Treasury Regulations under Section 1400Z-2 (October 2018 Proposed Regulations as modified and supplemented by April 2019 Proposed Regulations)

Page

§1.1400Z2(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:

(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 from section 1231 property*. The only gain arising from section 1231 property 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 the taxpayer's section 1231 property. The 180-day period described in paragraph (b)(4) of this section with respect to any capital gain net income from section 1231 property for a taxable year begins on the last day of the taxable year.

(iv) *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.

(v) *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 within the meaning of section 1092 and the regulations under section 1092, 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.

(vi) *No deferral for gain realized upon the acquisition of an eligible interest*. Gain is not eligible for deferral under section 1400Z-2(a)(1) if such gain is realized upon the sale or other transfer of property to a QOF in exchange for an eligible interest (see paragraph (b)(10)(i)(C) of this section) or the transfer of property to an eligible taxpayer in exchange for an eligible interest (see paragraph (b)(10)(iii) of this section).

(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 § 1.1400Z2(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.

(A) *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.

(B) *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.

(C) *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.

(D) *Example 4. Additional deferral of previously deferred gains—*

(1) *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.

(2) *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.

(i) *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.

(ii) *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.

(iii) *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.

(iv) *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.

(v) *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.

(vi) *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.

(vii) *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 × 400/800) and $350 is long-term capital gain ($700 × 400/800).

(9) *Making an investment for purposes of an election under section 1400Z-2(a) –*

(i) *Transfer of cash or other property to a QOF*. A taxpayer makes an investment for purposes of an election under section 1400Z-2(a)(1)(A) (section 1400Z-2(a)(1)(A) investment) by transferring cash or other property to a QOF in exchange for eligible interests in the QOF, regardless

of whether the transfer is one in which the transferor would recognize gain or loss on the property transferred.

(ii) *Furnishing services*. Services rendered to a QOF are not considered the making of a section 1400Z-2(a)(1)(A) investment. Thus, if a taxpayer receives an eligible interest in a QOF for services rendered to the QOF or to a person in which the QOF holds any direct or indirect equity interest, then the interest in the QOF that the taxpayer receives is not a section 1400Z-2(a)(1)(A) investment but is an investment to which section 1400Z-2(e)(1)(A)(ii) applies.

(iii) *Acquisition of eligible interest from person other than QOF*. A taxpayer may make a section 1400Z-2(a)(1)(A) investment by acquiring an eligible interest in a QOF from a person other than the QOF.

(10) *Amount invested for purposes of section 1400Z-2(a)(1)(A)*. In the case of any investments described in this paragraph (b)(10), the amount of a taxpayer's section 1400Z-2(a)(1)(A) investment cannot exceed the amount of gain to be deferred under the election. If the amount of the taxpayer's investment as determined under this paragraph (b)(10) exceeds the amount of gain to be deferred under the section 1400Z-2(a) election, the amount of the excess is treated as an investment to which section 1400Z-2(e)(1)(A)(ii) applies. See paragraph (b)(10)(ii) of this section for special rules applicable to transfers to QOF partnerships.

(i) *Transfers to a QOF—*

(A) *Cash*. If a taxpayer makes a section 1400Z-2(a)(1)(A) investment by transferring cash to a QOF, the amount of the taxpayer's section 1400Z-2(a)(1)(A) investment is that amount of cash.

(B) *Property other than cash – Nonrecognition transactions*. This paragraph (b)(10)(i)(B) applies if a taxpayer makes a section 1400Z-2(a)(1)(A) investment by transferring property other than cash to a QOF and if, but for the application of section 1400Z-2(b)(2)(B), the taxpayer's basis in the resulting investment in the QOF would be determined, in whole or in part, by reference to the taxpayer's basis in the transferred property.

(1) *Amount of section 1400Z-2(a)(1)(A) investment*. If paragraph (b)(10)(i)(B) of this section applies, the amount of the taxpayer's section 1400Z-2(a)(1)(A) investment is the lesser of the taxpayer's adjusted basis in the eligible interest received in the transaction, without regard to section 1400Z-2(b)(2)(B), or the fair market value of the

eligible interest received in the transaction, both as determined immediately after the contribution. Paragraph (b)(10)(i)(B) of this section applies separately to each item of property contributed to a QOF.

(2) *Fair market value of the eligible interest received exceeds its adjusted basis*. If paragraph (b)(10)(i)(B) of this section applies, and if the fair market value of the eligible interest received is in excess of the taxpayer's adjusted basis in the eligible interest received, without regard to section 1400Z-2(b)(2)(B), then the taxpayer's investment is an investment with mixed funds to which section 1400Z-2(e)(1) applies. Paragraph (b)(10)(i)(B)(1) of this section determines the amount of the taxpayer's investment to which section 1400Z-2(e)(1)(A)(i) applies. Section 1400Z-2(e)(1)(A)(ii) applies to the excess of the fair market value of the investment to which section 1400Z2-2(e)(1)(A)(i) applies over the taxpayer's adjusted basis therein, determined without regard to section 1400Z-2(b)(2)(B).

(3) *Transfer of built-in loss property and section 362(e)(2).* If paragraph (b)(10)(i)(B) of this section and section 362(e)(2) both apply to a transaction, the taxpayer is deemed to have made an election under section 362(e)(2)(C).

(C) *Property other than cash – Taxable transactions*. This paragraph (b)(10)(i)(C) applies if a taxpayer makes a section 1400Z-2(a)(1)(A) investment by transferring property other than cash to a QOF and if, without regard to section 1400Z-2(b)(2)(B), the taxpayer's basis in the eligible interest received would not be determined, in whole or in part, by reference to the taxpayer's basis in the transferred property. If this paragraph (b)(10)(i)(C) applies, the amount of the taxpayer's section 1400Z-2(a)(1)(A) investment is the fair market value of the transferred property, as determined immediately before the transfer. This paragraph (b)(10)(i)(C) applies separately to each item of property transferred to a QOF.

(D) *Basis in an investment with mixed funds*. If a taxpayer's investment in a QOF is an investment with mixed funds to which section 1400Z-2(e)(1) applies, the taxpayer's basis in the investment to which section 1400Z2-2(e)(1)(A)(ii) applies is equal to the taxpayer's basis in all of the QOF interests received,

determined without regard to section 1400Z-2(b)(2)(B), and reduced by the basis of the taxpayer's investment to which section 1400Z2-2(e)(1)(A)(i) applies, determined without regard to section 1400Z-2(b)(2)(B).

(ii) *Special rules for transfers to QOF partnerships*. In the case of an investment in a QOF partnership, the following rules apply:

(A) *Amounts not treated as an investment –*

(1) *Non-contributions in general*. To the extent the transfer of property to a QOF partnership is characterized other than as a contribution (for example, as a sale for purposes of section 707), the transfer is not a section 1400Z-2(a)(1)(A) investment.

(2) *Reductions in investments otherwise treated as contributions*. To the extent any transfer of cash or other property to a partnership is not disregarded under paragraph (b)(10)(ii)(A)(1) of this section (for example, it is not treated as a disguised sale of the property transferred to the partnership under section 707), the transfer to the partnership will not be treated as a section 1400Z-2(a)(1)(A) investment to the extent the partnership makes a distribution to the partner and the transfer to the partnership and the distribution would be recharacterized as a disguised sale under section 707 if (i) any cash contributed were non-cash property, and (ii) in the case of a distribution by the partnership to which §1.707-5(b) (relating to debt-financed distributions) applies, the partner's share of liabilities is zero.

(B) *Amount invested in a QOF partnership –*

(1) *Calculation of amount of qualifying and non-qualifying investments*. To the extent paragraph (b)(10)(ii)(A) of this section does not apply, the amount of the taxpayer's qualifying investment in a QOF partnership is the lesser of the taxpayer's net basis in the property contributed to the QOF partnership, or the net value of the property contributed by the taxpayer to the QOF partnership. The amount of the taxpayer's non-qualifying investment in the partnership is the excess, if any, of the net value of the contribution over the amount treated as a qualifying investment.

(2) *Net basis*. For purposes of paragraph (b)(10)(ii)(B)) of this section, net basis is the excess, if any, of –

(I) the adjusted basis of the property contributed to the partnership, over

(II) the amount of any debt to which the property is subject or that is assumed by the partnership in the transaction.

(3) *Net value*. For purposes of paragraph (b)(10)(ii)(B)) of this section, net value is the excess of –

(I) the gross fair market value of the property contributed, over

(II) the amount of the debt described in paragraph (b)(10)(ii)(B)(2)(II) of this section.

(4) *Basis of qualifying and non-qualifying investments*. The basis of a qualifying investment is the net basis of the property contributed, determined without regard to section 1400Z-2(b)(2)(B) or any share of debt under section 752(a). The basis of a non- qualifying investment (before any section 752 debt allocation) is the remaining net basis. The bases of qualifying and non-qualifying investments are increased by any debt allocated to such investments under the rules of §1.1400Z2(b)-1(c)(6)(iv)(B).

(5) *Rules applicable to mixed-funds investments*. If one portion of an investment in a QOF partnership is a qualifying investment and another portion is a non-qualifying investment, see §1.1400Z2(b)-1(c)(6)(iv) for the rules that apply.

(iii) *Acquisitions from another person*. If a taxpayer makes a section 1400Z-2(a)(1)(A) investment by acquiring an eligible interest in a QOF from a person other than the QOF, then the amount of the taxpayer's section 1400Z-2(a)(1)(A) investment is the amount of the cash, or the fair market value of the other property, as determined immediately before the exchange, that the taxpayer exchanged for the eligible interest in the QOF.

(iv) *Examples*. The following examples illustrate the rules of paragraph (b)(10) of this section. For purposes of these examples, B is an individual and Q is a QOF corporation.

(A) *Example 1. Transfer of built-in gain property with basis less than gain to be deferred*. B realizes $100 of eligible gain within the meaning of paragraph (b)(2) of this section. B transfers unencumbered property with a fair market value of $100 and an adjusted basis of $60 to Q in a transaction that is described in section 351(a). Paragraph (b)(10)(i)(B) of this section applies because B transferred property other than cash to Q and, but for the application of section 1400Z-2(b)(2)(B), B's basis in the eligible interests in Q would be determined, in whole or in part, by reference to B's basis in the transferred property. The fair market value of the eligible interest B received is $100, and, without regard to section 1400Z-2(b)(2)(B), B's basis in the eligible interest received would be $60. Thus, pursuant to paragraph (b)(10)(i)(B)(2) of this section, B's investment is an investment with mixed funds to which section 1400Z-2(e)(1) applies. Pursuant to paragraphs (b)(10)(i)(B)(1) and (2) of this section, B's section 1400Z- 2(a)(1)(A) investment is $60 (the lesser of the taxpayer's adjusted basis in the eligible interest, without regard to section 1400Z-2(b)(2)(B), of $60 and the $100 fair market value of the eligible interest received). Pursuant to section 1400Z-2(b)(2)(B)(i), B's basis in the section 1400Z-2(a)(1)(A) investment is $0. Additionally, B's other investment is $40 (the excess of the fair market value of the eligible interest received ($100) over the taxpayer's adjusted basis in the eligible interest, without regard to section 1400Z-2(b)(2)(B) ($60)). B's basis in the other investment is $0 (B's $60 basis in its investment determined without regard to section 1400Z-2(b)(2)(B), reduced by the $60 of adjusted basis allocated to the investment to which section1400Z-2(e)(1)(A)(i) applies, determined without regard to section 1400Z-2(b)(2)(B)). See paragraph (b)(10)(i)(D) of this section. Pursuant to section 362, Q's basis in the transferred property is $60.

(B) *Example 2. Transfer of built-in gain property with basis in excess of eligible gain to be deferred*. The facts are the same as Example 1 in paragraph (b)(10)(iviv)(A) of this section, except that B realizes $50 of eligible gain within the meaning of paragraph (b)(2) of this section. Pursuant to paragraph (b)(10) of this section, B's section 1400Z-2(a)(1)(A) investment cannot exceed the amount of eligible gain to be deferred (that is, the $50 of eligible gain) under the section 1400Z-2(a) election. Therefore, pursuant to paragraph (b)(10)(i)(B)(1) of this section, B's section 1400Z- 2(a)(1)(A) investment is $50 (the lesser of the taxpayer's adjusted basis in the eligible interest received, without regard to section 1400Z-2(b)(2)(B), of $60 and the $100 fair market value of the eligible

interest, limited by the amount of eligible gain to be deferred under the section 1400Z-2(a) election). B's section 1400Z-2(a)(1)(A) investment has an adjusted basis of $0, as provided in section 1400Z-2(b)(2)(B)(i). Additionally, B's other investment is $50 (the excess of the fair market value of the eligible interest received ($100) over the amount ($50) of B's section 1400Z-2(a)(1)(A) investment). B's basis in the other investment is $10 (B's $60 basis in its investment determined without regard to section 1400Z-2(b)(2)(B),), reduced by the $50 of adjusted basis allocated to B's section 1400Z-2(a)(1)(A) investment, determined without regard to section 1400Z- 2(b)(2)(B)).

(C) *Example 3. Transfers to QOF partnerships*.

(i) *Facts*. A and B each realized $100 of eligible gain and each transfers $100 of cash to a QOF partnership. At a later date, the partnership borrows $120 from an unrelated lender and distributes the cash of $120 equally to A and B.

(ii) *Analysis*. If the contributions had been of property other than cash, the contributions and distributions would have been tested under the disguised sale rules of §1.707-5(b) by, among other things, determining the timing of the distribution and amount of the debt allocated to each partner. Under paragraph (b)(10)(ii)(A)(2) of this section, the cash of $200 ($100 from A and $100 from B) is treated as property that could be sold in a disguised sale transaction and each partner's share of the debt is zero for purposes of determining the amount of the investment. To the extent there would have been a disguised sale applying the rule of paragraph (b)(10)(ii)(A)(2)) of this section, the amount of the investment would be reduced by the amount of the contribution so recharacterized.

(iii) *Property contributed has built-in gain*. The facts are the same as in paragraph (i) of this Example 3, except that the property contributed by A had a value of $100 and basis of $20 and the partnership did not borrow money or make a distribution. Under paragraph (b)(10)(ii)(B)(1) of this section, the amount of A's qualifying investment is $20 (the lesser of the net value or the net basis of the property that A contributed), and the excess of the $100 contribution over the $20 qualifying investment constitutes a non-qualifying investment. Under paragraph (b)(10)(ii)(B)(2) of

this section, A's basis in the qualifying investment (determined without regard to section 1400Z-2(b)(2)(B) or section 752(a)) is $20. After the application of section 1400Z-2(b)(2)(B) but before the application of section 752(a), A's basis in the qualifying investment is zero. A's basis in the non-qualifying investment is zero without regard to the application of section 752(a).

(iv) *Property contributed has built-in gain and is subject to debt*. The facts are the same as in paragraph (iii) of this Example 3, except that the property contributed by A has a gross value of $130 and is subject to debt of $30. Under paragraph (b)(10)(ii)(B)(1) of this section, the amount of A's qualifying investment is zero, the lesser of the property's $100 net value ($130 minus $30) or zero net basis ($20 minus $30, but limited to zero). The entire contribution constitutes a non-qualifying investment.

(v) *Property contributed has built-in loss and is subject to debt*. The facts are the same as in paragraph (iv) of this Example 3, except that the property contributed by A has a basis of $150. Under paragraph (b)(10)(ii)(B)(1) of this section, the amount of A's qualifying investment is $100, the lesser of the property's $100 net value ($130 minus $30) or $120 net basis ($150 minus $30). The non-qualifying investment is $0, the excess of the qualifying investment ($100) over the net value ($100). A's basis in the qualifying investment (determined without regard to section 1400Z-2(b)(2)(B) and section 752(a)) is $120, the net basis. After the application of section 1400Z-2(b)(2)(B), A's basis in the qualifying investment is zero, plus its share of partnership debt under section 752(a).

(c) *Special rules for pass-through entities—*

(1) *Eligible gains that a partnership elects to defer*. A partnership is an eligible taxpayer under paragraph (b)(1) of this section and may elect to defer recognition of some or all of its eligible gains under section 1400Z–2(a)(2).

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

(A) The partnership defers recognition of the gain under the rules of section 1400Z–2 (that is, the partnership does not recognize gain at

the time it otherwise would have in the absence of the election to defer gain recognition);

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

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

(2) *Eligible gains that the partnership does not defer—*

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

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

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

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

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

(iii) *180-day period for a partner electing deferral—*

(A) *General rule*. If a partner's distributive share includes a gain that is described in paragraph (c)(2)(ii)(C) of this section (gains that are

eligible gains with respect to the partner), the 180-day period with respect to the partner's eligible gains in the partner's distributive share generally begins on the last day of the partnership taxable year in which the partner's allocable share of the partnership's eligible gain is taken into account under section 706(a).

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

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

(1) *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).

(2) [Reserved]

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

(d) *Elections*. The Commissioner may prescribe in guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§ 601.601(d)(2) and 601.602 of this chapter), both the time, form, and manner in which an eligible taxpayer may elect to defer eligible gains under section 1400Z–2(a) and also the time, form, and manner in which a

partner may elect to apply the elective 180-day period provided in paragraph (c)(2)(iii)(B) of this section.

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

§1.1400Z2(b)-1 Inclusion of gains that have been deferred under section 1400Z-2(a).

(a) *Scope and definitions* –

(1) *Scope*. This section provides rules under section 1400Z-2(b) of the Internal Revenue Code regarding the inclusion in income of gain deferred under section 1400Z-2(a)(1)(A). This section applies to a QOF owner only until all of such owner's gain deferred pursuant to section 1400Z-2(a)(1)(A) has been included in income, subject to the limitations described in paragraph (e)(5) of this section. Paragraph (a)(2) of this section provides additional definitions used in this section and §§1.1400Z2(c)-1 through 1.1400Z2(g)-1. Paragraph (b) of this section provides general rules under section 1400Z-2(b)(1) regarding the timing of the inclusion in income of the deferred gain. Paragraph (c) of this section provides rules regarding the determination of the extent to which an event triggers the inclusion in income of all, or a portion, of the deferred gain. Paragraph (d) of this section provides rules regarding holding periods for qualifying investments. Paragraph (e) of this section provides rules regarding the amount of deferred gain included in gross income under section 1400Z-2(a)(1)(B) and (b), including special rules for QOF partnerships and QOF S corporations. Paragraph (f) of this section provides examples illustrating the rules of paragraphs (c), (d), and (e) of this section. Paragraph (g) of this section provides rules regarding basis adjustments under section 1400Z-2(b)(2)(B). Paragraph (h) of this section provides special reporting rules applicable to partners, partnerships, and direct or indirect owners of QOF partnerships. Paragraph (i) of this section provides dates of applicability.

(2) *Definitions*. The following definitions apply for purposes of this section and §§1.1400Z2(c)-1 and 1.1400Z2(g)-1:

(i) *Boot*. The term boot means money or other property that section 354 or 355 does not permit to be received without the recognition of gain.

(ii) *Consolidated group*. The term consolidated group has the meaning provided in §1.1502-1(h).

(iii) *Deferral election*. The term deferral election means an election under section 1400Z-2(a) made before January 1, 2027, with respect to an eligible interest.

(iv) *Inclusion event*. The term inclusion event means an event described in paragraph (c) of this section.

(v) *Mixed-funds investment*. The term mixed-funds investment means an investment a portion of which is a qualifying investment and a portion of which is a non-qualifying investment.

(vi) *Non-qualifying investment*. The term non-qualifying investment means an investment in a QOF described in section 1400Z-2(e)(1)(A)(ii).

(vii) *Property* –

(A) *In general*. The term property means money, securities, or any other property.

(B) *Inclusion events regarding QOF corporation distributions*. For purposes of paragraph (c) of this section, in the context in which a QOF corporation makes a distribution, the term property does not include stock (or rights to acquire stock) in the QOF corporation that makes the distribution.

(viii) *QOF*. The term QOF means a qualified opportunity fund, as defined in section 1400Z-2(d)(1) and associated regulations.

(ix) *QOF C corporation*. The term QOF C corporation means a QOF corporation other than a QOF S corporation.

(x) *QOF corporation*. The term QOF corporation means a QOF that is classified as a corporation for Federal income tax purposes.

(xi) *QOF owner*. The term QOF owner means a QOF shareholder or a QOF partner.

(xii) *QOF partner*. The term QOF partner means a person that directly owns a qualifying investment in a QOF partnership or a person that owns such a qualifying investment through equity interests solely in one or more partnerships.

(xiii) *QOF partnership*. The term QOF partnership means a QOF that is classified as a partnership for Federal income tax purposes.

(xiv) *QOF S corporation*. The term QOF S corporation means a QOF corporation that has elected under section 1362 to be an S corporation.

(xv) *QOF shareholder*. The term QOF shareholder means a person that directly owns a qualifying investment in a QOF corporation.

(xvi) *Qualifying investment*. The term qualifying investment means an eligible interest (as defined in §1.1400Z2(a)-1(b)(3)), or portion thereof, in a QOF

to the extent that a deferral election applies with respect to such eligible interest or portion thereof.

(xvii) *Qualifying QOF partnership interest*. The term qualifying QOF partnership interest means a direct or indirect interest in a QOF partnership that is a qualifying investment.

(xviii) *Qualifying QOF stock*. The term qualifying QOF stock means stock in a QOF corporation that is a qualifying investment.

(xix) *Qualifying section 355 transaction*. The term qualifying section 355 transaction means a distribution described in paragraph (c)(11)(i)(B) of this section.

(xx) *Qualifying section 381 transaction*. The term qualifying section 381 transaction means a transaction described in section 381(a)(2), except the following transactions:

(A) An acquisition of assets of a QOF by a QOF shareholder that holds a qualifying investment in the QOF;

(B) An acquisition of assets of a QOF by a tax-exempt entity as defined in §1.337(d)-4(c)(2);

(C) An acquisition of assets of a QOF by an entity operating on a cooperative basis within the meaning of section 1381;

(D) An acquisition by a QOF of assets of a QOF shareholder that holds a qualifying investment in the QOF;

(E) A reorganization of a QOF in a transaction that qualifies under section 368(a)(1)(G);

(F) A transaction, immediately after which one QOF owns an investment in another QOF; and

(G) A triangular reorganization of a QOF within the meaning of §1.358-6(b)(2)(i), (ii), or (iii).

(xxi) *Remaining deferred gain*. The term remaining deferred gain means the full amount of gain that was deferred under section 1400Z-2(a)(1)(A), reduced by the amount of gain previously included under paragraph (b) of this section.

(b) *General inclusion rule*. The gain to which a deferral election applies is included in gross income, to the extent provided in paragraph (e) of this section, in the taxable year that includes the earlier of:

(1) The date of an inclusion event, or

(2) December 31, 2026.

(c) *Inclusion events* –

(1) *General rule*. Except as otherwise provided in this paragraph (c), the following events are inclusion events (which result in the inclusion of gain under paragraph (b) of this section) if, and to the extent that--

(i) *Reduction of interest in QOF*. A taxpayer's transfer of a qualifying investment reduces the taxpayer's equity interest in the qualifying investment;

(ii) *Distribution of property regardless of whether the taxpayer's direct interest in the QOF is reduced*. A taxpayer receives property in a transaction that is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the taxpayer's ownership of the QOF; or

(iii) *Claim of worthlessness*. A taxpayer claims a loss for worthless stock under section 165(g) or otherwise claims a worthlessness deduction with respect to its qualifying investment.

(2) *Termination or liquidation of QOF or QOF owner* –

(i) *Termination or liquidation of QOF*. Except as otherwise provided in this paragraph (c), a taxpayer has an inclusion event with respect to all of its qualifying investment if the QOF ceases to exist for Federal income tax purposes.

(ii) *Liquidation of QOF owner* –

(A) *Portion of distribution treated as sale*. A distribution of a qualifying investment in a complete liquidation of a QOF owner is an inclusion event to the extent that section 336(a) treats the distribution as if the qualifying investment were sold to the distributee at its fair market value, without regard to section 336(d).

(B) *Distribution to 80-percent distributee*. A distribution of a qualifying investment in a complete liquidation of a QOF owner is not an inclusion event to the extent section 337(a) applies to the distribution.

(3) *Transfer of an investment in a QOF by gift*. A taxpayer's transfer of a qualifying investment by gift, whether outright or in trust, is an inclusion event, regardless of whether that transfer is a completed gift for Federal gift tax purposes, and regardless of the taxable or tax-exempt status of the donee of the gift.

(4) *Transfer of an investment in a QOF by reason of the taxpayer's death* –

(i) *In general*. Except as provided in paragraph (c)(4)(ii) of this section, a transfer of a qualifying investment by reason of the taxpayer's death is not an inclusion event. Transfers by reason of death include, for example:

(A) A transfer by reason of death to the deceased owner's estate;

(B) A distribution of a qualifying investment by the deceased owner's estate;

(C) A distribution of a qualifying investment by the deceased owner's trust that is made by reason of the deceased owner's death;

(D) The passing of a jointly owned qualifying investment to the surviving co-owner by operation of law; and

(E) Any other transfer of a qualifying investment at death by operation of law.

(ii) *Exceptions*. The following transfers are not included as a transfer by reason of the taxpayer's death, and thus are inclusion events, and the amount recognized is includible in the gross income of the transferor as provided in section 691:

(A) A sale, exchange, or other disposition by the deceased taxpayer's estate or trust, other than a distribution described in paragraph (c)(4)(i) of this section;

(B) Any disposition by the legatee, heir, or beneficiary who received the qualifying investment by reason of the taxpayer's death; and

(C) Any disposition by the surviving joint owner or other recipient who received the qualifying investment by operation of law on the taxpayer's death.

(5) *Grantor trusts* –

(i) *Contributions to grantor trusts*. If the owner of a qualifying investment contributes it to a trust and, under the grantor trust rules, the owner of the investment is the deemed owner of the trust, the contribution is not an inclusion event.

(ii) *Changes in grantor trust status*. In general, a change in the status of a grantor trust, whether the termination of grantor trust status or the creation of grantor trust status, is an inclusion event. Notwithstanding the previous sentence, the termination of grantor trust status as the result of the death of the owner of a qualifying investment is not an inclusion event, but the provisions of paragraph (c)(4) of this section apply to distributions or dispositions by the trust.

(6) *Special rules for partners and partnerships* –

(i) *Scope*. Except as otherwise provided in this paragraph (c)(6), in the case of a partnership that is a QOF or, directly or indirectly solely through one or more partnerships, owns an interest in a QOF, the inclusion rules of this paragraph (c) apply to transactions involving any direct or indirect partner of the QOF to the extent of such partner's share of any eligible gain of the QOF.

(ii) *Transactions that are not inclusion events* –

(A) *In general*. Notwithstanding paragraph (c)(1), (2), and, (c)(6)(iii) of this section, and except as otherwise provided in paragraph (c)(6)) of this section, no transaction described in paragraph (c)(6)(ii) of this section is an inclusion event.

(B) *Section 721 contributions*. Subject to paragraph (c)(6)(v) of this section, a contribution by a QOF owner, including any contribution by a partner of a partnership that, solely through one or more upper-tier partnerships, owns an interest in a QOF (contributing partner), of its direct or indirect partnership interest in a qualifying investment to a partnership (transferee partnership) in a transaction governed all or in part by section 721(a) is not an inclusion event, provided the interest transfer does not cause a partnership termination of a QOF partnership, or the direct or indirect owner of a QOF, under section 708(b)(1). See paragraph (c)(6)(ii)(C) of this section for transactions governed by section 708(b)(2)(A). Notwithstanding the rules in this paragraph (c)(6)(ii)(B), the inclusion rules in paragraph (c) of this section apply to any part of the transaction to which section 721(a) does not apply. The

transferee partnership becomes subject to section 1400Z-2 and the regulations thereunder with respect to the eligible gain associated with the contributed qualifying investment. The transferee partnership must allocate and report the gain that is associated with the contributed qualifying investment to the contributing partner to the same extent that the gain would have been allocated and reported to the contributing partner in the absence of the contribution.

(C) *Section 708(b)(2)(A) mergers or consolidations*. Subject to paragraph (c)(6)(v) of this section, a merger or consolidation of a partnership holding a qualifying investment, or of a partnership that holds an interest in such partnership solely through one or more partnerships, with another partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event. The resulting partnership or new partnership, as determined under §1.708-1(c)(1), becomes subject to section 1400Z-2, and regulations thereunder, to the same extent that the original partnership was so subject prior to the transaction, and must allocate and report any eligible gain to the same extent and to the same partners that the original partnership allocated and reported such items prior to the transaction. Notwithstanding the rules in this paragraph (c)(6)(ii)(C), the general inclusion rules of paragraph (c) of this section apply to the portion of the transaction that is otherwise treated as a sale or exchange under paragraph (c) of this section.

(iii) *Partnership distributions.* Notwithstanding paragraph (c)(6)(i) of this section, and subject to paragraph (c)(6)(v), and except as provided in paragraph (c)(6)(ii)(C) of this section, an actual or deemed distribution of property (including cash) by a QOF partnership to a partner with respect to its qualifying investment is an inclusion event only to the extent that the distributed property has a fair market value in excess of the partner's basis in its qualifying investment. Similar rules apply to distributions involving tiered partnerships. See paragraph (c)(6)(iv) of this section for special rules relating to mixed-funds investments.

(iv) *Special rules for mixed-funds investments* –

(A) *General rule*. The rules of paragraph (c)(6)(iv) of this section apply solely for purposes of section 1400Z-2. A partner that holds a mixed-funds investment in a QOF partnership (a mixed-funds partner) shall be treated as holding two separate interests in the QOF partnership, one a qualifying investment and the other a non-

qualifying investment (the separate interests). The basis of each separate interest is determined under the rules described in paragraphs (c)(6)(iv)(B) and (g) of this section as if each interest were held by different taxpayers.

(B) *Allocations and distributions*. All section 704(b) allocations of income, gain, loss, and deduction, all section 752 allocations of debt, and all distributions made to a mixed-funds partner shall be treated as made to the separate interests based on the allocation percentages of such interests as defined in paragraph (c)(6)(iv)(D) of this section. For purposes of this paragraph (c)(6)(iv)(B), in allocating income, gain, loss, or deduction between these separate interests, section 704(c) principles shall apply to account for any value-basis disparities attributable to the qualifying investment or non-qualifying investment. Any distribution (whether actual or deemed) to the holder of a qualifying investment is subject to the rules of paragraphs (c)(6)(iii) and (v) of this section, without regard to the presence or absence of gain under other provisions of subchapter K of chapter 1 of subtitle A of the Code.

(C) *Subsequent contributions*. In the event of an increase in a partner's qualifying or non-qualifying investment (for example, as in the case of an additional contribution for a qualifying investment or for an interest that is a non-qualifying investment or a change in allocations for services rendered), the partner's interest in the separate interests shall be valued immediately prior to such event and the allocation percentages shall be adjusted to reflect the relative values of these separate interests and the additional contribution, if any.

(D) *Allocation percentages*. The allocation percentages of the separate interests shall be determined based on the relative capital contributions attributable to the qualifying investment and the non-qualifying investment. In the event a partner receives a profits interest in the partnership for services rendered to or for the benefit of the partnership, the allocation percentages with respect to such partner shall be calculated based on (i) with respect to the profits interest received, the highest share of residual profits the mixed-funds partner would receive with respect to that interest, and (ii) with respect to the remaining interest, the percentage interests for the capital interests described in the immediately preceding sentence.

(v) *Remaining deferred gain reduction rule*. An inclusion event occurs when and to the extent that a transaction has the effect of reducing –

(A) the amount of remaining deferred gain of one or more direct or indirect partners, or

(B) the amount of gain that would be recognized by such partner or partners under paragraph (e)(4)(ii) of this section to the extent that such amount would reduce such gain to an amount that is less than the remaining deferred gain.

(7) *Special rule for S corporations* –

(i) *In general*. Except as provided in paragraph (c)(7)(ii), (iii), and (iv) of this section, none of the following is an inclusion event:

(A) An election, revocation, or termination of a corporation's status as an S corporation under section 1362;

(B) A conversion of a qualified subchapter S trust (as defined in section 1361(d)(3)) to an electing small business trust (as defined in section 1361(e)(1));

(C) A conversion of an electing small business trust to a qualified subchapter S trust;

(D) A valid modification of a trust agreement of an S-corporation shareholder whether by an amendment, a decanting, a judicial reformation, or a material modification;

(E) A 25 percent or less aggregate change in ownership pursuant to paragraph (c)(7)(iii) of this section in the equity investment in an S corporation that directly holds a qualifying investment; and

(F) A disposition of assets by a QOF S corporation.

(ii) *Distributions by QOF S corporation* –

(A) *General rule*. An actual or constructive distribution of property by a QOF S corporation to a shareholder with respect to its qualifying investment is an inclusion event to the extent that the distribution is treated as gain from the sale or exchange of property under section 1368(b)(2) and (c).

(B) *Spill-over rule*. For purposes of applying paragraph (c)(7)(ii) of this section to the adjusted basis of a qualifying investment, or

non-qualifying investment, as appropriate, in a QOF S corporation, the second sentence of §1.1367-1(c)(3) applies –

(1) With regard to multiple qualifying investments, solely to the respective bases of such qualifying investments, and does not take into account the basis of any non-qualifying investment; and

(2) With regard to multiple non-qualifying investments, solely to the respective bases of such non-qualifying investments, and does not take into account the basis of any qualifying investment.

(iii) *Aggregate change in ownership of an S corporation that is a QOF owner–*

(A) *General rule*. Solely for purposes of section 1400Z-2, an inclusion event occurs when there is an aggregate change in ownership, within the meaning of paragraph (c)(7)(iii)(B) of this section, of an S corporation that directly holds a qualifying investment in a QOF. The S corporation is treated as having disposed of its entire qualifying investment in the QOF, and neither section 1400Z-2(b)(2)(B)(iii) or (iv) nor section 1400Z-2(c) applies to the S corporation's qualifying investment after that date. The disposition under this paragraph (c)(7)(iii)(A) is treated as occurring on the date the requirements of paragraph (c)(7)(iii)(B) of this section are satisfied.

(B) *Aggregate ownership change threshold*. For purposes of paragraph (c)(7)(iii)(A) of this section, there is an aggregate change in ownership of an S corporation if, immediately after any change in ownership of the S corporation, the percentage of the stock of the S corporation owned directly by the shareholders who owned the S corporation at the time of its deferral election has decreased by more than 25 percent. The ownership percentage of each shareholder referred to in this paragraph (c)(7)(iii)(B) is measured separately from the ownership percentage of all other shareholders. Any decrease in ownership is determined with regard to the percentage held by the relevant shareholder at the time of the election under section 1400Z-2(a), and all decreases are then aggregated. Decreases in ownership may result from, for example, the sale of shares, the redemption of shares, the issuance of new shares, or the occurrence of section 381(a) transactions. The aggregate change in ownership is measured separately for each qualifying investment of the S corporation.

(iv) *Conversion from S corporation to partnership or disregarded entity* –

(A) *General rule*. Notwithstanding paragraph (c)(7)(i) of this section, and except as provided in paragraph (c)(7)(iv)(B) of this section, a conversion of an S corporation to a partnership or an entity disregarded as separate from its owner under §301.7701-3(b)(1)(ii) of this chapter is an inclusion event.

(B) *Exception for qualifying section 381 transaction*. A conversion described in paragraph (c)(7)(iv)(A) of this section is not an inclusion event if the conversion comprises a step in a series of related transactions that together qualify as a qualifying section 381 transaction.

(v) *Treatment of separate blocks of stock in mixed-funds investments*. With regard to a mixed-funds investment in a QOF S corporation, if different blocks of stock are created for otherwise qualifying investments to track basis in such qualifying investments, the separate blocks are not treated as different classes of stock for purposes of S corporation eligibility under section 1361(b)(1).

(vi) *Applicability*. Paragraph (c)(7)) of this section applies regardless of whether the S corporation is a QOF or a QOF shareholder.

(8) *Distributions by a QOF C corporation*. A distribution of property by a QOF C corporation with respect to a qualifying investment is not an inclusion event except to the extent section 301(c)(3) applies to the distribution. For purposes of this paragraph (c)(8), a distribution of property also includes a distribution of stock by a QOF C corporation that is treated as a distribution of property to which section 301 applies pursuant to section 305(b).

(9) *Dividend-equivalent redemptions* –

(i) *General rule*. Except as provided in paragraph (c)(9)(ii) or (iii) of this section, a transaction described in section 302(d) is an inclusion event with respect to the full amount of the distribution.

(ii) *Redemption of stock of wholly owned QOF*. If all stock in a QOF is held directly by a single shareholder, or directly by members of the same consolidated group, and if shares are redeemed in a transaction to which section 302(d) applies, see paragraph (c)(8) of this section (applicable to distributions by QOF corporations).

(iii) *S corporations*. S corporation section 302(d) transactions are an inclusion event to the extent the distribution exceeds basis in the QOF as adjusted under paragraph (c)(7)(ii) of this section.

(10) *Qualifying section 381 transactions –*

(i) *Assets of a QOF are acquired –*

(A) *In general*. Except to the extent provided in paragraph (c)(10)(i)(C) of this section, if the assets of a QOF corporation are acquired in a qualifying section 381 transaction, and if the acquiring corporation is a QOF immediately after the acquisition, then the transaction is not an inclusion event.

(B) *Determination of acquiring corporation's status as a QOF*. For purposes of paragraph (c)(10)(i)(A) of this section, the acquiring corporation is treated as a QOF immediately after the qualifying section 381 transaction if the acquiring corporation satisfies the certification requirements in §1.1400Z2(d)-1 immediately after the transaction and holds at least 90 percent of its assets in qualified opportunity zone property on the first testing date after the transaction (see section 1400Z-2(d)(1) and §1.1400Z2(d)-1).

(C) *Receipt of boot by QOF shareholder in qualifying section 381 transaction –*

(1) *General rule*. Except as provided in paragraph (c)(10)(i)(C)(2) of this section, if assets of a QOF corporation are acquired in a qualifying section 381 transaction and a taxpayer that is a QOF shareholder receives boot with respect to its qualifying investment, the taxpayer has an inclusion event. If the taxpayer realizes a gain on the transaction, the amount that gives rise to the inclusion event is the amount of gain under section 356 that is not treated as a dividend under section 356(a)(2). If the taxpayer realizes a loss on the transaction, the amount that gives rise to the inclusion event is an amount equal to the fair market value of the boot received.

(2) *Receipt of boot from wholly owned QOF*. If all stock in both a QOF and the corporation that acquires the QOF's assets in a qualifying section 381 transaction are held directly by a single shareholder, or directly by members of the same consolidated group, and if the shareholder receives (or group members receive) boot with respect to

the qualifying investment in the qualifying section 381 transaction, paragraph (c)(8) of this section (applicable to distributions by QOF corporations) applies to the boot as if it were distributed from the QOF to the shareholder(s) in a separate transaction to which section 301 applied.

(ii) *Assets of a QOF shareholder are acquired* –

(A) *In general*. Except to the extent provided in paragraph (c)(10)(ii)(B) of this section, a qualifying section 381 transaction in which the assets of a QOF shareholder are acquired is not an inclusion event with respect to the qualifying investment. However, if the qualifying section 381 transaction causes a QOF shareholder that is an S corporation to have an aggregate change in ownership within the meaning of paragraph (c)(7)(iii)(B) of this section, see paragraph (c)(7)(iii)(A) of this section.

(B) *Qualifying section 381 transaction in which QOF shareholder's qualifying investment is not completely acquired*. If the assets of a QOF shareholder are acquired in a qualifying section 381 transaction in which the acquiring corporation does not acquire all of the QOF shareholder's qualifying investment, there is an inclusion event to the extent that the QOF shareholder's qualifying investment is not transferred to the acquiring corporation.

(11) *Section 355 transactions* –

(i) *Distribution by a QOF* –

(A) *In general*. Except as provided in paragraph (c)(11)(i)(B) of this section, if a QOF corporation distributes stock or securities of a controlled corporation to a taxpayer in a transaction to which section 355, or so much of section 356 as relates to section 355, applies, the taxpayer has an inclusion event with respect to its qualifying investment. The amount that gives rise to such inclusion event is equal to the fair market value of the shares of the controlled corporation and the boot received by the taxpayer in the distribution with respect to its qualifying investment.

(B) *Controlled corporation becomes a QOF* –

(1) *In general*. Except as provided in paragraph (c)(11)(i)(B)(3) of this section, if a QOF corporation distributes stock or securities of a controlled corporation in a transaction to which section 355, or so much of section

356 as relates to section 355, applies, and if both the distributing corporation and the controlled corporation are QOFs immediately after the final distribution (qualifying section 355 transaction), then the distribution is not an inclusion event with respect to the taxpayer's qualifying investment in the distributing QOF corporation or the controlled QOF corporation. This paragraph (c)(11)(i)(B) does not apply unless the distributing corporation distributes all of the stock and securities in the controlled corporation held by it immediately before the distribution within a 30-day period. For purposes of this paragraph (c)(11)(i)(B), the term final distribution means the last distribution that satisfies the preceding sentence.

(2) *Determination of distributing corporation's and controlled corporation's status as QOFs*. For purposes of paragraph (c)(11)(i)(B)(1) of this section, each of the distributing corporation and the controlled corporation is treated as a QOF immediately after the final distribution if the corporation satisfies the certification requirements in §1.1400Z2(d)-1 immediately after the final distribution and holds at least 90 percent of its assets in qualified opportunity zone property on the first testing date after the final distribution (see section 1400Z-2(d)(1) and §1.1400Z2(d)-1)).

(3) *Receipt of boot*. If a taxpayer receives boot in a qualifying section 355 transaction with respect to its qualifying investment, and if section 356(a) applies to the transaction, the taxpayer has an inclusion event, and the amount that gives rise to the inclusion event is the amount of gain under section 356 that is not treated as a dividend under section 356(a)(2). If a taxpayer receives boot in a qualifying section 355 transaction with respect to its qualifying investment, and if section 356(b) applies to the transaction, see paragraph (c)(8) of this section (applicable to distributions by QOF corporations).

(4) *Treatment of controlled corporation stock as qualified opportunity zone stock*. If stock or securities of a controlled corporation are distributed in a qualifying section 355 transaction, and if the distributing corporation retains a portion of the controlled corporation stock after the initial distribution, the retained stock will not cease to qualify as

qualified opportunity zone stock in the hands of the distributing corporation solely as a result of the qualifying section 355 transaction. This paragraph (c)(11)(i)(B)(4) does not apply unless the distributing corporation distributes all of the stock and securities in the controlled corporation held by it immediately before the distribution within a 30-day period.

(ii) *Distribution by a QOF shareholder*. If a QOF shareholder distributes stock or securities of a controlled QOF corporation in a transaction to which section 355 applies, then for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section, the taxpayer has an inclusion event to the extent the distribution reduces the taxpayer's direct tax ownership of its qualifying QOF stock. For distributions by a QOF shareholder that is an S corporation, see also paragraph (c)(7)(iii) of this section.

(12) *Recapitalizations and section 1036 transactions –*

(i) *No reduction in proportionate interest in qualifying QOF stock –*

(A) *In general*. Except as otherwise provided in paragraph (c)(8) (relating to distributions subject to section 305(b)) or paragraph (c)(12)(i)(B) of this section, if a QOF corporation engages in a transaction that qualifies as a reorganization described in section 368(a)(1)(E), or if a QOF shareholder engages in a transaction that is described in section 1036, and if the transaction does not have the result of decreasing the taxpayer's proportionate interest in the QOF corporation, the transaction is not an inclusion event.

(B) *Receipt of property or boot by QOF shareholder*. If the taxpayer receives property or boot in a transaction described in paragraph (c)(12)(i)(A) of this section and section 368(a)(1)(E), then the property or boot is treated as property or boot to which section 301 or section 356 applies, as determined under general tax principles. If the taxpayer receives property that is not permitted to be received without the recognition of gain in a transaction described in paragraph (c)(12)(i)(A) of this section and section 1036, then, for purposes of this section, the property is treated in a similar manner as boot in a transaction described in section 368(a)(1)(E). For the treatment of property to which section 301 applies, see paragraph (c)(8) of this section. For the treatment of boot to which section 356 applies (including in situations in which the QOF is wholly and directly owned by a single shareholder or by members

of the same consolidated group), see paragraph (c)(10) of this section.

(ii) *Reduction in proportionate interest in the QOF corporation*. If a QOF engages in a transaction that qualifies as a reorganization described in section 368(a)(1)(E), or if a QOF shareholder engages in a transaction that is described in section 1036, and if the transaction has the result of decreasing the taxpayer's proportionate qualifying interest in the QOF corporation, then the taxpayer has an inclusion event in an amount equal to the amount of the reduction in the fair market value of the taxpayer's qualifying QOF stock.

(13) *Section 304 transactions*. A transfer of a qualifying investment in a transaction described in section 304(a) is an inclusion event with respect to the full amount of the consideration.

(14) *Deduction for worthlessness*. If a taxpayer claims a loss for worthless stock under section 165(g) or otherwise claims a worthlessness deduction with respect to all or a portion of its qualifying investment, then for purposes of section 1400Z-2 and the regulations thereunder, the taxpayer is treated as having disposed of that portion of its qualifying investment on the date it became worthless. Thus, the taxpayer has an inclusion event with respect to that portion of its qualifying investment, and neither section 1400Z-2(b)(2)(B)(iii) or (iv) nor section 1400Z-2(c) applies to that portion of the taxpayer's qualifying investment after the date it became worthless.

(15) *Other inclusion and non-inclusion events*. Notwithstanding any other provision of this paragraph (c), the Commissioner may determine by published guidance that a type of transaction is or is not an inclusion event.

(d) *Holding periods* –

(1) *Holding period for QOF investment* –

(i) *General rule*. Solely for purposes of sections 1400Z-2(b)(2)(B) and 1400Z-2(c), and except as otherwise provided in this paragraph (d)(1), the length of time a qualifying investment has been held is determined without regard to the period for which the taxpayer had held property exchanged for such investment.

(ii) *Holding period for QOF investment received in a qualifying section 381 transaction, a reorganization described in section 368(a)(1)(E), or a section 1036 exchange*. For purposes of section 1400Z-2(b)(2)(B) and 1400Z-2(c), the holding period for QOF stock received by a taxpayer in a qualifying section 381 transaction in which the target corporation was a

QOF immediately before the acquisition and the acquiring corporation is a QOF immediately after the acquisition, in a reorganization described in section 368(a)(1)(E), or in a section 1036 exchange, is determined by applying the principles of section 1223(1).

(iii) *Holding period for controlled corporation stock*. For purposes of section 1400Z-2(b)(2)(B) and 1400Z-2(c), the holding period of a qualifying investment in a controlled corporation received by a taxpayer on its qualifying investment in the distributing corporation in a qualifying section 355 transaction is determined by applying the principles of section 1223(1).

(iv) *Tacking with donor or deceased owner*. For purposes of section 1400Z-2(b)(2)(B) and 1400Z-2(c), the holding period of a qualifying investment held by a taxpayer who received that qualifying investment as a gift that was not an inclusion event, or by reason of the prior owner's death, includes the time during which that qualifying investment was held by the donor or the deceased owner, respectively.

(2) *Determination of original use of QOF assets –*

(i) *Assets acquired in a section 381 transaction*. For purposes of section 1400Z-2(d), including for purposes of determining whether the original use of qualified opportunity zone business property commences with the acquiring corporation, any qualified opportunity zone property transferred by the transferor QOF to the acquiring corporation in connection with a qualifying section 381 transaction does not lose its status as qualified opportunity zone property solely as a result of its transfer to the acquiring corporation.

(ii) *Assets contributed to a controlled corporation*. For purposes of section 1400Z-2(d), including for purposes of determining whether the original use of qualified opportunity zone business property commences with the controlled corporation, any qualified opportunity zone property contributed by the distributing corporation to the controlled corporation in connection with a qualifying section 355 transaction does not lose its status as qualified opportunity zone property solely as a result of its contribution to the controlled corporation.

(3) *Application to partnerships*. The principles of paragraphs (d)(1) and (2) of this section apply to qualifying QOF partnership interests with regard to non-inclusion transactions described in paragraph (c)(6)(ii) of this section.

(e) *Amount includible*. Except as provided in §1.1400Z2(a)-1(b)(4), the amount of gain included in gross income under section 1400Z-2(a)(1)(B) on a date described in paragraph (b) of this section is determined under this paragraph (e).

(1) *In general*. Except as provided in paragraphs (e)(2) and (e)(4) of this section, and subject to paragraph (e)(5) of this section, in the case of an inclusion event, the amount of gain included in gross income is equal to the excess of the amount described in paragraph (e)(1)(i) of this section over the amount described in paragraph (e)(1)(ii) of this section.

(i) The amount described in this paragraph (e)(1)(i) is equal to the lesser of:

(A) An amount which bears the same proportion to the remaining deferred gain, as

(1) The fair market value of the portion of the qualifying investment that is disposed of in the inclusion event, as determined as of the date of the inclusion event, bears to

(2) The fair market value of the total qualifying investment immediately before the inclusion event, or

(B) The amount described in paragraph (e)(1)(i)(A)(1) of this section.

(ii) The amount described in this paragraph (e)(1)(ii) is the taxpayer's basis in the portion of the qualifying investment that is disposed of in the inclusion event.

(iii) For purposes of paragraph (e)(1)(i)(A)(1) of this section, the fair market value of that portion is determined by multiplying the fair market value of the taxpayer's entire qualifying investment in the QOF, valued as of the date of the inclusion event, by the percentage of the taxpayer's qualifying investment that is represented by the portion disposed of in the inclusion event.

(2) *Property received from a QOF in certain transactions*. In the case of an inclusion event described in paragraphs (c)(6)(iii), (v), paragraphs (c)(8),(9), (10), (11), or paragraph (c)(12) of this section, the amount of gain included in gross income is equal to the lesser of:

(i) The remaining deferred gain, or

(ii) The amount that gave rise to the inclusion event. See paragraph (c) of this section for rules regarding the amount that gave rise to the inclusion event, and see paragraph (g) of this section for applicable ordering rules.

(3) *Gain recognized on December 31, 2026.* The amount of gain included in gross income on December 31, 2026 is equal to the excess of –

(i) The lesser of--

(A) The remaining deferred gain; and

(B) The fair market value of the qualifying investment held on December 31, 2026; over

(ii) The taxpayer's basis in the qualifying investment as of December 31, 2026, taking into account only section 1400Z-2(b)(2)(B).

(4) *Special amount includible rule for partnerships and S corporations*. For purposes of paragraphs (e)(1) and (3) of this section, in the case of an inclusion event involving a qualifying investment in a QOF partnership or S corporation, or in the case of a qualifying investment in a QOF partnership or S corporation held on December 31, 2026, the amount of gain included in gross income is equal to the lesser of:

(i) The product of:

(A) The percentage of the qualifying investment that gave rise to the inclusion event, and

(B) The remaining deferred gain, less any basis adjustments pursuant to section 1400Z-2(b)(2)(B)(iii) and (iv), or

(ii) The gain that would be recognized on a fully taxable disposition of the qualifying investment that gave rise to the inclusion event.

(5) *Limitation on amount of gain included after statutory five- and seven-year basis increases*. The total amount of gain included in gross income under this paragraph (e) is limited to the amount deferred under section 1400Z-2(a)(1), reduced by any increase in the basis of the qualifying investment made pursuant to section 1400Z-2(b)(2)(B)(iii) or (iv). See paragraph (g)(2) of this section for limitations on the amount of basis adjustments under section 1400Z-2(b)(2)(B)(iii) and (iv).

(f) *Examples*. The following examples illustrate the rules of paragraphs (c), (d) and (e) of this section. For purposes of these examples: A, B, C, W, X, Y, and Z are C corporations that do not file a consolidated Federal income tax return; Q is a QOF corporation or a QOF partnership, as specified in each example; and each divisive corporate transaction satisfies the requirements of section 355.

(1) *Example 1. Determination of basis, holding period, and qualifying investment* –

(i) *Facts*. A wholly and directly owns Q, a QOF corporation. On May 31, 2019, A sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A transfers unencumbered asset N to Q in exchange for a qualifying investment. Asset N, which A has held for 10 years, has a basis of $500 and a fair market value of $500. A elects to defer the inclusion of $500 in gross income under section 1400Z-2(a) and §1.1400Z2(a)-1.

(ii) *Analysis*. Under §1.1400Z2(a)-1(b)(10)(i)(B)(1), A made a qualifying investment of $500. Under section 1400Z-2(b)(2)(B)(i), A's basis in its qualifying investment in Q is $0. For purposes of sections 1400Z-2(b)(2)(B) and 1400Z-2(c), A's holding period in its new investment in Q begins on October 31, 2019. See paragraph (d)(1)(i) of this section. Other than for purposes of applying section 1400Z-2, A has a 10-year holding period in its new Q investment as of October 31, 2019.

(iii) *Transfer of built-in gain property*. The facts are the same as in paragraph (i) of this Example 1, but A's basis in transferred asset N is $200. Under §1.1400Z2(a)-1(b)(10)(i)(B)(1), A made a qualifying investment of $200 and a non-qualifying investment of $300.

(2) *Example 2. Transfer of qualifying investment –*

(i) *Facts*. On May 31, 2019, A sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A transfers $500 to newly formed Q, a QOF corporation, in exchange for a qualifying investment. On February 29, 2020, A transfers 25 percent of its qualifying investment in Q to newly formed Y in exchange for 100 percent of Y's stock in a transfer to which section 351 applies (the Transfer), at a time when the fair market value of A's qualifying investment in Q is $800.

(ii) *Analysis*. Under §1.1400Z2(a)-1(b)(10)(i)(A), A made a qualifying investment of $500 on October 31, 2019. In the Transfer, A exchanged 25 percent of its qualifying investment for Federal income tax purposes, which reduced A's direct qualifying investment. Under paragraph (c)(1)(i) of this section, the Transfer is an inclusion event to the extent of the reduction in A's direct qualifying investment. Under paragraph (e)(1) of this section, A therefore includes in income an amount equal to the excess of the amount described in paragraph (e)(1)(i) over A's basis in the portion of the qualifying investment that was disposed of, which in this case is $0. The amount described in paragraph (e)(1)(i) is the lesser of (A) $125 ($500 x ($200 / $800)), or (B) $200. As a result, A must include $125 of its deferred capital gain in income in 2020. After the Transfer, the Q stock is not qualifying Q stock in Y's hands.

(iii) *Disregarded transfer*. The facts are the same as in paragraph (i) of this Example 2, except that Y elects to be treated as an entity that is disregarded as an entity separate from its owner for Federal income tax purposes effective prior to the Contribution. Since the Transfer would be disregarded for Federal income tax purposes, A's transfer of its qualifying investment in Q would not be treated as a reduction in direct tax ownership for Federal income tax purposes, and the Transfer would not be an inclusion event with respect to A's qualifying investment in Q for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. Thus, A would not be required to include in income any portion of its deferred capital gain.

(iv) *Election to be treated as a corporation*. The facts are the same as in paragraph (iii) of this Example 2, except that Y (a disregarded entity) subsequently elects to be treated as a corporation for Federal income tax purposes. A's deemed transfer of its qualifying investment in Q to Y under §301.7701-3(g)(1)(iv) of this chapter is an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section.

(3) *Example 3. Part sale of qualifying QOF partnership interest in Year 6 when value of the QOF interest has increased –*

(i) *Facts*. In October 2018, A and B each realize $200 of eligible gain, and C realizes $600 of eligible gain. On January 1, 2019, A, B, and C form Q, a QOF partnership. A contributes $200 of cash, B contributes $200 of cash, and C contributes $600 of cash to Q in exchange for qualifying QOF partnership interests in Q. A, B, and C hold 20 percent, 20 percent, and 60 percent interests in Q, respectively. On January 30, 2019, Q obtains a nonrecourse loan from a bank for $1,000. Under section 752, the loan is allocated $200 to A, $200 to B, and $600 to C. On February 1, 2019, Q purchases qualified opportunity zone business property for $2,000. On July 31, 2024, A sells 50 percent of its qualifying QOF partnership interest in Q to B for $400 cash. Prior to the sale, there were no inclusion events, distributions, partner changes, income or loss allocations, or changes in the amount or allocation of debt outstanding. At the time of the sale, the fair market value of Q's qualified opportunity zone business property is $5,000.

(ii) *Analysis*. Because A held its qualifying QOF partnership interest for at least five years, A's basis in its partnership interest at the time of the sale is $220 (the original zero basis with respect to the contribution, plus the $200 debt allocation, plus the 10% increase for interests held for five years). The sale of 50 percent of A's qualifying QOF partnership interest to B requires A to recognize $90 of eligible gain, the lesser of 50 percent

of the remaining $180 deferred gain ($90) or the gain that would be recognized on a taxable sale of 50 percent of the interest ($390). A also recognizes $300 of gain relating to the appreciation of its interest in Q.

(4) *Example 4. Sale of qualifying QOF partnership interest when value of the QOF interest has decreased –*

(i) *Facts*. The facts are the same as in Example 3 of this paragraph (f), except that A sells 50 percent of its qualifying QOF partnership interest in Q to B for cash of $50, and at the time of the sale, the fair market value of Q's qualified opportunity zone business property is $1,500.

(ii) *Analysis*. Because A held its qualifying QOF partnership interest for at least five years, A's basis at the time of the sale is $220. Under section 1400Z-2(b)(2)(A), the sale of 50 percent of A's qualifying QOF partnership interest to B requires A to recognize $40 of eligible gain, the lesser of $90 (50 percent of A's remaining deferred gain of $180) or $40 (the gain that would be recognized by A on a sale of 50 percent of its QOF interest). A's remaining basis in its qualifying QOF partnership interest is $110.

(5) *Example 5. Amount includible on December 31, 2026 –*

(i) *Facts*. The facts are the same as in Example 3 of this paragraph (f), except that no sale of QOF interests takes place in 2024. Prior to December 31, 2026, there were no inclusion events, distributions, partner changes, income or loss allocations, or changes in the amount or allocation of debt outstanding.

(ii) *Analysis*. For purposes of calculating the amount includible on December 31, 2026, each of A's basis and B's basis is increased by $30 to $230, and C's basis is increased by $90 to $690 because they held their qualifying QOF partnership interests for at least seven years. Each of A and B is required to recognize $170 of eligible gain, and C is required to recognize $510 of eligible gain.

(iii) *Sale of qualifying QOF partnership interests*. The facts are the same as in paragraph (i) of this Example 5, except that, on March 2, 2030, C sells its entire qualifying QOF partnership interest in Q to an unrelated buyer for cash of $4,200. Assuming an election under section 1400Z-2(c) is made, the basis of C's Q interest is increased to its fair market value immediately before the sale by C. C is treated as purchasing the interest immediately before the sale and the bases of the partnership's assets are increased in the manner they would be if the partnership had an election under section 754 in effect.

(6) *Example 6. Mixed-funds investment –*

(i) *Facts*. On January 1, 2019, A and B form Q, a QOF partnership. A contributes $200 to Q, $100 of which is a qualifying investment, and B contributes $200 to Q in exchange for a qualifying investment. All the cash is used to purchase qualified opportunity zone property. Q has no liabilities. On March 30, 2023, when the values and bases of the qualifying investments remain unchanged, Q distributes $50 to A.

(ii) *Analysis*. Under paragraph (c)(6)(iv) of this section, A is a mixed-funds partner holding two separate interests, a qualifying investment and a non-qualifying investment. One half of the $50 distribution is treated under that provision as being made with respect to A's qualifying investment. For the $25 distribution made with respect to the qualifying investment, A is required to recognize $25 of eligible gain.

(iii) *Basis adjustments*. Under paragraph (g)(1)(ii)(B) of this section, prior to determining the tax consequences of the distribution, A increases its basis in its qualifying QOF partnership interest by $25 under section 1400Z-2(b)(2)(B)(ii). The distribution of $25 results in no gain under section 731. After the distribution, A's basis in its qualifying QOF partnership interest is $0 ($25-$25).

(7) *Example 7. Qualifying section 381 transaction of a QOF corporation –*

(i) *Facts*. X wholly and directly owns Q, a QOF corporation. On May 31, 2019, X sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, X contributes $500 to Q in exchange for a qualifying investment. In 2020, Q merges with and into unrelated Y (with Y surviving) in a transaction that qualifies as a reorganization under section 368(a)(1)(A) (the Merger). X does not receive any boot in the Merger with respect to its qualifying investment in Q. Immediately after the Merger, Y satisfies the requirements for QOF status under section 1400Z-2(d)(1) (see paragraph (c)(10)(i)(B) of this section).

(ii) *Analysis*. The Merger is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. See paragraph (c)(10)(i)(A) of this section. Accordingly, X is not required to include in income in 2020 its $500 of deferred capital gain as a result of the Merger. For purposes of section 1400Z-2(b)(2)(B) and 1400Z-2(c), X's holding period for its investment in Y is treated as beginning on October 31, 2019. For purposes of section 1400Z-2(d), Y's holding period in its assets includes Q's holding period in its assets, and Q's qualified opportunity zone business property continues to qualify as such. See paragraph (d)(2)(i) of this section.

(iii) *Merger of QOF shareholder*. The facts are the same as in paragraph (i) of this Example 7, except that, in 2020, X (rather than Q) merges with and into Y in a section 381 transaction in which Y acquires all of X's qualifying interest in Q, and Y does not qualify as a QOF immediately after the merger. The merger transaction is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. See paragraph (c)(10)(ii) of this section.

(iv) *Receipt of boot*. The facts are the same as in paragraph (i) of this Example 7, except that the value of X's qualifying investment immediately before the Merger is $1,000, X receives $100 of cash in addition to Y stock in the Merger in exchange for its qualifying investment, and neither Q nor Y has any earnings and profits. X realizes $1,000 of gain in the Merger. Under paragraphs (c)(10)(i)(C)(1) and (e)(2) of this section, X is required to include $100 of its deferred capital gain in income in 2020.

(v) *Realization of loss*. The facts are the same as in paragraph (iv) of this Example 7, except that the Merger occurs in 2025, the value of X's qualifying investment immediately before the Merger is $25, and X receives $10 of boot in the Merger. X realizes $25 of loss in the Merger. Under paragraphs (c)(10)(i)(C)(1) and (e)(2) of this section, X is required to include $10 of its deferred capital gain in income in 2020.

(8) *Example 8. Section 355 distribution by a QOF –*

(i) *Facts*. A wholly and directly owns Q, a QOF corporation, which wholly and directly owns Y, a corporation that is a qualified opportunity zone business. On May 31, 2019, A sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A contributes $500 to Q in exchange for a qualifying investment. On June 26, 2025, Q distributes all of the stock of Y to A in a transaction in which no gain or loss is recognized under section 355 (the Distribution). Immediately after the Distribution, each of Q and Y satisfies the requirements for QOF status (see paragraph (c)(11)(i)(B)(2) of this section).

(ii) *Analysis*. Because each of Q (the distributing corporation) and Y (the controlled corporation) is a QOF immediately after the Distribution, the Distribution is a qualifying section 355 transaction. Thus, the Distribution is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section.. See paragraph (c)(11)(i)(B) of this section. Accordingly, A is not required to include in income in 2025 any of its $500 of deferred capital gain as a result of the Distribution. For purposes of section 1400Z-2(b)(2)(B) and 1400Z-2(c), A's holding period for its

qualifying investment in Y is treated as beginning on October 31, 2019. See paragraph (d)(2)(i) of this section.

(iii) *Section 355 distribution by a QOF shareholder*. The facts are the same as in paragraph (i) of this Example 8, except that A distributes 80 percent of the stock of Q (all of which is a qualifying investment in the hands of A) to A's shareholders in a transaction in which no gain or loss is recognized under section 355. The distribution is an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section, and A is required to include in income $400 (80 percent of its $500 of deferred capital gain) as a result of the distribution. See paragraphs (c)(1) and (c)(11)(ii) of this section.

(iv) *Distribution of boot*. The facts are the same as in paragraph (i) of this Example 8, except that A receives boot in the Distribution. Under paragraphs (c)(8) and (c)(11)(i)(B)(3) of this section, the receipt of boot in the Distribution is an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section to the extent of gain recognized pursuant to section 301(c)(3).

(v) *Section 355 split-off*. The facts are the same as in paragraph (i) of this Example 8, except that Q stock is directly owned by both A and B (each of which has made a qualifying investment in Q), and Q distributes all of the Y stock to B in exchange for B's Q stock in a transaction in which no gain or loss is recognized under section 355. The distribution is a qualifying section 355 transaction and is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. Neither A nor B is required to include its deferred capital gain in income in 2025 as a result of the distribution.

(vi) *Section 355 split-up*. The facts are the same as in paragraph (v) of this Example 8, except that Q wholly and directly owns both Y and Z; Q distributes all of the Y stock to A in exchange for A's Q stock and distributes all of the Z stock to B in exchange for B's Q stock in a transaction in which no gain or loss is recognized under section 355; Q then liquidates; and immediately after the Distribution, each of Y and Z satisfies the requirements for QOF status. The distribution is a qualifying section 355 transaction and is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. Neither A nor B is required to include its deferred capital gain in income in 2025 as a result of the transaction.

(vii) *Section 355 split-off with boot*. The facts are the same as in paragraph (v) of this Example 8, except that B also receives boot. Under paragraph

(c)(11)(i)(B)(3) of this section, B has an inclusion event , and the amount that gives rise to the inclusion event is the amount of gain under section 356 that is not treated as a dividend under section 356(a)(2).

(9) *Example 9. Recapitalization* –

(i) *Facts*. On May 31, 2019, each of A and B sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A contributes $500 to newly formed Q in exchange for 50 shares of Q non-voting stock (A's qualifying investment) and B contributes $500 to Q in exchange for 50 shares of Q voting stock (B's qualifying investment). A and B are the sole shareholders of Q. In 2020, when A's qualifying investment is worth $600, A exchanges all of its Q non-voting stock for $120 and 40 shares of Q voting stock in a transaction that qualifies as a reorganization under section 368(a)(1)(E).

(ii) *Analysis*. Because A's proportionate interest in Q has decreased in this transaction, the recapitalization is an inclusion event under paragraph (c)(12)(ii) of this section. Thus, A is treated as having reduced its direct tax ownership of its investment in Q to the extent of the reduction in the fair market value of its qualifying QOF stock. The $120 that A received in the reorganization represents the difference in fair market value between its qualifying investment before and after the reorganization. Under paragraph (c)(12)(i)(B) and paragraph (e)(2) of this section, A is required to include $120 of its deferred capital gain in income in 2020. Because B's proportionate interest in Q has not decreased, and because B did not receive any property in the recapitalization, B does not have an inclusion event with respect to its qualifying investment in Q. See paragraph (c)(12)(i) of this section. Therefore, B is not required to include any of its deferred gain in income as a result of this transaction.

(10) Example 10. Debt financed distribution –

(i) *Facts*. On January 1, 2019, A and B form Q, a QOF partnership, each contributing $200 that is deferred under the section 1400Z-2(a) election to Q in exchange for a qualifying investment. On November 18, 2022, Q obtains a nonrecourse loan from a bank for $300. Under section 752, the loan is allocated $150 to A and $150 to B. On November 30, 2022, when the values and bases of the investments remain unchanged, Q distributes $50 to A.

(ii) *Analysis*. A is not required to recognize gain under §1.1400Z2(b)-1(c) because A's basis in its qualifying investment is $150 (the original zero basis with respect to the contribution, plus the $150 debt allocation). The distribution reduces A's basis to $100.

(11) *Example 11. Debt financed distribution in excess of basis –*

(i) *Facts*. The facts are the same as in Example 10 of this paragraph (f), except that the loan is entirely allocated to B under section 752. On November 30, 2024, when the values of the investments remain unchanged, Q distributes $50 to A.

(ii) *Analysis*. Under §1.1400Z2(b)-1(c)(6)(iii), A is required to recognize $30 of eligible gain under section §1.1400Z2(b)-1(c) because the $50 distributed to A exceeds A's $20 basis in its qualifying investment (the original zero basis with respect to its contribution, plus $20 with regard to section 1400Z-2(b)(2)(B)(iii)).

(12) *Example 12. Aggregate ownership change threshold –*

(i) *Facts*. On May 31, 2019, B, an S corporation, sells a capital asset to an unrelated party for cash and realizes $500 of capital gain. On July 15, 2019, B makes a deferral election and transfers the $500 to Q, a QOF partnership in exchange for a qualifying investment. On that date, B has outstanding 100 shares, of which each of individuals D, E, F, and G owns 25 shares. On September 30, 2019, D sells 10 shares of its B stock. On September 30, 2020, E sells 16 shares of its B stock.

(ii) *Analysis*. Under paragraph (c)(7)(iii)(A) of this section, the sales of stock by D and E caused an aggregate change in ownership of B because, the percentage of the stock of B owned directly by D, E, F, and G at the time of B's deferral election decreased by more than 25 percent. Solely for purposes of section 1400Z-2, B's qualifying investment in Q would be treated as disposed of. Consequently, B would have an inclusion event with respect to all of B's remaining deferred gain of $500, and neither section 1400Z-2(b)(2)(B)(iii) or (iv), nor section 1400Z-2(c), would apply to B's qualifying investment after that date.

(g) *Basis adjustments—*

(1) *Timing of section 1400Z-2(b)(2)(B)(ii) adjustments—*

(i) *In general*. Except as provided in paragraph (g)(1)(ii) of this section, basis adjustments under section 1400Z-2(b)(2)(B)(ii) are made immediately after the amount of gain determined under section 1400Z-2(b)(2)(A) is included in income under section 1400Z-2(b)(1). If the basis adjustment under section 1400Z-2(b)(2)(B)(ii) is being made as a result of an inclusion event, then the basis adjustment is made before determining the other tax consequences of the inclusion event.

(ii) *Specific application to section 301(c)(3) gain, S corporation shareholder gain, or partner gain—*

(A) *General rule*. This paragraph (g)(1)(ii) applies if a QOF makes a distribution to its owner, and if, without regard to any basis adjustment under section 1400Z-2(b)(2)(B)(ii), at least a portion of the distribution would be characterized as gain under section 301(c)(3) or paragraph (c)(6)(iii) and paragraph (c)(7)(ii) of this section with respect to its qualifying investment.

(B) *Ordering rule*. If paragraph (g)(1)(ii) of this section applies, the taxpayer is treated as having an inclusion event to the extent provided in paragraph (c)(6)(iii), paragraph (c)(7), paragraph (c)(8), paragraph (c)(9), paragraph (c)(10), paragraph (c)(11), or paragraph (c)(12) of this section, as applicable. Then, the taxpayer increases its basis under section 1400Z-2(b)(2)(B)(ii), before determining the tax consequences of the distribution.

(C) *Example*. The following example illustrates the rules of this paragraph (g)(1)(ii).

(1) *Example 1—*

(i) *Facts*. On May 31, 2019, A sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A contributes $500 to Q, a newly formed QOF corporation, in exchange for all of the outstanding Q common stock and elects to defer the recognition of $500 of capital gain under section 1400Z-2(a) and §1.1400Z2(a)-1. In 2020, when Q has $40 of earnings and profits, Q distributes $100 to A (the Distribution).

(ii) *Recognition of gain*. Under paragraph (g)(1)(ii)(A) of this section, the Distribution is first evaluated without regard to any basis adjustment under section 1400Z-2(b)(2)(B)(ii). Of the $100 distribution, $40 is treated as a dividend and $60 is treated as gain from the sale or exchange of property under section 301(c)(3), because A's basis in its Q stock is $0 under section 1400Z-2(b)(2)(B)(i). Under paragraphs (c)(8) and (e)(2) of this section, $60 of A's gain that was deferred under section 1400Z-2(a) and §1.1400Z2(a)-1 is recognized in 2020.

(iii) *Basis adjustments*. Under paragraph (g)(1)(ii)(B) of this section, prior to determining the further tax consequences of the Distribution, A increases its basis in its Q stock by $60 in accordance with section 1400Z-2(b)(2)(B)(ii). As a result, the Distribution is characterized as a dividend of $40 under section 301(c)(1) and a return of basis of $60 under section 301(c)(2). Therefore, after the section 301 distribution, A's basis in Q is $0 ($60 - $60).

(2) *Amount of basis adjustment*. The increases in basis under section 1400Z-2(b)(2)(B)(iii) and (iv) only apply to that portion of the qualifying investment that has not been subject to previous gain inclusion under section 1400Z-2(b)(2)(A).

(3) *Special partnership rules—*

(i) *General rule*. The initial basis under section 1400Z-2(b)(2)(B)(i) of a qualifying investment in a QOF partnership is zero, as adjusted to take into account the contributing partner's share of partnership debt under section 752.

(ii) *Tiered arrangements*. Any basis adjustment described in section 1400Z-2(b)(2)(B)(iii) and (iv) and section 1400Z-2(c) (the basis adjustment rules) shall be treated as an item of income described in section 705(a)(1) and shall be reported in accordance with the applicable forms and instructions. Any amount to which the basis adjustment rules or to which section 1400Z-2(b)(1) applies shall be allocated to the owners of the QOF, and to the owners of any partnership that directly or indirectly (solely through one or more partnerships) owns such QOF interest, and shall track to such owners' interests, based on their shares of the remaining deferred gain to which such amounts relate.

(4) *Basis adjustments in S corporation stock—*

(i) *S corporation investor in QOF—*

(A) *S corporation*. If an S corporation is an investor in a QOF, the S corporation must adjust the basis of its qualifying investment as set forth in this paragraph (g). This rule does not affect adjustments to the basis of any other asset of the S corporation.

(B) *S corporation shareholder—*

(1) *In general*. The S corporation shareholder's pro-rata share of any recognized capital gain that has been deferred at the

S corporation level will be separately stated under section 1366 and will adjust the shareholders' stock basis under section 1367.

(2) *Basis adjustments to qualifying investments*. Any adjustment made to the basis of an S corporation's qualifying investment under section 1400Z-2(b)(2)(B)(iii) or (iv), or section 1400Z-2(c), will not (1) be separately stated under section 1366, or (2) until the date on which an inclusion event with respect to the S corporation's qualifying investment occurs, adjust the shareholders' stock basis under section 1367.

(3) *Basis adjustments resulting from inclusion events*. If the basis adjustment under section 1400Z-2(b)(2)(B)(ii) is being made as a result of an inclusion event, then the basis adjustment is made before determining the other tax consequences of the inclusion event.

(ii) *QOF S corporation –*

(A) *Transferred basis of assets received*. If a QOF S corporation receives an asset in exchange for a qualifying investment, the basis of the asset shall be the same as it would be in the hands of the transferor, increased by the amount of the gain recognized by the transferor on such transfer.

(B) *Basis adjustments resulting from inclusion events*. If the basis adjustment under section 1400Z-2(b)(2)(B)(ii) for the shareholder of the QOF S corporation is being made as a result of an inclusion event, then the basis adjustment is made before determining the other tax consequences of the inclusion event.

(h) *Notifications by partners and partnerships, and shareholders and S corporations—*

(1) *Notification of deferral election*. A partnership that makes a deferral election must notify all of its partners of the deferral election and state each partner's distributive share of the eligible gain in accordance with applicable forms and instructions. A partner that makes a deferral election must notify the partnership in writing of its deferral election, including the amount of the eligible gain deferred.

(2) *Notification of deferred gain recognition by indirect QOF owner*. If an indirect owner of a QOF partnership or QOF S corporation sells a portion of its partnership interest or S corporation shares in a transaction to which

§1.1400Z2(b)-1(c)(6)(iv) applies, or which is subject to §1.1400Z2(b)-1(c)(7)(iii), such indirect owner must provide to the QOF owner notification and information sufficient to enable the QOF owner, in a timely manner, to recognize an appropriate amount of deferred gain.

(3) *Notification of section 1400Z-2(c) election by QOF partner or QOF partnership*. A QOF partner must notify the QOF partnership of an election under section 1400Z-2(c) to adjust the basis of the qualifying QOF partnership interest that is disposed of in a taxable transaction. Notification of the section 1400Z-2(c) election, and the adjustments to the basis of the qualifying QOF partnership interest(s) disposed of or to the QOF partnership asset(s) disposed of, is to be made in accordance with applicable forms and instructions.

(4) *S corporations*. Similar rules to those in paragraphs (h)(1) and (h)(3) of this section apply to S corporations as appropriate.

(i) *Applicability dates*. This section applies for 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. However, a taxpayer may rely on the proposed rules in this section with respect to taxable years that begin before that date, but only if the taxpayer applies the rules in their entirety and in a consistent manner.

§1.1400Z2(c)–1 Investments held for at least 10 years.

(a) *Scope and definitions—*

(1) *Scope*. This section provides rules under section 1400Z-2(c) of the Internal Revenue Code regarding the election to adjust the basis in a qualifying investment in a QOF or certain eligible property held by the QOF. See §1.1400Z2(b)-1(d) for purposes of determining the holding period of a qualifying investment for purposes of this section.

(2) *Definitions*. The definitions provided in §1.1400Z2(b)-1(a)(2) apply for purposes of this section.

(b) *Investment to which an election can be made—*

(1) *In general—*

(i) *Election by taxpayer*. If the taxpayer sells or exchanges a qualifying investment that it has held for at least 10 years, then the taxpayer can make an election described in section 1400Z-2(c) on the sale or exchange of the qualifying investment.

(ii) *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) 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. For rules governing the application of section 1400Z-2(c) to the portion of an investment in a QOF for which a loss has been claimed under section 165(g), see §1.1400Z2(b)-1(c)(14). See also §1.1400Z2(b)-1(c)(7)(iii) for rules governing the application of section 1400Z-2(c) to the portion of an investment in a QOF held by an S corporation QOF owner that has an aggregate change in ownership within the meaning of §1.1400Z2(b)-1(c)(7)(iii)(B).

(2) *Special election rules for QOF Partnerships and QOF S Corporations—*

(i) *Dispositions of qualifying QOF partnership interests*. If a QOF partner's basis in a qualifying QOF partnership interest is adjusted under section 1400Z-2(c), then the basis of the partnership interest is adjusted to an amount equal to the fair market value of the interest, including debt, and immediately prior to the sale or exchange, the basis of the QOF partnership assets are also adjusted, such adjustment is calculated in a manner similar to a section 743(b) adjustment had the transferor partner purchased its interest in the QOF partnership for cash equal to fair market

value immediately prior to the sale or exchange assuming that a valid section 754 election had been in place. This paragraph (b)(2)(i) applies without regard to the amount of deferred gain that was included under section 1400Z-2(b)(1), or the timing of that inclusion.

(ii) *Dispositions of QOF property by QOF partnerships or QOF S corporations—*

(A) *Taxpayer election—*

(1) *In general*. For purposes of section 1400Z-2(c), if a taxpayer has held a qualifying investment (as determined under §1.1400Z2(b)-1(c)(6)(iv)) in a QOF partnership or QOF S corporation for at least 10 years, and the QOF partnership or QOF S corporation disposes of qualified opportunity zone property after such 10 year holding period, the taxpayer may make an election to exclude from gross income some or all of the capital gain arising from such disposition reported on Schedule K-1 of the QOF partnership or QOF S corporation and attributable to the qualifying investment. To the extent that the Schedule K-1 of a QOF partnership or QOF S corporation separately states capital gains arising from the sale or exchange of any particular qualified opportunity zone property, the taxpayer may make an election with respect to such separately stated item.

(2) *Section 1231 gains*. An election described in paragraph (b)(2)(ii)(A)(1) of this section may be made only with respect to capital gain net income from section 1231 property for a taxable year to the extent of net gains determined under section 1231(a) reported on Schedule K-1 of a QOF partnership or QOF S corporation.

(B) *Validity of election*. To be valid, the taxpayer must make an election described in paragraph (b)(2)(ii)(A)(1) of this section for the taxable year in which the capital gain from the sale or exchange of QOF property recognized by the QOF partnership or QOF S corporation would be included in the taxpayer's gross income (without regard to the election set forth in this paragraph (b)(2)(ii)), in accordance with applicable forms and instructions.

(C) *Consequences of election*. If a taxpayer makes a valid election under this paragraph (b)(2)(ii) with respect to some or all of the capital gain reported on Schedule K-1 of a QOF partnership or

QOF S corporation, the amount of such capital gain that the taxpayer elects to exclude from gross income is excluded from the taxpayer's income for purposes of the Internal Revenue Code and the regulations thereunder. Such excluded amount is treated as an item of income under sections 705(a)(1) or 1366.

(c) *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.

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

(1) *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 (c) 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 paragraphs (a) and (b) 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).

(2) *Example 2*.

(i) *Facts*. In 2019, A and B each contribute $100 to a QOF partnership for qualifying QOF partnership interests.

(ii) *Sale of qualifying QOF partnership interest*. In 2030 when the QOF assets have a value of $260 and a bases of $200, A sells its partnership interest, recognizing $30 of gain, $15 of which is attributable to assets described in section 751(c) and (d), and for which sale A makes an election under section 1400Z-2(c) and paragraph (b)(2)(i) of this section. Because A's election under paragraph (b)(2)(i) of this section is in effect, with regard to the sale, the bases of the assets are treated as adjusted to fair market value immediately before A's sale and there is no gain recognized by A.

(iii) *Sale of QOF property*. The facts are the same as in paragraph (i) of this Example 2, except that the partnership sells qualified opportunity zone property with a value of $120 and a basis of $100, recognizing $20 of gain, allocable $10 to each partner and A makes an election under section 1400Z-2(c) and paragraph (b)(2)(ii) of this section for the year in which A's allocable share of the partnership's recognized gain would be included in A's gross income. Because A's election under paragraph (b)(2)(ii) of this section is in effect, A will exclude the $10 allocable share of the partnership's $20 of recognized gain.

(e) *Capital gain dividends paid by a QOF REIT that some shareholders may be able to elect to receive tax free under section 1400Z–2(c)—*

(1) *Eligibility*. For purposes of paragraph (b) of this section, if a shareholder of a QOF REIT receives a capital gain dividend identified with a date, as defined in paragraph (e)(2) of this section, then, to the extent that the shareholder's shares in the QOF REIT paying the capital gain dividend are a qualifying investment in the QOF REIT--

(i) The shareholder may treat the capital gain dividend, or part thereof, as gain from the sale or exchange of a qualifying investment on the date that the QOF REIT identified with the dividend; and

(ii) If, on the date identified, the shareholder had held that qualifying investment in the QOF REIT for at least 10 years, then the shareholder may apply a zero percent tax rate to that capital gain dividend, or part thereof.

(2) *Definition of capital gain dividend identified with a date*. A capital gain dividend identified with a date means an amount of a capital gain dividend, as defined in section 857(b)(3)(B), or part thereof, and a date that the QOF REIT designates in

a notice provided to the shareholder not later than one week after the QOF REIT designates the capital gain dividend pursuant to section 857(b)(3)(B). The notice must be mailed to the shareholder unless the shareholder has provided the QOF REIT with an email address to be used for this purpose. In the manner and at the time determined by the Commissioner, the QOF REIT must provide the Commissioner all data that the Commissioner specifies with respect to the amounts of capital gain dividends and the dates designated by the QOF REIT for each shareholder.

(3) *General limitations on the amounts of capital gain with which a date may be identified—*

(i) *No identification in the absence of any capital gains with respect to qualified opportunity zone property*. If, during its taxable year, the QOF REIT did not realize long-term capital gain on any sale or exchange of qualified opportunity zone property, then no date may be identified with any capital gain dividends, or parts thereof, with respect to that year.

(ii) *Proportionality*. Under section 857(g)(2), designations of capital gain dividends identified with a date must be proportional for all dividends paid with respect to the taxable year. Greater than de minimis violation of proportionality invalidates all of the purported identifications for a taxable year.

(iii) *Undistributed capital gains*. If section 857(b)(3)(C)(i) requires a shareholder of a QOF REIT to include a designated amount in the shareholder's long-term capital gain for a taxable year, then inclusion of this amount in this manner is treated as receipt of a capital gain for purposes of this paragraph (e) and may be identified with a date.

(iv) *Gross gains*. The amount determined under paragraph (e)(4) of this section is determined without regard to any losses that may have been realized on other sales or exchanges of qualified opportunity zone property. The losses do, however, limit the total amount of capital gain dividends that may be designated under section 857(b)(3).

(4) *Determination of the amount of capital gain with which a date may be identified*. A QOF REIT may choose to identify the date for an amount of capital gain in one of the following manners:

(i) *Simplified determination*. If, during its taxable year, the QOF REIT realizes long-term capital gain on one or more sales or exchanges of qualified opportunity zone property, then the QOF REIT may identify the first day of that taxable year as the date identified with each designated amount with respect to the capital gain dividends for that taxable year. A

designated identification is invalid in its entirety if the amount of gains that the QOF REIT identifies with that date exceeds the aggregate long-term capital gains realized on those sales or exchanges for that taxable year.

(ii) *Sale date determination—*

(A) *In general*. If, during its taxable year, the QOF REIT realizes long-term capital gain on one or more sales or exchanges of qualified opportunity zone property, then the QOF REIT may identify capital gain dividends, or a part thereof, with the latest date on which there was such a realization. The amount of capital gain dividends so identified must not exceed the aggregate long-term capital gains realized on that date from sales or exchanges of qualified opportunity zone property. A designated identification is invalid in its entirety if the amount of gains that the QOF REIT identifies with that date violates the preceding sentence.

(B) *Iterative application*. The process described in paragraph (e)(4)(ii) of this section is applied iteratively to increasingly earlier transaction dates (from latest to earliest) until all capital gain dividends are identified with dates or there are no earlier dates in the taxable year on which the QOF REIT realized long-term capital gains with respect to a sale or exchange of qualified opportunity zone property, whichever comes first.

(f) *Applicability date*. This section applies to taxable years of a taxpayer, QOF Partnership, QOF S corporation, or QOF REIT, as appropriate, that end on or after the date of publication in the Federal Register of a Treasury decision adopting these proposed rules as final regulations.

§1.1400Z2(d)–1 Qualified Opportunity Funds.

(a) *Becoming a Qualified Opportunity Fund (QOF)–*

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

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

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

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

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

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

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

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

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

(3) *Pre-existing entities*. There is no legal barrier to a pre-existing eligible entity becoming a QOF, but the eligible entity must satisfy all of the requirements of section 1400Z–2, 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 purposes of the 90-percent asset test in section 1400Z-2(d)(1), on an annual basis a QOF may value its assets using the applicable financial statement valuation method set forth in paragraph (b)(2) of this section, if the QOF has an applicable financial statement within the meaning of §1.475(a)-4(h), or the alternative valuation method set forth in paragraph (b)(3) of this section. During each taxable year, a QOF must apply consistently the valuation method that it selects under this paragraph (b)(1) to all assets valued with respect to the taxable year.

(2) *Applicable financial statement valuation method—*

(i) *In general*. Under the applicable financial statement valuation method set forth in this paragraph (b)(2), the value of each asset that is owned or leased by the QOF is the value of that asset as reported on the QOF's applicable financial statement for the relevant reporting period.

(ii) *Requirement for selection of method*. A QOF may select the applicable financial statement valuation method set forth in this paragraph (b)(2) to value an asset leased by the QOF only if the applicable financial statement of the QOF is prepared according to U.S. generally accepted accounting principles (GAAP) and requires an assignment of value to the lease of the asset.

(3) *Alternative valuation method—*

(i) *In general*. Under the alternative valuation method set forth in this paragraph (b)(3), the value of the assets owned by a QOF is calculated under paragraph (b)(3)(ii) of this section, and the value of the assets leased by a QOF is calculated under paragraph (b)(3)(iii) of this section.

(ii) *Assets that are owned by a QOF*. The value of each asset that is owned by a QOF is the QOF's unadjusted cost basis of the asset under section 1012.

(iii) *Assets that are leased by a QOF—*

(A) *In general*. The value of each asset that is leased by a QOF is equal to the present value of the leased asset as defined in paragraph (b)(3)(iii)(C) of this section.

(B) *Discount rate*. For purposes of calculating present value under paragraph (b)(3)(iii) of this section, the discount rate is the applicable Federal rate under section 1274(d)(1), determined by substituting the term "lease" for "debt instrument."

(C) *Present value*. For purposes of paragraph (b)(3)(iii) of this section, present value of a leased asset –

(1) Is equal to the sum of the present values of each payment under the lease for the asset;

(2) Is calculated at the time the QOF enters into the lease for the asset; and

(3) Once calculated, is used as the value for the asset by the QOF for all testing dates for purposes of the 90-percent asset test.

(D) *Term of a lease*. For purposes of paragraph (b)(3)(iii) of this section, the term of a lease includes periods during which the lessee may extend the lease at a pre-defined rent.

(4) *Option to disregard recently contributed property*. A QOF may choose to determine compliance with the 90-percent asset test by excluding from both the numerator and denominator of the test any property that satisfies all the criteria in paragraph (b)(4)(A) through (C) of this section. A QOF need not be consistent from one semi-annual test to another in whether it avails itself of this option.

(A) As the case may be, the amount of the property was received by the QOF partnership as a contribution or by the QOF corporation solely in exchange for stock of the corporation,

(B) This contribution or exchange occurred not more than 6 months before the test from which it is being excluded; and

(C) Between the date of that contribution or exchange and the date of the asset test, the amount was held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less.

(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 –*

(i) *In general*. 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 the requirements of paragraph (c)(4)(i)(A) through (E), as applicable, are satisfied.

(A) In the case of property that the QOF owns, the property was acquired by the QOF after December 31, 2017, by purchase as defined by section 179(d)(2) from a person that is not a related person within the meaning of section 1400Z-2(e)(2).

(B) In the case of property that the QOF leases –

(1) *Qualifying acquisition of possession*. The property was acquired by the QOF under a lease entered into after December 31, 2017;

(2) *Arms-length terms*. The terms of the lease were market rate (that is, the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity zone as determined under section 482 and the regulations thereunder) at the time that the lease was entered into; and

(3) *Additional requirements for leases from a related person*. If the lessee and the lessor are related parties, paragraph (c)(4)(i)(B)(4) and (5) of this section must be satisfied.

(4) *Prepayments of not more than one year*. The lessee at no time makes any prepayment in connection with the lease relating to a period of use of the property that exceeds 12 months.

(5) *Purchase of other QOZBP*. If the original use of leased tangible personal property in a qualified opportunity zone (within the meaning of in paragraph (c)(4)(i)(B)(6) of this section) does not commence with the lessee, the property is not qualified opportunity zone business property unless, during the relevant testing period (as defined in paragraph (c)(4)(i)(B)(7) of this section), the lessee becomes the owner of tangible property that is qualified opportunity zone business property having a value not less than the value of that leased tangible personal property. There must be substantial overlap of the zone(s) in which the owner of the property so acquired uses it and the zone(s) in which that person uses the leased property.

(6) *Original use of leased tangible property*. For purposes of paragraph (c)(4)(i)(B)(5) of this section, the original use of leased tangible property in a qualified opportunity zone commences on the date any person first places the property in service in the qualified opportunity zone for purposes of depreciation (or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner). For purposes of this paragraph (c)(4)(i)(B)(6), if property has been unused or vacant for an uninterrupted period of at least 5 years, original use in the zone commences on the date after that period when any person first uses or places the property in service in the qualified opportunity zone within the meaning of the preceding sentence. Used tangible property satisfies the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone.

(7) *Relevant testing period*. For purposes of paragraph (c)(4)(i)(B)(5) of this section, the relevant testing period is the period that begins on the date that the lessee receives possession under the lease of the leased tangible personal property and ends on the earlier of—the date 30-months after the date the lessee receives possession of the property under the lease; or the last day of the term of the lease (within the meaning of paragraph (b)(3)(iii)(D) of this section.

(8) For purposes of paragraph (c)(4)(i)(B)(5) of this section, the value of owned or leased property is required to be determined in accordance with the valuation methodologies provided in paragraph (b) of this section, and such value in the case of leased tangible personal property is to be determined on the date the lessee receives possession of the property under the lease.

(C) In the case of tangible property owned by the QOF, the original use of the owned 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 owned tangible property within the meaning of paragraph (c)(8) of this section (which defines substantial improvement in this context).

(D) In the case of tangible property that is owned or leased by the QOF, during substantially all of the QOF's holding period for the tangible property, substantially all of the use of the tangible property was in a qualified opportunity zone.

(E) In the case of real property (other than unimproved land) that is leased by a QOF, if, at the time the lease is entered into, there was a plan, intent, or expectation for the real property to be purchased by the QOF for an amount of consideration other than the fair market value of the real property determined at the time of the purchase without regard to any prior lease payments, the leased real property is not qualified opportunity zone business property at any time.

(ii) *Trade or business of a QOF*. The term trade or business means a trade or business within the meaning of section 162.

(iii) *Safe harbor for inventory in transit*. In determining whether tangible property is used in a qualified opportunity zone for purposes of section 1400Z-2(d)(2)(D)(i)(III), and of paragraphs (c)(4)(i)(D), (c)(6), (d)(2)(i)(D), and (d)(2)(iv) of this section, inventory (including raw materials) of a trade or business does not fail to be used in a qualified opportunity zone solely because the inventory is in transit--

(A) From a vendor to a facility of the trade or business that is in a qualified opportunity zone, or

(B) From a facility of the trade or business that is in a qualified opportunity zone to customers of the trade or business that are not located in a qualified opportunity zone.

(5) *Substantially all of a QOF's holding period for property described in paragraphs (c)(2), (3), and (c)(4)(i)(D) of this section.* For purposes of determining whether the holding period requirements in paragraphs (c)(2), (3), and (c)(4)(i)(D) of this section are satisfied, the term substantially all means at least 90 percent.

(6) *Substantially all of the usage of tangible property by a QOF in a qualified opportunity zone*. A trade or business of an entity is treated as satisfying the substantially all requirement of paragraph (c)(4)(i)(D) of this section if at least 70 percent of the use of the tangible property is in a qualified opportunity zone.

(7) *Original use of tangible property acquired by purchase—*

(i) *In general*. For purposes of paragraph (c)(4)(i)(C) of this section, the original use of tangible property in a qualified opportunity zone

commences on the date any person first places the property in service in the qualified opportunity zone for purposes of depreciation or amortization (or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner). For purposes of this paragraph (c)(7), if property has been unused or vacant for an uninterrupted period of at least 5 years, original use in the qualified opportunity zone commences on the date after that period when any person first so uses or places the property in service in the qualified opportunity zone. Used tangible property satisfies the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone. If the tangible property had been so used or placed in service in the qualified opportunity zone before it is acquired by purchase, it must be substantially improved in order to satisfy the requirements of section 1400Z-2(d)(2)(D)(i)(II).

(ii) *Lessee improvements to leased property*. Improvements made by a lessee to leased property satisfy the original use requirement in section 1400Z-2(d)(2)(D)(i)(II) as purchased property for the amount of the unadjusted cost basis under section 1012 of such improvements.

(8) *Substantial improvement of tangible property acquired by purchase—*

(i) *In general*. Except as provided in paragraph (c)(8)(ii) of this section, for purposes of paragraph (c)(8)(i) 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) *Unimproved land*. Unimproved land that is within a qualified opportunity zone and acquired by purchase in accordance with section 1400Z-2(d)(2)(D)(i)(I) is not required to be substantially

improved within the meaning of section 1400Z-2(d)(2)(D)(i)(II) and (d)(2)(D)(ii).

(9) *Substantially all of tangible property owned or leased by a QOF*—

(i) *Tangible property owned by a QOF*. Whether a QOF has satisfied the "substantially all" threshold set forth in paragraph (c)(6) of this section is to be determined by a fraction –

(A) The numerator of which is the total value of all qualified opportunity zone business property owned or leased by the QOF that meets the requirements in paragraph (c)(4)(i) of this section, and

(B) The denominator of which is the total value of all tangible property owned or leased by the QOF, whether located inside or outside of a qualified opportunity zone.

(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) In the case of tangible property that the entity owns, the tangible property was acquired by the entity after December 31, 2017, by purchase as defined by section 179(d)(2) from a person who is not a related person within the meaning of section 1400Z-2(e)(2).

(B) In the case of tangible property that the entity leases –

(1) *Qualifying acquisition of possession*. The property was acquired by the entity under a lease entered into after December 31, 2017;

(2) *Arms-length terms*. The terms of the lease are market rate (that is, the terms of the lease reflect common, arms-length market practice in the locale that includes the qualified opportunity zone as determined under section 482 and the regulations thereunder) at the time that the lease was entered into; and

(3) *Additional requirements for leases from a related person*. If the lessee and the lessor are related parties, paragraph (d)(2)(i)(B)(4) and (5) of this section must be satisfied.

(4) *Prepayments of not more than one year*. The lessee at no time makes any prepayment in connection with the lease relating to a period of use of the property that exceeds 12 months.

(5) *Purchase of other QOZBP*. If the original use of leased tangible personal property in a qualified opportunity zone (within the meaning of in paragraph (d)(2)(i)(B)(6) of this section) does not commence with the lessee, the property is not qualified opportunity zone business property unless, during the relevant testing period (as defined in paragraph (d)(2)(i)(B)(7) of this section), the lessee becomes the owner of tangible property that is qualified opportunity zone business property having a value not less than the value of that leased tangible personal property. There must be substantial overlap of the zone(s) in which the owner of the property so acquired uses it and the zone(s) in which that person uses the leased property.

(6) *Original use of leased tangible property*. For purposes of paragraph (d)(2)(i)(B)(5) of this section, the original use of leased tangible property in a qualified opportunity zone commences on the date any person first places the property in service in the qualified opportunity zone for purposes of depreciation (or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner). For purposes of this paragraph (d)(2)(i)(B)(6), if property has been unused or vacant for an

uninterrupted period of at least 5 years, original use in the qualified opportunity zone commences on the date after that period when any person first uses or places the property in service in the qualified opportunity zone within the meaning of the preceding sentence. Used tangible property satisfies the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone.

(7) *Relevant testing period*. For purposes of paragraph (d)(2)(i)(B)(5) of this section, the relevant testing period is the period that begins on the date that the lessee receives possession under the lease of the leased tangible personal property and ends on the earlier of—the date 30-months after the date the lessee receives possession of the property under the lease; or the last day of the term of the lease (within the meaning of paragraph (b)(3)(iii)(D) of this section).

(8) For purposes of paragraph (d)(2)(i)(B)(5) of this section, the value of owned or leased property is required to be determined in accordance with the valuation methodologies provided in paragraph (b) of this section, and such value in the case of leased tangible personal property is to be determined on the date the lessee receives possession of the property under the lease.

(C) In the case of tangible property owned by the entity, the original use of the owned tangible property in the qualified opportunity zone, within the meaning of paragraph (c)(7) of this section, commences with the entity, or the entity substantially improves the owned tangible property within the meaning of paragraph (d)(4) of this section (which defines substantial improvement in this context).

(D) In the case of tangible property that is owned or leased by the entity, 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.

(E) In the case of real property (other than unimproved land) that is leased by the entity, if, at the time the lease is entered into, there was a plan, intent, or expectation for the real property to be purchased by the entity for an amount of consideration other than

the fair market value of the real property determined at the time of the purchase without regard to any prior lease payments, the leased real property is not qualified opportunity zone business property at any time.

(ii) *Trade or business of an entity*. The term trade or business means a trade or business within the meaning of section 162.

(iii) *Substantially all of a qualified opportunity zone business's holding period for property described in paragraph (d)(2)(i)(D) of this section*. For purposes of the holding period requirement in paragraph (d)(2)(i)(D) of this section, the term substantially all means at least 90 percent.

(iv) *Substantially all of the usage of tangible property by a qualified opportunity zone business in a qualified opportunity zone*. The substantially all of the use requirement of paragraph (d)(2)(i)(D) of this section is satisfied if at least 70 percent of the use of the tangible property is in a qualified opportunity zone.

(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*. Whether a trade or business of the entity satisfies the 70-percent "substantially all" threshold set forth in paragraph (d)(3)(i) of this section is to be determined by a fraction –

(1) The numerator of which is the total value of all qualified opportunity zone business property owned or leased by the qualified opportunity zone business that meets the requirements in paragraph (d)(2)(i) of this section, and

(2) The denominator of which is the total value of all tangible property owned or leased by the qualified opportunity zone business, whether located inside or outside of a qualified opportunity zone.

(B) *Value of tangible property owned or leased by a qualified opportunity zone business—*

(1) *In general*. For purposes of the fraction set forth in paragraph (d)(3)(ii)(A) of this section, on an annual basis, the owned or leased tangible property of a qualified opportunity zone business may be valued using the applicable financial statement valuation method set forth in paragraph (d)(3)(ii)(B)(2) of this section, if the qualified opportunity zone business has an applicable financial statement within the meaning of §1.475(a)-4(h), or the alternative valuation method set forth in paragraph (d)(3)(ii)(B)(3) of this section. During each taxable year, the valuation method selected under this paragraph (d)(3)(ii)(B)(1) must be applied consistently to all tangible property valued with respect to the taxable year.

(2) *Applicable financial statement valuation method—*

(i) *In general*. Under the applicable financial statement valuation method set forth in this paragraph (d)(3)(ii)(B)(2), the value of tangible property of the qualified opportunity zone business, whether owned or leased, is the value of that property as reported, or as otherwise would be reported, on the qualified opportunity zone business's applicable financial statement for the relevant reporting period.

(ii) *Requirement for selection of method.* A qualified opportunity zone business may select the applicable financial statement valuation method set forth in this paragraph (d)(3)(ii)(B)(2) to value tangible property leased by the qualified opportunity zone business only if the applicable financial statement of the qualified opportunity zone business requires, or would otherwise require, an assignment of value to the lease of the tangible property.

(3) *Alternative valuation method—*

(i) *In general*. Under the alternative valuation method set forth in this paragraph (d)(3)(ii)(B)(3), the value of tangible property that is owned by the qualified opportunity zone business is calculated under paragraph (d)(3)(ii)(B)(3)(ii), and the value of

tangible property that is leased by the qualified opportunity zone business is calculated under paragraph (d)(3)(ii)(B)(3)(iii).

(ii) *Tangible property owned by a qualified opportunity zone business*. The value of tangible property that is owned by the qualified opportunity zone business is the unadjusted cost basis of the property under section 1012 in the hands of the qualified opportunity zone business for each testing date of a QOF during the year.

(iii) *Tangible property leased by a qualified opportunity zone business—*

(A) *In general*. The value of tangible property that is leased by the qualified opportunity zone business is equal to the present value of the leased tangible property as defined in paragraph (d)(3)(ii)(B)(3)(iii)(C) of this section.

(B) *Discount rate*. For purposes of calculating present value under paragraph (d)(3)(ii)(B)(3)(iii) of this section, the discount rate is the applicable Federal rate under section 1274(d)(1), determined by substituting the term "lease" for "debt instrument."

(C) *Present value*. For purposes of paragraph (d)(3)(ii)(B)(3)(iii), present value of leased tangible property

(1) Is equal to the sum of the present values of each payment under the lease for such tangible property;

(2) Is calculated at the time the qualified opportunity zone business enters into the lease for such leased tangible property; and

(3) Once calculated, is used as the value for such asset by the qualified

opportunity zone business for all testing dates for purposes of the 90-percent asset test.

(D) *Term of a lease*. For purposes of paragraph (d)(3)(ii)(B)(3)(iii) of this section, the term of a lease includes periods during which the lessee may extend the lease at a pre-defined rent.

(C) *Five Percent Zone Taxpayer*. If 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 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. 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.

(A) *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.

(B) [Reserved]

(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 qualified opportunity zone*. If a qualified opportunity zone business 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 in relation to the qualified opportunity zone business'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 qualified opportunity zone business's adjusted basis of the building does not require the qualified opportunity zone business to separately substantially improve the land upon which the building is located.

(B) *Unimproved land*. Unimproved land that is within a qualified opportunity zone and acquired by purchase in accordance with section 1400Z-2(d)(2)(D)(i)(I) is not required to be substantially improved within the meaning of section 1400Z-2(d)(2)(D)(i)(II) and (d)(2)(D)(ii).

(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. A trade or business meets the 50-percent gross income requirement in the preceding sentence if the trade or business satisfies any one of the four criteria described in paragraph (d)(5)(i)(A), (B), (C), or (D), of this section, or any criteria identified in published guidance issued by the IRS under §601.601(d)(2).

(A) *Services performed in qualified opportunity zone based on hours*. At least 50 percent of the services performed for the trade or business are performed in the qualified opportunity zone, determined by a fraction--

(1) The numerator of which is the total number of hours performed by employees and independent contractors, and employees of independent contractors, for services performed in a qualified opportunity zone during the taxable year, and

(2) The denominator of which is the total number of hours performed by employees and independent contractors, and employees of independent contractors, for services performed during the taxable year.

(B) *Services performed in qualified opportunity zone based on amounts paid for services*. At least 50 percent of the services performed for the trade or business are performed in the qualified opportunity zone, determined by a fraction--

(1) The numerator of which is the total amount paid by the entity for services performed in a qualified opportunity zone during the taxable year, whether by employees, independent contractors, or employees of independent contractors, and

(2) The denominator of which is the total amount paid by the entity for services performed during the taxable year, whether by employees, independent contractors, or employees of independent contractors.

(C) *Necessary tangible property and business functions*. The tangible property of the trade or business located in a qualified opportunity zone and the management or operational functions performed in the qualified opportunity zone are each necessary for the generation of at least 50 percent of the gross income of the trade or business.

(D) *Facts and circumstances*. Based on all the facts and circumstances, 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.

(E) *Examples*. The following examples illustrate the principles of paragraph (d)(5)(i)(C) and (d)(5)(i)(D) of this section.

(1) *Example 1*. A landscaping business has its headquarters in a qualified opportunity zone, its officers and employees manage the daily operations of the business (within and without the qualified opportunity zone) from its headquarters, and all its equipment and supplies are stored in the headquarters facilities. The activities occurring and the storage of equipment and supplies in the qualified opportunity zone are, taken together, a material factor in the generation of the income of the business.

(2) *Example 2*. A trade or business is formed or organized under the laws of the jurisdiction within which a qualified opportunity zone is located, and the business has a PO Box located in the qualified opportunity zone. The mail received at that PO Box is fundamental to the income of the trade or business, but there is no other basis for concluding that the income of the trade or business is derived from activities in the qualified opportunity zone. The mere location of the PO Box is not a material factor in the generation of gross income by the trade or business.

(3) *Example 3*. In 2019, Taxpayer X realized $w million of capital gains and within the 180-day period invested $w million in QOF Y, a qualified opportunity fund. QOF Y immediately acquired from partnership P a partnership

interest in P, solely in exchange for $w million of cash. P is a real estate developer that has written plans to acquire land in a qualified opportunity zone on which it plans to construct a commercial building for lease to other trades or businesses. In 2023, P's commercial building is placed in service and is fully leased up to other trades or businesses. For the 2023 taxable year, because at least 50 percent of P's gross income is derived from P's rental of its tangible property in the qualified opportunity zone. Thus, under P's facts and circumstances, P satisfies the gross income test under section 1397C(b)(2).

(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. For purposes of section 1400Z-2(d)(3)(ii) and the preceding sentence, the term substantial portion means at least 40 percent.

(B) *Active conduct of a trade or business* –

(1) *In general*. [Reserved]

(2) *Operating real property*. Solely for the purposes of section 1400Z-2(d)(3)(A), the ownership and operation (including leasing) of real property is the active conduct of a trade or business. However, merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business by such taxpayer.

(3) *Trade or business defined*. The term trade or business means a trade or business within the meaning of section 162.

(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 development of a trade or business in a qualified opportunity zone (as defined in section 1400Z–1(a)), including when appropriate the acquisition, construction, and/or substantial improvement of tangible property in such a zone.

(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. If consumption of the working capital assets is delayed by waiting for governmental action the application for which is complete, that delay does not cause a failure of this paragraph (d)(5)(iv)(C).

(D) *Ability of a single business to benefit from more than a single application of the safe harbor*. A business may benefit from multiple overlapping or sequential applications of the working capital safe harbor, provided that each application independently satisfies all of the requirements in paragraph (d)(5)(iv)(A) through (C) of this section.

(E) *Examples*. The following examples illustrate the rules of paragraph (d)(5)(iv) of this section.

(1) *Example 1. General application of working capital safe harbor—*

(i) *Facts*. QOF F creates a business entity E to open a fast-food restaurant and acquires almost all of the equity of E in exchange for cash. E has a written

plan and a 20-month schedule for the use of this cash to establish the restaurant. Among the planned uses for the cash are identification of favorable locations in the qualified opportunity zone, leasing a building suitable for such a restaurant, outfitting the building with appropriate equipment and furniture (both owned and leased), necessary security deposits, obtaining a franchise and local permits, and the hiring and training of kitchen and wait staff. Not-yet-disbursed amounts were held in assets described in section 1397C(e)(1), and these assets were eventually expended in a manner consistent with the plan and schedule.

(ii) *Analysis*. E's use of the cash qualifies for the working capital safe harbor described in paragraph (d)(5)(iv) of this section.

(2) *Example 2. Multiple applications of working capital safe harbor—*

(i) *Facts*. QOF G creates a business entity H to start a new technology company and acquires equity of H in exchange for cash on Date 1. In addition to H's rapid deployment of capital received from other equity investors, H writes a plan with a 30-month schedule for the use of the Date 1 cash. The plan describes use of the cash to research and develop a new technology (Technology), including paying salaries for engineers and other scientists to conduct the research, purchasing, and leasing equipment to be used in research and furnishing office and laboratory space. Approximately a year-and-a-half after Date 1, on Date 2, G acquires additional equity in H for cash, and H writes a second plan. This new plan has a 25-month schedule for the development of a new application of existing software (Application), to be marketed to government agencies. Among the planned uses for the cash received on Date 2 are paying development costs, including salaries for software engineers, other employees, and third-party consultants to assist in developing and marketing the new application to the anticipated customers. Not-yet-disbursed

amounts that were scheduled for development of the Technology and the Application were held in assets described in section 1397C(e)(1), and these assets were eventually expended in a manner substantially consistent with the plans and schedules for both the Technology and the Application.

(ii) *Analysis*. H's use of both the cash received on Date 1 and the cash received on Date 2 qualifies for the working capital safe harbor described in paragraph (d)(5)(iv) 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) *Real property straddling a qualified opportunity zone*. For purposes of satisfying the requirements in this paragraph (d)(5), when it is necessary to determine whether a qualified opportunity zone is the location of services, tangible property, or business functions, section 1397C(f) applies (substituting "qualified opportunity zone" for "empowerment zone"). If the amount of real property based on square footage located within the qualified opportunity zone is substantial as compared to the amount of real

property based on square footage outside of the qualified opportunity zone, and the real property outside of the qualified opportunity zone is contiguous to part or all of the real property located inside the qualified opportunity zone, then all of the property is deemed to be located within a qualified opportunity zone.

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

(A) *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.

(B) *Analysis of construction—*

(1) 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).

(2) 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).

(3) 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.

(4) 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).

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

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

(i) Any private or commercial golf course,

(ii) Country club,

(iii) Massage parlor,

(iv) Hot tub facility,

(v) Suntan facility,

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

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

(e) *Exceptions based on where an entity is created, formed, or organized—*

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

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

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

(f) *Applicability date*. This section applies for QOF taxable years that begin on or after the date of publication in the Federal Register of a Treasury decision adopting these proposed rules as final regulations. A QOF, however, may rely on the proposed rules in this section with respect to taxable years that begin before the date of applicability of this section, but only if the QOF applies the rules in their entirety and in a consistent manner. Notwithstanding the preceding sentence, a QOF may not rely on the proposed rules in paragraphs (c)(8)(ii)(B) and (d)(4)(ii)(B) of this section (which concern the qualification of land as QOZBP) if the land is unimproved or minimally improved and the QOF or the QOZB purchases the land with an expectation, an intention, or a view not to improve the land by more than an insubstantial amount within 30 months after the date of purchase.

§1.1400Z2(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):

(i) 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 § 1.752–3(a), 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).

(ii) [Reserved]

(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.

§1.1400Z2(f)-1 Failure of qualified opportunity fund to maintain investment standard.

(a) *In general*. Except as provided by §1.1400Z2(d)-1(a)(2)(ii) with respect to a taxpayer's first taxable year as a QOF, if a QOF fails to satisfy the 90-percent asset test in section 1400Z-2(d)(1), then the fund must pay the statutory penalty set forth in section 1400Z-2(f) for each month it fails meet the 90-percent asset test.

(b) *Time period for a QOF to reinvest certain proceeds*. If a QOF receives proceeds from the return of capital or the sale or disposition of some or all of its qualified opportunity zone property within the meaning of section 1400Z-2(d)(2)(A), and if the QOF reinvests some or all of the proceeds in qualified opportunity zone property by the last day of the 12-month period beginning on the date of the distribution, sale, or disposition, then the proceeds, to the extent that they are so reinvested, are treated as qualified opportunity zone property for purposes of the 90-percent asset test in section 1400Z-2(d)(1), but only to the extent that prior to the reinvestment in qualified opportunity zone property the proceeds are continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less. If reinvestment of the proceeds is delayed by waiting for governmental action the application for which is complete, that delay does not cause a failure of the 12-month requirement in this paragraph (b).

(c) *Anti-abuse rule—*

(1) *In general*. Pursuant to section 1400Z-2(e)(4)(C), the rules of section 1400Z-2 and §§1.1400Z2(a)-1 through 1.1400Z2(g)-1 must be applied in a manner consistent with the purposes of section 1400Z-2. Accordingly, if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of section 1400Z-2, the Commissioner can recast a transaction (or series of transactions) for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 1400Z-2. Whether a tax result is inconsistent with the purposes of section 1400Z-2 must be determined based on all the facts and circumstances.

(2) [Reserved].

(d) *Applicability date*. This section applies to taxable years of a QOF that end on or after the date of publication in the Federal Register of a Treasury decision adopting these proposed rules as final regulations. However, an eligible taxpayer may rely on the proposed rules in this section (other than paragraph (c) of this section) with respect to taxable years before the date of applicability of this section, but only if the eligible taxpayer applies the rules in their entirety and in a consistent manner. An eligible taxpayer may rely on the proposed rules in paragraph (c) of this section with respect to taxable years before the date of applicability of this section, but only if the eligible taxpayer applies the rules of section 1400Z-2 and §§1.1400Z2(a)-1 through 1.1400Z2(g)-1, as applicable, in their entirety and in a consistent manner.

§1.1400Z2(g)-1 Application of opportunity zone rules to members of a consolidated group.

(a) *Scope and Definitions—*

(1) *Scope*. This section provides rules regarding the Federal income tax treatment of QOFs owned by members of consolidated groups.

(2) *Definitions*. The definitions provided in §1.1400Z2(b)-1(a)(2) apply for purposes of this section.

(b) *QOF stock not stock for purposes of affiliation—*

(1) *In general*. Stock in a QOF corporation (whether qualifying QOF stock or otherwise) is not treated as stock for purposes of determining whether the issuer is a member of an affiliated group within the meaning of section 1504. Therefore, a QOF corporation can be the common parent of a consolidated group, but a QOF corporation cannot be a subsidiary member of a consolidated group.

(2) *Example*. The following example illustrates the rules of this paragraph (b).

(i) *Facts*. Corporation P wholly owns corporation S, which wholly owns corporation Q. P, S, and Q are members of a U.S. consolidated group (P group). In 2018, S sells an asset to an unrelated party and realizes $500 of capital gain. S contributes $500 to Q and properly elects to defer recognition of the gain under section 1400Z-2. At such time, Q qualifies and elects to be treated as a QOF.

(ii) *Analysis*. Under paragraph (b) of this section, stock of a QOF (qualifying or otherwise) is not treated as stock for purposes of affiliation under section 1504. Thus, once Q becomes a QOF, Q ceases to be affiliated with the P group members under section 1504(a), and it deconsolidates from the P group.

(c) *Qualifying investments by members of a consolidated group*. Except as otherwise provided in this section or in §1.1400Z2(b)-1, section 1400Z-2 applies separately to each member of a consolidated group. Therefore, for example, the same member of the group must both engage in the sale of a capital asset giving rise to gain and timely invest an amount equal to some or all of such gain in a QOF (as provided in section 1400Z-2(a)(1)) in order to qualify for deferral of such gain under section 1400Z-2.

(d) *Tiering up of investment adjustments provided by section 1400Z-2*. Basis increases in a qualifying investment in a QOF under sections 1400Z-2(b)(2)(B)(iii), 1400Z-2(b)(2)(B)(iv), and 1400Z-2(c) are treated as satisfying the requirements of §1.1502-32(b)(3)(ii)(A), and thus qualify as tax-exempt income to the QOF owner. Therefore, if

the QOF owner is a member of a consolidated group and is owned by other members of the same group (upper-tier members), the group members increase their bases in the shares of the QOF owner under §1.1502-32(b)(2)(ii). However, there is no basis increase under §1.1502-32(b)(2)(ii) in shares of upper-tier members with regard to basis increases under section 1400Z-2(c) and the regulations thereunder unless and until the basis of the qualifying investment is increased to its fair market value, as provided in section 1400Z-2(c) and the regulations thereunder.

(e) *Application of §1.1502-36(d)*. This paragraph (e) clarifies how §1.1502-36(d) applies if a member (M) transfers a loss share of another member (S) and S is a QOF owner that owns a qualifying investment in a QOF. To determine S's attribute reduction amount under §1.1502-36(d)(3), S's basis in its qualifying investment is included in S's net inside attribute amount to compute S's aggregate inside loss under §1.1502-36(d)(3)(iii)(A). However, S's basis in the qualifying investment is not included in S's category D attributes available for attribute reduction under §1.1502-36(d)(4). Thus, S's basis in the qualifying investment cannot be reduced under §1.1502-36(d). If S's attribute reduction amount exceeds S's attributes available for reduction, then to the extent of S's basis in the qualifying investment (limited by the remaining attribute reduction amount), the common parent is treated as making the election under §1.1502-36(d)(6) to reduce M's basis in the transferred loss S shares.

(f) *Examples*. The following examples illustrate the rules of this section.

(1) *Example 1. Basis adjustment when member owns qualifying QOF stock—*

(i) *Facts*. Corporation P is the common parent of a consolidated group (P group), and P wholly owns Corporation S, a member of the P group. In 2018, S sells an asset to an unrelated party and realizes $500 of capital gain. S contributes $500 to Q (a QOF corporation) and properly elects to defer the gain under section 1400Z-2(a) and §1.1400Z2(a)-1. S does not otherwise own stock in Q. In 2029, when S still owns its qualifying investment in Q, P sells all of the stock of S to an unrelated party.

(ii) *Analysis—*

(A) *5-year and 7-year basis increase and §1.1502-32 tier-up*. In 2023, when S has held the stock of Q for five years, under section 1400Z-2(b)(2)(B)(iii), S increases its basis in its Q stock by $50 (10 percent of $500, the amount of gain deferred by reason of section 1400Z-2(a)(1)(A)). The 10-percent basis increase qualifies as tax-exempt income to S under paragraph (d) of this section. Thus, P (an upper-tier member) increases its basis in S's stock by $50 under §1.1502-32(b)(2)(ii). Similarly, in 2025, when S has held the stock of Q for seven years, under section 1400Z-2(b)(2)(B)(iv), S increases its basis in its Q stock by an additional

$25 (5 percent of $500). The 5 percent basis increase also qualifies as tax-exempt income to S under paragraph (d) of this section, and P increases its basis in S's stock by an additional $25 under §1.1502-32(b)(2)(ii).

(B) *S's recognition of deferred capital gain in 2026*. S did not dispose of its Q stock prior to December 31, 2026. Therefore, under section 1400Z-2(b)(1)(B) and §1.1400Z2(b)-1(b)(2), S's deferred capital gain is included in S's income on December 31, 2026. The amount of gain included under section 1400Z-2(b)(2)(A) is $425 ($500 of deferred gain less S's $75 basis in Q). S's basis in Q is increased by $425 to $500, and P's basis in S also is increased by $425.

(C) *P's disposition of S. P's sale of S stock in 2029 results in the deconsolidation of S*. Q remains a non-consolidated subsidiary of S, and S is not treated as selling or exchanging its Q stock for purposes of section 1400Z-2(c). Therefore, no basis adjustments under section 1400Z-2 are made as a result of P's sale of S stock.

(iii) *S sells the stock of Q after 10 years*. The facts are the same as in paragraph (i) of this Example 1, except that in 2029, instead of P selling all of the stock of S, S sells all of the stock of Q to an unrelated party for its fair market value of $800. At the time of the sale, S has owned the Q stock for over 10 years, and S elects under section 1400Z-2(c) to increase its stock basis in Q from $500 (see the analysis in paragraph (ii)(B) of this Example 1) to the fair market value of Q on the date of the sale, $800. As a result of the election, S's basis in Q is $800 and S has no gain on the sale of Q stock. Additionally, the $300 basis increase in Q is treated as tax-exempt income to S pursuant to paragraph (d) of this section. Thus, P increases its basis in P's S stock by $300 under §1.1502-32(b)(2)(ii).

(2) *Example 2. Computation and application of the attribute reduction amount under §1.1502-36(d) when S owns a QOF—*

(i) *Facts*. Corporation P (the common parent of a consolidated group) wholly owns corporation M, which wholly owns corporation S, which wholly owns Q (a QOF corporation). In 2018, S sells an asset to an unrelated party and realizes $5,000 of capital gain. S contributes $5,000 to Q and properly elects to defer the gain under section 1400Z-2. In 2024, M sells all of its S stock to an unrelated party for fair market value of $100, and M's basis in the stock of S is $300. At the time of sale, S owns the stock of Q with a basis of $500 (S's basis in Q was increased under section 1400Z-2(b)(2)(B)(iii) to $500 in 2023), and S has a net operating loss carryover of $50. M's transfer of the S shares is a transfer of loss shares under

§1.1502-36. Assume that no basis redetermination is required under §1.1502-36(b) and no basis reduction is required under §1.1502-36(c).

(ii) *Attribute reduction under §1.1502-36(d).* Under §1.1502-36(d), S's attributes are reduced by S's attribute reduction amount. Section 1.1502-36(d)(3) provides that S's attribute reduction amount is the lesser of the net stock loss and S's aggregate inside loss. The net stock loss is the excess of the $300 aggregate basis of the transferred S shares over the $100 aggregate value of those shares, or $200. S's aggregate inside loss, which includes the basis of the stock of Q as provided by paragraph (e) of this section, is the excess of S's net inside attribute amount over the value of the S share. S's net inside attribute amount is $550, computed as the sum of S's $50 loss carryover and its $500 basis in Q. S's aggregate inside loss is therefore $450 ($550 net inside attribute amount over the $100 value of the S share). Accordingly, S's attribute reduction amount is the lesser of the $200 net stock loss and the $450 aggregate inside loss, or $200. Under §1.1502-36(d)(4), S's $200 attribute reduction is first allocated and applied to reduce S's $50 loss carryover to $0. Under §1.1502-36(d)(4)(i)(D), S generally would be able to reduce the basis of its category D assets (including stock in other corporations) by the remaining attribute reduction amount ($150). However, paragraph (e) of this section provides that S's basis in the QOF (Q) shares is not included in S's category D attributes that are available for reduction under §1.1502-36(d)(4), and the remaining $150 of attribute reduction amount cannot be used to reduce the basis of Q shares under §1.1502-36(d). Rather, under paragraph (e) of this section, P is treated as making the election under §1.1502-36(d)(6) to reduce M's basis in the transferred loss S shares by $150. As a result, P's basis in its M stock will also be reduced by $150.

(g) *Applicability date.* Except as otherwise provided in this paragraph (g), this section applies for 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. However, a QOF may rely on the proposed rules in this section with respect to taxable years that begin before the applicability date of this section, but only if the QOF applies the rules in their entirety and in a consistent manner.