Tax Report – Qualified Opportunity Zones: Final Regulations Released

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On December 19, 2019, the United States Treasury Department (“Treasury”) issued final regulations (the “Final Regulations”) under Section 1400Z of the Internal Revenue Code, as amended, (the “Code”), supplementing the second set of proposed regulations (“Proposed Regulations II”) issued on April 17, 2019 and the initial guidance issued by Treasury on October 19, 2018 (“Proposed Regulations I,” together with Proposed Regulations II, the “Proposed Regulations”).

The Final Regulations[1] provide clarification and further guidance on several issues, including:

- investment of the entire amount of gains from the sale of business property (“Section 1231 Property”) without regard to losses, and commencement of the 6-month investment period on the date of the sale of each asset, rather than the end of the year.
- extension of the 10-Year Basis Step-Up (defined below) to sales of assets by Qualified Opportunity Zone Businesses (“QOZBs”) treated as partnerships;
- treatment of leased property used in a Qualified Opportunity Zone (“QOZ”);[2]
- the aggregation of properties for purposes of the substantial improvement test and the reduction of the vacancy requirement for prior use property from five years to three years, and in some cases, as little as one year;
the provision of additional timing flexibility for the investment of partnership gains by partners of such partnership;
the provision of additional flexibility regarding the treatment of inventory as QOZBP (as defined below);
the extension of the Working Capital Safe Harbor (as defined below) to 62 months in certain circumstances;
the creation of a new six-month cure period during which an entity that fails to qualify as a QOZB may correct such failure and still be treated as a QOZB;
the treatment of mixed fund investments, where a taxpayer invests both eligible gains and other amounts in a QOF;
the treatment of transfers of noncash property to a QOF;
the application of the disguised sale rules and the exceptions for such rules (including the operating cash flow distributions exception);
guidance for QOF transactions that may trigger the inclusion of an investor's original deferred gain, including transfers by gift, transfers upon divorce, transfers at death, transfers to grantor trusts, and the making of S corporation elections;
the determination of what activities will constitute a trade or business for purposes of Section 1400Z-2, including clarification of when the lessor under a triple net lease could be treated as engaged in an active trade or business; and
determining the holding period for a QOF equity received in a qualifying Section 381(a)(2) transaction, a reorganization described in Section 368(a)(1)(E), an exchange under Section 1036, or a Section 355 reorganization, and further guidance on the treatment of QOFs treated as corporations for purposes of the consolidated return regime.

This Tax Report analyzes the provisions of the Final Regulations, noting changes from the Proposed Regulations.

Background

Sections 1400Z-1 and -2 were enacted as a part of The Tax Cuts and Jobs Act of 2017[3] to spur investment into certain economically distressed communities. The program provides taxpayers who have recently realized gains with a means of deferring, and to some extent avoiding, taxation of those gains as well as the taxation of the gain on the prospective appreciation of their investment.

Pursuant to Section 1400Z-2, taxpayers with recently realized gains from the sale of stock, securities, real estate, and other capital assets may defer and even escape some taxation on that gain to the extent the gains are invested in a QOF within 180 days of the sale giving rise to the gain (the “180-day period”). Once invested in a QOF, the taxpayer’s deferred gain must be recognized on the earlier of the date of sale of the taxpayer’s interest in the QOF (or any event treated as an “inclusion event” by the Proposed and Final Regulations) or December 31, 2026. However, if the taxpayer’s interest in the QOF is held for at least 5 years, the taxpayer’s basis in their QOF interest will be increased by 10 percent. Further, if such interest is held for at least 7 years, the taxpayer’s basis will be increased by an additional 5 percent. If such interest is held for at least 10 years, the taxpayer may elect to have the basis increased to fair market value (the “10-Year Basis Step-Up”) for purposes of a sale of the taxpayer’s QOF interest or the sale of assets by the QOF.

A QOF is defined as a corporation or partnership that is organized for the purpose of investing its assets in qualified opportunity zone property (“QOZP” and the equity interests in such corporation or partnership “QOZ Stock” and “QOZ Partnership Interest” respectively). A QOF is subject to a semi-annual requirement that at least 90% of its assets are invested in QOZP (the “90% Test”). The assets of a QOF are generally tested twice a year with the results being averaged. Noncompliance with the 90% Test will result in certain penalties applicable against a QOF and, in the case of a QOF structured as a partnership or S corporation, a QOF’s investors.
QOZP consists of (i) stock or partnership interests in an entity that qualifies as a QOZB or (ii) tangible property that qualifies as qualified opportunity zone business property ("QOZBP").


Timeline for Investing Section 1231 Gain

In a welcome response to numerous comments, the Final Regulations provide that the 180-day period for investing eligible Section 1231 gain (i.e., gain from the sale of property used in a taxpayer’s trade or business) into a QOF begins on the date of the sale or exchange that gives rise to the eligible Section 1231 gains.[4] Accordingly, taxpayers no longer have to wait until the end of their taxable year to net their Section 1231 gains against their Section 1231 losses to determine the amount of investment eligible 1231 gains they may have. They may simply invest the gross amount of 1231 gain and do so on the date of sale giving rise to the gain rather than waiting until the end of their taxable year. Upon recognition of the Section 1231 gain on December 31, 2026 or if earlier, on the date of an inclusion event, the included Section 1231 gain is treated as if it were a Section 1231 gain (within the meaning of Section 1231(a)(3)(A)) that was recognized on the date of inclusion.

Investment of Proceeds from Sales to QOFs or QOZBs

Treasury clarified that under step-transaction and circular cash flow principles, a taxpayer’s gain from a sale of property to an unrelated QOF as a part of a plan that includes the investment of the sale proceeds received by the taxpayer back into the same unrelated QOF is not eligible gain to the taxpayer because the transaction would not be characterized as a sale or exchange to an unrelated person for Federal income tax purposes. Instead, the sale would be disregarded, and the transaction would be treated as a contribution of property by the taxpayer to the QOF. In other words, there is no capital gain generated for the taxpayer to defer via investment into the QOF. Similarly, proceeds from a sale by a taxpayer of property to an unrelated QOZB are not treated as eligible gains if the sale occurs as part of a plan that includes the investment of the sale proceeds into the QOF that owns the purchaser QOZB followed by the QOF contributing the sale proceeds down to the lower tier purchaser QOZB. Treasury also noted that in the foregoing circumstance the same treatment would apply even if the QOF retained the sale proceeds (rather than contributing them to the purchaser QOZB).

Treatment of Gain Not Subject to Federal Income Tax

The Final Regulations reiterate that deferral of a gain under Section 1400Z-2(a)(1) is available only for capital gain that would be subject to Federal income tax but for the making of a valid deferral election. In addition, the Final Regulations provide that a foreign eligible taxpayer cannot make a deferral election with respect to an eligible gain unless the foreign eligible taxpayer irrevocably waives any treaty benefits that would exempt that gain from Federal income tax.[5]

Treatment of Gains from a Straddle

The Proposed Regulations provided that net gain from a straddle (as defined in Section 1092(c)(1)) is not eligible gain and therefore not eligible for deferral. However, the Final Regulations provide an exception for net gain from certain Section 1256 contracts.[6] The net gain from an identified straddle during the taxable year is equal to the excess of the capital gains recognized for Federal income tax purposes in the taxable year, determined without regard to Section 1400Z-2(a)(1), over the sum of the capital losses and net ordinary losses from all positions that were part of the straddle, including capital gains and losses from Section 1256 contracts and other positions marked to market on the last business day of the taxable year or upon transfer or termination and annual account net gain from positions in a mixed straddle account.
Under the Final Regulations, the 180-day period for RIC and REIT capital gain dividends generally begins at the close of the RIC or REIT shareholder’s taxable year in which the capital gain dividend would otherwise be recognized by the shareholder.[7] REITs determine that a dividend is eligible to be treated as a capital gain dividend after the REIT’s taxable year has ended, which potentially could have precluded RIC or REIT shareholders from making qualifying investments in QOFs. The Final Regulations also ensure that RIC and REIT shareholders do not have to wait until the end of their taxable year to invest capital gain dividends, instead, they may elect to begin the 180-day period on the day each capital gain dividend is paid.[8]

180-day Period for Installment Sales

Several commenters sought clarification regarding the application of the 180-day period to gains recognized in an installment sale. Specifically, commenters noted that it was unclear whether there was a single 180-day period for all income from the installment sale that began on the date and year of the sale or if there were multiple 180-day periods, each beginning in the year during which a payment is received and income is recognized under the installment method. The Final Regulations include a rule that accommodates both of the foregoing approaches.[9] For gains reported on the installment method pursuant to Code Section 453, a taxpayer may treat either the date the payment is received under the installment plan or the last day of the taxable year in which the taxpayer would have recognized the gain under the installment method as the beginning of the 180-day period for investment of the gain into a QOF. If an eligible taxpayer receives more than one payment under the installment method for the taxable year and elects to begin the 180-day period on the date of receipt of such payments, each payment will begin a new 180-day period.

Special 180-day Period for Partners, S Corporation Shareholders, and Trust Beneficiaries

The Proposed Regulations provided that the 180-day period during which a partner in a partnership must invest an amount equal to the partner’s distributive share of eligible partnership gains generally begins on the last day of the partnership’s taxable year in which the event giving rise to such gains occurred. However, the end of a partnership’s taxable year and the date in which a partner receives a K-1, may in fact take longer than 180 days to receive. Treasury acknowledged the potential problem with such timing and, accordingly, the Final Regulations provide partners of a partnership, shareholders of an S corporation, and beneficiaries of decedent’s estates and non-grantor trusts with the option to treat the 180-day period as commencing upon the due date of the entity’s tax return, not including any extensions.[10]

Additional Deferral of Previously Invested Gains

The preamble to the May 2019 Proposed Regulations explained that deferring an inclusion otherwise mandated by Section 1400Z-2(a)(1)(B) is permitted only if the taxpayer has disposed of their entire initial QOF investment. Comments to the Proposed Regulations requested that gain from an inclusion event in which a taxpayer disposed of less than its entire investment in a QOF be eligible for the deferral because gain arising from an inclusion event, whether such gain represents all or a portion of the originally deferred gain, represents new gain that should be eligible for deferral. Treasury agreed with these comments and, accordingly, the Final Regulations allow a taxpayer to defer gain from an inclusion event even though the taxpayer retains a portion of the initial qualifying investment subject to the inclusion event.[11]

Acquisition of Eligible Interest from a Person Other than a QOF
Consistent with the Proposed Regulations, the Final Regulations allow a taxpayer to invest in a QOF by acquiring an eligible interest from a person other than a QOF. The taxpayer acquiring an eligible interest need not be aware of whether the transferor made a prior election under Code Section 1400Z-2(a), as it is only necessary that the acquirer has eligible gain and makes a valid deferral election. Treasury also noted that if a taxpayer purchases an interest in an entity that existed prior to the enactment of Code Section 1400Z-2 but later became a QOF pursuant to Code Section 1.1400Z2(d)-(1)(a)(3), such interest is an eligible interest as long as the taxpayer has eligible gain and the acquisition of the interest was within the requisite 180-day window with respect to that gain. Accordingly, gain that is otherwise included in gross income as a result of an inclusion event, whether from disposition of an entire or partial interest in a QOF, may be eligible for deferral under Code Section 1400Z-2(a)(1), provided that all of the requirements to elect deferral are met. In determining whether such gain is eligible gain, the eligible taxpayer should treat such inclusion gain as if it were originally realized upon the occurrence of the inclusion event rather than the sale or exchange that gave rise to the eligible gain to which the inclusion event relates.[12] The 180-day period for investing gain from an inclusion event begins on the date of the inclusion event, and the holding period for a qualifying investment attributable to eligible gain arising from an inclusion event begins on the date that the gain is reinvested in a QOF.

**Eligibility of Built-in Gain for Deferral**

In response to comments regarding the eligibility of built-in gain for deferral from entities including REITs, RICs, or S Corporations, Treasury clarified that to the extent that the gain from such entities is eligible gain, a deferral election under Code Section 1400Z-2 may be made. The Final Regulations also permit corporations to make a deferral election for recognized built-in gain within the meaning of Code Section 382(h)(2)(A) and Code Section 1374(d)(3).[13]

**Identification of a Disposed Interest in a QOF**

Under the Proposed Regulations, a taxpayer disposing of less than all of their interests on a single day, where portions of such interests with identical rights were acquired on different days, was required to use the first-in-first-out rule (“FIFO”), or in cases where FIFO did not provide a complete answer, a pro-rata method. After receiving numerous comments on the topic, the Final Regulations permit taxpayers to specifically identify the QOF stock that they are disposing of, rather than imposing a mandatory use of FIFO or a pro-rata method. However, the FIFO method will apply in instances where the taxpayer fails to adequately identify which QOF shares are disposed of. Moreover, the Final Regulations contemplate that the pro-rata method will be used if, after application of the FIFO method, a taxpayer is treated as not having sold all of its investment interests that it acquired on the same day.[14] The Final Regulations also provide that if a taxpayer is required to include in income some or all of a previously deferred gain, such gain has the same attributes as it would have if the gain had not been deferred under Code Section 1400Z-2.[15]

**The Mixed-Fund Rules and Contribution of Cash or Property**

Section 1400Z recognizes that a taxpayer may invest in a QOF (a “QOF investment”)[16] in an amount that exceeds the taxpayer’s gain eligible for the deferral. The Final Regulations confirm the approach taken in the Proposed Regulations and treat such a contribution to a QOF as a mixed investment consisting of a deferred gain portion and a portion subject to normal tax treatment (i.e., a portion not eligible for QOF benefits). Such a mixed QOF investment[17] may occur intentionally, or unintentionally where the amount of the eligible gain is initially estimated and later determined to be smaller when tax returns are finalized, or when the amount is re-determined in connection with an audit of the taxpayer’s tax return (the rules determining the treatment of such mix QOF investments, the “QOF Mixed-Fund Rules”).[18]

In effect, the QOF Mixed-Fund Rules divide investments which exceed the amount of gain qualifying for the QOF election into two separate investments on the basis of a “vertical slice.” One slice, consisting of the qualifying QOF investment, is subject to the special QOF rules, and the other slice, consisting of the non-qualifying QOF investment, is treated under normal tax rules. The basis of each separate interest is determined as if such interest was held by different taxpayers, notwithstanding the normal pooling of basis rules applicable in determining a taxpayer’s basis in a partnership interest.
Consistent with the Proposed Regulations, the Final Regulations describe several fact patterns where a taxpayer is treated as having created a mixed-funds investment. A mixed-funds investment will result if a taxpayer contributes to a QOF, in a nonrecognition transaction such as a contribution under Section 721, property that has a fair market value in excess of the property’s adjusted basis. Similarly, a mixed-funds investment will result if the amount of the investment that might otherwise support a QOF election exceeds the amount of the taxpayer’s eligible gain. In each instance, that excess (that is, the excess of fair market value over adjusted basis, or the excess of the investment amount over eligible gain, as appropriate) is treated as an investment to which the QOF deferral election does not apply.

**Contributions of Property to a QOF in Nonrecognition Transactions – Application of the “Mixed-Fund” Rules**

If a taxpayer makes a QOF investment by transferring cash to a QOF, the amount of the taxpayer’s QOF investment is the amount of cash invested. On the other hand, the Final Regulations contemplate that a taxpayer may make a contribution of property to a QOF in a nonrecognition transaction (i.e., a transfer to a partnership under Section 721 or a transfer to a controlled corporation under Section 351) or in a taxable transaction.

The Final Regulations, consistent with the Proposed Regulations, provide that when a taxpayer contributes property to a QOF in a nonrecognition transaction, where under Sections 721 or 351 the taxpayer’s basis in the QOF would be determined, in whole or in part, by reference to taxpayer’s basis in the transferred property, the amount of the taxpayer’s QOF investment is the lesser of (a) the taxpayer’s adjusted basis in the contributed property plus any gain recognized in the transaction, which in turn equals the taxpayer’s basis in the eligible interest received in the transaction, without regard to Section 1400Z-2(b)(2)(B), or (b) the fair market value of the eligible interest received in the transaction, determined immediately after the contribution. This rule is applied separately to each item of property contributed to a QOF.

The Final Regulations provide that the QOF Mixed-Fund Rules come into play when a taxpayer contributes property to a QOF in a nonrecognition transaction (in whole or in part). For example, when the fair market value of the eligible interest in the QOF received by the taxpayer is in excess of the taxpayer’s adjusted basis in the eligible interest received, then the taxpayer’s investment is an investment subject to the QOF Mixed-Fund Rules.\[19\]

If a taxpayer’s investment in a QOF is subject to the QOF Mixed-Fund Rules, the taxpayer’s basis in its interest in the QOF is equal to the taxpayer’s basis in all of the QOF interests received, determined without regard to the QOF deferral and basis adjustment provisions,\[20\] and reduced by the basis of the taxpayer’s investment to which the QOF election applies.\[21\]

With respect to taxpayers who transfer property to a QOF partnership, the Final Regulations also provide that the amount of such taxpayer’s qualifying investment in the QOF partnership is the lesser of the taxpayer’s net basis in the property contributed to the QOF partnership, or the net value of the property contributed by the taxpayer to the QOF partnership.\[22\] The amount of such taxpayer’s non-qualifying investment in the QOF partnership is the excess, if any, of the net value of the contribution over the amount treated as a QOF investment.

When a taxpayer’s investment consists of both qualifying and non-qualifying investments, the basis of a qualifying investment is the net basis of the property contributed, determined without regard to Section 1400Z-2(b)(2)(B) or any share of debt under Section 752(a). The basis of a non-QOF investment (before any debt allocation under Section 752) is the remaining net basis. The bases of qualifying and non-qualifying investments are increased by any debt allocated to such investments.\[23\]

The Final Regulations clarify that where partnership level debt is incurred and results in a deemed contribution of money under Section 752(a), any basis increase resulting from the deemed Section 752(a) contribution is not taken into account in determining the portion of a partner’s investment under the Mixed-Fund Rules.\[24\] The Final Regulations further clarify that if a non-qualifying investment is made in a corporation but the taxpayer receives no additional stock in exchange for the subsequent contribution, the Mixed-Fund Rules apply to the non-qualifying portion of the investment.\[25\]
The Final Regulations also confirm that where a QOF shareholder makes a non-qualifying investment in a QOF but receives no stock in exchange (i.e., a “meaningless-gesture contribution”) such a non-qualifying investment results in a mixed-fund investment subject to the Mixed-Fund Rules.[26]

**Holding Periods for Interests in QOFs**

The Final Regulations provide holding period rules that apply to interests in a QOF for purposes of determining the 5-, 7-, and 10-year basis adjustments. Generally, unless otherwise provided, the length of time that an interest in a QOF has been held is determined without regard to the period for which the QOF investor had held property exchanged for such interest.

Special rules apply in QOF corporation transactions. The holding period for QOF stock received by a QOF investor in a qualifying Section 381(a)(2) transaction, a reorganization described in Section 368(a)(1)(E) or a Section 1036 exchange shall include the period for which the QOF investor held the stock exchanged in such transaction as long as the stock received has the same basis in whole or in part in the investor’s hands as the stock exchanged. The holding period of qualified stock in a controlled corporation received by a QOF investor from the distributing corporation in a Section 355 transaction shall include the period for which the investor held the stock exchanged, provided that the stock received has the same basis in whole or in part in the investor’s hands as the stock exchanged.

The holding period of an interest in a QOF held by an investor who received such interest as a gift (which was not an inclusion event) or by reason of the prior owner’s death includes the time during which the QOF interest was held by the donor or the deceased owner, respectively.

**Transfers by Gift, Transfers upon Divorce, Transfers at Death, Transfers to Grantor Trust, and S Corporation Elections**

The Final Regulations, consistent with the Proposed Regulations, provide that a transfer of a QOZ investment by gift, whether outright or in trust, is an inclusion event, regardless of whether that transfer is a completed gift for Federal gift tax purposes, and regardless of the taxable or tax-exempt status of the donee of the gift.[27] Transfer of a QOF Investment incident to divorce is also an inclusion event.[28]

Section 1400Z-2(e)(3) provides that in the case of a decedent, amounts not previously includible in the gross income of the decedent are includible in gross income as provided by Section 691, dealing with income in respect of a decedent (“IRD”). Under the IRD rules, there is no step up in the basis of the asset upon the death of the holder, and the intrinsic gain continues to be subject to the inclusion rules in the hands of the transferee – that is, the transferee “steps into the shoes” of the decedent, and a subsequent inclusion event will trigger the recognition of the Deferred Gain.

Consistent with the IRD tax regime, the Final Regulations provide that the transfer of a QOZ investment by reason of the taxpayer’s death is not an inclusion event.[29] Transfers by reason of death include a transfer to the deceased owner’s estate, a distribution of a QOZ investment by the deceased owner’s estate, a distribution of a QOZ investment by the deceased owner’s trust that is made by reason of the deceased owner’s death, the passing of a jointly owned QOZ investment to the surviving co-owner by operation of law, and any other transfer of a QOZ investment at death by operation of law. A transfer by reason of death does not include a subsequent sale, exchange, or other disposition by the deceased taxpayer’s estate or trust, which would instead constitute an inclusion event. Similarly, any disposition by a legatee, heir, or beneficiary who received the QOZ investment by reason of the taxpayer’s death and any disposition by the surviving joint owner or other recipient who received the QOZ investment by operation of law on the taxpayer’s death would be an inclusion event.
Under the grantor trust rules, the grantor of a grantor trust is treated as the deemed owner of the assets of the trust. Consistent with this construct, the Final Regulations provide that if the owner of a QOZ investment contributes the interest in the investment to a grantor trust, the contribution is not an inclusion event.[30] However, a change in the status of a grantor trust, whether the termination of grantor trust status or the creation of grantor trust status, is an inclusion event.[31] The termination of grantor trust status as the result of the death of the owner of a QOZ investment is not an inclusion event.[32] However, the provisions of the Final Regulations dealing with transfers of interests in QOF investments will apply to distributions or dispositions by the trust.

The Final Regulations clarify that an election, revocation, or termination of a corporation’s status as an S corporation is not an inclusion event.[33] Similarly, a conversion of a QSST to an ESBT is not an inclusion event provided the QSST beneficiary is the deemed owner of the grantor portion of the ESBT that receives the QOF investment and the deemed owner is not a nonresident alien, and a conversion of an ESBT to a QSST is not an inclusion event where the QOZ investment is held in the grantor portion of the ESBT and the QSST beneficiary is the deemed owner of the grantor portion of the ESBT.[34]

Application of Disguised Sale Rules to Investments in QOF Partnerships

The Proposed Regulations introduced rules that effectively treated transfers of property to a QOF partnership as non-qualifying QOF investments to the extent such a transfer is characterized as a transaction other than a contribution to a partnership (for example, a transfer treated as a disguised sale under the “disguised sale rules” of Section 707). In the preamble to the Final Regulations (the “Preamble”), Treasury confirmed that all existing administrative guidance under disguised sale rules of Section 707[35] is applicable, including any relevant exceptions. Treasury confirmed that the operating cash flow exception to Section 707 would be applicable in applying the disguised sale rules to transfers of property to QOF partnerships. However, Treasury noted that even if the operating cash flow exception were to apply to a distribution to investors of a QOF partnership, such a distribution will still result in an inclusion event and a reduction in such investor’s interest in the QOF partnership (to the extent such distribution exceeds the investor’s outside basis in its QOF interest).

In addition, Treasury confirmed that the intended effect of the Proposed Regulations rules incorporating Section 707 was that to the extent a transfer or property to a QOF partnership were to be treated as a disguised sale, the interest in the QOF received as a result of such transfer would not be eligible for benefits under Section 1400Z-2.

Application of At-Risk Basis Rules to Investments in QOF Partnerships

Commenters requested that Treasury clarify whether an investment in a QOF partnership will give an investor “at-risk basis” under Section 465. Treasury declined to explicitly provide such clarity in the Final Regulations but noted that, pursuant to Section 465, at-risk basis is generally determined by reference to the amount of money and the basis of property contributed to a partnership and not the basis of the partnership interest received in exchange for such contributed property. Accordingly, the zero outside basis rule of Section 1400Z-2(b)(2)(B) should have no effect on the determination of at-risk basis.

QOF Equity Interest Used as Collateral for Loan

Provided an eligible taxpayer owns an equity interest in the QOF, the status of such interest is not affected if the taxpayer uses the interest as collateral for a loan, whether as part of a purchase-money borrowing or otherwise.[36]

Application of Withholding and FIRPTA Rules in Investment in QOFs
Commenters requested that the Final Regulations provide various exemptions from withholding requirements for transactions where gain generated by such transaction is deferred via QOF investment. Treasury declined to include such exemptions in the Final Regulations noting that Section 1400Z-2 is not a nonrecognition provision[37] but is instead a deferral provision. Consequently, transactions giving rise to gains used to invest in a QOF will still be subject to normal withholding requirements.

**QOF Exit and Reinvestment**

Treasury declined to provide investors the ability to tack QOF holding periods together where an investor disposes of an entire qualifying interest in a QOF and reinvests the resulting proceeds in another QOF shortly thereafter. Commenters noted that such holding period tacking upon exit and reinvestment would allow investors to lower investment risk and facilitate investments in professionally managed QOFs by a wide variety of investors. Treasury acknowledged these potential benefits, but could not find support for tacking holding periods upon exit and reinvestment in the statutory text of Section 1400Z-2.

**Extension of the 10-Year Basis Step-Up to the Sale of Assets by QOZBs**

The Proposed Regulations extended the application of the 10-Year Basis Step-Up to sales of QOZ Property by QOFs. Under that rule, an investor who has held their interest in a QOF partnership or S corporation, is permitted to make an election under Section 1400Z-2(c) to effectively eliminate their allocable share of gain from the sale of QOZ Property by the QOF. Commenters requested that this rule be extended to the sale or property by a QOZB owned by a QOF partnership or QOF S Corporation. Treasury agreed with such requests and the Final Regulations include the long sought-after flexibility that such an extension would provide investors. Accordingly, pursuant to Reg. §1.1400Z2(c)-1(c), the 10-Year Basis Step-Up now applies to QOF investors’ allocable share of gain from the sale of assets of a QOZB partnership or QOZB S corporation owned by a QOF.

However, the Final Regulations stipulate that while depreciation recapture and gain from the sale by a QOZB partnership of non-QOZBP will be protected by the 10-Year Basis Step-Up, ordinary income generated from the sale of inventory by a QOZB partnership is not covered by the step-up and the allocable share of such income must be recognized by QOF partners.[38] In addition, the Final Regulations stipulate that the amount of a QOF partner’s gain that is eliminated by the application of the 10-Year Basis Step-Up upon the sale of assets by a QOF partnership or a QOZB partnership will correspondingly reduce the amount of the QOF partner’s interest in the QOF that is be treated as a qualifying interest. In other words, any gain eliminated via the 10-Year Basis Step-Up will reduce the amount of the gain that can be eliminated by the 10-year Basis Step-Up upon an investor’s sale of interests in the QOF. The effect of this provision is to ensure that pass through QOF investors are not allowed to double dip on the benefits of the 10-Year Basis Step-Up when they eventually sell their interest in the QOF.

Commenters also requested clarity as to whether the 10-year Basis Step-Up applies to sales of QOF assets that occur at different times. Treasury acknowledged that such a rule would provide beneficial flexibility for QOF investors. Accordingly, the Final Regulations permit that application of the 10-year Basis Step-Up to QOF sales of QOZBs or other QOZ Property occurring at different times.[39]

The Final Regulations also clarify that the 10-Year Basis Step-Up applies to adjust the basis of a qualifying interest in a QOF partnership being sold to an amount equal to the fair market value of such interest plus such selling investor’s applicable share of the QOF’s debt.[40] As a result, the cancellation of debt income should be eliminated by the 10-Year Basis Step-Up.
Commenters also requested that the basis adjustment rules of the Proposed Regulations (which effectively extend partner level basis adjustments under the 10-Year Basis Step-Up to the basis of QOF partnership assets in the event of a sale by a QOF investor of its interest in a QOF partnership) to the assets of lower tier partnerships (such as a QOZB). The Final Regulations confirm that such basis adjustments apply to the assets of subsidiary partnerships owned by a QOF partnership. The Final Regulation also state that no Section 754 election is necessary to affect such basis adjustments.

**Application of the 10-Year Basis Step-Up to CFCs and PFICs**

Commenters requested that the Final Regulations provide for the application of the 10-Year Basis Step-Up to the sale of assets by QOFs that are also CFCs or PFICs. Treasury noted that the rules for income inclusion for CFCs and PFICs are not analogous to pass-through entities such as partnerships and S corporations. In addition, Treasury stated that it has determined that there is no statutory or policy basis for an extension of the step-up to such entities. Accordingly, the Final Regulations do not extend the 10-Year Basis Step-Up to sales of assets by QOFs that are CFCs or PFICs.

**Mergers of QOF Partnerships**

The Final Regulations, consistent with the Proposed Regulations, provide that a merger or consolidation of a partnership that holds a qualifying investment in a QOF (the “original partnership”) with another partnership in a transaction governed by Code Section 708(b)(2)(A) is not an inclusion event to the extent Code Section 721(a) applies to the merger. To the extent the original partnership terminates in the merger, the resulting partnership or new partnership as determined under Reg. § 1.708-1(c)(1) becomes subject to Code Section 1400Z and the regulations thereunder to the same extent that the original partnership was so subject prior to the transaction and must allocate and report any deferred gain under Code Section 1400Z-2(b) to the same extent and to the same partners that the original partnership would have allocated and reported such items before the transaction. Also, a merger or consolidation of a QOF partnership with another QOF partnership in a transaction to which Code Section 708(b)(2)(A) applies is not an inclusion event if immediately after the merger or consolidation, the resulting partnership is a QOF. The continuing partnership under Reg. § 1.708-1(c)(1) becomes subject to Code Section 1400Z-2 and the regulation thereunder to the same extent that the terminated partnership was so subject prior to the transaction and must allocate and report any deferred gain under Code Section 1400Z-2(b) to the same extent and to the same partners that the terminated partnership would have allocated and reported such items prior to the transaction. Further, the general inclusion rules apply to any portion of the merger or consolidation that is otherwise treated as a sale or exchange under the inclusion rules.

**Partnership Distributions**

The Final Regulations, consistent with the Proposed Regulations, provide that an actual or deemed distribution of property, including cash, by a QOF partnership to a partner with respect to its qualifying investment is an inclusion event only to the extent that the distributed property has a fair market value in excess of the partner’s adjusted basis in its qualifying investment. In the case of a merger or consolidation of a QOF partnership with another QOF partnership in a transaction to which Code Section 708(b)(2)(A) applies, the fair market value of the distributed property is reduced by the fair market value of the QOF partnership interest received in the merger or consolidation. A distribution from a partnership that directly or indirectly owns a QOF is an inclusion event only if the distribution is a liquidating distribution. For this purpose, the distribution is not in complete liquidation if the partnership making the distribution is a partnership that terminates in the merger or consolidation under Reg. § 1.708-1(c), the continuing partnership in the merger or consolidation continues to directly or indirectly own an interest in the QOF, and the partners of this terminated partnership are distributed an interest in the resulting partnership as part of the merger or consolidation.

**Certification of an Entity as a QOF**
Section 1400Z-2(e)(4)(A) directs Treasury to prescribe regulations for the certification of QOFs for purposes of Section 1400Z-2. In order to facilitate the certification process and minimize the information collection burden placed on taxpayers, the Final Regulations generally permit any taxpayer that is a corporation or partnership for Federal income tax purposes to self-certify as a QOF, provided that the entity is eligible to do so.[45]

The self-certification must be reported annually on a timely filed Form 8996 that contains general information about the QOF, 90% Test calculations, and 90% Test penalty calculations. For the first period during which an entity certifies as a QOF, Form 8996 also requires the QOF to include in its organizing documents: (1) a statement of the purpose of investing in QOZ property, and (2) a description of the QOZ business that a QOF expects to engage in. In order to be treated as a QOF, an eligible entity must continue to self-certify, on an annual basis, that it remains in compliance with the requirements of the relevant standards.

Treasury received several comments regarding the certification process outlined in the Proposed Regulations generally advocating for additional information regarding the QOF and its investments to be included in the certification. The Final Regulations generally did not adopt commenters’ recommendations and the self-certification process remains the same as it was under the Proposed Regulations. However, Treasury has included in the Final Regulations a provision to allow a QOF to self-decertify, including a rule providing that the decertification of a QOF, whether voluntary or involuntary, is an inclusion event for eligible taxpayers that hold a qualifying investment in that QOF.[46]

Testing for Satisfaction of QOZB Requirements

The Final Regulations provide for purposes of satisfying the 90% Test a QOF’s determination of whether a subsidiary qualifies as a QOZ (and consequently, the QOF’s equity interest in the subsidiary qualifies as QOZ Property for purposes of the 90% Test) is made on a semiannual basis.[47] However, the Final Regulations also include a safe harbor wherein on a semiannual testing date a QOF can count as QOZ Property any equity in a subsidiary that (i) was a QOZ for at least 90% of the QOF’s holding period for such entity (A) beginning on the effective date of the QOF’s self-certification and (B) ending on the last day of the entity’s most recent tax year ending on or before the relevant semiannual testing date of the QOF or (ii) was not a QOZ as of the end of its last taxable year ending on or before a semiannual testing date of the QOF but cured any defect for qualification of a QOZ within six months of the date on which the subsidiary lost its qualification as a QOZ.[48]

Consideration of Synthetic Equity as QOZ Stock or Partnership Interest

Treasury received comments recommending that the Final Regulations include in the definition of QOZ Stock any interest constituting synthetic equity under Section 409(p)(6)(C) or an employee stock option plan. In the Preamble, Treasury noted that while it will continue to consider this issue, it has determined that specific rules to address synthetic equity would add unnecessary complexity to the Final Regulations. As a result, the Final Regulations do not incorporate the commenters’ recommendation and synthetic equity is not an acceptable form of QOZ Stock.

Treatment of Constructed Property as QOZBP

Commenters requested that clarification that the definition of QOZBP includes property constructed by a QOZB or QOF. Treasury acknowledged that tangible property is not disqualified from constituting QOZBP solely by reason of it being manufactured, constructed or produced rather than purchased and, accordingly, if such self-constructed property is used in the trade or business of the QOZ or QOF it will be eligible for treatment as QOZBP if it meets the other requirements of QOZBP under Section 1400Z-2(d)(2)(D)(i).
In addition, the Final Regulations provide that for purposes of the 90% Test and the “substantially all” requirement of Section 1400Z-2(d)(3)(A)(i) (the “70% Test”) self-constructed property will be treated as acquired by the QOZB or QOF on the date that physical work of a significant nature begins on such property.[49] In the Preamble, Treasury clarifies that physical work of a significant nature does not include preliminary activities such as planning or designing, securing financing, exploring or researching. Noting that the determination of the date physical work of a significant nature begins is a facts and circumstances determination, Treasury has included in the Final Regulations a safe harbor wherein a QOZB or QOF may determine the date on which it paid more than ten percent of the total cost of the self-constructed property (excluding the cost of land and preliminary activities).[50] Such date will be the relevant date acquisition date for the self-constructed property.

**Treatment of Property Contributed to a QOF as QOZBP**

In the Preamble, Treasury confirmed that property contributed to a QOF will not be eligible for treatment by the QOF as QOZBP because such property has not been purchased, leased or self-constructed by the QOF.

**Treatment of Real Property Purchased Under a “Sponsorship” Arrangement as QOZBP**

The Final Regulations stipulate that where real property is purchased by a QOF or QOZB and at the time of such purchase there is a plan that the seller of such real property repurchase the real property from the QOF or QOZB for an amount that is less than fair market value, the real property will not be treated as QOZBP in the hands of the QOF or QOZB.[51]

**Clarity on Leased Property Treated as QOZBP**

The Final Regulations stipulate that leased property in the hands of a QOF or QOZB will not constitute QOZBP if the lease was entered into prior to December 31, 2017. In the Preamble, Treasury noted that such a rule is necessary to achieve parity with the requirements for purchased tangible property (i.e., the requirement that tangible property be purchased by a QOF or QOZB after December 31, 2017 in order to be treated as QOZBP).

With respect to the Proposed Regulations requirement that lease terms of leased tangible property must be market rate,[52] the Final Regulations further provide for a rebuttable presumption wherein leases between unrelated parties will be presumed to be market rate.[53] In addition, the Final Regulations provide that tangible property leased from a state or local government or an Indian tribal government will not be considered to be leased from a related party (and would accordingly be eligible for the market rate rebuttable presumption).

**Treatment of Inventory as QOZBP**

After the release of the Proposed Regulations there remained significant uncertainty as to the treatment of inventory owned by a QOF or QOZB for purposes of the 90% Test and the 70% Test, respectively. Comments on the issue included a wide range of suggested positions. In light of such comments, Treasury provided flexibility for the treatment of inventory as QOZBP. The Final Regulations provide that for purposes of calculating compliance with the 90% Test and the 70% Test a QOF or QOZB, as applicable, may choose (i) to include inventory in both the numerator and the denominator or (ii) exclude inventory from both the numerator and the denominator of such calculation. Once a choice is made by a QOF or QOZB, as applicable, the Final Regulations provide that the choice will apply for all semiannual testing dates for as long as the QOF or QOZB, as applicable, holds the inventory.[54]

The Final Regulations also provide that the fact that inventory is briefly warehoused while in transit will not prohibit such inventory from qualifying for the safe harbor for inventory in transit provided for in the Proposed Regulations (which has been adopted in full by the Final Regulations).[55]
Substantial Improvement of QOZBP

Treasury received numerous comments suggesting various approaches to allowing the aggregation of assets for purposes of satisfying the substantial improvement test of Section 1400Z-2(d)(2)(D)(ii). In response, the Final Regulations provide for an aggregation of assets approach wherein QOFs and QOZBs can determine whether a non-original use asset (e.g., a preexisting building) has been substantially improved. Under the Final Regulations’ approach, purchased original use assets (that would qualify as QOZBP on their own) may be taken into account in determining whether additions to the basis of non-original use property (i.e., property that must be substantially improved) satisfies the substantial improvement requirement of Section 1400Z-2(d)(2)(D)(ii), provided that such purchased original use assets (i) are located in the same QOZ as the non-original use property (ii) are used in the same trade or business as the non-original used property and (iii) improve the functionality of the non-original use property. The Preamble discusses an example of this new aggregation approach. In the example a non-original use hotel is purchased and must be substantially improved. Purchased original use assets such as mattresses, linens, furniture, electronic equipment, or other similar tangible property are available for inclusion in the basis of the hotel for purposes of the substantial improvement test because those items are used in the same QOZ as the hotel, are used in the same trade or business as the hotel and improve the functionality of the hotel.

The Final Regulations also provide for the aggregation of multiple buildings for purposes of the substantial improvement requirement. Under this approach, two or more buildings located within a QOZ or a single series of contiguous QOZs can be treated as a single property. Buildings eligible for aggregation include building groups located entirely within a parcel of land described in a single deed and building groups spanning contiguous parcels of land described in separate deeds.

Treasury also responded to comments addressing the “insubstantial improvement exception” provided in the Proposed Regulations which required land purchased by a QOF or QOZB to be improved by more than an insubstantial amount. Commenters requested a bright line test for how much purchased land must be improved by to be treated as being improved by more than an insubstantial amount. Treasury declined to provide a specific percentage threshold but noted that improvements to the land, such as an irrigation system for a farming business or grading of the land with a sufficient nexus to a trade or business of a QOF or QOZB will be regarded as more than an insubstantial amount of improvement.

Notably, the Final Regulations did not provide any approach for the aggregation of multiple non-original use assets purchased as a part of the sale of an existing business (in a non-equity business purchase). In such a scenario, the purchaser would be required to take an asset by asset approach to the substantial improvement requirement in order for the purchased assets to qualify as QOZBP.

Tangible Property in the Process of Being Substantially Improved

Treasury acknowledged that all QOFs and some QOZBs will not be able to utilize the Working Capital Safe Harbor and that flexibility in meeting the requirements of the rules of Section 1400Z-2 would be beneficial to QOFs and such QOZBs. Accordingly, the Final Regulations provide that a QOF or QOZB may treat tangible property that is in the process of being substantially improved as QOZBP during the 30-month substantial improvement period; provided that such QOF or QOZB reasonably expects that such property will be substantially improved (as defined in Section 1400Z-2(d)(2)(D)(ii)) and used in a trade or business located in a QOZ by the end of the 30-month substantial improvement period.

Transactions Between QOZBs
The Proposed Regulations generally provided that the acquisition of a QOF corporation’s assets in a transaction described in Section 381 is not an inclusion event (so long as the acquiring corporation is a QOF within a certain period of time post-acquisition) and that the transfer of a direct or indirect interest in a QOF to a transferee partnership in a transfer pursuant to Section 708 will maintain the tax attributes of such interest (i.e., the transfer will not be an inclusion event). Treasury received comments noting that the Proposed Regulations did not address the merger of a QOZB corporation with another QOZB corporation, or the merger of a QOZB partnership with another QOZB partnership. The Final Regulations address these comments and provide that, in the case of transactions described in Sections 381(a)(2) or 708(b)(2)(A), a successor business will be treated as succeeding to the target business’s original use of and substantial improvements to QOZBP for purposes of Section 1400Z-2(d)(2)(D).

Assets that are transferred outside of Sections 381(a)(2) and 708(b)(2)(A) will not retain their status as qualified assets, because the acquiring entity is not deemed to be a “successor.” The Final Regulations also confirm that a QOF’s stock or partnership interest in the successor QOZB entity will be treated as acquired “solely in exchange for cash” for purposes of Section 1400Z-2(d)(2)(A) and (C). However, the Final Regulations make clear that a successor QOZB entity will not be allowed a new Working Capital Safe Harbor period, as such a result would be inconsistent with treating the entity as a “successor.”

Clarification on Section 1397C Requirements

The Final Regulations clarify that for purposes of a QOZB satisfying the 50% gross income test of Section 1397C(b)(2) (the “50% Gross Income Requirement”), all activities of a trade or business carried out among all QOZs in which the trade or business operates shall count towards the satisfaction of the 50% Gross Income Requirement (emphasis added). With respect to the safe harbor for satisfying the 50% Gross Income Requirement provided in Proposed Regulations II, the Final Regulations clarify that for purposes of the prong of the safe harbor that measures services performed in a QOZ based on hours and amounts paid for services, hours worked by and amounts paid to partners in a partnership for services provided to the partnership’s trade or business should be taken into account (provided that such partner was paid for such services via guaranteed payments (within the meaning of Section 707(c))).

With respect to the location and “use” of intangible property for purposes of the intangible property use test of Section 1397C(b)(4), the Final Regulations provide that intangible property of a QOZB is used in the active conduct of 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 in the QOZ in the performance of an activity of a trade or business that contributes to the generation of gross income for the trade or business.

Active Conduct of a Trade or Business of a QOZB and Triple-Net-Leasing

The Proposed Regulations provided that ownership and operation (including leasing) of real property used in a trade or businesses will be treated as the active conduct of a trade or business, but that merely entering into a triple-net-lease with respect to real property will not be treated as an active trade or business. Numerous commenters suggested revisions that would permit being the lessor of certain triple-net-leases to constitute the active conduct of a trade or business in certain circumstances. Treasury affirmed that merely being the lessor of a triple-net-lease does not constitute the active conduct of a trade or business. However, Treasury acknowledged that, in certain cases, QOZBs that utilize triple-net-leases as part of their leasing business could be treated as conducting an active trade or business. The Final Regulations include an example of an active trade or business which includes the utilization of triple-net leases wherein a lessor who leases one of three floors of a property pursuant to a triple-net-lease but also leases the other two floors under leases that do not constitute triple-net-leases, and the lessor’s employees meaningfully participate in the management and operations of those two floors. As a result, the example provides that the lessor is treated as carrying out an active trade or business with respect to the entire leased building solely for purposes of Section 1400Z-2(d)(3)(A).

Whether other scenarios involving triple-net-leases, including multiple triple-net-leases at a single property, would constitute the active conduct of a trade or business is left unanswered by the Final Regulations. Ultimately, the existence of a trade or business utilizing triple-net-leases will be a facts and circumstances determination.
The Final Regulations attempt to address commenter concerns regarding the application of the Section 162 trade or business standard to start-up businesses by expanding upon the working capital safe harbor provided for in the Proposed Regulations (the “Working Capital Safe Harbor”) with an additional 62-month Working Capital Safe Harbor for start-up businesses. To qualify, a start-up business must get multiple cash infusions — the first of which will allow it to qualify for the original 31-month Working Capital Safe Harbor, and the second of which will allow it to extend the Working Capital Safe Harbor for an additional 31 months (not to exceed 62 months in total, regardless of when the second cash infusion is received); provided that (1) the subsequent cash infusion is independently covered by an additional Working Capital Safe Harbor plan, and (2) such additional Working Capital Safe Harbor plan forms an integral part of the Working Capital Safe Harbor plan that applied to the initial cash infusion.[63] Additionally, the subsequent cash infusion must be more than a de minimis amount. If these requirements are met, then during this maximum 62-month period, Nonqualified Financial Property (as defined in Section 1397C(b)) in excess of the Section 1397C(b) 5% limitation will not cause a trade or business to fail to qualify as a QOZB, and gross income earned from the trade or business will be counted towards satisfying the Section 1397C(b)(2) 50% gross income requirement. In addition, tangible property purchased, leased, or improved by a QOZB with cash covered by the Working Capital Safe Harbor and pursuant to the applicable written plan will count towards satisfaction of the 70% Test, and intangible property purchased or licensed with such cash pursuant to such plan will likewise count towards the satisfaction of the Section 1397C(b)(4) 40% intangible property use test.

Notably, in the Preamble Treasury acknowledges comments requesting the application of Section 1397C safe harbors (including the Working Capital Safe Harbor) to QOFs. Treasury declined to make such safe harbors applicable to QOFs because the statutory text of Section 1400Z-2 supports the application of Section 1397C requirements to only QOZBs and not QOFs.

Adoption of a De Minimus Threshold for Leasing Property to Section 144(c)(6) “Sin Businesses”

The Final Regulations prohibit a QOZB from leasing more than 5% of its property to a Section 144(c)(6) sin business (i.e., any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling or store the principal business of which is the sale of alcoholic beverages for consumption off premises). Treasury also acknowledged that the Section 1400Z-2 does not prohibit a QOF from operating a sin business.

12-Month Reinvestment Period

Commenters submitted several requests to have 12-month reinvestment window for QOFs (as provided in Prop. Reg. §§1.1400Z2(f)-1(b)) (the “12-Month Reinvestment Period”) apply to QOZBs. Treasury acknowledged that a similar safe harbor period for reinvestment at the QOZB level would be beneficial to QOZBs engaged in the sale of assets. However, Treasury stated that the statutory direction to prescribe regulations[64] does not explicitly refer to QOZBs and, accordingly, the Final Regulations do not extend a safe harbor period for reinvestment to a QOZB. Treasury, however, noted that QOZBs may avail themselves of the Working Capital Safe Harbor to enable proceeds from an asset sale to qualify as QOZBP.

Treasury also responded to requests to extend the 12-Month Reinvestment Period if delays to reinvestment are caused by a Federally declared natural disaster. Accordingly, the Final Regulations allow for such an extension up to 24 months, provided that the QOF invest proceeds as originally planned before the disaster.[65] The Preamble provides an example wherein a QOF is unable to invest in a piece of QOZBP because the property is located in a federal declared disaster area and the QOF, under the extended 24-Month Reinvestment Period, reinvests the proceeds. The example states that the QOF must invest the proceeds in similar property located in the same QOZ.

Application of Anti-Abuse Rule to Land Banking
Treasury responded to comments requesting clarity regarding the Proposed Regulations prohibition on land banking by providing two examples of the application of the general anti-abuse rule of Prop. Reg. §§1.1400Z2(f)-1(c) (the “Anti-Abuse Rule”) to two land banking scenarios discussed by commenters. In the first, a taxpayer establishes a parking lot business on land located within a QOZ. The taxpayer builds a small structure on the lot to house a parking lot attendant and otherwise leaves the lot vacant land. Treasury stated that because a significant purpose for the acquisition of the land is to hold the land for speculative investment, the Anti-Abuse Rule functions to recharacterize the transaction so that the taxpayer is not eligible for the benefits of Section 1400Z-2. In the second example, a taxpayer acquires farmland and repurposes it for a different business activity (i.e., something other than farming) and makes a significant investment of capital and labor into that new business. Treasury noted that the taxpayer’s investment of capital and labor tends to show that land is being used to develop an operating business in the QOZ rather than merely be held primarily to receive the benefit of the appreciation of the land. Accordingly, the taxpayer’s acquisition of the farmland would be eligible for the benefits of Section 1400Z-2.

Consolidated Return Rules

The Proposed Regulations acknowledged that the framework of the qualified opportunity zone regime and the consolidated return regulations are incompatible in many respects and instead of trying to forcibly harmonize the two frameworks, the Proposed Regulations elected to treat stock in a QOF corporation as not stock for purposes of determining affiliation under the consolidated return rules. Accordingly, under the Proposed Regulations, a QOF corporation could be the common parent of a consolidated group but could not be a subsidiary member of a consolidated group. In response to comments to the Proposed Regulations, the Final Regulations depart from the position in the Proposed Regulations and allow a QOF classified as a corporation to be a subsidiary member of a consolidated group as long as the consolidated group member that makes the investment in the QOF corporation (the “Investor Member”) (i) maintains a direct equity investment in the QOF corporation and (ii) is wholly owned, directly or indirectly, by the common parent of the consolidated group.[66] Failure to satisfy either of the foregoing conditions will result in the deconsolidation of the QOF corporation.

The Final Regulations provide that upon deconsolidation of a QOF corporation, the deconsolidation is deemed to be a disposition for purposes of the excess loss account (“ELA”) rules and any ELA for the deconsolidated QOF corporation must be included in the income of the Investor Member if the deconsolidation event constitutes an inclusion event. The Final Regulations also require that the Investor Member take into account its ELA for the QOF corporation before its basis in the QOF corporation stock is adjusted to fair market value under Section 1400Z-2(c).

Under the Proposed Regulations, the member of the consolidated group that realized the eligible gain also had to be the consolidated group member that invested in the QOF in order for the gain to qualify for deferral. Under the Final Regulations, investment in a QOF is not limited to the consolidated group member that realized the capital gain, the investment in the QOF can be made by any of the other consolidated group members and the gain can qualify for deferral if the consolidated group so elects.

Effective/Applicability Dates
The Final Regulations are generally applicable for taxable years beginning 60 days after the Final Regulations are published in the Federal Registrar. The Final Regulations will be published in the Federal Registrar on January 13, 2020, giving them an effective date of March 13, 2020 (the “Final Regulations Effective Date”). Calendar-year taxpayers will mandatorily be subject to the Final Regulations for taxable years beginning on or after January 1, 2021. However, for (i) the post-December 22, 2017 portion of any tax year that straddles December 22, 2017 and (ii) taxable years beginning after December 21, 2017 (up until the Final Regulations Effective Date) taxpayers may choose to either (1) apply the Final Regulations or (2) to rely on the Proposed Regulations (excluding §1.1400Z2(c)-1), in each case only if the chosen set of regulations are applied in their entirety and in a consistent manner for all relevant taxable years. Taxpayers relying on the Proposed Regulations are required to apply §1.1400Z2(c)-1 of the Final Regulations (governing the election to exclude from gross income gains and losses from the disposition of property held by a QOF) for any elections made under section 1400Z-2(c).

In sum, for pre-2021 tax years, taxpayers may choose to rely on the Final Regulations in their entirety for prior years or may instead choose to rely on the Proposed Regulations until the Final Regulations Effective Date. In either case, taxpayers must consistently apply the chosen regulations.

If you have any questions or comments about the foregoing summary of the Final Regulations, please contact Gene Crick, Sabrina Conyers, Samantha Dangelo, Kay Gordon, Chip Gray, Wells Hall, Drew Hermiller, Maurice Holloway, Erin Reeves McGinnis, or Will Richmond who have contributed to the preparation of this Report, or any other member of the Nelson Mullins Opportunity Zone Practice Group.
[1] T.D. 9889, Reg. §§1.1400Z2(a)-1, 1.1400Z2(b)-1, 1.1400Z2(c)-1, 1.1400Z2(d)-1, 1.1400Z2(d)-2, 1.1400Z2(f)-1, 1.1502-14Z, and 1.1504-3
[8] Id.
[16] The Final Regulations refer to a qualifying investment in a QOF as a “section 1400Z-2(a)(1)(A) investment.” The term “QOF” investment” is used in this Tax Report for the convenience of the reader.
[17] The term “mixed-fund investment” is defined in Reg. §1.1400Z2-2(a)(15) as “an investment a portion of which is a qualifying investment and a portion of which is a non-qualifying investment.”
[18] Section 1400Z-2(e)(1).
[19] The Final Regulations further provide that where there is a transfer to a corporation of built-in loss property which is subject to Section 362(e)(2), the taxpayer is deemed to have made an election under Section 362(e)(2)(C), resulting in the adjustment of the transferor’s basis in the stock received for property so that it does not exceed the fair market value of the property transferred. Reg. §1.1400Z2-2(1)(c)(6)(B)(3).
[21] Section 1400Z-2(e)(1)(A)(i). In both cases, the Final Regulations provide that the taxpayer’s basis in the QOF subject to the QOF Mixed-Fund Rules is determined without regard to the QOF deferral and basis adjustment provisions of Section 1400Z-2(b)(2)(B).
[22] For these purposes, net basis is defined as the excess, if any, of the adjusted basis of the property contributed to the partnership, over the amount of any debt to which the property is subject or that is assumed by the partnership in the transaction. Net value is the excess of the gross fair market value of the property contributed, over the amount of the debt assumed. Reg. §1.1400Z2-2(a)(1)(c)(6)(iii).
[23] The Final Regulations provide for basis adjustments for debt allocable to the partner under Reg. §1.1400Z2-2(a)-1(c)(6)(iv)(B).
[26] Reg. §1.1400Z2(a)-1(f).
[27] Reg. §1.1400Z2(a)-1(c)(3).
[28] Id.
[29] Reg. §1.1400Z2(a)-1(c)(4).
[31] Reg. §1.1400Z2(b)-1(c)(5)(ii).
[32] Id
[33] Reg. §1.1400Z2(b)-1(c)(7)(i)(A).
[34] Reg. §1.1400Z2(b)-1(c)(7)(i)(B), (C).
[37] Section 897(e) and Reg. §1.897-6T.
[38] Reg. §1.1400Z2(a)-1(b)(2).
[40] Id.
[41] Reg. §1.1400Z2(c)-1(b)(3).
[51] Reg. §1.1400Z2(d)-2(b)(1).
[53] Reg. §1.1400Z2(d)-2(c)(3).
[56] Reg. § 1.1400Z2(d)-2(b)(4).
[57] Reg. § 1.1400Z2(d)-2(b)(4)(iii).
[58] Reg. § 1.1400Z2(d)-2(b)(4).
[59] Reg. § 1.1400Z2(b)-1(a)(10).
[60] Reg. § 1.1400Z2(d)-1(d)(3).
[61] Id.
[64] Section 1400Z-2(E)(4)(B).
[65] Reg. § 1.1400Z2(f)-1(b)(2).

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