

[4830-01-p]

DEPARTMENT OF TREASURY

Internal Revenue Service

26 CFR Part I

[REG-115420-18]

RIN 1545-BP03

Investing in Qualified Opportunity Funds

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

**SUMMARY:** This document contains proposed regulations that provide guidance under new section 1400Z-2 of the Internal Revenue Code (Code) relating to gains that may be deferred as a result of a taxpayer's investment in a qualified opportunity fund (QOF). Specifically, the proposed regulations address the type of gains that may be deferred by investors, the time by which corresponding amounts must be invested in QOFs, and the manner in which investors may elect to defer specified gains. This document also contains proposed regulations applicable to QOFs, including rules for self-certification, valuation of QOF assets, and guidance on qualified opportunity zone businesses. The proposed regulations affect QOFs and their investors. This document also provides notice of a public hearing on these proposed regulations.

**DATES:** Written (including electronic) comments must be received by [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]. Outlines of topics to be discussed at the public hearing scheduled for January 10, 2019 at 10 a.m. must be received by [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]. **ADDRESSES:** Send submissions to: CC:PA:LPD:PR (REG-115420-18), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-115420-18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224. Alternatively, taxpayers may submit comments electronically via the Federal Rulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS REG-115420-18). The public hearing will be held in the IRS auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

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

## SUPPLEMENTARY INFORMATION:

### Background

This document contains proposed regulations under section 1400Z-2 of the Code that amend the Income Tax Regulations (26 CFR Part 1). Section 13823 of the Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054, 2184 (2017) (TCJA), amended the Code to add sections 1400Z-1 and 1400Z-2. Section 1400Z-1 provides procedural rules for designating qualified opportunity zones and related definitions. Section 1400Z-2 allows a taxpayer to elect to defer certain gains to the extent that corresponding amounts are timely invested in a QOF.

Section 1400Z-2, in conjunction with section 1400Z-1, seeks to encourage economic growth and investment in designated distressed communities (qualified opportunity zones) by providing Federal income tax benefits to taxpayers who invest in businesses located within these zones. Section 1400Z-2 provides two main tax incentives to encourage investment in qualified opportunity zones. First, it allows for the deferral of inclusion in gross income for certain gains to the extent that corresponding amounts are reinvested in a QOF. Second, it excludes from gross income the postacquisition gains on investments in QOFs that are held for at least 10 years.

As is more fully explained in the Explanation of Provisions, these proposed regulations describe and clarify the requirements that must be met by a taxpayer in order properly to defer the recognition of gains by investing in a QOF. In addition, the proposed regulations provide rules permitting a corporation or partnership to self-certify as a QOF. Finally, the proposed regulations provide initial proposed rules regarding some of the requirements that must be met by a corporation or partnership in order to qualify as a QOF.

Contemporaneous with the issuance of these proposed regulations, the IRS is releasing a revenue ruling addressing the application to real property of the “original use” requirement in section 1400Z-2(d)(2)(D)(i)(II) and the “substantial improvement” requirement in section 1400Z-2(d)(2)(D)(i)(II) and 1400Z-2(d)(2)(D)(ii).

In addition, these proposed regulations address the substantial-improvement requirement with respect to a purchased building located in a qualified opportunity zone. They provide that for purposes of this requirement, the basis attributable to land on which such a building sits is not taken into account in determining whether the building has been substantially improved. Excluding the basis of land from the amount that needs to be doubled under section 1400Z-2(d)(2)(D)(ii) for a building to be substantially improved facilitates repurposing vacant buildings in qualified opportunity zones. Similarly, an absence of a requirement to increase the basis of land itself would address many of the comments that taxpayers have made regarding the need to facilitate repurposing vacant or otherwise unutilized land.

In connection with soliciting comments on these proposed regulations the Department of the Treasury (Treasury Department) and the IRS are soliciting comments on all aspects of the definition of “original use” and “substantial improvement.” In particular, they are seeking comments on possible approaches to defining the “original use” requirement, for both real property and other tangible property. For example, what metrics would be appropriate for determining whether tangible property has “original use” in an opportunity zone? Should the use of tangible property be determined based on its physical presence within an opportunity zone, or based on some other measure? What if the tested tangible property is a vehicle or other movable tangible property that was previously used within the opportunity zone but acquired from a person outside the opportunity zone? Should some period of abandonment or under-utilization of tangible property erase the property’s history of prior use in the opportunity zone? If so, should such a fallow period enable subsequent productive utilization of the tangible property to qualify as “original use”? Should the rules appropriate for abandonment and underutilization of personal tangible property also apply to vacant real property that is productively utilized after some period? If so, what period of abandonment, underutilization, or vacancy would

be consistent with the statute? In addition, comments are requested on whether any additional rules regarding the “substantial improvement” requirement for tangible property are warranted or would be useful.

The Treasury Department and the IRS are working on additional published guidance, including additional proposed regulations expected to be published in the near future. The Treasury Department and the IRS expect the forthcoming proposed regulations to incorporate the guidance contained in the revenue ruling to facilitate additional public comment. The forthcoming proposed regulations are expected to address other issues under section 1400Z-2 that are not addressed in these proposed regulations. Issues expected to be addressed include: the meaning of “substantially all” in each of the various places where it appears in section 1400Z-2; the transactions that may trigger the inclusion of gain that has been deferred under a section 1400Z-2(a) election; the “reasonable period” (see section 1400Z-2(e)(4)(B)) for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty; administrative rules applicable under section 1400Z-2(f) when a QOF fails to maintain the required 90 percent investment standard; and information-reporting requirements under section 1400Z-2.

The Treasury Department and the IRS welcome comments on what other additional issues should be addressed in forthcoming proposed regulations or guidance.

## **Explanation of Provisions**

### **I. Deferring Tax on Capital Gains by Investing in Opportunity Zones**

#### **A. Gains Eligible for Deferral**

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

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

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

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

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

### **C. Investments in a QOF**

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

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

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

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

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

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

Section 1400Z-2(a)(1)(B) and (b) require taxpayers to include in income previously deferred gains. The proposed regulations provide that all of the deferred gain's tax attributes are preserved through the deferral

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

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

## **II. Special rules**

### **A. Gain not already subject to an election.**

Under section 1400Z-2(a)(2)(A), no election may be made under section 1400Z2(a)(1) with respect to a sale or exchange if an election previously made with respect to that sale or exchange is in effect. There has been some confusion as to whether this language bars a taxpayer from making multiple elections within 180-days for various parts of the gain from a single sale or exchange of property held by the taxpayer. This rule in section 1400Z-2(a)(2)(A) is meant to exclude from the section 1400Z-2(a)(1) election multiple purported elections with respect to the same gain. (Although the gain itself can be deferred only once, a taxpayer might be seeking to multiply the investments eligible for various increases in basis.) Thus, the proposed regulations clarify that in the case of a taxpayer who has made an election under section 1400Z2(a) with respect to some but not all of an eligible gain, the term "eligible gain" includes the portion of that eligible gain as to which no election has been made. (All elections with respect to portions of the same gain would, of course, be subject to the same 180- day period.)

### **B. Section 1256 contracts**

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

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

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

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

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

An offsetting-positions transaction is defined in the proposed regulations as a transaction in which a taxpayer has substantially diminished the taxpayer's risk of loss from holding one position with respect to personal property by holding one or more other positions with respect to personal property (whether or not of the same kind). It does not matter whether either of the positions is with respect to actively traded personal property. An offsetting-positions transaction includes a straddle as defined in section 1092 and the regulations thereunder, including section 1092(d)(4), which 14 provides rules for positions held by related persons and certain flow-through entities (for example, a partnership). An offsetting-positions transaction also includes a transaction that would be a straddle (taking into account the principles referred to in the preceding sentence) if the straddle definition did not contain the active trading requirement in section 1092(d)(1).

### **III. Gains of Partnerships and Other Pass-Through Entities**

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

Proposed §1.1400Z-2(a)-1(c)(1) provides that a partnership may elect to defer all or part of a capital gain to the extent that it makes an eligible investment in a QOF. Because the election provides for deferral, if the election is made, no part of the deferred gain is required to be included in the distributive shares of the partners under section 702, and the gain is not subject to section 705(a)(1). Proposed §1.1400Z-2(a)-1(c)(2) provides that, to the extent that a partnership does not elect to defer capital gain, the capital gain is included in the distributive shares of the partners under section 702 and is subject to section 705(a)(1). If all or any portion of a partner's distributive share satisfies all of the rules for eligibility under section 1400Z-2(a)(1)

(including not arising from a sale or exchange with a person that is related either to the partnership or to the partner), then the partner generally may elect its own deferral with respect to the partner's distributive share. The partner's deferral is potentially available to the extent that the partner makes an eligible investment in a QOF.

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

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

#### **IV. How to Elect Deferral**

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

#### **V. Section 1400Z-2(c) Election for Investments Held At Least 10 Years**

##### **A. In General**

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

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

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

Section 1400Z-2(c), as stated above, permits a taxpayer to elect to increase the basis in its investment in a QOF if the investment is held for at least ten years from the date of the original investment in the QOF. However, under section 1400Z-1(f), the designations of all qualified opportunity zones now in existence will

expire on December 31, 2028. The loss of qualified opportunity zone designation raises numerous issues regarding gain deferral elections that are still in effect when the designation expires. Among the issues that the zone expiration date raises is whether, after the relevant qualified opportunity zone loses its designation, investors may still make basis step-up elections for QOF investments from 2019 and later.

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

The ability to make this election is preserved under these proposed regulations until December 31, 2047, 20½ years after the latest date that an eligible taxpayer may properly make an investment that is part of an election to defer gain under section 1400Z-2(a). Because the latest gain subject to deferral would be at the end of 2026, the last day of the 180-day period for that gain would be in late June 2027. A taxpayer deferring such a gain would achieve a 10-year holding period in a QOF investment only in late June 2037. Thus, this proposed rule would permit an investor in a QOF that makes an investment as late as the end of June 2027 to hold the investment in the QOF for the entire 10-year holding period described in section 1400Z-2(c), plus another 10 years.

The additional ten year period is provided to avoid situations in which, in order to enjoy the benefits provided by section 1400Z-2(c), a taxpayer would need to dispose of an investment in a QOF shortly after completion of the required 10-year holding period. There may be cases in which disposal shortly after the 10-year holding period would diverge from otherwise desirable business conduct, and, absent the additional time, some taxpayers may lose the statutory benefit.

The Treasury Department and the IRS request comments on this proposed fixed 20½-year end date for the section 1400Z-2(c) basis step-up election. In particular, whether some other time period would better align with taxpayers' economic interests and the purposes of the statute. Comments may also include an alternative to incentivizing investors to disinvest shortly before any such a fixed end date for the section 1400Z-2(c) basis step-up election. For example, should the regulations provide for a presumed basis step-up election immediately before the ability to elect a step-up upon disposition expires? If such a basis step-up without disposition is allowed, how should a QOF investment be properly valued at the time of the step-up?

## **VI. Rules for a Qualified Opportunity Fund**

### **A. Certification of an Entity as a QOF**

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

these proposed regulations.

## **B. Designating When a QOF Begins**

The proposed regulations allow a QOF both to identify the taxable year in which the entity becomes a QOF and to choose the first month in that year to be treated as a QOF. If an eligible entity fails to specify the first month it is a QOF, then the first month of its initial taxable year as a QOF is treated as the first month that the eligible entity is a QOF. A deferral election under section 1400Z-2(a) may only be made for investments 20 in a QOF. Therefore, a proper deferral election under section 1400Z-2(a) may not be made for an otherwise qualifying investment that is made before an eligible entity is a QOF.

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

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

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

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

## **D. Pre-Existing Entities**

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

As previously discussed, section 1400Z-2(d)(1) requires that a QOF must undergo semi-annual tests to determine whether its assets consist on average of at least 90 percent qualified opportunity zone property.

For purposes of these semiannual tests, section 1400Z-2(d)(2) requires that a tangible asset can be qualified opportunity zone business property by an entity that has self-certified as a QOF or an operating subsidiary entity only if it acquired the asset after 2017 by purchase. The Treasury Department and the IRS request comments on whether there is a statutory basis for additional flexibilities that might facilitate qualification of a greater number of pre-existing entities across broad categories of industries.

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

For purposes of the calculation of the 90-Percent Asset Test in section 1400Z2(d)(1) by the QOF, the proposed regulations require the QOF to use the asset values that are reported on the QOF's applicable financial statement for the taxable year, as defined in §1.475(a)-4(h) of the Income Tax Regulations. If a QOF does not have an applicable financial statement, the proposed regulations require the QOF to use the cost of its assets. The Treasury Department and the IRS request comments on the suitability of both of these valuation methods, and whether another method, such as tax adjusted basis, would be better for purposes of assurance and administration.

#### **F. Nonqualified Financial Property**

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

In response to these comments, the proposed regulations provide a working capital safe harbor for QOF investments in qualified opportunity zone businesses that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property used in a business operating in an opportunity zone. The safe harbor allows qualified opportunity zone businesses to apply the definition of working capital provided in section 1397C(e)(1) to property held by the business for a period of up to 31 months, if there is a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the opportunity zone, there is written schedule consistent with the ordinary business operations of the business that the property will be used within 31-months, and the business substantially complies with the schedule. Taxpayers would be required to retain any written plan in their records.

This expansion of the term "working capital" reflects the fact that section 1400Z2(d)(iii) anticipates situations in which a QOF or operating subsidiary may need up to 30 months after acquiring a tangible asset in which to improve the asset substantially. In seeking relief, some commenters based their requests on administrative practices that have developed under other sections of the Code that these commenters believe are analogous. The Treasury Department and the IRS request comments on the adequacy of the working-capital safe harbor and of ancillary safe harbors that protect a business during the working capital period, and on whether there is a statutory basis for any 24 additional relief. Comments are also requested about the appropriateness of any further expansion of the "working capital" concept beyond the acquisition, construction, or rehabilitation of tangible business property to the development of business operations in the opportunity zone.

#### **G. Qualified Opportunity Zone Business.**

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

held in the QOF as measured on the last day of the first 6-month period of the taxable year of the QOF and on the last day of the taxable year of the QOF.

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

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

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

Under section 1400Z-2(d)(2)(B)(i) and (C), to qualify as a qualified opportunity zone business, an entity must be a qualified opportunity zone business both (a) when the QOF acquires its equity interest in the entity and (b) during substantially all of the QOF's holding period for that interest. The manner of the QOF's acquisition of the equity interest must comply with certain additional requirements. Under section 1400Z-2(d)(3)(A), for a trade or business to qualify as a qualified opportunity zone business, it must (among other requirements) be one in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property.

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

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

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

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

1400Z-2(d)(2)(B)(ii)(III).

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

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

#### H. Eligible Entities.

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

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

The proposed regulations further define a U.S. possession to mean any jurisdiction outside of the 50 States and the District of Columbia in which a designated qualified opportunity zone exists under section 1400Z-1. This definition may include the following U.S. territories: American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands. A complete list of designated qualified opportunity zones is found in Notice 2018-48, 2018-28 I.R.B. 9.

#### **VII. Section 1400Z-2(e) Investments from Mixed Funds**

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

Commenters have questioned whether section 752(a) could result in investments with mixed funds under section 1400Z-2(e)(1). Section 1400Z-2(e)(1) requires a taxpayer to treat as two separate investments the combination of an investment to which a section 1400Z-2(a) gain-deferral election applies and an investment of any amount to which such an election does not apply. As previously noted, these proposed regulations clarify that deemed contributions of money under section 752(a) do not constitute an investment in a QOF; therefore, such a deemed contribution does not result in the partner having a separate investment under section 1400Z-2(e)(1). Thus, a partner’s increase in outside basis is not taken into account in determining what portion of the partner’s interest is subject to the deferral election under section 1400Z-2(a) or what portion is not subject to the deferral election under section 1400Z-2(a). Comments are requested on whether other pass-through entities require similar treatment. Comments are also requested on whether there may be certain circumstances in which not treating the deemed contribution under section 752(a) as

creating a separate investment for purposes of section 1400Z-2(e)(1) may be considered abusive or otherwise problematic.

### **Proposed Effective Date**

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

- An eligible taxpayer may rely on the rules of proposed §1.1400Z-2(a)-1 with respect to eligible gains that would be recognized before the final regulations' date of applicability, but only if the taxpayer applies the rules in their entirety and in a consistent manner.
- A taxpayer may rely on the rules in proposed § 1.1400Z-2(c)-1 with respect to dispositions of investment interests in QOFs in situations where the investment was made in connection with an election under section 1400Z2(a) that relates to the deferral of a gain such that the first day of 180-day period for the gain was before the final regulations' date of applicability. This reliance is dependent on the taxpayer's applying the rules of § 1.1400Z-2(c)-1 in their entirety and in a consistent manner.
- A QOF may rely on the rules in proposed §1.1400Z-2(d)-1 with respect to taxable years that begin before the final regulations' date of applicability, but only if the QOF applies the rules in their entirety and in a consistent manner.
- A taxpayer may rely on the rules in proposed § 1.1400Z-2(e)-1 with respect to investments and deemed contributions of money that occur before the final regulations' date of applicability, but only if the taxpayer applies the rules in their entirety and in a consistent manner.

### **Special Analyses**

#### **I. Regulatory Planning and Review**

Executive Orders 13771, 13563, and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility.

These proposed regulations have been designated by the Office of Management and Budget's Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. OIRA has determined that the proposed rulemaking is economically significant and subject to review under EO 12866 and section 1(c) of the Memorandum of Agreement. The Treasury Department and the IRS believe that significant investment will flow into qualified opportunity zones as a result of the TCJA legislation and proposed regulation. This investment is likely to be primarily from other areas of the United States. Accordingly, the proposed regulations have been reviewed by the Office of Management and Budget. In addition, the Treasury Department and the IRS expect the proposed regulation, when final, to be an Executive Order 13771 deregulatory action and request comment on this designation. Details on the costs of the proposed regulations can be found in this economic analysis.

#### **A. Background and Overview**

Congress enacted section 1400Z-2, in conjunction with section 1400Z-1, as a temporary provision to encourage private sector investment in certain lower-income communities designated as qualified opportunity zones (see Senate Committee on Finance, Explanation of the Bill, at 313 (November 22, 2017)). Taxpayers may elect to defer the recognition of capital gain to the extent of amounts invested in a QOF, provided that the corresponding amounts are invested during the 180-day period beginning on the date such capital gain

would have been recognized by the taxpayer. Inclusion of the deferred capital gain in income occurs on the date the investment in the QOF is sold or exchanged, or on December 31, 2026, whichever comes first. For investments in a QOF held longer than five years, taxpayers may exclude 10 percent of the deferred gain from inclusion in income, and for investment held longer than seven years, taxpayers may exclude a total of 15 percent of the deferred gain from inclusion in income. In addition, for investments held longer than 10 years, the post-acquisition gain on the qualifying investment in the QOF may also be excluded from income. In turn, a QOF must hold at least 90 percent of its assets in qualified opportunity zone property, as measured by the average percentage held at the last day of the first 6-month period of the taxable year of the fund and the last day of the taxable year. The statute requires a QOF that fails this 90 percent test to pay a penalty for each month it fails to maintain the 90-percent asset requirement.

The proposed regulations clarify several terms used in the statute, such as what type of gains are eligible for this preferential treatment, what type of taxpayers are eligible, the timing of transactions necessary for satisfying the requirements of the statute, including the time period for which the exclusion on gains for investments held longer than 10 years applies, and certain rules related to the creation and continued qualification of a fund as a QOF.

## **B. Need for the Proposed Regulations**

Taxpayers may be unwilling to make investments in QOFs without first having additional clarity on which investments in a QOF would qualify to receive the preferential tax treatment specified by the TCJA. This uncertainty could reduce the amount of investment flowing into lower-income communities designated as qualified opportunity zones below the congressionally intended effect. The lack of additional clarity could also lead to different taxpayers interpreting, and therefore applying, the same statute differently, which could distort the allocation of investment across the qualifying opportunity zones.

## **C. Economic Analysis**

### **1. Baseline**

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations.

### **2. Anticipated benefits**

#### **a. In general**

The Treasury Department and the IRS expect that the certainty and clarity provided by these proposed regulations, relative to the baseline, will enhance U.S. economic performance under the statute. Under the proposed regulations, taxpayers are provided clarity on the type and timing of transactions that would qualify for the beneficial tax treatment provided for investments in QOFs. As a primary benefit, the clarity provided by these proposed regulations would reduce planning costs for taxpayers and make it easier for taxpayers to make investment decisions that more precisely conform to the statutory requirements for QOFs. In addition, the reduction in uncertainty should encourage investment to flow into qualified opportunity zones, consistent with the intent of the TCJA.

The Treasury Department and the IRS considered various alternatives in the promulgation of the proposed regulations, with the major ones described in the following paragraphs. These alternatives included not issuing the proposed regulations under section 1400Z-2. This path was not chosen for several reasons. The TCJA provides both a reward in terms preferential tax treatment of deferred gains, but also a penalty if a QOF does not maintain compliance with the 90-percent asset test. Without the proposed regulations, some taxpayers may have foregone making promising investments within a qualifying opportunity zone out of concern that the investment may later be determined to not be a qualifying investment. As described in the following paragraphs, the proposed regulations help clarify several areas in which the statutory language was

either ambiguous or not very specific. Overall, the clarity provided by the proposed regulations should reduce planning costs by taxpayers and enable taxpayers to make economically efficient decisions given the context of the whole Code.

#### **b. Clarity regarding eligible gains**

The proposed regulations specify that only capital gains are eligible for deferral and potential exclusion under section 1400Z-2. As discussed in section I.A of the Explanation of Provisions, there is ambiguity that results from the variation between the operative statutory text and the section heading in the statute regarding what type of gains would be eligible for deferral. The Treasury Department and the IRS determined that Congress intended deferral only to be available to capital gains. This clarity provided in the proposed regulations would reduce uncertainty for taxpayers regarding what transactions would qualify for the preferential tax treatment and also reduce administrative and compliance costs.

#### **c. Clarity regarding application to eligible taxpayers**

The proposed regulations also clarify which taxpayers are eligible to defer the recognition of capital gain through investing in a QOF and describe how different types of taxpayers may satisfy the requirements for electing to defer capital gain consistent with the rules of section 1400Z-2 and the overall Code. In particular, the proposed regulations describe rules for how partnerships and partners in a partnership may invest in a QOF and elect to defer recognition of capital gains. Partnerships are expected to be a significant source of funds invested in QOFs. Without these proposed rules clarifying how partnerships and partners may satisfy the requirements for the preferential treatment of capital gains, partners may be less willing to invest in a QOF. The proposed regulations help provide a uniform signal to different types of taxpayers of the availability of this preferential treatment of capital gains and provide the mechanics of how these different taxpayers may satisfy the requirements imposed by the statute. Thus these different types of taxpayers may make decisions that are more economically efficient contingent on the overall Code.

#### **d. Clarity regarding electing post-10-year gain exclusion if zone designation expires**

Proposed §1.1400Z-2(c)-1 specifies that expiration of a zone designation would not impair the ability of a taxpayer to elect the exclusion from gains for investments held for at least 10 years, provided the disposition of the investment occurs prior to January 1, 2048. The Treasury Department and the IRS considered four alternatives regarding the interaction between the expiration of the designated zones and the election to exclude gain for investments held more than 10 years. A discussion of the economic costs and benefits of the four options follows.

#### **i. Remaining silent on electing post-10-year gain exclusion**

The first alternative would be for the proposed regulations to remain silent on this issue. Section 1400Z-2(c) permits a taxpayer to increase the basis in the property held in a QOF longer than 10 years to be equal to the fair market value of that property on the date that the investment is sold or exchanged, thus excluding post-acquisition capital gain on the investment from tax. However, the statutory expiration of the designation of qualified opportunity zones on December 31, 2028, makes it unclear to what extent investments in a QOF made after 2018 would qualify for this exclusion.

Some taxpayers may believe that only investments in a QOF made prior to January 1, 2019, would be eligible for the exclusion from gain if held greater than 10 years. Such taxpayers may rush to complete transactions within 2018, while others may choose to hold off indefinitely from investing in a QOF until they received clarity on the availability of the 10-year exclusion from gain for investments made later than 2018. Other taxpayers may plan to invest in a QOF after 2018 with the expectation that future regulations would be provided or the statute would be amended to make it clear that dispositions of assets within a QOF after 2028 would be eligible for exclusion if held longer than 10 years. The ambiguity of the statute is likely to lead to uneven response by different taxpayers, dependent on the taxpayer's interpretation of the statute, which may

lead to an inefficient allocation of investment across qualified opportunity zones.

## **ii. Providing a clear deadline for electing post-10-year gain exclusion**

The alternative adopted by the proposed regulations clarifies that as long as the investment in the QOF was made with funds subject to a proper deferral election under section 1400Z-2(a), which requires the investment to be made prior to June 29, 2027, then the 10-year gain exclusion election is allowed as long as the disposition of the investment occurs before January 1, 2048. This proposed rule would provide certainty to taxpayers regarding the timing of investments eligible for the 10-year gain exclusion. Taxpayers would have a more uniform understanding of what transactions would be eligible for the favorable treatment on capital gains. This would help taxpayers determine which investments provide a sufficient return to compensate for the extra costs and risks of investing in a QOF. This proposed rule would likely lead to an increase in investment within QOFs compared the proposed regulations remaining silent on this issue.

However, setting a fixed date for the disposition of eligible QOFs investments could introduce economic inefficiencies. Some taxpayers may dispose of their investment in a QOF by the deadline in the proposed regulation primarily in order to receive the benefit of the gain exclusion, but that selling date may not be optimal for the taxpayer in terms of the portfolio of assets that the taxpayer could have chosen to invest in were there no deadline. Setting a fixed deadline may also generate an overall decline in asset values in some qualified opportunity zones if many investors in QOFs seek to sell their portion of the fund within the same time period. This decline in asset values may affect the broader level of economic activity within some qualified opportunity zones or affect other investors in such zones that did not invest through a QOF. In anticipation of this fixed deadline, some taxpayers may choose to dispose of QOF assets earlier than the deadline to avoid an anticipated “rush to the exits,” but this would seem to conflict with the purpose of the incentives in the statute to encourage “patient” capital investment within qualified opportunity zones. While the proposed regulations may produce these inefficiencies, by providing a long time period for which taxpayers may dispose of their investment within a QOF and still qualify for the exclusion the proposed regulations will lead any such inefficiencies to be minor.

## **iii. Providing no deadline for electing gain exclusion**

As an alternative, the proposed regulations could have provided no deadline for electing the 10-year gain exclusion for investments in a QOF, while still stating that the ability to make the election is not impaired solely because the designation of one or more qualified opportunity zones ceases to be in effect. While this alternative would eliminate the economic inefficiencies associated with a fixed deadline and would likely lead to greater investment in QOFs, it could introduce substantial additional administrative and compliance costs. Taxpayers would also need to maintain records and make efforts to maintain compliance with the rules of section 1400Z-2 on an indefinite basis.

## **iv. Providing fair market value basis without disposition of investment**

Another alternative considered would allow taxpayers to elect to increase the basis in their investment in the QOF if held at least 10 years to the fair market value of the investment without disposing of the property, as long as the election was made prior to January 1, 2048. (Analogously, the proposed regulations could have provided that, at the close of business of the day on which a taxpayer first has the ability to make the 10-year gain exclusion election, the basis in the investment automatically sets to the greater of current basis or the fair market value of the investment.) This alternative would minimize the economic inefficiencies of the proposed regulations resulting from taxpayers needing to dispose of their investment in the opportunity zone at a fixed date not related to any factor other than the lapse of time. However, this approach would require a method of valuing assets that could raise administrative and compliance costs. It may also require the maintenance of records and trained compliance personnel for over two decades.

## **v. Summary**

As discussed in section V.B of the Explanation of Provisions, the Treasury Department and the IRS have determined the ability to exclude gains for investment held at least 10 years in a QOF is integral to the TCJA's purpose of creating qualified opportunity zones. The proposed regulations provide a uniform signal to all taxpayers on the availability of this tax incentive, which should encourage greater investment, and a more efficient distribution of investment, in QOFs than in the absence of these proposed regulations. The relative costs and benefits of the various alternatives are difficult to measure and compare. The proposed regulations would likely produce the lowest compliance and administrative costs among the alternatives and any associated economic inefficiencies are likely to be small.

#### **e. Safe harbors for statutory qualifying property tests**

Section 1400Z-2 contains several rules limiting taxpayers from benefitting from the deferral and exclusion of capital gains from income offered by that section without also locating investment within a qualifying opportunity zone. The proposed regulations clarify the rules related to nonqualified financial property and what amounts can be held in cash and cash equivalents as working capital. The statute requires that a QOF must hold 90 percent of its assets in qualified opportunity zone property, such as owning stock or a partnership interest in a qualified opportunity zone business. A qualifying opportunity zone business is subject to the requirements of section 1397C(b)(8), that less than 5 percent of the aggregate adjusted basis of the entity is attributable to nonqualified financial property. The proposed regulations establish a working capital safe harbor consistent with section 1397C(e)(1), under which a qualified opportunity zone business may hold cash or cash equivalents for a period not longer than 31 months and not violate section 1397C(b)(8).

The Treasury Department and the IRS expect that the establishment of safe harbors under these parameters will provide net economic benefits. Without specification of the working capital safe harbor, some taxpayers would not invest in a QOF for fear that the QOF would not be able to deploy the funds soon enough to satisfy the 90-percent asset test. Thus, this part of the proposed regulations would generally encourage investment in QOFs by providing greater specificity to how an entity may consistently satisfy the statutory requirements for maintaining a QOF without penalty. In addition, this part of the proposed regulations minimizes the distortion that may arise between purchasing existing property and sufficiently rehabilitating that property versus constructing new property, as the time frame specified under the statute and proposed regulations are similar (30 months after acquisition for rehabilitating existing property versus 31 months for acquiring and rehabilitating existing property or for constructing new property).

A longer or a shorter period could have been chosen for the working capital safe harbor. A shorter time period would minimize the ability of taxpayers to use the investment in a QOF as a way to lower taxes without actually investing in tangible assets within a qualified opportunity zone, but taxpayers may also forego legitimate investments within an opportunity zone out of concern of not being able to deploy the working capital fast enough to meet the requirements. A longer period would have the opposite effects. Taxpayers could potentially invest in a QOF and receive the benefits of the tax incentive for multiple years before the money is invested into a qualified opportunity zone.

#### **f. Definition of substantially all**

The proposed regulations specify that if at least 70 percent of the tangible property owned or leased by a trade or business is qualified opportunity zone business property, then the trade or business is treated as satisfying the substantially all requirement of section 1400Z-2(d)(3)(A)(i). This clarity would provide taxpayers greater certainty when evaluating potential investment opportunities as to whether the potential investment would satisfy the statutory requirements.

However, the 70 percent requirement for a trade or business will give QOFs an incentive to invest in a qualified opportunity zone business rather than owning qualified opportunity zone business property directly. For example, consider a QOF with \$10 million in assets that plans to invest 100 percent of its assets

in real property. If it held the real property directly, then at least \$9 million (90 percent) of the property must be located within an opportunity zone to satisfy the 90 percent asset test for the QOF. If instead, it invests in a subsidiary that then holds real property, then only \$7 million (70 percent) of the property must be located within an opportunity zone. In addition, if the QOF only invested \$9 million into the subsidiary, which then held 70 percent of its property within an opportunity zone, the investors in the QOF could receive the statutory tax benefits while investing only \$6.3 million (63 percent) of its assets within a qualified opportunity zone.

The Treasury Department and the IRS also considered setting this “substantially all” threshold at 90 percent. This would reduce, but not eliminate, the incentive the QOF has to invest in a qualified opportunity zone business rather than directly owning qualified opportunity zone business property compared to the 70 percent threshold. Please see earlier discussion and request for comment regarding this definition for additional detail.

### **3. Anticipated impacts on administrative and compliance costs**

The Treasury Department and the IRS anticipate decreased taxpayer compliance costs resulting from the proposed regulations due to the greater taxpayer certainty regarding how to comply with the requirements set forth in the statute. The Treasury Department also anticipates decreased administrative and enforcement costs for the IRS.

#### **D. Paperwork Reduction Act**

The collection of information in these proposed regulations with respect to QOFs is in proposed §1.1400Z-2(d)-1. The collection of information in proposed §1.1400Z2(d)-1 is satisfied by submitting a new reporting form, Form 8996, Qualified Opportunity Fund, with an income tax return. For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) (PRA), the reporting burden associated with proposed §1.1400Z2(d)-1 will be reflected in the Paperwork Reduction Act submission associated with new Form 8996 (OMB control number 1545-0123). Notice of the availability of the draft Form 8996 and request for comment will be available at [IRS.gov/DraftForms](https://www.irs.gov/DraftForms). In addition, the Treasury Department and the IRS request comments on any aspect of this collection in this proposed rulemaking.

The collection of information in proposed §1.1400Z-2(d)-1 requires each QOF, be it a corporation or partnership, to file a Form 8996 to certify that it is organized to invest in qualified opportunity zone property. In addition, a QOF files Form 8996 annually to certify that the qualified opportunity fund meets the investment standards of section 1400Z-2 or to figure the penalty if it fails to meet the investment standards.

#### **II. Regulatory Flexibility Act**

Under the Regulatory Flexibility Act (RFA) (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations, if adopted, would not have a significant economic impact on a substantial number of small entities that are directly affected by the proposed regulations. Therefore, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Although there is a lack of available data regarding the extent to which small entities invest in QOFs, this certification is based on the belief of the Treasury Department and the IRS that these funds will generally involve investments made by larger entities and investments are entirely voluntary. The Treasury Department and the IRS specifically solicit comment from any party, particularly affected small entities, on the accuracy of this certification.

Pursuant to section 7805(f), this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### **III. Unfunded Mandates Reform Act**

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of \$100 million in 1995 dollars, updated annually for inflation. In 2018,

that threshold is approximately \$150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

#### **IV. Executive Order 13132: Federalism**

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

#### **Statement of Availability of IRS Documents**

IRS Revenue Procedures, Revenue Rulings, and Notices cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS web site at <http://www.irs.gov>.

#### **Comments**

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic and written comments that are submitted timely to the IRS as prescribed in this preamble under the “ADDRESSES” heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at <http://www.regulations.gov> or upon request.

#### **Drafting Information**

The principal author of these proposed regulations is Erika C. Reigle, Office of Associate Chief Counsel (Income Tax & Accounting). However, other personnel from the Treasury Department and the IRS participated in their development.

#### **List of Subjects in 26 CFR Part 1**

Income Taxes, Reporting and recordkeeping requirements.

#### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR Part 1 is proposed to be amended as follows:

#### **Part 1—INCOME TAX**

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805\*\*\*

Section 1.1400Z-2(a)-1 also issued under 26 U.S.C. 1400Z-2(e)(4).

Section 1.1400Z-2(c)-1 also issued under 26 U.S.C. 1400Z-2(e)(4).

Section 1.1400Z-2(d)-1 also issued under 26 U.S.C. 1400Z-2(e)(4).

Section 1.1400Z-2(e)-1 also issued under 26 U.S.C. 1400Z-2(e)(4).

Par. 2. Section 1.1400Z-2(a)-1 is added to read as follows:

§1.1400Z-2(a)-1 Deferring tax on capital gains by investing in opportunity zones.

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

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

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

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

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

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

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

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

**(iii) Gains under section 1256 contracts--(A) General rule.** The only gain arising from section 1256 contracts that is eligible for deferral under section 1400Z-2(a)(1) is capital gain net income for a taxable year. This net amount is determined by taking into account the capital gains and losses for a taxable year on all of a taxpayer's section 1256 contracts, including all amounts determined under section 1256(a), both those determined on the last business day of a taxable year and those that section 1256(c) requires to be determined under section 1256(a) because of the termination or transfer during the taxable year of the taxpayer's position with respect to a contract. The 180-day period with respect to any capital gain net income from section 1256 contracts for a taxable year begins on the last day of the taxable year, and the character of that gain when it is later included under section 1400Z-2(a)(1)(B) and (b) is determined under the general rule in paragraph (b)(5) of this section. See paragraph (b)(2)(iii)(B) of this section for limitations on the capital gains eligible for deferral under this paragraph (b)(2)(iii)(A).

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

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

transaction includes positions in closely held stock or other non-traded personal property and substantially offsetting derivatives.

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

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

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

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

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

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

**Example 2. Capital gain dividends received by RIC and REIT shareholders.** If an individual RIC or REIT shareholder receives a capital gain dividend (as described in section 852(b)(3) or section 857(b)(3)), the shareholder's 180-day period with respect to that gain begins on the day on which the dividend is paid.

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

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

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

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

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

interests, then the first-in-first-out (FIFO) method must be used to identify which interests were disposed of. Fungible interests may be equivalent shares of stock in a corporation or partnership interests with identical rights.

**(ii) Consequences of identification.** The FIFO method determines--

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

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

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

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

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

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

**Example 2. Collectibles gain.** For 2018, taxpayer C properly made an election under section 1400Z-2 to defer a gain that, if not deferred, would have been collectibles gain as defined in IRC section 1(h)(5). In a later taxable year, section 1400Z-2(a)(1)(B) and (b) requires some or all of that deferred gain to be included in gross income. The gain included is collectibles gain.

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

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

**Example 5. FIFO method.** In 2018, before Corporation R became a QOF, Taxpayer F invested \$100 cash to R in exchange for 100 R common shares. Later in 2018, after R was a QOF, F invested \$500 cash

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

**Example 6. FIFO method.** The facts are the same as example 5, except that, in addition, during 2021 F sold an additional 400 R common shares. Under paragraph (b)(6)(i) of this section, F must apply the FIFO method to identify which investments in R were disposed of. As determined by this identification, F sold the 400 common shares which were associated with the deferral of \$500 of short-term capital gain. Thus, the deferred gain that must be included upon sale of the 400 R common shares is short-term capital gain.

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

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

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

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

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

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

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

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

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

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

(C) A gain in a partner's distributive share is an eligible gain with respect to the partner only if it is an eligible gain with respect to the partnership and it did not arise from a sale or exchange with a person that, within the meaning of section 1400Z2(e)(2), is related to the partner.

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

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

**(C) The following example illustrates the principles of this paragraph (c)(2)(iii).**

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

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

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

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

Par. 3. Section 1.1400Z-2(c)-1 is added to read as follows:

**§1.1400Z-2(c)-1 Investments held for at least 10 years.**

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

**(b) Extension of availability of the election described in section 1400Z-2(c).** The ability to make an election under section 1400Z-2(c) for investments held for at least 10 years is not impaired solely because,

under section 1400Z-1(f), the designation of one or more qualified opportunity zones ceases to be in effect. The preceding sentence does not apply to elections under section 1400Z-2(c) that are related to dispositions occurring after December 31, 2047.

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

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

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

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

Par. 4. Section 1.1400Z-2(d)-1 is added to read as follows:

#### **§1.1400Z-2(d)-1 Qualified Opportunity Funds.**

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

**(i) Time, form, and manner.** The self-certification must be effected at such time and in such form and manner as may be prescribed by the Commissioner in IRS forms or instructions or in publications or guidance published in the Internal Revenue Bulletin (see §§ 601.601(d)(2) and 601.602 of this chapter).

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

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

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

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

(1) made for that investment is invalid.

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

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

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

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

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

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

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

- (i) Qualified opportunity zone stock as defined in paragraph (c)(2) of this section,
- (ii) Qualified opportunity zone partnership interest as defined in paragraph (c)(3) of this section, and
- (iii) Qualified opportunity zone business property as defined in paragraph (c)(4) of this section.

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

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

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

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

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

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

**(B) Significant redemptions.** Stock issued by a corporation is not treated as qualified opportunity zone

stock if, at any time during the 2-year period beginning on the date 1 year before the issuance of the stock, the corporation made 1 or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of its stock as of the beginning of the 2-year period. Even if one or more of the disqualifying purchases occurs after the issuance, the stock was never qualified opportunity zone stock.

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

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

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

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

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

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

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

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

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

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

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

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

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

**(ii) Special rules for land and improvements on land--(A) Buildings located in the zone.** If a QOF purchases a building located on land wholly within a QOZ, under section 1400Z-2(d)(2)(D)(ii) a substantial improvement to the purchased tangible property is measured by the QOF's additions to the adjusted basis of the building. Under section 1400Z-2(d), measuring a substantial improvement to the building by additions to

the QOF's adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located.

**(B) [Reserved].**

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

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

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

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

**(2) Qualified opportunity zone business property of the qualified opportunity zone business for purposes of paragraph (d)(1)(i) of this section--(i) In general.** The tangible property used in a trade or business of an entity is qualified opportunity zone business property for purposes of paragraph (d)(1)(i) of this section if--

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

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

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

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

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

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

**(ii) Calculating percent of tangible property owned or leased in a trade or business--(A) In general.** If an entity has an applicable financial statement within the meaning of §1.475(a)-4(h), then the value of each asset of the entity as reported on the entity's applicable financial statement for the relevant reporting period is used for determining whether a trade or business of the entity satisfies the first sentence of paragraph (d)(3)(i) of this section (concerning whether the trade or business is a qualified opportunity zone business).

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

**(C) Five Percent Zone Taxpayer.** A **Five-Percent Zone Taxpayer** is a taxpayer that has self-certified as

a QOF and that holds stock in the entity (if it is a corporation) representing at least 5 percent in voting rights and value or holds an interest of at least 5 percent in the profits and capital of the entity (if it is a partnership).

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

**Example.** Entity ZS is a corporation that has issued only one class of stock and that conducts a trade or business. Taxpayer X holds 94% of the ZS stock, and Taxpayer Y holds the remaining 6% of that stock. (Thus, both X and Y are Five Percent Zone Taxpayers within the meaning of paragraph (d)(3)(ii)(C) of this section.) ZS does not have an applicable financial statement, and, for that reason, a determination of whether ZS is conducting a qualified opportunity zone business may employ the Compliance Methodology of X or Y. X and Y use different Compliance Methodologies permitted under paragraph (d)(3)(ii) (B) of this section for purposes of satisfying the 90- percent asset test of section 1400Z-2(d)(1). Under X's Compliance Methodology (which is based on X's applicable financial statement), 65% of the tangible property owned or leased by ZS's trade or business is qualified opportunity zone business property. Under Y's Compliance Methodology (which is based on Y's cost), 73% of the tangible property owned or leased by ZS's trade or business is qualified opportunity zone business property. Because Y's Compliance Methodology would produce the higher percentage of qualified opportunity zone business property for ZS (73%), both X and Y may use Y's Compliance Methodology to value ZS's owned or leased tangible property. If ZS's trade or business satisfies all additional requirements in section 1400Z-2(d)(3), the trade or business is a qualified opportunity zone business. Thus, if all of the additional requirements in section 1400Z-2(d)(2)(B) are satisfied, stock in ZS is qualified opportunity zone stock in the hands of a taxpayer that has self-certified as a QOF.

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

**(ii) Special rules for land and improvements on land--(A) Buildings located in the zone.** If a QOF purchases a building located on land wholly within a QOZ, under section 1400Z-2(d)(2)(D)(ii) a substantial improvement to the purchased tangible property is measured by the QOF's additions to the adjusted basis of the building. Under section 1400Z-2(d), measuring a substantial improvement to the building by 67 additions to the QOF's adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located.

**(B) [Reserved].**

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

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

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

**(iii) Nonqualified financial property limitation.** Section 1400Z-2(d)(3) incorporates section 1397C(b)(8), limiting in each taxable year the average of the aggregate unadjusted bases of the property of a qualified opportunity zone business that may be attributable to nonqualified financial property. Section 1397C(e)(1),

which defines the term nonqualified financial property for purposes of section 1397C(b)(8), excludes from that term reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less (working capital assets).

**(iv) Safe harbor for reasonable amount of working capital.** Solely for purposes of applying section 1397C(e)(1) to the definition of a qualified opportunity zone business under section 1400Z-2(d)(3), working capital assets are treated as reasonable in amount for purposes of sections 1397C(b)(2) and 1400Z-2(d)(3)(A)(ii), if all of the following three requirements are satisfied:

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

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

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

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

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

**(vii) Safe harbor for property on which working capital is being expended.** If paragraph (d)(5)(iv) of this section treats some financial property as being a reasonable amount of working capital because of compliance with the three requirements of paragraph (d)(5)(iv)(A)-(C) and if the tangible property referred to in paragraph (d)(5)(iv)(A) is expected to satisfy the requirements of section 1400Z-2(d)(2)(D)(1) as a result of the planned expenditure of those working capital assets, then that tangible property is not treated as failing to satisfy those requirements solely because the scheduled consumption of the working capital is not yet complete.

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

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

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

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

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

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

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

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

- (i) Any private or commercial golf course,
- (ii) Country club,
- (iii) Massage parlor,
- (iv) Hot tub facility,
- (v) Suntan facility,
- (vi) Racetrack or other facility used for gambling, or
- (vii) Any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

**(e) Exceptions based on where an entity is created, formed, or organized--(1) QOFs.** If a partnership or corporation (an entity) is not organized in one of the 50 states, the District of Columbia, or the U.S. possessions, it is ineligible to be a QOF. If an entity is organized in a U.S. possession but not in one of the 50 States or the District of Columbia, it may be a QOF only if it is organized for the purpose of investing in qualified opportunity zone property that relates to a trade or business operated in the U.S. possession in which the entity is organized.

**(2) Entities that can issue qualified opportunity zone stock or qualified opportunity zone partnership interests.** If an entity is not organized in one of the 50 states, the District of Columbia, or the U.S. possessions, an equity interest in the entity is neither qualified opportunity zone stock nor a qualified opportunity zone partnership interest. If an entity is organized in a U.S. possession but not in one of the 50 States or the District of Columbia, an equity interest in the entity may be qualified opportunity zone stock or a qualified opportunity zone partnership interest, as the case may be, only if the entity conducts a qualified opportunity zone business in the U.S. possession in which the entity is organized. An entity described in the preceding sentence is treated as satisfying the "domestic" requirement in section 1400Z-2(d)(2)(B)(i) or section 1400Z2(C)(i).

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

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

Par. 5. Section 1.1400Z-2(e)-1 is added to read as follows:

**§1.1400Z-2(e)-1 Applicable rules.**

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

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

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

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

**(b) [Reserved].**

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

Deputy Commissioner for Services and Enforcement.