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by Libin Zhang

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In this report, Zhang discusses emerging issues concerning the types of investments allowed in qualified opportunity zones.

Table of Contents

The Tax Cuts and Jobs Act (P.L. 115-97) created a new concept of qualified opportunity zones (QOZs), in which some investments receive tax deferral and tax exemption benefits. Although all the QOZs have now been identified, there is substantial uncertainty about investments allowed within the zones — potentially trillions of dollars' worth[1] — and the tax consequences for those investments. This report discusses some questions and concerns that have bubbled up and need Treasury guidance.

QOZ Benefits

Back in 2000, Congress created the section 45D new markets tax credit to stimulate investment in "low-income communities," which are census tracts that have a poverty rate of at least 20 percent or have a median family income that generally doesn't exceed 80 percent of statewide average and metropolitan area average.

The TCJA provides that around 25 percent of the low-income communities (including some adjacent census tracts) in each state, U.S. possession, or the District of Columbia may be designated as QOZs.[2] For example, a QOZ was designated in Manhattan for the blocks between 50th Street and 58th Street and between 10th Avenue and 12th Avenue. The designation lasts for 10 years, through 2028.[3]

For a taxpayer with gain from the sale or exchange of any property (with an unrelated person) through 2026, new section 1400Z-2 provides three tax benefits if the taxpayer invests an amount equal to that gain in a qualified opportunity (QO) fund during the 180-day period beginning on the sale or exchange date:

- up to 15 percent of the gain is permanently excluded from gross income;[4]
- recognition of the remaining 85 percent of the gain is deferred until December 31, 2026;[5] and

[1] *See* Tim Scott, "New Tax Law Will Spur Opportunity in Distressed Communities," *USA Today*, Feb. 14, 2018.

[2] Each state can have a minimum of 25 QOZs, and all low-income communities in Puerto Rico are QOZs under section 1400Z-1(b)(3) (added by the Bipartisan Budget Act of 2018, P.L. 115-123). For an overview of the QOZ designation process in section 1400Z-1(b), see Adam S. Wallwork and Linda B. Schakel, "Primer on Qualified Opportunity Zones," *Tax Notes*, May 14, 2018, p. 945.

[3] Section 1400Z-1(f).

[4] Section 1400Z-2(b)(2)(B).

[5] Section 1400Z-2(b)(1)(B).

- if the interest in the QO fund is held for at least 10 years, gain from any post-investment appreciation in the fund is permanently excluded.[6]

Example 1: A taxpayer has $100 of gain from the sale of a gold Krugerrand coin to an unrelated person on July 1, 2018. The gain is deferred if the taxpayer invests $100 in a QO fund by December 27, 2018.[7] The initial tax basis of the fund interest is $0 under section 1400Z-2(b)(2)(B)(i).

After the QO fund interest is held for five years, the tax basis is increased by 10 percent of the deferred gain, to $10. As a result, $10 of the deferred gain is permanently excluded from gross income on December 27, 2023.

The tax basis in the QO fund interest is increased by a further 5 percent of the deferred gain after the interest is held for seven years. The taxpayer's QO fund interest has a resulting $15 of tax basis, which corresponds to $15 of gain permanently excluded from gross income by December 27, 2025.

A sale of the QO fund interest after seven years would result in the taxpayer recognizing up to 85 percent of the deferred gain. Section 1400Z-2(a)(2) provides that the gain cannot be deferred again with a new QO fund investment. If the taxpayer keeps the interest, the remaining 85 percent of the deferred gain is recognized on December 31, 2026, up to the fair market value of the QO fund interest. The taxpayer recognizes up to $85 of its deferred gain as taxable income, and the tax basis in the interest increases by $85 to $100.

When the taxpayer sells the QO fund interest after holding it for at least 10 years (that is, on December 27, 2028, or later), the taxpayer may elect under section 1400Z-2(c) to increase the tax basis of the interest to equal the FMV on the date of the sale or exchange. The basis step-up election effectively allows the taxpayer to have tax-free gain from the post-investment appreciation in the QO fund interest. If the taxpayer has a loss in the interest, it can decline to make the election and recognize the loss.

As there is no time limit for the basis step-up election, a taxpayer could hold its QO fund interest indefinitely and defer all the appreciation. However, the fund must maintain its status as a QO fund as of the election date, and, as discussed later, it is unclear how the QOZ provisions apply to the QO fund once the QOZ designations expire after 2028.

The QOZ provisions are effective beginning December 22, 2017, so taxpayers with gains in late 2017 through 2026 can roll over their gain into a QO fund.

Example 2: A taxpayer exchanges some bitcoin for new bitcoin vibranium and has $500 of gain on December 1, 2026. The taxpayer may invest $500 of cash in a QO fund by May 29, 2027. Even though the $500 gain becomes taxable income on December 31, 2026, the taxpayer may have 10 years of tax-free post-investment appreciation for the $500 QO fund interest.

It isn't necessary for the QO fund investment cash to be traced to the cash proceeds from the sale or exchange that gave rise to the gain.

Example 3: On January 1, 2018, a taxpayer sells real property with $0 tax basis and $100 gross value, subject to $20 of liabilities. The $80 of net proceeds is transferred to a qualified intermediary, which acquires $80 of unencumbered replacement property for the taxpayer in a section 1031 like-kind exchange on June 30, 2018 — within 180 days. The taxpayer has $20 of boot that gives rise to taxable gain, which can be deferred by a $20 investment in a QO fund by June 29, 2018.

The tax benefits of gain deferral, 15 percent gain exclusion, and exclusion of 10 years or more of post-investment appreciation are available only for QO fund investments made from recognized gain. The gain from non-QO fund investments is effectively the entry fee to participate in the QOZ regime. If the taxpayer also invests non-gain cash in the QO fund, such as a return of tax basis from a sold asset, section 1400Z-2(e)(1) bifurcates the investment and denies QOZ tax benefits for the non-gain portion of the investment. The predecessor QOZ bills introduced by Senate Finance Committee member Tim Scott, R-S.C., and Rep. Patrick J. Tiberi, R-Ohio, did not contain

[6]Section 1400Z-2(c).

[7]The reinvestment period is the 180-day period beginning on the sale or exchange date, which includes July 1, December 27, and the 178 days in between.

a bifurcation rule; non-gain QO fund investments under those bills could have qualified for the exclusion for at least 10 years of post-investment appreciation.[8]

Example 4: On December 30, 2017, a taxpayer sells a used Rolex to an unrelated person for $500 cash, producing a $100 gain. The gain is deferred if the taxpayer invests $100 in a QO fund by June 27, 2018. The $100 QO fund interest has an initial tax basis of $0 and is entitled to the QOZ tax benefits. If the taxpayer invests all $500 of cash in the QO fund, the taxpayer has a separate $400 QO fund interest that doesn't qualify for any QOZ tax benefits. The taxpayer must therefore calculate its basis and gain in the sold property with great precision. However, the entire $500 fund interest must meet all requirements to be a QO fund.

The QOZ tax benefits are available only for a sale or exchange of property with an unrelated person, which is defined in section 1400Z-2(e)(2) by reference to sections 267(b) and 707(b)(1), but with a 20 percent relationship threshold for entities instead of 50 percent. The relationship status may be determined both before and after the sale or exchange.[9]

Example 5: A taxpayer owns 25 percent of a corporation's stock, and the other 75 percent is held by unrelated persons. The corporation redeems all of the taxpayer's stock, which is treated as an exchange under section 302. The taxpayer may not defer its gain with a QO fund investment because the corporation isn't an unrelated person. No relationship problem arises if the taxpayer owns 19 percent of the corporation's stock.

Example 6: A taxpayer owns property that has a $100 tax basis and is subject to $500 of liabilities. The taxpayer contributes the property to a newly formed corporation, along with contributions by other transferors, in a section 351 transaction. The taxpayer receives 25 percent of the corporation's stock and recognizes $400 of gain under section 357(c), which equals the amount by which the contributed property's liabilities exceed its tax basis. The taxpayer may not defer its gain with a QO fund investment because the corporation isn't an unrelated person. No relationship problem arises if the taxpayer owns 19 percent of the corporation's stock after the transaction.

There is no statutory tax exemption for the QO fund's post-investment operating income. The three QOZ tax benefits effectively give investing taxpayers a rate of return above the tax-free rate of return for the post-investment appreciation in the QO fund.

Example 7: An individual taxpayer subject to a 23.8 percent tax rate for long-term capital gain invests $1,000 of deferred long-term capital gain in a QO fund in 2018. The QO fund interest grows at 5 percent per year, to a value of $1,477 in 2026. The taxpayer recognizes $850 of deferred gain in 2026, which results in $202 (23.8 percent) of tax (or a different amount depending on the 2026 income tax rates). For simplicity, it is assumed that the QO fund makes a $202 tax-free distribution to the taxpayer to pay the tax, which reduces the QO fund interest to $1,275. Two years later, the QO fund interest grows in value to $1,406. At that point the taxpayer has held her QO fund interest for 10 years, and she disposes of it in a tax-free sale or redemption. Without the QOZ provisions, the taxpayer would have originally had $762 of after-tax proceeds. That amount grew at 6.316 percent per year, to $1,406, with the QOZ provisions. The result may be visualized for various pretax rates of return (see figure).

The QOZ tax benefits are not limited to any particular type of taxpayer, whether an individual or a corporation. A foreign person with gain from the sale of property effectively connected with a U.S. trade or business may defer the gain with a QO fund investment. If the property is a U.S. real property interest under section 897(c), it is unclear whether section 897(e) can disallow the QOZ benefits for a QO fund that is not subject to U.S. tax if sold by the foreign person.

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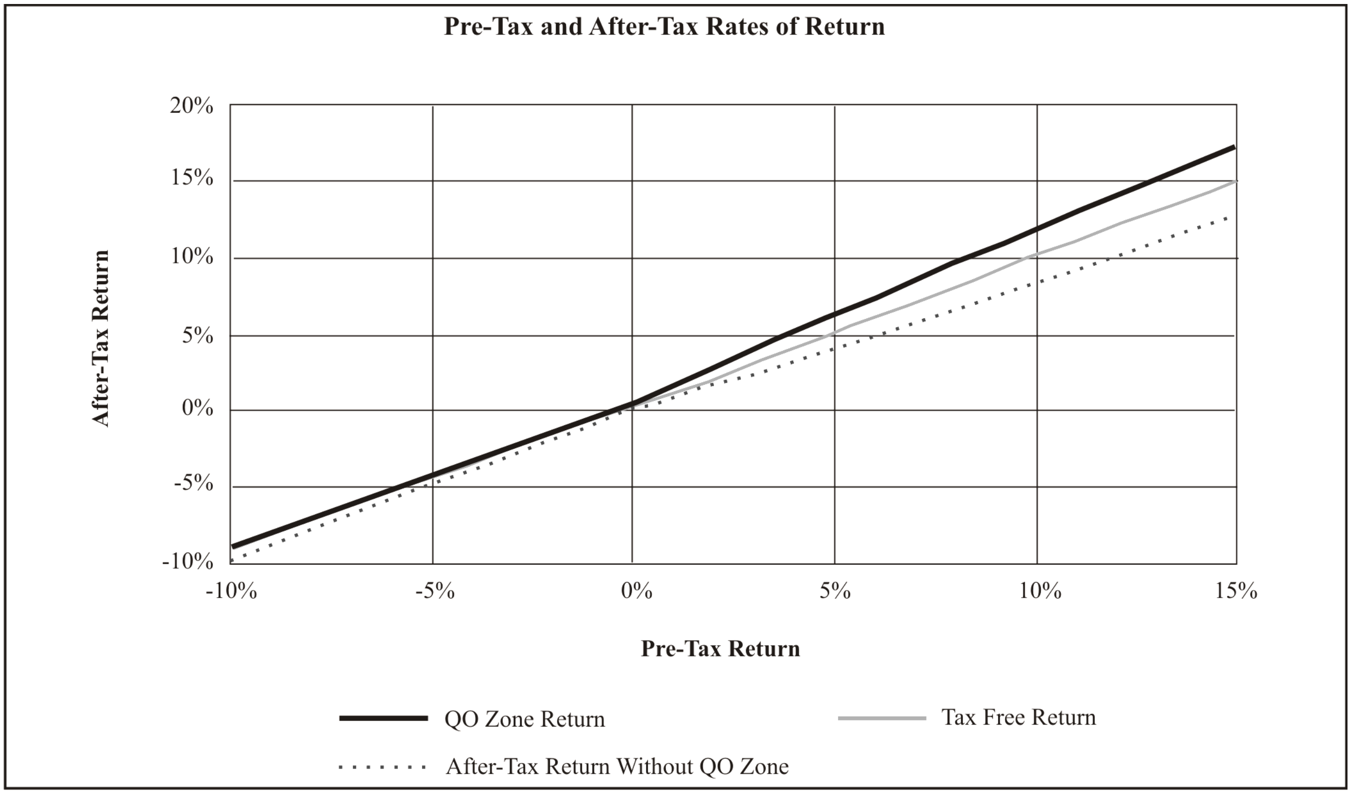
[8] The Investing in Opportunity Act (S. 293 and H.R. 828), introduced February 7, 2017.

[9] *See W.A. Drake Inc. v. Commissioner*, 145 F.2d 365 (10th Cir. 1944); and *Turner Broadcasting System Inc. v. Commissioner*, 111 T.C. 315 (1998).



Section 1400Z-2 does not describe the result when a partnership recognizes gain from a property disposition, but the deferral should be permitted for the partnership, which has both the gain and cash proceeds. The QOZ 180-day reinvestment rule is based on the 180-day reinvestment period for a section 1031 like-kind exchange, which is done solely at the partnership level.

Example 8: A partner has a tax basis of $10 in its 50 percent interest in a partnership, which owns one property with $200 of tax basis and $250 of value. The partnership has a negative $90 section 743(b) adjustment for the partner. The partnership sells its asset for $250 and recognizes $50 of partnership-level gain. The partner would normally be allocated $25 of the gain, which would be increased to $115 with the section 743(b) adjustment. The partnership may defer all $50 of partnership-level gain with a $50 QO fund investment, at which point the fate of the $90 section 743(b) adjustment is murky. The section 743(b) adjustment may be preserved and carried over into the QO fund interest, which effectively has a negative $90 tax basis for the partner. Alternatively, the partner may be required to recognize $90 of gain from the section 743(b) adjustment. The gain may be deferred if the partnership invests $140 into the QO fund, which would require a special allocation of $115 of the QO fund interest to the 50 percent partner.

If a partner can defer partnership-level gain, Treasury guidance should explain how the partner applies the 180-day reinvestment rule. A partner generally has taxable income and gain from the partnership when the partnership's tax year closes under section 706, and the partner may be unaware of partnership-level gain until it receives a Schedule K-1 on September 15, around 257 days later. Similar considerations apply to S corporations and non-grantor trusts.

QO Fund

A QO fund is defined in section 1400Z-2(d)(1) as any investment vehicle organized as a corporation or partnership to invest in QOZ property, of which there are three types:

- QOZ stock in a lower-tier domestic corporation;
- QOZ partnership interest in a lower-tier domestic partnership; and
- QOZ business property.

Each type of QOZ property has different requirements, which are based on the requirements for stock, partnership interests, and business property under the former section 1400B D.C. enterprise zone provisions (for 1999 through 2016 gains) and former section 1400F renewal community provisions (for 2002 through 2014 gains) (see table).

QO funds must hold at least 90 percent of their assets in QOZ property, which is determined for each year by generally averaging the fund's percentage of QOZ property assets on (1) the last day of the first six-month period of the fund's tax year and (2) the last day of its tax year. The semiannual testing provides a six-month window for QO funds to acquire QOZ property.

A QO fund's failure to meet the 90 percent test results in a monthly penalty based on the section 6621(a)(2) underpayment rate multiplied by some of the deferred gain (not the deferred tax) under section 1400Z-2(f)(1), unless the failure was due to reasonable cause and not willful neglect. Even though the underpayment rate is an annual interest rate approximately equal to the short-term applicable federal rate plus 3 percent, the penalty based on that rate seems to be imposed monthly.[10] The statute does not specifically state that a taxpayer's payment of the monthly penalty, or its having reasonable cause to avoid the penalty, also saves the QO fund from failing to qualify as QO fund, even though QO fund disqualification somewhat defeats the purpose of an ongoing monthly penalty.

Example 9: The taxpayer invests $100 in a new QO fund on May 1, 2018, which is also the beginning of the fund's calendar tax year. The QO fund must meet the 90 percent test by October 31, 2018, and December 31, 2018, and then on June 30 and December 31 of each subsequent year. If on October 31, 2018, the QO fund has only $40 of QOZ property instead of the required $90, the monthly penalty may be the $50 shortfall multiplied by the 5 percent underpayment rate, or $1.50 per month. The QO fund may also fail to qualify as a QO fund, which would end the taxpayer's $100 gain deferral, although it is unclear how long the monthly penalty would continue for a disqualified QO fund. The penalty might apply only to former QO funds, not funds that never qualified in the first place, in which case the investors should be relieved of the penalty.

A QO fund can be a corporation or partnership, whether domestic or foreign. It can apparently be an S corporation or real estate investment trust if the requirements are met.

In contrast, the lower-tier corporation or partnership must be a domestic corporation or a domestic partnership. The term "domestic," which is defined under section 7701(a)(4), excludes corporations and partnerships organized in Puerto Rico and other U.S. territories, even for QOZs in Puerto Rico. The domestic requirement seems to be based on a similar requirement for the former D.C. enterprise zone, which did not cover Puerto Rico.

For a QO fund that is acquiring QOZ stock in a lower-tier corporation, section 1400Z-2(d)(2)(B)(ii) provides generally that stock acquisitions do not count if there was any significant redemption from the QO fund or a related person within two years before and after the stock acquisition. This lookback for related redemptions doesn't apply to acquisitions of QOZ partnership interests in a lower-tier partnership nor to acquisitions of stock or interests in the QO fund itself. In contrast, the same lookback rule applied to both lower-tier corporations and lower-tier partnerships under former sections 1400B(b) and 1400F(b) for the D.C. enterprise zone and renewal community provisions. The section 707(a)(2)(B) disguised sale rules might apply to partnership interests, under regulations.

Former section 1400B(b)(6) of the D.C. enterprise zone provisions waived the asset acquisition requirements — such as the condition that a D.C. zone partnership interest be acquired directly from the partnership for cash — if the asset was a D.C. zone asset in the hands of a prior holder. No such rule exists for QOZ property, which must be acquired by the QO fund directly from the lower-tier partnership, the lower-tier corporation, or by purchase, as the case may be.

[10] *Compare with* section 453A (for some installment sales, the taxpayer owes an annual payment based on deferred tax multiplied by the underpayment rate).

	QOZ Stock	QOZ Partnership Interest	QOZ Business Property
Asset type	Stock of a domestic corporation (lower-tier corporation).	Capital or profits interest in a domestic partnership (lower-tier partnership).	Tangible property used in a trade or business of the QO fund.
Acquisition date and form	The QO fund acquired the stock in 2018 or later at original issue from the lower-tier corporation (directly or through an underwriter) solely in exchange for cash.	The QO fund acquired the interest in 2018 or later from the lower-tier partnership solely in exchange for cash.	The QO fund acquired the property by purchase (as defined in section 179(d)(2) with modifications) in 2018 or later.
Asset requirements	The lower-tier corporation was (or was newly organized to be) a QOZ business when the stock was issued to the QO fund and during substantially all of the QO fund's holding period for the stock.	The lower-tier partnership was (or was newly organized to be) a QOZ business when the interest was issued to the QO fund and during substantially all of the QO fund's holding period for the interest.	Substantially all of the use of the property is in the QOZ during substantially all of the QO fund's holding period for the property. The QO fund commenced the original use of the property in the QOZ, or the QO fund substantially improves the property by generally doubling the adjusted basis within a 30-month period.
QOZ business requirements	The lower-tier corporation's or partnership's trade or business must have substantially all of its owned or leased tangible property consist of QOZ business property (for example, acquired by purchase in 2018 or later, either original use in the QOZ or substantially improved by the corporation or partnership, etc. [see right column for "asset requirements"]), or property that was QOZ business property within the five prior years. The trade or business must meet the requirements of section 1397C(b)(2) (gross income), 1397C(b)(4) (intangible property), and 1397C(b)(8) (nonqualified financial property) and cannot be an excluded business described in section 144(c)(6)(B).		Not applicable.

Expiring Designations

A taxpayer that acquires a QO fund interest in 2019 must meet the 10-year requirement by holding a QO fund interest to 2029 to exclude all the post-investment appreciation in that interest from gross income. Similarly, a taxpayer that acquires a QO fund interest in 2027 must hold the interest to 2037. A QO fund that directly owns QOZ business property must have substantially all of the use of the property be in a QOZ, which may be difficult to achieve when QOZs cease to exist after 2028. A possible outcome is that the 10-year exclusion of post-investment appreciation applies only to gain invested in 2018 in a QO fund that directly owns QOZ business property.

For a QO fund that owns QOZ stock or a QOZ partnership interest, the lower-tier corporation or partnership must be engaged in a QOZ business that owns or leases mostly QOZ business property, or property that was QOZ business property within the prior five years under section 1400Z-2(d)(3)(B). The lower-tier corporation or partnership could thus maintain its status through 2033 by being deemed to own QOZ business property for the five years after QOZs cease to exist in 2028. The 2033 ending period would allow taxpayers with deferred gain invested in 2018 through 2023 to qualify for the exemption of 10 years of post-investment appreciation in the QO fund that owns QOZ stock or QOZ partnership interest.

There is no obvious congressional intent for the 10-year exemption to apply only to gain invested in 2018 in a QO fund that directly owns QOZ business property, and to gain invested in 2018 through 2023 in other QO funds. In contrast, a five-year holding period was required under the D.C. enterprise zone provisions, but former section 1400B(b)(5) provided that termination of the D.C. enterprise zone was disregarded in determining whether any property is D.C. zone business stock, D.C. zone partnership interest, or D.C. zone business property.

QOZ Business Restrictions

For a QO fund that owns QOZ stock or a QOZ partnership interest, the lower-tier corporation or partnership must satisfy the requirements for a QOZ business. In contrast, the QOZ business requirements do not apply to the extent that the QO fund directly owns QOZ business property. For comparison, substantially all D.C. zone business property had to be used in a D.C. zone business, whereas the word "business" was deleted in the comparable QOZ provisions, so that QOZ business property only have to be used in a QOZ.

For example, a QOZ business cannot be an excluded business described in section 144(c)(6)(B), which means that the lower-tier corporation or lower-tier partnership cannot run a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, or liquor store (any store whose principal business is the sale of alcoholic beverages for consumption off premises).[11] Because the section 144(c)(6)(B) limitation doesn't apply to QOZ business property, a QO fund can directly own a hot tub facility or liquor store. Regardless of the merits of a dry policy for QOZs overall, the legislative rationale for prohibiting only indirectly owned hot tub facilities and subsidiary liquor stores is not apparent.

A QO fund may develop significant goodwill and other intangible assets from the hot tub facility or other QOZ business property, which may be problematic given that intangible property itself does not qualify as QOZ business property and can cause the QO fund to violate the 90 percent test. Intangible property must be owned by a lower-tier corporation or partnership. A similar issue existed under the D.C. enterprise zone provisions, which didn't allow the capital gain exclusion for directly owned intangible property, although the D.C. enterprise zone did not involve funds and thus there was no risk of the entire fund being disqualified.[12]

Regulatory guidance would be helpful to clarify the scope of some excluded businesses. For example, a manufacturer of hot tubs might not be considered a "hot tub facility" since the remaining excluded businesses focus on direct-to-consumer services. A retailer of hot tubs may be analogized to the liquor store, as being in the principal business of the sale of hot tubs for consumption off premises.

Section 144(c)(6)(B) itself is a restriction on the issuance of tax-exempt qualified redevelopment bonds. It provides that bond proceeds cannot be used toward the excluded businesses. Section 144(c)(6)(A) contains an overlapping set of other excluded businesses, for which only 25 percent of bond proceeds may be used. By implication, a QOZ business can be a section 144(c)(6)(A) business (not otherwise in section 144(c)(6)(B)), which should be positive news for skating facility and non-country-club tennis club tycoons.

Other restrictions imposed on the QOZ business of a lower-tier corporation or partnership but not imposed on QOZ business property directly held by the QO fund are found in the section 1400Z-2(d)(3)(A)(ii) cross-references to section 1397C(b)(2), (4), and (8).

Section 1397C(b)(8) provides that less than 5 percent of the average aggregate unadjusted tax basis of the lower-tier corporation or partnership's properties can be attributable to nonqualified

[11] Section 144(c)(6)(B) was originally enacted by the Tax Reform Act of 1986 and has not been revised to reflect recent entrepreneurship developments, such as a marijuana dispensation facility or vaping facility.

[12] Joint Committee on Taxation, "General Explanation of 1997 Tax Legislation," JCS-23-97, at 102 n.141 (Dec. 17, 1997).

financial property, which is generally debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and similar property specified in regulations. However, nonqualified financial property does not include "reasonable amounts of working capital" held in cash, cash equivalents, and debt instruments with a term of 18 months or less, and also does not include accounts or notes receivable acquired in the ordinary course of business for services rendered or from the sale of inventory. The scope of the nonqualified financial property rule could use some clarification, such as how much cash held in reserve for construction and other improvements can be reasonable,[13] and whether the lower-tier corporation or partnership can own stock or interests in its own subsidiary corporations and partnerships.

QOZ business property held directly by a QO fund is not limited to 5 percent nonqualified financial property, but there is no working capital exception either for cash to qualify as QOZ business property. The QOZ business property may give rise to too much cash and other assets for the QO fund to meet the 90 percent test.

Section 1397C(b)(4) provides that a substantial portion of the entity's intangible property must be used in the active conduct of any "qualified business within an empowerment zone," and section 1397C(b)(2) provides that at least 50 percent of the entity's total gross income must be derived from the active conduct of a qualified business within an empowerment zone. If the entity has zero intangible property or no gross income, the requirements could be considered satisfied even if not entirely mathematically accurate.

The scope of the QOZ cross-references to section 1397C(b)(2) and (4), which are applied without any textual substitutions, is uncertain. The two section 1397C provisions refer only to empowerment zones, which may imply that a QOZ business must use all its intangible property in, and derive at least 50 percent of its gross income from, a section 1397C empowerment zone that is also within a QOZ. In light of the legislative intent to develop QOZs, a better interpretation is that any reference to an empowerment zone is implicitly replaced by a reference to a QOZ.

Another interpretive question is whether the cross-references to section 1397C and its "qualified business" language means that section 1400Z-2 should also import the section 1397C limitations on a qualified business, which is any trade or business except for:

- the rental to others of residential rental property;
- the rental to others of nonresidential real property if more than 50 percent of the rental income is not from zone businesses;
- the rental to others of tangible personal property if more than 50 percent of the rental is not by zone businesses or zone residents;
- a trade or business consisting predominantly of the development or holding of intangibles for sale or license;
- a trade or business in section 144(c)(6)(B); and
- a farming trade or business with generally more than $500,000 of assets.

The QOZ references to section 1397C could be read as importing the limitations on a qualified business in section 1397C, such as the exclusion of residential rental property. Such a result would parallel how the section 45D new markets tax credit also imported the qualified business definition in section 1397C, with some taxpayer-favorable modifications for the rental of nonresidential real property and tangible personal property. The section 1397C qualified business restrictions similarly applied to former D.C. enterprise zones and renewal communities.

However, the new markets tax credit, D.C. enterprise zone, and renewal community provisions were far more explicit in incorporating the section 1397C qualified business restrictions, with specific carveouts. Further, section 1397C(d)(1) prohibits any trade or business in section 144(c)(6)(B), which would render superfluous the same QOZ prohibition in section 1400Z-2(d)(3)(A)(iii) of any trade or business in section 144(c)(6)(B). Another interpretation, consistent with general QOZ industry practice, is that section 1400Z-2 is a well-considered and

[13] *Cf.* reg. section 1.45D-1(d)(4)(i)(E)(2) (new markets tax credit treats any funds that will be expended for construction of real property within 12 months as a reasonable amount of working capital).

integrated statutory scheme with only one reference to section 144(c)(6)(B), with the result that the other qualified business restrictions in section 1397C are not incorporated.

Example 10: A QO fund owns a lower-tier corporation, which owns a nonresidential real property building in a QOZ. The corporation substantially improves the building and leases the building to various retailers, such as a national coffee shop chain and a vendor of Goth and emo-inspired clothing and accessories. The leased building would not be a qualified business for empowerment zone purposes under section 1397C(d)(1)(B) if the tenants are not empowerment zone businesses, which depends on the deemed separate incorporation rules for zone branches in section 1394(b)(3)(E) and reg. section 1.1394-1(k). Treasury guidance should confirm whether the building qualifies for QOZ purposes.

Types of Gain

Section 1400Z-2 allows the deferral and exclusion of a taxpayer's gain from the sale of property, which is not limited to the taxpayer's net gain. A taxpayer with a tax loss from another disposition may elect to defer the gain and preserve the tax loss for another use.

Although the heading of section 1400Z-2 and some legislative history refer to "capital gain,"[14] the section 1400Z-2 statutory text refers only to the deferral and exclusion of "gain." Section 7806(b) and case law have long held that headings should not be used to construe statutory language.[15] For comparison, the former D.C. enterprise zone exclusion and the former section 1400F renewal community exclusion applied only to "qualified capital gain," which was defined in section 1400B(e)(1) as any gain recognized on the sale of a capital asset or property used in a trade or business. That definition specifically did not cover any gain that would be treated as ordinary income under the depreciation recapture provisions and any unrecaptured section 1250 gain. Section 1397B provided for nonrecognition of gain from the sale of a qualified empowerment zone asset held for more than one year except for gain treated as ordinary income.

If a technical correction were made to limit the section 1400Z-2 exclusion to capital gain, taxpayers should be able to defer long-term capital gain, unrecaptured section 1250 gain, collectibles gain, and short-term capital gain, including short-term capital gain from a carried interest subject to section 1061.

Section 1231 governs the character of gains and losses from section 1231 property, which is generally property used in a trade or business and held for more than one year. If section 1231 gains exceed section 1231 losses, the gains and losses are treated as capital gains and capital losses, which allows the gross amount of the section 1231 gains to be excluded with a QO fund investment while the section 1231 losses are preserved as capital losses. In contrast, if section 1231 gains don't exceed section 1231 losses, the gains and losses are treated as ordinary income and ordinary losses, and none of the section 1231 gains may be excluded if section 1400Z-2 applies only to capital gain. The resulting cliff effect is that a $101 section 1231 gain and a $100 section 1231 loss allow all $101 of gain to be excluded, whereas no exclusion may be permitted for a taxpayer with $100 or less of section 1231 gain and a $100 section 1231 loss.[16]

When section 1231 gain is recognized at the partnership level, the determination of the gain's character is generally made at the partner level after taking into account all of the partner's other section 1231 gains and losses. If section 1400Z-2 is applied at the partnership level, the result may be that section 1231 gain recognized by a partnership is treated differently from section 1231 gain recognized directly by a partner. The drafters of section 1400Z-2 may have struggled with defining capital gain in the context of partnership-level section 1231 gain before ultimately deciding to apply section 1400Z-2 to all gain.

Income that is gain under the code should be gain for all purposes, unless otherwise indicated.

[14] H.R. Rep. No. 115-466, at 538 (2017) (Conf. Rep.) (stating that the provision "allows for the temporary deferral of inclusion in gross income for capital gains that are reinvested in a qualified opportunity fund").

[15] *See, e.g., Grapevine Imports Ltd. v. United States*, 71 Fed. Cl. 324 (2006).

[16] In determining whether section 1231 gains exceed losses, section 1231(a)(4)(A) provides that gains and losses will be included only if and to the extent taken into account in computing gross income, which could create some circularity between sections 1231 and 1400Z-2.

For example, section 1276(a)(4) provides that market discount gain is treated as interest for all purposes, except for specified code provisions that do not include section 1400Z-2. In contrast, sections 1245(a)(1) and 1250(a)(2)(A) provide that for depreciation recapture treated as ordinary income, "such gain shall be recognized notwithstanding any other provision of this subtitle." Depreciation recapture results in recognized gain, which should be gain that may be excluded under section 1400Z-2.[17] A similar result should apply to gain from the disposition of property subject to some section 467 rental agreements, which is treated as ordinary income under section 467(c).

Because short-term capital gain is eligible for the section 1400Z-2 exclusion even though it is subject to ordinary income tax rates, the fact that other types of gain are taxed as ordinary income doesn't necessarily preclude the application of section 1400Z-2. Ordinary income under section 64 includes gain from the sale or exchange of inventory, property held for sale to customers in the ordinary course of business, self-created intangibles, and other assets that are neither capital assets nor section 1231 property.

In contrast, dividends are not gains, even if they are subject to capital gain tax rates for individuals. Section 1248(a) provides that in some circumstances, gain from the sale of foreign corporation stock is included in gross income as a dividend, which should not be excludable under section 1400Z-2.[18]

Section 1400Z-2 might apply to deemed sale transactions, depending on the answer to the philosophical question of whether a sale to nobody is a sale to an unrelated person. For example, some taxpayers can make a mark-to-market election under section 1256, under which some assets are treated as sold on the last day of the year, with 40 percent of the gain as short-term capital gain and 60 percent of the gain as long-term capital gain. A taxpayer can recognize gain under section 1259 on the constructive sale of an appreciated financial position. Section 877A provides that when a U.S. citizen or a long-term green card holder renounces her U.S. citizenship or green card, all her property is treated as sold for FMV, and any income or gain exceeding $600,000 is included in gross income. Gain from the cancellation, lapse, expiration, or other termination from an option or right is gain from the sale of a capital asset under section 1234A if the underlying asset is a capital asset.[19] A deemed asset sale may occur in connection with some corporate transactions under section 336(e) and section 338(a), which are specifically treated as sales to unrelated persons in reg. sections 1.336-2(b)(1)(i) and 1.338-1(a)(1). The latter two corporate provisions imply that deemed sale transactions are generally treated as being with unrelated persons.

For a shareholder of a REIT or a mutual fund (regulated investment company), capital gain is recognized upon the receipt or deemed receipt of a capital gain dividend.[20] A capital gain dividend will be treated by the shareholder as gain from the sale or exchange of a capital asset held for more than one year under section 857(b)(3)(A) or section 852(b)(3)(B), for which it is unclear whether the QOZ sales relationship is tested between the shareholder and the REIT (or RIC), the REIT and the purchaser of the REIT's property, or the shareholder and the purchaser of the REIT's property. Further, the REIT or RIC dividend that a taxpayer receives during the year might not be designated as a capital gain dividend until the beginning of the following year under section 857(b)(3)(b) or section 852(b)(3)(C), at which point the 180-day period allowed for gain deferral may have ended.

When the deferred gain is ultimately recognized (for example, in 2026), the recognized gain should likely have the same character as the deferred gain. If the deferred gain consists of different types, it is unclear whether the 15

[17] *Cf.* section 121(d)(6) (section 121 exclusion for gain from the sale of a principal residence does not apply to depreciation recapture); and section 1400B(e)(3) (qualified capital gain does not include any gain that would be treated as ordinary income under section 1245 or section 1250).

[18] *See also* section 1291(a)(2), under which gain from the disposition of stock in a passive foreign investment company is sometimes treated as if the gain were an excess distribution from the company, which is included in gross income as ordinary income.

[19] *Cf. CRI-Leslie LLC v. Commissioner*, 882 F.3d 1026 (11th Cir. 2018), *aff'g* 147 T.C. 217 (2016) (section 1234A doesn't apply to section 1231 property).

[20] *See* section 857(b)(9) (some REIT dividends are deemed received by a shareholder on December 31 even though paid in January of the following year).

percent basis increase and gain reduction should be applied to all gain types on a pro rata basis.

Example 11: A taxpayer has a tax basis of $0 in a $100 partnership interest. The taxpayer recognizes $100 of gain from the sale of the partnership interest, of which $20 is unrecaptured section 1250 gain and $80 is long-term capital gain. The $100 of gain is deferred into a $100 QO fund interest with $0 of tax basis.

In 2026 the taxpayer has $15 of tax basis in the QO fund interest, which is worth $100 or more, and it recognizes $85 of gain. Because the taxpayer would have first reduced its unrecaptured section 1250 gain if it had additional tax basis in the original partnership interest investment, a consistent lookback approach would be for the taxpayer to recognize $5 of unrecaptured section 1250 gain and $80 of long-term capital gain in 2026. Other approaches would be to reduce each gain type pro rata, to $17 of unrecaptured section 1250 gain and $68 of long-term capital gain, or to reduce only the long-term capital gain.

Basis Adjustment

When a taxpayer invests deferred gain in a QO fund, section 1400Z-2(b)(2)(B) provides that the taxpayer has a tax basis of $0 in the QO fund interest. If the QO fund is a partnership, there may be a disparity between the taxpayer's outside tax basis in the QO fund partnership interest and the inside tax basis of the QO fund's assets.

Example 12: A taxpayer invests $100 of deferred gain into a QO fund partnership, which invests $100 in a lower-tier partnership, which acquires $100 of depreciable personal property. The taxpayer has a tax basis of $0 in its QO fund interest. The difference between the $100 inside tax basis and $0 outside tax basis is not addressed by section 1400Z-2.

Regulatory guidance might require both the QO fund partnership and the lower-tier partnership to decrease the basis of the lower-tier partnership interest and the personal property, respectively, by $100 to a tax basis of $0. Both the QO fund partnership and the lower-tier partnership would recognize gain upon the sale of their assets.

After five years, the taxpayer increases its QO fund interest tax basis by $10, which should cause a corresponding $10 tax basis increase in the QO fund's assets and the lower-tier partnership's assets. The $10 tax basis in the lower-tier partnership's personal property may be depreciated over some period. An additional $5 tax basis increase occurs after seven years, and $85 of tax basis increase occurs on December 31, 2026.

The above result for partnerships is administratively complex and significantly favors the formation of QO fund corporations and lower-tier corporations. The corporation would experience a decrease in the tax basis of its stock but not its assets, and it may claim full depreciation. If the QO fund corporation is an S corporation, or if the QO fund corporation or the lower-tier corporation is a REIT, no double taxation is imposed.

Absent regulations to the contrary, the better result may be for the QO fund partnership to have a full tax basis in its assets and generate tax losses from the full amount of asset depreciation. The losses reduce the net income from the QOZ properties. The taxpayer partner starts out with a tax basis of zero in its partnership interest and cannot use any of the QO fund partnership's allocated tax losses under section 704(d)(1), but the partner may increase its outside tax basis in the partnership interest through an allocation of partnership-level liabilities under section 752, which would increase the allowed passthrough losses. However, a partnership interest tax basis increase under section 752 is treated as a partner contribution of money to the partnership, which might be subject to the mixed investment bifurcation rules for a non-gain QO fund investment under section 1400Z-2(e)(1).

Section 1400Z-2(e)(4) provides that Treasury regulations will ensure that a QO fund has reasonable time to reinvest the return of capital from investments in QOZ stock and partnership interests and to reinvest proceeds received from the sale or disposition of QOZ property.[21] The policy goal may be to permit a QO fund to generally not recognize QO fund-level gain as long as it continues to reinvest in QOZ property,

[21] The section 1400Z-2(d)(1) in S. 293 was more explicit in stating that "rules similar to the rules applicable to deferred like kind exchanges under section 1031 shall apply except that reinvestment in opportunity zone property need not require an intermediary party."

which may also be extended by Treasury regulations to treat operating income as tax-free income if reinvested by the QO fund in QOZ property.

Substantially Improved Property

A QO fund may directly invest in QOZ business property, or the QO fund may generally invest in a lower-tier corporation or lower-tier partnership, for which substantially all of its owned and leased assets are QOZ business property. QOZ business property must be tangible property used in a trade or business, acquired by purchase in 2018 or later generally from unrelated parties. Also, the QO fund, lower-tier corporation, or lower-tier partnership must either commence the original use of the QOZ business property in the QOZ or substantially improve the property by generally doubling the adjusted basis within a 30-month period. QOZ business property could have been used before the QO fund's purchase, as long as the use was outside the QOZ and the QO fund put the property to the first use within the QOZ.[22]

For QOZ business property qualifying under the substantial improvement prong, the 30-month improvement period may be "any" such period, which could be long after the acquisition of the property. It is unclear whether the property is QOZ business property before the 30-month period begins (which may have consequences for the QO fund satisfying its 90 percent test) and how the substantial improvement period interacts with the requirement that the property be substantially all used in the QOZ. Generally, under the D.C. enterprise zone provisions, substantially all of the use of the property had to be in the zone only after the property had been substantially improved, which improvement merely had to be done before the expiration of the zone designation.[23]

It is unclear how land may be QOZ business property, since it has generally been used before. The QO fund may try to substantially improve the land by doubling its adjusted tax basis within a 30-month period, except that the improvements may be considered a separate property of building or land improvements. The D.C. enterprise zone and renewal community provisions contained an original use or substantial improvement rule, which was met under former section 1400B(b)(4)(B) or former 1400F(b)(4)(B) for both land and building if only the building's tax basis was generally doubled over a 24-month period. In the context of empowerment zones, reg. section 1.1394-1(h) generally provides that if property was vacant for at least one year, use before that period is disregarded in determining original use. Similar rules could be enacted for QOZs to encourage the use of vacant real property.

The issue of land qualifying as QOZ business property also arises in the context of lower-tier corporations and partnerships, which must have substantially all of their owned or leased assets consist of QOZ business property. If a lower-tier corporation leases land on which it builds a qualified business with QOZ business property, the corporation still may have too much in nonqualifying leased assets and thereby fail to qualify as a lower-tier corporation.

Example 13: A QO fund's lower-tier corporation establishes a spicy taco retailing facility by renting an existing storefront in a QOZ. Although the taco business owns taco production equipment, taco-related inventory, and other QOZ business property, the business also leases the storefront, which is not QOZ business property because of insufficient improvements being made to it. The lower-tier corporation might not own a QOZ business, which could disqualify the QO fund. Even if the corporation substantially improves the storefront, it must still own or lease the land, which is not substantially improved and could cause the corporation to not have a QOZ business. The issue is avoided with a food truck.

Conclusion

The above issues are a few items from a larger pool of uncertainties about the QOZ provisions, all of which hopefully will be addressed by forthcoming regulations. Further questions arise from the fate of a QO fund interest that is transferred or bequeathed to a new person, and

[22] *Cf.* reg. section 1.1394-1(h); and JCS-23-97, *supra* note 12, at 100 ("The original use of the property in the D.C. Zone must commence with the taxpayer (however, property that has been used elsewhere may qualify).").

[23] JCS-23-97, *supra* note 12, at 103.

the definition of a qualified "purchase" of QOZ business property, which makes a cross-reference to section 179(d)(2) and a nonexistent section 1400Z-2(d)(8).

As QOZ opportunities diminish with the passage of time, official guidance becomes increasingly necessary on the most fundamental issues, such as the types of gain eligible for deferral, the qualifications for QOZ business and QOZ business property, and the effects on tax basis within the QO fund. Without clarity, taxpayers may find themselves in a slippery situation with a purported investment made too late or that otherwise fails to qualify for the deferral and exclusion tax benefits. ■