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Section 1400Z-2 final regulations; observations on correcting amendments (April 2020)

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The U.S. Treasury Department and IRS on April 1, 2020, released for publication in the Federal Register, corrective amendments ("Corrective Amendments")[1] to the section 1400Z-2[2] final regulations, as published in the Federal Register on January 13, 2020 ("Final Regulations").[3] These corrections apply as if included as part of the Final Regulations. While many of the corrections were minor, a few of the corrections did address some of the uncertainties and outstanding issues raised by practitioners after the issuance of the Final Regulation. These corrections and observations are outlined below.

Correction to annual reporting of qualifying investments

The Final Regulations provided generally that an eligible taxpayer must report whether eligible gains that have been deferred remain deferred at the end of the tax year, including the year of deferral, in accordance with guidance published by the IRS. The Corrective Amendments removed the requirement to report deferred gains and instead provide that an eligible taxpayer must report any qualifying investment held at any point during the tax year in accordance with guidance published in the Internal Revenue Bulletin or in forms and instructions.

KPMG observation

The correction to the final regulations appears to have been made to conform the regulatory language to the broader requirements of Form 8997, *Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments*, and to provide flexibility for future changes to the reporting requirements.

Correction to applicable dates: reliance on Proposed Regulations and Final Regulations

The effective date contained in the Final Regulations is for tax years beginning after March 13, 2020. For tax years prior to the effective date of the Final Regulations, a taxpayer generally may either (i) rely on the Final Regulations if applied in a consistent manner for all such tax years, or (ii) rely on the proposed regulations[4] (the "Proposed Regulations") if applied in a consistent manner for all such tax years. Thus, an "all or nothing" approach was established under the Final Regulations. The Corrective Amendments amended the regulatory language of section 1.1400Z2(a)-(1)(g) to read as follows:

> *(g) Applicability dates.*
> *(1) In general. The provisions of this section are applicable for taxable years beginning after March 13, 2020.*
> *(2) Prior periods. With respect to eligible gains that would be recognized (absent the making of a deferral election) during the portion of a taxpayer's first taxable year ending after December 21, 2017, and during taxable years beginning after December 21, 2017, and on or before March 13, 2020, a taxpayer may choose either—*
> > *(i) To apply the section 1400Z-2 regulations, if applied in a consistent manner for all such taxable years (reliance by a taxpayer under paragraph (g)(2)(ii) of this section,*

[1] See https://www.govinfo.gov/content/pkg/FR-2020-04-06/pdf/2020-07013.pdf [PDF 284 KB] for full text.
[2] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").
[3] For additional insights on the Final Regulations, see KPMG, The road has been paved—Analysis and observations about final regulations and future of opportunity zone investments, https://home.kpmg/us/en/home/insights/2020/01/tnf-kpmg-report-analysis-and-observations-about-final-regulations-and-future-of-opportunity-zone-investments.html
[4] REG-120186-18 and REG-115420-18.

§1.1400Z2(b)- 1(j)(2)(ii), §1.1400Z2(d)-1(e)(2)(ii), §1.1400Z2(d)- 2(e)(2)(ii), or §1.1400Z2(f)-1(d)(2)(ii), is disregarded solely for purposes of the consistency requirement under this paragraph (g)(2)(i)); or

(ii) To rely on the rules in proposed §1.1400Z2(a)-1 contained in the notice of proposed rulemaking (REG-115420-18) published on October 29, 2018, as amplified by the notice of proposed rulemaking (REG-120186-18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

The same regulatory language change was made to each of the other "applicability date" sections in the Final Regulations.

KPMG observation

The corrected regulatory language (specifically, the parenthetical in section 1.1400Z2(a)-(1)(g)(2)(i) above) allows taxpayers to rely, in part, on one or more of the sections in the Proposed Regulations (e.g., section 1.1400Z2(a)-1), and then rely for the remainder on other sections of the Final Regulations and still meet the consistency requirement contained in the Final Regulations. For example, taxpayers that relied on section 1.1400Z(a)-1 of the Proposed Regulations (which contains the rule requiring netting of section 1231 gains for purposes of determining eligible gain for deferral), but then apply the remainder of the other sections from the Final Regulations, will be treated as meeting the consistency requirement. Thus, this correction replaces the "all or nothing" approach originally contained in the Final Regulations.

Correction to how qualified opportunity zone business interest is valued for purposes of the alternative valuation method

The Corrective Amendments added a new sentence to section 1.1400Z2(d)-1(b)(4)(ii)(A) specifying that, solely for purposes of that paragraph, the acquisition by a Qualified Opportunity Fund (QOF) of Qualified Opportunity Zone (QOZ) stock or a QOZ partnership interest is treated as a purchase of such interest by the QOF. Section 1.1400Z2(d)-1(b)(4)(ii)(A) of the Final Regulations provides rules on how to value property purchased or constructed for purposes of the Alternative Valuation Method.

KPMG observation

The Alternative Valuation Method generally allows a QOF to value a property that is acquired by purchase using its unadjusted cost basis for purposes of the 90% test.[5] If a property is not acquired by purchase, the QOF must value the property by using its fair market value (FMV) determined on the last day of the relevant 90% testing period.[6] Prior to the Corrective Amendments, it was unclear whether a Qualified Opportunity Zone Business (QOZB) interest received by a QOF for contributions made would be treated as purchased and not be subject to semi-annual valuations in applying the Alternative Valuation Method. The addition of this new clause clarifies that such QOZB interest received by the QOF is treated as purchased solely for purposes of the Alternative Valuation Method. Thus, a QOF that chooses to apply the Alternative

[5] Section 1.1400Z2(d)-1(b)(4)(ii)(A).
[6] Section 1.1400Z2(d)-1(b)(4)(ii)(B).

Valuation Method can use its unadjusted cost basis in the QOZB interest (generally the amount of cash contributed in exchange for the interest) for purposes of the 90% test. However, interests in non-QOZB entities acquired by contribution are not treated as purchased for this purpose.

Corrections to safe harbor for working capital and property on which working capital is being expended

The Corrective Amendments added a new paragraph (D) to section 1.1400Z2(d)-1(d)(3)(vi) of the Final Regulations to provide separate provisions on the safe harbor for working capital (new section 1.1400Z2(d)-1(d)(3)(vi)(D)(1)) and for property on which working capital is being expended (new section 1.1400Z2(d)-1(d)(3)(vi)(D)(2)). The new paragraph (D)(1) reads as follow:

> *Working capital. If paragraph (d)(3)(v) of this section treats property of an entity that would otherwise be nonqualified financial property as being a reasonable amount of working capital because of compliance with the three requirements of paragraphs (d)(3)(v)(A) through (C) of this section, the entity (emphasis added) satisfies the requirements of section 1400Z-2(d)(2)(D)(i) (relating to the definition of QOZ business property) only during the working capital safe harbor period(s) for which the requirements of paragraphs (d)(3)(v)(A) through (C) of this section are satisfied; however such property is not qualified opportunity zone business property for any purpose (emphasis added).*

Newly added paragraph (D)(2) generally retains the existing rules contained in the Final Regulations relating to treating tangible property on which working capital is expended as QOZ business property.

KPMG observation

The correction appears to treat a QOZB as satisfying its requirement with respect to QOZ business property during the Working Capital Safe Harbor[7] period, notwithstanding that the QOZB does not actually satisfy its tangible property requirements. However, the working capital not yet spent is not treated as QOZ business property for any purpose.

This correction is very favorable and can have a very meaningful impact in structuring a QOF investment. The corrected regulatory language indicates that a QOZB is treated as satisfying its QOZ business property requirements during the Working Capital Safe Harbor period, notwithstanding that it actually may hold QOZ business property that is less than 70% of its total tangible property (determined by excluding unspent working capital from the calculation). For example, a QOZB that initially holds contributed land and unspent working capital, but that will ultimately spend the working capital on sufficient QOZ business property to actually meet the 70% test by the time the Working Capital Safe Harbor period is over, is treated as meeting its QOZ business property requirement during the entire Working Capital Safe Harbor period, even though it did not actually meet the requirement during the part of the Safe Harbor period in which the working capital had not been sufficiently spent. However, the QOZB must ensure that after the Working Capital Safe Harbor period ends it actually does satisfy the tangible property requirements (that is, the value of its QOZ business property equals or exceeds 70% of the value of all of its tangible assets). Also, this correction appears to eliminate any concern about a "zero-over-zero"

[7] The safe harbor for reasonable amount of working capital is defined under section 1.1400Z2(d)-1(d)(3)(v).

issue for purposes of the 70% test at the QOZB level (that is, the issue where both the numerator and the denominator of the test are zero) where a Working Capital Safe Harbor plan is in place.[8]

Corrections to the cure provision applicable to QOZBs

Section 1.1400Z2(d)-1(d)(6)(iii) was corrected to clarify that each QOF is permitted one correction for each trade or business.

KPMG observation

The Corrective Amendments clarify that a QOF is allowed one correction for each trade or business, which will generally mean each QOZB that it holds an interest in. This clarification is helpful when a single QOF holds multiple QOZBs.

Corrections to the anti-abuse provisions - Example 3

The Corrective Amendments added paragraph (B), *Circular movement of consideration,* to example 3 of section 1.1400Z2(f)-1(c)(3)(iii). Prior to the Corrective Amendments, example 3 illustrates a fact pattern where a QOF owns QOZ stock in a domestic corporation, Corp C, which operates a QOZB. QOF also owns Corp D stock, which is not QOZ stock and is less than 10% of the assets of the QOF. Under section 1400Z–2(e)(2), these stock holdings cause the QOF to be related to both Corp C and Corp D. On date 1, Individual S, who is not a related person with respect to QOF, Corp C, or Corp D within the meaning of section 1400Z-2(e)(2), sells tangible property (Asset 1) to Corp C for use in its business and sells a second asset (Asset 2) to Corp D. Both items sold were capital assets. As a result, Individual S realizes gain of $100 from the sale to Corp C and $75 from the sale to Corp D. At the time of the sale, Individual S has a plan or intent to invest $175 in the QOF and to make deferral elections under section 1400Z–2(a)(1) with respect to the gain from the two sales. On date 2, Individual S acquired an eligible interest in the QOF in exchange for $175, an acquisition that causes Individual S to become a related person with respect to QOF within the meaning of section 1400Z-2(e)(2). The analysis in the Final Regulations states that the $175 of gain is not an eligible gain and cannot be the subject a deferral election under section 1400Z-2(a)(1) because Individual S had a plan or intent to acquire sufficient equity in the QOF to become related to Corp C and Corp D. Thus, the gain fails to satisfy section 1.1400Z2(a)–1(b)(5)(C). Moreover, for the same reason, the tangible property that Corp C purchased from Individual S fails to satisfy the requirement that a purchase of QOZ business property must be from an unrelated person. See sections 1400Z-2(d)(2)(D)(i)(I) and 179(d)(2)(A).

Paragraph (B), *Circular movement of consideration,* was added (with the original example 3 discussed above re-designated as paragraph (A)) to exemplify the circular cash flow discussion previously found only in the preamble to the Final Regulations. Paragraph (B) generally follows the same facts as in the original example 3, except that the QOF further contributes the cash of $100 and $75 received from Individual S to Corp C and Corp D, respectively, as part of the same plan that includes each transaction described in the original example 3 above (collectively, the transaction series). The analysis under paragraph (B) states that under the step transaction doctrine and circular cash flow principles, this circular

[8] A fact pattern that can result in the zero-over-zero issue is when a QOZB holds solely unspent working capital. The Final Regulations seemed to indicate that "idle" working capital is ignored for purposes of the 70% test. While such treatment was not entirely clear from the Final Regulations, it is now clear given the newly added language "however such property is not qualified opportunity zone business property for any purpose."

movement of consideration is disregarded for U.S. federal income tax purposes and for purposes of section 1400Z-2. Therefore, the transaction series is treated for U.S. federal income tax purposes as a contribution by Individual S of Asset 1 and Asset 2 to the QOF in exchange for an eligible interest in the QOF, followed by a contribution by the QOF of Asset 1 and Asset 2 to Corp C and Corp D, respectively. The analysis further states that the result also would be obtained if Individual S were not related to the QOF immediately following Individual S's acquisition of its eligible interest from the QOF.

KPMG observation

The addition of paragraph (B) provides additional facts to complete the circular flow of cash from the original example.[9] Taxpayers structuring similar transaction should closely examine the facts for factors that may result in a circular movement of cash—e.g., whether (i) the transactions are prewired, [10] (ii) the transactions occur within a short period of each other,[11] and (iii) the cash originate from the same source.

Corrections to federally declared disasters relief for consumption of working capital assets and reinvestments

In sections 1.1400Z2(d)-1(d)(3)(v)(D)[12] and 1.1400Z2(f)-1(b)(2),[13] the Corrective Amendments removed the language "receive up to" and added in its place "receive not more than."

KPMG observation

While these corrections do not appear to have any substantial impact to the application of the rules, it is worth noting that as a result of the Covid-19 pandemic, all 50 states in the United States, the District of Columbia, and all major U.S. territories are now federally declared disaster areas.[14] As such, currently, a QOZB that is either adopting or executing on a Working Capital Safe Harbor plan may receive extra time to consume its working capital assets (but no more than 24 months).[15]

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[9] While not specifically stated in the analysis of the example, the recast transaction may also be subject to other tax provisions relevant to property contributions.

[10] The analysis in example 3 puts heavy emphasis on the fact that Individual S have always had an intent or plan, at the time of the sale, to acquire an interest in the QOF with the cash ultimately ending back in the hands of the corporations.

[11] The facts under example 3 indicate that Individual S acquired an interest in the QOF a day following the sale transaction.

[12] Section 1.1400Z2(d)-1(d)(3)(v)(D), following the change, generally provides that if the QOZB is located in a QOZ within a federally declared disaster (as defined in section 165(i)(5)(A)), the QOZB may receive not more than an additional 24 months to consume its working capital assets, as long as it otherwise meets the general requirements of the Working Capital Safe Harbor.

[13] Section .1400Z2(f)-1(b)(2), following the change, generally provides that If the QOF's plan to reinvest some or all of the proceeds (from the return of capital or the sale or disposition of some or all of its QOZ Property) is delayed due to a federally declared disaster (as defined in section 165(i)(5)(A)), the QOF may receive not more than an additional 12 months to reinvest such proceeds, provided that the QOF invests such proceeds in the manner originally intended before the disaster.

[14] https://www.fema.gov/coronavirus/disaster-declarations

[15] While the preamble to the final regulations indicates that, if a project that otherwise meets the Safe Harbor requirements is located within a QOZ designated as a part of a Federally declared disaster area (as defined in section

Correction to add debt borrowing to the multiple applications of working capital example

The example under original section 1.1400Z2(d)-1(d)(3)(viii)(B) was modified to include additional facts indicating that the QOZB in the example will raise additional working capital for the development project through a new revolving credit agreement with an unrelated lender.

KPMG observation

The change to the example seems to make clear that Treasury and the IRS believe that debt funding may count as working capital and/or additional working capital for purposes of a QOZB's Working Capital Safe Harbor(s).

165(i)(5)(A)), the qualified opportunity zone business may receive up to an additional 24 months to consume its working capital assets, provided the project is delayed due to that disaster. Note that, because the proviso was not included in the regulatory language, the project does not appear to need to be delayed due to the disaster to get the extra time.

Contact us

For more information, contact a tax professional with KPMG's Washington National Tax:

Andrew Lau
T: +1 (212) 872-3641
E: andrewlau@kpmg.com

Rich Blumenreich
T: +1 (202) 533-3032
E: rblumenreich@kpmg.com

www.kpmg.com

kpmg.com/socialmedia