OPPORTUNITY ZONES

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NEW IRS REGULATIONS WILL HELP SPUR INVESTMENT BUT MORE GUIDANCE IS NEEDED

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I. INTRODUCTION

A. Overview of Treasury Guidance Issued 10-19-2018

The Tax Cuts and Jobs Act (TCJA), passed in late 2017, contained many headline-grabbing new tax provisions, and during the initial wave of public reaction and acclaim the Opportunity Zones Act[1] (Ozone Act) embedded in the TCJA was largely overlooked. However, the Ozone Act has proven to be something of an iceberg, with only the tip visibly exposed: Beneath the surface, Ozones have developed into something quite large – and perhaps enormous.

According to the Economic Innovation Group (EIG), the Ozone Act could attract a staggering $6 *trillion* in investment funds, and could become a major force in the rehabilitation of American cities and the expansion of the American economy.

Although the Ozone Act has belatedly drawn a great deal of attention, it has proven to be awkwardly drafted and dauntingly complex, and so the vast majority of potential investors have thus far been on the sidelines awaiting further information and better guidance from the Treasury.

[1] Section 13823 of the Tax Cuts and Jobs Act of 2017, a amended from time to time, including Code Sections 1400Z-1 and 1400Z-2.

The first wave of Treasury guidance arrived on Friday, October 19, 2018, in the form of proposed regulations, specific examples, expanded FAQs and proposed IRS forms (collectively, the "Treasury Guidance").

How valuable was this first drop shipment of information? The good news is that many uncertain features of the Ozone Act have been fleshed out and defined in ways that will provide satisfactory guidance to the market place. However, some of the biggest issues and many complicated questions still remain unanswered, and so further guidance will likely be needed before the expected tidal wave of investment is unleashed. It is probably fair to state that the Ozone Act as originally drafted raised a ton of questions, and that this first shipment of Treasury Guidance provides about half a ton of answers.

Still to be answered are crucial questions including, whether the Treasury will sanction the use of feeder funds to aggregate large amounts of capital, whether it is okay to lease the real estate in connection with a qualified opportunity zone business, and several other key threshold questions that need to be answered before the financial floodgates are fully opened.

The following is a more detailed discussion of the issues that have been answered by the Treasury Guidance, and then a discussion of key issues that remain to be clarified.

B. **Summary of Guidance – The "Cheat Sheet"**

1. Eligible Gains. Only capital gains – but all types of capital gains – are eligible for Ozone Act investment and deferral benefits. Eligible gain is a tax item "treated as a capital gain for Federal income tax purposes."

2. Eligible taxpayers. Eligible taxpayer is any person that may recognize gains for purposes of Federal income tax accounting. Thus, eligible taxpayers include individuals; C corporations, including regulated investment companies (RICs) and real estate investment trusts (REITs); partnerships; S corporations; trusts and estates.

3. Eligible Interest in a Qualified Opportunity Fund (QOF) is an equity interest issued by the QOF, including preferred stock or a partnership interest with special allocations. The term eligible interest excludes any debt instrument.

4. Gains of partnerships

   a. A partnership may elect to defer all (or part) of a capital gain item.

   b. If the partnership makes an election to defer all or part of the gain, the deferred portion is not included in the distributive shares of the partners.

   c. If the partnership does not elect to defer all of the gain, each partner may elect deferral with respect to such partner's distributive share of the gain not deferred.

d. The partner's 180-day period for investment in a QOF generally begins when the gain is deemed distributed (i.e., the last day of the partnership tax year).

e. However, a partner may choose to begin the 180-day investment period on the same date as the start of the partnership's 180-day period.

5. Character of deferred gain. All tax attributes of deferred gain (e.g., short-term gain, collectibles gain) are preserved until the end of the deferral period and are taken into account at the time the deferred gain is recognized, e.g., 12-31-2026.

6. Qualified Opportunity Fund (QOF).

a. Eligibility. To be eligible to be a QOF, an entity must be classified as a corporation or partnership for Federal income tax purposes, and must be organized in one of the 50 U.S. states, D.C., or a U.S. possession (and only if it is organized to invest in QOZ Property in that specific possession).

b. A limited liability company can qualify as a QOF; however, be thoughtful and cautious about using an LLC, because an LLC can become ineligible if all the membership interests become held by a single person.

7. Designating When a QOF Begins.

a. An eligible entity can choose which month will be the "first month" in the taxable year in which the entity will be a QOF.

b. The first month of the taxable year will be chosen by default if no other month is chosen.

c. The "first 6-month period of the taxable year of the fund" means the first 6-month period composed entirely of months which are within the taxable year and during which the entity is a QOF.

8. Valuation Method for Applying the 90-Percent Asset Test. The QOF uses the asset values that are reported on the QOF's applicable financial statement for the taxable year (as defined in §1.475(a)-4(h)), or, if the QOF has no applicable financial statement, the QOF uses the cost of its assets (i.e., unadjusted tax basis).

9. Section 752(a) Deemed Contributions. Debt incurred by a QOF taxable as a partnership does not count as an investment by any of its partners; however, debt also does not count as a contribution of non-eligible gain that could cause such debt to be treated as a non-eligible investment in a mixed-use fund, and so does not diminish the tax benefits on sale of a QOF after ten years.

10. Guidance Relevant to QOZ Businesses.

a. "Substantially all" for purposes of the tangible property test means 70 percent of tangible property. Thus, 70% of a partnership or corporation's tangible property owned or leased must be qualified opportunity zone business property (QOZBP).

b. However, there is currently no guidance on how to calculate and apply the 70% test where a Qualified Opportunity Zone Business (QOZ Business) leases real property from an unrelated party at market lease rates. See Exhibit C for a detailed discussion of leasing issues.

11. Reasonable Working Capital Safe Harbor.

a. The Treasury Guidance declined to provide a "safe harbor" for working capital at the QOF level.

b. Instead, it provides a safe harbor at the QOZ Business level for businesses that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property, used in a business operating in an opportunity zone.

c. The safe harbor allows a reasonable amount of working capital to be held for a period of up to 31 months, if three requirements are met:

i. Intended uses are designated in writing.

ii. There is a reasonable written schedule.

iii. The working capital is used in a manner substantially consistent with the designated uses and written schedule.

12. Pre-Existing Entities.

Pre-existing entities can qualify as a QOF or a QOZ Business, provided they satisfy the necessary requirements.

13. Effect of Expiring Opportunity Zone Designations.

a. The expiration of OZ designations after 2028 will not negatively impact the eligibility of investors in a QOF to elect a step-up in tax basis with respect to such property where the ten-year holding period is met after 2028 or the property is sold after 2028.

b. The eligibility to make a basis step-up election on sale of the QOF investment after ten years continues until an outside date of December 31, 2047. Treasury is still consider whether there must be a sale before such date or whether eligible investments if QOFs will have an automatic step-up in tax basis on that date.

C. **Comments Requested from Public on Treasury Guidance.**

1. The Treasury Guidance provides notice of a public hearing on these proposed regulations and requests that written (including electronic) comments be submitted within 60 days of publication in the federal register. Send submissions to: CC:PA:LPD:PR (REG-115420-18), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-115420-18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224. Alternatively, taxpayers may submit comments electronically via the Federal Rulemaking Portal at www.regulations.gov (IRS REG-115420-18). The public hearing will be held in the IRS auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

2. FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Erika C. Reigle of the Office of Associate Chief Counsel (Income Tax and Accounting), (202) 317-7006 and Kyle C. Griffin of the Office of Associate Chief Counsel (Income Tax and Accounting), (202) 317-4718; concerning the submission of comments, the hearing, or to be placed on the building access list to attend the hearing, Regina L. Johnson, (202) 317-6901 (not toll-free numbers).

3. The Treasury Department and the IRS are working on additional published guidance, including additional proposed regulations expected to be published in the near future. The Treasury Department and the IRS expect the forthcoming proposed regulations to incorporate the guidance contained in the revenue ruling to facilitate additional public comment.

4. The forthcoming proposed regulations are expected to address other issues under section 1400Z-2 that are not addressed in these proposed regulations. Issues expected to be addressed include:

a. the meaning of "substantially all" in each of the various places where it appears in section 1400Z-2;

b. the transactions that may trigger the inclusion of gain that has been deferred under a section 1400Z-2(a) election;

c. the "reasonable period" (see section 1400Z-2(e)(4)(B)) for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty;

d. administrative rules applicable under section 1400Z-2(f) when a QOF fails to maintain the required 90 percent investment standard; and

e. information-reporting requirements under section 1400Z-2.

II. DEFERRING TAX ON CAPITAL GAINS BY INVESTING IN OPPORTUNITY ZONES

A. **Gains Eligible for Deferral.**

1. Treasury Guidance.

The proposed regulations clarify that only capital gains are eligible for deferral under section 1400Z-2(a)(1). In setting forth the gains that are subject to deferral, the text of section 1400Z-2(a)(1) specifies "gain from the sale to, or exchange with, an unrelated person of any property held by the taxpayer," to the extent that such gain does not exceed the aggregate amount invested by the taxpayer in a QOF during the 180-day period beginning on the date of the sale or exchange (emphasis added). The statutory text is silent as to whether Congress intended both ordinary and capital gains to be eligible for deferral under section 1400Z-2. (Sections 1221 and 1222 define these two kinds of gains.) However, the statute's legislative history explicitly identifies "capital gains" as the gains that are eligible for deferral. The Treasury Department and the IRS believe, based on the legislative history as well as the text and structure of the statute, that section 1400Z-2 is best interpreted as making deferral available only for capital gains. The proposed regulations provide that a gain is eligible for deferral if it is treated as a capital gain for Federal income tax purposes. Eligible gains, therefore, generally include 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.

The proposed regulations address two additional gain deferral requirements. First, the gain to be deferred must be gain that would be recognized, if deferral under section 1400Z-2(a)(1) were not permitted, not later than December 31, 2026, the final date under section 1400Z-2(a)(2)(B) for the deferral of gain. Second, the gain must not arise from a sale or exchange with a related person as defined in section 1400Z-2(e)(2). Section 1400Z-2(e)(2) incorporates the related person definition in sections 267(b) and 707(b)(1) but substitutes "20 percent" in place of "50 percent" each place it occurs in section 267(b) or section 707(b)(1).

2. **JBD3 Comments**:

The Ozone Act referred to "gain from the sale …of any property held by the taxpayer" but most observers expected the IRS to limit the eligible gain to "capital gain" and that is exactly where the Treasury Guidance comes out. This was a complete non-surprise. Also as expected, the definition of capital gain is broadly construed to include, apparently, all gain that is classified as "capital gain" under Code Section 1, which would include short-term capital gain, long-term capital gain, unrecaptured Code Section 1250 gain, collectibles gain, Code Section 1231 gain, REIT capital gain dividends, RIC capital gain dividends, and any other "capital gain."

B. **Types of Taxpayers Eligible to Elect Gain Deferral.**

1. Treasury Guidance.

The proposed regulations clarify that taxpayers eligible to elect deferral under section 1400Z-2 are those that recognize capital gain for Federal income tax purposes. These taxpayers include individuals, C corporations (including regulated investment companies (RICs) and real estate investment trusts (REITs)), partnerships, and certain other pass-through entities, including common trust funds described in section 584, as well as, qualified settlement funds, disputed ownership funds, and other entities taxable under §1.468B of the Income Tax Regulations.

In order to address the numerous issues raised by new section 1400Z-2 for pass-through entities, the proposed regulations include special rules for partnerships and other pass-through entities, and for taxpayers to whom these entities pass through income and other tax items. Under these rules, the entities and taxpayers can invest in a QOF and thus defer recognition of eligible gain. The Treasury Department and the IRS request comments on whether the rules are sufficient and whether more detailed rules are required to provide additional certainty for investors in pass-through entities that are not partnerships.

2. **JBD3 Comments**:

The identity of the "taxpayer" was a crucial early issue, especially with respect to capital gain recognized by a partnership. Was the party eligible to invest the gain the partnership or its partners? The very generous answer from the IRS is: BOTH! As will be discussed more fully below, the IRS provides an "either/or" approach. A partnership gets the first crack at being treated as the taxpayer and can elect to reinvest gain within 180 days of the sale by the partnership; or, if the partnership chooses not to take full advantage of the right to reinvest gain under the Ozone Act, the right passes to its partners, who can take advantage of the investment opportunity for any gain not already used by the partnership. The partner's reinvestment of gain must occur within (a) 180 days after the last day of the partnership's taxable year (when the gain is deemed distributed to the partner under Code Section 706) or, if the partner is aware of the sale of property by the partnership and so elects, within 180 days of the sale of the property by the partnership.

Note that "similar" rules are supposed to apply to S corporations, trusts, and estates. See the more detailed discussion of this topic at Section IV.A, below.

C. **Investments in a QOF.**

1. Treasury Guidance.

The proposed regulations clarify that, to qualify under section 1400Z-2(a)(1)(A), (that is, to be an eligible interest in a QOF), an investment in the QOF must be an equity interest in the QOF, including preferred stock or a partnership interest with special allocations. Thus, an eligible interest cannot be a debt instrument within the meaning of section 1275(a)(1) and §1.1275-1(d). Provided that the eligible taxpayer is the owner of the equity interest for Federal income tax purposes, status 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. The proposed regulations also clarify that deemed contributions of money under section 752(a) do not result in the creation of an investment in a QOF.

2. **JBD3 Comments.**

The exact nature of a Qualified Opportunity Fund (QOF) was unclear in many ways, and the proposed regulations provide welcome specificity on a number of key points. The investment in the QOF must be made in exchange for stock (in a corporation) or for a partnership interest (in a partnership) and cannot be made in exchange for a debt instrument.

Equity in a QOF can be pledged as collateral for a loan without causing the QOF to lose eligibility under the Ozone Act, even if the loan is to provide the funds for investment into the QOF. This result is exactly what everyone was hoping for, but the clarification is good. For example, borrowing funds from an outside party and pledging the QOF interest provides a viable way for taxpayers who recognize phantom gain, for example, to obtain the necessary funds in order to invest timely in the QOF.

On the other hand, money borrowed by at the QOF level by a QOF that is a partnership does not count as an "investment" in the QOF by its partners. This creates a curious dichotomy. As noted in the preceding paragraph, a taxpayer can borrow money from a bank, pledge the OZ partnership interest to secure the loan, and upon contribution of the loan proceeds to the QOZ that arrangement will count as a qualifying investment of funds into the QOF. But if the QOF borrows the same loan amount from the same bank and the partner guarantees the loan, this arrangement will NOT be treated as an investment in the QOF. This contrasting set of rules means that form will tend to control over substance at least in this corner of the OZ world – and may be a harbinger of further technical distinctions related to debt as the Treasury Guidance is developed.

The biggest take away appears to be that debt incurred by a Qualified Opportunity Zone Business (QOZ Business) structured as a partnership will, by itself, not cause a QOF investing in such partnership to be characterized as a "mixed fund," and instead will allow taxpayers investing in a QOF that in turn invests in a leveraged partnership to treat the entire QOF investment as a qualified investment rather than as a mixed fund.

D. **180-Day Rule for Deferring Gain by Investing in a QOF**

1. Treasury Guidance.

Under section 1400Z-2(a)(1)(A), to be able to elect to defer gain, a taxpayer must generally invest in a QOF during the 180-day period beginning on the date of the sale or exchange giving rise to the gain. Some capital gains, however, are the result of Federal tax rules deeming an amount to be a gain from the sale or exchange of a capital asset, and, in many cases, the statutory language providing capital gain treatment does not provide a specific date for the deemed sale. The proposed regulations address this issue by providing that, except as specifically provided in the proposed regulations, the first day of the 180-day period is the date on which the gain would be recognized for Federal income tax purposes, without regard to the deferral available under section 1400Z-2. The proposed regulations include examples that illustrate the general rule by applying it to capital gains in a variety of situations (including, for example, gains from the sale of exchange-traded stock and capital gain dividend distributions).

If a taxpayer acquires an original interest in a QOF in connection with a gain-deferral election under section 1400Z-2(a)(1)(A), if a later sale or exchange of that interest triggers an inclusion of the deferred gain, and if the taxpayer makes a qualifying new investment in a QOF, then the proposed regulations provide that the taxpayer is eligible to make a section 1400Z-2(a)(2) election to defer the inclusion of the previously deferred gain. Deferring an inclusion otherwise mandated by section 1400Z-2(a)(1)(B) in this situation is permitted only if the taxpayer has disposed of the entire initial investment without which the taxpayer could not have made the previous deferral election under section 1400Z-2. The complete disposition is necessary because section 1400Z-2(a)(2)(A) expressly prohibits the making of a deferral election under section 1400Z-2(a)(1) with respect to a sale or exchange if an election previously made with respect to the same sale or exchange remains in effect. The general 180-day rule described above determines when this second investment must be made to support the second deferral election. Under that rule, the first day of the 180-day period for the new investment in a QOF is the date that section 1400Z-2(b)(1) provides for inclusion of the previously deferred gain.

Comments are requested as to whether the final regulations should contain exceptions to the general 180-day rule and whether it would be helpful for either the final regulations or other guidance to illustrate the application of the general 180-day rule to additional circumstances, and what those circumstances are.

2. **<u>JBD3 Comments.</u>**

The Treasury Guidance VERY QUICKLY gets highly technical, as these provisions illustrate.

First, if there is capital gain recognized by a deemed event, the 180-day clock starts on the day the gain is recognized for federal income tax purposes. Not a big surprise, and probably a workable rule in most if not all cases.

The second paragraph is very interesting: It allows a taxpayer to cash out of an OZ investment before the ten-year period has run, and reinvest the ORIGINAL deferred gain (plus, presumably, additional gain from the OZ investment itself) so long as the taxpayer makes a new qualifying investment in a QOF within 180 days of the sale. This is nice but it is NOT what

taxpayers really hoped for and care about. What taxpayers were hoping for was that they could have the QOF sell a qualifying investment in QOZ Property during the ten-year period and roll that money over into a new investment in QOZ Property. However, half a loaf is better than none at all, and the ability to take advantage of market fluctuations and liquidate an investment (by selling the QOF interest) and then roll the proceeds into a new QOF investment, is not a bad outcome. Presumably gain from appreciation in the QOF investment (as well as the ORIGINAL gain) will start a ten-year holding period for purposes of enjoying the tax benefits of Code Section 1400Z-2(c)[i.e., full step-up in tax basis on sale of an interest in a QOF after ten years].

Not surprisingly, answers from the IRS often merely beget lots of additional questions.

E. **Attributes of Included Income When Gain Deferral Ends.**

1. Treasury Guidance.

Section 1400Z-2(a)(1)(B) and (b) require taxpayers to include in income previously deferred gains. The proposed regulations provide that all of the deferred gain's tax attributes are preserved through the deferral period and are taken into account when the gain is included. The preserved tax attributes include those taken into account under sections 1(h), 1222, 1256, and any other applicable provisions of the Code. Furthermore, the proposed regulations address situations in which separate investments providing indistinguishable property rights (such as serial purchases of common stock in a corporation that is a QOF) are made at different times or are made at the same time with separate gains possessing different attributes (such as different holding periods). If a taxpayer disposes of less than all of its fungible interests in a QOF, the proposed regulations provide that the QOF interests disposed of must be identified using a first-in, first-out (FIFO) method. Where the FIFO method does not provide a complete answer, such as where gains with different attributes are invested in indistinguishable interests at the same time, the proposed regulations provide that a pro-rata method must be used to determine the character, and any other attributes, of the gain recognized. Examples in the proposed regulations illustrate this rule.

Comments are requested as to whether different methods should be used. Any such alternative methods must both provide certainty as to which fungible interest a taxpayer disposes of and allow taxpayers to comply easily with the requirements of section 1400Z-2(a)(1)(B) and (b),which require that certain dispositions of an interest in a QOF cause deferred gain be included in a taxpayer's income.

2. **JBD3 Comments.**

When gain is deferred as a result of a qualifying investment under the Ozone Act, the character of that gain (e.g., short-term capital gain, long-term capital gain, collectibles gain) is preserved and the same tax character applies when the gain is finally recognized. (NOTE: This is what everyone expected, but now we have a clear answer.)

Where there is a partial recognition of deferred gain from a sale of less than all the interests in the QOF, the regulations provide two rules: FIFO (first in, first out) in the case of serial investment in the QOF, and pro-rata if there is a simultaneous investment at the same time of separate gains possessing different tax characters. These rules are technical, but logical, and are neither a big surprise nor a big deal.

III. SPECIAL RULES

A. Gain Not Already Subject To An Election

1. Treasury Guidance.

Under section 1400Z-2(a)(2)(A), no election may be made under section 1400Z-2(a)(1) with respect to a sale or exchange if an election previously made with respect to that sale or exchange is in effect. There has been some confusion as to whether this language bars a taxpayer from making multiple elections within 180-days for various parts of the gain from a single sale or exchange of property held by the taxpayer. This rule in section 1400Z-2(a)(2)(A) is meant to exclude from the section 1400Z-2(a)(1) election multiple purported elections with respect to the same gain. (Although the gain itself can be deferred only once, a taxpayer might be seeking to multiply the investments eligible for various increases in basis.) Thus, the proposed regulations clarify that in the case of a taxpayer who has made an election under section 1400Z-2(a) with respect to some but not all of an eligible gain, the term "eligible gain" includes the portion of that eligible gain as to which no election has been made. (All elections with respect to portions of the same gain would, of course, be subject to the same 180-day period.)

2. JBD3 Comments.

Ah, a mystery solved. The rather confusing language in the statute is explained in a reasonable manner, to wit: If you have gain from a single sale transaction, you can potentially divide or bifurcate that gain amount and use portions of that gain for multiple qualifying investments. What you cannot do is use the same gain two or more times – e.g., the same $100,000 of gain cannot be used for five separate investments in an effort to exempt all five investments from gain recognition after ten years.

NOTE: This rule, and a number of others in the Treasury Guidance, suggests that the Treasury is trying to provide fair, sensible and even taxpayer-friendly rules under the Ozone Act. In general, to the extent the Treasury Guidance is disappointing, it is mostly because the Ozone Act itself is drafted in a manner that does not lend itself to a more favorable interpretation.

B. **Section 1256 contracts**

1. Treasury Guidance.

The proposed regulations provide rules for capital gains arising from section 1256 contracts. Under section 1256, a taxpayer generally "marks to market" each section 1256 contract at the termination or transfer of the taxpayer's position in the contract or on the last business day of the taxable year if the contract is still held by the taxpayer at that time. The mark causes the taxpayer to take into account in the taxable year any not-yet recognized appreciation or depreciation in the position. This gain or loss, if capital, is treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. Currently, for federal income tax purposes, the only relevant information required to be reported by a broker to the IRS and to individuals and certain other taxpayers holding section 1256 contracts, is the taxpayer's net recognized gain or loss from all of the taxpayer's section 1256 contracts held during the taxable year. Some taxpayers holding section 1256 contracts, however, report the gain or loss from section 1256 contracts to the IRS on a per contract basis rather than on an aggregate basis. To minimize the burdens on taxpayers, brokers, and the IRS from tax compliance and tax administration, the proposed regulations allow deferral under section 1400Z-2(a)(1) only for a taxpayer's capital gain net income from section 1256 contracts for a taxable year. In addition, because the capital gain net income from section 1256 contracts for a taxable year is determinable only as of the last day of the taxable year, the proposed regulations provide that the 180-day period for investing capital gain net income from section 1256 contracts in a QOF begins on the last day of the taxable year.

Finally, the proposed regulations do not allow any deferral of gain from a section 1256 contract in a taxable year if, at any time during the taxable year, one of the taxpayer's section 1256 contracts was part of an offsetting-positions transaction (as defined later in the proposed regulations and described below) in which any of the other positions was not also a section 1256 contract.

Comments are requested on this limitation and on whether capital gain from a section 1256 contract should be eligible for deferral under section 1400Z-2 on a per contract basis rather than on an aggregate net basis. Reporting on a per contract basis might require a significant increase in the number of information returns that taxpayers would need to file with the IRS as compared to the number of information returns that are currently filed on an aggregate net basis. Comments are requested on how to minimize the burdens and complexity that may be associated with reporting on a per contract basis for section 1256 contracts.

2. **JBD3 Comments**

Section 1256 contracts are complicated instruments from a federal income tax perspective, and Treasury clearly spend a fair amount of time addressing how to treat the deemed gain recognized each under these "mark to market" assets. In general, the IRS – perhaps unfortunately – felt obligated to start at the top of the Ozone Act and define in detail the basic concepts such as "Who is the taxpayer?" and "What is gain?" when far more

important issues (with all due respect to Section 1256 contracts) remain thus far unaddressed. The problem is that the IRS needs to address ALL these issues sooner or later, and it had to start somewhere. So: We now know how to treat Section 1256 contracts.

C. **Offsetting-positions transactions, including straddles**

1. Treasury Guidance.

The Treasury Department and the IRS considered allowing deferral under section 1400Z-2(a)(1) for a net amount of capital gain related to a straddle (as defined in section 1092(c)(1)) after the disposition of all positions in the straddle. However, such a rule would pose significant administrative challenges. For example, additional rules would be needed for a taxpayer to defer such a net amount of capital gain when positions are disposed of in different taxable years (and likely would require affected taxpayers to file amended tax returns). Further, additional rules might be needed to take into account the netting requirements for identified mixed straddles described in §1.1092(b)-3T or 1.1092(b)-6 and for mixed straddle accounts described in §1.1092(b)-4T. Accordingly, in the interest of sound tax administration and to provide consistent treatment for transactions involving off-setting positions in personal property, the proposed regulations provide that any capital gain from a position that is or has been part of an offsetting-positions transaction (other than an offsetting-positions transaction in which all of the positions are section 1256 contracts) is not eligible for deferral under section 1400Z-2.

An offsetting-positions transaction is defined in the proposed regulations as a transaction in which a taxpayer has substantially diminished the taxpayer's risk of loss from holding one position with respect to personal property by holding one or more other positions with respect to personal property (whether or not of the same kind). It does not matter whether either of the positions is with respect to actively traded personal property. An offsetting-positions transaction includes a straddle as defined in section 1092 and the regulations thereunder, including section 1092(d)(4), which provides rules for positions held by related persons and certain flow-through entities (for example, a partnership). An offsetting-positions transaction also includes a transaction that would be a straddle (taking into account the principles referred to in the preceding sentence) if the straddle definition did not contain the active trading requirement in section 1092(d)(1).

2. **JBD3 Comments.**

The big take-away from the Treasury Guidance is that individual capital gain transactions can be eligible for the investment provisions of the Ozone Act, even if the taxpayer has other capital loss transactions that would be netted against the capital gain for the taxable year. In effect, if you have gains and losses, you can rollover your gains, and claim your losses currently.[2] The fact that the IRS gave what appears to be a great deal of

[2] Since capital losses can generally be deducted only against capital gains, plus $3,000 per year, this rule is perhaps not as wonderful as it may initially sound, but the point is that gross capital gains can be rolled over even

consideration about whether to allow the "gain" leg of a straddle to be eligible gain under the Ozone Act suggests that the Treasury was trying to take a pretty liberal position with respect to eligible gain. This pro-taxpayer tilt is found in other parts of the Treasury Guidance, which policy orientation bodes well for future guidance on other key issues.

IV. GAINS OF PARTNERSHIPS AND OTHER PASS-THROUGH ENTITIES

A. **Partnerships.**

1. Treasury Guidance.

Commenters have requested clarification regarding whether deferral is possible under section 1400Z-2 any time a partnership would otherwise recognize capital gain. The proposed regulations provide rules that permit a partnership to elect deferral under section 1400Z-2 and, to the extent that the partnership does not elect deferral, provide rules that allow a partner to do so. These rules both clarify the circumstances under which each can elect and clarify when the applicable 180-day period begins.

Proposed §1.1400Z-2(a)-1(c)(1) provides that a partnership may elect to defer all or part of a capital gain to the extent that it makes an eligible investment in a QOF. Because the election provides for deferral, if the election is made, no part of the deferred gain is required to be included in the distributive shares of the partners under section 702, and the gain is not subject to section 705(a)(1).

Proposed §1.1400Z-2(a)-1(c)(2) provides that, to the extent that a partnership does not elect to defer capital gain, the capital gain is included in the distributive shares of the partners under section 702 and is subject to section 705(a)(1). If all or any portion of a partner's distributive share satisfies all of the rules for eligibility under section 1400Z-2(a)(1) (including not arising from a sale or exchange with a person that is related either to the partnership or to the partner), then the partner generally may elect its own deferral with respect to the partner's distributive share. The partner's deferral is potentially available to the extent that the partner makes an eligible investment in a QOF.

Consistent with the general rule for the beginning of the 180-day period, the partner's 180-day period generally begins on the last day of the partnership's taxable year, because that is the day on which the partner would be required to recognize the gain if the gain is not deferred. The proposed regulations, however, provide an alternative for situations in which the partner knows (or receives information) regarding both the date of the partnership's gain and the partnership's decision not to elect deferral under section 1400Z-2. In that case, the partner may choose to begin its own 180-day period on the same date as the start of the partnership's 180-day period.

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if the taxpayer also has substantial capital losses (including capital loss carryforwards) that might otherwise offset such capital gain for the applicable taxable year.

2. **JBD3 Comments**.

These rules are remarkably generous and liberal, and will make for some very interesting planning opportunities. First, a partnership has the first shot at electing to defer capital gain under the Ozone Act, and if it does so successfully the gain is excluded from the partner's distributable share of partnership tax items reported on the Form K-1. If the partnership does not elect to defer gain (or apparently if it elects to defer some but not all of the gain) the non-deferred gain flows through to the partners on the last day of the taxable year, and the partners then have 180 days from the end of the partnership tax year to elect to reinvest the gain at the partner level into a QOF. Since partnerships generally have calendar-year tax years (especially if the partnership is comprised predominantly of individuals) this means that partnership gain recognized at ANY time in 2018 would be eligible for investment at any time up during the first 180 days of 2019!! Whoa!!

Furthermore, if the partnership informs the partner about both the date of the partnership's gain and the partnership's decision not to elect full deferral under the Ozone Act, the partner can choose to "jump the gun" and start the 180-day period on the same date as the partnership's 180-day period instead of waiting until year end. (NOTE: This creates a very anomalous situation, where if a partnership sells property for capital gain on February 15th, the partner can potentially choose to reinvest gain during either of two non-contiguous periods, the first running for 180 days from February 15th, and the second running for 180 days from December 31. But apparently the partner can NOT invest during the period that runs after the first 180-period ends and before the second 180-day period begins. An odd concatenation of events, to say the very least.]

Over all, these partnership rules are remarkably flexible and are more generous than almost anyone anticipated.

B. **Other Pass-Through Entities**

1. Treasury Guidance.

The proposed regulations state that rules analogous to the rules provided for partnerships and partners apply to other pass-through entities (including S corporations, decedents' estates, and trusts) and to their shareholders and beneficiaries. Comments are requested regarding whether taxpayers need additional details regarding analogous treatment for pass-through entities that are not partnerships.

2. **JBD3 Comments**.

The Treasury clearly anticipates that "analogous" rules will apply to S corporations, which will be interesting because, unlike partnerships, S corporations do not explicitly distribute items of gain (or other tax items) on the last day of the S corporation tax year. The IRS would hopefully adopt rules as overtly flexible as those advanced for a partnership, but the income allocation rules under Subchapter S (including the "default" rule that S

corporation items are allocated per share/per day but subject to an election under Code Section 1377(a)(2) to have an interim closing for a departing shareholder) will make for an interesting (future) read when (and if) the IRS gets around to addressing these distinctions. What seems clear is that an S corporation with gain can elect to take advantage of the Ozone Act; and then, to the extent that gain is not deferred and instead passes through to shareholders, the shareholders can PROBABLY take advantage of the gain as well, assuming Treasury adopts the same "two bites at the apple" philosophy that was applicable to partnerships and partners.

For estates and trusts, the issue may also be complicated but for different reasons: Capital gain recognized by a trust may be attributable to the non-distributable corpus and so the trustee may not have discretion about whether to "keep" the gain (and this elect the benefits of the Ozone Act by making a qualifying investment) or whether to distribute the gain to beneficiaries. This is because, under the typical Income and Principal Act, gain with respect to "principal" may be part of the corpus may be required to be held in trust and not distributed to beneficiaries.

EDUCATED GUESS: The Treasury got a huge number of inquiries about how to treat gain recognized by a partnership (especially investment partnerships and hedge funds) and so the nuances of how to treat partnership gain was both a primary focus of public inquiry and also, because of the unique characteristics of partnership taxation, relatively easy to address with clear rules. Treasury probably postponed issuing detailed rules for S corporations, trusts and estates precisely because each type of taxpayer has materially different tax characteristics as compared to a partnership.

V. HOW TO ELECT DEFERRAL

A. <u>Treasury Guidance</u>

The proposed regulations require deferral elections to be made at the time and in the manner provided by the Commissioner of Internal Revenue (Commissioner). The Commissioner may prescribe in regulations, revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin or in forms and instructions the time, form, and manner in which an eligible taxpayer may elect to defer eligible gains under section 1400Z-2(a). It is currently anticipated that taxpayers will make deferral elections on Form 8949, which will be attached to their Federal income tax returns for the taxable year in which the gain would have been recognized if it had not been deferred. Form instructions to this effect are expected to be released very shortly after these proposed regulations are published. Comments are requested whether additional proposed regulations or other guidance are needed to clarify the required procedures. In addition IRS released draft forms for public review and comments. These drafts are posted to www.IRS.gov/DraftForms and include a cover sheet that indicates how to submit comments.

B. **JBD3 Comments.**

One of the interesting questions for taxpayers who are trying to wrap their heads around the Ozone Act but who have a clock ticking on gain that recognized, say, 175 days ago, is whether the taxpayer can stick money into a QOF entity for the moment, but later decide to unwind the transaction. The answer seems to be that an easy way to "unwind" the arrangement is simply to avoid making the necessary election to defer eligible gains, i.e., do NOT file Form 8949 with the applicable tax return. Another alternative, of course, would be to unwind the transaction before the end of the year, but simply choosing not to file Form 8949 should suffice. The benefits of the Ozone Act are elective, not mandatory,[3] and so one effectively elects "out" of the transaction at any point in time simply by declining to elect "in" at the required times in the required manner.

VI. ELECTION FOR INVESTMENTS HELD AT LEAST 10 YEARS

A. In General

1. Treasury Guidance.

Under section 1400Z-2(c), a taxpayer that holds a QOF investment for at least ten years may elect to increase the basis of the investment to the fair market value of the investment on the date that the investment is sold or exchanged.

The basis step-up election under section 1400Z-2(c) is available only for gains realized upon investments that were made in connection with a proper deferral election under section 1400Z-2(a). It is possible for a taxpayer to invest in a QOF in part with gains for which a deferral election under section 1400Z-2(a) is made and in part with other funds (for which no section 1400Z-2(a) deferral election is made or for which no such election is available). Section 1400Z-2(e) requires that these two types of QOF investments be treated as separate investments which receive different treatment for Federal income tax purposes. Pursuant to section 1400Z-2(e)(1)(B), the proposed regulations reiterate that a taxpayer may make the election to step-up basis in an investment in a QOF that was held for 10 years or more only if a proper deferral election under section 1400Z-2(a) was made for the investment.

2. **JBD3 Comments.**

This explanation merely reiterates the statutory scheme whereby a rollover of "gains" enjoys the tax benefits of the Ozone Act, while non-gain funds (i.e., funds for which no section 1400Z-2(a) deferral election is made or for which no such election is available) are treated as a separate investment that do not enjoy the OZ tax benefits.

[3] Just as a counterpoint example, an exchange of property that qualifies as a like-kind exchange is mandatory if all the applicable statutory requirements are met – even if the taxpayer does not want exchange treatment.

No one (thus far) has put forward a reason why it might be better NOT to "elect in" on the tax benefits under the Ozone Act if a taxpayer has gain and makes a timely investment into a QOF, but there will presumably be situations where this in fact arises. It is also conceivable that a taxpayer might intentionally choose to treat a QOF as a mixed fund, based on specific circumstances. Perhaps the biggest news related to a "mixed fund" is that debt incurred either at the QOF or QOZB level by a partnership entity will NOT be treated as a contribution of non-gain funds and thus will not automatically create a mixed fund.

B. **QOF Investments and the 10-Year Zone Designation Period.**

1. Treasury Guidance.

Section 1400Z-2(c), as stated above, permits a taxpayer to elect to increase the basis in its investment in a QOF if the investment is held for at least ten years from the date of the original investment in the QOF. However, under section 1400Z-1(f), the designations of all qualified opportunity zones now in existence will expire on December 31, 2028. The loss of qualified opportunity zone designation raises numerous issues regarding gain deferral elections that are still in effect when the designation expires. Among the issues that the zone expiration date raise is whether, after the relevant qualified opportunity zone loses its designation, investors may still make basis step-up elections for QOF investments from 2019 and later.

Section 1400Z-2 does not contain specific statutory language like that in some other provisions, such as the D.C. enterprise zones provision in section 1400B(b)(5), that expressly permits a taxpayer to satisfy the requisite holding period after the termination of the designation of a zone. Commenters have raised the question described in the preceding paragraph—whether a taxpayer whose investment in a QOF has its 10-year anniversary after the 2028 calendar year will be able to take advantage of the basis step-up election provided in section 1400Z-2(c). The incentive provided by this benefit is integral to the primary purpose of the provision (see H.R. Rept. 115-466, 537, which describes the intent to attract an influx of capital to designated low income communities). For this reason, the proposed regulations permit taxpayers to make the basis step-up election under section 1400Z-2(c) after a qualified opportunity zone designation expires.

The ability to make this election is preserved under these proposed regulations until December 31, 2047, 20-1/2 years after the latest date that an eligible taxpayer may properly make an investment that is part of an election to defer gain under section 1400Z-2(a). Because the latest gain subject to deferral would be at the end of 2026, the last day of the 180-day period for that gain would be in late June 2027. A taxpayer deferring such a gain would achieve a 10-year holding period in a QOF investment only in late June 2037. Thus, this proposed rule would permit an investor in a QOF that makes an investment as late as the end of June 2027 to hold the investment in the QOF for the entire 10-year holding period described in section 1400Z-2(c), plus another 10 years.

The additional ten year period is provided to avoid situations in which, in order to enjoy the benefits provided by section 1400Z-2(c), a taxpayer would need to dispose of an investment

in a QOF shortly after completion of the required 10-year holding period. There may be cases in which disposal shortly after the 10-year holding period would diverge from otherwise desirable business conduct, and, absent the additional time, some taxpayers may lose the statutory benefit.

The Treasury Department and the IRS request comments on this proposed fixed 20-1/2-year end date for the section 1400Z-2(c) basis step-up election, in particular, whether some other time period would better align with taxpayers' economic interests and the purposes of the statute. Comments may also include an alternative to incentivizing investors to disinvest shortly before any such a fixed end date for the section 1400Z-2(c) basis step-up election. For example, should the regulations provide for a presumed basis step-up election immediately before the ability to elect a step-up upon disposition expires? If such a basis step-up without disposition is allowed, how should a QOF investment be properly valued at the time of the step-up?

2. **JBD3 Comments.**

The first substantive rule is that taxpayers can sell an investment in a QOF after holding it for ten years (and after December 31, 2028) and can at that time elect the step-up in tax basis (the crown jewel of the OZ tax incentives) even though the designations of all qualified opportunity zones now in existence will expire on December 31, 2028. That was always the only interpretation of the statute that made any sense, but the statute itself was silent on this explicit issue and so this regulatory guidance provides comfort to a few nervous nellies.

At the other end of the time spectrum, the regulations propose that all QOF gain eligible for the step-up in tax basis needs to be recognized no later than the end of 2047. This is, admittedly, a long time away, but there is nothing in the statute that expressly identifies this type of outside time limit, either. An investment in a QOF made in 2018 would enjoy almost thirty years to tax-free appreciation. Interestingly, almost nobody has spent a lot time thinking about the far end-game of exiting from a QOF, and so these rules – although apparently made up more or less out of thin air – are not going to bother anyone at the moment. We are too busy trying to figure out how to get funds into a QOF and make eligible investments in QOZBs to worry about the end game in 2047.

But that said, it probably make sense to allow taxpayers to make a "sale to themselves" election (e.g., an election to step-up tax basis in the QOF interests tax-free on December 31, 2047) so that there is not a compulsion to sell a perfectly good investment merely because of this rather arbitrary deadline. We will recommend and concur in the "step-up election" alternative in our letter to the IRS responding to their request for comments.

VII. RULES FOR A QUALIFIED OPPORTUNITY FUND

A. Certification of an Entity as a QOF

1. Treasury Guidance.

Section 1400Z-2(e)(4) allows the Secretary of the Treasury to prescribe regulations for the certification of QOFs for purposes of section 1400Z-2. In order to facilitate the certification process and minimize the information collection burden placed on taxpayers, the proposed regulations generally permit any taxpayer that is a corporation or partnership for tax purposes to self-certify as a QOF, provided that the entity self-certifying is statutorily eligible to do so. The proposed regulations permit the Commissioner to determine the time, form, and manner of the self-certification in IRS forms and instructions or in guidance published in the Internal Revenue Bulletin. It is expected that taxpayers will use Form 8996, Qualified Opportunity Fund, both for initial self-certification and for annual reporting of compliance with the 90-Percent Asset Test in section 1400Z-2(d)(1). It is expected that the Form 8996 would be attached to the taxpayer's Federal income tax return for the relevant tax years. The IRS released a draft of this form contemporaneous with the release of the proposed regulations.

2. JBD3 Comments.

The Ozone Act provided for the IRS to prescribe regulations for the certification of QOFs, and the IRS punted on that task early on, providing in an early FAQ that QOFs would self-certify. Interestingly, in addition to a self-certification with respect to qualification, the Form 8996 will also require annual reporting on whether the QOF meets the "90-Percent Asset Test," meaning that 90 percent of the QOF's assets are invested in qualified investments at the applicable testing dates (the mid-year mark and the year-end of the QOF's taxable year).

Presumably, the IRS will also require the QOF to self-report any "penalty" if the 90-Percent Asset Test is not met. The penalty itself was not well explained, so an early peek at the Form 8996 is addressed, below.

B. Designating When a QOF Begins

1. Treasury Guidance.

The proposed regulations allow a QOF both to identify the taxable year in which the entity becomes a QOF and to choose the first month in that year to be treated as a QOF. If an eligible entity fails to specify the first month it is a QOF, then the first month of its initial taxable year as a QOF is treated as the first month that the eligible entity is a QOF. A deferral election under section 1400Z-2(a) may only be made for investments in a QOF. Therefore, a proper deferral election under section 1400Z-2(a) may not be made for an otherwise qualifying investment that is made before an eligible entity is a QOF.

2. **JBD3 Comments.**

This is one of the many areas where the Treasury Guidance is remarkably lenient and taxpayer-friendly. Basically, an existing business entity can choose to be a QOF, and can also pick the first month (i.e., retroactively) that it wishes to begin its eligibility. This is a HUGE benefit to entities that organized before 2018, or that organized early in 2018 but before the Ozone Act was publicized, and that bought eligible property (generally real estate) located in an Opportunity Zone. Partnerships (including LLCs) are typically used for real estate transactions, and these are now likely to be eligible to make a retroactive designation of QOF status for property purchased in 2018. The retroactive election will not help for property purchased before 2018.

NOTE: This sounds like a great rule, in theory, but in fact trying to make a retroactive QOF designation and then structuring the business activity after the fact is likely to be a major challenge. First of all, operating any qualifying business activity at the QOF level is a separate (major) challenge, in significant part because there is no ability to hold investment proceeds (gain) at the QOF level during the period that real property is being substantially improved. If this hurdle can be overcome, there is then the on-going operating inconvenience of being required to meet the 90-Percent Asset Test every six months in perpetuity. Also, money invested earlier in 2018 may not have any associated capital gain, and thus the initial funds will likely not qualify as "good funds" for purposes of the Ozone Act. In short, it MAY be workable in some cases but will not make it easy to qualify retroactively in many other cases.

C. **Becoming a QOF in a Month Other Than the First Month of the Taxable Year.**

1. Treasury Guidance.

The proposed regulations provide guidance regarding application of the 90-Percent Asset Test in section 1400Z-2(d)(1) with respect to an entity's first year as a QOF, if the entity chooses to become a QOF beginning with a month other than the first month of its first taxable year. The phrase "first 6-month period of the taxable year of the fund" means the first 6-month period composed entirely of months which are within the taxable year and during which the entity is a QOF. For example, if a calendar-year entity that was created in February chooses April as its first month as a QOF, then the 90-Percent-Asset-Test testing dates for the QOF are the end of September and the end of December. Moreover, if the calendar-year QOF chooses a month after June as its first month as a QOF, then the only testing date for the taxable year is the last day of the QOF's taxable year. Regardless of when an entity becomes a QOF, the last day of the taxable year is a testing date.

The proposed regulations clarify that the penalty in section 1400Z-2(f)(1) does not apply before the first month in which the entity qualifies as a QOF. The Treasury Department and the IRS intend to publish additional proposed regulations that will address, among other issues, the applicability of the section 1400Z-2(f)(1) penalty and conduct that may lead to potential decertification of a QOF.

Section 1400Z-2(e)(4)(B) authorizes regulations to ensure that a QOF has "a reasonable period of time to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests, and to reinvest proceeds received from the sale or disposition of qualified opportunity zone business property." For example, if a QOF sells qualified opportunity zone property shortly before a testing date, that QOF should have a reasonable amount of time in which to bring itself into compliance with the 90-Percent Asset Test. Soon-to-be-released proposed regulations will provide guidance on these reinvestments by QOFs. Many stakeholders have requested guidance not only on the length of a "reasonable period of time to reinvest" but also on the Federal income tax treatment of any gains that the QOF reinvests during such a period. In the forthcoming notice of proposed rulemaking, the Treasury Department and the IRS will invite additional public comment on the scope of statutorily permissible policy alternatives. The Treasury Department and the IRS will carefully consider those comments in evaluating the widest range of statutorily permissible possibilities.

2. **JBD3 Comments**.

The dates used to measure the 90-Percent Asset Test have always suggested that taxpayers need to do a lot of game playing and careful planning about when money goes into a QOF and when it get invested (paid out). These rules about when a business entity becomes a QOF and the month in which if first elects QOF status are probably designed to provide maximum flexibility – the IRS is doing its best to interpret the law in a way that achieves the "widest range of statutorily permissible possibilities." The problem is that with respect to the 90-Percent Asset Test, the statutory possibilities are inherently narrow. The IRS apparently does not believe that it can allow taxpayers to hold funds at the QOF level beyond the stringent time limits of the 90-Percent Asset Test, so it is trying to give a little more flexibility about when the percentages are tested.

D. **Pre-Existing Entities.**

1. Treasury Guidance.

Commenters have inquired whether a pre-existing entity may qualify as a QOF or as the issuer of qualified opportunity zone stock or of a qualified opportunity zone partnership. For example, commenters have asked whether a pre-existing entity may self-certify as a QOF or whether, after 2017, a QOF may acquire an equity interest in a pre-existing operating partnership or corporation. The proposed regulations clarify that there is no prohibition to using a pre-existing entity as a QOF or as a subsidiary entity operating a qualified opportunity business, provided that the pre-existing entity satisfies the requirements under section 1400Z-2(d).

As previously discussed, section 1400Z-2(d)(1) requires that a QOF must undergo semi-annual tests to determine whether its assets consist on average of at least 90 percent qualified opportunity zone property. For purposes of these semi-annual tests, section 1400Z-2(d)(2) requires that a tangible asset can be qualified opportunity zone business property by an entity

that has self-certified as a QOF or an operating subsidiary entity only if it acquired the asset after 2017 by purchase. The Treasury Department and the IRS request comments on whether there is a statutory basis for additional flexibilities that might facilitate qualification of a greater number of pre-existing entities across broad categories of industries.

2. **JBD3 Comments.**

Again, the 90-Percent Asset Test is brutal and the Treasury is trying to provide as much flexibility as it can. A Pre-Existing Entity can qualify as an QOF, but note that if a pre-existing business elects to be a QOF and takes in funds, it must not only expend those funds within the applicable time periods, but must also be at least 90% invested in Qualified Opportunity Zone Property. It is not clear how a pre-existing business is likely to meet these requirements except it fairly specific factual circumstances.

E. **Valuation Method for Applying the 90-Percent Asset Test.**

1. Treasury Guidance.

For purposes of the calculation of the 90-Percent Asset Test in section 1400Z-2(d)(1) by the QOF, the proposed regulations require the QOF to use the asset values that are reported on the QOF's applicable financial statement for the taxable year, as defined in §1.475(a)-4(h) of the Income Tax Regulations. If a QOF does not have an applicable financial statement, the proposed regulations require the QOF to use the cost of its assets. The Treasury Department and the IRS request comments on the suitability of both of these valuation methods, and whether another method, such as tax adjusted basis, would be better for purposes of assurance and administration.

2. **JBD3 Comments.**

The valuation of assets for purposes of the 90-Percent Asset Test is important, but is less important than, say, determining how to calculate whether "substantially all" the tangible property held by a QOZ Business is QOZBP. Using cost basis (i.e., freezing the value at purchase price) strikes me immediately as better than methods that would allow depreciation (e.g., tax adjusted basis) and thus reduce the value of qualified investment property over time.

Practically speaking, QOFs are likely to take in money and immediately spend all (at least 90%) on qualified property, and thereafter will be a passive holding vehicle, except that if cash is distributed to the QOF the QOF will need to get the cash out to its owners by year end. Keeping the investment amount easily known and fixed will facilitate that goal – having it move at all (and especially if it moves a lot) is not a good idea.

F. **Nonqualified Financial Property.**

1. Treasury Guidance.

Commenters have recommended that the Treasury Department and the IRS adopt a rule that provides that cash be an appropriate QOF property for purposes of the 90-Percent Asset Test, if the cash is held with the intent of investing in qualified opportunity zone property. Specifically, commenters indicated that, because developing a new business or the construction or rehabilitation of real estate may take longer than six months, QOFs should be given longer than the six months provided under section 1400Z-2(d)(1) to invest in qualifying assets.

In response to these comments, the proposed regulations provide a working capital safe harbor for QOF investments in qualified opportunity zone businesses that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property used in a business operating in an opportunity zone. The safe harbor allows qualified opportunity zone businesses 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 there is a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the opportunity zone, there is written schedule consistent with the ordinary business operations of the business that the property will be used within 31-months, and the business substantially complies with the schedule. Taxpayers would be required to retain any written plan in their records.

This expansion of the term "working capital" reflects the fact that section 1400Z-2(d)(iii) anticipates situations in which a QOF or operating subsidiary may need up to 30 months after acquiring a tangible asset in which to improve the asset substantially. In seeking relief, some commenters based their requests on administrative practices that have developed under other sections of the Code that these commenters believe are analogous. The Treasury Department and the IRS request comments on the adequacy of the working-capital safe harbor and of ancillary safe harbors that protect a business during the working capital period, and on whether there is a statutory basis for any additional relief. Comments are also requested about the appropriateness of any further expansion of the "working capital" concept beyond the acquisition, construction, or rehabilitation of tangible business property to the development of business operations in the opportunity zone.

2. **JBD3 Comments**.

One of the biggest challenges in making the Ozone Act practical to implement is deciding where to let money "sit" while the business details are being organized and implemented so that they money can then be spent effectively. As largely anticipated, the Treasury is not going to let money sit at the QOF level, but will allow money to be treated as "working capital" for a period of up to 31 months at the level of a QOZ Business (i.e., a business entity into which the QOF invests). This was always the only really logical way to interpret the statute as written, and Treasury has put a quiet – but clear – kibosh on the possibility of holding cash at the QOF level.

This of course confirms the importance of making sound strategic decisions on (1) when to form (or elect) QOF treatment during a calendar year, (2) when to take money into the QOF, and (3) then to make sure that any money accepted by the QOF is then invested promptly into the applicable QOZ Business.

G. Qualified Opportunity Zone Business

1. Treasury Guidance.

Under section 1400Z-2(d)(1), a QOF is any investment vehicle organized as a corporation or partnership for the purpose of investing in qualified opportunity zone property (other than another QOF). A QOF must hold at least 90 percent of its assets in qualified opportunity zone property. Compliance with the 90 Percent Asset Test is determined by the average of the percentage of the qualified opportunity zone property held in the QOF as measured on the last day of the first 6-month period of the taxable year of the QOF and on the last day of the taxable year of the QOF.

Under section 1400Z-2(d)(2)(A), the term qualified opportunity zone property includes qualified opportunity zone business property. Qualified opportunity zone property may also include certain equity interests in an operating subsidiary entity (either a corporation or a partnership) that qualifies as a qualified opportunity zone business by satisfying certain requirements pursuant to section 1400Z-2(d)(2)(B) and (C).

Consequently, if a QOF operates a trade or business directly and does not hold any equity in a qualified opportunity zone business, at least 90 percent of the QOF's assets must be qualified opportunity zone property.

The definition of qualified opportunity zone business property requires property to be used in a QOZ and also requires new capital to be employed in a QOZ. Under section 1400Z-2(d)(2)(D)(i), qualified opportunity zone business property means tangible property used in a trade or business of a QOF, but only if (1) the property was acquired by purchase after December 31, 2017; (2) the original use of the property in the QOZ commences with the QOF, or the QOF substantially improves the property; and (3) during substantially all of the QOF's holding period for the property, substantially all of the use of the property was in a QOZ.

Under section 1400Z-2(d)(2)(B)(i) and (C), to qualify as a qualified opportunity zone business, an entity must be a qualified opportunity zone business both (a) when the QOF acquires its equity interest in the entity, and (b) during substantially all of the QOF's holding period for that interest. The manner of the QOF's acquisition of the equity interest must comply with certain additional requirements.

Under section 1400Z-2(d)(3)(A), for a trade or business to qualify as a qualified opportunity zone business, it must (among other requirements) be one in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property.

If an entity qualifies as a qualified opportunity zone business, the value of the QOF's entire interest in the entity counts toward the QOF's satisfaction of the 90 Percent Asset Test. Thus, if a QOF operates a trade or business (or multiple trades or businesses) through one or more entities, then the QOF can satisfy the 90 Percent Asset Test if each of the entities qualifies as a qualified opportunity zone business. The minimum amount of qualified opportunity zone business property owned or leased by a business for it to qualify as a qualified opportunity zone business is controlled by the meaning of the phrase substantially all in section 1400Z-2(d)(3)(A)(i).

In determining whether an entity is a qualified opportunity zone business, the proposed regulations propose a threshold to determine whether a trade or business satisfies the substantially all requirement in section 1400Z-2(d)(3)(A)(i).

If at least 70 percent of the tangible property owned or leased by a trade or business is qualified opportunity zone business property (as defined section 1400Z-2(d)(3)(A)(i)), the trade or business is treated as satisfying the substantially all requirement in section 1400Z-2(d)(3)(A)(i). The 70 percent threshold provided in these proposed regulations is intended to apply only to the term "substantially all" as it is used in section 1400Z-2(d)(3)(A)(i).

The phrase substantially all is also used in several other places in section 1400Z-2. That phrase appears in section 1400Z-2(d)(3)(A)(i), in which a qualified opportunity zone business is generally defined as a trade or business "in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property (determined by substituting 'qualified opportunity zone business' for 'qualified opportunity fund' each place it appears in section 1400Z-2(d)](2)(D))." In addition, substantially all appears in section 1400Z-2(d)(2)(D)(i)(III), which establishes the conditions for qualifying as an opportunity zone business property "during substantially all of the qualified opportunity fund's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone" and section 1400Z-2(d)(2)(B)(ii)(III).

Several requirements of section 1400Z-2(d) use substantially all multiple times in a row (that is, "substantially all of ... substantially all of ...substantially all of ..."). This compounded use of substantially all must be interpreted in a manner that does not result in a fraction that is too small to implement the intent of Congress.

The Treasury Department and the IRS request comments regarding the proposed meaning of the phrase substantially all in Section 1400Z-2(d)(3)(A)(i) as well as in the various other locations in section 1400Z-2(d) where that phrase is used.

2. JBD3 Comments.

The foregoing discussion is like a "good news/bad news" joke: The "good news" is that the IRS is defining the "substantially all" test for tangible property as "just" 70%, meaning "at least 70 percent of the tangible property owned or leased by a trade or business is qualified opportunity zone business property…" This percentage is lower than many feared

– for example, 85% was the relevant "substantially all" test for the New Markets Tax Credit, and 70% was the absolutely the lowest percentage that anyone expected. Now for the bad news: We STILL don't know how to calculate the percentage! The test in question (now a "70-Percent Tangible Property Test") requires that 70% of all tangible property "owned or leased" by the business must be QOZBP – which, by definition, can only be owned (among other requirements). So we can determine the numerator, but not the denominator.

In my speaking notes from the Novogradac Conference held in New Orleans on October 2, 2018, a copy of which are attached hereto, I addressed in detail how the Treasury will hopefully deal with this percentage computation – either by counting lease property in the numerator or, alternatively, treating property leased from an unrelated person at market rates as having "zero" value for purposes of the computation. The first is more favorable, but the second is sufficient. They key issue is that QOZ Businesses are going to want to lease, rather than purchase, the real property they occupy in an Ozone, and if the lease issue is not addressed favorably then the Ozone Act will be much narrower and far less beneficial than Congress intended.

Unfortunately, the guidance offers some good news (a 70% test) but does not actually tell us how to calculate it (the bad news, and it is REALLY bad news until we know the answer to the fundamental calculation methodology).

H. **Eligible Entities.**

1. Treasury Guidance.

The proposed regulations clarify that a QOF must be an entity classified as a corporation or partnership for Federal income tax purposes. In addition, it must be created or organized in one of the 50 States, the District of Columbia, or a U.S. possession. In addition, if an entity is organized in a U.S. possession but not in one of the 50 States or in the District of Columbia, then it may be a QOF only if it is organized for the purpose of investing in qualified opportunity zone property that relates to a trade or business operated in the possession in which the entity is organized.

The proposed regulations further clarify that qualified opportunity zone property may include stock or a partnership interest in an entity classified as a corporation or partnership for Federal income tax purposes. In addition, it must be a corporation or partnership created or organized in, or under the laws of, one of the 50 States, the District of Columbia, or a U.S. possession. Specifically, if an entity is organized in a U.S. possession, but not in one of the 50 States or the District of Columbia, an equity interest in the entity may be qualified opportunity zone stock or a qualified opportunity zone partnership interest, as the case may be, only if the entity conducts a qualified opportunity zone business in the U.S. possession in which the entity is organized.

The proposed regulations further define a U.S. possession to mean any jurisdiction outside of the 50 States and the District of Columbia in which a designated qualified

opportunity zone exists under section 1400Z-1. This definition may include the following U.S. territories: American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands. A complete list of designated qualified opportunity zones is found in Notice 2018-48, 2018-28 I.R.B. 9.

2. JBD3 Comments.

A relatively minor issue raised at the outset of the QOF discussions was whether a limited liability company classified as a partnership (or corporation) for federal income tax purposes would be an entity eligible to be a QOF. Most people assumed that the Treasury would bless an LLC taxable as a partnership or corporation as an eligible entity, but to be conservative, early QOFs were often structured as limited partnerships.

A second, even more compelling reason to use an LP rather than an LLC is because an LLC with two or more members who then make transfers of interests such that only one person becomes the sole member will cease to be a partnership and thus will LOSE eligibility to be a QOF. As a tax professional, you learn to anticipate that whatever can go wrong will go wrong, and so to make the arrangement bullet-proof, a better approach may be to use an LP with a corporate general partner (likely an S corporation) and a 99% limited partner. That way, even if a single person owns 100% of the LP interests directly or indirectly (by owning the corporate general partner and all limited partnership interests) the entity will still qualify as a partnership for federal income tax purposes.

VIII. INVESTMENTS FROM MIXED FUNDS

A. Treasury Guidance.

If only a portion of a taxpayer's investment in a QOF is subject to the deferral election under section 1400Z-2(a), then section 1400Z-2(e) requires the investment to be treated as two separate investments, which receive different treatment for Federal income tax purposes. Pursuant to section 1400Z-2(e)(1)(B), the proposed regulations reiterate that a taxpayer may make the election to step-up basis in an investment in a QOF that was held for 10 years or more only if a proper deferral election under section 1400Z-2(a) was made for the investment.

Commenters have questioned whether section 752(a) could result in investments with mixed funds under section 1400Z-2(e)(1). Section 1400Z-2(e)(1) requires a taxpayer to treat as two separate investments the combination of an investment to which a section 1400Z-2(a) gain-deferral election applies and an investment of any amount to which such an election does not apply. As previously noted, these proposed regulations clarify that deemed contributions of money under section 752(a) do not constitute an investment in a QOF; therefore, such a deemed contribution does not result in the partner having a separate investment under section 1400Z-2(e)(1).

Thus, a partner's increase in outside basis is not taken into account in determining what portion of the partner's interest is subject to the deferral election under section 1400Z-2(a) or

what portion is not subject to the deferral election under section 1400Z-2(a). Comments are requested on whether other pass-through entities require similar treatment. Comments are also requested on whether there may be certain circumstances in which not treating the deemed contribution under section 752(a) as creating a separate investment for purposes of section 1400Z-2(e)(1) may be considered abusive or otherwise problematic.

B. **JBD3 Comments.**

This is a case of saving the best for last. The single biggest determination by the Treasury and IRS under the Guidance is the conclusion that Code Section 752(a) is not treated as a contribution of money by the partners of a partnership (including a QOF set up as a partnership).

This Treasury pronouncement means that borrowed funds, whether borrowed at the QOF level or at the QOZ Business level (assuming the business is set up as a partnership), will not result in the dreaded "mixed fund" designation that would have greatly reduced the real and anticipated tax benefits of the Ozone Act.

Think if it this way: If Taxpayer X recognizes $1 million of LTCG and invests in a single owner QOF (e.g., an LP where Taxpayer X owns all the interests in the QOF including through a corporate general partner), which in turn invests in a development partnership (a QOZ Business) that then borrows $4 million in order to construct a new $5 million building, the $1 million invested in the QOF is essentially leveraged by the $4 million in funds borrowed at the QOZ Business level, and so Taxpayer X, on selling the QOF interest more than ten years later, will be able to step up the entire tax basis in the QOF on sale and recognize zero gain on the transaction. THAT…IS…HUGE!

IX. PROPOSED EFFECTIVE DATE

A. **Treasury Guidance.**

The regulations generally are proposed to be effective on or after the date of publication in the Federal Register of a Treasury decision adopting these proposed rules as final regulations (final regulations publication date). However—

- An eligible taxpayer may rely on the rules of proposed §1.1400Z-2(a)-1 with respect to eligible gains that would be recognized before the final regulations' date of applicability, but only if the taxpayer applies the rules in their entirety and in a consistent manner.
- A taxpayer may rely on the rules in proposed § 1.1400Z-2(c)-1 with respect to dispositions of investment interests in QOFs in situations where the investment was made in connection with an election under section 1400Z-2(a) that relates to the deferral of a gain such that the first day of 180-day reliance is dependent on the taxpayer's applying the rules of § 1.1400Z-2(c)-1 in their entirety and in a consistent manner.

- A QOF may rely on the rules in proposed §1.1400Z-2(d)-1 with respect to taxable years that begin before the final regulations' date of applicability, but only if the QOF applies the rules in their entirety and in a consistent manner.
- A taxpayer may rely on the rules in proposed § 1.1400Z-2(e)-1 with respect to investments and deemed contributions of money that occur before the final regulations' date of applicability, but only if the taxpayer applies the rules in their entirety and in a consistent manner.

B. **JBD3 Comments.**

The Treasury Guidance is primarily proposed regulations but there is zero chance the regulations will be finalized before the end of 2018, and so, as with some other major regulations issued in connection with TCJA, the proposed regulations may be relied upon until final regulations are issued.

That is all well and good – except that there are many key issues that still need to be addressed. Even so, we are off to a good start. This will not trigger a flood of money, but it should start money flowing and deals moving forward.

X. REVENUE RULING 2018-29.

A. **Summary of Rev. Rul. 2018-29.**

As part of the Treasury Guidance, the IRS published Revenue Ruling 2018-29, which addresses and provides examples on the requirements to satisfy the "substantial improvement" standard under the Ozone Act. The full text of the ruling is attached hereto as Exhibit B.

The ruling addresses the factual situation where a QOF purchases an existing building, and reached the following conclusions:

1. The original use of the building in the QOZ is not considered to have commenced with the QOF (i.e., the building will be QOZ Property, if at all, under the "substantial improvement" test).

2. The requirement that the original use of tangible property in the QOZ commence with a QOF is not applicable to the land on which the building is located.

3. Whether the project meets the "substantial improvement" requirement is measured by the QOF's additions to the adjusted tax basis of the building (and specifically excluding the tax basis in the land).

4. The QOF is not required to separately substantially improve the land upon which the building is located.

B. **JBD3 Comments.**

1. ***This ruling is very useful because it expressly excludes the tax basis in land in determining whether there has been "substantial improvement" in the applicable real estate. This will make it mathematically significantly easier to meet the substantial improvement test, which requires that the rehabilitation expenses must exceed the existing tax basis in the property.***

2. ***Obviously, valuations and allocation of purchase price between land and building will be important.***

3. ***The ruling also includes an example suggesting that residential rental property is an eligible trade or business for a QOF. This issue will no doubt get much more attention in future Treasury Guidance, but for the moment this is a positive foreshadowing of such guidance.***

XI. KEY REMAINING ISSUES TO BE ADDRESSED

A. **JBD3 Comments.**

The following is a brief (and by no means complete) list of the unanswered questions that need to be addressed by the IRS in follow up Guidance:

1. ***Feeder Funds.***

The guidance on partnerships as taxpayers was very favorable with respect to eligible taxpayers recognizing gain, but a key issue will be whether taxpayers can invest into a QOF indirectly through a partnership organized as a feeder fund. Feeder funds will allow large financial organizations to aggregate large amounts of eligible gain and invest the funds under professional management. That is the guidance that will truly open the flood gates of QOF investment.

2. ***How to Account for a Lease of Real Estate Under the 70% Tangible Property Test for a QOZ Business.***

The IRS provided guidance on the meaning of "substantially all" and provided a VERY FAVORABLE 70% test (most observers were fearing an 85% test or even a 90% test). However, it is not clear how to count leased real estate in either the numerator or the denominator of this fraction. Rev. Rul. 2018-29 does not take tax basis of the underlying land into account for purposes of the "substantial improvement" test, and instead only counts the tax basis in the building/improvements to the land. This, unfortunately, does not really answer how a business that leases a building as the home for its new Ozone-based business should count a lease of real estate (clearly tangible property) in connection with the 70% test.

3. ***Is Triple-Net Leasing of Real Property an Eligible Trade of Business?***

Lots of real estate developers would like to build improved real property in an Ozone and then lease it under a NNN lease to a new business; and lots of business founders would love to find good quality real estate (or build to suit real estate) that the business can lease, so that scarce business capital can be deployed in building the business rather than owning the real estate. Allowing NNN leasing to qualify as a trade of business would trigger a huge surge in both real estate and related businesses. The existing tax law is very complicated, and is outlined in the Speaking Notes from October 2, 2018, attached hereto as Exhibit C.

4. ***Interim gains.***

The Treasury Guidance provided favorable rules on reinvesting gain on the sale of a QOF into a new QOF, with an ability to continue the deferred character both of Original Gain and of New Gain realized on such a sale. What is not addressed is the "wish" of all real estate developers and owners that the QOF could sell the underlying real estate directly to a buyer, and then somehow "rollover" that gain into new QOZ Property. The statute does not easily lend itself to this interpretation, but Treasury will at least take comment on the issue in the next round of comments.

5. ***Reasonable period" for Reinvestment.***

the Treasury Guidance also did not address the definition of a "reasonable period" within which a QOF must reinvest proceeds from a sale of assets without being subject to penalty under the 90-Percent of Assets Test. Note that the Treasury Guidance conspicuously failed to provide for a "safe harbor" period for a QOF to invest cash received from an investor, and so contributed cash must be pushed out the door and invested in QOZ Property on or before the six-month measuring dates under the 90-Percent of Assets Test.

6. ***The definition of "Substantially all" other than the 70-Percent of Tangible Property Test.***

The definition of "substantially all" for all other definitions and purposes was left undefined, and Treasury has asked for comments.

Exhibit A

TEXT OF PROPOSED REGULATIONS

§1.1400Z-2(a)-1 DEFERRING TAX ON CAPITAL GAINS BY INVESTING IN OPPORTUNITY ZONES.

(a) In general. Under section 1400Z-2(a) of the Internal Revenue Code (Code) and this section, an eligible taxpayer may elect to defer recognition of some or all of its eligible gains to the extent that the taxpayer timely invests (as provided for by section 1400Z-2(a)(1)(A)) in eligible interests of a qualified opportunity fund (QOF), as defined in section 1400Z-2(d)(1). Paragraph (b) of this section defines eligible taxpayers, eligible gains, and eligible interests and contains related operational rules. Paragraph (c) of this section provides rules for applying section 1400Z-2 to a partnership, S corporation, trust, or estate that recognizes an eligible gain or would recognize such a gain if it did not elect to defer the gain under section 1400Z-2(a).

(b) Definitions and related operating rules. The following definitions and rules apply for purposes of section 1400Z-2 and the regulations thereunder:

(1) Eligible taxpayer. An eligible taxpayer is a person that may recognize gains for purposes of Federal income tax accounting. Thus, eligible taxpayers include individuals; C corporations, including regulated investment companies (RICs) and real estate investment trusts (REITs); partnerships; S corporations; trusts and estates. An eligible taxpayer may elect to defer recognition of one or more eligible gains in accordance with the requirements of section 1400Z-2.

(2) Eligible gain--(i) In general. An amount of gain is an eligible gain, and thus is eligible for deferral under section 1400Z-2(a), if the gain--

(A) Is treated as a capital gain for Federal income tax purposes;

(B) Would be recognized for Federal income tax purposes before January 1, 2027, if section 1400Z-2(a)(1) did not apply to defer recognition of the gain; and

(C) Does not arise from a sale or exchange with a person that, within the meaning of section 1400Z-2(e)(2), is related to the taxpayer that recognizes the gain or that would recognize the gain if section 1400Z-2(a)(1) did not apply to defer recognition of the gain.

(ii) Gain not already subject to an election. In the case of a taxpayer who has made an election under section 1400Z-2(a) with respect to some but not all of an eligible gain, the term "eligible gain" includes the portion of that eligible gain with respect to which no election has yet been made.

(iii) Gains under section 1256 contracts--(A) General rule. The only gain arising from section 1256 contracts that is eligible for deferral under section 1400Z-2(a)(1) is capital gain net income for a taxable year. This net amount is determined by taking into account the capital gains and losses for a taxable year on all of a taxpayer's section 1256 contracts, including all amounts determined under section 1256(a), both those determined on the last business day of a taxable year and those that section 1256(c) requires to be determined under section 1256(a) because of the termination or transfer during the taxable year of the taxpayer's position with respect to a contract. The 180-day period with respect to any capital gain net income from section 1256 contracts for a taxable year begins on the last day of the taxable year, and the character of that gain when it is later included under section 1400Z-2(a)(1)(B) and (b) is

determined under the general rule in paragraph (b)(5) of this section. See paragraph (b)(2)(iii)(B) of this section for limitations on the capital gains eligible for deferral under this paragraph (b)(2)(iii)(A).

(B) Limitation on deferral for gain from 1256 contracts. If, at any time during the taxable year, any of the taxpayer's section 1256 contracts was part of an offsetting positions transaction (as defined in paragraph (b)(2)(iv) of this section) and any other position in that transaction was not a section 1256 contract, then no gain from any section 1256 contract is an eligible gain with respect to that taxpayer in that taxable year.

(iv) No deferral for gain from a position that is or has been part of an offsetting-positions transaction. If a capital gain is from a position that is or has been part of an offsetting-positions transaction, the gain is not eligible for deferral under section 1400Z-2(a)(1). For purposes of this paragraph (b)(2)(iv), an offsetting-positions transaction is a transaction in which a taxpayer has substantially diminished the taxpayer's risk of loss from holding one position with respect to personal property by holding one or more other positions with respect to personal property (whether or not of the same kind). It does not matter whether either of the positions is with respect to actively traded personal property. An offsetting-positions transaction includes a straddle as defined in section 1092 and the regulations thereunder, including section 1092(d)(4), which provides rules for positions held by related persons and certain flow-through entities (for example, a partnership). An offsetting-positions transaction also includes a transaction that would be a straddle (taking into account the principles referred to in the preceding sentence) if the straddle definition did not contain the active trading requirement in

section 1092(d)(1). For example, an offsetting-positions transaction includes positions in closely held stock or other non-traded personal property and substantially offsetting derivatives.

(3) Eligible interest--(i) In general. For purposes of section 1400Z-2, an eligible interest in a QOF is an equity interest issued by the QOF, including preferred stock or a partnership interest with special allocations. Thus, the term eligible interest excludes any debt instrument within the meaning of section 1275(a)(1) and §1.1275-1(d).

(ii) Use as collateral permitted. Provided that the eligible taxpayer is the owner of the equity interest for Federal income tax purposes, status as an eligible interest is not impaired by using the interest as collateral for a loan, whether as part of a purchase-money borrowing or otherwise.

(iii) Deemed contributions not constituting investment. See §1.1400Z-2(e)-1(a)(2) for rules regarding deemed contributions of money to a partnership pursuant to section 752(a).

(4) 180-day period--(i) In general. Except as otherwise provided elsewhere in this section, the 180-day period referred to in section 1400Z-2(a)(1)(A) with respect to any eligible gain (180-day period) begins on the day on which the gain would be recognized for Federal income tax purposes if the taxpayer did not elect under section 1400Z-2 to defer recognition of that gain.

(ii) Examples. The following examples illustrate the principles of paragraph (b)(4)(i) of this section.

Example 1. Regular-way trades of stock. If stock is sold at a gain in a regular-way trade on an exchange, the 180-day period with respect to the gain on the stock begins on the trade date.

Example 2. Capital gain dividends received by RIC and REIT shareholders. If an individual RIC or REIT shareholder receives a capital gain dividend (as described in section

852(b)(3) or section 857(b)(3)), the shareholder's 180-day period with respect to that gain begins on the day on which the dividend is paid.

Example 3. Undistributed capital gains received by RIC and REIT shareholders. If section 852(b)(3)(D) or section 857(b)(3)(D) (concerning undistributed capital gains) requires the holder of shares in a RIC or REIT to include an amount in the shareholder's long-term capital gains, the shareholder's 180-day period with respect to that gain begins on the last day of the RIC or REIT's taxable year.

Example 4. Additional deferral of previously deferred gains--(i) Facts. Taxpayer A invested in a QOF and properly elected to defer realized gain. During 2025, taxpayer A disposes of its entire investment in the QOF in a transaction that, under section 1400Z-2(a)(1)(B) and (b), triggers an inclusion of gain in A's gross income. Section 1400Z-2(b) determines the date and amount of the gain included in A's income. That date is the date on which A disposed of its entire interest in the QOF. A wants to elect under section 1400Z-2 to defer the amount that is required to be included in income.

(ii) Analysis. Under paragraph (b)(4)(i) of this section, the 180-day period for making another investment in a QOF begins on the day on which section 1400Z-2(b) requires the prior gain to be included. As prescribed by section 1400Z-2(b)(1)(A), that is the date of the inclusion-triggering disposition. Thus, in order to make a deferral election under section 1400Z-2, A must invest the amount of the inclusion in the original QOF or in another QOF during the 180-day period beginning on the date when A disposed of its entire investment in the QOF.

(5) Attributes of gains that section 1400Z-2(a)(1)(B) includes in income. If section 1400Z-2(a)(1)(B) and (b) require a taxpayer to include in income some or all of a previously deferred gain, the gain so included has the same attributes in the taxable year of inclusion that it would have had if tax on the gain had not been deferred. These attributes include those taken into account by sections 1(h), 1222, 1256, and any other applicable provisions of the Code.

(6) First-In, First-Out (FIFO) method to identify which interest in a QOF has been disposed of--(i) FIFO requirement. If a taxpayer holds investment interests with identical rights (fungible interests) in a QOF that were acquired on different days and if, on a single day, the taxpayer disposes of less than all of these interests, then the first-in-first-out (FIFO) method

must be used to identify which interests were disposed of. Fungible interests may be equivalent shares of stock in a corporation or partnership interests with identical rights.

(ii) Consequences of identification. The FIFO method determines--(A) Whether an investment is described in section 1400Z-2(e)(1)(A)(i) (an investment to which a gain deferral election under section 1400Z-2(a) applies) or section 1400Z-2(e)(1)(A)(ii) (an investment which was not part of a gain deferral election under section 1400Z-2(a));

(B) In the case of investments described in section 1400Z-2(e)(1)(A)(i), the attributes of the gain subject to a deferral election under section 1400Z-2(a), at the time the gain is included in income (the attributes addressed in paragraph (b)(5) of this section); and

(C) The extent, if any, of an increase under section 1400Z-2(b)(2)(B) in the basis of an investment interest that is disposed of.

(7) Pro-rata method. If, after application of the FIFO method, a taxpayer is treated as having disposed of less than all of the investment interests that the taxpayer acquired on one day and if the interests acquired on that day vary with respect to the characteristics described in paragraph (b)(6)(ii) of this section, then a proportionate allocation must be made to determine which interests were disposed of (pro-rata method).

(8) Examples. The following examples illustrate the rules of paragraph (b)(5) through (7) of this section.

Example 1. Short-term gain. For 2018, taxpayer B properly made an election under section 1400Z-2 to defer $100 of gain that, if not deferred, would have been recognized as short-term capital gain, as defined in section 1222(1). In 2022, section 1400Z-2(a)(1)(B) and (b) requires taxpayer B to include the gain in gross income. Under paragraph (b)(5) of this section, the gain included is short-term capital gain.

Example 2. Collectibles gain. For 2018, taxpayer C properly made an election under section 1400Z-2 to defer a gain that, if not deferred, would have been collectibles gain as

defined in IRC section 1(h)(5). In a later taxable year, section 1400Z-2(a)(1)(B) and (b) requires some or all of that deferred gain to be included in gross income. The gain included is collectibles gain.

<u>Example 3. Net gains from section 1256 contracts.</u> For 2019, taxpayer D had a QOF and properly made an election under section 1400Z-2 to defer that $100 of gain. In 2023, section 1400Z-2(a)(1)(B) and (b) requires taxpayer D to include that deferred gain in gross income. Under paragraph (b)(5) of this section, the character of the inclusion is governed by section 1256(a)(3) (which requires a 40:60 split between short-term and long-term capital gain). Accordingly, $40 of the inclusion is short-term capital gain and $60 of the inclusion is long-term capital gain.

<u>Example 4. FIFO method.</u> For 2018, taxpayer E properly made an election under section 1400Z-2 to defer $300 of short-term capital gain. For 2020, E properly made a second election under section 1400Z-2 to defer $200 of long-term capital gain. In both cases, E properly invested in QOF Q the amount of the gain to be deferred. The two investments are fungible interests and the price of the interests was the same at the time of the two investments. E did not purchase any additional interest in QOF Q or sell any of its interest in QOF Q until 2024, when E sold for a gain 60 percent of its interest in QOF Q. Under paragraph (b)(6)(i) of this section, E must apply the FIFO method to identify which investments in QOF Q that E disposed of. As determined by this identification, E sold the entire 2018 initial investment in QOF Q. Under section 1400Z-2(a)(1)(B) and (b), the sale triggered an inclusion of deferred gain. Because the inclusion has the same character as the gain that had been deferred, the inclusion is short-term capital gain.

<u>Example 5. FIFO method.</u> In 2018, before Corporation R became a QOF, Taxpayer F invested $100 cash to R in exchange for 100 R common shares. Later in 2018, after R was a QOF, F invested $500 cash to R in exchange for 400 R common shares and properly elected under section 1400Z-2 to defer $500 of independently realized short-term capital gain. Even later in 2018, on different days, F realized $300 of short-term capital gain and $700 of long-term capital gain. On a single day that fell during the 180-day period for both of those gains, F invested $1,000 cash in R in exchange for 800 R common shares and properly elected under section 1400Z-2 to defer the two gains. In 2020, F sold 100 R common shares. Under paragraph (b)(6)(i) of this section, F must apply the FIFO method to identify which investments in R F disposed of. As determined by that identification, F sold the initially acquired 100 R common shares, which were not part of a deferral election under section 1400Z-2. R must recognize gain or loss on the sale of its R shares under the generally applicable Federal income tax rules, but the sale does not trigger an inclusion of any deferred gain.

<u>Example 6. FIFO method.</u> The facts are the same as example 5, except that, in addition, during 2021 F sold an additional 400 R common shares. Under paragraph (b)(6)(i) of this section, F must apply the FIFO method to identify which investments in R were disposed of. As determined by this identification, F sold the 400 common shares which were associated

with the deferral of $500 of short-term capital gain. Thus, the deferred gain that must be included upon sale of the 400 R common shares is short-term capital gain.

Example 7. Pro-rata method. The facts are the same as in examples 5 and 6, paragraph (b)(6)(i) of this section, F must apply the FIFO method to identify which investments in R were disposed of. In 2022, F is treated as holding only the 800 R common shares purchased on a single day, and the section 1400Z-2 deferral election associated with these shares applies to gain with different characteristics (described in paragraph (b)(6)(ii) of this section). Under paragraph (b)(7) of this section, therefore, R must use the pro-rata method to determine which of the characteristics pertain to the deferred gain required to be included as a result of the sale of the 400 R common shares. Under the pro-rata method, $150 of the inclusion is short-term capital gain ($300 ×400/800) and $350 is long-term capital gain ($700 × 400/800).

(c) Special rules for pass-through entities--(1) Eligible gains that a partnership elects to defer. A partnership is an eligible taxpayer under paragraph (b)(1) of this section and may elect to defer recognition of some or all of its eligible gains under section 1400Z-2(a)(2).

(i) Partnership election. If a partnership properly makes an election under section 1400Z-2(a)(2), then--

(A) The partnership defers recognition of the gain under the rules of section 1400Z-2 (that is, the partnership does not recognize gain at the time it otherwise would have in the absence of the election to defer gain recognition);

(B) The deferred gain is not included in the distributive shares of the partners under section 702 and is not subject to section 705(a)(1); and

(ii) Subsequent recognition. Absent any additional deferral under section 1400Z-2(a)(1)(A), any amount of deferred gain that an electing partnership subsequently must include in income under sections 1400Z-2(a)(1)(B) and (b) is recognized by the electing partnership at the time of inclusion and is subject to sections 702 and 705(a)(1) in a manner consistent with recognition at that time.

(2) Eligible gains that the partnership does not defer--(i) Tax treatment of the partnership. If a partnership does not elect to defer some, or all, of the gains for which it could make a deferral election under section 1400Z-2, the partnership's treatment of any such amounts is unaffected by the fact that the eligible gain could have been deferred under section 1400Z-2.

(ii) Tax treatment by the partners. If a partnership does not elect to defer some, or all, of the gains for which it could make a deferral election under section 1400Z-2--

(A) The gains for which a deferral election are not made are included in the partners' distributive shares under section 702 and are subject to section 705(a)(1);

(B) If a partner's distributive share includes one or more gains that are eligible gains with respect to the partner, the partner may elect under section 1400Z-2(a)(1)(A) to defer some or all of its eligible gains; and

(C) A gain in a partner's distributive share is an eligible gain with respect to the partner only if it is an eligible gain with respect to the partnership and it did not arise from a sale or exchange with a person that, within the meaning of section 1400Z-2(e)(2), is related to the partner.

(iii) 180-day period for a partner electing deferral--(A) General rule. If a partner's distributive share includes a gain that is described in paragraph (c)(2)(ii)(C) of this section (gains that are eligible gains with respect to the partner), the 180-day period with respect to the partner's eligible gains in the partner's distributive share generally begins on the last day of the partnership taxable year in which the partner's allocable share of the partnership's eligible gain is taken into account under section 706(a).

(B) Elective rule. Notwithstanding the general rule in paragraph (c)(2)(iii)(A) of this section, if a partnership does not elect to defer all of its eligible gain, the partner may elect to treat the partner's own 180-day period with respect to the partner's distributive share of that gain as being the same as the partnership's 180-day period. (C) The following example illustrates the principles of this paragraph (c)(2)(iii).

Example. Five individuals have identical interests in partnership P, there are no other partners, and P's taxable year is the calendar year. On January 17, 2019, P realizes a capital gain of $1000x that it decides not to elect to defer. Two of the partners, however, want to defer their allocable portions of that gain. One of these two partners invests $200x in a QOF during February 2020. Under the general rule in paragraph (c)(2)(iii)(A) of this section, this investment is within the 180-day period for that partner (which begins on December 31, 2019). The fifth partner, on the other hand, decides to make the election provided in paragraph (c)(2)(iii)(B) of this section and invests $200x in a QOF during February 2019. Under that elective rule, this investment is within the 180-day period for that partner (which begins on January 17, 2019).

(3) Pass-through entities other than partnerships. If an S corporation; a trust; or a decedent's estate recognizes an eligible gain, or would recognize an eligible gain if it did not elect to defer recognition of the gain under section 1400Z-2(a), then rules analogous to the rules of paragraph (c)(1) and (2) of this section apply to that entity and to its shareholders or beneficiaries, as the case may be.

(d) Elections. The Commissioner may prescribe in guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§ 601.601(d)(2) and 601.602 of this chapter), both the time, form, and manner in which an eligible taxpayer may elect to defer eligible gains under section 1400Z-2(a) and also the time, form, and manner in which a partner may elect to apply the elective 180-day period provided in paragraph (c)(2)(iii)(B) of this section.

(e) Applicability date. This section applies to eligible gains that would be recognized in the absence of deferral on or after the date of publication in the Federal Register of a Treasury decision adopting these proposed rules as final regulations. An eligible taxpayer, however, may rely on the proposed rules in this section with respect to eligible gains that would be recognized before that date, but only if the taxpayer applies the rules in their entirety and in a consistent manner.

§1.1400Z-2(c)-1 INVESTMENTS HELD FOR AT LEAST 10 YEARS.

(a) Limitation on the 10-year rule. As required by section 1400Z-2(e)(1)(B) (treatment of investments with mixed funds), section 1400Z-2(c) (special rule for investments held for at least 10 years) applies only to the portion of an investment in a QOF with respect to which a proper election to defer gain under section 1400Z-2(a)(1) is in effect.

(b) Extension of availability of the election described in section 1400Z-2(c). The ability to make an election under section 1400Z-2(c) for investments held for at least 10 years is not impaired solely because, under section 1400Z-1(f), the designation of one or more qualified opportunity zones ceases to be in effect. The preceding sentence does not apply to elections under section 1400Z-2(c) that are related to dispositions occurring after December 31, 2047.

Examples. The following examples illustrate the principles of paragraphs (a) and (b) of this section.

Example 1. (i) Facts. In 2020, taxpayer G invests $100 in QOF S in exchange for 100 common shares of QOF S and properly makes an election under section 1400Z-2(a) to defer $100 of gain. G also acquires 200 additional common shares in QOF in exchange for $z. G does not make a section 1400Z-2(a) deferral election with respect to any of the $z investments. At the end of 2028, the qualified opportunity zone designation expires for the population census tract in which QOF S primarily conducts its trade or business. In 2031, G sells all of its 300 QOF S shares, realizes gain, and makes an election to increase the qualifying basis in G's QOF S shares to fair market value. But for the expiration of the designated zones in section 1400Z-

1(f), QOF S and G's conduct is consistent with continued eligibility to make the election under section 1400Z-2(c).

(ii) Analysis. Under paragraph (b) of this section, although the designation expired on December 31, 2028, the expiration of the zone's designation does not, without more, invalidate G's ability to make an election under section 1400Z-2(c). Accordingly, pursuant to that election, G's basis is increased in the one-third portion of G's investment in QOF S with respect to which G made a proper deferral election under section 1400Z-2(a)(2) (100 common shares / 300 common shares). Under section 1400Z-2(e)(1) and paragraph (a) of this section, however, the election under section 1400Z-2(c) is unavailable for the remaining two-thirds portion of G's investment in QOF S because G did not make a deferral election under section 1400Z-2(a)(2) for this portion of its investment in QOF S (200 common shares / 300 common shares).

(d) Applicability date. This section applies to an election under section 1400Z-2(c) related to dispositions made after the date of publication in the Federal Register of a Treasury decision adopting these proposed rules as final regulations. A taxpayer, however, may rely on the proposed rules in this section with respect to dispositions of investment interests in QOFs in situations where the investment was made in connection with an election under section 1400Z-2(a) that relates to the deferral of a gain such that the first day of 180-day period for the gain was before the date of applicability of that section. The preceding sentence applies only if the taxpayer applies the rules of this section in their entirety and in a consistent manner.

§1.1400Z-2(d)-1 QUALIFIED OPPORTUNITY FUNDS.

(a) Becoming a QOF-(1) Self-certification. Except as provided in paragraph (e)(1) of this section, if a taxpayer that is classified as a corporation or partnership for Federal tax purposes is eligible to be a QOF, the taxpayer may self-certify that it is QOF. This section refers to such a taxpayer as an eligible entity. The following rules apply to the self-certification:

(i) Time, form, and manner. The self-certification must be effected at such time and in such form and manner as may be prescribed by the Commissioner in IRS forms or instructions

or in publications or guidance published in the Internal Revenue Bulletin (see §§ 601.601(d)(2) and 601.602 of this chapter).

(ii) First taxable year. The self-certification must identify the first taxable year that the eligible entity wants to be a QOF.

(iii) First month. The self-certification may identify the first month (in that initial taxable year) in which the eligible entity wants to be a QOF.

(A) Failure to specify first month. If the self-certification fails to specify the month in the initial taxable year that the eligible entity first wants to be a QOF, then the first month of the eligible entity's initial taxable year as a QOF is the first month that the eligible entity is a QOF.

(B) Investments before first month not eligible for deferral. If an investment in eligible interests of an eligible entity occurs prior to the eligible entity's first month as a QOF, any election under section 1400Z-2(a)(1) made for that investment is invalid.

(2) Becoming a QOF in a month that is not the first month of the taxable year. If an eligible entity's self-certification as a QOF is first effective for a month that is not the first month of that entity's taxable year--

(i) For purposes of section 1400Z-2(d)(1)(A) and (B) in the first year of the QOF's existence, the phrase first 6-month period of the taxable year of the fund means the first 6 months each of which is in the taxable year and in each of which the entity is a QOF. Thus, if an eligible entity becomes a QOF in the seventh or later month of a 12-month taxable year, the 90-percent test in section 1400Z-2(d)(1) takes into account only the QOF's assets on the last day of the taxable year.

(ii) The computation of any penalty under section 1400Z-2(f)(1) does not take into account any months before the first month in which an eligible entity is a QOF.

(3) Pre-existing entities. There is no legal barrier to a pre-existing eligible entity becoming a QOF, but the eligible entity must satisfy all of the requirements of section 1400Z-2 and the regulations thereunder, including the requirements regarding qualified opportunity zone property, as defined in section 1400Z-2(d)(2). In particular, that property must be acquired after December 31, 2017.

(b) Valuation of assets for purposes of the 90-percent asset test--(1) In general. For a taxable year, if a QOF has an applicable financial statement within the meaning of §1.475(a)-4(h), then the value of each asset of the QOF for purposes of the 90-percent asset test in section 1400Z-2(d)(1) is the value of that asset as reported on the QOF's applicable financial statement for the relevant reporting period.

(2) QOF without an applicable financial statement. If paragraph (b)(1) of this section does not apply to a QOF, then the value of each asset of the QOF for purposes of the 90-percent asset test in section 1400Z-2(d)(1) is the QOF's cost of the asset.

(c) Qualified opportunity zone property--(1) In general. Pursuant to section 1400Z-2(d)(2)(A), the following property is qualified opportunity zone property:

(i) Qualified opportunity zone stock as defined in paragraph (c)(2) of this section,

(ii) Qualified opportunity zone partnership interest as defined in paragraph (c)(3) of this section, and

(iii) Qualified opportunity zone business property as defined in paragraph (c)(4) of this section.

(2) Qualified opportunity zone stock--(i) In general. Except as provided in paragraphs (c)(2)(ii) and (e)(2) of this section, if an entity is classified as a corporation for Federal tax purposes (corporation), then an equity interest (stock) in the entity is qualified opportunity zone stock if--

(A) The stock is acquired by a QOF after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash,

(B) As of the time the stock was issued, the corporation was a qualified opportunity zone business as defined in section 1400Z-2(d)(3) and paragraph (d) of this section (or, in the case of a new corporation, the corporation was being organized for purposes of being such a qualified opportunity zone business), and

(C) During substantially all of the QOF's holding period for the stock, the corporation qualified as a qualified opportunity zone business as defined in section 1400Z-2(d)(3) and paragraph (d) of this section.

(ii) Redemptions of stock. Pursuant to section 1400Z-2(d)(2)(B)(ii), rules similar to the rules of section 1202(c)(3) apply for purposes of determining whether stock in a corporation qualifies as qualified opportunity zone stock.

(A) Redemptions from taxpayer or related person. Stock acquired by a QOF is not treated as qualified opportunity zone stock if, at any time during the 4-year period beginning on the date 2 years before the issuance of the stock, the corporation issuing the stock purchased (directly or indirectly) any of its stock from the QOF or from a person related (within the meaning of section 267(b) or 707(b)) to the QOF. Even if the purchase occurs after the issuance, the stock was never qualified opportunity zone stock.

(B) Significant redemptions. Stock issued by a corporation is not treated as qualified opportunity zone stock if, at any time during the 2-year period beginning on the date 1 year before the issuance of the stock, the corporation made 1 or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of its stock as of the beginning of the 2-year period. Even if one or more of the disqualifying purchases occurs after the issuance, the stock was never qualified opportunity zone stock.

(C) Treatment of certain transactions. If any transaction is treated under section 304(a) as a distribution in redemption of the stock of any corporation, for purposes of paragraphs (c)(2)(ii)(A) and (B) of this section, that corporation is treated as purchasing an amount of its stock equal to the amount that is treated as such a distribution under section 304(a).

(3) Qualified opportunity zone partnership interest. Except as provided in paragraph (e)(2) of this section, if an entity is classified as a partnership for Federal tax purposes (partnership), any capital or profits interest (partnership interest) in the entity is a qualified opportunity zone partnership interest if--

(i) The partnership interest is acquired by a QOF after December 31, 2017, from the partnership solely in exchange for cash,

(ii) As of the time the partnership interest was acquired, the partnership was a qualified opportunity zone business as defined in section 1400Z-2(d)(3) and paragraph (d) of this section (or, in the case of a new partnership, the partnership was being organized for purposes of being a qualified opportunity zone business), and

(iii) During substantially all of the QOF's holding period for the partnership interest, the partnership qualified as a qualified opportunity zone business as defined in section 1400Z-2(d)(3) and paragraph (d) of this section.

(4) Qualified opportunity zone business property of a QOF. Tangible property used in a trade or business of a QOF is qualified opportunity zone business property for purposes of paragraph (c)(1)(iii) of this section if--

(i) The tangible property satisfies section 1400Z-2(d)(2)(D)(i)(I);

(ii) The original use of the tangible property in the qualified opportunity zone, within the meaning of paragraph (c)(7) of this section, commences with the QOF, or the QOF substantially improves the tangible property within the meaning of paragraph (c)(8) of this section (which defines substantial improvement in this context); and

(iii) During substantially all of the QOF's holding period for the tangible property, substantially all of the use of the tangible property was in a qualified opportunity zone.

(5) Substantially all of a QOF's holding period for property described in paragraphs (c)(2), (c)(3), and (c)(4) of this section. [Reserved].

(6) Substantially all of the usage of tangible property by a QOF in a qualified opportunity zone. [Reserved].

(7) Original use of tangible property. [Reserved].

(8) Substantial improvement of tangible property--(i) In general. Except as provided in paragraph (c)(8)(ii) of this section, for purposes of paragraph (c)(4)(ii) of this section, tangible property is treated as substantially improved by a QOF only if, during any 30-month period beginning after the date of acquisition of the property, additions to the basis of the property in

the hands of the QOF exceed an amount equal to the adjusted basis of the property at the beginning of the 30-month period in the hands of the QOF.

(ii) Special rules for land and improvements on land--(A) Buildings located in the zone. If a QOF purchases a building located on land wholly within a QOZ, under section 1400Z-2(d)(2)(D)(ii) a substantial improvement to the purchased tangible property is measured by the QOF's additions to the adjusted basis of the building. Under section 1400Z-2(d), measuring a substantial improvement to the building by additions to the QOF's adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located.

(B) [Reserved].

(d) Qualified opportunity zone business--(1) In general. A trade or business is a qualified opportunity zone business if--

(i) Substantially all of the tangible property owned or leased by the trade or business is qualified opportunity zone business property as defined in paragraph (d)(2) of this section,

(ii) Pursuant to section 1400Z-2(d)(3)(A)(iii), the trade or business satisfies the requirements of section 1397C(b)(2), (4), and (8) as defined in paragraph (d)(5) of this section, and

(iii) Pursuant to section 1400Z-2(d)(3)(A)(iii), the trade or business is not described in section 144(c)(6)(B) as defined in paragraph (d)(6) of this section.

(2) Qualified opportunity zone business property of the qualified opportunity zone business for purposes of paragraph (d)(1)(i) of this section--(i) In general. The tangible property

used in a trade or business of an entity is qualified opportunity zone business property for purposes of paragraph (d)(1)(i) of this section if--

(A) The tangible property satisfies section 1400Z-2(d)(2)(D)(i)(I);

(B) The original use of the tangible property in the qualified opportunity zone commences with the entity or the entity substantially improves the tangible property within the meaning of paragraph (d)(4) of this section (which defines substantial improvement in this context); and

(C) During substantially all of the entity's holding period for the tangible property, substantially all of the use of the tangible property was in a qualified opportunity zone.

(ii) Substantially all of a qualified opportunity zone business's holding period for property described in paragraph (d)(2)(i)(C) of this section. [Reserved].

(iii) Substantially all of the usage of tangible property by a qualified opportunity zone business in a qualified opportunity zone. [Reserved].

(3) Substantially all requirement of paragraph (d)(1)(i) of this section--(i) In general. A trade or business of an entity is treated as satisfying the substantially all requirement of paragraph (d)(1)(i) of this section if at least 70 percent of the tangible property owned or leased by the trade or business is qualified opportunity zone business property as defined in paragraph (d)(2) of this section.

(ii) Calculating percent of tangible property owned or leased in a trade or business--(A) In general. If an entity has an applicable financial statement within the meaning of §1.475(a)-4(h), then the value of each asset of the entity as reported on the entity's applicable financial statement for the relevant reporting period is used for determining whether a trade or business

of the entity satisfies the first sentence of paragraph (d)(3)(i) of this section (concerning whether the trade or business is a qualified opportunity zone business).

(B) Entity without an applicable financial statement. If paragraph (d)(3)(ii)(A) of this section does not apply to an entity and a taxpayer both holds an equity interest in the entity and has self-certified as a QOF, then that taxpayer may value the entity's assets using the same methodology under paragraph (b) of this section that the taxpayer uses for determining its own compliance with the 90-percent asset requirement of section 1400Z-2(d)(1) (Compliance Methodology), provided that no other equity holder in the entity is a Five-Percent Zone Taxpayer. If paragraph (d)(3)(ii)(A) of this section does not apply to an entity and if two or more taxpayers that have self-certified as QOFs hold equity interests in the entity and at least one of them is a Five-Percent Zone Taxpayer, then the values of the entity's assets may be calculated using the Compliance Methodology that both is used by a Five-Percent Zone Taxpayer and that produces the highest percentage of qualified opportunity zone business property for the entity.

(C) Five Percent Zone Taxpayer. 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).

(iii) Example. The following example illustrates the principles of paragraph (d)(3)(ii) of this section.

Example. Entity ZS is a corporation that has issued only one class of stock and that conducts a trade or business. Taxpayer X holds 94% of the ZS stock, and Taxpayer Y holds the remaining 6% of that stock. (Thus, both X and Y are Five Percent Zone Taxpayers within the meaning of paragraph (d)(3)(ii)(C) of this section.) ZS does not have an applicable financial statement, and, for that reason, a determination of whether ZS is conducting a qualified opportunity zone business may employ the Compliance Methodology of X or Y. X and Y use

different Compliance Methodologies permitted under paragraph (d)(3)(ii) (B) of this section for purposes of satisfying the 90-percent asset test of section 1400Z-2(d)(1). Under X's Compliance Methodology (which is based on X's applicable financial statement), 65% of the tangible property owned or leased by ZS's trade or business is qualified opportunity zone business property. Under Y's Compliance Methodology (which is based on Y's cost), 73% of the tangible property owned or leased by ZS's trade or business is qualified opportunity zone business property. Because Y's Compliance Methodology would produce the higher percentage of qualified opportunity zone business property for ZS (73%), both X and Y may use Y's Compliance Methodology to value ZS's owned or leased tangible property. If ZS's trade or business satisfies all additional requirements in section 1400Z-2(d)(3), the trade or business is a qualified opportunity zone business. Thus, if all of the additional requirements in section 1400Z-2(d)(2)(B) are satisfied, stock in ZS is qualified opportunity zone stock in the hands of a taxpayer that has self-certified as a QOF.

(4) Substantial improvement of tangible property for purposes of paragraph (d)(2)(i)(B) of this section--(i) In general. Except as provided in paragraph (d)(4)(ii) of this section, for purposes of paragraph (d)(2)(i)(B) of this section, tangible property is treated as substantially improved by a qualified opportunity zone business only if, during any 30-month period beginning after the date of acquisition of such tangible property, additions to the basis of such tangible property in the hands of the qualified opportunity zone business exceed an amount equal to the adjusted basis of such tangible property at the beginning of such 30-month period in the hands of the qualified opportunity zone business.

(ii) Special rules for land and improvements on land--(A) Buildings located in the zone. If a QOF purchases a building located on land wholly within a QOZ, under section 1400Z-2(d)(2)(D)(ii) a substantial improvement to the purchased tangible property is measured by the QOF's additions to the adjusted basis of the building. Under section 1400Z-2(d), measuring a substantial improvement to the building by additions to the QOF's adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located.

(B) [Reserved].

(5) Operation of section 1397C requirements incorporated by reference--(i) Gross income requirement. Section 1400Z-2(d)(3)(A)(iii) incorporates section 1397C(b)(2), requiring that for each taxable year at least 50 percent of the gross income of a qualified opportunity zone business is derived from the active conduct of a trade or business in the qualified opportunity zone.

(ii) Use of intangible property requirement--(A) In general. Section 1400Z-2(d)(3) incorporates section 1397C(b)(4), requiring that, with respect to any taxable year, a substantial portion of the intangible property of an opportunity zone business is used in the active conduct of a trade or business in the qualified opportunity zone.

(B) Active conduct of a trade or business. [Reserved].

(iii) Nonqualified financial property limitation. Section 1400Z-2(d)(3) incorporates section 1397C(b)(8), limiting in each taxable year the average of the aggregate unadjusted bases of the property of a qualified opportunity zone business that may be attributable to nonqualified financial property. Section 1397C(e)(1), which defines the term nonqualified financial property for purposes of section 1397C(b)(8), excludes from that term reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less (working capital assets).

(iv) Safe harbor for reasonable amount of working capital. Solely for purposes of applying section 1397C(e)(1) to the definition of a qualified opportunity zone business under section 1400Z-2(d)(3), working capital assets are treated as reasonable in amount for purposes

of sections 1397C(b)(2) and 1400Z-2(d)(3)(A)(ii), if all of the following three requirements are satisfied:

(A) Designated in writing. These amounts are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone, as defined in section 1400Z-1(a).

(B) Reasonable written schedule. There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets. Under the schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets.

(C) Property consumption consistent. The working capital assets are actually used in a manner that is substantially consistent with paragraph (d)(5)(iv)(A) and (B) of this section.

(v) Safe harbor for gross income derived from the active conduct of business. Solely for purposes of applying the 50-percent test in section 1397C(b)(2) to the definition of a qualified opportunity zone business in section 1400Z-2(d)(3), if any gross income is derived from property that paragraph (d)(5)(iv) of this section treats as a reasonable amount of working capital, then that gross income is counted toward satisfaction of the 50-percent test.

(vi) Safe harbor for use of intangible property. Solely for purposes of applying the use requirement in section 1397C(b)(4) to the definition of a qualified opportunity zone business under section 1400Z-2(d)(3), the use requirement is treated as being satisfied during any period in which the business is proceeding in a manner that is substantially consistent with paragraphs (d)(5)(iv)(A) through (C) of this section.

(vii) Safe harbor for property on which working capital is being expended. If paragraph (d)(5)(iv) of this section treats some financial property as being a reasonable amount of working capital because of compliance with the three requirements of paragraph (d)(5)(iv)(A)-(C) and if the tangible property referred to in

paragraph (d)(5)(iv)(A) is expected to satisfy the requirements of section 1400Z-2(d)(2)(D)(1) as a result of the planned expenditure of those working capital assets, then that tangible property is not treated as failing to satisfy those requirements solely because the scheduled consumption of the working capital is not yet complete.

(viii) Example. The following example illustrates the rules of this paragraph (d)(5):

(i) Facts. In 2019, Taxpayer H realized $w million of capital gains and within the 180-day period invested $w million in QOF T, a qualified opportunity fund. QOF T immediately acquired from partnership P a partnership interest in P, solely in exchange for $w million of cash. P immediately placed the $w million in working capital assets, which remained in working capital assets until used. P had written plans to acquire land in a qualified opportunity zone on which it planned to construct a commercial building. Of the $w million, $x million was dedicated to the land purchase, $y million to the construction of the building, and $z million to ancillary but necessary expenditures for the project. The written plans provided for purchase of the land within a month of receipt of the cash from QOF T and for the remaining $y and $z million to be spent within the next 30 months on construction of the building and on the ancillary expenditures. All expenditures were made on schedule, consuming the $w million. During the taxable years that overlap with the first 31-month period, P had no gross income other than that derived from the amounts held in those working capital assets. Prior to completion of the building, P's only assets were the land it purchased, the unspent amounts in the working capital assets, and P's work in process as the building was constructed.

(ii) Analysis of construction--(A) P met the three requirements of the safe harbor provided in paragraph (d)(5)(iv) of this section. P had a written plan to spend the $w received from QOF T for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone, as defined in section 1400Z-1(a). P had a written schedule consistent with the ordinary start-up for a business for the expenditure of the working capital assets. And, finally, P's working capital assets were actually used in a manner that was substantially consistent with its written plan and the ordinary start-up of a business. Therefore, the $x million, the $y million, and the $z million are treated as reasonable in amount for purposes of sections 1397C(b)(2) and 1400Z-2(d)(3)(A)(ii).

(B) Because P had no other gross income during the 31 months at issue, 100 percent of P's gross income during that time is treated as derived from an active trade or business in the qualified opportunity zone for purposes of satisfying the 50-percent test of section 1397C(b)(2).

(C) For purposes of satisfying the requirement of section 1397C(b)(4), during the period of land acquisition and building construction a substantial portion of P's intangible property is treated as being used in the active conduct of a trade or business in the qualified opportunity zone.

(D) All of the facts described are consistent with QOF T's interest in P being a qualified opportunity zone partnership interest for purposes of satisfying the 90-percent test in section 1400Z-2(d)(1).

(iii) Analysis of substantial improvement. The above conclusions would also apply if P's plans had been to buy and substantially improve a pre-existing commercial building. In addition, the fact that P's basis in the building has not yet doubled does not cause the building to fail to satisfy section 1400Z-2(d)(2)(D)1)(III)

(6) Trade or businesses described in section 144(c)(6)(B) not eligible. Pursuant to section 1400Z-2(d)(3)(A)(iii), the following trades or businesses described in section 144(c)(6)(B) cannot qualify as a qualified opportunity zone business:

(i) Any private or commercial golf course,

(ii) Country club,

(iii) Massage parlor,

(iv) Hot tub facility,

(v) Suntan facility,

(vi) Racetrack or other facility used for gambling, or

(vii) Any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

(e) Exceptions based on where an entity is created, formed, or organized--(1) QOFs. If a partnership or corporation (an entity) is not organized in one of the 50 states, the District of

Columbia, or the U.S. possessions, it is ineligible to be a QOF. If an entity is organized in a U.S. possession but not in one of the 50 States or the District of Columbia, it may be a QOF only if it is organized for the purpose of investing in qualified opportunity zone property that relates to a trade or business operated in the U.S. possession in which the entity is organized.

(2) Entities that can issue qualified opportunity zone stock or qualified opportunity zone partnership interests. If an entity is not organized in one of the 50 states, the District of Columbia, or the U.S. possessions, an equity interest in the entity is neither qualified opportunity zone stock nor a qualified opportunity zone partnership interest. If an entity is organized in a U.S. possession but not in one of the 50 States or the District of Columbia, an equity interest in the entity may be qualified opportunity zone stock or a qualified opportunity zone partnership interest, as the case may be, only if the entity conducts a qualified opportunity zone business in the U.S. possession in which the entity is organized. An entity described in the preceding sentence is treated as satisfying the "domestic" requirement in section 1400Z-2(d)(2)(B)(i) or section 1400Z-2(C)(i).

(3) U.S. possession defined. For purposes of this paragraph (e), a U.S. possession means any jurisdiction other than the 50 States and the District of Columbia where a designated qualified opportunity zone exists under section 1400Z-1.

(f) Applicability date. This section applies for QOF taxable years that begin on or after the date of publication in the Federal Register of a Treasury decision adopting these proposed rules as final regulations. A QOF, however, may rely on the proposed rules in this section with respect to taxable years that begin before the date of applicability of this section, but only if the QOF applies the rules in their entirety and in a consistent manner.

§1.1400Z-2(e)-1 APPLICABLE RULES.

(a) Treatment of investments with mixed funds--(1) Investments to which no election under section 1400Z-2(a) applies. If a taxpayer invests money in a QOF and does not make an election under section 1400Z-2(a) with respect to that investment, the investment is one described in section 1400Z-2(e)(1)(A)(ii) (a separate investment to which section 1400Z-2(a), (b), and (c) do not apply).

(2) Treatment of deemed contributions of money under 752(a). In the case of a QOF classified as a partnership for Federal income tax purposes, the deemed contribution of money described in section 752(a) does not create or increase an investment in the fund described in section 1400Z-2(e)(1)(A)(ii). Thus, any basis increase resulting from a deemed section 752(a) contribution is not taken into account in determining the portion of a partner's investment subject to section 1400Z-2(e)(1)(A)(i) or (ii).

(3) Example. The following example illustrates the rules of this paragraph (a):

Taxpayer A owns a 50 percent capital interest in Partnership P. Under section 1400Z-2(e)(1), 90 percent of A's investment is described in section 1400Z-2(e)(1)(A)(i) (an investment that only includes amounts to which the election under section 1400Z-2(a) applies), and 10 percent is described in section 1400Z-2(e)(1)(A)(ii) (a separate investment consisting of other amounts). Partnership P borrows $8 million. Under section 752 and the regulations thereunder, taking into account the terms of the partnership agreement, $4 million of the $8 million liability is allocated to A. Under section 752(a), A is treated as contributing $4 million to Partnership P. Under paragraph (2) of this section, A's deemed $4 million contribution to Partnership P is ignored for purposes of determining the percentage of A's investment in Partnership P subject to the deferral election under section 1400Z-2(a) or the portion not subject to such the deferral election under section 1400Z-2(a). As a result, after A's section 752(a) deemed contribution, 90 percent of A's investment in Partnership P is described in section 1400Z-2(e)(1)(A)(i) and 10 percent is described in section 1400Z-2(e)(1)(A)(ii).

(b) [Reserved].

(c) Applicability date. This section applies to investments in, and deemed contributions of money to, a QOF that occur on or after the date of publication in the **Federal Register** of a Treasury decision adopting these proposed rules as final regulations. An eligible taxpayer, however, may rely on the proposed rules in this section with respect to investments, and deemed contributions, before the date of applicability of this section, but only if the taxpayer applies the rules in their entirety and in a consistent manner.

Exhibit B

Rev. Rul. 2018-29

ISSUES

(1) If a qualified opportunity fund (QOF), as defined in § 1400Z-2(d)(1) of the Internal Revenue Code (Code), purchases an existing building located on land that is wholly within a qualified opportunity zone (QOZ), as defined in § 1400Z-1, can the original use of the building or the land in the QOZ be considered to have commenced with the QOF?

(2) If a QOF purchases an existing building in a QOZ and the land upon which the building is located in a QOZ, is a substantial improvement to the building measured by additions to the adjusted basis in the building or is it measured by additions to the adjusted basis in the building and the land?

(3) If a substantial improvement to the building is measured by additions to the QOF's adjusted basis in the building, does § 1400Z-2(d) require the QOF to separately substantially improve the land?

FACTS

In September 2018, QOF A purchases for $800x Property X, which is located wholly within the boundaries of a QOZ. Property X consists of a building previously used as a factory erected prior to 2018 and land on which the factory building is located. QOF A intends to convert the factory building to residential rental property. Sixty percent ($480x) of the $800x purchase price for Property X is attributable to the value of

the land and forty percent ($320x) is attributable to the value of the building. Within 24 months after the date of QOF A's acquisition of Property X, QOF A invests an additional $400x in converting the building to residential rental property.

LAW AND ANALYSIS

Pursuant to § 1400Z-1(b)(1)(A) of the Code, the Chief Executive Officer of each State nominated a limited number of population census tracts to be designated as QOZs for purposes of §§ 1400Z-1 and 1400Z-2.

Under § 1400Z-2(d)(1), the term "qualified opportunity fund" (QOF) means any investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (Zone Property) (other than another QOF) that holds at least 90 percent of its assets in Zone Property.

Under § 1400Z-2(d)(2)(A), Zone Property means property that is either qualified opportunity zone stock (Zone Stock), qualified opportunity zone partnership interest (Zone Partnership Interest), or qualified opportunity zone business property (Zone Business Property). Zone Business Property is defined in § 1400Z-2(d)(2)(D). Section 1400Z2(d)(2)(D)(i) provides that Zone Business Property is tangible property used in a trade or business of the QOF if (a) such tangible property is purchased by the QOF after December 31, 2017, (b) the original use of such tangible property commences with the QOF or the QOF substantially improves the tangible property, and (c) during substantially all of the QOF's holding period for such tangible property, substantially all of the use of such tangible property is in a QOZ.

Under § 1400Z-2(d)(2)(D)(ii), tangible property used in a QOF's trade or business is treated as substantially improved by the QOF only if, during any 30-month period beginning

after the date of acquisition of such tangible property, additions to basis with respect to such tangible property in the hands of the QOF exceed an amount equal to the adjusted basis of such tangible property at the beginning of such 30-month period in the hands of the QOF.

Questions have arisen as to whether for purposes of § 1400Z-2(d)(2)(D)(i) the original use of land in the QOZ can ever be considered to have commenced with a QOF and, therefore, constitute Zone Business Property. In addition, if the original use of land in the QOZ cannot commence with a QOF and if land is treated as property separate from a building for purposes of § 1400Z-2(d), must land be substantially improved in order to qualify as Zone Business Property?

Given the permanence of land, land can never have its original use in a QOZ commencing with a QOF. Section 1400Z-2 seeks to encourage economic growth and investment in the designated QOZs by providing Federal income tax benefits to taxpayers who newly invest in businesses located within these economically distressed communities. Consistent with this intent, a building located on land within a QOZ is treated as substantially improved within the meaning of § 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 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 Zone Business Property.

Under the facts of this revenue ruling, QOF A purchased Property X, a factory building and the land on which was located (both wholly within a QOZ), for $800x with the intent to convert the building into residential rental property. Sixty percent ($480x) of the purchase price for Property X was attributable to the value of the land and forty percent ($320x) was attributable to the value of the building. Section 1400Z2(d)(2)(D)(ii) does not apply to the land on which the factory building is located, but does apply to the building. Because the factory building existed on land within the QOZ prior to QOF A's purchase of Property X, the building's original use within the QOZ did not commence with QOF A. However, under § 1400Z-2(d)(2)(D)(ii) QOF A substantially improved Property X because during the 30-month period beginning after the date of QOF A's acquisition of Property X QOF A's additions to the basis of the factory building ($400x) exceed an amount equal to QOF A's adjusted basis of the building at the beginning of the 30-month period ($320x). The fact that the cost of the land on which the building is located is not included in QOF A's adjusted basis of the building does not mean that QOF A is required to separately substantially improve the land.

HOLDING

(1) If a QOF purchases an existing building located on land that is wholly within a QOZ, the original use of the building in the QOZ is not considered to have commenced with the QOF for purposes of § 1400Z-2(d)(2)(D)(i), and the requirement under § 1400Z-2(d)(2)(D)(i) that the original use of tangible property in the QOZ commence with a QOF is not applicable to the land on which the building is located.

(2) If a QOF purchases a building wholly within a QOZ, under § 1400Z2(d)(2)(D)(ii)

a substantial improvement to the building is measured by the QOF's additions to the adjusted basis of the building.

(3) Under § 1400Z-2(d), measuring a substantial improvement to the building by additions to the QOF's adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located.

DRAFTING INFORMATION

The principal author of this revenue ruling is Erika C. Reigle of the Office of Associate Chief Counsel Income Tax & Accounting. For further information regarding this revenue ruling, contact Erika C. Reigle at (202) 317-7006 (not a toll-free call).

Exhibit C

JBD3 Speaking Notes from October 2, 2018 at
Novogradac Conference on Opportunity Zones

Opportunity Zone Conference – New Orleans, LA October 2nd – 3rd, 2018
Qualified Opportunity Zone Businesses
Tuesday October 2, 2018 4:15 – 5:00 PM

SPEAKER'S NOTES
By Joseph B. Darby III
Sullivan & Worcester, LLP
October 2, 2018

1. ***Does a triple net lease of real estate constitute an active trade or business (or otherwise qualify as an eligible trade or business) for purposes of a Qualified Opportunity Zone Business?***

Triple net leasing ("NNN leasing") of real estate is an extremely common method of financing construction of new business facilities. Walgreen's and CVS are just two examples of businesses that have financed a tremendous amount of growth by using NNN leasing to finance the construction of their new facilities. If NNN leasing can be classified as a Qualified Opportunity Zone Business, then a greater amount of real estate is likely to be built, developed or rehabilitated in Opportunity Zones.

This first question comes down to whether Code Section 1400Z-2, as embodied in its current ambiguous statutory format (herein the "OZ Act"), should be interpreted such that it:

a. requires an "active" conduct of a trade or business, as opposed to the mere "conduct of a trade or business",[1] and

[1] The definition of "trade or business" usually begins with the meaning of that phrase for purposes of Code Section 162. For example, both the Net Investment Income Tax ("NIIT") definition of trade or business (Reg. Section 1.1411-1(d)(12)) and the recently issued Proposed Regulations under Code Section 199A refer to Code Section 162 as the meaning of the definition of "trade or business." A major problem with this cross-reference is that relatively few cases on the definition of "trade or business" are decided under Section 162, because even if a deduction is not deductible under Section 162 it is likely deductible under Code Section 212, which specifically applies when the activity for profit is not a trade or business, so it is usually a "who cares" issue for Code Section 162 purposes. Far more cases, including Hazard discussed below, are decided under Code Section 1231.

Another knotty question is whether "trade or business" means the same thing within the Code for the over 60 different sections and situations where it is used. One court has asserted that where Code sections have a similar purpose, the phrase should be given a consistent interpretation. See Folker v. Johnson, 230 F.2d 906, 908 (2d Cir. 1956).

b. if the "active" requirement is in fact pulled into the OZ Act from the cross-reference to Code Section 1397C(b)(2), whether the term "active" should be given:

i. the extremely favorable interpretation given to that term under the New Markets Tax Credit (basically, any activity that reasonably expects to generate revenues within three years); or

ii. whether it would be given a more stringent interpretation such as that given under Gulf Opportunity Zones ("GO Zones") (a facts and circumstances test that clearly prohibits NNN leases from qualifying under the applicable guidance).

As an initial observation, the OZ Act refers to the phrase "trade or business" twice[2] and does not require an "active" trade or business either time the phrase is mentioned in the OZ Act. The word "active" is brought in – if at all – through the cross reference to Code Section 1397C(b)(2). Is the correct test "active" conduct of a trade or business or merely "conduct of a trade or business?[3]

A fair amount turns on that distinction, because under the strange history of a series of US Tax Court cases dating back to Leland Hazard,[4] the US Tax Court may, to this day, take the

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[2] The first time is in the definition of "Qualified Opportunity Zone Business Property," which is defined as "tangible property used in a trade or business of the qualified opportunity fund if…[three criteria are met]." The three criteria are (i) the property is acquired by purchase from an unrelated person after December 31, 2017, (ii) the property is either original use property or substantially improved property, and (iii) substantially all the use of the property by the fund is in the opportunity zone.

The second use is in the definition of "qualified opportunity zone business" and means "a trade or business" that meets three criteria, including the statutory requirements imported from Code Section 1397C(b), once of which, under Section 1397C(b)(2), is that "at least 50 percent of the total gross income of such entity is derived from the active conduct of such business…"

[3] See Warren R. Miller, Sr., 51 T.C. 755 (1968) (the incorporation of one statute into another by cross-reference calls for practical and sensible interpretation in fitting the provisions of the adopted statute into the scheme of the adopting one).

[4] 7 T.C. 372 (1946). In the Hazard case, the issue was whether the rental of a single family residential property constituted a trade or business, and thus resulted in an ordinary loss (rather than a capital loss) on sale. The court opinion in Hazard does not discuss or identify any services provided by the lessor to the lessee, nor does it discuss the lease terms.

The IRS acquiesced to the Hazard case. See 1946-2 C.B. 3. Much later in time (1981), a request was made by the IRS National Office Audit Division to reverse the acquiescence in Hazard. This request was rejected by the IRS General Counsel. GCM 38779, 7-27-81. That GCM is quoted in detail in the next footnote.

Therefore, Hazard to this day has acquiescence from the IRS. The Hazard case continues to represent the Tax Court's continuing position in every jurisdiction in the U.S. except the 2nd Circuit, where the Court of Appeals in Grier v. U.S., 218 F.2d 603 (2nd Cir. 1955) declined to follow Hazard and held that more "activity" was needed in order for a rental of real estate to constitute a trade or business.

Hazard was reaffirmed (more or less) in Balsamo v. Comm'r., T.C. Memo 1987-477, in which the Tax Court stated as follows: "Our historical position that rental of one property constitutes a trade or business establishes a general not an absolute rule. See Fegan v. Commissioner, 71 T.C. 791, 814 (1979), affd. without published opinion (10th Cir. 1981), wherein we referred to "our longstanding definition of 'trade or business' as including under

position that the "general rule" is that a lease of a single parcel of real estate constitutes a "trade of business."[5]

The language of GCM 38779 provides a basis for cautious optimism that taxpayers could potentially prevail on this issue, even if the "management" activities were relatively minimal.[6]

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appropriate circumstances the rental of one property" (emphasis added)." In Balsamo, the taxpayer was ultimately denied an ordinary loss, not because of the trade or business analysis of a bona fide lease of one property, but because the taxpayer in that case did not actually rent the property to anyone.

[5] See "'ACTIVE CONDUCT' DISTINGUISHED FROM 'CONDUCT' OF A RENTAL REAL ESTATE BUSINESS," by John W. Lee, Tax Lawyer Vol. 25, No. 2, 1972; see also Comment, "The Single Rental as a 'Trade or Business' under the Internal Revenue Code," 23 U. CHI. L. Rev. 111 (1955); see also Balsamo, supra, that seems to confirm and reiterate (more or less) this standard as the continuing standard of the US Tax Court in all federal circuits except the Second Circuit, where the Grier case mandates a facts and circumstances analysis of the actual management exercised by the taxpayer-lessor.

[6] GCM 38779 states as follows:

> Although Grier appears to support a stricter test for determining when the rental of property will constitute a trade or business, its analysis is much the same as that of the other cases that have followed Hazard. In the recent case of Curphey v. Commissioner, 73 T.C. 766 (1980), the Tax Court noted that the rental of a single piece of real property has repeatedly been recognized as the conduct of a trade or business. The court stated, however, that the ownership and rental of real property does not, as a matter of law, constitute a trade or business. After citing Grier, the court concluded: "In the final analysis, the issue is ultimately one of fact in which the scope of the ownership and management activities may be an important consideration."
>
> We read the majority of cases that have been decided since Hazard as turning upon a factual finding that a particular taxpayer was engaged in a trade or business. In the typical case, the taxpayer has offered evidence of the various activities involved in managing the rental property and the court has accepted this evidence as indicating that the taxpayer was engaged in a trade or business. Even in a case such as that described in your recent technical advice memorandum, the taxpayer undoubtedly could offer evidence of various efforts to collect unpaid rents and other activities with respect to the property. Based upon the decided cases, there is substantial doubt that the Service would prevail if such a case were litigated.
>
> For these reasons, we question whether a change in Service position in this area is advisable. The problem that you raise is not with the legal standard applied by the courts, *but with the relatively small amount of activity that the courts have found to be indicative of a trade or business*. [Emphasis supplied.] In view of the number of cases that have been decided on this issue, only some of which have been cited above, *it is unlikely that the Service could now persuade the courts to take a more restrictive approach with respect to the amount of activity required to find that a taxpayer's rental activity constituted a trade or business.* [Emphasis supplied.]
>
> Finally, we would note that the Service's acquiescence in Hazard has little bearing on this issue. The acquiescence merely represents the Service's acceptance of the court's decision on what was admittedly a factual question. Moreover, although Hazard has been cited frequently in subsequent cases, the courts have not viewed the acquiescence as indicating Service position to be that every rental of real property is a trade or business. At most, it has been cited for the fact that rental of even a single piece of property may be a trade or business, a proposition with which we do not disagree. Thus, we believe that withdrawal of the Hazard acquiescence would have little effect on future cases.

Without beating the issue to death, the cross reference to Code Section 1397C(b)(2) is at the very least disturbing, and it is difficult to see how taxpayers can safely conclude that a NNN lease of a single property by an Qualified Opportunity Zone Business meets the relevant standard without an IRS pronouncement on the issue.

Given the IRS's general antagonism in recent years to the idea that a NNN lease of a single property rises to the level of a "trade or business,"[7] it seems far more likely that the IRS will need to "interpret" the "active" business requirement as it applies specifically to the OZ Act. Ideally, one would hope for a definition similar to the definition in the New Markets Tax Credit area. Treasury Regulation Section 1.45D-1(d)((4)(iv), states in relevant part as follows:

> "For purposes of paragraph (d)(4)(i) of this section, an entity will be treated as engaged in the active conduct of a trade or business if, at the time the CDE makes a capital or equity investment in, or loan to, the entity, the CDE reasonably expects that the entity will generate revenues (or, in the case of a nonprofit corporation, engage in an activity that furthers its purpose as a nonprofit corporation) within three (3) years after the date the investment or loan is made."

An alternative (less congenial) possibility is that the IRS may take a relatively strong position against NNN leasing of a single property, similar to its position found in the GO Zone guidance under Notice 2006-77, which states in relevant part as follows:

> *.02 ACTIVE CONDUCT OF A TRADE OR BUSINESS REQUIREMENT.*
>
> *(1) TRADE OR BUSINESS DEFINITION. For purposes of section 1400N(d)(2)(A)(ii), the term "trade or business" has the same meaning as in section 162 and the regulations thereunder. Thus, property held merely for the production of income or used in an activity not engaged in for profit (as described in section 183) does not qualify for the GO Zone additional first year depreciation deduction.*
>
> *(2) ACTIVE CONDUCT. Solely for purposes of section 1400N(d)(2)(A)(ii), the determination of whether a trade or business is actively conducted by the taxpayer is to be made based on all of the facts and circumstances. A taxpayer generally is considered to actively conduct a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business.*
>
> ** * * * **
>
> *(c) EXAMPLE 3. During 2006, PRS, a partnership, constructs and places in service a new small commercial building in the GO Zone and leases it to E, an unrelated party, who uses the building as a fast food restaurant. This building is the only property owned by*

[7] See, for example, the IRS's position under the NIIT regulations that a single NNN lease is not a trade or business.

PRS. The lease agreement between PRS and E is a triple net lease under which E is responsible for all of the costs relating to the building (for example, paying all taxes, insurance, and maintenance expenses) in addition to paying rent. Because of the triple net lease, PRS does not meaningfully participate in the management or operations of the building and the building is not used in the active conduct of a trade or business by PRS in the GO Zone. Accordingly, the building does not qualify for the GO Zone additional first year depreciation deduction.

Since the "active" trade or business "problem" is imported from the Enterprise Zone provisions of Code Section 1397C in the first place, it is possible that the IRS might try to find some interpretive guidance from that Code Section. However, there is essentially none to be had. Code Section 1397C provides very detailed guidance on what constitutes a "qualifying business" for purposes of that provision, and it is "any trade or business." Code Section 1397C states that rental real estate is (generally) a "qualified business" but then goes on to restrict the kinds of real estate activities that will qualify, by expressly disallowing residential rental real estate from qualifying, imposing a requirement that 50% of rents must come from enterprise zone businesses, and also barring any trade or business "consisting predominantly of the development or holding of intangibles for sale or license." It is also not clear under Code Section 1397C whether a rental real estate activity, even if it is a qualified business, must also meet an additional "active" requirement. Whereas the GO Zone guidance is clear that "active" is an additional hurdle above and beyond the existence of a trade or business, Code Section 1397C is not clear on this issue.

NOTE: There is also a residual concern that the cross-reference to Code Section 1397C(b)(2) could pull in ALL the corollary provisions of Code Section 1397C, including these extreme limitations on the types of businesses that would qualify. However, for the policy reasons expressed in footnote 2, above, it seems extremely unlikely that such a wholesale importing of Code Section 1397C would be a reasonable interpretation of Congressional intent. In fact, it is even questionable whether the "active" requirement should be considered to be imported as opposed to merely the "50%" requirement.

Concern about the "active" issue is sufficiently prominent that the IRS must ultimately provide guidance on that issue – or, failing concrete guidance, taxpayers should for the moment plan around it (including in the manner addressed in Question 2, below). However, the definitional exceptions to a qualifying business under Code Section 1397C should not be imported and it seems unlikely the IRS would reach such an unwarranted (not to mention adverse) interpretation.

2. ***Can a triple net lease of real estate in any event meet all the requirements of Qualified Opportunity Zone Property if the real property is owned directly by the Qualified Opportunity Fund?***

The answer to this question – in essence, can we bypass all the goofy mumbo-jumbo of the "active" trade or business requirement by acquiring and then NNN leasing real property at

the Qualified Opportunity Fund level – seems to be a cautious "yes," given the continuing validity of the Hazard case, the IRS acquiescence in that case, and the candor of GCM 38779 in acknowledging the "relatively small amount of activity that the courts have found to be indicative of a trade or business."

First of all, the requirements of a Qualified Opportunity Fund ("OZ Fund") are completely different than the requirements of a Qualified Opportunity Zone Business. The specific business requirements imported from Code Section 1397C do not apply, including specifically the requirement under Code Section 1397C(b)(2) that at least 50% of the gross income must come from active conduct of the applicable trade or business. An OZ Fund merely needs to be 90% invested in Qualified Opportunity Zone Business Property ("QOZBP"), which does, of course, imply the existence of a "trade or business." Even under a NNN lease, GCM 38779 acknowledges that a lessor-taxpayer "undoubtedly could offer evidence of various efforts to collect unpaid rents and other activities with respect to the property." Obviously, if there is concern that a NNN lease creates too little "activity" for the lessor, the lease can be drafted to put more responsibility on the lessor, up to the level of a full operating lease.

Ideally, of course, Treasury will provide guidance confirming that a NNN lease qualifies as a trade or business for purposes of the OZ Act.

A NNN lease of real property to a single long-term tenant would seem to fit well with ownership at the OZ Fund level – in fact it may be a VERY good fit. Note that for more than 14 years, since the issuance of Rev. Proc. 2004-86, the real estate industry has provided a "landing place" for taxpayers looking to reinvest in real estate for purposes of completing a Section 1031 like-kind exchange, and has offered the Delaware Statutory Trust ("DST") as an investment vehicle. The DST must be carefully structured to avoid the "seven deadly sins" and generally is a very awkward vehicle through which to own real estate, even when the real estate is subject to a NNN lease.

The OZ Fund, though hardly flexible, is probably MORE flexible and functional as a holding vehicle of real estate than a DST. The biggest constraint is that 90% of the assets in an OZ Fund need to be invested in QOZBP. This requirement is measured by averaging the investment status at the six-month and 12-month dates in the Fund's taxable year, and if the Fund falls below 90% there is a penalty. This is not likely to prove terribly problematical, especially when compared to a DST, where 100% of the proceeds in a 1031 like-kind exchange need to be invested immediately in the qualifying property. DST investments come pre-packaged with the NNN lease and, if applicable, the related bank financing. The same pre-packaged structure should be entirely viable for investors looking to acquire property subject to a NNN lease through an OZ Fund.

The OZ Fund may be given an investment hiatus by the IRS during the initial period of time that it receives investments of gain from its investors, and it is possible – though far from certain – that the IRS will allow an OZ Fund to have a working capital reserve as a permanent concept. However, even without such a working capital reserve, an OZ Fund will be allowed to

retain up to a 10% cushion in non-QOZBP assets. The nature of a NNN lease is that you do not really need any financial reserves *per se*, and distributing out cash flow and profits to the investors will make the investment all that much more attractive. REITs, after all, have essentially the same investment and distribution requirements, at least in terms of the magnitude of investment requirements and profits distributions, as an OZ Fund.

In tenancy-in-common ("TIC") transactions structured to conform to Rev. Proc. 2002-22, it was not uncommon to have a capital reserve fund set aside by the lessee of the real property, often in an account with the lending bank, to anticipate maintenance, repair and capital improvements, and this was generally accepted by the IRS.

If the OZ Fund later needs to make a capital call on its investors for whatever reason, this can probably be baked into the OZ Fund partnership agreement – e.g., capital calls in specified situations, possibly capped by the amount of prior distributions, and so forth. It could also allow investors to meet the capital calls of other investors who fail to meet their capital call obligations – and all this will be far easier than the awkward (at best) capital call structures that were baked into TIC agreements under Rev. Proc. 2002-22.

An OZ Fund structured in the foregoing manner could be a serious direct competitor to DST investment structures. Taxpayers do not need to go through the complications of using a qualified intermediary ("QI"), do not need to identify replacement investments within 45 days (they merely need to close within 180 days), and, best of all, they only need to reinvest the gain rather than the entire proceeds from the sale of the relinquished property.

All in all a pretty satisfactory situation.

3. ***One of the key requirements of a Qualified Opportunity Zone Business is that "substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property" ("QOZBP"). The definition of QOZBP includes a requirement that the property must acquired by purchase from an unrelated party – and there is nothing in the definition that suggests "leased property" can be QOZBP. How should this critically important provision be interpreted?***

The technical language of the provisions suggests that "substantially all" (which we anticipate could be anywhere from 80 % to 90%) of all the tangible property "owned or leased" by the business must be QOZBP. But QOZBP by definition can only be purchased. This is the one complete "headshaker" provision in the OZ Act – well, not the only one, but probably the biggest. In submissions to Treasury by various groups on requested guidance, the recurring theme was that the language as written appears to be a drafting glitch or drafting error.

For example, a letter submitted by EIG, dated June 18, 2018, commented as follows: "In an apparent attempt to prevent the use of limiting purchases to those meeting the Section 179 definition, the language could be read to imply that QOZ Business Property cannot be acquired by lease. *This cannot be the case.* [Emphasis supplied.] Section 1400Z-2(d)(3) expressly

indicates that both owned and leased tangible property count as Ozone Business property for purposes of percent-of-assets test… ."

Similarly, the first letter submitted by the Novogradac Opportunity Zone Working Group, dated March 9, 2018, makes the following suggestion: "Clarify that leased property can be QOZBP (Qualified Opportunity Zone Business Property), even though the acquisition of QOZBP is required to be by purchase, by adopting the working group's recommendation to modify QOZBP rules to include leased property." The working group goes on to recommend that leased property be valued at a reasonable amount established by the QOZB, similar to how lease property is valued under the New Markets Tax Credit Program.

Both of the comments above have substantial merit, at least in terms of addressing a change that is almost necessary in order to make the OZ Act a workable program. EIG notes that the problem is the consequence of an effort to achieve a shorthand adoption of the related party standards of Code Section 179(d)(2), and inadvertently limited the definition of QOZBP to a "purchase" when it should cover both a purchase and a lease.[8]

One possibility (short of a legislative fix by Congress) is for the IRS to interpret the definition of QOZBP such that leased tangible property is counted towards both the numerator and the denominator in the "substantially all" calculation. This of course makes sense – except that the statute is not drafted in this manner. Note that under Code Section 45D, the New Markets Tax Credit defines a "qualified low-income community business" with various requirements, including the requirement that "a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within any low-income community… ."

The related regulation, Reg. Section 1.45D-1(d)(1)(B)(i), states as follows:

> At least 40 percent of the use of the tangible property of such entity (whether owned or leased) is within any low-income community. This percentage is determined based on a fraction the numerator of which is the average value of the tangible property owned or leased by the entity and used by the entity during the taxable year in a low-income community and the denominator of which is the average value of the tangible property owned or leased by the entity and used by the entity during the taxable year. Property owned by the entity is valued at its cost basis as determined under section 1012. Property leased by the entity is valued at a reasonable amount established by the entity.

The problem, again, is that the language under Code Section 45D expressly includes the leased tangible property in the numerator as well as the denominator, while such statutory clarity is not present in the awkwardly drafted OZ Act.

[8] EIG recommended that a leased tangible property be subject to the same related party limitations as when such property is purchased.

Could the IRS fix the problem by making a rather creative reinterpretation of the statutory language? Yes. Are they likely to do so? Not clear.

One alternative argument, which actually has some justification in logic, is to note that a Qualified Opportunity Zone Business may not need to include the leased tangible property in the numerator of the "substantially all" test so long as the amount added to the denominator is zero. The logic is as follows:

A contract to lease property at fair market value actually has no inherent value, since the right to use property at fair market value confers no better advantage than simply going to the market place and acquiring (or leasing) equivalent property at the market price. If a lease of tangible property (whether real property or personal property) is with an unrelated party and the value is assumed to be fair market value, it is arguably not a stretch – either in economics or in tax law – to value that contract at the time it is entered into at zero. There are numerous situations in federal income tax law where the "value" of an asset for tax purposes is set at the time of acquisition, and "zero" may be good enough for a Qualified Opportunity Zone Business to pass the "substantially all" test. In effect, this proposed methodology would eliminate arms-length leasing arrangements with unrelated parties from both the numerator and denominator of the "substantially all" calculation.

Of course, most taxpayers would love to count leased property as "good" property, and hopefully the IRS will accommodate what everything "thinks" the OZ Act should say. However, the alternative of valuing an arms length lease with an unrelated party at zero may be good enough to make the provision workable.

A second alternative, of course, is to conclude that a Qualified Opportunity Zone Business cannot lease any significant amount of tangible property (i.e., at most about 15% of all tangible property). The biggest impediment will be the acquisition and use of real estate in an Opportunity Zone. A substantial number of business organizations will not want to purchase and own real estate in an Opportunity Zone, and instead will want to devote scarce capital to funding the core business operations and the acquisition of tangible personal property. If a business can enter into an arms-length lease of real property in an Opportunity Zone with an unrelated party and have that count favorably toward the "substantially all" test, that would be great; but simply having such a lease count as "zero" should be enough to make many business opportunities viable within the limitations and constraints imposed by the definition of a Qualified Opportunity Zone Business.

The treatment of leased real property in an Opportunity Zone is probably the single biggest uncertainty – and currently the single biggest constraint – to a successful and dynamic implementation of the OZ Act in the area of Qualified Opportunity Zone Businesses.

EXHIBIT D

INSIGHTS, OBSERVATIONS AND INTERESTING QUESTIONS

Q: Does Eligible "Capital Gain" for Purposes of Investing in a QOF Include Code Section 1231 Gain?

The term "Eligible Gains" is defined such that "only capital gains – but all types of capital gains – are eligible for Ozone Act investment and deferral benefits. Eligible gain is a tax item 'treated as a capital gain for Federal income tax purposes.'"

Code Section 1231 requires that gain be netted against losses, and the question is whether it is truly "capital gain" if, after netting, overall net losses are characterized as ordinary losses.

The Ozone Proposed Regs. provide extensive details about some things – 1256 contracts, and 1092 straddles – but manage to omit explicit guidance on Section 1231 gain, and also, frankly, do not really even clearly address the fact that capital gain from the sale of a single capital asset is NOT NETTED against loss from the sale of other capital assets.

The "single sale" rule seems to be inherent in the "straddle" rule, namely, the IRS position in the regulations is that if there is an offsetting straddle position then capital gain from the sale of property cannot be utilized. This discussion makes zero sense if there is not a "single sale" rule -- you would generally not need a straddle rule if gains and losses are netted anyhow, and instead the discussion would focus solely on transactions that straddle tax years.

In turn, if a single sale of capital gain property is not offset by another sale of capital loss property, then it seems that there should not be any different rule for 1231 gain and 1231 loss. To be sure, a capital asset is always a capital asset, whether there is gain or loss, while a sale of section 1231 property produces either capital gain or ordinary loss.

HOWEVER, there are specific recapture rules under Code Section 1231(c) that deal with the obvious opportunity for manipulation of capital gain and ordinary loss under code Section 1231, and these anti-abuse rules exist independent of the Ozone tax incentives. In particular, it would be very easy for a taxpayer to have 1231 gain in Year 1 and ordinary loss in Year 2 simply by timing sales of 1231 gain property and 1231 loss property. What Section 1231(c) does is track the 1231 gains and losses, and, if the losses exceed the gains, then for the next five years any additional 1231 gains are recharacterized as ordinary income. This seems to protect the IRS from any material risk of abuse – investing gain in a QOF in order to avoid a matching of 1231 gain with 1231 loss under the Ozone legislation is not really any different than simply recognizing 1231 gain on December 31 of Year 1 and recognizing a 1231 loss on January 2 of Year 2.

It would also be breathtakingly embarrassing for the IRS to beat to death in the Proposed Regulations the proposed rules governing the treatment of gain from Section 1256 Contracts and then later concede that they failed to address netting rules applicable to gain and loss from sales of Code Section 1231 property.

Q: Does an "eligible interest" in a QOF include a so-called "carried interest?"

I read and interpret the IRS guidance relatively conservatively when the proposed regulations say that eligible interests in a QOF can include "preferred stock or a partnership interest with special allocations." Prop. Reg. Sec. 1400Z-2(a)-1(b)(3)(i).

I read and interpret the language permitting "a partnership interest with special allocations" to mean a partnership interest that is the equivalent of preferred stock, e.g., a partnership interest that specially allocates income to the "preferred partnership interest" ahead of common partnership interests. I do NOT interpret that provision to mean that eligible interests include a conventional "carried interest" where the sponsor receives a general partnership interest as a "profits interest" for services and without a meaningful investment of "capital gain" from the sale of property to an unrelated party.

I specifically anticipate that a person who does not invest a material amount of "capital gain" under 1400Z-2(a) will not enjoy the tax benefits under 1400Z -2(a) through 2(c). The whole point of the legislation is to reward people who invest capital gain by giving them the Ozone tax benefits. People who "tag along" as the fund managers and who do not contribute capital gain (or only de minimis amount of capital gain) are not clearly within (and in fact are pretty far removed from) the intended scope of 1400Z-2(a). These persons may in fact hold an "eligible interest" in a partnership, but that is not the only leg of the test – they also need to make an investment of "eligible gain."

I will also point out that the RIGHT place to put a carried interest is by giving it either to the person serving as the general partner of a QOZ Business (where the nature of the partnership interest can be whatever you want and, specifically, does not have to be an investment of eligible gain) or at the "feeder fund" level -- if and when the IRS approves feeder funds, which seems like it has a good chance to be allowed by the IRS in the next round of regulations (or the next…)

Q: When Must Gain Recognized by a Partnership with Individual Partners Be Reinvested Under the 180-Day Rule?

Under §1400Z-2(a)(1)(A), to be able to elect to defer capital gains, a taxpayer must generally invest in a QOF during the 180-day period beginning on the date of the sale or exchange giving rise to the capital gain. However, in the case of gain recognized by a partnership, the Regulations allow "two bites at the apple," and thereby provide the opportunity to make strategic timing decisions about when to begin and end the 180-day investment period.

According to the Regulations, a partnership may elect to defer all or part of a capital gain to the extent it makes an eligible investment in a QOF. If the partnership itself makes an eligible investment in a QOF within the 180-day period following the date of the transaction giving rise to the capital gain, the capital gain that is invested by the partnership in the QOF is not included in the net capital gain allocated to the partners under Code Sections 702 and 706.

If, however, the partnership chooses to not reinvest the full amount of gain in a QOF, then any capital gain not eligible for deferral will be included in the gain distributed on the partnership K-1 to its partners.

In turn, a separate 180-day investment period for the partners begins on the last day of the partnership's taxable year, which is the date when the partnership-level gain is treated as distributed to the partners under Code Section 706.

The Regulations then go one step further and add a feature that gives further flexibility to the partners. If a partner knows that the partnership has recognized eligible gain on a sale or exchange to an unrelated party, and also knows that the partnership has chosen to not make an eligible investment in a QOF, then the partner may treat his/her own 180-day period as beginning on the same date that the partnership's 180-day period commences.

> **Example:**
>
> *Assume a partnership sells stock held for investment and recognizes capital gain on March 1, 2019. The partnership would have 180 days (i.e., until August 27, 2019) to invest the gain in a QOF. If the partnership elects to invest this gain in a QOF, the invested gain will not be included in capital gain distributed to its partners for the tax year. If the partnership chooses not to invest this gain in a QOF, then the individual partners are permitted to invest their distributive share of the partnership gain in an QOF. Under these circumstances, the 180-day period would commence on December 31, 2019 (assuming the partnership is a calendar year taxpayer), and partners would have 180 days (i.e., until June 28, 2020) to make an eligible QOF investment.*
>
> *If, however, a partner is aware that the partnership recognized the gain on March 1, 2019 and has made the decision not to invest in a QOF, such partner can decide whether to invest his/her distributive share of the partnership gain during the partnership's 180-day period (i.e., from March 1, 2019 until August 27, 2019), or, alternatively, during the second 180 period beginning on December 31, 2019 and ending on June 28, 2020.*

Although it seems anomalous, it appears that the individual partner cannot make a qualifying investment related to the partnership gain during the period after August 27, 2019 and before December 31, 2019.

These timing rules provide exceptional flexibility in managing the 180-day investment period, especially when there is good communication between the partnership and its partners. At the

extreme, gain recognized by a calendar-year partnership on January 1, 2019 could potentially be invested successfully in a QOF by an individual partner as late as June 28, 2020.

The proposed regulations further state that rules analogous to the rules provided for partnerships and partners apply to other pass-through entities (including S corporations, decedents' estates, and trusts) and to their shareholders and beneficiaries. Comments are requested regarding whether taxpayers need additional details regarding analogous treatment for pass-through entities that are not partnerships.

JBD3 Comments: ***The Treasury clearly intends and anticipates that "analogous" rules will apply to S corporations, which will be interesting because, unlike partnerships, S corporations do not explicitly distribute items of gain (or other tax items) on the last day of the S corporation tax year. The IRS would hopefully adopt rules as overtly flexible as those advanced for a partnership, but the income allocation rules under Subchapter S (including the "default" rule that S corporation items are allocated per share/per day over the entire year, but subject to an election under Code Section 1377(a)(2) to have an interim closing for a departing shareholder) will make for an interesting (future) read when (and if) the IRS gets around to addressing these distinctions. What seems clear is that an S corporation with gain can elect to take advantage of the Ozone Act; and then, to the extent that gain is not deferred and instead passes through to shareholders, the shareholders can PROBABLY take advantage of the gain as well, assuming Treasury adopts the same "two bites at the apple" philosophy that was applicable to partnerships and partners.***

For estates and trusts, the issue is even more complicated: Capital gain recognized by a trust may be attributable to the non-distributable corpus of the trust, and so the trustee may not have discretion about whether to "keep" the gain (and thus elect the benefits of the Ozone Act by making a qualifying investment) or whether to distribute the gain to beneficiaries. This is because, under the typical Income and Principal Act, MGL c. 203C, gain with respect to "principal" may be considered "corpus" and thus may be required to be held in trust and not allowed to be distributed to beneficiaries.

EDUCATED GUESS: The Treasury got a huge number of inquiries about how to treat gain recognized by a partnership (especially investment partnerships and hedge funds) and so the nuances of how to treat partnership gain was both a primary focus of public inquiry and also, because of the unique characteristics of partnership taxation, relatively easy to address with clear rules. Treasury probably postponed issuing detailed rules for S corporations, trusts and estates, and other pass-through entities precisely because each type of pass-through entity has materially different tax characteristics as compared to a partnership.