THE BOOK ON QUALIFIED OPPORTUNITY ZONES

A COMPREHENSIVE GUIDE FOR INVESTORS, DEVELOPERS, BUSINESS OWNERS AND PROFESSIONAL ADVISORS

THE COMPLETE SOURCE FOR LEGAL, PRACTICAL AND BUSINESS ANALYSIS OF QUALIFIED OPPORTUNITY ZONES

INCLUDES DETAILED TECHNICAL ANALYSIS PLUS STRUCTURING IDEAS AND PLANNING OPPORTUNITIES

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THE BOOK ON QUALIFIED OPPORTUNITY ZONES

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The development of the *Book on Qualified Opportunity Zones* arose following dozens of real-life transactions (many of which have culminated in the creation of qualified opportunity funds that are currently developing real estate and business projects under the program). Over the past year, we have prepared detailed transaction memos, researched every component of the statute and regulations and developed practical tools for stakeholders. Ultimately, we felt that combining our work into a comprehensive "book" will benefit our team, our clients, and other participants in the new industry focusing on the opportunity zone program.

This book is broken out into five parts as follows:

Part 1 ("General Overview") sets forth an overview and background of the qualified opportunity zone program, together with a summary of the tax benefits and the structure of the program.

Part 2 ("Analysis for Tax and Legal Professionals") provides a comprehensive and detailed analysis of all aspects of the qualified opportunity zone program suitable for tax and real estate professional advisors.

Part 3 ("Investor Roadmap") provides a roadmap for investors to benefit from the qualified opportunity zone legislation and navigate the complex rules to maximize investment outcomes.

Part 4 ("Real Estate Developer Planning") describes how real estate developers can benefit from engaging in real estate development opportunities in qualified opportunity zones.

Part 5 ("Business Owner Planning") details how a business owner (outside of the real estate context) may benefit utilizing qualified opportunity zones for its business operations and create value inside of a qualified entity.

Note: The intended audience for Part 2 consists of tax professionals. Accordingly, Part 2 may not be approachable for readers that are not tax or legal professionals. However, Part 2 may serve as a detailed reference for all readers with respect to any of the requirements under the program. Investors, developers and business owners may skip to Parts 3 through 5 (and reference Part 2 for any specific areas for which additional detail is required).

Our team is excited about the significant impact we have already had for large opportunity zone projects, having closed over $1 billion of projects to date. We look forward to many more comparable opportunities. To that end, we believe that RS&F is the ideal accounting firm partner for real estate and venture funds, law firms representing opportunity zone projects, family office investors and business owners that are considering operations in the opportunity zone.

We are also excited to share our book with the burgeoning opportunity zone community. If you have any comments or ideas that you wish to have included in the book, we will gladly accept any contributions. We would be honored if this became, in part, a community effort that we can develop into a tool to assist all stakeholders in the Qualified Opportunity Zone ("QOZ") program.

This book is intended as a comprehensive technical resource for tax and real estate professionals, as well as other stakeholders in the QOZ community. This book is not, however, designed to provide specific structuring advice or address topics outside of the scope of the QOZ program (such as partnership or corporate tax matters). The design and structure of a particular project under the QOZ program, and structuring ideas relating to specific project goals should be addressed with our team on a project-specific basis, after we have obtained a thorough understanding of the facts, the tax attributes of the parties and related pertinent information.

To assist our readers, we have included several appendices. We highly recommend that readers familiarize themselves with key terminology. To that end, Appendix A (the "ABCs of OZs") includes a detailed glossary of key terms that will help readers that are not familiar with the QOZ program to understand the terminology, abbreviations and technical items contained in this book. Appendix B provides a sample chronology which provides straightforward view of the lifecycle of a QOZ investment.

The author invites suggested changes, whether substantive or even to point out typos, corrections (or criticism of my cover design or font size). I am not perfect, and have little doubt that the community can find opinions, conclusions or statements that should be corrected. To that end, I encourage the community to provide their own opinions that can be included in future versions of this Book. The views expressed herein reflect the author's thoughts when initially written and any opinions or conclusions are subject to change.

DISCLAIMER: Before using any information contained in these materials, a taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor. Tax advisors should research these issues independently rather than rely on these materials. This book is a reference for educational use for the community and should not be relied upon without independent verification of the underlying law.

Please do not hesitate to contact our team to assist you or your clients with an opportunity zone project. We have gone deeper than virtually any group in the entire country and would love to share our hard work with you.

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PART 1: OVERVIEW AND BACKGROUND

A. Background of the Opportunity Zone Legislation

The 2017 tax reform legislation (which is commonly referred to as the Tax Cut and Jobs Act of 2017 or the "TCJA") created one of the most ambitious tax incentive programs in modern history: ***Qualified Opportunity Zones***.[1] The qualified opportunity zone program is based on the bipartisan "Investing in Opportunity Act" originally introduced in the House of Representatives and separately in the Senate in February 2017 with the support of dozens of Republicans and Democrats.[2] The original concept behind the program is credited to a white paper from April 2015 issued by the Economic Innovation Group ("EIG") entitled "Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas".[3] Prominent supporters of the legislation include Senator Tim Scott (R) of South Carolina and Senator Cory Booker (D) of New Jersey (both of whom were sponsors of the Senate version of the bill), in addition to dozens of politicians, government officials, and business leaders.

The basic design of the opportunity zone legislation is to incentivize investors to (i) realize capital gains in the broader market in exchange for near-term and long-term tax benefits, and (ii) reinvest the gains in real estate development and operating business activities in low income communities. According to EIG, United States households held unrealized capital gains of $3.8 trillion and domestic corporations held an additional $2.2 trillion of unrealized capital gains.[4] EIG provided significant support for the proposition that investment in low income communities and distressed communities are not receiving an adequate share of investment activities in the United States.[5]

In general, the opportunity zone legislation turned out to be much broader in application as compared to previous tax incentive programs designed to spur investment in low income communities. The larger scope of the program is possible due to a number of factors including, among others:

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[1] Section 1400Z-1 and Section 1400Z-2 of the Internal Revenue Code of 1986, as amended ("Code"). All Section references contained herein refer to such section of the Code or the Treasury Regulations promulgated thereunder (including proposed regulations, as applicable). This program, is sometimes referred to as the "qualified opportunity zone legislation" or "QOZ legislation".

[2] The House version of the Investing in Opportunity Act was sponsored by Rep. Patrick Tiberi (R) and cosponsored by 81 representatives comprised of 45 Republicans and 36 Democrats. The Senate version was sponsored by Senator Tim Scott and cosponsored by 14 Senators comprised of 7 Republicans and 7 Democrats.

[3] The referenced white paper issued by EIG was authored by Jared Bernstein of the Center on Budget and Policy Priorities and Kevin A. Bassett of the American Enterprise Institute. EIG describes itself as "a bipartisan public policy organization that combines innovative research and data-driven advocacy to address America's most pressing economic challenges."

[4] https://www.forbes.com/sites/jenniferpryce/2018/08/14/theres-a-6-trillion-opportunity-in-opportunity-zones-heres-what-we-need-to-do-to-make-good-on-it/#7a26fb006ffc

[5] https://eig.org/opportunityzones/history

1. ***Geographic Scope of QOZ Program.*** The geographic scope of the opportunity zone program is huge. Under the first part of the legislation, 25% of the low-income census tracts in the United States were nominated as "qualified opportunity zones" by the respective Governors of every state (in addition to the District of Columbia and US Possessions). According to the Congressional Research Service, there were 8,761 census tracts (equal to 25% of the total eligible census tracts, adjusted for the 25 census tract minimum per State) nominated as qualified opportunity zones.[6] With approximately 74,000 census, this equates to approximately 12 percent of the entire country.

2. ***No Dollar Limitations***. The benefits under the program are not limited to a fixed, annual dollar amount requiring allocation by government officials. Also, the complexity of the opportunity zone program is reduced for investors, developers and municipalities, as compared to prior programs such as the New Market Tax Credit or Enterprise Zones Tax Credit, both of which require investors to understand how to obtain and use qualifying tax credits to offset current year income.

3. ***(Relatively) Easy to Understand***. The tax incentives are relatively easy to understand for investors, developers and business owners with substantial tax benefits realized immediately (through capital gains deferral), while the most significant tax benefit (tax-free appreciation) is achieved only after the expected benefits to low income communities are realized. Thus, the coordination of the benefits for investors and developers, and the realization of the desired outcomes for communities are aligned to achieve short and long term goals.

4. ***Large Number of Potential Participants***. Given the sheer volume of individuals and businesses and that incur capital gains on a regular basis, the number of stakeholders that may benefit from investing under the program is vast. Moreover, since capital gains are constantly being generated, the ability to benefit will recur time and again during the life of the program.

B. Summary of Qualified Opportunity Zones

The qualified opportunity zone legislation was passed into law under the TCJA, effective for tax years after December 31, 2017. The genesis of the law is that Republicans and Democrats whose focus was to improve low income communities backed legislation that would incentivize taxpayers to unlock capital gains and reinvest those gains into low income communities. There were two parts to the QOZ legislation passed under the TCJA.

The first part of the legislation authorized each State (in addition to the District of Columbia and US possessions) to designate twenty-five percent of the low-income census tracts in such State as

[6] https://fas.org/sgp/crs/misc/R45152.pdf

"qualified opportunity zones". The designation process was completed and the zones were finalized in June 2018.[7]

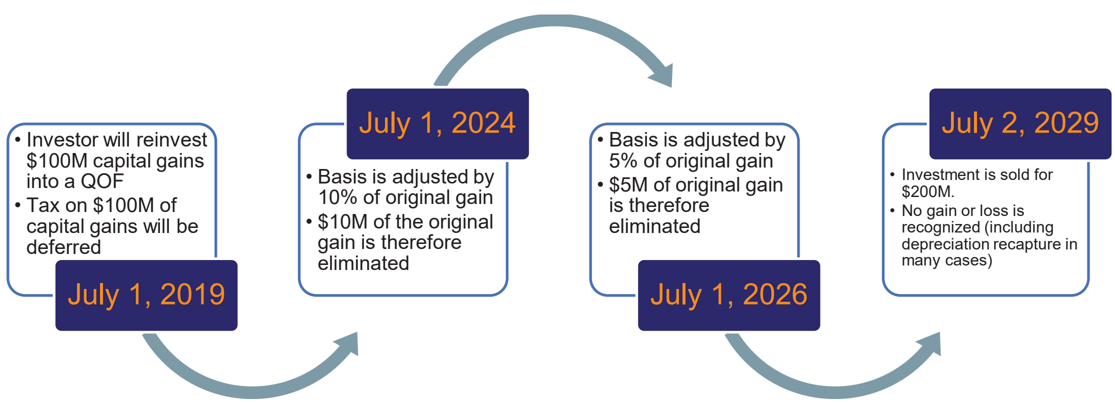
The second part of the legislation provided tax incentives to investors. Specifically, the law provides the following tax benefits to investors that reinvest capital gains into a qualified opportunity fund ("QOF"):

a. ***Deferral of Capital Gains.*** A taxpayer that reinvests capital gains within the 180 day period beginning on the date such gain was recognized, in a QOF, may defer the gain until the earlier of (i) the date that the taxpayer sells or exchanges its QOF investment; or (ii) December 31, 2026.[8]

b. ***Step-Up in Basis (Elimination of a Portion of Original Deferred Gain)***. If the taxpayer holds its investment in the QOF for at least 5 years, ten percent (10%) of the original gain will be eliminated. If the taxpayer holds its investment in the QOF for at least 7 years, an additional five percent (5%) of the original gain will be eliminated (for a total of 15%).

c. ***Tax-Free Appreciation***. If the taxpayer holds its investment in the QOF for ten (10) years, all of the capital gain attributable to the appreciation in the QOF (in excess of the original investment which will be taxed in 2026) will be tax-free when the taxpayer disposes of its interests in the QOF.

d. ***Avoid Recapture.*** Typically, a leveraged real estate or private equity investment generates tax losses for many years due to depreciation and amortization of assets acquired with debt. When such investment is sold, these losses are "recaptured" (create additional taxable income when the losses are reversed). A QOF will generate the same tax losses, however, many taxpayers would avoid "recapture", resulting in the taxpayer benefiting from deductions over time that may <u>never</u> be offset with additional income.



[7] Notice 2018-48.

[8] This rule makes December 31, 2026 the last day that any deferred capital gains would be recognized (and the last day that any gains could be invested in a QOF would therefore be June 28, 2027). For many taxpayers, this recognition date would effectively defer payment of the tax until April 15, 2027 (subject to estimated tax liabilities).

Note that prior to the completion of the ten-year holding period, the taxpayer will pay (in 2027) the tax on the lesser of the (A) remaining deferred capital gains for the 2026 tax year reduced by any QOF basis adjustments; or (B) the fair market value of its equity investment (as of December 31, 2026), reduced by any QOF basis adjustments. The QOF basis adjustment will either be 0%, 10% or 15% of the original deferred gain, depending on the taxpayer's holding period.

Thus, the taxpayer will defer and reduce (but not eliminate) the tax on the original invested capital. If the taxpayer meets the statutory requirements, the tax on the gain relating to the appreciation of the investment may be completely eliminated *regardless of the amount of such gain*. Accordingly, there is no limit to the amount of gains that may be eliminated under the QOZ legislation.

Ultimately, the effect of these tax benefits is to greatly enhance an investor's return (as compared to a traditional investment without such tax benefits). Most fund-type investments will reflect an increased return of 25% to 50%.

The qualified opportunity fund program created an entirely new set of terminology (a literal alphabet soup of new terms). The following listing of abbreviations may be necessary to capture the essence of the program structure (the full listing of key terms is described in *Appendix A: The ABCs of OZs*):

Abbreviation	Meaning
QOF	*Qualified Opportunity Fund* (an investment vehicle to invest in QOZP)
QOZ	*Qualified Opportunity Zone* means the census tracts designated as qualified opportunity zones.
QOZP	*Qualified Opportunity Zone Property* means either a "qualified opportunity zone partnership interest", "qualified opportunity zone stock" or QOZBP.
QOZBP	*Qualified Opportunity Zone Business Property* means property that meets certain acquisition, use or improvement and physical location attributes.
QOZB	To qualify as "qualified opportunity zone partnership interest" or "qualified opportunity zone stock", such business must meet the definition of a QOZB. A QOZB is a business that meets various criteria, including holding at least 70% of its interest as QOZBP.

In order to achieve the tax benefits offered by the opportunity zone legislation noted above, the investor must reinvest capital gains in a QOF. A QOZ investment will either be structured as a (A) QOF that directly owns QOZBP, or (B) by a QOF that operates a QOZB through QOZ partnership interests or QOZ stock. The rules for each of these business structure choices contain significant differences.

In each case, three requirements must be met to be considered qualified property:

1. ***Acquisition Requirement***. The property must be acquired by purchase or lease after December 31, 2017;

2. ***Original Use or Substantial Improvement Tes***t. The original use of the property must commence with the QOF or the property must be substantially improved by the QOF; and

3. ***Substantially All Test for Holding Period and Use of Property***. During at least 90% of the holding period of such property, at least 70% of the use of the property must be used in the QOZ.

At a high level, the use of a partnership or corporation that is operated as a qualified opportunity zone business is preferable in most cases. Using this structure, a QOF will meet the 90% test so long as the underlying partnership or corporation is itself a QOZB.[9]

The primary reason that the use of a QOZB is beneficial is that a QOZB may avail itself of a 31-month working capital safe harbor (treating cash, cash equivalents and short-term loans as "good" property during the 31-month period). Also, only 70% of the property of a QOZB must be qualified property (instead of 90%). These benefits typically outweigh any disadvantages (see below chart) of the QOZB structure.

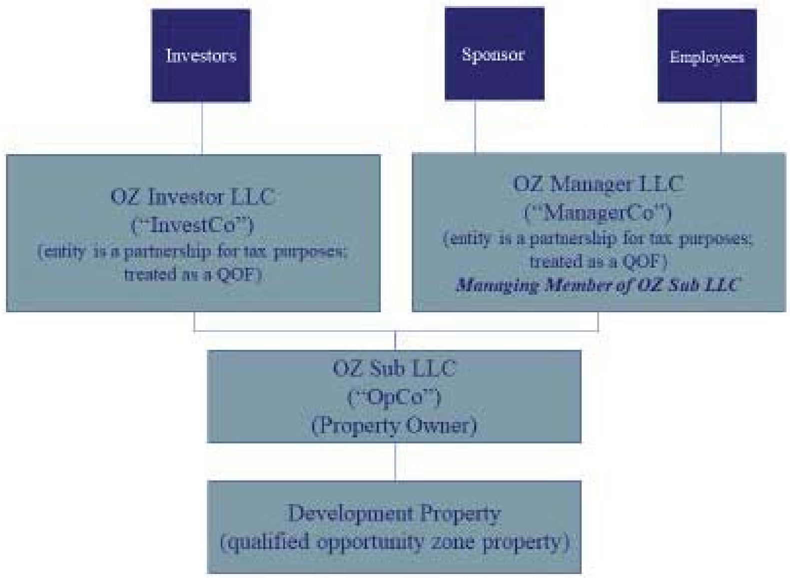
On the other hand, a QOF that owns QOZBP directly (rather than conducting a QOZB through a partnership or corporation) is required to have 90% of its property be qualified property. Moreover, only cash contributed during the prior 6 months is considered "good" property if held as cash, cash equivalents or short-term loans. After that time period, any financial property (*e.g.*, cash, securities) is considered nonqualified, which would cause the QOF to potentially fail the 90% asset holding test. The chart below illustrates the difference between these two approaches:

QOF that owns QOZBP directly	QOF owns interests in an entity operating a QOZB
90% of QOF's assets must be QOZBP	70% of QOZB's assets must be QOZBP
Working capital safe harbor does not apply. Intangible and financial assets (*e.g.*, cash) will be treated as nonqualifying assets for purposes of 90% test	The working capital safe harbor allows for cash, cash equivalents and short-term debt obligations held for use subject to a written plan to be ignored for purposes of calculating the 70% test for up to 31 months
No active conduct standard	50% gross income from active trade or business requirement
Intangible property counts towards the 90% test (as a nonqualifying asset)	Can own an unlimited amount of intangible property so long as 40% is used in the active conduct of a trade or business.
No restrictions on type of businesses	Prohibition on "sin" businesses

[9] Such interests will be considered a QOZB if (1) at least 70% of its property is considered QOZBP; (2) 50% of the gross income is derived from the active conduct of the trade or business; (3) at least 40% of the intangible property of the business is used in the active conduct of the trade or business; (4) no more than 5% of the property of the QOZB consists of financial property (*e.g.*, cash and investments); and (5) the trades or businesses are not comprised of "sin" businesses.

Therefore, most projects and businesses will be structured using a two-tier structure such that a QOF (or multiple QOFs) own interests in a partnership that is qualified as a QOZB.

The following represents a sample structure reflecting the use of a QOZB:



The following detailed example reflects the timeline of a QOF:

1. Investors makes investment on July 1, 2019 of $10,000,000 (of reinvested gains that would have been recognized during the prior 180 days) in QOF. Investors will defer capital gains on such $10,000,000.

2. QOF contributes $10,000,000 of cash on July 1, 2019 to QOZP Sub (which is a qualified opportunity zone partnership interest). Since QOZP Sub is a partnership for tax purposes, it must have a second partner. This may be a sponsor or employee, or may be another QOF (related or unrelated).

3. QOZP Sub acquires land and building on July 2, 2019 for $10,000,000 of cash, and then enters into construction loan for $20,000,000. QOZ Sub begins to make improvements to the Property using funds under the construction loan.

4. From July 2, 2019 through December 31, 2021, the QOZP Sub constructs improvements on the Property greater than the allocated cost of the acquired tangible property. This will satisfy the substantial improvement test. During this time, the working capital safe harbor will apply (with a 31-month period applying to all cash received as contributions or loans, beginning on the date of receipt).

5. On March 15, 2020 (or September 15, 2020 if extended), the QOF files its initial partnership tax return (Form 1065). The partnership will self-certify as a QOF by filing Form 8996 with its 2019 tax return and select July 2019 as the initial month of the QOF. Likewise, QOZP Sub will file its partnership tax return (but will not be required to file Form 8996).

6. On April 15, 2020 (or October 15, 2020 if extended), the Investors will file their individual tax returns. On their individual returns, the Investors will defer capital gains by making the appropriate election on Form 8949.

7. On July 1, 2024, the Investors will receive a basis adjustment equal to $1,000,000 with respect to their investment. The effect of this adjustment is to eliminate $1,000,000 of the initial capital gains (*i.e.*, the 10% reduction on $10,000,000 investment after 5 years).

8. On July 1, 2026, he Investors will receive a basis adjustment equal to $500,000 with respect to their investment. The effect of this adjustment is to eliminate $500,000 of the initial capital gains (*i.e.*, the additional 5% reduction on $10,000,000 investment after 5 years).

9. On December 31, 2026, the Investors will recognize the lesser of (1) $8,500,000 of capital gains (equal to the deferred capital gains, less the 15% basis adjustment) or (2) the fair market value of their investment, less the 15% basis adjustment. Assuming that the investment has not declined in value, the investors will have tax liability of approximately $2,720,000 (assuming a 32% tax rate). Following the inclusion of capital gain, the Investor will have basis in its investment (excluding debt basis) of $10,000,000.

10. On April 15, 2027, the Investors will pay the tax liability of $2,720,000 with their timely filed tax return or extension (subject to estimated tax liabilities that would cause payment to be made during 2026).

11. On July 3, 2029, the Investors sell their investment in the QOF for $25,000,000. Alternatively, the QOZP Sub may sell the Property (and pay off liabilities) with net distributable proceeds of $25,000,000. At this time, the Investors have basis in their investment of $0 (after additional depreciation deductions have reduced basis from the $8,500,000 included in 2026 to $0).

12. On April 15, 2030, The Investors will make an election to adjust the basis of their investment to fair market value at the time of sale.[10] The Investors will recognize no gain on the sale of their interests. Since the Investors had basis of $0, the $25,000,000 of gain that is excluded from income results in tax savings of approximately $8,750,000 (assuming a blended 35% tax rate, including unrecaptured Section 1250 gain).

[10] If the underlying property as sold, the Investors would instead elect to exclude the K-1 income. If such election is made, some of the gain may not be eliminated due to limitations inherent in the asset sale exclusion election (which are described in much more detail in Part 5).

PART 2: A COMPREHENSIVE GUIDE TO OPPORTUNITY ZONES FOR TAX AND REAL ESTATE PROFESSIONALS

A. Framework of the Qualified Opportunity Zone Program

The qualified opportunity zone legislation passed under the 2017 tax act (commonly referred to as the Tax Cut and Jobs Act, or "TCJA") allows taxpayers to defer gains that are reinvested in certain investment vehicles. After recognizing such deferred gains by 2026, the taxpayer may ultimately dispose of their investment tax-free. The qualified opportunity zone program combines specific policy objectives of investing in lower-income communities with tax objectives that target multiple stakeholders: investors, fund managers, developers and business owners.

The legislation consists of two separate statutes that, respectively, (i) designate certain geographic areas as "qualified opportunity zones" (sometimes referred to herein as a "QOZ" or "QOZs") and (ii) provide for tax benefits in connection with an investment in a "qualified opportunity fund" ("QOF").

First, Section 1400Z-1 authorizes each State and the District of Columbia to designate up to 25 percent of low-income community census tracts (which consist of "low income communities",[11] designated by census tracts meeting certain income-based criteria) in such jurisdiction as a "qualified opportunity zone". The designation process was completed, and the zones finalized in June 2018.[12]

Second, the TCJA enacted the rules to enable an investment to qualify for the various tax benefits under Section 1400Z-2:

1. Tax Benefits for Investors. Under the opportunity zone program, investors will be able benefit from tax deferral (with respect to cash or property invested in a qualified entity) and tax reduction/elimination (accomplished through basis adjustments following statutory holding periods). The net effect of these tax benefits is to substantially increase the after-tax return for an investor in a QOF.

2. Requirements of a QOF. The statute reflects the structure and requirements of the entity that will serve as the investment vehicle (including the application to underlying business operations).

Since the QOZ designations are complete, the focus now relates to the availability of benefits for investors (relating to gain deferral, inclusion, and tax-free appreciation) and applicable funds (generally relating to structure, operational requirements, and compliance issues).

[11] See Section 45D

[12] Notice 2018-48

The QOZ program is based on the rules set forth in Section 1400Z-2 of the Internal Revenue Code and Proposed Regulations §§ 1.1400Z-2(a)-(f).[13] The statute (and Proposed Regulations) reflect the five major components of the law:

- **Investment of Capital Gains**. What constitutes qualifying reinvested capital gains eligible for deferral?
- **Deferral and Inclusion of Gains**. When is gain deferred and when (and how much) deferred gain is included in income?
- **Tax-Free Dispositions After Ten Years**. How are taxable gains treated (and eliminated) for property disposed of following a ten year holding period?
- **Formation and Structure of a Qualified Opportunity Fund**. What are the requirements of a qualified opportunity fund?
- **Other Rules and Compliance Matters**. Miscellaneous rules pertaining to mixed investments, related party rules, income in respect of a decedent, certification, and how opportunity fund profits may be reinvested.

B. Tax Benefits of Investing in a Qualified Opportunity Fund

The qualified opportunity zone legislation specifies four explicit, statutory tax benefits. Implicit in the statute (and in some cases, clarified under the Proposed Regulations), additional substantial tax benefits are applicable to investors in a QOF.

The tax benefits for an investor will generally consist of the following statutory tax benefits:

a. A taxpayer may **defer reinvested capital gains** until the date that is the earlier of (i) the date that the investment is sold or exchanged or (ii) December 31, 2026.[14]

b. After the investor has held its investment for 5 years, it is entitled to a **step-up in basis** equal to 10% of the original deferred gain.[15]

[13] On October 19, 2018, Treasury issued the first set of proposed regulations with respect to Section 1400Z-2 (the "2018 Proposed Regulations" and on April 17, 2019, Treasury issued the second set of proposed regulations with respect to the QOZ program (the "2019 Proposed Regulations" and, together with the 2018 Proposed Regulations, the "Proposed Regulations").

[14] Section 1400Z-2(a)(1) and Section 1400Z-2(b)

[15] Section 1400Z-2(b)(2)(B)(iii)

c. After the investor has held its investment for 7 years, it is entitled to another **step-up in basis** equal to an additional 5% of the original deferred gain (for a total of 15%).[16]

d. After the investor has held its investment for ten years, any capital gain resulting from the sale or exchange of such investment will be **tax-free gain** (which is accomplished through a basis adjustment to fair market value as of the date of the sale or exchange or an election to exclude capital gain).[17]

In some cases, an investor will benefit from the following tax benefits that are inherent in the structure of the program:

a. A taxpayer will **not recognize any depreciation recapture or trigger minimum gain** for properly structured investments held more than 10 years.

b. If the fair market value of the taxpayer's investment is less than the remaining deferred gain as of December 31, 2026, the taxpayer will **never recognize a portion of their remaining deferred gain**.[18]

The effect of the foregoing tax incentives is to greatly enhance the after-tax return on a taxpayer's investment in a QOF. Indeed, in many cases the after-tax internal rate of return ("IRR") for typical investment deals will be increased by 25-50% (based solely on the benefits under the opportunity zone program as compared to an identical investment without such tax benefits).[19] In the context of operating businesses, the tax benefits can be even more significant if the entire business is sold after a 10-year holding period.

C. Investment of Capital Gains.

The threshold requirement to obtain the opportunity zone tax benefits is that an investor must reinvest capital gains (*i.e.*, recognize capital gains, and within 180 days, invest such amount in a fund). Section 1400Z-2(a) provides that if a taxpayer (i) realizes gain from the sale to, or exchange with, an unrelated person, and (ii) invests such gain in a QOF during the 180-day period beginning on the date of such sale or exchange, the taxpayer may elect to defer such gain until the earlier of (a) the date that the investment is sold or exchanged or (b) December 31, 2026. In other words, a taxpayer will not recognize taxable gain (yet) on the amount of eligible gain that is invested in a QOF.

[16] Section 1400Z-2(b)(2)(B)(iv)

[17] Section 1400Z-2(c)

[18] Section 1400Z-2(b)(2)(A)(i)

[19] Part 3, C. contains a brief economic analysis and sample IRR calculation.

The statute explicitly provides that investors will include the previously incurred gain as provided by the inclusion rules under Section 1400Z-2(b) and that qualifying investments held for over 10 years will be tax-free under Section 1400Z-2(c).[20]

The separate components of the statute (listed below) are discussed in detail in the following pages.

- What is "gain" that qualifies for reinvestment?
- What constitutes a "sale or exchange"?
- Which related party rules apply (*i.e.*, what is an "unrelated person")?
- How does a taxpayer make an election to defer gain?
- What is a considered a 'taxpayer' eligible to make an election?
- What constitutes an "investment"?
- How is the 180-day period determined?

1. What Gains Will Qualify for Reinvestment?

a. Eligible Gains

Section 1400Z-2(a) provides that "gain from the sale or exchange" may be deferred as provided in the statute. There is no reference to whether the gain may be long term or short term, ordinary or capital, or even whether it includes portfolio gains. The Proposed Regulations clarify this ambiguity by defining what constitutes an "eligible gain".[21] To be treated as eligible gain, such gain (A) must be treated as capital gain for income tax purposes; (B) would be recognized for federal income tax purposes before January 1, 2027 if Section 1400Z-2 did not apply;[22] and (C) does not arise from a sale or exchange with a related person.[23] Thus, a taxpayer may reinvest capital gains that are recognized on or before December 31, 2026. A taxpayer will have made a qualifying investment so long as the investment is made in a QOF on or before June 28, 2027.

If a taxpayer has already made an election to defer gain, such elected gain is no longer "eligible gain" (*i.e.*, a single gain cannot be treated as a qualifying gain twice, although a single (larger) gain can be spread among multiple QOF investments).[24] As a result of this rule, a taxpayer must

[20] Section 1400Z-2(a)(1)(B) provides that the amount of gain excluded (as provided in the previous paragraph) will be *included* as provided in Section 1400Z-2(b) (in accordance with the "inclusion rules" discussed below). Section 1400Z-2(a)(1)(C) explicitly provides that the tax-free gain applicable to investments held over ten years will apply to a qualifying investment.

[21] Prop. Reg. § 1.1400Z-2(a)-1(b)(2).

[22] A technical question arises as to whether a taxpayer may opt out of installment sale treatment for a post-2026 gain under Section 453(d) followed by a deferral of gain through reinvestment in a QOF. Since the taxpayer would only opt-out because it is eligible to defer under Section 1400Z-2, arguably this provision could cause inclusion for post 2026 gains.

[23] Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(ii)

[24] Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(iii)

dispose of its entire original investment in a QOF in order to reinvest such QOF gains into another QOF (since such gain remains subject to the original deferral election).[25]

Under the definition of "eligible gains", the gains must be capital in nature, but will include both short and long term gains. The preamble to the 2018 Proposed Regulations note that the legislative history explicitly identifies "capital gains" as the gains that are eligible for deferral. Thus, the Proposed Regulations state that in order to be an eligible gain it must be "treated as capital gain for income tax purposes". Many types of gain are generally treated as capital gains, even when taxed at differing rates including: long and short term capital gains from the sale of capital assets; Section 1231 gain; unrecaptured Section 1250 gain;[26] and collectibles gains.[27] Types of gain that are characterized in the foregoing categories (such as Section 1256 gains) will also be treated as capital gains eligible for deferral. The nature of gain recognition is irrelevant; gains are eligible from an actual or deemed sale or exchange. Ultimately, any other gain (except as provided below) that is required to be included in the computation of capital gain will be eligible for reinvestment.

i. Section 1231 Gains

Section 1231 gain is gain from the disposition of property (including real property) used in a trade or business (or gains resulting from involuntary conversions of certain property). Section 1231 gains are recognized under general tax principles only as of the last day of the taxable year (by netting all 1231 gains and 1231 losses of a taxpayer).[28] Gain arising from Section 1231 property that is eligible for a deferral is the capital gain net income for the year.[29] Thus, the taxpayer must wait until the end of the tax year to determine its net capital gain and the time period to reinvest the gains begins on January of the following year. The effect of this rule (relating to netting gains and losses) is not favorable to the taxpayer. Although capital gains may be deferred and capital losses recognized, only net Section 1231 gains are allowed for deferral each year (which would be recognized as of December 31 each year).[30]

On the other hand, the delay to begin the "clock" until December 31 may be highly favorable. The treatment as capital gain as compared to Section 1231 gain changes the timing requirements to

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[25] Prop. Reg. § 1.1400Z-2(a)-1(b)(4)(ii) (Example 4). This example confirms that gains resulting from a QOF may be reinvested in a QOF.

[26] Note the distinction between "unrecaptured Section 1250 gain" which is capital gain taxed at a higher rate as opposed to Section 1250 depreciation recapture, which is taxed at ordinary rates. Only the unrecaptured Section 1250 gain that is treated as capital gain is eligible for reinvestment.

[27] Section 1(h)

[28] Section 1231(c)(3) (defining "net section 1231 gain")

[29] Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(iii). Often, taxpayers do not necessarily know whether gain will be treated as Section 1231 gains or capital gains. However, the timing of a prospective investment may depend on this determination. Accordingly, it is critical that taxpayers intending to invest in a QOF to ascertain at the time of sale which tax treatment will apply to such portion of the gain.

[30] The full amount of regular capital gains are allowed to be reinvested (irrespective of losses). This rule therefore has the effect of limiting Section 1231 gain reinvestment compared to regular capital gains.

begin the 180-day period significantly. ***In many cases, the rule applicable to Section 1231 gains will be helpful since it effectively gives a taxpayer the remainder of the year, plus 6 months to identify and make such investment (resulting in up to 18 months to reinvest the gains from the date of the underlying transaction).***

From a planning perspective, taxpayers may have flexibility in characterizing some gains as capital gains as compared to Section 1231 gains. In such cases, the effect of the netting rule and timing requirements should be considered to determine the best result for the taxpayer.

In many cases, the disposition of rental real estate or assets of a business will be treated as Section 1231 gain. The effect of this rule is to delay the taxpayer's ability to invest in a QOF until the following tax year. This could significantly delay reinvestment of the gain that would otherwise be invested early in the year (within 180 days of the transaction giving rise to the gain). Moreover, this causes issues with current investors that have 1231 gains from early 2019 and cannot reinvest until 2020 (in some cases, these funds may have already been earmarked for a specific investment under the assumption that 1231 gains would be eligible immediately for reinvestment).[31] **Fortunately, the IRS recognized this issue for early investors, and determined that Section 1231 gains that were reinvested prior to the end of the 2018 tax year will qualify for reinvestment based on the date of the transaction itself.**[32]

Another potential consequence of the timing rules for Section 1231 gains is that it is not clear whether partnerships may reinvest Section 1231 gains. The Proposed Regulations do not explain whether a partnership is considered a taxpayer for purposes of determining net Section 1231 gains. Since rental real estate is generally considered Section 1231 property, if a partnership is not able to reinvest Section 1231 gains, then the reinvestment opportunities for partnerships will be very limited.

Section 1231 losses incurred during the prior 5 years are subject to recapture. The effect of this rule is that Section 1231 gains in a subsequent tax year will be treated as ordinary income instead of capital gains up to the amount of carryover Section 1231 losses. For purposes of the QOZ program, it does not appear that the rules for current Section 1231 gains are affected by prior year Section 1231 losses (such that Section 1231 gains may be reinvested without recapture). In other words, a taxpayer may reinvest all of its net Section 1231 gain for the year and the potential recapture of prior losses (and conversion to ordinary income) could be avoided if no Section 1231 gains are incurred during the remaining recapture period. If that is a correct interpretation of the rule, a taxpayer may be able to avoid recapture by investing net Section 1231 gains from one year until the prior year Section 1231 losses have expired for purposes of calculating net Section 1231 gains – which has the effect of eliminating potential ordinary income permanently.

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[31] Note that in many instances, taxpayers and tax preparers are indifferent about whether gains are treated as a capital gains or Section 1231 gains (if, for example, the taxpayer has no current or expected Section 1231 losses). However, some taxpayers will need to explore whether the applicable gains are treated as capital gains or Section 1231 gains (or allocated between these categories) to meet reinvestment goals under the opportunity zone program.

[32] https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions

ii. Section 1256 Gains

Similarly, in the case of Section 1256 contracts, only the capital gain net income will be eligible for deferral for that year (which is determined by aggregating all of the taxpayer's Section 1256 gains and losses for the year) rather than each transaction being eligible independently.[33] Moreover, since the net gain from Section 1256 contracts can only be determined at the close of the tax year, the 180 day period begins on the last day of the tax year for the net gain resulting from Section 1256 contracts. The Proposed Regulations contains an onerous restriction on the use of offsetting positions transactions (defined below) which provides that if a taxpayer engaged in *any* offsetting positions transactions with a Section 1256 contract and any other provision in that transaction was *not* a 1256 contract, then *no gain from any* Section 1256 contract will be eligible for deferral for that year.[34]

If capital gain arises from a position that is or has been part of an offsetting-position transaction, the gain is not eligible for deferral under Section 1400Z-2(a)(1).[35] In general, an offsetting-position transaction is a hedging transaction, including a straddle (as defined under Section 1092) or a position that would be a straddle if the straddle definition did not contain the active trading requirement in Section 1092(d)(1). An offsetting-positions transaction also includes a position in closely held stock or other non-traded personal property and substantially offsetting derivatives.

b. Non-Eligible Gains: Deemed Gains Arising as a Result of Section 752 Liabilities

Finally, the Proposed Regulations prohibit the deferral of gain that was realized upon the shift of liabilities that resulted from the transfer (which is a deemed disposition) of property to a QOF in exchange for an eligible interest or the transfer of property to an eligible taxpayer for an eligible interest.[36] The effect of this prohibition is to disqualify gains resulting from a shift in Section 752 liabilities for deferral treatment, when the gain itself results from the investment in that QOF. This rule is consistent with the treatment of Section 752 liabilities for contribution purposes (*i.e.*, deemed contributions due to an assumption of liabilities by a partner will not be considered a contribution for purposes of determining an investor's contribution to a QOF).

c. Tax Attributes for Gain Inclusion

To the extent that previously deferred gain is included in income, the gain at the time it is included is considered to have the same attributes as it would have had if the tax on the gain was not deferred.[37] Such attributes include those described in Sections 1(h), 1222, 1256 and any other

[33] Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(v)(A) (formerly Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(iii)(A))

[34] Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(v)(B) (formerly Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(iii)(B))

[35] Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(vi) (formerly Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(iv))

[36] Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(vi) (possibly misnumbered and should be (iv)?)

[37] Prop. Reg. § 1.1400Z-2(a)-1(b)(5)

applicable provisions of the Code. Accordingly, the character of short-term capital gain, Section 1231 gain, Section 1256 gain, etc. will not change merely because the deferred gain is recognized in a subsequent tax year. Note also that changes in tax rates may be detrimental. If rate increases are scheduled to occur, taxpayers may look for ways to create an inclusion event prior to December 31, 2026 (as to deferred capital gains) that does not impact the 10 year holding period in order to mitigate the impact of a pending rate increase.

The foregoing rules must be considered at the time that a taxpayer elects to defer any of its gains. For example, if a taxpayer is in a low-income tax bracket in the year of deferral, it may benefit by deferring long term rather than short term gains (in order to take advantage of the lower rate when the gain is ultimately recognized).[38]

If a taxpayer acquired interests in a QOF with identical rights (referred to in the Proposed Regulations as "fungible interests"), but at different times, and such taxpayer disposes of some, but not all, of such interests on the same day, the taxpayer will use the first-in first-out ("FIFO") method to determine which interests were disposed of.[39] The FIFO method is used for three purposes under the Proposed Regulations: (A) to determine whether an investment was an eligible investment in a QOF or deemed to be made with mixed funds;[40] (B) to identify the attributes of the investment at the time the gain is included in income;[41] and (C) to calculate the extent, if any, of an increase in basis of such investment under Section 1400Z-2(b)(2)(B) when such investment is disposed of.[42] The Proposed Regulations do not explicitly apply the FIFO rules to basis step up and dispositions under Section 1400Z-2(c). Thus, as drafted, the Proposed Regulations do not provide for FIFO treatment in determining tax free treatment for dispositions after 10 years. This omission potentially causes a partial sale of interests after 10 years as being partially taxable (when it would have been tax-free under the FIFO method).

Under traditional partnership tax rules, the disposition of an interest is treated as a proportionate disposition of the entire partnership interest (*i.e.,* a partner is deemed to hold a single partnership interest, with different holding periods based on the timing of the acquisition of such interests). The use of the FIFO method is therefore advantageous to taxpayers as compared to regular tax principles and will allow taxpayers to maximize the benefits under the QOZ program.

The Proposed Regulations adopt a pro rata method if the FIFO method is inapplicable. In this regard, if, after the application of the FIFO method, a taxpayer is treated as having disposed of less than all of the investment interests that the taxpayer acquired one day and, if the interests that were

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[38] In order to determine the economic impact of such a strategy, we recommend analyzing the tax consequences on a present value basis.

[39] Prop. Reg. § 1.1400Z-2(a)-1(b)(6)

[40] Prop. Reg. § 1.1400Z-2(a)-1(b)(6)(ii)(A)

[41] Prop. Reg. § 1.1400Z-2(a)-1(b)(6)(ii)(B)

[42] Prop. Reg. § 1.1400Z-2(a)-1(b)(6)(ii)(C)

so acquired on that day vary with respect to its characteristics (under Prop. Reg. § 1.1400Z-2(a)-1(b)(6)(ii)), the proportionate allocation method must be made to determine which interests were disposed of.

The timing of gain inclusion has important state tax considerations (which are discussed in much greater detail in *Section G* below). Most states follow the Code as enacted under the TCJA. Some states have not yet adopted conformity with the TCJA but otherwise follow the Code. A taxpayer could defer the gain when such taxpayer resides in a high-tax state, and recognize the gain in a year in which the taxpayer resides in a low tax state.[43]

Planning Tip

A taxpayer could defer the gain when such taxpayer resides in a high-tax state, and recognize the gain in a year in which the taxpayer resides in a low tax state.

2. What Constitutes a "Sale or Exchange"?

Section 1400Z-2(a)(1) provides that gain may be deferred resulting from "the sale to, or an exchange with" an unrelated person. Although the term "sale or exchange" (or the past tense "sold or exchanged") is used throughout the statute and the Proposed Regulations, such term is not defined for purposes of Section 1400Z-2. Nonetheless, the term "sale or exchange" is commonly used for other purposes of the Code and the meaning of such term should likewise be applicable under the qualified opportunity zone legislation.

The preamble to the 2018 Proposed Regulations provides that eligible gains generally include "capital gain from an actual, or deemed, sale or exchange". Thus, for purposes of Section 1400Z-2, a sale or exchange refers to any actual or deemed sale or exchange of a capital asset that gives rise to capital gains. The Proposed Regulations note that non-sale or exchange transactions such as gifts, bequests, charitable contributions, and abandonments of qualifying investments are not considered sales or exchanges.

Generally, the term "sale or exchange" refers to a transfer of property to another party in exchange for monetary or other consideration. Even though the term "sale or exchange" is widely used in the Code, Regulations, official tax rulings and case law, there is no specific statutory definition of the phrase. Rather, the phrase "sale or exchange" or the term "sale" or "exchange" must be interpreted using its common meaning for tax purposes (as applied in the context of opportunity zones). While §1001(a) (determination of capital gains) uses the phrase "sale or other disposition," the phrase "sale or exchange" has a narrower meaning than a "sale or other disposition."[44] As a

[43] Note that while this approach will work for portfolio capital gains (which is based on a taxpayer's residence), it may not apply to capital gains resulting from the sale of assets that are specifically apportioned to a state. In other words, where the gain is capital gain because of a business nexus to that state (as compared to whether state taxation arises solely due to the taxpayer's residence) then such state tax may still apply.

[44] Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1941).

result, a transaction can be a "sale or other disposition" but still not be a "sale or exchange" of a capital asset. In addition, Congress has enacted a number of special provisions that determine whether or not certain transactions are treated as sales or exchanges.

The Tax Court has listed various factors indicating whether a sale or exchange exists: (1) whether legal title has passed; (2) how the parties treat the transaction; (3) whether the purchaser has acquired an equity interest in the property; (4) whether the transaction creates a current obligation on the seller to transfer legal title for an agreed-upon consideration; (5) whether the right to possession has vested in the purchaser; (6) which party pays the property taxes; (7) whether the purchaser bears the risk of loss; and (8) whether the purchaser receives the profits (including appreciation in the value of the property) from the operation and sale of the property.[45]

Although the term "sale" is not defined in the Code or in the regulations, courts have generally used the ordinary meaning of the term (in common usage).[46] Thus, a sale has occurred when there is a transfer of property for money or its equivalent[47] or a promise to pay money.[48] Whether a sale has occurred, or whether an agreement is merely an intent to sell in the future, is typically an issue of fact.[49] The determination of whether a sale has occurred is governed by the tax law (and not necessarily by the taxpayer's intent), usually relying on applicable state law.[50]

An "exchange" is a transfer of property for other property.[51] In determining whether gain or loss is realized from an exchange, the property being exchanged must be "different materially either in kind or in extent."[52] The Supreme Court[53] interpreted Reg. §1.1001-1(a) to mean that properties that are exchanged must be materially different so as to embody "legally distinct entitlements." The Supreme Court has held that an exchange will be deemed to have occurred if the transferred assets are materially different, whether or not the parties have experienced a change in their economic positions.

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[45] Grodt &McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981).

[46] See Nahey v. Commissioner, 111 T.C. 256 (1998), aff'd on other grounds, 196 F.3d 866 (7th Cir. 1999), cert. denied, 121 S. Ct. 45 (2000).

[47] Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981).

[48] Rogers v. Commissioner, 103 F.2d 790 (9th Cir. 1939); Guardian Indus. Corp. v. Commissioner, 97 T.C. 308 (1991).

[49] Derr v. Commissioner, 77 T.C. 708, 724 (1981).

[50] See United States v. Ivey, 414 F.2d 199 (5th Cir. 1969); Guardian Indus. Corp. v. Commissioner, 97 T.C. 308, 308 fn. 5 (1991).

[51] Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1941).

[52] Reg. §1.1001-1(a).

[53] Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991).

One of the most common forms of a taxable exchange results from the material modification of a debt instrument.[54] In some circumstances, a taxpayer attempt to structure a debt workout to have it treated as a material modification (resulting in capital gains) instead of cancellation of indebtedness under Section 108.[55] Such a material modification would also be eligible for deferral under Section 1400Z-2(a)(1) as an "exchange" that resulted in capital gains.

3. How Are the Related Party Rules Applied?

Section 1400Z-2(a)(1) only permits deferral of capital gains derived from the sale to, or exchange with, an "unrelated person". For purposes of the QOZ program, persons are related under the tests of Section 267(b) and Section 707(b)(1), determined by substituting 20 percent for 50 percent (which has the effect of requiring transactions to be between taxpayers that are 80 percent unrelated).[56]

Section 267 is a common related party test used for many purposes of the Code. In general, under Section 267, the following persons are considered related: (1) members of a family (as defined in Section 267(c)(4)); (2) individual and a 50% owned corporation; (3) two corporations that are members of the same control group; (4) a grantor and a fiduciary of any trust; (5) a fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts; (6) a fiduciary of a trust and beneficiary of such trust; (7) a fiduciary of a trust and the beneficiary of another trust, if the same person is a grantor of both trusts; (8) a fiduciary of a trust and a corporation that is 50% owned by the grantor of such trust; (9) a person and a tax-exempt organization that is controlled by members of the family of such individual; (10) a corporation and partnership if the same person owns 50% or more of each entity; (11) an S corporation and another S corporation if the same persons own 50% of each; (12) an S corporation and a C corporation if the same person owns 50% or more of each entity; and (13) an executor of an estate and a beneficiary of such estate.[57]

Under Section 267, constructive ownership rules apply to determine whether an individual is deemed to own property that is indirectly owned by such individual or a close relative.[58] Under these rules, an individual is considered to own interests held by such individual's family. The

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[54] See Reg. §1.1001-3. See also Rev. Proc. 2001-21, 2001-9 I.R.B. 742 (election to treat a substitution of DIs in certain circumstances as a realization event even though it does not result in a significant modification).

[55] Note that taxpayers often prefer to treat income resulting from a debt workout or restructuring as cancellation of indebtedness ("COD") income under Section 108. First, COD income may be excluded under Section 108(a)(1) for a taxpayer that is bankrupt, insolvent (up the amount of insolvency) or for qualified real property business indebtedness. To the extent that income is excluded under these rules, the taxpayer will have to reduce various tax attributes (*e.g.*, basis in depreciable property or net operating losses). The ability to reinvest gains in a QOF resulting from a material modification (if not characterized as COD income) may be a solution for taxpayers that cannot benefit from the exclusions under the COD rules.

[56] Section 1400Z-2(e)(2)

[57] Section 267(b)

[58] Section 267(c)

family of an individual includes such individual's brothers and sisters, spouse, ancestor and lineal descendants.[59]

Section 707(b)(2) provides that that transactions between (A) partnership and a person owning (directly or indirectly) more than 50 percent of the capital interest, or the profits interest in such partnership or (B) 2 partnerships with the same person owning (directly or indirectly) more than 50 percent of the capital interests or profits interests, are subject to related party restrictions.

One exception to the related party rules that is commonly utilized in real estate tax planning is a so-called Bramblett transaction.[60] Under this approach, a sale of non-depreciable property from a partnership to an S corporation is not subject to either the Section 267 or the Section 707(b)(2) rules.[61] Thus, the sale of land to a commonly owned S corporation is not considered a sale to a relate party under Section 267 or Section 707(b)(2). Under this line of reasoning, such a sale to a 'related' S corporation and reinvestment into a QOF would be eligible for tax benefits under Section 1400Z-2(a)(1)(A).

4. How Does A Taxpayer Make an Election to Defer Gain?

Section 1400Z-2(a)(1) provides that gain is deferred "at the election of the taxpayer". The IRS has issued instructions under its authority[62] under the statute pursuant to which a taxpayer may defer gains. On the taxpayer's income tax return, the taxpayer may defer the reinvested capital gains for in the manner as provided on page 10 of the Instructions to Form 8949. Specifically, the gain will be reported on Schedule D and Form 8949. The deferral will be reported as follows (*the below instructions are copied verbatim from the IRS Instructions for Form 8996*):

1. Report the deferral of the eligible gain on its own row of Form 8949 in Part I with box C checked or Part II with box F checked (depending on whether the gain being deferred is short-term or long-term).

2. If you made multiple investments in different QO Funds or in the same QO Fund on different dates, use a separate row for each investment.

3. If you invested eligible gains of the same character (but from different transactions) on the same date into the same QO Fund, you can group those investments on the same row.

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[59] Section 267(c)(4)

[60] Bramblett v. Commissioner, 960 F.2d 526, 531 (5th Cir. 1992)

[61] If depreciable property as sold, Section 1239 would cause recharacterization of such gains as ordinary income which are not eligible for deferral.

[62] Prop. Reg. § 1.1400Z-2(a)-1(d) provides that 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."

4. In column (a), enter only the EIN of the QO Fund into which you invested.

5. In column (b), enter the date you invested in the QO Fund. Leave columns (c), (d), and (e) blank.

6. Enter code "Z" in column (f) and the amount of the deferred gain as a negative number (in parentheses) in column (g).

5. When Does a Person or Entity Constitute a 'Taxpayer' Eligible to Make an Election?

An eligible taxpayer is a person that may recognize gains for purposes of federal income tax accounting including individuals, C corporations (including RICs and REITs), partnerships, S corporations, trusts and estates.[63]

The statute, however, defines the investment in the QOF by reference to the taxpayer investing in the QOF (*i.e.*, in the case of gain from the sale of any property *by the taxpayer* . . . gross income shall not include the amount *invested by the taxpayer*). Thus, the taxpayer that is deferring the gain (whether the entity or individual owner) should be the investor.

The Proposed Regulations do not explicitly permit a new partnership (of which the taxpayer is a partner) to invest in a QOF and elect to defer the capital gains invested in the QOF. Barring further guidance, since a QOF cannot invest in another QOF, the investor should be the taxpayer, or a disregarded entity owned by the taxpayer (unless such partnership incurred the capital gains itself).

If a taxpayer wishes to make an investment in a QOF using a partnership (other than a partnership that incurred gains directly that it elects to reinvest) as the investor, the same result may be accomplished by causing the partner acquire an interest in a QOF and then contribute its interest in a QOF to a new partnership in a contribution for which Section 721(a) will apply.[64] Likewise, a partner could invest directly in a QOF and then sell a portion of its interest to another partner (at no gain or loss).[65]

6. What Constitutes an "Investment"?

Under Section 1400Z-2(a)(1)(A), the deferred gains must be "invested by the taxpayer in a qualified opportunity fund" to be eligible for the respective tax benefits. What is an investment in

[63] Prop. Reg. § 1.1400Z-2(a)-1(b)(1)

[64] Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(ii)(B)

[65] Prop. Reg. § 1.1400Z-2(a)-1(b)(10)(iii). The investment of a qualifying investment followed by the sale of such interest is the equivalent of a deferral and an inclusion event in the same year. Thus, the taxpayer is in the same position as if it invested only the unsold portion. However, if the investment was originally made with mixed funds (due to insufficient capital gains), the immediate sale would reduce the relative proportion of qualifying investment).

a QOF? Investment can be in the form of cash or property, may be actual contributions or deemed contributions, and can be in the form of debt or equity.

The Proposed Regulations use the concept of an "eligible interest" to define what constitutes an eligible investment for purposes of the statute. An eligible interest is an equity interest in a QOF, including preferred stock or a partnership interest with special allocations.[66] Since an equity interest is required, the term eligible interest excludes any debt instrument within the meaning of Section 1275(a)(1) and § 1.1275-1(d). Moreover, an eligible interest will retain that classification even if it is used as collateral for a loan, or in comparable situations.[67]

Although the statute is ambiguous regarding whether the investment in a QOF must be in the form of cash, the Proposed Regulations explicitly allow an investment to be made with cash or property.[68] Thus, a taxpayer makes an investment for purposes of Section 1400Z-2 if it transfers cash or property to a QOF in exchange for eligible interests in the QOF.[69] The Proposed Regulations also permit an interest in a QOF acquired from a person other than a QOF (that otherwise is treated as an eligible interest) to be treated as an eligible interest. Accordingly, the acquisition of an eligible interest from an existing equity owner of a QOF will be a qualifying interest, however, the 10 year holding period will begin as of the date of acquisition by the new owner.

Planning Tip

There does not appear to be a restriction on the use of convertible debt. Arguably, a fund could structure its investment as a convertible note which is convertible at the initial fair market value and returns a coupon that is equivalent to the preferred return. The investor could then convert its debt into equity at any time which would allow the investor to control the timing of the investment of gains. Note, however, that the 10 year holding period would not begin until the time that such conversion was made and the economic rights of the equity holders and debt holders may differ (at least in regard to residual allocations of profits and/or cash flows).

Moreover, the use of debt may be used as an alternative to equity if an investor does not have any remaining capital gains. The 2019 Proposed Regulations describe how the contribution of property to a QOF is permitted. A QOF could issue a promissory note to an investor in exchange for cash. The taxpayer's subsequent contribution of the promissory note to the QOF in exchange for an interest (at a time that the investor has eligible capital gains) should be considered a qualifying investment.

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[66] Prop. Reg. § 1.1400Z-2(a)-1(b)(3)(i)

[67] Prop. Reg. § 1.1400Z-2(a)-1(b)(3)(ii)

[68] Prop. Reg. § 1.1400Z-2(a)-1(b)(9)(i)

[69] Such transaction constitutes an eligible investment whether or not the transferor recognized gain or loss on the property transferred)

Importantly, the Proposed Regulations provide that deemed contributions under Section 752(a) (relating to the tax treatment of the assumption of liabilities of a partner in a partnership being treated as contributing cash to such partnership under Section 752(a)) will not constitute an eligible investment.[70] This is consistent with the treatment of Section 752 liabilities for purposes the QOZ program (which also does not include Section 752 gain as eligible gain for reinvestment in the same QOF). Moreover, this treatment is fortunate for taxpayers that would otherwise have to determine if the assumption of a Section 752 liability would be treated as a contribution to the QOF, which would cause a mixed funds investment for such investor.

The amount of an investment that is treated as an eligible interest is limited to a taxpayer's elected deferred capital gains that it invests in the respective QOF.[71] If a taxpayer invests more than the amount of gain deferred, the excess will not be eligible for the opportunity zone tax benefits. Rather, such gains will be treated in the manner of mixed-investment funds described in Section 1400Z-2(e)(1)(A)(ii) (discussed in more detail below). Since debt is not considered an interest, a taxpayer may avoid having a mixed-fund investment by contributing cash for equity (in an amount up to the taxpayer's aggregate capital gains that may be deferred) and contributing any excess as debt (which may later be contributed).[72]

Planning Tip

Since debt is not considered an interest, a taxpayer may avoid having a mixed-fund investment by contributing cash for equity (in an amount up to the taxpayer's aggregate capital gains that may be deferred) and contributing any excess as debt (which may later be contributed).

The amount of the investment in a QOF is equal to the amount of cash invested if the investment is made in cash.[73] In the case of a contribution of property (with adjusted basis different than such property's fair market value), the amount of the investment is based on the following rules:

1. If the QOF's basis of the transferred property is determined by reference to the adjusted basis of the transferred property,[74] the amount of the investment is equal

[70] Prop. Reg. § 1.1400Z-2(e)-1(a)(2)

[71] Prop. Reg. § 1.1400Z-2(a)-1(b)(10)

[72] Under any such structure in which there was a prearranged formula for which the debt could be converted to equity, the general debt/equity principles would be presumably apply to determine that the interest was an equity interest that may be treated as an eligible interest.

[73] Prop. Reg. § 1.1400Z-2(a)-1(b)(10)(i)(A)

[74] The Proposed Regulations contain an error in this section. Prop. Reg. § 1.1400Z-2(a)-1(b)(10)(i)(B)(3) Provides that the nonqualifying portion of an investment is equal to the excess of fair market value of the investment to which Section 1400Z-2(e)(1)(A)(i) applies over the taxpayer's adjusted basis (determined without regard to Section 1400Z-2(b)(2)(B) (the special basis rule). As is correctly demonstrated in Example 1, the correct computation is the excess of the fair market value of the *eligible investment* over the adjusted basis (determined without regard to the special zero basis rule).

to the lesser of the adjusted basis of the contributed property or the fair market value of the contributed property.[75]

2. A potential trap exists for property owners that intend to contribute property to a QOF if a taxpayer contributes property with a fair market value that exceeds the taxpayer's adjusted basis. Such taxpayer will be deemed to have made an investment with mixed funds as described in Section 1400Z-2(e)(1).[76] Thus, a portion of such investment will not qualify for opportunity zone tax benefits.

3. The Proposed Regulations provide that in the case of property transferred with a built-in loss and Section 362(e)(2) applies (relating to determination of basis of property transferred to a corporation with a built in loss), the taxpayer is deemed to have made an election under Section 362(e)(2)(C) (limiting the basis of the transferee to the transferor's stock basis).[77]

4. To the extent that a taxpayer contributes property to a QOF and the basis of the property is not determined by reference to the adjusted basis of the contributed property (such as in the case of property that causes gain recognition under Section 752), the amount of the investment will equal to the fair market value of the property immediately before the transfer.[78]

The effect of these rules is that when a taxpayer contributes property (other than cash) to a QOF, if the property value exceeds its adjusted basis (which is likely to be the case in the context of many development projects, particularly real estate developments), the taxpayer will be treated as having made an investment with mixed funds. A taxpayer could avoid having a mixed-funds investment with respect to the contribution of appreciated property to a QOF by instead *selling* property to the QOF (in exchange for cash or a note) and reinvesting any recognized gains.[79]

A sale of appreciated property will have the effect of accelerating the seller's capital gain (since there are no gains resulting from a contribution of property). If the gains are reinvested, the acceleration will be delayed until the date that gain is included (usually December 31, 2026). The benefit is that the entire investment will be eligible for the QOZ tax benefits. If such a scenario arises, the investor should "run the numbers" to determine the best approach.

To the extent that an investment in a QOF consists of an eligible investment in part, and an investment that is not eligible, in part, it will be considered an investment with mixed funds. Under Section 1400Z-2(e)(1), such an investment will be treated as 2 separate investments: (i) an

[75] Prop. Reg. § 1.1400Z-2(a)-1(b)(10)(i)(B)

[76] Prop. Reg. § 1.1400Z-2(a)-1(b)(10)(i)(B)(2)

[77] Prop. Reg. § 1.1400Z-2(a)-1(b)(10)(i)(B)(3)

[78] Prop. Reg. § 1.1400Z-2(a)-1(b)(10)(i)(C)

[79] A sale may not be preferable since the seller may not have cash to cover the liability when the gain is recognized (likely in 2026).

investment that was made with a qualifying investment and is subject to the rules for an eligible interest for which a deferral election was made and (ii) an investment for which no such election was made (which is not subject to the benefits under the QOZ program).[80]

The Proposed Regulations also enacted specific rules regarding what will constitute an investment in a partnership.

1. To qualify as an investment in a partnership, such investment must be treated as a contribution for tax purposes (*e.g.*, a transfer of property that is treated as a disguised sale is not considered an investment under Section 1400Z-2(a)(1)(A)).[81]

2. If a contribution to a partnership is followed by a distribution of property that would be recharacterized as a disguised sale under Section 707 in certain circumstances relating to contribution of non-cash property or resulting from debt financed distributions, it will not be treated as an investment for purposes of Section 1400Z-2(a).[82] ***Accordingly, any transactions involving a contribution of cash or property to a QOF, followed by an actual or deemed distribution of cash or property, must be examined to determine whether it is treated as a disguised sale and does not qualify as an eligible investment under Section 1400Z-2.*** Under this rule, an investor will need to assess the impact of any distribution within the first two years following the date of the investment.[83]

3. The Proposed Regulations provide rules that take into account debt basis and mixed fund investments to reflect that the amount of the taxpayer's investment is the lesser of the taxpayer's "net basis" or "net value" (to ensure consistent application with the concepts described in Prop. Reg. 1.1400Z-2(a)-1(b)(10)(i)(A)).

The Proposed Regulations also provide that an interest in a QOF may be acquired directly from a person other than the QOF (*i.e.*, an existing owner of such QOF interest).[84] If a QOF is acquired from a person other than a QOF, the amount of the investment will equal the cash, or fair market value of other property, that the taxpayer exchanged for such QOF interest. Note, however, that the purchaser must acquire such interest with reinvested capital gains in order for the investment to be treated as a qualifying investment.

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[80] Section 1400Z-2(e)(1). Also, as provided in Prop. Reg. § 1.1400Z-2(a)-1(b)(10)(i)(D), if a taxpayer's investment is considered to be made with mixed funds under the rules of Section 1400Z-2(e)(1), the taxpayer's basis in the investment is equal to the taxpayer's basis in all QOF interests received, reduced by the investment to which Section 1400Z-2(e)(1)(A) applies (determined without regard to the basis adjustment of section 1400Z-2(b)(2)(B)).

[81] Prop. Reg. § 1.1400Z-2(a)-1(b)(10)(ii)(A)(1)

[82] Prop. Reg. § 1.1400Z-2(a)-1(b)(10)(ii)(A)(2)

[83] The impact of this rule is significant. If a disguised sale is deemed to occur, not only will the investor have gain, the original investment will be recharacterized as a nonqualifying investment (resulting a mixed funds investment for the investor).

[84] Prop. Reg. § 1.1400Z-2(a)-1(b)(10)(iii)

Profits interests (*e.g.*, carried interests or promote interests) that are issued by a QOF to a taxpayer in exchange for services rendered or to be rendered are not considered an eligible investment since the interests were not issued in exchange for cash or property.[85] Query whether a different approach could be used in lieu of profits interests such that the speculative remaining value of a leveraged partnership could be acquired for cash (with the interest designed and valued in a similar manner as the risky tranches of a bond fund or CDO), resulting in such interest being treated as a qualifying interest rather than a profits interests issued in exchange for services.

The treatment of profits interests as nonqualified interests applies solely for the issuance of such interests by a QOF. There is no explicit prohibition against an upper-tier profits interest being issued by an entity that is a qualified investor in a QOF, with a fully qualifying investment in a QOF. Thus, if a partnership invests in a QOF, and issues a profits interest to a partner at the upper-tier level, the interests held by the partnership/investor that are qualified interests made with qualified gains will be fully qualified investments and the profits interests issued by the upper-tier entity may ultimately benefit from tax-free gains.[86]

7. How is the 180-Day Period Determined?

The 180-day rule provides that the 180-day period to reinvest capital gains begins on the date of the sale or exchange.[87] As the QOZ program became law, the question of when gain is recognized in various situations under the program was of paramount importance (as it drives the threshold requirement that the investment occur in the 180-day time period following the gain). The Proposed Regulations expand on this definition, providing that the 180-day period begins on the date that the gain would be recognized for federal income tax purposes (assuming the elections discussed below are not made). For example, the 180-day period begins: (i) on the trade date, for a regular stock trade; (ii) the date that the dividend is paid, with respect to capital gains dividends received by REIT and RIC shareholders, (iii) on the last day of the tax year, for REIT and RIC undistributed capital gains.[88] Likewise, Section 1231 gains and Section 1256 gains are recognized on the last day of the tax year.[89]

The Proposed Regulations also provide an additional example that explicitly provides that the date that capital gains would be included from the disposition of an investment in a QOF begins the 180-day period to defer reinvestment of the now included gain (and a reinvestment in the same QOF is permitted). [90]

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[85] Prop. Reg. § 1.1400Z-2(a)-1(b)(9)(ii)

[86] We would need to analyze the potential transactions to determine whether the distribution of cash would result in distributions in excess of basis even if no gain is allocated to the profits interest partner.

[87] Section 1400Z-2(a)(1)(A)

[88] Prop. Reg. § 1.1400Z-2(a)-1(b)(4)(ii)(Example 1 through Example 3)

[89] Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(iii) and Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(v)(A)

[90] Prop. Reg. § 1.1400Z-2(a)-1(b)(4)(ii)(Example 4)

Importantly, the Proposed Regulations created substantial flexibility for taxpayers by permitting elective provisions that favor either partnerships or their partners (or similar pass-through entities). These rules (detailed below) are complicated. However, the following steps reflect how partnership gains are treated by the respective partnerships and their partners:

1. The partnership that recognizes gain determines whether it will defer some or all of such gain by making an investment in a QOF.

2. Any gain not deferred by such partnership is included in its partners' distributive share.

3. Each partner that elects to defer gain included in its distributive share will either use the last day of the partnership's tax year as its recognition date to start the 180-day time period or elect to use the date that the partnership recognized the gain to start the 180-day time period.

A partnership is an eligible taxpayer and may elect to defer recognition of income (at the partnership level) under Section 1400Z-2(a).[91] If a partnership makes such an election to defer gain, the deferred gain is deferred under the rules of Section 1400Z-2, and the deferred gain is not included in the partners' distributive shares (and such amounts are included in the partner's shares if the partnership does not defer gain recognition).[92]

The Regulations provide that for a partner electing deferral with respect to gains that are included in a partner's distributive share of a partnership, the 180-day period will generally begin on the last day of the partnership's tax year (or such partner's last day in which its allocable share includes such eligible gain).[93] However, a partner may elect instead to use the date that would have been the underlying partnership's commencement of the 180-day period rather than the last day of the tax year.[94] The Regulations clarify that different partners of the same partnership may use either the default rule (using the last day of the tax year) or the elective rule (using the actual date of the recognized sale or exchange by the underlying partnership).[95] Rules similar to those applicable for partnerships also apply in the case of S corporations, trusts and estates.[96] Many taxpayers would benefit by transferring securities or closely held stock to a partnership which could enable such taxpayers to increase the time period eligible for deferral to as long as 18 months.

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[91] Prop. Reg. § 1.1400Z-2(a)-1(c)(1)

[92] Prop. Reg. § 1.1400Z-2(a)-1(c)(2)(i)-(ii)

[93] Prop. Reg. § 1.1400Z-2(a)-1(c)(2)(iii)(A)

[94] Prop. Reg. § 1.1400Z-2(a)-1(c)(2)(iii)(B)

[95] Prop. Reg. § 1.1400Z-2(a)-1(c)(2)(iii)(C) (Example)

[96] Prop. Reg. § 1.1400Z-2(a)-1(c)(3)

Planning Tip

Many taxpayers would benefit (and create additional flexibility) by transferring securities or closely held stock to a partnership which could enable such taxpayers to increase the time period eligible for deferral to as long as 18 months.

The 2018 Proposed Regulations provide that a partnership may elect to defer "some or all" of the gains.[97] If such gain is not deferred, it is considered eligible gain under Prop. Reg. § 1.1400Z-2(a)-1(c)(2)(ii)(C). If a partner's distributive share includes a gain that is described in Prop. Reg. § 1.1400Z-2(a)-1(c)(2)(ii)(C), such gain is eligible be deferred by the partner. At the partner level, the partner generally treats such gain as arising on the last day of the partnership's tax year.[98] However, 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 allocable share of *that* gain as being the same as the partnership's 180 day period.[99]

Thus, the partnership may elect to defer some or all of the gain that is eligible for reinvestment. If such partnership defers some, but not all of such gain, the balance is included in the partners' distributive share. The language of the Regulation appears to allow for such partner to *either* treat the gain as occurring on the last day of the partnership's tax year, or otherwise elect to treat *that gain* as occurring on the date that the 180-day period began with respect to the partnership. It does not appear that, at the partner level, the partner may elect to treat some portion of the gain included in such partner's distributive share as recognized on the last day of the tax year and another portion of the same gain to be treated as occurring on the date of the transaction that gave rise to the gain or loss.

For the purposes of the respective provisions that provide for gain recognition as of the last day of the tax year, or on December 31, 2026, the first day of the 180 day period is December 31 or the last day of the tax year (and not the first day of the subsequent tax year). Thus, if the last day of the tax year is December 31, 2026 with respect to any eligible gain, the last day for possible reinvestment will be June 28, 2027.

D. Deferral of Gains and Inclusion of Deferred Gains in Income

Section 1400Z-2(b) describes the timing of deferred gains and when such gains are included in income. Gain that is properly deferred under Section 1400Z-2(a) will be included in income the earlier of (i) the date that such investment is sold or exchanged; or (ii) December 31, 2026.[100] The

[97] Prop. Reg. § 1.1400Z-2(a)-1(c)(2)(i)

[98] Prop. Reg. § 1.1400Z-2(a)-1(c)(2)(iii)

[99] Prop. Reg. § 1.1400Z-2(a)-1(c)(2)(iii)(A)-(B)

[100] Section 1400Z-2(b)(1)

result of this rule is that the deferred gain (or the fair market value of the investment, if less) will be recognized on December 31, 2026, with the tax liability due on April 15, 2027 (subject to estimated tax penalties, if applicable).

If the investor holds the investment for sufficient time before the date that gain is included in income (generally December 31, 2026), the amount of the gain will be reduced. The original gain that is included is reduced by ten percent (10%) if the investment is held for 5 years and the amount of the gain that is included in income is reduced by another five percent (5%) if the investment in the QOF is held for at least 7 years (in each cases, the holding period must be met prior to the date that gain is included in income to obtain the gain reduction).

1. Events Causing Inclusion of Gain in Income (or Not)

The reinvested gain is deferred until December 31, 2026 unless the taxpayer is considered to have sold or exchanged its interest at an earlier date. In some cases, the determination of whether an investment has been sold or exchanged is straightforward (as in the case of an actual sale of an interest to a third party for cash). In other cases, however, a taxpayer is deemed to have sold or exchanged all, or part, of its investment and is therefore required to include deferred gain into income. The Proposed Regulations detail the circumstances in which previously deferred gain is included in income and will be taxed (referred to as an "inclusion event"). Thus, the Proposed Regulations provide the general rule that deferred gain is included in gross income on the earlier of the (1) date of an inclusion event or (2) December 31, 2026.[101]

The Proposed Regulations provide a list of the transactions that are considered inclusion events.[102] The determination of what constitutes an inclusion event is one of the most technical and complicated areas of the regulatory regime. Indeed, the Proposed Regulations add 21 new definitions[103] and dozens of specific situation rules to address the determination of when an investment in a QOF is treated as sold or exchanged.

The determination of gain inclusion is subject to special rules and not based solely on general income tax principles since the investment in a QOF is effectively made with pre-tax dollars (until inclusion). While the return of cash or property in a traditional investment vehicle may be properly considered the return of capital that reduces a taxpayer's basis in its investment, an investor in a QOF has no basis with respect its investment (except for debt basis) and certain transactions must then be characterized as the inclusion of previously deferred gain. **Any transaction involving a QOF interest (e.g., transfer, distribution) could lead to the inadvertent inclusion of gains under the QOZ program (prior to December 31, 2026) even if the same transaction would not be taxable under general income tax principles.**

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[101] Prop. Reg. § 1.1400Z-2(b)-1(b)

[102] Prop. Reg. § 1.1400Z-2(b)-1(c)

[103] Prop. Reg. § 1.1400Z-2(b)-1(a)(2)(i)-(xxi)

a. GENERAL RULES FOR INCOME INCLUSION

The first inclusion rule (and the general rule) provides that if, and to the extent that, such event is (i) a reduction of a taxpayer's equity interest in a QOF; (ii) a distribution of property (other than cash) regardless of whether the taxpayer's direct interest in the QOF is reduced; or (iii) results in the taxpayer claiming a loss for worthlessness with respect to its qualifying investment in a QOF,[104] such event will be an inclusion event (except as otherwise provided below).

The equity reduction rule and worthless equity rule were expected in light of the statutory language causing inclusion as of the date of a sale or exchange. However, the treatment of any property distribution as an inclusion event effectively functions as a mechanism to prevent potentially abusive property transfers to equity holders that had previously deferred gains on the disposition of property.

b. TERMINATIONS AND LIQUIDATIONS

The termination of a QOF (for federal income tax purposes) is considered an inclusion event.[105] If the QOF ceases to exist for federal income tax purposes, the taxpayer has an inclusion event with respect to all of its qualifying investment. This rule applies whether or not the liquidation of the QOF would otherwise be treated as a gain recognition event. Thus, in the case of a partnership termination followed by an in-kind distribution of the partnership's assets to its partners (which would otherwise be generally non-taxable under Section 731), this rule would cause gain inclusion for purposes of Section 1400Z-2(b). Investors and their advisors should be very cautious with respect to QOF restructuring during the deferral period to avoid the consequences of this rule.

The liquidation of an *owner* of a QOF is also treated as an inclusion event in certain circumstances.[106] Specifically, a distribution of a qualifying investment in complete liquidation of a QOF owner is an inclusion event to the extent that such distribution is treated as if the qualifying investment were sold to the distributee under Section 336(a) (upon complete liquidation of a corporation) at fair market value (without regard to Section 336(d) (relating to the limitation of losses for certain corporate liquidations)).[107] However, a distribution of a qualifying investment to a distributee in a corporate liquidation will not be considered an inclusion event to the extent

[104] Prop. Reg. § 1.1400Z-2(b)-1(c)(1). Prop. Reg. § 1.1400Z-2(b)-1(c)(14) elaborates on this rule by providing that (i) the date that he taxpayer treats it investment as worthless will be the date of the inclusion event; and (ii) the rules governing basis adjustments under Section 1400Z-2(b)(2)(B)(iii) or Section 1400Z-2(c) will not apply after the date that the stock becomes worthless. We also recognize that this rule may not have any significant economic effect since the taxpayer has no basis in its qualifying QOF investment except to the extent of the 10% and 5% basis adjustments.

[105] Prop. Reg. § 1.1400Z-2(b)-1(c)(2)(i)

[106] Prop. Reg. § 1.1400Z-2(b)-1(c)(2)(ii)

[107] Prop. Reg. § 1.1400Z-2(b)-1(c)(2)(ii)(A)

that Section 337(a) applies to the transaction (nonrecognition treatment in the case of a distribution to an 80-percent shareholder in a complete liquidation).[108]

c. LIFETIME GIFTS AND TRANSFERS UPON DEATH

i. Gifts.

Most transfers by gift are also considered inclusion events. A transfer of a qualifying investment by gift, whether outright or in trust, is an inclusion event (this results applies even if the transfer is not considered a completed gift for Federal gift tax purposes, and regardless of the taxable or tax exempt status of the donee).[109]

This rule has one important exception: if the owner of a qualifying investment contributes it to a grantor trust (such that under the grantor trust rules, the transferor is the deemed owner of the trust), such contribution is not an inclusion event.[110] The contribution of an investment to a grantor trust will often be treated as a gift for gift tax purposes, but will not be treated as a contribution, sale or exchange for income tax purposes (such transactions are often referred to as transfers to a "defective grantor trust" which is recognized as a separate trust for gift and estate tax purposes).

The preamble to the Proposed Regulations explicitly provides that a transfer by gift to a grantor trust is not an inclusion event. Indeed, the preamble states (in Section VII, Part E) that "[t]he rationale for this exception is that, for Federal income tax purposes, the owner of the grantor trust is treated as the owner of the property in the trust until such time that the owner releases certain powers that cause the trust to be treated as a grantor trust. Accordingly, the owner's qualifying investment is not reduced or eliminated for Federal income tax purposes upon the transfer to such a grantor trust."

The grantor trust exception applies in the case of a contribution to a grantor trust. For estate planning purposes, assets are often sold to a 'defective' grantor trust in exchange for a cash down payment and a promissory note for the balance (in a transaction that is not recognized for income tax purposes).[111] In such a circumstance, the transfer is generally ignored for income tax purposes (even though it is, economically, a sale or exchange). Since a sale to a grantor trust is ignored for income tax recognition purposes, given the underlying rationale of not treating a transfer to a

[108] Prop. Reg. § 1.1400Z-2(b)-1(c)(2)(ii)(B). The term "QOF Owner" means either a QOF Shareholder or QOF partner.

[109] Prop. Reg. § 1.1400Z-2(b)-1(c)(3)

[110] Prop. Reg. § 1.1400Z-2(b)-1(c)(5)(i)

[111] A defective grantor trust is a trust that is treated as a grantor trust for income tax purposes under Section 671-678 of the Code, but is not included in a decedent's estate under Section 2038. For example, a trust that that provides a grantor with the right to substitute trust property, but is otherwise an irrevocable trust outside of the grantor's control, will be treated as a grantor trust for income tax purposes under Section 675(4) but the trust assets will not be included in the grantor's estate under Section 2038.

grantor trust as an inclusion event, a sale to a defective grantor trust should also be permitted without causing gain inclusion.

Planning Tip

Since a sale to a grantor trust is ignored for income tax recognition purposes, given the underlying rationale of not treating a transfer to a grantor trust as an inclusion event, a sale to a defective grantor trust should also be permitted without causing gain inclusion.

ii. Estates.

Generally, transfers that occur solely as a result of the death of a taxpayer and the administration of such taxpayer's estate to do not result in gain inclusion.[112] Thus, the following transactions are not considered inclusion events: (i) a transfer to a decedent's estate as a result of the owner's death;[113] (ii) a distribution of a qualifying investment by the deceased owner's estate;[114] (iii) a distribution of a qualifying investment by a deceased owner's trust that is made by reason of the deceased owner's death;[115] (iv) the passing of jointly owned qualifying property to the surviving co-owner by operation of law;[116] or (v) any other transfer of a qualifying investment at death by operation of law.[117]

On the other hand, dispositions involving estates that are not considered to have been made as a result of the owner's death will be inclusions events.[118] Such transactions (to the extent not explicitly permissible as described above) include (i) a sale, exchange or other disposition by the deceased taxpayer's estate or trust;[119] (ii) any disposition by a legatee, heir or beneficiary of the deceased owner's estate who received the qualifying investment as a result of the taxpayer's death;[120] and (iii) any disposition by the surviving joint owner or other recipient that received the interest as a result of the taxpayer's death.[121]

[112] Prop. Reg. § 1.1400Z-2(b)-1(c)(4)(i)

[113] Prop. Reg. § 1.1400Z-2(b)-1(c)(4)(i)(A)

[114] Prop. Reg. § 1.1400Z-2(b)-1(c)(4)(i)(B)

[115] Prop. Reg. § 1.1400Z-2(b)-1(c)(4)(i)(C)

[116] Prop. Reg. § 1.1400Z-2(b)-1(c)(4)(i)(D)

[117] Prop. Reg. § 1.1400Z-2(b)-1(c)(4)(i)(E)

[118] Prop. Reg.(ii) 1.1400Z-2(b)-1(c)(4)(ii)

[119] Prop. Reg. § 1.1400Z-2(b)-1(c)(4)(ii)(A)

[120] Prop. Reg. § 1.1400Z-2(b)-1(c)(4)(ii)(B)

[121] Prop. Reg. § 1.1400Z-2(b)-1(c)(4)(ii)(C)

Presumably, the rules described above will not cause gain inclusion if such interest is transferred first to a beneficiary as a result of the original owner's death, and then transferred as a result of the second owner's death. Since the beneficiary receives such property without causing an inclusion event since it was received in a distribution as a result of the original owner's death, such person becomes the owner of the investment. In such capacity, the above rules should prevent the inclusion resulting from an otherwise permissible transfer at the second owner's death. This result is important for older investors that may not live to until the QOF interest is sold and intend to leave their assets to a surviving spouse, and then to their descendants.

To the extent that a qualifying interest in a QOF is owned by a grantor trust, the change to non-grantor trust status (other than by reason of the grantor's death) will be an inclusion event.[122] Likewise, the creation of grantor trust status (by a non-grantor trust) is an inclusion event. These grantor trust rules are otherwise subject to the inclusion rules of Prop. Reg. § 1.1400Z-2(b)-1(c)(4) (relating to the distributions and dispositions upon the death of an owner).

Importantly, in certain circumstances, a QOF interest can effectively achieve an after-death basis step up for an asset that is otherwise not included in a decedent's estate. Most practitioners take the position that if an asset is not included in a decedent's estate if it was transferred to a grantor trust that is not included in the decedent's estate under Section 2038, the estate (or trust) is not entitled to a basis step up under Section 1014. However, a tax-free step up could be achieved under the QOZ program as described below.

Assume that a taxpayer transfers an interest in a QOF (by gift) to a defective grantor trust and subsequently dies while the defective grantor trust holds the investment. Under the rules applicable to grantor trusts and QOF interests, the death of a grantor will cause the trust to be treated as a non-grantor trust. However, the conversion to non-grantor trust status as a result of the grantor's death is not an inclusion event.[123] Following the death of a grantor during the ten year holding period, the QOF interest will be held by the trust (which has converted to a non-grantor trust). Following the sale or exchange of the QOF interest (or the underlying assets), the effect is that the trust receives a basis step up under Section 1400Z-2(c) and that the gain is tax-free to the trust. Thus, the taxpayer would have removed the QOF interests from its estate through the gift of the interest during lifetime, but the trust will receive a basis step up at disposition. The net effect is that the QOF interest will never be taxed for estate <u>or</u> income tax purposes under this fact pattern.[124]

[122] Prop. Reg. § 1.1400Z-2(b)-1(c)(5)(ii)

[123] Prop. Reg. § 1.1400Z-2(b)-1(c)(5)(ii)

[124] Note that the same result will apply if the QOF interest is transferred to the defective grantor trust and the grantor remains alive until disposition. The basis step up would occur even though the asset remains outside of the transferor's estate.

d. Partnership Non-Recognition Transactions

The Proposed Regulations provide for special rules in the case of partnerships that are a QOF, or that directly or indirectly own interests in a QOF, whereby the inclusion rules apply to such partner's share of such QOF to the extent of its share of gain of such underlying QOF.[125] These rules are primarily intended to avoid causing inclusion in the case of certain partnership non-recognition transactions.

First, the contribution of a QOF owner (including a contribution by a partner or partnership that owns interests in a QOF solely through upper tier partnerships), of its direct or indirect interest in a qualifying investment (*a contributing partner*) to a partnership in a transaction that is tax-free under Section 721(a) (*a transferee partnership*) is not an inclusion event (except in the case that it results in a termination of the partnership QOF or the direct or indirect owner of a QOF under Section 708(b)(1)).[126] Importantly, when read literally, this section reflects that even the termination of an upper-tier partnership that is an indirect owner of a qualifying interest in a QOF will be an inclusion event (even in a transaction for which Section 721(a) will otherwise result in no recognition of gain or loss). A partnership transaction for which Section 721(a) does not apply will be subject to the inclusion rules otherwise applicable under Prop. Reg. § 1.1400Z-2(b)-1(c).

Second, a merger or consolidation of a partnership holding a qualifying investment (directly or indirectly through one or more partnerships) in a transaction for which Section 708(b)(2)(A) (relating to the treatment of a merged or consolidated partnership as a continuation of the preexisting partnerships) will not be an inclusion event.[127]

Following any permitted partnership transaction (as described in the preceding two paragraphs), the transferee partnership or surviving partnership must allocate and report the gain with respect to the qualifying investment to the same extent that the gain would have been allocated and reported (to the same partner or partners) in the absence of such contribution.[128]

e. Partnership Distributions

Partnerships may generally make distributions to a partner on a tax-free basis, to the extent that the fair market value of the cash or other property that is distributed to a partner does not exceed the partner's basis (including debt basis) of its investment.[129] Often, leveraged partnerships make distributions from financing proceeds (*i.e.*, debt-financed distributions) without causing gain recognition since the distributee partner's share of liabilities (as determined under Section 752 and the regulations promulgated thereunder) is greater than the value of the cash or property

[125] Prop. Reg. § 1.1400Z-2(b)-1(c)(6)

[126] Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(ii)(B)

[127] Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(ii)(C)

[128] Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(ii)(B)

[129] Section 731(a)(1)

distributed. This rule is extended to leveraged QOZ partnerships explicitly, such that notwithstanding the general inclusion rule, actual or deemed distributions of property (including cash) to a partner by a partnership result in gain only if the fair market value of the distributed property exceeds the taxpayer's basis in its qualifying investment.[130]

Note that this rule applies without regard to the general inclusion rule (which provides that the distribution of property is an inclusion event),[131] providing that a partnership may make a distribution of property to a partner without causing inclusion of previously deferred gains.

The Proposed Regulations appear inconsistent on this point. Under the general rule, except as otherwise provided in [the inclusion rules] if and to the extent that a taxpayer receives property in a transaction that is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the taxpayer's ownership of the QOF, such distribution will be an inclusion event.[132] However, paragraph (6)(iii) of Prop. Reg. § 1.1400Z-2(b)-1(c) overrides that rule, providing that "an actual or deemed distribution of *property* (including cash) by a QOF partnership to a partner is an inclusion event *only to the extent that* the distributed property has a fair market value in excess of its adjusted basis in its qualifying investment.[133] These two provisions seem diametrically opposed in that it would allow a partnership to distribute property (this is explicitly allowed under the Proposed Regulations) even though the general rule would cause the same property distribution to be treated as an inclusion event in all other circumstances.

Note to Readers: We welcome your comments or feedback on this point as we are trying to reconcile these drastically different results and need to determine whether a property distribution to a partner is a viable strategy in certain circumstances.

f. Treatment of Mixed-Funds

The partnership rules applicable to qualified opportunity zone investments also provide special rules in the case of mixed-use funds. In general, a taxpayer with mixed-funds investment (*i.e.*, a qualifying portion and a non-qualifying portion of an investment in a QOF partnership) will be treated, for purposes of Section 1400Z-2, as holding two separate interests in the QOF.[134] The separate interests rule is applicable for purposes of (i) determining basis (with the qualifying and non-qualifying investment having separate bases in the same manner as if they were held by separate taxpayers);[135] (ii) allocations and distributions under Section 704(b), and allocation of

[130] Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(iii)

[131] Prop. Reg. § 1.1400Z-2(b)-1(c)(1)(ii)

[132] Prop. Reg. § 1.1400Z-2(b)-1(c)(1)(ii)

[133] Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(iii)

[134] Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(iv)

[135] Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(iv)(A). Note that it will be up to the investor to track the basis of the qualified and non-qualified portion of their investment since the QOF will not know what interests are qualified interests.

liabilities under Section 752 (which are both deemed made to the separate interests);[136] (iii) subsequent contributions (requiring a revaluation of separate interests and the adjustment of allocation percentages);[137] and (iv) allocation percentages, which shall be determined based on the relative capital contributions attributable to the qualifying and non-qualifying investment.[138]

Profits Interests

In the case of a partner that received a profits interest in exchange for services (which is a non-qualifying investment), the allocation percentages of such partner shall be calculated based on (i) with respect to the profits interest received, the highest share of residual profits the mixed-fund partner would receive with respect to such interest, and (ii) with respect to the remaining interest, the percentage interests for the capital interests (based on the relative values of qualifying and non-qualifying interests).[139] This has the effect of increasing the non-qualifying portion of the interest since the profits interest percentage will apply only using the maximum percentage of such profits interest (which may be higher than the actual profit percentage based on the distribution waterfall). ***There does not appear to be a prohibition on the use of a profits interest at an upper-tier partnership that itself has made an election for deferral (and will later make an election to step-up basis after 10 years) to avoid having such interests treated as a mixed-fund investment.***

Under this profits interest rule, an owner of a promote interest may have a greater share of its interest be treated as nonqualifying (based on the highest percentage rule) as compared to the actual economics of a sale or exchange. It may make sense to counter the negative ramifications of the above rule for the owner of a promote interest that also contributed capital by making the investment and issuing the profits (promote) interests to separate taxpayers (one holding a capital interest and one holding a profits interest) so that a disproportionate share of the gains will not be taxed (and gains will therefore be more closely aligned with the taxable and non-taxable portion of the interests).

Remaining Gain Reduction Rule

Finally, the special partnership provisions provide that an inclusion event occurs when and to the extent that a transaction has the effect of reducing (i) the amount of remaining deferred gain of one or more of the direct or indirect partners, or (ii) the amount of gain that would be recognized by such partner(s) under Prop. Reg. 1.1400Z-2(b)-1(e)(4)(ii) (relating to the amount of gain included by a partnership at the time of an inclusion event).[140] This rule attempts to align the treatment of

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[136] Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(iv)(B). Sensibly, the Proposed Regulations provide that Section 704(c) principles shall apply to account for value-basis disparities attributable to qualifying investments. Although these rules are complicated, they are well established and can be readily applies to interests in a partnership that have disproportionate differences between outside basis (of equity interests) and inside basis (of the partner's share of the partnership's basis in its assets).

[137] Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(iv)(C)

[138] First sentence of Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(iv)(D)

[139] Second sentence of Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(iv)(D)

[140] Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(v)

deferred gain with the amount of gain includible (and is referred to as the "remaining gain reduction rule").

It is unclear how the remaining gain reduction rule should be applied. For example, a partner may be entitled to a cash flow preference such that it receives its invested capital plus a preferred return and is also entitled to a share of the residual interests. The investor may receive cash flow from operations or through refinancing distributions that reduce the remaining preferred return. Such transactions could, in theory, reduce the remaining deferred gain if the value of the investment falls below the amount of the remaining deferred gain. The gain would be included "when and to what extent" the remaining deferred gain is reduced. In most cases, this value cannot be ascertained with any degree of certainty since we do not know what the value will be on December 31, 2026 (and therefore do not know to what extent the remaining deferred gain is reduced, if at all).

For example, it is not unusual for equity value of preferred investors to be reduced due to a cash out refinance that returns capital to such investors. The value may even be decreased substantially with a substantial portion of the invested equity returned to an investor through a cash out refinance. However, the value of the residual equity will continue to increase as debt is repaid and property values increase, often resulting in no actual reduction in deferred gain as of December 31, 2026.

Tracking of Separate Interests

The separate interests rule (used by taxpayers to track mixed fund investments) creates some level of administrative and taxpayer complexity. In most circumstances, the respective partnership tracks important information relating to partnership tax items. However, in a QOF with mixed-fund investments, only the investor knowns the investments and portions thereof attributable to qualified and non-qualified investments (subject to notification requirements in Part 2, Section B.5. Accordingly, the taxpayer will bear the responsibility to make these determinations. This is not very much of a burden in the case of a single investment. However, taxpayers with multiple investments in a fund (or funds), as well as taxpayers that have an investment and also receive a profits interest, will endure greater complexity under the separate interests rule.

g. RULES APPLICABLE TO S CORPORATIONS

The Proposed Regulations similarly apply special rules for S corporations that are either a QOF or an investor (directly or indirectly) in a QOF. Certain transactions specific to S corporations are explicitly not treated as inclusion events: (i) an election, revocation or termination of S corporation status under Section 1362;[141] (ii) a conversion of a qualified subchapter S trust (as defined in Section 1361(d)(3) (a "QSST")) to an electing small business trust (as defined in Section

[141] Prop. Reg. § 1.1400Z-2(b)-1(c)(7)(i)(A)

1361(e)(1) ("an "ESBT");[142] (iii) a conversion of an ESBT to a QSST;[143] (iv) a valid modification of a trust agreement by an S corporation shareholder;[144] (v) a 25 percent or less aggregate change in ownership in the equity investment in an S corporation that directly holds a qualifying investment;[145] and (vi) a disposition of assets by a QOF S corporation. [146]

As with partnerships, an actual or constructive distribution of property from a QOF S corporation to a shareholder with respect to its qualifying investment is an inclusion event only to the extent that the distribution is treated as gain from the sale or exchange of property under Section 1368(b)(2) and (c) (reflecting that distributions in excess of basis are treated as gain from the sale or exchange of property).[147] Unlike partners in partnerships, S corporation shareholders do not have basis from S corporation liabilities. As a result, debt-financed distributions will often result in gain for S corporation shareholders (which is an inclusion event) even if identical transactions in the partnership context would not result in current gain inclusion.

The Proposed Regulations also provide a spillover rule for S corporations such that adjustments to basis (that are generally applied pro rata to a shareholder's interests) are instead applied separately for qualifying investments and non-qualifying investments.[148] Effectively, the shareholder tracks its qualifying and non-qualifying interests separately, and basis adjustments are likewise applied separately.

The change in the ownership equity of an S corporation by 25% or more of the aggregate equity of such corporation that directly owns a qualifying investment in a QOF is an inclusion event.[149] To the extent that such a change occurs, the S corporation is treated as disposing of its entire qualifying interest (not limited to the pro rata share). Moreover, following such equity shift, the tax benefits of Section 1400Z-2 will no longer apply with respect to such interest.[150] Such disposition is deemed to occur when the requirements described in the following paragraph are met.

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[142] Prop. Reg. § 1.1400Z-2(b)-1(c)(7)(i)(B)

[143] Prop. Reg. § 1.1400Z-2(b)-1(c)(7)(i)(C)

[144] Prop. Reg. § 1.1400Z-2(b)-1(c)(7)(i)(D)

[145] Prop. Reg. § 1.1400Z-2(b)-1(c)(7)(i)(E). This section references the ownership percentage pursuant to Section c(7)(iii) of this Proposed Regulation (described below). Importantly, this rule only applies to S corporation with a direct investment in a QOF. Thus, if an S corporation was in investment entity, and structured its investment by using an intermediary partnership, this rule would not apply.

[146] Prop. Reg. § 1.1400Z-2(b)-1(c)(7)(i)(F)

[147] Prop. Reg. § 1.1400Z-2(b)-1(c)(7)(ii)

[148] Prop. Reg. § 1.1400Z-2(b)-1(c)(7)(iii)

[149] Prop. Reg. § 1.1400Z-2(b)-1(c)(7)(iii)(A).

[150] Prop. Reg. § 1.1400Z-2(b)-1(c)(7)(iii)(A) (second sentence)

An aggregate equity change in ownership greater than 25% is met if, immediately after the change in ownership of the S corporation, the percentage of stock owned directly by the shareholders at the time of its deferral election has decreased more than 25%. The aggregate change in ownership is measured separately for each qualifying investment of the S corporation, and is based on the ownership percentages as of the time of the capital gains deferral election.

Since the inclusion event due to a 25% equity shift of an S corporation only applies for a direct QOF owner, it may be possible to structure a transaction to avoid the ramifications of this rule. The S Corporation could contribute its QOF interest to a partnership in a non-recognition transaction which is not an inclusion event.[151] Following such contribution, the S Corporation will no longer be a direct owner of the QOF. Accordingly, the 25% equity change in ownership rule is no longer applicable.[152]

The conversion of an S corporation to either a partnership or a disregarded entity is an inclusion event,[153] unless such conversion is treated as a qualifying Section 381 transaction.[154] To the extent an S corporation engages in a redemption that is treated as a distribution or property (to which Section 302(d) applies), such distribution will be treated as an inclusion event only to the extent that the distributions exceed the shareholder's basis in the QOF.[155]

The Proposed Regulations also clarify that differing rights of S corporation stock for a QOF or QOF equity owner will not be treated as separate classes of stock under Section 1361(b)(1).[156] All of the provisions applicable to S corporations under Prop. Reg. 1.1400Z-2(b)-1(c)(7) apply to such S corporation to the extent that it is a QOF, or the QOF shareholder.

h. Rules Applicable to All Eligible Corporations (including C Corporations)

A distribution of property by a corporation with respect to a qualifying investment is not an inclusion event except to the extent that Section 301(c)(3) (relating to distributions in excess of basis being treated as a sale or exchange) applies to the distribution.[157] Likewise, a redemption that is treated as a distribution of property (under section 302(d)) is an inclusion amount for the full amount of the distribution.[158] However, if all of the stock of a QOF is held by a single

[151] Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(ii)(B)

[152] To be confirmed that this approach will work under the Proposed Regulations.

[153] Prop. Reg. § 1.1400Z-2(b)-1(c)(7)(iv)(A)

[154] Prop. Reg. § 1.1400Z-2(b)-1(c)(7)(iv)(B)

[155] Prop. Reg. § 1.1400Z-2(b)-1(c)(9)(ii)

[156] Prop. Reg. § 1.1400Z-2(b)-1(c)(7)(v)

[157] Prop. Reg. § 1.1400Z-2(b)-1(c)(8). Under this rule, a distribution of property will include a distribution of stock by a QOF C corporation to the extent that Section 301 is applicable, pursuant to Section 305.

[158] Prop. Reg. § 1.1400Z-2(b)-1(c)(9)(i)

shareholder, or directly by members of a consolidated group, and if shares are redeemed in a redemption that is treated as a distribution of property, then the transaction will only be treated as an inclusion event to the extent that Section 301(c)(3) (relating to distributions in excess of basis being treated as a sale or exchange) applies to the distribution.[159]

The Proposed Regulations also provide specific rules for certain extraordinary corporate transactions as follows.

- Section 381 transactions (relating to certain corporate acquisitions, including asset acquisitions) will generally not be considered inclusion events if the acquirer is a QOF immediately after acquisition,[160] subject to inclusion rules in the case of boot distributed to shareholders.[161]

- Section 355 transactions (relating to distribution of stock of controlled corporations) are also subject to special rules: (i) distribution of stock by a QOF corporation is generally considered an inclusion event with respect to its qualifying investment;[162] and (ii) to the extent that a QOF distributes stock of a controlled corporation, and after such distribution both the distributing corporation and controlled corporations are QOFs immediately after the final distribution in a qualifying Section 355 transaction, the distribution will not be treated as an inclusion event.[163] Moreover, if a Section 355 transaction results in the reduction of a QOF shareholders' "direct tax ownership" of qualifying stock, the shareholder will have an inclusion event to the extent of such reduction.[164]

- Type "E" reorganizations (a recapitalization governed by Section 368(a)(1)(E)) and Section 1036 transactions (stock for stock transactions of the same corporation) will generally not be treated as inclusion events, except to the extent of boot distributed to shareholders, or of the shareholder's equity in QOF stock is reduced.[165]

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[159] Prop. Reg. § 1.1400Z-2(b)-1(c)(9)(ii)

[160] Prop. Reg. § 1.1400Z-2(b)-1(c)(10)(i)(A)

[161] Prop. Reg. § 1.1400Z-2(b)-1(c)(10)(i)(C)

[162] Prop. Reg. § 1.1400Z-2(b)-1(c)(11)(1)(A). The amount that gives rise to such inclusion event is equal to the fair market value of the shares of the controlled corporation and the boot received by the taxpayer with respect to the qualifying investment.

[163] Prop. Reg. § 1.1400Z-2(b)-1(c)(11)(i)(B). This rule is subject to (i) meeting qualification standards as a QOF under Prop. Reg. § 1.1400Z-2(b)-1(c)(11)(B); (ii) adjustments for boot being distributed to a shareholder; and (iii) a modification of the definition to allow for controlled corporation stock to be treated as qualified opportunity zone stock.

[164] Prop. Reg. § 1.1400Z-2(b)-1(c)(11)(ii)

[165] Prop. Reg. § 1.1400Z-2(b)-1(c)(12)

- A Section 304 transaction (a redemption through the use of related corporations) will be treated as an inclusion event.[166]

2. Holding Period

The holding period for a QOF investment is also clarified by the Proposed Regulations. The holding period for a qualifying investment is subject to the following regulations: (i) the length of a time a qualifying investment has been held is determined without regard to the period which the taxpayer held property exchanged for such investment;[167] (ii) Section 1223(1) principles will apply in determining the holding period of stock acquired in a transaction for which Section 355,[168] Section 368(a)(1)(E), Section 381 or Section 1036 will apply;[169] and (iii) a tacked holding period will be applicable to persons that received qualifying investments as a gift or by reason of the prior owner's death, which was not an inclusion event.[170] The effect of these rules is to reflect that QOF property acquired in a non-recognition event (*i.e.*, the QOF property was originally acquired with eligible gains, and is then transferred in a nonrecognition transaction) will receive a tacked holding period. This is the correct result as it follows the intent of the program. Likewise, no tacked holding period arises in the event of an exchange since that transaction is not considered a gain recognition event that preceded the QOF investment.

Consistent with the foregoing rules, QOF assets acquired in Section 355 or Section 381 transaction will continue to be treated as qualified opportunity zone property, and the original use requirement follow the initial treatment for such transferred qualified opportunity zone property.[171] The Proposed Regulations also provide that the principles described in the previous sentence will also apply to partnership interests with regard to non-inclusion transactions.[172]

3. Amount of Gain Included in Income for an Inclusion Event or on December 31, 2026

In general, a taxpayer will recognize gain (with respect to the originally deferred gain) equal to the lesser of the (A) remaining deferred capital gains for the 2026 tax year; or (B) the fair market value

[166] Prop. Reg. § 1.1400Z-2(b)-1(c)(13)

[167] Prop. Reg. § 1.1400Z-2(b)-1(d)(1)(i). In other words, the taxpayer's holding period (for purposes of Section 1400Z-2) begins as of the date of the investment in the QOF, rather than the date that the taxpayer acquired the original (and since disposed of capital asset.

[168] Prop. Reg. § 1.1400Z-2(b)-1(d)(1)(iii)

[169] Prop. Reg. § 1.1400Z-2(b)-1(d)(1)(ii)

[170] Prop. Reg. § 1.1400Z-2(b)-1(d)(1)(iv) This would apply (as a result of death of the grantor) to a grantor trust that became a non-grantor trust, the near or legatee of an estate, or beneficiary of a trust.

[171] Prop. Reg. § 1.1400Z-2(b)-1(d)(2)

[172] Prop. Reg. § 1.1400Z-2(b)-1(d)(3)

of its equity investment (as of December 31, 2026), in each case reduced by any QOF basis adjustments. The QOF basis adjustment will either be 0%, 10% or 15% of the original deferred gain, depending on the taxpayer's holding period.

Specifically, the amount of gain that is included in gross income at the time of any inclusion event (or December 31, 2026) is the amount by which (i) the *lesser of* (A) the amount of gain excluded under the gain deferral rules of Section 1400Z-2(a)(1) or (B) the fair market value of the investment as of December 31, 2026 (or the date of inclusion, if different), exceeds (ii) the taxpayer's basis in the investment.[173] A taxpayer's basis in its investment for purposes of applying the inclusion rules under Section 1400Z-2 will be zero, except for adjustments with respect (i) gain inclusion of previously deferred gain or (ii) statutory basis adjustments under Sections 1400Z-2(b)(2)(B)(iii)-(iv).[174] Finally, the Proposed Regulations explicitly provide that the maximum gain that is included after the five-year and seven-year basis adjustments of Section 1400Z-2(b)(2)(B) is limited to the amount deferred under Section 1400Z-2(a)(1), less the amount of the basis adjustments allowed under Section 1400Z-2(b)(2)(B).

The Proposed Regulations provides additional detail on applying this rule in the context of partial inclusion events by adopting the following rule:

The amount of gain includible is equal to the excess of (*copied verbatim from the Proposed Regulations*):[175]

> (i) the lesser of (A) an amount which bears the same proportion to the remaining deferred gain, as (x) the fair market value of the portion of the qualifying investment that is disposed of in the inclusion event (as determined on the date of the inclusion event), bears to (y) the fair market value of the total qualifying investment before the inclusion event, or (B) the fair market value of the portion of the qualifying investment that is disposed of in the inclusion event (as determined on the date of the inclusion event); *over*
>
> (ii) the taxpayer's basis in the portion of the qualifying investment that is disposed of in the inclusion event.
>
> (iii) the fair market value of that portion (described in Prop. Reg. 1.1400Z-2(b)-1(e)(1)(i)(A)(1) is determined by multiplying the fair market value of taxpayer's qualifying investment in the QOF, valued on the date of the inclusion event, by the percentage of the taxpayer's qualifying investment that is represented by the portion disposed of in the inclusion event.

[173] Section 1400Z-2(b)(2)(A). The statute references that this rule applies to gain included under Section 1400Z-2(a)(1)(A) which relates to when gain is not included in gross income, rather than Section 1400Z-2(a)(1)(B) which provides when gain is included in income. Nonetheless, the Proposed Regulations make clear that this rule will apply to gain inclusion as of the applicable inclusion date.

[174] Section 1400Z-2(b)(2)(B)(i) and Prop. Reg. § 1.1400Z-2(b)-1(e)(3)

[175] Prop Reg. § 1.1400Z-2(b)-1(e)(1)

In many cases, the amount of gain that is includible upon the occurrence of an inclusion event is not easily determinable. As these rules provide, the lesser of rule requires taxpayers to determine the fair market value of their respective interests and will only include in income the lesser of such fair market value or the remaining deferred gain, reduced by the basis of such investment as determined under Section 1400Z-2.[176] By limiting the remaining deferred gain to the lesser of the (a) remaining deferred gain or (b) fair market value of the QOF interests as of December 31, 2026, the gain included is effectively reduced if the fair market value of the investment declines by December 31, 2026.

The inclusion rules provide a number of circumstances in which gain is recognized for property distributions;[177] in these situations, the amount of gain included in income is the lesser of (i) the remaining deferred gain or (ii) the amount that gave rise to the inclusion event.

The Proposed Regulations also issue clarifying rules which apply to gains that are deferred by S corporations or partnerships that are designed to apply the included deferred gain to the shareholders or partners (as the case may be), in proportion to their respective share of such deferred gain.[178]

Implications of the "Lesser Of" Rule

The effect of allowing taxpayers to include only the lesser of the gain or the fair market value is significant in two respects: valuation issues and recognition of loss.

First, the taxpayer must determine the fair market value of its investment as of any inclusion date or on December 31, 2026. In general, the valuation of the investment will follow the general valuation principles commonly utilized to value closely held interests.[179] The general rule articulated under prior tax rulings is to define fair market value as the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." In this context, an appraiser will almost always apply discounts for lack of control and lack of marketability of QOF interests (which will almost always be closely held business interests).

[176] Interestingly, this rule allows for taxpayers to, in effect, take a loss with respect to its investment at December 31, 2026 even though the taxpayer has not disposed of its investment and the fair market value may in fact increase in value up through the date that investment is sold or exchanged without any tax liability applicable at the time of sale.

[177] Prop. Reg. § 1.1400Z-2(b)-1(c)(8)-(12)

[178] Prop. Reg. § 1.1400Z-2(b)-1(e)(4). Note that it the "lesser of" rule applicable for paragraph (e)(3) which reduces gain inclusion to fair market value also applies to a partnership such that the gain in a fully taxable transaction would be less than the remaining deferred gain.

[179] Treas. Reg. § 1.170A-1(c)(2). See also Rev. Rul. 59-60 and Rev. Rul. 83-120. Although Revenue Ruling 59-60 (which describes the valuation of closely held business interests) was issued to value interests for purposes of estate and gift valuations, the ruling has been widely adopted by the valuation community for various tax-related purposes, and general valuation principles for non-tax purposes as well. This ruling details the specific attributes and criteria that should be used to determine the fair market value of such interests (including factors that reduce fair market value, such as lack of control and lack of marketability with respect to such interests).

The "lesser of" rule creates administrative complexity and lack of clarity as to an investor's tax liability. In order to ascertain the value (and reduce risk that the valuation is challenged by the IRS) of such interests, the taxpayer would benefit from obtaining a third-party appraisal of such interest if the value of such interest may be below the amount of the remaining deferred gain. Nonetheless, such third-party appraisal remains subject to challenge which will cause some taxpayers to overpay tax liability to avoid risk of noncompliance, and others to obtain below market valuations in order to reduce taxation. **Each inclusion event (as well as the inclusion on December 31, 2026) creates a valuation issue with respect to both the valuation of interest itself, and the size of the discounts used for lack of control and lack of marketability.**

Second, to the extent that valuation is less than the remaining deferred gain, the net result to the taxpayer is the recognition of loss with respect to the original deferred gain by the difference between the remaining deferred gain and the fair market value of the interest. Technically, the amount of gain that is included is less than it would have been (so there is no technical recognition of a loss) but the effect is that the taxpayer suffers a loss as a result of holding equity interests (in the QOF) without actually reducing the taxpayer's equity in such investment vehicle. If the investment later becomes valuable, and then sells after the ten-year holding period for a substantial return, the investor would have avoided a substantial portion of the capital gain on the original capital gain (*i.e.*, more than 15% of the original capital gain) and all of the capital gain on the disposition after ten years.

4. Adjustments to the Taxpayer's Basis in a Qualifying Investment

Section 1400Z-2 effectively maintains its own basis rules, independent of regular tax principles. The taxpayer's basis in a qualifying investment in a QOF is zero,[180] which will be adjusted as provided below:

a. To the extent that a taxpayer includes gain in income under Section 1400Z-2(a)(1)(B) and Section 1400Z-2(b)(1), the taxpayer's basis in the investment is increased by such amount of gain so included in the taxpayer's gross income.[181]

b. If a taxpayer holds a qualifying investment for at least five years, the basis of such investment is increased by an amount equal to ten percent (10%) of the original deferred gain (which gain was deferred under Section 1400Z-2(a)(1)).[182]

c. If a taxpayer holds a qualifying investment for at least seven years, the basis of such investment is increased by an amount equal to five percent (5%) of the original deferred

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[180] Section 1400Z-2(b)(2)(B)(i)

[181] Section 1400Z-2(b)(2)(B)(ii)

[182] Section 1400Z-2(b)(2)(B)(iii)

gain (which gain was deferred under Section 1400Z-2(a)(1))[183] (in addition to the 10% basis adjustment above).

d. If a taxpayer holds a qualifying investment for at least ten years, the taxpayer may elect to increase the basis to fair market value at time that the investment is sold or exchanged.[184]

The basis adjustments described above are made immediately after the amount of gain is included in income under Section 1400Z-2(b)(2)(A).[185] If such basis adjustment is made as a result of an inclusion event, the basis adjustment is made before determining other tax consequences of the inclusion event (*e.g.*, determination of distribution in excess of basis).[186]

A special rule is applicable to gains resulting from a ***distribution in excess of basis*** (for corporations, partnerships and S corporations).[187] Specifically, the rule provides in the event of a distribution, any portion of which results in gain resulting from a distribution in excess of basis (determined without regard to a basis adjustment resulting from an inclusion event), (a) such gain is treated as an inclusion event[188] and (b) the taxpayer increases its basis in the qualifying investment before determining the tax consequences of the distribution.[189] The amount of any basis adjustment described in this section will only apply to that portion of the qualifying investment that has not previously been subject to gain inclusion.[190]

The Proposed Regulations contain additional provisions to reflect rules consistent with the foregoing to apply to partnerships[191] and S corporations, S corporation shareholders and a QOF S Corporation.[192] In the case of partnerships, the normal rules of subchapter K are followed under the Proposed Regulations such that debt basis is added to determine the partner's adjusted basis in its partnership interest.[193]

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[183] Section 1400Z-2(b)(2)(B)(iv)

[184] Section 1400Z-2(c)

[185] Prop. Reg. § 1.1400Z-2(b)-1(g)(1)(i) (first sentence)

[186] Prop. Reg. § 1.1400Z-2(b)-1(g)(1)(i)(second sentence)

[187] Prop. Reg. § 1.1400Z-2(b)-1(g)(1)(ii)

[188] As determined under Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(iii) and Prop. Reg. § 1.1400Z-2(b)-1 (c)(7)-(12)

[189] Prop. Reg. § 1.1400Z-2(b)-1(g)(1)(ii)(A)-(B). See Prop. Reg. § 1.1400Z-2(b)-1(g)(1)(ii)(C) for an example illustrating the application of this rule.

[190] Prop. Reg. § 1.1400Z-2(b)-1(g)(2)

[191] Prop. Reg. § 1.1400Z-2(b)-1(g)(3)

[192] Prop. Reg. § 1.1400Z-2(b)-1(g)(4)

[193] Prop. Reg. § 1.1400Z-2(b)-1(g)(3)(i)

With respect to S corporation shareholders, two modifications are applied:

1. An adjustment to basis of an S corporation's qualifying investment (with regard to the five-year basis adjustment, seven-year basis adjustment or basis adjustment at disposition following a ten-year holding period) (i) will not be separately stated (as provided by Section 1366) or (ii) adjust the shareholder's stock under Section 1367, until the date that an inclusion event occurs with respect to the S corporation's qualifying investment; and

2. Basis adjustments made as a result of an inclusion event are made before determining other tax consequences of such inclusion event.[194]

5. Notification Requirements for Pass-Through Entities

Partnerships are required to notify partners of the partnership's deferral election and the partner's share of the eligible gain in accordance with the applicable forms and instructions. Importantly, the partner is also required to notify the partnership, in writing, of its deferral election, including the amount of the eligible gain deferred.[195] If an indirect owner of a QOF partnership or QOF S corporation sells a portion of its partnership interests or shares that result in certain inclusion events,[196] such indirect owner must notify the QOF owner sufficient to enable the QOF owner to recognize an appropriate amount of gain.[197] A QOF partner must also notify a QOF of an election made by such partner under Section 1400Z-2(c) to adjust the basis of a qualifying QOF partnership interest that is disposed of in a taxable transaction.[198]

A partner must notify the QOF of various tax items including the eligible gain that is deferred, when an investment is sold or exchanged and if an election made under Section 1400Z-2(c). It does not appear, however, that a partner must notify the partnership if a transaction occurs that gives rise to an inclusion event (nor must the partner notify the partnership of the amount of gain recognized on December 31, 2026). There are several key implications from this inconsistent set of rules. First, the partner has obligations that will be required for the partnership to file its tax return. This may cause errors, delays or amendments to such tax return. Second, the partnership is required (irrespective of a Section 754 election) to make inside basis adjustments with respect to a disposition and election made under Section 1400Z-2(c). The partnership will therefore incur time and expense to comply with the regulatory regime on behalf of any such partner. Such partnership may consider requiring that such partner bear the cost of this additional work in its

[194] Prop. Reg. § 1.1400Z-2(b)-1(g)(4)(i)(B)

[195] Prop. Reg. § 1.1400Z-2(b)-1(h)(1). Partners are not generally given very many obligations to provide a partnership with timely information required for tax compliance purposes (indeed, even information or Section 743 adjustments made as a result of a Section 754 election may be provided late).

[196] As provided in Prop. Reg. § 1.1400Z-2(b)-1(c)(6)(iv) (relating to mixed fund investments) or (c)(7)(iii)(relating to aggregate changes in S corporation equity ownership).

[197] Prop. Reg. § 1.1400Z-2(b)-1(h)(2)

[198] Prop. Reg. § 1.1400Z-2(b)-1(h)(3)

partnership agreement. Third, since a partner is not obligated to provide information relating to inclusion events or gain recognized in December 31, 2026, failing to provide such information will prevent the partnership from making any inside basis adjustment with respect to such items if such adjustments are appropriate.

Similar rules to those applicable to partnerships will apply to S corporations.[199]

E. Gain Recognition for Investments Held at Least Ten Years

1. Gain or Loss Upon Disposition after 10 Years

Section 1400Z-2(c) provides that if a taxpayer makes an election with respect to a qualifying investment held for at least ten years, the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged. **There is no limit to the amount of gain that can be excluded as a result of this rule.** The basis adjustment under Section 1400Z-2(c) is only applicable to that portion of an investment in a QOF for which a gain deferral election was made.[200] Thus, in the case of a mixed-funds investment, a portion of the gain would be tax free under this section, with the remaining portion treated as being disposed of in a taxable transaction. If the disposition after 10 years resulted in a loss, a taxpayer would not make the election since by making such election, the taxpayer's loss would be reduced to zero.

It was unclear under the statute how the step up in basis upon disposition of a qualifying investment after the cessation of the qualified opportunity fund program would be treated. The much needed clarification in the Proposed Regulations provides that the ability to make an election under Section 1400Z-2(c) (to step up the basis of a qualifying investment at disposition) may be made until December 31, 2047.[201] Thus, a QOF owner will have until December 31, 2047 to dispose of its investment (or the QOF will have until such date to dispose of property and make the election under Prop. Reg. § 1.1400Z-2(c)-1(b)(2).

Unlike the rule for gains eligible for capital gains deferral which require a sale to an unrelated party, no such related party rule exists for the sale after 10 years. Accordingly, subject to ordinary gain inclusion rules (*e.g.*, Section 1239 and 707(b)(2)), a taxpayer may be able to structure the sale of their QOF interests to a related party after 10 years such that the seller would have no tax on the gain, and the related party buyer receives a stepped up basis in the acquired property.

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[199] Prop. Reg. § 1.1400Z-2(b)-1(h)(4)

[200] Prop. Reg. § 1.1400Z-2(c)-1(a) citing Section 1400Z-2(e)(1)(B) [**is this now (c) instead of (a)?**

[201] Prop. Reg. § 1.1400Z-2(c)-1(b) (**what is the correct citation now?)**

Planning Tip

Subject to ordinary gain inclusion rules (*e.g.*, Section 1239 and 707(b)(2)), a taxpayer may be able to structure the sale of their QOF interests to a related party after 10 years such that the seller would have no tax on the gain, and the related party buyer receives a stepped up basis in the acquired property.

2. Basis Step Up at Disposition (to Eliminate Gain Upon a Sale or Exchange)

There are three approaches that are contemplated under the Statute and Proposed Regulations to obtain tax-free treatment under Section 1400Z-2(c):

First, in the manner generally described in the statute, if the taxpayer sells or exchanges a qualifying investment that it has held for at least ten years, the taxpayer may make the Section 1400Z-2(c) election (which will allow the taxpayer to step up the value of its investment to fair market value).[202] However, this election only applies to the sale or exchange of its investment.[203] In many cases involving pass-through entities, the underlying assets of the QOF would be sold rather than each equity holder selling its interests. Thus, without the special rules adopted by the Proposed Regulations (described below), in order to obtain the tax benefits of the basis step up, the taxpayer would need to liquidate the investment entity in the same tax year as the gain is recognized to obtain the tax-free treatment. Moreover, this would result in the taxpayer reflecting significant gain and significant loss in the same year. These extra steps or reporting positions cause unnecessary complexity and potential for noncompliance.

Second, the Proposed Regulations provide an alternative approach. The QOF is required to adjust the basis of partnership assets if the QOF partner's basis is adjusted as a result of a Section 1400Z-2(c) election.[204] Addressing the issues raised above with the statutory framework, Prop. Reg. 1.1400Z-2(c)-1(b)(2)(i) provides that a QOF shall adjust the basis of partnership assets in a manner similar to a Section 743(b) adjustment (which generally applies to adjust the basis of partnership assets upon the sale or exchange of partnership interests assuming a Section 754 election was in place or the death of a partner) if such partner has disposed of its investment and made the election.[205] This section applies without regard to the amount of deferred gain that was included

[202] Prop. Reg. § 1.1400Z-2(c)-1(b)(1)(i)

[203] Since this election applies solely to an investment, a number of issues are present that could potentially disrupt the legislative intent to cause such a sale (in the manner contemplated under the statute) to be tax-free: First, it is not clear whether a liquidation would be treated as a sale or exchange of the qualifying investment. In many cases, an underlying partnership will sell its assets, distribute the net cash proceeds to its partners, and then liquidate. Second, if the election is made upon disposition, and the disposition is deemed to occur after final distributions in a liquidation, the step up in basis as a result of the election would be zero.

[204] Prop. Reg. § 1.1400Z-2(c)-1(b)(2)

[205] Since this rule is likely to be interpreted as expanding the statutory regime, it is only applicable after the final regulations with respect to Section 1400Z-2(c) are adopted. See Prop. Reg. § 1.1400Z-2(c)-1(f)

in income or the timing of such inclusion event. Note that Prop. Reg. § 1.1400Z-2(c)-1(d)(2)(ii) (Example 2) reflects that no gain will be recognized when such election is made even if a portion of the gain included in a partner's distributive share is attributable to the disposition of Section 751(c) property (unrealized receivables) that are taxed at ordinary gains rates. Note the distinction between the result under this approach (ordinary income is eliminated) and the use of the election described below (in which only capital gains are excluded from income). This rule underscores the importance of a partner notifying the partnership of its election so that the basis adjustment is properly made.

Third, the Proposed Regulations provide for an election in the event of an asset sale. If a taxpayer has held a qualifying investment in a pass-through entity for at least ten years, and such QOF partnership or QOF S corporation disposes of qualifying property after the ten year holding period, the taxpayer may make an election to exclude the capital gains arising from such disposition as reported on Schedule K-1 and attributable to the qualifying investment (the "Asset Sale Election").[206] A taxpayer may also make such an election with respect to any separately stated item. The foregoing election (to exclude gain) may only be made with respect to net Section 1231 gain for a taxable year to the extent of net gains from such QOF entity and not with respect to all positive Section 1231 gains.

Note that this election only applies to the disposition of "qualified property". Since a portion of a QOF's property may not be qualified, an investor may have some gain following an asset sale (with respect to the gain attributable to the nonqualified property) if the election is made. Likewise, this election applies only to capital gains. A disposition of assets by a QOF that includes ordinary income assets will therefore result in taxable income when a similar disposition of the equity interests will not result in gains.[207]

Planning Tip

There will be, in many QOF transactions, a strong incentive to structure the disposition as a sale of the investment rather than an asset sale in order to avoid ordinary income. For example, the disposition of assets that include accounts receivables, depreciated personal property or certain ordinary income property (which is the case with most operating businesses) would be tax-free if the equity in the investment is sold, but the gain attributable to such items would be *fully taxable at ordinary income rates* if the Asset Sale Election is utilized instead.

3. Making the Election upon Disposition Following Ten Year Holding Period

An election made under Prop. Reg. 1.1400Z-2(c)-1(b)(2)(A)(1) will be valid if it is made, consistent with applicable forms and instructions, for the taxable year in which capital gains are

[206] Prop. Reg. § 1.1400Z-2(c)-1(b)(2)(ii)

[207] The important of this rule cannot be understated. A taxpayer with an improperly structure sale will be in a "world of hurt"

recognized from the sale or exchange of QOF property recognized by the QOF partnership or S corporation.[208] The excluded gain is excluded for all purposes of the Code, but will be treated as an item of income for purposes of Section 705(a)(1) or Section 1366 (relating to the determination of basis for partnerships and S corporations, respectively).[209]

4. Treatment of Gains by a QOF REIT

Similar to the election available for investors in a pass-through entity, a shareholder of a QOF REIT that receives a capital gains dividend identified with a date (to the extent that the shareholder's shares in the QOF REIT are a qualifying investment) (i) may treat the applicable capital gains dividend as gain from the sale or exchange of a qualifying investment on the date identified; and (ii) has held such qualifying investment in the QOF REIT for at least ten years, the shareholder may apply a zero percent capital gains rate to the capital gains dividend.[210] A capital gains dividend identified with a date means (a) the amount of capital gains dividend (as defined in Section 857(b)(3)(B)) and (b) a date that the QOF REIT designates in a notice provided to the shareholder not later than one week after the QOF REIT designates the capital gain dividend pursuant to Section 857(b)(3)(B).[211]

Additional rules apply in the case of QOF REITs that provide (i) there is no identification permitted if there are no capital gains from the disposition of qualifying property;[212] (ii) designations of capital gains dividends identified with a date must be proportionate for all dividends paid with respect to the taxable year;[213] (iii) undistributed capital gains may be identified with a date for purposes of excluding gain from income for the taxable year;[214] and (iv) the amount of capital gains determined under these rules is determined without regard to any losses that may have been realize on other sales or exchanges of qualified opportunity zone property (but such identified gains may be limited by the aggregate capital gains dividends that may be designated under Section 857(b)(3)).[215] A QOF REIT has two choices in determining the amount of gain with a date that may be identified: (a) the QOF REIT may identify the first day of the taxable year as the date

[208] Prop. Reg. § 1.1400Z-2(c)-1(b)(2)(ii)(B). No such instructions have yet been issued.

[209] Prop. Reg. § 1.1400Z-2(c)-1(b)(2)(ii)(C)

[210] Prop. Reg. § 1.1400Z-2(c)-1(e)

[211] Prop. Reg. § 1.1400Z-2(c)-1(e)(2). The notice must be mailed to the shareholder unless the shareholder has provided the QOF REIT with an email address to be used for such purposes. Moreover, the QOF REIT must provide the IRS with the data specified by the IRS with respect to the amounts and dates of capital gains dividends designated by the QOF REIT for each shareholder.

[212] Prop. Reg. § 1.1400Z-2(c)-1(e)(3)(i)

[213] Prop. Reg. § 1.1400Z-2(c)-1(e)(3)(ii)

[214] Prop. Reg. § 1.1400Z-2(c)-1(e)(3)(iii)

[215] Prop. Reg. § 1.1400Z-2(c)-1(e)(3)(iv)

identified with each designated amount for that taxable year;[216] or (b) the QOF REIT may use the latest date of each transaction (from latest to earliest) on an iterative basis until all capital gains are identified with dates or there are no earlier date sin which the QOF REIT realized long term capital gains.[217]

F. Qualified Opportunity Funds

The vehicle that is used under the opportunity zone program to provide for reinvestment into low income communities and allow for tax benefits investors is the "qualified opportunity fund" or "QOF". Section 1400Z-2(d)(1) provides that the term "qualified opportunity fund" means any investment vehicle which is organized as a corporation or partnership for the purposes of investing in QOZP (other than another qualified opportunity fund) that holds at least 90 percent of its assets in QOZP. The 90 percent test is determined by the average of the percentage of the QOZP held by the QOF as measured (A) on the last day of the first six month period of the taxable year of the QOF, and (B) on the last day of the taxable year of the QOF.

In effect, the statutory framework creating the "qualified opportunity fund" created a binary choice between a structure based on a (A) QOF holding QOZBP or a (B) QOF holding QOZ stock or QOZ partnership interest, which must be qualified as a qualified opportunity zone business or QOZB. Note that the term "qualified opportunity zone business property" is distinct from the term "qualified opportunity zone business". ***In most cases, the two-tier structure that is structured as a QOZB is preferable. As we will address below, this approach "wins" in most cases since it allows for a QOF to hold cash and financial assets for 2 ½ years instead of only 6 months and requires that only 70% (instead of 90%) of the underlying assets be treated as QOZBP.***

As provided in the statute, in order to be considered a QOF, such entity must satisfy 4 requirements: (i) be organized as a corporation or partnership; (ii) for the purposes of investing in QOZP; (iii) that holds at least 90 percent of its assets; (iv) in QOZP.

1. General Requirements of a QOF.

a. Treatment of Entity as Partnership or Corporation

The first requirement to be considered a QOF is that the entity must be organized as a corporation or partnership for federal tax purposes. The IRS has clarified that a limited liability company that is treated as a partnership or corporation for federal tax purposes will qualify as a QOF.[218] An

[216] Prop. Reg. § 1.1400Z-2(c)-1(e)(4)(i). Note that if a QOF REIT identifies an amount that exceeds the aggregate long term capital gains realized on such sales or exchanges for that taxable year, the the designated identification is invalid in its entirety.

[217] Prop. Reg. § 1.1400Z-2(c)-1(e)(4)(ii)

[218] https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions. In general for federal income tax purposes, the term partnership or corporation generally refers to any entity that is treated as a corporation or partnership (as the case may be) for federal income tax purposes, which would refer to any entity that is so eligible

entity that is disregarded for income tax purposes (*e.g.*, a single member LLC), however, will not be treated as a partnership or corporation and is therefore not eligible to be a QOF (nor is a disregarded entity eligible to be a QOZ partnership interest or QOZ stock). Likewise, the Proposed Regulations reflect that the federal tax treatment of a corporation or partnership will govern such that the following entities are explicitly described as QOFs under the Proposed Regulations: S corporations,[219] REITs, RICs and foreign corporations organized in a US possession. The determination of an entity as a partnership or corporation for federal income tax purposes (such that such entity is required to file a tax return reflecting such tax treatment) will be sufficient for QOF status.

Under the Proposed Regulations, only entities that are organized in one of the 50 states, the District of Columbia, or the US Possessions are eligible to be treated as a QOF.[220] The same requirements requiring a domestic entity apply in the case of QOZ partnership interests and QOZ stock.[221]

b. . . . Formed for the Purpose of Investing in Qualified Opportunity Zone Property

The second requirement to be a QOF provides that an entity that desires to be a QOF must be formed for the purpose of investing in QOZP.[222] This rule manifests itself by requiring a number of specific requirements under the Code and Proposed Regulations. First, a QOF must self-certify as a QOF by filing Form 8996 with their annual tax return[223] in which the QOF (i) identifies the first taxable year that the eligible entity desires to be treated as a QOF;[224] and (ii) identifies the first month the QOF in which the eligible entity wants to be treated as a QOF.[225] ***If an investment is made in an eligible entity that will be treated as a QOF, prior to the date that the QOF elects to be treated as a QOF, such investment will not be eligible for gain deferral (and such portion of the investment in the eligible entity will be a non-qualifying investment).***[226] The self-

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to be treated as either a corporation or partnership including, without limitation, a general or limited partnership, limited liability company, business trust, real estate investment trust, regulated investment company, etc.

[219] See *e.g.*, Prop. Reg. § 1.1400Z-2(b)-1(a)(2)(xiv)(defining "QOF S corporation"); Prop. Reg. § 1.1400Z-2(c)-1(e)

[220] Prop. Reg. § 1.1400Z-2(d)-1(e)) If a QOF is organized in a US Possession, it must be formed for the purpose of investing in qualified opportunity zone property that relates to a trade or business operated in the US Possession in which the entity was formed.

[221] Prop. Reg. § 1.1400Z-2(d)-1(e)(2)

[222] Section 1400Z-2(d)(1)

[223] Prop. Reg. § 1.1400Z-2(d)-1(a)(1)(i)

[224] Prop. Reg. § 1.1400Z-2(d)-1(a)(1)(ii)

[225] Prop. Reg. § 1.1400Z-2(d)-1(a)(1)(iii). If a QOF fails to identify its first month, the first month of the eligible entity's taxable year will be the first month that the eligible entity is a QOF.

[226] Prop. Reg. § 1.1400Z-2(d)-1(a)(1)(iii)(B). If an investor invests in an entity prior to the date it elects to be treated as a QOF, and remains within the 180 day period, to avoid the risk that such investment is not treated as an eligible

certification is made by filing Form 8996 in which the required information is provided to the Commissioner.

Second, the QOF must certify on Form 8996 that by the end of the taxpayer's first qualified opportunity fund year, the taxpayer's organizing documents include a statement of the entity's purpose of investing in QOZP and the description of the QOZB.[227] The term "organizing documents" is not defined. However, both organization or incorporation documents and partnership/operating agreements are often considered to be "organizing documents". Accordingly, in the absence of further guidance, taxpayers should include such language in both the state organizational documents and the QOF's operating agreement (or comparable agreement for the respective type of entity).

Planning Tip

Accordingly, in the absence of further guidance, taxpayers should include such language in both the state organizational documents and the QOF's operating agreement (or comparable agreement for the respective type of entity).

Third, in light of the purpose requirement, a pre-existing entity (*i.e.*, an entity that existing prior to the enactment of the opportunity zone legislation) is expressly permitted to be a QOF, but the eligible entity must satisfy all of the requirements of Section 1400Z-2, including the requirements regarding QOZP, as defined in Section 1400Z-2(d)(2) (particularly, that the property must be acquired after December 31, 2017).[228]

c. NINETY PERCENT (90%) ASSET TEST

Section 1400Z-2(d)(1) provides that a QOF must hold at least 90 percent of its assets in QOZP. Section 1400Z-2(d)(2)(A) provides that QOZP means property which is (i) QOZBP; (ii) QOZ stock; or (iii) QOZ partnership interest. If an eligible entity self-certifies as a QOF for a month other than the first month of the taxable year, for purposes of the 90 percent testing requirements: (i) the phrase "first 6-month period of the taxable year" of the fund means (i) the first 6 months of the taxable year in which the eligible entity is a QOF or (ii) if the taxable year ends prior to 6 months after the eligible entity is formed, then on the last day of its taxable year. Thus, if an eligible entity becomes a QOF in seventh month or later in the taxable year, then the 90 percent test of Section 1400Z-2(d)(1) takes into account only the QOF's assets on the last day of the taxable year;[229] and (ii) the computation of any penalty under Section 1400Z-2(f)(1) does not take into

investment as of the election date, the cash invested should be treated as a loan that is then converted to equity at the time that the entity elects to be treated as a QOF.

[227] IRS Form 8996, Part I. The Form does not contemplate a situation in which a QOF owns an interest in more than one QOZB. Nonetheless, there are no restrictions to invest in more than one QOZB in the statute or the Proposed Regulations and such investment should be permitted.

[228] Prop. Reg. § 1.1400Z-2(d)-1(a)(3)

[229] Prop. Reg. § 1.1400Z-2(d)-1(a)(2)(i)

account any month before the month that the eligible entity becomes a QOF.[230] The testing date rules are illustrated in the below chart (for calendar year entities):

Month Entity Elects to be QOF	1st Testing Period	2nd Testing Period
January	June 30	December 31
April	September 30	December 31
September	December 31	June 30 of the following year

Under the applicable forms and instructions, Form 8996 provides the mechanism by which the 90% test is measured. Under these rules, the test measures simply the average of the percentage for the first testing period, and the percentage of the second period. So long as the average of these two percentages is greater than 90%, no penalty will apply. The penalty is computed if the average is below 90%. Note that the asset base for each period is not relevant in making this determination.

The Proposed Regulations provide two choices to determine the valuation of assets for purposes of this rule. The general rule provides that the value of owned or leased tangible property is valued under either the applicable financial statement valuation method[231] or the alternative valuation method (please note that the chosen method must be consistent within each taxable year but may be changed for each separate taxable year).[232]

The applicable financial statement valuation method provides that the entity will use, for purposes of valuing the tangible property for the 90% test, the value set forth on such entity's applicable financial statement (within the meaning of §1.475(a)-4(h)).[233]

Under the alternative valuation method (i) the value of tangible property that is owned by the QOZB is the unadjusted cost basis of the property under Section 1012 in the hands of the QOZB for each testing date of a QOF during the taxable year; and (ii) the value of tangible property that is leased by the QOZB is equal to the present value of the leased tangible property.[234] The present value of the leased tangible property (1) is equal to the sum of the present values of each payment under the lease for such property; (2) is calculated at the time that the QOZB enters into the lease for such leased tangible property; and (3) once calculated, is used as the value for such asset by the QOZB for all testing dates for purposes of the 90-percent asset test. The discount rate used for these purposes is the discount rate set forth in Section 1274(d)(1) (by substituting the term

[230] Prop. Reg. § 1.1400Z-2(d)-1(a)(2)(ii)

[231] See Prop. Reg. § 1.1400Z-2(d)-1(b)(2)(ii). A QOF may select the applicable financial statement valuation method to value an asset leased by the QOF only if the applicable financial statement of the QOF is prepared according to U.S. generally accepted accounting principles (GAAP) and requires an assignment of value to the lease of the asset.

[232] Prop. Reg. § 1.1400Z-2(d)-1(b)(1)

[233] Prop. Reg. § 1.1400Z-2(d)-1(b)(2). The "applicable financial statement" method may only be used if such applicable financial statement requires, or would otherwise require, an assignment of value to the lease of tangible property.

[234] Prop. Reg. § 1.1400Z-2(d)-1(b)(3)

"lease" for "debt instrument"). The lease term used for these purposes is the lease term including extensions which contain a pre-defined rent.[235]

The Proposed Regulations also provide a taxpayer-friendly rule that allows a QOF to disregard contributions made during the six month period following such contribution.[236] Under this rule, a QOF may choose to disregard property contributed during the prior six month period by excluding such amounts from both the numerator and denominator of the applicable test, so long as (A) the property was received by the (i) QOF partnership as a contribution or (ii) QOF corporation solely in exchange for stock of the corporation;[237] (B) the contribution or exchange occurred not more than six months before the test from which it is excluded;[238] and (C) the amount of the contribution was held in cash, cash equivalents or debt instruments with a term of 18 months or less.[239] Importantly, the QOF does not need to be consistent from one semi-annual test to the next if it uses this six-month exception option.[240]

The effect of this rule is to allow for a QOF that operates its business through directly owned QOZBP to hold cash for up to six months without being treated as failing to hold QOZ property. A QOZB does not need to utilize this rule since it may avail itself of the 31 month working capital safe harbor (described in more detail below).

Section 1400Z-2(e)(4)(B) authorizes Treasury to issue regulations to ensure that a QOF has a reasonable amount of time to reinvest the return of capital from qualified investments and to reinvest proceeds from the sale or disposition of QOZP. The Proposed Regulations provide that a QOF will have 12-months to reinvest such proceeds (beginning on the date of the respective distribution, sale or disposition) in QOZP, without running afoul of the 90% asset test.[241] Under this rule, the proceeds must be held in cash, cash equivalents or debt instruments with a term of 18 months or less. As with the working capital safe harbor, if reinvestment of the proceeds is delayed due to waiting for governmental action (so long as the application has been completed with respect to such action) such delay does not cause a failure of the 12-month reinvestment requirement.

The Proposed Regulations provide a special rule that treats certain property as QOZBP even if it is in transit to or from a QOZ. A business may own tangible property that is in transit to a QOZ. To avoid such property being treated as non-qualifying property (since it is not physically in the opportunity zone while it is in transit), the Proposed Regulations provide a safe harbor such that:

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[235] The term "pre-defined rent" is not defined. Presumably, this may include either a fixed, stated rent or a rent determined by formula.

[236] Prop. Reg. § 1.1400Z-2(d)-1(b)(4)

[237] Prop. Reg. § 1.1400Z-2(d)-1(b)(4)(A)

[238] Prop. Reg. § 1.1400Z-2(d)-1(b)(4)(B)

[239] Prop. Reg. § 1.1400Z-2(d)-1(b)(4)(C)

[240] Prop. Reg. § 1.1400Z-2(d)-1(b)(4). Since the QOF may choose whether or not to include the recently contributed cash or exclude it, the selection o include or exclude such assets will not bind the QOF in the subsequent testing period.

[241] Prop. Reg. § 1.1400Z-2(f)-1(b)

(i) inventory (including raw materials) of a trade or business does not fail to be used in a QOZ solely because the inventory is in transit (A) from a vendor to a facility of the trade or business that is in the opportunity zone; or (B) from a facility of the trade or business that is in the QOZ to customers of the trade or business that are not located in the QOZ.[242]

It is not clear how the "in transit" rule will be applied to a company that is considered to be a drop shipper (such that the business will have legal ownership of property at the time of delivery) which would mean that the products are never actually titled and owned in the QOZ. If such a business is a drop shipper located in a QOZ, its inventory will be shipped from a third party (likely not in a QOZ) to its customer (also likely not in a QOZ). The challenge with a drop shipper is that the business is effectively an intermediary between the seller and end user and the ownership of such property by a QOF until title is transferred to the end user could cause a QOF to fail the percentage tests since the property in transit is likely not being transferred from a QOZ to a non-QOZ customer. Nonetheless, a business that engages in drop shipping is not necessarily trying to avoid the QOZ rules; rather many subcontractors and distributors are drop shippers with respect to inventory and personal property that are sold to customers.

2. Operating a QOF (Directly or Through a Qualified Opportunity Zone Business)

As noted above, a QOF will be operated either through a QOF holding 'qualified opportunity zone business property' directly, or more likely, by owning QOZ stock or QOZ partnership interest that in turn operates as a 'qualified opportunity zone business' (which incorporates the rules applicable to qualified opportunity zone business property). The mechanics of these requirements are discussed below.

a. Qualified Opportunity Zone Business Property

The term "qualified opportunity zone business property" means tangible property used in a trade or business of the qualified opportunity fund if the following requirements are satisfied:

1. ***Acquisition Test.*** Such property was acquired by the QOF by purchase (as defined in Section 179(d)(2)) after December 31, 2017;

2. ***Original Use or Substantial Improvement Test***. The original use of the property in the QOZ commences with the QOF or the QOF substantially improves the property; and

3. ***Substantially All Test(s)***. During *substantially all* of the QOF's holding period for such property, *substantially all* of the use of such property was in a QOZ.[243]

[242] Prop. Reg. § 1.1400Z-2(d)-1(c)(4)(iii)

[243] Section 1400Z-2(d)(2)(D)

Tangible property used in a trade or business of a QOF is QOZBP if the requirements set forth below are satisfied: [244]

i. Acquired by Purchase (or Lease)…

The first test is that the property must be acquired *by purchase* after December 31, 2017. In this regard, the term "purchase" means any acquisition of property, but only if (A) the property is not acquired from a related party (as defined in Section 267 or Section 707(b));[245] (B) the property is not acquired by one component member of a controlled group from another component member of the same controlled group, and (C) the basis of the property in the hands of the acquiring party is not determined (i) in whole or in part by reference to the adjusted basis of the transferring party or (ii) under Section 1014 (relating to property acquired from a decedent). Moreover, the Proposed Regulations add the requirement (which is already implicit by reference to Section 179(d)(2)) that the property must be acquired from an unrelated party (within the meaning of Section 1400Z-2(e)(2) and which defines related party by reference to Section 267 and Section 707(b), by substituting "20 percent" for "50 percent" each place in which it appears).[246]

There are no statutory restrictions on acquiring leasehold interests in property (including from a related party). The Proposed Regulations provide much broader latitude in obtaining leasehold interests in property as compared to acquiring property by purchase. To that end, the Proposed Regulations effectively allow nearly all leased property to be treated as QOZP, subject to certain limitations to avoid abusive transactions. Below are the rules (and limitations) for acquiring property so that it will be treated as QOZP:

1. The leased property acquired by the QOF must be pursuant to a lease entered into after December 31, 2017.[247]

2. The terms of the lease must be market rate (reflecting common, arms-length market practice in the locale that includes the QOZ as determined under Section 482) at the time that the lease was entered into.[248]

3. If the lessee and lessor are related parties, the (i) the lessee cannot at any time make any prepayment under the lease relating to a period of use that exceeds 12 months; and (ii) if the original use of the property in QOZ[249] does not commence with the lessee, the property

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[244] As set forth in Prop. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(A) through (E) are satisfied.
[245] Section 179(d)(2)(A). For purposes of applying the related party rules under Section 267 for purposes of this rule, in applying Section 267(b) and (c), paragraph 4 of Section 267(c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors and lineal descendants.

[246] Prop. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(A)

[247] Prop. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(B)(1)

[248] Prop. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(B)(2)

[249] Within the meaning of Prop. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(B)(6)

is not QOZBP unless, during the relevant testing period,[250] the lessee becomes the owner of tangible property that is QOZBP having a value not less than that leased tangible property. Under this rule, there must be substantial overlap of the zones in which the owner of the property so acquired uses it and the zones in which that person uses the leased property.[251] The effect of this rule is to prohibit a party that uses non-qualified property in a QOZ to effectively convert it to QOZP by leasing the same property to a related party without otherwise satisfying the qualified property rules. By requiring that such related party must own property with at least the same value as under the related party lease, it reflects that the related party is meeting the intent of the program to reinvest in the QOZ.

Planning Tip

Subject to certain anti-abuse provisions, a QOF may lease property (including real property) from a related party and meet the requirements of the QOZ program. Although complicated, this approach may be necessary to allow a party with preexisting land holdings to benefit from the QOZ tax benefits.

ii. Original Use or Substantial Improvement of Tangible Property Requirement

The second test requires that either (i) the original use of tangible property will commence with the QOF or that such property is substantially improved by the QOF (or the QOZB).

(1) Original Use

If the original use of tangible property commences with the QOF under Section 1400Z-2(d)(2)(D), such property will meet the test to be treated as QOZBP (subject to the acquisition rules in addition to the holding period and usage requirements).

Under the Proposed Regulations, a haphazard (and not particularly well organized) list of rules apply to determine whether property satisfies the original use requirement.

General Rule (Placed in Service Requirement). For this purpose, the original use of tangible property in a QOZ commences on the date that any person first places property in service in the QOZ for purposes of depreciation and amortization (or first uses it in a manner that would allow depreciation or amortization if that person was the property's owner).[252]

[250] As defined in Prop. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(B)(7), which is generally the 30 month period beginning on the date that the lessee receives possession of property under the lease and ends the earlier of the date that is 30 months after the date that the lessee received possession, or the last day of the term of the lease.

[251] Prop. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(B)(5)

[252] Prop. Reg. § 1.1400Z-2(d)-1(c)(7)

Used Property. Used tangible property satisfies the original use requirement if the property has not been previously so used or placed in service in the QOZ (if it had been so used, it must be substantially improved in order to be treated as QOZBP).

In light of these rules, a QOF business could fail this standard if it acquires used equipment that will not be substantially improved. Although most businesses use new equipment, certain businesses utilize used equipment (*e.g.*, heavy construction equipment, vehicles, restaurant equipment) to save costs. Such businesses should examine their proposed business plan in light of the QOF rules.

Vacant Property. If the property has been unused or vacant for an uninterrupted period of at least five years, original use in the zone commences on the date after the period when any person first uses or places the property in service in the QOZ (within the meaning of the preceding paragraph).[253]

Leased Property. The improvements made by a lessee to leased property satisfy the original use requirement as purchased property for the amount of unadjusted cost basis under Section 1012 of such improvements.[254]

Property Leased to a Related Party. For the purposes of the rule requiring a related party to own property of at least equal value to certain property leased from a related party, the original use of the leased tangible property in the opportunity zone commences on the date that any person first places the property in service in the QOZ for the purposes of depreciation or amortization (or first uses it in a manner that would allow depreciation and amortization if the person was the property's owner).[255]

Leased Real Property. In the case of real property (other than unimproved land) that is leased by a QOF, if, at the time that the lease was entered into, there was a plan, intent or expectation for the real property to be purchased by the QOF for an amount of consideration other than the fair market value of the real property (determined at the time of purchase without regard to prior lease payments), the leased real property is not treated as QOZBP.[256]

(2) Substantial Improvement

In general, to qualify as QOZBP, such property must be substantially improved by the QOF.[257] Property is treated as substantially improved by the QOF only if, during the 30 month period beginning after the date of acquisition of such property, additions to basis with respect to such

[253] Second sentence of Prop. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(B)(6)

[254] Prop. Reg. § 1.1400Z-2(d)-1(c)(7)(ii)

[255] First sentence of Prop. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(B)(6)

[256] Prop. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(E)

[257] Section 1400Z-2(d)(2)(D)(i)(III)

property in the hands of the QOF exceed an amount equal to the adjusted basis of such property at the beginning of such 30 month period.[258] However, if a QOF purchases a building located on land wholly within a QOZ, a substantial improvement to the purchased tangible property is measured by the QOF's adjusted basis to the building.[259] For purposes of measuring whether the QOF meets the substantial improvement test, the QOF is not required to separately substantially improve the land upon which the building is located.[260]

This rule is illustrated in Rev. Rul. 2018-29 by describing a situation in which a QOF acquires property for \$800K (located wholly in a QOZ) which consists of land (valued at \$480K) and a vacant factory (valued at \$320K).[261] Over the following 24 months, the QOF invests \$400K to convert the building to a residential rental property. The ruling held that the substantial improvement is measured solely by the additions to the basis of the building and not the land, and that the foregoing example met the substantial improvement test. The fact that no improvements were made to the land reflects the rule that a QOF is not required to separately substantially improve the land upon which the building is located. Unimproved land that is within a QOZ and acquired by purchase is not required to be substantially improved.[262] Rather, the land will be treated as QOZBP immediately (so long as the other requirements under the QOZ program are satisfied).

iii. Substantially All

The third test for property to be treated as QOZBP is that during substantially all of the QOF's holding period for such property, substantially all of the use of such property was in a QOZ.[263]

Be aware that this rule contains two different tests, for two different uses of the term "substantially all". The first requirement relates to the QOF's holding period. The second requirement relates to the use of property in a QOZ. In this regard, the term 'substantially all of the QOF's holding period' means during at least **90%** of the QOF's holding period.[264] However, the term

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[258] Section 1400Z-2(d)(2)(D)(ii); Prop. Reg. § 1.1400Z-2(d)-1(c)(8)

[259] Prop. Reg. § 1.1400Z-2(d)-1(c)(8)(ii)

[260] Prop. Reg. § 1.1400Z-2(d)-1(c)(8)(ii)

[261] This ruling also illustrates, as set forth in the facts, the conversion of a building from industrial use to multi-family residential use is permitted and that a 60% allocation to land and a 40% allocation to building is reasonable under these facts.

[262] Prop. Reg. § 1.1400Z-2(d)-1(c)(8)(ii)(B)

[263] Section 1400Z-2(d)(2)(D)(i)(III) and Prop. Reg. § 1.1400Z-2(d)-1(c)(4)(i)(D). The Proposed Regulations follow the statutory language, requiring that in the case of tangible property that is owned or leased by the QOF, 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.

[264] Prop. Reg. § 1.1400Z-2(d)-1(c)(5)

'substantially all of the usage of tangible property by a QOF in a QOZ' requires at least **70%** of the use of tangible property in a QOZ.[265]

While the manner in which holding period is determined is clear, the determination of the "use" requirement requires interpretation. Accordingly, the Proposed Regulations focus the respective rules on the manner in which a QOF or QOZB will meet the "use" requirement under the substantially all test.

Whether the QOF has satisfied the substantially all threshold (relating to the required 70% usage of tangible property in a zone) is determined by a fraction (A) the numerator of which is the total value of all QOZBP owned or leased by the QOF (which is qualifying property) and (B) the denominator of which is the total value of all tangible property owned or leased by the QOF, whether located inside or outside of a zone. [266]

In order to be treated as QOZBP, such property must be used in the trade or business of a QOF (in order to satisfy the "use" requirement). For this purpose, the term "trade or business" means a trade or business within the meaning of Section 162.[267] In general, Section 162 refers to the deductibility of business expenses providing that a taxpayer is allowed a deduction for all ordinary and necessary expenses paid or incurred in carrying on a trade or business.[268] However, the term "trade or business", despite being used in nearly 500 separate subsections of the Code and nearly 700 separate Treasury Regulations, has not been defined under the Code, Regulations or by the IRS for purposes of Section 162. Rather, case law drives the determination of what constitutes a Section 162 trade or business.

The evolution of case law in this area culminated in the determination in Groetzinger v. Commissioner in which the Supreme Court held that the taxpayer was engaged in a trade or business when the following factors were met: (i) the activity must be conducted for profit; (ii) the activity must be engaged in with some regularity and continuity (even if not by the taxpayer personally); and (iii) the taxpayer must have commenced operations.[269]

The courts have consistently applied any applicable tests to the facts and circumstances of each situation. In this regard, the determination of whether an activity constitutes a trade or business is based on the facts and circumstances.[270]

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[265] Prop. Reg. § 1.1400Z-2(d)-1(c)(6). This is a very taxpayer friendly result. Under the New Markets Tax Credit program, the "substantially all" threshold is 85%. The QOZ program is more flexible and less likely to cause inadvertent noncompliance.

[266] Prop. Reg. § 1.1400Z-2(d)-1(c)(9)

[267] Prop. Reg. § 1.1400Z-2(d)-1(c)(4)(ii)

[268] Section 162(a)

[269] Commissioner v. Groetzinger, 480 U.S. 23 (1987)

[270] Higgins v. Commissioner, 312 U.S. 212 (1941). The test in Higgins is very fact intensive, as it requires a determination with respect to the course of conduct of the taxpayer to ascertain whether the business-related activity undertaken is sufficient to qualify as a trade or business.

Under the Proposed Regulations, the "use" requirement will only be satisfied to the extent that a QOF operates a trade or business. Accordingly, the mere holding of property without conducting an activity that is considered a trade or business under Section 162 will fail the substantially all test under the Statute and Proposed Regulations.

b. QUALIFIED OPPORTUNITY ZONE BUSINESS

The threshold requirement to operate an opportunity zone business is that the equity interests held by the QOF must consist of either QOZ stock or QOZ partnership interest. Note that a QOZB must hold at least 70% of its assets as QOZBP, and the QOZB must satisfy this test.

i. Qualified Opportunity Zone Stock

Qualified opportunity zone stock means any stock in a *domestic* corporation[271] if:

(i) such stock is acquired by the QOF after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash;[272]

(ii) as of the time that such stock was issued, such corporation was a QOZB (or, in the case of a new corporation, such corporation was being organized for the purpose of being a QOZB), and

(iii) during *substantially all* (*i.e.*, at least 90%)[273] of the QOF's holding period for such stock, such corporation qualified as a QOZB.

Since the first requirement of the statute is that the QOF acquires the QOZ stock solely in exchange for cash (see below for the comparable rule in the case of partnerships), it is critical that if property (other than cash) will be contributed to such entity, the equity interests in the QOZ stock are originally acquired for at least a nominal amount of cash (proportionately by the equity holders of such entity) prior to the contribution of property.[274] Thus, capitalizing a QOZB will be two-step

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[271] Prop. Reg. § 1.1400Z-2(d)-1(c)(2) provides that if an entity is classified as a corporation for federal tax purposes, then an equity interest in the entity is qualified opportunity zone stock if the criteria below are otherwise satisfied.

[272] Section 1400Z-2(d)(2)(B)

[273] Prop. Reg. § 1.1400Z-2(d)-1(c)(5) provides that the term "substantially all" – as applied to the QOF's *holding period*, means 90 percent. The Preamble to the Second Proposed Regulations reflects that since "taxpayers are more easily able to control and determine the period for which they hold property" the 90 percent threshold (as compared to the 70 percent threshold utilized for another purposes) is appropriate.

[274] It is not clear whether a subsequent contribution of property (other than cash) to a corporation in a transaction to which Section 351 applied could cause the QOF to be treated as having acquired the stock of the qualified opportunity zone stock in exchange for property other than cash. If that would be the case, the transactions involving the QOF and the qualified opportunity zone stock should be structured in light of these rules.

process if it will be capitalized property other than cash (with the cash originally issued in exchange for equity, followed by property contributions).

Under the statute, rules similar to Section 1202(c)(3) (with respect to certain redemptions) apply for purposes of determining whether stock in a corporation qualifies as QOZ stock. Specifically, this provision provides that certain redemptions will cause the acquired stock to not be treated as qualified stock (in the case of Section 1202, for qualified small business stock). The Proposed Regulations § 1.1400Z-2(d)-1(c)(2)(ii) clarify this rule (consistent with the requirements of Section 1202(c)(3)) such that:

(A) stock acquired by the QOF is not treated as QOZ stock if, during the four year time period beginning two years before the issuance of such stock, the issuing corporation purchased (directly or indirectly) any of its stock from the QOF or from a person related (within the meaning of Section 267(b) or Section 707(b)) to the QOF.[275]

(B) stock issued by the corporation is not treated as QOZ stock if, during the two year time period beginning one years before the issuance of such stock, the issuing corporation purchased (directly or indirectly) an aggregate of five percent of the value of the stock (as of the beginning of the two year period).[276]

(C) if any transaction is treated under Section 304(a) as a distribution in redemption of stock of any corporation, such corporation is treated as purchasing an amount of its stock equal to the amount that is treated as a distribution under Section 304(a).[277]

ii. Qualified Opportunity Zone Partnership Interest

Qualified opportunity zone partnership interest means any capital or profits interest in a *domestic* partnership[278] if:

(i) such partnership interest is acquired by the QOF after December 31, 2017, from the partnership solely in exchange for cash;[279]

[275] Prop. Reg. § 1.1400Z-2(d)-1(c)(2)(ii)(A). This section also notes that even if the purchase occurs after issuance, the stock was never qualified opportunity zone stock.

[276] Prop. Reg. § 1.1400Z-2(d)-1(c)(2)(ii)(B). This section also notes that even if the purchase occurs after issuance, the stock was never qualified opportunity zone stock.

[277] Prop. Reg. § 1.1400Z-2(d)-1(c)(2)(ii)(C)

[278] Prop. Reg. § 1.1400Z-2(d)-1(c)(2) provides that if an entity is classified as a partnership for federal tax purposes, then a capital or profits interest in the entity is qualified opportunity zone partnership interests if the criteria below are otherwise satisfied.

[279] Section 1400Z-2(d)(2)(C)

(ii) as of the time that such partnership interest was acquired, such partnership was a QOZB (or, in the case of a new corporation, such partnership was being organized for the purpose of being a QOZB), and

(iii) during *substantially all* (*i.e.*, at least ninety percent)[280] of the QOF's holding period for such partnership interest, such partnership qualified as a QOZB.

As with QOZ stock, the QOF must acquire the QOZ partnership interests solely in exchange for cash. Thus, the equity interests of the QOZ partnership interests should be acquired for at least a nominal amount of cash (proportionately by the equity holders of such entity) prior to any subsequent contribution of property.[281]

iii. Qualified Opportunity Zone Business

The QOZ legislation has a substantial structural flaw in that it creates different treatment for a QOF that operate its business directly (through the ownership of 90% or more of its assets consisting of QOZP) rather than through QOZ stock or QOZ partnership interests (as the case may be). In the case of QOZ stock or QOZ partnership interests, such corporation or partnership must meet the requirements of a "qualified opportunity zone business" or QOZB.

In most cases, the treatment as QOZB is desirable since (i) the QOZP owned or leased by the QOZB must exceed 70% (rather than 90%) of the total property owned or leased by such entity; and (ii) the QOZB may avail itself of the working capital safe harbor.

A QOZB means a trade or business (i) in which substantially all of the tangible property owned or leased by the taxpayer is QOZBP; (ii) which satisfies certain requirements relating to the active conduct of a trade or business, as well as holding requirements with respect to nonqualified financial property; and (iii) does not consist of the following trades or businesses (or providing the land for such businesses): private or commercial golf course, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or liquor stores (with a principal business for consumption off the premises) (the foregoing, collectively, are referred to as 'sin' businesses).[282]

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[280] Prop. Reg. § 1.1400Z-2(d)-1(c)(5) provides that the term "substantially all" – as applied to the QOF's *holding period*, means 90 percent. The Preamble to the Second Proposed Regulations reflects that since "taxpayers are more easily able to control and determine the period for which they hold property" the 90 percent threshold (as compared to the 70% threshold utilized for other purposes) is appropriate.

[281] It is not clear whether a subsequent contribution of property (other than cash) to a partnership in a transaction to which Section 721(a) applied could cause the QOF to be treated as having acquired the partnership interest of the qualified opportunity zone stock in exchange for property other than cash. If that would be the case, the transactions involving the QOF and the qualified opportunity zone stock should be structured in light of these rules.

[282] Section 1400Z-2(d)(3)(a) and Prop. Reg. § 1.1400Z-2(d)-1(d)(6)

Since the second of these requirements (relating to criteria described in Section 1397) contains three separate requirements, to meet the definition of a QOZB, such QOZ partnership or QOZ corporation must meet ***five*** separate requirements:

1. ***70% QOZBP Requirement***. At least 70% of the tangible property owned by the QOZB is QOZBP;

2. ***50% Active Trade or Business Requirement***. At least 50% of the total gross income of such entity is derived from the active conduct of a trade or business;

3. ***Use of intangible Property in Trade or Business***. At least 40% of the intangible property is used in the active conduct of the business;

4. ***Limitation on Nonqualified Financial Property***. Less than 5% of the aggregate adjusted bases of property is attributable to nonqualified financial property; and

5. ***Certain Business Prohibited***. The business does not consist of 'sin' businesses.

Tangible property of a QOZB that ceases to be QOZBP will continue to be treated as QOZBP for the lesser of (i) 5 years after the date that the property ceased being so qualified, or (ii) the date on which the tangible property is no longer held by the QOZB.

(1) Substantially All Requirement

The first component is met when substantially all of the property meets the tests to be treated as QOZBP. For these purposes, the term "substantially all" means at least **70%** of the tangible property used or leased by the trade or business is QOZBP.[283] This percentage is calculated as follows: (A) if the entity has an applicable financial statement,[284] the value of each asset as set forth on such applicable financial statement is the value used for applying the 70% test; and (B) if the entity does not have an applicable financial statement, it may generally use the methodology that such taxpayer uses to measure compliance with the 90% test for a QOF holding QOZP.[285]

It is not clear how the use of property will be measured for purposes of meeting the substantially all test (**and there are no safe harbor tests as there are with respect to the gross income requirement**). Under this rule, substantially all of the use of property must be in the QOZ. Business property, however, *moves* from one place to another. Vehicles, computers, phones, even

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[283] Prop. Reg. § 1.1400Z-2(d)-1(d)(3)(i)

[284] Within the meaning of Reg. 1.475(a)-4(h)

[285] Prop. Reg. § 1.1400Z-2(d)-1(d)(3)(ii). Under this rule, special rules apply for the testing applicable to entities and a "Five Percent Zone Taxpayer" (which is generally taxpayer that has self-certified as a QOF and holds stock the entity representing at least five percent of the voting rights and value (in the case of a corporation) or profits and capital (in the case of a partnership). The purpose of this rule is allow the use by all taxpayers of the highest percentage taking into account the methodology employed by either the QOF or any of its Five Percent Zone Taxpayers. See Prop. Reg. § 1.1400Z-2(d)-1(d)(3)(iii).

expensive testing and monitoring equipment are mobile and physically travels into and outside of the QOZ. It would be helpful if Treasury extends similar safe harbor rules (which are detailed below) for purposes of meeting the substantially all tests. ***In the absence of any guidance, we would expect that Treasury would apply tests consistent with the intent of the statute, however we cannot be certain of that outcome barring additional guidance.***

The Proposed Regulations defining the operations of a QOZB replicate the rules that apply to QOZBP (for purposes of meeting the qualifications as a QOZB) as follows:

- The Proposed Regulations clarify that the substantial improvement rule for purposes of meeting the requirements of a QOZB will apply the same test previously outlined (*e.g.*, the 30 month period to improve the tangible property by an amount exceeding its original basis).[286] Likewise, the building and land rules apply to a QOZB. If a QOF purchases a building located on land wholly within a QOZ, a substantial improvement to the purchased tangible property is measured by the QOF's adjusted basis to the building.[287] For purposes of measuring whether the QOF meets the substantial improvement test, the QOF is not required to separately substantially improve the land upon which the building is located.[288]

- The Proposed Regulations incorporate the specific rules for QOZBP set forth in Prop. Reg. §1.1400Z-2(d)-1(c)(4)(i)(B) to the definition of QOZB through Prop. Reg. § 1.1400Z-2(d)-1(d)(2)(i). Specifically, the rules are as follows:

    1. post December 31, 2017 acquisition of owned or leased property;[289]

    2. arm's length term for leases;[290]

    3. related party rules for lease prepayments and determination of values for acquisition from related parties;[291]

    4. original use of leased tangible property;[292]

    5. relevant testing period;[293] and

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[286] Prop. Reg. § 1.1400Z-2(d)-1(d)(4)(i)

[287] Prop. Reg. § 1.1400Z-2(d)-1(d)(4)(ii)

[288] Prop. Reg. § 1.1400Z-2(d)-1(d)(4)(ii)

[289] Prop. Reg. § 1.1400Z-2(d)-1(d)(2)(i)(A) and (B)(1)

[290] Prop. Reg. § 1.1400Z-2(d)-1(d)(2)(i)(B)(2)

[291] Prop. Reg. § 1.1400Z-2(d)-1(d)(2)(i)(B)(3)-(5)

[292] Prop. Reg. § 1.1400Z-2(d)-1(d)(2)(i)(B)(6)

[293] Prop. Reg. § 1.1400Z-2(d)-1(d)(2)(i)(B)(7)

6. applicable valuation methodologies, are applicable to a QOZB.[294]

Likewise, the QOZB must apply the trade or business requirements of Section 162.[295] The 90% substantially all rule (for determination of the holding period) and 70% substantially all rule (for the use of tangible property in a zone) also apply to a QOZB.[296]

- The valuation rules of Prop. Reg. §1.1400Z-2(d)(3)(ii)(A) are also adapted from rules issued with respect to QOZBP. In this regard, whether a trade or business satisfies the 70% substantially all threshold is determined by the following fraction:

Total Value of All QOZBP Owned or Leased by The QOF (Which Is Qualifying Property)

Total Value of All Tangible Property Owned or Leased By The QOF, Whether Located Inside or Outside of a Zone.[297]

- The Proposed Regulations adopt the general rule that the value of owned or leased tangible property is valued under either the applicable financial statement valuation method or the alternative valuation method. The chosen method must be consistent for each taxable year.[298] The applicable financial statement valuation method provides that the entity will use, for purposes of valuing the tangible property for the 70% test,[299] the value set forth on such entity's applicable financial statement.[300] The "applicable financial statement" method may only be used if such applicable financial statement requires, or would otherwise require, an assignment of value to the lease of tangible property.[301]

- Under the alternative valuation method (i) the value of tangible property that is owned by the QOZB is the unadjusted cost basis of the property under Section 1012 in the hands of

[294] In addition, the special rules relating to (i) original use of owned property; (ii) substantial improvement of owned or leased property; and (iii) anti-abuse rule for real estate transactions are set forth in Prop. Reg. § 1.1400Z-2(d)-1(d)(2)(i)(C)-(E)

[295] Prop. Reg. § 1.1400Z-2(d)-1(d)(2)(ii)

[296] Prop. Reg. § 1.1400Z-2(d)-1(d)(2)(iii)-(iv)

[297] Prop. Reg. § 1.1400Z-2(d)-1(d)(3)(A) (which is identical to Prop. Reg. § 1.1400Z-2(d)-1(c)(9))

[298] Prop. Reg. § 1.1400Z-2(d)-1(d)(3)(ii)(B)(1). This rule reflects that a QOF could change the methodology each year to achieve optimal outcomes, although the same methodology must applied consistently in the aggregate for each taxable year (and not asset by asset).

[299] See Prop. Reg. § 1.1400Z-2(d)-1(c)(ii)(A)

[300] Prop. Reg. § 1.1400Z-2(d)-1(d)(3)(ii)(B)(2)(i), which is determined in accordance with the definition of "applicable financial statement" as defined in Reg. 1.1475(a)-4(h)

[301] Prop. Reg. § 1.1400Z-2(d)-1(d)(3)(ii)(B)(2)(ii)

the QOZB for each testing date of a QOF during the year;[302] and (ii) the value of tangible property that is leased by the QOZB is equal to the present value of the leased tangible property.[303] The present value of the leased tangible property is (1) equal to the sum of the present values of each payment under the lease for such property; (2) calculated at the time that the QOZB enters into the lease for such leased tangible property; and (3) used as the value for such asset by the QOZB for all testing dates for purposes of the 90-percent asset test.[304] The discount rate used for these purposes is the discount rate set forth in Section 1274(d)(1) (by substituting the term "lease" for "debt instrument").[305] The lease term used for these purposes is the original lease term including extensions at a pre-defined rent.[306]

- The Proposed Regulations also provide a comparable rule for a QOZB for a Five Percent Zone Taxpayer identical to the concept used for Prop. Reg. §1.1400Z-2(d)-1(d)(3)(iii) that allows flexibility for the use of valuation methodology.[307]

(2) Section 1397C Requirements: 50% Gross Income Test

Active Conduct of Trade or Business

The second requirement is that at least 50 percent of the total gross income of such entity is derived from the active conduct of such business.[308] The Proposed Regulations provide four tests that an entity may use to determine whether it meets the 50 percent threshold. In this regard, the entity will satisfy the requirements if any of the four tests are satisfied.

Effectively, the active conduct rule requires that an entity (1) meets the definition of a "trade or business" under Section 162 and (2) satisfies at least one of the safe harbor tests.

At a high-level, the tests to determine active conduct of a trade or business in a QOZ are fairly broad and provide enough flexibility to capture nearly any type of business (with a facts and circumstances test as an additional safety net). That said, the administrative burden to track hours and compensation for all workers, including independent contractors providing services to a QOF or QOZB may be overly burdensome. These rules can therefore create an additional compliance challenge for a business that conducts an operating business (even while affording greater flexibility).

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[302] Prop. Reg. § 1.1400Z-2(d)-1(d)(3)(ii)(B)(3)(ii)

[303] Prop. Reg. § 1.1400Z-2(d)-1(d)(3)(ii)(B)(3)(iii)(A)

[304] Prop. Reg. § 1.1400Z-2(d)-1(d)(3)(ii)(B)(3)(iii)(C)

[305] Prop. Reg. § 1.1400Z-2(d)-1(d)(3)(ii)(B)(3)(iii)(B)

[306] Prop. Reg. § 1.1400Z-2(d)-1(d)(3)(ii)(B)(3)(iii)(D)

[307] Prop. Reg. § 1.1400Z-2(d)-1(d)(3)(ii)(C)

[308] Section 1397C(b)(2) (referenced by Section 1400Z-2(d)(3)(A)(ii))

Treatment as a "trade or business"

The Proposed Regulations also provide that certain activities will not be considered the active conduct of a trade or business. For purposes of this rule, the ownership and operation (including leasing) of real property is the active conduct of a trade or business. However, merely entering into a triple net lease with respect to real property owned by the taxpayer is not the active conduct of a trade or business by such taxpayer.[309] The term trade or business is defined (as it is elsewhere for opportunity zone purposes) as having the same meaning that such term has under Section 162.[310]

Section 162(a) permits a taxpayer, including a corporation, to deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business.[311] Section 162 expenses are fully deductible from gross income. A trade or business expense is ordinary for such purpose if it is normal or customary within a particular trade, business, or industry, and it is necessary if it is appropriate and helpful for the development of the business.[312]

The phrase "trade or business" is not defined in the Code or the Treasury Regulations. However, the Supreme Court has stated there are three (3) requirements for an activity to constitute a trade or business: (i) the activity must be conducted for profit; (ii) the activity must be engaged in with some regularity and continuity (even if not by the taxpayer personally); and (iii) the taxpayer must have commenced operations.[313]

In the context of rental real estate, the tax court has permitted a single family rental to be treated as a trade or business.[314] A landlord that owned and managed apartment buildings (even through an agent that performed the work) would qualify as a trade or business.[315] However, a triple net lease was not afforded such treatment. Rather, the Tax Court has held that simply renting a property and collecting rents without more does not rise to the level of a trade or business.[316]

Prior to regulations and notices issued for other purposes of the TCJA, the IRS and courts have had a few occasions to address the treatment of triple net leases. Under Section 871, there are special rules for the taxation of nonresident aliens who are engaged in trade and business in the

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[309] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(ii)(B)(2)

[310] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(ii)(B)(3)

[311] See Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345, 352 (1971).

[312] See Commissioner v. Heininger, 320 U.S. 467, 471 (1943).

[313] Commissioner v. Groetzinger, 480 U.S. 23 (1987).

[314] Hazard v. Commissioner, 7 T.C. 372 (T.C. 1946)

[315] Schwarcz v. Commissioner, 24 T.C. 733 (1955).

[316] Hendrickson v. Commissioner, 78 T.C.M. 322 (1999).

United States. Revenue Ruling 73-522 provides that a rental under a net lease is not considered a trade or business for the purposes of Section 871.

In a case in the 7th Circuit Court of Appeals, the court determined whether certain "trades or businesses" would be treated as a single employer for purposes in the context of a dispute over pension withdrawal liability.[317] The taxpayer in that case owned several properties subject to triple net leases. As a result of the properties being subject to triple net leases, the taxpayer only spent five hours per year involved with the properties. Therefore, the court held that "mere holding of leases for ten years by shareholder was not such continuous and regular activity as to constitute a trade or business". In deciding a similar issue, the same court reached the opposite conclusion holding that the taxpayer was much more frequently engaged in activities related to leasing such as buying and selling multiple properties annually, and advertising such properties, and was therefore deemed to have engaged in conduct that was regular and continuous.[318]

Treasury recently released Final Regulations with respect to the qualified business income deduction under Section 199A. Like the QOZ rules, the 199A rules do not permit the deduction with respect to triple net leases that do not rise to the level of a trade or business under Section 162. The IRS issued Notice 2019-7 providing for a safe harbor reflecting when rental activities are considered a trade or business. Under this Notice, rental services include advertising to rent, negotiating and executing leases, verifying tenant applications, collection of rent, daily operation and maintenance, management of the real estate, purchase of materials, and supervision of employees and independent contractors. The term rental services does not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; or hours spent traveling to and from the real estate.

Under the Notice (similar to QOZ rules), real estate that is rented or leased under a triple net lease is not eligible for the safe harbor. A triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities (including a lease agreement that requires the payment of such tenant or lessee's allocable portion of taxes, fees insurance and maintenance).

In determining whether a rental real estate activity is a section 162 trade or business, relevant factors might include, but are not limited to (i) the type of rented property (commercial real property versus residential property), (ii) the number of properties rented, (iii) the owner's or the owner's agents day-to-day involvement, (iv) the types and significance of any ancillary services provided under the lease, and (v) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease). A number of commentators believe that having multiple triple net leases may rise to the level of a trade or business even where a single lease will likely not meet the standard.

Safe Harbor Tests

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[317] C. States, S.E. and S.W. Areas Pension Fund v. Fulkerson, 238 F.3d 891 (7th Cir. 2001).

[318] C. States, S.E. and S.W. Pension Fund v. Personnel, Inc., 974 F.2d 789 (7th Cir. 1992).

Treasury issued four tests intended to provide taxpayers with clarity to meet the 50% gross income standard. Although the tests are by no means perfect, they provide adequate parameters to eliminate risk of noncompliance in most cases. Moreover, there is enough flexibility to allow close cases to qualify under the QOZ program.

First, a QOZB will meet the threshold if at least 50 percent of the services performed for the trade or business are performed in the opportunity zone (the "Hours Test").[319] The Hours Test is calculated by dividing (1) the total number of hours performed by employees and independent contractors, and employees of independent contractors, for services performed in a QOZ during the taxable year, by (2) the total number of hours performed by employees and independent contractors, and employees of independent contractors, for services performed during the taxable year (in any location).[320]

Second, a QOZB will satisfy the test if at least 50 percent of the services are considered to be performed based on the amount paid for such services (the "Compensation Test").[321] The Compensation Test is measured by determining the fraction, the numerator of which is (1) the total amount paid by the entity for services performed in a QOZ during the taxable year, whether by employees, independent contractors, or employees of independent contractors, and (2) the denominator of which is the total amount paid by the entity for services performed during the taxable year whether by employees, independent contractors, or employees of independent contractors (regardless of the location).[322]

Third, the 50 percent test will be satisfied by a QOZB if the tangible property of the trade or business located in a QOZ and the management or operational functions performed in the QOZ are each necessary for the generation of at least 50 percent of the gross income of the trade or business.[323] This test is less definitive, but presumably would be measured by the rental or other operating income derived from the tangible property, together with an appropriate allocation of management and operational functions that are performed in a zone.

Fourth, a QOZB may determine, based on the facts and circumstances that at least 50 percent of the gross income of a QOZB is derived from the active conduct of a trade or business in the QOZ.[324]

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[319] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(i)(A)

[320] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(i)(A)(1)-(2)

[321] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(i)(B)

[322] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(i)(B)(1)-(2)

[323] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(i)(C)

[324] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(i)(D)

The Proposed Regulations provide a helpful example in which a landscaping business has its headquarters in a QOZ, its employees and officers manage the operations of the business (within and outside of the zone) and all of its equipment and supplies are stored at its headquarters in the zone. Such activities are considered a material factor in generating the income of the business.[325] On the other hand, where a business has a PO Box in the opportunity zone and the mail received at such PO Box is fundamental to the business, but there is no other basis for concluding that the income of the trade or business is derived from activities in the zone, the test would not be satisfied. Rather, the mere location of the PO Box is not a material factor in the generation of gross income by the trade or business.[326]

In a situation in which the trade or business derived no gross income for a number of years, had no employees and did not pay for services (*i.e.*, in the case of a real estate development), so long as the taxpayer prior to such time has otherwise complied with the requirements for a QOZB (*e.g.*, has written plans to acquire land in which it plans to construct a building for lease to other trades or businesses as required under the working capital safe harbor rules discussed below), the taxpayer satisfies the facts and circumstances test.[327] In this example, the QOZB ultimately leased the constructed building and derived more than 50% of the entity's gross income from the rental of the property in the QOZ.

(3) Section 1397C Requirements: Use of Intangible Property

The third requirement is that a substantial portion of the intangible property of such entity is used in the active conduct of the trade or business.[328] For purposes of this rule, the term "substantial portion" means at least 40 percent.[329]

The working capital safe harbor rules also provide that the use requirement of intangible property will be deemed satisfied if the QOZB otherwise complies with the requirements under the working capital safe harbor (providing for a written plan reflecting the use of the nonqualified financial property and the actual use of such property consistent with the written plan).[330]

To illustrate this rule, the Proposed Regulations provide an example reflecting that during the period of land acquisition and building construction a substantial portion of the taxpayer's intangible property is treated as being used in the active conduct of a trade or business in the QOZ.[331]

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[325] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(i)(E)(1) (Example 1)

[326] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(i)(E)(2) (Example 2)

[327] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(i)(E)(3) (Example 3)

[328] Section 1397C(b)(4) (referenced by Section 1400Z-2(d)(3)(A)(ii))

[329] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(ii)(A)

[330] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(vi).

[331] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(viii)(ii)(C)

(4) Section 1397C Requirements: Nonqualified financial property and the working capital safe harbor

The fourth requirement is that less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.[332] The term nonqualified financial property means debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities and other similar property, but does not include (1) reasonable amounts of working capital held in cash, cash equivalents or debt instruments with a term or18 months or less; or (2) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale property described in Section 1221(a)(1) (*i.e.*, stock in trade, inventory or property held for sale to customers in the ordinary course of business).[333] Accordingly, the exception to treatment as nonfinancial property allows a QOZB to (i) hold cash, cash equivalents and short term notes (*i.e.*, working capital assets) and (ii) hold reasonable working capital without violating this rule.[334]

Unfortunately, the inclusion of this rule has the effect of causing certain businesses to fail to qualify as a QOZB. For example, banks, certain financial management and advisory companies, and other companies that deal with financial products such as mortgage lenders may not qualify since their assets will consist of "bad" assets including nonqualified financial property. Such businesses could potentially use a single-tier structure (where the QOF owns QOZBP) since the restrictions under Section 1397C are not applicable.

The Proposed Regulations provided latitude for a QOZB to utilize these exceptions by creating a working capital safe harbor.[335] Under this rule, a QOZB may hold cash, cash equivalents or debt instruments with a term of 18 months or less for 31 months (following the receipt of funds) without having such financial assets cause the QOZB to fail the asset testing requirements. A QOZB satisfies the working capital safe harbor if the following conditions are satisfied:

(A) these amount (of working capital assets) are designated in writing for the development of a trade or business in a QOZ, including when appropriate the acquisition, construction and/or substantial improvement of tangible property in such zone;[336]

(B) 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 such assets;[337]

[332] Section 1397C(b)(8) (referenced by Section 1400Z-2(d)(3)(A)(ii))

[333] Section 1397C(e)

[334] See Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(iii)

[335] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(iv)

[336] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(iv)(A)

[337] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(iv)(B)

(C) the working capital assets are actually used in a manner that is substantially consistent with the first two requirements listed above. However, if consumption of the working capital assets is delayed by waiting for governmental action the application or which is complete, the delay does not cause a failure under this paragraph;[338] and

(D) a business may benefit from multiple overlapping or sequential applications of the working capital safe harbor (provided that each allocation independently satisfies all of the requirements of sections (A)-(C) above).[339]

The working capital safe harbor applies only to a QOZB (and not directly to a QOF that hold QOZBP). Although the Preamble to the 2018 Proposed Regulations reflects that the working capital safe harbor is intended for “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”, the rule is only applicable to a QOZB, which may only be operated as a QOZ partnership interest or QOZ stock.

From a planning perspective, a QOZB may meet the working capital safe harbor if it holds debt instruments with a term of 18 months or less (and the income with respect to such loans is considered “good” income under the active trade or business rules). ***A QOZB that receives excess contributions or financing proceeds can therefore utilize such funds (including loaning them to related parties).***

The Proposed Regulations provided an example where a partnership placed qualified funds in working capital, where it remained until used. The partnership had written plans to acquire land in a QOZ on which it planned to construct a commercial building. The written plans provided for the purchase of land within a month of receipt and a portion allocated to the construction of the building and other necessary expenses to be spent within the next 30 months. All expenditures were made on schedule. During the 31-month period, the Partnership had no gross income other than derived from the working capital. In its analysis, the partnership met all three requirements of the working safe harbor and the expenditures are deemed reasonable as there was a written plan consistent with a startup and the funds were used within 31 months as provided for in the written plan. [340]

Importantly, the Proposed Regulations provide certain safe harbors to avoid causing entities that utilize the working capital safe harbor to fail other criteria under the opportunity zone program.

First, for purposes of applying the 50 percent test applicable to the active conduct of a trade or business, gross income from property that is properly classified as a reasonable amount of working capital will count towards the satisfaction of such 50 percent test.[341]

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[338] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(iv)(C)

[339] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(iv)(D)

[340] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(viii)

[341] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(v)

Second, for purposes of applying the use requirement for intangible property, 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 the working capital safe harbor requirements section (A)-(C) above.

Third, if some financial property is being treated as a reasonable amount of working capital due to compliance with the working capital safe harbor and if the tangible property is expected to satisfy the substantial improvement test as a result of the planned expenditure of the working capital assets, then that tangible property will not be deemed to fail the substantial improvement requirements solely because the scheduled consumption of the working capital is not yet complete.[342]

Fourth, for purposes of satisfying the rules under the working capital safe harbor, when it is necessary to determine whether an QOZ is the location of services, tangible property or business functions, the rules utilized for purposes of Section 1397C (relating to the treatment of businesses straddling census lines for enterprise zones) will apply. If the amount of real property (based on square footage) located within the opportunity zone is substantial as compared to square footage outside the opportunity zone, and the outside real property is contiguous with real property located in the zone, then all of the property is deemed to be located within the QOZ.

The Proposed Regulations provide significant guidance for purchasing, constructing and rehabilitating real estate. However, it may provide compliance challenges for operating businesses such as retailers, financial institutions, consultants and other operating business. These challenges and the required benchmarks need to be addressed in the planning stages of setting up a QOZB.

(5) Certain Activities are Prohibited (No "Sin" Businesses)

The fifth requirement of the rule applicable to a QOZB is that certain activities will not qualify as a QOZB. Specifically, a QOZB may not engage in the trade or business of (including the provision of land for) any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. [343]

While not specifically enumerated in Section 144 as a "sin business", Treasury Secretary Steven Mnuchin advised against marijuana businesses claiming benefits under Section 1400Z-2, even if they are legal at the state level.[344]

While a QOZB may not be a "sin" business, under the available statutory and regulatory guidance, there is no such prohibition of a QOF investing in, or conducting, a "sin business".

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[342] Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(vi)

[343] Section 1400Z-2(d)(3(A)(iii) referring to Section 144(c)(6)(B).

[344] *Opportunity Zone Tax Breaks for Weed Businesses? Mnuchin Says No*, O'Neal, Bloomberg Tax Daily Tax Report, May 16, 2019.

While it is unclear as to the regulatory intent, it appears that as long as QOF meets the 90% holding test, it could potentially invest or participate in a "sin" business.

G. State Taxation

In general, state income taxes (with respect to states that impose income taxes) follow federal tax rules as set forth under the Code, except as modified by state income tax statutes. Eighteen states, as well as the District of Columbia, automatically conform to new federal tax laws. Nineteen states must update their fixed-date conformity statutes in order to adopt the new provisions. All other states either have no tax or conform selectively as set forth in the following table.

State	Status	Date
Alabama	Conforming	Rolling
Alaska	No Capital Gains Tax	N/A
Arizona	Conforming	Fixed Date
Arkansas	Partially Conforming	N/A
California	Partially Conforming	N/A
Colorado	Conforming	Rolling
Connecticut	Conforming	Rolling
Delaware	Conforming	Rolling
District of Columbia	Conforming	Rolling
Florida	No Capital Gains Tax	N/A
Georgia	Conforming	Fixed Date
Hawaii	Nonconforming	N/A
Idaho	Conforming	Fixed Date
Illinois	Conforming	Rolling
Indiana	Conforming	Fixed Date
Iowa	Conforming	Fixed Date
Kansas	Conforming	Rolling
Kentucky	Conforming	Fixed Date
Louisiana	Conforming	Rolling
Maine	Conforming	Fixed Date
Maryland	Conforming	Rolling
Massachusetts	Nonconforming	N/A
Michigan	Conforming	Fixed Date
Minnesota	Conforming	Fixed Date
Mississippi	Nonconforming	N/A
Missouri	Conforming	Rolling
Montana	Conforming	Rolling
Nebraska	Conforming	Rolling
Nevada	No Capital Gains Tax	N/A
New Hampshire	No Capital Gains Tax	N/A
New Jersey	Conforming	Rolling
New Mexico	Conforming	Rolling
New York	Conforming	Rolling
North Carolina	Nonconforming	N/A
North Dakota	Conforming	Rolling
Ohio	Conforming	Fixed Date
Oklahoma	Conforming	Rolling
Oregon	Conforming	Fixed Date
Pennsylvania	Nonconforming	N/A
Rhode Island	Conforming	Rolling
South Carolina	Conforming	Fixed Date
South Dakota	No Capital Gains Tax	N/A
Tennessee	No Capital Gains Tax	N/A
Texas	No Capital Gains Tax	N/A

Utah	Conforming	Rolling
Vermont	Conforming	Fixed Date
Virginia	Conforming	Fixed Date
Washington	No Capital Gains Tax	N/A
West Virginia	Conforming	Fixed Date
Wisconsin	Conforming	Fixed Date
Wyoming	No Capital Gains Tax	N/A

North Carolina explicitly decoupled from the QOZ provision and requires that the deferred gain be included in the state's taxable income calculation, as well as any additions related to any step-up basis under Section 1400Z-2(c).[345]

Originally, Hawaii decoupled from Sections 1400Z-1 and 1400Z-2.[346] However, on June 13, 2019, Hawaii approved legislation, S.B. 1130, to conform its tax code to the Internal Revenue Code, although the tax benefits are limited to investments held in Hawaii.

New Hampshire issued guidance stating that its taxpayers will be required to make adjustments for Section 1400Z.[347]

QOZ designations may overlap with local, state and federal programs that were passed to promote investments in economically distressed communities.

The Ohio General Assembly introduced House Bill 727 to further incentivize investments in Opportunity Zones by creating a nonrefundable income tax credit up to 10% of any qualifying investment. The House Bill was referred to be reviewed by the Finance Committee. Missouri passed Senate Bill 773 that will provide annual historic preservation tax credits for projects located in low-income census tracts that may coincide with federal Opportunity Zones.

In order to promote the tax benefits of the QOZ, several states have complementary programs that work either independently or in conjunction with federal requirements. Potentially, a single QOF transaction could involve multiple jurisdictions. This could result in a necessary state apportionment of the capital gains and/or differing recognition periods. Taxpayers seeking QOZ investment opportunities should consider available local, state and other federal incentives. Based on the investment, a review of each specific state's regulations, complimentary programs and tax effects should be considered before setting up an investment vehicle.

H. Coordination with Other Federal Credit and Incentive Programs

A QOF (or QOZB) may qualify for federal tax credits in addition to the tax incentives available under the QOZ program. Indeed, it is likely that many (if not most) QOFs will be eligible for

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[345] N.C. Gen. State § 105-130.5(a)(26), (27).

[346] Haw. Rev. Stat. § 235-2.3(b)(51).

[347] *Technical Information Release TIR 2019-002*, New Hampshire Department of Revenue Administration, February 4, 2019, ¶200-944.

additional credits under complementary tax credit programs including the New Markets Tax Credit ("NMTC"),[348] federal historic rehabilitation tax credit,[349] or low income housing tax credit ("LIHTC").[350] Likewise, the development activities of a QOF (which may be infrastructure, energy or operating business related) may also permit credits for research and development,[351] energy property (which may consist of solar, wind, geothermal and renewable energy sources),[352] and workforce development.[353]

The NMTC is the most obvious complement to the QOZ program. The NMTC provides tax credits for certain investments in low-income communities. Since QOZs are, by definition, a "low-income community" as defined in Section 45D(e) (or an adjacent parcel that meets certain criteria),[354] nearly all QOZs will be located in geographic areas eligible for the NMTC. The vehicle utilized for purposes of obtaining credits under the NMTC program is the use of a "qualified community development entity" ("QCDE").[355]

QOZs that intend to utilize NMTCs may face stiff competition to obtain the credits in in the coming years. The NMTC program has an annual limit of $3.5 billion (as of 2019) of NMTCs allocated by Treasury's Community Development Financial Institution's Fund. Since almost all QOFs may qualify under the NMTC program, and the QOZ program will spur extensive new development in low-income communities, the $3.5 billion allocation may be insufficient in light of the increase in projects.

A QOF may qualify as a QCDE, which generally would allow an investor to generate tax credits equal to 39% the investment by an investor into a QDCE. Such credits are generated over six years (in seven installments).[356] In order to structure a QCDE that will qualify as a QOF, the QCDE would likely make an equity investment into an active trade or business activity in a low-income community.[357]

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348 See Section 45D

349 See Section 47

350 See Section 42

351 See Section 41

352 See Section 48

353 See Section 51

354 See Section 1400Z-1(e)

355 Section 45D(c)

356 Section 45D(a)(2)

357 The details of the NMTC program are beyond the scope of this guide. However, the differences in the structures of the respective programs do not allow for the typical, common structure utilized for QCDEs of making loans in low income communities, requiring an equity investment model to apply. Moreover, the types of investments allowed under the NMTC program are generally more restrictive than under the QOZ program (e.g, residential rental real estate is not a qualifying investment).

Under the NMTC program, the minimum investment period is typically seven years. This period may run concurrently with the 10-year period for an investor to hold its QOF investment and obtain tax-free capital gains at disposition.

Treasury has issued guidance to address the coordination of the rules under the NMTC program and the QOZ program. For example, the working capital safe harbor for a QOZB allows for a 31-month period in which financial assets will not cause penalties or disqualification; the NMTC program only permits 12 months for a similar purpose. Likewise, under Section 45D(h), the issuance of a credit under the NMTC program to an investor causes a reduction in the investor's basis. If the investor has no basis (since an investor's basis in a QOF is zero, until the basis is subsequently adjusted), the credit may either cause taxable gain or could be at-risk (alternatively, the credit would be allowed if the investor has sufficient debt basis at the time that the credit allocated to the investor).

The LIHTC program may also be coordinated with a QOF investment. Under the LIHTC program, an investor is able to obtain tax credits over a 10 year period with respect to the construction of low-income housing projects.[358] The credits under the LIHTC program are allocated by state agencies in exchange for a building providing low-income housing for 15 or 30 years. Although the qualification under the LIHT program is outside the scope of this discussion, a low income housing development project (that meets the substantial improvement test) and is located in a QOZ could generate substantial additional tax benefits to an investor.[359]

For certain specific projects, the historic rehabilitation tax credit may also be utilized in conjunction with a QOF investment. Similar the QOZ program, the historic rehabilitation credit requires that the basis of the building be doubled over a 24 month period.[360] The credit is allowed over a five year period that may run concurrent with an investor's holding period of a QOF.[361] As with the other credit programs, the basis rules under Section 47 will need to be reconciled with the basis rules under Section 1400Z-2 (so that required basis reductions can be properly reflected).

Outside of real estate, Section 1202 provides for tax-free gains from the disposition of qualified small business stock ("QSBS") after a 5 year holding period.[362] QSBS must be stock in a C corporation that conducts an active trade or business (and meets certain other requirements). Since a QOF or a QOZB may be a C corporation, such entity could qualify for both incentives. The

[358] See Section 42

[359] Since the credits under the LIHTC program are based on the entity's tax basis in the low-income housing project, clarification by Treasury of the impact on the zero basis rule for a QOF for an LIHTC investment would be helpful to ensure that none of the LIHTC credits are lost due to the zero basis rule in Section 1400Z-2(b). Presumably, this would not affect the inside basis of the assets, however, without any guidance by Treasury, this point remains uncertain.

[360] Section 47(c)(1)(B)

[361] Section 47(a)

[362] See Sectin 1202

primary advantage of using QSBS is that the holding period to obtain tax-free gains is only 5 years.[363] The QOF program allows for potential for unlimited tax-free appreciation and does not contain restrictions on the amount of business assets. Thus, the Section 1202 incentives can, in effect, provide a hedge for early stage businesses that could monetize in a shorter time frame than is provided for under the QOZ program.

Planning Tip
Section 1202 incentives can, in effect, provide a hedge for early stage businesses that could monetize in a shorter time frame than is provided for under the QOZ program.

I. Anti-Abuse Provisions

The rules of Section 1400Z must be applied in a manner consisted with the purposes of Section 1400Z-2. The operative statute provides that "the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including . . . rules to prevent abuse."[364] If Treasury determines that the purpose of a transaction is inconsistent with Section 14000-Z, it can recast a transaction as appropriate to achieve tax results consistent with the QOZ program.[365] Whether a tax result is inconsistent must be determined based on all the facts and circumstances.[366]

The Preamble to the 2019 Proposed Regulations describe a situation that implicates this rule. Specifically, Treasury provided as follows:

> "[I]n certain instances, the treatment of unimproved land as QOZBP could lead to tax results that are inconsistent with the purposes of section 1400Z-2. For example, a QOF's acquisition of a parcel of land currently utilized entirely by a business for the production of an agricultural crop, whether active or fallow at that time, potentially could be treated as QOZBP without the QOF investing any new capital investment in, or increasing any economic activity or output of, that parcel. In such instances, the Treasury Department and the IRS have determined that the purposes of section 1400Z-2 would not be realized, and therefore the tax incentives otherwise provided under section 1400Z-2 should not be available. If a significant purpose for acquiring such unimproved land was to achieve that inappropriate tax result, the general anti-abuse rule set forth in proposed §1.1400Z2(f)-1(c) (and described further in part X of this Explanation of Provisions) would apply to treat the

[363] In order to qualify as QSBS, the stock must be held in a C corporation, that conducts an active trade or business (excluding certain types of businesses) and at the time that the stock was issued, the gross assets of the corporation did not exceed $50 million. Thus, this structure is often utilized for venture investments.

[364] Section 1400Z-2(e)(4)(C)

[365] Prop. Reg. § 1.1400Z-2(f)-1(c)

[366] Prop. Reg. § 1.1400Z-2(f)-1(c)

acquisition of the unimproved land as an acquisition of non-qualifying property for section 1400Z-2 purposes."

If a QOF fails to meet the 90% requirement, the QOF shall pay a penalty for each month it fails to meet the requirement.[367] The penalty is calculated based on the excess of (i) amount equal to 90% of its aggregate assets over (ii) the aggregate amount of QOZP held by the QOF multiplied by the underpayment established under Section 6621(a)(2). [368]The underpayment rate is the sum of the federal short term rate plus 3%. [369] For a partnership, the penalty shall be taken into account proportionally as part of the distributive share of each partner.[370]

The penalty will not be imposed when the failure to meet the 90% requirement is based on reasonable cause.[371]

[367] Section 1400Z-2(f)(1)

[368] Section 1400Z-2(f)(1)

[369] Section 6621(a)(2)

[370] Section 1400Z-2(f)(2)
[371] Section 1400Z-2(f)(3)

PART 3: INVESTOR ROADMAP AND PLANNING CONCEPTS

The qualified opportunity zone ("QOZ")[372] program is based on the premise that investors will reinvest their profits from their investment activities (including sales of closely held stock or real estate) in a qualified opportunity fund ("QOF") for a minimum ten-year holding period. A QOF is, basically, an investment vehicle that will invest in real estate development projects or operating businesses located in a "qualified opportunity zone" (generally consisting of low-income communities throughout the country). To the extent that an investor reinvests capital gain into a QOF, such investor will be eligible for substantial tax benefits that have the effect of increasing its after-tax return on the investment. In many cases, an investor's internal rate of return ("IRR") will be increased by 25% or more as a result of the tax benefits under the program.

The tax benefits available to an investor consist of the (i) deferral of invested capital gains until December 31, 2026; (ii) reduction of the original capital gain of up to 15% (or more, in certain circumstances); (iii) tax-free appreciation if the investment is held at least ten years (including no recognition of depreciation recapture) if structured properly.

A. Life Cycle of an Investment in a QOF (Investor's Perspective)

The life cycle of an investor in a QOF can be summarized in the following scenario. Note that the below scenario reflects an example of one particular investment structure and a selected method of eventual disposition. Different choices are available depending on the facts (and desired outcomes) of a particular investment and related transactions.

Assume that the proposed investment requires that investors (collectively) invest $100 million[373] into a QOF in exchange for a membership interest that provides for an 8% preferred return on unreturned invested capital (compounded annually) and 60% of all residual profits after payment of the preferred return. The remaining 40% of the residual profits (after payment of the preferred return) is the sponsor's promote interest. Assume that the QOF (or underlying operating entities) borrows $200 million (pursuant to a construction loan) to fund development expenses for a single real estate development project, resulting in total cost of the project of $300 million.[374] The investment will close (i.e., the funds will be contributed) on April 30, 2019. We further assume

[372] Since readers may have skipped Part 2, we have defined certain terms (even if defined previously in this book) in this Part 3.

[373] In our example we use a $100 million investment. The same math will apply whether the investment size is $1 million or $100 billion and the use of $100 million is merely to illustrate the effect with respect to a project under the QOZ program.

[374] We typically use a 65% loan to value (LTV) as a baseline for a construction loan. To keep the math as simple as possible, we have kept the nominal amounts 'simple" (which results in a 67% LTV), which is close enough to the baseline for illustration purposes.

that the property will be sold on May 1, 2029 for $600 million (reflecting a compounded annual growth rate of approximately 7.2%).

Step 1: Pre-Investment Activities (January 1, 2018 through April 30, 2019)

The Investor must recognize capital gain of $100M during the 180-day period preceding the date of the investment. The recognized capital gain may either (i) consist of capital gains that were recognized upon the sale or exchange of a capital asset during the 180 day period preceding the investment (November 1, 2018 through April 30, 2019 in our example); or (ii) capital gains that are considered to be recognized on the last day of the 2018 tax year (Section 1231 gains, Section 1256 gains, or certain distributions of capital gains by REITs or RICs).

Capital gains (not including Section 1231 gains or Section 1256 gains) that are recognized by a pass-through entity (partnership, S corporation, trust or estate) may be recognized by the partner under either approach. Thus, a partner may choose to use either the actual date of the sale or exchange, or the last day of the tax year, to start the clock for the 180-day period.

An investor in a QOF may be an individual or entity. An investor may not reinvest gains recognized from a sale to a related party.

Step 2: Making the Investment (April 30, 2019)

The investor that incurred the capital gain must directly invest in a QOF (the use of a single member LLC is permitted but a contribution of cash or property to another partnership or S corporation that in turn invests in a QOF is not explicitly permitted). The investment must be considered equity for tax purposes. Thus, a convertible debt instrument or similar structure will not qualify as an investment under the QOZ program.

The investment may be in the form of either cash or property. However, if an investor contributes property, the amount of the qualifying investment (eligible for QOZ tax benefits) is equal to the adjusted basis of the contributed property; the fair market value of property in excess of such amount will be a non-qualifying investment which is not eligible for any of the QOZ tax benefits (it will be treated like a normal real estate investment). Similarly, if an investor contributes cash for an equity investment that exceeds the investor's capital gains during the applicable 180-day period, the portion in excess of recognized capital gains will be a non-qualifying investment.

A QOF may be either a partnership or corporation. There is no requirement that a QOF be "fund" in the traditional usage of the term (*i.e.*, comparable to a private equity fund or similar structure). Rather, a QOF may be a closely held partnership with two or more partners or be structured as a fund with many investors. A QOF corporation may have a single owner.

Step 3: Making the Election (April 15, 2020 or the extended due date)

The investor must make an election by reporting the exclusion from income on Form 8949 of its tax return by specifying which gains will be deferred. A pass-through entity may make the election to defer gain. However, if such pass-through entity does not make the election, the individual (which may be a partner, shareholder or beneficiary) may make the election on Form 1040. Each partner is required to notify the QOF with respect to the making of, and amount, of gain that is deferred under its election.

Step 4: Construction Phase and Commencement of Rental Activity (April 30, 2019 through April 30, 2024)

During the initial five years of the project, the project will be constructed using the invested proceeds and the construction loan. During this timeframe, the project will be nearly identical from an economic and tax perspective as compared to a traditional real estate investment. The one major tax difference is that the investor will have no basis in its qualified investment (but it will have debt basis). Thus, for partnership investors, the tax treatment will in most cases be the same as a regular investment (so long as the investors are allocated their proportionate share of qualified nonrecourse liabilities). Investors in an S corporation will not be so lucky, as the lack of stock basis will cause all losses to be at-risk and suspended.

Following the completion of construction and the commencement of rental activities (until the property is stabilized), the project would likely be refinanced with a permanent loan. To the extent that such refinancing allows for debt financed distributions to the preferred investors, the investors will be able to use debt basis to avoid tax (or the inclusion of previously deferred gains).

During the early years of the project, it is likely that the project will generate tax losses (due in large part to the allowable depreciation of the $300M costs and the higher amount of interest expense in the early years of a loan). Losses are likely even if the project generates distributable cash flow. In other words, the project will have essentially the same tax attributes as a traditional leveraged real estate investment.

Step 5: Basis Adjustment on April 30, 2024

On April 30, 2024, the Investor will have held its investment for five (5) years. Accordingly, the Investor's basis in their interest in the QOF will be increased by ten percent (10%) of the original deferred gain (an increase of $10 million). Thus, in our example, the investor (that originally invested cash of $100 million) will have basis of $10 million following this basis adjustment.

Step 6: Basis Adjustment on April 30, 2026

On April 30, 2024, the Investor will have held its investment for seven (7) years. Accordingly, the Investor's basis in their interest in the QOF will be increased by an additional five percent (5%) of the original deferred gain (for a total of 15%) (an increase of $5 million). Thus, in our example, the investor (that originally invested cash of $100 million) will have basis of $15 million following this second basis adjustment.

Step 7: Inclusion of Gain on December 31, 2026

On December 31, 2026, the Investor must recognize in income the amount of the remaining deferred gain (or the fair market value of the investment, if less than the remaining deferred gain), less the amount of the basis adjustments for meeting the five and seven year holding periods (described in Steps 5 and 6). The tax attribute of the gains included in income will be the same as if the gains had been included in 2019 (*i.e.*, short or long term, collectibles, Section 1231, or 1256 gains). The tax rate, however, will be the tax rates applicable in the year of inclusion.

Assuming that the fair market value of the investment did not decrease, the investor will recognize $85 million of gain (which will increase its basis by $85 million).

Step 8: Continued Operations Until May 1, 2029

From 2026 through 2029, the project will continue operations. It is anticipated that by this point in the lifetime of the project, the annual distributions will at least cover the preferred return. Ideally, the project will maximize value upon the sale or exchange following a ten-year holding period. In generally economic terms, it is possible that the expiration of the ten-year holding period (over the 3-5 year period in which most QOFs were funded) will create glut of sellers. In some markets, this could cause relative oversupply (which could decrease prices). An investor may weigh the market conditions against the after-tax return of continuing to own the investment.

Note that an investor will have until 2047 to sell its investment and be eligible for the tax benefits. A longer holding period can reduce the risk that excess supply of QOZ properties will negatively impact prices and investor returns.

Step 9: Disposition of the Property (May 1, 2029)

On May 1, 2029, the property (which cost $300 million) will be sold for $600 million. After repayment of debt (approximately $147 million) and payment of transaction costs (approximately $20 million), the balance of $433 million will be distributed to the partners in accordance with the respective operating agreements of the QOF and its subsidiary entities. To the extent that the refinance at the time of permanent financing and cash flow from operations covered the payment for preferred return (but not the principal), the distribution to partners at the time of the sale will be approximately (i) $100 million return of invested capital to preferred investors; (ii) $200 million to preferred members (equal to 60% of residual cash flow) and (iii) $133 million with respect to the promote interest (equal to 40% of residual cash flow). Thus, the project generated a pre-tax return for the investors of 16.61% (calculated using the Excel XIRR formula).

To the extent that the property (consisting of personal property, qualified improvements, residential rental property and commercial rental property) was depreciated from $300 million to $100 million, the investors have capital account balances of negative $100 million. Thus, the sale of the property (under normal tax rules) for $600 million would generate taxable gain of $680 million (after taking into account transaction costs). Of this amount, $200 million consists of depreciation recapture (assumed to be Section 1250 gain taxed an aggregate federal and state tax rate of 37%) and the remainder is capital gain (taxed at an aggregate federal and state tax rate of 32%). Accordingly, the estimated federal and state tax liability resulting from the sale if no election is made (as described in Step 10 below) will be $228 million.

Step 10: Making the Election with respect to the Sale of the Investment or Property (April 15, 2030)

The taxpayer may avoid the taxable gain (including the $200 million (described in Section 9 above) recapture income that is treated as capital gains) resulting from the disposition of the property by making an election to exclude the capital gain arising from the disposition as reported on the investor's K-1 received from the QOF. Note that there is also an election to step up the basis in the investment at the time the investment is sold or exchanged (which would not be the structure that is generally utilized in a sale of real estate assets). In either case, the investor will not have taxable capital gains with respect to the disposition of the property.

B. Applicability of Opportunity Zone Program for Investors

In order for an investor (the "Investor") to maximize tax benefits under the QOZ program, the investor will need to take the following steps:

1. Recognize capital gains.
2. Select a Qualified Opportunity Fund (or form a new QOF)
3. Invest in a QOF (within the applicable time period).
4. Elect to defer capital gains.
5. (Potentially) increase the basis of the investment in the QOF.
6. Recognize all or a portion of the previously deferred capital gains in income.
7. Elect to step up basis upon disposition to eliminate tax liability.

1. The Investor Must Recognize Capital Gains.

The threshold requirement is that an investor in a QOF ("Investor") must recognize capital gains. For purposes of the QOZ program, a capital gain means any gain that is treated as capital gains for federal income tax purposes that would be recognized prior to January 1, 2027 (and does not arise from a sale or exchange with a related party). The gains may be short term or long term, Section 1231 gains, Section 1250 gains, Section 1256 gains or collectibles gains (or any other gains that are used to calculate federal capital gains tax).

The timing of gain recognition is critical. To obtain the tax incentives, an amount of money equal to the amount of capital gains that the taxpayer desires to defer must be invested in a qualified opportunity fund within 180 days of the date that the capital gain is recognized for income tax purposes. The following chart reflects when gain is recognized for federal income tax purposes (such that the 180 day period commences for meeting the reinvested gains requirement):

Type of Gains	Timing of Gain Recognition
Ordinary Capital Gains	Gain recognized at the time of the sale or exchange (on the trade date, in the case of marketable securities)
REIT and RIC Capital Gains Dividends	Date that the dividend is paid
REIT and RIC Undistributed Capital Gains	Last day of the tax year of the REIT or RIC
Section 1231 Gains	Gain recognized on last day of the investor's tax year equal to the net Section 1231 gain for the year
Section 1256 Gain	Gain recognized on last day of tax year equal to the investor's net Section 1256 gain for the year (offsetting-position transactions are not eligible)
Gain Resulting from a Shift in Section 752 Liabilities	Not eligible to defer gains with deemed 752 gains
Special Rule for Pass-Through Entities	In the case of partnerships, S corporations, estate and trusts, the taxpayer will treat the gain as occurring on the last day of the investor's tax year unless the taxpayer elects to treat the date as occurring on the date that gain is otherwise recognized by the pass through entity for federal income tax purposes

Note that unlike the most widely recognized tax-deferral strategy, a like-kind exchange governed by Section 1031, the QOF program does not require careful tracing of cash. Rather, the only requirement is that the cash or property is invested, and that the investor had that amount of recognized capital gains that it elects to defer.

2. THE INVESTOR MUST SELECT A QOF OR FORM A NEW QOF.

The investor must choose to invest in a third party QOF (many of which are being formed and operated as real estate or private equity funds) or to form its own QOF with respect to a closely held business or real estate investment. The program does not permit a QOF to invest in another QOF.

Third-party funds with professional managers are being formed regularly to invest in projects or companies that enable such fund to qualify as a QOF. Effectively, the investment opportunities are comparable to funds in the marketplace today (except, of course, that a QOF must invest in property in a QOZ and follow the myriad of rules set forth in the QOZ program) including leveraged real estate QOFs and venture capital QOFs.

Since a QOF may be any partnership or corporation that properly invests in qualified property, a closely held QOF is easy to form and not costly to maintain. All QOFs must meet the various criteria discussed below in terms of QOF compliance and structure.

3. THE INVESTOR MUST INVEST IN A QOF (WITHIN 180 DAYS OF RECOGNIZING GAINS)

During the 180-day period beginning on the date that capital gains are recognized (see above chart), the investor must invest an amount of cash (or the adjusted basis of property) into a QOF. The investment must be treated as an equity investment for income tax purposes. Thus, an investment structured as convertible debt will likely not qualify as an eligible investment (although the conversion to equity should be able to qualify as an eligible investment at the time of conversion).

Potential Pitfalls for Investors

Investors must be very careful if they intend to contribute property to a QOF. If the contributed property has a fair market value in excess of the adjusted basis of such property, the value in excess of the adjusted basis will be considered a nonqualified investment that is not eligible for the tax benefits under the QOZ program (the amount attributable to the property's adjusted basis will be a qualified investment). As noted above, the amount of gain deferred for contributions of property will be the adjusted basis of the property (and not fair market value).

An investor is permitted to acquire a QOF interest from an existing QOF owner (*i.e.*, a sale in the secondary market). The purchased interest will be treated as qualifying property (and gains up the amount purchase price can be deferred from income). Note that an investor's holding period begins as of the date of purchase. Thus, if an interest is acquired in the secondary market (such that an investor's holding period begins as of the date that the investment was acquired in the secondary market) and the property will be sold by the QOF prior to the ten year period, the secondary market purchaser will not be able to avail itself of the tax-free appreciation rule.

The issuance of a profits interest in exchange for services will not be considered a qualified investment. Thus, the owner of a carried interest will not be eligible for the tax benefits under the QOZ program. Investors that contribute cash and also receive a profits interest should carefully structure their interests to avoid having a disproportionate share of their interests taxed under regular tax rules.

4. The Investor Must Elect to Defer Capital Gains

The investor must defer capital gains. A taxpayer that may make such deferral election includes an individual, partnership, S corporation, C corporation, trust, or estate. If gains are incurred by an entity, the deferral may be made by the entity that previously incurred capital gains eligible for reinvestment. If the entity (or any upper-tier entity that is a direct or indirect owner of such entity) does not make the election to defer gains, the individual partners may elect to defer gains on their individual tax return.

The investor (whether an individual or an entity) will make the election by identifying the gains that will be deferred in accordance with IRS instructions on Form 8949 and Schedule D of the applicable tax return. A taxpayer may use any portion of a larger gain for multiple investments.

5. The Investor May Adjust the Basis of its Investment

The Investor is entitled to tax benefits (accomplished through increases to the basis of the Investor's investment) by meeting certain holding period requirements. After the Investor has held its investment in a QOF for at least 5 years it will increase its basis in the investment by10% of the original deferred gain. After the investor has held its investment in a QOF for at least 7 years it will increase its basis in the investment by an additional 5% of the original deferred gain. These basis adjustments has the effect of eliminating the tax liability with respect to up to 15% percent of the original deferred gain.

6. THE INVESTOR WILL RECOGNIZE PREVIOUSLY DEFERRED GAIN.

The investor will recognize a portion of the previously deferred gain on the earlier of (A) the date that the investment (or any portion) is sold or exchanged (or deemed to be sold or exchanged due to an inclusion event) or (B) December 31, 2026. In some cases, an investment will be treated as sold for purposes of including previously deferred gains (in whole or in part) if it is sold, transferred, gifted, contributed, or liquidated (any such event is considered an "inclusion event"). Likewise, if the QOF engages in a transaction that results in an investor recognizing gain (*i.e.*, with respect to distributions in excess of basis, or taxable boot in a non-recognition transaction), the investor will be considered to have sold or exchanged a portion of its investment. The transfer of equity ownership of upper-tier entities may also result previously deferred gain being included in income.

In general, if a QOF or an investor engages in a transfer that is treated as a non-recognition transaction (under partnership or corporate rules), previously deferred gain will not be included in income. Similarly, a transfer by an investor to a grantor trust (which is treated as owned by the grantor for income tax purposes) will not result in gain inclusion. The receipt by an estate (or distribution from an estate) of a QOF interest is not an inclusion event.

On December 31, 2026, the Investor will recognize income the lesser of (A) the remaining deferred gain or (B) the fair market value of the investment as of that date, less the amount of basis adjustments (due to the statutory adjustments based on the investor's holding period or with respect to a prior gain inclusion).[375]

The effect of the "lesser of" rule is that a taxpayer will need to ascertain the fair market value of its investment as of the date of any inclusion event (including December 31, 2026) and compare this amount with its deferred capital gain. If the value of the investment is less, the Investor will only recognize an amount of income equal to such fair market value (less allowable basis). The fair market value should be determined under normal federal income tax principles (including the applicability of discounts for lack of control and lack of marketability).

7. THE INVESTOR WILL AVOID GAIN UPON THE DISPOSITION OF QUALIFIED PROPERTY.

After the Investor has held its investment for 10 years, the sale or exchange of such investment will be tax free. The Investor accomplishes tax free treatment by making an election to (A) increase its basis in its investment to the fair market value or (B) exclude the capital gain arising from the disposition of qualified property by the QOF.

Since the tax-free appreciation is adjusted through a step-up in basis to fair market value, the Investor (in a properly structured transaction) will never have any depreciation recapture with

[375] For any other inclusion event, the amount of gain that an investor will include in income (as of the respective inclusion date) is the proportionate amount of the remaining deferred gain based on the fair market value of the investment that was deemed to be sold.

respect to a qualified investment for which such election is made. This will not prevent the Investor from recognizing losses (whether active or passive) during the time period in which the investment is held.

C. Economic Outcomes for Qualified Opportunity Zone Investors

Investors typically use the internal rate of return (IRR) concept as a metric to measure the return on an investment in the context of a leveraged real estate investment. The IRR model reflects the compounded annual return of a series of cash flows. In the context of an opportunity zone investment, we can measure the effect of the tax benefits under the program by treating such tax benefits or liabilities as cash paid or received at the time the tax would otherwise have been paid without regard to the opportunity zone program.

We can compute the (1) tax liability that is *not* paid on the date of the investment (or the date that such tax liability would have been due), (2) tax that will be paid on an inclusion date or December 31, 2026 (since the tax would normally be due on April 15, 2027) and (3) tax that is not paid at the time of sale. These three tax amounts can then be treated as additional cash inflows (since they would normally be paid by an investor that is basing return on a pre-tax IRR) which can be entered into the IRR formula to determine the pre-tax IRR. This approach is described below as the "IRR" approach.

Arguably, this method overstates the IRR since it assumes the tax liability on the deferred capital gain is invested at the full project level IRR (as if the saved taxes are invested in the transaction). It may not be accurate to suggest that an Investor increased its investment to account for the immediate tax savings. Thus, an alternative method to measure the deferred capital gain savings is using a basic present value formula at conservative interest rate (which makes sense for investors that would invest the money to pay this future tax liability using a lower risk asset allocation). This approach is described below as the "NPV" approach.

We have therefore modeled our IRR comparisons using each of the respective approaches. We have used a projection prepared for a development project that generated a pre-tax IRR of 14.72% with a disposition of the property after 10 years. The IRR of a QOF that obtained all of the tax benefits (whether using NPV or reinvestment of tax savings) is significantly higher as set forth in the table below:

	Plain IRR	**IRR with QOZ Benefits**	***Increase***
NPV	**14.72%**	**19.57%**	***32.91%***
IRR	**14.72%**	**21.53%**	***46.19%***

This example is consistent with prior deals that we have analyzed which reflect an increase in the return of 25-50%. There is no predictable way to model general corporate investment, however, similar benefits would apply to the average return for private equity or venture fund investments.[376]

[376] Note that for venture funds that generate substantial tax-free gains under Section 1202 for dispositions of qualified small business stock, the increased IRR from a QOZ will be reduced substantially.

PART 4: HOW REAL ESTATE DEVELOPERS CAN MAXIMIZE THE VALUE OF OPPORTUNITY ZONE PROJECTS

The industry that most obviously should benefit from the opportunity zone program is the real estate development business.

First, the tax incentives for real estate investors in the opportunity zone program are relatively predictable. For example, if real estate is held for ten years, there is a decreased risk (as compared to an operating business) that timing of the property disposition will have a drastic effect on investors' return (valuations of stabilized real estate assets are less volatile over an extended time horizon). Most leveraged real estate investments generate substantial depreciation deductions and the opportunity zone program allows for the depreciation recapture to be eliminated. This allows leveraged real estate investments that do not meet expectations to nonetheless have acceptable after-tax returns for a QOZ investment.

Second, a real estate investment is relatively easy to qualify for the QOZ program. Since the mechanical rules provide for strict guidelines on timing of the (i) capital investment, (ii) location of physical property and (iii) performance of services, a real estate QOF has less risk of failing conform to QOF guidelines. Unlike an operating business that may require capital as the business needs dictate, additional capital is less likely to be required after the initial construction phase of a real estate project (which makes it easier for all investors to obtain tax benefits under the QOZ program). The fact that real estate will be physically located in the QOZ eliminates the risk that the QOF will cease to qualify as business operations cause activities to be conducted (in a substantial manner) out of the QOZ.

A. Life Cycle of a Leveraged Real Estate QOF (from the perspective of a real estate developer or sponsor)

The following steps reflect the life cycle of a leveraged real estate QOF and the steps and decisions that the developer or sponsor must take in connection with the formation, operations and ultimate disposition of the project.

We assume the same fact pattern as in the previous example (in Part 2), as follows:

Assume that the proposed investment requires that investors (collectively) invest $100 million into a QOF in exchange for a membership interest that provides for an 8% preferred return on unreturned invested capital (compounded annually) and 60% of all residual profits after payment of the preferred return. The remaining 40% of the residual profits (after payment of the preferred return) is the sponsor's promote interest. Assume that the QOF (or underlying operating entities) borrows $200 million (pursuant to a construction loan) to fund development expenses for a single real estate development project (the "Project"), resulting in total cost of the project of $300 million. The investment will close (*i.e.*, the funds will be contributed) on April 30, 2019. We further assume that the property will be sold on May 1, 2029 for $600 million (reflecting a compounded annual growth rate of approximately 7.2%).

Step 1: Pre-Development Activities (January 1, 2018 through April 30, 2019)

Frequently, a real estate developer will begin pre-development activities prior to the actual acquisition of real property. In some cases, a developer will have a property under contract based on contingencies to obtain governmental approvals, zoning changes, and permits. These activities include preliminary due diligence, certain aspects of the entitlement process, engaging in negotiations with potential tenants and other soft costs.

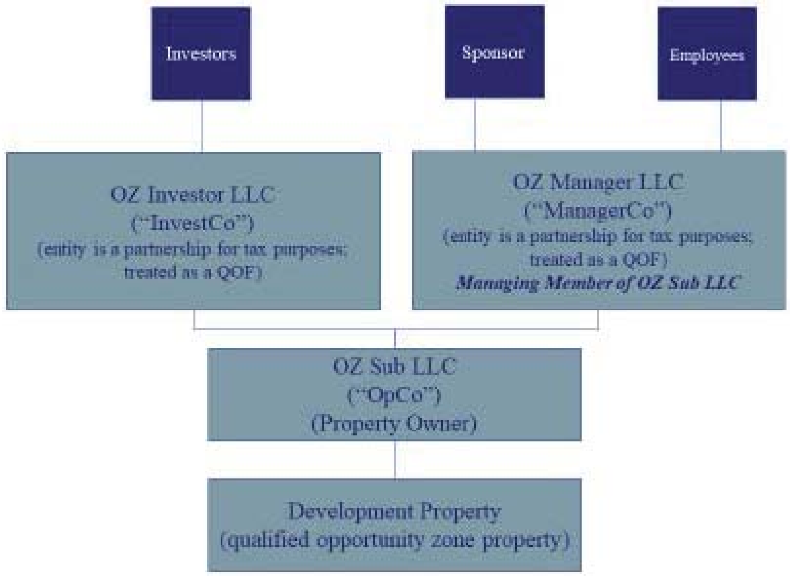
In the context of a QOF investing in real estate, such pre-development assets (*i.e.*, the soft costs incurred for pre-development activities) will not be considered QOZP. ***Accordingly, the developer will need to determine whether such assets should be contributed or sold to the QOF when it is formed.*** Likewise, if a developer intended to use capital gains to fund its investment, it may make sense to fund pre-development costs through a loan to the operating entity, which will be repaid following the date that the entity elects to be treated as a QOF.

Step 2: Capital Raising Activities (January 1, 2018 through April 30, 2019)

Once the project is "ready to go", the developer or sponsor must line up capital. However, in this context, the developer or sponsor must cause the investors to contribute capital up to the amount of capital gains recognized (and deferred) by such investor during the applicable 180-day timeframe (if such investors intend to benefit from opportunity zones). Thus, the typical structure of a leveraged real estate fund (with many projects owned directly by the fund) is generally not recommended for a QOF. Instead, the QOFs will either be set up separately for each project or the capital could be called all at once and will then be held by the QOF until it is needed.

Step 3: Structuring the QOF (April 2019)

The developer/sponsor should structure its project in order to maximize the tax benefits under the QOZ program. To accomplish this result, the developer will form three limited liability companies that will be treated as partnerships for tax purposes (this structure is used so that the QOF may benefit from the specific benefits available for a QOZB ("QOZB"). The following chart reflects the general investment structure.



OZ Investor LLC ("InvestCo") and OZ Manager LLC ("ManagerCo") (the owners of OZ Sub LLC ("OpCo")) will each be treated as a separate QOF (so long as each of InvestCo and ManagerCo elect to be treated as a QOF).

The organizational documents for both InvestCo and ManagerCo will include a provision providing that the QOF was formed for the purpose of investing in QOZP.

OpCo is treated as a QOZ partnership interest. Accordingly, the operating business may (i) avail itself of the working capital safe harbor; and (ii) meet the tangible property holding period requirement if at least 70% of its assets consist of QOZBP.

To the extent that ManagerCo is issued a profits interest under OpCo's operating agreement in exchange for services (or at the ManagerCo level to a member), such interests will not be treated as qualified interests and any subsequent gains with respect to such interests will be taxable.

Step 4: Capitalizing the QOF (April 30, 2019)

The Investors will contribute $100 million of cash (or property) to the QOFs on April 30, 2019 in exchange for a preferred interest entitling such investors to an 8% preferred return and 60% of the residual profits thereafter. ManagerCo will be entitled to the remaining 40% residual profits as its promote interest.

The QOFs (InvestCo and ManagerCo) will contribute the $100M of cash invested by the Investors to OpCO (the QOZB) in exchange for all of the membership interests of OpCo. The preferred return and promote will be reflected in OpCo's operating agreement.

Step 5: Satisfy Initial Working Capital Requirements (May 2019)

A QOF must meet certain requirements in order to utilize the working capital safe harbor (allowing a QOZB to hold cash or equivalents for up to 31 months without such assets being treated as nonqualifying property).

First, the QOF must designate in writing that such working capital amounts are for the development of a trade or business in a QOZ, including when appropriate the acquisition, construction and/or substantial improvement of tangible property in such zone.

Second, the QOF must prepare 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 such assets.

Third, the working capital assets are actually used in a manner that is substantially consistent with the development plan and schedule described above. Importantly, if use of the working capital assets is delayed due to governmental inaction on a completed application, the delay does not cause a failure to meet the qualified property tests (which may extend the requirement to spend the working capital assets past 31 months).

Step 6: Acquire Property by Purchase or Lease (May 15, 2019)

A QOZB then acquires property by purchase or lease (the property must have been acquired after December 31, 2017). Acquisition of property from a 20% or greater related person will not be treated as qualified property, but leases from a related party, are permitted subject to certain anti-abuse rules.

The QOZB will borrow $200 million (pursuant to a construction loan typical for such Project).

Under our facts, we assume that the QOZB uses $100 million of cash to acquire land and buildings. We assume that $60 million is properly allocable to the buildings and personal property, and the remaining $40 million is allocable to raw land.

Step 7: Satisfy Original Use or Substantial Improvement Test (May 15, 2019 through November 15, 2021)

A QOF must satisfy either the original use test or the substantial improvement test. In order to be treated as qualified property, either the original use of such property must commence with the QOF or the property must be substantially improved by the QOF (as explained below).

Original Use

Property may be treated as qualified property (subject to the acquisition and substantially all requirements) if the original use commences with the establishment of the QOF in a QOZ. If property (new or used) is first placed in service for purposes of depreciation or amortization with the QOF, it will meet the original use test. Likewise, property that was unused or vacant for an uninterrupted period of at least five years, it will be treated as original use property by the QOF.

Used property that has not been previously used in a QOZ will meet the original use requirement. If used property had previously been used in an opportunity zone, it must be substantially improved by the QOF in order to be treated as qualified property.

Substantial Improvement

A QOF (and QOZB) must substantially improve the acquired property by making an investment equal in value to the cost of the tangible property that is acquired by the QOF. Land is excluded for purposes of calculating substantial improvement. Thus, if a QOF acquires land and building for $100 million, with $40 million of the purchase price allocable to land and $60 million allocable to a building, the QOF is required to make improvements to the property of at least $60 million (equal to the acquisition basis of the building).

Under our facts, the QOZB owns the property and will use the $200 million construction loan proceeds to construct the Project (consisting of residential and commercial rental property).

In large part, leveraged real estate projects will be constructed on newly acquired land and vacant or in-service buildings. Thus, the substantial improvement tests will likely apply in such circumstances. Development projects should have little problem meeting the substantial improvement requirements (since the construction costs typically exceed the land cost by a significant margin). Major renovation projects may also satisfy the substantial improvement requirements. At the margin, the opportunity zone program could substantiate a broader rehabilitation or redevelopment in certain circumstances where expected construction would otherwise enable the developer to nearly, but not quite, meet the substantial improvement thresholds.

Step 8: Satisfy Working Capital Safe Harbor (April 30, 2019 through November 30, 2021)

The QOF must first satisfy the initial working capital requirements described in Step 5 above (which effectively requires the QOF to document its business plan for the use of funds). Thereafter, the QOF may avail itself of the working capital safe harbor. Under this safe harbor, cash, cash equivalents and debt instruments with a term of 18 months or less will not be counted towards the testing requirements (described below) for the 31 month period following the receipt of such funds (from any source) by the business. Thus, cash and qualifying financial property will not disqualify a QOF from meeting the requirement that the QOF hold qualified tangible property.

Funds that call capital (or borrow funds) at different times will have multiple 31 month periods to utilize the working capital safe harbor. The requirements above (reflecting the written plan and use of funds) must be completed with respect to each separate receipt of funds by the QOF or an operating subsidiary.

Step 9: First Testing Period (October 1, 2019)

On October 1, 2019 (the 6-month anniversary of QOF formation), each of the QOFs must test its assets in accordance with the 90% test. The sole asset of each QOF consists of the membership interests in OpCo. So long as OpCo is considered a QOZB, 100% of the QOF's interests in the QOZB is considered qualified property, which will satisfy the 90% test for each QOF.

During the testing period (the first six-month period of the QOF's existence), OpCo must qualify as a QOZB in order for the QOF to meet the 90% test. OpCo's assets consisted of contributed cash, borrowed cash, land and building acquired on May 15, and any improvements to the land made during the testing period. However, all cash that is contributed during the prior six-month period (from April 1 to September 30, 2019) is excluded from the calculation. Likewise, since the QOZB is eligible for the working capital safe harbor, cash, cash equivalents and short term debt obligations will be excluded from the calculation for the 31 month period beginning as of the date of receipt of cash or property. Therefore, so long as 70% of the balance of OpCo's assets consist of qualified property (and OpCo otherwise meets the QOZB requirements for active conduct of a trade or business, use of intangible property and no 'sin' businesses), OpCo will be treated as a QOZB.

Step 10: Second Testing Period (December 31, 2019)

On December 31, 2019, each of the QOFs must test its assets in accordance with the 90% test (for the period from October 1, 2019 through December 31, 2019). The sole asset of each QOF consists of the membership interests in OpCo. So long as OpCo is considered a QOZB, each QOF will satisfy the 90% test.

Step 11: Self-Certify as a QOF (March 15, 2020)

On or before March 15, 2020 (or September 15, 2020 if the QOF filed an extension), each QOF will file their respective partnership tax returns (Form 1065) and file, with its tax return, Form 8896 to self-certify as a QOF effective April 2019. The QOF will also need to make sure that its organizing documents reflect its purposes to invest in QOZP. Finally, Form 8996 will reflect the results of the 90% testing requirements.

Step 12: Permanent Financing (December 2021)

After construction of the project is complete, the QOZB will refinance the existing construction loan with permanent financing (assuming that the property is stabilized). Often, the permanent financing will provide sufficient excess cash to pay the preferred return to investors and, in some circumstances, repay a portion of the original invested capital to investors.

The QOZ rules explicitly permit cash out refinance using debt financed distributions (so long as the recipient has sufficient basis resulting from its share of liabilities). In most leveraged real estate fund investments, investors will be allocated a share of the partnership's debt which will be sufficient to receive debt financed distributions tax free.

Step 13: Ongoing Operations (December 2021 through May 1, 2029)

In general, the QOFs and the QOZB will be operated in the same manner as a traditional leveraged real estate investment. Thus, the investors will, effectively, have the same tax treatment and economic returns as they would be entitled to in the absence of the QOZ program.

Each QOF will continue to test its assets every six-month period and file Form 8996 with its partnership tax return to reflect its qualifications as a QOF and to determine any penalties for failure to meet the asset tests, as well as the other requirements to be treated as a QOZB.

To the extent that a subsequent capital contribution is made: (i) in order to obtain the QOZ tax incentives, it must be made with reinvested capital gains to be treated as an eligible investment; and (ii) a new holding period begins with respect to such subsequent investment.

Step 14: Gain Recognition for Investors (December 31, 2026)

From the perspective of the QOF, the December 31, 2026 "inclusion date" (which is the last day that any invested capital gains will be recognized by the investor if not previously recognized) does not create any obligation on behalf of a QOF. However, the investors of the QOF will recognize their original capital gains (subject to basis adjustments, as applicable) and will owe tax. In some cases, it may be ideal to refinance near this time frame and distribute cash to investors so that they have cash to pay the tax liability on the original deferred gain.

In unprofitable deals, the investor would benefit by including in income the fair market value of their investment, less basis (instead of the remaining deferred gain). Thus, the QOF may assist investors to coordinate valuations (which will reduce costs and possibly, the risk that the valuation would be challenged.

Step 15: Disposition After 10 Years (June 1, 2029)

On June 1, 2029, the property will be sold for $600 million. After repayment of debt (approximately $147 million) and payment of transaction costs (approximately $20 million), the balance of $433 million will be distributed to the partners in accordance with the respective operating agreements of the QOF and its subsidiary entities. To the extent that the refinance at the time of permanent financing and cash flow from operations covered the payment for preferred return (but not the principal), the distribution to partners at the time of the sale will be approximately (i) $100 million return of invested capital to preferred members; (ii) $200 million to preferred members (equal to 60% of residual cash flow) and (iii) $133 million with respect to the promote interest (equal to 40% of residual cash flow). Thus, the project generated a pre-tax return for the investors of 16.61% (calculated using the Excel XIRR formula).

To the extent that the property (consisting of personal property, qualified improvements, residential rental property and commercial rental property) was depreciated from $300 million to $100 million, the investors have capital account balances of negative $100 million. Thus, the sale of the property (***under normal tax rules***) for $600 million would generate taxable gain of $680 million (after taking into account transaction expenses). Of this amount, $200 million consists of depreciation recapture (assumed to be Section 1250 gain taxed an aggregate federal and state tax rate of 37%) and the remainder is capital gain (taxed at an aggregate federal and state tax rate of 32%). Accordingly, the estimated federal and state tax liability resulting from the sale if no election is made will be $228 million.

The QOF must carefully structure its sale to allow its investors to maximize their tax benefits. A sale of QOF equity interests will allow for the investors to step up the basis to fair market value (and a corresponding inside basis step up will be made by the QOF), resulting in no gain or loss (even with respect to the QOF's share of nonqualified assets and ordinary income assets).

If a QOF sells its assets, the taxpayer may only exclude any capital gain from the disposition of qualified property and will pay tax on any other income. In a leveraged real estate transaction, these two approaches will likely have very similar outcomes. However, there are circumstances where the disposition of large, complex real estate projects will generate ordinary income (*e.g.*, the disposition of depreciated personal property such as vehicles or maintenance equipment) or will contain nonqualified assets.

B. Planning Ideas for a Leveraged Real Estate QOF

1. Timing Investor Contributions

In a typical real estate fund, capital is called as required for investment into new projects (typically at the time of land acquisition for development projects with the balance derived from construction loans). This structure is problematic since investors must use capital gains to invest into a fund in order to qualify for the tax benefits. Accordingly, alternative structure must be considered.

One approach is that funds may be raised on a project by project basis. This is inefficient from a capital raise perspective, but solves the problem of having investors with potential for disallowed gains.

In some cases, the fund could have all capital contributed up front, even if projects are not yet ready to go. This is potentially costly for the fund (if the investors will be paid a preferred return on invested capital) but allows for all investors to ensure that they will be able to defer capital gains.

In some cases, a QOF may require cash up front that exceeds the investor's current availability of eligible gains. This problem may be solved using convertible debt. A fund could structure its investment as a convertible note that is convertible at the initial fair market value and returns a coupon that is equivalent to the preferred return. The investor could then convert its debt into equity at any time which would allow the investor to control the timing of the investment of gains. Note, however, that the 10 year holding period would not begin until the time that such conversion was made and the economic rights of the equity holders and debt holders may differ (at least in regard to residual allocations of profits and/or cash flows).

2. General Structuring Matters

As is detailed in various sections of this book, most QOFs will be structured with two or more separate partnerships or other taxpayers (which may be treated as QOFs) that in turn own equity interests in a QOZB. The two-tier structure is required for most projects so that the QOZB can utilize the working capital safe harbor and the 70% qualifying asset test (instead of 90%).

Since restructuring a QOF is not particularly easy (as many transactions would cause inclusion events), the manner in which a QOF and QOZB are structured up-front will have tax ramifications upon disposition. A properly structured fund will allow for a mechanism by with investors holding qualifying investments will be able to sell equity rather than utilize the asset election to exclude gain. This approach may not be necessary in the context of a leveraged real estate fund (since ordinary income may be negligible and the fund may not hold any nonqualifying assets that are sold at a gain). However, the sale of equity would eliminate any potential for such tax inefficiencies.

3. Tax Treatment of Promote and Profits Interests

Profits interests are not eligible for the tax benefits under the QOZ program. To the extent that a sponsor has a promote interest that is part capital interest and part profits interest, the non-qualifying portion is based on the highest residual profit percentage attributable to the profits or promote interests.

In some cases, the promote interest increases after certain IRR hurdles are achieved. The literal reading of the Proposed Regulations reflects requiring that the promote interest holder treats the portion of its interest as non-qualifying based on the highest percentage interest attributable to the profits or promote interest. This rule could artificially increase the share of interests that are non-qualifying. Thus, an investor that also receives a promote interest may benefit from having its capital interest issued to one taxpayer and the profits interest issued to a separate taxpayer (with common ownership).

Moreover, it is not clear whether the equity structure of a business may be designed to allow for a sponsor to acquire a speculative equity interest for cash rather than receive a profits interest. For example, a sponsor could receive fee income that properly compensates the sponsor for services, and acquire residual interests that are comparable to the risky tranches of a bond fund or CDO for cash.

Alternatively, an upper-tier profits interest may be issued to a partner that itself is an investor in a QOF.

4. Substantial Improvements of Property

In the context of a development project, meeting the substantial improvement requirement is often not very difficult (since there is no requirement to improve land, and the value attributable to land is excluded from the calculation). In some cases, however, meeting the substantial improvement requirement will be difficult if it involves rehabilitation of structures.

In such a circumstance, a taxpayer would benefit with a larger allocation to land. To avoid the risk that the tax benefits of a QOF would be eliminated, any such allocations may be clarified by an appraiser to reduce the risk that the QOF would be deemed to fail the substantial improvement test.

In some cases, certain parcels could be substantially improved, while others would not be. In such cases, the parcels that would be improved could be acquired by a QOF (or QOZB) and the remaining parcels could be acquired through a separate (non-QOZ) entity.

5. Structuring Dispositions

The Proposed Regulations provides for a stark difference in tax treatment between the sale of equity interests and the sale of the underlying assets. An investor may elect to exclude income (resulting from an asset sale) solely with respect to capital gains from the disposition of qualified property. The asset sale election therefore will require the investors to distinguish between taxable income with respect to the disposition of ordinary income assets (*e.g.,* cash basis accounts receivables, depreciated personal property) and non-qualified property (which arguably could include intangible assets such as goodwill that is not used in a trade or business). Note that in the context of real estate, these issues may not be problematic; they would certainly arise in the context of the sale of an operating business.

The effect of this rule is that the disposition of a QOF or QOZB necessitate structure to allow for the sale of membership interests or stock rather than the sale of underlying assets. The fact pattern of a particular business and industry (as well as the relationship and intent of the investor owners) are relevant to determine how such interests could be properly structured.

6. Valuation Matters at December 31, 2026

Operating business QOFs and QOZBs may benefit from the "lesser of" rule that requires an investor to recognize as of any inclusion date or December 31, 2026 (subject to basis adjustments), the remaining deferred gain (or proportion thereof) or the fair market value of the investment at such time. The fair market value of equity interests in an operating business may be lower than the value as of the date of investment.

In certain types of funds, this effect is more prevalent. For example, a fund could return capital to a preferred investor without limiting such investor's potential upside (such that equity is not considered reduced at the time that the capital is repaid in part). Market fluctuations could then cause the investor's equity to have decreased when valued as of December 31, 2026. Moreover, contractual arrangements may create substantial additional discounts that are appropriate for determining the fair market value of the equity interest as of December 31, 2026 (*e.g.*, a permanent loan may be subject to onerous prepayment penalties or defeasance costs and may contain restrictions on the use of funds, the fund could prohibit transfers (or require an offer of the interests to the fund)).

In such a case, the investor may reduce or eliminate gain entirely with respect to the original deferred gain while continuing to own the equity interests. If the equity interests are subsequently sold (years later) at a large gain, the investor will have effectively eliminated (or nearly eliminated) tax on both the original deferred gain and the appreciation of the investment.

To the extent that equity interests in the fund would be valued at fair market value (reducing the deferred gain), the fund may be able to assist its investors to reduce costs by coordinating a valuation from an intendent third party valuation firm. This may also reduce risk for the investor group since the larger group's reliance (and sign off of their respective advisors) provides legitimacy to the conclusion of value.

Note that a leveraged real estate fund (that is sensitive to its investor's cash needs) may try to time a cash out refinance in a manner to provide cash for investors to cover their potential tax obligation.

PART 5: APPLYING OPPORTUNITY ZONES TO BUSINESS OWNERS

Real estate investments allow for relatively predictable cash flows, and benefit from an extremely robust market that allows for virtually all real estate to attract ready buyers (without significant cost) for sale at reasonable market prices.[377] An operating business, on the other hand, is much less predictable with respect to operating cash flows and the ability to sell at a particular point in time. Thus, an operating business' ability to benefit from the QOZ program is not assured. Indeed, I have referred to the use of a QOF structure for an operating business as buying a "lottery ticket" since it requires the confluence of a number of factors

Nonetheless, the function of the QOZ for an operating business is effectively identical to that for leveraged real estate. The following steps reflect the life cycle of an operating business QOF and the consequences. For purposes of consistency, we have used an example that is economically similar to the prior scenarios.

Note that many of the steps and planning tips are identical to those set forth in Part 4. Where appropriate, we have highlighted where the differences are meaningful.

A. Life Cycle of a Business QOF (from the perspective of a business owner or sponsor)

Assume that the proposed investment requires that investors (collectively) invest $100 million into a QOF in exchange for a membership interest that provides for an 8% preferred return on unreturned invested capital (compounded annually) and 60% of all residual profits after payment of the preferred return. The remaining 40% of the residual profits (after payment of the preferred return) is the sponsor's promote interest. The $100 million investment will be used to fund research and development for a software technology platform. The investment will close (*i.e.*, the funds will be contributed) on April 30, 2019. We further assume that the company will be sold on May 1, 2029 for $400 million.

Step 1: Preliminary Activities (January 1, 2018 through April 30, 2019)

Often, a start-up business will engage in business activities prior to its initial capital raise. In this stage, a technology development company will often (i) engage in formation and legal structuring; (ii) prepare a business plan; and (iii) create a proof of concept with respect to the proposed technology.

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[377] This statement is not intended to reflect that a real estate seller can easily obtain the actual fair market value of a real estate holding. However, it is not difficult to find a potential buyer of raw land or vacant buildings (although the price offered may be far less than the seller's expectatations) while finding a buyer for any operating business is a much more arduous task. The market for revenue generating real estate is extremely active – and therefore one can obtain market prices.

Business assets developed prior to the formation of a QOF will not be qualified assets. Such assets will need to be contributed, leased/licensed or sold to the QOF following formation. In a typical (i.e., non-QOZ) arrangement, the founder would contribute such assets to the operating business (so that the investors have rights without limitation on valuable intellectual property). The contribution of such assets could result in a mixed fund investment for the contributor.

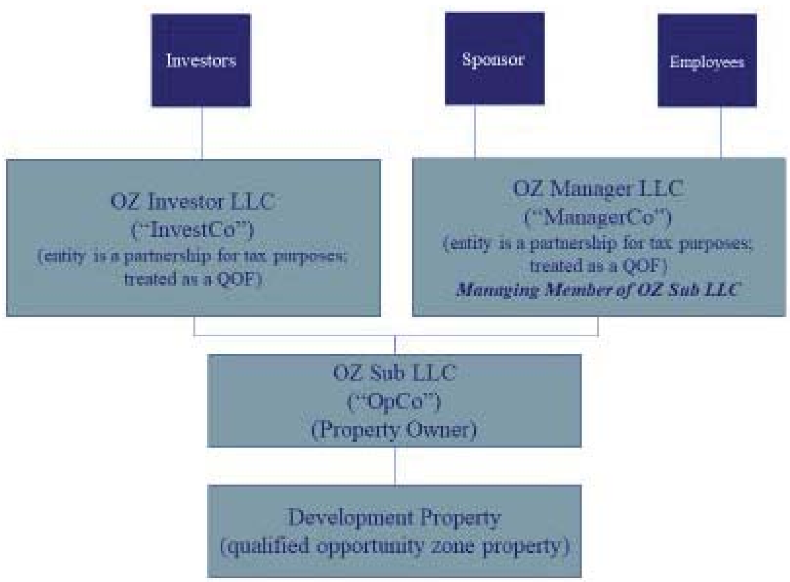
Thus, it may make sense for the business founder to *sell* all of the assets to the newly formed QOF after its formation and then contribute the cash received back (from such sale) to the QOF (this could be built into the economic arrangement).[378]

Step 2: Capital Raising Activities (January 1, 2018 through April 30, 2019)

Once the proof of concept is complete, the sponsor must line up capital. However, in this context, the developer or sponsor must cause the investors to contribute capital that consists of capital gains recognized by such investor during the applicable 180-day timeframe (if such investors intend to benefit from opportunity zones).

Step 3: Structuring the QOF (April 2019)

The sponsor will structure the business in order to maximize the tax benefits under the QOZ program and form the respective entities (including the QOF or QOFs). In this regard, the sponsor will form three limited liability companies that will be treated as partnerships for tax purposes. The following structure chart reflects the general structure (which is identical to the structure for the leveraged real estate example used in Part 4).



[378] If the founder contributed, rather than sold, nonqualified assets to the QOF, it would likely result in a mixed funds investment for the owner and could cause the QOF to fail the asset qualification tests.

The operating business is treated as a QOZ partnership interest. Accordingly, the operating business may (i) avail itself of the working capital safe harbor; and (ii) meet the tangible property holding period requirement if at least 70% of its assets consist of QOZBP.

Each of OZ Investor LLC ("InvestCo") and OZ Manager LLC ("ManagerCo") (the owners of OZ Sub LLC ("OpCo")) will be treated as a QOF.

Note that the QOFs should determine whether OpCo may benefit from being treated as a qualified small business corporation (which may be sold after a five-year holding period with 100% of gain excluded up to certain thresholds). This approach is commonly used for venture funds and may likewise be appropriate for certain QOF businesses.

The organizational documents for both InvestCo and ManagerCo (to the extent that each will elect to be treated as a QOF) will include a provision providing that the QOF was formed for the purpose of investing in QOZP.

To the extent that ManagerCo is issued a profits interest under OpCo's operating agreement in exchange for services (or at the ManagerCo level to a member), such interests will not be treated as qualified interests and any subsequent gains with respect to such interests will be taxable.

Step 4: Capitalizing the QOF (April 30, 2019)

The investors will contribute $100 million of cash (or property) to the QOFs on April 30, 2019 in exchange for a preferred interest entitling such investors to an 8% preferred return and 60% of the residual profits thereafter. ManagerCo will be entitled to the remaining 40% residual as its promote interest.

The QOFs will contribute the $100M of cash to OpCO (the QOZB) in exchange for all of the membership interests of OpCo. The preferred return and promote will be reflected in OpCo's operating agreement (or in either or both of the QOF operating agreements, as appropriate).

Step 5: Satisfy Initial Working Capital Requirements (May 2019)

A QOF must meet certain requirements in order to utilize the working capital safe harbor (allowing a QOZB to hold cash or equivalents for up to 31 months without such assets being treated as nonqualifying property).

First, the QOF must reflect that such working capital amounts are designated in writing for the development of a trade or business in a QOZ, including when appropriate the acquisition, construction and/or substantial improvement of tangible property (which may be real or personal property) in such zone.

Second, the QOF must prepare 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 such assets.

Third, the working capital assets must actually be used in a manner that is substantially consistent with the development plan and schedule described above. Please note that if use of the working capital assets is delayed due to governmental inaction on a completed application, the delay does not cause a failure (i.e., extends the time) to meet the qualified property tests. ***In the context of an operating business, the extension of time may apply based on applications for approvals made to the FDA (in the case of medical device or biotechnology companies) or other governmental approvals in the case of any regulated business.***

Step 6: Acquire Property by Purchase or Lease (May 15, 2019)

A QOZB may acquire property by purchase *or* lease (the property must have been acquired after December 31, 2017). Leases from a related party, however, are permitted subject to certain anti-abuse rules. Note that the acquisition of property from a 20% or greater related person will not be treated as qualified property.

Under our facts, we assume that the QOZB uses $100 million of cash to fund the development of a technology platform. The business will likely spend only a relatively small proportion of the contributed capital on purchasing tangible property (which would consistent of leasehold improvements, computer equipment, software and office equipment). Other tangible property (such as real estate) would likely be leased by the company. The remainder of the funds would be set aside for research and development (primarily comprised of compensation for employees and payments to third-party independent contractors). This point reflects that the capital that is raised is not required to be spent on tangible property, so longer as the other criteria to satisfy the QOZ program tests are met.

Step 7: Satisfy Original Use or Substantial Improvement Test (May 15, 2019 through November 15, 2021)

A QOF must satisfy either the original use test or the substantial improvement test. In order to be treated as qualified property, either the original use of such property must commence with the QOF or the property must be substantially improved by the QOF.

Original Use

Property may be treated as qualified property (subject to the acquisition and substantially all requirements) if the original use commences with the QOF in a QOZ. If property (new or used) is first placed in service for purposes of depreciation or amortization with the QOF, it will meet the original use test. Likewise, property that was unused or vacant for an uninterrupted period of at least five years, it will be treated as original use property by the QOF. Used property that has not been previously used in a QOZ will meet the original use requirement. Note that if used property had previously been used in the opportunity zone, it must be substantially improved by the QOF or it will not be treated as qualifying property.

For most operating businesses, the original use test will allow such businesses to satisfy these tests, as most of the property acquired will be new tangible equipment, furniture and fixtures that is acquired by the QOF or QOZB.

Substantial Improvement

A QOF (and QOZB) must substantially improve the acquired property by making an investment equal in value to the cost of the tangible property that is acquired by the QOF. Many operating businesses will not acquire used equipment and the substantial improvement test will be inapplicable. Indeed, operating businesses that intend to qualify as a QOF or QOZB should not acquire (by purchase) used equipment that will not be improved since such property would not be qualifying property under the QOZ program (and such property could cause penalties or even the failure to meet the qualifications).

Step 8: Satisfy Working Capital Safe Harbor (April 30, 2019 through November 30, 2021)

The QOF must first satisfy the initial working capital requirements described in Step 5 above (which effectively requires the QOF to document its business plan for the use of funds). Thereafter, the QOF may avail itself of the working capital safe harbor. Under this rule, cash, cash equivalents and debt instruments with a term of 18 months or less will not be counted towards the testing requirements (described below) for the 31-month period following the receipt of such funds (from any source) by the business.

Funds that call capital (or borrow funds) at different times will have multiple 31-month periods to utilize the working capital safe harbor. The requirements above (reflecting the written plan and use of funds) must be completed with respect to each separate receipt of funds by the QOF or an operating subsidiary.

Step 9: First Testing Period (October 1, 2019)

On October 1, 2019 (the 6-month anniversary of QOF formation), each of the QOFs must test its assets in accordance with the 90% test (requiring at least 90% of its assets to be treated as QOZBP). The sole asset of each QOF consists of the membership interests in OpCo. So long as OpCo is considered a QOZB, each QOF will satisfy the 90% test.

During the testing period, OpCo must qualify as a QOZB in order for the QOF to meet the 90% asset test. The QOZB, in turn, must meet the 70% test (requiring that at least 70% of its assets qualify as QOZBP). OpCo's assets consisted of contributed cash, office and computer equipment, leasehold improvements, and any developed software that is appropriately capitalized. However, all cash that is contributed during the prior six-month period is excluded from the calculation. Likewise, since the QOZB is eligible for the working capital safe harbor, cash, cash equivalents and short term debt obligations will be excluded from the calculation for the 31 month period beginning as of the date of receipt of cash or property.

For this business, the QOZB must ensure that it meets the gross income test (such that at least 50% of its gross income is derived from the active conduct of a trade or business in a QOZ). In the case of a software development business, this will likely be satisfied under the Hours or Compensation test if the work is being performed in a QOZ. Likewise, the QOZB should be able to satisfy the requirement that at least 40% of the intangible assets of the business are used in the active conduct of the trade or business since, under our facts, all intangible assets are used in the trade or business.

Thus, so long as 70% of the balance of OpCo's assets consist of qualified property (and OpCo otherwise meets the QOZB requirements for active conduct of trade or business, use of intangible property and no 'sin' businesses), OpCo will be treated as a QOZB.

Step 10: Second Testing Period (December 31, 2019)

On December 31, 2019, each of the QOFs must test its assets in accordance with the 90% test. The sole asset of each QOF consists of the membership interests in OpCo. So long as OpCo is considered a QOZB, each QOF will satisfy the 90% test.

Step 11: Self-Certify as a QOF (March 15, 2020)

On or before March 15, 2020 (or September 15, 2020 if the QOF filed an extension), each QOF will file their respective partnership tax returns (Form 1065) and file, with its tax return, Form 8896 to self-certify as a QOF effective April 2019. The QOF will also reflect that its organizing documents reflect its purposes to invest in QOZP. Finally, Form 8996 will reflect the results of the 90% testing requirements.

Step 12: Ongoing Operations (December 2021 through May 1, 2029)

In general, the QOFs and the QOZB will be operated in the same manner as a traditional software development company each year. Thus, the investors will, effectively, have the same tax treatment and economic returns as they would be entitled to in the absence of the QOZ program.

To the extent that a subsequent capital contribution is made: (i) it must be made with reinvested capital gains to be treated as an eligible investment to obtain the QOZ tax incentives; and (ii) a new holding period begins with respect to such subsequent investment.

Each QOF will continue to test its assets every six-month period and file Form 8996 with its partnership tax return to reflect its qualifications as a QOF and to determine any penalties for failure to meet the asset tests, as well as the other requirements to be treated as a QOZB.

Step 13: Gain Recognition for Investors (December 31, 2026)

From the perspective of the QOF, the December 31, 2026 inclusion date does not create any obligation on behalf of a QOF. However, the investors of the QOF will recognize their original capital gains (subject to basis adjustments, as applicable) and will owe tax.

In unsuccessful deals, the investor would benefit by including in income the fair market value of their investment, less basis (instead of the remaining deferred gain). Thus, the QOF may assist investors to coordinate valuations (which will reduce costs and possibly, the risk that the valuation would be challenged.

In the context of a software development business, if the developed software is not yet producing revenues and/or profits, it is possible that the company will be valued at a low valuation. In that case, the investors may only recognize a fraction of the original deferred gain.

Step 14: Disposition After 10 Years (June 1, 2029)

On June 1, 2029, the property will be sold for $400 million. After payment of transaction costs (approximately $10 million), the balance of $390 million will be distributed to the partners in accordance with the respective operating agreements of the QOF and its subsidiary entities. To the extent that cash flow from operations covered the payment for preferred return (but not the principal), the distribution to partners at the time of the sale will be approximately (i) $100 million return of invested capital to preferred members; (ii) $174 million to preferred members (equal to 60% of residual cash flow) and (iii) $116 million with respect to the promote interest (equal to 40% of residual cash flow). Thus, the project generated a pre-tax return for the investors of ___% (calculated using the Excel XIRR formula).

The QOF must carefully structure its sale to allow its investors to maximize their tax benefits. A sale of QOF equity interests will allow for the investors to step up the basis to fair market value (and a corresponding inside basis step up will be made by the QOF), resulting in no gain or loss, even with respect to the share of nonqualified assets and ordinary income assets.

B. Planning Ideas for a Business Owners

1. Coordination with Qualified Small Business Stock Incentives

Many venture investments are structured using qualified small business stock ("QSBS") which provides for tax-free gains on the disposition of QSBS that is held for at least 5 years. A qualified small business ("QSB") is a C corporation with $50 million or less in gross assets (at the time that the stock was issued) that engages in an active trade or business (with certain businesses excluded). The rationale for using a QSB as a vehicle for venture investing is that gains from the disposition of QSBS, if held for at least 5 years, will be tax-free up to the lesser of 10 times the adjusted basis in the stock or $10 million.

A QOF or QOZB may be structured as a QSB.

The net effect of combining these approaches is that:

1. The investor may defer *any* capital gains under the QOZ program (under the QSB tax incentive, gains from the sale of QSBS may only be deferred if reinvested in another QSB).

2. If the investor disposes of stock in the QSB after 5 years, but prior to 10 years, the investor will still receive at least partial tax-free gain treatment. If the stock is held for 10 years, the entire gain will be tax free under the QOZ program.

In the context of venture fund investing, the use of a C corporation structure for underlying investments is preferred by many institutional investors (primarily for compliance reasons, and due to the tax rules for tax-exempt entities).

Note that many businesses will benefit, on an after-tax basis, using a pass-through (*i.e.*, partnership) structure. For such businesses, the use of QSBS will not be the preferred structure.

2. Building Intangible Value in a Zone Entity

Closely held businesses are typically sold using actual or deemed asset sales. When the assets of a business are sold, the primary value is considered "goodwill" which generally represents the value of the intangible assets of a business (*i.e.*, brand, marks, customer list, reputation, processes, know-how, etc.).

Building the goodwill value inside of an opportunity zone is easy for businesses that solely exist as a QOF or QOZB. However, businesses that grow may ultimately consist of a QOZ entity and a non-zone entity. In these situations, it is critical that a business understand how to build (and retain) goodwill value in QOZ.

For example, the initial intellectual property rights (such as brand name, trademarks, technology) are owned by the QOZ and QOZB (subject to the testing requirements for intangibles that are self-created). Reflecting value of such attributes is buttressed if the marketing, advertising, research and development, and corporate strategy personnel work from the QOZ entity.

The relationship between a QOZ entity and non-QOZ entity are also important. The non-zone entities should have a very specific purpose, with limited upside potential (this may be accomplished through such entity acting as a licensee or franchisee of the zone entity).

Ultimately, upon disposition of a businesses, the various assets and/or equity interests of entities will be valued by the buyer and seller. The facts will govern the value in the zone entity as compared to a non-zone entity. By planning early, a business should be able to maximize the value of the QOF or QOZB as compared to non-zone entities. Ultimately, this approach will greatly reduce taxation (and increase the after-tax return for investors).

3. Tax Treatment of Promote and Profits Interests

Profits interests are not eligible for the tax benefits under the QOZ program. To the extent that a sponsor has a promote interest that is part capital interest and part profits interest, the non-qualifying portion is based on the highest residual profit percentage attributable to the profits or promote interests.

In some cases, the promote interest increases after certain IRR hurdles are achieved. The literal reading of the Proposed Regulations reflects requiring that the promote interest holder treats the portion of its interest as non-qualifying based on the highest percentage interest attributable to the profits or promote interest. This rule could artificially increase the share of interests that are non-qualifying. Thus, an investor that also receives a promote interest may benefit from having its capital interest issued to one taxpayer and the profits interest issued to a separate taxpayer (with common ownership).

Moreover, it is not clear whether the equity structure of a business may be designed to allow for a sponsor to acquire a speculative equity interest for cash rather than receive a profits interest. For example, a sponsor could receive fee income that properly compensates the sponsor for services, and acquire residual interests that are comparable to the risky tranches of a bond fund or CDO for cash.

Alternatively, an upper-tier profits interest may be issued to a partner that itself is an investor in a QOF.

4. Structuring Dispositions

The Proposed Regulations provides for a stark difference in tax treatment between the sale of equity interests and the sale of the underlying assets. An investor may elect to exclude income (resulting from an asset sale) solely with respect to capital gains from the disposition of qualified property. The asset sale election therefore will require the investors to recognize taxable income with respect to the disposition of ordinary income assets (*e.g.,* cash basis accounts receivables, depreciated personal property) and for non-qualified property (which arguably could include intangible assets such as goodwill that is not used in a trade or business). Note that in the context of real estate, these issues may not be problematic; they would certainly arise in the context of the sale of an operating business.

The effect of this rule is that the disposition of a QOF or QOZB necessitate structure to allow for the sale of membership interests or stock rather the sale of underlying assets. The fact pattern of a particular business and industry (as well as the relationship and intent of the investor owners) are relevant to determine how such interests could be properly structured.

5. Valuation Matters at December 31, 2026

Operating business QOFs and QOZBs may benefit from the "lesser of" rule that requires an investor to recognize as of any inclusion date or December 31, 2026 (subject to basis adjustments), the remaining deferred gain (or proportion thereof) or the fair market value of the investment at such time. The fair market value of equity interests in an operating business may be lower than the value as of the date of investment.

In certain types of businesses, this effect is more prevalent. For example, a business that remains in the development stage (*i.e.*, pre-revenue) may be valued (by a certified valuation analyst) on December 31, 2026 at a very low value. In such a case, the investor may reduce or eliminate gain entirely with respect to the original deferred gain while continuing to own the equity interests. If the equity interests are subsequently sold (years later) at a large gain, the investor will have effectively eliminated (or nearly eliminated) tax on both the original deferred gain and the appreciation of the investment.

PART 6: APPENDICES

A. The ABCs of OZs (a Glossary of Key Terms and Abbreviations)

"**Inclusion event**" means an event described in paragraph (c) of Prop. Reg. § 1.1400Z-2(b)-1, reflecting the circumstances in which deferred gain is included in income.[379]

"**Mixed-funds investment**" means an investment a portion of which is a qualifying investment and a portion of which is a non-qualifying investment.[380]

"**Non-qualifying investment**" means an investment in a QOF described in section 1400Z-2(e)(1)(A)(ii) (relating to the treatment of an investment with mixed funds).[381]

"**QOF**" or "**qualified opportunity fund**" means any investment vehicle that is organized as a partnership or corporation (for the purpose of investing in qualified opportunity zone property) that holds at least 90 percent of its assets in QOZP.[382]

"QOF corporation" means a QOF that is classified as a corporation for Federal income tax purposes.[383]

"**QOF C corporation**" means a QOF corporation other than a QOF S corporation.[384]

"**QOF owner**" means a QOF shareholder or a QOF partner.[385]

"**QOF S corporation**" means a QOF corporation that has elected under section 1362 to be an S corporation.[386]

"**QOF shareholder**" means a person that directly owns a qualifying investment in a QOF corporation.[387]

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[379] Prop. Reg. § 1.1400Z-2(b)-1(b)(2)(iv)

[380] Prop. Reg. § 1.1400Z-2(b)-1(b)(2)(v)

[381] Prop. Reg. § 1.1400Z-2(b)-1(b)(2)(vi)

[382] Section 1400Z-2(d)(1)

[383] Prop. Reg. § 1.1400Z-2(b)-1(b)(2)(x)

[384] Prop. Reg. § 1.1400Z-2(b)-1(b)(2)(ix)

[385] Prop. Reg. § 1.1400Z-2(b)-1(b)(2)(x)

[386] Prop. Reg. § 1.1400Z-2(b)-1(b)(2)(xiv)

[387] Prop. Reg. § 1.1400Z-2(b)-1(b)(2)(xv)

"**QOZB**" or "**qualified opportunity zone busines**s" means a trade or business (i) 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 paragraph (2)(D)), (ii) which satisfies the requirements of paragraphs (2), (4), and (8) of section 1397C(b), and (iii) which is not described in section 144(c)(6)(B).

"**QOZBP**" or "**qualified opportunity zone business property**" means tangible property used in a trade or business of the qualified opportunity fund if (I) such property was acquired by the qualified opportunity fund by purchase (as defined in section 179(d)(2)) after December 31, 2017, (II) the original use of such property in the qualified opportunity zone commences with the qualified opportunity fund or the qualified opportunity fund substantially improves the property, and (III) 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.[388]

"**QOZ Partnership**" or "**qualified opportunity zone partnership interest**" means any capital or profits interest in a domestic partnership if (i) such interest is acquired by the qualified opportunity fund after December 31, 2017, from the partnership solely in exchange for cash, (ii) as of the time such interest was acquired, such partnership was a qualified opportunity zone business (or, in the case of a new partnership, such partnership was being organized for purposes of being a qualified opportunity zone business), and (iii) during substantially all of the qualified opportunity fund's holding period for such interest, such partnership qualified as a qualified opportunity zone business.[389]

"**QOZP**" or "**qualified opportunity zone property**" means property which is (i) qualified opportunity zone stock, (ii) qualified opportunity zone partnership interest, or (iii) qualified opportunity zone business property.[390]

"**QOZ Stock**" or "**qualified opportunity zone stock**" means any stock in a domestic corporation if (I) such stock is acquired by the qualified opportunity fund after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash, (II) as of the time such stock was issued, such corporation was a qualified opportunity zone business (or, in the case of a new corporation, such corporation was being organized for purposes of being a qualified opportunity zone business), and (III) during substantially all of the qualified opportunity fund's holding period for such stock, such corporation qualified as a qualified opportunity zone business.[391]

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[388] Section 1400Z-2(d)(20(D)

[389] Section 1400Z-2(d)(2)(C)

[390] Section 1400Z-2(d)(2)(A)

[391] Section 1400Z-2(d)(2)(B)

"**Qualifying investment**" means an eligible interest (as defined in §1.1400Z2(a)-1(b)(3)), or portion thereof, in a QOF to the extent that a deferral election applies with respect to such eligible interest or portion thereof.[392]

"**Remaining deferred gain**" means the full amount of gain that was deferred under section 1400Z-2(a)(1)(A), reduced by the amount of gain previously included as a result of an inclusion event.

"Working Capital Safe Harbor" is not an explicitly defined term, but refers to the working capital safe harbor described in Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(iv) that provides that for a period of 31 months, a QOZB will fail to meet the asset holding tests if it holds qualifying financial property (i.e., cash, cash equivalents or debt instruments with a term of 18 months or less) that will be used (pursuant to a written plan) to acquire, construct or develop QOZBP.

[392] Prop. Reg. § 1.1400Z-2(b)-1(b)(2)(xvi)

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B. Sample Calendar

TIMELINE OF A QOF INVESTMENT

July 1, 2019

Reinvest $10 million of Capital Gains in a QOF

July 1, 2019

QOF contributes $10 million to QOZB Sub

July 2, 2019

QOZB Sub Acquires Land and Buildings for $10 million and enters into $20 million construction loan

July 2, 2019 through December 31, 2021

QOZB Sub constructs project (satisfying substantial improvement test)

2019 Tax Filing Deadlines (March-October 2020)

QOF files tax return self-certifying as a QOF

Investor files tax return deferring capital gains

July 1, 2024

Investor's basis is increased by $1 million (10% of original deferred gain)

July 1, 2026

Investor's basis is increased by $500K (5% of original deferred gain)

December 31, 2026

Investor recognizes $8.5M of capital gains (tax will be due on April 15, 2027). Investor's basis is increased by $8.5 million.

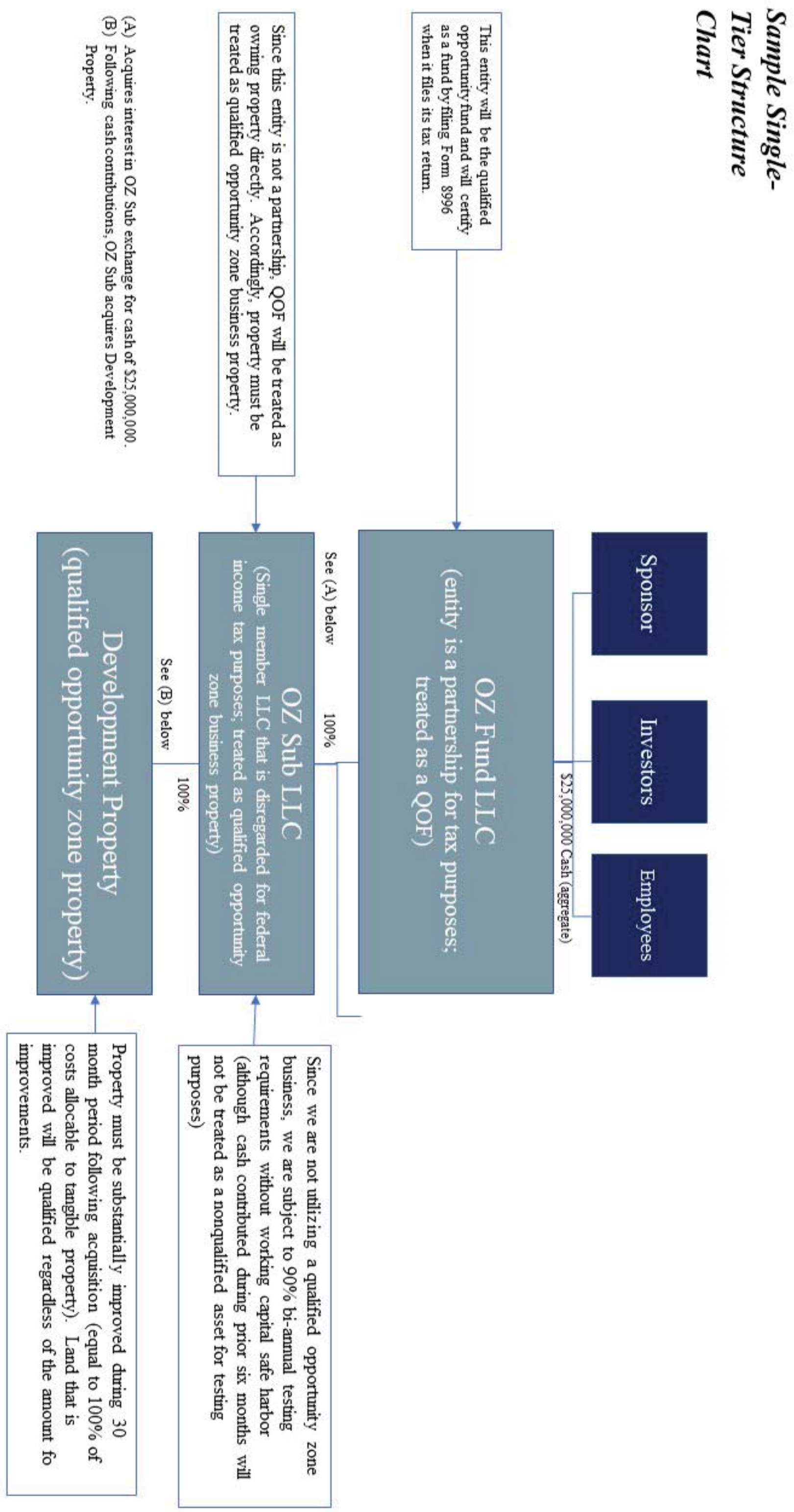
July 3, 2029

Investors sell investment in QOF for $25 million.

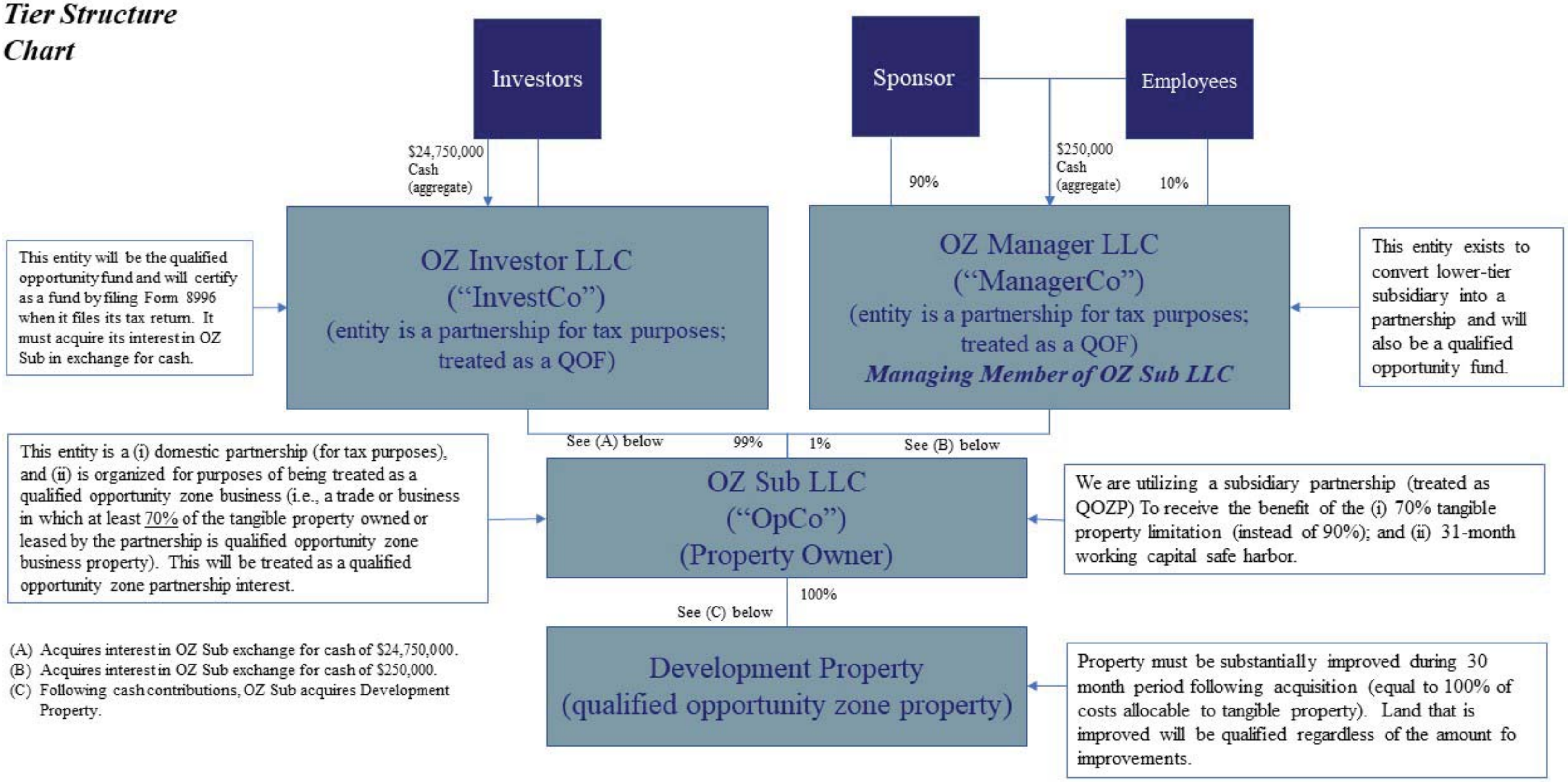
April 15, 2030

Investor makes election to increase basis to $25 million as of the date of the sale. The QOF adjusts the basis of its assets based on the $25 million sale price.

C. Sample Structure Charts



Sample Two-Tier Structure Chart



D. Contributors

My colleague, **Vadim Ronzhes, Esq., CPA**, who has recently joined our team at RS&F, provided valuable content, edits and clarifications without which, the book would not be complete. We anticipate Vadim quickly becoming a go-to resource in his own right for all opportunity zone matters.

We are grateful to the detailed and thoughtful comments provided by **Peter Palson of Biegel Waller LLC**. We were fortunate that Peter (one of the foremost international tax advisors in the region and an author in his own right) volunteered to review and edit our "book". Peter, together with Jim Waller and their firm have been excellent contributors to the tax community and we were very excited to receive their contributions on this project.

After spending hours discussing opportunity zones with the excellent real estate attorney **Christopher Smith, Esq. of Zarren Law Group LLC**, he has generously provided us with comprehensive notes and ideas for this book. We are extremely thankful to Christopher and Adam Zarren for their work, their support of our firm and their growing contributions to the opportunity zone community.

E. About RS&F

Rosen, Sapperstein & Friedlander, LLC (RS&F) is the leading firm in the Mid-Atlantic region that provides business consulting and accounting services that cater to middle-market businesses and ultra-high net worth families. Our team is comprised of outstanding professionals who service clients with passion, focus, and entrepreneurial spirit. As a full-service CPA firm, RS&F provides consulting, tax, audit, forensic accounting, business valuation, and accounting services. The Firm works with clients in a variety of industries, including healthcare, real estate, nonprofits, government contractors, construction, business services, manufacturers, distributors, automotive, technology, and mortgage lending.

RS&F is headquartered in Towson, MD, with offices in Annapolis, MD, Columbia, MD, and Delray Beach, FL.

Mission

RS&F engages clients and team members in the spirit of partnership to provide entrepreneurial business guidance, focused client service, and enhanced value with passion and innovation.

Vision

RS&F approaches business as entrepreneurs and this mindset permeates through our client relationships, service delivery, and outstanding team. Our clients deserve sophisticated guidance to help them make effective decisions affecting their businesses, family, and community. Values such as quality, integrity, independence, and accessibility are important, but can be used to describe most professional service firms. RS&F is atypical and our clients benefit from our teams' clarity, creativity, focus, humility, and persistence. The pace of change in today's world requires our clients to rapidly evolve and partner with a team of advisors who are committed to their success.

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THE BOOK ON QUALIFIED OPPORTUNITY ZONES

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David S. Rosen, Esq., CPA serves as the Chair of RS&F's tax department and is widely recognized for complex and creative tax planning on behalf of real estate developers, large closely held businesses and ultra-high net worth families (including numerous family office clients). Prior to joining RS&F in 2009, David practiced as a tax attorney for seven years on behalf of a similar client base.

David personally oversees RS&F's most complex tax planning and transactional matters. Leveraging his legal and accounting background, David brings creative and practical advice to business structuring and restructuring, mergers and acquisitions and estate planning topics. As the opportunity zone program has developed, David has emerged as one of the leaders in the industry, advising on many of the largest projects in the region.

In recent years, David has led the tax structuring for many of the largest and most significant real estate and business transactions in the greater Baltimore-Washington region in recent years. David has represented real estate developers and investors in acquisitions, dispositions, financings and developments with an aggregate project value of over $10 billion. Over the prior three years, David has led corporate mergers and acquisitions (sell side and buy side) exceeding $1 billion. In addition, David oversees complex structuring for large family office clients, having led the family office structuring (and related estate and gift planning) for a number of Forbes 400 families.

As Chair of the Firm's Tax Department, David oversees RS&F's talented and experienced team handling tax return preparation on behalf of hundreds of business, real estate and ultra-high net worth clients. He was recognized by the Baltimore Business Journal 40 under 40 and the Maryland Daily Record Top 40 professionals under 40.

David is a graduate of the University of Maryland – College Park and Emory University School of Law. He is a CPA and attorney, licensed in the state of Maryland. He regularly writes for the Baltimore Business Journal and has been published in the Baltimore Sun and various technical journals. David lives in Baltimore with his wife Monica, and two young sons, Benjamin (age 5) and Noah (age 3).

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