May 8, 2019

Guidance on Tax Incentives for Investments in Qualified Opportunity Zones

On April 17, 2019, the Treasury Department and the Internal Revenue Service ("IRS") issued a second set of proposed regulations (the "Proposed Regulations") that addresses the scope of new tax incentives for investments in qualified opportunity funds (each a "QOF"). These benefits were introduced as part of the Tax Cuts and Jobs Act.

The Proposed Regulations supplement guidance issued last October (the "October Guidance").[1] The preamble to the Proposed Regulations indicates that at least some of the remaining open issues will be addressed in future guidance.[2] Taxpayers can generally rely on the Proposed Regulations and October Guidance provided that they adhere to them in their entirety.[3]

The most notable new rules in the Proposed Regulations are:

- The benefit of capital gain exclusion for QOF investments held for at least 10 years is extended to certain capital gain allocations or distributions from QOF partnerships, S corporations, or REITs.
- The portion of any QOF equity received in exchange for services (e.g., carry) is not eligible for the new tax benefits.
- QOF equity acquired on a secondary market may be eligible for the new tax benefits.
- While QOF equity acquired for property other than cash may be eligible for the new tax benefits, the amount is eligible generally capped at the lesser of the property's basis or fair market value when the QOF equity is received in a carryover basis transaction.
- Proceeds realized and reinvested by a QOF within 12 months may be "good assets" for purposes of QOF qualification.
- Cash or cash equivalents and short-term debt contributed to a QOF may be disregarded for six months for purposes of QOF qualification.
- Leased property, including property leased from a related party, may qualify as a "good asset" for purposes of QOF qualification.
- Unimproved land may qualify as a "good asset" for purposes of QOF qualification without regard to the "original use" or "substantial improvement" requirements.
- Three alternative safe harbors are now available for determining whether at least 50% of gross income has come from a qualified opportunity zone.

Background

The tax incentives for QOF investments were introduced to spur development in qualified opportunity zones ("QOZs"), which are economically distressed census tracts. [4] Investments in QOF equity are potentially eligible for three tax benefits.

[1] Rev. Rul. 2018-29 and § 1.1400Z-2, Proposed Income Tax Regulations, 83 Fed. Reg. 54279 (proposed October 29, 2018).
[2] Supplementary Information to the Proposed Regulations.
[3] This does not apply to the rules of Prop. Reg. § 1.1400Z2(c)-1 (relating to investments held for at least 10 years) as these rules do not apply until January 1, 2028. Supplementary Information to the Proposed Regulations.
[4] Section 1400Z-1 (see link).

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First, the recognition of capital gain treated as timely invested in QOF equity (a "Qualifying Investment" and any other investment in a QOF, a "Non-Qualifying Investment") may be deferred until the earlier of December 31, 2026 or the disposition of the Qualifying Investment (a "Deferral Election").[5] Second, the tax basis of the Qualifying Investment may be increased by 10% or 15% of such deferred gain upon satisfaction of a five- or seven- year holding period, respectively (the "Exclusion Benefit"), thereby permanently excluding from tax such 10% or 15% amount.[6] Third, all appreciation from the Qualifying Investment may be permanently excluded from tax if the Qualifying Investment is held for at least 10 years (the "Gain Exclusion Election").[7]

A QOF is an entity that meets three requirements. First, it must be classified for tax purposes as a partnership or corporation, which means any of a corporation (a "QOF Corporation"), a partnership or limited liability company ("QOF Partnership"), a real estate investment trust ("QOF REIT") or an S corporation ("QOF S Corporation") may potentially be a QOF.[8] Second, it must be organized for the purpose of investing in qualified opportunity zone property ("QOZ Property").[9] Third, it must hold at least 90% of its assets in QOZ Property, as measured at the end of its taxable year based on the average of two testing dates (the "90% Test").[10]

QOZ Property can consist of either of two types of property: (i) tangible property used in a trade or business of the QOF within a QOZ ("QOZ Business Property") or (ii) equity interests in a qualified opportunity zone business ("QOZ Business"), which is defined by reference to its ownership and use of QOZ Business Property and place of business.[11]

In general, property qualifies as QOZ Business Property only if (i) it is tangible property the QOF or QOZ Business, as applicable, uses in a trade or business it conducts in a QOZ, (ii) either its "original use" commences with the QOF or QOZ Business or the QOF or QOZ Business "substantially improves" the property during any 30-month period beginning after the date of acquisition, and (iii) during substantially all of the holding period for such property, substantially all of the use of such property takes place in a QOZ (the "Substantial QOZ Use Test").[12]

In general, a trade or business qualifies as a QOZ Business only if (i) 70% of the tangible property it owns or leases is QOZ Business Property used in its trade or business (the "70% Test"), (ii) it derives at least 50% of its gross income from the active conduct of a trade or business in a QOZ (the "50% Gross Income Test"), (iii) it uses a substantial portion of its intangible property in the active conduct of a trade or business in a QOZ (the "Intangible Property Test"), (iv) less than 5% of the average aggregate adjusted basis of its assets constitute "nonqualified financial property" (the "Financial Property Test") and (v) it is not engaged in certain specified "sin" businesses.[13] The October Guidance provides a safe harbor that allowed a QOZ Business to hold reasonable amounts of working capital without violating the Financial Property Test (the "Working Capital Safe Harbor").[14]

Highlights from the Proposed Regulations for QOF Managers

No QOF Tax Benefits for QOF Interest Received in Exchange for Services

The Proposed Regulations provide that QOF equity received for services (e.g., carried interest) rendered to the QOF or to a person in which the QOF holds any direct or indirect equity interest is a Non-Qualifying Investment and, as such, is

[5] § 1400Z-2(a).
[6] § 1400Z-2(b)(2)(B).
[7] § 1400Z-2(c).
[8] § 1400Z-2(d)(1).
[9] *Id.*
[10] *Id.*
[11] § 1400Z-2(d)(2).
[12] § 1400Z-2(d)(2)(D).
[13] § 1400Z-2(d)(3)(A)(iii).
[14] Prop. Reg. 1.1400Z2(d)-1(d)(5)(iv).

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ineligible for the QOF tax benefits.[15] If QOF equity is acquired for both cash (or property) and services, only the portion of the QOF equity received for cash (or property) is eligible to be a Qualifying Investment, and the remaining portion must be treated as a separate Non-Qualifying Investment (a "Mixed Funds Investment"). Although the Proposed Regulations do not specify how the service-related portion of a Mixed Funds Investment should be determined, they provide rules for how QOF Partnerships should divide allocations and distributions between the two portions.[16] Furthermore, the treatment of equity as a Non-Qualifying Investment on this basis does not appear to be limited to circumstances when the equity received is either taxable as compensation or qualifies as "carried interest" in a partnership, but arguably appears to apply to any equity that is wholly or partly received for services.

Expansion of the Gain Exclusion Election

The Proposed Regulations expand the availability of the Gain Exclusion Election, which should make multi-asset QOF Partnerships, QOF S Corporations, and QOF REITs more attractive. Under the statute, the Gain Exclusion Election appears to be available only for the disposition of a Qualifying Investment. The Proposed Regulations also make the Gain Exclusion Election available where the taxpayer retains its Qualifying Investment in a QOF Partnership, S Corporation, or REIT and the QOF disposes of its interests in QOZ Property. The Proposed Regulations appear not to make the Gain Exclusion Election available with respect to capital gains that a subsidiary of a QOF that is a QOZ Business recognizes upon a disposition of any of its QOZ Business Property. Thus, investors in a two-tiered QOF structure in which the QOF holds an interest in a QOZ Business or Businesses with underlying QOZ Business Property may not be able to use the Gain Exclusion Election with respect to capital gain a QOF recognizes when a QOZ Business disposes of its QOZ Business Property.

Specifically, the Proposed Regulations provide that if a taxpayer holds a Qualifying Investment in a QOF Partnership or S Corporation for at least 10 years, and the QOF Partnership or QOF S Corporation disposes of QOZ Property after such 10-year holding period, the taxpayer can make a Gain Exclusion Election with respect to the capital gain arising from such disposition reported on the Schedule K-1 of the QOF Partnership or QOF S Corporation.[17] The Gain Exclusion Election appears to be available regardless of the QOF's holding period in the underlying QOZ Property. To the extent that the Schedule K-1 separately states capital gains arising from the sale or exchange of any particular QOZ Property, the taxpayer can make a Gain Exclusion Election with respect to each separately stated item, and the amount of the exclusion does not appear to be limited to net gain of the QOF.[18]

The Proposed Regulations also provide that if a taxpayer receives a capital gain dividend on a Qualifying Investment in a QOF REIT held for at least 10 years and if the QOF REIT properly identifies the dividend as attributable to long-term capital on its sale of QOZ Property, the taxpayer may apply a zero percent tax rate to that capital gain dividend.[19] As with QOF Partnerships, QOF REITs that recognize capital gain from asset sales by subsidiary QOZ Businesses appear not to be able to dividend those gains in a manner in which they would be eligible for the Gain Exclusion Election.

Safe Harbor: Exclusion of New Investment from the 90% Test

The Proposed Regulations allow a QOF to choose to apply the 90% Test by disregarding cash, cash equivalents and debt instruments with a term of not more than 18 months if such property was received by the QOF for its equity not more than

[15] Prop. Reg. § 1.1400Z2(a)-1(b)(9)(ii).
[16] Prop. Reg. § 1.1400Z2(b)-1(c)(6)(iv)(D) provides some guidance on the allocation of income, gain, loss, and deduction and distributions by a partnership in which partners hold Mixed Funds Investments.
[17] Prop. Reg. § 1.1400Z2(c)-1(b)(2)(ii).
[18] If section 1231 property is disposed of, the taxpayer can make the Gain Exclusion Election only with respect to capital gain net income from section 1231 property to the extent of net gains determined under section 1231(a) reported on Schedule K-1 of the QOF Partnership or S Corporation.
[19] Prop. Reg. § 1.1400Z2(c)-1(e).

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six months before the testing date and continuously held by it through the testing date.[20] Outside of this grace period, cash, cash equivalents and debt instruments do not qualify as QOZ Property for purposes of the 90% Test. In addition, because the Proposed Regulations do not disregard these contributions for purposes of the qualifications tests applicable to a QOZ Business, a manager of a two-tiered QOF structure may need to consider whether and when to hold cash, cash equivalents and debt instruments at the QOF level rather than at the QOZ Business level.

Expansion of QOZ Business Property

Leased Property

The Proposed Regulations generally permit leased property to qualify as QOZ Business Property for purposes of the 90% and 70% Tests if (i) the lease is entered into after December 31, 2017, (ii) the terms of the lease are arms' length at the time the lease was entered into, and (iii) at least 70% of the leased property is used within a QOZ during at least 90% of the period for which the QOF or QOZ Business leases the property.[21]

Two additional requirements apply if the lessee and lessor are related parties.[22] First, the lessee must at no time make any prepayment in connection with the lease relating to a period of use of the property that exceeds 12 months.[23] Second, if the related-party lease is of tangible personal property and if the original use of the leased tangible personal property does not commence with the lessee, the leased tangible personal property is not QOZ Business Property unless the lessee becomes the owner of other tangible property that is QOZ Business Property having a value at least equal to the value of that leased tangible personal property within a specified "relevant testing period" and there is "substantial overlap" of the QOZs in which the owner of the other tangible property so acquired uses it and the QOZs in which that owner uses the leased tangible personal property.[24]

A lease of real property (other than unimproved land) is not QOZ Business Property at any time, if, at the time the lease is entered into, there was a plan, intent or expectation for the real property to be purchased by the QOF or QOZ Business for an amount of consideration other than the fair market value of the real property determined at the time of the purchase without regard to any prior lease payments.[25]

The Proposed Regulations provide that a QOF or QOZ Business may value leased property for purposes of the QOF rules using the applicable financial statement method or the alternative valuation method, provided that for any specific taxable year, the selected method is applied consistently to all applicable assets.[26] Under the applicable financial statement method, the value of the leased property is as reported on the applicable financial statement, if any, of the QOF or QOZ Business.[27] Under the alternative valuation method, the value of a leased tangible property is equal to the sum of the present values of each payment under the lease calculated at the time the QOF or QOZ Business enters into the lease (discounted at the applicable Federal rate).[28]

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[20] Prop. Reg. § 1.1400Z2(d)-1(b)(4).
[21] Prop. Reg. § 1.1400Z2(d)-1(c)(4) – (6); Prop. Reg. § 1.1400Z2(d)-1(d)(2)(i), (iii), (iv).
[22] Prop. Reg. § 1.1400Z2(d)-1(c)(4)(i)(B)(3); Prop. Reg. § 1.1400Z2(d)-1(d)(2)(i)(B)(3).
[23] Prop. Reg. § 1.1400Z2(d)-1(c)(4)(i)(B)(4); Prop. Reg. § 1.1400Z2(d)-1(d)(2)(i)(B)(4).
[24] Prop. Reg. § 1.1400Z2(d)-1(c)(4)(i)(B)(5); Prop. Reg. § 1.1400Z2(d)-1(d)(2)(i)(B)(5). "Relevant testing period" is defined in § 1.1400Z2(d)-1(c)(4)(i)(B)(7) and § 1.1400Z2(d)-1(d)(2)(i)(B)(7) as the period that begins on the date that the lessee receives possession under the lease of the leased tangible personal property and ends on the earlier of—the date 30-months after the date the lessee receives possession of the property under the lease; or the last day of the term of the lease. "Substantial overlap" is currently not defined.
[25] Prop. Reg. § 1.1400Z2(d)-1(c)(4)(i)(E); Prop. Reg. § 1.1400Z2(d)-1(d)(2)(i)(E).
[26] Prop. Reg. § 1.1400Z2(d)-1(b)(1); Prop. Reg. § 1.1400Z2(d)-1(d)(3)(ii)(A) and (B)(1).
[27] Prop. Reg. § 1.1400Z2(d)-1(b)(2); Prop. Reg. § 1.1400Z2(d)-1(d)(3)(ii)(B)(2).
[28] Prop. Reg. § 1.1400Z2(d)-1(b)(3); Prop. Reg. § 1.1400Z2(d)-1(d)(3)(ii)(B)(3).

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Land

As noted, tangible property is generally QOZ Business Property only if the original use of such property in the QOZ commences with the QOF or QOZ Business or the QOF or QOZ Business "substantially improves" the property during any 30-month period beginning after the date of acquisition. The October Guidance provides that the original use requirement does not apply to land, whether the land is improved or unimproved. The Proposed Regulations further provide that the substantial improvement requirement does not apply to unimproved land acquired by purchase.[29] Similarly, there is no substantial improvement or original use requirement for a third-party lease of land.[30] Thus, unimproved land is generally QOZ Business Property if the QOF or QOZ Business uses it in its trade or business.

However, the preamble to the Proposed Regulations states that, if a significant purpose for acquiring unimproved land was to achieve an inappropriate tax result, such unimproved land will not be treated as QOZ Business Property under the general anti-abuse rule. An example of such abuse, according to the preamble, is use of the land entirely for the production of an agricultural crop, whether active or fallow at that time, in the absence of any new capital investment in or increase of any economic activity or output of the land.

QOF Reinvestment Rule

The Proposed Regulations provide a one-year reinvestment rule to allow QOFs adequate time to reinvest proceeds from QOZ Property. This rule does not defer any gain recognition from sales of QOZ Property.

If a QOF receives proceeds from the return of capital or the sale or disposition of some or all of its QOZ Property, the proceeds are QOZ Property to the extent that (i) the QOF reinvests the proceeds during the 12-month period beginning on the date of the distribution, sale, or disposition and (ii) prior to the reinvestment the QOF continuously holds the proceeds in cash, cash equivalents, or debt instruments with a term of 18 months or less.[31] A QOF does not fail the 12-month reinvestment requirement by reason of reinvestment delays caused by waiting for government action, the application for which is complete.[32] The Proposed Regulations do not provide an analogous rule for QOF Businesses, though comments are requested on whether an analogous rule would be beneficial.

Safe Harbors for a Business to Qualify as a QOZ Business

The Proposed Regulations provide three safe harbors each of which, if met, would allow a business that seeks to qualify as QOZ Business to satisfy the 50% Gross Income Test even when significant business activity occurs outside of a QOZ.[33]

A business satisfies one of these safe harbors when:

- At least 50% of the total number of hours spent by its employees and independent contractors (and employees of independent contractors) in performing services for the business during the taxable year are performed within a QOZ;[34]

[29] Prop. Reg. § 1.1400Z2(d)-1(c)(8)(ii)(B); Prop. Reg. § 1.1400Z2(d)-1(d)(4)(ii)(B).
[30] Prop. Reg. § 1.1400Z2(d)-1(c)(4)(i)(C); Prop. Reg. § 1.1400Z2(d)-1(d)(2)(i)(C).
[31] Prop. Reg. § 1.1400Z2(f)-1(b).
[32] *Id.*
[33] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(i)(A) – (C).
[34] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(i)(A).

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- At least 50% of the total amount paid by the business for employee and independent contractor (and employees of independent contractors) services performed for the business during the taxable year are performed within a QOZ;[35] or
- Both (i) the tangible property of the business that is in a QOZ and (ii) the management or operational functions performed for the business in a QOZ are necessary for the generation of 50% of the gross income of the business.[36]

Although the first two safe harbors provide bright line tests, the Proposed Regulations do not provide any bright lines as to when a business satisfies the third safe harbor. However, the Proposed Regulations provide two examples of what does and does not constitute a "material factor" in the income of a business. In the first example, a landscaping business serves customers within and without a QOZ, its officers and employees manage its daily operations from its headquarters in a QOZ, and it stores all of its equipment at its headquarters. The Proposed Regulations state that the activities occurring and the storage of equipment and supplies in the QOZ are, taken together, "a material factor in the generation of income of the business."[37] In the second example, a business has its PO Box located in a QOZ, the mail received at that PO Box is fundamental to the income of the business, but there is no other basis for concluding that the business derives income from activities in the QOZ. The Proposed Regulations state that the "mere location" of the PO Box "is not a material factor in the generation of gross income by the trade or business."[38]

If a business does not satisfy any of these safe harbors, it may still satisfy the 50% Gross Income Test if, based on all the facts and circumstances, at least 50% of the gross income of the entity is derived from the active conduct of a trade or business in a QOZ.[39] The Proposed Regulations include an example where a real estate development business satisfies the facts and circumstances test when it develops and leases a commercial building located within a QOZ and derives at least 50% of its gross income from its rental of tangible property in the QOZ.[40]

Clarification and Relaxation of Original Use Requirement

The Proposed Regulations provide that tangible property acquired by purchase generally satisfies the "original use" requirement for treatment as QOZ Business Property when any person first places the property in service, for purposes of depreciation or amortization (or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner), in the QOZ.[41] Used tangible property satisfies the original use requirement if the property has not been previously so used or placed in service in the QOZ.[42] Accordingly, if the tangible property has been so used or placed in service in the QOZ before it was purchased by a QOF or QOZ Business, the property is generally not QOZ Business Property unless the QOF or QOZ Business "substantially improves" the property. However, the Proposed Regulations allow property that has been unused or vacant for an uninterrupted period of at least five years prior to being purchased by a QOF or QOZ Business to satisfy the "original use" requirement.[43]

Other Guidance Relevant to Managers in the Proposed Regulations

The Proposed Regulations also provide, among other things, that:

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[35] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(i)(B).
[36] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(i)(C).
[37] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(i)(E)(1).
[38] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(i)(E)(2).
[39] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(i)(D).
[40] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(i)(E)(3).
[41] Prop. Reg. § 1.1400Z2(d)-1(c)(4)(i)(C); Prop. Reg. § 1.1400Z2(d)-1(c)(7); Prop. Reg. § 1.1400Z2(d)-1(d)(2)(i)(C).
[42] *Id.*
[43] *Id.*

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- For property to be QOZ Business Property, during at least 90% of a QOF's or QOZ Business's holding period for the property,[44] at least 70% of the use of such property must be in a QOZ.[45]
- Improvements made by a lessee to leased property satisfy the original use requirement.[46]
- Inventory in transit to or from a QOZ may satisfy the Substantial QOZ Use Test via a safe harbor.[47]
- For purposes of qualifying as a QOZ Business, a business satisfies the Intangible Property Test if it uses at least 40% of its intangible property in the active conduct of a trade or business in a QOZ.[48]
- Under the Working Capital Safe Harbor, a business may treat as reasonable working capital amounts it designates in writing for the development of a trade or business in a QOZ.[49]
- A business does not violate the 31-month requirement under the Working Capital Safe Harbor when waiting for government action, the application for which it completed during the 31-month period, delays its use of working capital.[50]
- A business may benefit from multiple overlapping or sequential applications of the Working Capital Safe Harbor.[51]
- For purposes of qualifying as a QOZ Business, ownership and operation of real property is the active conduct of a trade or business, but merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business.[52]
- For purposes of the 50% Gross Income Test, the Intangible Property Test, and the Financial Property Test, real property that is both within and outside a QOZ may be deemed to be located inside the QOZ in its entirety if the amount of real property in the QOZ is substantial compared to the amount outside the QOZ.[53]
- The determination of whether a QOF or QOZ Business substantially improves property is determined on an asset-by-asset basis, although the Treasury Department and IRS have requested comments on whether to adopt an aggregate standard that groups certain tangible assets together for this purpose.[54]
- A general anti-abuse rule allows the IRS to recast a transaction or series of transactions for U.S. federal income tax purposes if a significant purpose of such transaction or series of transaction is to achieve a tax result that is inconsistent with the purposes of the QOF tax benefits.[55]

Highlights from the Proposed Regulations for QOF Investors

QOF Interests Obtained by Contributions of Cash or Other Property to a QOF

The Proposed Regulations provide that an investor may make a Qualifying Investment in a QOF by exchanging cash or property other than cash to the QOF for QOF equity. The amount of the Qualifying Investment determines (i) the amount of

[44] Prop. Reg. § 1.1400Z2(d)-1(c)(5); Prop. Reg. § 1.1400Z2(d)-1(d)(2)(iii).
[45] Prop. Reg. § 1.1400Z2(d)-1(c)(6); Prop. Reg. § 1.1400Z2(d)-1(d)(2)(iv).
[46] Prop. Reg. § 1.400Z2(d)-1(c)(7)(ii).
[47] Prop. Reg. § 1.1400Z2(d)-1(c)(4)(iii).
[48] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(ii)(A).
[49] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(iv)(A).
[50] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(iv)(C).
[51] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(iv)(D).
[52] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(ii)(B)(2).
[53] Prop. Reg. § 1.1400Z2(d)-1(d)(5)(viii).
[54] Supplementary Information to the Proposed Regulations.
[55] Prop. Reg. § 1.1400Z2(f)-1(c).

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capital gain that the investor can defer or exclude under the Deferral Election and Exclusion Benefit and (ii) the base for determining how much appreciation can be excluded under the Gain Exclusion Election.

Very generally, the amount of a Qualifying Investment is limited to the cash or the value of the property transferred or, if less and if the transfer is a carryover basis transaction, the tax basis of the property contributed as increased by any gain recognized from the transfer; provided that in the case of contributions to a QOF Partnership for its equity, the amount of the Qualifying Investment is further reduced by any debt assumed (or taken subject to) the contribution.[56] For example, QOF equity received in a carryover basis transaction is a Mixed Funds Investment. Gain recognized in the transfer cannot be deferred by reason of the receipt of QOF equity from the transfer.[57] Limiting the amount of the Qualifying Investment to the basis of the contributed property is presumably intended to prevent an investor from using the Gain Exclusion Election to permanently avoid tax on the built-in gain contributed to a QOF.

QOF Interests Acquired from a Person other than a QOF

The Proposed Regulations provide that a taxpayer may make a Qualifying Investment in a QOF when it acquires equity of a QOF from a person other than the QOF in exchange for cash or other property. The amount of the Qualifying Investment equals the amount of cash, or the fair market value of other property, as determined immediately before the exchange, that the taxpayer exchanged for the Qualifying Investment.[58]

Events that Accelerate the Recognition of Deferred Gain

The Proposed Regulations describe a broad range of events that trigger the taxation of deferred capital gain prior to December 31, 2026 (such events, "Inclusion Events").[59] Very generally and subject to certain exceptions, Inclusion Events occur if and to the extent that a transaction reduces a taxpayer's equity interest in its Qualifying Investment.[60] In addition, certain distributions of property by a QOF to a taxpayer can generate an Inclusion Event.[61] The Proposed Regulations also include detailed rules concerning the timing and amount of otherwise deferred capital gain subject to taxation due to an Inclusion Event.

The Proposed Regulations identify specific transactions that are generally Inclusion Events, including, but not limited to:

- A greater than 25% ownership change of an S corporation that directly holds an Qualifying Investment.[62]
- A redemption by a QOF Corporation that is treated for federal income tax purposes as a distribution of property with respect to stock rather than a sale or exchange of QOF Corporation stock, unless the taxpayer wholly owns the QOF Corporation.[63]
- A termination or liquidation of a QOF or a taxable liquidation of an owner of a QOF.[64]
- A transfer of a Qualifying Investment by gift.[65]

[56] Prop. Reg. § 1.1400Z2(a)-1(b)(10)(ii)(B).
[57] Prop. Reg. § 1.1400Z2(a)-1(b)(2)(vi).
[58] Prop. Reg. § 1.1400Z2(a)-1(b)(9)(iii).
[59] Under § 1400Z-2(b)(1), gain subject to deferral is included in income in the taxable year which includes the earlier of the date on which the investment is sold or exchanged or December 31, 2026.
[60] Prop. Reg. § 1.1400Z2(b)-1(c)(1)(i).
[61] Prop. Reg. § 1.1400Z2(b)-1(c)(1)(ii).
[62] Prop. Reg. § 1.1400Z2(b)-1(c)(7)(iii).
[63] Prop. Reg. § 1.1400Z2(b)-1(c)(9).
[64] Prop. Reg. § 1.1400Z2(b)-1(c)(2).
[65] Prop. Reg. § 1.1400Z2(b)-1(c)(3).

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- A transfer by a partner of an interest in a QOF Partnership or a partnership that itself directly or indirectly holds a Qualifying Investment.[66]

The Proposed Regulations also identify specific transactions that are generally not Inclusion Events, including, but not limited to:

- A contribution of a Qualifying Investment to a partnership.[67]
- A contribution of a Qualifying Investment to a grantor trust.[68]
- A distribution by a QOF Partnership to a partner holding a Qualified Investment in the QOF Partnership, but only to the extent the amount of cash and the fair market value of property distributed with respect to the Qualifying Investment does not exceed the partner's basis in the Qualifying Investment.[69]
- A distribution by a QOF S Corporation to a shareholder holding a Qualifying Investment in the QOF S Corporation, but only to the extent the amount distributed is not treated as gain from the sale or exchange of property for federal income tax purposes.[70]
- A distribution by a QOF Corporation with respect to its stock, but only to the extent such distribution is treated as a dividend or a return of capital and not as a sale or exchange of property for federal income tax purposes.[71]
- A transfer of a Qualifying Investment by reason of the taxpayer's death.[72]

Other Guidance Relevant to Investors in the Proposed Regulations

The Proposed Regulations also provide, among other things, that:

- The amount of capital gain arising from a disposition of property used in a trade or business that is eligible to support a Qualifying Investment is the net amount of capital gain and losses from such property incurred by the taxpayer in the taxable year.[73]
- For purposes of determining treatment under the Exclusion Benefit and Gain Exclusion Election, the holding period of any QOF interest excludes the period for which the investor held property exchanged for such interest.[74]
- A partner's basis in a QOF Partnership interest will take into account the partner's share of partnership debt.[75]
- For purposes of the Gain Exclusion Election, the fair market value of a partner's interest in a QOF Partnership includes the proportionate value of partnership debt; in addition, immediately before the disposition of the QOF Partnership interest, the basis of the QOF Partnership assets are also adjusted to fair market value.[76]

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[66] Prop. Reg. § 1.1400Z2(b)-1(c)(1)(i).
[67] Prop. Reg. § 1.1400Z2(b)-1(c)(6)(ii)(B).
[68] Prop. Reg. § 1.1400Z2(b)-1(c)(5).
[69] Prop. Reg. § 1.1400Z2(b)-1(c)(6)(iii).
[70] Prop. Reg. § 1.1400Z2(b)-1(c)(7)(ii).
[71] Prop. Reg. § 1.1400Z2(b)-1(c)(8).
[72] Prop. Reg. § 1.1400Z2(b)-1(c)(4).
[73] Prop. Reg. § 1.1400Z2(a)-1(b)(2)(iii).
[74] Prop. Reg. § 1.1400Z2(b)-1(d)(1)(i).
[75] Prop. Reg. § 1.1400Z2(b)-1(g)(3). As noted above, a distribution from a QOF Partnership to a partner not in excess of the partner's basis in the QOF Partnership interest does not constitute an Inclusion Event. This means that debt-financed distributions from a QOF Partnership may not trigger an Inclusion Event.
[76] Prop. Reg. § 1.1400Z2(c)-1(b)(2)(i).

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