MCLE Self-Study Article: Qualified Opportunity Zones: An Uneasy Path to Significant Tax Benefits

Check the end of this article for information on how to access one MCLE self-study credit.

Alexander Y. Loshiloff and Kyle J. Recker

Alexander Loshiloff is special counsel at Coblentz Patch Duffy & Bass LLP in San Francisco, with over 20 years of general, transactional, and international tax experience. He was previously Senior Director for Tax Planning at one of the largest computer technology companies in the world and a tax partner at a large international law firm. Alex received his J.D. from the University of South Carolina School of Law.

Kyle Recker is a partner at Coblentz Patch Duffy & Bass LLP in San Francisco, where he advises institutional lenders, owners, developers, and investors in finance and real estate transactions. Kyle received his J.D., magna cum laude, from the University of Michigan Law School.

I. INTRODUCTION

Effective on December 22, 2017, as part of the Tax Cuts and Jobs Act, Congress enacted Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code.[1] Section 1400Z-1 allows the chief executive officer of each state and United States possession to nominate a limited number of primarily low-income population census tracts for designation as "qualified opportunity zones" ("QOZ"), and it authorizes the Secretary of the Treasury to certify such nominations and officially designate QOZs across the United States and its possessions. Section 1400Z-2 offers, under certain conditions, significant tax benefits to taxpayers who invest in QOZs.

According to the Internal Revenue Service (the "IRS"), QOZs "are an economic development tool—that is, they are designed to spur economic development and job creation in distressed communities."[2] On July 9, 2018, the IRS published an official list of over 8,700 QOZs in all 50 states, the District of Columbia, and five U.S. territories (879 of such QOZs are in California).[3] A map of all designated QOZs, along with the instructions on how to find a QOZ by address and census tract number, can be found on the website of the Community Development Financial Institutions Fund of the U.S. Treasury Department.[4] That fund, however, will not be able to provide confirmation that a specific property is in a QOZ, so an interested party will need to consult the official list.

The primary tax benefit of Section 1400Z-2 is the manner in which it affects the taxation of capital gains. In general, for U.S. individual taxpayers, long-term capital gains from the disposition of capital assets held for more than one year are currently taxed at preferential rates of 0%, 15%, or 20%, depending on a taxpayer's income tax bracket; short-term capital gains from the disposition of investments held for one year or less are taxed as ordinary income (there are presently seven marginal income tax brackets, with the highest rate at 37%).[5] Capital gains may also be taxed by the state where the taxpayer lives. For corporations, under Code Section 11(b), the federal income tax rate currently is a flat 21% on both capital gains and ordinary income. Section 1400Z-2 modifies the above regime in three important ways.

First, a taxpayer can elect to defer tax on capital gain by investing the gain in a "qualified opportunity fund" ("QOF")[6] within 180 days of the sale or exchange. The deferred gain will become subject to taxation on the earlier of (i) the date on which the investment in a QOF is sold or exchanged in a taxable transaction, and (ii) December 31, 2026.

Second, if, prior to December 31, 2026, the QOF investment has been held for at least five years, there is a 10% exclusion of the deferred gain (in the form of a step-up in tax basis), and if held for at least seven years, there is an additional 5% exclusion (also in the form of a step-up in tax basis) for a maximum of 15% permanent tax exclusion of the initially deferred gain.

Third, if a taxpayer holds its appreciated investment in the QOF for at least 10 years (and makes an election at the time of sale to increase the tax basis in the investment to its fair market value), any gain on any post-acquisition appreciation in the value of the QOF investment is permanently excluded from tax.[7]

Example: On February 26, 2019, an individual U.S. taxpayer sells shares of stock to an unrelated party, giving rise to a capital gain of $10 million. The taxpayer elects to defer that gain and within the required 180-day period invests $10 million in a QOF. The taxpayer's initial tax basis in the QOF investment is zero. After five years, the basis is increased to $1 million, or 10% of the initially deferred gain of $10 million. After seven years, the basis is increased to $1.5 million, or 15% of the initially deferred gain of $10 million. On December 31, 2026 (assuming that the fair market value of the QOF investment is then at least $10 million), the Section 1400Z-2 deferral period will end, and the taxpayer will be required to recognize $8.5 million of capital gain at that time ($10 million of the initially deferred gain minus $1.5 million of the tax basis) (*and at that time, the taxpayer will need to come up with cash to pay the tax on that gain*). At that point, the tax basis in the QOF investment becomes $10 million ($1.5 million of the tax basis as increased at seven years, plus $8.5 million of the gain triggered at December 31, 2026). The taxpayer sells the QOF investment for $19 million on January 1, 2030. Because the taxpayer held the QOF investment for at least 10 years prior to the 2030 sale, the taxpayer can make the election to increase the tax basis in the QOF investment to its fair market value at the time of the sale. Provided that this election is made, the $9 million post-acquisition gain is permanently excluded from tax ($19 million sale price - $19 million tax basis = $0 taxable gain). There is no dollar limit on how much post-acquisition gain can be excluded.

Note that some states that impose personal and corporate income tax have not implemented rules similar to the federal QOZ/OQF tax regime (including, as of August 26, 2019, California), and in those states, a taxpayer would not be entitled to defer taxation of capital gains at the state level. The state income tax implications should be carefully considered before making the decision to invest in a QOF.

Although Section 1400Z-2 seems to be fairly simple on the surface, its provisions are far from clear in terms of how they should be read in relation to one another and how they fit into the overall context of federal income tax rules. Fortunately, the IRS has issued two sets of helpful proposed regulations on which taxpayers, with a limited exception noted below, are permitted to rely (hereinafter, the "Proposed Regulations," or "Prop. Treas. Reg. §").[8] This article is not an exhaustive technical analysis of the applicable rules; rather, its main purpose is to serve as a general guide to assist investors and their lawyers in navigating the statute and the Proposed Regulations in a comprehensible and systematic manner. Section II of this article describes certain important rules applicable to investors and their investments in QOFs, and Section III of this article describes the requirements applicable to QOFs.

II. INVESTORS AND THEIR INVESTMENTS IN QOFS

A. Initial Investments

The types of taxpayers that are eligible for the tax benefits of Section 1400Z-2 include individuals, C corporations (including real estate investment trusts ("REITs")), partnerships, S corporations, trusts, estates, certain other pass-through entities, and limited liability companies taxed as corporations or partnerships.[9]

1. Qualifying Gains

For Section 1400Z-2 to apply, a taxpayer must have a capital gain from the sale to, or exchange with, an "unrelated person" no later than December 31, 2026.[10] A taxpayer is allowed to invest less than all of the prior capital gain in a QOF and, in that case, only the part of the gain which was invested in the QOF would qualify for the tax benefits. Although a taxpayer is able to invest more than the prior capital gain, those additional funds will not qualify for the QOF tax benefits.[11] A taxpayer can invest its eligible gain in several QOFs.[12]

Under Section 1400Z-2, virtually any capital gain (long-term, short-term, collectibles, etc.) could qualify for QOF tax benefits as long as it is treated as capital gain for federal income tax purposes and would be recognized but for the deferral provisions.[13] However, if a capital gain is derived from a transaction that is or has been part of an "offsetting-position transaction," a situation where the risk of loss from holding one position with respect to personal property is substantially diminished by holding one or more other positions with respect to personal property, such as a straddle, the capital gain will not be eligible for the QOF tax benefits.[14] In addition, Section 1231 gains (gains on the disposition of certain business-use property) are eligible only to the extent of capital gain net income, which is defined as the excess of capital gains over capital losses with respect to all of the taxpayer's Section 1231 property, as calculated at the end of a taxable year.

2. *Eligible Interests*

An eligible interest in a QOF is an equity interest issued by the QOF and may include preferred stock or partnership interests with special allocations. Debt instruments issued by a QOF to a taxpayer will not qualify; however, a taxpayer may use its QOF investment as collateral for a loan as part of a purchase-money borrowing or otherwise.[15] The ability to borrow by using a QOF investment as collateral may be useful as it might allow taxpayers to obtain the cash needed to pay the tax on any gain that, as described above, will be automatically triggered on December 31, 2026.

An interest in a QOF that is taxed as a partnership (a "QOF partnership") which is received in exchange for services will not be eligible for the QOF tax benefits. If the investment in a QOF partnership consists of both cash and an interest received for services, only that portion of the QOF investment received for cash could qualify for the QOF tax benefits.[16] A taxpayer may also defer capital gains by acquiring an eligible interest in a QOF from a person other than the QOF.[17] This arrangement may facilitate greater liquidity and marketability of QOF interests and even develop, over the next seven years or so, a secondary trading market for such interests. Also, note that one member of a consolidated group cannot use another's member capital gain for deferral purposes.[18]

3. *Cash and Non-Cash Contributions*

When a taxpayer acquires an eligible QOF interest by transferring cash to the QOF (or by buying such interest for cash from a person other than a QOF), the amount eligible for the QOF tax benefits is the amount of the cash, but only to the extent of the prior capital gain desired to be deferred.[19] In addition, a taxpayer may defer prior capital gains by contributing non-cash property to a QOF, or exchanging such non-cash property for an eligible QOF interest from a person or entity other than a QOF.

Under general tax rules, depending upon circumstances, contributions of appreciated property (non-cash contributions) to a QOF may or may not be taxable to the contributing taxpayer. If such non-cash contribution is taxable, any capital gain triggered by the contribution itself is not eligible for the QOF tax benefits; however, the amount treated as invested in the QOF, and, therefore, potentially eligible for the QOF tax benefits (to the extent of any prior eligible capital gains), is the fair market value of the contributed property determined immediately prior to the contribution.[20]

When a taxpayer transfers non-cash property in a tax-free transaction, the amount eligible for the QOF tax benefits (to the extent of any prior eligible capital gains) is generally the lesser of the taxpayer's adjusted tax basis in the QOF interest received (disregarding, for these purposes, the special QOF rule initially setting that basis to zero), and the fair market value of such interest determined immediately after the contribution.[21] A special rule applicable to tax-free contributions to QOF partnerships provides that the amount eligible for the QOF tax benefits (to the extent of any prior eligible capital gains) is the lesser of the taxpayer's net basis in the property contributed, or the net value of such property.[22]

4. *Holding Periods*

The holding period for a QOF investment is an important concept because the QOF tax benefits—including the 10% and 15% permanent tax exclusions and the 100% permanent tax exclusion for the post-acquisition gain—all require that a taxpayer has held its QOF investment for a certain period of time. The general rule in the Proposed Regulations is that, solely for the purposes of the QOF rules, the holding period of a QOF investment is determined without regard to the period for which a taxpayer has held the property exchanged for the QOF investment. Instead, the holding period begins on the day a taxpayer contributes property (cash or non-cash) to a QOF and receives a QOF interest in exchange.[23] Tacking-on of holding periods is only permitted for certain limited transactions, such as transfers as a result of death, a qualifying Section 381 transaction in which the acquiring corporation is a QOF immediately thereafter, a qualifying recapitalization of a QOF, a qualifying receipt of a QOF's shares in a Section 355 spin-off, and a qualifying receipt of an interest in a QOF partnership as a result of certain partnership mergers.[24]

Therefore, care should be exercised by the holder of a QOF investment prior to any transfer of that interest because, while it may be a tax-free transfer under general federal income tax rules, it could nonetheless reset the holding period for the QOF investment. A taxpayer who sells or otherwise disposes in a taxable transaction with an unrelated party all of its investment in a particular QOF prior to December 31, 2026 can elect to defer the resulting gain by timely investing the proceeds in that or another QOF, but that later investment will have its own holding period.[25]

B. The 180-Day Rule

To obtain the tax benefits of Section 1400Z-2, a taxpayer must make an investment in a QOF during the 180-day period beginning on the date of the sale or exchange that gave rise to the capital gain desired to be deferred.[26] Generally, that 180-day period begins on the date on which the gain would be recognized for federal income tax purposes but for the deferral election. Recognition usually occurs on the date of the sale or exchange, but a taxpayer should consult other sections of the Code to determine whether particular circumstances affect the timing of recognition. For example, if a taxpayer sells shares in a regular trade on an exchange, the 180-day period begins on the trade date. But if an individual REIT shareholder receives capital gain dividends from a REIT, that period would begin on the date the dividend is paid. In the case of undistributed capital gains of a REIT, however, that period would begin on the last day of the REIT's taxable year.[27] In addition, Section 1231 net capital gains can only be calculated at the end of a taxable year. Thus, for these gains, the 180-day period begins on the last day of the taxpayer's taxable year.[28]

There is a special rule for capital gains from a sale or exchange by entities taxed as partnerships and other pass-through entities (such as S corporations, trusts, and estates). Either a partnership itself may elect to defer the gain or, if it does not, the partners to whom the gain is allocated may defer the gain. If a partnership elects to defer, the 180-day period begins on the date the gain would be recognized for federal income tax purposes but for the deferral (usually, the date of the sale or exchange). If a partnership does not defer all or some of the eligible gains, the 180-day period for a partner generally begins on the last day of the partnership's tax year. However, if a partnership does not elect to defer all of its eligible gain, a partner may elect to treat the partner's 180-day period as being identical to the partnership's period (i.e., the date of the gain recognition but for the deferral).[29] For example, if a partnership's tax year ends on December 31, 2019, and the eligible gain was realized by the partnership on May 31, 2019, the partnership may elect to defer the gain, and the 180-day period will begin on May 31, 2019. If the partnership does not defer, the default rule is that a partner's 180-day period will begin on December 31, 2019; but the partner may elect to have that period begin on May 31, 2019 instead.[30]

A partnership that makes a deferral election must notify all of its partners of that election and state each partner's distributive share of the deferred gain in accordance with applicable forms and instructions (not yet issued), and a partner who makes a deferral election must also notify the partnership in writing, including providing information about the amount of the deferred gain.[31]

C. Debt-Financed Distributions by QOF Partnerships

Under partnership tax rules, generally, when a partnership borrows money, the tax basis of the partnership interest held by each partner will increase by the partner's share of that debt.[32] In addition, a cash distribution by a partnership to its partners generally is taxable only to the extent that the cash exceeds a partner's tax basis in its partnership interests.[33] Thus, if a partnership borrows money and distributes the proceeds to its partners, that debt-financed distribution would not usually be taxable immediately if it does not exceed a partner's tax basis in its partnership interest. Since the enactment of Section 1400Z-2, there has been some uncertainty regarding a QOF partnership's ability to make debt-financed distributions without jeopardizing its investors' eligibility to defer gain under Section 1400Z-2.

The Proposed Regulations clarify this issue in two significant respects. First, a QOF investor's initial tax basis in its interest in a QOF partnership is initially zero but, consistent with the usual partnership tax rules, it will be increased by the investor's allocable share of the QOF partnership's debt.[34] Second, as described below, a distribution by a QOF partnership will not typically trigger recognition of a partner's deferred gain unless the distribution exceeds the partner's tax basis in its QOF interest.[35] In principle, a QOF partnership can therefore make debt-financed distributions that could be non-taxable to the investors. However, under a special rule, cash and non-cash contributions by investors to a QOF partnership and subsequent distributions from the QOF partnership to the investors are subject to certain modified "disguised sale" rules.[36] Under these modified "disguised sale" rules, a distribution by a QOF partnership to an investor that is made within two years of such investor's contribution to the QOF partnership would generally be treated as a sale of such investor's QOF interest that triggers recognition of the deferred gain.[37] As a consequence, advance tax planning will be required in cases of any contemplated debt-financed distributions by a QOF partnership, especially if those distributions may be made within two years of the investors' contributions to the partnership.

D. Gain Inclusion and Its Attributes

As noted above, if a taxpayer makes an eligible QOF investment and continues to hold such investment beyond 2026, the deferred gain will automatically be triggered and included in income in the taxpayer's taxable year that includes December 31, 2026. For U.S. individual taxpayers, recognition will occur on December 31, 2026. For non-individual taxpayers, generally, this will occur in their fiscal year that includes December 31, 2026. The amount of the inclusion is the excess of (1) the lesser of (i) the amount of the initially deferred capital gain, or (ii) the fair market value of the QOF investment on December 31, 2026 over (2) the taxpayer's tax basis in its QOF investment (as explained above, that tax basis is initially set to zero but may be increased by 10% or 15% of the deferred gain).[38] Thus, if the value of the QOF investment has decreased as of December 31, 2026, the taxpayer will recognize less than the initially deferred gain, as if the QOF investment had been sold on that date for its fair market value. But if the value of the QOF investment has increased as of December 31, 2016, the taxpayer will be required to recognize only the initially deferred gain. Should a taxpayer continue to hold its QOF investment beyond 2026 (which, presumably, will be the case for many taxpayers who would want to hold their QOF investments for at least 10 years to permanently exclude any post-acquisition gain), as noted above, the cash to pay the tax triggered as of December 31, 2026 (referred to as "phantom income," that is, income that is subject to tax but which is not actually received in cash or property) would need to come from sources other than a sale of the QOF investment.

The tax attributes (i.e., the character) of the initially deferred gain triggered at December 31, 2026, will be the same as that of the initially deferred gain. For example, if the initially deferred gain was short-term capital gain, the gain triggered at December 31, 2026, will be treated as short-term as well; if it was collectibles gain, the gain triggered will be treated as collectibles gain.[39]

1. *Sales of Less Than All of an Investors' QOF Interests*

If a taxpayer sells or otherwise has a gain inclusion event on account of its QOF investment prior to December 31, 2026, the taxpayer will calculate its gain by taking into account the tax basis of its QOF investment, which, as noted above, is initially set to zero. If a taxpayer owns QOF interests with identical rights that were acquired on different days (e.g., a partnership interest in a QOF partnership, portions of which were acquired on different days) and, on a single day, the taxpayer sells less than all of its QOF interests, then, in certain situations, the first-in-first-out method must be used in identifying the relevant portions of the QOF interests sold, and in certain other situations, the pro-rata method must be used.[40]

As discussed below, the Code contains additional rules for properly calculating the amount of the triggered gain in situations where a taxpayer disposes of less than its entire QOF investment or has an Inclusion Event (defined below) prior to December 31, 2026, with respect to only part of its QOF investment.[41]

2. *Inclusion Events*

As a very significant step in the development of the QOF regime, the Proposed Regulations enumerate certain transfers and transactions that, if undertaken prior to December 31, 2026, would accelerate the recognition of the previously deferred gain ("Inclusion Events"). The Proposed Regulations also specify certain transfers and transactions that are not considered Inclusion Events. The general rule (which is subject to a number of exceptions) is that if, as the result of a transaction, a taxpayer reduces its equity interest in a QOF or receives a distribution from a QOF, such transaction or distribution will be an Inclusion Event.[42] A technical analysis of these rules is beyond the scope of this article. However, taxpayers and their advisors should note that many transfers and transactions, that, under the general tax rules, would not be immediately taxable, nonetheless could be Inclusion Events.

In addition to direct taxable dispositions of QOF investments, the following are enumerated Inclusion Events:

- claiming a worthlessness deduction for a QOF interest;
- a termination or liquidation of a QOF (or, in certain cases, its owner);
- a transfer by gift whether outright or in trust, regardless of whether that transfer is a completed gift for tax purposes and regardless of the taxable or tax-exempt status of the donee of the gift;
- a change in a grantor trust's status during the lifetime of the grantor; a more than 25% change in ownership of an S corporation that directly holds a QOF interest;

- a distribution by a QOF partnership of property in excess of an investor's tax basis in its QOF investment;

- a conversion from an S corporation to a partnership or disregarded entity; an otherwise tax-free transfer to a controlled corporation under Section 351, and transfers under Section 304; and

- under certain conditions, an otherwise tax-free spin-off under Section 355.[43]

Certain types of otherwise tax-free redemptions, reorganizations, and recapitalizations will also be Inclusion Events.[44] The IRS also may determine by future published guidance which transactions will or will not be Inclusion Events.[45]

On the other hand, the Proposed Regulations also list certain transactions that are not Inclusion Events, such as:

- a transfer of a QOF interest by reason of the taxpayer's death (including a transfer of the QOF interest to the deceased owner's estate);

- a distribution of the QOF interest by such estate;

- a distribution by the deceased owner's trust;

- the passing of a jointly-owned QOF investment to the surviving co-owner and any other transfer at death by operation of law or otherwise;

- a termination of a grantor trust at the grantor's death;

- a qualifying liquidation of a corporate owner of a QOF investment;

- a distribution by a QOF partnership unless it exceeds the investor's tax basis in its QOF investments;

- a distribution by a QOF taxed as a C or S corporation unless it is treated as a sale or exchange for federal income tax purposes; a qualifying contribution of a QOF interest to a partnership (the apparent intent of this provision is to allow the use of feeder funds, where a partnership, or an LLC taxed as a partnership, is the holding entity that owns interests in multiple QOFs);

- a qualifying merger of partnerships;

- an election, revocation, or termination of S corporation status;

- the disposition of assets by a QOF taxed as an S corporation (or by an S corporation that is a shareholder in the QOF); and

- certain tax-free corporate Section 381 asset reorganizations, as well as certain tax-free corporate spin-offs and recapitalizations unless either (1) not all the assets of a QOF have been acquired in the transaction, or (2) "boot" (*e.g.*, cash) is received by a QOF investor in the transaction.[46]

E. Elections to Exclude Post-Acquisition Gain After 10 Years

Assuming a taxpayer has held its QOF investment for at least 10 years and properly recognized all the initially deferred gain as of December 31, 2026, or earlier, the statute permits the taxpayer to make an election to increase the tax basis of its QOF investment to the fair market value of that investment at the time of its taxable disposition (the "General Gain Exclusion Election").[47] This is how the post-acquisition gain in a QOF interest is intended to be excluded. However, as drafted, the statute implies that a taxpayer can only make the General Gain Exclusion Election with regard to its directly held QOF investment (that is, shares in a QOF corporation or its QOF partnership interest) and must sell that investment to exclude the post-acquisition gain (for REIT shareholders the same result can be achieved by the REIT selling its assets and liquidating).

In the context of a QOF partnership, prior to the issuance of the Proposed Regulations, it was unclear whether the General Gain Exclusion Election would apply in cases where the QOF partnership sells the qualifying property that it owns. This uncertainty could have led investors to avoid structures where one QOF partnership would own multiple properties acquired at different times. Instead, each property that "mirrors" each tranche of deferred gains would be held in a separate partnership, increasing the overall complexity and compliance burdens with no rational policy reasons justifying this complexity. The Proposed Regulations clarify certain issues in this regard (with a caveat that the rules below, unlike other guidance in the Proposed Regulations, cannot be relied upon by a taxpayer until those rules are finalized in the final regulations).[48]

First, the Proposed Regulations provide that (i) in cases where an investor in a QOF partnership sells its investment and makes the General Gain Exclusion Election, the tax basis of such investor's QOF investment is adjusted to its fair market value, including the investor's share of the QOF debt (if any), and (ii) immediately prior to the sale, the tax basis of the assets of the QOF partnership are also adjusted to their fair market value. As a result, the seller will not recognize any gain on the sale of its QOF investment, including any recapture gain or possible gain on account of the seller's relief from its share of the QOF debt.[49]

Second, if a QOF partnership sells its property (similar rules apply to S corporations that are QOFs), an investor may make an election to exclude from gross income any capital gains arising from such disposition as reported on Schedule K-1 of the QOF partnership (the "Capital Gain Exclusion Election"). If there are any Section 1231 gains, such capital gains can only be excluded to the extent of net gains reported on Schedule K-1.[50] Recapture gains (e.g., depreciation recapture) cannot be excluded by virtue of the Capital Gain Exclusion Election because it applies only to capital gains.

Third, shareholders of a QOF REIT may treat capital gain dividends received from the REIT as gain on the sale or exchange of their QOF investment to the extent specifically identified by the QOF REIT as arising from the sale or exchange by the QOF REIT of qualifying property. Thus, for shares held for at least 10 years, such shareholders may exclude from their income any capital gain dividend then paid and so identified by the QOF REIT, and the REIT would not need to be liquidated.[51]

III. REQUIREMENTS APPLICABLE TO QOFS

A QOF is an entity taxed as a corporation or a partnership that is organized in one of the 50 states, the District of Columbia, or a U.S. possession, for investing in eligible property located in a QOZ. A QOF is prohibited from holding an interest in another QOF.[52] In addition, a QOF taxed as a corporation cannot be a subsidiary member of a consolidated group, but it is permitted to be the common parent of such a group.[53]

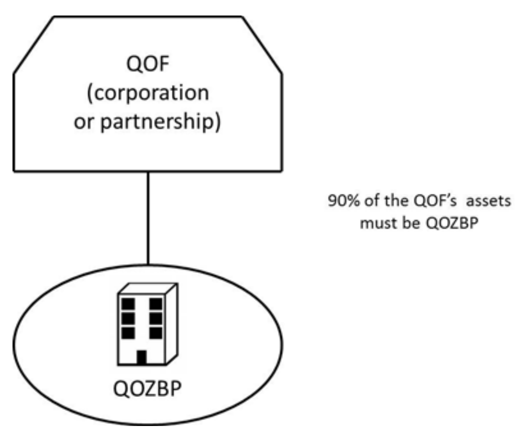
If a taxpayer is eligible to be a QOF, the taxpayer may self-certify that it is a QOF, and that certification must identify the first taxable year that the entity wants to be a QOF and it may also identify the first month in which it wants to be a QOF.[54] The flexibility of choosing the year and the month of the eligibility for a QOF status is important as it may allow some advance planning in view of the multiple requirements for a QOF and the penalties that may be imposed for failure to comply with the applicable investment standards, as will be discussed below. Currently, the certification is made on IRS Form 8996, which must be filed annually to report that the QOF continues to meet the applicable investment standards and to determine the penalty if it fails to meet these standards.[55]

Regarding the investment standards and operational requirements for a QOF, the nomenclature used by the statute is important because the provisions of Section 1400Z-2 (and the IRS guidance) apply somewhat different rules to a QOF that operates a qualified business directly ("a single-tier QOF") as compared to those that apply to a QOF that acts as a holding company and operates a qualified business through a subsidiary corporation or partnership ("a two-tier QOF"). It becomes important to understand the concepts of "qualified opportunity zone business" ("QOZB"), "qualified opportunity zone property" ("QOZP"), and "qualified opportunity zone business property" ("QOZBP"), and how they fit into the overall statutory scheme.

1. *Qualified Opportunity Zone Property in Single-Tier QOFs*

In a single-tier structure, the QOF must directly hold at least 90% of its assets in QOZP, which in the case of a single-tier QOF is defined by statute as QOZBP (the "90-percent QOZBP test").[56] The QOF must use the QOZBP in its trade or business.[57] Thus, in a single-tier QOF structure, QOZP = QOZBP.

Single-Tier QOF



The 90-percent QOZBP test is based on the average of the percentage of the value of QOZBP as measured on (1) the last day of the first six-month period of the taxable year of the QOF, and (2) on the last day of its taxable year.[58] The QOF may value its owned and leased assets by using its "applicable financial statement" (within the meaning of Treasury Regulation section 1.475(a)-4(h)). For owned assets, the QOF may also use their unadjusted cost basis under Section 1012, and for leased property, the QOF may also use the present value of that property (as discussed below).[59] The

QOF generally may disregard any proceeds that it received for its equity interests in the preceding six months, provided the proceeds are held in cash, cash equivalents, or debt instruments with a term of no more than 18 months.[60] Since cash is not QOZBP, this rule may allow single-tier QOFs to maintain their prior QOF status while deploying recent cash contributions in a qualifying business for six months (*compare* the 31-months working capital safe harbor for two-tier QOFs discussed below).

QOZBP is the key to understanding how QOFs are supposed to operate and spur economic developments in QOZs. QOZBP is defined as tangible property (1) acquired by a QOF by purchase from an unrelated person after December 31, 2017 (so a tax-free contribution of property will not be a "purchase"), (2) (a) the "original use" of which commences with the QOF or (b) if the original use does not commence with the QOF, the QOF must "substantially improve" that tangible property, and (3) at least 70% of the use of which was in a QOZ during at least 90% of the QOF's holding period for QOZBP.[61]

The original use of QOZBP acquired by purchase commences when it is first placed in service in the QOZ for purposes of depreciation or amortization.[62] Thus, if a QOF purchases QOZBP that was already eligible for depreciation in the QOZ, such property will not qualify unless the QOF "substantially improves" it.[63] That requirement is met when, within 30 months of the acquisition, the QOF has spent enough money on improving the property so as to double its initial tax basis.[64] Despite the 30-month period within which these improvements can be made, that time period should be evaluated in light of the shorter, six-month safe harbor period during which a single-tier QOF can exclude cash from being a disqualifying asset for purposes of the 90% test (as discussed above). The substantial improvement requirement does not apply to acquired land—that is, a QOF will not be required to double its basis to substantially improve raw land; however, that land must be used in the QOF's trade or business.[65]

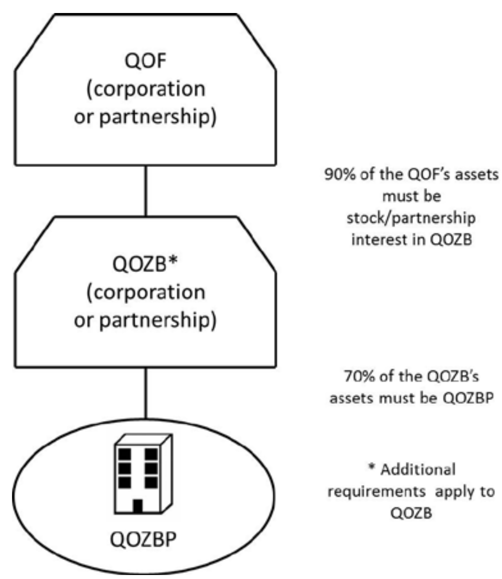
Despite some opposing implications in the wording of the statute, in a very pro-taxpayer move, the Proposed Regulations allow a single-tier QOF to treat certain leased tangible property as good QOZBP without imposing the original use or substantial improvement requirement. To qualify, the lease must (1) be entered into after December 31, 2017, (2) be at arm's length when entered into, and (3) satisfy the 90% holding and the 70% use test per the definition of QOZBP. If the lessor and lessee are related, the lessee cannot make a prepayment of rent more than a year in advance, and if the original use of the leased property did not commence with the lessee, then within 30 months the lessee must acquire additional tangible property from unrelated persons having a value at least equal to the value of the leased property.[66] In the case of leased real property (other than unimproved land), if, at the time of the lease, there was a plan, intent, or expectation that the real property would be purchased by the lessor QOF for less than the fair market value determined at the time of the purchase without regard to any prior lease payments, such leased real property will not be QOZBP.[67]

For purposes of the 90-percent QOZBP test, a QOF may value its leased assets using its applicable financial statement or it may value such assets at their present value, which is the sum of the present value of all payments under the lease (discounted using the applicable federal rate under Section 1274(d)(1)), calculated for the entire lease term, which will include any periods during which the lessee may extend the lease at a pre-defined rent.[68]

2. *Qualified Opportunity Zone Property in Two-Tier QOFs*

In a two-tier QOF structure, the upper tier QOF must hold at least 90% of the value of its assets in QOZP, which is either (1) qualified opportunity zone stock in a QOZB or (2) qualified opportunity zone partnership interests in a QOZB.[69]

Two-Tier QOF



The 90% test described above in a two-tier QOF is determined by the average of the percentage of the value of qualified opportunity zone stock (or, where applicable, qualified opportunity zone partnership interests) as measured on the last day of the first six-month period of the taxable year of the QOF and on the last day of its taxable year.[70]

Qualified opportunity zone stock means any stock in a domestic corporation if (1) such stock is acquired by the QOF after December 31, 2017 at its original issue from the issuing corporation solely in exchange for cash (meaning that a tax-free contribution of property will not qualify), (2) when the stock was issued, the issuing corporation was a QOZB (or, if a new corporation, it was being organized to be a QOZB), and (3) during 90% of the QOF's holding period for such stock, the issuing corporation qualified as a QOZB.[71]

A qualified opportunity zone partnership interest means any capital or profits interest in a domestic partnership if (1) such interest is acquired by the QOF after December 31, 2017 from the partnership solely in exchange for cash (meaning that a tax-free contribution of property will not qualify), (2) as of the time such interest was acquired, the partnership was a QOZB (or, in the case of a new partnership, it was being organized to be a QOZB), and (3) during 90% of the QOF's holding period for such interest, the partnership qualified as a QOZB.[72]

The core of the two-tier QOF structure is the meaning of QOZP and a QOZB. The latter is defined as a trade or business: (1) in which at least 70% of the tangible property is QOZBP,[73] and (2) which satisfies certain additional requirements.[74] This essentially means that in a two-tier QOF structure, 90% of the parent entity's assets must consist of the equity interest in a lower-tier entity, which, in turn, must hold at least 70% of its assets in a QOZBP, with the end result being that the QOZBP needs to constitute only 63% of the overall assets of the two entities (90% x 70% = 63%).

The divergence between a single-tier QOF structure and a two-tier QOF structure begins in the statute by virtue of the different meaning of QOZP in each of these structures. If it is a single-tier structure, QOZP means the same QOZBP. But in a two-tier structure, QOZP is a multifaceted concept that could mean stock or partnership interests issued by an entity, the issuing entity, active trade, or business with regard to the QOZBP owned or leased by the entity, and includes, as compared to a single-tier QOF structure, certain additional requirements (discussed below). This inter-layer statutory construct in which one definition changes its meaning depending upon the number of tiers causes different tax requirements to apply solely as a result of differences in ownership structure. For this reason, the selection of the particular tier form in which an investor should hold its QOF investment becomes important in view of the taxpayer's particular circumstances and objectives. For example, generally, a two-tier QOF structure is subject to more forgiving safe harbors when it comes to the 90% asset test and working capital requirements.

As a substantive matter, the requirements applicable to QOZBP held by a QOZB entity, including leases and the valuation of the QOZBP, operate in essentially identical manner as those found in a single-tier QOF structure and discussed above (as if the QOZB entity were the QOF in a single-tier structure).[75]

3. *Additional Requirements Applicable to QOZBs*

The additional requirements applicable to a QOZB are: (1) at least 50% of the QOZB's gross income must be derived from the *active* conduct of a trade or business in the QOZ (the "50-percent gross income test"), (2) at least 40% of the intangible property of the QOZB must be used in that conduct of a trade or business in the QOZ, (3) less than 5% of the aggregate unadjusted bases of the QOZB's property is "nonqualified financial property" (generally defined as debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, annuities, and similar property), except for reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less (the "NFP 5-percent test"), and (4) the QOZB is not a private or commercial golf course, country club, suntan or hot tub facility, racetrack, gambling establishment, massage parlor, or a store whose principal business is the sale of alcohol for consumption off premises.[76]

For purposes of the 50-percent gross income test, a business may rely on one of three safe harbors, and, if it cannot rely on any of them, it may use a facts-and-circumstances approach to establish that it satisfied the test. The first safe harbor requires that at least 50% of the total hours spent by the QOZB entity's employees and independent contractors be spent within the QOZ. The second safe harbor will be met if at least 50% of the total compensation paid by the QOZB entity to its employees and independent contractors is paid for services performed within the QOZ. The third safe harbor will be met if the tangible property is located in a QOZ and the management or operational functions performed there are each necessary for the generation of at least 50% of the gross income of the QOZB entity. If a QOZB entity cannot rely on any of the three safe harbors, it may use a facts-and-circumstances approach to establish that, based on all the facts and circumstances, at least 50% of its gross income in a QOZ is derived from the active trade or business there.[77] For purposes of determining whether services, tangible property, or business functions are located in a QOZ, if a particular parcel of real estate is located both within and without a QOZ, then the entire parcel will be treated as being within the QOZ if more than 50% of the parcel's square footage is within the QOZ.[78]

In applying the NFP 5-percent test, the Proposed Regulations provide for a safe harbor that permits a QOZB entity to hold reasonable amounts of working capital provided that (1) the amounts are designated in writing for the development of a business in a QOZ, (2) there is a written schedule consistent with the ordinary practice of a start-up business for the expenditures of the working capital within 31 months of the receipt of the funds, and (3) the working capital is actually spent in a manner substantially consistent with items (1) and (2) above, except that if the expenditure is delayed beyond the expiration of the 31-month period due to pending governmental action on an application, then so long as the application is complete within the 31-month period, that delay will not prevent the QOZB from relying on this safe harbor.[79] A QOZB entity may benefit from overlapping or sequential application of this working capital safe harbor, so presumably, each tranche of raised capital could qualify for this safe harbor separately.[80]

4. *Reinvestment of Sale Proceeds Within 12 Months*

As noted above, at least 90% of a single-tier QOF's assets must be QOZBP, and at least 90% of a two-tier QOF's assets must be stock or partnership interests in a QOZB. The Proposed Regulations provide that if a QOF sells its assets and within 12 months reinvests the sale proceeds in other qualifying QOZ property, then such sale will not cause the QOF to fail these 90% tests.[81] However, any such asset sale will be a taxable event to either the QOF (if it is taxed as a corporation) or to the QOF's investors (if the QOF is taxed as a pass-through entity). It remains to be seen whether this provision could be used as an exit strategy for those investments that underperform, in which case for sales after December 31, 2026, there may not be any taxes due because the value of the QOF investment has gone down from what it was on December 31, 2026.

IV. CONCLUSION

The QOZ/QOF legislation offers significant tax benefits to investors while attempting to stimulate economic growth in distressed communities across the country. However, the complexity of the applicable rules will require both investors and sponsors of QOFs to rely on expert professional advice. The good news is that should this program work as intended, it will benefit both economically distressed communities and investors.

Endnotes

1 Pub. L. No. 115-97, 131 Stat. 2504, 2184 (2017). Unless otherwise indicated, all "Section" references herein are to the Internal Revenue Code of 1986, as amended (the "Code").

2 Opportunity Zones FAQs, https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions (as updated on Apr. 17, 2019).

3 Notice 2018-48, 2018-28 IRB 9.

4 https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

5 Code Section 1(h). In addition, if a taxpayer's income exceeds a certain level (e.g., $250,000 of modified adjusted gross income for married taxpayers filing a joint tax return), capital gains may also be subject to an additional tax of 3.8%.

6 The election to defer the gain, in whole or in part, is made on the federal tax return for the year of the sale or exchange, to which IRS Form 8949 reporting information about the sale or exchange needs to be attached, and "[p]recise instructions on how to use that form to elect deferral of the gain will be forthcoming shortly." *See* Opportunity Zones FAQs, *supra* note 2.

7 The exclusions are achieved by corresponding increases in the tax basis of a taxpayer's investment in a QOF at five and seven years. That basis is set to zero upon the initial acquisition of such interest. A taxpayer who has held its QOF interest for at least 10 years can make an election to increase the tax basis to the fair market

value of the QOF investment on the date it is sold or exchanged. *See* Code Section 1400Z-2(b)(2)(B), -2(c).

8 REG-115420-18, 83 Fed. Reg. 54279 (Oct. 29, 2018), as corrected by 83 Fed. Reg. 67171 (Dec. 28, 2018), and REG-12186-18, 84 Fed. Reg. 18652 (May 1, 2019). Importantly, in interpreting these Proposed Regulations, one should keep in mind that they contain an overriding anti-abuse rule stating that the IRS can recast a transaction if a significant purpose of the transaction was to achieve a tax result inconsistent with the purposes of the QOZ/QOF legislation. *See* Prop. Treas. Reg. §1.1400Z2(f)-1(c).

9 *See* Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(1).

10 *See* Code Section 1400Z-2(a)(1), -2(a)(2)(B). A "related person" under Code Section 1400Z-2 will include certain members of an individual taxpayer's family, as well as certain entities in which a taxpayer owns, directly, indirectly, or constructively, more than 20%. *See* Code Section 1400Z-2(d)(2)(D)(i)(I), -2(d)(2)(D)(iii), -2(e)(2). Any cash or property investment in a QOF without prior capital gain will not qualify for the QOF tax benefits.

11 *See* Code Section 1400Z-2(a)(1)(A), -2(e)(1); Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(2)(ii).

12 *See* Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(2)(ii).

13 *See* Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(2)(i). Also, there is a special rule for the so-called "Code Section 1256 contracts" (generally, regulated futures, foreign currency, non-equity options, dealer equity option, and dealer securities future contracts). Only capital gain net income, that is, the net amount of all capital gains over losses for a taxable year on all of a taxpayer's Section 1256 contracts, is taken into account. *See* Prop. Treas. Reg. § 1400Z2(a)-1(b)(2)(iv).

14 *See* Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(2)(v).

15 *See* Prop. Treas. Reg. §§ 1.1400Z2(a)-1(b)(3)(i), (ii).

16 *See* Prop. Treas. Reg. §§ 1.1400Z2(a)-1(b)(9)(ii), 1.1400Z2(b)-1(c)(6)(iv).

17 *See* Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(9)(iii).

18 *See* Prop. Treas. Reg. § 1.1400Z2(g)-1(c).

19 *See* Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(10)(i), (iii).

20 *See* §§ 1.1400Z2(a)-1(b)(2)(iv), -1(b)(10)(i)(C), (iii). In addition, as will be explained in Part II, a contribution of non-cash property may raise certain issues regarding the status of the entity to which such property was contributed as a valid QOF because, generally, to satisfy the 90% asset test, tangible property in a QOZ must be purchased from an unrelated seller to qualify as a QOZBP.

21 *See* Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(10)(i)(B), (iii).

22 Net basis and net value are determined by excluding any debt to which the contributed property is subject or that is assumed by the QOF partnership in the contribution. *See* Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(10)(ii)(B).

23 *See* Prop. Treas. Reg. § 1.1400Z2(b)-1(d)(1)(i), -1(f), ex. 1-2.

24 *See* Preamble, 84 Fed. Reg. 18688; Prop. Treas. Reg. § 1.1400Z2(b)-1(d)(1)(ii) to (iv), -1(d)(3).

25 *See* Preamble, 84 Fed. Reg. 18688; Prop. Treas. Reg. § 1.1400Z2(b)-1(d)(1)(i), § 1.1400Z2(a)-1(b)(2), (4)(ii), ex. 4.

26 *See* Code Section 1400Z-2(a)(1)(A).

27 *See* Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(4)(i)-(ii), ex. 1-3.

28 *See* Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(2)(iii).

29 *See* Prop. Treas. Reg. § 1.1400Z2(a)-1(c).

30 This is a very pro-taxpayer rule. However, note that there could be a time gap (in this case, after November 26, 2019, and until December 30, 2019) during which an investment by a partner in a QOF nonetheless would not be timely made.

31 *See* Prop. Treas. Reg. § 1.1400Z2(b)-2(h). In addition, certain notification requirements apply to indirect owners of QOF partnerships who sell portions of their partnership interests that are only partially eligible for deferral, and to partners of QOF partnerships who have held their QOF interests for at least ten years and who elect to step up the tax basis in those interests to the fair market value. Similar rules apply to S corporations, as appropriate. *Id.*

32 *See* Code Section 752.

33 *See* Code Section 731.

34 *See* Prop. Treas. Reg. § 1.1400Z2(b)-1(g)(3)(i).

35 *See* § 1.1400Z2(b)-1(c)(6)(iii).

36 *See* Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(10)(ii).

37 *See* Code Section 707; Treas. Reg. §1.707-3, -5(b).

38 *See* Code Section 1400Z-2(b)(2).

39 *See* Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(5).

40 *See* Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(6) to (7).

41 *See* Prop. Treas. Reg. § 1.1400Z2(b)-1(e)(1) to (5).

42 *See* Prop. Treas. Reg. § 1.1400Z2(b)-1(c)(1)(i) to (ii).

43 *See* Prop. Treas. Reg. § 1.1400Z2(b)-1(c)(1) to (15).

44 *Id.*

45 *Id.*

46 *Id.*

47 *See* Code Section 1400Z-2(c).

48 *See* Prop. Treas. Reg. § 1.1400Z2(c)-1(f).

49 *See* Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i).

50 *See* Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i), (ii)(A)(1) to (2).

51 *See* Prop. Treas. Reg. § 1.1400Z2(c)-1(e)(1) to (4).

52 *See* Code Section 1400Z-2(d)(1); Prop. Treas. Reg. § 1.1400Z2(d)-1(e)(1). If an entity is organized in a U.S. possession which is listed in Notice 2018-48, the entity must be engaged in qualifying activities in that possession.

53 *See* Prop. Treas. Reg. § 1.1400Z2(g)-1(b).

54 *See* Prop. Treas. Reg. § 1.1400Z2(d)-(1)(a)(1).

55 The tax penalty is paid for each month of the failure and is calculated by multiplying the underpayment rate of Code Section 6621(a)(2) by the excess of 90% of the QOF's aggregate assets over its aggregate qualifying assets. *See* Code Section 1400Z-2(f).

56 *See* Code Section 1400Z-2(d)(1), (2)(A)(iii).

57 "Trade or business" in this context means a trade or business within the meaning of Code Section 162. *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(4)(ii). Thus, leasing of real property by a QOF should qualify but the holding of land for investment will not. *See* Preamble, 84 Fed. Reg. 18654-18655. In addition, a QOF should also be able to hold its QOZBP though a wholly-owned single-member LLC that is a disregarded entity for federal income tax purposes.

58 *See* Code Section 1400Z-2(d)(1). If an eligible entity becomes a QOF in the seventh or later month of a 12-month taxable year, the 90-percent QOZBP test takes into account only the QOF's assets on the last day of the taxable year. *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(a)(2)(i).

59 *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(b)(1) to (3).

60 *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(b)(4).

61 *See* Code Section 1400Z-2(d)(2)(D); Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(4) to(c)(6). The 70% use is determined by dividing the value of all QOZBP of a QOF by the value of its total tangible property, whether located inside or outside of a QOZ. *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(9). Inventory and raw materials in transit are counted as being used in the QOZ. *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(4)(iii).

62 *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(7). In addition, improvements made by a lessee to leased property will be considered as purchased property in the amount of the unadjusted cost basis. *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(7)(ii).

63 If tangible property (such as a building) has been vacant or unused for an uninterrupted period of at least five years, it will satisfy the original use requirement when a QOF purchases it and places it in service. *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(7)(i). In addition, other used tangible property will satisfy the original use requirement in a QOZ if the property has not been previously used or placed in service in that particular QOZ. *Id.*

64 *See* Code Section 1400Z-2(d)(2)(D)(ii). The determination of whether there has been a substantial improvement of purchased tangible property is currently made on an asset-by-asset basis. *See* Preamble, 84 Fed. Reg. 18655. If an unimproved (or minimally improved) land was purchased by a QOF, the land will not be a QOZBP if there was an expectation, intention, or a view not to improve the land by more than an insubstantial amount within thirty months after the purchase. *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(f).

65 *See* Rev. Rul. 2018-29, 2018-45 I.R.B. 765 (Oct. 19, 2018); Treas. Reg. § 1.1400Z2(d)-1 (c)(8)(ii)(B). However, if a significant purpose for acquiring unimproved land is to achieve an inappropriate tax result, that land will be non-qualified property. *See* Prop. Treas. Reg. § 1.1400Z2(f)-1(c) Preamble, 84 Fed. Reg. 18655.

66 *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(4)(i)(A) to (D). In addition, there must be substantial overlap of the QOZ(s) in which that acquired property and the leased property are used. *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(4)(i)(B)(5).

67 *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(4)(i)(E).

68 *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(b)(3).

69 *See* Code Section 1400Z-2(d)(2)(A)(i)-(ii).

70 *See* Code Section 1400Z-2(d)(1).

71 *See* Code Section 1400Z-2(d)(2)(B); Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(2), -1(d)(2)(iii).

72 *See* Code Section 1400Z-2(d)(2)(C), Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(3), -1(d)(2)(iii).

73 Under a special rule applicable only in a two-tier QOF structure, tangible property that ceases to be a QOZBP will nonetheless retain that character until the earlier of: (i) five years, or (ii) the date on which such property is no longer held by the QOZB. *See* Code Section 1400Z-2(d)(3)(B).

74 *See* Section 1400Z-2(d)(3); Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(3)(i).

75 *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(2).

76 *See* Code Section 1400Z-2(d)(2)(3)(A)(ii) to (iii); Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5).

77 *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5). It should be noted that for these purposes, the ownership and operation (including leasing) of real property constitutes the active conduct of a trade or business, but entering into a triple-net lease generally does not. *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(ii)(B)(2).

78 *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(viii) Preamble, 84 Fed. Reg. 18658.

79 *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(iv)(A) to (C). In addition, any gross income (e.g., interest) derived from the working capital that is subject to this safe harbor will count as active business income in satisfying the 50-percent gross income test. *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(v).

80 *See* Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(iv)(D).

81 *See* Prop. Treas. Reg. § 1.1400Z2(f)-1(b) (given the express language of this regulation that provides that for the safe-harbor to apply, a QOF must sell its asset, if the lower-tier entity, which is a QOZB and not a QOF by statutory definition, sells its assets in a two-tier QOF structure, this twelve-month safe harbor would appear not to apply).