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[Opportunity Zones: Government Issues Proposed Regulations - Shearman & Sterling]

On Friday, October 19, 2018, the Treasury Department and the Internal Revenue Service issued highly-anticipated proposed regulations regarding “Qualified Opportunity Zones.” The Qualified Opportunity Zone regime was introduced as part of the Tax Cuts and Jobs Act of 2017 to encourage private investment in distressed communities.[1] Under the regime, investors that wish to defer capital gains recognized upon a sale or exchange of an asset to an unrelated party (and to derive other tax benefits) can invest that gain in a Qualified Opportunity Fund, which in turn invests in so-called “Qualified Opportunity Zone Property.” Since its enactment, industry participants have been awaiting the release of additional guidance to address many of the uncertainties regarding the application and implementation of the regime, particularly regarding how an entity will qualify as a Qualified Opportunity Fund and timing for investing capital gains into such funds. This note provides a detailed analysis of the most important clarifications and changes made by the proposed regulations and identifies certain key issues which still require guidance.[1]

Part I – Background

Included among the many significant changes contained in the Tax Cuts and Jobs Act of 2017 (the “Act”) was the establishment of a new tax regime relating to qualified opportunity zones (“QOZs”) under Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code of 1986, as amended (the “Code”), to encourage private investment in distressed communities throughout the United States. Under that regime, and as described in greater detail below, investors that wish to defer capital gains recognized upon a sale or exchange of an asset to an unrelated party on or prior to Dec. 31, 2026 can invest that gain in a Qualified Opportunity Fund (“QOF”), which in turn invests in so-called “qualified opportunity zone property.”

Each individual State, possession of the United States and the District of Columbia was permitted to nominate as QOZs a certain number of census tracts that qualify as “low income communities” as such term is defined under Code Section 45D(e). To date each State, possession and the District of Columbia has identified the permitted number of QOZs. The designated QOZs can be found here (https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx) and are not subject to change.

The Act provided the framework for the QOF program, but practitioners and industry participants have recognized that guidance from the Treasury Department (“Treasury”) and the Internal Revenue Service (“IRS”) would be critical to making the QOZ regime usable in the manner Congress had intended. Many interested parties submitted comments on the QOZ regime to the government and on Friday, Oct. 19, 2018, highly-anticipated proposed regulations (the “Regulations”) on the QOZ regime were issued.

The Regulations demonstrate that Treasury and IRS are being responsive to the comments they received and are showing a thoughtful approach to the issues raised. Nevertheless, the government indicated that additional guidance (including another round of proposed regulations) will be forthcoming as the Regulations did not address all of the significant issues that have been identified.

The government also highlighted in the preamble to the Regulations areas where they are soliciting additional comments.

The question now becomes: what do the Regulations and related guidance mean for the implementation of the QOZ regime and the formation of and investment in QOFs? It is clear from the guidance that Treasury intends for taxpayers and fund sponsors to start taking advantage of the QOF program. Although the Regulations will not be effective until published in final form, the government confirmed that the Regulations generally may be relied upon currently if applied consistently. Many QOF sponsors and potential investors were awaiting guidance (in the form of the Regulations) prior to investing in or launching QOFs, as applicable. With the current round of guidance, our expectation is that sponsors and investors generally will feel comfortable moving forward on their QOF offerings and investments, notwithstanding that many key issues remain unresolved.

Part II – Eligibility for Investors to Receive QOZ Tax Benefits

As described in detail below, the benefits of the QOZ regime are generally available when an "eligible taxpayer" invests "eligible gain" into a QOF within 180 days of the recognition of such gain.

Eligible Taxpayers

The benefits of the QOZ regime generally are available to eligible taxpayers that invest in a QOF in a manner that satisfies all of the requirements of the QOZ regime and make what is referred to as a "gain-deferral election."

Important Clarification

- The Regulations clarify that the benefits of the QOZ regime are available to any "eligible taxpayer," which is defined to include any taxpayer that recognizes capital gain for federal income tax purposes (including individuals, C corporations (including RICs and REITs), partnerships, and certain other pass-through entities).
- The Regulations provide rules that permit a partnership to get the benefits of the QOZ regime by investing eligible gains and, to the extent that the partnership does not do so, provide rules that allow a partner to invest such partner's share of eligible gains not invested in a QOF by the partnership into a QOF.
- Specifically, if all or any portion of a partner's distributive share of a partnership's capital gain satisfies the rules for QOF investment eligibility (including not arising from a sale or exchange with a person that is a "related person" with respect to either the partnership or the partner),[2] the partner generally may make a gain-deferral election with respect to an eligible investment of such capital gain in a QOF.[3]
- The Regulations state that rules analogous to the rules provided for partnerships and partners apply to other pass-through entities (including S corporations, decedents' estates, and trusts) and to their shareholders and beneficiaries.

Eligible Gains

Gain is treated as "eligible gain" for purposes of the QOF program if it satisfies the following requirements:

- the gain must be treated as capital gain for federal income tax purposes,
- the gain must be gain that would otherwise be recognized no later than Dec. 31, 2026, and
- the gain must not be recognized as a result of a sale or exchange engaged in by the taxpayer with a

related person.

Important Clarifications

- The Regulations clarify that QOZ tax benefits are available only with respect to the investment of capital gains. Thus, ordinary income (including as a result of depreciation recapture) is ineligible to receive the benefits of the regime.
- The Regulations provide that where a taxpayer recognizes a single capital gain, it may invest different parts of such gain into different QOFs and make the gain-deferral election with respect to each such investment.
- Special rules are provided that may limit the ability of taxpayers to make the gain-deferral election with respect to the investment of gains from “section 1256 contracts.”

The 180-Day Investment Period

A taxpayer’s investment of “eligible gains” into a QOF must be made within the 180-day period beginning on the date of the transactions or events giving rise to the gain.

Important Clarifications

- The Regulations provide that the first day of the 180-day period generally is the date on which the gain would be recognized for tax purposes (determined without regard to the gain-deferral election).
- For example, where publicly-traded stock is sold at a gain in a regular-way trade on an exchange, the 180-day investment period begins on the trade date for such sale (i.e., the date on which such gain would otherwise be recognized).
- However, in the case of a partner investing its distributive share of partnership gains into a QOF, the partner’s 180-day investment period generally begins on the last day of the partnership’s taxable year, but the partner may choose to begin its own 180-day investment period on the same date as the start of the partnership’s 180-day investment period where the partner knows (or receives information) regarding both the date of the partnership’s gain and the partnership’s decision not to elect deferral under the QOZ regime.

Investment of Amounts in Excess of Eligible Gain

If an investor makes an investment in a QOF in excess of its eligible gains, its investment in the QOF is treated as two separate investments: one investment relating to its recent sales or exchanges, which may qualify for the QOZ tax benefits; and a separate investment, consisting of the excess amount, which will not qualify for those tax benefits (even if the investor holds its QOF interest for at least 10 years).

Important Clarification

- The Regulations clarify that, where the QOF is a partnership, a deemed contribution of money resulting from an allocation of QOF-level liabilities under Section 752(a) of the Code does not constitute an investment in the QOF. As a result, such a deemed contribution does not result in the partner having a separate, non-qualifying investment in the QOF.

Special Rule for Offsetting-Position Transactions

The Regulations provide that any capital gain from a position that is or has been part of an “offsetting-positions transaction” is not eligible to receive QOZ tax benefits upon investment in a QOF. For this purpose, an “offsetting-positions transaction” means (i) any straddle and (ii) any other transaction in which a taxpayer has substantially diminished its risk of loss from holding one position with respect to personal property by holding one or more other positions with respect to personal property (whether or not of the same kind), regardless of whether either of the positions is with respect to actively traded personal property.

How to Elect QOZ Gain Deferral

The preamble to the Regulations indicates that a taxpayer will make the gain-deferral election on Form 8949 (Sales and Other Dispositions of Capital Assets) to be attached to its federal income tax return for the taxable year in which the gain would have been recognized if it had not been deferred. Revised instructions to Form 8949 are expected to be released shortly to prescribe the information that the taxpayer must provide to make the gain-deferral election.

Part III –Tax Benefits from Investing in QOFs

An investor may obtain three types of federal income tax benefits as a result of its investment in a QOF. These benefits, and the extent to which the Regulations clarify their availability and operation, are discussed below.

Deferral of Capital Gains

The first benefit of the QOZ regime is that an eligible taxpayer receives a temporary deferral of any eligible gains invested into a QOF so long as such gains are invested within the 180-day investment period and the taxpayer makes the gain-deferral election. The deferral of gain extends until the earlier of (i) the investor's disposition of its interest in the QOF, or (ii) Dec. 31, 2026.

Important Clarifications

- Under the Regulations, if a taxpayer acquires an interest in a QOF and makes a gain-deferral election in connection with such acquisition, and the taxpayer later sells its QOF interest, the taxpayer may further defer the recognition of the originally deferred gain (presumably as well as any subsequent appreciation in the original QOF interest) by investing such gain in a QOF within the 180-day investment period and making a gain-deferral election with respect to such new QOF investment. Continued deferral of the originally deferred gain upon the new QOF investment is permitted, however, only if the taxpayer has disposed of its entire investment in the original QOF.
- The Regulations provide that the tax attributes of deferred gain are preserved through the deferral period, such that the attributes of such deferred gain are taken into account when the gain is included. For example, if a taxpayer made a gain-deferral election with respect to the investment of short-term capital gain into a QOF, the deferred gain later recognized by the taxpayer on Dec. 31, 2026 (or, if earlier, the date of the sale of the taxpayer's QOF interest) will be short-term capital gain.
- The Regulations also address situations in which a taxpayer invests into a single QOF at different times and receives interests in such QOF with identical rights (i.e., fungible interests). In such a case, if the taxpayer later disposes of less than all of its interests in the QOF, the Regulations require that the QOF interests disposed of be identified using a first-in, first-out (FIFO) method. Similarly, where a taxpayer acquires a QOF interest in a single purchase but with separate gains possessing different tax attributes, the Regulations provide that a pro-rata method must be used to determine the character, and any other attributes, of the gain recognized. Where the QOF is a corporation (e.g.¸ a REIT), these rules deviate from the normal rule permitting the specific identification of the shares being sold.
- The Regulations also confirm that a taxpayer's use of a QOF interest as collateral for a loan will not impair the eligibility of the taxpayer for gain deferral (and the other QOZ regime tax benefits) so

long as the taxpayer remains the owner of such interest for federal income tax purposes.

Elimination of a Portion of Deferred Gains Upon Fifth and Seventh Anniversaries

The second benefit of the QOZ regime is that up to 15 percent of the gains invested in a QOF can be eliminated, depending on the investor's holding period with respect to its interest in the QOF. If an investor holds its QOF interest for at least five years, the tax basis of the QOF interest is increased on the fifth anniversary of the investment by ten percent of the amount of gain initially invested in the QOF. If an investor holds its QOF interest for at least seven years, the tax basis of the QOF interest is increased on the seventh anniversary of the investment by an additional five percent of the amount of gain initially invested in the QOF. The Regulations did not clarify or otherwise modify the rules relating to the gain elimination occurring on the fifth and seventh anniversaries of the investment.

Unanswered Question

- It remains unclear whether, in a case where the fifth and/or seventh anniversary of a taxpayer's acquisition of an interest in a QOF occurs after Dec. 31, 2026, the taxpayer will still be entitled to the benefit of the basis step-up otherwise available when those anniversaries occur no later than Dec. 31, 2026. From a practical perspective, this will not be an issue for taxpayers investing in QOFs on or before Dec. 31, 2019.

No Gain upon Sale or Exchange of QOF Interest after the Tenth Anniversary of the Investment

The third benefit of the QOZ regime is that if an investor holds its interest in the QOF for 10 years or more, for purposes of determining the gain or loss the investor recognizes from the sale or exchange of such QOF interest, the investor may elect for the basis of such QOF interest to be equal to its fair market value on the date such QOF interest is sold or exchanged (the "FMV Basis Election"). As a result, the investor generally will not recognize gain and will not owe tax on the sale or exchange of its QOF interest 10 years or more after it acquired the QOF interest.

Important Clarification

- Under the Code, the designations of all QOZs now in existence will end on December 31, 2028. Taxpayers and practitioners had expressed concern that the termination of QOZ status could jeopardize the QOZ tax benefit for QOF interests sold after the 10-year holding period where such sales occur after 2028. The Regulations address this concern by permitting taxpayers to make the FMV Basis Election, even after QOZ designations expire, until Dec. 31, 2047. We note that the government has requested comments regarding whether this provision should provide even more flexibility to taxpayers, either by extending the Dec. 31, 2047 deadline for making the FMV Basis Election or by allowing QOF investors to receive the benefit of a FMV Basis Election without being required to sell their QOF interests by a particular date.

Unanswered Questions

- Where a QOF is a partnership, the FMV Basis Election will not always achieve Congress's intention of eliminating the taxable gain that would otherwise be realized upon the sale of the QOF interest after the tenth anniversary of its acquisition because the FMV Basis Election does not specifically take into account the fact that the taxpayer's "amount realized" for tax purposes would exceed the fair market value of such interest by virtue of the partnership's allocation of a portion of its liabilities to the taxpayer. If this issue is not addressed in subsequent guidance, a taxpayer may

recognize significant amounts of gain upon its disposition of a QOF partnership interest, notwithstanding its FMV Basis Election.
- As currently drafted, the QOZ regime permits the FMV Basis Election only upon the sale of a QOF interest. The government received a number of comment letters requesting that the regime should allow taxpayers to benefit from the FMV Basis Election to avoid gain recognition when a QOF sells one or more underlying properties after the taxpayer has held the QOF interest for ten years. Such a change would make the regime more flexible and avoid the need to establish multiple QOFs to acquire separate properties that are unlikely to be sold together. The Regulations do not address this point, although it is possible that subsequent guidance will provide relief.
- Some commentators have suggested that a service provider could benefit from the FMV Basis Election when it sells its carried interest in the QOF (or a capital interest in the QOF acquired at least in part on account of services provided to the QOF), as long as the service provider acquired its original interest in the QOF in part by making a capital investment of eligible gain. In this regard, the Regulations confirm that an "eligible interest" includes a partnership interest "with special allocations." In the absence of guidance specifically addressing this issue, however, it is unclear whether a carried interest acquired by a service provider in exchange for both services and an investment of eligible gain would be treated in full as an eligible interest (or, instead, would be treated as two separate interests where only the portion of the interest acquired in exchange for the capital investment would qualify as an eligible interest).

Part IV – Qualification of an Entity as a Qualified Opportunity Fund

Types of Entities That May Be a QOF and Qualifying Investments in a QOF

Under the Code, a QOF must be "organized as a corporation or a partnership" for the purpose of investing in "qualified opportunity zone property" (which does not include interests in another QOF). A REIT may qualify as a QOF.[4]

Important Clarifications

- The Regulations clarify that any entity classified as a corporation or partnership for federal income tax purposes is eligible to be treated as a QOF. Thus, a QOF may be organized as a limited liability company.
- The Regulations provide that there is no prohibition on using a pre-existing entity as a QOF (or as a subsidiary entity operating a qualified opportunity zone business) so long as the pre-existing entity satisfies all of the requirements set forth in the Regulations. Nevertheless, even though an entity in existence prior to 2018 may qualify as a QOF, property acquired by such an entity prior to 2018 will not qualify as qualified opportunity zone property.
- The Regulations state that a QOF must be organized in one of the 50 States, the District of Columbia or, if the QOF is organized for the purpose of investing in qualified opportunity zone property that relates to a trade or business operated in U.S. possession, such U.S. possession.
- The Regulations clarify that only equity interests in a QOF (including preferred stock or a partnership interest with special allocations) may qualify for QOZ tax benefits. Thus, a debt instrument cannot be an eligible interest.

Satisfaction of the 90-Percent Asset Test by a QOF

In order to qualify as a QOF, an entity must hold at least 90 percent of its assets in "qualified opportunity zone property" ("QOZ property"). This test (the "90-Percent Asset Test") is applied by taking the average of the percentage of QOZ property held by the QOF (1) on the last day of the first six-month period of the taxable year of the QOF and (2) on the last day of the taxable year of the QOF.

Important Clarifications

For purposes of the 90-Percent Asset Test, the Regulations helpfully adopt a 31-month working capital safe harbor for QOF investments in QOZ businesses that acquire, construct, or rehabilitate tangible business property in a QOZ. The safe harbor allows a QOF, in determining whether a trade or business in which it has invested is a QOZ business, to treat the trade or business's cash, cash equivalents, and debt instruments with a term of 18 months or less as working capital that does not disqualify the trade or business from being a QOZ business so long as:

- there is a written plan that identifies the working capital as held for the acquisition, construction, or substantial improvement of tangible property in a QOZ,
- there is written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets within 31 months of the receipt by the business of the assets, and
- the business substantially complies with the schedule.

We think that the first two of these requirements should not impose significant additional obligations on QOFs or QOF sponsors and are consistent with business plans and construction schedules that are customary in construction projects. However, substantial compliance with the schedule is a point which may require additional guidance because developers may deviate from construction schedules due to events such as force majeure, contractor defaults and customary change orders. While we do not think that the intention was for these events to impact compliance, additional guidance would be useful and we expect comments to request clarification.

- In connection with the 31-month working capital safe harbor for certain financial property, the Regulations provide a much-needed safe harbor for tangible property of a QOZ business. If (i) a business utilizes the working capital safe harbor described directly above, (ii) the tangible property for which the working capital is dedicated is expected to satisfy the necessary requirements to be QOZ business property as a result of the planned expenditure of the working capital assets within the 31 months immediately after the working capital was acquired, and (iii) the working capital assets are actually used in a manner that is substantially consistent with the business's 31-month schedule, then that tangible property is treated as QOZ business property for purposes of determining whether the QOF's interest in the business is QOZ property.
- The Regulations address how the 90-Percent Asset Test is to be applied with respect to an entity's first year as a QOF if the entity elects to become a QOF beginning with a month other than the first month of its first taxable year. In such a case, the testing to be done for the first six-month period occurs at the end of the first six months during the year when the entity was a QOF. If an entity elects to be treated as a QOF beginning in a month after June, the only testing date for the first year of QOF treatment will be at the end of the Dec.
- For example, if a calendar-year entity that was created in January elects to begin treatment as a QOF in April, the first 90-Percent Asset Test testing date is at the end of Sept. (i.e., the end of the first six-month period during which it was treated as a QOF). (There would also be another testing date at the end of Dec.) This could be useful if the QOF would have trouble satisfying the 90-Percent Asset Test if the first testing date were earlier in the year. However, the treatment of the entity in this case as a QOF would not begin until April so that any investment of gain in the QOF made during Jan., Feb. or March would not benefit from the QOZ regime.
- For purposes of the 90-Percent Asset Test, the Regulations require the QOF to use the asset values that are reported on its "applicable financial statement" for the taxable year.[5] If a QOF does not have an applicable financial statement, the Regulations require the QOF to use the cost of its assets. Presumably, the "cost" of an asset is its original acquisition price, and is not reduced by depreciation or otherwise adjusted.

Self-Certification as a QOF

To qualify as a QOF, the applicable entity will need to complete a self-certification form and attach that form to the entity's timely filed (taking extensions into account) federal income tax return for the taxable year. Thus, no pre-approval or action by the IRS is required.

Important Clarification

- Contemporaneous with the issuance of the Regulations, the IRS released Form 8996 (Qualified Opportunity Fund), as well as instructions to that form, to be used by QOFs both for initial self-certification and for annual reporting of compliance with the 90-Percent Asset Test. It is expected that Form 8996 will be attached to the QOF's federal income tax return for the relevant tax years.

Part V – QOZ Property

QOZ property means any of the following: (1) qualified opportunity zone business property ("QOZ business property;") (2) qualified opportunity zone stock ("QOZ stock;") and (3) qualified opportunity zone partnership interests ("QOZ partnership interests.") The rules and definitions relevant to determining what constitutes QOZ property are described directly below.

QOZ Business Property

QOZ business property is tangible property used in a trade or business of a QOF if (i) such property was acquired by the QOF by purchase from an unrelated party after Dec. 31, 2017, (ii) either the "original use" of such property in the QOZ commences with the QOF or the QOF "substantially improves the property" and (iii) during substantially all of the QOF's holding period for such property, substantially all of the use of such property was in a QOZ. Property shall be treated as substantially improved by the QOF only if, during any 30-month period after the QOF acquires such property, additions to basis with respect to such property in the hands of the QOF exceed an amount equal to the adjusted basis (in the hands of the QOF) of such property at the beginning of such 30-month period.

Important Clarifications

- The Regulations provide that in determining whether a building has been substantially improved, improvements are measured by the QOF's additions to the adjusted basis of the building itself, and not the land on which the building is located. Thus, if a QOF spends $200 to acquire land together with a building on the land, and $120 of the purchase price is allocated to the building and $80 is allocated to the land, the QOF will need to spend more than $120 (and not $200) to substantially improve the property.
- Contemporaneous with the issuance of the Regulations, the IRS released Revenue Ruling 2018-29, which addresses the application of the "original use" and "substantial improvement" requirements to land and structures that are acquired together by a QOF. Of particular importance, the ruling provides:
- The requirement that the original use of tangible property in the QOZ commence with a QOF is not applicable to land on which a building the QOF has acquired is located.
- While not explicitly stated, the ruling indicates that land will constitute a qualifying asset for purposes of the 90-Percent Asset Test as long as the QOF owning the land satisfies the original use or substantial improvement test for a building situated on the land.

QOZ Stock and QOZ Partnership Interests

QOZ stock and QOZ partnership interests are any equity interests issued to a QOF after Dec. 31, 2017, solely in exchange for cash, by an entity classified as a domestic corporation or partnership for federal tax purposes the only trade or business of which is (or will be) a qualified opportunity zone business ("QOZ business") (as described below). As of the time such interests are issued, the issuing partnership or corporation must either conduct a QOZ business or, in the case of a new partnership or corporation, must be organized for purposes of conducting a QOZ business. For the QOZ stock or QOZ partnership interest to retain this designation, the issuing entity needs to be an entity the only trade or business of which is a QOZ business for "substantially all" of the QOF's holding period for such equity interest. The Regulations do not provide any guidance on the meaning of "substantially all" of the QOF's holding period.

QOZ Business

An entity is a "QOZ business" if:

- substantially all of the tangible property owned or leased by such entity is QOZ business property (determined as if such owner were a QOF),
- such entity does not operate, or lease land to, any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises,
- at least 50 percent of the total gross income of such entity is derived from the active conduct of a trade or business in a single QOZ,
- a substantial portion of the intangible property of such entity is used in the active conduct of a trade or business in a single QOZ, and
- less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to "nonqualified financial property" (e.g., stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts and annuities).

For purposes of determining whether an entity satisfies the requirements above, tangible property that ceases to be QOZ business property shall continue to be treated as QOZ business property until the earlier of:

- the five-year anniversary of 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 entity.

Important Clarifications

- In determining whether an entity is a QOZ business, the Regulations provide that if at least 70 percent of the tangible property owned or leased by a trade or business is QOZ business property, then the business will be treated as satisfying the requirement that substantially all of its tangible property consist of QOZ business property. We note, however, that the Regulations did not adopt the same 70 percent standard for the many other uses of the phrase "substantially all" throughout the rules (which the government indicated would be addressed in future guidance).
- The requirements that (x) at least 50 percent of gross income must be derived from the active conduct of a trade or business in the QOZ, and (y) a substantial portion of the intangible property must be used in the active conduct of such trade or business, will be deemed satisfied during the 31-month start-up period if the only income of the business during that period is from working capital.

Part VI – What Comes Next for QOFs?

In issuing the Regulations, the government made clear that it is continuing to work on additional published guidance, including more proposed regulations to be issued in the "near future." The government indicated that it expects the forthcoming proposed regulations to address the following issues:

- the meaning of "substantially all" in each of the various places where it appears in the QOZ provisions (other than as provided above);
- the transactions that may trigger the inclusion of gain that has been deferred under a gain deferral election;
- the "reasonable period" for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty;
- the administrative rules that apply when a QOF fails to maintain the 90-Percent Assets Test; and
- information reporting requirements relating to the QOZ regime.

The government also solicited comments with respect to numerous aspects of the Regulations, as well as other issues relating to QOFs and the QOZ regime. In the meantime, taxpayers generally may rely on the Regulations as long as they do so consistently.

As noted above, notably absent from the Regulations is additional guidance on whether a FMV Basis Election will be available when a QOF disposes of property (rather than the QOF investor selling its QOF interest). While it is possible that future guidance will provide more flexibility with respect to QOF dispositions, challenges continue to exist for using a single QOF to invest in multiple properties given the lack of relief on this issue. Also notable is that the Regulations did not provide relief from the apparent requirement that a QOF invest in property either directly or through first-tier investment entities (and thus the use of more than one level of regarded entities below a QOF to hold operating assets could potentially disqualify the QOF).

Given the scope of the guidance provided by the Regulations (and in particular the manner in which the Regulations addressed land and financial assets held by QOFs), we expect that what has been very keen interest in the QOF program will turn into actual QOF investments and QOZ projects under development. We expect that when investing in QOFs, sponsors and investors will rely on advice from legal and tax practitioners in analyzing the Regulations based on their specific circumstances.

Footnotes
[1] For a general overview of the Qualified Opportunity Zone regime, see our prior client publication dated May 14, 2018 entitled "Opportunity Zones: A Preliminary Examination" available at www.shearman.com.

[2] Throughout this memorandum, parties are "related" to each other if such parties have more than 20 percent common ultimate ownership, or one party directly or indirectly owns more than 20 percent of the equity interests of the other party.

[3] The partner's eligible investment of such capital gain must be made no more than 180 days after the end of the partnership taxable year in which the capital gain was realized. QOFs cannot invest in other QOFs. Thus, under current Treasury guidance, the only way for a partner in a QOF to defer gains recognized by the QOF is to timely make an additional investment of such partner's own cash in that QOF, or another QOF, in either case within the applicable 180-day investment period and before the end of 2026.

[4] REIT status, as compared to partnership status, may result in state or local income tax benefits and may allow non-U.S. investors in the QOF to avoid tax return filing obligations. Furthermore, ordinary REIT dividends entitle shareholders that are U.S. domestic individuals to claim a 20

percent deduction under the Act through 2025.

[5] A taxpayer has an “applicable financial statement” if it has one of the following:

A financial statement that is required to be filed with the Securities and Exchange Commission (SEC);
A financial statement that the taxpayer is required to provide to a federal agency other than the IRS; or
A certified audited financial statement that the taxpayer provides to creditors for purposes of making lending decisions, to equity holders for purposes of evaluating their investment in the taxpayer, or for other substantial non-tax purposes, but only if the taxpayer reasonably anticipates that the statement will be directly relied on for the purposes for which it was provided.

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