A new path forward

Summary and observations on the proposed Qualified Opportunity Zone regulations published in the Federal Register on May 1, 2019

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Second Round of Proposed IRS/Treasury Regulations Provides Investor Confidence to Make Investments in Qualified Opportunity Zones

The IRS and Treasury Department recently issued the much-anticipated second round of Opportunity Zone guidance in the form of proposed regulations[1] implementing the new Opportunity Zone provisions under the 2017 Tax Cuts and Jobs Act.[2]

The statutory Opportunity Zone regime allows the deferral of all or part of a 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 29, 2018, the IRS and Treasury Department published in the Federal Register a first set of proposed regulations ("existing regulations"), which provided basic rules such as the definition of an eligible taxpayer, eligible gains, QOF self-certification, special rules for qualified Opportunity Zone business assets, and the deployment of funds to acquire and improve property in an Opportunity Zone.[3]

A second set of proposed regulations, published in the Federal Register on May 1, 2019, ("new regulations") provides clarity on the interaction of the subchapter K partnership rules, workable strategies for the exit/unwind of an investment from a QOF, the treatment of land including the definition of "original use," and further clarification on the Qualified Opportunity Zone Business (QOZB) requirements.

While the Opportunity Zone statute and the existing regulations provide an overall structure for the program and answer some basic questions, investors and those interested in developing zone-based businesses have been awaiting more detailed guidance. The new regulations appear to answer many (though certainly not all) of the questions taxpayers have been asking, and provide some welcome flexibility to investors and businesses that want to take advantage of the Opportunity Zone incentives.

This article summarizes the IRS and the Treasury guidance and offers KPMG observations as to how these rules may be applied in capital formation, organizing, investing in, operating, and exiting QOFs.

Opportunity Zone Investment Benefits

Under the Opportunity Zone provisions, including the existing regulations, 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.[4] The QOF then must invest in Qualified Opportunity Zone (QOZ) property. QOZ property includes QOZ stock, a QOZ partnership interest, and QOZ business property.

There are designated QOZs in all 50 states, US territories including American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands, and the District of Columbia.[5]

A taxpayer's gains that are invested in a QOF are deferred until the earlier of the date that: (i) the taxpayer sells or

1. Proposed regulations under section 1400Z-2 of the Code that would amend the Income Tax Regulations (26 CFR Part 1). Section 13823 of the Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054, 2184 (2017) (TCJA).
2. Section 1400Z, H. R. 1-115th Congress (2017-2018).
3. For the summary of the first set of the proposed regulations, refer to *KPMG Report: New Rules for Opportunity Zones*. (October 2018).
4. Note that the sale or exchange must be with an unrelated third party (relationship tested under sections 267(b) and 707(b)(1) (percentage reduced to greater than 20%).
5. A complete list of designated qualified Opportunity Zones is found in Notice 2018-48, 2018-28 I.R.B. 9. See discussion below regarding the treatment of Indian Tribal Lands.

exchanges its interest in the QOF or (ii) December 31, 2026. Once the gain is triggered, the amount included in income 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 exclusion of up to 15% of its initially invested gains.[6]

The partial exclusion 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,[7] the basis of the investment is increased by 10% of the deferred gain. If the QOF investment is held for 7 years,[8] the basis of the investment is increased by an additional 5% of the deferred gain for a total of a 15% basis increase.[9]

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 New Regulations

The new regulations are separated into seven sections, Prop. Treas. Reg. sections 1.1400Z2-1(a) through 1.1400Z2-1(g). In this article, we discuss how the rules contained in the new regulations may be applied through the lifecycle of the QOZ investment, including the following key stages:

A. Investing Capital Gains into QOFs;

B. Organizing, Structuring, and Basis Issues Related to the Investment in the QOF;

C. Investing in the QOZ by the QOF;

D. Operating within the QOZ;

E. Exiting the QOF; and

F. Additional Guidance.

A. Investing Capital Gains into QOFs

1. Treatment of Section 1231 Gains as Eligible Gains –

The existing regulations provided that gain is eligible for deferral via QOF investment if it is *treated* as a capital gain for Federal income tax purposes, including capital gain from an actual, or deemed, sale or exchange, or any other gain that is required to be included in a taxpayer's computation of capital gain. As such, each short term and long term capital gain under section 1221 qualifies.[10] The existing regulations, however, did not address the treatment of section 1231 gains as eligible gains.

The new regulations specifically address this issue and provide that the only gain arising from section 1231 property that is an eligible gain is *capital gain net income* for a tax year. This net amount is determined by taking into account all the section 1231 gains and section 1231 losses during a tax year on all of the taxpayer's section 1231 property. Additionally, the 180-day period to reinvest into a QOF with respect to the capital gain net income from section 1231 property for a tax year begins on the last day of the taxpayer's tax year, not when properties are sold.[11]

Observation 1: *While not specifically addressed in the new regulations, the reference to taxpayer for purposes of the special rule regarding the 180-day period to roll over capital gain net income from section 1231 property appears to indicate that a partnership and an S corporation may be treated as a taxpayer for this purpose.*

Observation 2: *The fact that a portion of the net section 1231 gain may be treated as unrecaptured section 1250 gain under section 1(h) should not change this eligible gain treatment, as the unrecaptured section 1250 gain is taxed as capital gain but at a higher (25%) tax rate.*

Observation 3: *While these rules relating to section 1231 gains are generally favorable in permitting section 1231 gains to qualify, the IRS could have allowed more flexibility for a netting rule to determine if the section 1231 gains were treated as capital gains but allowed the deferral election to start at the end of the tax year OR when the property was sold.*

6. 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 deferred gain.
7. Assuming that gains rolled into a 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.
8. Assuming that gains rolled into a QOF are triggered December 31, 2026, a taxpayer would need to make a QOF investment by the end of 2019 in order to benefit from this 7-year basis step-up.
9. Section 1400Z-2(b)(2)(B).
10. See Prop. Treas. Reg. §1.1400Z2(a)-1(b)(2).
11. See Prop. Treas. Reg. §1.1400Z2(a)-1(b)(2)(iii).

Observation 4: *This netting rule does not appear to take into account section 1231(c), related to recapture of section 1231 losses from prior years. If this is the case, section 1231 losses from prior years would not impact the current year net 1231 gains that are eligible gains to be invested.*

2. **Purchase of an Eligible Interest from an Existing QOF Owner (Secondary Acquisitions) –**

The new regulations provide that a taxpayer can qualify for the tax benefits of the QOZ regime by purchasing an eligible interest from an existing owner of a QOF. An eligible interest in a QOF is an equity interest issued by a QOF, including common stock, preferred stock, and different types of partnership interests, including those with special allocations.[12] If an eligible interest is purchased from an existing QOF owner, the amount of the purchaser's qualifying investment is equal to the amount of cash and the fair market value (FMV) of any other property exchanged for the eligible interest.[13]

Observation 1: *It appears that an eligible interest that is not a qualifying investment (e.g., an interest acquired in exchange for something other than rolled-over capital gains) can become a qualifying investment in the hands of a purchaser if the purchaser acquires the eligible interest in exchange for rolled-over capital gains.*

Observation 2: *Although it is not clear that the IRS and the Treasury intended this restriction, one reading of this rule may be that the fund may have to have elected QOF status effective prior to the issuance of the interest in order for the interest to be an eligible interest.*

3. **Effect of Debt on QOF Investment Eligibility –**

Under the existing regulations, the status of a QOF investment as an eligible interest is not impaired by the taxpayer's use of the interest as collateral for a loan, whether a purchase-money borrowing or otherwise, and deemed contributions of money under section 752(a) do not result in the creation of an investment in a QOF.[14] However, the existing regulations did not address the extent to which distributions from a QOF partnership may affect the taxpayer's equity interest in its qualifying investment in the QOF (*i.e.,* may cause an inclusion of deferred capital gains or other potential consequences as discussed further herein).

The new regulations provide that a taxpayer's equity interest in its qualifying investment is reduced to the extent the partnership makes a distribution to the partner and the transfer to the partnership and the distribution by the partnership would be recharacterized as a disguised sale under section 707(a)(2)(B) if (i) any cash contributed were non-cash property, and (ii) in the case of a debt-financed distribution by the partnership (to which Treas. Reg. §1.707-5(b) applies), the partner's share of the liability is zero.[15]

Observation 1: *QOFs may be able to replace equity with debt outside of the disguised sale rules under section 707(a)(2)(B).*

Observation 2: *The new regulations do not address the extent to which distributions within the disguised sale presumption period for reimbursements of preformation expenditures, operating cash flow distributions, and reasonable preferred return/guaranteed payments may reduce a taxpayer's equity interest in its qualifying investment. While it appears that those distributions may not cause a disguised sale under this rule, the partner may not have sufficient tax basis to avoid gain recognition on the distribution.*

4. **Treatment of Profits Interests for Services and Noncash Contributions –**

QOZ benefits are available for those partners that contribute capital in the form of cash and tax basis in non-cash assets and receive a return from that capital. To the extent that the fair market value of the non-cash asset exceeds its tax basis, that portion of the interest is not a qualifying investment. If a taxpayer receives an equity interest in a QOF for services rendered to the QOF or to a person in which the QOF holds any direct or indirect equity interest, then the interest in the QOF that the taxpayer receives is not an eligible interest. To the extent the taxpayer receives an equity interest in the QOF in exchange for property, including cash, with respect to an eligible gain, and also receives a non-eligible interest described above, the total investment would be treated as a mixed-fund investment.[16] While the new regulations provide some guidance on bifurcating the allocation percentage for each separate investment, exactly how the IRS is going to measure the extent to which an interest is received for services is not clear.[17]

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12. See Prop. Treas. Reg. §1.1400Z2(a)-1(b)(3).
13. See Prop. Treas. Reg. §1.1400Z2(a)-1(b)(9)(iii).
14. See Prop. Treas. Reg. §1.1400Z2(a)-1(b)(3)(ii) and (iii). See also Prop. Treas. Reg. §1.1400Z2(e)-1(a)(2).
15. See Prop. Treas. Reg. §1.1400Z2(a)-1(b)(10)(ii)(A)(2).
16. The term "mixed-funds investment" means an investment a portion of which is a qualifying investment and a portion of which is a non-qualifying investment.
17. See generally Prop. Treas. Reg. §1.1400Z2(a)-1(b)(10)(ii) for special rules for the treatment of various situation when cash and other property is transferred to a QOF partnership.See Prop. Treas. Reg. §1.1400Z2(a)-1(b)(9)(ii).

Observation 1: *Taxpayers should consider holding any profits interest received for services separate from other interests. This is because the new regulations apply special rules in calculating the allocation percentage to partners who receive profits interests for services, with the percent attributable to the profits interest being treated as a non-qualifying investment to the extent of the highest percentage interest in residual profits attributable to the interest.*[18]

Observation 2: *It is not clear in what situations it will be beneficial for an investor to contribute non-cash property to a QOF because QOFs cannot further contribute non-cash property to QOZBs (under the QOZ statute, only transfers of cash to a QOZB result in qualifying investments).*

B. Organizing, Structuring, and Basis Issues Related to Investment in a QOF

1. Basis Adjustment under Section 1400Z-2 (other than the 10 year rule)

The new regulations contain special rules regarding the timing of basis adjustments and provide special rules for QOFs taxed as partnerships and S corporations.[19] In particular, for QOF partnerships, basis adjustments for a qualifying interest are treated as an item of income described in section 705(a)(1) and are allocated to the owners of any upper-tier partnership that directly or indirectly own an eligible interest. Those basis adjustments track to the eligible taxpayer's interest in the upper-tier partnership, based on the taxpayer's share of remaining deferred gain to which the basis adjustment amount relates.[20] QOF S corporations have less favorable rules in that the basis adjustment does not flow up to the S corporation shareholder to adjust its basis in the S corporation until the date of an inclusion event.[21]

2. Notifications by Partners and Partnerships, and Shareholders and S Corporations –

The new regulations require a partnership making a deferral election to notify all of its partners of such election and state each partner's share of the eligible gain. A partner making a deferral election must notify the partnership in writing of its deferral election including the amount of the eligible gain deferred.

Additionally, if an upper-tier partnership sells a portion of its partnership interest in a transaction that is treated as an inclusion event, the indirect owner must provide the QOF owner notification and information sufficient to enable the QOF owner, in a timely manner, to recognize an appropriate amount of deferred gain.

Notification is also required in the case of an election made by a QOF partner to adjust the basis of its interest to fair market value under the 10-year basis adjustment rule.

Similar notification rules apply to S corporations and their shareholders.[22]

3. Transfers of QOF Interests in Certain Non-recognition Transactions –

The new regulations address the consequences of the QOF interest holder transferring its interest in a section 721(a) transaction, or receiving an interest pursuant to a partnership or corporate merger or other corporate nontaxable reorganization.[23]

Specifically, a contribution by a QOF owner of its direct or indirect partnership interest in a qualifying investment to a partnership in a section 721(a) transaction is not an event that requires the QOF owner to include any of the deferred gain in income (referred to as an "inclusion event" as further discussed herein), provided the interest transfer does not cause a termination of the QOF partnership, or the direct or indirect owner of a QOF, under section 708(b)(1).[24] See discussion of how to structure an aggregator entity below.

In addition, a merger or consolidation of a partnership holding a direct or indirect interest in a qualifying investment does not result in an inclusion event except for the portion of the transaction that is otherwise treated as a sale or exchange.

Observation 1: *While the new regulations provide that partnerships holding qualifying investments in QOFs may merge without causing an inclusion event, they do not address whether partnership QOFs may merge without causing an inclusion event.*

Observation 2: *Partnership QOF divisions are also not addressed in the new regulations, but certain corporate QOF divisions are addressed, and can be done without causing an inclusion event.*

18. See Prop. Treas. Reg. §1.1400Z2(a)-1(c)(6)(iv)(D).
19. See Prop. Treas. Reg. §1.1400Z2(b)-1(g).
20. See Prop. Treas. Reg. §1.1400Z2(b)-1(g)(3).
21. See Prop. Treas. Reg. §1.1400Z2(b)-1(g)(4)(i).
22. The notification rules are contained in See Prop. Treas. Reg. §1.1400Z2(b)-1(h).
23. See Prop. Treas. Reg. §1.1400Z2(b)-1(c)(6)(ii).Distributions from a QOF to its partners generally are treated as inclusion events.See Prop. Treas. Reg. §1.1400Z2(b)-1(c)(6)(iii).
24. See Prop. Treas. Reg. §1.1400Z2(b)-(1)(6)(ii)(B) and (C).

4. **Contributing QOF Interests to an Upper-Tier Partnership (*e.g.*, Aggregator Entity) –**

The new regulations do not permit an eligible taxpayer to contribute rollover dollars to a non-QOF (*e.g.*, an aggregator or feeder entity) for further contribution to a QOF and have the contribution be treated as a qualifying investment. However, an eligible taxpayer that contributes rollover dollars to a QOF is permitted under the new regulations to contribute its interest in the QOF to an upper-tier partnership that is not a QOF. In such a circumstance, the upper-tier partnership that owns the interest in the QOF becomes subject to the QOZ rules with respect to the eligible gain associated with the contributed qualifying investment. That partnership must allocate and report the gain that is associated with the contributed qualifying investment to the contributing partner to the same extent that the gain would have been allocated and reported to the contributing partner in the absence of the contribution.[25]

Observation 1: *Care needs to be taken to ensure the proper sequencing of the two transactions (i.e., the transfer to the QOF followed by the transfer of the QOF interest to the upper-tier entity), as the taxpayer will lose its QOF benefits if such sequencing is not respected. By sequencing events properly, an owner of multiple QOFs can reduce the number of Schedule K-1's it receives to one by contributing those QOF interests to an upper-tier partnership.*

Observation 2: *If the partner in the upper-tier entity sells its interest in that entity, it is unclear whether the partner will get the same treatment as selling a direct interest in the QOF.*

5. **Debt-Financed and Other Distributions From QOF Partnerships –**

The new regulations generally allow debt-financed distributions (subject to the rules discussed above related to the disguised sale rules) provided that the amount distributed does not exceed a partner's basis in its partnership interest.[26]

The new regulations also allow for distributions of cash or other property from a QOF partnership to a partner without triggering an inclusion event, provided the amount of cash and the FMV of the property distributed does not exceed the partner's basis in its partnership interest.[27]

Observation 1: *In the real estate industry, investors may receive distributions of cash or other property from a QOF partnership once a new building is completed (subject to the restrictions related to the disguised sale rules discussed above), while maintaining their original QOF tax benefits.*

6. **Tiered Partnerships –**

The new regulations do not specifically address whether eligible gains can flow up through tiers to the ultimate taxpayer or be used anywhere along the line by an upper-tier partnership. It may be that the IRS thought it was clear enough from the existing regulations. As further support, see discussion above for tiering up investments in QOFs through a section 721(a) transaction.

7. **QOF Sale of QOZ Property during 10 Year Holding Period –**

If a QOF makes a sale of QOZ property during the 10-year holding period, the new regulations provide for a 12-month reinvestment period so that the proceeds can be rolled into other QOZ property without the proceeds (during the 12-month period) being treated as non-QOZ property and causing the QOF to fail the 90-Percent asset test (as defined below). The new regulations require that the proceeds are held as short-term investments (*e.g.*, working capital) in the interim.[28] A delay in reinvesting due to waiting for governmental action pauses the 12-month period. Note that similar rules do *not* apply to QOZBs with respect to their assets, although comments have been requested to expand these rules to QOZBs.

Observation 1: *The new regulations do* ***not*** *exempt the recognition of income or loss by the QOF or its owners on the disposition of the QOZ property during the initial 10-year holding period.*

Observation 2: *It may be possible for an investor in a QOF to defer the recognition of gain from a QOF's sale of property during the 10-year holding period by investing such gain (assuming it is treated as capital gain) in another QOF.*

Observation 3: *For real estate investments, it appears that the QOF may utilize a section 1031 transaction to avoid recognizing gain on the exchange of QOZ business property.*

25. See Prop. Treas. Reg. §1.1400Z2(b)-1(c)(6)(ii)(B).
26. See Prop. Treas. Reg. §1.1400Z2(a)-1(c)(6)(iii).
27. See discussion above for distributions that would trigger a disguised sale based on certain modifications to those rules.
28. See Prop. Treas. Reg. §1.1400Z2(f)-1(b).

C. Investing by the QOF in QOZ Property

As background, for an entity to be treated as a QOF, the entity must meet certain requirements. It must –

— Self-certify as a QOF;

— Be organized (*i.e.*, taxed) as a corporation or a partnership; and

— Invest and hold at least 90 percent of its assets in QOZ property determined by the average of the percentage of QOZ property held in the QOF as measured as of the first 6-month period and on the last day of the QOF's taxable year (90-Percent asset test).

Additionally, QOZ property includes QOZ business property. Property is QOZ business property if it is tangible property used in a trade or business and:

— The property was acquired by purchase after December 31, 2017;

— The original use in the QOZ commenced with the taxpayer or the taxpayer substantially improves the property; and

— During substantially all (as defined below) of the taxpayer's holding period, substantially all (as defined below) of the use of such property was in a designated QOZ.[29]

1. 90-Percent and 70-Percent Asset Test Valuation Methods –

The new regulations modify the existing regulations and allow QOFs and QOZBs to choose between two valuation methods if they have applicable financial statements: (1) the financial statement valuation method, or (2) an alternative valuation method.[30] The new regulations require that, during each tax year, the valuation method selected must be applied consistently to all tangible property valued with respect to the tax year.[31]

Financial statement valuation method – Under this method, the value of each asset that is owned or leased by the QOF or QOZB is the value of that asset as reported on the applicable financial statement for the relevant reporting period. The entity may select this method only if the applicable financial statement is prepared in accordance with GAAP and requires an assignment of value to the lease of the asset.[32]

Alternative valuation method – Under this method, assets owned by the QOF are treated as having a value equal to their unadjusted cost bases under section 1012, and assets leased by the QOF or QOZB as having a value equal to the present value of the payments under the lease discounted by using the AFR (similar to debt instruments), as determined at the inception of the lease. For this purpose, the term of a lease includes lessee extensions at a pre-defined rent.[33]

Observation 1: *This rule now gives QOFs and QOZBs with financial statements a choice of methods to use in valuing their assets for qualification purposes for a tax year. While the Alternative Valuation Method may be disadvantageous in that it does not account for depreciation of the basis of the assets, the Financial Statement Valuation Method may be even more disadvantageous when it uses fair value accounting, which would market to market all assets to fair value.*

Observation 2: *It appears clear that a QOF or QOZB with financial statements must apply a consistent valuation method to its assets for a tax year, but may apply a different valuation method to its assets for each tax year. Note also that the new regulations provides that if two or more QOFs own an equity interest in a QOZB and at least one of the QOFs is a Five-Percent Zone Taxpayer, then the QOZB's assets may be calculated using the methodology of the Five-Percent-Zone Taxpayer and produces the highest percentage of QOZ business property for the QOZB. A Five-Percent Zone Taxpayer is a taxpayer that has self-certified as a QOF and that holds stock in the entity (if it is a corporation) representing at least 5 percent in voting rights and value or holds an interest of at least 5 percent in the profits and capital of the entity (if it is a partnership).*

2. 90-Percent Asset Test Penalty Exceptions –

The new regulations provide relief for contributions to a QOF within 6 months of a testing date. Under these regulations, a QOF may choose to determine compliance with the 90-Percent asset test on any testing date without regard to recent capital contributions received by the QOF, if the following requirements are met –

— The amounts received by the QOF are solely in exchange for an interest in the QOF;

— The exchange occurred not more than 6 months before the testing date; and

— Between the date of that exchange and the testing date, the amount was held in certain short-term investments.[34]

29. Section 1400Z-2(d)(3)(A).
30. See Prop. Treas. Reg. §§1.1400Z2(d)-1(b)(1) and -1(d)(3)(ii)(B).
31. See Prop. Treas. Reg. §1.1400Z2(d)-1(d)(3)(ii)(B)(1).
32. See Prop. Treas. Reg. §§1.1400Z2(d)-1(b)(2) and -1(d)(3)(ii)(B)(2).
33. See Prop. Treas. Reg. §§1.1400Z2(d)-1(b)(3) and -1(d)(3)(ii)(B)(3).
34. See Prop. Treas. Reg. §1.1400Z2(d)-1(b)(4).

Observation 1: *This rule allows QOFs greater time to satisfy the 90-Percent asset test when, for example, rollover gains are contributed close to a testing date and the QOF has not identified a qualifying investment. The flexibility provided by this rule should be helpful for QOFs that require capital calls and for multi-asset QOFs.*

Observation 2: *This rule can also be used in conjunction with the 31-month working capital rule for QOZBs (as discussed below).*

3. Definition of "Original Use" –

Under the statute, QOZ business property means any tangible property used in a trade or business in which (i) the "original use" in the QOZ commenced with the taxpayer or (ii) the taxpayer substantially improved the property.[35]

The new regulations provide that, for purchased tangible property, the original use commences on the date any person first places the property in service in the QOZ for depreciation or amortization purposes (or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner).[36] Thus for acquisitions of partially completed buildings, the original use would appear to commence when the purchaser completes the building and places the building into service for depreciation purposes. In addition, the new regulations provide guidance with respect to original use on several situations that the existing regulations did not address:[37]

- For property that has been unused or vacant for an uninterrupted period of at least 5 years, original use commences on the date after that period when any person first so uses or places in service the property in a QOZ.
- For used property that has never been used or placed in service in a QOZ before its purchase, original use commences when it is used or placed in service in the QOZ. Otherwise, used property that has previously been used in the QOZ must be substantially improved.
- Improvements made by a lessee to leased property satisfy the original use test as purchased property for the amount of the unadjusted cost basis under section 1012 of such improvements.[38]

Observation 1: *The definition of original use described above permits development projects to be qualifying QOZ business property without respect to the 30-month timeframe for substantial improvement.*

4. Holding and Use periods for determining "Substantially all" Tests for QOZ business property –

The existing regulations permit tangible property acquired after December 31, 2017, to qualify as QOZ business property if during substantially all of the holding period of the property, substantially all of the use of the property was in a qualified Opportunity Zone.

While "substantially all" is defined under the existing regulations as at least 70-percent for determining whether substantially all of the tangible property owned or leased by a taxpayer is QOZ business property,[39] other areas where "substantially all" was used in the statue were not addressed. The new regulations clarify the "substantially all" requirements for (i) the holding period and (ii) the use of the tangible business property as follows:

- For use of the property, at least 70 percent of the property must be used in a QOZ.[40]
- For determining substantially all of the QOF's or QOZB's holding period of the tangible property, such property must be held for at least 90 percent of the QOF's or QOZB's holding period.[41]
- For the holding period of a QOZB owned by a QOF, such entity must be a QOZB for at least 90 percent of the QOF's holding period.[42]

5. Requirement for Leased Property to be QOZ business property –

Under the statute, Opportunity Zone property must be "purchased" within the meaning of section 179(d)(2) to qualify as QOZ business property. However, the statute does not address how to treat leased property, other than referring to tangible property owned or leased in the tangible asset test for the QOZB.[43]
The new regulations provide special rules in lieu of the purchase requirement for leases to qualify as QOZ

35. Section 1400Z2(d)(3)(A).
36. See Prop. Treas. Reg. §1.1400Z2(d)-1(c)(7)(i).
37. See *id*.
38. See Prop. Treas. Reg. §1.1400Z2(d)-1(c)(7)(ii).
39. See Prop. Treas. Reg. §1.1400Z2(d)-1(d)(2) and (3).
40. See Prop. Treas. Reg. §1.1400Z2(d)-1(d)(2)(iv).
41. See Prop. Treas. Reg. §§1.1400Z2(d)-1(c)(5) and -1(d)(2)(iii).
42. See Prop. Treas. Reg. §1.1400Z2(d)-1(c)(5).
43. Section 1400Z-2(d)(3)(A).

business property. The proposed regulations provide that leased property is QOZ business property if the following requirements are met:

— The lease is entered into after December 31, 2017.

— Terms of the lease are market rate at the time the lease was entered into.

— If the lease is between related parties,[44] (i) the lease cannot contain a prepayment of more than 12 months, and (ii) if the original use of leased tangible personal property does not commence with the lessee, the lessee, in addition to its leased property, must acquire tangible QOZ business property of value at least equal to the value of the related-party leased tangible personal property (such property must be acquired during the relevant testing period – generally the earlier of 30 months after the date the lessee receives possession of the leased property or the last day of the lease term). In addition, there must be a substantial overlap of the QOZ(s) in which the acquired property and the leased property is used.

  – For purposes of these related-party lease requirements, the original use of leased property in a QOZ commences on the date any person first places the leased property in service in the QOZ for depreciation purposes (applying the same general original use rules with respect to first use and vacant purchased property). In addition, used tangible property satisfies the original use requirement if the property has not been previously used or placed in service in the QOZ.

The new regulations contain an anti-abuse rule regarding leased property to prevent the use of leases to circumvent the substantial improvement requirements (which do not apply to leased property). The rule provides that, in the case of real property (other than unimproved land), leased by a QOF or QOZB, there cannot be a plan, intent, or expectation that the QOF or QOZB would purchase the property for other than FMV determined at the time of purchase, without regard to any prior lease payments. A violation of this rule results in the leased property not being considered QOZ business property at any time.

Observation 1: *These rules permit holders of assets in QOZs prior to January 1, 2018, to have their assets qualify as good QOZ business property by leasing the property to a QOF or QOZB. Also, leased tangible property does not need to be acquired from a lessor that is unrelated to the QOF or the QOZB that is the lessee under the lease.*[45]

Observation 2: *For existing leases, taxpayers may apply these rules for an otherwise qualifying lease entered into after December 31, 2017, and prior to finalization of the regulations. However, reliance is conditioned on taxpayers applying this section of the new regulations in their entirety.*

Observation 3: *Note that fixed price purchase options at a value estimated to be the FMV at the time of purchase would not appear to qualify.*

Observation 4: *An owner of land in a QOZ may achieve its business goals by entering into a long-term lease with an unrelated party. It appears that any prepayment treated as a loan under section 467 may be treated as non-qualified financial property.*

Observation 5: *Taxpayers should not assume that a lease can have a zero value for testing purposes.*

6. Active Conduct of a Trade or Business for QOZ business property – Real Property and Triple Net Leased Property –

The new regulations provide that the ownership and operation (including leasing) of real property is the active conduct of a trade or business. However, merely entering into a triple net lease of property is not the active conduct of a trade or business for QOZB purposes.

Observation 1: *Leases should be reviewed to determine whether the terms of the lease would be considered triple net leases under current law and, therefore, not be considered the active conduct of a trade or business.*

Observation 2: *At the QOF level, it appears that a trade or business does not have to be actively conducted to qualify. For this purpose, trade or business, is defined under section 162. This raises the question whether a "mere triple net lease" can be transacted as the QOF level, instead of at the QOZB level. Note that, if a triple net lease can be transacted at the QOF level, the amount of non-qualifying assets at the QOF level is limited to 10 percent of the QOF's total assets.*

7. Treatment of Land –

Under the existing regulations and other guidance, a building located on land within a QOZ is treated as substantially improved within the meaning of section 1400Z-2(d)(2)(D)(ii) if, during any 30-month period beginning after the date of acquisition of the building, additions to the taxpayer's basis in the *building* exceed an amount equal to the taxpayer's adjusted basis of the building at the beginning of such 30-month period. Further, the fact that the cost of the land

44. For the definition of related party, see Section 1400Z-2(e)(2).

45. Note that the unrelated third party test is determined under sections 267(b) or 707(b)(1) (percentage reduced to greater than 20%).

within the QOZ upon which the building is located is *not* included in the taxpayer's adjusted basis in the building does not mean that the taxpayer is required to separately substantially improve such land for it to qualify as QOZ Business Property.[46]

This guidance, however, raised many questions by commentators. One of the main issues on which guidance was requested was how an acquired interest in land will be treated for purposes of applying the 90-Percent and 70-Percent asset tests and the "substantial improvement" requirement.

The new regulations provide that unimproved land within a QOZ that is acquired by purchase is not required to be substantially improved.[47] However, as indicated above, if the land is unimproved or minimally improved and the QOF or the QOZB purchases the land with an expectation, an intention, or a view not to improve the land by more than an insubstantial amount within 30 months after the date of purchase, then the land is not QOZ business property.

The new regulations measure substantial improvement of a building wholly located on land in a QOZ in relation to the QOZB's additions to the basis of each individual *building*. As such, it does not appear that capital expenditures for constructing a related building qualify as improvements to the existing building.[48]

Observation 1: *The Treasury Department and the IRS have requested comments on whether anti-abuse rules are needed to prevent unimproved land or "land banking" transactions by QOFs or QOZBs, and on possible approaches to prevent such abuse. For example, a QOF's acquisition of land used for the production of an agricultural crop, may technically qualify as a QOZ business property, but may not result in any new capital investment in, or increase any economic activity within the QOZ which is inconsistent with the purpose of the statute. The Preamble language suggests that QOZ benefits should not be available in this instance.*

8. *Definition of Trade or Business for Use of Property by a QOF and QOZB –*

Under the new regulations, the term "trade or business" as it relates to property used by a QOF or QOZB means a trade or business within the meaning of section 162.[49] The United States Supreme Court held that "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit."[50]

9. Active Conduct of a Trade or Business –

Under the existing regulations, a QOZB must be engaged in the active conduct of a trade or business in the QOZ.[51] Under general tax law principles, start-up businesses generally may not be treated as engaged in a trade or business until the business is able to generate revenue. While no specific safe harbor was provided for start-up businesses under the new regulations, as discussed below, the safe harbor in the existing regulations for reasonable amounts of working capital was expanded and very helpful safe harbors were established for determining if 50 percent of the QOZB's gross income is derived in the active conduct of a trade or business in a QOZ.

Observation 1: *The IRS and Treasury could have also provided a safe harbor for start-up businesses to allow them to be treated as engaged in the active conduct of a trade or business if, at the time that the qualifying investment is made, there is a reasonable expectation that within some designated period of time the business will generate revenue. This approach is available under the NMTC program. See Treas. Reg. section 1.45D-1(d)(4)(iv)(A) and the* ***QOZB 50% of Gross Income Rule*** *discussion below.*

10. QOZB 50% of Gross Income Rule –

The new regulations continue the requirement that at least 50 percent of the QOZB's gross income be derived from the active conduct of a trade or business within a QOZ.[52] However, the new regulations provide a series of helpful safe harbors to determine if this requirement is met based on where the QOZB's tangible property, employees, and independent contractors are located. Even if the safe harbors cannot be met, the new regulations provide that a QOZB can meet the 50% of gross income test based on all the facts and circumstances.[53]

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46. See Prop. Treas. Reg. §1.1400Z2(d)-1(c)(8)(i) and (ii).See also Rev. Rul. 2018-29.
47. See Prop. Treas. Reg. §1.1400Z2(d)-1(d)(4)(ii)(B).
48. See Prop. Treas. Reg. §1.1400Z2(d)-1(d)(4)(ii)(A); *cf.* Treas. Reg. §1.1250-1(a)(2)(ii) which allows for more than one building to be treated as a single item of section 1250 property.
49. See Prop. Treas. Reg. §§1.1400Z2(d)-1(c)(4)(ii) and -1(d)(2)(ii).
50. Commissioner v. Groetzinger, 480 U.S. 23 (1987).
51. It was unclear from the section 1400Z-2(d)(3)(A)(ii)'s reference to section 1397C(b)(4) whether the tangible asset usage requirement must be "in the Qualified Opportunity Zone."Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(5)(ii) indicates that it must so be in the QOZ.
52. See Prop. Treas. Reg. §1.1400Z2(d)-1(d)(5)(i).
53. See Prop. Treas. Reg. §1.1400Z2(d)-1(d)(5)(A)-(D).

The proposed safe harbors are:

— At least 50 percent of the services performed, based on hours, by the QOZB's employees and independent contractors (and employees of the independent contractors) are performed within a QOZ.

— At least 50 percent of the amounts paid by the QOZB for services executed by employees and independent contractors (and employees of the independent contractors) are performed within a QOZ.

— The tangible property of the QOZB located in a QOZ and the management or operational functions performed for the business in the QOZ are each necessary to generate at least 50 percent of the gross income of the trade or business within a QOZ.

Observation 1: *A QOZB need only satisfy one of the above safe harbors to meet the 50% gross income requirement. Many different and diverse businesses may be able to utilize one of these safe harbors to meet this gross income requirement.*

Observation 2: *The ultimate location of the customer does not appear to impact a QOZBs ability to qualify for one of these safe harbors.*

Observation 3: *It appears these safe harbors are not limited to transactions or other activities with unrelated parties. In addition, it appears that, in certain cases, larger businesses may be able to segment components of their business into separate businesses for this purpose.*

Observation 4: *With respect to the third safe harbor, it appears that as a start-up business without significant tangible asset needs to expand, the business may be able to meet this safe harbor by keeping management functions within the QOZ and have employees and others located outside of the QOZ.*

11. Substantial Portion Rule for QOZB Intangible Property –

The new regulations provide that, for purposes of determining whether a substantial portion of any intangible property of a QOZB is used in the active conduct of a trade or business in a QOZ, the term substantial portion means at least 40 percent.[54]

Observation 1: *The 40-percent test is a low bar that may allow more valuable intangibles to be held by a QOZB, whereas intangibles held at the QOF level are limited to 10-percent of total QOZ property held by the QOF.*

Observation 2: *The new rule for real property straddling a QOZ (discussed below) provides additional flexibility for purposes of measuring where a QOZB's intangibles are used.*

12. Real Property Straddling a QOZ –

The new regulations provide a rule that allows a business that holds real property in multiple census tracts, where not all the census tracts are QOZs, to determine whether the location of services, tangible property, or business functions of a business are within a QOZ in order to satisfy the QOZB requirements.

Under the new regulations, if the amount of a business's real property located within the QOZ is substantial, based on the square footage in the QOZ compared to the square footage outside the QOZ, and the real property outside the QOZ is *contiguous* to part of all of the real property located inside the QOZ, then all of the property is deemed to be located within a QOZ for these determinations.[55]

Observation 1: *This rule only applies for purposes of the various determinations under section 1397C(b) applicable to QOZBs; by its terms, it does not apply to the requirement of a QOZB that substantially all of its tangible property is QOZ business property (i.e., will not count property outside a QOZ as property within a QOZ for this purpose).*

Observation 2: *It appears that property not contiguous with the property within a QOZ (e.g., separated by a street) would not be eligible for this rule.*

D. Operating within the Qualified Opportunity Zone

1. Safe Harbor for Inventory in Transit –

In defining what it means to "use" property in a QOZ, the new regulations provide a safe harbor for inventory in transit.[56] The new regulations provide that inventory (including raw materials) of a trade or business will not fail to be used within a QOZ solely because the inventory is in transit (i) from a vendor to a facility of the trade or business that is within a QOZ, or (ii) from a facility of the trade or business that is in a QOZ to customers of the trade or business that are not located within a QOZ.[57]

54. See Prop. Treas. Reg. §1.1400Z2(d)-1(d)(5)(ii).

55. See Prop. Treas. Reg. §1.1400Z2(d)-1(d)(5)(viii).This rule applies section 1397C(f) (relating to property straddling empowerment zones) to the QOZB's requirements under section 1397C,by substituting "QOZ" for "empowerment zone."

56. Section 1400Z-2(d)(2)(D)(i)(III) provides the requirement that the use of QOZ business property is in a QOZ during substantially all of the QOF's holding period of such property.

57. See Prop. Treas. Reg. §1.1400Z2(d)-1(c)(4)(iii).

Observation 1: *By implication, this provision indicates that inventory may be a good asset for purposes of the 90-Percent and 70-Percent asset tests.*

Observation 2: *For builders, developers, and others who may hold significant value in inventory on a regular basis, or just at certain points of their business's lifecycle, the fact that inventory may be a good asset and that it is considered used in the trade business for QOZ purposes may be helpful in satisfying the QOF and QOZB tests.*

2. Working Capital Safe Harbor for QOZB Test –

The existing regulations provided a working capital safe harbor for QOZBs that allowed them to apply the definition of working capital provided in section 1397C(e)(1) to property held by the business for a period of up to 31 months, if three requirements were met: (i) there is a written plan that identifies the working capital assets as property held for the acquisition, construction, or substantial improvement of tangible property in the QOZ; (ii) there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets, and under that schedule, the working capital assets are spent within 31 months of the receipt by the business; and (iii) the working capital assets are actually used in a manner that is substantially consistent with the schedule. Taxpayers would be required to retain any written plan in their records.[58]

Under the new regulations, the first requirement with respect to the written designation has been revised and now requires a QOZB to provide for the development of a trade or business in the QOZ including, when appropriate, the acquisition, construction, and/or substantial improvement of tangible property in a QOZ. More significantly, the new regulations essentially provide that any delays during the 31-month working capital deployment period that are the result of waiting for governmental action the application for which is complete will extend the 31-month period. In addition, the new regulations provide that a QOZB can benefit from multiple overlapping or sequential applications of the 31-month working capital safe harbor for separate capital contributions by QOFs, provided each application independently satisfies all the requirements of the safe harbor.

Observation 1: *The changes to the 31-month working capital safe harbor should provide some relief in situations that often arise for start-up businesses or developments (e.g., permitting, inspections).*

Observation 2: *Analogous relief is provided for QOF reinvestments if failure to meet the 12-month deadline is attributable to delay in government action the application for which is complete.*

3. General Rule for determining if an event requires the Inclusion of All or a Portion of the Deferred Gain ("General Inclusion Event Rule") –

Certain transactions or events at the QOF level and/or QOF owner level may cause all or a portion of the deferred gain associated with a qualifying investment to be triggered. The new regulations provide a general rule for determining if an event is an inclusion event ("General Inclusion Event Rule") and contain a nonexclusive list of inclusion events.[59] The General Inclusion Event Rule provides that, except as otherwise provided, an event is an inclusion event if and to the extent either (i) it has the effect of reducing the taxpayer's equity interest in the qualifying investment, (ii) the taxpayer receives property that is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the taxpayer's ownership in the QOF,[60] or (iii) the taxpayer claims a loss for worthless stock under section 165(g) or otherwise claims a worthlessness deduction with respect to its qualifying investment.[61]

Observation 1: *It is unclear the extent to which an inclusion event may also affect the taxpayer's ability to benefit from the 10-year rule with respect to its eligible interest.*

The following is a nonexclusive list of inclusion events from the new regulations:

a. A termination or liquidation of the QOF or QOF owner,[62]

b. A transfer of a QOF interest by gift, whether outright or in trust, regardless of whether the transfer is a completed gift for Federal income tax purposes, and regardless of the taxable or tax-exempt status of the donee.[63]

58. See Prop. Treas. Reg. §1.1400Z2(d)-1(d)(5)(iv).

59. See Prop. Treas. Reg. §1.1400Z2(b)-1(c)(1).

60. For this purpose, property means money, securities, or any other property.Prop. Treas. Reg. §1.1400Z2(b)-1(a)(2)(vii)(A). The term "property" does not include stock (or rights to acquire stock) in a QOF corporation that makes the distribution.Prop. Treas. Reg. §1.1400Z2(b)-1(a)(2)(vii)(B). *But see* Prop. Treas. Reg. §1.1400Z2(b)-1(c)(8) (regarding distributions under section 305(b)).

61. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(1)(iii).

62. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(2).

63. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(3). Note that transfers involving grantor trusts are also covered in Prop. Treas. Reg. §1.1400Z2(b)-1(c)(5).

c. Certain transfers or dispositions by estates or heirs (although an initial transfer of a deceased QOF owner's interest by operation of law is generally not an inclusion event).[64]

The Government has proposed seventeen pages of regulatory language to articulate the inclusion event rules (including multiple exceptions and special rules); careful attention to the details is required in navigating these rules.

4. Partnership-Related Events that Require Inclusion of All or a Portion of the Deferred Gain –

The new regulations provide that, in the case of a partnership that is a QOF or, directly or indirectly solely through one or more partnerships owns an interest in a QOF, the General Inclusion Event Rule applies.[65] The new regulations also provide exceptions to this general rule for the following transactions:[66]

a. A section 721(a) contribution by a QOF owner, including any contribution by a partner of a partnership that, solely through one or more upper-tier partnerships, owns an interest in a QOF, of its direct or indirect partnership interest in a qualifying investment to a transferee partnership, provided the interest transfer does not cause a termination of a QOF partnership or the direct or indirect owner of a QOF, under section 708(b)(1).

b. A section 708(b)(2)(A) merger or consolidation of a partnership holding a qualifying investment (or holding the interest through partnership tiers) with another partnership.

c. An actual or deemed distribution of property (including cash) by a QOF partnership to a partner is an inclusion event, but only to the extent the distributed property has a fair market value in excess of the partner's basis in its qualifying investment. Similar rules apply to distributions involving tiered partnerships.

The new regulations also provide an exception to these exceptions to prevent the reduction of the remaining deferred gain attributable to the eligible taxpayer's direct or indirect interest. The new regulations provide that an inclusion event occurs when and to the extent that a transaction has the effect of reducing – (i) the amount of remaining deferred gain of one or more direct or indirect partners, or (ii) the amount of gain that would be recognized by such partner upon an inclusion event to the extent that the remaining gain is reduced below the remaining deferred gain.

Observation 1: *The new regulations do not provide an exception for a section 708(b)(2)(B) division of a partnership holding qualifying investments.*

5. S corporation-Related Events that Require Inclusion of All or a Portion of the Deferred Gain –

An actual or constructive distribution of property by a QOF S corporation to a shareholder with respect to its qualifying investment is an inclusion event to the extent that the distribution is treated as gain from the sale or exchange of property under section 1368(b)(2) and (c).[67]

In addition, an inclusion event occurs when there is an aggregate change in ownership (generally defined as a change of ownership of greater than 25-percent) of an S corporation that directly holds a qualifying investment in a QOF.[68]

Furthermore, a conversion of an S corporation to a partnership or an entity disregarded as separate from its owner under section 301.7701-3(b)(1)(ii) is an inclusion event (unless the conversion comprises a step in a series of related transactions that together qualify as a section 381 transaction).[69]

The new regulations also provide that the following transactions will not constitute an inclusion event:[70]

a. An election, revocation, or termination of a corporation's status as an S corporation under section 1362;

b. A conversion of a qualified subchapter S trust (as defined in section 1361(d)(3)) to an electing small business trust (as defined in section 1361(e)(1));

c. A conversion of an electing small business trust to a qualified subchapter S trust;

d. A valid modification of a trust agreement of an S-corporation shareholder whether by an amendment, a decanting, a judicial reformation, or a material modification;

64. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(4).
65. See Prop. Treas. Reg. §1.1400Z2(b)-1(c)(6)(i).
66. See Prop. Treas. Reg. §1.1400Z2(b)-1(c)(6)(ii).
67. Prop. Treas. Reg. §1.1400Z2(b)-(1)(c)(7)(ii).
68. Prop. Treas. Reg. §1.1400Z2(b)-(1)(c)(7)(iii).
69. Prop. Treas. Reg. §1.1400Z2(b)-(1)(c)(7)(iv).
70. Prop. Treas. Reg. §1.1400Z2(b)-(1)(c)(7)(i).

e. A 25-percent or less aggregate change in ownership in the equity investment in an S corporation that directly holds a qualifying investment; and

f. A disposition of assets by a QOF S corporation.

The new regulations also provide that with respect to mixed-fund investments in a QOF S corporation, if different blocks of stock are created for otherwise qualifying investments to track basis in such qualifying investments, the separate blocks are not treated as different classes of stock for purposes of S corporation eligibility under section 1361(b)(1).[71]

6. C Corporation-Related Events that Require Inclusion of All or a Portion of the Deferred Gain –

The following are inclusion events involving C corporations from the new regulations:

a. A cessation or liquidation of the QOF, where the QOF ceases to exist for Federal income tax purposes (*e.g.*, a merger, or actual or deemed dissolution or liquidation, of a QOF C corporation);[72]

b. A liquidation of the QOF investor other than a liquidation qualifying for non-recognition under section 337(a) (*i.e.*, only the taxable portion of a liquidation of the QOF investor is an inclusion event);[73]

Observation 1: *While a liquidation of the QOF investor that qualifies for non-recognition under section 337 is not an inclusion event, the preamble to the new regulations specifically notes that an inclusion event includes an acquisitive asset reorganization in which a corporate QOF investor transfers its assets to the QOF corporation and terminates (or is deemed to terminate) for U.S. Federal income tax purposes.[74] As a result, directionality appears to matter when considering eliminating a QOF shareholder, as an upstream transaction will not result in an inclusion event while a downstream transaction will.*

c. A transfer of stock in a QOF C corporation or an interest in a QOF partnership in transaction to which a section 351 applies. The preamble to the new regulations explains that a section 351 exchange is an inclusion event because such an exchange reduces a QOF owner's direct interest in the QOF.[75] A contribution by a QOF shareholder of a portion of its qualifying QOF stock to the QOF itself in a section 351 exchange is not an inclusion event if the contribution does not reduce the taxpayer's equity interest in the QOF (*e.g.*, if the QOF shareholders make a pro rata contribution of QOF stock to the QOF).[76]

Observation 1: *A contribution of QOF interests to a corporation as part of electing REIT status for the QOF, and/or as part of a contribution of QOF interests to an S corporation feeder fund, would be an inclusion event.*

d. A reorganization of a QOF C corporation within the meaning of section 368(a).[77] However, an acquisition of a QOF C corporation's assets in a reorganization qualifying under section 368(a)(1)(A), (C), (D), or (F) (other than an upstream reorganization, an acquisition by a tax-exempt entity or entity operating on a cooperative basis, or a triangular reorganization) is generally not an inclusion event if the acquiring corporation is a QOF immediately after the acquisition (a "qualifying section 381 transaction").[78] Even though a qualifying section 381 transaction generally is not an inclusion event, if a shareholder of the QOF receives money or other property with respect to its qualifying investment requiring gain recognition under section 355 or 356 ("boot"), the taxpayer has an inclusion event to the extent the gain recognized is not treated as a dividend under section 356(a)(2).[79] If all of the stock in the target QOF corporation and the acquiring QOF corporation is held directly by a single shareholder or by members of a single consolidated group, the boot received in an Excepted Reorganization is treated as received in a separate section 301 distribution;[80]

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71. Prop. Treas. Reg. §1.1400Z2(b)-(1)(c)(7)(v).
72. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(2)(i); Prop. Treas. Reg. §1.1400Z2(b)-1(a)(2)(xx)(A). See also Preamble. A limited exception can apply where the QOF ceases to exist in a qualifying section 381(a) transaction. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(10). *See also* Prop. Treas. Reg. §1.1400Z2(b)-1(a)(2)(xx) (definition of a qualifying section 381 transaction).
73. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(2)(ii).
74. See Prop. Treas. Reg. §1.1400Z2(b)-1(a)(2)(xx)(D) (a transaction in which a QOF acquires the assets of a QOF shareholder that holds a qualifying investment in the QOF is *not* a qualifying section 381 transaction).
75. *See* Preamble [pages 42, 62]. Contrast the general inclusion rule's proposed regulatory language, which refers to a reduction in the taxpayer's equity interest without specifying that the focus in on a reduction of a *direct* interest.
76. *See* Preamble. [Page 62].
77. *See* Preamble. [Pages 42, 57-60].
78. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(10)(i).
79. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(10)(ii). If the taxpayer realizes a loss on the transaction, the amount that gives rise to the inclusion event is an amount equal to the fair market value of the boot received. *Id.*
80. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(10)(ii).

Observation 1: *A QOF shareholder that has both a qualifying investment and an additional investment in a non-wholly owned QOF might seek to manage the potential application of the boot-gain rule in a reorganization through an allocation of any boot received to the non-qualifying portion of its investment in the QOF.*[81]

e. An acquisition of the assets of a QOF shareholder within the meaning of section 368(a)(1)(A), (C), (D), (F), or (G) either (i) by the QOF or (ii) in an acquisition that results in one QOF owning an interest in another QOF.[82] Otherwise a reorganization of a QOF shareholder within the meaning of section 368(a)(1)(A), (C), (D), (F), or (G) (including triangular reorganizations) will not be an inclusion event unless the acquiring corporation does not acquire all of the QOF shareholder's QOF interests. If the acquiring corporation only acquires part of the QOF shareholder's QOF interests, there is an inclusion event to the extent that the interests are not transferred to the acquiring corporation;[83]

f. A distribution by a QOF corporation of subsidiary stock to its QOF shareholders in a transaction to which section 355 applies if either the distributing corporation or the controlled corporation is not a QOF.[84] Despite the foregoing, if a shareholder of the QOF receives boot and section 356(a) applies to the transaction, the taxpayer has an inclusion event to the extent the gain recognized is not treated as a dividend under section 356(a)(2);[85]

g. A distribution by a QOF shareholder of its QOF stock to its shareholders in a transaction to which section 355 applies to the extent the distribution reduces the QOF shareholder's direct ownership of the QOF stock (*i.e.*, if a QOF shareholder doesn't distribute all of its stock in the QOF as permitted by section 355(a)(1)(D)(ii) then there may only be a partial inclusion event);[86]

h. A recapitalization within the meaning of section 368(a)(1)(E) ("Recapitalization") of a QOF corporation or a transaction described in section 1036 with respect to the stock of a QOF if the transaction has the result of reducing the taxpayer's proportionate interest in the QOF corporation.[87] If the QOF shareholder receives boot in the Recapitalization, such boot is treated as property or boot subject to section 301 or 356 as determined under general tax principles.[88] Rules similar to those applicable to a Recapitalization apply if property that is not permitted to be received without the recognition of gain is received in a transaction described in section 1036 that does not otherwise result in an inclusion event.

i. A disposition of qualifying QOF stock in a transaction to which section 304 applies to the extent of the consideration received in the exchange subject to section 304.[89]

j. A dividend-equivalent redemption by a QOF C corporation.[90] Generally, the full amount of the redemption is taken into account as an inclusion event; however, a redemption by the QOF C corporation that (i) is directly and wholly-owned by a single shareholder or by members of a single consolidated group and (ii) would be treated as a distribution to which section 301 applies under section 302(d) is only an inclusion event to the extent it is treated as a sale or exchange under section 301(c)(3);[91]

Observation 1: *Under the new regulations, a pro rata redemption by a QOF C corporation can result in an inclusion event even though there has been no proportionate reduction in the QOF, and even though an actual distribution of a cash dividend might not trigger an inclusion. Specifically, a pro rata redemption falls into the general category of a transaction that is treated as a distribution (regardless of whether there is a reduction in the investor's interest) due to the Government's concern that "a redemption could reduce a shareholder's direct equity investment without triggering an inclusion event (if the full amount of the redemption proceeds is characterized as either a dividend or as the recovery of basis).*[92] *Thus, the form in which a distribution is cast can be significant.*

81. See Treas. Reg. §1.356-1(b), which provides that to the extent the terms of a reorganization exchange specify the boot that is received in exchange for a particular share of stock surrendered, the terms control provided the terms are commercially reasonable.
82. Prop. Treas. Reg. §1.1400Z2(b)-1(a)(2)(xx)(D) and (F) and (c)(10)(ii)(A).
83. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(10)(ii)(B).
84. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(11)(i)(A) and (B)(1).
85. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(11)(i)(B)(3). If the QOF shareholder receives boot in a section 355 transaction and section 356(b) applies, the rules applicable to distributions under section 301 in Prop. Treas. §1.1400Z2(b)-1(c)(8) apply.
86. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(11)(ii).
87. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(12)(i)(A) and (ii).
88. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(12)(i)(B).
89. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(13).
90. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(9)(i). A dividend-equivalent redemption is a redemption of stock that is treated under section 302(d) as a distribution of property to which section 301 applies.
91. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(9)(ii).
92. *See* Preamble. [Page 61].

7. Special Holding Period Rules –

The new regulations provide special rules related to the holding period necessary to achieve the 5, 7, and 10 year basis step-ups. Under the new regulations, the length of time a qualifying investment has been held is determined without regard to the taxpayer's holding period for any property exchanged for such investment. As such, an eligible taxpayer's holding period for its interest in a QOF generally begins on the date a contribution of cash or other property is made to the QOF.

The holding period of a qualifying investment acquired by gift that did not result in an inclusion event, or by reason of the prior owner's death, includes the time held by the donor or the deceased owner.

With respect to corporate QOFs, special tracking rules are provided for certain qualifying section 381 transactions if the target corporation was a QOF immediately before the acquisition and the acquiring corporation is a QOF immediately after the acquisition, and for controlled corporation stock acquired in a qualifying section 355 transaction. Under these rules, for purposes of determining the holding period of a corporate QOF (i) to the extent a taxpayer receives stock in an acquiring QOF corporation in a reorganization of a QOF within the meaning of section 368(a), in a section 1036 exchange, or in distribution subject to section 355, and (ii) such reorganization, exchange, or distribution is not an inclusion event (other than by virtue of receiving boot or the equivalent thereof), a QOF shareholder's holding period in the stock received will include the period during which such person owned stock in the QOF target corporation (assuming such stock was held as a capital asset).[93]

8. Amounts Includible in Income Upon an Inclusion Event –

The new regulations provide rules for determining the amount includible in gross income upon an inclusion event. Different rules apply depending on the type of inclusion event.[94] Generally, the amount of gain included in gross income is equal to the lesser of: (i) the product of—(A) the percentage of the qualifying investment that gave rise to the inclusion event, and (B) the remaining deferred gain, less any applicable QOF basis adjustments, or (ii) the gain that would be recognized on a fully taxable disposition of the qualifying investment that gave rise to the inclusion event.[95] Special inclusion amount rules apply for partnerships and S corporations.[96]

Observation 1: *Allowing a claim of worthlessness to be an inclusion event is a taxpayer favorable rule in that it allows a taxpayer to trigger inclusion at a point in time when the fair market value of the investment will be less than the amount of the initial deferred gain. As a result, the amount of gain includible in the taxpayer's gross income will be zero. This is a function of the rule in the statute providing that the amount of gain includible is the lesser of (i) the deferred gain or (ii) the fair market value of the investment as of the date of the inclusion event, over the taxpayer's basis in the investment.*[97]

Observation 2: *If a QOF investor claims a worthless stock loss with respect to its interest in a QOF, the investor foregoes the ability to partially or permanently exclude future gain from the sale of the interest in the QOF.*[98]

E. Exiting the Qualified Opportunity Fund

As generally provided in the statute, in the case of an investment held for at least 10 years, a taxpayer may elect to step-up the basis of its interest in the QOF to FMV on the date the qualifying investment is sold or exchanged, resulting in no gain upon such disposition.[99] However, the rule in the statute does not specify if a step-up occurs upon a QOF's sale of its assets after an investor has held its interest in the QOF for at least 10 years.

1. Special Rules for Investments held for at Least 10 Years –

The new regulations provide that the amount of the step up to FMV on a sale of an interest in a QOF after the 10 year holding period is met is the *gross* FMV of the interest. In addition, if the basis in a QOF partnership interest is stepped up, the bases of the partnership's assets are also adjusted, with such adjustments calculated in a manner similar to a section 743(b) basis adjustment (treated as if the transferor partner had purchased the interest for FMV).

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93. Prop. Treas. Reg. §1.1400Z2(b)-1(d)(1)(ii) and (iii).
94. See Prop. Treas. Reg. §1.1400Z2(b)-1(e).
95. See Prop. Treas. Reg. §1.1400Z2(b)-1(e)(1).
96. See Prop. Treas. Reg. §1.1400Z2(b)-1(e)(4).
97. Section 1400Z-2(b)(2)(A).A taxpayer's basis in its QOF investment starts at zero and is increased based on the taxpayer's holding period in the QOF investment. Section 1400Z-2(b)(2)(B) and (c).
98. Prop. Treas. Reg. §1.1400Z2(b)-1(c)(14).
99. Section 1400Z-2(c).

Observation 1: *The new regulations do not specify whether the basis adjustment can be pushed down to the assets of a QOZB. However, if a QOZB partnership has a section 754 election in effect, and the QOF's interest in the QOZB partnership is stepped up, then it appears that the QOZB's basis in its assets would also be stepped up.*[100]

Observation 2: *The push down of the stepup in basis to partnership assets may be particularly significant for businesses that have long lived assets but that are recovered for tax purposes over a shorter period (e.g., renewable energy investments). The effect of the step up in basis to the assets is that the section 751(a) ("hot asset") amount on the sale of the QOF interest should be zero.*

The new regulations also provide that if a taxpayer has held a qualifying investment in a QOF partnership or S corporation for at least 10 years, and the QOF disposes of QOZ property after such 10 year period, the taxpayer may make an election to exclude from gross income some or all of the gains treated as *capital gain* (including net section 1231 gains) arising from such disposition reported on Schedule K-1 and attributable to the qualifying investment.

The new regulations further provide that, to the extent the Schedule K-1 separately states capital gains arising from the sale or exchange of any particular QOZ property, the taxpayer may make an election with respect to such separately stated item and exclude it from gross income.

Observation 1: *This rule only will eliminate capital gain generated from the sale of a QOF's QOZ property, whereas all gain is eliminated if the QOF interest is sold or exchanged. Note that unrecaptured section 1250 gain is capital gain for this purpose.*

Observation 2: *This election does not apply to property disposed of by a QOZB.*

Observation 3: *The new regulations do not address divisions of QOFs to facilitate a sale of a single property through a sale of all the interests in a newly divided QOF.*

Observation 4: *It is unclear what the new regulations mean by "separately stated" on a K-1, and whether a footnote indicating what portion is from disposition of QOF property will satisfy this separately stated requirement.*

F. Additional Guidance

1. Applicable Tax Rate for Deferred Gain –

After publication of the existing regulations, commentators suggested that deferred gain invested in QOFs should be taxed at the end of the deferral period at the same rate in effect in the tax year in which the gain was originally recognized, because the reference to section 1(h) (which specifies a tax rate) in the definition of eligible gains provides support for such position.

The Treasury and the IRS have not provided such a rule. Instead, the new regulations require that the taxpayer simply include the gain in income in the year in which the deferral period ends, which would appear to require that the taxpayer pay tax based on the prevailing tax rates in that year.

2. Consolidated Group Rules –

Neither the statute nor the existing regulations address the application of the QOZ provisions to an affiliated group of corporations electing to file a consolidated return (a "consolidated group"); however, the new regulations provide several rules clarifying the application of the QOZ rules to consolidated groups.

The new regulations specify that stock in a QOF corporation is not treated as stock for purposes of affiliation, meaning that a QOF corporation cannot be a subsidiary member of a consolidated group. A QOF corporation can, however, be the common parent of a one tier consolidated group (due to restrictions on the asset composition of an entity the stock of which is intended to constitute QOF stock and thus qualify as QOZ property, a consolidated group for which a QOF is the common parent would not be more than one tier).[101]

Observation 1: *Because a QOF corporation can be a common parent of a consolidated group, a QOF corporation and an entity the stock of which constitutes QOF stock could form a consolidated group. However, due to restrictions on the asset composition of an entity the stock of which is intended to constitute QOF stock and thus qualify as QOZ property, a consolidated group for which a QOF is the common parent would not be more than one tier (i.e., the common parent would not indirectly own any second-tier subsidiaries). If corporate form is chosen for a QOF (for example, if for commercial reasons QOF investors do not wish to receive K-1s) it may make sense for the QOF to also chose corporate form for each QOZB subsidiary in which it invests and elect to file a consolidated return with those subsidiaries to share losses amongst a consolidated group.*[102]

100. See Rev. Rul. 87-115, 1987-2 C.B. 163.

101. See Prop. Treas. Reg. §1.1400Z2(g)-1(b).

102. See section 1400Z-2(d)(3) (incorporating section 1397C(b)(8) for purposes of defining a QOZB).

For purposes of qualifying for deferral, members of consolidated group are not treated as a single entity, and section 1400Z-2 applies separately to each member of a group. Thus, the member that recognizes the gain eligible for deferral must also be the member that makes the investment in the QOF.[103]

Observation 1: *There may be an argument that where there is a sale by one member of a consolidated group (the "Selling Member") to another member of the same group (the "Buying Member") followed by a sale to an unrelated person, gains (if any) of both Selling Member and Buying Member may be eligible for deferral under the QOZ provisions. In particular, the matching rule in Treas. Reg. §1.1502-13(c) could apply to redetermine the attributes of Selling Member's sale to Buying Member such that that the Selling Member's gain is redetermined to be eligible for deferral under the QOZ rules. This is because the matching rule requires recharacterization of attributes of a transaction to the extent necessary to produce the same result as if the sale between the Selling Member and the Buying Member had been between divisions of a single corporation.[104] Note that under the rules in the new regulations, Selling Member and Buying Member would have to each contribute their respective sale proceeds to a QOF.*

If a member of a consolidated group owns an interest in a QOF and a basis adjustment is made with respect to the QOF interest, the member of the group will be treated as receiving tax-exempt income for purposes of the investment adjustment rules in Treas. Reg. §1.1502-32 (*i.e.*, the basis in the stock of the member owning the QOF will be increased).[105] However, such adjustments do not tier-up to upper-tier members of the consolidated group unless and until the basis of the QOF interest is increased to its fair market value.[106] The new regulations also address the application of the Unified Loss Rule in Treas. Reg. §1.1502-36 to situations involving the transfer of a loss share of the stock of a member of the group that owns an interest in a QOF.[107]

3. Indian Tribal Governments as QOFs –

Under the QOZ statute and existing regulations, QOFs must be formed as domestic corporations or partnerships.[108] Tribal governments are distinct political entities that have the power to self-govern and exercise sovereignty over their citizens and territory. As sovereign nations, tribal governments have powers and capabilities not available to other individuals in the United States. Many tribes conduct business activities through tribally-chartered corporations or Federally-chartered corporations formed under Section 17 of the Indian Reorganization Act.

The new regulations provide that for purposes of both Prop. Treas. Reg. §1.1400Z2(d)-1(e)(1) and (2) (which impose the QOF organization requirements), an entity "organized in" one of the 50 states includes an entity organized under the law of a Federally recognized Indian tribe if the entity's domicile is located in one of the 50 states. Such entity satisfies the requirement in section 1400Z-2(d)(2)(B)(i) and (C) that QOZ stock is stock in a domestic corporation and a QOZ partnership interest is an interest in a domestic partnership.[109] In addition, while acknowledging the sovereignty of Federally recognized Indian tribes, the preamble to the new regulations notes that an entity that is eligible to be a QOF will be subject to Federal income tax under the Code, regardless of the laws under which it is established or organized.

As stated in the preamble to the new regulations, the Treasury Department and the IRS will schedule Tribal Consultation with Tribal Officials before finalizing these regulations to obtain additional input, within the meaning of the Tribal Consultation Policy, on QOF entities organized under the laws of a Federally recognized Indian tribe and whether any additional guidance may be needed regarding QOFs leasing tribal government Federal trust lands or regarding leased real property located on such lands, as well as other Tribal implications of the proposed regulations.

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103. See Prop. Treas. Reg. §1.1400Z2(g)-1(c).
104. Treas. Reg. §1.1502-13(c)(1)(i).
105. See Prop. Treas. Reg. §1.1400Z2(g)-1(d).
106. The basis in a QOF interest is increased to FMV on the date that interest is sold or exchanged if such interest is held at least 10 years, and, if the taxpayer so elects, the basis of the property is equal to the fair market value of the investment on the date that the investment is sold or exchanged. Section 1400Z-2(c).
107. See Prop. Treas. Reg. §1.1400Z2(g)-1(e). If, after applying the basis redetermination and basis reduction rules in Treas. Reg. §§1.1502-36(b) and (c), a share of stock in a member that is being transferred ("S") has basis in excess of its value, Treas. Reg. §1.1502-36(d) provides that S must reduce its attributes to the extent they duplicate a loss on shares of S stock. In some cases, an election may be made to reduce basis in the S stock instead of reducing inside attributes. In determining whether to reduce the attributes of a subsidiary under Treas. Reg. §1.1502-36(d), a QOF investment is taken into account in determining whether there is a duplicated loss. However, if there is a duplicated loss, basis in such investment is not subject to attribute reduction. Instead, all other attributes are reduced and then, to the extent an interest in a QOF would otherwise be subject to attribute reduction, the basis in the subsidiary stock is reduced to the extent that the QOF interest would otherwise have been reduced.
108. See Prop. Treas. Reg. §1.1400Z2(d)-1(e)(2).
109. See IRC Section 7701(a)(4).

Proposed Effective/Applicability Dates—
The new regulations generally are proposed to be effective on or after the date final regulations adopting these rules are published in the Federal Register. Nonetheless, taxpayers may generally rely on the rules contained in each section of the new regulations (except as noted below) for periods prior to the finalization of each section if they apply those proposed rules for that section consistently and in their entirety. Treasury and the IRS did *not* provide taxpayers the ability to rely on the rules in Prop. Treas. Reg. §1.1400Z2(c)-1 relating to investments held for more than 10 years, because, as explained in the preamble to the new regulations, these rules do not apply until January 1, 2028.

Observation 1: *The inability to rely on the rules in Prop. Treas. Reg. §1.1400Z2(c)-1 may impact the willingness of QOF investors and operators to structure multi-asset QOFs.*

Comments Requested—
Comments are requested by June 30, 2019 on the following:

— Proposed definitions of "substantially all" for purposes of section 1400Z-2(d)(2);

— Reasonableness of the proposed vacancy period requirements for buildings or other structures being purchased by a QOF or QOZB;

— Whether anti-abuse rules are needed to prevent transactions such as "land banking" by QOFs or QOZBs and on possible approaches to prevent such abuse;

— Whether the ability to disregard prior use for purposes of the original use requirement should depend on whether the property has been fully depreciated for Federal income tax purposes, or whether other adjustments for any undepreciated or unamortized basis of such property would be appropriate;

— Feedback on the potential advantages and disadvantages of adopting an aggregate (rather than asset-by-asset) approach for substantial improvement;

— The application of the substantial improvement requirement with respect to tangible personal property acquired by purchase that is not capable of being substantially improved. Specifically, comments are requested regarding whether the term "property" should be interpreted in the aggregate to permit the purchase of items of non-original use property together with items of original use property that do not directly improve such non-original use property to satisfy the substantial improvement requirement;

— In the context of substantial improvement requirements, the treatment of purchases of multiple items of separate tangible personal property that have the same applicable depreciation method, applicable recovery period, and applicable convention, and which are placed in service in the same year by a QOF or QOZB in one or more general asset accounts;

— Whether the location of where inventory is warehoused should be relevant and whether inventory (including raw materials) should be excluded from both the numerator and denominator of the 70-percent asset test for QOZBs;

— Whether inventory, as well as other property, is used in a QOZ, may warrant additional consideration;

— For treatment of leased tangible property, whether the terms of the lease reflect common, arms-length market practice in the locale that includes the QOZ takes into account the simultaneous combination of all terms of the lease, including rent, term, possibility of extension, presence of an option to purchase the leased asset, and the terms of purchase;

— Whether taxpayers and the IRS may encounter undue burden or difficulty in determining whether a lease is market rate;

— Whether the limitations intended to prevent abusive situations through the use of leased property are appropriate, or whether modifications are warranted;

— Whether modifications to the proposed valuation methods are warranted regarding the treatment and valuation of leased tangible property;

— Feedback on the proposed safe harbor rules regarding the 50-percent gross income requirement, including comments offering possible additional safe harbors, and whether certain modifications would be warranted to prevent potential abuses.

— Feedback on the definition of a "trade or business" for purposes of section 1400Z-2(d)(3).

— The proposed treatment of section 1231 gains;

— Whether an analogous rule for QOF subsidiaries to reinvest proceeds from the disposition of QOZ property would be beneficial;

— Feedback on the proposed rules regarding the timing of basis adjustments;

— Feedback on the dollar-for-dollar rule and the circumstances in which this rule would apply under these proposed regulations;

— Whether additional approaches should be considered for accounting for a partner holding a mixed-funds investment in a QOF partnership, including distributions;

- Whether an ordering rule treating the distribution as attributable to the qualifying or non-qualifying investment portion first is appropriate, and how any alternative approach would simplify the calculations;
- Whether additional considerations are needed regarding ownership changes in S corporations that are QOF owners;
- Feedback on the proposed treatment of the receipt of boot as an inclusion event;
- Whether additional rules are needed to prevent abuse governing inclusion events;
- Whether a rule is needed to treat QOF stock as not stock only for the purposes of consolidation, as well as whether the burden of potentially applying two different sets of consolidated return rules would be outweighed by benefits of permitting QOF C corporations to be subsidiary members of consolidated groups; and
- Whether additional details regarding what tax results are inconsistent with the purposes of section 1400Z-2 are required or whether examples of particular types of abusive transactions would be helpful.

The public hearing to discuss these topics is scheduled for July 9, 2019 at the New Carrollton Federal Building at 5000 Ellin Road in Lanham, Maryland 20706.

Reporting Standards—
In addition to the new regulations, the Treasury and the IRS published a Request for Information seeking public input on the development of information collection and tracking related to investment in QOFs. The purpose of information collection and tracking is to measure the effectiveness of the QOZ regime in achieving its stated goals, and to ensure that the investment opportunity remains an attractive option for investors.

A QOF is required to file Form 8996 as part of its annual Federal income tax return. On this form, the QOF reports the amount of assets in the QOF and what portion of those assets are QOZ property.[110] Based on annual data provided in Form 8996, if authorized the IRS could determine and report publicly on (i) the number of QOFs, (ii) the aggregate amount of investment in QOFs, and (iii) the portion of that investment reported by QOFs as QOZ property.

However, the information reported on the current version of Form 8996 lacks sufficient granularity for the IRS to determine the amount and type of investment that flows into individual QOZs through QOFs. This type of information would be valuable for evaluating the success of the QOZ tax incentive on increasing investment and economic activity within QOZs. In the coming weeks, Treasury and the IRS have suggested that revisions to the Form 8996 may be proposed for tax years following 2018.

It is expected that such proposed revisions to the Form 8996 could require additional information such as (1) the employer identification number (EIN) of the QOZB owned by a QOF and (2) the amount invested by QOFs and QOZBs located in particular census tracts designated as QOZs.

As noted in the preamble of the new regulations, in the future Treasury and the IRS will be releasing guidance to address the administrative rules applicable to a QOF that fails to maintain the required 90-percent investment standard.

Conclusion—
The Opportunity Zone program offers investors not only tax benefits but the opportunity to improve and enhance the economic condition of underserved areas. The potential for unprecedented infusions of capital into Opportunity Zones across the nation and its possessions is causing businesses and investors alike to rethink traditional investment strategies to align with the Opportunity Zones rules. With the guidance released by the IRS and Treasury Department through the two proposed regulation packages, taxpayers have received the clarity needed to begin investing, and making impacts in Opportunity Zone communities.

110. As defined in Section 1400Z-2(d)(2).

Notes

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About KPMG

Capturing potential QOZ benefits involves a cross-functional approach. Addressing the needs of our clients related to QOZ investment, KPMG has assembled a diverse team of specialists who are able to provide a wide-ranging suite of services that mitigate risk, enhance efficiencies, and deliver value.

We believe that our experience and knowledge can help you address today's challenges and prepare for tomorrow's QOZ opportunities.

Learn more: **read.kpmg.us/opportunity-zones**

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