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Analysis and observations about final regulations and future of opportunity zone investments

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The U.S Treasury Department and the IRS on January 13, 2020 published in the Federal Register final regulations under section 1400Z-2, implementing the Opportunity Zone provisions under the 2017 Tax Cuts and Jobs Act.[1] These regulations (the "final regulations") finalize rules that were promulgated in two tranches of proposed regulations in October 2018 and May 2019 (collectively, the "proposed regulations").

The statutory Opportunity Zone regime allows the deferral of all or part of a taxpayer's gain that would otherwise be includible in income if the gain is invested into a Qualified Opportunity Fund (QOF). The gain is deferred until the investment is sold or exchanged or December 31, 2026, whichever is earlier. If the investment is held for at least 10 years, investors may be able to permanently exclude gain from the sale or exchange of an investment in a QOF.

On October 19, 2018 and May 1, 2019, the Treasury Department and the IRS published the proposed regulations, which provided rules addressing basic issues such as the definition of eligible taxpayers and eligible gains, the QOF self-certification process, what qualified as Opportunity Zone business assets, aspects of the requirements for operation of businesses in Qualified Opportunity Zones (QOZs), and timing of the deployment of funds to acquire and improve property in a QOZ.[2]

The eagerly anticipated final regulations provide clarity around a host of issues that were of critical importance to both potential investors in the program and businesses interested in leveraging the incentives provided for operating in QOZs. The final regulations also provide several new rules and expansions of previously provided safe harbors that are by-and-large highly-favorable in terms of investment, development, and operation of projects in QOZs. However, with respect to several different issues about which the government received comments, the final regulations did not provide hoped-for relief, and in some cases the final regulations actually restrict planning and structuring that many viewed as possible under the statute and the proposed regulations.

This article summarizes certain important aspects of the final regulations and offers KPMG LLP's (KPMG) observations as to how these rules may be applied to capital formation of, organizing, investing in, operating, and exiting QOFs.

Background: Opportunity Zone Investment Benefits

Under the Opportunity Zone regime, a taxpayer who sells property to an unrelated person in a transaction that generates capital gains may defer taxation on those gains (or a portion of the gains) by investing those gains (or a portion of the gains) in a QOF within 180 days of the transaction that generated the gains.[3] The QOF then must invest its capital in Qualified Opportunity Zone property (QOZ property). QOZ property includes QOZ stock, a QOZ partnership interest, and QOZ business property.

[1] *Section 1400Z, H. R. 1-115th Congress (2017-2018).*

[2] *For summaries of the proposed regulations, refer to KPMG Report: New Rules for Opportunity Zones (October 2018) and KPMG Report: A New Path Forward (May 2019).*

[3] *Note that the sale or exchange must be with an unrelated third party (relationship tested under sections 267(b) and 707(b) (percentage reduced to greater than 20%).*

There are designated QOZs in all 50 states, U.S. territories including American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, the U.S. Virgin Islands, and the District of Columbia.[4]

A taxpayer's gains that are invested in a QOF are deferred generally until the earlier of the date that: (i) the taxpayer sells or exchanges its interest in the QOF or (ii) December 31, 2026. Under the statute, once the gain is triggered, the amount included in income generally is the excess of (a) the lesser of the deferred gain or the fair market value of the QOF investment, over (b) the taxpayer's basis in the QOF investment.

Depending on the length of time a taxpayer holds a QOF investment, the taxpayer may be entitled to a permanent reduction of up to 15% of its initially invested gains.[5]

The partial reduction is achieved through the operation of the basis adjustment rules. Under the general QOZ rules, a taxpayer's initial basis in a QOF is zero. If the QOF investment is held for 5 years,[6] the basis of the investment is increased by 10% of the deferred gain. If the QOF investment is held for 7 years,[7] the basis of the investment is increased by an additional 5% of the deferred gain for a total of a 15% basis increase.

There is also a special gain exclusion for QOF investments held for at least 10 years. If a QOF investment is held at least 10 years, and, if the taxpayer so elects, on the date that the investment is sold or exchanged the basis of the QOF investment will be stepped-up to its fair market value. Consequently, all gain attributable to the appreciation of a QOF investment held for at least 10 years may be permanently excluded upon the sale of the QOF investment.

The Final Regulations

The final regulations are separated into six sections, Treas. Reg. sections 1.1400Z2(a)-1 through 1.1400Z2(f)-1, as well as two sections addressing consolidated group issues with respect to corporate QOFs, Treas. Reg. sections 1.1502-14Z and 1.1504-3. In this article, we discuss how the rules contained in the final regulations may be applied through the lifecycle of the QOZ investment and make observations about critical aspects of the program as it now stands after the final regulations. The discussion and observations are divided among the following categories:

A. *Investing in QOFs*
B. *Investing in QOZ Property*
C. *Operating within the QOZ*
D. *Inclusion of Deferred Gains*
E. *Exiting the QOF*
F. *Other Significant Issues*

A Investing in QOFs: Eligible Gains, Investors, and Timing

Under the QOZ statute an eligible taxpayer that realizes a capital gain as a result of a sale to an unrelated party can defer tax on that gain, and potentially obtain other QOZ tax benefits, by investing the gain in a QOF within 180 days of realizing such gain. The proposed regulations provided helpful guidance on the meaning of eligible taxpayer, what an eligible gain is, and how the 180-day period for investment is determined with respect to various types of gains.

The final regulations make several clarifications and changes to the rules for investing in QOFs. Notably, they clarify that certain gains of non-U.S. investors and tax-exempt investors are eligible, gains from inclusion events (i.e., triggered gains that were previously invested in QOFs) are eligible, gains from installment sales are eligible, and gross section 1231 gains are eligible. These and other changes in the final regulations are discussed in this section.

1. Section 1231 gains

One of the most significant changes made by the final regulations is the treatment of section 1231 gains. The final regulations provide that any gains from the sale of section 1231(b) property that are *not* recharacterized as ordinary income under sections 1245 or 1250 are "qualified section 1231 gains," meaning they can be deferred if invested in a QOF.[8] The proposed regulations had provided that only *net*

[4] *A complete list of designated Qualified Opportunity Zones is found in Notice 2018-48, 2018-28 I.R.B. 9.*

[5] *That permanent exclusion could be higher if the fair market value of the investment on the earlier of the triggering date or December 31, 2026 is less than the remaining deferred gain.*

[6] *Assuming that gains rolled into QOF are triggered December 31, 2026, a taxpayer would need to make a QOF investment by the end of 2021 in order to benefit from this 5-year basis step-up.*

[7] *Under the current statutory rules, investments in QOFs made after December 31, 2019 are not eligible to qualify for the additional 5% basis step-up because taxpayers will not be able to achieve a 7-year holding period by the December 31, 2026 date, when initial deferred gains must be triggered.*

[8] *See Treas. Reg. §1.1400Z2(a)-1(b)(11)(iii).*

section 1231 gain amounts were eligible for deferral. The final regulations change from a net section 1231 gain concept to a gross section 1231 gain concept means that qualified section 1231 gains may be invested as they are realized throughout the tax year – another significant departure from the proposed regulations – and so the 180-day period to invest and defer qualified section 1231 gains generally begins on the date of the sale or exchange giving rise to the gain.

Although the QOZ rules generally require that gains be capital in nature in order to have a qualifying investment in a QOF, the final regulations essentially turn off that requirement with respect to qualified section 1231 gains by virtue of the gross treatment noted above. The preamble to the regulations makes clear that gains from the sale of section 1231(b) property that are not recharacterized under sections 1245 or 1250 are qualified gains regardless of whether the general rules of section 1231(a) would have determined such gains to be ordinary in character for a tax year.[9]

The final regulations also make clear in the preamble that the loss recapture provisions of section 1231(c) do continue to apply with respect to qualified section 1231 gains that are deferred via investment in a QOF. However, the section 1231(c) recapture, if applicable, will apply when the deferred section 1231 gains are subsequently included in the taxpayer's income, either on December 31, 2026 or upon the occurrence of an earlier inclusion event under the QOZ rules. So the relevant losses, if any, will be the non-recaptured section 1231 losses from the five most recent years preceding the year of the inclusion event.

Observation 1: *To the extent investors had net section 1231 gains in 2019 that they either invested at the end of the year or were planning to invest in a QOF during the 180-day period starting December 31, 2019, such gains should still be eligible. The final regulations allow taxpayers to rely on the proposed regulations for eligible gains recognized in 2019.*

Observation 2: *While the final regulations do not specifically address section 1231 gains flowing up to taxpayers from passthrough entities, those gains should be subject to the same rules as other passthrough gains such that taxpayers may elect to begin their 180-day periods either on the date a lower-tier passthrough entity realized a qualified section 1231 gain, the last day of the passthrough entity's taxable year, or the date that the passthrough entity's tax return without extensions is due.*

Observation 3: *Under the new rules in the final regulations there are likely to be significant planning opportunities for taxpayers who have both gains and losses on section 1231 property in a given tax year.*

Observation 4: *As a result of section 1231 gains being eligible, the IRS will need to provide a deferral election on Form 4797.*

2. Gains of non-U.S. investors

The final regulations add a new requirement that eligible gains must be recognized and subject to tax under subtitle A of the Income Tax Code (the Code) before January 1, 2027.[10] Furthermore, with respect to non-U.S. persons, whether a gain would be subject to tax under subtitle A is determined after application of any treaty exemption provision that an eligible taxpayer elects to apply under any applicable U.S. income tax convention.[11] An eligible non-U.S. person or an eligible U.S. person who is treated as a non-resident, cannot defer an otherwise eligible gain unless such person irrevocably waives any treaty benefits that would exempt such person's gain from being subject to Federal income tax at the time of inclusion. In order to waive treaty benefits, a taxpayer will have to file in accordance with forms and instructions that are to be published in the future or, until such time, file a written statement under penalties of perjury that notices the irrevocably election.

The final regulations provide that a partnership is an eligible taxpayer notwithstanding whether it may have indirect non-U.S. partners, but provide that a partnership formed or availed of with a significant purpose to avoid the requirement that eligible gain be subject to tax could be disregarded under anti-abuse rules.[12]

Observation 1: *Because non-U.S. investors were not specifically listed as eligible taxpayers in the proposed regulations, previously there were questions about the ability of non-U.S. investors to take advantage of the QOZ tax benefits. These rules clarify that non-U.S. investors are eligible investors to the extent they have eligible gains.*

Observation 2: *The final regulations do not provide relief from the requirement that buyers of U.S. real property withhold from non-U.S. sellers on a gross basis, and therefore the ability of non-U.S. investors to take full advantage of Opportunity Zone investments may be impaired absent additional structuring.*

[9] *Section 1231(a)(2) provides that if a taxpayer's section 1231 gains for the tax year do not exceed its section 1231 losses for the tax year then such gains and losses are not treated as capital in nature.*

[10] *See Treas. Reg. §1.1400Z2(a)-1(b)(11)(i)(B).*

[11] *See Treas. Reg. §1.1400Z2(a)-1(b)(11)(ix).*

[12] *See Treas. Reg. §1.1400Z2(f)-1(c)(2)(ii)*

Observation 3: *Though the anti-abuse rules should be considered, it appears that preexisting partnerships with non-U.S. partners should generally be eligible to roll eligible gains into QOFs notwithstanding that the gains would not have been subject to U.S. tax in the hands of direct or indirect non-U.S. partners.*

3. Gains of tax-exempt investors

As noted above, the final regulations provide that for capital gains to be eligible they must not only be recognized for Federal income tax purposes before January 1, 2027, but also be subject to tax under subtitle A of the Code.[13] This means that only certain tax-exempt entities that have gains subject to unrelated business income tax (UBIT) are eligible investors in QOFs.

Private foundations and some educational institutions, which are subject to tax on their net investment income (including capital gains), appear to be foreclosed by the regulations from taking advantage of the QOZ benefits because these taxes are imposed under subtitle D, rather than subtitle A, of the Code. It is unclear what the statutory justification is for this distinction, or, more broadly, why the Treasury Department and the IRS decided to make any tax benefits of investing in a QOZ unavailable to most tax-exempt organizations. Many tax-exempt organizations may have capital gains, but they are generally not subject to UBIT (unless considered "debt-financed income"). Tax-exempt organizations may want to invest in QOFs alongside taxable investors, particularly where the QOF investment will result in a charitable impact as well as a financial return. There seems to be no statutory bar to a tax-exempt organization investing its capital gains in a QOF and taking advantage of the 10-year basis step-up to eliminate the capital gains and potential taxes on the appreciation in the QOF (such as the taxes on net investment income of private foundations and some educational institutions and on debt-financed income). However, the final regulations seem to preclude this.

Observation 1: *In order to make a qualifying investment, the QOZ statute only requires a taxpayer to have gain from the sale or exchange of property with an unrelated party. As such, there may be tax-exempt investors who invested gains from a sale or exchange in a QOF expecting to get at least the 10-year benefit, even though the income would be excluded from tax under section 512. While the final regulations do not permit such investments to qualify for QOZ benefits, it is unclear whether this is the case for investments made prior to the effective date of the final regulations.*

Observation 2: *As noted above in the discussion of non-U.S. investors, the final regulations provide that a partnership is an eligible taxpayer notwithstanding whether its indirect partners were subject to tax, but provide that a partnership formed or availed of with a significant purpose to avoid the requirement that eligible gain be subject to tax could be disregarded under anti-abuse rules.*

4. Inclusion event gains

The final regulations change the rules with respect to the eligibility of gains that result from inclusion events.[14] Under the QOZ rules, inclusion events trigger the recognition of deferred gains that have been invested in QOFs. Under the proposed regulations, it was clear that a taxpayer could reinvest, or rollover, a previously deferred gain if the taxpayer disposed of 100% of its qualifying investment in a QOF, but it was unclear whether partial dispositions or gains from other inclusion events were eligible to be deferred by investing them in a different QOF. The final regulations provide that gain that is triggered by virtue of an inclusion event, whether fully or partially, may be deferred by re-investing such gain in another QOF.[15] The inclusion event gain is treated as arising at the time of the inclusion event (i.e., it is not retroactive to the time of the original QOF investment) and the 180-day period for the taxpayer to re-invest the inclusion gain begins on the date of the inclusion event. Following a rollover of an inclusion event gain into a different QOF, a taxpayer's holding period for purposes of the partial reduction of deferred gain and the 10-year exclusion rules restarts on the date of the new investment.

Observation 1: *The ability to re-invest gains from inclusion events means that QOF investors can, if desired, diversify their QOF investments. This may prove valuable, for instance, if after several years an initial QOF investment is successful and stabilized and the investor wants to extract some capital from that QOF and invest in one or more other QOFs. Under this new rule, that strategy can be executed without current recognition of either the initial deferred gain or any gain from the appreciation of the first QOF investment.*

Observation 2: *Only gains from inclusion events prior to the end of 2026 are eligible to be re-invested into another QOF and qualify for the QOZ incentives.*

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[13] *See Treas. Reg. §1.1400Z2(a)-1(b)(11)(i)(B).*

[14] *For the definition of an "inclusion event," see the discussion below and Treas. Reg. §1.1400Z2(b)-1(c).*

[15] *See Treas. Reg. §1.1400Z2(a)-1(b)(11)(iv).*

> **Observation 3:** *A partial sale or other inclusion event will stop the holding period of a portion of the original QOF investment. As such, consideration should be given as to whether to wait until achieving the basis step up from a 5-year hold prior to a partial sale or other disposition that causes an inclusion event.*

5. Installment sale gains

Unlike the proposed regulations, the final regulations provide rules for the treatment of gains from installment sales. Installment sale gains are eligible for deferral under the QOZ rules, including gains from installment sales that occurred prior to enactment of the QOZ regime in December 2017.[16] For gains reported on the installment sale method, taxpayers have two options in terms of when their 180-day period for investment begins. They can use the date a payment is received as the first day of the 180-day period or they may use the last day of their taxable year in which the gain would have been recognized as the first day of the 180-day period.

> **Observation 1:** *The installment sale gain must either be a section 1231 gain or a capital gain in order to be eligible for deferral.*
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> **Observation 2:** *Under the rules in the final regulations, it is clear that a taxpayer could have multiple 180-day periods during the year if the taxpayer received multiple payments under its installment sale. What is less clear is whether a taxpayer can elect to use a specific payment date for one or more payments and then use a year end date for one or more other payments received during the year. The rules appear to require consistent treatment of payments within a tax year.*

6. Gains from sales to a QOF or QOZB

The QOZ statute provides that gains from the sale of property to a person related to a taxpayer (the percentage of relatedness for these purposes is more than 20%)[17] are not eligible gains for purposes of investing in a QOF and obtaining a qualifying investment. The preamble to the final regulations discusses the application of this rule to transactions wherein a taxpayer sells property to an unrelated QOF (or an unrelated QOF's QOZB) and then invests the gain from that sale in the purchasing QOF. While noting that general Federal income tax principles (e.g., the step-transaction doctrine and circular-cash flow principles) apply, the preamble to the final regulations states that if, as part of a plan to invest in the acquiring QOF, a taxpayer sells property to an unrelated QOF, then the gain from such sale is not an eligible gain if invested in the acquiring QOF. The preamble also states that, under the same theory, a sale to an acquiring QOF's QOZB that is part of a plan to invest in the QOF may not result in eligible gain.

> **Observation 1:** *Prior to publication of the final regulations, there were questions as to whether transactions like those described in the preamble did result in eligible gains. While the preamble notes the existence of general Federal income tax principles that are obviously relevant to the inquiry, the regulations themselves do not impose any new rules or requirements that should impact the analysis of transactions like those described in the preamble.*[18] *Therefore, while it is important and relevant to note the government's awareness of this potential issue, nothing in the final regulations appears to change the actual analysis required to determine whether or not a sale to a QOF or QOZB followed by an investment by the seller in the QOF should be recast.*
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> **Observation 2:** *If a transaction like the one described above was recast under general tax principles as a contribution of property to the QOZB rather than a sale and subsequent investment in the QOF, then not only would the seller/investor not have a qualifying investment in the QOF, but also the QOZB would not have acquired the property by purchase and the property could not qualify as QOZ business property.*[19]

7. Timing for partners deferring gains from partnerships

The final regulations add flexibility in terms of timing for partners who want to defer gains flowing up from partnerships.[20] Under the proposed regulations partners could start their 180-day period for eligible gains that the partnership itself did not elect to defer on either (i) the day the partnership realized the gain, or (ii) the last day of the partnership's taxable year. This second date remains the general rule but the final regulations acknowledge that

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16 *See Treas. Reg. §1.1400Z2(a)-1(b)(11)(viii).*

17 *See section 1400Z-2(e)(2) and Treas. Reg. §1.1400Z2(a)-1(b)(39).*

18 *The final regulations do contain an example, see Treas. Reg. §1.1400Z2(f)-1(c)(3), Example 3, under the anti-abuse rule section of the regulations that analyzes a sale and contribution in a scenario where the seller has a "plan or intent" to invest sales proceeds in the acquiring QOF.*

19 *QOZ business property is defined and discussed below.*

20 *See Treas. Reg. §1.1400Z2(a)-1(c)(8).*

partners may not be in receipt of sufficient information to make their determinations beginning on the last day of the partnership's taxable year and so provide that partners may also elect to begin their 180-day period on the due date for the partnership's tax return without extensions.[21]

Observation *This new elective beginning of the 180-day period for partners in a partnership allows 2019 gains of such partners to be invested in QOFs as late as September 11, 2020, which is past the June 27, 2020 date that many potential QOF investors have been focused on. Under this rule, gain from a transaction that occurred as early as January 1, 2019 could be invested in a QOF by a partner as late as September 11, 2020 and still qualify for deferral. Furthermore, investments after July 1, 2020 were the first that the relevant QOF has accepted, in some scenarios the QOF might not encounter its first asset testing date until as late as June 30, 2021.*

8. Other categories of eligible taxpayers

In addition to those discussed above, the final regulations make some changes to the categories of taxpayers eligible to defer gains by investing in QOFs. The final regulations provide that nongrantor trusts and decedents' estates may defer gains using rules analogous to those that apply to partnerships, and, in the case of a grantor trust that realizes an eligible gain, either the trust itself or the deemed owner of the trust may make a qualifying investment.[22] The final regulations also provide that the rules for timing of deferral of eligible gains from S corporations, nongrantor trusts, and estates are analogous to the timing rules applicable to partnerships.[23] The flexibility on timing of the 180-day period does not, however, apply with respect to gains of grantor trusts.[24]

The final regulations also make significant changes with respect to the interaction of the QOZ rules and the consolidated group rules. Of particular interest under the category of eligible taxpayers, the final regulations provide that a consolidated group member may make a qualifying investment in a QOF despite the fact that the gain being deferred was realized by another member of the consolidated group.

A more specific and robust discussion of the changes to the corporate and consolidated group rules in the context of QOZs can be found later in this report.

9. Disguised sales and other issues with partner contributions

The proposed regulations contained rules and discussion of the interaction of the partnership disguised sale rules with contributions to QOF partnerships. Essentially the proposed regulations indicated that a contribution that was recharacterized as other than a contribution under section 707 would not result in a qualifying investment. The final regulations do not make changes to the proposed regulations related to the disguised sale rules, but in response to comments the preamble makes some potentially helpful observations.[25]

The preamble to the final regulations states that it is the Treasury Department's and the IRS's intent that section 707 should provide an analytical framework for evaluating contributions to QOF partnerships and therefore all section 707 guidance, including exceptions, should be applicable. The preamble specifically notes that the operating cash flow distribution exception to disguised sale treatment may be applied in the QOF context.

The preamble also discusses the issue of "overfunded" QOF partnerships, meaning situations where the QOF partners have contributed more capital than the QOF needs for its investments and so the QOF distributes the excess contributions back to the partners. The final regulations provide an example illustrating that in this situation the distribution of the excess capital does not impair or recharacterize the original qualifying investment, but the distribution is an inclusion event that therefore reduces the QOF investor's remaining qualified investment.[26]

The final regulations confirm the rule in the proposed regulations that the deemed contribution of money to a QOF under section 752(a) by virtue of a partner's assumption of partnership liabilities does not create or increase an investment in the QOF and therefore cannot create a mixed-fund investment.[27]

[21] *See Treas. Reg. §1.1400Z2(a)-1(c)(8)(iii)(B).*

[22] *See Treas. Reg. §1.1400Z2(a)-1(c)(9)(i).*

[23] *See Treas. Reg. §1.1400Z2(a)-1(c)(9)(i).*

[24] *See Treas. Reg. §1.1400Z2(a)-1(c)(9)(ii).*

[25] *See Treas. Reg. §1.1400Z2(a)-1(c)(6)(iii)(A).*

[26] *See Treas. Reg. §1.1400Z2(a)-1(c)(6)(v)(D), Example 4.*

[27] *See Treas. Reg. §1.1400Z2(a)-1(f)(2).*

10. Gains from RICs and REITs

The final regulations provide shareholders of RICs and REITs additional flexibility in terms of determining the 180-day period they have to invest capital gain dividends in QOFs. The general rule for such capital gain dividends is that the 180-day period begins on the last day of the shareholder's taxable year in which the capital gain dividend would otherwise be recognized.[28] In the alternative, a shareholder may elect to begin its 180-day period on the date a capital gain dividend is paid.[29] Finally, for undistributed capital gain dividends, a shareholder may elect to begin the 180-day period on (i) the last day of the shareholder's taxable year in which the dividend would be recognized, or (ii) the last day of the RIC's or REIT's taxable year.[30]

11. Attributes of eligible gains

The final regulations retain the rules regarding attributes of invested gains. This means that, upon inclusion, deferred gains retain their characteristics and are subject to the same provisions and rates that would apply to these gains as if they were recognized in the year of inclusion (e.g., short-term capital gains remain short-term, section 1231 gains remain section 1231 gains).[31]

The final regulations also add rules about the sequencing of eligible gains and how they are associated with particular deferred gains.[32] These new rules only apply if taxpayers had multiple eligible gains that may have been eligible for deferral at the time they made their qualifying investment(s) and the deferred gain is not clearly associated with a particular investment. In such cases, the final regulations provide that taxpayers are treated as making QOF investments first from their earliest eligible gains, and then proceeding on in order of realizations. In the event there are two or more eligible gains that were realized on the same day, the gains are allocated proportionately to the QOF investment.

12. Allocations to profits interests in Mixed-Fund investments

The proposed regulations provided that a profits interest in a QOF partnership that is received for services is a non-qualifying investment and a partner who holds both a non-qualifying investment and a qualifying investment must allocate all of its partnership items between those interests (a "mixed-fund" investment). The proposed regulations further provided that if a partner received a profits interest in a QOF partnership in exchange for services, the allocation percentage for the profits interest was based on the highest share of residual profits that the partner would receive with respect to that interest. The final regulations retain the general approach to these mixed-fund partners[33] but provide that if the highest residual share associated with the profits interest provided in the partnership agreement is not reasonably likely to apply, then that share is disregarded in determining the allocation percentages of this mixed-fund partner, and the allocation percentage for the profits interest will be the residual share of profits provided in the partnership agreement that is likely to apply.[34]

> **Observation:** *As was the case under the proposed regulations, QOF investors who want a promote but also wish to avoid holding a mixed-fund investment and the complications that can come with that, can avoid mixed-fund status by holding the promote via a separate tax entity.*

B Investing in QOZ Property

There are several fundamental requirements that the QOZ statute imposes on QOFs and QOZBs in terms of acquiring and maintaining a sufficient level of investment in QOZs. QOFs must satisfy a 90% investment standard. More specifically, on an annual basis, a QOF must establish that 90% of its assets are held in Qualified Opportunity Zone property (QOZ property). QOZBs must satisfy a 70% tangible property standard. More specifically, on an annual basis, a QOZB must establish that 70% of its tangible assets are Qualified Opportunity Zone business property (QOZ business property).

For QOFs, interests held in qualifying QOZBs are "good" QOZ property, and for many QOFs interests in QOZBs are the only assets that they may hold. Therefore, maintaining a QOZB's qualifying status is critical. Although the 90% investment standard is evaluated on an annual basis, it generally is determined based on the average of a QOF's QOZ property held at two testing dates during the year (the "semi-annual testing dates").

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28 *See Treas. Reg. §1.1400Z2(a)-1(b)(7)(ii)(A).*

29 *See Treas. Reg. §1.1400Z2(a)-1(b)(7)(ii)(B).*

30 *See Treas. Reg. §1.1400Z2(a)-1(b)(7)(ii)(C).*

31 *See Treas. Reg. §1.1400Z2(a)-1(c)(1)(i).*

32 *See Treas. Reg. §1.1400Z2(a)-1(c)(1)(iii).*

33 *See Treas. Reg. §1.1400Z2(a)-1(c)(5)(ii).*

34 *See Treas. Reg. §1.1400Z2(b)-1(c)(6)(iv)(D).*

The final regulations provide much-needed guidance on the investment standard, the QOZB tangible property standard, the relevance and application of the semi-annual testing dates at both the QOF and QOZB level, and the definition of QOZ business property. These issues are discussed below.

1. The 90% investment standard for QOFs

In response to comments the final regulations clarify several issues related to the QOF's 90% investment standard.[35] The final regulations confirm that all of a QOF's assets should be valued at each testing date for purposes of determining compliance, but that mere organizational and operational expenses are not included or taken into account.[36] Specifically, the preamble to the final regulations notes that selling commissions, organization expenses, offering expenses, and similar expenses that do not result in an "asset cognizable for tax purposes" can be excluded in terms of testing the QOF's 90% investment standard.

> **Observation:** *Many QOFs had assumed they would need to use the AFS valuation method (defined below) in their start-up year to avoid capitalized startup costs being treated as "bad" assets that could cause the QOF to fail the 90% investment standard for that year; this change generally provides welcome relief in the context of the specific costs identified in the final regulations.*

2. Holding periods and testing dates

Under the QOZ regime, holding periods are a critical concept. For a QOZB to qualify as such, and in order for QOZ business property to qualify as such, the QOZ statute requires that the QOZB or QOZ business property remain compliant with other substantive statutory requirements during "substantially all" of the holding period during which they are owned. The proposed regulations defined "substantially all" in the context of QOZ holding periods to be 90% of the holding period, but when and how that 90% should be tested remained an open question. The final regulations provide some answers.

The final regulations provide that the 90% holding period requirement is generally tested on a semi-annual basis and satisfaction of the requirement is based on the cumulative amount of time that the QOF has held the QOZB or the QOZB has held the QOZ business property.[37] Specifically, for a QOF that holds a QOZB interest, the relevant period to test is the date that the QOF self-certifies as a QOF (or the date the QOF acquired the QOZB interest, if later) through the relevant semi-annual testing date. In terms of tangible property held by a QOZB (or a QOF), the relevant testing period is the entire time the QOZB (or QOF) has held the tangible property.

The final regulations also provide a safe harbor for determining whether a QOZB is a "good" QOZB for at least 90% of the cumulative holding period. Under this safe harbor, a QOF may limit its testing period with respect to a QOZB to the period of time from the date when a QOF became a QOF through the last day of the QOZB's taxable year that ends on or before the relevant semi-annual testing date. Essentially this safe harbor provides flexibility in situations where a QOF's tax year does not align with the tax year of its QOZB.

> **Observation:** *Prior to the final regulations, taxpayers may have intended to comply with the 90% holding period test on a basis other than cumulative (e.g., over the projected life of the investment). It may be important for such taxpayers to consider the effective dates for the final regulations, and that a failure of compliance in an earlier year or period cannot be cured by holding the QOZB for a longer period of time.*

3. Curing a QOZB compliance failure

The final regulations provide QOFs a one-time opportunity to cure a defect that prevents an entity from qualifying as a QOZB and thereby causes a failure of a QOF's 90% holding period requirement and the 90% investment standard. This new rule provides that if an entity in which a QOF is invested fails to qualify as a QOZB on a given testing date, there is a 6-month grace period during which the QOF may nonetheless treat the entity as a qualifying QOZB.[38] At the end of the 6-month period, if the entity has not come into compliance as a QOZB, the QOF must assess its own compliance with the 90% investment standard while treating the entity as non-QOZ property. At that point, if the QOF fails its 90% investment standard, the applicable QOF penalty rules apply. The final regulations provide that "[e]ach QOF is permitted only one correction" pursuant to this rule.[39]

> **Observation:** *The new cure provision provided by the final regulations is obviously a welcome change. The language providing that a cure can only be used one time is somewhat ambiguous. It is not entirely clear whether*

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35 *See Treas. Reg. §1.1400Z2(a)-1(b)(4).*

36 *See Treas. Reg. §1.1400Z2(d)-1(b)(2)(ii)(A).*

37 *See Treas. Reg. §1.1400Z2(a)-1(b)(5) and (b)(6) and Treas. Reg. §1.1400Z2(d)-2(d)(3).*

38 *See Treas. Reg. §1.1400Z2(d)-1(d)(6)(i).*

39 *See Treas. Reg. §1.1400Z2(d)-1(d)(6)(iii).*

the one-time availability applies to the QOF or applies to the QOF one time for each QOZB that is owned by the QOF. Adding to the confusion, the preamble to the final regulations says that "a qualified opportunity zone business can utilize a six-month cure period only once."

4. Cost basis valuation no longer available for certain intangible assets of a QOF

The proposed regulations provided two valuation methodologies that QOFs were permitted to use in determining compliance with their 90% investment standard: (i) an applicable financial statement (AFS) methodology, and (ii) an unadjusted cost basis methodology. The latter methodology generally permitted QOFs to use the unadjusted cost basis of any asset as determined under section 1012 as the value of such asset for purposes of determining compliance with the 90% investment standard (essentially "locking in" the value of such assets). The final regulations restrict the ability of QOFs to use the unadjusted cost basis methodology to only those assets that are acquired by purchase or constructed for fair market value.[40]

The final regulations provide that the value of any asset of a QOF that is not purchased or constructed for fair market value equals the asset's fair market value.[41] Thus, for example, a QOF that was issued or granted a partnership interest in a lower-tier entity would be required to value such interest at fair market value. The fair market value for such assets is determined on each of the QOF's testing dates.

Observation 1: *This rule appears to target structures wherein QOFs are granted profits interests in a partnership in exchange for services that, absent this new rule, could be held at cost (which would be minimal) during the initial 10-year holding period of a QOF, and then receive a step up to fair market value immediately before disposition. Although this rule may be intended to target profits interests and carried interest structures, the potential application could be much broader and it is unclear whether the government intends that result.*

Observation 2: *Because this rule is a significant change from the proposed regulations, and is more restrictive than the rule in the proposed regulations, it is somewhat surprising that the rule was finalized without the benefit of notice and comment.*

5. Additional time to administer recently contributed capital

The proposed regulations allowed QOFs to disregard recently contributed capital for purposes of satisfying their 90% investment standards. Specifically, capital that had been contributed to a QOF could be excluded from the numerator and denominator for purposes of the percentage test on a QOF's testing date if such capital had been contribution within the prior 6 months. The option to exclude recently contributed capital was only available if, from the time of contribution through the relevant testing date, the capital had been held by the QOF in cash, cash equivalents, or short-term debt instruments.

These rules are all retained in the final regulations and, in addition, the final regulations provide some administrative flexibility by allowing a QOF until the fifth day after a contribution of capital to invest that capital in appropriate short-term investment assets in order to comply with the rules that allow the new capital to be disregarded.[42]

6. QOZ business property

Under the QOZ statute, there are three requirements for tangible property to qualify as QOZ business property: (i) it must be *acquired by purchase from an unrelated party* after December 31, 2017, (ii) its *original use* in the QOZ must commence with the taxpayer or the taxpayer must *substantially improve* the property, and (iii) during *substantially all of the entity's holding period* of the property *substantially all of its use* must be in the QOZ. In addition to tangible property that is owned, the proposed regulations extended QOZ business property status to otherwise qualifying leased property. Much of the proposed regulations was devoted to interpreting and explaining these statutory requirements, but significant ambiguity remained. The final regulations provide clarity in several ways.

a. Original use of property

In general the proposed regulations provided that the original use of tangible property in a QOZ commenced on the date any person first placed the property in service in the QOZ for purposes of depreciation or amortization. The final regulations largely adhere to the proposed regulations' rules with respect to definitions and requirements for original use of property. Although they fail to provide a bright line test for when property is placed in service for this purpose, they do add some helpful examples and answer several questions that were raised by commenters.

[40] *See Treas. Reg. §1.1400Z2(d)-1(b)(4)(ii)(A).*

[41] *See Treas. Reg. §1.1400Z2(d)-1(b)(4)(ii)(B).*

[42] *See Treas. Reg. §1.1400Z2(d)-1(b)(2)(i)(B).*

i. New construction

The final regulations generally provide that tangible property that is manufactured or constructed in a QOZ may be treated as QOZ business property even though it is not technically "acquired by purchase."[43] In order to be QOZ business property, the tangible property must be manufactured, constructed, or produced by the eligible entity (e.g., the QOZB) with the intention of using such property in a trade or business of the eligible entity in a QOZ. Also, the materials and supplies used to produce the tangible property must themselves be QOZ business property—meaning, among other requirements, they must have been acquired by purchase from an unrelated party and be original use property or substantially improved.[44]

The final regulations provide that self-constructed tangible property is treated as acquired on the date physical work of a significant nature begins. There is also a safe harbor available that allows an eligible entity to elect to treat physical work of a significant nature as beginning when more than 10% of the total cost of the property has been incurred (excluding the cost of land and preliminary activities such as planning, securing financing, and research).[45]

The final regulations also provide an example that confirms that a newly-constructed building may be acquired prior to being placed in service and can be considered original use, but declined to adopt a rule that would tie determination of original use to a temporary certificate of occupancy (TCO) or any other status granted under local law.

Observation 1: *Prior to the release of the final regulations, taxpayers and practitioners had not really questioned that self-constructed property could meet the acquired by purchase requirement because the materials would be acquired by purchase. The self-constructed property rule may introduce more uncertainty than it resolves.*

Observation 2*: Placed in service generally is determined by when the property is ready and available for its intended use in the taxpayer's trade or business. Because of variations in state law over when a TCO may be issued based on the condition of the building at the time, it could be that a building is placed in service before the TCO is granted (if it is granted at all).*

ii. Improvements to non-qualifying property

In the preamble to the final regulations, the Treasury Department and the IRS decline to adopt a commenter's recommendation that the regulations affirmatively provide that improvements to non-qualified property used in a QOZ may satisfy the original use requirement. The reasoning given in the preamble is that tracking improvements to non-qualified property would be administratively burdensome.

The discussion in the preamble suggests that the Treasury Department and the IRS do not believe that improvements to non-qualifying property, despite themselves being original use, should be treated as "good" QOZ business property. This is a significant assertion and one that does not necessarily follow from the language of the statute or regulations (proposed or final). The preamble language might be read to imply that if a QOZB acquired a dilapidated building and land as a contribution, and then renovates and rehabilitates the building, even if the new construction was significantly more in terms of capital and investment than the value of the old building, the renovations to the building would not be QOZ business property.

Observation: *Proper interpretation of this language may require an analysis of what constitutes "property" for purposes of the statute, a term that remains undefined. Regardless, this preamble language (if indicative of a new rule/requirement) could present theoretical challenges for existing QOF/QOZB structures where property has been contributed or acquired from a related party.*

iii. Vacant property, brownfields, and under-used property

The proposed regulations provided that for vacant property to be considered original use, the property must have been vacant for at least five years. The final regulations shorten the required vacancy period and provide a definition of vacancy for purposes of the QOZ rules.

The final regulations provide different vacancy periods depending on when the QOZ in which vacant property is located was designated as a QOZ. If a property was vacant at the time the QOZ in which it is located was designated as a QOZ and remained vacant until acquired by an eligible entity, then only one year of vacancy is necessary for the property to be considered original use.[46] If the property was not vacant at the time the QOZ in which it is located was designated as a QOZ but the property later became vacant, then a three

43 *See Treas. Reg. §1.1400Z2(d)-2(b)(1)(iii)(A).*

44 *See id.*

45 *See Treas. Reg. §1.1400Z2(d)-2(b)(1)(iii)(C).*

46 *See Treas. Reg. §1.1400Z2(d)-2(b)(3)(i)(B).*

year period of vacancy is necessary for the property to be considered original use property.[47]

The final regulations define vacancy as being "significantly unused," and provide that standard is met if more than 80% of the useable square footage of land or of a building is not being used.[48]

In response to comments, the final regulations also add provisions that treat certain categories of property as original use regardless of current or historic activities on such property. So-called brownfield sites, meaning commercial or industrial facilities that require environmental remediation, are deemed to satisfy the original use requirement of the QOZ statute as long as the acquiring entity takes certain steps to ensure basic safety standards are achieved.[49] In addition, the final regulations provide that any property that is acquired by an eligible entity from a local government that itself acquired such property by involuntary transfer (e.g., abandonment, foreclosure) is deemed to satisfy the original use requirement.[50]

> **Observation:** *Taken together these new rules significantly expand the category of original use property and may result in reevaluations of certain properties in QOZs that were not previously candidates for investments by QOFs.*

b. Substantial improvement

Under the QOZ statute, tangible property that is not original use may become QOZ business property if it is substantially improved (meaning essentially that basis in the property is more than doubled) within 30 months of acquisition. The final regulations make several positive changes to the rules about how non-original use property must be substantially improved in order to qualify as QOZ business property. Most significantly, the final regulations depart from the proposed regulations' strict asset-by-asset approach and allow for flexibility in terms of aggregating improvements.

i. Aggregation by virtue of functionality

When determining whether a non-original use asset has been substantially improved, the final regulations allow an eligible entity, meaning a QOZB or QOF, to take into account other purchased original use assets that would otherwise qualify as QOZ business property if those assets are (i) used in the same trade or business in the QOZ (or a contiguous QOZ) in which the non-original use asset is used, and (ii) improve the functionality of the non-original use asset.[51] If an eligible entity opts to use this methodology to satisfy its substantial improvement requirement, the purchased original use assets will not be treated as original use property but will instead be added to the basis of the non-original use property for qualification purposes.

Taxpayers can use this method in order to demonstrate substantial improvement with respect to non-original use real property, but if they do so the final regulations provide that the real property itself must still be improved by more than an insubstantial amount.[52]

> **Observation:** *Examples in the final regulations point to acquisition of linens, furniture and fixtures, but it is not clear that other property (e.g., an adjacent parking lot or shared facilities) could not also satisfy this test so long as the other property is original use (though aggregation may also be achieved pursuant to the "eligible building group" rule discussed below).*

ii. Aggregation of eligible building groups

The final regulations provide that multiple non-original use buildings located in a QOZ (or a series of contiguous QOZs) may be aggregated and treated as a single property for purposes of meeting the substantial improvement requirement.[53] If the relevant eligible buildings are not on a parcel of land described on one deed, then there are additional requirements if they are to be treated as a single property. In such case, each building must be operated as part of one or more trades or businesses that (i) are operated exclusively by the eligible entity, (ii) share significant facilities or centralized business elements, and (iii) are operated in coordination or reliance upon one another.[54]

> **Observation**: *This rule is a welcome change for mixed use developments, and will generally permit buildings or components that would not otherwise meet the substantial improvement test to be included as "good" QOZ business property, jointly financed, and sold together.*

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[47] *See id.*

[48] *See Treas. Reg. §1.1400Z2(d)-2(b)(3)(iii).*

[49] *See Treas. Reg. §1.1400Z2(d)-2(b)(3)(iv).*

[50] *See Treas. Reg. §1.1400Z2(d)-2(b)(3)(v).*

[51] *See Treas. Reg. §1.1400Z2(d)-2(b)(4)(iii)(A).*

[52] *See Treas. Reg. §1.1400Z2(d)-2(b)(4)(iii)(B).*

[53] *See Treas. Reg. §1.1400Z2(d)-2(b)(4)(v).*

[54] *See Treas. Reg. §1.1400Z2(d)-2(b)(4)(v)(C).*

iii. Qualification of property during the substantial improvement process

The final regulations provide a helpful safe harbor that allows a QOF or QOZB to treat eligible property that is in the process of being improved as satisfying the substantial improvement requirements during the 30-month period when it is being improved.[55] In order to avail itself of this safe harbor, the QOF or QOZB must have a reasonable expectation that by the conclusion of the 30-month period the property will be sufficiently improved and used in a trade or business in a QOZ.

> **Observation 1:** *This safe harbor will generally be helpful where the construction is not financed with working capital (complementary safe harbor discussed below).*
>
> **Observation 2:** *It is notable that this new substantial improvement safe harbor applies at both the QOZB and QOF levels. Although in typical structures the QOZ project or business is conducted at the QOZB level, the availability of this safe harbor at the QOF is helpful for those situations where by choice or necessity the QOF is the entity holding the relevant QOZ investment that must be substantially improved in order to qualify as QOZ business property.*

iv. Improvements to unimproved land

The proposed regulations and other administrative guidance explicitly exempted land from the substantial improvement requirement. The proposed regulations did, however, provide that unimproved land would not be considered QOZ business property if the taxpayer's intent with respect to such land was merely to hold such land and "bank" it as a speculative investment. Therefore, the proposed regulations required, and the final regulations retain the same rule, that unimproved land is required to be improved by "more than an insubstantially amount" within 30 months from the date of acquisition. Commenters on the proposed regulations requested more quantitative guidance on this rule, but the Treasury Department and the IRS declined to elaborate. The final regulations do discuss some improvements (e.g., grading, clearing, and remediation) that may be considered a factor in assessing the intent of a QOF or QOZB to make improvements to land.[56]

c. Planned repurchases of real property

The final regulations provide that any purchase of real property that includes a plan, intent, or expectation, at the time the QOF or QOZB acquires the real property, that the seller will at some point re-acquire the property for an amount other than fair market value, determined at the time of repurchase by the seller, is not a qualifying acquisition for QOZ purposes.[57]

d. Inventory

The proposed regulations allowed inventory to be considered QOZ business property, which therefore meant that inventory would be included for purposes of testing compliance with the 90% investment standard for QOFs and the 70% tangible property standard for QOZBs. In response to solicited comments, the final regulations change the rules related to treating inventory as QOZ business property. The final regulations give eligible entities the option to either include or exclude inventory.[58] Whichever option the eligible entity chooses, inventory will be excluded from or included in both the numerator and the denominator when testing semi-annual compliance. Once it opts to include or exclude inventory, the eligible entity must apply that choice consistently within the taxable year of the eligible entity.

The final regulations also provide new rules about inventory in transit. These new rules clarify that neither the distance inventory travels nor warehousing of inventory in transit are factors that should prevent inventory in transit from being considered used in a QOZ.[59]

7. Rules for leased property

Under the proposed regulations, in order for leased property to be considered QOZ business property, there were generally two requirements: (i) the lease was market rate, and (ii) the lease was entered into after December 22, 2017. Despite these seemingly simple requirements, there was significant commentary related to leased property issues after the publication of the proposed regulations.

The final regulations provide some helpful clarifications and additions to the proposed rules related to leased property

[55] *See Treas. Reg. §1.1400Z2(d)-2(b)(4)(ii).*

[56] *See Treas. Reg. §1.1400Z2(d)-2(b)(4)(iv)(C).*

[57] *See Treas. Reg. §1.1400Z2(d)-2(b)(1)(ii).*

[58] *See Treas. Reg. §1.1400Z2(d)-1(b)(2)(iii).*

[59] *See Treas. Reg. §1.1400Z2(d)-2(d)(4)(viii).*

in a QOZ. Most significantly, the final regulations provide a rebuttable presumption that leases between unrelated parties are market rate.[60] In addition, when determining the present value of leases for purposes of asset testing under the QOZ rules, the final regulations require taxpayers to use the short-term applicable Federal rate (AFR) to discount the payments under the lease.[61] The final regulations also provide some clarifying rules for purposes of determining the term of leases that may be subject to extensions. Generally, the term of a lease will include periods during which the lessee may extend the lease at a pre-defined market rate rent, which does not include the option to renew at fair market value as determined at the time of renewal. Finally, the final regulations set forth a rebuttable presumption that the terms of extensions of leases among unrelated parties are assumed to be market rate for QOZ purposes.[62]

The final regulations retain the rules from the proposed regulations regarding tangible property leased from a related person. Specifically those rules say that with respect to related-party leases, there can be no prepayments of more than 12 months, and, in the case of tangible personal property that is leased from a related party, if such property is not original use then the lessee must acquire QOZ business property of at least equal value within 30 months for use in the QOZ in order to also qualify the related-party non-original use property as QOZ business property.[63]

8. Reinvestment of proceeds by a QOF

The proposed regulations allowed a QOF that received proceeds from a sale or exchange of QOZ property to treat those proceeds as qualifying QOZ property for purposes of meeting its 90% investment standard if (i) the QOF re-invested the proceeds in other QOZ property within 12 months, and (ii) the proceeds were held in cash and cash equivalents during the interim prior to re-investment. The final regulations retain this rule from the proposed regulations and continue to allow additional time beyond the 12 months to rollover proceeds if there is a delay caused by waiting on governmental action.[64] The final regulations also extend the 12 month reinvestment period noted above in the case of investments in a Federally-declared natural disaster area. Despite requests from commenters, the final regulations do not provide relief from gain recognition on "interim gains."

> **Observation 1***: This rule is different from the new clarification that gains from inclusion events may be reinvested prior to 2026 (that rule effectively resets the holding period). This rule pertains to gains from the sale of property at the QOF/QOZB level and does not reset the holding period of investors in the QOF.*
>
> **Observation 2***: In the context of this rule (as opposed the 10-year gain exclusion rules discussed below), the final regulations specify that for proceeds to be eligible for reinvestment by a QOF the proceeds must be from the sale of "QOZ property," meaning such property must be either interests in a QOZB or QOZ business property. The final regulations also say that the proceeds must be reinvested in "QOZ property." This is an important limitation to bear in mind if a QOF plans any churn in its investments.*

C Operating within the QOZ

The final regulations confirm that an eligible entity that is engaged in a trade or business is a QOZB if it satisfies the QOZB requirements, as determined at the end of the entity's taxable year.[65] This QOZB status applies for the entire taxable year of the entity. The 70% tangible property standard applicable to QOZBs was discussed above. Certain other QOZB requirements under the final regulations are discussed immediately below.

1. The 70% "use" test

The QOZ statute provides that "substantially all" of the "use" of a QOZB's tangible property must be within the geographic boundaries of a QOZ. The proposed regulations defined "substantially all" as at least 70% of the use for these purposes, but the concept and measurement of "use" remained ambiguous. The final regulations provide more clarity around this concept.

The final regulations generally provide that tangible property of a QOZB satisfies the use test to the extent it is: (i) located within a QOZ, and (ii) used in the QOZ in the QOZB's trade or business.[66]

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60 *See Treas. Reg. §1.1400Z2(d)-2(c)(2)(ii).*

61 *See Treas. Reg. §1.1400Z2(d)-1(b)(4)(iii)(B).*

62 *See Treas. Reg. §1.1400Z2(d)-1(b)(4)(iii)((D)(2). The final regulations also exempt leases with certain categories of governmental and tribal entities from the market-rate requirement. Treas. Reg. §1.1400Z2(d)-1(b)(4)(iii)((D)(3).*

63 *See Treas. Reg. §1.1400Z2(d)-2(c)(3).*

64 *See Treas. Reg. §1.1400Z2(f)-1(b)(1).*

65 *See Treas. Reg. §1.1400Z2(d)-1(d)(1).*

66 *See Treas. Reg. §1.1400Z2(d)-2(d)(4)(ii).*

The final regulations also provide a revised calculation for determining percentage of use. The final regulations clarify that the use of tangible property in multiple QOZs can and should be aggregated, based on number of days of use between two consecutive semi-annual testing dates, for determining satisfaction of the 70% use requirement, and that use is evaluated on an asset-by-asset basis.[67]

> **Observation***: This 70% use test is generally not an issue for real estate investments, or operating business investments that do not involve significant amounts of "mobile tangible property" (e.g., trucks, construction equipment, heavy electronics).*

a. Use of mobile tangible property in and out of QOZs

The final regulations also address the use requirements with respect to mobile tangible property that may go in and out of the QOZ(s). The final regulations contain a safe harbor that allows up to 20% of a trade or business's tangible property to qualify as QOZ business property for purposes of the 70% use test, even if it is used both inside and outside of QOZs if: (i) the trade or business has an office or other facility located within a QOZ ("QOZ office"), and (ii) the tangible property is operated by employees of the trade or business who regularly used a QOZ office in the course of carrying out their duties and who are managed directly, actively and substantially on a day-to-day basis by employees of the trade or business at a QOZ office.[68] This safe harbor is not available for property that is operated exclusively outside of a QOZ for a period longer than 14 consecutive days for the generation of gross income for the trade or business.

b. Leasing of mobile tangible property by QOZBs

The final regulations also provide a somewhat similar safe harbor for tangible property that a QOZB leases to customers on a short-term basis in the ordinary course of its business. This safe harbor generally requires that (i) the tangible property must be stored or parked in a QOZ when it is not leased out to customers, and (ii) the lease term cannot exceed 30 consecutive days.[69]

> **Observation:** *The safe harbor for leased mobile tangible property does not have the same 20% cap with respect to a QOZB's mobile property. The safe harbor appears intended to specifically allow short-term equipment leasing businesses to be QOZ-based.*

2. The gross income test

The QOZ statute, by cross reference to section 1397C, generally requires that a QOZB must derive at least 50% of its gross income from the active conduct of a trade or business in a QOZ. The proposed regulations contained three different safe harbors as well as a facts-and-circumstances catch all provision that provided guidance on the 50% gross income requirement for QOZBs. The final regulations expand and clarify various aspects of those rules.[70]

The final regulations confirm that a QOZB may conduct a trade or business across multiple QOZs and derive qualifying gross income from such QOZs. Even though many believed this to be the rule under the proposed regulations, there was ambiguous language that the government helpfully clarified.

a. Measuring gross income based on hours or compensation

A QOZB may determine its compliance with the 50% gross income test by comparing (i) the number of hours of services performed for the trade or business in a QOZ during the taxable year by employees, partners, independent contractors, and employees of independent contractors to (ii) the total number of hours of services performed by those same categories of people on behalf of the trade or business. The final regulations provide that amounts paid to partners are only taken into account for purposes of this calculation to the extent they are guaranteed payments under section 707(c).[71]

As an alternative to measuring gross income based on hours, a QOZB may instead avail itself of a similar safe harbor calculated based on the amounts paid for services to the categories of people described above.

> **Observation 1:** *The final regulations do not define "independent contractor" or provide sought after relief around counting hours of unrelated and larger third-party organizations (e.g., law firms, consultants) to which services are outsourced. Operating businesses in this category may need to either rely on another gross income safe harbor (or facts and circumstances) and/or a complementary safe harbor during their working capital safe harbor period.*

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67 *See id.*

68 *See Treas. Reg. §1.1400Z2(d)-2(d)(4)(iii) and (iv).*

69 *See Treas. Reg. §1.1400Z2(d)-2(d)(4)(v).*

70 *See Treas. Reg. §1.1400Z2(d)-1(d)(3).*

71 *See Treas. Reg. §1.1400Z2(d)-1(d)(3)(i)(A) and (B). The final regulations specifically refer to "amounts paid to partners" in the subsection discussing the safe harbor based on number of hours worked. This appears to be a mistake in the final regulations and this language appears to mean hours spent by partners that are compensated by guaranteed payments.*

Observation 2: *The language in the final regulations does provide a subtle but helpful clarification in terms of measuring hours and/or compensation of independent contractors and their employees. There was some question under the proposed regulations about whether all of the hours of independent contractors or their employees would have to be taken into account by a QOZB. The final regulations make it clear that only those hours or amounts paid to independent contractors for services performed for the QOZB are relevant.*

b. Determining gross income based on location of property and business functions

The final regulations retain the rule from the proposed regulations that a QOZB can determine its compliance with the 50% gross income test by demonstrating that "[t]he 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."[72] Several comments on the proposed regulations asked for additional detail or clarity with respect to how a QOZB could satisfy this safe harbor, and while the preamble to the final regulations acknowledges the potential challenges of interpreting this language in the context of various, and sometimes unconventional, business structures, the language of the safe harbor was not revised.

Observation: *By applying this safe harbor, it may be possible for the headquarters of a business where management decisions are made, contracts are signed, and other significant functions are located to meet the 50% of gross income test and, thus, potentially qualify for QOZ benefits.*

3. Use of intangible property in a QOZ

The QOZ statute, again by cross reference to section 1397C, generally requires that, with respect to any taxable year, a QOZB must use a "substantial portion" of its intangible property in the active conduct of a trade or business in a QOZ. The proposed regulations defined "substantial portion" for these purposes to be at least 40%. Numerous comments requested additional clarity on the determination and measurement of use for purposes of this requirement. In response, the final regulations provide that intangible property of a QOZB is used in a trade or business in a QOZ if (i) the use of the intangible property is normal, usual, or customary in the conduct of the trade or business, and (ii) the intangible property is used within the QOZ in the performance of an activity of the trade or business that contributes to the generation of gross income.[73] The final regulations also maintain the 40% test, including favorable preamble language to the effect that 40% was the right number taking into account that QOZBs may expand outside of QOZs over the course of the 10-year holding period.

Observation: *Acknowledgment of future growth of QOZBs indicates a favorable stance generally toward QOZBs that have operations both within and outside of QOZs.*

4. The non-qualified financial property (NQFP) limitation

The QOZ statute, once again by cross reference to section 1397C, limits the amount of NQFP that a QOZB may hold to less than 5% of its property. This rule is intended to prevent QOZBs from accumulating and holding more than a very small amount of investment or investment-type assets. Despite a variety of comments and requests on the subject, the final regulations do not make any changes with respect to the NQFP rules.[74]

5. The trade or business requirement

The QOZ statute imposes a trade or business requirement on QOZBs (and QOFs if QOZ business property is held at the QOF level). The proposed regulations referenced section 162 as defining what a trade or business is for purposes of the QOZ rules. There is a significant amount of authority and case law for determining whether an entity is in a trade or business within the meaning of section 162, but even following two rounds of proposed regulations there were several significant questions about what it meant to be a trade or business in the context of QOZs. The final regulations address some of these questions.

a. Start-up businesses

Under the proposed regulations, start-up businesses, which many supporters of the program hoped would be early adopters of QOZ planning, in some cases found it difficult to navigate the trade or business requirement because they did not expect to generate profits for a significant period of time. Start-ups were concerned that they could not meet the standard to be a trade or business under section 162. As discussed in the preamble to the final regulations, the Treasury Department and the IRS expect that the expanded working capital safe harbor of up to 62 months (discussed in detail below) should provide relief for many start-up businesses by giving them up to 62 months to begin a section 162 trade or business.

[72] *See Treas. Reg. §1.1400Z2(d)-1(d)(3)(i)(C).*

[73] *See Treas. Reg. §1.1400Z2(d)-1(d)(3)(ii)(B).*

[74] *See Treas. Reg. §1.1400Z2(d)-1(d)(3)(iv).*

b. Real estate and triple-net leases

The question of what constitutes a real estate trade or business under section 162 is a frequently debated and litigated issue. Because the proposed regulations used the section 162 standard for determining whether or not a QOZB had a trade or business for QOZ purposes, questions about certain real estate arrangements, e.g., triple-net leases, often came up in the commentary related to the proposed regulations. The proposed regulations did provide that ownership and operation of real estate in general and the leasing of real property specifically generally constitutes the active conduct of a trade or business for QOZ purposes. However, the proposed regulations also provided an exception to the leasing rule that said entering into a "mere" triple-net lease would not be sufficient to establish a trade or business.

The final regulations maintain the same general rules and exceptions with respect to real estate businesses and section 162. They do, however, provide some examples of the types of leases that rise to the level of a trade or business.[75]

> **Observation:** *The qualification of a real estate lease as a trade or business remains a complicated question that requires analysis on a case-by-case basis under the final regulations and applicable case law.*

6. The working capital safe harbor

The proposed regulations created a safe harbor for QOZBs (the working capital safe harbor) that allowed them to hold a significant percentage of liquid assets for up to 31 months without violating the NQFP rule and without having to comply with various other QOZB requirements provided the QOZB was using its capital to build up or build out a business or project in a QOZ.[76] Eligibility for the working capital safe harbor requires a written plan with a reasonable schedule of development and deployment or consumption of capital that is in line with the schedule. The working capital safe harbor is critical for planning and development of QOZ projects. The final regulations clarify aspects of the working capital safe harbor and also provide for the ability of QOZBs to extend the working capital safe harbor for up to 62 months in certain circumstances.[77]

a. The 62-month safe harbor and sequential safe harbors

The final regulations provide that a QOZB may take advantage of multiple overlapping or sequential safe harbors for up to a maximum working capital safe harbor period of 62 months.[78] In order to obtain a subsequent extension of the working capital safe harbor (beyond the initial 31 months), the final regulations require (i) subsequent infusions of working capital, and (ii) that the subsequent infusion(s) is related to an integral part of the plan covered by the initial working capital plan. The final regulations provide that an overlapping or sequential working capital safe harbor must include a "substantial amount" of additional working capital.

> **Observation 1:** *While the language of the final regulations could be clearer, it appears that subsequent infusions of debt-sourced capital would entitle a QOZB to adopt a subsequent working capital safe harbor and extend its safe harbor for up to 62 months.*
>
> **Observation 2:** *The final regulations do not define "substantial amount" when referencing the required amount of additional working capital and the examples in the final regulations do not contain numerical information that could provide insight or quantification of this term.*

b. Tolling working capital safe harbor period

The proposed regulations provided that the working capital safe harbor could be tolled if the QOZB was waiting on governmental action the application for which is complete (e.g., permitting, zoning approval). The final regulations retain that rule without elaboration,[79] but the preamble to the final regulations suggests that the government expects QOZBs to take action and continue development of projects, if practical, during periods of governmental delay.

In addition, if a QOZB's project is located within a Federally-declared disaster area, the final regulations allow up to 24 additional months for a working capital deployment plan to be completed.[80]

c. QOZB requirements during and after the working capital safe harbor period

Under the proposed regulations it was unclear what would happen at the end of the working capital safe harbor period if a QOZB had not completed its project or established

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[75] *See Treas. Reg. §1.1400Z2(d)-1(d)(3)(iii)(C).*

[76] *To qualify for the working capital safe harbor, the QOZB's capital must be held exclusively in cash, cash equivalents, or short-term debt instruments.*

[77] *See Treas. Reg. §1.1400Z2(d)-1(d)(3)(v).*

[78] *See Treas. Reg. §1.1400Z2(d)-1(d)(3)(v)(F).*

[79] *See Treas. Reg. §1.1400Z2(d)-1(d)(3)(v)(C).*

[80] *See Treas. Reg. §1.1400Z2(d)-1(d)(3)(v)(D).*

an active trade or business. For example, in the case of a real estate development, if at the end of the then-applicable 31-month safe harbor period, construction was not complete and the QOZB had not started a business, it was unclear whether the work-in-progress would continue to qualify as good QOZ business property for purposes of the 70% asset testing standard. The preamble to the final regulations seems to resolve this ambiguity and states that by the end of the working capital safe harbor period the QOZB must have an active trade or business.

The final regulations provide that during the working capital safe harbor period tangible assets that are acquired, constructed, or leased using the working capital are considered used in a trade or business of the QOZB and are treated as QOZ business property.[81] In addition, during the safe harbor period (i) any income derived from the working capital is good gross income for purposes of a QOZB's 50% gross income test,[82] and (ii) any intangible property purchased or licensed by the QOZB is considered used in a trade or business.[83] However, by the end of the working capital safe harbor period (which as noted above can, under certain circumstances, be extended to 62 months) in order for acquired or constructed assets to be considered QOZ business property, they must be used in a trade or business of the QOZB. In addition, the final regulations make it clear that unexpended amounts of working capital on hand at the end of the working capital safe harbor period will count as NQFP at that point unless they can qualify as reasonable working capital under general tax principles.

Observation 1: *It is important to note that while the final regulations establish that many of the QOZB requirements are deemed satisfied during the working capital safe harbor period, the final regulations do not say that actual working capital should be treated as QOZ business property. This could be interpreted to mean that the amounts held by QOZBs in cash, cash equivalents, and short-term debt instruments during the safe harbor period are not included in the numerator or denominator when calculating the QOZB's 70% tangible property standard.*

If that is the rule the government intends here, then it will present challenges for projects where "bad" assets are acquired or contributed to a QOZB. Many QOZBs assumed or intended to rely on the qualification of working capital as good QOZ business property during the safe harbor period. If they cannot so rely, then any non-QOZ business property at the outset of a project may jeopardize satisfaction of the 70% tangible property standard because QOZBs may need time to acquire sufficient QOZ business property to meet the 70% test (which is what many assumed the safe harbor periods were intended to provide).

Observation 2: *The requirement that a QOZB have a trade or business at the end of the working capital safe harbor period was a subject of debate and commentary under the proposed regulations. For many larger real estate projects and start-up businesses, this was an issue of concern. The ability to take advantage of a longer safe harbor period may allay those concerns in many situations, but careful consideration must now be taken in terms of the timing of completion of projects and the runway for getting operating businesses to the point where they have an active trade or business under section 162.*

7. Property Straddling QOZs

The proposed regulations provided that for purposes of sourcing gross income and use of a QOZB's property in situations in which a QOZB owned property straddling multiple census tracts, partly in a QOZ and partly not, all of the property would be deemed to be in the QOZ for purposes of assessing the location of services, functions, and property of a QOZB if (i) the amount of real property based on square footage located within the QOZ was substantial as compared to the real property located outside the QOZ, and (ii) the real property located outside the QOZ was contiguous with the real property in the QOZ. The final regulations retain this rule and add the option to test substantiality based on unadjusted cost basis.[84]

The final regulations also add definitions related to the requirement that straddling property must be contiguous with property in the QOZ. The final regulations provide that tracts or parcels of land will generally be considered contiguous for these purposes if they possess common boundaries and would be contiguous but for the interposition of a road, street, railroad, stream, or similar physical interruption.[85]

Observation: *The final regulations adopt the concept of property straddling QOZs and apply the same rules to the 70% use requirements with respect to QOZ business*

[81] *See Treas. Reg. §1.1400Z2(d)-1(d)(3)(viii).*

[82] *See Treas. Reg. §1.1400Z2(d)-1(d)(3)(vi).*

[83] *See Treas. Reg. §1.1400Z2(d)-1(d)(3)(vii).*

[84] *See Treas. Reg. §1.1400Z2(d)-1(d)(3)(ix).*

[85] *See Treas. Reg. §1.1400Z2(d)-1(d)(3)(ix)(F).*

property. This means that the use of tangible property outside of a QOZ may qualify as "good" use provided the use is in a contiguous property that meets the requirements discussed above.

8. Sin Businesses – de minimis rule

The QOZ statute expressly prohibits QOZBs from engaging in any business described in section 144(c)(6)(B), so-called "sin businesses," which businesses include golf courses, country clubs, gambling facilities, and liquor stores. The final regulations adopt a new rule that a QOZB may (i) lease less than 5% of its property to, and (ii) receive less than 5% of its gross income from businesses described in section 144(c)(6)(B).[86] The 5% leasing restriction means less than 5% of the net rentable square feet for real property and less than 5% of the value for other tangible property.

Observation: *There was much discussion of whether a QOF conducting a sin business was consistent with the purpose of the statute; that the preamble uses a "purpose of the statute" rationale to add a new rule restricting leasing seems to suggest that the failure to restrict QOF level activity was intentional.*

9. QOFs and QOZBs organized in U.S. territories

The final regulations do not make changes to the proposed rules applicable to entities organized in U.S. territories.

D Inclusion of Deferred Gains

The final regulations retain the general inclusion event rules contained in the proposed regulations, specifically that any of the following result in an inclusion of some or all of a taxpayer's deferred gain: (i) a transfer of a qualifying investment that reduces a taxpayer's direct equity interest, (ii) the receipt of a distribution which constitutes a "cashing out" of a taxpayer's qualifying investment, and (iii) a claim of a worthlessness deduction with respect to a qualifying investment.[87] The final regulations do, however, clarify and make changes to certain aspects of the inclusion event rules.

1. Continuing qualification of a QOF investment after partial inclusion

The final regulations clarify that a partial inclusion event with respect to a qualifying investment does not disqualify the remaining portion of a qualifying investment.[88] Such remaining portion is still eligible for the basis step-ups after the appropriate holding periods.[89] Some commenters had questions based on the ambiguous language of the proposed regulations about whether an inclusion event with respect to any part of a qualifying investment would make the continuing investment in a QOF ineligible for QOZ tax benefits. The final regulations helpfully clarify this issue.

2. Decertification of a QOF

The final regulations added some rules and commentary about de-certification of a QOF. The rules provide that a QOF may voluntarily elect to de-certify and, if it does so, the de-certification becomes effective the first day of the month following the month in which it elects to de-certify.[90] A de-certification cannot be effective earlier than the month that a taxpayer files to de-certify, meaning a QOF cannot retroactively de-certify. If a QOF is decertified, it is an inclusion event.[91] In the preamble to the final regulations, the Treasury Department and the IRS acknowledge that they are still considering rules related to potential involuntary de-certification of QOFs, but the final regulations do not address the issue.

Observation: *Voluntary decertification could be helpful to mitigate potential penalties in the case of changed circumstances, or if future regulations adjust the penalty regime to make it more punitive.*

3. Corporate distributions, redemptions, and liquidations

The final regulations generally treat distributions by QOF C corporations as inclusion events to the extent section 301(c)(3) or section 1059(a)(2) applies, and expands this general rule to include equivalent distributions under section 305(b) (but not section 305(a), as discussed below). The final regulations provide, however, that such distributions do not result in the related qualifying investment being ineligible for the five and seven year basis increases.[92]

[86] *See Treas. Reg. §1.1400Z2(d)-1(d)(4)(i) and (ii).*

[87] *See Treas. Reg. §1.1400Z2(b)-1(c)(1).*

[88] *See Treas. Reg. §1.1400Z2(a)-1(c)(34).*

[89] *See Treas. Reg. §1.1400Z2(b)-1(g)(2).*

[90] *See Treas. Reg. §1.1400Z2(d)-1(a)(3).*

[91] *See Treas. Reg. §1.1400Z2(b)-1(c)(15).*

[92] *See Treas. Reg. §1.1400Z2(b)-1(g)(2).*

The final regulations generally retain the rules in the proposed regulations treating the full amount of a dividend-equivalent redemption described in section 302(d) or section 306(a)(2) by a QOF C corporation as an inclusion event but provide some exceptions.[93] The final regulations exempt (i) redemptions by wholly-owned QOF C corporations or those held directly by members of a single consolidated group, and (ii) pro rata section 302(d) redemptions by QOF C corporations that have only one class of stock.[94] In both cases, such redemptions are not inclusion events except to the extent section 301(c)(3) applies, i.e., no inclusion to the extent the distributed amounts do not exceed the taxpayer's basis in its stock. Note that within a consolidated group, distributions in excess of basis result in an excess loss account (ELA) rather than income under section 301(c)(3) and are similarly treated as inclusion events to the extent the distribution otherwise would create or increase an ELA in the QOF member stock.

In response to comments, the final regulations address the treatment of section 305(a) distributions of stock by QOF C corporations. The new rules provide that upon a section 305(a) distribution, the new stock distributed by the QOF is qualifying stock with the same holding period as the original QOF stock, and the deferred gain of the taxpayer is allocated between the old QOF stock and the new QOF stock.[95]

The final regulations retain the rules in the proposed regulations that 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; however a distribution 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 is an inclusion event.

> **Observation:** *These rules are generally favorable to QOF C corporations and may allow for favorable planning opportunities, including with respect to preferred equity investing.*

4. Corporate reorganizations

a. Reorganizations of QOF corporations

The final regulations provide that a transaction is not an inclusion event where assets of a QOF corporation are acquired in a "qualifying section 381 transaction" and the acquiring corporation itself is a QOF immediately after the acquisition. A "qualifying section 381 transaction" is a transaction described in section 381(a)(2), with certain exceptions enumerated in the final regulations.[96] To be a QOF immediately after the acquisition, the acquiring corporation must satisfy the certification requirements in the final regulations immediately after the transaction and hold at least 90% of its assets in qualified opportunity zone property on the first testing date after the transaction.

Although a transaction that meets the foregoing requirements is not an inclusion event, a QOF shareholder will have an inclusion event to the extent that such QOF shareholder receives boot in such a transaction under the final regulations. Such QOF shareholder is treated as disposing of the same portion of the qualifying investment (as measured 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. The preamble makes clear that this rule applies even where the QOF shareholder owns 100% of the QOF and whether the QOF shareholder recognizes gain or loss on the transaction.

b. Reorganizations of QOF shareholders

Where the assets of a QOF shareholder are acquired in a qualifying section 381 transaction, the transaction is not an inclusion event with respect to the qualifying investment and a QOF shareholder will only have an inclusion event to the extent that the acquiring corporation does not acquire all of the QOF shareholder's qualifying investment. The QOF shareholder is treated as disposing of and having an inclusion event with respect to the portion of its qualifying investment that is not transferred to the acquiring corporation.

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[93] *See Treas. Reg. §1.1400Z2(b)-1(c)(8)(i).*

[94] *See Treas. Reg. §1.1400Z2(b)-1(c)(9(i)(B)).*

[95] *See Treas. Reg. §1.1400Z2(b)-1(c)(8(ii)).*

[96] *A "qualifying section 381 transaction" is a transaction described in section 381(a)(2), other than: "(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)." Treas. Reg. section 1.1400Z2(a)-1(b)(38).*

c. Section 355 transactions

Except to the extent that a transaction is a "qualifying section 355 transaction," a QOF corporation's distribution of stock or securities of a controlled corporation to a QOF shareholder in a transaction to which section 355 (or so much of section 356 as relates to section 355) applies is treated as an inclusion event. The QOF shareholder is treated as disposing of a portion of its qualifying investment in an amount equal to the sum of (1) the FMV of the shares of the controlled corporation distributed and (2) the FMV of any boot received.

The final regulations provide an exception for a "qualifying section 355 transaction" where both the distributing corporation and controlled corporation in a transaction to which section 355, or so much of section 356 as relates to section 355, applies are QOF corporations immediately after the final distribution. A transaction is not a qualifying section 355 transaction unless the distributing corporation distributes all of the stock and securities in the controlled QOF corporation within a 30-day period (and whether or not each of distributing and controlled are QOF corporations are tested after the last distribution in such 30 day period).

The final regulations clarify the treatment of boot in a qualifying section 355 transaction. Where section 356(a) applies to the transaction, boot is subject to the rules applicable to qualifying section 381 transactions of QOF corporations. Where 356(b) applies to the transaction, the rules applicable to dividends and redemptions apply to the receipt of boot by the QOF shareholder.

d. Recapitalizations and section 1036 transactions

Recapitalizations (i.e., a reorganization that qualify under section 368(a)(1)(E)) of a QOF corporation or section 1036 exchanges by a QOF shareholder are generally not inclusion events. However, where as part of such transaction a QOF shareholder would be treated as receiving property or boot with respect to its qualifying investment, the final regulations apply the same rules applicable to distributions and redemptions or the receipt of boot described above to recapitalizations and section 1036 transactions.

e. 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.

f. QOF successor rules

The final regulations provide that an acquiring corporation succeeds to the target corporation's status as the QOF shareholder with respect to the qualifying investment if the assets of a QOF shareholder are acquired in a qualifying section 381 transaction. However, as discussed above, an acquiring corporation in a qualifying section 381 transaction will not automatically succeed to the QOF status of a target QOF corporation.

g. Holding periods

Certain corporate transactions qualify for a "tacked" holding period under the final regulations. A QOF owner is permitted to tack its holding period with respect to a qualifying investment received in (1) distributions in which 305(a) applies, (2) qualifying section 381 reorganizations of QOF corporations, (3) qualifying section 355 transactions, (4) a recapitalization or a section 1036 exchange, or (5) a distribution of a qualifying investment in a complete liquidation of a QOF owner to the extent section 337(a) applies to the distribution.

5. Partnership transactions as inclusion events

The final regulations provide several changes and clarifications with respect to what were inclusion events in the context of partnership transactions.[97]

The proposed regulations provided that a merger of upper-tier partnerships holding QOF interests was not an inclusion event but did not except the merger of a QOF partnership itself. The final regulations generally except QOF partnership mergers from being inclusion events.[98] The new rules 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, there is generally no inclusion event for a partner that receives only a partnership interest in the resulting QOF partnership. However, if a partner receives other property that exceeds the partner's basis in its QOF partnership, there is an inclusion event to the extent of such excess basis.

Despite commenters asking for flexibility with respect to partnership divisions, the final regulations retain the proposed regulations' treatment of partnership divisions as inclusion events. Similarly, requests to exclude partnership conversions to corporations from being inclusion events were not accepted by the government. This is consistent with the general treatment of section 351 transactions as inclusion events under the final regulations. The preamble to the final regulations make clear that 351 transactions generally, rather than 351 transactions that reduce a QOF shareholder's interest in a QOF corporation, are intended to be treated as inclusion events under the final regulations. This was not clear in the proposed regulations.

[97] *See Treas. Reg. §1.1400Z2(b)-1(c)(6).*

[98] *See Treas. Reg. §1.1400Z2(b)-1(c)(6)(ii)(C)(2).*

The final regulations provide that distributions by upper-tier partnerships that owns interests in a QOF are not inclusion events for the indirect QOF owners unless the distribution is a liquidating distribution within the meaning of the partnership rules.[99]

> **Observation:** *The restriction on partnership conversions to corporations may limit the use of "baby REITs" or other types of planning (non-QOZ related) within QOZ structures, particularly in the context of secondary sales.*

6. Determination of amount of deferred gain includible in income for partnerships and S corporations

The proposed regulations contained a special rule for the amount includible by QOF partnerships and QOF S corporations that altered the general statutory rule and stated that upon an inclusion event the includible amount is based on the lesser of (i) the remaining deferred gain less the basis of the investment, or (ii) the gain that would be recognized if the interest were sold at fair market value in a fully taxable transaction. The latter provision departs from the QOZ statute which just uses the "fair market value of the investment" over the basis of the investment. Despite numerous comments on this issue, the final regulations retain the rule.[100]

> **Observation:** *This rule is intended to prevent taxpayers from reducing or avoiding recognition of their deferred gain by virtue of debt-financed distributions and will generally be relevant for debt-financed investments in depreciating assets.*

7. S corporation inclusion events

The final regulations generally retain the rules regarding S corporation inclusion events from the proposed regulations with one notable change. The proposed regulations provided a special inclusion rule for S corporations that held interests in QOFs. This rule triggered a 100% inclusion of an S corporation's deferred gain if there was a more than 25% aggregate change in the ownership of the S corporation. The final regulations eliminate this rule.[101]

The final regulations provide that the election, revocation, or termination of a corporation's status as an S corporation under section 1362 is not an inclusion event, but the conversion of an S corporation to a partnership or disregarded entity generally is an inclusion event.[102]

> **Observation:** *This is a welcome change for S corporations, where one shareholder's QOZ benefits would have been affected by the activities of another shareholder.*

8. Trust, estate, and gift inclusion event issues

The final regulations provide clarity on a number of issues related to inclusion events in the context of trusts, estates, and gifts.

The final regulations state 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.[103] Furthermore, while the final regulations retain the rule that changes in the status of a grantor trust that owns a qualifying investment in a QOF (other than as a result of the death of the owner) are inclusion events, they clarify that this rule only applies to a grantor trust owning a qualifying investment.[104]

In the context of estates, the final regulations provide that the tax on a 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.[105] The preamble to the final regulations notes that the Treasury Department and the IRS declined to adopt a rule suggested by commenters that would allow an affirmative election to treat death as an inclusion event.

The final regulations retain the rule that inter-vivos gifts of a qualifying investment (except as provided in the case of a transfer to a grantor trust) are inclusion events, notwithstanding the possibility that such transfers may be nonrecognition events for Federal income tax purposes.[106] In addition, the final regulations clarify that gifts, or transfers between spouses which are incident to divorce, are inclusion events, notwithstanding the fact that such transactions are generally nonrecognition events for Federal income tax purposes.[107]

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[99] *See Treas. Reg. §1.1400Z2(b)-1(c)(6)(iii).*

[100] *See Treas. Reg. §1.1400Z2(b)-1(e)(4).*

[101] *See generally, Treas. Reg. §1.1400Z2(b)-1(c)(7) for special S corporation inclusion event rules.*

[102] *See Treas. Reg. §1.1400Z2(b)-1(c)(7)(i)(A) and (iii)(A).*

[103] *See Treas. Reg. §1.1400Z2(b)-1(c)(5)(i).*

[104] *See Treas. Reg. §1.1400Z2(b)-1(c)(5)(ii).*

[105] *See Treas. Reg. §1.1400Z2(b)-1(c)(4)(iii).*

[106] *See Treas. Reg. §1.1400Z2(b)-1(c)(3)(i).*

[107] *See Treas. Reg. §1.1400Z2(b)-1(c)(3)(ii).*

9. Basis issues

The final regulations provide a number of clarifications with respect to basis step-ups associated with QOF investments, whether as a result of inclusion events, death of the owner, or as a consequence of the 5-year and 7-year holding period rules.

With respect to QOF corporations, the final regulations clarify that if a shareholder sells less than 100% of its QOF stock in an exchange subject to section 1001, then the basis increase resulting from the recognition of the gain should be made only to those shares that were sold (i.e., the basis increase applies only with respect to the portion of the qualifying investment that is disposed of).[108] Likewise, any basis increase for any section 301(c)(3) gain or 1059(a)(2) gain shall be made only to the redeemed shares.

With respect to the interaction of the QOZ basis rules and section 1014, which pertains to basis of property acquired from a decedent, the preamble to the final regulations states that section 1014 does not apply to adjust the basis of a qualifying investment that is inherited from a decedent.[109] To the extent a decedent held a mixed-fund investment in a QOF, section 1014 would apply to the non-qualifying investment.

The final regulations clarify that the basis increases to partnership interests and S corporation stock that result from the 5-year and 7-year holding periods under the QOZ rules are treated as basis for all purposes of the Code, including for purposes of suspended losses under sections 704(d) and 1366(d).[110]

Observation: *There was no clarification of how the basis rules might interact with the ability to take investment tax credits from a QOF partnership; though there are indications that the issue might be addressed in future guidance.*

E Exiting the QOF

The final regulations add significant flexibility in terms of disposing of investments after the requisite 10-year QOF holding period. The regulations expand the types of gains that may be eligible for gain exclusion and the availability of gain exclusion at both the QOF and QOZB level.

1. Ability to exclude post 10-year gains

Under the QOZ statute and the proposed regulations a taxpayer was eligible to elect to step up its basis in its QOF interest to fair market value under section 1400Z-2(c) at the time of a post 10-year sale or exchange of the QOF interest. It is this election that allows for a completely tax-free exit from a QOF investment (e.g., no concern about potential hot assets or depreciation recapture). However, the proposed regulations applied different rules that excluded only certain gains (i.e., capital gains) on sales or exchanges by QOFs of their interests in QOZBs, and did not provide for any exclusion on a sale or exchange of assets by a QOZB of its assets. The final regulations change these rules in several significant and beneficial ways.

The final regulations provide that after the requisite 10-year holding period, taxpayers may exclude *all gains* (with the exception of those from the sale of inventory in the ordinary course of business) from both *dispositions by a QOF of interests* in a QOZB partnership or QOZB S corporation and *sales or exchanges, directly or indirectly, by lower-tier QOZBs* of QOF partnership and QOF S corporations.[111]

The final regulations also provide that a transferee in a section 721(a) contribution that receives a qualifying investment that has been held for at least 10 years can make the step up election under section 1400Z-2(c).[112] For a section 721 transferee to be eligible for the election, it is required to file a statement documenting the transfer with the IRS and also file a Form 8997 with its timely filed tax return.[113]

Observation 1: *The ability of QOFs and QOZBs to exclude all non-inventory gains on the sale of property after 10 years is among the most significant changes made by the final regulations. This change should provide additional flexibility in terms of upfront structuring and exit planning. The elimination of gain recapture issues should enhance financial returns and make additional projects viable as QOF investments.*

Observation 2: *The provision in the final regulations that allows QOFs and QOZBs to exclude gains from post 10-years sales is titled "Sales or exchanges of QOF property by QOF partnerships or QOF S corporation," but the language of the regulation itself, which is controlling, does not restrict or limit the gain exclusion to QOZ property. Therefore, it appears that gains from all non-inventory sales or exchanges of property, even non-QOZ business property, are eligible for exclusion.*

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108 *See Treas. Reg. §1.1400Z2(b)-1(g)(1)(iii).*

109 *See Treas. Reg. §1.1400Z2(b)-1(g)(6)(i).*

110 *See Treas. Reg. §1.1400Z2(b)-1(g)(4)(ii) and (5)(i).*

111 *See Treas. Reg. §1.1400Z2(c)-1(b)(2)(ii)(A).*

112 *See Treas. Reg. §1.1400Z2(c)-1(b)(1)(ii)(A).*

113 *See Treas. Reg. §1.1400Z2(c)-1(b)(1)(ii)(B).*

2. Consequences of gain exclusion for QOF partnerships and QOF S corporations

To take advantage of the gain exclusion rule noted above, there are two requirements. First, a taxpayer must make an election for each taxable year in which it chooses to exclude the relevant gains.[114] Second, the QOF owner(s) must track the amount of gains excluded under this rule and reduce its qualifying investment by the amount of the net proceeds from asset sales on the last day of the QOF's tax year.[115] This latter requirement is intended to prevent QOF owners from potentially getting duplicate benefits as a result of the gain exclusion and the mechanism by which it is achieved in the final regulations is complicated. First, the final regulations provide that a partner or shareholder in a QOF partnership or QOF S corporation that makes the election to exclude gains is treated as receiving a distribution of cash at the end of the entity's taxable year and then immediately recontributing the cash in exchange for a non-qualifying investment in the QOF.[116] Under the final regulations, the amount of cash deemed to be distributed and recontributed generally is equal to (i) the partner's or shareholder's share of net proceeds[117] from all sales or exchanges of property (excluding inventory) for the taxable year, 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.

Observation 1: *In the absence of a rule like this, a QOF that was beyond the 10-year holding period and had significantly appreciated QOZ assets could sell assets, continually reinvest the gains in non-QOZ property, and potentially let the appreciation accumulate for years before ultimately disposing of the entire investment in a tax-free manner. This result would not be consistent with the policy behind the QOZ statute.*

Observation 2: *The result of these rules appears to be that a QOZB/QOF should distribute the cash from the sale of the assets that are stepped up to the QOF partners. The QOF partners could then reinvest the cash in a new venture separate from the QOF.*

3. The fair market value of QOF partnerships with debt

The proposed regulations provided that a QOF investor that makes the section 1400Z-2(c) election with respect to a QOF partnership interest would step up the basis in the interest to the fair market value of the interest "including debt." The final regulations clarify this rule and provide that the basis of a partnership interest is adjusted to equal its net fair market value plus the partner's share of the partnership's debt related to the interest.[118] The final regulations also provide that the fair market value of a partnership interest cannot be less than the partner's allocable share of non-recourse debt.

With respect to QOF S corporations, the final regulations provide that the basis adjustment upon a section 1400Z-2(c) election is equal to the fair market value of the S corporation shares.

4. Step up in basis of assets of lower-tier partnerships

The final regulations clarify the rule from the proposed regulations that a QOF partnership's assets are also stepped up at the time of an election at the QOF level. The final regulations make it clear that the adjustment[119] applies not only to step up the basis of the QOF partnership's assets, but also with respect to any partnerships owned directly or indirectly by the QOF partnership.[120] The rules also clarify that no actual section 754 election is required to be in place in order to achieve this result.

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[114] *See Treas. Reg. §1.1400Z2(c)-1(b)(2)(ii)(D).*

[115] *See Treas. Reg. §1.1400Z2(c)-1(b)(2)(ii)(B)(1).*

[116] *See id. The final regulations provide that this deemed distribution and recontribution is solely for purposes of tracking the investor's interest in the QOF and will have no other Federal income tax consequences.*

[117] *See Treas. Reg. §1.1400Z2(c)-1(b)(2)(ii)(B)(2). Net proceeds for purposes of this rule are defined for QOF partnerships as the amount realized from the sale of property less any indebtedness included in the amount realized that would constitute a qualified liability under Treas. Reg. section 1.7017-5(a)(6) if the sold property had been contributed to a lower-tier partnership subject to the debt. For QOF S corporations, net proceeds are defined as the amount realized from the sale of the property less any indebtedness included in the amount realized that would constitute a qualified liability under the principles of Treas. Reg. section 1.707-5(a)(6). Treas. Reg. §1.1400Z2(c)-1(b)(2)(ii)(B)(3)(ii).*

[118] *See Treas. Reg. §1.1400Z2(c)-1(b)(2)(i).*

[119] *The adjustment is calculated in the 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 a valid section 754 election had been in place.*

[120] *See Treas. Reg. §1.1400Z2(c)-1(b)(2)(i).*

5. Identifying corporate QOF interests

In terms of dispositions of corporate QOF interests, the final regulations require taxpayers that hold shares of QOF stock to identify which specific interests are disposed of if less than all of the QOF stock is sold.[121] This identification may be done under the principles of the section 1012 regulations and, if a taxpayer does not itself specify which shares are disposed of, it will be treated as disposed of under a first-in, first-out method.

6. Treatment of capital gain dividends from REITs extended to RICs

Under the proposed regulations, if a QOF REIT shareholder holding a qualifying investment received a capital gain dividend identified with a date, then the shareholder could (i) treat the capital gain dividend as gain from the sale or exchange of a qualifying investment on such date, and (ii) if the shareholder had held the qualifying investment for the requisite 10-year period, the shareholder could exclude such capital gain from its taxable income. The final regulations retain these rules and also extend the application to shareholders of qualifying investments in QOF RICs.[122]

F Additional Significant Issues

1. Effective dates

Each section of the final regulations contains the same effective date language.[123] Generally the final regulations are applicable for tax years beginning 60 days after the date the final regulations were published in the Federal Register (January 13, 2020). The final regulations also provide that for tax years that begin before that date, taxpayers have the option of applying (i) the final regulations or (ii) the proposed regulations. While not clear from the effective date provisions in final regulations, it appears that, with respect to tax years that begin before the final regulations apply, it was intended that taxpayers consistently apply, on a section-by-section basis, the provisions of whichever of the proposed or final regulations they opt to apply in a consistent manner for all such taxable years.

> **Observation 1:** *A purely technical reading of the effective date provisions after each section of the final regulations for tax years to which the final regulations do not apply, would require the taxpayer to either consistently apply (1) the final regulations in totality, or (2) that section of the proposed regulations. Technically, this would mean that if a taxpayer chooses to apply any section of the proposed regulations, then the taxpayer could not rely on the final regulations for any other section as the taxpayer would not be applying the final regulations in totality. It appears that was not intended and there is hope that the effective date rule will be clarified in the near future.*
>
> **Observation 2:** *The applicability date language of the final regulations, perhaps unintentionally, has created a dual regime for calendar-year taxpayers who invest in or establish QOFs in 2020. If the final regulations had been effective before December 31, 2019, the issue would not be as impactful, but as it stands calendar year taxpayers will have to navigate, and can potentially take advantage of, the rules under both the proposed and final regulations.*

2. Annual reporting of qualified investments

The final regulations provide that taxpayers must report whether their deferred gains remained deferred at the end of each taxable year, including the initial year of deferral.[124] Any failure to report on an annual basis will result in a rebuttable presumption that an inclusion event has occurred.

> **Observation:** *The reporting rules in the final regulations are in line with proposed forms and instructions recently issued by the IRS. It does not appear that reporting is required for 2019, but prospectively these rules should apply.*

3. Additional reporting requirements

The final regulations include several new rules about reporting and required notifications. These rules generally track guidance that has been published or announced by the IRS. Among the new required notifications are the following: (i) a partnership that elects to defer a gain and invest it in a QOF must notify its partners of the deferral election and provide each partner with information on its distributive share of the deferred gain, (ii) an indirect owner of a QOF interest must notify the direct QOF owner of any disposition or other transaction that results in an inclusion event, (iii) a QOF partner must notify the QOF partnership of an election to step up its basis via the post 10-year election if the QOF partner disposes of its interest in the QOF partnership, and (iv) an S corporation QOF and their owners must provide similar notifications.[125]

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[121] *See Treas. Reg. §1.1400Z2(1)-1(c)(2).*

[122] *See Treas. Reg. §1.1400Z2(c)-1(e)(1).*

[123] *See e.g., Treas. Reg. §1.1400Z2(a)-1(g).*

[124] *See Treas. Reg. §1.1400Z2(a)-1(d)(2).*

[125] *See Treas. Reg. §§1.1400Z2(b)-1(h)(1) through (h)(4).*

Observation: *It is unclear how certain of these notification requirements will operate in practice and what the implications might be for failure to comply.*

4. Anti-abuse rules

In response to suggestions from commenters, the final regulations include a statement of purpose with respect to the QOZ program. The final regulations state that, "[t]he 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."[126] They go on to state that if a significant purpose of a transaction (or transactions) is to achieve a result inconsistent with such purposes then, based on all the facts and circumstances, the transaction (or transactions) may be recast or recharacterized. There is also a special partnership anti-abuse rule that provides that if a partnership is formed or availed to satisfy the requirement that an eligible gain must be recognized and subject to tax under subtitle A of the Code, such partnership may disregarded.[127]

Observation: *The QOZ anti-abuse rules do not appear particularly different or burdensome as compared to the general anti-abuse rules that exist throughout the Code and in common law, but taxpayers must always be aware of the potential application of anti-abuse rules and there are several examples in the final regulations that are specific to QOZ structuring.*

5. Consolidated group rules

The final regulations significantly revamp the treatment of consolidated groups and their members in the context of QOF investments.[128] Under the proposed regulations, QOF corporations could not be subsidiary members of a consolidated group but could be the common parent thereof. The final regulations revise this rule and allow QOF corporations to be subsidiary consolidated group members (QOF members), subject to conditions and provided an irrevocable election under new Treas. Reg. §1.1504-3(b)(2) is made with the consolidated group's return in the first year in which the subsidiary QOF corporation is eligible, unless it is a pre-existing entity subject to the transition rules described below.

In order for a QOF corporation to be a subsidiary group member under the final regulations, all QOF investor members must be wholly-owned, directly or indirectly, by the common parent of the consolidated group, a higher threshold than is required for membership in a consolidated group generally. In addition, a consolidated group member that makes an investment in a QOF member generally must maintain a direct equity interest in the QOF member (i.e., subject to the deferral election discussed below, such interest in the QOF member cannot be transferred without triggering gain). If the above conditions are not maintained, the QOF member will be deconsolidated from the group.

a. Additional operational rules

The final regulations also contain a number of provisions that are intended to coordinate the general consolidated group rules with the overall QOZ regime. As discussed in the preamble, these rules are meant to harmonize the somewhat incompatible regimes and also to prevent inappropriate results from being obtained by virtue of the special tax benefits afforded to QOF investments (e.g., basis step-ups and gain exclusion).

In particular, the final regulations include special rules for intercompany transactions under Treas. Reg. §1.1502-13 and for ELAs under Treas. Reg. §1.1502-19.

The final regulations coordinate the intercompany transaction rules of Treas. Reg. §1.1502-13 with the QOZ regime by excluding certain categories of transactions from the scope of Treas. Reg. §1.1502-13's deferral regime. A rule applicable to transactions between a QOF member's separate affiliated group (SAG) and other members of the consolidated group essentially turns off Treas. Reg. §1.1502-13 for sales or exchanges of property. Conversely, sales or exchanges among members of a SAG are intercompany transactions under the final regulations. Separately, a member's transfers of a qualifying investment to another member is an inclusion event and Treas. Reg. 1.1502-13 will only apply to defer the gain from that inclusion event as well as a built-in gain if the intercompany transaction is fully taxable (and not, for example, in a section 351 transaction).

The final regulations turn off limitations on re-determining intercompany gain under Treas. Reg. §1.1502-13(c) as exempt to effect the "free" basis step up on part of the reinvested gain at the 5-year and 7-year holding period dates, and for any post-reinvestment gain after the 10-year holding period. In addition, where a QOF member has transferred a qualifying investment to another member in a

[126] *See Treas. Reg. §1.1400Z2(f)-1(c)(1).*

[127] *See Treas. Reg. §1.1400Z2(f)-1(c)(2)(ii).*

[128] *See Treas. Reg. §1.1502-14Z.*

fully taxable transaction, the transferee member is entitled to make the election under section 1400Z-2(c).

The final regulations provide that the amount of gain included in gross income of a QOF investor member upon an inclusion event is computed in a manner that allows the QOF investor member to take into account basis adjustments under the consolidated return regime (rather than such gain being calculated solely by reference to the investor's basis in the qualifying investment). Specifically, the amount of gain 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. These rules are similar to the gain calculation rules for partnerships and S corporations.

The final regulations also provide rules coordinating the QOZ regime and ELAs. A distribution (or redemption) 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. This is similar to the treatment for distributions subject to section 301(c)(3) (discussed above). In addition, if there is an ELA in the stock of a qualifying QOF member at the time of a basis adjustment under section 1400Z-2(c), the ELA is taken into account prior to adjusting the basis under section 1400Z-2(c).

Other consolidated group provisions in the final regulations include a rule that provides for purposes of testing a QOF member's QOZ investment standard requirements, the consolidated group is not treated as a single entity; and a general anti-abuse rule.

b. Transition rules

In recognition of the fact that the rules applicable to consolidated groups changed so significantly from the proposed regulations, the final regulations provide a number of transition rules with elective relief for taxpayers that may have established a QOF corporation that satisfied the requirements for membership in a consolidated group (without regard to the final regulations) as of May 1, 2019.

Under the final regulations, certain already established QOF corporations may make a reclassification election to be treated as (i) a QOF partnership effective retroactive to its date of formation, (ii) a QOF corporation that is not a member of the consolidated group, (iii) a member of the group that is not a QOF (a "reclassification election") or (iv) if it meets certain conditions, a QOF member. A reclassification election is effective as of the first day an eligible QOF corporation was acquired or formed by members of a consolidated group. There are special rules for a QOF corporation that elects to become a QOF member, and in such case the QOF corporation will have until April 13, 2020, to satisfy these requirements.

c. Group members making investments in QOF members

As noted above in the discussion of eligible taxpayers, unlike the proposed regulations, the final regulations allow consolidated group members to invest in QOFs even though another member of the consolidated group is the member that realized an eligible gain. This flexibility is provided by an election that the consolidated group makes, and if it does so the final regulations treat the transactions as if the member with the eligible gain made the qualifying investment and then immediately sold the investment for fair market value to the member that actually made the investment.

The final regulations also clarify that gains from intercompany transactions can be eligible gains for purposes of QOF investment. Such gains are treated as eligible to the extent they would be eligible if the consolidated group members realizing the gains were divisions of a single entity. This applies to both the amount and timing of such gains.

Observation 1: *Because QOFs could not be subsidiary members of consolidated groups under the proposed regulations, most corporate investors opted to establish QOF partnerships for their QOZ investments. The changes under the final regulations may change the prospective calculus and considerations for some of those investors.*

Observation 2: *To the extent taxpayers established QOF corporations prior to the May 2019 proposed regulations, such taxpayers should immediately be evaluating whether an elective reclassification is desirable. Taxpayers only have a limited window to take advantage of that relief provision*

6. Issues reserved for future guidance

The final regulations reserved a number of issues for future potential guidance. Specifically the preamble notes the following issues that may be addressed in the future: involuntary de-certification, FIRPTA withholding, the method and availability of a basis step-up in the year 2047, the use of synthetic equity for QOF interests, and the so-called "twinning" of tax credits with the QOZ tax benefits. The final regulation package does not suggest a timetable for when guidance, if any, addressing such issues might be provided.

Conclusion

The final Opportunity Zone regulations significantly advance the status of the overall program. They provide clarity on many of the critical issues and allow additional time to get businesses up and running in Opportunity Zones. It seems clear that the Treasury Department and the IRS gave consideration to the comments received on the two sets of proposed regulations, and where they had authority sought to implement the rules in a way that will encourage investment and that hopefully will align with the broader policy goals of lifting up some traditionally underserved areas. While taxpayers did not receive answers to every question, or maximal flexibility on certain issues, the final regulations should spur increased interest and investments in Opportunity Zones over the next several years.

Notes

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