Investments in Qualified Opportunity Funds: Newly Proposed Regulations Offer Significant Clarification

October 25, 2018

The 2017 Tax Cuts and Jobs Act offers generous tax incentives for taxpayers investing in "qualified opportunity funds" ("**QOFs**")—entities that invest in businesses located within "qualified opportunity zones." The tax incentives are designed to encourage long-term investments in economically distressed communities by permitting taxpayers to defer tax on capital gain reinvested in the designated zones and to eliminate tax on any additional appreciation in the new QOF investment. The U.S. Treasury has certified over 8,700 communities as qualified opportunity zones, spanning all 50 states, the District of Columbia, and five U.S. territories including Puerto Rico and the U.S. Virgin Islands.[1]

On October 19, 2018, the Treasury Department and the Internal Revenue Service issued proposed regulations that address many of the significant questions arising under the new legislation, but important questions remain.

The proposed regulations clarify, among other things, that:

- Either a partnership or its partners may elect to roll partnership gains into QOF investments;
- QOF investors need not sell their QOF investments when opportunity zone designations expire in 2028 in order to eliminate tax on all post-investment appreciation in their QOF investments—QOF investments can be sold as late as 2047;
- QOF investors need not hold the same QOF investment for 10 years, but are permitted to roll a QOF investment into another QOF investment;
- QOFs that invest in opportunity zones through lower-tier entities can hold as little as 63% of their tangible assets in opportunity zones;
- QOFs that invest in opportunity zones through lower-tier entities will have at least 31 months from receipt of cash proceeds from investors to acquire and develop real property in qualified opportunity zones; and
- "Substantial improvements" to land purchased with existing buildings are measured only with respect to the portion of total purchase price allocable to the building, potentially significantly reducing required improvement expenditures.

However, several important questions remain unanswered, including:

- The effects of leverage in QOF structures involving partnerships; and
- The basis of assets acquired by a QOF with tax-deferred capital gain proceeds.

While the regulations are not proposed to be effective until they are issued in final form, taxpayers may rely on them before they become effective if applied consistently. (Some questions were also addressed in a simultaneously issued Internal Revenue Service revenue ruling, upon which taxpayers are presently entitled to rely.)

---

[1] A map depicting the designated zones can be found at https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml. The designation process is now complete.

This memorandum first describes the potential tax benefits available for qualified opportunity zone investments and basic QOF structuring alternatives and then highlights key implications of the proposed regulations on real estate investments within qualified opportunity zones.

Tax Benefits Available for Qualified Opportunity Zone Investments

Two significant tax benefits are potentially available for taxpayers investing in QOFs:

- **Deferral of capital gain on investments until 2026 (and permanent exclusion of up to 15% of such gain) to the extent corresponding amounts are invested in QOFs within 180 days**
  - Taxpayers who recognize capital gain from sale or disposition of investments (e.g., stock portfolio investments) can elect to defer recognizing the gain if they invest corresponding amounts in equity interests in QOFs within 180 days of the sale or disposition.[2]
  - The taxpayer's initial tax basis in the QOF investment is zero, but the basis is stepped up to 10% of the deferred gain if the QOF is held for five years, and again by an additional 5% if the investment is held for seven years.
  - Recognition of the gain is deferred until the earlier of the year the QOF interest is sold or December 31, 2026. The amount recognized in 2026 is the lower of the deferred gain and the fair market value of the QOF investment as of December 31, 2026 over any basis step-up as described above.
- **Permanent exclusion from gross income of all appreciation on investment in QOFs held for at least 10 years**
  - If the taxpayer holds the QOF investment interest for at least ten years, the taxpayer can elect to step up the basis in the QOF investment to fair market value on the date the investment is sold or disposed of.
  - For example, an investor who sells stock in 2019 for a $1 million capital gain, invests $1 million in an eligible interest in a QOF within 180 days of the stock sale, and then sells the QOF interest in 2029 for $10 million, could elect to receive a step-up in basis in the QOF interest to $10 million immediately before the 2029 sale and pay no federal income tax on the $9 million of gain on the QOF investment.[3]

General tax rules apply to the operating income earned by QOFs.[4]

---

[2] Unlike the strict tracing rules that apply to Section 1031 exchanges, there is no requirement that the actual proceeds arising from the realization of capital gains be reinvested in the QOZ investment. Thus, for example, an investor can qualify for the benefits by selling property with built-in gain, reinvesting the proceeds elsewhere, and using funds from other sources (including secured financing) to invest an amount corresponding to the gain in a QOF.

[3] As described above, 85% of the original deferred $1 million gain would have been recognized in 2026.

[4] If the QOF is treated as a partnership for tax purposes, income and deductions will flow through to investors as in the case of any partnership investment, and the new 20% pass-through deduction may be available to investors if the requirements of those rules are satisfied. If the QOF is treated as a corporation for tax purposes, the QOF will be subject to tax at the new 21% corporate tax rate, and distributions of earnings to investors will be taxable as dividend income, as in the case of any corporate investment. A corporation that elects to be treated as a REIT may also qualify as a QOF. Note that ordinary dividends distributed by a REIT will also be eligible for the 20% pass-through deduction.

Basic QOF Structuring Alternatives

A QOF can be any legal entity that is classified for U.S. tax purposes as a partnership or corporation, whether or not it is organized as a partnership or corporation in legal form. It must be organized under the laws of a U.S. state, the District of Columbia, or a U.S. possession.[5]

A QOF must maintain an average of 90% of its assets invested in "**QOZ property**," measured as of the middle and end of its tax year.[6] QOZ property includes "**QOZ stock**," "**QOZ partnership interests**," and "**QOZ business property**."

- QOZ business property is tangible property acquired by purchase after December 31, 2017, the original use of which commences with the QOF (or, as described below, a lower-tier QOZ business) or is "substantially improved" by the QOF or QOZ business. Property is considered to be substantially improved if, during any 30-month period, the QOF or QOZ business improves the property by more than the amount of the adjusted basis of the property at the beginning of the 30-month period in the hands of the QOF or QOZ business. The rules also requires that for substantially all of the QOF's holding period, substantially all of the use of the property must be within a QOZ.
- QOZ stock and QOZ partnership interests are stock or partnership interests acquired for cash from a corporation at original issue or from a partnership that is, in each case, a "**QOZ business**" at the time of such acquisition and remains a QOZ business for substantially all of the QOF's holding period.
- A QOZ business, in turn, is a business in which "substantially all" of the tangible property is QOZ business property and certain other conditions are satisfied. The proposed regulations provide that this "substantially all" requirement is satisfied if at least 70% of the tangible property owned or leased[7] by the business is QOZ business property.
    - A QOZ business must also derive at least 50% of its gross income from the active conduct of a business in a qualified opportunity zone, may not hold more than 5% of the unadjusted bases of its assets in "nonqualified financial property" (discussed below), and may not be an excluded business (e.g., a golf course, country club, liquor store or massage parlor).

Because 100% of an interest in a QOZ business is considered QOZ property, it is much easier for a QOF to satisfy the 90% QOZ property requirement by holding QOZ stock or QOZ partnership interests rather than by holding QOZ business property directly. The preamble to the proposed regulations acknowledges this incentive to structure QOF investments with lower-tier QOZ businesses.

A simplified diagram depicting these three structural options is set forth on the next page.

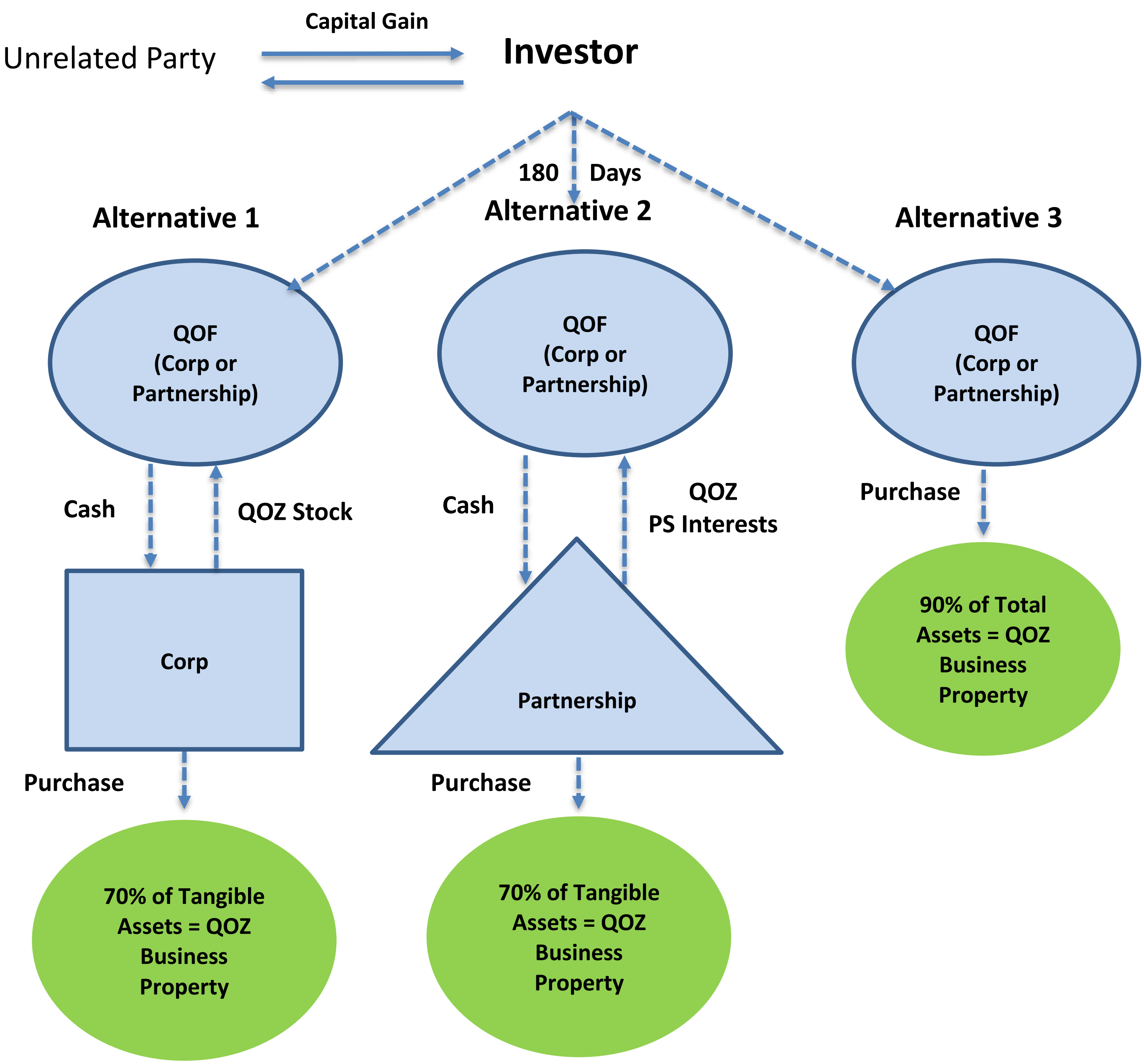
---

[5] Special rules apply in the case of QOFs organized under the laws of U.S. possessions.

[6] As described below, the proposed regulations include rules for the valuation of assets.

[7] The rules appear to have been intended to count tangible property whether it is owned or leased, but it is difficult to reconcile that intention with the statutory requirement that the property be "acquired by purchase" in order to qualify as QOZ business property.

QOF Structural Alternatives



Key Takeaways

1. Deferring Tax on Gain by Investing in Opportunity Zones

- **Only capital gain is eligible for deferral** – Although the text of the statute would appear to offer the deferral benefits with respect to any "gain" from the disposition of any "property," the proposed regulations limit eligible gain to gain treated as *capital* gain for tax purposes. This means that, under the proposed regulations, gain that is treated as ordinary income will not be eligible for deferral.
    - *Gain from sales of tangible property* – Generally, under Section[8] 1231, gain recognized on the sale of property used in a trade or business for more than one year is treated as capital gain and so should be eligible for deferral if invested in a QOF. Depreciation recapture on Section 1245 property (e.g., equipment), however, is treated as ordinary income and thus is not eligible gain. Unrecaptured Section 1250 gain (i.e., gain attributable to the straight-line depreciation of real property (which is subject to a special 25% tax rate)) should not be excluded because it is treated as capital gain.
    - *Gain from stock sales* – Most gain from sales of stock will be capital gain.
    - *Gain passed through to partners via profits interests and promotes* – Capital gain allocated to partners who hold a profits interest or promote is eligible gain.
- **Gain must be from sale to unrelated party** – Related person status generally requires at least a 20% ownership relationship or a specific familial relationship with the taxpayer.
- **Gain must be from taxable transaction arising before 2027** – It is also required that the gain "would be recognized for Federal tax purposes" before January 1, 2027 in order for the taxpayer to make the election to defer the gain by investing it in a QOF. As a result, gain that is "realized" but not "recognized" under, for example, Sections 351 or 721 is not eligible.
- **Special rules for Section 1256 contracts and offsetting positions transactions** – The proposed regulations limit the deferral of gain from Section 1256 contracts to the net capital gain from all Section 1256 contracts of the taxpayer for the tax year. Gain from a position that is or has been part of an "offsetting positions transaction" where risk of loss is substantially diminished is not eligible for deferral.
- **Partial or staggered deferral election available –** A deferral election may be made with respect to some or all of the amount of eligible gain, and if an election is made with respect to a portion of eligible gain, a subsequent election may be made for other portions of the gain provided the investment is made within the 180-day window.
- **Taxpayers eligible to elect deferral** – Any taxpayer that recognizes gain for U.S. federal tax purposes may elect to defer gain invested in a QOF. This includes individuals, corporations (including RICs, REITs, and S corporations), partnerships, trusts and estates.
    - *Optionality for gain recognized by partnerships and other pass-through entities* – The proposed regulations offer special options in the case of gain recognized at the level of a pass-through entity such as a partnership. The partnership itself is entitled to make the deferral election, but if it does not do so, individual partners may make the deferral election with respect to the portion of partnership gains allocable to them. This flexibility has important timing significance with respect to the 180-day period, as discussed below.

[8] "Section" references are to the Internal Revenue Code of 1986, as amended.

  - *Non-U.S. investors* – The statute and proposed regulations do not require investors to be U.S. persons in order to take advantage of the tax benefits of an investment in a QOF. For example, foreign investors who recognize capital gain from the disposition of a U.S. real property interest may benefit from investing in a QOF.

- **180-day period for deferring gain** – The 180-day period begins on the date that gain otherwise would have been required to be recognized. For example, capital gain dividends from a RIC or REIT are includible when paid and the 180-day period starts at payment, while for undistributed capital gain that is required to be included in income, the 180-day period starts from the last day of the taxable year of the RIC or REIT.

  - *Timing considerations for partnerships and partners* – In the case of a partnership that recognizes capital gain, the partnership may itself elect to invest corresponding amounts in QOFs within 180 days of sale and defer recognition of the gain at the partnership level. If the partnership does not elect to do so, individual partners have 180 days from the last day of the tax year in which the partnership's gain is recognized to reinvest their distributive shares of the gain (or they may alternatively elect to count the 180 days as of the date of the partnership's recognition of the gain). Partners in a non-electing partnership thus will often have significantly more than 180 days from sale to reinvest gain recognized by the partnership. This is especially significant for gain recognized by calendar-year partnerships in 2018 as it allows partners to reinvest gain recognized by partnerships in early 2018 within 180 days after December 31, 2018. An analogous rule applies to other pass-through entities such as S corporations.

    - *Observation* – Because partners are required to make QOF investments with respect to partnership gains within 180 days of the close of the partnership taxable year, partners may seek to have their partnerships report the partners' share of capital gains earlier than is current common practice so that they have sufficient time to invest in QOFs.

  - *Gain from sale of QOF interests can also be deferred* – If a QOF investment is sold before December 31, 2026, the QOF investment will have been held for less than 10 years and thus will be ineligible for the 100% basis step-up. However, if amounts up to the amount of gain that would be recognized on the sale of the original QOF investment are invested within 180 days in a new QOF, the proposed regulations provide that the taxpayer may defer recognition of those amounts. Such gain is eligible for deferral only if the taxpayer's entire investment in the first QOF is sold.

    - *Observation* – If the first QOF investment has appreciated, it is unclear from the proposed regulations what amount of gain must be recognized as of December 31, 2026. For example, if an investor has $20 of capital gain in 2022 and purchases an interest in a QOF for $20 within 180 days, then sells the QOF interest for $100 in 2024 and invests $100 in a new QOF within 180 days, it is unclear whether the investor must recognize $20 or $100 as of December 31, 2026 (assuming the QOF is worth at least $100 as of December 31, 2026). It is also unclear whether such a rollover causes the 10-year holding period for a basis step-up to reset.

- **Attributes of original gain preserved when gain deferral ends** – Deferred gain retains its tax attributes when it is later included in income. Accordingly, for example, gain that would have been short-term capital gain or gain from a Section 1256 contract when a deferral election was made will be treated as short-term capital gain or as gain from a Section 1256 contract upon its later inclusion in income.

- **Eligible interests in a QOF include preferred equity** – Only equity interests in a QOF are eligible for deferral, but this includes preferred stock and partnership interests with special allocations.

    - *Profits interests* – If a taxpayer with eligible gain contributes only services to a QOF in return for a profits interest, the contribution would not seem to constitute an "amount invested by the taxpayer" in the QOF as required by the statute and thus would not be eligible for deferral and basis step-up. The proposed regulations do not specifically address this question.

- **No restrictions on using QOF investments as loan collateral** – The proposed regulations specify that the status of a QOF investment as an eligible investment is not impaired by using the QOF interest as collateral for a loan, whether part of a purchase-money borrowing or otherwise.

2. Eliminating Tax on Appreciation in Opportunity Zone Investments

- **Mixed investments and the 10-year step-up election** – The election to step up to fair market value the tax basis in a QOF investment held for at least 10 years may be made only with respect to QOF investments as to which initial gain deferral elections were made. If a taxpayer invests excess amounts in QOF interests, the proposed regulations treat the QOF investment as two separate investments that receive different treatment for tax purposes.

    - *Partnership leverage* – If a QOF is treated as a partnership for tax purposes, under general tax principles each partner is treated as having made a contribution of money to the partnership in respect of its share of partnership liabilities. The proposed regulations provide that this deemed contribution is not treated as a separate investment in a QOF.

        - *Observation* – Because this deemed contribution is not treated as a separate investment, the basis in the investment in the QOF can be stepped up to its full fair market value. However, because the amount realized on the sale of a partnership interest includes the reduction of the partner's share of the partnership's liabilities as well as the amount paid for the equity interest, this rule creates the perhaps unintended result that the step-up will not eliminate the gain recognizable as a result of the reduction in the partner's share of partnership liabilities.[9]

- **10-year step-up election available well after qualified opportunity zone designations expire in 2028** – The proposed regulations address a significant timing concern relating to the interplay between the 10-year holding period requirement for QOF basis step-ups and the scheduled expiration of qualified opportunity zone designations in 2028. The question had been whether investors would be required to sell QOF investments before the zone designations expire in order to claim the step-up benefit. This concern raised the possibility that investments made after 2018 could not have qualified for the step-up election. It also raised the issue of potentially devastating "fire sale" market conditions in low-income communities in 2028. The proposed regulations address these concerns by providing that sales of QOF investments through 2047 will be eligible for the basis step-up election regardless of whether the zone designation has expired at the time of the sale.

    - *Observation* – Additionally, Treasury has requested comments as to whether an investor should be permitted to step up its basis in the QOF investment before December 31, 2047 even without selling the QOF investment. This suggestion makes sense; it is consistent with the goal of encouraging long-term investments within these designated low-income communities.

---

[9] An example is included below under "Remaining Uncertainties—Leverage."

- **Appreciation on profits interests and promotes** – Neither the statute nor the proposed regulations specifically address whether all appreciation in a QOF interest will be entitled to the 10-year step-up when eligible gain is invested in exchange for a partnership interest in a QOF that also entitles the investor to a profits or "promote" interest. For example, assume a real estate operator triggered $50,000 of capital gain and invested it in a QOF organized as a partnership that owned $5,000,000 of property in exchange for an interest therein entitling the operator to 20% of the profits generated by the QOF. It seems clear that the operator could elect to defer tax on the $50,000 of gain, but could the operator sell its interest 10 years after acquiring it and step up its basis in the partnership interest to fair market value in conjunction with the sale? The proposed regulations provide that partnership interests with special allocations qualify as eligible QOF investments but do not specifically address the issue of profits and promote interests.
- **Accounting for staggered sales of QOF interests** – If an investor holds identical interests in a QOF that were acquired at different times and then sells some but not all of these interests, a first-in-first-out method applies for determining which interests were sold for purposes of counting the holding period and for the character of gain to be included. If all of the interests an investor holds were purchased on the same day and they have different gain characteristics, then the determination is made on a pro-rata basis.

3. Qualifying as a QOF

- **Flexibility as to legal form of QOF entity** – As noted above, the proposed regulations clarify that a QOF can be any legal entity that is classified for U.S. tax purposes as a partnership or corporation, whether or not it is a partnership or corporation in legal form. This means that entities organized as limited liability companies or trusts can qualify as QOFs so long as they are not single-member LLCs or grantor trusts that are disregarded as separate entities for tax purposes. The QOF must be organized under the laws of a U.S. state, the District of Columbia, or a U.S. possession.
  - *U.S. possessions* – A QOF may be organized under the laws of a U.S. possession but only if it is organized for the purpose of investing in QOZ property that relates to a trade or business operated in the U.S. possession in which the entity is organized.
- **Pre-existing entities** – There is no legal barrier to a pre-existing entity becoming a QOF. However, the pre-existing entity must satisfy the 90% asset test, which includes the requirement that the underlying QOZ business property be acquired by purchase after December 31, 2017.
- **Timing for QOF designation election and self-certification** – Although no IRS pre-approval is required for entities seeking to qualify as QOFs, a deferral election for gain invested in a QOF cannot be made before the entity's self-certification as a QOF is effective. The QOF self-certifies by filing a Form 8996 at the end of the taxable year and specifying the first month in the taxable year during which the entity is a QOF, which need not be the first month of its taxable year. Form 8996 also requires that the QOF certify that by the end of its first QOF year its organizing documents include a statement of purpose of investing in QOZ property and a description of the QOZ business. The entity must meet the average 90% asset test measured as of six months from the month in which it specifies it is a QOF and as of the end of the taxable year in which it certifies. (If there are less than six months left in the first taxable year, the entity must meet the 90% asset test only at the end of the taxable year.)
  - *Observation* – This may create some tension between investors' 180-day timing considerations and the QOF's own asset test timing considerations as an investor may have gain to rollover more than 180 days before an entity is ready to self-certify as a QOF and meet the asset test requirements. Careful consideration should be given to these factors when the QOF determines which month to specify for its designation election.

- **Valuation of assets for purposes of the QOF's 90% asset test** – The QOF is required to hold 90% of its assets in QOZ property determined by the average of the percentage measured on the last day of the first six-month period of the taxable year and the last day of the taxable year. The proposed regulations provide that the value of each asset of the QOF for purposes of the 90% asset test (as well as for purposes of the 70% "substantially all" test discussed immediately below, applicable to the QOF's interests in lower-tier corporations or partnerships that are "QOZ businesses") is the value that is reported on the relevant entity's "applicable financial statement"[10] for the relevant reporting period. If the relevant entity does not have an applicable financial statement, then the value of each asset is "the QOF's cost of the asset." This "cost" reference appears to mean the original undepreciated cost of the asset. Treasury has requested comments as to the "suitability" of these valuation methods, and whether another method, such as "tax adjusted basis," would be "better for purposes of assurance and administration."
  - *Observation* – Reliance on financial statement valuations subjects QOFs to risk that GAAP depreciation will reduce their qualifying assets and cause them to fail the 90% or 70% tests even if they meet the tests in earlier years and do not substantially vary their investments. Taxpayers should carefully monitor their financial statements to ensure continued compliance with the 90% and 70% asset tests.
- **70% tangible asset holding requirement for satisfying "substantially all" test applicable to lower-tier "QOZ businesses"** – Although QOFs that directly operate businesses in qualified opportunity zones are required to hold 90% of their total assets in "qualified opportunity zone business property," lower-tier QOZ businesses need only hold "substantially all" of their "tangible" assets in such property. The proposed regulations provide that this "substantially all" test is satisfied if at least 70% of the tangible property owned or leased by the QOZ business is qualified opportunity zone business property.
  - *Observation* – Because 100% of the stock or partnership interests in a QOZ business is considered QOZ property, it is much easier for a QOF to satisfy the 90% QOZ property requirement by holding stock or partnership interests in a lower-tier QOZ business than by holding QOZ business property directly. When a QOF holds interests in a QOZ business, only 63% of the underlying tangible assets (70% of 90%) need to be QOZ business property, while if the property is owned directly, it must make up 90% of the QOF's total assets. The preamble to the proposed regulations acknowledges this incentive to structure QOF investments with lower-tier QOZ businesses.
- **Working capital safe harbor for lower-tier "QOZ businesses" but not for QOFs operating directly** – The proposed regulations offer no safe harbor for QOFs that directly hold liquid assets for working capital purposes. If 90% of a QOF's assets do not consist of either (i) tangible property that qualifies as "qualified opportunity zone business property" or (ii) stock or partnership interests in lower-tier QOZ businesses at the average of the relevant periods, the QOF will have failed to satisfy a mandatory requirement and will be subject to significant penalties. The proposed regulations do, however, offer a meaningful working capital safe harbor for the lower-tier QOZ businesses. This creates additional incentives for QOFs to hold interests in lower-tier entities operating QOZ businesses rather than operate such businesses directly.

[10] For most private real estate investors, an applicable financial statement is a certified audited financial statement that is prepared in accordance with U.S. GAAP and that is given to creditors for purposes of making lending decisions, given to equity holders for purposes of evaluating their investment, or provided for other substantial non-tax purposes.

- *Working capital safe harbor for QOZ businesses.* An entity may fail to qualify as a QOZ business if it holds 5% or more of its assets in "nonqualified financial property." Generally, nonqualified financial property includes stocks, bonds, and other financial instruments. Reasonable amounts of working capital are excluded from the definition of nonqualified financial property. The proposed regulations provide a safe harbor in which an otherwise eligible entity that holds working capital assets such as cash can nevertheless qualify as a QOZ business. The safe harbor requires that:
    - (1) the working capital amounts are <u>designated in writing</u> for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone;
    - (2) there is a <u>written schedule</u> consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets and under which the working capital assets must be spent <u>within 31 months</u> of their receipt by the QOZ business; and
    - (3) the working capital assets are actually used in a manner that is "<u>substantially consistent</u>" with the schedule.
    - *Observation* – It is unclear whether the "substantially consistent" requirement allows for reasonable delays in construction schedules.

  The proposed regulations also provide safe harbors with respect to gross income derived from the working capital and unfinished construction of tangible property owned by the QOZ business. Moreover, they include a safe harbor relating to the requirement that "a substantial portion of the intangible property" of a QOZ business be "used" in the active conduct of the business during "any period in which the business is proceeding in a manner that is substantially consistent" with the working capital safe harbor plan.

- **Original use and substantial improvement** – As noted above, in the case of a two-tier QOF structure, 70% of the lower-tier QOZ business's tangible property must be QOZ business property, which generally means that it is acquired by "purchase"—a specially defined term—from an unrelated person after 2017 and either originally used by the QOZ business or substantially improved by the QOZ business. The proposed regulations reserve on the meaning of original use, but provide that, if a QOF purchases land with a building located within a QOZ, substantial improvement to the property purchased by the QOF is measured by the QOF's additions to the adjusted basis of the building and that the QOF does not need to separately substantially improve the land on which the building is located. The same rules apply when a QOZ business acquires a building on land located within a QOZ. An example in the proposed regulations suggests that any improvement on vacant land is considered "originally used" by the QOF or QOZ business. However, the proposed regulations do not explicitly address the treatment of the land for purposes of the 90% asset test and 70% tangible asset test.

- **Disqualification of QOZ stock due to corporate redemptions** – Stock acquired by a QOF from a corporation that is a QOZ business will not qualify as QOZ stock if the corporation purchases any of its stock from the QOF or a related person within two years before or after the date of purchase. Stock of a QOZ business will also be disqualified if within one year before or after the date of purchase, the corporation purchases in the aggregate more than 5% of the value of its stock as of a year before the date of purchase. Section 304 deemed redemptions are regarded as purchases of stock for these purposes. These rules are intended to prevent sellers and buyers from washing a stock sale by passing it through the corporation as a redemption and (re)issuance and having it treated as stock acquired at original issuance.

Remaining Uncertainties Relevant to Real Estate Industry

Leverage

As mentioned above, under Section 752, a decrease in a partner's share of partnership liabilities as a result of a sale or exchange of a partnership interest is treated as an amount realized by the partner. It is unclear how this rule interacts with the rule in Section 1400Z-2(c),[11] which provides that, in the case of an investment held for 10 years, "the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged." This uncertainty is best illustrated by examining the following example:

> Assume taxpayers A and B collectively invest $40 of eligible gain in a QOF organized as a partnership. Assume the QOF incurs $60 of debt and uses the $60 debt proceeds and $40 gain proceeds to purchase a property for $100. In December 2026, assume A and B recognize what remains of the deferred gain and have a combined basis in the QOF of $100, reflecting the $40 equity investment and the $60 share of the debt. Assume that the property is worth $200 ten years from A and B's investment and the $60 debt is still outstanding.

The proposed regulations suggest that the only property eligible for this basis step-up is the interest in the QOF. In the example above, the fair market value of the QOF interest is $140 (i.e., the $200 asset value minus the $60 liability). If A and B's combined basis is stepped up to $140 and they sell the QOF interest for $140 in cash, they would recognize $60 of gain (i.e., $140 cash proceeds *plus* $60 decrease in their share of partnership liabilities *minus* $140 basis). This is because, if a partnership interest is sold or exchanged, the reduction in the transferor partner's share of partnership liabilities is treated as an amount realized. This is not the rule in the corporate context. If the QOF were a corporation (such as a REIT), the QOF's liabilities would not be included in A's basis and a sale of the QOF shares for cash would not result in A being treated as receiving money to the extent of the reduction of A’s share of the QOF's liabilities. As a result, A and B could elect to step up their $40 basis to $140 and recognize no gain on the sale of the QOF shares for $140.

It is difficult to reconcile the result in the partnership context with the language in the proposed regulations providing that a taxpayer's basis increase resulting from a deemed contribution of money to a QOF under Section 752 is not taken into account for the purposes of determining which portion of a QOF is an investment of gain eligible for basis step-up and post-investment appreciation exclusion.

Partnership Investors in QOFs

The proposed regulations do not address numerous questions that arise when partnerships invest in QOFs. As an example, the following scenario illustrates the uncertainty that can result when a partner sells an interest in a partnership that invests in a QOF.

> Assume partnership PRS invests $100 of gain in a QOF. Assume that the QOF purchases property for $100. Assume that, in 2022, the property is still worth $100 and that A, a 50% partner in PRS, sells its PRS interest to C for $50. C will take a $50 basis in its interest in the PRS. In 2026, when PRS recognizes what remains of the deferred $100 gain, it is possible that C would be allocated 50% of that gain, bringing its basis in PRS to $100. If the property is still worth only $100, C will now have a $50 built-in loss in its partnership interest. But is this the proper result or should C have avoided the $50 gain in the first place? Would a Section 754 election solve the problem?

---

[11] The statutory provisions addressing opportunity zones are set forth in Sections 1400Z-1 and 1400Z-2 (an unusual format for Internal Revenue Code provisions).

In addition, no rules in the statute or proposed regulations address whether the basis step-up of the interest in the QOF would affect the outside basis of investors in a partnership that owns the QOF, but any gain recognized by the partnership (such as the gain recognized in 2026) would presumably increase the outside bases of the partners' interests in the partnership.

Underlying Asset Basis

Section 1400Z-2(b)(2)(B) provides that the basis of a QOF interest received in exchange for an investment of deferred gain is generally zero. It is unclear from the statute and the proposed regulations if the QOF itself also takes a zero basis in assets purchased with the deferred gain. If that is the case, investors seeking to shelter rental income with depreciation deductions will need to rely on leverage for basis in the QOF's assets, resulting in the uncertainty described above.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Po Sit	**212 450 4571**	**po.sit@davispolk.com**
Leslie J. Altus	**212 450 4008**	**leslie.altus@davispolk.com**
Dao Fu	**212 450 4079**	**dao.fu@davispolk.com**
James Manzione	**212 450 3413**	**james.manzione@davispolk.com**
Joseph M. Gerstel	**212 450 3504**	**joseph.gerstel@davispolk.com**