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Detailed Analysis: IRS Issues Second Installment of Qualified Opportunity Zone Fund (QOF) Proposed Regulations

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The following is a detailed practical analysis of the impact on structuring, operating, and investing in Qualified Opportunity Funds (**QOFs**) of the second installment of proposed regulations (**New Proposed Regulations**) related to the Qualified Opportunity Zone (**QOZ**) program that were issued by the U.S. Treasury Department on April 17, 2019.[1]

The QOZ Incentive Program

The Tax Cuts and Jobs Act of 2017 created an important new tax incentive in the form of the QOZ program. Due to the broad base of potential investors and eligible real estate projects and operating businesses, this program has the ability to provide substantial tax advantaged returns to investors and to attract increased levels of capital for eligible projects and businesses. In 2018, over 8,700 QOZs were designated and certified nationwide, covering every state and metropolitan market.

The QOZ program allows taxpayers to defer short-term or long-term capital gains tax due upon a disposition of property from 2018 through 2026 if the capital gain portion of the disposition (**Deferred Gain**) is reinvested in a QOF within 180 days.[2]

An investor who makes a qualifying investment in a QOF may receive the following three tax benefits:

1. the investor does not have to pay tax on the amount of the Deferred Gain that is invested in a QOF until the earlier of the occurrence of an inclusion event[3] or Dec. 31, 2026,[4]
2. such Deferred Gain is reduced by up to 15% if the investment in the QOF is held for at least seven years, and
3. the investor does not have to pay capital gain tax on the appreciation in value of its QOF interest if the QOF interest is held for at least 10 years.

New Proposed Regulations Issued

On April 17, 2019, the U.S. Treasury Department released the 169 pages of New Proposed Regulations that amplify and clarify an earlier set of proposed regulations that was released in October 2018 (**October Proposed Regulations**), which primarily addressed the operative rules of real estate investments within the QOZ program. The New Proposed Regulations provide further clarification and guidance with respect to real estate and also provide many important guidelines that will be helpful to operating businesses and venture capital.[5] Although the New Proposed Regulations are robust and provide some useful answers, integral issues remain unclear or unaddressed altogether. We remain hopeful that a third set of proposed regulations will be issued later this year to address remaining open issues, but the response from Treasury and the IRS with respect to a third set of proposed regulations has been noncommittal thus far.

Except as discussed below, taxpayers may immediately rely upon the New Proposed Regulations, even before the rules are finalized. Disappointingly, however (as discussed later), *a crucial section of the New Proposed Regulations that would allow investors to elect to receive the benefits of the program upon a sale of the underlying assets owned by the QOF after 10 years (rather than requiring the investor to sell its interest in the QOF itself), may not be relied upon until it is finalized*.[6]

The New Proposed Regulations do include many provisions that will be helpful to investors and practitioners alike, including the following:

1. Election to Exclude Capital Gain from Disposition of QOZ Property

The step-up in basis for a QOF interest sold after being held for 10 years or longer is only available for a sale of the investor’s interest in the QOF itself. If, instead, a QOF or qualified opportunity zone business (**QOZB**) sells its assets, each investor would be required to report its share of the gain from the sale. This has made it difficult to structure multi-asset QOFs because in order to achieve the QOZ tax benefits for the investors, a purchaser would need to buy all of the investors’ equity interests in the QOF. This would mean that the purchaser would have to be willing to (i) indirectly acquire the QOF’s entire portfolio of assets and (ii) take the additional risks associated with buying equity interests and not assets.

The New Proposed Regulations acknowledge this issue and provide that an investor can elect to exclude from gross income any capital gain allocated to the investor from a QOF partnership’s sale of qualified opportunity zone property.[7] Some QOFs directly own their business assets. But many QOF transactions are organized in a two-tier structure, in which a QOF owns an interest in a lower tier partnership referred to as a QOZB. In this format, the real estate or other business assets are owned by the QOZB. The new rule is helpful in that it allows the exclusion of capital gain after 10 years even if the QOF sells its assets (or its partnership interest in the QOZB) rather than requiring each investor to sell his or her QOF interest. However, the new rule is still inadequate because (i) it is unclear whether gain arising from a sale of property owned by the QOZB would also be permitted to be excluded under the election, and (ii) the election does not apply to QOF corporations. ***Moreover, this provision of the New Proposed Regulations may not be relied upon by taxpayers unless and until it is finalized*.** Even if finalized, the continuing uncertainty around the treatment of sales of underlying assets will have a chilling effect on such sales and structuring multiple-asset QOFs.

2. Operation of 10-Year Basis Step-Up

A primary tax benefit of the QOZ program is that an investor may sell its QOF interest after 10 years without paying capital gain tax on the appreciation in the value of the amount invested in the QOF. This is accomplished through a fair market value basis step-up in the QOF interest immediately prior to the sale of the interest. The New Proposed Regulations state that when a QOF partnership interest is sold after 10 years, the basis of the QOF partnership's assets is also stepped up immediately prior to the sale of the partnership interest (likening the calculation to a transfer with a Section 754 election in effect).[8] This inside basis step-up will apply to all QOF assets, including unrealized receivables and inventory, which should avoid the possibility of both ordinary income and capital losses resulting from the asset sale (which might have otherwise occurred pursuant to the rules of Section 751). This may mean that depreciation will not be recaptured upon a sale of a QOF partnership interest after a 10-year holding period.

Although this new rule would permit the basis of the assets of a QOF to be increased, it appears that the basis of assets owned in a subsidiary QOZB may not be stepped up under the current language.

This provision of the New Proposed Regulations may not be relied upon by taxpayers unless and until it is finalized.[9]

3. Ability to Roll Up QOFs into a Parent Company

Generally, if an investor transfers his or her interest in a QOF, there will be an "inclusion event" and the investor will be required to recognize the Deferred Gain. However, under certain circumstances, *the New Proposed Regulations allow an investor to transfer his or her QOF interest to another partnership* (**Parent Partnership**) *in a tax-deferred capital contribution under Section 721 without triggering Deferred Gain if the QOF remains alive*. As a result of the transfer, the Parent Partnership will own the interest in the QOF and the Parent Partnership will step into the investor's shoes for purposes of reporting the Deferred Gain. The Parent Partnership is required to allocate and report the gain associated with the transferred interest to the contributing partner. In other words, there is no reduction in the amount of the remaining Deferred Gain, and that amount will be reported to the transferring partner by the Parent Partnership if there is a future inclusion event. This provision may be particularly useful to permit all of the members of related QOFs to contribute (roll up) their interests in multiple QOFs to a single Parent Partnership, which would then be the owner of multiple subsidiary QOFs. If and when the IRS finalizes the rule permitting a QOF partnership to sell its interest in a QOZB,[10] each "rolled-up" QOF would be able to sell its interest in its QOZB, making it unnecessary for every individual investor to sell his or her interest.[11]

Note that the New Proposed Regulations inexplicably do not permit the reverse – a Parent Partnership may not form a subsidiary QOF.

4. Losses and Debt Financed Distributions – Debt Creates Basis for Investors

The New Proposed Regulations clarify that a QOF (other than a REIT) may distribute financing proceeds in certain circumstances on a tax-free basis (i.e., without triggering an inclusion event of the investor's Deferred Gain).

Under the QOZ program, an investor generally starts out with a zero basis in its investment in a QOF. In the case of a QOF structured as a partnership, it was unclear whether an investor could deduct losses from the QOF or receive distributions from the QOF without triggering a taxable inclusion event. The New Proposed Regulations clarify that general partnership tax principles apply and that an investor will receive a basis step-up in its QOF partnership interest:

a. to the extent the investor is allocated a share of the partnership's liabilities under Section 752; and

b. to the extent the investor is allocated income or gain from the partnership. Additionally, an investor will receive a basis step-up in its QOF partnership interest (i) in an amount equal to 10% of the investor's Deferred Gain upon holding the interest for five years, (ii) in an amount equal to an additional 5% of the investor's Deferred Gain upon holding the interest for seven years; and

c. upon recognition of the remainder of the investor's Deferred Gain on Dec. 31, 2026, or the earlier occurrence of an inclusion event.

The New Proposed Regulations clarify that these basis adjustments provide basis for all tax purposes and, accordingly, to the extent of such basis adjustments, an investor may:

a. receive distributions from a QOF partnership without being taxed upon receipt of such distributions, and

b. claim its allocable share of losses and deductions from the QOF partnership. Just as in conventional investment structures, such distributions and losses remain subject to the various loss limitation rules provided throughout the Code.

Note that distributions made to an investor that are not dependent on the entrepreneurial risks of the QOF's business may be considered a return of the investor's initial investment and might reduce the amount of the investor's investment that is eligible to be deferred. Any distributions of financing proceeds made within 24 months after the investor's capital contribution would be presumed not to be dependent on the entrepreneurial risks of the QOF's business, and should be avoided.

This provision appears to allow QOF partnerships to make traditional refinancing distributions, including distributions timed to allow investors to pay their tax on the phantom income generated by the automatic Deferred Gain recognition on Dec. 31, 2026.

5. Original Use and Substantial Improvement

Generally, to qualify as qualified opportunity zone business property (QOZBP), tangible property acquired by purchase by a QOF or a QOZB must, among other things, meet either an "original use" test or a "substantial improvement" test.

a. **Original Use.** The New Proposed Regulations provide a number of helpful rules:

i. "**original use**" of tangible property begins when the property has been placed in service in the QOZ with respect to depreciation or amortization;

ii. the original use and substantial improvement requirements do not apply to land. This means that nearly completed projects that have not yet been placed in service may be acquired by a QOF or QOZB without any need to "double the cost basis" of the existing improvements;

iii. a QOF may purchase or lease used property which has not been previously depreciated or amortized within a QOZ, and such used property may be considered "original use" property;

iv. a building that was vacant for at least five years prior to its acquisition by a QOF or QOZB may be considered “original use” property with respect to the QOF or QOZB; and

v. improvements constructed on leased land will satisfy the original use requirement and will be treated as purchased property in an amount equal to the unadjusted basis of such improvements;

Substantial Improvement. Property acquired by purchase that is not “original use” property must be “substantially improved” to qualify as QOZBP. Property is considered substantially improved if, during any 30-month period beginning after the acquisition date, additions to the basis of the property owned by the QOF or QOZB exceed an amount equal to the adjusted basis of the property at the beginning of the 30-month period.

Asset-by-Asset Test. The New Proposed Regulations clarify that the substantial improvement test must be applied using an asset-by-asset approach. The IRS is seeking comments regarding whether an aggregate approach may be appropriate under certain circumstances.

Land*.* The New Proposed Regulations provide that land is not subject to the substantial improvement requirement and will qualify as QOZBP if the land is used in an active trade or business of the QOF or QOZB. The New Proposed Regulations try to distinguish between (a) QOFs or QOZBs that buy unimproved land with the intention of developing the land as part of a business plan, and (b) QOFs or QOZBs that buy unimproved land for investment (land banking) or to conduct a modest business without making a new capital investment in the property. In this regard:

i. the New Proposed Regulations include an anti-abuse rule that is intended to apply where the QOF does not intend to invest new capital or increase the economic activity on the land; and

ii. unimproved or minimally improved land is subject to the substantial improvement requirement if purchased with the expectation that the QOF will not improve the land by more than an insubstantial amount within the 30 months following the purchase.

6. Leased Property

The New Proposed Regulations clarify that, notwithstanding the statutory requirement that QOZBP be acquired “by purchase,” property leased by a QOF or QOZB can qualify as QOZBP if certain requirements are met.[12] These requirements include:

a. the lease must be entered into after Dec. 31, 2017,

b. substantially all of the use of the leased property must be in a QOZ during substantially all of the period that it is leased by the QOF or QOZB, and

c. the terms of the lease must be market rate (determined under Section 482 and the regulations thereunder).

Importantly, several requirements that apply to purchased property do not apply to leased property:

a. leased property is not subject to the original use or substantial improvement requirements, and

b. property can be leased from a related party. However, if the leased property is leased by a QOF or QOZB from a related party, two other requirements must be met:

i. the QOF or QOZB must not make a prepayment of rent for a period longer than 12 months, and

ii. in the case of leased tangible personal property (the original use of which in the QOZ does not commence with the lessee), the lessee QOF or QOZB must also (1) acquire by purchase other tangible property that qualifies as QOZBP with a value at least equal to the value of the leased property and (2) purchase such additional property within 30 months of possessing the leased property or by the end of the term of the lease for the leased property, whichever is earlier.

Anti-Abuse Rule. The New Proposed Regulations include an anti-abuse provision that prevents qualification of leased real property (other than land) where there is an expectation that the QOF will purchase the real property for less than fair market value at the time of the future purchase.

These leased property provisions will now allow related party leases of property that was owned on or prior to Dec. 31, 2017. The improvements made thereon by the tenant will be deemed to have satisfied the original use requirement.

7. Active Conduct of a Trade or Business

A QOZB must derive at least 50% of its gross income from the active conduct of a trade or business in a QOZ. The New Proposed Regulations provide several guidelines to help taxpayers comply with this requirement. For purposes of the QOZ program, the term “trade or business” will have the same meaning as used in Section 162, which has a large body of case law and administrative guidance interpreting the meaning of such term. Specifically, the New Proposed Regulations provide that the ownership and operation (including leasing) of real property is the active conduct of a trade or business. ***However, a triple net lease of real property owned by a QOZB will not be considered the active conduct of a trade or business***.

8. Carried Interest

The New Proposed Regulations clarify that an interest in a QOF received in exchange for services, such as a carried interest, ***is not*** a qualifying investment in the QOF. Deferred Gain invested by a partner who also receives a carried interest would remain eligible for the tax benefits of the program, however a carried or promoted interest will be accounted for separately for purposes of the program and (as a “mixed-fund” investment) will not be eligible for the QOZ program tax benefits.[13]

9. Working Capital Safe Harbor:

Generally, less than 5% of the average aggregate unadjusted basis of a QOZB’s property may consist of “nonqualified financial property.” For this purpose, “*reasonable amounts of working capital*” are not considered nonqualified financial property. The October Proposed Regulations provided that a QOZB’s working capital would be considered “reasonable” if: (A) the amounts were designated in writing for the acquisition, construction and/or substantial improvement of tangible property in a QOZ, (B) there was a written schedule for the amounts to be expended within 31 months, and (C) the working capital is actually used in a manner substantially consistent with (A) and (B).

The New Proposed Regulations expand the working capital safe harbor by clarifying that

a. working capital can be used to develop an operating trade or business (not just for the development of real property or other tangible property),

b. if a QOZB receives capital contributions at different times, multiple overlapping or sequential 31-month periods may be used, as long as each application of the safe harbor can independently satisfy each of the requirements of the safe harbor, and

c. if consumption of the working capital is delayed by waiting for government action beyond the applicable 31-month period (the application for which is completed during the 31-month period), the delay will not violate the actual use requirement in clause (C) above.

10. "Substantially All" Thresholds

A "substantially all" requirement is used in several places in the QOZ program statute, including:

a. during "substantially all" of a QOF's holding period of qualified opportunity zone stock (**QOZS**) or a qualified opportunity zone partnership interest (**QOZPI**), such corporation or partnership must qualify as a QOZB;

b. during "substantially all" of a QOF's or QOZB's holding period of QOZBP, "substantially all" of the use of such QOZBP must be in a QOZ; and

c. "substantially all" of the tangible property owned or leased by a QOZB must be QOZBP (this clause is referred to as the "**Tangible Property Test**").[14]

Because Section 1400Z-2 does not clarify the standard that must be met to satisfy each of these "substantially all" requirements, the regulations have provided guidance.

The October Proposed Regulations clarified that a QOZB must hold at least 70% of its assets in QOZBP to satisfy the Tangible Property Test, but they did not provide guidance as to the other places the term was used. The New Proposed Regulations fill in this gap and provide that:

a. during at least 90% of a QOF's holding period of QOZS or a QOZPI, such corporation or partnership must qualify as a QOZB; and

b. during at least 90% of a QOF's or QOZB's holding period of QOZBP, at least 70% of the use of such QOZBP must be in a QOZ (regardless of whether such QOZBP is owned or leased).

11. The 90% Test - QOF Capital Contributions and Reinvestments

a**. Six-Month Extension to Invest**

To qualify as a QOF, at least 90% of the QOF's assets must be qualifying property. This test is measured by taking the average of the percentage of qualifying property held by the QOF as measured (i) on the last day of the first six-month period of the taxable year of the QOF, and (ii) on the last day of the taxable year of the QOF. Cash and cash equivalents are not qualifying property. Accordingly, without a special rule, this 90% test was hard to satisfy if, for example, a QOF receives a capital contribution close to the end of the year and has not had time to deploy the capital by the end of the year. *To alleviate this problem, the New Proposed Regulations permit a QOF to exclude all capital contributions received in the prior six months from the 90% asset test calculations so long as the capital is held in cash or permitted short-term debt.*

b. **Valuation of Property for 90% Test**

When valuing property for purposes of meeting the 90% asset test or the 70% "substantially all" Tangible Property Test,[15] the QOF or QOZB formerly was required to use the values set forth on its "applicable financial statement," provided it had an audited financial statement determined in accordance with GAAP. Instead, the New Proposed Regulations provide two valuation options: (i) the applicable financial statement valuation method, or (ii) an alternative valuation method using the unadjusted cost basis of the assets. The same options are allowed for valuing leased property, except that (A) the applicable financial statement valuation method may be used only if the financial statement actually assigns a value to the leased asset, and (B) under the alternative valuation method, the leased property is valued by using the present value of the lease payments.[16]

c. **Reinvestment**

Congress understood that a QOF might want to sell assets and reinvest in new QOZ assets during its term and directed the IRS to give QOFs a reasonable time to reinvest the sale proceeds in a QOZ without violating the 90% test.

The New Proposed Regulations provide that any such sale proceeds will constitute qualifying assets so long as the QOF reinvests the proceeds during the 12-month period (or longer if due to delay in governmental action) beginning on the date of the asset sale. Until the sale proceeds are reinvested, they must be held in cash or permitted short term debt.

d. **Gain Recognition Despite Reinvestment**.

Because an investor's QOZ tax benefits are tied to his or her continued investment in the QOF (not in any particular QOF asset), the QOF's sale of an asset does not accelerate the Deferred Gain or change the investor's holding period in his or her QOF interest. It should be noted that the reinvestment provisions apply only to QOFs – not to QOZBs. The IRS is seeking comments regarding whether this rule should be extended to QOZBs.

Note that although the QOF may redeploy the sale proceeds without triggering a recognition of the investor's Deferred Gain*, the gain from the sale of the QOF's asset is generally subject to tax (unless the sale is structured in a way, such as a Section 1031 exchange of real property, that is otherwise not subject to tax).* Accordingly, advance planning is needed to protect investors from phantom income if sale proceeds will be reinvested by the QOF.

12. Section 1231 Gains as Eligible Deferred Gain

Section 1231 gains arise only after they have been netted against relevant Section 1231 losses for the entire tax year. The New Proposed Regulations clarify that, while an investor's Section 1231 gains are eligible for investment in a QOF with the attendant tax benefits, the investor must wait to invest such gains until the conclusion of its tax year and the required netting has taken place. This could be a benefit, as it delays the start of the investor's 180-day investment clock. However, by forcing the investor to wait until the end of the investor's tax year to reinvest such gain, the investor might miss out on investment opportunities that arise earlier in the year.

13. Real Property Straddling a QOZ

Questions have arisen about how a QOZB satisfies the requirement that 50% of its gross income and a substantial portion of its intangible property be derived from the conduct of a business in a QOZ where the business operates from property partly within and partly outside a QOZ. The New

Proposed Regulations provide that the real property located outside the QOZ will be considered located within the QOZ and eligible if:

a. the portion of the real property located outside a QOZ is contiguous to real property located within a QOZ, and

b. the square footage of the real property located within the QOZ is “substantial” compared to the square footage of the real property located outside the QOZ. In the preamble to the New Proposed Regulations, the IRS indicated that property located within the QOZ should be considered “substantial” if the unadjusted cost of the real property inside the QOZ is greater than the unadjusted cost of real property outside the QOZ.

14. Bequests at Death, Gifts, and Transfers to Trust

The New Proposed Regulations clarify that:

a. an estate or inheritor of a QOF interest may continue to hold the interest with the same holding period of the decedent and without a recognition event so long as the decedent’s estate or the heir does not sell the interest until after the decedent’s 10-year holding period;

b. a transfer of a QOF interest to a grantor trust (which is disregarded for federal income tax purposes) will not trigger an inclusion event (however, a later change in the status of the trust, to other than a grantor trust, will constitute an inclusion event); and

c. a transfer by gift or charitable contribution of a QOF interest will be an inclusion event that causes an acceleration of the Deferred Gain.

15. Acquisition of a QOF Interest

The New Proposed Regulations provide the following regarding the acquisition of a QOF interest:

a. An investor may acquire a QOF interest by purchase from an existing partner or shareholder. The amount of the investor’s qualifying investment will be equal to the purchase price of the QOF interest.[17]

b. An investor may acquire a QOF interest in exchange for a contribution of non-cash property to the QOF. The amount of the investor’s qualifying investment will be the lesser of (i) the contributed property’s net basis or (ii) the net fair market value (i.e., net of any mortgage or other debt to which the contributed property is subject) on the date of contribution.[18] If the property’s fair market value exceeds its basis, the investor will be treated as making a non-qualifying (i.e., a mixed-fund) investment equal to the amount of the excess.[19]

16. Provisions for Operating Businesses

The New Proposed Regulations include many provisions that apply to operating businesses looking to take advantage of the QOZ program. The October Proposed Regulations failed to address many of the issues associated with operating a business under the QOZ program. Several of those questions were answered by the New Proposed Regulations in helpful ways.

a. **Gross Income Test Safe Harbors**

A QOZB must derive at least 50% of its gross income from the active conduct of a trade or business in a QOZ. The New Proposed Regulations provide several safe harbors and a facts and circumstances test that will be particularly helpful to operating businesses. A trade or business will satisfy this 50% gross income test if:

i. at least 50% of the services performed (based on hours) for such business by its employees and independent contractors (and by the employees of independent contractors) are performed within the QOZ,[20] **or**

ii. at least 50% of the services performed for the business by its employees and independent contractors (and by the employees of independent contractors) are performed in the QOZ, based on amounts paid by the business to the employees and/or independent contractors for the services performed,[21] **or**

iii. the combination of the tangible property of the business that is located in a QOZ and the management or operational functions performed for the business in the QOZ are each necessary to generate 50% of the gross income of the trade or business.[22]

Even if none of these safe harbors apply, a QOZB may still satisfy the 50% gross income test, if based on all the facts and circumstances, at least 50% of the gross income of the QOZB is derived from the active conduct of a trade or business in the QOZ.

b. **Inventory in Transit**

Substantially all the use of a QOZB's property must be in a QOZ. Some observers were concerned that inventory in transit at the end of a taxable year would not be considered to be used in a QOZ. The New Proposed Regulations clarify that inventory will not fail to be considered to be used in the QOZ simply because the inventory is in transit (a) from a vendor to the QOZB or (b) from the QOZB to a customer.

c. **Intangible Property Threshold**

To qualify as a QOZB, a partnership or corporation must use a substantial portion of its intangible property in the active conduct of a trade or business in a QOZ. The New Proposed Regulations have set the threshold for a "substantial portion" at 40%. This manageable threshold will be of particular significance for investors and businesses in the tech sector.

Conclusion

The New Proposed Regulations are generally favorable for investors and businesses looking to take advantage of the generous tax benefits afforded by the QOZ program. Real estate received some additional clarifications, and operating businesses received guidance that was nearly nonexistent in the October Proposed Regulations. These New Proposed Regulations now allow many QOFs focused on operating businesses and venture capital investment to proceed with QOZ investments. Nonetheless, several important issues remain unaddressed, most notably the issue surrounding the disposition of assets by QOFs and QOZBs (instead of requiring a sale of the investor's interest in the QOF). Treasury and the IRS have alluded to the possibility of issuing a third set of proposed regulations but have stopped short of making a commitment to do so. We will keep you posted as new guidance is issued.

[1] For a quick reference guide to the key changes made by the New Proposed Regulations, see our GT Executive Summary of the New Proposed Regulations (available at https://www.natlawreview.com/article/executive-summary-irs-issues-second-installment-qualified-opportunity-zone-fund-qof

[2] The 180-day period for investors who realize their capital gains via a pass-through entity may begin either at the date of the sale or upon the conclusion of the tax year of the pass-through entity. The 180-day period for investors with Section 1231 gains will begin at the end of their tax year.

[3] An “inclusion event” is an event that causes a QOF investor to recognize some or all of its Deferred Gain. An inclusion event will be triggered upon the earlier of the occurrence of certain events specified in the New Proposed Regulations or Dec. 31, 2026. The term “inclusion event” does not refer to other circumstances where a QOF investor may be required to recognize gain, such as when capital gain is allocated from a QOF partnership.

[4] Even if an investor continues to own its interest in the QOF, an automatic recognition event will occur on Dec. 31, 2026 in the amount of the lesser of (i) the remaining Deferred Gain (accounting for earned basis step-ups) or (ii) the fair market value of the investment in the QOF. Because of this automatic recognition event, liquidity in or prior to 2026 will be important for many investors.

[5] *See* section (16) “Provisions for Operating Businesses” below.

[6] *See* section (1) “Election to Exclude Capital Gain from Disposition of QOZ Property” below.

[7] The New Proposed Regulations also provide a similar rule whereby an investor in a QOF REIT may elect to treat certain capital gain dividends paid by the REIT as a transfer of the investor’s QOF REIT interest. ***However, like the QOF partnership provision (see section (2) “Operation of 10-Year Basis Step-Up” below), this section of the New Proposed Regulations cannot be relied upon unless and until it is finalized****.*

[8] Section references herein mean sections of the Internal Revenue Code of 1986 (**Code**).

[9] See section (1) “Election to Exclude Capital Gain from Disposition of QOZ Property” above for a corresponding problem with the new election to exclude gain from asset sales.

[10] *See* section (1) “Election to Exclude Capital Gain from Disposition of QOZ Property” above.

[11] Sponsors of related QOFs should make sure their partnership agreements permit this type of roll-up transaction.

[12] Section 1400Z-2(d)(D)(i)(I) provides that, in order to qualify as QOZBP, tangible property must be, among other things, acquired by a QOF or QOZB “by purchase” after Dec. 31, 2017. However, Section 1400Z-2(d)(3)(A)(i) provides that a trade or business is a QOZB only if, among other things, substantially all of the tangible property “owned or leased” by such trade or business is QOZBP.

[13] If a sponsor both invests Deferred Gain and also receives a carried interest, the New Proposed Regulations provide that the sponsor will have a mixed-funds investment, which will be treated as two separate interests in the QOF, one a qualifying investment and the other a non-qualifying investment.

In determining how to allocate the sponsor's interest between the qualifying and nonqualifying interests, the Preamble to the New Proposed Regulations provides that the **highest** percentage share of a variable carried interest of a service partner is the percentage of such partner's aggregate distributions that will be treated as ineligible for QOZ benefits. Accordingly, to avoid having a mixed-funds investment, the sponsor should segregate its carried interest in a separate entity (such as the general partner) from the entity through which the sponsor makes contributions of Deferred Gain (such as through an affiliated limited partner).

[14] In the case of improvements constructed after Dec. 31, 2017, on land that is (a) owned by the QOZB on or before Dec. 31, 2017, or (b) acquired by a related party QOZB after that date, it is unclear whether the Treasury Department will consider the improvements to qualify as "good assets" (in the 70% category) for purposes of the Tangible Property Test. *But note that, to meet the 70% test at every semi-annual testing date, the amount actually expended on improvements (and not just held in the working capital reserve) must equal at least 70% of the QOZB's total tangible assets on that date.* Until the IRS issues relief here, this may require the pre-2018 land to be leased (instead of being purchased) from the related party by the QOZB.

[15] *See* section (10) "Substantially All Thresholds" above.

[16] Although methods (A) and (B) should produce similar values in the first year of a lease, the values will differ over time because the GAAP value of a lease depreciates over time, while the alternative value remains constant. Advance modeling is important here.

[17] This removes the risk under the October Proposed Regulations that an investment in a QOF could be disqualified if there were a disguised sale of the interest by another partner resulting from a portion of an investor's Deferred Gain contribution being paid out to the other partner who overfunded its contributions.

[18] Note, however, that the contributed property likely would not be qualifying property for purposes of the 90% test because it is not being acquired by the QOF "by purchase."

[19] As mentioned above in section (8) "Carried Interests," an investor may not receive a qualifying QOF interest in exchange for services.

[20] This test is intended to address businesses located in a QOZ that primarily provide services.

[21] This test is intended to address businesses that employ highly skilled (and more highly compensated) labor within a QOZ, but may also have a number of lower-wage employees located outside the QOZ, for example, at a call center.

[22] An example given by the New Proposed Regulations of a business that may qualify under this safe harbor is a landscape company headquartered within a QOZ that stores its equipment in the QOZ, but whose employees may perform services primarily outside the QOZ.

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