead of selling the stock themselves, the individuals form a domestic partnership with a significant purpose of using that partnership to make a deferral election with respect to the stock under the exception in § 1.1400Z2(a)-1(b)(11)(ix)(B). The individuals contribute their stock to the partnership in exchange for partnership interests, after which the partnership sells the stock and invests the \$50 gain in a QOF. Had the partnership not made a deferral election, the individuals would not be subject to tax on their allocated portion of the partnership's recognized gain on the sale of the stock.

(B) Analysis. Based on these facts, the partnership is formed and availed of with a significant purpose to avoid the requirements of § 1.1400Z2(a)-1(b)(11)(i)(B). Thus, under paragraph (c)(2) of this section, the partnership is disregarded for purposes of applying § 1.1400Z2(a)-1(b)(11)(ix)(B) to the \$50 gain, and therefore the partnership's investment in the QOF is not a qualifying investment.

(ii) Example 2-

(A) Facts. The facts are the same as in paragraph (c)(3)(i)(A) of this section (Example 1), except the individuals contribute their stock to an existing partnership, the sole partners of which are U.S. citizens, with a significant purpose of the individuals' use of the partnership being to make an investment in a QOF and a deferral election under the § 1.1400Z2(a)-1(b)(11)(ix)(B) exception for partnerships. During the year, the partnership sells property it owned before the individuals' contribution, resulting in capital gain of \$100, all of which is eligible to be invested in a QOF. It also sells the stock contributed by the individuals, resulting in \$50 of capital gain. The partnership invests \$150 in a QOF and makes the requisite gain deferral election.

(B) Analysis. Based on these facts, the partnership is availed of by the individuals with a significant purpose to avoid the requirements of § 1.1400Z2(a)-1(b)(11)(i)(B). Thus, under paragraph (c)(2) of this section, the partnership is disregarded for purposes of applying § 1.1400Z2(a)-1(b)(11)(i)(B) and (b)(11)(ix)(B) with respect to the \$50 capital gain from the sale of the individuals' contributed stock and that gain fails to be eligible gain. Under § 1.1400Z2(a)-1(b), no section 1400Z-2(a) election is available for that gain and the partnership will have a mixed-funds investment, \$100 of which is a qualifying investment and \$50 of which is a non-qualifying investment.

(iii) Example 3-

(A) Facts. Entity C is a QOF that meets the requirements of section 1400Z-2(d)(1). Entity C owns qualified opportunity zone stock in a domestic corporation described in section 1400Z-2(d)(2)(B) (Corporation C), which operates a qualified opportunity zone business. Entity C also owns Corporation D stock, which is not qualified opportunity zone stock, which stock is less than 10% of the assets of Entity C. Under section 1400Z-2(e)(2), these stock holdings cause

Entity C to be related to both Corporation C and Corporation D. On date 1, under section 1400Z-2(e)(2), Individual S is not a related person with respect to Entity C, Corporation C, or Corporation D. On that date, Individual S sells tangible property to Corporation C for use in Corporation C's qualified opportunity zone business and sells a second asset to Corporation D. Both items sold were capital assets (as defined in section 1221). As a result, Individual S realizes gain of \$100 from the sale to Corporation C and \$75 from the sale to Corporation D. At the time of the sale Individual S has a plan or intent to invest \$175 in Entity C and to make deferral elections under section 1400Z-2(a)(1) with respect to the gain from the two sales. On date 2, for \$175 Individual S acquired an eligible interest in Entity C, an acquisition that causes Individual S to become a related person with respect to Entity C within the meaning of section 1400Z-2(e)(2).

(B) Analysis. Under paragraph (c)(1) of this section, Individual S's \$175 gain is not an eligible gain and cannot be the subject a deferral election under section 1400Z-2(a)(1). The gain fails to satisfy § 1.1400Z2a-1(b)(11)(i)(C) because of Individual S's plan to acquire sufficient equity in Entity C to become related to Corporations C and D. Moreover, for the same reason, the tangible property that Corporation C purchased from Individual S fails to satisfy the requirement that a purchase of qualified opportunity zone business property must be from an unrelated person. See sections 1400Z-2(d)(2)(D)(i)(I) and 179(d)(2)(A).

(iv) Example 4-

(A) Facts. Entity D is a QOF that meets the requirements of section 1400Z-2(d)(1). Entity D owns a majority qualified opportunity zone partnership interest in a domestic partnership, Partnership D described in section 1400Z-2(d)(2)(C). Entity D organized Partnership D for the purpose of being a qualified opportunity zone business. Partnership D acquires a tract of land located in a qualified opportunity zone. At the time of the acquisition of that land, there was no plan or intent to develop or otherwise utilize the land in a trade or business that would increase substantially the economic productivity of the land. Instead, there was a plan to pave the land for use as a parking lot. Partnership D planned to install a gate to the paved parking area, a small structure that would serve as an office for a parking attendant, and two self-pay stations for use by customers. The parking lot was not reasonably expected to expand significantly, and the initial small number of employees was not reasonably expected significantly to increase. A significant purpose for the acquisition of the land was to sell the land at a profit and to exclude any gain from appreciation by making an election under section 1400Z-2(c).

(B) Analysis. Under paragraph (c)(1) of this section, the acquisition of the land is a transaction carried out to achieve a tax result that is inconsistent with the purposes of section 1400Z-2 and the section 1400Z-2 regulations. Consequently, the land is not qualified opportunity zone business property and gain from the sale of the land will not be eligible to be excluded from gross income under section 1400Z-2(c). This recharacterization of the qualification of the land for Federal tax purposes is appropriate to ensure that the tax results of the transaction, including the status of Partnership D as a qualified opportunity zone business, are consistent with the purposes of section 1400Z-2 and the section 1400Z-2 regulations.

Partnership D fails to be a qualified opportunity zone business unless other assets that it owns or leases are qualified opportunity zone business property that satisfy section 1400Z-2(d)(3)(A)(i), and the other requirements of section 1400Z-2 and the section 1400Z-2 regulations.

(v) Example 5-

(A) Facts. The facts are the same as in paragraph (c)(3)(iv) of this section, except that Partnership D, in year 1, acquired a tract of land located in a qualified opportunity zone that was previously used for hog and pig farming. On its Form 1065T the previous owner, also a partnership, properly described those activities with the principal business activity code 112210. During the several-year period ending on the date of the acquisition of the land, the value of the land had significantly increased and D projected the land to continue to increase in value by ten-fold during the following 10-year period. At the time of the acquisition, Partnership D intended to conduct sheep and goat farming activities on the land and, accordingly, planned to use principal business activity code 112400 on its Form 1065. According to its plan, Partnership D conducted sheep and goat farming activities on the land during the 10-year period beginning on the date of acquisition of the land. During the 10-year period, Partnership D made significant capital improvements to the land, including improvements to existing farm structures, construction of new farm structures, and installation of a new irrigation system. As expected, the value of the land substantially increased during the following decade. The owners' entire interest in Partnership D was a qualifying investment, and, after having held it for at least 10 years the owners sold the entire interest at a large gain. As planned the owners made an election under section 1400Z-2(c) in order to avoid tax on the gain from the sale.

(B) Analysis. The modification of the land to suit sheep and goat farming activity from its previous use of hog and pig farming and the significant capital improvements made to land, is a significant investment in the business activities on the land. Thus, Partnership D did not hold the land solely for speculative investment. As a result, under paragraph (c)(1) of this section, the acquisition of the land, the activities conducted on the land, the capital improvements made to the land, and the later disposition of the land for a significant profit are not inconsistent with the purposes of section 1400Z-2 and the section 1400Z-2 regulations.

(vi) Example 6-

(A) Facts. Individuals intend to sell stock at a capital gain and invest the resulting gain in a QOF pursuant to a deferral election under section 1400Z-2(a). The individuals form Entity F and file Form 8996 certifying that Entity F is a QOF organized for the purpose of investing in qualified opportunity zone property. Individuals have no intention of investing in qualified opportunity zone property. Instead individuals intend to invest in property other than qualified opportunity zone property hoping that the property will appreciate substantially in value and the individuals will be able to exclude any appreciation on their investment from gross income by making an election under section 1400Z-2(c). Each year Entity F files Form 8996 and pays the

applicable penalty under section 1400Z-2(f). After holding their interests in Entity F for 10 years, individuals sell their interest in Entity F to an unrelated third party for a substantial gain and make an election to exclude the appreciation on their investment under section 1400Z-2(c).

(B) Analysis. A significant purpose of the transaction is to achieve a tax result that is inconsistent with the purposes of section 1400Z-2 and the section 1400Z-2 regulations, and the transaction will be recast and recharacterized for Federal tax purposes so that Entity F is not a QOF and the individuals are not eligible for the elections under sections 1400Z-2(a) and (c).

(vii) Example 7-

(A) Facts. Entity E treats itself as a QOF that meets the requirements of section 1400Z-2(d)(1). Entity E owns all of the stock in a domestic corporation, Corporation E, and Entity E treats this stock as qualified opportunity zone stock. Corporation E uses the majority of the cash invested by Entity E to purchase gold bars from unrelated parties within the meaning of section 1400Z-2(e)(2). The aggregate value of the gold bars is \$1000. Corporation E rents a safe deposit box in a qualified opportunity zone and hires one employee to manage the purchase and sale of the gold bars. Each year Corporation E purchases a small number of additional gold bars and sells to customers a portion of the gold bars on hand. The aggregate value of both the purchases and sales approximates half the value of the bars held at the beginning of the year. Corporation E seeks to treat the gold bars as qualified opportunity zone business property within the meaning of section 1400Z-2(d)(3). At the time that Corporation E began the gold bar business, it did not reasonably expect the business to expand significantly, nor was the number of employees reasonably expected to increase. Gold, however, was reasonably expected to appreciate. Ten years after the formation of Entity E, the investors in Entity E sell all of their interests in the entity and seek to make an election under section 1400Z-2(c) to exclude any gain from appreciation.

(B) Analysis. Under paragraph (c)(1) of this section, a significant purpose of Corporation E's activities is to achieve a tax result that is inconsistent with the purposes of section 1400Z-2 and the section 1400Z-2 regulations. The gold bar business carried out by Corporation E was merely speculative in nature and was not expected to increase economic activity in the subject qualified opportunity zone in a manner consistent with the purposes of section 1400Z-2 and the section 1400Z-2 regulations. As a result, Corporation E's activities are carried on to achieve tax results that are inconsistent with the purposes of section 1400Z-2 and the section 1400Z-2 regulations. Consequently, the gold bars are not qualified opportunity zone property. Corporation E fails to be a qualified opportunity zone business unless other assets that it owns or leases are qualified opportunity zone business property that satisfy section 1400Z-2(d)(3)(A)(i) (along with other requirements). If Corporation E fails to be a qualified opportunity zone business, Corporation E's stock fails to be qualified opportunity zone property in the hands of Entity E.

(d) Applicability date-

(1) In general. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) Prior periods. With respect to the portion of a taxpayer's first taxable year ending after December 21, 2017, that began on December March 13, 2020, a taxpayer may choose either-

(i) To apply the section 1400Z-2 regulations, if applied in a consistent manner for all such taxable years, or

(ii) To rely on the rules in proposed § 1.1400Z2(f)-1 contained in the notice of proposed rulemaking (REG-115420-18) published on October 29, 2018, as amplified by the notice of proposed rulemaking (REG-120186-18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

▪ Par. 10. Section 1.1502-14Z is added to read as follows:

§ 1.1502-14Z Application of opportunity zone rules to members of a consolidated group.

(a) Scope and definitions-

(1) Scope. This section provides rules regarding the Federal income tax treatment of QOFs owned by members of a consolidated group (as defined in § 1.1502-1(b) and (h), respectively). Rules in the section 1400Z-2 regulations (as defined in § 1.1400Z2(a)-1(b)(41)) apply to consolidated groups except as modified in this section. Paragraph (b) of this section generally provides rules regarding the effects of an election under § 1.1504-3(b)(2) to treat a subsidiary QOF C corporation as a member of a consolidated group. Paragraph (c) of this section provides rules regarding qualifying investments made by members of a consolidated group (including an election to treat the investment by one member as a qualifying investment by another member) and the application of § 1.1502-13 to intercompany transfers of a qualifying investment. Paragraph (d) of this section provides coordinating rules for basis adjustments within a consolidated group. Paragraph (e) of this section provides coordinating rules for § 1.1502-36(d). Paragraph (f) of this section provides elective transition relief to taxpayers that consolidated a subsidiary QOF C corporation prior to May 1, 2019. Paragraph (g) of this section

provides rules regarding the consequences of a deconsolidation of a QOF C corporation. Paragraph (h) of this section provides instructions for making the elections provided by paragraphs (c) and (f) of this section. Paragraph (i) of this section is reserved. Paragraph (j) of this section provides examples. Paragraph (k) of this section provides the applicability dates.

(2) Definitions-

(i) In general. The definitions provided in §§ 1.1400Z2(a)-1(b) and 1.1400Z2(d)-1 apply for purposes of this section.

(ii) Definitions for consolidated groups-

(A) Day one. The term day one means the date members of the consolidated group formed or acquired section 1504 control of the pre-existing QOF sub. If a pre-existing QOF sub was a member of the consolidated group prior to becoming a QOF C corporation, day one is the first day of the first month in which the member self-certified as, or is treated as, a QOF C corporation, whichever is earlier.

(B) Election date. The term election date means the date on which an election under paragraph (c) or (f) of this section is made.

(C) Pre-existing QOF sub. The term pre-existing QOF sub means a subsidiary QOF C corporation that meets the affiliation requirements in section 1504 (without regard to § 1.1504-3(b)(1)) as of May 1, 2019.

(D) QOF investor member. The term QOF investor member means any member holding a qualifying investment in the QOF member.

(E) QOF member. The term QOF member means a subsidiary QOF C corporation that is treated as a member of a consolidated group pursuant to an election in § 1.1504-3(b)(2).

(F) QOF member stock. The term QOF member stock means the QOF stock of a QOF member.

(G) QOF SAG. The term QOF SAG means, with respect to a QOF member, the affiliated group that would be determined under section 1504(a) if the QOF member were the common parent.

(H) Subsidiary QOF C corporation. The term subsidiary QOF C corporation means a QOF C corporation that meets the requirements to be a member of an affiliated group (as defined in section 1504(a)(1), and without regard to § 1.1504-3(b)(1)) other than the common parent of such consolidated group.

(b) Subsidiary QOF C corporation treated as member of the consolidated group-

(1) Effects of election to treat a subsidiary QOF C corporation as a member-

(i) Determining whether a distribution is an inclusion event. A distribution of property with respect to qualifying QOF stock by a QOF member to a QOF investor member is an inclusion event to the extent the distribution would create or increase an excess loss account (ELA) in the qualifying QOF stock, without regard to any inclusion resulting from application of this paragraph (b)(1)(i). Solely for purposes of determining whether a distribution creates or increases an ELA during a taxable year, investment adjustments pertaining to a distribution on qualifying QOF stock by a QOF member are made after all other investment adjustments under § 1.1502-32 for that year.

(ii) Determining the amount of deferred gain includible by the QOF investor member. The amount of gain included in gross income of a QOF investor member under section 1400Z-2(a)(1)(B) on a date described in § 1.1400Z2(b)-1(b) (modified by paragraph (c)(3) of this section, as applicable) is determined under this paragraph (b)(1)(ii). The amount of gain included in gross income of the QOF investor member is the lesser of:

(A) The product of:

(1) The percentage of the qualifying investment that gave rise to the inclusion event; and

(2) The remaining deferred gain (see § 1.1400Z2(a)-1(b)(40)), less any basis adjustments pursuant to section 1400Z-2(b)(2)(B)(iii) and (iv); or

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

(iii) Application of ELA rules on the disposition of QOF member stock. When a QOF investor member disposes of a share of qualifying QOF member stock, any ELA in the share is taken into account as income or gain from the disposition under § 1.1502-19(b)(1) before the basis of the share is increased under section 1400Z-2(c), if applicable. See paragraph (g)(3)(i) of this section for the general rule regarding the treatment of an ELA upon the deconsolidation of a QOF member.

(iv) Transactions between the QOF member and other members of the consolidated group-

(A) In general. This paragraph (b)(1)(iv) governs transactions between a member of the QOF SAG and other members of the consolidated group.

(B) Sale or exchange of property. A sale or exchange of property between a member of the QOF SAG and a member of the consolidated group that is not a member of such QOF SAG is not treated as an intercompany transaction (as defined in § 1.1502-13(b)(1)) and is not subject to the rules in § 1.1502-13. In contrast, a sale or exchange of property between members of the QOF SAG is an intercompany transaction that is subject to the rules in § 1.1502-13.

(C) Other transactions. Any transaction between a member of the QOF SAG and a member of the consolidated group that is not a member of such QOF SAG that is not a sale or exchange of property is an intercompany transaction subject to the rules in § 1.1502-13.

(v) Separate-entity application of QOF qualifying rules to QOF member. A consolidated group is not treated as a single entity for purposes of determining whether a QOF member or a qualified opportunity zone business that is a consolidated group member satisfies the investment standard rules in section 1400Z-2(d) and (f) and §§ 1.1400Z2(d)-1 and 1.1400Z2(f)-1; instead, the rules in this paragraph (b)(1)(v) apply on a separate-entity basis. Therefore, for example, the QOF member's satisfaction of the requirements under section 1400Z-2(d) is determined by taking into account only property (including qualified opportunity zone stock or qualified opportunity zone partnership interests) held by the QOF member, without regard to property transferred by the QOF member to other members of the consolidated group.

(2) Anti-avoidance rule. The purposes of section 1400Z-2 and the section 1400Z-2 regulations are to provide specified tax benefits to owners of QOFs to encourage the making of longer-term investments, through QOFs and qualified opportunity zone businesses, of new capital in one or more qualified opportunity zones and to increase the economic growth of such qualified opportunity zones. If a transaction is engaged in or structured with a view to avoid the application of the rules of section 1400Z-2, the section 1400Z-2 regulations, or the regulations in this part under section 1502 of the Code (including this section), appropriate adjustments will be made to carry out the purposes of section 1400Z-2 and the section 1400Z-2 regulations. For example, if a consolidated group engages in a restructuring (such as a distribution described in section 355) with a view to using stock basis adjustments under § 1.1502-32 resulting from increases in the basis of stock under section 1400Z-2(b) in a sale or exchange transaction without disposing of any part of the consolidated group's direct ownership of the relevant qualifying investment, the transaction will be treated as an inclusion event with regard to an appropriate amount of deferred gain.

(c) Qualifying investments by members of a consolidated group-

(1) In general. Except as otherwise provided in this section or in § 1.1400Z2(b)-1 (see, for example, § 1.1400Z2(b)-1(c)(9)(i)(B)(1)), section 1400Z-2 applies separately to each member of a consolidated group. Therefore, for example, the same member of the consolidated group generally must both engage in the sale of a capital asset giving rise to eligible gain and timely invest an amount equal to some or all of such gain in a QOF (as provided in section 1400Z-2(a)(1)) in order to qualify for deferral of such gain under section 1400Z-2.

(2) Election to treat investment of one member as a qualifying investment by another member-

(i) Availability of election. If members of a consolidated group satisfy the requirements of this paragraph (c)(2), the consolidated group may elect to treat the investment by one member as a qualifying investment by another member. The election provided by this paragraph (c)(2) is available when a member of a consolidated group (M1) has eligible gain and a second member (M2) makes an investment in a QOF that would be a qualifying investment if M1, rather than M2, had made the investment. For example, if M1 has \$100x of eligible gain but M2 has none, and M2 makes a \$120x investment in a QOF C corporation, only \$100x of M2's investment in the QOF C corporation is eligible for the election under this paragraph (c)(2). See paragraph (h)(2) of this section for the form and manner of making this election. If M2 has its own eligible gain, M2 may make a qualifying investment on its own behalf and defer such eligible gain under section 1400Z-2(a)(1)(A) and § 1.1400Z2(a)-1.

(ii) Effect of election. If a consolidated group makes an election under this paragraph (c)(2), then M1 is treated as having made the investment in the QOF that is actually made by M2. M1 is then treated as having immediately sold such investment to M2 for fair market value. The deemed sale by M1 is subject to the rules in paragraph (c)(3) of this section. The consolidated group must treat the deemed investment by M1 and the deemed sale by M1 to M2 as having occurred for all Federal income tax purposes.

(3) Intercompany transfers of a qualifying investment-

(i) In general. Except as otherwise provided in this paragraph (c)(3), when one member (S) transfers its qualifying investment to another member (B), the transaction is not treated as an intercompany transaction within the meaning of § 1.1502-13(b)(1) for purposes of applying the rules of section 1400Z-2 and the section 1400Z-2 regulations. Therefore, § 1.1502-13(c) does not apply to treat S and B as divisions of a single entity for purposes of section 1400Z-2. For example, if S transfers its qualifying investment to B in a section 351 transaction, the transfer is an inclusion event for S under § 1.1400Z2(b)-1(c). In addition, because the transfer is not an intercompany transaction for purposes of section 1400Z-2, § 1.1502-13 does not apply to continue S's deferral under § 1.1400Z2(b)-1(b).

(ii) Application of § 1.1502-13 to fully taxable intercompany transfers of a qualifying investment-

(A) Applicable transactions. Notwithstanding paragraph (c)(3)(i) of this section, if S transfers its qualifying investment to B in a fully taxable transaction, the transaction is treated as an intercompany transaction, and § 1.1502-13(c) applies to treat S and B as divisions of a single entity for purposes of applying section 1400Z-2.

(B) Treatment of S's intercompany gain on its qualifying investment. If a transaction is described in paragraph (c)(3)(ii)(A) of this section, § 1.1502-13(c)(6)(ii) is inapplicable in determining the excludability of S's gain (or the treatment of such gain as tax-exempt income) on the application of section 1400Z-2(b) and (c) to S and B as a single entity. Thus, S's gain on the qualifying investment (including the amount includible under § 1.1400Z2(b)-1(e)) may be redetermined to be excluded from gross income (or treated as tax-exempt income), as appropriate, to achieve single-entity treatment between S and B with regard to the ownership and disposal of the qualifying investment. To qualify for benefits under section 1400Z-2, S and B must otherwise satisfy the requirements of section 1400Z-2. See also § 1.1502-13(j)(4) (concerning multiple or successive intercompany transactions).

(C) Investment adjustments and adjustments to earnings and profits. Income of S excluded under section 1400Z-2 by application of paragraphs (c)(3)(ii)(A) and (B) of this section and § 1.1502-13 results in adjustments to S's earnings and profits and is treated as tax-exempt income to S for purposes of § 1.1502-32(b)(2)(ii).

(D) Election under section 1400Z-2(c). To the extent paragraph (c)(3)(ii)(A) of this section applies to S's transfer of its qualifying investment to B, B (and not S) is entitled to make the election under section 1400Z-2(c) at the time when, treating S and B as divisions of a single entity, the single entity would be entitled to make such an election. For example, pursuant to § 1.1502-13(c)(1)(ii), B takes S's holding period into account in determining whether B is treated as holding the transferred qualifying investment for 10 years. In addition, the attributes of S's intercompany item on the transfer of the qualifying investment may be redetermined based on B's election.

(4) Intercompany transfer as qualifying investment in a QOF member. A transfer by a consolidated group member with an eligible gain to a QOF member before January 1, 2027, is not treated as an intercompany transaction within the meaning of § 1.1502-13 and may constitute a qualifying investment. But see § 1.1504-3(b)(2) regarding conditions for consolidating a QOF C corporation.

(5) Intercompany gain as eligible gain. When S sells property to B, § 1.1502-13 applies to determine if, and when, S's intercompany gain and B's corresponding gain constitute eligible gain. S's gain and B's gain are treated as eligible gain only to the extent such gain would be eligible gain if S and B were divisions of a single entity. For example, if S sells a piece of property to B at a gain, B subsequently sells that property to an unrelated party at a further gain, and the gains are treated as capital gain under § 1.1502-13(c)(1) and (4), then both S's gain and

B's gain are eligible gains at the time B sells the property to the unrelated party. In contrast, if S sells a piece of property to B at a loss, and B subsequently sells that property to an unrelated party at a gain, then B's corresponding gain on the property is eligible gain only to the extent that S and B, if treated as divisions of a single entity, would have eligible gain on the sale of property to the unrelated party. See § 1.1502-13(a)(1).

(d) Tiering-up of investment adjustments provided by section 1400Z-2. Basis increases in a qualifying investment in a QOF under sections 1400Z-2(b)(2)(B)(iii), 1400Z-2(b)(2)(B)(iv), and 1400Z-2(c) are treated as satisfying the requirements of § 1.1502-32(b)(3)(ii)(A) and thus qualify as tax-exempt income to the QOF owner. Therefore, if the QOF owner is a member of a consolidated group and is owned by other members of the same consolidated group (upper-tier members), the upper-tier members increase their bases in the shares of the QOF owner under § 1.1502-32(b)(2)(ii). However, there is no basis adjustment under § 1.1502-32(b)(2)(ii) or (iii) in shares of upper-tier members with regard to a basis adjustment under section 1400Z-2(c) and § 1.1400Z2(c)-1 unless and until the basis of the qualifying investment is adjusted to its fair market value, as provided in section 1400Z-2(c) and § 1.1400Z2(c)-1.

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

(f) Transition relief-

(1) Overview. This paragraph (f) provides options for elective relief to pre-existing QOF subs. An election under this paragraph (f) is made in the manner provided in paragraph (h)(3) of this section. If a timely election under this paragraph (f) is not made, the pre-existing QOF sub is treated as deconsolidating on March 13, 2020.

(2) Reclassification election-

(i) In general. A consolidated group may make one of the alternative, irrevocable elections provided in paragraphs (f)(2)(ii) through (iv) of this section for its pre-existing QOF subs. All elective relief provided in this paragraph (f)(2) is effective on day one.

(ii) Treatment as a QOF partnership-

(A) Election. A consolidated group may elect to treat certain pre-existing QOF subs as QOF partnerships (electing QOF partnership). To be eligible for the election in this paragraph (f)(2)(ii)(A), a pre-existing QOF sub must have converted to an entity treated as a partnership for Federal income tax purposes as of the election date.

(B) Effect of the QOF partnership election. As a result of making the election under this paragraph (f)(2)(ii), the pre-existing QOF sub is treated as a QOF partnership from day one. Consequently, the consolidated group must file amended or superseding returns, as applicable, to account for the electing QOF partnership's income, gain, deduction, and loss; the electing QOF partnership also must file its own partnership returns for taxable periods beginning on day one, as applicable. The electing QOF partnership must include its self-certification under § 1.1400Z2(d)-1(a) with its own returns, and the self-certification will be treated as timely so long as the consolidated group filed a timely self-certification under § 1.1400Z2(d)-1(a) for the pre-existing QOF sub. In addition, appropriate adjustments must be made to account for the change in status of the electing QOF partnership from day one, including modifications to investment adjustments to the basis in members' stock made under § 1.1502-32 and adjustments to members' earnings and profits made under § 1.1502-33.

(C) Pre-existing QOF sub with single owner. If a pre-existing QOF sub is wholly owned by one member of a consolidated group, then for purposes of making the election under this paragraph (f)(2)(ii), the electing QOF partnership is deemed to have had a nominal partner from day one until the date the electing QOF partnership is treated as a partnership for Federal income tax purposes without regard to this paragraph (f)(2)(ii).

(D) Example. The following example illustrates the election under this paragraph (f)(2)(ii).

(1) Facts. P, the common parent of a consolidated group (P group), wholly owns M1 and M2. On July 1, 2018, M1 and M2 each sell an asset to an unrelated party and realize \$70x and \$30x of eligible gain, respectively. On August 13, 2018, M1 and M2 form Q12 (a QOF C corporation that was formed as a corporation under state law). Also on August 13, 2018, M1 and M2 contribute \$70x and \$30x, respectively, to Q12 in exchange for stock of Q12 and properly elect to defer their respective eligible gains under section 1400Z-2(a) and § 1.1400Z2(a)-1. The P group also makes a timely self-certification under § 1.1400Z2(d)-(1)(a) for Q12. Following March 13, 2020, the P group intends to timely elect under this paragraph (f)(2)(ii) to treat Q12 as a QOF partnership.

(2) Analysis-

(i) Eligibility to elect. For the P group to elect to treat Q12 as a QOF partnership under this paragraph (f)(2)(ii), by the date of the election, Q12 must either convert to a state law partnership or another entity treated as a partnership for Federal income tax purposes.

(ii) Consequences of the election. As a result of making the election under this paragraph (f)(2)(ii), Q12 is treated as a QOF partnership from August 13, 2018 (day one). The P group must file amended or superseding returns, as applicable and as necessary, to account for Q12's

income, gain, deduction, and loss. In addition, Q12 must file its own returns for the taxable period beginning on August 13, 2018, as applicable. The returns must be filed within the time frame provided in paragraph (h)(3)(iii) of this section. Finally, because the P group filed a timely self-certification under § 1.1400Z2(d)-(1)(a) for Q12 as a QOF C corporation, Q12's self-certification as a QOF partnership would be considered timely filed.

(3) Deemed nominal partner-

(i) Facts. The facts are the same as paragraph (f)(2)(iii)(D)(1) of this section, except that on July 1, 2018, only M1 sells an asset to an unrelated party and realizes \$70x of eligible gain. On August 13, 2018, M1 contributes cash of \$70x to Q12 in exchange for stock of Q12 and properly elects to defer the eligible gain under section 1400Z-2(a) and § 1.1400Z2(a)-1. As of the date the election is made to treat Q12 as a partnership from day one, a second party invests in Q12, and Q12 is an entity treated as a partnership for Federal income tax purposes.

(ii) Analysis. The analysis is generally the same as in paragraph (f)(2)(iii)(D)(2) of this section. In addition, because Q12 is wholly owned by M1, solely for purposes of treating Q12 as a QOF partnership from August 13, 2018, Q12 is deemed to have a nominal partner from August 13, 2018 until the election date or the date Q12 qualifies as a partnership, if earlier.

(iii) Treatment as a non-member QOF C corporation-

(A) Election. A consolidated group may elect to treat the pre-existing QOF sub as a QOF C corporation that is not a member of the consolidated group.

(B) Effect of the non-member QOF C corporation election. As a result of making the election under this paragraph (f)(2)(iii), the pre-existing QOF sub is treated as not being a member of the consolidated group from day one. Consequently, the consolidated group must file amended or superseding returns, as applicable, to exclude all of the pre-existing QOF sub's income, gain, deduction, and loss from the consolidated returns; the pre-existing QOF sub also must file its own returns for taxable periods beginning on day one, as applicable. In addition, all adjustments resulting from the pre-existing QOF sub's operations must be eliminated from the consolidated group, including investment adjustments made under § 1.1502-32 to basis in members' stock (as well as stock in the pre-existing QOF sub) and adjustments made under § 1.1502-33 to members' earnings and profits.

(iv) Treatment as a non-QOF C corporation-

(A) Election. A consolidated group may elect to treat a pre-existing QOF sub as if it never self-certified to be a QOF pursuant to § 1.1400Z2(d)-1.

(B) Effect of the non-QOF C corporation election. As a result of making the election under this paragraph (f)(2)(iv), the pre-existing QOF sub is treated from day one as a member of the consolidated group and not as a QOF. Therefore, section 1400Z-2 is not applicable, and amended returns or superseding returns must be filed, as applicable, to account for the eligible gain that was invested in the pre-existing QOF sub. In addition, appropriate adjustments must be made to account for the non-applicability of section 1400Z-2, including adjustments to members' stock basis and earnings and profits under §§ 1.1502-32 and 1.1502-33, respectively.

(3) Election to continue treating pre-existing QOF sub as a member of the consolidated group-

(i) Election. A consolidated group may elect to have a pre-existing QOF sub retain its QOF status and remain a member of the consolidated group.

(ii) Effects of electing to remain a QOF and a member of the consolidated group. As a result of making the election under this paragraph (f)(3), the conditions and effects provided in § 1.1504-3(b)(2) and paragraph (b)(1) of this section will apply to the pre-existing QOF sub and the consolidated group as of the effective date of this election. See paragraph (h)(1) of this section for the effective date of this election, and see paragraph (h)(3)(iii) of this section regarding the timing for meeting the requirements in § 1.1504-3(b)(2)(ii).

(g) Deconsolidation rules-

(1) In general. This paragraph (g) provides rules applicable on any deconsolidation of a QOF C corporation (deconsolidating QOF).

(2) Deconsolidation and inclusion event. A deconsolidation event is not an inclusion event unless the deconsolidation is the result of an actual transfer of the QOF member stock or a worthlessness event within the meaning of § 1.1502-80(c). For example, when a consolidated group fails to meet the conditions in § 1.1504-3(b)(2) of this section and causes a QOF member

to deconsolidate, the deconsolidation event is not an inclusion event solely as a result of the consolidated group's failure to meet the requirements in § 1.1504-3(b)(2) of this section.

(3) Basis in the deconsolidating QOF at time of deconsolidation-

(i) ELA in a deconsolidating QOF. Any ELA in stock of the deconsolidating QOF at the time of the deconsolidation is taken into account under the rules of § 1.1502-19. See paragraph (b)(1)(iii) of this section for rules coordinating the application of section 1400Z-2(c) with § 1.1502-19.

(ii) Positive basis in the deconsolidating QOF resulting from § 1.1502-32. Consolidated group members retain any positive basis in the deconsolidating QOF resulting from investment adjustments under § 1.1502-32 following its deconsolidation. However, following the deconsolidation, for purposes of determining the amount includible under § 1.1400Z2(b)-1(e), the amount of basis referred to in section 1400Z-2(b)(2)(A)(ii) is computed by applying only those rules applicable to corporations that do not file a consolidated return (that is, the basis rules under subchapter C and section 1400Z-2). Therefore, any positive basis resulting from § 1.1502-32 adjustments is not taken into account in computing the includible amount under § 1.1400Z2(b)-1(e).

(4) Deconsolidating QOF's earnings and profits-

(i) Deconsolidation on or before December 31, 2026. Notwithstanding § 1.1502-33(e)(1), if a deconsolidating QOF deconsolidates before December 31, 2026, the deconsolidating QOF retains its earnings and profits under this paragraph (g)(4)(i). Any earnings and profits of the deconsolidating QOF that were taken into account by any other members under § 1.1502-33 are eliminated from those members as of the end of the day on which the deconsolidating QOF deconsolidates.

(ii) Deconsolidation after December 31, 2026. If the deconsolidating QOF deconsolidates after December 31, 2026, the rules under § 1.1502-33(e) apply.

(5) Consequences under § 1.1502-36. See § 1.1502-36(f)(10)(i)(B) for the treatment of a deconsolidation as a transfer of all of the stock in the deconsolidating member held by other members of the consolidated group.

(h) Form and manner of making an election under this section-

(1) In general. The elections provided in this section are irrevocable. The information required for each election is provided in this paragraph (h). A reclassification election under paragraph (f)(2) of this section is effective as of day one. All other elections are effective on the election date.

(2) Election under paragraph (c)(2) of this section to treat investment by M2 as qualifying investment by M1-

(i) Form of election. The election under paragraph (c)(2) of this section must be made in the form of a statement titled "THIS IS AN ELECTION UNDER § 1.1502-14Z(c)(2) TO TREAT AN INVESTMENT BY [insert name and employer identification number (E.I.N.) of M2] AS A QUALIFYING INVESTMENT BY [insert name and E.I.N. of M1]." The statement must be included with the consolidated group's timely filed return (original, superseding, or amended return, as applicable, including extensions). In addition, the statement must include the information required under paragraph (h)(2)(ii) of this section.

(ii) Required information.

(A) The amount of M1's eligible gain;

(B) The amount of the investment M2 has made in a QOF, including identification of the amount of the investment that is eligible for treatment as a qualifying investment under paragraph (c)(2) of this section and the amount (if any) that is not eligible for such treatment; and

(C) The date on which M1 recognized its eligible gain, and the date on which M2 made the investment in the QOF.

(3) Elections under paragraph (f) of this section for transition relief-

(i) Form of election. The elections under paragraph (f) of this section must be made in the form of a statement titled "THIS IS AN ELECTION UNDER § 1.1502-14Z(f) FOR [insert name and E.I.N. of pre-existing QOF sub]." All actions necessary to make these elections, including the filing of an amended return (or superseding return, as applicable), or filing an original return, as applicable, must be completed within the time designated in paragraph (h)(3)(iii) of this section. The statement must be included on or with any amended prior-year consolidated return (or superseding or original return, as applicable) and on or with the consolidated group's timely filed return (original or amended if filed by the due date for the return, including extensions) for the election year. In addition, the statement must include the information required in paragraph (h)(3)(ii) of this section.

(ii) Required information-

(A) Reclassification election under paragraph (f)(2)(ii) of this section.

(1) A statement that the pre-existing QOF sub is electing to be a QOF partnership;

(2) The election date;

(3) The effective date of the election;

(4) Specification of the appropriate adjustments required under paragraph (f)(2)(ii) of this section made by the pre-existing QOF sub and the consolidated group; and

(5) Certification that the appropriate change under state law or the entity classification election under § 301.7701-3 of this chapter (as applicable) has been made, and the date of the change or entity classification election.

(B) Reclassification election under paragraph (f)(2)(iii) or (iv) of this section.

(1) A statement that the pre-existing QOF sub is changing its status;

(2) The pre-existing QOF sub's new status (either a non-member QOF C corporation, under paragraph (f)(2)(iii) of this section, or a non-QOF C corporation, under paragraph (f)(2)(iv) of this section);

(3) The election date;

(4) The effective date of the election; and

(5) Specification of the appropriate adjustments made the by pre-existing QOF sub and the consolidated group pursuant to paragraph (f)(2)(iii) or (iv) of this section, as applicable.

(C) Election to continue treating the pre-existing QOF sub as a subsidiary member of the consolidated group under paragraph (f)(3) of this section.

(1) A statement that the pre-existing QOF sub is electing to retain its status as a QOF C corporation and remain a member of the consolidated group;

(2) The election date; and

(3) Certification that the pre-existing QOF sub and the consolidated group are in compliance with the conditions under § 1.1504-3(b)(2)(ii) as of the date that the pre-existing QOF sub and the consolidated group are in compliance with the conditions under § 1.1504-3(b)(2)(ii).

(iii) Time for completing the elections under paragraph (f) of this section.

(A) If the pre-existing QOF sub is making an election under paragraph (f)(2)(ii) or (f)(3) of this section, all actions necessary to make such election must be completed by April 13, 2020. Specifically, if the pre-existing QOF sub is making the election under paragraph (f)(3) of this section, the conditions in § 1.1504-3(b)(2)(ii) must be met by April 13, 2020. In addition, the consolidated group's amended return (or superseding return, as applicable), taking into account the relevant changes, if applicable, must be filed by May 12, 2020. Moreover, if the electing QOF partnership had been a QOF partnership on day one and the electing QOF partnership's return would have been due, then such return also must be filed by May 12, 2020].

(B) If the pre-existing QOF sub is making a reclassification election under paragraph (f)(2)(iii) or (iv) of this section, all actions necessary to make such election, including the filing of the pre-existing QOF sub's own return (if the return would have been due had the pre-existing QOF sub not been included in the consolidated group on day one), and the consolidated group's amended return (or superseding return, as applicable), if applicable, must be completed by April 13, 2020.

(iv) Extension of statute of limitations. If, as a result of making a reclassification election in paragraph (f)(2) of this section, the consolidated group is required to file an amended return, and the electing QOF partnership is required to file a return by May 12, 2020 or the pre-existing QOF sub is required to file a return by April 13, 2020 (collectively, the related returns), then the consolidated group (and the pre-existing QOF sub, if an election under paragraph (f)(2)(iii) of this section is made) also must consent to extend the period of limitations on assessment with respect to any issues arising under section 1400Z-2 in the related returns of the consolidated group (and the pre-existing QOF sub, if applicable). This consent must be effected at such time and in such form and manner as may be prescribed by the Commissioner of Internal Revenue in Internal Revenue Service forms or instructions or in publications or guidance published in the Internal Revenue Bulletin (see §§ 601.601(d)(2) and 601.602 of this chapter).

(i) [Reserved]

(j) Examples. The following examples illustrate the rules of this section. For purposes of these examples, and unless otherwise stated: P is the common parent of the P consolidated group (P group); S, B, and M are members of the P group; Q is a QOF C corporation that is not a member of the P group; and X is an unrelated party.

(1) Example 1: Distribution by a QOF member and inclusion events-

(i) Facts. P wholly owns S. In 2018, S sells an asset to an unrelated party and realizes \$500x of eligible gain. S forms a new QOF C corporation Q2, contributes \$500x to Q2 in exchange for stock of Q2, and properly elects to defer the eligible gain under section 1400Z-2(a) and § 1.1400Z2(a)-1. The P group elects under § 1.1504-3(b)(2) to consolidate Q2. In 2024, Q2 distributes \$20x to S when S's basis in Q2 is \$50x, the value of Q2 exceeds \$500x, and Q2 has no earnings and profits. There are no other events in 2024 that results in investment adjustments to Q2 stock.

(ii) Analysis. Under §§ 1.1502-13(f)(2) and 1.1502-32, the intercompany distribution from Q2 to S of \$20x reduces S's basis in Q2 to \$30x (\$50x-\$20x). Under paragraph (b)(1)(i) of this section, because the distribution does not create or increase an ELA in Q2 stock, the distribution is not an inclusion event.

(iii) Distribution that creates an ELA. The facts are the same as in paragraph (j)(1)(i) of this section except that in 2024 Q2 distributes \$70x to S. Under §§ 1.1502-13(f)(2) and 1.1502-32, the intercompany distribution from Q2 to S of \$70x reduces S's basis in Q2 to \$0 and creates an ELA of \$20x (\$50x-\$70x). Under paragraph (b)(1)(i) of this section, because an ELA is created in Q2's stock, the distribution is an inclusion event to the extent of the increase in the ELA. S therefore includes \$20x of its deferred gain into income in 2024. See § 1.1400Z2(b)-1(e)(2). In addition, under § 1.1400Z2(b)-1(g)(1)(ii), the adjustment to S's basis in Q2 under section 1400Z-2(b)(2)(B)(ii) is applied before determining the other Federal income tax consequences of the distribution. Therefore, as a result of the inclusion event, S's basis in Q2 is first increased to \$70x (\$50x + \$20x), and then S's basis in Q2 is reduced by \$70x (the amount of the distribution) to \$0 under § 1.1502-32.

(2) Example 2: Basis adjustment when member owns qualifying QOF stock-

(i) Facts. P wholly owns S. In 2018, S sells an asset to an unrelated party and realizes \$500x of eligible gain. S contributes \$500x to Q in exchange for stock of Q and properly elects to defer the eligible gain under section 1400Z-2(a) and § 1.1400Z2(a)-1. S does not otherwise own stock in Q. In 2026, the fair market value of S's qualifying investment in Q exceeds \$500x. In 2029, when S still owns its qualifying investment in Q, P sells all of the stock of S to X. S retains its stock in Q.

(ii) Analysis-

(A) Five-year and seven-year basis increase and § 1.1502-32 tier-up. In 2023, when S has held the stock of Q for five years, under section 1400Z-2(b)(2)(B)(iii), S increases its basis in its Q stock by \$50x (10 percent of \$500x, the amount of gain deferred by reason of section 1400Z-2(a)(1)(A)). The 10-percent basis increase qualifies as tax-exempt income to S under paragraph (d) of this section. Thus, P (an upper-tier member) increases its basis in S's stock by \$50x under § 1.1502-32(b)(2)(ii). Similarly, in 2025, when S has held the stock of Q for seven years, under section 1400Z-2(b)(2)(B)(iv), S increases its basis in its Q stock by an additional \$25x (5 percent of \$500x). The 5-percent basis increase also qualifies as tax-exempt income to S under paragraph (d) of this section, and P increases its basis in S's stock by an additional \$25x under § 1.1502-32(b)(2)(ii).

(B) S's recognition of deferred capital gain in 2026. S did not dispose of its Q stock prior to December 31, 2026. Therefore, under section 1400Z-2(b)(1)(B) and § 1.1400Z2(b)-1(b)(2), S's remaining deferred gain is included in S's income on December 31, 2026. The amount of gain included under section 1400Z-2(b)(2)(A) and § 1.1400Z2(b)-1(e)(3) is \$425x (\$500x of remaining deferred gain less S's \$75x basis in Q). S's basis in Q is increased by \$425x to \$500x, and P's basis in S also is increased by \$425x under § 1.1502-32(b)(2)(i).

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

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

(3) Example 3: Intercompany sale of qualifying investment-

(i) Facts. In 2018, S sells an asset to an unrelated party and realizes \$100x of eligible gain. Also in 2018, S contributes \$100x to Q in exchange for Q stock and properly elects to defer the eligible gain under section 1400Z-2(a) and § 1.1400Z2(a)-1. S does not otherwise own stock in Q. In 2021, S sells all of its Q stock to B for \$250x in a fully taxable transaction. In 2026, the fair market value of Q is \$300x. In 2030, B sells the Q stock to X for \$800x.

(ii) Analysis-

(A) Intercompany sale treated as an inclusion event. In 2021, S's sale of its Q stock to B is an inclusion event under section 1400Z-2(b)(1) and § 1.1400Z2(b)-1(c). The amount includible pursuant to § 1.1400Z2(b)-1(e)(1) is \$100x (the lesser of the remaining deferred gain of \$100x and the fair market value of the qualifying investment of \$250x, over S's basis in Q, \$0). As a result of the inclusion, S's basis in Q increases from \$0 to \$100x and S also realizes a capital gain of \$150x (\$250x of amount realized less its \$100x basis in the Q stock) from the intercompany sale of Q to B. Because S's sale of its Q stock to B is a fully taxable transaction, paragraph (c)(3)(ii) of this section applies to treat the sale as an intercompany transaction and S's intercompany gains are taken into under § 1.1502-13(c)(2)(ii). Thus, S defers the inclusion of its \$100x of remaining deferred gain and its \$150x of capital gain in 2021. B has a \$250x basis in its Q stock.

(B) Five-year basis increase in 2023. Pursuant to paragraph (c)(3)(ii) of this section, S and B are treated as divisions of a single entity for purposes of applying section 1400Z-2. In 2023, the single entity would have held the QOF investment for five years and its basis in Q would be increased to \$10x ($\$100x \times 10\%$) under section 1400Z-2(b)(2)(B)(iii). To achieve this single entity result, \$10x of S's \$100x of remaining deferred gain is redetermined to be tax-exempt income. See § 1.1502-13(c)(1); see also paragraph (c)(3)(ii)(B) of this section making § 1.1502-13(c)(6)(ii) inapplicable in determining the excludability of S's intercompany gain. Therefore, in 2023, S is treated as having \$10x of tax-exempt income, S's remaining deferred gain is \$90x ($\$100x - \$10x$), while B's basis in Q remains \$250x.

(C) Seven-year basis increase in 2025. The same analysis in paragraph (j)(3)(ii)(B) of this section applies for the year 2025. Therefore, in 2025, S is treated as having \$5x ($\$100x \times 5\%$) of tax-exempt income, S's remaining deferred gain is \$85x ($\$90x - \$5x$), and B's basis in Q remains \$250x.

(D) Inclusion of S's remaining deferred gain in 2026. B continues to own the Q stock through 2026, and, treating S and B as divisions of a single entity for purposes of section 1400Z-2, the single entity would include its remaining deferred gain in income on December 31, 2026. See section 1400Z-2(b)(1), § 1.1400Z2(b)-1(b). On a single-entity basis, the amount includible pursuant to § 1.1400Z2(b)-1(e) is \$85x (the lesser of the remaining deferred gain of \$100x and the fair market value of the qualifying investment of \$300x, over the single entity's basis in Q, \$15x). B does not otherwise have an income event with respect to its Q stock in 2026. Therefore, under § 1.1502-13(c), all \$85x of S's remaining deferred gain is taken into account in 2026. In addition, S's \$150x of capital gain on its Q stock sale continues to be deferred, and B's basis in Q remains \$250x.

(E) B sells the Q stock in 2030. In 2030, B sells all its Q stock to X for \$800x. Under paragraph (c)(3)(ii)(D) of this section, B is entitled to make the election under section 1400Z-2(c) if, treating S and B as a single entity, the single entity would be eligible to make the election. Taking into account S's holding period, B has held Q for over 10 years, and B is eligible for the election when it sells Q to X in 2030. B makes the section 1400Z-2(c) election at the time of sale. Following the election, if S and B were divisions of a single entity, the single entity's basis in Q would increase from \$100x to its fair market value of \$800x, causing to be excluded the \$700x of gain on the sale of Q stock. To achieve this single entity result, § 1.1502-13(c)(1) redetermines B's \$550x ($\$800x - \$250x$) of gain and S's deferred \$150x of capital gain to be tax-exempt income. See paragraph (c)(3)(ii)(B) of this section making § 1.1502-13(c)(6)(ii)

inapplicable in determining the excludability of S's intercompany gain. Therefore, as a result of the sale of the Q stock and B making the section 1400Z-2(c) election, S has \$150x of tax-exempt income, and B has \$550x of tax-exempt income.

(4) Example 4: Intercompany sale of qualifying investment followed by sale of QOF at a loss outside of the consolidated group-

(i) Facts. The facts are the same as in paragraph (j)(3)(i) of this section, except that in 2030, B sells the stock of Q for \$225x to X.

(ii) Analysis. The analysis for tax years prior to 2030 is the same as in paragraphs (j)(3)(ii)(A) through (D) of this section. In addition, applying the analysis in paragraph (j)(3)(ii)(E) of this section, B is entitled to make the election under section 1400Z-2(c) and B makes the election. Following the election, if S and B were divisions of a single entity, the single entity's basis in Q would increase from \$100x to \$225x, causing to be excluded the \$125x of gain on the sale of Q stock. To achieve this single entity result, § 1.1502-13(c)(1) redetermines B's \$25x ($\$225x - \$250x$) of loss to be a noncapital, nondeductible expense and S's deferred \$150x of capital gain to be tax-exempt income. Therefore, as a result of the sale of Q stock and B making the section 1400Z-2 election, S has \$150x of tax-exempt income, and B has \$25x of noncapital, nondeductible expense.

(5) Example 5: Intercompany section 351 transfer of qualifying investment-

(i) Facts. In 2018, M sells an asset to an unrelated party and realizes \$100x of eligible gain. Also in 2018, M contributes \$100x to Q in exchange for Q stock and properly elects to defer the eligible gain under section 1400Z-2(a) and § 1.1400Z2(a)-1. M does not otherwise own stock in Q. In 2021, when the value of Q is \$200x, M contributes all of its Q stock to S in exchange for S stock in a transaction that qualifies under section 351.

(ii) Analysis. In 2021, M's contribution of its Q stock to S is an inclusion event under section 1400Z-2(b)(1) and § 1.1400Z2(b)-1(c). The amount includible pursuant to § 1.1400Z2(b)-1(e) is \$100x (the lesser of the remaining deferred gain of \$100x and the fair market value of the qualifying investment of \$200x, over S's basis in Q, \$0). Because M's contribution of its Q stock to S is not a fully taxable transaction, the general rule in paragraph (c)(3)(i) of this section applies to treat the contribution as not an intercompany transaction for purposes of applying section 1400Z-2, and § 1.1502-13 does not apply to treat M and S as a single entity for purposes of section 1400Z-2. Thus, as a result of the transfer, M takes its \$100x of remaining deferred gain into account, M's basis in S is \$100x, and S's basis in Q is \$100x.

(6) Example 6: Intercompany sale of qualifying investment followed by a tax-free transfer of the qualifying investment-

(i) Section 351 transfer to another member of the consolidated group-

(A) Facts. In 2018, S sells an asset to an unrelated party and realizes \$100x of eligible gain. Also in 2018, S contributes \$100x to Q in exchange for Q stock and properly elects to defer the eligible gain under section 1400Z-2(a) and § 1.1400Z2(a)-1. S does not otherwise own stock in Q. In 2021, when the fair market value of the Q stock is \$250, S sells all of its Q stock to B for \$250x in a fully taxable transaction. In 2024, B transfers all its Q stock to another member of the P group, B2, in a section 351 transaction. At such time, the fair market value of the Q stock is \$300x.

(B) Analysis-

(1) Intercompany sale in 2021. In 2021, S's sale of its Q stock to B is an inclusion event under section 1400Z-2(b)(1) and § 1.1400Z2(b)-1(c). The amount includible pursuant to § 1.1400Z2(b)-1(e) is \$100x (the lesser of the remaining deferred gain of \$100x and the fair market value of the qualifying investment of \$250x, over S's basis in Q, \$0). As a result of the inclusion, S's basis in its Q stock increases from \$0 to \$100x and S also realizes a capital gain of \$150x (\$250x of amount realized less its \$100x basis in the Q stock) from the intercompany sale of the Q stock to B. Because S's sale of its Q stock to B is a fully taxable transaction, paragraph (c)(3)(ii) of this section applies to treat the sale as an intercompany transaction. Therefore, S's intercompany gains are taken into account under § 1.1502-13(c) and (d). Thus, S defers the inclusion of its \$100x of remaining deferred gain and its \$150x of capital gain in 2021. B has a \$250x basis in its Q stock.

(2) Five-year basis increase in 2023. Pursuant to paragraph (c)(3)(ii) of this section, S and B are treated as divisions of a single entity for purposes of applying section 1400Z-2. In 2023, the single entity has held the QOF investment for five years and its basis in the Q stock would be increased to \$10x ($\$100x \times 10\%$) under section 1400Z-2(b)(2)(B)(iii). To achieve this single entity result, \$10x of S's \$100x of remaining deferred gain is redetermined to be tax-exempt income. See § 1.1502-13(c)(1); see also paragraph (c)(3)(ii)(B) of this section making § 1.1502-13(c)(6)(ii) inapplicable in determining the excludability of S's intercompany gain. Therefore, in 2023, S is treated as having \$10x of tax-exempt income, S's remaining deferred gain is \$90x ($\$100x - \$10x$), and B's basis in the Q stock remains \$250x.

(3) Intercompany transfer in a section 351 transaction. In 2024, B's contribution of its Q stock to B2, a member of the P group, is an inclusion event under section 1400Z-2(b)(1) and § 1.1400Z2(b)-1(c). The amount includible pursuant to § 1.1400Z2(b)-1(e) is \$90x (the remaining deferred gain as determined in paragraph (j)(6)(i)(B) of this section). Because B's contribution of its Q stock to B2 is not a fully taxable transaction, the general rule in paragraph (c)(3)(i) of this section applies to prevent the contribution from being treated as an intercompany transaction for purposes of section 1400Z-2. As a result, for purposes of section 1400Z-2, § 1.1502-13 does

not apply to treat B and B2 as a single entity, and the application of § 1.1502-13(j) is adjusted accordingly. As a result of the section 351 transfer, S takes its \$90x of remaining deferred gain into account. B's basis in its B2 stock is \$250x, and B's basis in its Q stock is \$250x. However, because S's \$150x of capital gain from the intercompany sale of its Q stock to B in 2021 is not an item related to section 1400Z-2, it continues to be deferred under § 1.1502-13 because B2 is a member of the P group. See § 1.1502-13(j)(4) regarding successive intercompany transactions.

(ii) Section 351 transfer to a non-member-

(A) Facts. The facts are the same as in paragraph (j)(6)(i)(A) of this section, except that B2 is not a member of the P group, and B contributes all its Q stock to B2 in a transaction that qualifies under section 351.

(B) Analysis-

(1) Intercompany sale in 2021 and five-year basis increase in 2023. The analysis for the 2021 and 2023 tax years are the same as in paragraphs (j)(6)(i)(B)(1) and (2) of this section.

(2) Transfer of Q to a non-member in a section 351 transaction. In 2024, B's contribution of its Q stock to B2, a non-member of the P group, is an inclusion event under section 1400Z-2(b)(1) and § 1.1400Z2(b)-1(c). The amount includible pursuant to § 1.1400Z2(b)-1(e) is \$90x (the remaining deferred gain as determined in paragraph (j)(6)(ii)(B)(1) of this section). S's deferred capital gain of \$150x is taken into account in 2024 under the acceleration rule of § 1.1502-13(d) because the Q stock has left the P group. B2's holding period for the qualifying investment does not include the time during which B and S held the qualifying investment.

(iii) Section 721(a) transfer to a partnership-

(A) Facts. The facts are the same as in paragraph (j)(6)(i)(A) of this section, except that B2 is a partnership, and an unrelated party is the other partner in B2. B's transfer of all of its Q stock to B2 qualifies for non-recognition treatment under section 721(a). In 2026, the fair market value of Q is \$330x.

(B) Analysis-

(1) Intercompany sale in 2021 and five-year basis increase in 2023. The analysis for the 2021 and 2023 tax years are the same as in paragraphs (j)(6)(i)(B)(1) and (2) of this section.

(2) Transfer of Q stock to a partnership in a section 721(a) transaction. In 2024, B transfers its Q stock to B2, a partnership, in a section 721(a) transaction. Although a section 721(a) transaction is not an inclusion event under § 1.1400Z2(b)-1(c)(7), under the acceleration rule of § 1.1502-13(d), S must take into account its \$90x of remaining deferred gain because B2 has benefited from an increased basis in the Q stock as a result of the intercompany sale between S and B such that this is the appropriate time to take the remaining deferred gain into account. S's deferred capital gain of \$150x is taken into account in 2024 for the same reason.

(7) Example 7: Computation and application of the attribute reduction amount under § 1.1502-36(d) when S owns a QOF-

(i) Facts. In 2018, S sells an asset to an unrelated party and realizes \$5,000x of eligible gain. S contributes \$5,000x to Q in exchange for stock of Q and properly elects to defer the eligible gain under section 1400Z-2(a) and § 1.1400Z2(a)-1. In 2024, M sells all of its S stock to X for its fair market value of \$100x, and M's basis in the stock of S is \$300x. At the time of sale, S owns the Q stock with a basis of \$500x (S's basis in its Q stock was increased under section 1400Z-2(b)(2)(B)(iii) to \$500x in 2023), and S has a net operating loss carryover of \$50x. M's transfer of the S shares is a transfer of loss shares under § 1.1502-36. Assume that no basis redetermination is required under § 1.1502-36(b) and no basis reduction is required under § 1.1502-36(c).

(ii) Attribute reduction under § 1.1502-36(d). Under § 1.1502-36(d), S's attributes are reduced by S's attribute reduction amount. Section 1.1502-36(d)(3) provides that S's attribute reduction amount is the lesser of the net stock loss and S's aggregate inside loss. The net stock loss is the excess of the \$300x aggregate basis of the transferred S shares over the \$100x aggregate value of those shares, or \$200x. S's aggregate inside loss, which includes the basis of the stock of Q as provided by paragraph (e) of this section, is the excess of S's net inside attribute amount over the value of the S share. S's net inside attribute amount is \$550x, computed as the sum of S's \$50x loss carryover and its \$500x basis in Q. S's aggregate inside loss is therefore \$450x (\$550x net inside attribute amount over the \$100x value of the S share). Accordingly, S's attribute reduction amount is the lesser of the \$200x net stock loss and the \$450x aggregate inside loss, or \$200x. Under § 1.1502-36(d)(4), S's \$200x attribute reduction is first allocated and applied to reduce S's \$50x loss carryover to \$0. Under § 1.1502-36(d)(4)(i)(D), S generally would be able to reduce the basis of its category D assets (including stock in other corporations) by the remaining attribute reduction amount (\$150x). However, paragraph (e) of this section provides that S's basis in the stock of Q is not included in S's Category D attributes that are available for reduction under § 1.1502-36(d)(4), and the remaining \$150x of attribute reduction

amount cannot be used to reduce the basis of Q shares under § 1.1502-36(d). Rather, under paragraph (e) of this section, P is treated as making the election under § 1.1502-36(d)(6) to reduce M's basis in the transferred loss S shares by \$150x. As a result, P's basis in its M stock is also reduced by \$150x.

(k) Applicability dates-

(1) In general. This section applies for taxable years beginning after March 13, 2020.

(2) Prior periods. With respect to the portion of a consolidated group's first taxable year ending after December 21, 2017, that began on December 22, 2017, and for taxable years beginning after December 21, 2017, and on or before March 13, 2020, a consolidated group may choose either-

(i) To apply the section 1400Z-2 regulations, if applied in a consistent manner for all such taxable years; or

(ii) To rely on the rules in proposed § 1.1400Z2(g)-1 contained in the notice of proposed rulemaking (REG-120186-18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

▪ Par. 11. Section 1.1504-3 is added to read as follows:

§ 1.1504-3 Treatment of stock in a QOF C corporation for purposes of consolidation.

(a) Scope and definitions-

(1) Scope. This section provides rules regarding the treatment of stock in a QOF C corporation for purposes of determining whether such corporation can join in the filing of a consolidated return. Paragraph (b) of this section generally prevents a subsidiary QOF C corporation from joining in the filing of a consolidated return, but it provides an election to consolidate a subsidiary QOF C corporation (subject to certain conditions). Paragraph (c) of this section provides instructions for making the election provided by paragraph (b) of this section.

Paragraph (d) of this section provides an example. Paragraph (e) of this section provides the applicability dates.

(2) Definitions. The definitions provided in §§ 1.1400Z2(a)-1(b) and 1.1502-14Z(a)(2)(ii) apply for purposes of this section.

(b) QOF stock not stock for purposes of affiliation-

(1) In general. Except as otherwise provided in paragraph (b)(2) of this section, stock in a QOF C corporation (whether qualifying QOF stock or otherwise) is not treated as stock under section 1504 for purposes of determining whether the issuer may join in the filing of a consolidated return under section 1501. Therefore, a QOF C corporation can be the common parent of a consolidated group, and a QOF C corporation generally can be a member of an affiliated group for purposes of section 1504, but a QOF C corporation cannot join in the filing of a consolidated return as a subsidiary member (except as provided in paragraph (b)(2) of this section).

(2) Election to consolidate a subsidiary QOF C corporation-

(i) In general. Notwithstanding paragraph (b)(1) of this section, a consolidated group may elect to consolidate a subsidiary QOF C corporation that was formed, or section 1504 control of which was acquired, by the consolidated group after May 1, 2019, and that otherwise meets the affiliation requirements under section 1504. If a pre-existing corporation was a member of the consolidated group prior to becoming a QOF C corporation, a consolidated group may elect to continue to consolidate such pre-existing corporation if it self-certified to be a QOF after May 1, 2019. The consolidated group must make the election under this paragraph (b)(2) with regard to the first taxable year during which the subsidiary QOF C corporation otherwise meets the section 1504 affiliation requirements (without regard to paragraph (b)(1) of this section). See § 1.1502-14Z(f)(3) for an election available with regard to a subsidiary QOF C corporation that met the section 1504 affiliation requirements as of May 1, 2019. The election under this paragraph (b)(2) is effective on the later of May 1, 2019, or the first date on which the QOF C corporation otherwise meets the requirements of section 1504. If a consolidated group makes the election under this paragraph (b)(2), then the conditions in paragraph (b)(2)(ii) of this section apply to the consolidated group and to the QOF member. See paragraph (c) of this section for the form and manner of making this election.

(ii) Conditions to consolidate a subsidiary QOF C corporation-

(A) Ownership status of QOF investor member. On and at all times after the date of the investment, the common parent must directly or indirectly own all shares of all classes of stock (including non-qualified preferred stock) issued by any QOF investor member.

(B) Direct investment. Except as provided in § 1.1502-14Z(c), each QOF investor member must maintain direct ownership of its qualifying investment (see, for example, §

1.1400Z2(b)-1(c), which generally treats transfers of a qualifying investment as an inclusion event). See § 1.1502-14Z(c)(4) for rules regarding the treatment of intercompany transfers as qualifying investments in a QOF member. See also § 1.1502-14Z(c)(2) and (c)(3)(ii) for rules regarding actual and deemed intercompany transfers of qualifying investments.

(3) Failure of continued qualification. Consolidation of a subsidiary QOF C corporation is contingent upon continued satisfaction of all of the conditions of paragraph (b)(2)(ii) of this section. The requirements of paragraph (b)(2) of this section continue to apply (with appropriate modifications to reflect single-entity treatment) following any intercompany transfer of the QOF member stock that is subject to § 1.1502-14Z(c)(3)(ii). For example, following an intercompany transfer of the QOF member stock that is subject to § 1.1502-14Z(c)(3)(ii), the buying member must maintain a direct investment in the QOF member. On the failure to satisfy any condition of paragraph (b)(2), the QOF member will deconsolidate, and § 1.1502-14Z(g) will apply with respect to such deconsolidation.

(c) Election under paragraph (b)(2) of this section to consolidate a subsidiary QOF C corporation-

(1) In general. The election under paragraph (b)(2) of this section is irrevocable and is made in the form provided in paragraph (c)(2) of this section.

(2) Form of election. The election under paragraph (b)(2) of this section must be made in the form of a statement titled "THIS IS AN ELECTION UNDER § 1.1504-3(b)(2) TO CONSOLIDATE [insert name and employer identification number (E.I.N.) of subsidiary QOF C corporation] as of [insert date]." The statement must be included with the consolidated group's timely filed return (original, superseding, or amended return, as applicable, including extensions) for the year the election under § 1.1504-3(b)(2) is made.

(d) Example. The following example illustrates the treatment of QOF stock as not stock for purposes of affiliation as described in paragraph (b)(1) of this section.

(1) QOF stock as not stock for purposes of affiliation to join in the filing of a consolidated return-

(i) Facts. P wholly owns S, which wholly owns corporation Q1. P, S, and Q1 are members of the P group. In 2021, S sells an asset to an unrelated party and realizes \$500x of eligible gain. S contributes \$500x to Q1 and properly elects to defer the eligible gain under

section 1400Z-2(a) and § 1.1400Z2(a)-1. At such time, Q1 qualifies and elects to be treated as a QOF, but the P group does not elect to consolidate Q1 under paragraph (b)(2) of this section.

(ii) Analysis. Under paragraph (b)(1) of this section, stock of a QOF C corporation (qualifying or otherwise) is not treated as stock for purposes of determining whether the QOF C corporation may join in the filing of a consolidated return. Thus, because no election has been made under paragraph (b)(2) of this section, once Q1 becomes a QOF, Q1 ceases to be affiliated with the P group members for purposes of section 1501, and it deconsolidates from the P group. See §§ 1.1502-1 through - 1.1502-100 generally for the consequences of deconsolidation.

(2) [Reserved]

(e) Applicability dates-

(1) In general. This section applies for taxable years beginning after March 13, 2020.

(2) Prior periods. With respect to the portion of a consolidated group's first taxable year ending after December 21, 2017, that began on December 22, 2017, and for taxable years beginning after December 21, 2017, and on or before March 13, 2020, a consolidated group may choose either-

(i) To apply the section 1400Z-2 regulations, if applied in a consistent manner for all such taxable years; or

(ii) To rely on the rules in proposed § 1.1400Z2(g)-1 contained in the notice of proposed rulemaking (REG-120186-18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

Approved: December 18, 2019

David J. Kautter,

Assistant Secretary (Tax Policy).

1 One source of ambiguity is determining whether gain from selling an item of section 1231 property that is potentially eligible for deferral should be included in the summation of 1231 property in the year the deferral begins or the year the deferral ends.

2 The Treasury Department and the IRS also considered the option of not issuing specific guidance on this topic but determined that this was clearly inferior to the two main options.

3 For a given set of section 1231 sales, positive gains for each individual taxpayer will never be lower under the gross approach than the net approach; this result follows from mathematical principles and is not specific to this example. In practice, taxpayers might choose to recognize gains differently under the two approaches. This difference complicates any projection of actual gains that would be eligible for deferral.

4 The Treasury Department and the IRS also considered taking no action but determined that providing a definition of vacancy and setting a time period for when vacant property could be purchased and considered original use property would be beneficial relative to providing no specific guidance.

5 Under the statute, the value of leased property is included in the denominator of the substantially all test. The statute is ambiguous, however, as to whether leased property should be included in the numerator.