

Qualified Opportunity Zone Investments: Overview

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A Practice Note discussing the Qualified Opportunity Zone program created under the Tax Cuts and Jobs Act of 2017. This Note provides an overview of the tax benefits provided by the program and the requirements for structuring and investing capital gains in qualified opportunity funds.

Under the Tax Cuts and Jobs Act (Pub. L. No. 115-97 (2017)), changes were made to the Internal Revenue Code (Code) that provide tax benefits to investors in Qualified Opportunity Zones (QOZs) (26 U.S.C. §§ 1400Z-1 and 1400Z-2). Investments in QOZs may allow investors to:

- Temporarily defer recognition of capital gains that are reinvested in a Qualified Opportunity Fund (QOF).
- Reduce the amount of recognized deferred capital gains by an increase in basis.
- Exempt from taxation any appreciation in their QOF investment if they meet certain requirements.

This Note outlines:

- The criteria for structuring and investing in QOFs.
- The tax benefits if the Code requirements are properly met.

The Treasury Department and the IRS issued final Treasury Regulations (Final Regulations) governing the QOZ program on December 19, 2019 (Treas. Reg. §§ 1.1400Z2(a)-1 to 1.1400Z2(f)-1, 85 FR 1866-01). The Final Regulations replace two previous sets of proposed regulations (Proposed Regulations) that were issued on October 19, 2018 (Prop. Treas. Reg. §§ 1.1400Z2(a)-1 to 1.1400Z2(e)-1, 83 FR 54279-01) and April 17, 2019 (Prop. Treas. Reg. §§ 1.1400Z2(a)-1 to 1.1400Z2(g)-1, 84 FR 18652-01).

The Final Regulations are applicable for tax years beginning after March 13, 2020. For prior tax years, investors may elect to apply the Proposed Regulations or the Final Regulations, provided the rules are applied consistently.

The Final Regulations are extensive and complex. They significantly modify certain aspects of the Proposed Regulations and clarify others. This Note provides an overview of the material Final Regulations but other topics are beyond the scope of this Note, including special rules for Section 1256 contracts, offsetting-positions transactions, and straddles, consolidated group rules, and rules on adjustments to partnership basis for losses, partnership debt, and distributions.

For a graphic illustration of the QOZ investment structure and tax benefits, see Qualified Opportunity Zone Investments Flowchart and Timeline ([W-019-2441](#)).

QUALIFIED OPPORTUNITY ZONES

Code Section 1400Z-1 authorizes the designation of QOZs, which are low-income communities that are:

- Identified and proposed by the chief executive officers of the fifty states and other US possessions (District of Columbia and US territories).
- Designated by the Secretary of the Treasury (Secretary).

The purpose of designating a QOZ is to spur economic development and job creation by encouraging new long-term investment in these low-income communities.

QOZ DESIGNATION PROCESS

A QOZ is a population census tract that is:

- A low-income community (or, for a limited number of QOZs, contiguous with a low-income community that has been designated as a QOZ).
- Nominated as a QOZ by a state's governor or a territory's chief executive officer.
- Certified and designated by the Secretary as a QOZ within the consideration period.

The term "low-income community" has the same meaning as it does in Code Section 45D(e) for the New Markets Tax Credit.

QOZs have been identified in all 50 states, the District of Columbia, and five US possessions. The final list and a map of designated QOZs can be found [here](#).

QUALIFIED OPPORTUNITY FUNDS

To qualify for the tax benefits provided by the QOZ program, an investor must invest capital gains in a QOF. A QOF is an investment vehicle that is:

- Formed in a US state, the District of Columbia, or a US possession. A QOF that is formed in a US possession must only invest in that possession.
- Taxed either as a corporation or a partnership for federal income tax purposes.
- Organized for the purpose of investing in Qualified Opportunity Zone Property (QOZ Property) (see Qualified Opportunity Zone Property).

(I.R.C. § 1400Z-2(d)(1).)

While limited liability companies taxed as partnerships are eligible for the program, single-member limited liability companies are not eligible because they are disregarded entities for federal income tax purposes.

The investment in a QOF must be an equity investment, which includes preferred stock or a partnership interest with special allocations. The investment cannot be a debt instrument or a deemed contribution of money under Section 752(a) of the Code (an increase in a partner's share of or assumption of partnership liabilities by a partner). However, a taxpayer may use its equity investment in a QOF as collateral for a loan. (Treas. Reg. § 1.1400Z2(a)-1(b)(12)(ii), 85 FR 1866-01.)

An investor may invest cash or other property in a QOF. (Treas. Reg. § 1.1400Z2(a)-1(c)(2)(ii)(B)(5)(i), 85 FR 1866-01.)

90% ASSET TEST

A QOF must also hold at least 90% of its assets in QOZ Property (see Qualified Opportunity Zone Property). The QOF's property holdings are determined by the average of the percentage of QOZ Property held by the QOF, as measured on the last day of both:

- The first six-month period of the taxable year of the QOF.
- The taxable year of the QOF.

(I.R.C. § 1400Z-2(d)(1).)

A QOF may choose to become a QOF in a month other than the first month of the taxable year but any investments made before the elected month do not qualify for QOZ tax benefits (Treas. Reg. § 1.1400Z2(d)-1(a)(2)(iii), 85 FR 1866-01). Regardless of when an entity becomes a QOF, the last day of the taxable year is a testing date. Therefore, if an entity becomes a QOF in the seventh or later month of a 12-month taxable year, the 90% test is applied on the QOF's assets on only the last day of the taxable year (Treas. Reg. § 1.1400Z2(d)-1(a)(2)(iv)(A), 85 FR 1866-01).

To provide relief to a QOF that receives an investment shortly before a test date, the QOF may apply the 90% asset test without taking into account any investment received in the preceding six months provided those investments are:

- In the case of a QOF partnership, received by the QOF as a contribution or, in the case of a QOF corporation, received by the QOF solely in exchange for stock of the corporation.

- Held continuously from the fifth business day after contribution or exchange, as applicable, through the test date in:
 - cash;
 - cash equivalents; or
 - debt instruments with a term of 18 months or less.

(Treas. Reg. § 1.1400Z2(d)-1(b)(2)(B), 85 FR 1866-01.)

Sale proceeds from the distribution, sale, or disposition of the QOF's assets will count as QOZ Property for purposes of the 90% asset test provided:

- They are reinvested in other QOZ Property within 12 months of the distribution, sale, or disposition, subject to extension for government-related delays and federally-declared disasters.

- Before reinvestment they are continuously held in:

- cash;
- cash equivalents; or
- debt instruments with a term of 18 months or less.

(Treas. Reg. § 1.1400Z2(f)-1(b), 85 FR 1866-01.)

Valuation Method for 90% Asset Test

For purposes of the 90% asset test, the Final Regulations allow the QOF to use either:

- The asset values reported on the QOF's applicable financial statement for the taxable year.
- An alternative valuation method, generally described as:
 - the unadjusted cost basis for owned assets purchased or constructed for fair market value;
 - the fair market value of property not purchased or constructed for fair market value; and
 - the present values of lease payments for leased assets.

(Treas. Reg. § 1.1400Z2(d)-1(b)(3), (4), 85 FR 1866-01.)

A taxpayer's applicable financial statement is generally a financial statement prepared under US generally accepted accounting principles (GAAP), as defined in Treasury Regulation Section 1.475(a)-4(h).

CERTIFICATION AS A QUALIFIED OPPORTUNITY FUND

A QOF must self-certify annually that it satisfies the 90% asset test. A pre-existing entity may also self-certify as a QOF if applicable requirements under Section 1400Z-2 are met. (Treas. Reg. § 1.1400Z2(d)-1(a)(1)(iii), 85 FR 1866-01.)

A QOF :

- Must identify the taxable year in which the entity becomes a QOF.
- May choose the first month in that year to be treated as a QOF. (Treas. Reg. § 1.1400Z2(d)-1(a)(2), 85 FR 1866-01.)

A gain deferral election is not effective for an investment that is made before an eligible entity certifies as a QOF.

DECERTIFICATION AS A QUALIFIED OPPORTUNITY FUND

A QOF may self-decertify as a QOF. If a QOF decertifies:

- The decertification is effective at the beginning of the month following the month specified by the QOF.
- It is an inclusion event for the investors in the QOF (see Gain Inclusion Events).

(Treas. Reg. §§ 1.400Z2(d)-1(a)(3), (b)-1(c)(15), 85 FR 1866-01.)

QUALIFIED OPPORTUNITY ZONE PROPERTY

For QOF investors to receive the intended tax benefits, a QOF must be organized to invest in QOZ Property. QOZ Property includes the following three types of property:

- QOZ Stock (see QOZ Stock).
- QOZ Partnership Interests (see QOZ Partnership Interests).
- QOZ Business Property (see QOZ Business Property).

(I.R.C. § 1400Z-2(d)(2)(A).)

QOZ STOCK

If an entity is classified as a corporation for federal income tax purposes, then an equity interest (stock) in the entity qualifies as QOZ stock (QOZ Stock) if:

- 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.
- As of the time the stock is issued, the corporation is a QOZ Business (or, in the case of a new corporation, is being organized for purposes of being a QOZ Business) (see QOZ Business).
- During substantially all the QOF's holding period for the stock, the corporation is a QOZ Business. The Final Regulations:
 - define "substantially all" for this purpose as at least 90%;
 - determine the holding period on a cumulative basis; and
 - provide a one-time six-month cure period.

(I.R.C. § 1400Z-2(d)(2)(B); Treas. Reg. §§ 1.1400Z2(d)-1(c)(2)(i)(C), -1(d)(6), 85 FR 1866-01.)

QOZ PARTNERSHIP INTERESTS

If an entity is classified as a partnership for federal income tax purposes, then an equity interest in the entity qualifies as a QOZ partnership interest (QOZ Partnership Interest) if:

- The partnership interest is acquired by a QOF after December 31, 2017 from the entity solely in exchange for cash.
- As of the time the interest is issued, the entity is a QOZ Business (or, in the case of a new entity, is being organized for purposes of being a QOZ Business) (see QOZ Business).
- During substantially all the QOF's holding period for the interest, the entity is a QOZ Business. The Final Regulations:
 - define "substantially all" for this purpose as at least 90%;
 - determine the holding period on a cumulative basis; and
 - provide a one-time six-month cure period.

(I.R.C. § 1400Z-2(d)(2)(C); Treas. Reg. § 1.1400Z2(d)-1(c)(3)(i)(C), -1(d)(6), 85 FR 1866-01.)

QOZ BUSINESS PROPERTY

Tangible property used in a trade or business of a QOF or QOZ Business (see QOZ Business) qualifies as QOZ business property (QOZ Business Property) if:

- The tangible property was acquired by the QOF or QOZ Business by purchase or lease after December 31, 2017.
- During at least 90% of the QOF's or QOZ Business's holding period or lease term for the tangible property, at least 70% of the use of the tangible property is in a QOZ. The Final Regulations provide safe harbors for:
 - tangible property used in rendering services both inside and outside a QOZ;
 - tangible property owned by leasing business with offices in a QOZ; and
 - inventory in transit.
- (Treas. Reg. §§ 1.1400Z2(d)-2(c)(4)(iii), (v), (viii), 85 FR 1866-01.)
- For purchased tangible property, it was purchased from an unrelated party (unrelated parties means having no more than 20% common ownership) and either:
 - the original use of the tangible property in the QOZ commences with the QOF or QOZ Business (see Original Use Requirement); or
 - the QOF or QOZ Business substantially improves the tangible property (see Substantial Improvement Requirement).
- For leased tangible property:
 - the lease is market rate;
 - there is no plan, intent, or expectation that the lessee will purchase the real property for less than fair market value; and
 - if the lessor and lessee are related parties: (i) no prepayment of rent exceeds 12 months; and (ii) if the original use of leased personal property in the QOZ does not commence with the lessee, the lessee must purchase tangible property that is QOZ Business Property within 30 months (or by the end of the lease term, if earlier) having a value not less than the value of the leased personal property.

(I.R.C. § 1400Z-2(d)(2)(D); Treas. Reg. § 1.1400Z2(d)-2(c), 85 FR 1866-01.)

Tangible property manufactured, constructed, or produced for use in a QOZ by the QOF or QOZ Business qualifies as QOZ Business Property if both:

- The manufacture, construction, or production begins after December 31, 2017.
- The materials and supplies used to manufacture, construct, or produce the property are also QOZ Business Property.

(Treas. Reg. § 1.1400Z2(d)-2(b)(1)(iii), 85 FR 1866-01.)

Original Use Requirement

Revenue Ruling 2018-29 addresses the original use requirement for two types of tangible property, land and existing buildings. The rules are as follows:

- **Land.** The Revenue Ruling states that, given the permanence of land, its original use can never commence with a QOF or QOZ Business, so the original use requirement does not apply to the land on which a building is located. However, the Final Regulations

require land to be used in a trade or business of a QOF or QOZ Business to prevent holding land for speculative purposes (see Substantial Improvement Requirement).

- **Buildings.** The original use of an existing building located on land also does not commence with the QOF or QOZ Business. They instead must substantially improve the building for the building to qualify as QOZ Property. For purposes of determining whether or not the building is substantially improved:
 - the land’s adjusted basis is not included in a building’s adjusted basis; and
 - the land on which a substantially improved building is located does not itself need to be separately substantially improved for the building to qualify as QOZ Property.

(Rev. Rul. 2018-29.)

The Final Regulations provide the following guidelines for the original use requirement:

- **Commencement date.** Original use of tangible property commences on the date any person first places the property in service in the QOZ for purposes of depreciation or amortization.
- **Vacant property.** Real property satisfies the original use requirement if, on the date of its purchase by a QOF or QOZ Business, it has been uninterruptedly vacant for:
 - at least one calendar year before the QOZ in which it is located was designated a QOZ and remained vacant until purchased; or
 - at least three calendar years beginning after the QOZ designation and remained vacant until purchased.

Vacancy is defined as more than 80% of the building or land, as measured by square footage of useable space, not being used.
- **Leased tangible property.** Improvements made by a lessee to leased property satisfy the original use requirement.
- **Used property.** Used tangible property satisfies the original use requirement if it was not previously used or placed in service in that QOZ by any person.
- **Brownfield sites.** All property, including the land and structures thereon, composing a brownfield site (as defined in CERCLA) satisfies the original use requirement if the owner ensures it meets basic safety standards within a reasonable period.
- **Local government property.** Real property (including the land and structures thereon) purchased from a local government satisfies the original use requirement if the local government held the property as the result of an involuntary transfer such as:
 - abandonment;
 - bankruptcy;
 - foreclosure; or
 - receivership.

(Treas. Reg. § 1.1400Z2(d)-2(b)(3), 85 FR 1866-01.)

Substantial Improvement Requirement

Tangible property is treated as substantially improved by the QOF only if, during any 30-month period beginning after the property acquisition date, the QOF adds to the basis of the property an amount equal to more than the adjusted basis of the property at the

beginning of the 30-month period. The Final Regulations provide the following guidelines for the substantial improvement requirement:

- For buildings located on land wholly within a QOZ, the QOF must only substantially improve the building and not the land.
- A QOF is not required to substantially improve unimproved land, but it will not be considered QOZ Business Property if the QOF purchases the land with an intent not to improve the land by more than an insubstantial amount within 30 months, unless it is substantially improved.
- Two or more buildings in a single QOZ or in contiguous QOZs may be aggregated for purposes of the substantial improvement test if they meet specified requirements.

(Treas. Reg. § 1.1400Z2(d)-2(b)(4), 85 FR 1866-01.)

QOZ BUSINESS

An entity that issues stock or partnership interests to a QOF must qualify as a QOZ Business for investors to receive the intended tax benefits. A trade or business is a QOZ Business if:

- Substantially all the tangible property owned or leased by the trade or business is QOZ Business Property (see QOZ Business Property). The Final Regulations define substantially all in this context as at least 70%. (Treas. Reg. § 1.1400Z2(d)-1(d)(2), 85 FR 1866-01.)
- For each taxable year, at least 50% of its gross income is derived from the active conduct of a trade or business in the QOZ. The Final Regulations:
 - define a trade or business for purposes of the QOZ program as a trade or business within the meaning of Code Section 162;
 - provide that the ownership and operation (including leasing, except for merely entering into a triple-net lease) of real property qualifies as the active conduct of a trade or business;
 - set out three safe harbors and a facts and circumstances test for determining whether the 50% gross income test is satisfied; and
 - for business conducted on real property located partly within and partly outside of a QOZ, include methods for determining whether the property is deemed to be located in the QOZ.

(Treas. Reg. §§ 1.1400Z2(d)-1(d)(1), -1(d)(3)(i), (iii), (ix), 85 FR 1866-01.)
- A substantial portion of its intangible property is used in the active conduct of a trade or business in the QOZ. The Final Regulations define “substantially all” in this context as at least 40%. (Treas. Reg. § 1.1400Z2(d)-1(d)(3)(ii), 85 FR 1866-01.)
- In each taxable year, less than 5% of the average aggregate unadjusted bases of its property is attributable to nonqualified financial property, subject to a working capital safe harbor (see Working Capital Safe Harbor). Nonqualified financial property is defined as:
 - debt;
 - stock;
 - partnership interests;
 - options;
 - futures contracts;
 - forward contracts;
 - warrants;

- notional principal contracts;
- annuities; and
- other similar property.

(I.R.C. § 1397C(e); Treas. Reg. § 1.1400Z2(d)-1(d)(3)(iv), 85 FR 1866-01.)

- It is not a “sin business” or a business leasing more than a de minimis amount of property to a sin business. Sin business is defined as a:
 - private or commercial golf course;
 - country club;
 - massage parlor;
 - hot tub facility;
 - suntan facility;
 - racetrack or other facility used for gambling; or
 - store the principal business of which is the sale of alcoholic beverages for consumption off premises.

(I.R.C. § 1400Z-2(d)(3); Treas. Reg. § 1.1400Z2(d)-1(d)(4), 85 FR 1866-01.)

Working Capital Safe Harbor

QOZ Businesses may hold reasonable amounts of working capital in:

- Cash.
- Cash equivalents.
- Debt instruments with a term of 18 months or less.

The working capital may be held for a period of up to 31 months if:

- There is a written plan that designates these amounts for:
 - the acquisition, construction, and/or substantial improvement of tangible property in the QOZ; or
 - the development of a trade or business in the QOZ.
- There is a written schedule consistent with the ordinary start-up of a trade or business requiring the working capital assets to be spent within 31 months.
- The business substantially complies with the plan and schedule, subject to delay for government action on a completed application.

The Final Regulations provide additional flexibility by:

- Allowing an additional 24 months to spend the working capital if the QOZ Business is located in a QOZ within a federally declared disaster area.
- Allowing overlapping and sequential safe harbor applications.
- Creating a 62-month safe harbor (in the form of multiple overlapping or sequential applications of the 31-month working capital safe harbor) for start-up businesses that establish the subsequent infusions of capital formed an integral part of the QOZ Business’s initial written plan.

(Treas. Reg. §§ 1.1400Z2(d)-1(d)(3)(v), 85 FR 1866-01.)

Any gross income earned from this working capital is counted toward the satisfaction of the 50% gross income test above. The “use of intangible property” requirement for a QOZ Business is also treated as satisfied during any period in which the business is proceeding in a manner consistent with the plan and schedule described above.

QOZ PROGRAM TAX BENEFITS

There are three tax incentives to encourage investment in QOFs:

- **Temporary capital gains tax deferral.** An investor may defer income tax on gains from the sale or exchange of capital assets by reinvesting the amount of gain into a QOF within 180 days of the sale or exchange, subject to certain special rules (see 180 Day Rule). Taxes are deferred until the earlier of:
 - the date the QOF investment is disposed of or another gain inclusion event occurs (see Gain Inclusion Events); and
 - December 31, 2026.
 (I.R.C. §§ 1400Z-2(a), (b)(1).)
- **Step-up in basis/capital gains reduction.** If the investment in the QOF is held for five years, the investor receives an increase in basis equal to 10% of the deferred gain invested in the fund. If the investment is held for another two years, up to December 31, 2026, the investor receives an additional increase in basis equal to 5% of the deferred gain invested in the fund (for a total of 15%). (I.R.C. § 1400Z-2(b)(2).)
- **Tax exemption.** If the investment in the QOF is held for ten or more years, the investor may elect to increase its basis in the QOF investment to the fair market value of the interest on the date sold or exchanged. The investor is not taxed on any capital gains resulting from the appreciation of the investment in the QOF. This option is available until December 31, 2047. In addition, if a QOF partnership or S corporation (or any partnership directly or indirectly owned by such entity) sells QOZ Property after the ten-year holding period, an investor in the QOF may elect to exclude all of its allocated capital gain from gross income and receive the benefit of the fair market value basis increase. (I.R.C. § 1400Z-2(c), Treas. Reg. § 1.1400Z2(c)-1(b)(2), 85 FR 1866-01.)

To illustrate, if an investor realizes a gain of \$100,000 from the sale or exchange of a capital asset and reinvests that money into a QOF within 180 days, the tax on that \$100,000 is deferred until the earlier of:

- December 31, 2026.
- The date the investor disposes of its interest.

The investor’s initial basis in its QOF investment is zero.

If the investor holds the investment for five years, the investor receives a \$10,000 increase in basis, which is excluded from income tax when the investor recognizes the deferred gain. If the investor leaves the investment in place for an additional two years, the investor receives an additional \$5,000 increase in basis, amounting to a total of \$15,000 excluded from income tax. The investor must pay taxes on the \$85,000 balance of the deferred gain as of December 31, 2026 and its basis is increased to \$100,000 at that time.

If the investor holds the investment for a minimum of ten years, the investor has the option to avoid capital gains tax on any appreciation in the \$100,000 QOF investment in addition to the \$15,000 increase in basis. Therefore, after ten years, the investor may only pay tax on \$85,000 of gain.

For a graphic illustration of the tax benefits, see Qualified Opportunity Zone Investments Flowchart and Timeline ([W-019-2441](#)).

RULES FOR QOF INVESTMENT HOLDING PERIODS

Specific rules apply for determining an investor's holding period of a QOF investment. Most notably:

- The holding period for the QOF investment does not include the period the investor held property that was transferred to the QOF in exchange for the investment.
- If an investor disposes of its QOF interest and reinvests in another QOF, the investor's holding period for its investment in the second QOF begins on the date of its investment in the second QOF, not the first QOF.

There are exceptions for certain mergers and acquisitions of QOF investments that allow for the tacking of a holding period in the initial QOF investment. (Treas. Reg. § 1.1400Z2(b)-1(d), 85 FR 1866-01.)

TAXPAYERS ELIGIBLE FOR GAIN DEFERRAL

All taxpayers that recognize capital gain for federal income tax purposes are eligible to elect deferral, including:

- Individuals.
- C corporations.
- Regulated investment companies (RICs).
- Real estate investment trusts (REITs).
- Partnerships.
- Other pass-through entities (including certain common trust funds, qualified settlement funds, and disputed ownership funds).

(Treas. Reg. § 1.1400Z2(a)-1(b)(13), 85 FR 1866-01.)

Rules for Partnerships

Either a partnership or a partner may elect deferral of capital gains.

If a partnership elects to defer all or part of a capital gain by making an investment in a QOF, then:

- It must notify all of its partners of the deferral election.
- No part of the deferred gain is included in the distributive share of the partners.
- The gain is not included in the partners' basis.

If the partnership does not elect to defer the gain, then:

- The gain is included in the partners' distributive shares and basis.
- Each individual partner may elect its own deferral regarding the gain and must notify the partnership of its deferral election.

(Treas. Reg. §§ 1.1400Z2(a)-1(c)(2)(ii)(B)(8), (b)-1(h)(1), 85 FR 1866-01.)

Foreign Investors

A foreign investor wanting to make a capital gain deferral election must irrevocably waive any tax treaty benefits that would exempt the gain from being subject to federal income tax. (Treas. Reg. § 1.1400Z2(a)-1(b)(11)(ix), 85 FR 1866-01.)

GAIN ELIGIBLE FOR DEFERRAL

Although the statute refers to gains from the sale of property, the Treasury Regulations clarify that only capital gains are eligible for deferral (Treas. Reg. § 1.1400Z2(a)-1(b)(11)(i)(A), 85 FR 1866-01). Any type of capital gains are eligible, including gross Section 1231 gains and installment sales gains. The gain must:

- Be gain that would be recognized by no later than December 31, 2026, if the opportunity zone provisions did not apply to defer recognition of the gain deferral.
- Arise from a sale or exchange with an unrelated person. To be unrelated persons, the two parties generally must have no more than 20 percent common ownership.

(Treas. Reg. § 1.1400Z2(a)-1(b)(11), 85 FR 1866-01.)

An investor may invest more than the capital gain amount, but only the capital gain amount receives tax deferral. In this case, the QOF investment is treated as two separate interests: one that qualifies for tax benefits and one that does not. (Treas. Reg. § 1.1400Z2(a)-1(c)(2)(ii)(B)(6)(i), 85 FR 1866-01.)

An investor may also:

- Not invest the entire capital gain amount. Any capital gain not reinvested is subject to payment of tax.
- Split its capital gains for investment in multiple QOFs.

A taxpayer may make an investment in a QOF by transferring cash or other property to the QOF, whether or not the transferor would recognize gain or loss on the property transferred. (Treas. Reg. § 1.1400Z2(a)-1(c)(2)(ii)(B)(5)(i), 85 FR 1866-01.) However, any property contributed to the QOF may not qualify as QOZ Business Property, which requires that the property be acquired from an unrelated person and that the basis of the property not be determined by reference to the transferor's basis.

A partnership interest in a QOF received in exchange for services (carried interest) is not eligible for the QOZ tax benefits. (Treas. Reg. § 1.1400Z2(a)-1(c)(2)(ii)(B)(5)(ii), 85 FR 1866-01.) Services are not considered making an investment for purposes of the QOZ program. Although the tax rules provide that an investor that also receives a carried interest has a unitary basis and capital account in its partnership interest, for purposes of the QOZ program the partner will be treated as holding two separate interests in the QOF.

180 DAY RULE

To be eligible for QOZ tax benefits, an investor must invest its capital gains in a QOF within a 180-day period. The 180-day period generally begins on the day the gain would be recognized for federal income tax purposes if the taxpayer did not elect to defer recognition of the gain under Code Section 1400Z-2, with the following exceptions:

- **Pass-through entities.** A partner's 180-day period generally begins on the last day of the partnership's taxable year, which is the day on which the partner would otherwise recognize the gain if the gain was not deferred. The partner may instead choose to start the 180-day period on either:
 - the same date as the beginning of the partnership's 180-day period, if the partner knows the date of the partnership gain and that the partnership is not electing to defer the gain; or
 - the due date for the partnership's tax return (without extension) for the tax year in which the partnership realized the gain.

(Treas. Reg. § 1.1400Z2(a)-1(c)(2)(ii)(B)(8)(iii), 85 FR 1866-01.)

- **Section 1231 property.** The 180-day period to invest gross capital gain from Section 1231 property (real property used in a trade or business and held for more than one year) starts on the date of the sale or exchange. (Treas. Reg. § 1.1400Z2(a)-1(b)(7)(i), 85 FR 1866-01.)

- **RICs and REITs.** At the shareholder's election with respect to capital gain dividends, the 180-day period starts on either:
 - the last day of the shareholder's taxable year; or
 - the date of the dividend distribution.
 (Treas. Reg. § 1.1400Z2(a)-1(b)(7)(ii), 85 FR 1866-01.)
- **Installment sales.** A taxpayer may elect to start the 180-day period on either:
 - the date each installment sale payment is received, so that each payment begins a new 180-day period; or
 - the last day of the taxable year in which it would have recognized the gain under the installment method.
 (Treas. Reg. § 1.1400Z2(a)-1(b)(11)(viii), 85 FR 1866-01.)

GAIN INCLUSION EVENTS

An investor in a QOF must pay tax on its deferred gain on the earlier of:

- The date the QOF investment is sold or exchanged.
- December 21, 2026.

The Final Regulations define a non-exclusive list of inclusion events that reduce or terminate a QOF investor's equity interest, requiring recognition of deferred gain. The Final Regulations also describe certain types of transfers and exchanges that are not considered inclusion events. (Treas. Reg. § 1.1400Z2(b)-1(c), 85 FR 1866-01.)

An inclusion event that affects only a portion of the deferred gain is proportionately applied to the remaining gain exclusion and basis step-ups. (Treas. Reg. § 1.1400Z2(b)-1(g), 85 FR 1866-01.)

Each taxpayer must report annually whether the gains remain deferred. Failure to report creates a rebuttable presumption that an inclusion event has occurred during that year. (Treas. Reg. § 1.1400Z2(a)-1(d)(2), 85 FR 1866-01.)

RULES FOR MULTIPLE QOF INVESTMENTS

The Proposed Regulations address the treatment of multiple investments in a QOF by a single investor as follows:

- **First-in, first-out (FIFO) method.** This method must be used to identify the interest that was sold if a taxpayer:
 - holds investments with identical rights in a QOF that were acquired on different days; on a single day, disposes of less than all its interest; and
 - the taxpayer does not adequately identify which of the interests are disposed of.
- **Pro-rata method.** If after the application of the FIFO method, a taxpayer is treated as having disposed of less than all the investments that the taxpayer acquired on one day, and if the interests acquired on that day have different tax attributes, then a pro-rata allocation must be made to determine which interests were disposed of.

(Treas. Reg. § 1.1400Z2(a)-1(c)(1)(iii)(C)(2), 85 FR 1866-01.)

ROLLOVER OF QOF INVESTMENT

An investor may elect to defer gain from the disposition of all its QOF interest by reinvesting the gain in another QOF within 180 days from the sale, provided the rollover investment is made before December 31, 2026 (Treas. Reg. § 1.1400Z2(a)-1(b)(7)(iv)(D), Example 4, 85 FR 1866-01.)

The holding period for the original QOF investment is not added to the new QOF investment holding period for the purpose of calculating tax benefits (see Rules for QOF Investment Holding Periods).

If the new QOF investment is held for at least ten years and disposed of before 2048, any future appreciation should be eligible for tax exemption.

STATE INCOME TAX

Whether the federal income tax benefits of investing in a QOF also apply for state income tax purposes depends on whether the state:

- Conforms with the Code and as of when it does so.
- Imposes a tax on capital gains.

ANTI-ABUSE RULES

The Final Regulations permit the IRS to recast or recharacterize a transaction or series of transactions for federal tax purposes if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of the QOZ program, based on all facts and circumstances. (Treas. Reg. § 1.1400Z2(f)-1(c), 85 FR 1866-01.)

ADVANTAGES AND DISADVANTAGES OF ALTERNATE INVESTMENT STRUCTURES

DIRECT VERSUS INDIRECT INVESTMENT

There are advantages and disadvantages of a QOF investing in a QOZ through a subsidiary (by acquiring QOZ Stock or QOZ Partnership Interests in a QOZ Business), versus investing directly in QOZ Business Property.

For example, when investing in a QOZ Business only 70% of the tangible assets must consist of QOZ Business Property. On the other hand, up to 90% may be required if investing directly in QOZ Business Property. An investment in a QOZ Business can also take advantage of the working capital safe harbor and thus hold more working capital assets.

However, a QOZ Business is subject to additional restrictions including the 50% active gross income test, restrictions on conducting sin businesses, and limits on holding nonqualified financial assets (see QOZ Business). Investors and sponsors should carefully consider these factors and their business needs when structuring their investment.

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