this section, without regard to the definition of proceeds in paragraph (a)(2)(ii) of this section, to bonds issued under section 1397E that are sold before September 14, 2007.

(D) *Bonds issued before July 1, 1999.* Paragraphs (b) and (h)(10) of this section may not be applied to bonds issued under section 1397E that are issued before July 1, 1999.

(3) *Scope of reliance for bonds issued under sections 54A and 54E.* Except to the extent inconsistent with the successor statutory provisions for QZABs in sections 54A and 54E or applicable public administrative or regulatory guidance under those provisions and except as otherwise provided in this paragraph (m)(3), issuers and taxpayers may apply these regulations to QZABs issued under sections 54A and 54E that are sold after October 3, 2008. In the case of QZABs that are issued under sections 54A and 54E for which the issuer makes an irrevocable election under section 6431(f) to receive payments with respect to credits under section 6431, issuers and taxpayers may not apply the remedial action provisions under paragraph (h)(8) of this section.

[T.D. 8755, 63 FR 673, Jan. 7, 1998; 63 FR 8528, Feb. 19, 1998, as amended by T.D. 8826, 64 FR 35574, July 1, 1999. Redesignated and amended by T.D. 8903, 65 FR 57733, Sept. 26, 2000; T.D. 9339, 72 FR 38774, July 16, 2007;T.D. 9495, 75 FR 44904, July 30, 2010; T.D. 9495, 75 FR 52267, Aug. 25, 2010]

RULES RELATING TO INDIVIDUALS' TITLE 11 CASES

SOURCE: Sections 1.1398–1 and 1.1398–2 appear at T.D. 8537, 59 FR 24937, May 13, 1994, unless otherwise noted.

§ 1.1398–1 Treatment of passive activity losses and passive activity credits in individuals' title 11 cases.

(a) *Scope.* This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) *Definitions and rules of general application.* For purposes of this section—

(1) *Passive activity* and *former passive activity* have the meanings given in section 469 (c) and (f)(3);

(2) The unused passive activity loss (determined as of the first day of a taxable year) is the passive activity loss (as defined in section 469(d)(1)) that is disallowed under section 469 for the previous taxable year; and

(3) The unused passive activity credit (determined as of the first day of a taxable year) is the passive activity credit (as defined in section 469(d)(2)) that is disallowed under section 469 for the previous taxable year.

(c) *Estate succeeds to losses and credits upon commencement of case.* The bankruptcy estate (estate) succeeds to and takes into account, beginning with its first taxable year, the debtor's unused passive activity loss and unused passive activity credit (determined as of the first day of the debtor's taxable year in which the case commences).

(d) *Transfers from estate to debtor*—(1) *Transfer not treated as taxable event.* If, before the termination of the estate, the estate transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange), the transfer is not treated as a disposition for purposes of any provision of the Internal Revenue Code assigning tax consequences to a disposition. The transfers to which this rule applies include transfers from the estate to the debtor of property that is exempt under section 522 of title 11 of the United States Code and abandonments of estate property to the debtor under section 554(a) of such title.

(2) *Treatment of passive activity loss and credit.* If, before the termination of the estate, the estate transfers an interest in a passive activity or former passive activity to the debtor (other than by sale or exchange)—

(i) The estate must allocate to the transferred interest, in accordance with § 1.469–1(f)(4), part or all of the estate's unused passive activity loss and unused passive activity credit (determined as of the first day of the estate's taxable year in which the transfer occurs); and

(ii) The debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the transfer occurs, the unused passive activity loss and unused passive activity credit (or part thereof) allocated to the transferred interest.

(e) *Debtor succeeds to loss and credit of the estate upon its termination.* Upon termination of the estate, the debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the termination occurs, the passive activity loss and passive activity credit disallowed under section 469 for the estate's last taxable year.

(f) *Effective date*—(1) *Cases commencing on or after November 9, 1992.* This section applies to cases commencing on or after November 9, 1992.

(2) *Cases commencing before November 9, 1992*—(i) *Election required.* This section applies to a case commencing before November 9, 1992, and terminating on or after that date if the debtor and the estate jointly elect its application in the manner prescribed in paragraph (f)(2)(v) of this section (the election). The caption ''ELECTION PURSUANT TO §1.1398–1'' must be placed prominently on the first page of each of the debtor's returns that is affected by the election (other than returns for taxable years that begin after the termination of the estate) and on the first page of each of the estate's returns that is affected by the election. In the case of returns that are amended under paragraph (f)(2)(iii) of this section, this requirement is satisfied by placing the caption on the amended return.

(ii) *Scope of election.* This election applies to the passive and former passive activities and unused passive activity losses and passive activity credits of the taxpayers making the election.

(iii) *Amendment of previously filed returns.* The debtor and the estate making the election must amend all returns (except to the extent they are for a year that is a closed year within the meaning of paragraph (f)(2)(iv)(D) of this section) they filed before the date of the election to the extent necessary to provide that no claim of a deduction or credit is inconsistent with the succession under this section to unused losses and credits. The Commissioner may revoke or limit the effect of the election if either the debtor or the estate fails to satisfy the requirement of this paragraph (f)(2)(iii).

(iv) *Rules relating to closed years*—(A) Estate succeeds to debtor's passive activity loss and credit as of the commencement date. If, by reason of an election under this paragraph (f), this section applies to a case that was commenced in a closed year, the estate, nevertheless, succeeds to and takes into account the unused passive activity loss and unused passive activity credit of the debtor (determined as of the first day of the debtor's taxable year in which the case commenced).

(B) *No reduction of unused passive activity loss and credit for passive activity loss and credit not claimed for a closed year.* In determining a taxpayer's carryover of a passive activity loss or credit to its taxable year following a closed year, a deduction or credit that the taxpayer failed to claim in the closed year, if attributable to an unused passive activity loss or credit to which the taxpayer succeeded under this section, is treated as a deduction or credit that was disallowed under section 469.

(C) *Passive activity loss and credit to which taxpayer succeeds reflects deductions of prior holder in a closed year.* A loss or credit to which a taxpayer would otherwise succeed under this section is reduced to the extent the loss or credit was allowed to its prior holder for a closed year.

(D) *Closed year.* For purposes of this paragraph (f)(2)(iv), a taxable year is closed to the extent the assessment of a deficiency or refund of an overpayment is prevented, on the date of the election and at all times thereafter, by any law or rule of law.

(v) *Manner of making election*—(A) *Chapter 7 cases.* In a case under chapter 7 of title 11 of the United States Code, the election is made by obtaining the written consent of the bankruptcy trustee and filing a copy of the written consent with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(B) *Chapter 11 cases.* In a case under chapter 11 of title 11 of the United States Code, the election is made by incorporating the election into a bankruptcy plan that is confirmed by the bankruptcy court or into an order of such court and filing the pertinent portion of the plan or order with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(vi) *Election is binding and irrevocable.* Except as provided in paragraph (f)(2)(iii) of this section, the election, once made, is binding on both the debtor and the estate and is irrevocable.

§ 1.1398–2 Treatment of section 465 losses in individuals' title 11 cases.

(a) *Scope.* This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) *Definition and rules of general application.* For purposes of this section—

(1) *Section 465 activity* means an activity to which section 465 applies; and

(2) For each section 465 activity, the unused section 465 loss from the activity (determined as of the first day of a taxable year) is the loss (as defined in section 465(d)) that is not allowed under section 465(a)(1) for the previous taxable year.

(c) *Estate succeeds to losses upon commencement of case.* The bankruptcy estate (the estate) succeeds to and takes into account, beginning with its first taxable year, the debtor's unused section 465 losses (determined as of the first day of the debtor's taxable year in which the case commences).

(d) *Transfers from estate to debtor*—(1) *Transfer not treated as taxable event.* If, before the termination of the estate, the estate transfers an interest in a section 465 activity to the debtor (other than by sale or exchange), the transfer is not treated as a disposition for purposes of any provision of the Internal Revenue Code assigning tax consequences to a disposition. The transfers to which this rule applies include transfers from the estate to the debtor of property that is exempt under section 522 of title 11 of the United States Code and abandonments of estate property to the debtor under section 554(a) of such title.

(2) *Treatment of section 465 losses.* If, before the termination of the estate, the estate transfers an interest in a section 465 activity to the debtor (other than by sale or exchange) the debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the transfer occurs, the transferred interest's share of the estate's unused section 465 loss from the activity (determined as of the first day of the estate's taxable year in which the transfer occurs). For this purpose, the transferred interest's share of such loss is the amount, if any, by which such loss would be reduced if the transfer had occurred as of the close of the preceding taxable year of the estate and been treated as a disposition on which gain or loss is recognized.

(e) *Debtor succeeds to losses of the estate upon its termination.* Upon termination of the estate, the debtor succeeds to and takes into account, beginning with the debtor's taxable year in which the termination occurs, the losses not allowed under section 465 for the estate's last taxable year.

(f) *Effective date*—(1) *Cases commencing on or after November 9, 1992.* This section applies to cases commencing on or after November 9, 1992.

(2) *Cases commencing before November 9, 1992*—(i) *Election required.* This section applies to a case commencing before November 9, 1992, and terminating on or after that date if the debtor and the estate jointly elect its application in the manner prescribed in paragraph (f)(2)(v) of this section (the election). The caption ''ELECTION PURSUANT TO § 1.1398–2'' must be placed prominently on the first page of each of the debtor's returns that is affected by the election (other than returns for taxable years that begin after the termination of the estate) and on the first page of each of the estate's returns that is affected by the election. In the case of returns that are amended under paragraph (f)(2)(iii) of this section, this requirement is satisfied by placing the caption on the amended return.

(ii) *Scope of election.* This election applies to the section 465 activities and unused losses from section 465 activities of the taxpayers making the election.

(iii) *Amendment of previously filed returns.* The debtor and the estate making the election must amend all returns (except to the extent they are for a year that is a closed year within the meaning of paragraph (f)(2)(iv)(D) of this section) they filed before the date of the election to the extent necessary to provide that no claim of a deduction is inconsistent with the succession under this section to unused losses

from section 465 activities. The Commissioner may revoke or limit the effect of the election if either the debtor or the estate fails to satisfy the requirement of this paragraph (f)(2)(iii).

(iv) *Rules relating to closed years*—(A) *Estate succeeds to debtor's section 465 loss as of the commencement date.* If, by reason of an election under this paragraph (f), this section applies to a case that was commenced in a closed year, the estate, nevertheless, succeeds to and takes into account the section 465 losses of the debtor (determined as of the first day of the debtor's taxable year in which the case commenced).

(B) *No reduction of unused section 465 loss for loss not claimed for a closed year.* In determining a taxpayer's carryover of an unused section 465 loss to its taxable year following a closed year, a deduction that the taxpayer failed to claim in the closed year, if attributable to an unused section 465 loss to which the taxpayer succeeds under this section, is treated as a deduction that was not allowed under section 465.

(C) *Loss to which taxpayer succeeds reflects deductions of prior holder in a closed year.* A loss to which a taxpayer would otherwise succeed under this section is reduced to the extent the loss was allowed to its prior holder for a closed year.

(D) *Closed year.* For purposes of this paragraph (f)(2)(iv), a taxable year is closed to the extent the assessment of a deficiency or refund of an overpayment is prevented, on the date of the election and at all times thereafter, by any law or rule of law.

(v) *Manner of making election*—(A) *Chapter 7 cases.* In a case under chapter 7 of title 11 of the United States Code, the election is made by obtaining the written consent of the bankruptcy trustee and filing a copy of the written consent with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(B) *Chapter 11 cases.* In a case under chapter 11 of title 11 of the United States Code, the election is made by incorporating the election into a bankruptcy plan that is confirmed by the bankruptcy court or into an order of such court and filing the pertinent portion of the plan or order with the returns (or amended returns) of the debtor and the estate for their first taxable years ending after November 9, 1992.

(vi) *Election is binding and irrevocable.* Except as provided in paragraph (f)(2)(iii) of this section, the election, once made, is binding on both the debtor and the estate and is irrevocable.

§ 1.1398–3 Treatment of section 121 exclusion in individuals' title 11 cases.

(a) *Scope.* This section applies to cases under chapter 7 or chapter 11 of title 11 of the United States Code, but only if the debtor is an individual.

(b) *Definition and rules of general application.* For purposes of this section, section 121 exclusion means the exclusion of gain from the sale or exchange of a debtor's principal residence available under section 121.

(c) *Estate succeeds to exclusion upon commencement of case.* The bankruptcy estate succeeds to and takes into account the section 121 exclusion with respect to the property transferred into the estate.

(d) *Effective date.* This section is applicable for sales or exchanges on or after December 24, 2002.

[67 FR 78367, Dec. 24, 2002]

§ 1.1400L(b)–1 Additional first year depreciation deduction for qualified New York Liberty Zone property.

(a) *Scope.* This section provides the rules for determining the 30-percent additional first year depreciation deduction allowable under section 1400L(b) for qualified New York Liberty Zone property.

(b) *Definitions.* For purposes of section 1400L(b) and this section, the definitions of the terms in § 1.168(k)–1(a)(2) apply and the following definitions also apply:

(1) *Building* and *structural components* have the same meanings as those terms are defined in § 1.48–1(e).

(2) *New York Liberty Zone* is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York.

(3) *Nonresidential real property* and *residential rental property* have the same

meanings as those terms are defined in section 168(e)(2).

(4) *Real property* is a building or its structural components, or other tangible real property.

(c) *Qualified New York Liberty Zone property*—(1) *In general.* Qualified New York Liberty Zone property is depreciable property that meets all the following requirements in the first taxable year in which the property is subject to depreciation by the taxpayer whether or not depreciation deductions for the property are allowable—

(i) The requirements in §1.1400L(b)–1(c)(2) (description of property);

(ii) The requirements in §1.1400L(b)–1(c)(3) (substantial use);

(iii) The requirements in §1.1400L(b)–1(c)(4) (original use);

(iv) The requirements in §1.1400L(b)–1(c)(5) (acquisition of property by purchase); and

(v) The requirements in §1.1400L(b)–1(c)(6) (placed-in-service date).

(2) *Description of qualified New York Liberty Zone property*—(i) *In general.* Depreciable property will meet the requirements of this paragraph (c)(2) if the property is—

(A) Described in §1.168(k)–1(b)(2)(i); or

(B) Nonresidential real property or residential rental property depreciated under section 168, but only to the extent it rehabilitates real property damaged, or replaces real property destroyed or condemned, as a result of the terrorist attacks of September 11, 2001. Property is treated as replacing destroyed or condemned property if, as part of an integrated plan, the property replaces real property that is included in a continuous area that includes real property destroyed or condemned. For purposes of this section, real property is considered as destroyed or condemned only if an entire building or structure was destroyed or condemned as a result of the terrorist attacks of September 11, 2001. Otherwise, the real property is considered damaged real property. For example, if certain structural components (for example, walls, floors, and plumbing fixtures) of a building are damaged or destroyed as a result of the terrorist attacks of September 11, 2001, but the building is not destroyed or condemned, then only costs related to replacing the damaged or destroyed structural components qualify under this paragraph (c)(2)(i)(B).

(ii) *Property not eligible for additional first year depreciation deduction.* Depreciable property will not meet the requirements of this paragraph (c)(2) if—

(A) Section 168(k) or §1.168(k)–1 applies to the property;

(B) The property is described in section 168(f);

(C) The property is required to be depreciated under the alternative depreciation system of section 168(g) pursuant to section 168(g)(1)(A) through (D) or other provisions of the Internal Revenue Code (for example, property described in section 263A(e)(2)(A) if the taxpayer (or any related person) has made an election under section 263A(d)(3), or property described in section 280F(b)(1));

(D) The property is included in any class of property for which the taxpayer elects not to deduct the additional first year depreciation under paragraph (e) of this section; or

(E) The property is qualified New York Liberty Zone leasehold improvement property as described in section 1400L(c)(2).

(3) *Substantial use.* Depreciable property will meet the requirements of this paragraph (c)(3) if substantially all of the use of the property is in the New York Liberty Zone and is in the active conduct of a trade or business by the taxpayer in New York Liberty Zone. For purposes of this paragraph (c)(3), ''substantially all'' means 80 percent or more.

(4) *Original use.* Depreciable property will meet the requirements of this paragraph (c)(4) if the original use of the property commences with the taxpayer in the New York Liberty Zone after September 10, 2001. The original use rules in §1.168(k)–1(b)(3) apply for purposes of this paragraph (c)(4). In addition, used property will satisfy the original use requirement in this paragraph (c)(4) so long as the property has not been previously used within the New York Liberty Zone.

(5) *Acquisition of property by purchase*—(i) *In general.* Depreciable property will meet the requirements of this paragraph (c)(5) if the property is acquired by the taxpayer by purchase (as

defined in section 179(d) and §1.179–4(c)) after September 10, 2001, but only if no written binding contract for the acquisition of the property was in effect before September 11, 2001. For purposes of this paragraph (c)(5), the rules in §1.168(k)–1(b)(4)(ii) (binding contract), the rules in §1.168(k)–1(b)(4)(iii) (self-constructed property), and the rules in §1.168(k)–1(b)(4)(iv) (disqualified transactions) apply. For purposes of the preceding sentence, the rules in §1.168(k)–1(b)(4)(iii) shall be applied without regard to 'and before January 1, 2005.'

(ii) *Exception for certain transactions.* For purposes of this section, the new partnership of a transaction described in §1.168(k)–1(f)(1)(ii) (technical termination of a partnership) or the transferee of a transaction described in §1.168(k)–1(f)(1)(iii) (section 168(i)(7) transactions) is deemed to acquire the depreciable property by purchase.

(6) *Placed-in-service date.* Depreciable property will meet the requirements of this paragraph (c)(6) if the property is placed in service by the taxpayer on or before December 31, 2006. However, nonresidential real property and residential rental property described in paragraph (c)(2)(i)(B) of this section must be placed in service by the taxpayer on or before December 31, 2009. The rules in §1.168(k)–1(b)(5)(ii) (relating to sale-leaseback and syndication transactions), the rules in §1.168(k)–1(b)(5)(iii) (relating to a technical termination of a partnership under section 708(b)(1)(B)), and the rules in §1.168(k)–1(b)(5)(iv) (relating to section 168(i)(7) transactions) apply for purposes of this paragraph (c)(6).

(d) *Computation of depreciation deduction for qualified New York Liberty Zone property.* The computation of the allowable additional first year depreciation deduction and the otherwise allowable depreciation deduction for qualified New York Liberty Zone property is made in accordance with the rules for qualified property in §1.168(k)–1(d)(1)(i) and (2).

(e) *Election not to deduct additional first year depreciation*—(1) *In general.* A taxpayer may make an election not to deduct the 30-percent additional first year depreciation for any class of property that is qualified New York Liberty Zone property placed in service during the taxable year. If a taxpayer makes an election under this paragraph (e), the election applies to all qualified New York Liberty Zone property that is in the same class of property and placed in service in the same taxable year, and no additional first year depreciation deduction is allowable for the class of property.

(2) *Definition of class of property.* For purposes of this paragraph (e), the term class of property means—

(i) Except for the property described in paragraphs (e)(2)(ii), (iv), and (v) of this section, each class of property described in section 168(e) (for example, 5-year property);

(ii) Water utility property as defined in section 168(e)(5) and depreciated under section 168;

(iii) Computer software as defined in, and depreciated under, section 167(f)(1) and the regulations thereunder;

(iv) Nonresidential real property as defined in paragraph (b)(3) of this section and as described in paragraph (c)(2)(B) of this section; or

(v) Residential rental property as defined in paragraph (b)(3) of this section and as described in paragraph (c)(2)(B) of this section

(3) *Time and manner for making election*—(i) *Time for making election.* Except as provided in paragraph (e)(4) of this section, the election specified in paragraph (e)(1) of this section must be made by the due date (including extensions) of the Federal tax return for the taxable year in which the qualified New York Liberty Zone property is placed in service by the taxpayer

(ii) *Manner of making election.* Except as provided in paragraph (e)(4) of this section, the election specified in paragraph (e)(1) of this section must be made in the manner prescribed on Form 4562, ''Depreciation and Amortization,'' and its instructions. The election is made separately by each person owning qualified New York Liberty Zone property (for example, for each member of a consolidated group by the common parent of the group, by the partnership, or by the S corporation). If Form 4562 is revised or renumbered, any reference in this section to that form shall be treated as a reference to the revised or renumbered form.

(4) *Special rules for 2000 or 2001 returns.* For the election specified in paragraph (e)(1) of this section for qualified New York Liberty Zone property placed in service by the taxpayer during the taxable year that included September 11, 2001, the taxpayer should refer to the guidance provided by the Internal Revenue Service for the time and manner of making this election on the 2000 or 2001 Federal tax return for the taxable year that included September 11, 2001 (for further guidance, *see* sections 3.03(3) and 4 of Rev. Proc. 2002–33 (2002–1 C.B. 963), Rev. Proc. 2003–50 (2003–29 I.R.B. 119), and §601.601(d)(2)(ii)(*b*) of this chapter).

(5) *Failure to make election.* If a taxpayer does not make the election specified in paragraph (e)(1) of this section within the time and in the manner prescribed in paragraph (e)(3) or (e)(4) of this section, the amount of depreciation allowable for that property under section 167(f)(1) or under section 168, as applicable, must be determined for the placed-in-service year and for all subsequent taxable years by taking into account the additional first year depreciation deduction. Thus, the election specified in paragraph (e)(1) of this section shall not be made by the taxpayer in any other manner (for example, the election cannot be made through a request under section 446(e) to change the taxpayer's method of accounting).

(6) *Alternative minimum tax.* If a taxpayer makes an election under this paragraph (e) for a class of property, the depreciation adjustments under section 56 and the regulations under section 56 apply to the property to which the election applies for purposes of computing the taxpayer's alternative minimum taxable income.

(7) *Revocation of election*—(i) *In general.* Except as provided in paragraph (e)(7)(ii) of this section, an election under this paragraph (e), once made, may be revoked only with the written consent of the Commissioner of Internal Revenue. To seek the Commissioner's consent, the taxpayer must submit a request for a letter ruling.

(ii) *Automatic 6-month extension.* If a taxpayer made an election under this paragraph (e) for a class of property, an automatic extension of 6 months from the due date of the taxpayer's Federal tax return (excluding extensions) for the placed-in-service year of the class of property is granted to revoke that election, provided the taxpayer timely filed the taxpayer's Federal tax return for the placed-in-service year of the class of property and, within this 6-month extension period, the taxpayer (and all taxpayers whose tax liability would be affected by the election) files an amended Federal tax return for the placed-in-service year of the class of property in a manner that is consistent with the revocation of the election.

(f) *Special rules*—(1) *Property placed in service and disposed of in the same taxable year.* Rules similar to those provided in §1.168(k)–1(f)(1) apply for purposes of this paragraph (f)(1).

(2) *Redetermination of basis.* If the unadjusted depreciable basis (as defined in §1.168(k)–1(a)(2)(iii)) of qualified New York Liberty Zone property is redetermined (for example, due to contingent purchase price or discharge of indebtedness) on or before December 31, 2006 (or on or before December 31, 2009, for nonresidential real property and residential rental property described in paragraph (c)(2)(i)(B) of this section), the additional first year depreciation deduction allowable for the qualified New York Liberty Zone property is redetermined in accordance with the rules provided in §1.168(k)–1(f)(2).

(3) *Section 1245 and 1250 depreciation recapture.* The rules provided in §1.168(k)–1(f)(3) apply for purposes of this paragraph (f)(3).

(4) *Coordination with section 169.* Rules similar to those provided in §1.168(k)–1(f)(4) apply for purposes of this paragraph (f)(4).

(5) *Like-kind exchanges and involuntary conversions.* This paragraph (f)(5) applies to acquired MACRS property (as defined in §1.168(k)–1(f)(5)(ii)(A)) or acquired computer software (as defined in §1.168(k)–1(f)(5)(ii)(C)) that is eligible for the additional first year depreciation deduction under section 1400L(b) at the time of replacement provided the time of replacement is after September 10, 2001, and on or before December 31, 2006, or in the case of acquired MACRS property or acquired computer software that is qualified New York Liberty Zone property described in paragraph (c)(2)(i)(B) of this

section, the time of replacement is after September 10, 2001, and on or before December 31, 2009. The rules and definitions similar to those provided in §1.168(k)–1(f)(5) apply for purposes of this paragraph (f)(5).

(6) *Change in use.* Rules similar to those provided in §1.168(k)–1(f)(6) apply for purposes of this paragraph (f)(6).

(7) *Earnings and profits.* The rule provided in §1.168(k)–1(f)(7) applies for purposes of this paragraph (f)(7).

(8) *Section 754 election.* Rules similar to those provided in §1.168(k)–1(f)(9) apply for purposes of this paragraph (f)(8).

(9) *Coordination with section 47.* Rules similar to those provided in §1.168(k)–1(f)(10) apply for purposes of this paragraph (f)(9).

(10) *Coordination with section 514(a)(3).* Rules similar to those provided in §1.168(k)–1(f)(11) apply for purposes of this paragraph (f)(10).

(g) *Effective date*—(1)*In general.* Except as provided in paragraphs (g)(2), (3), and (5) of this section, this section applies to qualified New York Liberty Zone property acquired by a taxpayer after September 10, 2001.

(2) *Technical termination of a partnership or section 168(i)(7) transactions.* If qualified New York Liberty Zone property is transferred in a technical termination of a partnership under section 708(b)(1)(B) or in a transaction described in section 168(i)(7) for a taxable year ending on or before September 8, 2003, and the additional first year depreciation deduction allowable for the property was not determined in accordance with paragraph (f)(1) of this section, the Internal Revenue Service will allow any reasonable method of determining the additional first year depreciation deduction allowable for the property in the year of the transaction that is consistently applied to the property by all parties to the transaction.

(3) *Like-kind exchanges and involuntary conversions.* If a taxpayer did not claim on a federal tax return for a taxable year ending on or before September 8, 2003, the additional first year depreciation deduction for the remaining carryover basis of qualified New York Liberty Zone property acquired in a transaction described in section 1031(a), (b), or (c), or in a transaction to which section 1033 applies and the taxpayer did not make an election not to deduct the additional first year depreciation deduction for the class of property applicable to the remaining carryover basis, the Internal Revenue Service will treat the taxpayer's method of not claiming the additional first year depreciation deduction for the remaining carryover basis as a permissible method of accounting and will treat the amount of the additional first year depreciation deduction allowable for the remaining carryover basis as being equal to zero, provided the taxpayer does not claim the additional first year depreciation deduction for the remaining carryover basis in accordance with paragraph (g)(4)(ii) of this section.

(4) *Change in method of accounting*—(i) *Special rules for 2000 or 2001 returns.* If a taxpayer did not claim on the federal tax return for the taxable year that included September 11, 2001, any additional first year depreciation deduction for a class of property that is qualified New York Liberty Zone property and did not make an election not to deduct the additional first year depreciation deduction for that class of property, the taxpayer should refer to the guidance provided by the Internal Revenue Service for the time and manner of claiming the additional first year depreciation deduction for the class of property (for further guidance, *see* section 4 of Rev. Proc. 2002–33 (2002–1 C.B. 963), Rev. Proc. 2003–50 (2003–29 I.R.B. 119), and §601.601(d)(2)(ii)(*b*) of this chapter).

(ii) *Like-kind exchanges and involuntary conversions.* If a taxpayer did not claim on a federal tax return for any taxable year ending on or before September 8, 2003, the additional first year depreciation deduction allowable for the remaining carryover basis of qualified New York Liberty Zone property acquired in a transaction described in section 1031(a), (b), or (c), or in a transaction to which section 1033 applies and the taxpayer did not make an election not to deduct the additional first year depreciation deduction for the class of property applicable to the remaining carryover basis, the taxpayer may

claim the additional first year depreciation deduction allowable for the remaining carryover basis in accordance with paragraph (f)(5) of this section either—

(A) By filing an amended return (or a qualified amended return, if applicable (for further guidance, *see* Rev. Proc. 94–69 (1994–2 C.B. 804) and § 601.601(d)(2)(ii)(*b*) of this chapter)) on or before December 31, 2003, for the year of replacement and any affected subsequent taxable year; or,

(B) By following the applicable administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, *see* Rev. Proc. 2002–9 (2002–1 C.B. 327) and § 601.601(d)(2)(ii)(*b*) of this chapter).

(iii) *Revisions made in paragraphs (b)(4) and (c)(2)(ii) of this section.* If a taxpayer did not claim on a Federal tax return for a taxable year ending on or after September 11, 2001, and on or before September 1, 2006, any additional first year depreciation deduction for qualified New York Liberty Zone property because of the application of § 1.1400L(b)–1T(b)(4) or because the taxpayer made an election under § 1.168(k)–1T(e)(1) for a class of property that included such qualified New York Liberty Zone property, the taxpayer may claim the additional first year depreciation deduction for such qualified New York Liberty Zone property under this section in accordance with the applicable administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in method of accounting. Section 481(a) applies to a request to claim the additional first year depreciation deduction for such qualified New York Liberty Zone property under this paragraph (g)(4)(iii).

(5) *Revision to paragraphs (b)(4) and (b)(6).* The addition of ''(or, in the case of multiple units of property subject to the same lease, within three months after the date the final unit is placed in service, so long as the period between the time the first unit is placed in service and the time the last unit is placed in service does not exceed 12 months)'' to § 1.168(k)–1(b)(3)(iii)(B) and § 1.168(k)–1(b)(5)(ii)(B) applies to property sold after June 4, 2004, for purposes of paragraphs (b)(4) and (b)(6) of this section.

(6) *Rehabilitation credit.* If a taxpayer did not claim on a Federal tax return for a taxable year ending on or before September 1, 2006, the rehabilitation credit provided by section 47(a) with respect to the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures and the qualified rehabilitation expenditures are qualified New York Liberty Zone property, and the taxpayer did not make the election specified in paragraph (e)(1) of this section for the class of property that includes the qualified rehabilitation expenditures, the taxpayer may claim the rehabilitation credit for the remaining rehabilitated basis (as defined in § 1.168(k)–1(f)(10)(i)(B)) of the qualified rehabilitated building that is attributable to the qualified rehabilitation expenditures (assuming all the requirements of section 47 are met) in accordance with paragraph (f)(9) of this section by filing an amended Federal tax return for the taxable year for which the rehabilitation credit is to be claimed. The amended Federal tax return must include the adjustment to the tax liability for the rehabilitation credit and any collateral adjustments to taxable income or to the tax liability (for example, the amount of depreciation allowed or allowable in that taxable year for the qualified rehabilitated building). Such adjustments must also be made on amended Federal tax returns for any affected succeeding taxable years.

[T.D. 9091, 68 FR 53004, Sept. 8, 2003; T.D. 9091, 68 FR 63734, Nov. 10, 2003. Redesignated and amended by T.D. 9283, 71 FR 51746, Aug. 31, 2006]

§ 1.1400Z2–0 Table of Contents.

This section lists the table of contents for §§ 1.1400Z2(a)–1 through 1.1400Z2(f)–1.

(2) Prior periods.

[T.D. 9889, 85 FR 1953, Jan. 13, 2020; 85 FR 19082, Apr. 6, 2020]

§ 1.1400Z2(a)–1 Deferring tax on capital gains by investing in opportunity zones.

(a) *Deferring tax on capital gains*—(1) *Overview*. Under section 1400Z–2(a) of the Internal Revenue Code (Code) and the section 1400Z–2 regulations (as defined in paragraph (b)(41) of this section), an eligible taxpayer may elect to defer recognition of some or all of one or more eligible gains that otherwise would be recognized by the eligible taxpayer in the taxable year to the extent that the eligible taxpayer timely acquires a qualifying investment in a qualified opportunity fund (QOF) within the meaning of section 1400Z–2(d)(1) and § 1.1400Z2(d)–1. Paragraph (a)(2) of this section describes how a taxpayer elects to defer gain. Paragraph (b) of this section defines terms used in the section 1400Z–2 regulations. Paragraph (c) of this section provides operational rules for applying section 1400Z–2 and the section 1400Z–2 regulations, including special rules regarding the election to defer gain under section 1400Z–2(a) and this section when an eligible taxpayer that is a partnership, S corporation, trust, or decedent's estate recognizes an eligible gain in a taxable year. Paragraph (d) of this section provides the manner in which a deferral election under section 1400Z–2(a) must be made. Paragraph (e) of this section provides the treatment of section 1400Z–2 for purposes of § 1.897–6T. Paragraph (f) of this section provides rules for mixed-funds investments. Paragraph (g) of this section provides dates of applicability. See §§ 1.1502–14Z and 1.1504–3 for special rules applicable to consolidated groups that invest in QOFs.

(2) *Procedure for deferring gain*. A taxpayer defers gain, in whole or in part, by making an election on its Federal income tax return for the taxable year in which the gain would be included if not deferred. The election must be made in the manner prescribed by the Internal Revenue Service in guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§ 601.601(d)(2) and 601.602 of this chapter).

(b) *Definitions*. The following definitions apply for purposes of section 1400Z–2 and the section 1400Z–2 regulations:

(1) *30-month substantial improvement period*. The term *30-month substantial improvement period* means any 30-month period, beginning after the date of acquisition of tangible property, in which additions to the basis of the tangible property in the hands of the QOF or qualified opportunity zone business (see § 1.1400Z2(d)–2(b)(4)) exceed an amount equal to the adjusted basis of such property at the beginning of the 30-month period in the hands of the QOF or qualified opportunity zone business.

(2) *70-percent tangible property standard*. The term *70-percent tangible property standard* means the requirement in section 1400Z–2(d)(3)(A)(i) that a qualified opportunity zone business must satisfy with respect to qualified opportunity zone business property (see § 1.1400Z2(d)–2) that the qualified opportunity zone business holds, whether the qualified opportunity zone business property is owned by the qualified opportunity zone business or leased by the qualified opportunity zone business from another person.

(3) *70-percent use test*. The term *70-percent use test* means the test described in § 1.1400Z2(d)–2(d)(4)(ii) that is used to determine if a QOF or qualified opportunity zone business satisfies the requirement in sections 1400Z–2(d)(2)(D)(i)(III) and 1400Z–2(d)(3)(A)(i) that substantially all of the use of tangible property was in a qualified opportunity zone.

(4) *90-percent investment standard*. The term *90-percent investment standard* means the requirement provided in section 1400Z–2(d)(1) that a QOF must hold at least 90 percent of its assets in qualified opportunity zone property, as defined in section 1400Z–2(d)(2) and § 1.1400Z2(d)–1(c)(1), determined by the average of the percentage of qualified opportunity zone property held by the QOF as measured on the last day of the first six-month period and on the last day of the taxable year of the QOF.

(5) *90-percent qualified opportunity zone property holding period*. The term *90-percent qualified opportunity zone*

property holding period means the minimum portion of a QOF's holding period in stock of a corporation or interests in a partnership, during which the corporation or partnership qualifies as a qualified opportunity zone business in order for the stock or the partnership interests to meet the substantially all requirement under section 1400Z–2(d)(2)(B)(i)(III) to be treated as qualified opportunity zone stock or the substantially all requirement under section 1400Z–2(d)(2)(C)(iii) to be treated as qualified opportunity zone partnership interests, as applicable, held by the QOF.

(6) *90-percent qualified opportunity zone business property holding period.* The term *90-percent qualified opportunity zone business property holding period* means the minimum portion of a QOF's or qualified opportunity zone business's holding period in tangible property during which the 70-percent use test with respect to the tangible property must be satisfied, in order for the tangible property to meet the requirement under section 1400Z–2(d)(2)(D)(i)(III) to be treated as qualified opportunity zone business property held by the QOF or qualified opportunity zone business.

(7) *180-day period*—(i) *In general.* Except as otherwise provided elsewhere in this section, the term *180-day period* means the 180-day period referred to in section 1400Z–2(a)(1)(A) with respect to any eligible gain meeting the requirements of paragraph (b)(11) of this section that begins on the day on which the gain would be recognized for Federal income tax purposes if the eligible taxpayer did not elect under section 1400Z–2 and the section 1400Z–2 regulations to defer recognition of that gain.

(ii) *180-day period for RIC and REIT capital gain dividends*—(A) *General rule.* Unless the shareholder of a regulated investment company (RIC) or real estate investment trust (REIT) chooses to apply paragraph (b)(7)(ii)(B) of this section, the 180-day period for a RIC or REIT capital gain dividend begins on the last day of the shareholder's taxable year in which the capital gain dividend would otherwise be recognized by the shareholder.

(B) *Elective rule.* Notwithstanding the general rule in paragraph (b)(7)(ii)(A) of this section, a shareholder of a RIC or REIT may choose to treat the 180-day period with respect to a capital gain dividend that the shareholder receives from the RIC or REIT as beginning on the date of the dividend distribution; provided, however, that the aggregate amount of the shareholder's eligible gain with respect to capital gain dividends from the RIC or REIT is limited to the aggregate amount of capital gain dividends reported for that shareholder by the RIC for that shareholder's taxable year or designated for that shareholder by the REIT for that shareholder's taxable year.

(C) *Undistributed capital gains.* If section 852(b)(3)(D) or 857(b)(3)(C) (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 rule in paragraph (b)(7)(ii)(B) of this section does not apply to that amount. The 180-day period with respect to the included undistributed capital gain begins, at the shareholder's election, on either the last day of the RIC or REIT's taxable year or the last day of the shareholder's taxable year in which the amount would otherwise be recognized as long-term capital gains by the shareholder.

(iii) *180-day period for partners, S corporation shareholders, and owners of other passthrough entities.* See paragraph (c)(8) and (9) of this section for rules relating to the determination of the 180-day period for partners, S corporation shareholders, or beneficiaries of a trust or decedent's estate in cases in which a partnership, S corporation, trust, or decedent's estate is not an eligible taxpayer with respect to an eligible gain, or does not make a deferral election with respect to an eligible gain.

(iv) *Examples.* The following examples illustrate the principles of paragraph (b)(7)(i) through (iii) of this section.

(A) *Example 1. Regular-way trades of stock.* Individual A sells stock at a gain in a regular-way trade on an exchange (that is, in a transaction in which a trade order is placed on the trade date, and settlement of the transaction, including payment and delivery of the stock, occurs a standardized number of days after the trade date). The 180-day period with respect to A's gain on the stock begins on the trade date.

(B) *Example 2. Capital gain dividends received by a REIT shareholder.* REIT and Shareholder are calendar year taxpayers. REIT distributes a dividend to Shareholder on March 1, Year 1. REIT designates the March 1 dividend as a capital gain dividend before 30 days after the close of Year 1. Shareholder's 180-day period with respect to that capital gain dividend begins on December 31, Year 1. However, Shareholder may choose to begin the 180-day period on March 1, Year 1. If so, an equity interest in a QOF received by Shareholder in exchange for an investment of an amount corresponding to that capital gain dividend may be a qualifying investment to the extent that Shareholder's aggregate elected deferrals of dividends from REIT for Year 1 do not exceed Shareholder's aggregate capital gain dividends from REIT for the taxable year.

(C) *Example 3. Multiple capital gain dividends received by a RIC shareholder.* RIC is a calendar year taxpayer. RIC distributes a dividend of $100 to Shareholder, a calendar year taxpayer, on March 1, Year 1 and distributes another dividend of $50 to Shareholder on June 1, Year 1. RIC reports both the March 1 and June 1 dividends as capital gain dividends on Shareholder's Form 1099–DIV for Year 1. Shareholder's 180-day period with respect to both capital gain dividends begins on December 31, Year 1. However, Shareholder may choose to begin the 180-day period for the $100 RIC capital gain dividend on March 1, Year 1, and may choose to begin the 180-day period for the $50 RIC capital gain dividend on June 1, Year 1. Thus, if Shareholder makes a single investment of $200 in a QOF in exchange for an eligible interest (as defined in paragraph (b)(12) of this section) on July 1, Year 1, absent any other eligible gain, Shareholder may treat $150 of the eligible interest as a qualifying investment in the QOF (that is, the amount that corresponds to the aggregate amount of the RIC capital gain dividends in Year 1) and $50 of the eligible interest as a non-qualifying investment therein.

(D) *Example 4. Additional deferral of previously deferred gains—(1) Facts.* Taxpayer A invested in a QOF and properly elected to defer realized gain. On March 15, 2025, A disposes of its entire investment in the QOF in a transaction that, under sections 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 March 15, 2025, the date on which A disposed of its entire interest in the QOF. A wants to make a deferral election with respect to A's gain from the disposal of the QOF investment.

(*2*) *Analysis.* Under paragraph (b)(7)(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 March 15, 2025, 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 March 15, 2025, the date when A disposed of its entire investment in the QOF.

(8) *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.

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

(10) *Deferral election.* The term *deferral election* means an election under section 1400Z–2(a) and the section 1400Z–2 regulations made before January 1, 2027, with respect to an eligible gain.

(11) *Eligible gain*—(i) *In general.* An amount of gain is an *eligible gain,* and thus is eligible for deferral under section 1400Z–2(a) and the section 1400Z–2 regulations, if the gain—

(A) Is treated as a capital gain for Federal income tax purposes or is a qualified 1231 gain within the meaning of paragraph (b)(11)(iii)(A) of this section, determined by—

(*1*) Not taking into account any losses unless otherwise specified in the section 1400Z–2 regulations; and

(*2*) Taking into account any other provision of the Code that requires the character of potential capital gain to be recharacterized or redetermined as ordinary income, as defined in section 64, for purposes of the Code;

(B) Would be recognized for Federal income tax purposes and subject to tax under subtitle A of the Code before January 1, 2027 (subject to Federal income tax), 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 of property with a person that, within the meaning of section 1400Z–2(e)(2), is related to—

(*1*) The eligible taxpayer that would recognize the gain in the taxable year in which the sale or exchange occurs if section 1400Z–2(a)(1) and the section 1400Z–2 regulations did not apply to defer recognition of the gain; or

(*2*) Any passthrough entity or other person recognizing and allocating the

gain to the eligible taxpayer described in paragraph (b)(11)(i)(C)(*1*) of this section.

(ii) *Portion of eligible gain not already subject to a deferral election*. In the case of an eligible taxpayer who has made an election under section 1400Z–2(a) and the section 1400Z–2 regulations regarding some but not all of an eligible gain, the portion of that eligible gain with respect to which no election under section 1400Z–2(a) and the section 1400Z–2 regulations has been made remains an eligible gain for which a deferral election may be made.

(iii) *Qualified 1231 gains*—(A) *Definition*. A section 1231 gain (as defined in section 1231(a)(3)(A)) recognized on the sale or exchange of property defined in section 1231(b) (1231(b) property) is a *qualified 1231 gain* to the extent that it exceeds any amount with respect to the 1231(b) property that is treated as ordinary income under section 1245 or section 1250.

(B) *180-day period*. For the applicable 180-day period with respect to a qualified 1231 gain, see paragraph (b)(7) of this section.

(C) *Attributes of included income when deferral ends*. For the Federal income tax treatment of the later inclusion of a qualified 1231 gain deferred under section 1400Z–2(a)(1) and the section 1400Z–2 regulations, see paragraph (c)(1) of this section.

(iv) *Gain arising from an inclusion event*—(A) *In general*. Gain that is otherwise required to be included in gross income under §1.1400Z2(b)–1(e)(1), whether from the disposition of an entire interest in a QOF or a disposition of a partial interest, may be eligible for deferral under section 1400Z–2(a)(1), provided that all of the requirements to elect to defer gain under section 1400Z–2(a)(1)(A) are met. For purposes of determining whether such gain is eligible gain under section 1400Z–2(a)(1)(A) and this paragraph (b)(11)(iv)(A), the eligible taxpayer should treat such inclusion gain as if it was originally realized upon the occurrence of the inclusion event rather than on the sale or exchange that gave rise to the eligible gain to which the inclusion event relates.

(B) *180-day period*. The 180-day period for investing gain from an inclusion event begins on the date of the inclusion event.

(C) *Holding period*. The holding period for a qualifying investment attributable to eligible gain arising from an inclusion event begins on the date that the gain is reinvested in a QOF.

(v) *No deferral for gain realized upon the acquisition of an eligible interest*. Gain is not eligible for deferral under section 1400Z–2(a)(1) and the section 1400Z–2 regulations if such gain is realized upon the contribution, exchange, or other transfer of property to a QOF in exchange for an eligible interest (see paragraph (c)(6)(ii)(C) of this section) or the transfer of property to an eligible taxpayer in exchange for an eligible interest (see paragraph (c)(6)(iv) of this section).

(vi) *Gain from section 1256 contracts and from positions in a straddle*—(A) *General rule*. Except as otherwise explicitly provided in paragraph (b)(11)(vi)(B), (C), or (D) of this section, eligible gain for a taxable year does not include—

(*1*) Gain from a section 1256 contract as defined in section 1256(b);

(*2*) Gain from a position that was part of a straddle as defined in section 1092 (straddle) during the taxable year; or

(*3*) Gain from a position that was part of a straddle in a previous taxable year if, under section 1092(a)(1)(B), a loss from any position in that straddle is treated as sustained, subject to the limitations of section 1092(a)(1)(A), during the taxable year.

(B) *Exception for net gain from certain section 1256 contracts*. Paragraph (b)(11)(vi)(A)(*1*) of this section does not apply to the net gain during the taxable year from section 1256 contracts that were not part of a straddle at any time during the taxable year (qualified section 1256 contracts). For purposes of this paragraph (b)(11)(vi)(B), the net gain during the taxable year from qualified section 1256 contracts is determined by taking into account all capital gains and losses from such contracts for the taxable year that are recognized for Federal income tax purposes, determined without regard to section 1400Z–2(a)(1). The 180-day period with respect to any eligible gain described in this paragraph (b)(11)(vi)(B)

begins on the last day of the taxable year, and the character of that gain when it is later included under sections 1400Z–2(a)(1)(B) and 1400Z–2(b) is determined under the general rule in paragraph (c)(1) of this section. If, under section 1256(a)(4), section 1092 does not apply to a straddle, such straddle is not treated as a straddle for purposes of this paragraph (b)(11)(vi)(B).

(C) *Exception for net gain from certain identified straddles*—(*1*) Paragraph (b)(11)(vi)(A) of this section does not apply to the net gain during the taxable year from positions in a straddle if—

(*i*) During the taxable year, the positions were part of an identified straddle under section 1092(a)(2), part of an identified mixed straddle under §1.1092(b)–3T (and, as applicable, §1.1092(b)–6), part of an identified straddle under section 1256(d), or included in a mixed straddle account under §1.1092(b)–4T;

(*ii*) All gains and losses with respect to the positions that were part of such straddle or included in such mixed straddle account are recognized by the end of the taxable year (other than gain that would be recognized but for deferral under section 1400Z–2(a)(1));

(*iii*) None of the positions in such straddle or mixed straddle account were part of a straddle during the taxable year, other than a straddle described in paragraph (b)(11)(vi)(C)(*1*)(*i*) and (*ii*) of this section; and

(*iv*) None of the positions in such straddle or mixed straddle account were part of a straddle in a previous taxable year if, under section 1092(a)(1)(B), a loss from any position in such straddle is treated as sustained, subject to the limitations of section 1092(a)(1)(A), during the taxable year.

(*2*) For purposes of paragraph (b)(11)(vi)(C)(*1*) of this section, net gain during the taxable year from an identified straddle or mixed straddle account described in paragraph (b)(11)(vi)(C)(*1*)(*i*) through (*iv*) of this section is equal to the excess of the capital gains recognized in the taxable year for Federal income tax purposes, determined without regard to section 1400Z–2(a)(1), from all of the positions that were part of that straddle over the sum of the capital losses and net ordinary loss (if any) from all of the positions that were part of that straddle. For purposes of this paragraph (b)(11)(vi)(C)(*2*), capital gains and losses from an identified straddle or mixed straddle account include capital gains and losses from section 1256 contracts and other positions marked to market either upon termination or on the last business day of the taxable year, as well as annual account net gain from positions in a mixed straddle account covered by §1.1092(b)–4T. In addition, for purposes of this paragraph (b)(11)(vi)(C)(*2*), *net ordinary loss* means the excess of ordinary losses over ordinary gains.

(*3*) If a straddle is an identified straddle described in section 1092(a)(2), the basis adjustment provisions described in sections 1092(a)(2)(A)(ii) and (iii) must be applied in determining the net gain during the taxable year from positions that were part of that straddle.

(*4*) The 180-day period with respect to any eligible gain described in paragraph (b)(11)(vi)(C)(*2*) of this section begins on the earlier of the date when all of the positions that are, or have been, part of the straddle are disposed of (or otherwise terminated) or the last day of the taxable year.

(*5*) If net gain described in paragraph (b)(11)(vi)(C)(*2*) of this section is deferred under section 1400Z–2(a)(1), that gain is not treated as unrecognized gain for purposes of section 1092(a)(3)(A)(ii).

(D) *Additional exceptions to the general rule.* Additional exceptions to the general rule in paragraph (b)(11)(vi)(A) of this section may be prescribed in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(E) *Examples.* The following examples illustrate the rules described in paragraph (b)(11)(vi) of this section. All of the examples assume that Taxpayer holds the positions described as capital assets and that Taxpayer holds no offsetting positions other than those described in the examples.

(*1*) *Example 1.* Taxpayer owns 100 shares of publicly traded Company X common stock and acquires put options on 100 shares of Company X common stock during the taxable year. Taxpayer does not make any straddle

identifications under section 1092. During the taxable year, Taxpayer sells all 100 shares of its Company X common stock and has a $40 capital gain. During the taxable year, Taxpayer also closes out all of its put options on Company X common stock and has a $30 capital loss. That $40 of capital gain is from a position that was part of a straddle during the taxable year because the position in Company X common stock and the position in put options on Company X stock are offsetting positions as defined in section 1092(c). Under paragraph (b)(11)(vi)(A) of this section, none of Taxpayer's $40 of capital gain is eligible gain.

(*2*) *Example 2*. Taxpayer's taxable year is the calendar year. Taxpayer owns 100 shares of publicly traded Company Y common stock and has a basis in each share of $10.00. Taxpayer also owns put options on 100 shares of Company Y common stock. Taxpayer makes a valid and timely identification under section 1092(a)(2) of the 100 shares of Company Y common stock and the put options on the 100 shares of Company Y common stock. On January 10, Year 1, Taxpayer closes out all of the put options and has a $30.00 capital loss. On March 10, Year 1, Taxpayer sells 40 shares of the Company Y common stock for $11.00 per share. At the end of Year 1, the fair market value of each of the 60 remaining shares of Company Y common stock held by Taxpayer is $10.50. Under section 1092(a)(2)(A)(ii), when the put options are closed out at a loss of $30.00, the basis of each of Taxpayer's shares of Company Y common stock is increased by $0.30 ($30.00/100). Thus, Taxpayer has a gain of $28.00 ((40 * $11.00) – (40 * $10.30)) on the sale of the 40 shares of Company Y common stock. Paragraph (b)(11)(vi)(A) of this section applies to all of Taxpayer's gain during the taxable year from the straddle. Because Taxpayer has unrecognized gain from the straddle at the end of the taxable year, paragraph (b)(11)(vi)(C) of this section does not shield any of Taxpayer's gain from that result. The $28 of gain is thus not eligible gain. Taxpayer must recognize and include in taxable income for the taxable year the $28.00 capital gain. Under section 1092(a)(2)(A)(iv), Taxpayer may not deduct the $30.00 loss from the put options.

(*3*) *Example 3*. The facts are the same as in paragraph (b)(11)(vi)(E)(*2*) of this section (*Example 2*), except Taxpayer sells the 100 shares of Company Y common stock on March 10, Year 1, for $11.50 per share. Under section 1092(a)(2)(A)(ii), as in paragraph (b)(11)(vi)(E)(*2*) of this section (*Example 2*), when the put options are closed out at a loss of $30.00, the basis of each of Taxpayer's shares of Company Y common stock is increased by $0.30 ($30.00/100). Taxpayer has a gain of $120.00 ((100 * $11.50) – (100 * $10.30)) on the sale of the 100 shares of Company Y common stock. Taxpayer has net gain during the taxable year from the identified straddle of $120.00. Under paragraph (b)(11)(vi)(C) of this section, paragraph (b)(11)(vi)(A) of this section does not apply to prevent the $120.00 net gain from being eligible gain. As in paragraph (b)(11)(vi)(E)(*2*) of this section (*Example 2*), under section 1092(a)(2)(A)(iv), Taxpayer may not deduct the $30.00 loss from the put options.

(*4*) *Example 4*. Taxpayer's taxable year is the calendar year. Taxpayer owns 100 shares of publicly traded Company Z common stock and has a basis in each share of $10. Taxpayer also owns put options on 100 shares of Company Z common stock. In Year 1, Taxpayer closes out the put options at a $100 loss. At the end of Year 1, the fair market value of each of the shares of Company Z common stock held by Taxpayer is $15 and, under section 1092(a)(3), Taxpayer has $500 of unrecognized gain. Because Taxpayer's unrecognized gain on the Company Z common stock at the end of Year 1 exceeds Taxpayer's loss on the put options, Taxpayer's loss is deferred under section 1092(a)(1). During Year 2, Taxpayer sells 40 shares of Company Z common stock for $14 per share. Taxpayer has a gain of $160 ((40 * $14) – (40 * $10)) on the sale of the 40 shares of Company Z common stock. Under paragraph (b)(11)(vi)(A) of this section, because Taxpayer's Company Z common stock was part of a straddle in a previous taxable year and a loss from a position in that straddle was deferred under section 1092(a) at the end of Year

1, the preceding taxable year, Taxpayer's $160 Year 2 gain on the sale of the Company Z common stock is not eligible gain. At the end of Year 2, the fair market value of each of the 60 remaining shares of Company Z common stock held by Taxpayer is $10 and Taxpayer has no unrecognized gain on its Company Z common stock. Under section 1092(a)(1)(B), Taxpayer's $100 loss from Year 1 is treated as sustained in Year 2. Because Taxpayer has no unrecognized gain on its Company Z common stock at the end of Year 2, Taxpayer may deduct the $100 loss in Year 2. In Year 3, Taxpayer sells the remaining 60 shares of Company Z common stock for $50 per share. Taxpayer has a gain of $2,400 ((60 * $50) − (60 * $10)) on the sale of the 60 shares of Company Z common stock. Because there was no loss from the straddle deferred under section 1092(a) at the end of Year 2, paragraph (b)(11)(vi)(A) of this section does not apply to prevent the $2,400 of Year 3 net gain from being eligible gain.

(*5*) *Example 5*. Taxpayer's taxable year is the calendar year. On October 5, Year 1, Taxpayer buys 100 shares of publicly traded Exchange Traded Fund A (ETF A) and acquires offsetting section 1256 contracts on the index that underlies the ETF A shares. Taxpayer makes a valid and timely identification of all 100 ETF A shares and the offsetting section 1256 contracts under § 1.1092(b)–3T. On December 31, Year 1, the fair market value of the ETF A shares has increased by $500, and the fair market value of the section 1256 contracts has decreased by $450. On December 31, Year 1, Taxpayer sells the ETF shares for a $500 gain. In addition, under section 1256(a)(1), the section 1256 contracts are treated as sold for fair market value on December 31, Year 1, for a $450 loss. Pursuant to § 1.1092(b)–3T(b)(4), Taxpayer has a net short term capital gain from the identified mixed straddle of $50 ($500–$450). Under paragraph (b)(11)(vi)(C) of this section, paragraph (b)(11)(vi)(A) of this section does not apply to prevent the $50 of net short term capital gain from being eligible gain.

(vii) [Reserved]

(viii) *Eligible installment sale gains*—(A) *In general*. The term *eligible gain* includes gains described in this paragraph (b)(11) that would be recognized by an eligible taxpayer under the installment method pursuant to section 453 and with §§ 1.453–1 through 1.453–12 for a taxable year, provided such gain otherwise meets the requirements of this paragraph (b)(11). This includes gains recognized under the installment method under section 453 from an installment sale that occurred before December 22, 2017.

(B) *180-day period for gain from installment sales*. For gains reported on the installment method, an eligible taxpayer may treat the date the payment on the installment sale is received or the last day of the taxable year in which the eligible taxpayer would have recognized the gain under the installment method as the beginning of the 180-day period described in paragraph (b)(7) of this section. Thus, if an eligible taxpayer receives one or more payments on an installment sale and treats the date the payment on the installment sale is received as the beginning of the 180-day period, each payment will begin a new 180-day period.

(ix) *Additional rules for determining if gain is subject to Federal income tax*—(A) *Application of a treaty*—(*1*) *In general*. For purposes of paragraph (b)(11)(i)(B) of this section, whether gain would be subject to Federal income tax is determined after application of any treaty exemption provision that an eligible taxpayer elects to apply under any applicable U.S. income tax convention.

(*2*) *Treaty waiver*. An eligible taxpayer who is not a United States person within the meaning of section 7701(a)(30) (or an eligible taxpayer who is a United States person within the meaning of section 7701(a)(30) but who is treated as a resident of another country under an applicable U.S. income tax convention) may not make an election to defer gain pursuant to section 1400Z–2(a) after the applicability date of this section (see paragraph (g) of this section) unless such eligible taxpayer irrevocably waives, in accordance with forms and instructions (see § 601.602 of this chapter), any treaty benefits that would exempt such gain from being subject to Federal income tax at the time of inclusion pursuant to an applicable U.S. income tax convention. In the event

that such forms and instructions that include such waiver have not yet been published when an election pursuant to paragraph (d)(1) of this section is required to be made, such an eligible taxpayer must attach a written statement, signed under penalties of perjury, to any forms on which an election is made pursuant to paragraph (d)(1) of this section, which states ''With respect to gain deferred pursuant to an election under section 1400Z–2(a), the below signed taxpayer irrevocably waives any treaty benefits that would exempt such gain from being subject to Federal income tax at the time of inclusion pursuant to an applicable U.S. income tax convention.'' If such an eligible taxpayer chooses to apply the section 1400Z–2 regulations in a consistent manner for all taxable years (see paragraph (g)(2)(i) of this section), the taxpayer must include the signed statement required under this paragraph (b)(11)(ix)(A)(*2*) with the first annual report described in paragraph (d)(2) of this section that is required to be filed on a date that is after March 13, 2020. An eligible taxpayer not described in the first sentence of this paragraph (b)(11)(ix)(A)(*2*) will only be required to make the waiver described in this paragraph (b)(11)(ix)(A)(*2*) if and to the extent required in forms and instructions (see § 601.602 of this chapter).

(*3*) *Non-application to certain entities.* This paragraph (b)(11)(ix)(A) does not apply to an entity described in paragraph (b)(11)(ix)(B) of this section.

(B) *Gain of a partnership.* Subject to § 1.1400Z2(f)–1(c), with respect to a partnership, the requirement in paragraph (b)(11)(i)(B) of this section that a gain be subject to Federal income tax does not apply to an otherwise eligible gain of the partnership, provided the partnership acquires the eligible interest with respect to such gain. See § 1.1400Z2(f)–1(c)(3)(i) and (ii), *Examples 1 and 2*, for illustrations of the application of § 1.1400Z2(f)–1(c) (providing an anti-abuse rule) to a partnership.

(12) *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 including those within the meaning of section 1275(a)(1) and § 1.1275–1(d). An eligible interest includes a pre-existing interest in an entity that becomes a QOF pursuant to § 1.1400Z2(d)–1(a)(1)(iii).

(ii) *Use as collateral permitted.* Provided that the eligible taxpayer is the owner of the equity interest in the QOF 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 creating mixed-funds investment.* See paragraph (f)(2) of this section for rules regarding deemed contributions of money to a partnership pursuant to section 752(a).

(13) *Eligible taxpayer.* An *eligible taxpayer* is a person that is required to report the recognition of gains during the taxable year under Federal income tax accounting principles. Thus, for example, eligible taxpayers include individuals; C corporations, including RICs and REITs; organizations subject to tax under section 511; and partnerships, S corporations, trusts, and decedents' estates to the extent permitted by paragraphs (c)(7) through (9) of this section.

(14) *Inclusion event.* The term *inclusion event* has the meaning provided in § 1.1400Z2(b)–1(c).

(15) *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.

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

(17) *Property*—(i) *In general.* The term *property* means money, securities, or any other property.

(ii) *Inclusion events regarding QOF corporation distributions.* For purposes of § 1.1400Z2(b)–1(c), 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.

(18) *QOF.* The term *QOF* means a qualified opportunity fund, as defined in section 1400Z–2(d)(1) and § 1.1400Z2(d)–1.

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

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

(21) *QOF RIC*. The term *QOF RIC* means a QOF that elects to be taxed as a RIC for Federal income tax purposes. For purposes of section 1400Z–2 and the section 1400Z–2 regulations, a *RIC* is a regulated investment company within the meaning of section 851.

(22) *QOF REIT*. The term *QOF REIT* means a QOF that elects to be taxed as a REIT for Federal income tax purposes. For purposes of section 1400Z–2 and the section 1400Z–2 regulations, a *REIT* is a real estate investment trust within the meaning of section 856.

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

(24) *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.

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

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

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

(28) *QOZ designation notice*. The term *QOZ designation notice* means a notice designating population census tracts as qualified opportunity zones (QOZs) in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(29) *Qualified opportunity zone business*. The term *qualified opportunity zone business* has the meaning provided in section 1400Z–2(d)(3) and § 1.1400Z2(d)–1(d).

(30) *Qualified opportunity zone business property*. The term *qualified opportunity zone business property* has the meaning provided in section 1400Z–2(d)(2)(D) and § 1.1400Z2(d)–2.

(31) *Qualified opportunity zone partnership interest*. The term *qualified opportunity zone partnership interest* has the meaning provided in section 1400Z–2(d)(2)(C) and § 1.1400Z2(d)–1(c)(3).

(32) *Qualified opportunity zone property*. The term *qualified opportunity zone property* has the meaning provided in section 1400Z–2(d)(2)(A) and § 1.1400Z2(d)–1(c)(1).

(33) *Qualified opportunity zone stock*. The term *qualified opportunity zone stock* has the meaning provided in section 1400Z–2(d)(2)(B) and § 1.1400Z2(d)–1(c)(2).

(34) *Qualifying investment*. The term *qualifying investment* means an eligible interest, or portion thereof, in a QOF to the extent that a deferral election is made and applies with respect to such eligible interest or portion thereof and the IRS has been timely notified of the deferral election. An eligible interest in a QOF ceases to be a qualifying investment of the owner upon, and to the extent of, the occurrence of an inclusion event with regard to that eligible interest, or portion thereof, except as is expressly provided otherwise in § 1.1400Z2(b)–1(c) or other provisions of the section 1400Z–2 regulations.

(35) *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.

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

(37) *Qualifying section 355 transaction*. The term *qualifying section 355 transaction* means a distribution described in § 1.1400Z2(b)–1(c)(11)(i)(B).

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

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

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

(iii) An acquisition of assets of a QOF by an entity operating on a cooperative

basis within the meaning of section 1381;

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

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

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

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

(39) *Related persons*. The term *related* when used with regard to persons and the term *related persons* means that there is a relationship described in section 267(b) or 707(b)(1), determined by substituting ''20 percent'' for ''50 percent'' each place it occurs in such sections. The term *unrelated* when used with regard to persons means that there is no relationship described in preceding sentence.

(40) *Remaining deferred gain*. With respect to a qualifying investment, 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 §1.1400Z2(b)–1(b). After December 31, 2026, an eligible taxpayer's remaining deferred gain is $0.

(41) *Section 1400Z–2 regulations*. The term *section 1400Z–2 regulations* means the regulations in this chapter, which are prescribed in whole or in part under section 1400Z–2.

(c) *Operational and special rules*—(1) *Attributes of gains included in income under section 1400Z–2(a)(1)(B)*. If section 1400Z–2(a)(1)(B), section 1400Z–2(b), and the section 1400Z–2 regulations require a taxpayer to include in income some or all of a previously deferred gain, the rules of paragraphs (c)(1)(i) and (ii) of this section apply with respect to such gain.

(i) *Deferral year attributes*. The gain so included per paragraph (c)(1) of this section has the same attributes in the taxable year of inclusion that the gain would have had if recognition of the gain had not been deferred under section 1400Z–2(a)(1)(A). These attributes include those taken into account by sections 1(h), 1222, 1231(b), 1256, and any other applicable provisions of the Code.

(ii) *Inclusion year treatment*. The gain so included per paragraph (c)(1) of this section is subject to the same Federal income tax provisions and rates that would apply to any other gains that are realized and recognized at the same time as the included gain and that have the same attributes as the deferred gain. For example, when a deferred qualified 1231 gain, as defined in paragraph (b)(11)(iii) of this section, is required to be included in income, the included section 1231 gain is treated as if it were a section 1231 gain (within the meaning of section 1231(a)(3)(A)) that was recognized on the date of inclusion.

(iii) *Rules for associating included gain with deferred gains*—(A) *In general*. For purposes of paragraphs (c)(1)(i) and (ii) of this section, a taxpayer determines which previously deferred gain is associated with a qualifying investment in accordance with guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§601.601(d)(2) and 601.602 of this chapter). The rules of paragraphs (c)(1)(iii)(B) and (C) of this section apply only to the extent a deferred gain is not clearly associated with a particular qualifying investment under this paragraph (c)(1)(iii)(A).

(B) *Only one eligible gain associated with a deferral election*. If only one eligible gain could have been deferred with respect to a qualifying investment, that deferred gain is associated with that qualifying investment. For example, if an eligible taxpayer makes a deferral election with respect to an investment in a QOF and only one eligible gain of the taxpayer satisfies the 180-day period with respect to the investment in the QOF, that eligible gain is the gain deferred with respect to the qualifying investment for purposes of paragraphs (c)(1)(i) and (ii) of this section.

(C) *Multiple eligible gains associated with a deferral election—(1) In general*. If more than one eligible gain may have been deferred with respect to an investment in a QOF for which a deferral election has been made, then for purposes of paragraphs (c)(1)(i) and (ii) of this section, the eligible taxpayer is treated as making the investment in

the QOF first with respect to the earliest realized eligible gain, followed by the next earliest eligible gain and any other eligible gains in order of the date of their realization.

(*2*) *Rule for gains realized on the same day*. If in the application of paragraph (c)(1)(iii)(C)(*1*) of this section, two eligible gains are realized on the same day, such gains are allocated to the investment in the QOF proportionately.

(2) *Identification of which interest in a QOF corporation has been disposed of*—(i) *Need for identification*. If a taxpayer holds shares of QOF stock with identical rights (*fungible interests*), and if the taxpayer disposes of less than all of the fungible interests, it is necessary to identify which interest or interests were disposed of. A taxpayer may effect this identification in accordance with the rules and principles of §1.1012–1(c). Consistent with §1.1012–1(c), if a taxpayer does not adequately identify which of the fungible interests are disposed of, the first-in, first-out identification method (*FIFO method*) applies.

(ii) *Consequences of identification*. The identification determines—

(A) Whether an investment disposed of is a qualifying investment or a nonqualifying investment; and

(B) In the case of qualifying investments—

(*1*) The attributes of the gain addressed in paragraph (c)(1) of this section; and

(*2*) 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.

(3) *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 (c)(2)(ii) of this section, then a proportionate allocation must be made to determine which interests were disposed of (*pro-rata method*).

(4) *Examples*. The following examples illustrate the rules of paragraph (c)(1) through (3) 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 eligible gain that, if not deferred, would have been recognized as short-term capital gain, as defined in section 1222(1). In 2022, sections 1400Z–2(a)(1)(B) and (b) require taxpayer B to include the gain in gross income. Under paragraph (c)(1) of this section, the gain included in 2022 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 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 capital gain from section 1256 contracts*. For 2019, taxpayer D had $100 of net capital gain realized from section 1256 contracts that is eligible gain under paragraph (b)(11)(vi)(B) of this section. 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 D to include that deferred gain in gross income. Under paragraph (c)(1) 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 corporation Q the amount of the gain to be deferred, resulting in a total investment in Q of $500. 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 Q or sell any of its interest in Q until 2024, when E sold for a gain 60 percent of its interest in Q. E did not adequately identify which investment in QOF Q E sold. Under paragraph (c)(2)(i) of this section, E must apply the FIFO method to identify

which investments in Q that E disposed of. 60 percent of E's total investment in Q is $300 (60% × $500), thus under the FIFO method, E sold its entire 2018 initial investment of $300 in 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 to R in exchange for 100 R common shares. Later in 2018, after R was a QOF, F invested $500 to R in exchange for 400 R common shares and properly elected under section 1400Z–2 to defer $500 of realized short-term capital gain from a separate investment. 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 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. F did not adequately identify which investment in R F sold. Under paragraph (c)(2)(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 in paragraph (c)(4)(v) of this section (*Example 5*), except that, in addition, during 2021 F sold an additional 400 R common shares, and, as with the other sale, F did not adequately identify which investment in QOF R F sold. Under paragraph (c)(2)(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 (c)(2)(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 (c)(2)(ii) of this section). Under paragraph (c)(3) 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).

(5) *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 in a QOF 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.* Rendering services to a QOF is not a transfer of cash or other property to a QOF. 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 a nonqualifying investment.

(iii) *Acquisition of eligible interest from person other than QOF.* An eligible taxpayer may make an investment in a QOF by acquiring an eligible interest in a QOF from a person other than the QOF, provided that all of the requirements of section 1400Z–2(a)(1) and the section 1400Z–2 regulations for making a valid deferral election with respect to that investment are otherwise satisfied with respect to such acquisition. For

example, an eligible taxpayer who acquires an eligible interest in a QOF other than from the QOF also must have an eligible gain within the 180-day period prior to the eligible taxpayer's acquisition of the eligible interest in the QOF.

(6) *Amount invested for purposes of section 1400Z–2(a)(1)(A)*—(i) *In general.* In the case of any investments described in this paragraph (c)(6), the amount of a taxpayer's qualifying investment cannot exceed the amount of eligible gain to be deferred under the deferral election. If the amount of an otherwise qualifying investment exceeds the amount of eligible gain to be deferred under the deferral election, the amount of the excess is treated as a non-qualifying investment. See paragraph (c)(6)(iii) of this section for special rules applicable to transfers to QOF partnerships.

(ii) *Transfers to a QOF*—(A) *Cash.* If a taxpayer makes an investment in a QOF by transferring cash to a QOF, the amount of the taxpayer's investment is that amount of cash.

(B) *Property other than cash—Nonrecognition transactions.* This paragraph (c)(6)(ii)(B) applies if a taxpayer makes an investment in a QOF by transferring property other than cash to a QOF and if, but for the application of section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations, 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. This paragraph (c)(6)(ii)(B) applies separately to each item of property transferred to a QOF.

(*1*) *Amount of qualifying investment.* If paragraph (c)(6)(ii)(B) of this section applies, the amount of the taxpayer's qualifying 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) and the section 1400Z–2 regulations, or the fair market value of the eligible interest received in the transaction, both determined immediately after the transfer.

(*2*) *Fair market value of the eligible interest received exceeds its adjusted basis.* If paragraph (c)(6)(ii)(B) of this section applies, and if the fair market value of the eligible interest received is in excess of the eligible taxpayer's adjusted basis in the eligible interest received, without regard to section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations, then the eligible taxpayer's investment in a QOF is a mixed-funds investment to which section 1400Z–2(e)(1) applies. In such a case, an amount equal to the adjusted basis of the eligible interest in the hands of the eligible taxpayer is the eligible taxpayer's qualifying investment, and the excess is the eligible taxpayer's non-qualifying investment.

(*3*) *Transfer of built-in loss property and section 362(e)(2).* If paragraph (c)(6)(ii)(B) of this section and section 362(e)(2) both apply to a transaction, the eligible taxpayer and the QOF are deemed to have made an election under section 362(e)(2)(C).

(C) *Property other than cash—Taxable transactions.* This paragraph (c)(6)(ii)(C) applies if an eligible taxpayer makes an investment in a QOF by transferring property other than cash to a QOF and if, without regard to section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations, the eligible taxpayer's basis in the eligible interest received would not be determined, in whole or in part, by reference to the eligible taxpayer's basis in the transferred property. If this paragraph (c)(6)(ii)(C) applies, the amount of the eligible taxpayer's investment in a QOF is the fair market value of the transferred property, as determined immediately before the transfer. This paragraph (c)(6)(ii)(C) applies separately to each item of property transferred to a QOF.

(D) *Basis in a mixed-funds investment.* If a taxpayer's investment in a QOF is a mixed-funds investment to which section 1400Z–2(e)(1) applies, the taxpayer's basis in the non-qualifying investment is equal to the taxpayer's basis in all of the eligible interests received, determined without regard to section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations, and reduced by the basis of the taxpayer's qualifying investment, determined without regard to section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations.

(iii) *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 a qualifying investment—(1) Non-contributions in general.* To the extent the transfer of property to a QOF partnership is characterized other than as a contribution, such as characterization as a sale under section 707 and the regulations in this part under section 707 of the Code, the transfer is not treated as being made in exchange for a qualifying investment.

(*2*) *Reductions in investments otherwise treated as contributions.* If any transfer of cash or other property to a partnership is not treated as a contribution, in whole or in part, under paragraph (c)(6)(iii)(A)(*1*) of this section, the part of the transfer to the partnership that is not disregarded is not a qualifying 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 and the regulations in this part under section 707 of the Code if:

(*i*) Any cash contributed were noncash 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 (c)(6)(iii)(A) of this section does not apply, the amount of equity received by an eligible taxpayer in a QOF partnership in exchange for the lesser of the net basis or net value of the property contributed to the QOF partnership by the eligible taxpayer is a qualifying investment. The amount of equity received by an eligible taxpayer in a QOF partnership that is a non-qualifying investment is the excess, if any, of the total equity received by the eligible taxpayer over the amount treated as a qualifying investment.

(*2*) *Net basis.* For purposes of paragraph (c)(6)(iii)(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 (c)(6)(iii)(B) of this section, net value is the excess of—

(*i*) The gross fair market value of the property contributed to the partnership; over

(*ii*) The amount of the debt described in paragraph (c)(6)(iii)(B)(*2*)(*ii*) of this section.

(*4*) *Basis of qualifying and non-qualifying investments.* The initial basis of a qualifying investment, before application of section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations or any section 752 debt allocation, is the net basis of the property contributed. The basis of a non-qualifying investment, before any section 752 debt allocation, is the remaining net basis. The basis of the qualifying investment is adjusted as provided in section 1400Z–2(b)(2)(B) and the section 1400Z–2 regulations. The bases of qualifying and non-qualifying investments are increased by any debt allocated to those 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.

(iv) *Acquisitions from another person.* An eligible taxpayer may make an investment in a QOF by acquiring in a sale or exchange to which § 1.1001–1(a) applies an eligible interest in a QOF from a person other than the QOF. The amount of the eligible taxpayer's investment in the QOF with respect to which the eligible taxpayer may make a deferral election is the amount of the cash, or the net fair market value of the other property, as determined immediately before the exchange, that the eligible taxpayer exchanged for the eligible interest in the QOF.

(v) *Examples.* The following examples illustrate the rules of this paragraph (c)(6).

(A) *Example 1. Transfer of built-in gain property with basis less than gain to be deferred—(1) Facts.* Individual B realizes $100 of eligible gain within the meaning of paragraph (b)(11) of this section. B transfers unencumbered property with

a fair market value of $100 and an adjusted basis of $60 to QOF Q, a C corporation, in a transaction that is described in section 351(a).

(*2*) *Analysis*. Paragraph (c)(6)(ii)(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 (c)(6)(ii)(B)(*2*) of this section, B's investment is a mixed-funds investment to which section 1400Z–2(e)(1) applies. Pursuant to paragraphs (c)(6)(ii)(B)(*1*) and (*2*) of this section, B's qualifying 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 qualifying investment is $0. Additionally, B's non-qualifying 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 non-qualifying 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 section 1400Z–2(e)(1)(A)(i) applies, determined without regard to section 1400Z–2(b)(2)(B)). See paragraph (c)(6)(ii)(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 in paragraph (c)(6)(v)(A)(*1*) of this section (*Example 1*), except that B realizes $50 of eligible gain within the meaning of paragraph (b)(11) of this section. Pursuant to paragraph (c)(6)(i) of this section, B's qualifying 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 (c)(6)(ii)(B)(*1*) of this section, B's qualifying 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 qualifying investment has an adjusted basis of $0, as provided in section 1400Z–2(b)(2)(B)(i). Additionally, B's non-qualifying 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 non-qualifying 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 qualifying investment, determined without regard to section 1400Z–2(b)(2)(B).

(C) *Example 3. Transfers to QOF partnerships*—(*1*) *Facts*. A and B each realized $100 of eligible gain and each transfers $100 to a QOF partnership. In a subsequent year, the partnership borrows $120 from an unrelated lender and distributes $120 equally to A and B.

(*2*) *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 section 707 and the regulations in this part under section 707 of the Code, determining the timing of the distribution and amount of the debt allocated to each partner. Under paragraph (c)(6)(iii)(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 qualifying investment. To the extent there would have been a disguised sale applying the rule of paragraph (c)(6)(iii)(A)(*2*) of this section, the amount of the qualifying investment would be reduced by the amount of the contribution so recharacterized.

(D) *Example 4. Return of capital by QOF partnership*—(*1*) *Facts*. A realized $100 of eligible gain and transfers $100 of cash to a QOF partnership. Later in

the partner's tax year, the partnership distributes $20 to A in a distribution that is not recharacterized under paragraph (c)(6)(iii)(A)(*2*) of this section. At the time of the distribution, no allocations of income, gain, loss, or deduction had been made to A, and A's share of the partnership's debt was zero under section 752.

(*2*) *Analysis*. Because the contribution and distribution are not recharacterized under paragraph (c)(6)(iii)(A)(*2*) of this section, the amount of A's qualifying investment is $100 despite the $20 distribution. At the time the $20 distribution is made to A, A's basis in its qualifying investment is zero, and thus the distribution is an inclusion event under § 1.1400Z2(b)–1(c)(6)(iii).

(E) *Example 5. Property contributed has built-in gain*. The facts are the same as in paragraph (c)(6)(v)(C)(*1*) of this section (*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 (c)(6)(iii)(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 is a non-qualifying investment. Under paragraph (c)(6)(iii)(B)(*4*) 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).

(*F*) *Example 6. Property contributed has built-in gain and is subject to debt*. The facts are the same as in paragraph (c)(6)(v)(E) of this section (*Example 5*), except that the property contributed by A has a gross value of $130 and is subject to debt of $30. Under paragraph (c)(6)(iii)(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 $0 net basis ($20 minus $30, but limited to zero). The entire contribution constitutes a non-qualifying investment.

(G) *Example 7. Property contributed has built-in loss and is subject to debt*. The facts are the same as in paragraph (c)(6)(v)(F) of this section (*Example 6*), except that the property contributed by A has a basis of $150. Under paragraph (c)(6)(iii)(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 net value ($100) over the qualifying investment ($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).

(7) *Eligible gains that a partnership elects to defer*. A partnership generally is an eligible taxpayer under paragraph (b)(13) of this section and may elect to defer recognition of some or all of its eligible gains under section 1400Z–2(a)(2) and the section 1400Z–2 regulations.

(i) *Partnership deferral election*. If a partnership properly makes a deferral election, then—

(A) The partnership defers recognition of the eligible gain under the rules of section 1400Z–2 and the section 1400Z–2 regulations, that is, the partnership does not recognize gain at the time it otherwise would have in the absence of the deferral election; and

(B) The deferred eligible gain is not included in the distributive shares of the partners under section 702 and is not treated as an item described in section 705(a)(1).

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

(8) *Eligible gains that the partnership does not defer*—(i) *Federal income tax treatment of the partnership.* If a partnership does not elect to defer some, or all, of its eligible gains, the partnership's treatment of any such amounts is unaffected by the fact that the eligible gains could have been deferred under section 1400Z–2 and the section 1400Z–2 regulations.

(ii) *Federal income tax treatment by the partners.* If a partnership does not elect to defer some, or all, of the eligible gains—

(A) The gains for which a deferral election are not made are included in the partners' distributive shares under section 702 and are treated as items described in 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) and the section 1400Z–2 regulations to defer some or all of such 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) and the section 1400Z–2 regulations, 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)(8)(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 distributive 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)(8)(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—

(*1*) The same as the partnership's 180-day period; or

(*2*) The 180-day period beginning on the due date for the partnership's tax return, without extensions, for the taxable year in which the partnership realized the gain that is described in paragraph (c)(8)(ii)(C) of this section.

(C) *Example.* The following example illustrates the principles of this paragraph (c)(8)(iii).

(*1*) *Facts.* Four individuals, A, B, C, and D, have equal interests in a partnership, P. P has no other partners, and P's taxable year is the calendar year. On January 17, 2019, P realizes a capital gain of $1000*x* that P decides not to elect to defer.

(*2*) *Analysis of A's election.* A is aware of the capital gain realized by P, and decides to defer its distributive shares of P's eligible gain. A invests $250*x* in a QOF during February 2020. Under the general rule in paragraph (c)(8)(iii)(A) of this section, this investment is within the 180-day period for A, which began on December 31, 2019, the last day of P's taxable year in which A's share of P's eligible gain is taken into account under section 706(a).

(*3*) *Analysis of B's election.* B is also aware of the capital gain realized by P, and decides to defer its distributive shares of P's eligible gain. B decides to make the election provided in paragraph (c)(8)(iii)(B)(*1*) of this section, and invests $250*x* in a QOF during February 2019. Under the elective rule in paragraph (c)(8)(iii)(B)(*1*) of this section, this investment is within the 180-day period for B, which began on January 17, 2019, the same day as P's 180-day period.

(*4*) *Analysis of C's election.* On March 15, 2020, P provides all of its partners with their Schedules K–1. Upon learning that its distributive share of income from P included eligible gain, C decides to make a deferral election, and also makes the election provided in paragraph (c)(8)(iii)(B)(*2*) of this section. It then invests $250*x* in a QOF during June 2020. Under the elective rule in paragraph (c)(8)(iii)(B)(*2*) of this section, this investment is within the 180-day period for C, which began on March 15, 2020, the 180-day period beginning on the due date for P's tax return without extensions, for the taxable year in which P realized eligible gain.

(9) *Passthrough entities other than partnerships*—(i) *S corporations, nongrantor trusts, and estates.* If an S corporation, a nongrantor trust, or a decedent's estate realizes an eligible gain, then rules analogous to the rules of paragraphs (c)(7) and (8) of this section apply to that entity and to its shareholders or its beneficiaries, as the case may be, to the extent they receive or are deemed to receive an allocable share of the eligible gain.

(ii) *Grantor trusts.* If a grantor trust realizes an eligible gain, either the trust or the deemed owner of the trust may make the election to defer recognition of the gain and make the qualifying investment under rules analogous to the rules of paragraphs (c)(7) and (8) of this section (other than the rule in paragraph (c)(8)(iii) of this section regarding the 180-day period), whether or not the gain is distributed to the deemed owner of the trust.

(d) *Elections*—(1) *Taxable year of deferral election.* For a deferral election with respect to any eligible gain to be valid, an eligible taxpayer must make such election in accordance with guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§ 601.601(d)(2) and 601.602 of this chapter), as to the required time, form, and manner in which an eligible taxpayer (including a partner, S corporation shareholder, or beneficiary applying the elective 180-day period provided in paragraphs (c)(8)(iii)(B) and (c)(9) of this section) may make a deferral election.

(2) *Annual reporting of qualifying investments.* An eligible taxpayer must report any qualifying investment held at any point during the taxable year in accordance with guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§ 601.601(d)(2) and 601.602 of this chapter). A failure to make this report for any given taxable year will result in a rebuttable presumption that the taxpayer has had an inclusion event described in § 1.1400Z2(b)–1(c) during that year. The presumption described in the previous sentence may be rebutted by the taxpayer making the report described in the first sentence of this paragraph (d)(2) or by the taxpayer establishing to the satisfaction of the Commissioner that an inclusion event described in § 1.1400Z2(b)–1(c) did not occur during that taxable year.

(e) *Interaction of section 1400Z–2 and § 1.897–6T.* Section 1400Z–2 is not a nonrecognition provision, as defined in § 1.897–6T(a)(2), for purposes of § 1.897–6T.

(f) *Treatment of mixed-funds investments*—(1) *Investments to which no election under section 1400Z–2(a) applies.* If a taxpayer invests in a QOF and makes a deferral election with respect to less than all of that investment, the portion of the investment to which the election does not apply is a non-qualifying investment. Similarly, an investment in a QOF with respect to which no deferral election is made is a non-qualifying investment.

(2) *Treatment of deemed contributions of money under section 752(a).* In the case of a QOF partnership, the deemed contribution of money described in section 752(a) does not create or increase an investment in the QOF 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). See § 1.1400Z2(b)–1(c)(6)(iv)(B) for rules relating to the application of section 752 to a mixed-funds investment.

(3) *Treatment of contributions to QOF corporation in which no stock is received.* If a taxpayer with a qualifying investment or a non-qualifying investment in a QOF corporation subsequently makes a non-qualifying investment or a qualifying investment, respectively, and if the taxpayer receives no additional QOF stock in exchange for the subsequent investment, the taxpayer has a mixed-funds investment.

(4) *Example.* The following example illustrates the rules of this paragraph (f):

(i) *Facts.* Taxpayer A realizes $1 million of eligible gain and on the next day contributes $1 million to a QOF, Partnership P, in exchange for a 50 percent interest in Partnership P. Taxpayer A makes an election under section 1400Z–2(a) with respect to $900,000 of that eligible gain. 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.

(ii) *Analysis*. Under section 752(a), A is treated as contributing $4 million to Partnership P. Under paragraph (f) 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 the deferral election under section 1400Z–2(a). As a result, after A's section 752(a) deemed contribution, $900,000, or 90 percent, of A's investment in Partnership P is described in section 1400Z–2(e)(1)(A)(i) and $100,000, or 10 percent, is described in section 1400Z–2(e)(1)(A)(ii).

(g) *Applicability dates*–(1) *In general*. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) *Prior periods*. With respect to eligible gains that would be recognized (absent the making of a deferral election) during the portion of a taxpayer's first taxable year ending after December 21, 2017, and during taxable years beginning after December 21, 2017, and on or before March 13, 2020, a taxpayer may choose either—

(i) To apply the section 1400Z–2 regulations, if applied in a consistent manner for all such taxable years (reliance by a taxpayer under paragraph (g)(2)(ii) of this section, § 1.1400Z2(b)–1(j)(2)(ii), § 1.1400Z2(d)–1(e)(2)(ii), § 1.1400Z2(d)–2(e)(2)(ii), or § 1.1400Z2(f)–1(d)(2)(ii), is disregarded solely for purposes of the consistency requirement under this paragraph (g)(2)(i)); or

(ii) To rely on the rules in proposed § 1.1400Z2(a)–1 contained in the notice of proposed rulemaking (REG–115420–18) published on October 29, 2018, as amplified by the notice of proposed rulemaking (REG–120186–18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

[T.D. 9889, 85 FR 1954, Jan. 13, 2020; 85 FR 19083, Apr. 6, 2020]

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

(a) *Scope*. This section provides rules under section 1400Z–2(b) of the Internal Revenue Code and the section 1400Z–2 regulations (as defined in § 1.1400Z2(a)–1(b)(41)) regarding the inclusion in income of gain deferred by a QOF owner under section 1400Z–2(a)(1)(A) and the section 1400Z–2 regulations. This section applies to a QOF owner only until all of such owner's gain deferred pursuant to a deferral election has been included in income, subject to the limitations described in paragraph (e)(5) of this section, and except as otherwise provided in paragraph (c) or (d) of this section. 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)(1) of this section provides the general rule regarding the determination of the extent to which an event triggers the inclusion in gross income of all, or a portion, of an eligible taxpayer's deferred gain, and paragraphs (c)(2) through (16) of this section provide specific rules for certain events that are or are not treated as inclusion events. 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) is reserved. Paragraph (j) of this section provides dates of applicability.

(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 and in accordance with the rules of § 1.1400Z2(a)–1(c)(1), 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) *In general*. Except as otherwise provided in this paragraph (c), an event is an inclusion event, if, and to the extent that—

(i) The event reduces an eligible taxpayer's direct equity interest for Federal income tax purposes in the qualifying investment;

(ii) An eligible taxpayer receives property in the event with respect to its qualifying investment and the event is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the eligible taxpayer's ownership of the QOF;

(iii) An eligible taxpayer claims a loss for worthless stock under section 165(g) or otherwise claims a worthlessness deduction with respect to its qualifying investment; or

(iv) A QOF in which an eligible taxpayer holds a qualifying investment loses its status as a QOF.

(2) *Termination or liquidation of QOF or QOF owner*—(i) *Termination or liquidation of QOF*. Except as otherwise provided in this paragraph (c), an eligible taxpayer has an inclusion event with respect to all of its qualifying investment if the QOF ceases to exist for Federal income tax purposes. For example, if a QOF partnership converts to a QOF C corporation, or if a QOF C corporation converts to a QOF partnership or to an entity disregarded as separate from its owner for Federal income tax purposes, all investors in the QOF have an inclusion event with respect to all of their qualifying investments in the QOF.

(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 or incident to divorce*—(i) *Transfer of an investment in a QOF by gift*. Except to the extent provided in paragraph (c)(5) of this section, a taxpayer's transfer of a qualifying investment by gift, as defined for purposes of chapter 12 of subtitle B of the Code, 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.

(ii) *Transfers between spouses incident to divorce*. A transfer between spouses or incident to divorce or otherwise as provided in section 1041 of the Code is an inclusion event.

(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:

(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.

(iii) *Liability for deferred Federal income tax.* If the owner of a qualifying investment in a QOF dies before an inclusion event and the deferred gain is not includable in the decedent's gross income, the gain that the decedent elected to defer under section 1400Z–2(a) and the section 1400Z–2 regulations will be includable in the gross income, for the taxable year in which occurs an inclusion event, of the person described in section 691(a)(1).

(iv) *Qualifying investment in the hands of the person described in section 691(a)(1).* A qualifying investment received in a transfer by reason of death listed in paragraph (c)(4)(i) of this section continues to be a qualifying investment under § 1.1400Z2(a)–1(b)(34).

(5) *Grantor trusts*—(i) *Contributions to grantor trusts.* If the owner of a qualifying investment contributes it to a trust and, under subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code (grantor trust rules), the contributing owner of the investment is the deemed owner of the trust (grantor trust), the contribution to the grantor trust is not an inclusion event. Similarly, a transfer of the investment by the grantor trust to the trust's deemed owner is not an inclusion event. For all purposes of the section 1400Z–2 regulations, references to the term *grantor trust* mean the portion of the trust that holds the qualifying investment in the QOF, and such a grantor trust, or portion of the trust, is a wholly grantor trust as to the deemed owner. Such contributions may include transfers by gift or any other type of transfer between the grantor and the grantor trust that is a nonrecognition event as a result of the application of the grantor trust rules (that is, subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code).

(ii) *Changes in grantor trust status.* In general, a change in the income tax status of an existing trust owning a qualifying investment in a QOF, 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. If a qualifying investment is held in the grantor portion of an electing small business trust (ESBT), as defined in section 1361(e)(1), and the ESBT converts into a qualified subchapter S trust (QSST), as defined in section 1361(d)(3), the beneficiary of which is the deemed owner of the grantor portion of the ESBT, there has been no change in the grantor trust status because the deemed owner continues to be taxable under subtitle A of the Code on the income and gain from the qualifying investment.

(iii) *Conversions of QSSTs and ESBTs.* With regard to conversions of QSSTs and ESBTs, see paragraphs (c)(7)(i)(B) and (C) of this section. For purposes of paragraph (c)(5)(ii) of this section, if a qualifying investment is held by a QSST that converts to an ESBT, the beneficiary of the QSST is the deemed owner of the grantor portion of the ESBT that then holds the qualifying investment, and the deemed owner is not a nonresident alien for purposes of this section (and thus notwithstanding § 1.1361–1(j)(8)), there has been no change in the grantor trust status because the deemed owner continues to be taxable under subtitle A of the Code on the income and gain from the qualifying investment.

(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 a QOF partner, the inclusion rules of this paragraph (c) apply to transactions involving any direct or indirect partner of the QOF to the extent of that partner's share of any eligible gain of the QOF.

(ii) *Transactions that are not inclusion events*—(A) *In general.* Notwithstanding paragraphs (c)(1) and (2) 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 (contributing partner), of its qualifying QOF stock, qualifying QOF partnership interest, or direct or indirect partnership interest in a qualifying investment to a partnership (transferee partnership) to the extent the transaction is governed 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). 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 section 1400Z–2 regulations with respect to the eligible gain associated with the contributed qualifying investment. The transferee partnership must allocate and report the remaining deferred gain that is associated with the contributed qualifying investment to the contributing partner to the same extent that the remaining deferred gain would have been allocated and reported to the contributing partner in the absence of the contribution. Additionally, the transferee partnership must allocate the basis increases described in section 1400Z–2(b)(2)(B)(iii) and (iv) to the contributing partner. If a transferee partnership is a direct QOF owner, only the transferee partnership may make the elections under section 1400Z–2(c) and the regulations in this part under section 1400Z–2(c) of the Code with respect to the contributed qualifying investment. See §1.1400Z2(c)–1(b)(1)(ii) (election by transferee partnership).

(C) *Section 708(b)(2)(A) mergers or consolidations—(1) Merger of a partnership that is a QOF partner*. Subject to paragraphs (c)(6)(iii) and (v) of this section, a merger or consolidation of a partnership that is a QOF partner (original partnership) with another partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event to the extent section 721(a) applies to the merger. To the extent the original partnership terminates in the merger, as determined under §1.708–1(c)(1), the partnership that is a continuation of the original partnership becomes subject to section 1400Z–2 and the section 1400Z–2 regulations to the same extent that the original partnership was so subject prior to the transaction, and must allocate and report any gain under section 1400Z–2(b) 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)(*1*), 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.

(*2*) *Merger of QOF partnerships*. Subject to paragraph (c)(6)(v) of this section, a merger or consolidation of a QOF partnership with another QOF partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event under paragraph (c)(2)(i) of this section if, immediately after the merger or consolidation, the resulting partnership is a QOF. The continuing partnership, as determined under §1.708–1(c)(1), becomes subject to section 1400Z–2 and the section 1400Z–2 regulations to the same extent that the terminated partnership was so subject prior to the transaction, and must allocate and report any gain under section 1400Z–2(b) to the same extent and to the same partners that the terminated partnership would have allocated and reported such items prior to the transaction. Notwithstanding the rules in this paragraph (c)(6)(ii)(C)(*2*), 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.

(D) *Example*. The following example illustrates the rules of this paragraph (c)(6)(ii).

(*1*) *Example—(i) Facts*. In 2019, taxpayer A contributes $100 of eligible gain to a QOF partnership, X, in exchange for a qualifying QOF partnership interest in X, and taxpayer B contributes $100 of eligible gain to another QOF partnership, Y, in exchange for a qualifying QOF partnership interest in Y. In 2021, in transactions governed by section 721(a), A

contributes her qualifying QOF partnership interest in X, and B contributes her qualifying QOF partnership interest in Y, to a newly formed partnership, UTP. In 2024, C receives a profits interest in UTP for services that she will provide to UTP. In 2031, X sells a non-inventory asset and allocates X's distributive share of the gain to UTP. No distributions are ever made from X, Y, or UTP.

(*ii*) *Analysis*. On December 31, 2026, UTP recognizes $170 of remaining deferred gain relating to the QOF interests. Of that gain, A is allocated the $85 of gain relating to the $100 of eligible gain that she invested in X, and B is allocated the $85 of gain relating to the $100 of eligible gain that she invested in Y. C recognizes no gain at this time. In 2031, because UTP's holding period in X includes A's holding period in X, UTP has a holding period in X that exceeds 10 years, and may make an election under §1.1400Z2(c)–1(b)(2)(ii) to exclude the gain from X's asset sale. Even though A was the original investor in X, she may not make the election. If UTP makes the election, UTP will exclude its distributive share of gain from the sale of the X asset.

(*2*) [Reserved]

(iii) *Partnership distributions*. Subject to paragraph (c)(6)(v) 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. For purposes of this paragraph (c)(6)(iii), in the case of a merger or consolidation of a QOF partnership with another QOF partnership in a transaction to which section 708(b)(2)(A) applies, the fair market value of the distributed property is reduced by the fair market value of the QOF partnership interest received in the merger or consolidation. A distribution from a partnership that directly or indirectly owns a QOF is an inclusion event only if the distribution is a liquidating distribution. For purposes of this paragraph (c)(6)(iii), the distribution is not in complete liquidation if the partnership making the distribution is a partnership that terminates in a partnership merger or consolidation under §1.708–1(c), the continuing partnership in the merger or consolidation continues to directly or indirectly own an interest in the QOF, and the distributee is distributed an interest in the resulting partnership as part of the merger or consolidation. See paragraph (c)(6)(iv) of this section for special rules relating to mixed-funds investments.

(iv) *Special rules for mixed-funds investments*—(A) *In general*. The rules of this paragraph (c)(6)(iv) 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 (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 will be treated as made to the separate interests based on the allocation percentages of those 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 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 Internal Revenue Code.

(C) *Subsequent contributions*. In the event of an increase in a partner's qualifying or non-qualifying investment, as for example, 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 must be valued immediately prior to the event and the

allocation percentages 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 will 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 QOF partnership for services provided to or for the benefit of the QOF partnership, the allocation percentage with respect to the profits interest is based on the share of residual profits the mixed-funds partner would receive with respect to that interest, disregarding any allocation of residual profits for which there is not a reasonable likelihood of application.

(E) *Examples*. The following examples illustrate the rules of this paragraph (c)(6)(iv).

(*1*) *Example 1. Allocation of residual profits for which there is no reasonable likelihood of application*—(*i*) *Facts*. A realizes $100 of eligible gain and B realizes $900 of eligible gain. A and B form Q, a QOF partnership. B contributes $900 to Q in exchange for a qualifying QOF partnership interest (B's capital interest). A contributes $100 to Q in exchange for a qualifying QOF partnership interest (A's capital interest and, with B's capital interest, the capital interests) and agrees to provide services to Q in exchange for a profits interest in Q (A's profits interest). Q's partnership agreement provides that Q's profits are first allocated to the capital interests until the capital interest holders receive a 10 percent preferred return with respect to those interests. Next, Q's profits are allocated 15 percent to A with respect to A's profits interest, 10 percent to A with respect to A's capital interest, and 75 percent to B until the capital interests receive a 1,000% preferred return. Thereafter, Q's profits are allocated 1 percent to A's profits interest and 99 percent to the capital interests. There is not a reasonable likelihood that Q's profits will be sufficient to result in an allocation in the last tranche.

(*ii*) *Analysis*. Under paragraph (c)(6)(iv)(D) of this section, the allocation percentage with respect to A's profits interest is calculated based on the share of residual profits that A would receive with respect to A's profits interest, disregarding any allocation of residual profits that has no reasonable likelihood of being achieved. Under Q's partnership agreement, A's share of Q's residual profits with respect to A's profits interest is 1 percent. However, there is no reasonable likelihood that this 1 percent allocation will apply because it is unlikely that the capital interests will receive a 1,000% preferred return. Therefore, under paragraph (c)(6)(iv)(D) of this section, A's share of Q's residual profits with respect to A's profits interest is 15 percent, the final allocation of Q's profits to A's profits interest that is reasonably likely to apply. The allocation percentage for A's capital interest in Q is 10 percent under paragraph (c)(6)(iv)(D) of this section. Thus, allocations and distributions made to A are treated as made 60 percent (15/25) to A's nonqualifying profits interest and 40 percent (10/25) to A's qualifying QOF partnership interest.

(*2*) *Example 2. Separate entity holding profits interest*—(i) *Facts*. The facts are the same as in paragraph (c)(6)(iv)(E)(*1*) of this section (*Example 1*), except that A is a partnership that has no eligible gain and P, a partnership that is owned by the same taxpayers who own A, realizes $100 of eligible gain and contributes $100 to Q for its qualifying investment.

(*ii*) *Analysis*. Under paragraph (c)(6)(iv)(D) of this section, A's profits interest is a nonqualifying investment in Q. Because P directly holds only a qualifying QOF partnership interest in Q, P is not a mixed-funds partner in Q, and 100 percent of the allocations and distributions made to P are attributable to P's qualifying QOF partnership interest.

(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 rules for S corporations*—(i) *In general*. Except as provided in paragraphs (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 QSST to an ESBT, but only if the QSST beneficiary is the deemed owner of the grantor portion of the ESBT that receives the qualifying investment and if the deemed owner is not a nonresident alien;

(C) A conversion of an ESBT to a QSST, where the qualifying investment is held in the grantor portion of the ESBT and the QSST beneficiary is the deemed owner of the grantor portion of the ESBT; and

(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.

(ii) *Distributions by QOF S corporation*—(A) *General rule.* An actual or constructive distribution of property by a QOF S corporation to a QOF 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). For the treatment of a distribution by a QOF S corporation to which section 305(a) applies, see paragraph (c)(8)(ii). For the treatment of a distribution to which section 302(d) or section 306(a)(2) applies, see paragraph (c)(9)(ii) of this section.

(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) *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)(iii)(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)(iii)(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.

(iv) *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 separate 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).

(v) *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 corporation*—(i) *General rule for distributions by a QOF C corporation.* If a QOF C corporation distributes property to a QOF shareholder with respect to a qualifying investment, only the amount of the distribution to which section 301(c)(3) or 1059(a)(2) applies gives rise to an inclusion event. For purposes of this paragraph (c)(8)(i), a distribution of property includes a distribution of stock in the QOF C corporation making the distribution (or rights to acquire such stock) if the distribution is treated as a distribution of property to which section 301 applies pursuant to section 305(b).

(ii) *Section 305(a) distributions.* A distribution with respect to qualifying QOF stock to which section 305(a) applies is not an inclusion event. QOF stock received in such a distribution is qualifying QOF stock. The shareholder's remaining deferred gain is allocated pro rata between the new qualifying QOF stock received and the qualifying QOF stock with respect to which the distribution was made in proportion to the fair market values of each on the date of distribution. See § 1.307–1(a).

(9) *Dividend-equivalent redemptions and redemptions of section 306 stock.*—(i) *Redemptions by QOF C corporations*—(A) *In general.* Except as provided in paragraph (c)(9)(i)(B) of this section, if a QOF C corporation redeems its stock

from a QOF shareholder in a transaction described in section 302(d) or section 306(a)(2), the full amount of such redemption gives rise to an inclusion event.

(B) *Redemptions of stock of wholly owned QOF C corporation and pro rata redemptions.* Paragraph (c)(8)(i) of this section applies to a redemption described in paragraph (c)(9)(i)(A) of this section if, at the time of such redemption—

(*1*) All stock in the QOF C corporation is held directly by a single shareholder, or directly by members of a single consolidated group; or

(*2*) The QOF C corporation has outstanding only one class of stock, as defined in section 1361 and §1.1361–1(l), and the redemption is pro rata as to all shareholders of the redeeming QOF C corporation.

(ii) *Redemptions by QOF S corporations.* If a QOF S corporation redeems its stock from a QOF shareholder in a transaction described in section 302(d) or section 306(a)(2), the amount that gives rise to an inclusion event is the amount by which the distribution exceeds basis in the QOF stock 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.* This paragraph (c)(10)(i)(C) applies if assets of a QOF corporation are acquired in a qualifying section 381 transaction and an eligible taxpayer that is a QOF shareholder receives boot with respect to its qualifying investment. If this paragraph (c)(10)(i)(C) applies, the QOF shareholder has an inclusion event and is treated as disposing of a portion of its qualifying investment that bears the same proportion to the QOF shareholder's total qualifying investment immediately before the inclusion event as the fair market value of the boot received by the QOF shareholder with respect to its qualifying investment in the qualifying section 381 transaction bears to the fair market value of the total consideration received by the QOF shareholder with respect to its qualifying investment in the qualifying section 381 transaction.

(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 and the acquiring corporation succeeds to the target corporation's status as the QOF shareholder with respect to the qualifying investment.

(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, the QOF shareholder has an inclusion event and is treated as disposing of the portion of its qualifying investment that 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 QOF shareholder with respect to a qualifying investment in the QOF corporation in a transaction to which section 355 (or so much of section 356 as relates to section 355) applies, the QOF shareholder has an inclusion event and is treated as disposing of a portion of

its qualifying investment equal in value to the fair market value of the shares of the controlled corporation and the fair market value of any boot received by the QOF shareholder 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 a QOF shareholder'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 QOF shareholder receives boot in a qualifying section 355 transaction with respect to its qualifying investment, and if section 356(a) applies to the transaction, paragraph (c)(10)(i)(C) of this section applies. If a QOF shareholder receives boot in a qualifying section 355 transaction with respect to its qualifying investment, and if section 356(b) applies to the transaction, paragraph (c)(8)(i) of this section applies.

(*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 QOF shareholder has an inclusion event and is treated as disposing of the portion of its qualifying QOF stock over which it no longer has direct Federal income tax ownership.

(12) *Recapitalizations and section 1036 transactions*—(i) *In general*. Except as otherwise provided in paragraph (c)(12)(ii) of this section, if a QOF corporation engages in a transaction that qualifies as a reorganization described in section 368(a)(1)(E) (a recapitalization), or if a QOF shareholder engages in a transaction that is described in section 1036 (a section 1036 exchange), the transaction is not an inclusion event.

(ii) *Receipt of property or boot by QOF shareholder*. If a QOF shareholder receives property or boot, or is treated as having received property or boot, with respect to its qualifying investment in a recapitalization, then the property or boot is treated as property or boot to which section 301 or section 356(a) or (c) applies, as determined under general Federal income tax principles. If, in a section 1036 exchange, a QOF shareholder receives property with respect to its qualifying investment that

is not permitted to be received without the recognition of gain, then, for purposes of this section, the receipt of the property is treated in a similar manner as the receipt of such property or boot in a recapitalization. Paragraph (c)(8)(i) of this section applies to property to which section 301 applies. Paragraph (c)(10)(i)(C) of this section applies to boot to which section 356(a) or (c) applies.

(13) *Section 304 transactions.* If a QOF shareholder transfers its qualifying investment in a transaction described in section 304(a), the full amount of the consideration gives rise to an inclusion event.

(14) *Deduction for worthlessness.* If an eligible 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 section 1400Z–2 regulations, the eligible taxpayer has an inclusion event and is treated as having disposed of that portion of its qualifying investment on the date it became worthless. Thus, neither section 1400Z–2(b)(2)(B)(iii) or (iv) nor section 1400Z–2(c) applies to that portion of the eligible taxpayer's qualifying investment after the date it became worthless.

(15) *Decertification of a QOF.* The decertification of a QOF, whether a self-decertification pursuant to §1.1400Z2(d)–1(a)(3) or an involuntary decertification pursuant to §1.1400Z2(d)–1(a)(4), is an inclusion event.

(16) *Other inclusion and non-inclusion events.* Notwithstanding any other provision of this paragraph (c), the Commissioner may determine in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) that a type of transaction is or is not an inclusion event.

(d) *Holding periods*—(1) *Holding period for qualifying investment*—(i) *In general.* Solely for purposes of section 1400Z–2(b)(2)(B), section 1400Z–2(c), and the section 1400Z–2 regulations, 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 eligible taxpayer had held property exchanged for such investment (even if such period would be relevant for determining the length of time for other Federal income tax purposes).

(ii) *Holding period for qualifying investment received in certain transactions with respect to QOFs.* For purposes of section 1400Z–2(b)(2)(B), section 1400Z–2(c), and the section 1400Z–2 regulations, the principles of section 1223(1) or (4) apply to determine the holding period for a qualifying investment received by a QOF owner in—

(A) A distribution described in paragraph (c)(2)(ii)(B) of this section;

(B) A distribution to which section 305(a) applies;

(C) A qualifying section 381 transaction described in paragraph (c)(10)(i) or (ii) of this section;

(D) A qualifying section 355 transaction described in paragraph (c)(11)(i)(B) of this section;

(E) A recapitalization or a section 1036 exchange described in paragraph (c)(12) of this section;

(F) A contribution of a QOF interest to a partnership to the extent section 721(a) applies to the transfer; or

(G) A distribution of a QOF interest to the extent the interest was received in a merger of two or more QOF partnerships in a transaction described in section 708(b)(2)(A).

(iii) *Tacking with deceased owner or deemed owner of a grantor trust.* For purposes of section 1400Z–2(b)(2)(B), section 1400Z–2(c), and the section 1400Z–2 regulations, the holding period of a qualifying investment held by an eligible taxpayer who received that qualifying investment by reason of the prior owner's death includes the time during which that qualifying investment was held by the deceased owner. The rule in the preceding sentence also applies to allow a grantor trust to tack the holding period of the deemed owner if the grantor trust acquires the qualifying investment from the deemed owner in a transaction that is not an inclusion event.

(2) *Status of QOF assets as qualified opportunity zone property.* For purposes of section 1400Z–2(d) and the section 1400Z–2 regulations, including for purposes of determining whether the original use of qualified opportunity zone business property commences with the

acquiring corporation or partnership, qualified opportunity zone property does not lose its status as qualified opportunity zone property solely as a result of—

(i) Its transfer by the transferor corporation to the acquiring corporation in a qualifying section 381 transaction described in paragraph (c)(10)(i) of this section;

(ii) Its transfer by the distributing corporation to the controlled corporation in a qualifying section 355 transaction described in paragraph (c)(11)(i)(B) of this section; or

(iii) Its transfer by the transferor partnership to the acquiring partnership in a transaction to which section 708(b)(2)(A) applies, but only to the extent section 721(a) applies to the transaction.

(e) *Amount includible.* Except as provided in §§ 1.1400Z2(a)–1(b)(7) and 1.1400Z2(f)–1(b), the amount of gain included in gross income under section 1400Z–2(a)(1)(B) and this section 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 (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 eligible taxpayer's basis in the portion of the qualifying investment that is disposed of in 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.

(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 bears to—

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

(B) The fair market value of the portion of the qualifying investment that is disposed of in the inclusion event.

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

(2) *Property received from a QOF in certain transactions.* In the case of an inclusion event described in paragraph (c)(6)(iii) or (v), (c)(7)(ii), (c)(8)(i), or (c)(9) or (13) of this section (or in paragraph (c)(11) or (12) of this section, to the extent the rules in paragraph (c)(8)(i) of this section apply to the inclusion event), 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.

(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 eligible 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 at fair market value of the qualifying investment that gave rise to the inclusion event.

(5) *Limitation on amount of gain included after statutory five-year 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) and the section 1400Z–2 regulations, reduced by any increase in the basis of the qualifying investment made pursuant to section 1400Z–2(b)(2)(B)(iii) and (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 the following 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(c)(6)(ii)(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 (f)(1)(i) of this section (this *Example 1*), but A's basis in transferred asset N is $200. Under § 1.1400Z2(a)–1(c)(6)(ii)(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, taxpayer 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 (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(c)(6)(ii)(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) of this section 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 $125 ($500 × ($200/$800)) or $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 (f)(2)(i) of this section (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 Transfer. Since the Transfer is disregarded for Federal income tax purposes, A's transfer of its qualifying investment in Q is not treated as a reduction in direct tax ownership for Federal income tax purposes, and the Transfer is not 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 is not 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 (f)(2)(iii) of this section (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 partnership 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 gain, the lesser of $90, which is 50 percent of $180 (the $200 remaining deferred gain less the $20 five-year basis adjustment), or $390, which is the gain that would be recognized on a taxable sale of 50 percent of the interest. 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 partnership interest has decreased*—(i) *Facts*. The facts are the same as in paragraph (f)(3) of this section (*Example 3*), 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 gain, the lesser of $90 (50 percent of the excess of A's $200 remaining deferred gain over A's $20 five-year adjustment) 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 paragraph (f)(3) of this section (*Example 3*), 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 gain, and C is required to recognize $510 of gain.

(iii) *Sale of qualifying QOF partnership interests*. The facts are the same as in paragraph (f)(5)(i) of this section (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 in exchange for 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 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) (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 (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) of this section.

(iii) *Merger of QOF shareholder*. The facts are the same as in paragraph (f)(7)(i) of this section (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 investment 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 (f)(7)(i) of this section (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 with a fair market value of $900 in the Merger in exchange for its qualifying investment, and neither Q nor Y has any earnings and profits. Under paragraph (c)(10)(i)(C) of this section, X is treated as disposing of 10 percent ($100/$1000) of its qualifying investment. Under paragraph (e)(1) of this section, X is required to include $50 ($500 × ($100/$1000)) 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 (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 (c), A's holding period for its qualifying investment in Y is treated as beginning on October 31, 2019. See paragraph (d)(1)(ii) of this section.

(iii) *Section 355 distribution by a QOF shareholder*. The facts are the same as in paragraph (f)(8)(i) of this section (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. At the time of the distribution, the fair market value of A's Q stock exceeds $500. 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 (f)(8)(i) of this section (this *Example 8*), except that A receives boot in the Distribution. Under paragraphs (c)(8)(i) 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 (f)(8)(i) of this section (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 (f)(8)(v) of this section (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 (f)(8)(v) of this section (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 is treated as disposing of a portion of its qualifying investment that bears the same proportion to B's total qualifying investment immediately before the inclusion event as the fair market value of the boot bears to the fair market value of the total consideration received by B.

(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 class A stock of Q (A's qualifying investment) and B contributes $500 to Q in exchange for 60 shares of class B stock of Q (B's qualifying investment). A and B are the sole shareholders of Q. In 2020, B exchanges all of its class B stock of Q for 40 shares of class A stock of Q as well as other property in a transaction that qualifies as a reorganization under section 368(a)(1)(E).

(ii) *Analysis*. Because A did not receive any boot in the transaction, A does not have an inclusion event with respect to its qualifying investment in Q. See paragraph (c)(12)(i) of this section. Therefore, A is not required to include any of its deferred gain in income as a result of this transaction. However, under paragraph (c)(12)(ii) of this section, B has an inclusion event. If section 301 applies to the boot received by B, B has an inclusion event to the extent of its section 301(c)(3) gain. If section 356(a) or (c) applies to the boot received by B, B is treated as disposing of a portion of its qualifying investment that bears the same proportion to B's total qualifying investment immediately before the inclusion event as the fair market value of the boot bears to the fair market value of the total consideration received by B.

(10) *Example 10. Debt financed distribution*—(i) *Facts*. On September 24, 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 paragraph (c) of this section 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 paragraph (f)(10) of this section (*Example 10*), 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 paragraph (c)(6)(iii) of this section, A is required to recognize $30 of eligible gain under paragraph (c) of this section 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)).

(g) *Basis adjustments*—(1) *Basis adjustments under section 1400Z–2(b)(2)(B)(ii) resulting from the inclusion of deferred gain*—(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 Federal income tax consequences of the inclusion event.

(ii) *Specific application to section 301(c)(3) gain, section 1059(a)(2) gain, S corporation shareholder gain, or partner gain*—(A) *Applicability*. 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), section 1059(a)(2), or paragraphs (c)(6)(iii) and (c)(7)(ii) of this section with respect to the owner's qualifying investment in the QOF.

(B) *Ordering rule*. If paragraph (g)(1)(ii) of this section applies, an eligible taxpayer is treated as having an inclusion event to the extent provided in paragraph (c)(6)(iii), (c)(7)(ii), or (c)(8), (9), (11), (12), or (13) of this section, as applicable. Then, the eligible taxpayer increases its basis under section 1400Z–2(b)(2)(B)(ii) before determining the Federal income tax consequences of the distribution.

(iii) *Shares in QOF C corporations to which section 1400Z–2(b)(2)(B)(ii) adjustments are made.* If a shareholder of a QOF C corporation disposes of qualifying QOF stock in an exchange subject to section 1001, basis adjustments under section 1400Z–2(b)(2)(B)(ii) are made only to the portion of the qualifying investment that is disposed of in the inclusion event.

(2) *Amount of basis adjustment under section 1400Z–2(b)(2)(B)(iii) and (iv).* The increases in basis under section 1400Z–2(b)(2)(B)(iii) and (iv) are limited to 10 percent and 5 percent, respectively, of the remaining deferred gain with respect to a qualifying investment as of the dates on which basis is increased under that section.

(3) *Examples.* The following examples illustrate the rules of paragraphs (g)(1) and (2) of this section.

(i) *Example 1*—(A) *Facts.* On May 31, 2019, A, a C corporation, 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 C 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 (Distribution).

(B) *Recognition of gain.* Under paragraph (g)(1)(ii)(B) 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)(i) 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. Pursuant to §1.312–6(b), A's earnings and profits increase by $60.

(C) *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).

(ii) *Example 2*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(i) of this section (*Example 1*), except that, instead of receiving a distribution, A sells half of the Q stock for $250 in 2020. A continues to hold the remainder of its Q stock through 2024.

(B) *Recognition of gain and basis adjustments in 2020.* Under paragraphs (c)(1) and (e)(1) of this section, $250 of A's gain that was deferred under section 1400Z–2(a) and §1.1400Z2(a)–1 is recognized in 2020. Under paragraphs (g)(1)(i) and (iii) of this section, A increases its basis to $250 in the sold shares in accordance with section 1400Z–2(b)(2)(B)(ii) immediately before the sale. Accordingly, A has no gain or loss on the sale ($250 − $250). Pursuant to §1.312–6(b), A's earnings and profits increase by $250. A's basis in its remaining shares of Q stock remains $0.

(C) *Basis adjustment in 2024.* Under paragraph (g)(2) of this section, A increases its basis in its remaining shares of Q stock in accordance with section 1400Z–2(b)(2)(B)(iii). Pursuant to §1.312–6(b), A's earnings and profits are increased by the amount of the basis adjustment.

(4) *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) *Treatment of basis adjustments.* Any basis adjustment to a qualifying investment in a QOF partnership described in section 1400Z–2(b)(2)(B)(iii) and (iv) and section 1400Z–2(c) is basis for all purposes, including for purposes of suspended losses under section 704(d).

(iii) *Tiered arrangements.* Any basis adjustment described in section 1400Z–2(b)(2)(B)(iii) and (iv) and section 1400Z–2(c) (basis adjustment rules) will be treated as an item of income described in section 705(a)(1) and must 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 will 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 the eligible interest, and will track to the owners' interests, based on their shares of the remaining deferred gain to which such amounts relate.

(5) *Basis adjustments in S corporation stock*—(i) *Treatment of basis adjustments.* Any basis adjustment to a qualifying investment in a QOF S corporation described in section 1400Z–2(b)(2)(B)(iii)

and (iv) and section 1400Z–2(c) is basis for all purposes, including for purposes of suspended losses under section 1366(d).

(ii) *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). The rule in this paragraph (g)(5)(ii)(A) 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 when recognized and will adjust the shareholders' stock bases under section 1367 at that time.

(*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:

(*i*) Be separately stated under section 1366; or

(*ii*) Until the date on which an inclusion event with respect to the S corporation's qualifying investment occurs, adjust the shareholders' stock bases 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 tax consequences of the inclusion event other than the computation of the tax on the deferred gain.

(iii) *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 tax consequences of the inclusion event other than the computation of the tax on the deferred gain.

(6) *Basis in the hands of a taxpayer who received a qualifying investment in a QOF by reason of the prior owner's death*—(i) *In general*. The basis of a qualifying investment in a QOF, transferred by reason of a decedent's death in a transfer that is not an inclusion event, is zero under section 1400Z–2(b)(2)(B)(i), as adjusted for increases in basis as provided under section 1400Z–2(b)(2)(B)(ii) through (iv) and (c). See paragraph (c)(4) of this section.

(ii) *Examples*. The following examples illustrate the rule of this paragraph (g)(6).

(A) *Example 1*. Taxpayer A, an individual, contributed $50X to a QOF in exchange for a qualifying investment in the QOF in January 2019. This $50X was capital gain that was excluded from A's gross income under section 1400Z–2(a)(1)(A). A's basis in the qualifying investment is zero. As of January 2024, A's basis in the QOF is increased by an amount equal to 10 percent of the amount of gain deferred by reason of section 1400Z–2(a)(1)(A), so that A's adjusted basis in 2024 is $5X. A dies in 2025 and A's heir inherits this qualifying investment in the QOF. A's death is not an inclusion event for purposes of section 1400Z–2. The heir's basis in the qualifying investment is $5X.

(B) *Example 2*. The facts are the same as in paragraph (g)(6)(ii)(A) of this section (*Example 1*), except that A dies in November 2027, when the fair market value of the qualifying investment was $75X. A was required to pay the tax on the excess of the deferred capital gain over A's basis as part of A's 2026 income. Therefore, at the time of A's death, A's basis in the qualifying investment is the sum of three basis adjustments: The adjustment made in January 2024 described in paragraph (g)(6)(ii)(A) (*Example 1*) ($5X); an additional adjustment made as of January 2026 equal to 5 percent of the amount of gain deferred by reason of section 1400Z–2(a)(1)(A) ($2.5X); and the adjustment as of December 31, 2026, by reason of section 1400Z–2(b)(1)(B) and (b)(2)(B)(ii) ($42.5X). Accordingly, the basis of the qualifying investment in the hands of A's heir is $50X.

(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 deferred gain in accordance with applicable forms and instructions.

(2) *Notification of deferred gain recognition by indirect QOF owner*. If an indirect owner of a QOF partnership sells or otherwise disposes of all or a portion of its indirect interest in the QOF partnership in a transaction that is an inclusion event under paragraph (c) of this section, 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*. A QOF partner or QOF S corporation shareholder must notify the QOF partnership or QOF S corporation, as appropriate, of an election under section 1400Z–2(c) to adjust the basis of the qualifying QOF partnership interest or qualifying QOF stock, as appropriate, 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) or qualifying QOF stock disposed of, or to the QOF partnership asset(s) or QOF S corporation asset(s) disposed of, as appropriate, is to be made in accordance with applicable forms and instructions.

(i) [Reserved]

(j) *Applicability dates*—(1) *In general*. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) *Prior periods*. With respect to the portion of a taxpayer's first taxable year ending after December 21, 2017, that began on December 22, 2017, and for taxable years beginning after December 21, 2017, and on or before March 13, 2020, a taxpayer may choose either—

(i) To apply section 1400Z–2 regulations, if applied in a consistent manner for all such taxable years; or

(ii) To rely on the rules in proposed §1.1400Z2(b)–1 contained in the notice of proposed rulemaking (REG–120186–18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

[T.D. 9889, 85 FR 1964, Jan. 13, 2020; 85 FR 19083, Apr. 6, 2020]

EDITORIAL NOTE: At 85 FR 19083, April 6, 2020, §1.1400Z2(b)–1 was amended in part by revising paragraphs (j)(2) introductory text and (j)(2)(i); however, the amendment could not be incorporated due to inaccurate amendatory instruction.

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

(a) *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 in certain eligible property held by the QOF. See §1.1400Z2(b)–1(d) for rules for determining the holding period of a qualifying investment for purposes of this section.

(b) *Investment for which an election can be made*—(1) *In general*—(i) *Election by taxpayer*. An eligible taxpayer who makes a deferral election with respect to, or acquires by reason of a transaction that is not an inclusion event, a qualifying investment in a QOF, recognizes gain (if any) on December 31, 2026, of an amount determined under §1.1400Z2(b)–1(e)(3) (and so much of §1.1400Z2(b)–1(e)(4) as relates to §1.1400Z2(b)–1(e)(3)) with respect to that qualifying investment, and whose holding period in that qualifying investment is at least ten years, is eligible to make an election described in section 1400Z–2(c) on the sale or exchange of that qualifying investment. Except as otherwise provided in this paragraph (b)(1), to the extent a taxpayer described in the preceding sentence has an inclusion event described in §1.1400Z2(b)–1(c) with respect to any portion of a qualifying investment, that portion is no longer a qualifying investment and the taxpayer is not eligible to make an election pursuant to section 1400Z–2(c) and this section with respect to that portion. See §1.1400Z2(c)–1(b)(2) for special election rules for QOF partnerships and QOF S corporations.

(ii) *Transferee partnership to make an election under section 1400Z–2(c)*—(A) *In general*. This paragraph (b)(1)(ii)(A) applies if an eligible taxpayer (transferor) transfers its qualifying investment to a transferee in a transaction described in §1.1400Z2(b)–1(c)(6)(ii) to the extent governed by section 721(a). If this paragraph (b)(1)(ii)(A) applies, and if the

transferee sells or exchanges a qualifying investment that has a holding period of at least 10 years under §1.1400Z2(b)–1(d)(1)(ii)(F), then the transferee can make an election described in section 1400Z–2(c) on the sale or exchange of the qualifying investment. See §1.1400Z2(b)–1(c)(6)(ii)(B) (transferee partnership makes section 1400Z–2(c) election regarding contributed qualifying investment).

(B) *Conditions for transferee partnership or merged partnership to make an election described in section 1400Z–2(c).* A transferee referred to in paragraph (b)(1)(ii)(A) of this section is eligible to make an election described in section 1400Z–2(c) with respect to a qualifying investment only if the transferee:

(*1*) Files a statement, at the time and in the manner that the Commissioner of Internal Revenue may prescribe by Internal Revenue Service forms and instructions or by publication in the Internal Revenue Bulletin (see §601.601(d)(ii)(b) of this chapter), providing the name of the transferor, the date of the transfer, and the transferor's holding period in the transferred qualifying investment immediately before the transfer; and

(*2*) Files form 8997, *Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments*, with the transferee's timely filed Federal Tax Return.

(iii) *Limitation on the 10-year rule.* As required by section 1400Z–2(e)(1) (treatment of investments with mixed funds), section 1400Z–2(c) applies only to the portion of an investment in a QOF that is a qualifying investment. 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) or otherwise, see §1.1400Z2(b)–1(c)(14).

(iv) *Transactions to which section 301(c)(3), section 1059(a)(2), or section 1368(b)(2) or (c)(3) applies.* The receipt of amounts treated as gain from the sale or exchange of property under section 301(c)(3), section 1059(a)(2), or section 1368(b)(2) or (c)(3) with respect to qualifying QOF stock in a transaction treated as an inclusion event under §1.1400Z2(b)–1(c) does not prevent the QOF shareholder from making a subsequent election described in section 1400Z–2(c) with respect to that qualifying QOF stock.

(v) *Partnership distributions in excess of basis.* The occurrence of an inclusion event described in §1.1400Z2(b)–1(c)(6)(iii), which addresses a distribution of property by a QOF partnership to a QOF partner where the distributed property has a fair market value in excess of the QOF partner's basis in its qualifying investment, does not prevent the QOF partner from making a subsequent election described in section 1400Z–2(c) with respect to the QOF partner's qualifying QOF partnership interest.

(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) upon the disposition of a qualifying investment, then the basis of the QOF partnership interest is adjusted to an amount equal to the net fair market value of the interest, plus the QOF partner's share of QOF partnership indebtedness under section 752 with respect to that interest, and immediately prior to the sale or exchange, the bases of the assets of the QOF partnership and of any partnership owned directly or indirectly by the QOF partnership solely through one or more partnerships are also adjusted with respect to the disposed-of qualifying investment. For purposes of this paragraph (b)(2)(i), section 7701(g) will apply in determining the value of a qualifying investment in a QOF partnership. The adjustments in this paragraph (b)(2)(i) are calculated in a manner similar to the section 743(b) adjustments that would have been made if the transferor QOF partner had purchased its interest in the QOF partnership for cash equal to the fair market value of the interest immediately prior to the sale or exchange, assuming that valid section 754 elections had been in place with respect to the QOF partnership and any partnerships directly or indirectly owned by the QOF partnership, whether or not an actual section 754 election is in place for any of the partnerships. 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) *Sales or exchanges of QOF property by QOF partnerships or QOF S corporations*—(A) *Election to exclude gains and losses*. If a taxpayer has held a qualifying investment in a QOF partnership or QOF S corporation for at least 10 years, as determined under §1.1400Z2(b)–1(d), and the QOF partnership or QOF S corporation or any partnership that is owned directly, or indirectly solely through one or more partnerships, by the QOF partnership or QOF S corporation sells or exchanges property, the taxpayer may make an election under this paragraph (b)(2)(ii)(A) to exclude from the taxpayer's income all gains and losses allocable to the qualifying investment that arise from all such sales or exchanges for the QOF partnership's or QOF S corporation's taxable year. In order for the election to be valid, the requirements set forth in paragraph (b)(2)(ii)(B) of this section must be satisfied. For purposes of paragraph (b)(2)(ii) of this section, gains and losses include all gains and losses other than gains or losses from the sale or exchange of any item of inventory, as defined in section 1221(a)(1), in the ordinary course of business.

(B) *Deemed distribution and recontribution*—(*1*) *In general*. If any partner of a QOF partnership, or shareholder of a QOF S corporation, makes an election under paragraph (b)(2)(ii)(A) of this section, the taxpayer is treated as receiving a distribution of cash as calculated under paragraph (b)(2)(ii)(B)(*2*) of this section, from the QOF partnership or QOF S corporation at the end of the QOF partnership's or QOF S corporation's taxable year and immediately recontributing the cash to the QOF partnership or QOF S corporation in exchange for a non-qualifying investment in the QOF partnership or QOF S corporation. In determining the post-contribution qualifying investment and non-qualifying investment, the QOF will value each interest based on the underlying values of the QOF's assets determined at the end of its taxable year in accordance with the principles of §1.704–1(b)(2)(iv) (in the case of a QOF partnership) or fair market value (in the case of a QOF S corporation). If the QOF partner or QOF S corporation shareholder is a mixed-funds partner or shareholder prior to the sale or exchange, the deemed distribution will be treated as made proportionately with respect to the partner's or shareholder's qualifying investment and non-qualifying investment in the QOF partnership in accordance with §1.1400Z2(b)–1(c)(6)(iv)(B), or the QOF S corporation. The distribution and recontribution rule of paragraph (b)(2)(ii)(B) of this section is solely for purposes of determining the taxpayer's interests in the QOF partnership or QOF S corporation that constitute a qualifying investment and a non-qualifying investment, and has no other Federal income tax consequence (for example, the rule does not affect the accumulated adjustments account of an S corporation and cannot be treated as a disproportionate distribution by an S corporation).

(*2*) *Amount of deemed distribution and re-contribution*. The amount of cash referred to in paragraph (b)(2)(ii)(B)(*1*) of this section that is deemed distributed by and recontributed to the QOF partnership or QOF S corporation is equal to—

(*i*) The partner's or shareholder's share of net proceeds from all sales and exchanges of property described in paragraph (b)(2)(ii)(A) of this section (other than sales of inventory in the ordinary course of business) for the taxable year for which the election under paragraph (b)(2)(ii)(A) is made (calculated without regard to whether any gain or loss is recognized with regard to such property); less

(*ii*) All actual distributions of cash by the QOF partnership or QOF S corporation with respect to any such sale or exchange that is made within 90 days of the sale or exchange.

(*3*) *Meaning of net proceeds*—(*i*) *QOF partnerships*. For purposes of paragraph (b)(2)(ii)(B)(*2*)(*i*) of this section, with respect to QOF partnerships, the term ''net proceeds'' means the amount realized from the sale of property described in paragraph (b)(2)(ii)(A) of this section less any indebtedness included in the amount realized that would constitute a qualified liability under §1.707–5(a)(6) if the sold or exchanged property had

been contributed to a lower-tier partnership subject to the debt.

(*ii*) *QOF S corporations*. For purposes of paragraph (b)(2)(ii)(B)(*2*)(*i*) of this section, with respect to QOF S corporations, the term ''net proceeds'' means the amount realized from the sale of property described in paragraph (b)(2)(ii)(A) of this section less any indebtedness included in the amount realized that would constitute a qualified liability under the principles of §1.707–5(a)(6).

(C) *Treatment as exempt income*—(*1*) *General rule*. With respect to the taxpayer making an election under paragraph (b)(2)(ii) of this section, the excess of any gains over losses excluded from income under paragraph (b)(2)(ii) of this section is treated as income of the partnership or S corporation that is exempt from tax under the Internal Revenue Code for purposes of section 705(a)(1)(B) or section 1367(a)(1)(A). Section 265 or any similar provisions do not apply to disallow any deductions otherwise allowable under subtitle A for amounts paid or incurred by a taxpayer that are allocable to any gain excluded from income under paragraph (b)(2)(ii) of this section.

(*2*) *Special rule regarding accumulated adjustments account*. Solely for purposes of determining whether an adjustment must be made to the accumulated adjustments account of an S corporation, the excess amount described in paragraph (b)(2)(ii)(C)(*1*) of this section is not treated as tax exempt income.

(D) *Time and manner of making the election to exclude gain*. An election under paragraph (b)(2)(ii)(A) of this section is made by filing the applicable form with the taxpayer's timely filed income tax return, without extensions, for its taxable year that includes the taxable year end of the QOF partnership or QOF S corporation. A taxpayer must make the election under paragraph (b)(2)(ii)(A) of this section for each taxable year in which it wishes to exclude gains and losses of a QOF partnership or QOF S corporation.

(3) *Basis adjustments upon sale or exchange of qualifying QOF stock*—(i) *In general*. Except as provided in paragraph (b)(3)(ii) of this section, if a QOF shareholder's basis in qualifying QOF stock is adjusted under section 1400Z–2(c), then the basis of the qualifying QOF stock is adjusted to an amount equal to the fair market value of the qualifying QOF stock immediately prior to the sale or exchange. This paragraph (b)(3)(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) *Specific application to transactions to which section 301(c)(3), section 1059(a)(2), or section 1368(b)(2) or (c)(3) applies*—(A) *Applicability*. This paragraph (b)(3)(ii) applies if a QOF corporation makes a distribution to a QOF shareholder, at least a portion of the distribution would be characterized as gain from a sale or exchange under section 301(c)(3), section 1059(a)(2), or section 1368(b)(2) or (c)(3) with respect to the QOF shareholder's qualifying QOF stock without regard to any basis adjustment under section 1400Z–2(c), and the QOF shareholder elects to adjust the basis of its qualifying QOF stock under section 1400Z–2(c).

(B) *Ordering rule*. If paragraph (b)(3)(ii) of this section applies with respect to a QOF corporation, the QOF shareholder increases its basis by the lesser of the amount of the distribution characterized as gain from a sale or exchange or the fair market value of the QOF shareholder's qualifying QOF stock before determining the Federal income tax consequences of the distribution.

(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 A invests $100 in QOF S, a QOF S corporation, in exchange for a qualifying investment and defers $100 of gain. 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, A sells all of its QOF S

shares, realizes gain, and makes an election to increase the qualifying basis in its QOF S shares to fair market value. But for the expiration of the designated zones in section 1400Z–1(f), QOF S and A'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 A's ability to make an election under section 1400Z–2(c). Accordingly, pursuant to that election, A's basis in the QOF stock is increased to its fair market value and A recognizes no gain or loss on the sale.

(2) *Example 2*—(i) *Facts.* In 2019, taxpayer A realizes $100 of eligible gain and contributes $100 to a QOF partnership, X, in exchange for a qualifying QOF partnership interest in X, and taxpayer B contributes $100 of eligible gain to another QOF partnership, Y, in exchange for a qualifying QOF partnership interest in Y. In 2021, in transactions governed by section 721(a), A contributes her qualifying QOF partnership interest in X, and B contributes her qualifying QOF partnership interest in Y, to a newly formed partnership, UTP. In 2024, C receives a profits interest in UTP for services that she will provide to UTP. In 2031, X sells a non-inventory asset and allocates X's distributive share of the gain to UTP. No distributions are ever made from X, Y, or UTP.

(ii) *Analysis.* On December 31, 2026, UTP recognizes $170 of remaining deferred gain relating to the QOF interests. Of that gain, A is allocated the $85 of gain relating to the $100 of eligible gain that she invested in X, and B is allocated the $85 of gain relating to the $100 of eligible gain that she invested in Y. C recognizes no gain at this time. In 2031, because UTP's holding period in X includes A's holding period in X, UTP has a holding period in X that exceeds 10 years, and may make an election under §1.1400Z2(c)–1(b)(2)(ii)(A) to exclude the gain from X's asset sale. Even though A was the original investor in X, she may not make the election. If UTP makes the election, UTP will exclude its distributive share of gain from the sale of the X asset.

(3) *Example 3*—(i) *Facts.* In 2019, taxpayer B invests $100 in P, a QOF partnership, in exchange for a qualifying investment and properly makes an election under section 1400Z–2(a) to defer $100 of eligible gain. B's interest in the partnership is 50 percent. In 2030, when B's interest in P has a value of $130 and a basis of $100, B sells the interest, recognizing $30 of gain, $15 of which is attributable to inventory assets of P. B makes an election under section 1400Z–2(c) with respect to the sale.

(ii) *Analysis.* Because B's election under section 1400Z–2(c) is in effect with respect to the sale, the bases of B's interest in P and of P's assets with respect to the interest sold are adjusted to fair market value immediately before B's sale under paragraph (b)(2)(i) of this section, and B recognizes no gain or loss on the sale.

(4) *Example 4*—(i) *Facts.* The facts are the same as in paragraph (d)(3) of this section (*Example 3*), except that P sells qualified opportunity zone property that is not inventory sold in the ordinary course of business and distributes all of the proceeds from the sale to partners within 90 days of the sale (the qualified opportunity zone property was the only property sold by P in the taxable year). The sold property has a value of $60 and a basis of $40. P recognizes $20 of gain, $10 of which is allocable to B, and B makes an election under paragraph (b)(2)(ii)(A) of this section for the year in which B's allocable share of the partnership's recognized gain would be included in B's gross income.

(ii) *Analysis.* Because B's election under paragraph (b)(2)(ii)(A) of this section is in effect, B will exclude its entire $10 allocable share of the partnership's $20 of recognized gain. Because $10 of the sale proceeds were actually distributed to B within 90 days of the sale, P is not treated as making a deemed distribution and receiving a recontribution under paragraph (b)(2)(ii)(B) of this section with respect to B.

(5) *Example 5*—(i) *Facts.* In 2019, taxpayer C invests $100 in Q, a QOF partnership, in exchange for a qualifying investment and properly makes an election under section 1400Z–2(a) to defer $100 of eligible gain. C's interest in Q is 50%. Q's taxable year ends on December 31. In 2025, Q purchases three qualified opportunity zone properties, X, Y, and Z. On January 22, 2031, Q sells property X for $200, recognizing $140 of gain. On July 31, 2031, Q sells property Y for $80, recognizing $20 of loss. Q makes no distributions to its partners in 2031, has no indebtedness, and has no other gain or loss other than from the sales of properties X and Y. Property Z has a value of $280 at all times throughout 2031. C's share of Q's gain and loss is $70 and $10, respectively, for a net gain of $60, and C makes an election under paragraph (b)(2)(ii)(A) of this section to exclude the gains and losses from its income.

(ii) *Analysis.* Because C has made an election under paragraph (b)(2)(ii)(A) of this section, under paragraph (b)(2)(ii)(B) of this section, C is treated as receiving a cash distribution of $140 from Q, C's share of the net proceeds from the sales of properties X and Y, on December 31, 2031, and immediately recontributing $140 to Q in exchange for a non-qualifying investment in Q. Beginning on January 1, 2032, 50 percent of A's interest in Q is a qualifying investment, and 50 percent of A's investment in Q is a non-qualifying investment. This amount is calculated as a fraction, the numerator of which is $140, the

amount deemed distributed and recontributed, and the denominator of which is $280, the value of C's interest prior to the deemed distribution.

(6) *Example 6*—(i) *Facts*. The facts are the same as in paragraph (d)(5) of this section (*Example 5*), except that Q distributes all of the proceeds from the sale of property X to its partners on March 30, 2031. Q does not make any distribution of proceeds from the sale of property Y.

(ii) *Analysis*. Under paragraph (b)(2)(iii)(B)(*2*)(*ii*) of this section, the actual distribution of cash to C on March 30, 2031, reduces the amount of the deemed distribution and recontribution with respect to C on December 31, 2031. Accordingly, the amount of C's deemed distribution and recontribution is $40, which increases C's non-qualifying investment to 22 percent. This amount is calculated as a fraction, the numerator of which is $40, the amount deemed distributed and recontributed, and the denominator of which is $180, the value of C's interest.

(7) *Example 7. Section 301(c)(3) gain*—(i) *Facts*. In 2020, taxpayer X makes an investment in Q, a QOF corporation, in exchange for a qualifying investment. In 2031, when X's qualifying Q stock is worth $1000x, Q makes a distribution to X with respect to X's qualifying QOF stock, $500x of which is treated as gain from a sale or exchange under section 301(c)(3). In 2032, X disposes of all of its qualifying QOF stock in Q.

(ii) *Analysis*—(A) *Section 301(c)(3) distribution*. X is eligible to make an election described in section 1400Z–2(c) in 2031 with respect to its $500x gain. Under paragraph (b)(3)(ii) of this section, the basis adjustment is $500x, the lesser of $500x, the amount of the distribution treated as gain from the sale or exchange of property, and $1000x, the fair market value of the qualifying QOF stock before the distribution. As a result of the election, X increases its basis in its qualifying QOF stock in Q by $500x immediately before the distribution; consequently, the $500x is treated as a return of basis under section 301(c)(2).

(B) *Disposition of qualifying QOF stock*. X is eligible to make an election described in section 1400Z–2(c) in 2032 with respect to all of its qualifying QOF stock in Q, notwithstanding X's receipt of a section 301(c)(3) distribution in 2031. See paragraph (b)(1)(iv) of this section.

(e) *Capital gain dividends paid by a QOF RIC or 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 RIC or 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 RIC or QOF REIT paying the capital gain dividend are a qualifying investment in the QOF RIC or 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 RIC or QOF REIT identified with the dividend; and

(ii) If, on the date identified, the shareholder had held that qualifying investment in the QOF RIC or QOF REIT for at least 10 years, then the shareholder may exclude that capital gain dividend, or part thereof, from its taxable income for the taxable year.

(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 852(b)(3)(C) or 857(b)(3)(B), or part thereof, and a date that the QOF RIC reports or QOF REIT designates in a notice provided to the shareholder not later than one week after the QOF RIC reports or QOF REIT designates the capital gain dividend pursuant to section 852(b)(3)(C) or 857(b)(3)(B). The notice must be mailed to the shareholder unless the shareholder has provided the QOF RIC or 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 RIC or QOF REIT must provide the Commissioner all data that the Commissioner specifies with respect to the amounts of capital gain dividends and the dates reported or designated by the QOF RIC or 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 RIC or QOF REIT did not recognize 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*. Reportings and designations of capital gain dividends identified with a date must be proportional for all capital gain dividends

paid with respect to the taxable year. See section 857(g)(2). Greater than *de minimis* violation of proportionality invalidates all of the purported identifications for a taxable year.

(iii) *Undistributed capital gains*. If section 852(b)(3)(D)(i) or 857(b)(3)(C)(i) requires a shareholder of a QOF RIC or QOF REIT to include a reported or 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 recognized 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 reported or designated under section 852(b)(3) or section 857(b)(3).

(4) *Determination of the amount of capital gain with which a date may be identified*. A QOF RIC or 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 RIC or QOF REIT recognizes long-term capital gain on one or more sales or exchanges of qualified opportunity zone property, then the QOF RIC or QOF REIT may identify the first day of that taxable year as the date identified with each reported or designated amount with respect to the capital gain dividends for that taxable year. A reported or designated identification is invalid in its entirety if the amount of gains that the QOF RIC or QOF REIT identifies with that date exceeds the aggregate long-term capital gains recognized on those sales or exchanges for that taxable year.

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

(B) *Iterative application*. The process described in paragraph (e)(4)(ii)(A) 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 RIC or QOF REIT recognized long-term capital gains with respect to a sale or exchange of qualified opportunity zone property, whichever comes first.

(f) *Applicability dates*. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

[T.D. 9889, 85 FR 1974, Jan. 13, 2020; 85 FR 19083, Apr. 6, 2020]

§ 1.1400Z2(d)–1 Qualified opportunity funds and qualified opportunity zone businesses.

(a) *Overview*. This section provides rules that an eligible entity (as defined in paragraph (a)(1) of this section) must satisfy to be a qualified opportunity fund (QOF) or a qualified opportunity zone business. Paragraphs (a)(2) through (4) of this section provide rules that eligible entities must follow to be certified as QOFs, as well as rules for the de-certification of QOFs. Paragraph (b) of this section provides rules for determining whether the property held by a QOF satisfies the *90-percent investment standard* of section 1400Z–2(d)(1) or the property held by a qualified opportunity zone business satisfies the *70-percent tangible property standard* of section 1400Z–2(d)(3)(A)(i). Paragraph (c) of this section provides rules regarding qualified opportunity zone property that a QOF must hold to satisfy the 90-percent investment standard. Paragraph (d) of this section provides rules that an eligible entity must satisfy to be a qualified opportunity zone business that is owned, in whole or in part,

by one or more QOFs. Paragraph (e) of this section provides applicability dates for this section. See § 1.1400Z2(d)–2 for rules that must be satisfied for tangible property of an eligible entity to be treated as qualified opportunity zone business property.

(1) *Eligible entity*—(i) *In general*. Except as provided in paragraph (a)(1)(ii) of this section, the term *eligible entity* means an entity that is classified as a corporation or partnership for Federal income tax purposes. In order to be treated as a QOF, an eligible entity must self-certify on an annual basis that it satisfies the requirements of paragraphs (b) and (c) of this section, as appropriate. An eligible entity is a qualified opportunity zone business if it satisfies the requirements of paragraph (d) of this section.

(ii) *Exceptions based on where an entity is created, formed, or organized*—(A) *QOFs*. An entity classified as a corporation or partnership for Federal income tax purposes (an entity) but that is not organized under the law of the United States or the law of one of the 50 states, a government of a federally recognized tribe (Indian tribal government), the District of Columbia, or a U.S. territory, is not an eligible entity and is ineligible to be a QOF. An entity described in the preceding sentence is also ineligible to be a qualified opportunity zone business, and therefore an equity interest in the entity is neither qualified opportunity zone stock nor a qualified opportunity zone partnership interest for purposes of section 1400Z–2(d)(2).

(B) *Entities organized in a U.S. territory*—(*1*) *In general*. If an entity is organized in a U.S. territory but not in one of the 50 States or the District of Columbia, the entity may be a QOF only if the entity is organized for investing in qualified opportunity zone property that relates to a trade or business operated in the U.S. territory in which the entity is organized. If an entity is organized in a U.S. territory 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. territory in which the entity is organized. An entity described in the preceding sentence is treated as satisfying the requirement, as applicable, of being a domestic corporation for purposes of section 1400Z–2(d)(2)(B)(i) or of being a domestic partnership for purposes of section 1400Z–2(d)(2)(C).

(*2*) *U.S. territory defined*. For purposes of this paragraph (a)(1), the term *U.S. territory* means American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, the U.S. Virgin Islands, and any other territory not under the jurisdiction of one of the 50 States, an Indian tribal government, or the District of Columbia where a qualified opportunity zone has been designated under section 1400Z–1.

(iii) *Pre-existing entities*. There is no legal barrier to a pre-existing eligible entity qualifying as a QOF or a qualified opportunity zone business, but the pre-existing eligible entity must satisfy all of the applicable requirements of section 1400Z–2, this section, and § 1.1400Z2(d)–2.

(2) *Self-certification as a QOF*. The following rules apply to the required self-certification of an eligible entity as a QOF:

(i) *Time, form, and manner*. The self-certification must be timely-filed and effected annually in such form and manner as may be prescribed by the Commissioner of Internal Revenue (Commissioner) in the Internal Revenue Service (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 for which the self-certification takes effect.

(iii) *First month*. The self-certification may identify the first month (in that initial taxable year) in which the self-certification takes effect.

(A) *Failure to specify first month*. If the self-certification fails to specify the month in the initial taxable year that the self-certification takes effect, then the self-certification is treated as taking effect in the first month of that taxable year.

(B) *Investments before entity's first month as QOF 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 and the investment is a non-qualifying investment.

(iv) *Becoming a QOF in a month that is not the first month of the taxable year.* This paragraph (a)(2)(iv) applies to an eligible entity if its self-certification as a QOF is first effective for a month that is not the first month of that entity's taxable year.

(A) For purposes of applying section 1400Z–2(d)(1)(A) and (B) in the first year of the QOF's existence, the phrase *first six-month period of the taxable year of the fund* means the first six 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 investment standard in section 1400Z–2(d)(1) takes into account only the QOF's assets on the last day of the QOF's taxable year.

(B) 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) *Self-decertification of a QOF.* If a QOF chooses to self-decertify as a QOF, the following rules apply:

(i) *Form and manner.* The self-decertification must be effected 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) *Time.* The self-decertification becomes effective at the beginning of the month following the month specified by the taxpayer, which month must not be earlier than the month in which the taxpayer files its self-decertification as provided in paragraph (a)(3)(i) of this section.

(4) [Reserved]

(b) *Valuation of property for purposes of the 90-percent investment standard and the 70-percent tangible property standard*—(1) *In general.* An eligible entity may value its owned or leased property using the valuation methods provided in paragraphs (b)(3) and (4) of this section to determine whether—

(i) In the case of an eligible entity that has self-certified as a QOF, the assets owned or leased by the QOF satisfy the 90-percent investment standard in section 1400Z–2(d)(1); and

(ii) In the case of an eligible entity that has issued qualified opportunity zone partnership interests or qualified opportunity zone stock to a QOF, the tangible property owned or leased by the eligible entity satisfies the *70-percent tangible property standard* in section 1400Z–2(d)(3)(A)(i).

(2) *Special rules*—(i) *QOFs*—(A) *In general.* To meet the *90-percent investment standard* in section 1400Z–2(d)(1), on a semiannual basis, a QOF may value its assets using the applicable financial statement valuation method set forth in paragraph (b)(3) 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)(4) of this section. During each taxable year, a QOF must apply consistently the valuation method that it selects under paragraph (b) of this section to all assets valued with respect to the taxable year.

(B) *Option for QOFs to disregard recently contributed property.* A QOF may choose to determine compliance with the *90-percent investment standard* by excluding from both the numerator and denominator of the test any property that satisfies all the criteria in paragraphs (b)(2)(i)(B)(*1*) through (*3*) of this section. A QOF need not be consistent from one semiannual test to another in whether it avails itself of the option in this paragraph (b)(2)(i)(B).

(*1*) 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;

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

(*3*) Between the date of the fifth business day after the contribution or exchange and the date of the semiannual test, the amount was held continuously

in cash, cash equivalents, or debt instruments with a term of 18 months or less.

(C) *Safe harbor for QOFs to determine whether equity in an entity is qualified opportunity zone property.* A QOF may choose to determine compliance with the *90-percent investment standard* for each semiannual testing date of the QOF by including in both the numerator and denominator of the test the equity of each entity the QOF holds on that testing date that satisfies all the criteria in paragraph (b)(2)(i)(C)(*1*) or (*2*) of this section.

(*1*) The entity was a qualified opportunity zone business for at least 90 percent of the QOF's cumulative holding period for that equity of the entity—

(*i*) Beginning on the date the QOF's self-certification as a QOF is first effective; and

(*ii*) Ending on the last day of the entity's most recent taxable year ending on or before the semiannual testing date of the QOF.

(*2*) An entity that would not be a qualified opportunity zone business as of the end of its last taxable year ending on or before a semiannual testing date of the QOF is a qualified opportunity zone business with respect to the QOF for that taxable year of the entity if—

(*i*) A cure is achieved for the entity under paragraph (d)(6) of this section; and

(*ii*) The QOF files its Federal income tax return for the taxable year of the QOF containing the testing date on a date that is timely (taking extensions into account) and that is not earlier than when that cure is achieved.

(ii) *Qualified opportunity zone businesses*—(A) *In general.* For purposes of the fraction set forth in paragraph (d)(2)(ii)(A) of this section, 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 (b)(3) 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 (b)(4) of this section. During each taxable year, the valuation method selected under this paragraph (b) must be applied consistently to all tangible property valued with respect to the taxable year.

(B) *Five-percent zone taxpayer.* If a taxpayer both has self-certified as a QOF and holds an equity interest in an eligible entity that is tested as a qualified opportunity zone business, then that taxpayer may value the eligible entity's tangible property for purposes of satisfying the *70-percent tangible property standard* using the same valuation methodology under this paragraph (b) that the taxpayer uses for determining its own compliance with the 90-percent investment standard (compliance methodology), provided that no other equity holder in the eligible entity is a five-percent zone taxpayer. If two or more taxpayers that have self-certified as QOFs hold equity interests in the eligible entity and at least one of them is a five-percent zone taxpayer, then the values of the eligible entity's tangible property 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 eligible entity for purposes of the *70-percent tangible property standard.* 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).

(*1*) *Example.* The example in paragraph (b)(2)(ii)(B)(*2*) of this section illustrates the principles of paragraph (b)(2)(ii)(B) of this section.

(*2*) *Example.* Entity JH is a corporation that has issued only one class of stock and that conducts a trade or business. Taxpayer X holds 94% of the JH 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 (b)(2)(ii)(B) of this section.) JH does not have an applicable financial statement, and, for that reason, a determination of whether JH 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 (b)(2)(i)(A) of this section for purposes of satisfying the *90-percent investment standard* 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 JH'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 JH'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 JH (73%), both X and Y may use Y's compliance methodology to value JH's owned or leased tangible property. If JH'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 JH is qualified opportunity zone stock in the hands of a taxpayer that has self-certified as a QOF.

(iii) *Inventory*. In determining whether the *90-percent investment standard* in section 1400Z–2(d)(1) or the *70-percent tangible property standard* in section 1400Z–2(d)(3)(A)(i) is satisfied, an eligible entity may choose to exclude from both the numerator and denominator of the applicable test the value of all inventory (including raw materials) of the trade or business, if applied consistently within a taxable year of the eligible entity.

(3) *Applicable financial statement valuation method*—(i) *In general*. Under the applicable financial statement valuation method set forth in this paragraph (b)(3), the value of each property that is owned or leased by an eligible entity is the value of that asset as reported on the eligible entity's applicable financial statement for the relevant reporting period.

(ii) *Requirement for selection of method*. An eligible entity may select the applicable financial statement valuation method set forth in this paragraph (b)(3) to value an asset leased by the eligible entity only if the applicable financial statement of the eligible entity is prepared according to U.S. generally accepted accounting principles (GAAP) and requires an assignment of value to the lease of the asset.

(4) *Alternative valuation method*—(i) *In general*. Under the alternative valuation method set forth in this paragraph (b)(4), the value of the property owned by an eligible entity is calculated under paragraph (b)(4)(ii) of this section, and the value of the property leased by an eligible entity is calculated under paragraph (b)(4)(iii) of this section.

(ii) *Property owned by an eligible entity*—(A) *Property purchased or constructed*. The value of each property owned by an eligible entity that is acquired by purchase for fair market value or constructed for fair market value is the eligible entity's unadjusted cost basis of the asset under section 1012 or section 1013. Solely for purposes of this paragraph (b)(4)(ii)(A), the acquisition by a QOF of qualified opportunity zone stock or a qualified opportunity zone partnership interest is treated as a purchase of such interest by the QOF.

(iii) *Property leased by an eligible entity*—(A) *In general*. The value of each property that is leased by an eligible entity is equal to the present value of the leased property as defined in paragraph (b)(4)(iii)(C) of this section.

(B) *Discount rate*. For purposes of calculating present value under paragraph (b)(4)(iii) of this section, the discount rate is the short-term applicable Federal rate under section 1274(d)(1), based on semiannual compounding, for the month in which the eligible entity enters into the lease. For purposes of the preceding sentence, the three month rule in section 1274(d)(2) does not apply to determine the applicable Federal rate.

(C) *Present value*. For purposes of paragraph (b)(4)(iii) of this section, present value of a leased property—

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

(*2*) Is calculated at the time the eligible entity enters into the lease for the property; and

(*3*) Once calculated, is used as the value for the property by the eligible

entity for all testing dates during the term of the lease for purposes of the *90-percent investment standard* or the *70-perecent tangible property standard*.

(D) *Term of a lease*. For purposes of paragraph (b)(4)(iii) of this section, the term of a lease includes periods during which the lessee may extend the lease at a pre-defined market rate rent. For nonresidential real property or residential real property, pre-defined rent does not include the option to renew at fair market value, determined at the time of renewal. The terms of the pre-defined rent must satisfy the following criteria:

(*1*) *General rule*. The terms of the pre-defined rent are market rate (that is, the terms of the pre-defined rent reflect common, arms-length market pricing in the locale that includes the qualified opportunity zone as determined under section 482 and all section 482 regulations in this chapter) at the time the lease is entered into.

(*2*) *Rebuttable presumption regarding leases not between related persons*. There will be a rebuttable presumption that the terms of the extension of the lease are market rate for leases not between related persons (within the meaning of section 1400Z–2(e)(2)), and thus, the parties to the lease are not required to perform a section 482 analysis.

(*3*) *Exception for state, local, and Indian tribal governments*. For purposes of this paragraph (b)(4)(iii)(D), tangible property acquired by lease from a state or local government, or an Indian tribal government, is not considered tangible property acquired by lease from a related person.

(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 § 1.1400Z2(d)–2.

(2) *Qualified opportunity zone stock*—(i) *In general*. Except as provided in paragraph (c)(2)(ii) of this section, if an eligible entity is classified as a corporation for Federal income tax purposes (corporation), then an equity interest (stock) in the eligible entity is *qualified opportunity zone stock* if the requirements described in this paragraph (c)(2)(i) are satisfied:

(A) *Date of acquisition*. 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) *Qualified opportunity zone business*. 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) *90-percent qualified opportunity zone property holding period*—(*1*) *Cumulative holding period test*. During at least 90 percent of the QOF's holding period for the corporation's stock, determined on a cumulative basis in accordance with paragraph (c)(2)(i)(C)(*2*) of this section, the corporation qualified as a qualified opportunity zone business.

(*2*) *Semiannual qualified opportunity zone business test*. For purposes of determining satisfaction of the cumulative 90-percent qualified opportunity zone property holding period test described in paragraph (c)(2)(i)(C)(*1*) of this section, the determination of whether a corporation engaged in a trade or business qualifies as a qualified opportunity zone business may be made by the QOF on a semiannual basis pursuant to section 1400Z–2(d)(1). However, a QOF may choose to apply the safe harbor rule in paragraph (b)(2)(i)(C) of this section to make this determination.

(ii) *Redemptions of stock*. Pursuant to section 1400Z–2(d)(2)(B)(ii), the following rules 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 either directly or indirectly any

of its stock from the QOF or from a person related (within the meaning of section 1400Z–2(e)(2)) to the QOF. Even if the purchase occurs after the issuance, the stock was never qualified opportunity zone stock.

(B) *Significant redemptions*—(*1*) *In general*. 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 one year before the issuance of the stock, the corporation made one or more purchases of more than a de minimis amount of its stock and the purchased stock has 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. The aggregate value is determined as of the time of the stock purchases. Even if one or more of the disqualifying purchases occurs after the issuance, the stock was never qualified opportunity zone stock.

(*2*) *De minimis amount*. For purposes of this paragraph (c)(2)(ii)(B), stock acquired from the taxpayer or a related person exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of the stock held by the taxpayer and related persons (within the meaning of section 1400Z–2(e)(2)) is acquired. The rules in the following sentences of this paragraph (c)(2)(ii)(B)(*2*) apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

(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).

(D) *Principles of § 1.1202–2(c) and (d)*. The principles of § 1.1202–2(c) and (d) apply in determining whether stock is redeemed or purchased for purposes of paragraph (c)(2)(ii) of this section.

(iii) *Reorganizations of corporations otherwise qualifying as qualified opportunity zone businesses*—(A) *Qualification as qualified opportunity zone stock*. Stock that meets all of the requirements of paragraph (c)(2)(i) of this section except for the requirement in paragraph (c)(2)(i)(A) of this section is qualified opportunity zone stock if it is received solely in exchange for qualified opportunity zone stock in a transaction described in section 381(a)(2). The requirements in paragraphs (c)(2)(i)(B) and (C) of this section must be met with respect to both the stock held before such transaction and the stock for which it is exchanged in such transaction.

(B) *Satisfaction of original use and substantial improvement tests*. The requirements of § 1.1400Z2(d)–2 apply to property of a qualified opportunity zone business acquired from a qualified opportunity zone business in a transaction described in section 381(a)(2) as if the acquiring corporation had held the property during the period in which the target corporation held the property. For example, an item of property must be substantially improved by the same date by which the target corporation was required to satisfy the substantial improvement test for such property.

(C) *Reorganizations of qualified opportunity zone businesses within a consolidated group*. See §§ 1.1502–14Z and 1.1504–3 for special rules applicable to consolidated groups.

(3) *Qualified opportunity zone partnership interest*—(i) *In general*. If an *eligible* entity is classified as a partnership for Federal tax purposes (partnership), any capital or profits interest (partnership interest) in the eligible entity is a *qualified opportunity zone partnership interest* if—

(A) *Date of acquisition*. The partnership interest is acquired by a QOF after December 31, 2017, from the partnership solely in exchange for cash;

(B) *Qualified opportunity zone business*. 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

(C) *90-percent qualified opportunity zone property holding period*—(*1*) *Cumulative holding period test*. During at least 90-percent of the QOF's holding period for the partnership interest, determined on a cumulative basis in accordance with paragraph (c)(3)(i)(C)(*2*) of this section, the partnership qualified as a qualified opportunity zone business.

(*2*) *Semiannual qualified opportunity zone business test*. For purposes of determining satisfaction of the cumulative 90-percent qualified opportunity zone property holding period test described in paragraph (c)(3)(i)(C)(*1*) of this section, the determination of whether a partnership engaged in a trade or business qualifies as a qualified opportunity zone business is made by the QOF on a semiannual basis pursuant to section 1400Z–2(d)(1). However, a QOF may choose to apply the safe harbor rule in paragraph (b)(2)(i)(C) of this section to make this determination.

(ii) *Reorganizations of partnerships otherwise qualifying as qualified opportunity zone businesses*—(A) *Qualification as a qualified opportunity zone partnership interest*. A partnership interest that meets all of the requirements of paragraph (c)(3)(i) of this section except for the requirement in paragraph (c)(3)(i)(A) of this section is a qualified opportunity zone partnership interest if it is received solely in exchange for a qualified opportunity zone partnership interest in a merger or consolidation transaction described in section 708(b)(2)(A). The requirements in paragraphs (c)(3)(i)(B) and (C) of this section must be met with respect to both the partnership interest held before the transaction and the partnership interest for which it is exchanged in the transaction.

(B) *Satisfaction of original use and substantial improvement tests*. The requirements of §1.1400Z2(d)–2 apply to property of a qualified opportunity zone business acquired from a qualified opportunity zone business in a transaction described in section 708(b)(2)(A) as if the resulting partnership had held the property during the period in which the merging or consolidating partnership held the property. For example, an item of property must be substantially improved by the same date by which the merging or consolidating partnership was required to satisfy the substantial improvement test for such property.

(d) *Qualified opportunity zone business*—(1) *In general*. An eligible entity engaged in a trade or business within the meaning of section 162 is a *qualified opportunity zone business* if the entity satisfies, as determined at the end of its taxable year, all the criteria in paragraphs (d)(1)(i) through (*iii*) of this section. An eligible entity's status as a qualified opportunity zone business applies for the entire taxable year of the entity.

(i) Pursuant to section 1400Z–2(d)(3)(A)(i), the eligible entity engaged in the trade or business satisfies the *70-percent tangible property standard* with respect to its tangible property, as provided in paragraph (d)(2) of this section;

(ii) Pursuant to section 1400Z–2(d)(3)(A)(ii), the eligible entity engaged in the trade or business satisfies the requirements of section 1397C(b)(2), (4), and (8), as provided in paragraph (d)(3) of this section; and

(iii) Pursuant to section 1400Z–2(d)(3)(A)(iii), the eligible entity engaged in the trade or business is not described in section 144(c)(6)(B) as provided in paragraph (d)(4) of this section.

(2) *Satisfaction of 70-percent tangible property standard*—(i) *In general*. A trade or business of an eligible entity satisfies the *70-percent tangible property standard* 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 §1.1400Z2(d)–2).

(ii) *Calculating percent of tangible property owned or leased in a trade or business*—(A) *In general*. Whether a trade or business of the eligible entity satisfies the *70-percent tangible property standard* set forth in paragraph (d)(2)(i) of this section is determined by a fraction—

(*1*) The numerator of which is the total value of all tangible property owned or leased by the qualified opportunity zone business that is qualified opportunity zone business property; 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) *Valuation*. See paragraph (b)(2)(ii) of this section for rules regarding the valuation of tangible property for purposes of the *70-percent tangible property standard*.

(3) *Operation of section 1397C requirements adopted by reference*—(i) *Gross income requirement*. Section 1400Z–2(d)(3)(A)(ii) 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 (or in multiple qualified opportunity zones). 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)(3)(i)(A), (B), (C), or (D) of this section, or any criteria identified in published guidance issued by the Commissioner under § 601.601(d)(2) of this chapter.

(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 a qualified opportunity zone, determined by the fraction described in paragraphs (d)(3)(i)(A)(*1*) and (*2*) of this section. Amounts paid to partners that provide services to the trade or business of a partnership are taken into account in the numerator and denominator set forth in paragraphs (d)(3)(i)(A)(*1*) and (*2*) of this section only to the extent the amounts paid to the partners are guaranteed payments for services provided to the partnership within the meaning of section 707(c).

(*1*) The numerator of the fraction is the total number of hours of services performed for the trade or business in a qualified opportunity zone during the taxable year by employees, partners that provide services to a partnership, independent contractors, and employees of independent contractors; and

(*2*) The denominator of the fraction is the total number of hours of services performed for the trade or business during the taxable year by employees, partners that provide services to a partnership, independent contractors, and employees of independent contractors.

(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 a qualified opportunity zone, determined by the fraction described in paragraphs (d)(3)(i)(B)(*1*) and (*2*) of this section. Amounts paid to partners that provide services to the trade or business of a partnership are taken into account in the numerator and denominator set forth in paragraphs (d)(3)(i)(B)(*1*) and (*2*) of this section only to the extent the amounts paid to the partners are guaranteed payments for services provided to the partnership within the meaning of section 707(c).

(*1*) The numerator of the fraction is the total amount paid by the entity for services performed in a qualified opportunity zone during the taxable year, whether by employees, partners that provide services to a partnership, independent contractors, or employees of independent contractors; and

(*2*) The denominator of the fraction is the total amount paid by the entity for services performed during the taxable year, whether by employees, partners that provide services to a partnership, 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 a 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 a qualified opportunity zone.

(E) *Examples*. The following examples illustrate the principles of paragraphs (d)(3)(i)(C) and (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 (inside and outside 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, necessary for 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 P.O. Box located in the qualified opportunity zone. The mail received at that P.O. 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 P.O. Box is not necessary for 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, 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)(A)(ii) incorporates section 1397C(b)(4), requiring that, with respect to any taxable year, a substantial portion of the intangible property of a qualified opportunity zone business is used in the active conduct of a trade or business in a qualified opportunity zone. For purposes of section 1400Z–2(d)(3)(A)(ii) and the preceding sentence, the term *substantial portion* means at least 40 percent.

(B) *Use of intangible property*. For purposes of section 1400Z–2(d)(3)(A)(ii) and paragraph (d)(3)(ii)(A) of this section, intangible property of a qualified opportunity zone business is used in the active conduct of a trade or business in a qualified opportunity zone if—

(*1*) The use of the intangible property is normal, usual, or customary in the conduct of the trade or business; and

(*2*) The intangible property is used in the qualified opportunity zone in the performance of an activity of the trade or business that contributes to the generation of gross income for the trade or business.

(iii) *Active conduct of a trade or business*—(A) *Operating real property*. Solely for 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.

(B) *Lessee is responsible for certain costs*. Merely entering into a triple-net-lease with respect to real property owned by a taxpayer does not constitute the active conduct of a trade or business by such taxpayer.

(C) *Examples*. The following examples illustrate the rules of paragraph (d)(3)(iii) of this section.

(*1*) *Example 1. Mere triple-net-lease not active conduct of trade or business*—(*i*) *Facts*. Company N constructs and places into service a new, three-story office building in a qualified opportunity zone and leases the entire building to tenant X, an unrelated person, which uses the building as office space for its software development firm. This building is the only property owned by Company N. The lease agreement between Company N and tenant X is a triple-net-lease under which tenant X is responsible for all of the costs relating to the office building (for example, paying all taxes, insurance, and maintenance expenses) in addition to paying rent. Company N also maintains an office in the building with staff members

to address any issues that may arise with respect to the triple-net-lease.

(*ii*) *Analysis*. Solely for purposes of section 1400Z–2(d)(3)(A), Company N is treated as not engaged in the active conduct of a trade or business with respect to the leased office building. Company N leases the building to tenant X under a triple-net-lease, and therefore the employees of Company N do not meaningfully participate in the management or operations of the building. The fact that Company N maintains an office in the leased building with staff members to address any issues that may arise with respect to the triple-net-lease does not alter this result. Therefore, Company N does not conduct an active trade or business in a qualified opportunity zone.

(*2*) *Example 2. Triple-net-lease and managerial and operational activities can constitute active conduct of trade or business*—(*i*) *Facts*. Company N constructs and places into service a new, three-story mixed-use building in a qualified opportunity zone and leases a floor to each of unrelated tenants X, Y, and Z, respectively. This building is the only property owned by Company N. The lease agreement between Company N and tenant X is a triple-net-lease under which tenant X is responsible for all of the costs relating to the third floor of the building (for example, paying all such taxes, insurance, and maintenance expenses) in addition to paying rent. The lease agreement between Company N and tenant Y is not a triple-net-lease and employees of Company N manage and operate the second floor of the building. Likewise, the lease agreement between Company N and tenant Z is not a triple-net-lease and employees of Company N manage and operate the first floor of the building. Company N maintains an office in the building, which the employees regularly use to carry out their managerial and operational duties with respect to the first and second floors, and address any other issues that may arise with respect to the three leases.

(*ii*) *Analysis*. Solely for purposes of section 1400Z–2(d)(3)(A), Company N is treated as engaged in the active conduct of a trade or business with respect to the leased mixed-use building. While Company N leases the third floor of the building to tenant X merely under a triple-net-lease, and therefore the employees of Company N do not meaningfully participate in the management or operations of that floor, the employees of Company N meaningfully participate in the management and operations of the first and second floors of the leased building. Therefore, in carrying out the overall leasing business of Company N with respect to the mixed-use building, employees of Company N conduct meaningful managerial and operational activities. As a result, Company N conducts an active trade or business in a qualified opportunity zone.

(iv) *Nonqualified financial property limitation*. Section 1400Z–2(d)(3)(A)(ii) incorporates section 1397C(b)(8), which requires that in each taxable year less than 5 percent of the average of the aggregate unadjusted bases of the property of a qualified opportunity zone business is 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) and debt instruments described in section 1221(a)(4).

(v) *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 requirements in paragraphs (d)(3)(v)(A) through (C) of this section 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 the writing and written schedule described in paragraphs (d)(3)(v)(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)(3)(v)(C).

(D) *Federally declared disasters.* If the qualified opportunity zone business is located in a qualified opportunity zone within a federally declared disaster (as defined in section 165(i)(5)(A)), the qualified opportunity zone business may receive not more than an additional 24 months to consume its working capital assets, as long as it otherwise meets the requirements of paragraph (d)(3)(v) of this section.

(E) *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 paragraphs (d)(3)(v)(A) through (C) of this section.

(vi) *Safe harbor for section 1397C requirements other than ''sin business'' prohibition*—(A) *Maximum 62-month safe harbor for start-up businesses.* Property described in paragraphs (d)(3)(vi)(B), (C), and (D) of this section may benefit from one or more 31-month periods, for a total of 62 months, in the form of multiple overlapping or a sequential application of the working capital safe harbor if—

(*1*) Each application independently satisfies all of the requirements in paragraphs (d)(3)(v)(A) through (C) of this section;

(*2*) The working capital assets from an expiring 31-month period were expended in accordance with the requirements in paragraphs (d)(3)(v)(A) through (C) of this section;

(*3*) The subsequent infusions of working capital assets form an integral part of the plan covered by the initial working capital safe harbor period; and

(*4*) Each overlapping or sequential application of the working capital safe harbor includes a substantial amount of working capital assets (which may include debt instruments described in section 1221(a)(4)).

(B) *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)(3)(v) of this section treats as a reasonable amount of working capital, then that gross income is counted toward satisfaction of the 50-percent test.

(C) *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), intangible property purchased or licensed by the trade or business, pursuant to the reasonable written plan with a written schedule for the expenditure of the working capital, satisfies the use requirement during any period in which the business is proceeding in a manner that is substantially consistent with paragraphs (d)(3)(v)(A) through (C) of this section.

(D) *Safe harbor for working capital and property on which working capital is being expended*—(*1*) *Working capital.* If paragraph (d)(3)(v) of this section treats property of an entity that would otherwise be nonqualified financial property as being a reasonable amount of working capital because of compliance with the three requirements of paragraphs (d)(3)(v)(A) through (C) of this section, the entity satisfies the requirements of section 1400Z–2(d)(2)(D)(i) only during the working capital safe harbor period(s) for which the requirements of paragraphs (d)(3)(v)(A) through (C) of this section are satisfied; however such property is not qualified opportunity zone business property for any purpose.

(*2*) *Tangible property acquired with covered working capital.* If tangible property referred to in paragraph (d)(3)(v)(A) of this section is expected to satisfy the requirements of section

1400Z–2(d)(2)(D)(i) as a result of the planned expenditure of working capital described in paragraph (d)(3)(v)(A), and is purchased, leased, or improved by the trade or business, pursuant to the written plan for the expenditure of the working capital, then the tangible property is treated as qualified opportunity zone business property satisfying the requirements of section 1400Z–2(d)(2)(D)(i), during that and subsequent working capital periods the property is subject to, for purposes of the 70-percent tangible property standard in section 1400Z–2(d)(3).

(vii) *Examples*. The following examples illustrate the rules of paragraphs (d)(3)(v) and (vi) of this section.

(A) *Example 1. General application of working capital safe harbor—(1) Facts*. QOF F creates a domestic C corporation 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.

(*2*) *Analysis*. E's use of the cash qualifies for the working capital safe harbor described in paragraph (d)(3)(v) of this section.

(B) *Example 2. Multiple applications of working capital safe harbor—(1) Facts*. QOF G creates a domestic C corporation 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 18 months 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.

(*2*) *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)(3)(v) of this section.

(C) *Example 3. General application of working capital safe harbor—(1) 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.

(*2*) *Analysis*—P met the three requirements of the safe harbor provided in paragraphs (d)(3)(v)(A) through (C) 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. First, 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). Second, 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). Third, 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. Fourth, 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 investment standard in section 1400Z–2(d)(1).

(*3*) *Analysis if P had purchased an existing building*. The 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 would not cause the building to fail to satisfy section 1400Z–2(d)(2)(D)(i)(III).

(D) *Example 4. Multiple applications of working capital safe harbor to tangible property*—(*1*) *Facts*. QOF A forms a domestic C corporation B to develop a large mixed-use real estate development that will consist of commercial and residential real property, owning almost all of the equity of B in exchange for cash. To raise additional working capital for the mixed-use real estate development, B also will borrow cash under a new revolving credit agreement with an unrelated lender. B has a master written plan for the completion of the commercial and residential real property over a 55-month period. The plan provides that the commercial real property will be completed over a 30 month schedule and subsequently, the residential real property will be completed over a 25 month schedule. The plan further provides that a portion of the commercial real property is unable to be used in a trade or business after the completion of the commercial real property since that portion of the commercial real property will be unusable during the residential construction phase. Pursuant to B's original master plan for the completion of the real estate development, QOF A acquires additional equity in B for cash after the completion of the commercial development phase, and B commences use of those working capital assets for residential development phase.

(*2*) *Analysis*. B's use of the cash for the commercial and residential phase qualified for the working capital safe harbor described in paragraph (d)(3)(v) of this section. In addition, all of B's commercial real property developed pursuant to B's original master plan is treated as qualified opportunity zone business property under paragraph (d)(3)(vi)(D) of this section.

(viii) *Safe harbor for property on which working capital is being expended*—(A) *In general*. If paragraph (d)(3)(v) of this section treats property that would otherwise be nonqualified financial property as being a reasonable amount of working capital because of compliance

with the three requirements of paragraphs (d)(3)(v)(A) through (C) of this section and if the tangible property referred to in paragraph (d)(3)(v)(A) is expected to satisfy the requirements of section 1400Z–2(d)(2)(D)(i) as a result of the planned expenditure of those working capital assets, then tangible property purchased, leased, or improved by the trade or business, pursuant to the written plan for the expenditure of the working capital assets, is treated as qualified opportunity zone business property satisfying the requirements of section 1400Z–2(d)(2)(D)(i), during that and subsequent working capital periods the property is subject to, for purposes of the *70-percent tangible property standard* in section 1400Z–2(d)(3).

(B) *Example. Multiple applications of working capital safe harbor to tangible property*—(i) *Facts.* B also borrows cash and forms a domestic C corporation B to develop a large mixed-use real estate development that will consist of commercial and residential real property, owning almost all of the equity of B in exchange for cash. QOF A has a master written plan for the completion of the commercial and residential real property over a 55 month period. The plan provides that the commercial real property will be completed over a 30 month schedule and subsequently, the residential real property will be completed over a 25 month schedule. The plan further provides that a portion of the commercial real property is unable to be used in a trade or business after the completion of the commercial real property since that portion of the commercial real property will be unusable during the residential construction phase. Pursuant to B's original master plan for the completion of the real estate development, QOF A acquires additional equity in B for cash after the completion of the commercial development phase, and B commences use of those working capital assets for residential development phase.

(*ii*) *Analysis.* B's use of the cash for the commercial and residential phase qualified for the working capital safe harbor described in paragraph (d)(3)(v) of this section. In addition, all of B's commercial real property developed pursuant to B's original master plan is treated as qualified opportunity zone business property under paragraph (d)(3)(viii) of this section.

(ix) *Real property straddling a qualified opportunity zone.* For purposes of satisfying the requirements in this paragraph (d)(3) in the case of real property that straddles a qualified opportunity zone, a qualified opportunity zone is the location of services, tangible property, or business functions if—

(A) The trade or business uses the portion of the real property located within a qualified opportunity zone in carrying out its business activities;

(B) The trade or business uses the real property located outside of a qualified opportunity zone in carrying out its business activities;

(C) The amount of the real property located within a qualified opportunity zone is substantial compared to the amount of real property located outside of a qualified opportunity zone; and

(D) The real property located in the qualified opportunity zone is contiguous to part, or all, of the real property located outside of the qualified opportunity zone.

(E) In general, one of the two methods in paragraph (d)(3)(ix)(E)(*1*) and (*2*) of this section may be chosen to determine whether the amount of real property located in the qualified opportunity zone is substantial compared to the amount of real property located outside the qualified opportunity zone.

(*1*) *Square footage test.* If the amount of real property based on square footage located within the qualified opportunity zone is greater than 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. The test in this paragraph (d)(3)(ix)(E)(*1*) is carried out at the time at which the subject real property is acquired.

(*2*) *Unadjusted cost test.* If the unadjusted cost of the real property located inside a qualified opportunity zone is greater than the unadjusted cost of the real property outside the qualified opportunity zone, and the

real property outside of the qualified opportunity zone is contiguous to all or part 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. The unadjusted cost basis of property acquired as a single tract is presumed to be allocated on the basis of the square footage of the property. The test in this paragraph (d)(3)(ix)(E)(*2*) is carried out at the time at which the subject real property is acquired.

(F) For purposes of the two tests described in paragraph (d)(3)(ix)(E)(*1*) and (*2*) of this section, two or more tracts or parcels of land are contiguous if they share common boundaries or would share common boundaries but for the interposition of a road, street, railroad, stream or similar property. Tracts or parcels of land which touch only at a common corner are not contiguous.

(x) *Example*. The following example illustrates the rules of paragraph (d)(3) of this section—

(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*—(*1*) P met the three requirements of the safe harbor provided in paragraph (d)(3)(v) 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 investment standard* in section 1400Z–2(d)(1).

(C) *Analysis if P had purchased an existing building*. The conclusions in paragraph (d)(3)(x)(B) of this section 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 would not cause the building to fail to satisfy section 1400Z–2(d)(2)(D)(i)(III).

(4) *Trade or businesses described in section 144(c)(6)(B) not eligible*—(i) Pursuant to section 1400Z–2(d)(3)(A)(iii), the following trades or businesses, and businesses leasing more than a de minimis amount of property to the following trades or businesses, cannot qualify as a qualified opportunity zone business:

(A) Any private or commercial golf course;

(B) Country club;

(C) Massage parlor;

(D) Hot tub facility;

(E) Suntan facility;

(F) Racetrack or other facility used for gambling; or

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

(ii) De minimis amounts of gross income attributable to a business described in section 144(c)(6)(B) will not cause a trade or business to fail to be a qualified opportunity zone business.

(iii) The term *de minimis amount of property*, used in paragraph (d)(4)(i) of this section, means less than 5 percent of the net rentable square feet for real property and less than 5 percent of the value for all other tangible property. The term *de minimis amount of gross income*, used in paragraph (d)(4)(ii) of this section, means less than 5 percent of the gross income of the qualified opportunity zone business may be attributable to the types of business described in section 144(c)(6)(B).

(iv) The following examples illustrate the rules of paragraph (d)(4) of this section:

(A) *Example 1.* Entity A is a QOF that meets the requirements of section 1400Z–2(d)(1). Entity A owns qualified opportunity zone stock in a domestic corporation described in section 1400Z–2(d)(2)(B), which operates a hotel located in a qualified opportunity zone that qualifies as a trade or business. As part of that trade or business, the hotel operates a spa that provides massages and other therapies. Less than 5 percent of the hotel's total gross income is attributable to the spa, and less than 5 percent of the net rentable square feet for real property and less than 5 percent of the value for all other tangible property is attributable to the spa. As a result, the operation of the spa, which is a business described in section 144(c)(6)(B), will not prevent the operation of the hotel from qualifying as a qualified opportunity zone business.

(B) *Example 2—(1) Facts.* Entity B is a qualified opportunity zone business that meets the requirements of section 1400Z–2(d)(3). Entity B plans to acquire a commercial golf course that consists of land and other related buildings and equipment in a qualified opportunity zone, that will satisfy each requirement for qualified opportunity zone business property set forth in section 1400Z–2(d)(2)(D). Instead of directly managing and operating the commercial golf course business, Entity B will lease the land and other related buildings and equipment to a third party to manage and operate the commercial golf course. The leased real property represents more than 5 percent of the net rentable square feet of Entity B's real property and the leased and other tangible property represents more than 5 percent of the value for all other tangible property of Entity B.

(*2*) *Analysis.* Because a golf course is prohibited from being a qualified trade or business under section 1400Z–2(d)(3)(A)(iii), the leasing arrangement will cause Entity B to fail to be a qualified opportunity zone business regardless of the satisfaction of each requirement set forth in section 1400Z–2(d)(2)(D).

(C) *Example 3—(1) Facts.* Entity B meets the explicit requirements of section 1400Z–2(d)(1) and has certified itself as a QOF. Entity B owns a commercial golf course that consists of land and other related buildings and equipment in a qualified opportunity zone, and the land and buildings satisfy all explicit requirements (in section 1400Z–2(d)(2)(D)) to be qualified opportunity zone business property. Entity B manages and operates the commercial golf course business, but does not manage or operate any other trade or business not described in section 144(c)(6)(B) (listing businesses not eligible to be a qualified opportunity zone business pursuant to section 1400Z–2(d)(3)(A)(iii)). Entity B chose to operate the commercial golf course through Entity B, rather than through a qualified opportunity zone business, in order to avoid the requirement in section

1400Z–2(d)(3)(A)(iii), which provides that a qualified opportunity zone business cannot operate a commercial golf course due to the inclusion of that trade or business in section 144(c)(6)(B).

(*2*) *Analysis*. The ownership and operation of the golf course at the QOF level will not disqualify the QOF because the prohibition on businesses described in section 144(c)(6)(B) is not applicable at the QOF level. In addition, if each requirement set forth in section 1400Z–2(d)(2)(D) is satisfied, the property used in the commercial golf course will qualify as qualified opportunity zone business property held by Entity B for purposes of section 1400Z–2(d)(2)(A).

(5) *Tangible property of a qualified opportunity zone business that ceases to be qualified opportunity zone business property*. For qualified opportunity zone businesses, tangible property that ceases to be qualified opportunity zone business property shall continue to be treated as qualified opportunity zone business property for the lesser of five years after the date on which such tangible property ceases to be so qualified or the date on which such tangible property is no longer held by the qualified opportunity zone business. However, tangible property is not eligible for the benefits provided in this paragraph (d)(5) unless the tangible property ceasing to qualify as qualified opportunity zone business property was qualified opportunity zone business property used by a qualified opportunity zone business in a qualified opportunity zone for two years. For purposes of this paragraph (d)(5), tangible property purchased, leased, or improved by a trade or business, that is treated as satisfying the requirements of section 1400Z–2(d)(2)(D)(i) during that working capital safe harbor period pursuant to paragraph (d)(3)(v) of this section or that 30-month substantial improvement period described in §1.1400Z2(d)–2(b)(4), is not treated as used by a qualified opportunity zone business in a qualified opportunity zone for any portion of the two year period described in this paragraph (d)(5).

(6) *Cure period for qualified opportunity zone businesses*. (i) For purposes of the *90-percent qualified opportunity zone business holding period* requirements set forth in sections 1400Z–2(d)(2)(B)(i)(III), 1400Z–2(d)(2)(C)(iii), and 1400Z–2(d)(2)(D)(i)(III), if a trade or business causes the QOF to fail the *90-percent investment standard* on a semiannual testing date, the QOF may treat the stock or partnership interest in that trade or business as qualified opportunity zone property for that semiannual testing date provided the trade or business corrects the failure within 6 months of the date on which the stock or partnership interest lost its qualification.

(ii) If the failure occurs on the last testing date of the taxable year, the six-month cure period described in paragraph (d)(6)(i) of this section is available to the QOF only if the QOF files a valid application for an extension of time to file its tax return.

(iii) Each QOF is permitted only one correction for a trade or business pursuant to this paragraph (d)(6). If the entity, at the end of the additional six-month cure period, fails to qualify as a qualified opportunity zone business, then the QOF becomes subject to the penalty under section 1400Z–2(f)(1) for each month the entity failed to qualify as a qualified opportunity zone business beginning with the first month following the last month that the QOF met the *90-percent investment standard*.

(e) *Applicability dates*—(1) *In general*. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) *Prior periods*. With respect to the portion of a taxpayer's first taxable year ending after December 21, 2017, and for taxable years beginning after December 21, 2017, and on or before March 13, 2020, a taxpayer may choose either—

(i) To apply the section 1400Z–2 regulations, if applied in a consistent manner for all such taxable years (reliance by a taxpayer on paragraph (e)(2)(ii) of this section, §1.1400Z2(a)–1(g)(2)(ii), §1.1400Z2(b)–1(j)(2)(ii), §1.1400Z2(d)–2(e)(2)(ii), or §1.1400Z2(f)–1(d)(2)(ii), is disregarded solely for purposes of the consistency requirement under this paragraph (e)(2)(i)); or

(ii) To rely on the rules in proposed §1.1400Z2(d)–1 contained in the notice of proposed rulemaking (REG–115420–

18) published on October 29, 2018, as amplified by the notice of proposed rulemaking (REG–120186–18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

[T.D. 9889, 85 FR 1977, Jan. 13, 2020; 85 FR 19083, April 6, 2020]

EDITORIAL NOTE: At 85 FR 19083, April 6, 2020, § 1.1400Z2(d)–1 was amended in part by redesignating paragraphs (d)(3)(ix) and (x) as (d)(3)(viii) and (ix); however, the amendment could not be incorporated due to inaccurate amendatory instruction.

§ 1.1400Z2(d)–2 Qualified opportunity zone business property.

(a) *Qualified opportunity zone business property*—(1) *In general*. This section provides rules for determining whether owned or leased tangible property held by an eligible entity (within the meaning of § 1.1400Z2(d)–1(a)(1)) is qualified opportunity zone business property within the meaning of section 1400Z–2(d)(2)(D). Paragraph (a)(2) of this section provides general requirements that tangible property must satisfy to be qualified opportunity zone business property. Paragraph (b) of this section provides rules related to owned tangible property. Paragraph (c) of this section provides rules related to leased tangible property (that is, tangible property that the eligible entity acquires by lease from a lessor). Paragraph (d) of this section provides rules related to the 90-percent qualified opportunity zone business property holding period requirement and the 70-percent use test of section 1400Z–2(d)(2)(D)(i)(III). Paragraph (e) of this section provides the dates of applicability of this section.

(2) *Qualified opportunity zone business property requirements*. The term *qualified opportunity zone business property* means tangible property owned or leased by an eligible entity (as defined in § 1.1400Z2(d)–1(a)(1)) that—

(i) Is used by the eligible entity in a trade or business within the meaning of section 162; and

(ii) Satisfies the requirements of paragraphs (b), (c), and (d) of this section, as applicable.

(b) *Tangible property owned by an eligible entity*—(1) *Purchase requirement*—(i) *In general*. In the case of tangible property that is owned by an eligible entity, the tangible property must be acquired by the eligible entity 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) (providing that persons are related to each other if such persons are described in section 267(b) or section 707(b)(1), determined by substituting ''20 percent'' for ''50 percent'' each place it appears in such sections).

(ii) *Plan, intent, or expectation for seller to repurchase acquired property*. In the case of real property that is purchased by an eligible entity, if, at the time of the purchase, there was a plan, intent, or expectation for the acquired real property to be repurchased by the seller of the real property for an amount of consideration other than the fair market value of the real property, determined at the time of the repurchase by the seller, the purchased real property is not qualified opportunity zone business property.

(iii) *Property manufactured, constructed, or produced for use in a qualified opportunity zone*—(A) *In general*. In the case of tangible property manufactured, constructed, or produced by an eligible entity, if the property is manufactured, constructed, or produced for use by an eligible entity with the intent to use such property in a trade or business in a qualified opportunity zone, then such property satisfies the requirements of paragraph (b)(1)(i) of this section if the manufacture, construction, or production begins after December 31, 2017. The materials and supplies used to manufacture, construct, or produce qualified opportunity zone business property by the eligible entity must also be qualified opportunity zone business property.

(B) *Time when manufacture, construction or production considered to begin*. For purposes of paragraph (b)(1)(iii) of this section, the acquisition date of such property is the date on which the manufacture, construction, or production of property (as defined in paragraph (b)(1)(iii) of this section) begins. The manufacture, construction, or production of property begins when physical work of a significant nature begins. Physical work does not include

preliminary activities such as planning or designing, securing financing, exploring or researching. The determination of when physical work of a significant nature begins depends on the facts and circumstances. For example, if a factory is to be constructed on-site, construction begins when physical work of a significant nature commences at the site; this could occur, for example, when work begins on the excavation of footings, or the pourings of pads for the factory. Preliminary work, such as clearing or testing of soil condition, does not constitute the beginning of construction.

(C) *Safe harbor*. For purposes of paragraph (b)(1)(iii)(B) of this section, a taxpayer may choose to determine when physical work of a significant nature begins in accordance with this paragraph (b)(1)(iii)(C). Physical work of a significant nature will not be considered to begin before the taxpayer incurs or pays more than 10 percent of the total cost of the property (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching).

(2) *Original use or substantial improvement requirement*—(i) *In general*. In the case of tangible property owned by the eligible entity either—

(A) The original use of the owned tangible property in the qualified opportunity zone, within the meaning of paragraph (b)(3) of this section, must commence with the eligible entity; or

(B) The eligible entity must substantially improve the owned tangible property within the meaning of paragraph (b)(4) of this section (which defines substantial improvement in this context).

(ii) *Inventory*. Inventory (including raw materials) of a trade or business produced by an eligible entity after December 31, 2017, is deemed to satisfy the requirements set forth in paragraphs (b)(1) and (b)(2)(i) of this section.

(3) *Original use of tangible property acquired by purchase*—(i) *Original use*—(A) *In general*. For purposes of paragraph (b)(2) 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.

(B) *Commencement of original use of vacant property*. For purposes of this paragraph (b)(3), if real property, including land and buildings, has been vacant for an uninterrupted period of at least one calendar year beginning on a date prior to the date on which the qualified opportunity zone in which the property is located is listed as a designated qualified opportunity zone in a QOZ designation notice and the property has remained vacant through the date on which the property was purchased by the eligible entity, or if the property has been vacant for an uninterrupted three calendar year period beginning on a date after the date of publication of the QOZ designation notice that lists as designated the qualified opportunity zone in which the property is located and the property has remained vacant through the date on which the property was purchased by the eligible entity, 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. Such property must satisfy the definition of vacancy under paragraph (b)(3)(iii) of this section.

(C) *Used tangible property*. 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).

(D) *Example*. The following example illustrates the principles of paragraph (b)(3)(i)(A) of this section.

(*1*) *Facts*. On January 1, 2019, QOF A purchases from a developer a newly constructed hotel building located in a qualified opportunity zone for $10 million. The developer purchased a parcel of land in that qualified opportunity

zone, and constructed the hotel building thereon, with the intent and expectation to sell the building to a QOF. As of the time of the purchase, the developer had not placed the hotel building in service in the qualified opportunity zone for purposes of depreciation. Other than the original use requirement, assume that the hotel building satisfies all requirements under section 1400Z–2(d)(2)(D). In addition, assume that, at the time of the purchase, the developer had no plan, intent, or expectation to repurchase the hotel building.

(*2*) *Analysis*. At the time of QOF A's purchase of the hotel building, the original use of the hotel building had not commenced because the developer had not yet placed the hotel building into service for purposes of depreciation in a qualified opportunity zone. See paragraph (b)(3)(i)(A) of this section. Therefore, the original use of the hotel building in the qualified opportunity zone in which the building is located is treated as commencing with QOF A. See paragraph (b)(3)(i)(A) of this section. As a result, the hotel building purchased by QOF A is treated as satisfying the original use requirement 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.

(iii) *Vacancy*. Solely for purposes of meeting the requirements of section 1400Z–2, real property, including land and buildings, is considered to be in a state of vacancy if the property is significantly unused. A building or land will be considered significantly unused if more than 80 percent of the building or land, as measured by the square footage of useable space, is not currently being used.

(iv) *Brownfield sites*. An eligible entity that purchases a parcel of land that is a brownfield site, as defined by section 101 of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (42 U.S.C. 9601) (brownfield site), may treat all property composing the brownfield site (including the land and structures thereon) as satisfying the original use requirement of section 1400Z–2(d)(2)(D)(i)(II), if, within a reasonable period, the eligible entity makes investments in the brownfield site to ensure that all property composing the brownfield site meets basic safety standards for both human health and the environment.

(v) *Property involuntarily transferred to local government*. An eligible entity that purchases real property from a local government that the local government holds as the result of an involuntary transfer (including through abandonment, bankruptcy, foreclosure, or receivership) may treat all property composing the real property (including the land and structures thereon) as satisfying the original use requirement of section 1400Z–2(d)(2)(D)(i)(II).

(4) *Substantial improvement of tangible property acquired by purchase*—(i) *In general*. Except as provided in paragraph (b)(4)(iv) of this section, for purposes of paragraph (b)(2) of this section, tangible property is treated as substantially improved by an eligible entity only if it meets the requirements of section 1400Z–2(d)(2)(D)(ii) during the *30-month substantial improvement period*. The property has been substantially improved when the additions to basis of the property in the hands of the QOF exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the QOF (substantial improvement requirement).

(ii) *Treatment of property in the 30-month substantial improvement period*. For purposes of the *90-percent investment standard* under section 1400Z–2(d)(1), tangible property purchased, leased, or improved by a trade or business that is undergoing the substantial improvement process but has not yet been placed in service by the eligible entity or used in the eligible entity's trade or business is treated as satisfying the requirements of section 1400Z–2(d)(2)(D)(i) and paragraph (b)(2) of this section for the *30-month substantial improvement period* with respect to that property provided the eligible entity reasonably expects that the property will be substantially improved as defined in paragraph (b)(4)(i) of this section and used in the eligible entity's

trade or business in a qualified opportunity zone by the end of such 30-month period. Tangible property described in the preceding sentence is not considered qualified opportunity zone business property for purposes of the special rule in section 1400Z–2(d)(3)(B) unless the tangible property is qualified opportunity zone business property for at least two years without regard to this paragraph (b)(4)(ii).

(iii) *Aggregation of original use property that improves the functionality of non-original use property*—(A) *General rule*. The cost of purchased property that would otherwise qualify as qualified opportunity zone business property may be taken into account in determining whether additions to the basis of non-original use property acquired by purchase satisfy the substantial improvement requirement under section 1400Z–2(d)(2)(D)(ii), so long as the purchased property is located in the same qualified opportunity zone (or a contiguous qualified opportunity zone) as the non-original use property, is used in the same trade or business as the non-original use property, and improves the functionality of the non-original use property.

(B) *Improvement of non-original use real property*. If an eligible entity chooses to apply this paragraph (b)(4)(iii) to non-original use real property, the eligible entity must improve the non-original use real property by more than an insubstantial amount within the meaning of paragraph (b)(4)(iv)(C) of this section.

(C) *Effect on purchased property*. If an eligible entity chooses to apply this paragraph (b)(4)(iii), the purchased property that would otherwise qualify as qualified opportunity zone business property will not be treated as original use property, and instead the basis of that purchased property will be taken into account in determining whether additions to the basis of the non-original use property satisfy the requirements under section 1400Z–2(d)(2)(D)(i)(II) and (d)(2)(D)(ii).

(D) *Examples*. The following examples illustrate the principles of paragraph (b)(4)(iii) of this section.

(*1*) *Example 1*—(*i*) *Facts*. On January 1, 2019, QOF A purchases the assets of a hotel business located in a qualified opportunity zone for $5 million. The purchased assets include land, a building, linens, furniture and other fixtures attached to the building. $1 million of the purchase price is allocated to land and the remaining $4 million is allocated to the building, furniture and fixtures. During the course of renovations over the 30-month substantial improvement period, the QOF spent $1 million replacing linens, mattresses and furniture, $500,000 on the purchase of new exercise equipment for a gym located in the hotel building, $1 million on renovations for a restaurant (including restaurant equipment) attached to the hotel, and $1.5 million on structural renovations to the hotel. The QOF chooses to apply paragraph (b)(4)(iii) of this section to determine whether the substantial improvement requirement in section 1400Z–2(d)(2)(D)(ii) is met.

(*ii*) *Analysis*. In order for the hotel to be considered qualified opportunity zone business property, QOF A must substantially improve the hotel as the hotel had previously been placed in service in the qualified opportunity zone. (QOF A was not required to substantially improve the land on which the hotel was located pursuant to paragraph (b)(4)(iv) of this section.) Because the amount of basis allocated to the hotel was $4 million, QOF A must expend $4 million to improve the hotel within the 30-month substantial improvement period provided in section 1400Z–2(d)(2)(D)(ii). The new linens, mattresses and furniture, new exercise equipment, and new restaurant equipment all qualify as original use assets under section 1400Z–2(d)(2)(D)(i)(II). QOF A also substantially improved the hotel, which was the asset that needed to be improved under section 1400Z–2(d)(2)(D)(i)(II). QOF A chose, at the start of the 30-month period, to include the costs of the newly purchased assets that improve the functionality of the hotel to the basis of the hotel. Thus, the cost of these items is eligible to be added to the hotel's basis pursuant to paragraph (b)(4)(iii) of this section. Therefore, QOF A has met the substantial improvement requirement under section 1400Z–2(d)(2)(D)(i)(II) by doubling its basis in the hotel and its fixtures within the 30-month substantial improvement period. The amounts

spent replacing linens, mattresses, furniture, exercise equipment, and new restaurant equipment that were counted toward the substantial improvement requirement for the hotel are not considered original use assets for purposes of the *90-percent investment standard*.

(*2*) *Example 2*—(*i*) *Purchase of unrelated property*. The facts are the same as in paragraph (b)(4)(iii)(D)(*1*)(*i*) of this section, except that in addition to purchasing the hotel and the related land, QOF A also purchases an apartment building one block away from the hotel for $10 million. The apartment building is located in the same qualified opportunity zone as the hotel.

(*ii*) *Analysis*. QOF A may not include any improvements made to the apartment building, including purchased property that improves the functionality of the apartment building, to the basis of the hotel. QOF A may choose, under paragraph (b)(4)(iii) of this section, to include the purchased property that improves the functionality of the apartment building in the basis of the apartment building for purposes of the substantial improvement requirement under section 1400Z–2(d)(2)(D)(i)(II).

(iv) *Special rules for land and improvements on land*—(A) *Buildings located in a qualified opportunity zone*. In accordance with the rules set forth in this paragraph (b)(4)(iv)(A), if an eligible entity purchases a building located on a parcel of land within the geographic borders of a qualified opportunity zone, for purposes of section 1400Z–2(d)(2)(D)(ii), a substantial improvement to the building is measured by the eligible entity's additions to the basis of the building, as determined under section 1012.

(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).

(C) *Exception for insubstantially improved land*. Notwithstanding paragraph (b)(4)(iv)(B) of this section, if the land is unimproved or minimally improved and the eligible entity purchases the land with an expectation or an intention to not improve the land by more than an insubstantial amount within 30 months after the date of purchase, paragraph (b)(4)(iv)(B) of this section does not apply with respect to such land and such land is not considered qualified opportunity zone business property unless it is substantially improved within the meaning of sections 1400Z–2(d)(2)(D)(i)(II) and (d)(2)(D)(ii). In determining whether an eligible entity had an expectation or an intention to improve the land by more than an insubstantial amount, improvements to the land by the eligible entity (including grading, clearing of the land, remediation of the contaminated land, or acquisition of related qualified opportunity zone business property that facilitates the use of the land in a trade or business of the eligible entity) will be taken into account.

(D) *Remediation of contaminated land*. Betterments to land within the meaning of § 1.263(a)–3(j)(1)(i) may be added to the basis of the purchased land and included for purposes of section 1400Z–2(d)(2)(D)(ii) if the betterments are paid for by the eligible entity.

(E) *Separate improvement to underlying land not required*. In determining whether the substantial improvement test under section 1400Z–2(d)(2)(D) has been met with respect to a building, there is no requirement that the eligible entity separately substantially improve the land upon which the building is located.

(v) *Aggregation of purchased buildings*—(A) *Substantial improvement requirement for eligible building group*. For purposes of applying the substantial improvement requirement under sections 1400Z–2(d)(2)(D)(i)(II) and 1400Z–2(d)(2)(D)(ii), an eligible entity may apply paragraph (b)(4)(v)(D) of this section with respect to two or more buildings located within a qualified opportunity zone or a single series of contiguous qualified opportunity zones, as described in paragraph (b)(4)(v)(B) or (C) of this section (eligible building group), respectively.

(B) *Eligible building group located entirely within parcel of land described in single deed*. All buildings comprising an eligible building group may be treated as a single property as that term is

used in section 1400Z–2(d)(2)(D)(ii) (single property), if each building comprising the eligible building group is located entirely within the geographic borders of a parcel of land described in a single deed.

(C) *Eligible building group spanning contiguous parcels of land described in separate deeds.* An eligible entity may treat all buildings comprising an eligible building group located entirely within the geographic borders of contiguous parcels of land described in separate deeds as a single property to the extent each building is operated as part of one or more trades or businesses that—

(*1*) Are operated exclusively by the eligible entity;

(*2*) Share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; and

(*3*) Are operated in coordination with, or reliance upon, one or more of the trades or businesses (for example, supply chain interdependencies or mixed-use facilities).

(D) *Calculation of aggregate building basis and additions to basis of single property—*(*1*) *In general.* For purposes of the substantial improvement requirement under section 1400Z–2(d)(2)(D)(ii), the amount of basis required to be added to the portion of an eligible building group treated as a single property equals the total amount of basis calculated by adding the basis of each building comprising the single property at the beginning of the 30-month period and additions to the basis of each building comprising the single property are aggregated to determine satisfaction of the substantial improvement requirement.

(*2*) *Aggregation of original use property that improves the functionality of single property.* In applying paragraph (b)(4)(v)(D)(*1*) of this section, purchased property that would otherwise qualify as qualified opportunity zone business property may be taken into account in determining whether additions to the basis of a single property described in paragraph (b)(4)(v)(B) or (C) of this section satisfy the substantial improvement requirement under section 1400Z–2(d)(2)(D)(ii).

(c) *Tangible property leased by an eligible entity.* In the case of tangible property with respect to which an eligible entity is a lessee—

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

(2) *Arms-length terms*—(i) *General rule.* The terms of the lease must be market rate (that is, the terms of the lease reflect common, arms-length market pricing in the locale that includes the qualified opportunity zone as determined under section 482 and all section 482 regulations in this chapter) at the time that the lease was entered into.

(ii) *Rebuttable presumption regarding unrelated persons.* There will be a rebuttable presumption that the terms of the lease were market rate for leases between persons not related within the meaning of section 1400Z–2(e)(2) (unrelated persons), and thus, the parties to the lease are not required to perform a section 482 analysis.

(iii) *Exception for state, local, and Indian tribal governments.* For purposes of this paragraph (c)(2), tangible property acquired by lease from a state or local government, or an Indian tribal government, is not considered tangible property acquired by lease from a related person within the meaning of section 1400Z–2(e)(2) (related person).

(3) *Additional requirements for tangible property leased from a related person.* If the lessor is a related person with respect to an eligible entity that is the lessee of tangible property, the requirements of paragraphs (c)(3)(i) and (ii) of this section, as applicable, must be satisfied in order for the tangible property to be treated as qualified opportunity zone business property.

(i) *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 tangible property that exceeds 12 months.

(ii) *Purchase of other qualified opportunity zone business property.* In the case of leased tangible property that is personal property, if the original use of the leased tangible personal property in a qualified opportunity zone (within

the meaning of paragraph (c)(3)(iii) 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)(3)(iv) 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 qualified opportunity zone(s) in which the owner of the tangible property so acquired uses it and the qualified opportunity zone(s) in which that person uses the leased tangible personal property.

(iii) *Original use of leased tangible property*—(A) *In general.* For purposes of paragraph (c)(3)(ii) 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 the property in the qualified opportunity zone in a manner that would allow depreciation or amortization if that person were the property's owner).

(B) *Used leased tangible property.* Used leased tangible personal property can satisfy the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone.

(iv) *Relevant testing period.* For purposes of paragraph (c)(3)(ii) 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—

(A) The date 30-months after the date the lessee receives possession of the leased tangible personal property under the lease; or

(B) The last day of the term of the lease (within the meaning of § 1.1400Z2(d)–1(b)(4)(iii)(D)).

(4) *Plan, intent, or expectation for purchases not for fair market value.* In the case of real property that is leased by an eligible 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 eligible 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.

(d) *Holding period and use within a qualified opportunity zone of owned or leased tangible property*—(1) *In general.* In the case of tangible property that is owned or leased by an eligible entity, during substantially all of the eligible entity's holding period for the tangible property, substantially all of the use of the tangible property must be in a qualified opportunity zone.

(2) *Valuation of owned and leased property.* For purposes of the 70-percent use test in paragraph (d)(4) of this section, the value of owned and leased property is required to be determined in accordance with the valuation methodologies provided in § 1.1400Z2(d)–1(b), and such value in the case of leased tangible personal property is to be determined on the date the lessee receives possession of the tangible personal property under the lease.

(3) *Substantially all of an eligible entity's holding period for owned or leased tangible property*—(i) *In general.* For purposes of determining whether the holding period requirement in paragraph (d)(1) of this section is satisfied, the term *substantially all* means at least 90 percent. The holding period requirement is applied on a semiannual basis, based on the entire amount of time the eligible entity has owned or leased such property. Thus, on each semiannual testing date of the eligible entity, the tangible property satisfies the 90-percent qualified opportunity zone business property holding period requirement of section 1400Z–2(d)(2)(D)(i)(III) only if, during at least 90 percent of the period during which the QOF has owned or leased the property, the property has satisfied the 70-percent use test in paragraph (d)(4) of this section.

(ii) *Semiannual qualified opportunity zone business test.* For purposes of determining satisfaction of the 90-percent qualified opportunity zone business property holding period test described in paragraph (d)(3)(i) of this section in the case of a QOF, the determination of

whether property satisfies the 70-percent use test is made on a semiannual basis pursuant to section 1400Z–2(d)(1) and paragraph (d)(4) of this section.

(4) *Substantially all of the use of owned or leased tangible property in a qualified opportunity zone*—(i) *Qualified tangible property*. Tangible property used in a trade or business of an eligible entity satisfies the *substantially all* requirement of paragraph (d)(1) of this section if and only if the tangible property is qualified tangible property. Qualified tangible property is tangible property that satisfies the requirements of paragraph (d)(4)(ii), (iii) (subject to the limitation in paragraph (d)(4)(iv) of this section), or (v) of this section.

(ii) *70-percent use test*. Tangible property held by a trade or business is qualified tangible property to the extent, based on the number of days between two consecutive semiannual testing dates, not less than 70 percent of the total utilization of the tangible property by the trade or business occurs at a location within the geographic borders of a qualified opportunity zone (that is, the 70-percent use test).

(iii) *Safe harbor for tangible property utilized in rendering services inside and outside of a qualified opportunity zone*. Subject to the limitation described in paragraph (d)(4)(iv) of this section, tangible property utilized by a trade or business in rendering services both inside and outside of the geographic borders of a qualified opportunity zone may be treated as qualified tangible property if—

(A) The tangible property utilized in rendering the service directly generates gross income for the trade or business both inside and outside of the geographic borders of a qualified opportunity zone;

(B) The trade or business has an office or other facility located within the geographic borders of a qualified opportunity zone (QOZ office);

(C) The tangible property is operated by employees of the trade or business who—

(*1*) Regularly use a QOZ office of the trade or business in the course of carrying out their duties; and

(*2*) Are managed directly, actively, and substantially on a day-to-day basis by one or more employees of the trade or business who carry out their duties at a QOZ office; and

(D) The tangible property is not operated exclusively outside of the geographic borders of a qualified opportunity zone for a period longer than 14 consecutive days for the generation of gross income for the trade or business.

(iv) *Limitation*. For purposes of the *70-percent tangible property standard*, the safe harbor provided in paragraph (d)(4)(iii) of this section may not be used to treat more than 20 percent of the tangible property of the trade or business as qualified tangible property.

(v) *Safe harbor for tangible property owned by leasing businesses with QOZ offices*. Tangible property of a trade or business, the employees of which use a QOZ office of the trade or business to regularly lease such tangible property to customers of the trade or business, may be treated as qualified tangible property if—

(A) Consistent with the normal, usual, or customary conduct of the trade or business, when not subject to a lease to a customer of the trade or business, the tangible property is parked or otherwise stored at a QOZ office; and

(B) No lease under which a customer of the trade or business acquires possession of the tangible property is for a duration (including extensions) longer than 30 consecutive days.

(vi) *Use of tangible property in one or more qualified opportunity zones*. In accordance with paragraphs (d)(4)(ii) through (v) of this section, if qualified tangible property is utilized by the trade or business in one or more qualified opportunity zones, satisfaction of the 70-percent use test is determined by aggregating the number of days the tangible property is utilized by the trade or business in each qualified opportunity zone.

(vii) *Real property straddling a qualified opportunity zone*. For purposes of satisfying the requirements in this paragraph (d), the rules of § 1.1400Z2(d)–1(d)(3)(ix) apply to a QOF or qualified opportunity zone business for determining whether real property is situated in a qualified opportunity zone.

(viii) *Safe harbor for inventory in transit*—(A) *In general*. In determining

whether tangible property is used in a qualified opportunity zone for purposes of applying the 70-percent use test under paragraph (d)(4) 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—

(*1*) From a vendor to a facility of the trade or business that is in a qualified opportunity zone; or

(*2*) 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.

(B) *No effect from certain events in transit*. The distance traveled by the inventory while it is in transit, or the fact that the inventory is briefly warehoused while in transit, does not affect the application of the safe harbor described in paragraph (d)(4)(viii) of this section.

(e) *Applicability dates*—(1) *In general*. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) *Prior periods*. With respect to the portion of a taxpayer's first taxable year ending after December 21, 2017, and for taxable years beginning after December 21, 2017, and on or before March 13, 2020, a taxpayer may choose either—

(i) To apply the section 1400Z–2 regulations, if applied in a consistent manner for all such taxable years (reliance by a taxpayer on paragraph (e)(2)(ii) of this section, §1.1400Z2(a)–1(g)(2)(ii), §1.1400Z2(b)–1(j)(2)(ii), §1.1400Z2(d)–1(e)(2)(ii), or §1.1400Z2(f)–1(d)(2)(ii), is disregarded solely for purposes of the consistency requirement under this paragraph (e)(2)(i)); or

(ii) To rely on the rules in proposed §1.1400Z2(d)–1 contained in the notice of proposed rulemaking (REG–115420–18) published on October 29, 2018, as amplified by the notice of proposed rulemaking (REG–120186–18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

[T.D. 9889, 85 FR 1986, Jan. 13, 2020, 85 FR 19085, Apr. 6, 2020]

§ 1.1400Z2(e)–1 [Reserved]

§ 1.1400Z2(f)–1 Administrative rules-penalties, anti-abuse, etc.

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

(b) *Time period for a QOF to reinvest certain proceeds*—(1) *In general*. 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 investment standard 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).

(2) *Federally declared disasters*. If the QOF's plan to reinvest some or all of the proceeds described in paragraph (b)(1) of this section in qualified opportunity zone property is delayed due to a federally declared disaster (as defined in section 165(i)(5)(A)), the QOF may receive not more than an additional 12 months to reinvest such proceeds, provided that the QOF invests such proceeds in the manner originally intended before the disaster.

(c) *Anti-abuse rules*—(1) *General anti-abuse rule*. Pursuant to section 1400Z–2(e)(4)(C), the rules of section 1400Z–2 and §§1.1400Z2(a)–1 through 1.1400Z2(d)–(2), 1.1400Z2(f)–1, 1.1502–14Z, and 1.1504–3

must be applied in a manner consistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations (as defined in §1.1400Z2(a)–1(b)(41)). The purposes of section 1400Z–2 and the section 1400Z–2 regulations are to provide specified Federal income tax benefits to owners of QOFs to encourage the making of longer-term investments, through QOFs and qualified opportunity zone businesses, of new capital in one or more qualified opportunity zones and to increase the economic growth of such qualified opportunity zones. Accordingly, if a significant purpose of a transaction is to achieve a Federal income tax result that is inconsistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations, a transaction (or series of transactions) will be recast or recharacterized for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations. This recasting and recharacterization may include, as appropriate, treating an investment as other than a qualifying investment. A determination of whether a Federal income tax result is inconsistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations must be based on all facts and circumstances.

(2) *Special anti-abuse rule for partnerships*—(i) *In general*. In addition to being subject to the general anti-abuse rule of paragraph (c)(1) of this section, the application of the rules of section 1400Z–2 and §§1.1400Z2(a)–1 through 1.1400Z2(d)–2, 1.1400Z2(f)–1, 1.1502–14Z, and 1.1504–3 to partnerships is also subject to the special anti-abuse rule set forth in paragraph (c)(2)(ii) of this section.

(ii) *Special partnership anti-abuse rule*. If a partnership is formed or availed of with a significant purpose of avoiding the requirements of §1.1400Z2(a)–1(b)(11)(i)(B) that a gain be subject to Federal income tax in order to be an eligible gain, the partnership will be disregarded in whole or in part for purposes of §1.1400Z2(a)–1(b)(11)(i)(B) and (b)(11)(ix)(B) to prevent the creation of a qualifying investment by the partnership with respect to any partner or partners that would not otherwise satisfy such requirements.

(3) *Examples*. The following examples illustrate the anti-abuse rule of paragraph (c) of this section.

(i) *Example 1*—(A) *Facts*. Two nonresident alien individuals (collectively, the individuals) plan to sell stock at a gain of $50, to invest the amount of the resulting capital gain in a QOF, and to make a deferral election under section 1400Z–2(a). They make this election with the intent of holding the QOF investment for 10 years and then making an election to increase the qualifying basis to fair market value under section 1400Z–2(c). A gain on a sale of the stock by the individuals, however, would not be subject to Federal income tax, and so the gain would not support their making a deferral election as a result of the requirement in §1.1400Z2(a)–1(b)(11)(i)(B). Instead of selling the stock themselves, the individuals form a domestic partnership with a significant purpose of using that partnership to make a deferral election with respect to the stock under the exception in §1.1400Z2(a)–1(b)(11)(ix)(B). The individuals contribute their stock to the partnership in exchange for partnership interests, after which the partnership sells the stock and invests the $50 gain in a QOF. Had the partnership not made a deferral election, the individuals would not be subject to tax on their allocated portion of the partnership's recognized gain on the sale of the stock.

(B) *Analysis*. Based on these facts, the partnership is formed and availed of with a significant purpose to avoid the requirements of §1.1400Z2(a)–1(b)(11)(i)(B). Thus, under paragraph (c)(2) of this section, the partnership is disregarded for purposes of applying §1.1400Z2(a)–1(b)(11)(ix)(B) to the $50 gain, and therefore the partnership's investment in the QOF is not a qualifying investment.

(ii) *Example 2*—(A) *Facts*. The facts are the same as in paragraph (c)(3)(i)(A) of this section (*Example 1*), except the individuals contribute their stock to an existing partnership, the sole partners of which are U.S. citizens, with a significant purpose of the individuals' use of the partnership being to make an investment in a QOF and a deferral election under the §1.1400Z2(a)–

1(b)(11)(ix)(B) exception for partnerships. During the year, the partnership sells property it owned before the individuals' contribution, resulting in capital gain of $100, all of which is eligible to be invested in a QOF. It also sells the stock contributed by the individuals, resulting in $50 of capital gain. The partnership invests $150 in a QOF and makes the requisite gain deferral election.

(B) *Analysis*. Based on these facts, the partnership is availed of by the individuals with a significant purpose to avoid the requirements of §1.1400Z2(a)–1(b)(11)(i)(B). Thus, under paragraph (c)(2) of this section, the partnership is disregarded for purposes of applying §1.1400Z2(a)–1(b)(11)(i)(B) and (b)(11)(ix)(B) with respect to the $50 capital gain from the sale of the individuals' contributed stock and that gain fails to be eligible gain. Under §1.1400Z2(a)–1(b), no section 1400Z–2(a) election is available for that gain and the partnership will have a mixed-funds investment, $100 of which is a qualifying investment and $50 of which is a non-qualifying investment.

(iii) *Example 3*—(A) *Facts*. Entity C is a QOF that meets the requirements of section 1400Z–2(d)(1). Entity C owns qualified opportunity zone stock in a domestic corporation described in section 1400Z–2(d)(2)(B) (Corporation C), which operates a qualified opportunity zone business. Entity C also owns Corporation D stock, which is not qualified opportunity zone stock, which stock is less than 10% of the assets of Entity C. Under section 1400Z–2(e)(2), these stock holdings cause Entity C to be related to both Corporation C and Corporation D. On date 1, under section 1400Z–2(e)(2), Individual S is not a related person with respect to Entity C, Corporation C, or Corporation D. On that date, Individual S sells tangible property to Corporation C (Asset 1) for use in Corporation C's qualified opportunity zone business and sells a second asset to Corporation D (Asset 2). Both items sold were capital assets (as defined in section 1221), and had an adjusted basis of $0. As a result, Individual S realizes gain of $100 from the sale to Corporation C and $75 from the sale to Corporation D. At the time of the sale Individual S has a plan or intent to invest $175 in Entity C and to make deferral elections under section 1400Z–2(a)(1) with respect to the gain from the two sales. On date 2, for $175 Individual S acquired an eligible interest in Entity C, an acquisition that causes Individual S to become a related person with respect to Entity C within the meaning of section 1400Z–2(e)(2). *Analysis*. Under paragraph (c)(1) of this section, Individual S's $175 gain is not an eligible gain and cannot be the subject a deferral election under section 1400Z–2(a)(1). The gain fails to satisfy §1.1400Z2a–1(b)(11)(i)(C) because of Individual S's plan to acquire sufficient equity in Entity C to become related to Corporations C and D. Moreover, for the same reason, the tangible property that Corporation C purchased from Individual S fails to satisfy the requirement that a purchase of qualified opportunity zone business property must be from an unrelated person. *See* sections 1400Z–2(d)(2)(D)(i)(I) and 179(d)(2)(A).

(B) *Circular movement of consideration*. The facts are the same as in paragraph (c)(3)(iii)(A) of this section (this Example 3), except that Entity C contributes the $100 and $75 (received from Individual S) to Corporations C and D, respectively, as part of a plan that includes each transaction described in paragraph (c)(3)(iii)(A) (collectively, the transaction series). Under the step transaction doctrine and circular cash flow principles, this circular movement of consideration is disregarded for Federal income tax purposes, including for purposes of section 1400Z–2 and the section 1400Z–2 regulations. Therefore, the transaction series is treated for Federal income tax purposes as a contribution by Individual S of Assets 1 and 2 to Entity C in exchange for an eligible interest in Entity C, followed by a contribution by Entity C of Assets 1 and 2 to Corporations C and D, respectively. This result also would obtain if Individual S were not related to Entity C immediately following Individual S's acquisition of its eligible interest from Entity C. *See* Rev. Rul. 83–142, 1983–2 C.B. 68; Rev. Rul. 78–397, 1978–2 C.B. 150.

(iv) *Example 4*—(A) *Facts*. Entity D is a QOF that meets the requirements of section 1400Z–2(d)(1). Entity D owns a majority qualified opportunity zone

partnership interest in a domestic partnership, Partnership D described in section 1400Z–2(d)(2)(C). Entity D organized Partnership D for the purpose of being a qualified opportunity zone business. Partnership D acquires a tract of land located in a qualified opportunity zone. At the time of the acquisition of that land, there was no plan or intent to develop or otherwise utilize the land in a trade or business that would increase substantially the economic productivity of the land. Instead, there was a plan to pave the land for use as a parking lot. Partnership D planned to install a gate to the paved parking area, a small structure that would serve as an office for a parking attendant, and two self-pay stations for use by customers. The parking lot was not reasonably expected to expand significantly, and the initial small number of employees was not reasonably expected significantly to increase. A significant purpose for the acquisition of the land was to sell the land at a profit and to exclude any gain from appreciation by making an election under section 1400Z–2(c).

(B) *Analysis*. Under paragraph (c)(1) of this section, the acquisition of the land is a transaction carried out to achieve a tax result that is inconsistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations. Consequently, the land is not qualified opportunity zone business property and gain from the sale of the land will not be eligible to be excluded from gross income under section 1400Z–2(c). This recharacterization of the qualification of the land for Federal tax purposes is appropriate to ensure that the tax results of the transaction, including the status of Partnership D as a qualified opportunity zone business, are consistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations. Partnership D fails to be a qualified opportunity zone business unless other assets that it owns or leases are qualified opportunity zone business property that satisfy section 1400Z–2(d)(3)(A)(i), and the other requirements of section 1400Z–2 and the section 1400Z–2 regulations.

(v) *Example 5*—(A) *Facts*. The facts are the same as in paragraph (c)(3)(iv) of this section, except that Partnership D, in year 1, acquired a tract of land located in a qualified opportunity zone that was previously used for hog and pig farming. On its Form 1065T the previous owner, also a partnership, properly described those activities with the principal business activity code 112210. During the several-year period ending on the date of the acquisition of the land, the value of the land had significantly increased and D projected the land to continue to increase in value by ten-fold during the following 10-year period. At the time of the acquisition, Partnership D intended to conduct sheep and goat farming activities on the land and, accordingly, planned to use principal business activity code 112400 on its Form 1065. According to its plan, Partnership D conducted sheep and goat farming activities on the land during the 10-year period beginning on the date of acquisition of the land. During the 10-year period, Partnership D made significant capital improvements to the land, including improvements to existing farm structures, construction of new farm structures, and installation of a new irrigation system. As expected, the value of the land substantially increased during the following decade. The owners' entire interest in Partnership D was a qualifying investment, and, after having held it for at least 10 years the owners sold the entire interest at a large gain. As planned the owners made an election under section 1400Z–2(c) in order to avoid tax on the gain from the sale.

(B) *Analysis*. The modification of the land to suit sheep and goat farming activity from its previous use of hog and pig farming, and the significant capital improvements made to land, comprise a significant investment in the business activities on the land. Thus, Partnership D did not hold the land solely for speculative investment. As a result, under paragraph (c)(1) of this section, the acquisition of the land, the activities conducted on the land, the capital improvements made to the land, and the later disposition of the land for a significant profit are not inconsistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations.

(vi) *Example 6*—(A) *Facts*. Individuals intend to sell stock at a capital gain

and invest the resulting gain in a QOF pursuant to a deferral election under section 1400Z–2(a). The individuals form Entity F and file Form 8996 certifying that Entity F is a QOF organized for the purpose of investing in qualified opportunity zone property. Individuals have no intention of investing in qualified opportunity zone property. Instead individuals intend to invest in property other than qualified opportunity zone property hoping that the property will appreciate substantially in value and the individuals will be able to exclude any appreciation on their investment from gross income by making an election under section 1400Z–2(c). Each year Entity F files Form 8996 and pays the applicable penalty under section 1400Z–2(f). After holding their interests in Entity F for 10 years, individuals sell their interest in Entity F to an unrelated third party for a substantial gain and make an election to exclude the appreciation on their investment under section 1400Z–2(c).

(B) *Analysis*. A significant purpose of the transaction is to achieve a tax result that is inconsistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations, and the transaction will be recast and recharacterized for Federal tax purposes so that Entity F is not a QOF and the individuals are not eligible for the elections under sections 1400Z–2(a) and (c).

(vii) *Example 7*—(A) *Facts*. Entity E treats itself as a QOF that meets the requirements of section 1400Z–2(d)(1). Entity E owns all of the stock in a domestic corporation, Corporation E, and Entity E treats this stock as qualified opportunity zone stock. Corporation E uses the majority of the cash invested by Entity E to purchase gold bars from unrelated parties within the meaning of section 1400Z–2(e)(2). The aggregate value of the gold bars is $1000. Corporation E rents a safe deposit box in a qualified opportunity zone and hires one employee to manage the purchase and sale of the gold bars. Each year Corporation E purchases a small number of additional gold bars and sells to customers a portion of the gold bars on hand. The aggregate value of both the purchases and sales approximates half the value of the bars held at the beginning of the year. Corporation E seeks to treat the gold bars as qualified opportunity zone business property within the meaning of section 1400Z–2(d)(3). At the time that Corporation E began the gold bar business, it did not reasonably expect the business to expand significantly, nor was the number of employees reasonably expected to increase. Gold, however, was reasonably expected to appreciate. Ten years after the formation of Entity E, the investors in Entity E sell all of their interests in the entity and seek to make an election under section 1400Z–2(c) to exclude any gain from appreciation.

(B) *Analysis*. Under paragraph (c)(1) of this section, a significant purpose of Corporation E's activities is to achieve a tax result that is inconsistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations. The gold bar business carried out by Corporation E was merely speculative in nature and was not expected to increase economic activity in the subject qualified opportunity zone in a manner consistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations. As a result, Corporation E's activities are carried on to achieve tax results that are inconsistent with the purposes of section 1400Z–2 and the section 1400Z–2 regulations. Consequently, the gold bars are not qualified opportunity zone property. Corporation E fails to be a qualified opportunity zone business unless other assets that it owns or leases are qualified opportunity zone business property that satisfy section 1400Z–2(d)(3)(A)(i) (along with other requirements). If Corporation E fails to be a qualified opportunity zone business, Corporation E's stock fails to be qualified opportunity zone property in the hands of Entity E.

(d) *Applicability date*—(1) *In general*. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2) *Prior periods*. With respect to the portion of a taxpayer's first taxable year ending after December 21, 2017, that began on March 13, 2020, a taxpayer may choose either—

(i) To apply the section 1400Z–2 regulations, if applied in a consistent manner for all such taxable years (reliance by a taxpayer on paragraph (d)(2)(ii) of this section, §1.1400Z2(a)–1(g)(2)(ii),

§ 1.1400Z2(b)–1(j)(2)(ii), § 1.1400Z2(d)–1(e)(2)(ii), or § 1.1400Z2(d)–2(e)(2)(ii), is disregarded for purposes of the consistency requirement under this paragraph (d)(2)(i)); or

(ii) To rely on the rules in proposed § 1.1400Z2(f)–1 contained in the notice of proposed rulemaking (REG–115420–18) published on October 29, 2018, as amplified by the notice of proposed rulemaking (REG–120186–18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.

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