Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on the Impact of Proposed Regulations Regarding Investments in Qualified Opportunity Funds Under Section 1400Z-2 on Consolidated Groups

Dear Commissioner Rettig:

Enclosed please find comments supplementing our comments provided on July 1, 2019, on the proposed regulations regarding qualified opportunity funds under section 1400Z-2 of the Internal Revenue Code. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury William M. Paul, Deputy Chief Counsel (Technical), Internal Revenue Service Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury Jeffrey Van Hove, Office of Tax Policy, Department of the Treasury Colin Campbell, Attorney-Advisor, Department of the Treasury Hon. Michael Desmond, Chief Counsel, Internal Revenue Service Robert H. Wellen, Associate Chief Counsel (Corporate), Internal Revenue Service Lisa Fuller, Deputy Associate Chief Counsel (Corporate), Internal Revenue Service Marie Milnes-Vasquez, Special Counsel to the Associate Chief Counsel (Corporate), Internal Revenue Service

Kevin M. Jacobs, Senior Technician Reviewer, Internal Revenue Service
Comments on Proposed Regulations Addressing Issues Related to Consolidated Groups in Section 1400Z-2

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section of Taxation") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Scott M. Levine. Significant contributions were made by William Alexander, Jack Cummings, Alden Dilanni-Morton, Mark R. Hoffenberg, Rebecca J. Holtje, Matthew D. Mosby, William Pauls, Brian Peabody, Ross E. Poulsen, Angela R. Russo, Robert C. Stevenson, Jeffrey L. Vogel, and Dan C. White. They were reviewed by Lisa M. Zarlenga, Chair of the Committee on Government Submissions and Eric B. Sloan, Vice Chair for Government Regulations for the Section of Taxation.

Although members of the Section of Taxation may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

Contacts:  Scott M. Levine
(202) 879-3437
smlevine@jonesday.com

Date:    July 8, 2019
I. Executive Summary

Section 1400Z-2\(^1\) provides special rules for capital gains invested in qualified opportunity zones (within the meaning of section 1400Z-1(a) (“QOZs”)) through a qualifying opportunity fund (within the meaning of section 1400Z-2(d)(1) (a “QOF”)). Section 1400-2 was enacted as part of Public Law 115-97 (the “Act”), enacted on December 22, 2017.\(^2\) On May 1, 2019, the Internal Revenue Service (the “Service”) and the Department of Treasury (“Treasury”) published Proposed Regulations under section 1400Z-2 (the “Proposed Regulations”).\(^3\)

We commend Treasury and the Service for their commitment to providing helpful guidance in an expedited manner. There are, however, certain areas of the Proposed Regulations in which additional clarification would be helpful and portions of the Proposed Regulations that we recommend be reconsidered. To provide context for our recommendations, we summarize section 1400Z-2 in Part II.A of these Comments and summarize the relevant portions of the Proposed Regulations throughout Part II. These Comments supplement comments filed by the Section on July 1, 2019.\(^4\)

Our recommendations are summarized below and discussed in more detail in Part II.C of this letter.

1. Inclusion Events and Distributions

   a. In the interest of simplification and a consistent framework for determining whether there has been an inclusion event, we recommend that all distributions under section 301, all section 302(d) redemptions,\(^5\) section 305(b) distributions, and redemptions of Section 306 Stock treated as distributions under section 301 pursuant to section 306(a)(2) be treated similarly. That is, each distribution or deemed distribution should be an inclusion event only to the extent section 301(c)(3) applies.

   b. Recognizing that in some section 302(d) redemptions, a taxpayer may cease to actually own stock in a QOF C corporation, recommendation #1(a) could be

---

\(^1\) References to a “section” or “I.R.C. §” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and regulation references are to the Regulations promulgated thereunder (the “Regulations” or “Reg. §”), unless otherwise indicated.


\(^4\) ABA Tax Section Comments on Proposed Regulations Regarding Investments in Qualified Opportunity Funds Under Section 1400Z-2, reproduced in ABA Tax Section Suggests Further O-Zone Guidance, 2019 TAX NOTES TODAY129-26 (July 5, 2019).

\(^5\) If recommendation 1(a) is not adopted, we recommend that, at a minimum, section 302(d) redemptions where each shareholder surrenders a pro rata percentage of its shares (pursuant to an overall plan) should not be treated as inclusion events.
adopted with an exception for section 302(d) redemptions in which the taxpayer
ceases to own any direct equity in the QOF C corporation. In such cases, the
redemption would be an inclusion event to the extent of the full amount of the
distribution.

c. We also recommend that Treasury and the Service clarify that stock received in a
section 305(a) redemption is a qualifying investment with the remaining deferred
gain being allocated pro rata between the old stock and the new stock.

2. **Liquidation/Reorganization of QOF Owner**

   We recommend that Treasury and the Service add a rule similar to Proposed
   Regulation section 1.1400Z2(b)-1(c)(6)(ii)(C) clarifying that, following a
   Qualifying Owner Liquidation or Qualifying Owner Reorganization (each term as
   defined in Part II.C.1.a.iii.1 of these comments, the acquiring corporation is
   subject to section 1400Z-2 and the Regulations thereunder to the same extent that
   the original QOF owner or QOF shareholder was before the liquidation or
   reorganization.

3. **QOF Asset Acquisitions and Recapitalizations**

   We recommend that Treasury and the Service create a single inclusion event rule
   applicable to certain reorganizations enumerated in section 381(a)(2) (as modified
   by Proposed Regulation section 1.1400Z(b)-1(a)(2)(xx)), section 368(a)(1)(E)
   reorganizations, and section 1036 transactions.

4. **Mixed Funds**

   We recommend that Treasury and the Service clarify that where a QOF
   shareholder has a pre-existing qualifying investment in a QOF C corporation and
   subsequently makes a non-qualifying investment in that QOF C corporation and
   receives no stock in exchange, such an investment is a mixed fund investment to
   which section 1400Z-2(e)(1) applies. Moreover, we recommend that Treasury
   and the Service clarify that, similar to Proposed Regulation section 1.1400Z2(a)-
   1(b)(10)(i)(3)(D), the basis in the portion of the investment that is a non-
   qualifying investment be determined without regard to section 1400Z-2(b)(2)(B)
   (i.e., the generally applicable rules for determining basis apply to the non-
   qualifying investment).

5. **Interaction with Section 1059**

   a. We recommend that the final Regulations clarify that section 1400Z-2(b)(2)(B)(ii)
      basis adjustments are made only to that portion of the qualifying investment that
      is subject to the inclusion event.

   b. We recommend that the final Regulations either exclude qualifying investments in
      QOF C corporations from the application of section 1059 or adopt the
      coordination rules discussed in Part II.C.2.b.iii of these comments.
6. **Step-Transaction Issues**

We recommend that, similar to other rules, including Proposed Regulation section 1.168(k)-2(b)(3)(iii)(C), Treasury and the Service consider adopting a rule permitting the investor and the QOF/QOZ Business, as applicable, to take into account the steps in the same overall plan in determining whether a sale to a related party, or a purchase from a related party, that becomes unrelated qualifies as an eligible gain or as QOZ Business Property, respectively.

7. **Consolidated Group Issues**

a. We recommend that the final Regulations provide that a QOF C corporation can be a subsidiary member of a consolidated group.

b. If a QOF C corporation cannot be a subsidiary member of a consolidated group, we recommend that a QOF C corporation be permitted to qualify as a subsidiary member of an affiliated group for purposes of its applicable shareholders claiming the 100% dividends received deduction under section 243(a)(3).

c. If a QOF C corporation cannot be a subsidiary member of a consolidated group, we recommend that a QOF C corporation formed prior to the release of the Proposed Regulations be grandfathered and eligible to continue to file as a subsidiary member of a consolidated group.

d. If a preexisting QOF C corporation is not grandfathered, we recommend that Treasury and the Service provide clear rules addressing the tax implications to the QOF C corporation and its shareholders in connection with the deconsolidation, including the application of the investment adjustment rules under Regulation section 1.1502-32, the excess loss account rules under Regulation section 1.1502-19, and the unified loss rules under Regulation section 1.1502-36. We have provided two recommended approaches to take into account these rules: the “Prospective Approach” and the “Retrospective Approach.”

e. We recommend that final Regulations should clarify that, in cases like Example 10 described in Part II.C.5.c.i., the selling member’s deferred gain is redetermined to be excluded from gross income under Regulation section 1.1502-13(c)(6)(ii) and that such excluded amounts be treated as permanently excluded from gross income for purposes of Regulation section 1.1502-32(b)(3)(ii)(A).

f. We recommend that Treasury and the Service should reconsider Proposed Regulation section 1.1400Z2(g)-1(c) and that the final Regulations provide that an eligible taxpayer includes all members of a consolidated group as a single taxpayer when any member recognizes a qualifying capital gain and a timely qualifying QOF investment is made by a member of the same consolidated group. In such a case, the selling member should be deemed to make the qualifying QOF investment and then to sell such investment to the actual investing member in an intercompany sale.
# Table of Contents

I. Executive Summary .................................................................................................................. 2

II. Detailed Discussion .................................................................................................................. 6

A. Background .......................................................................................................................... 6

B. Proposed Regulations .......................................................................................................... 7

C. Comments ........................................................................................................................... 7

1. Corporate-Related Inclusion Events .................................................................................. 7
   a. Inclusion Events ............................................................................................................... 7
   b. Section 1.1400Z-2(e)(1), Mixed Funds ........................................................................ 16

2. Allocation of Deferred Gain and Section 1059 ............................................................... 18
   a. Basis Adjustments Resulting from Inclusion Events ................................................... 18
   b. Interaction of the Proposed Regulations and Section 1059 ........................................ 20

3. Step-Transaction Issues ..................................................................................................... 29
   a. Background ................................................................................................................... 29
   b. Related Person Becomes Unrelated ............................................................................. 29
   c. Unrelated Person or Property Becomes Related ......................................................... 30

4. Excluding QOFs from Consolidated Groups ................................................................. 31
   a. Introduction .................................................................................................................... 31
   b. Issues Relating to a QOF C Corporation as a Subsidiary Member of a Consolidated Group .................................................................................................................. 31

5. Consolidated Intercompany Transactions and Investment Adjustment Rule Guidance in the Proposed Regulations ................................................................. 47
   a. Regulation Section 1.1502-13: Intercompany Transaction Rules Generally ............ 48
   b. The Consolidated Investment Adjustment Regulations Generally .......................... 51
   c. Interaction of the Proposed Regulations with the Intercompany Transaction and Investment Adjustment Regulations ................................................................. 52
   d. Capital Gain and QOF Investment by Different Members ....................................... 55
II. Detailed Discussion

A. Background

Newly enacted sections 1400Z-1 and 1400Z-2 provide a regime that enables a taxpayer to defer and, in some cases, eliminate tax liability by investing in a QOF (the “Opportunity Zone Regime”). This regime was intended to encourage investment in QOZs in order to “help revitalize economically distressed communities which suffer from a lack of investment and business growth.” Accordingly, QOZs are designated in low-income communities within the meaning of section 1400Z-1(c)(1) by the chief executive officer of the state, territory, or possession in which the community exists.

Under the Opportunity Zone Regime, eligible taxpayers with eligible gains that make qualifying investments in QOFs within 180 days of the realization of their eligible gain may (i) defer recognition of the eligible gain until the earlier of (a) the sale or exchange of the qualifying investment or (b) December 31, 2026; (ii) avoid recognition of up to 15% of the eligible gain; and (iii) avoid recognition of gain on appreciation of the qualifying investment. To make a qualifying investment, the taxpayer must (i) realize a capital gain from the sale of property to an unrelated person; (ii) within 180 days of such sale, invest an amount equal to such gain in a QOF; and (iii) elect to treat such investment as an opportunity zone investment.

A QOF is any investment vehicle organized as a corporation or partnership for the purpose of investing in qualified opportunity zone property within the meaning of section 1400Z-2(d)(2) other than another QOF (“QOZ Property”), provided that such investment vehicle holds at least 90% of its assets in QOZ Property as determined by the average of the percentages on (A) the last day of the first six-month period of the taxable year, and (B) the last day of the taxable year.

QOZ Property is property that is either (i) qualified opportunity zone stock within the meaning of section 1400Z-2(d)(2)(B) (“QOZ Stock”); (ii) qualified opportunity zone partnership interest within the meaning of section 1400Z-2(d)(2)(C) (“QOZ Partnership Interest”); or (iii) qualified opportunity zone business property within the meaning of section 1400Z-2(d)(2)(D) (“QOZ Business Property”).

Broadly speaking, QOZ Stock is stock acquired by the QOF after December 31, 2017 at original issue solely in exchange for cash, if that stock is in a domestic corporation that, when the stock was issued, was a qualified opportunity zone business within the meaning of section

---

7 I.R.C. § 1400Z-1(a)-(b). See also Notice 2018-48, 2018-28 I.R.B. 9. Section 1400Z-1(e) provides that a limited number of census tracts that do not qualify as low-income communities may be designated as QOZs if they are contiguous to a designated low-income community. Despite some technical inconsistencies in the statute that result from this provision, Notice 2018-48 seems clearly to indicate the Service’s intention to treat such census tracts as QOZs.
8 For the purposes of this section, persons are related if such persons are described by section 267(b) or 707(b)(1), with “20 percent” substituted for “50 percent” each place it occurs in such sections. I.R.C. § 1400Z-2(e)(2).
1400Z-2(d)(3)(A) (a “QOZ Business”), and that qualified as a QOZ Business during substantially all of the QOF’s holding period for such stock.\(^\text{12}\) Similarly, a QOZ Partnership Interest is any capital or profits interest in a domestic partnership acquired by the QOF after December 31, 2017 from the partnership in exchange for cash, if at the time such partnership was a QOZ Business and qualified as a QOZ Business during substantially all of the QOF’s holding period for such interest.\(^\text{13}\) Finally, QOZ Business Property is tangible property used in the trade or business of the QOF and acquired by purchase (within the meaning of section 179(d)(2)) after December 31, 2017, if such property was either used for the first time in a QOZ by the QOF or substantially improved (within the meaning of section 1400Z-2(d)(2)(D)(ii)) by the QOF, and if substantially all use of such property was in a QOZ during substantially all of the QOF’s holding period for such property.\(^\text{14}\)

B. Proposed Regulations

On October 29, 2018, Treasury and the Service published its first notice of proposed rulemaking relating to gains that may be deferred as a result of a taxpayer’s investment in a QOF and the requirements to qualify as a QOF or a QOZ Business. On May 1, 2019, Treasury and the Service published a second notice of proposed rulemaking supplementing the rules contained in the first notice of proposed rulemaking and also addressing inclusion events, special rules for an investment in a QOF held by a taxpayer for at least ten years, as well as consolidated return issues (i.e., the Proposed Regulations). We discuss the Proposed Regulations, as relevant to our Comments, in detail below in Part II.C.

C. Comments

1. Corporate-Related Inclusion Events

a. Inclusion Events

i. Proposed Regulation Section 1.1400Z2(b)-1(c)(1), General Inclusion Event Rule

Proposed Regulation section 1.1400Z2(b)-1(c)(1) provides three general circumstances giving rise to an inclusion event requiring a taxpayer to take into account some or all of its gain deferred pursuant to an election under section 1400Z-2(a). First, to the extent that “[a] taxpayer’s transfer of a qualifying investment reduces the taxpayer’s equity interest in the qualifying investment” such transfer is an inclusion event.\(^\text{15}\) Second, to the extent that “[a] taxpayer receives property in a transaction that is treated as a distribution for Federal income tax purposes,” such receipt is an inclusion event even if the receipt does not reduce the taxpayer’s ownership of the QOF.\(^\text{16}\) Third, to the extent a taxpayer claims a worthless stock deduction with


\(^{13}\) I.R.C. § 1400Z-2(d)(2)(C).


\(^{15}\) Prop. Reg. § 1.1400Z2(b)-1(c)(1)(i).

\(^{16}\) Prop. Reg. § 1.1400Z2(b)-1(c)(1)(ii).
respect to its qualifying investment, such deduction is an inclusion event. Each of these rules is limited to the extent otherwise set forth in Proposed Regulation section 1.1400Z2(b)-1(c).

The first inclusion event rule could be read as indicating that so long as the taxpayer retains an equity interest (direct or indirect) in a qualifying investment after a transfer there is no inclusion event. However, the preamble to the Proposed Regulations (“Preamble”) indicates that Treasury and the Service intended the rule to define an inclusion event to include any reduction in a taxpayer’s direct interest in a qualifying investment other than in the case of partnerships and to make clear that an inclusion event may not be avoided by the retention of an indirect interest (other than in the case of a partnership). If this was the intention of Treasury and the Service, we recommend that the language of the final Regulation be clarified to reflect that intent.

ii. Distributions

1) In General

Distributions of property by a QOF C corporation are subject to multiple inclusion event determination rules under the Proposed Regulations. Proposed Regulation section 1.1400Z2(b)-1(c)(1)(ii) provides the general inclusion event rule for distributions: a taxpayer has an inclusion event if and to the extent that it receives property in a transaction that is treated as a distribution for U.S. federal income tax purposes, whether or not the receipt reduces the taxpayer’s ownership of the QOF. Proposed Regulation section 1.1400Z2(b)-1(c)(8) then provides a more specific rule that a distribution of property by a QOF C corporation with respect to a qualifying investment is an inclusion event only to the extent section 301(c)(3) applies to the distribution. In the Preamble, Treasury and the Service explain:

A distribution to which section 301(c)(3) applies results in inclusion because that portion of the distribution is treated as gain from the sale or exchange of property. Actual

17 Prop. Reg. § 1.1400Z2(b)-1(c)(1)(iii).

18 See, e.g., Preamble at 18,662 (“Each …transaction[ ] would be an inclusion event because each would reduce or terminate the QOF investor’s direct (or, in the case of partnerships, indirect) qualifying investment for Federal income tax purposes or (in the case of distributions) would constitute a ‘cashing out’ of the QOF investor’s qualifying investment.”). The Preamble also states that “[a]ctual distributions treated as dividends under section 301(c)(1) are not inclusion events because such distributions neither reduce a QOF shareholder’s direct equity investment in the QOF nor constitute a ‘cashing out’ of the QOF shareholder’s equity investment in the QOF.” Id. (emphasis added). With respect to redemptions under section 302(d), the Preamble states that it is necessary to treat the full amount of the redemption as an inclusion event “[o]therwise, such a redemption could reduce a shareholder’s direct equity investment without triggering an inclusion event ….” Id. (emphasis added). Similarly, with respect to section 351 exchanges, the Preamble states “[t]he transfer by a QOF owner of its qualifying QOF stock or qualifying QOF partnership interest in a section 351 exchange generally would be an inclusion event under the proposed regulations, because the contribution would reduce the QOF owner’s direct interest in the QOF.” Id. (emphasis added).

19 Section 301(c)(1) provides that, to the extent of the distributing corporation’s earnings and profits, the amount of the distribution will be considered a dividend. Next, section 301(c)(2) provides that the distribution amount in excess of the dividend amount will be a return of basis to the shareholders to the extent of the shareholders’ basis in their distributing corporation stock. Lastly, section 301(c)(3) provides that, to the extent the distribution amount is not covered by section 301(c)(1) or (2), the remaining amount of the distribution in excess of basis will be treated as gain from the sale or exchange of property.
distributions treated as dividends under section 301(c)(1) are not inclusion events because such distributions neither reduce a QOF shareholder’s direct equity investment in the QOF nor constitute a ‘cashing out’ of the QOF shareholder’s equity investment in the QOF. In turn, actual distributions to which section 301(c)(2) applies are not inclusion events because the reduction of basis under that statutory provision is not treated as gain from the sale or exchange of property.  

Other Code sections treat transactions as distributions under section 301. For example, in a section 305(b) distribution, a shareholder generally receives a distribution of additional shares of stock of the distributing corporation that has a disproportionate effect (e.g., some shareholders receive cash and some receive stock, or some receive common stock and some receive preferred stock). Such a distribution is treated as a distribution of property to which section 301 applies. Another example is a section 302(d) transaction, in which a corporation redeems its stock from a shareholder in exchange for property and that redemption is more like a dividend than an exchange. Similarly, if the disposition of section 306 stock within the meaning of section 306(c) (“Section 306 Stock”) is a redemption, the amount realized is treated as a distribution of property to which section 301 applies. The Proposed Regulations contain a number of rules addressing distributions and redemptions by corporations; those rules do not treat all distributions and redemptions consistently or address all distributions treated as section 301 distributions. For the reasons discussed below and in the interest of simplifying the framework for identifying inclusion events, we recommend that, to the greatest extent possible, a single rule apply to section 301 distributions and transactions treated as section 301 distributions.

2) Treatment of Distributions under Section 305 and Redemptions of Section 306 Stock

For purposes of determining whether and the extent to which there is an inclusion event, the Proposed Regulations treat section 305(b) distributions of stock as inclusion events subject to the general rules applicable to distributions (i.e., only the portion of the distribution subject to section 301(c)(3) is an inclusion event). Treasury and the Service have requested comments as to whether a distribution of stock by a QOF that is treated as a distribution of property to which section 301 applies under section 305(b) should be inclusion events even though such distribution does not reduce the recipient’s interest in the QOF.

While a distribution of stock under section 305(b) generally results in an increase in a shareholder’s interest in the corporation, there is an argument that there has been a cashing out of the shareholder’s interest in the corporation and thus, section 305(b) distributions should be treated the same as other section 301 distributions. That is, if the distributing corporation had distributed cash instead of stock and then the distributee had reinvested that cash in stock of the distributing corporation (assuming the form of such a transaction were respected), to the extent

---

20 Preamble at 18,666.
21 I.R.C. § 306(a)(2). Section 306 Stock is defined generally as stock that was received as part of a nonrecognition transaction, including a stock dividend under section 305(a), a tax-free reorganization or spin-off, or a transaction in which the shareholder receives a transferred or substituted basis. I.R.C. § 306(c).
22 Prop. Reg. § 1.1400Z2(b)-1(c)(8).
23 Preamble at 18,666.
section 301(c)(3) applied to the cash distribution, there would be a cashing out as contemplated by the Proposed Regulations. Under this view, the fact that the cash distribution has been bypassed arguably should not result in section 305(b) distributions being treated differently from section 301 distributions for purposes of identifying an inclusion event. Accordingly, we agree that section 305(b) distributions be included as distributions subject the rule in Proposed Regulation section 1.1400Z2(b)-1(c)(8).

While Proposed Regulation section 1.1400Z2(b)-1(c)(8) includes section 305(b) distributions in its purview, no similar rule is provided for redemptions subject to section 306(a)(2). Section 306(a) generally treats a sale or redemption of Section 306 Stock as ordinary income or as a distribution under section 301. Of particular relevance, section 306(a)(2) provides that where Section 306 Stock is redeemed, the amount of consideration received in the redemption is treated as a distribution of property to which section 301 applies. Section 306 Stock includes stock (other than common stock issued with respect to common stock) received in a section 305(a) distribution (i.e., a distribution of stock of a corporation by that corporation to its shareholders that is not included in gross income). Where stock is received in a section 305(a) distribution, the basis of the new stock received and the stock with respect to which the distribution is made (the “old stock”) is determined by allocating the basis of the old stock between the old stock and the new stock in proportion to fair market value. The holding period for the new stock received in a section 305(a) distribution is the same as the holding period for the old stock.

There are no rules in the Proposed Regulations that alter the general basis or holding period rules for new stock received in a section 305(a) distribution with respect to qualifying QOF stock. We would expect, however, that the new stock received in such a distribution is also qualifying QOF stock given that the basis and holding period are determined by reference to the basis and holding period of the old stock. However, the Proposed Regulations do not specify that stock received in a section 305(a) distribution with respect to qualifying QOF stock is qualifying QOF stock. We recommend that Treasury and the Service clarify that stock received in a section 305(a) distribution with respect to qualifying QOF stock is also qualifying QOF stock.

If Treasury and the Service determine that stock received in a section 305(a) distribution with respect to qualifying QOF stock is qualifying QOF stock, then we also recommend that Treasury and the Service clarify that a redemption of Section 306 Stock treated as a distribution to which section 301 applies under section 306(a)(2) is subject to the general rules applicable to section 301 distributions under Proposed Regulation section 1.1400Z2(b)-1(c)(8).

---

24 We note that such treatment is still eligible for section 1(h)(11) treatment provided its requirements are otherwise satisfied.
26 Reg. § 1.307-1(a).
27 I.R.C. § 1223(4).
3) Treatment of Section 302 Redemptions under the Proposed Regulations

The Proposed Regulations apply disparate treatment to section 301 distributions and section 302(d) redemptions. Specifically, Proposed Regulation section 1.1400Z2(b)-1(c)(9)(i) provides that a transaction described in section 302(d) generally is an inclusion event with respect to the full amount of the distribution; however, if all the stock in a QOF is held directly by a single shareholder (or directly by members of the same consolidated group) and if shares are redeemed in a transaction to which section 302(d) applies, then the general rule applicable to distributions in Proposed Regulation section 1.1400Z2(b)-1(c)(8) applies (i.e., the redemption is an inclusion event only to the extent the redemption is treated as a distribution under section 301(c)(3)).

Treasury and the Service explain the need for such dissimilar treatment as follows:

Otherwise, such a redemption could reduce a shareholders’ direct equity investment without triggering an inclusion event (if the full amount of the redemption proceeds is characterized as either a dividend or the recovery of basis). However, there are circumstances in which the shareholder’s interest in the QOF is not reduced by a redemption (for example, if the shareholder wholly owns the distributing corporation).

We acknowledge that a section 302(d) redemption technically reduces a taxpayer’s direct equity interest. Nevertheless, the Code does not treat such reductions as rising to a level meriting treatment as a sale or exchange nor as automatically generating capital gain; instead the Code treats such redemptions as the equivalent of a section 301 distribution. Moreover, as with a section 301 distribution, unless a section 302(d) redemption results in a section 301(c)(2) distribution, there is no change in the redeemed shareholder’s basis. As a result, the taxpayer should still be able to track its deferred gain with respect to any retained stock.

Moreover, we appreciate Treasury and the Service’s aim to ensure that all transactions resulting in any reduction in direct equity interest (other than with respect to reductions in partnership interests) are inclusion events. However, the result is that transactions that are otherwise subject to similar treatment under the Code are subject to a variety of different rules for purposes of identifying inclusion events. This disparate treatment creates complexity in the Proposed Regulations and may present traps for the unwary and opportunities for inappropriate tax planning. Moreover, Congress chose to treat transactions under section 302(d) as distributions under section 301 because there was an insufficient relinquishment in ownership of

29 Preamble at 18,666.
30 Regulation section 1.302-2(c) provides that “[i]n any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed.” Regulation section 1.302-2(c), Ex. (1) illustrates a “proper adjustment” by concluding that following a redemption under section 302(d), the shareholder’s basis in the redeemed shares is added to the basis of the shareholder’s retained shares. The outcome is less clear where the shareholder does not actually hold any shares following a section 302(d) redemption. See Reg. § 1.302-2(c), Ex. (2); Notice 2001-45, 2001-2 C.B. 129; Prop. Reg. § 1.302-5, REG-14368607, 2009-1 C.B. 579 (withdrawn by 84 Fed. Reg. 11,686 (March 28, 2019)).
the corporation to merit sale or exchange treatment. For the same reasons, all section 302(d) redemptions should be treated the same as section 301 distributions for purposes of identifying inclusion events. Accordingly, we recommend that all section 302(d) redemptions be subject to the rules applicable to section 301 distributions in Proposed Regulation section 1.1400Z2(b)-1(c)(8).

4) Recommendations

In the interest of simplification and a consistent framework for determining whether there has been an inclusion event, we recommend that all distributions under section 301, all section 302(d) redemptions, section 305(b) distributions, and redemptions of Section 306 Stock treated as distributions under section 301 pursuant to section 306(a)(2) be treated similarly. That is, each distribution or deemed distribution should be an inclusion event only to the extent section 301(c)(3) applies.

Recognizing that in some section 302(d) redemptions, a taxpayer may cease to actually own stock in a QOF C corporation, the foregoing recommendation could be adopted with an exception for section 302(d) redemptions in which the taxpayer ceases to own any direct equity in the QOF C corporation. In such cases, the redemption would be an inclusion event to the extent of the full amount of the distribution.

We also recommend that Treasury and the Service clarify that stock received in a section 305(a) redemption is a qualifying investment with the remaining deferred gain being allocated pro rata between the old stock and the new stock.

iii. Proposed Regulation Section 1.1400Z2(b)-1(c)(2)(ii) and (10)(ii), Liquidation or Reorganization of QOF Owner

1) In General

Proposed Regulation section 1.1400Z2(b)-1(c)(2)(ii)(B) provides that a liquidation of a QOF owner is not an inclusion event to the extent that section 337(a) applies (i.e., the liquidating distribution is a non-recognition event for the liquidating corporation) (such liquidation, a “Qualifying Owner Liquidation”). Similarly, Proposed Regulation section 1.1400Z2(b)-1(c)(10)(ii)(A) and (B) provides that “a qualifying section 381 transaction in which the assets of a QOF shareholder are acquired is not an inclusion event with respect to the qualifying investment” so long as the QOF shareholder’s entire qualifying investment is acquired. Relevant for these purposes, a qualifying section 381 transaction includes an acquisition of the assets of the QOF shareholder (other than by a QOF) in a reorganization within the meaning of section 368(a)(1)(A), (C), (D), or (F) so long as the reorganization does not result in a QOF owning an investment in another QOF (such reorganizations, “Qualifying Owner Reorganizations”).

---

31 If this recommendation is not adopted, we recommend that, at a minimum, section 302(d) redemptions where each shareholder surrenders a pro rata percentage of its shares (pursuant to an overall plan) should not be treated as inclusion events.

There is no rule similar to Proposed Regulation section 1.1400Z2(b)-1(c)(6)(ii)(C) for Qualifying Owner Liquidations or Qualifying Owner Reorganizations. As a result, a mechanism is needed to clarify that the acquiring corporation in these transactions is subject to section 1400Z-2 and the Regulations thereunder to the same extent that the original QOF owner was prior to the liquidation or reorganization.33

2) Recommendation

We recommend that Treasury and the Service add a rule similar to Proposed Regulation section 1.1400Z2(b)-1(c)(6)(ii)(C) clarifying that following a Qualifying Owner Liquidation or Qualifying Owner Reorganization, the acquiring corporation shall be subject to section 1400Z-2 and the Regulations thereunder to the same extent that the original QOF owner or QOF shareholder was prior to the liquidation or reorganization.

iv. Proposed Regulation Section 1.1400Z2(b)-1(c)(10) and (12), QOF Asset Acquisitions and Recapitalizations

1) In General

The Proposed Regulations provide one set of inclusion event rules regarding certain reorganizations enumerated in section 381(a)(2), as modified by Proposed Regulation section 1.1400Z(b)-1(a)(2)(xx) (“Qualifying Section 381 Transactions”),34 and another for section 368(a)(1)(E) reorganizations (“E Reorganizations”)35 and section 1036 transactions.36 We recommend creating a single rule applicable to all such transactions.

2) Proposed Regulation Section 1.1400Z2(b)-1(c)(10)(i)(A), QOF Asset Acquisitions

Proposed Regulation section 1.1400Z2(b)-1(c)(10)(i)(A) provides that a transaction generally is not an inclusion event (a “Qualifying QOF Reorganization”) if the assets of a QOF C corporation are acquired in a Qualifying Section 381 Transaction by an acquiring corporation that is a QOF immediately after the acquisition. Boot received in a Qualifying QOF Reorganization may result in an inclusion event, but disparate treatment applies depending on

---

33 We note that Proposed Regulation section 1.1400Z2(b)-1(c)(6)(ii)(C) provides that “a merger or consolidation of a partnership holding a qualifying investment, or of a partnership that holds an interest in such partnership solely through one or more partnerships, with another partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event.” In this situation, the resulting partnership becomes subject to section 1400Z-2 and the Regulations thereunder to the same extent that the original partnership was so subject.

34 For example, a Qualifying Section 381 Transaction does not include an acquisition of assets of a QOF by a QOF shareholder that holds a qualifying investment in the QOF or vice versa, an acquisition of assets of a QOF by a tax-exempt entity or a cooperative, or a triangular reorganization.

35 Section 368(a)(1)(E) provides that a reorganization includes a recapitalization.

36 Section 1036(a) provides that “no gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.”
whether the same shareholder (or members of the same consolidated group) owns all of the stock of the QOF and the acquiring corporation.

Specifically, if all stock in both the target QOF C corporation and the acquiring corporation are held directly by a single shareholder (or directly by members of the same consolidated group) and if the shareholder(s) receives boot with respect to its qualifying investment in the Qualifying QOF Reorganization, for purposes of determining the amount of inclusion, the boot is treated as a separate transaction to which section 301 applies. As a result, there is only an inclusion event to the extent the distribution would be treated as a distribution under section 301(c)(3). If stock in the QOF C corporation and the acquiring corporation are not held by the same shareholder (or members of the same consolidated group) and the shareholders receive boot with respect to their qualifying investment in the Qualifying QOF Reorganization, for purposes of determining the amount of the inclusion event, Proposed Regulation section 1.1400Z2(b)-1(c)(10)(i)(C)(1) provides:

- If the taxpayer realizes a gain on the transaction, the amount that gives rise to the inclusion event is the amount of gain under section 356 that is not treated as a dividend under section 356(a)(2).
- If the taxpayer realizes a loss on the transaction, the amount that gives rise to the inclusion event is an amount equal to the fair market value of the boot received.

As with redemptions under section 302(d), the creation of two different rules applicable to similar transactions (i.e., reorganizations where the target and acquirer are wholly owned by the same shareholder versus all other reorganizations), seems unnecessarily complicated. While boot received in a Qualifying QOF Reorganization of a QOF held directly by a single shareholder (or directly by members of the same consolidated group) may be more likely to be treated as a dividend under section 356(a)(2), that likelihood does not seem to necessitate two separate sets of rules which adds complexity and creates traps for the unwary and opportunities for inappropriate tax planning.

3) Proposed Regulation Section 1.1400Z2(b)-1(c)(12), Recapitalizations

Where a QOF C corporation undergoes an E Reorganization or engages in a transaction under section 1036, there will not be an inclusion event unless the transaction has the result of decreasing the taxpayer’s proportionate interest in the QOF (such a transaction where there is no reduction in interest, a “Qualifying Recapitalization”). Where, however, a taxpayer receives property or boot in a Qualifying Recapitalization, there is an inclusion event. If property is

---

37 Prop. Reg. § 1.1400Z2(b)-1(c)(10)(i)(C)(2); see also Prop. Reg. § 1.1400Z2(b)-1(c)(8).

38 For the same reasons as discussed in footnote 31 relating to section 302(d) redemptions, in the event that our recommendation is not adopted, we believe that, at a minimum, reorganizations where the shareholder owns both target and acquirer in the same proportion should also not be treated as inclusion events.


treated as received in a distribution to which section 301 applies, the property is subject to the inclusion event rules applicable to distributions in Proposed Regulation section 1.1400Z2(b)-1(c)(8). If boot is received in a Qualifying Recapitalization and treated as though section 356 applies, the rules applicable to the receipt of boot in a Qualifying QOF Reorganization under Proposed Regulation section 1.1400Z2(b)-1(c)(10) apply (including rules applicable in situations in which the QOF is wholly and directly owned by a single shareholder or by multiple members of the same consolidated group).

There is no explanation as to why a separate set of rules effectively reaching the same result is needed for Qualifying Section 381 Transactions on the one hand and Qualifying Recapitalizations on the other; a single set of rules could apply.

The only difference between the two sets of rules appears to be that a reduction in the shareholder’s proportionate interest in a Qualifying Recapitalization is treated as an inclusion event. A reduction of a shareholder’s proportionate interest is just as likely in the context of a Qualifying Recapitalization as in a Qualifying QOF Reorganization; however, the Proposed Regulations do not treat Qualifying QOF Reorganizations as inclusion events unless boot is received. If there is a reduction in a taxpayer’s proportionate interest in a corporation in an E Reorganization or a section 1036 exchange that is not a Qualifying Recapitalization, the taxpayer is likely to receive consideration in exchange for its reduction in interest (i.e., boot) and thus, if treated similarly to Qualifying QOF Reorganizations, the boot rules would apply to require an inclusion. If the taxpayer does not receive some amount as consideration for the lack of fair market value exchange, U.S. federal income tax principles will generally attempt to provide an explanation for the value shift (e.g., the shareholder received fair market value and then made a gift to the other shareholder(s)) and the shareholder should have an inclusion event as a result of the deemed transaction. As a result, in our view it is unnecessary to treat Qualifying Recapitalizations as separate inclusion events unless boot or property is received or deemed received.

---

41 For example, Shareholder A owns 100% of QOF C corporation, Q. A’s Q stock has a fair market value of $100. In a Qualifying Section 381 Transaction, Q merges into Corporation R, which is a QOF C corporation immediately after the merger. In the merger, A receives solely R stock constituting a 15% interest in R. However, because the merger is a Qualifying Section 381 Transaction and the acquiring corporation is a QOF immediately after the acquisition, the transaction is not an inclusion event. Prop. Reg. § 1.1400Z2(b)-1(c)(10)(i)(A).

42 See Rev. Rul. 74-269, 1974-1 C.B. 87 (with respect to an exchange of common for preferred stock, the Service explained that “if [the majority shareholder] receives shares of preferred stock having a fair market value in excess of the fair market value of the common stock surrendered, or surrenders shares of common stock having a fair market value in excess of the fair market value of the preferred stock received, the amount representing such excess will be treated as having been used to make gifts, pay compensation, satisfy obligations of any kind, or for whatever purpose the facts indicate.”); Rev. Rul. 1958-614, 1958-2 C.B. 920 (in ruling that a remaining shareholder of a corporation does not receive a constructive dividend by way of enhancement in the value of his stock as a result of a purchase by the corporation of another shareholder’s stock, the Service explained that “[i]n these transactions, if a shareholder surrenders stock to a corporation for less than its fair market value, such surrender may be gift or compensation to the shareholders who remain interested in the corporation. Conversely, if a corporation pays more than fair market value for its stock, the payment may be compensation to the shareholder surrendering stock or may be a gift to him from the shareholders who remain interested in the corporation.”).
4) Recommendation

In the interest of simplification and because there does not appear to be a compelling policy reason for treating Qualifying QOF Reorganizations differently from Qualifying Recapitalizations, we recommend that a single rule address these three categories of transactions. We recommend revising the definition of transactions subject to Proposed Regulation section 1.1400Z-1(c)(10) to include E Reorganizations and section 1036 exchanges. This would require broadening and perhaps changing the defined term “Qualifying Section 381 Transactions” (e.g., changing term to “Permitted Reorganizations” or “Qualifying Reorganizations”). In connection with this revision, we recommend that, like Qualifying QOF Reorganizations, E Reorganizations and section 1036 transactions should not be inclusion events unless boot is received. If boot is received in an E Reorganization or section 1036 transaction, then the same rules applicable to Qualifying QOF Reorganizations in which boot is received would apply. If boot is received in connection with an E Reorganization or section 1036 transaction and is subject to section 301, such property would be analyzed as an inclusion event under the rules applicable to distributions in Proposed Regulation section 1.1400Z2(b)-1(c)(8).

In addition, for the reasons discussed above, we recommend that all Qualifying QOF Reorganizations involving boot be subject to a rule similar to that in Proposed Regulation section 1.1400Z2(b)-1(c)(10)(i)(C)(1).

b. Section 1.1400Z-2(e)(1), Mixed Funds

i. In General

Section 1400Z-2(e)(1) provides that in the case of an investment in a QOF only a portion of which consists of investments of gain to which an election to defer gain under section 1400Z-2(a) is in effect (such an investment a “mixed fund investment”), such mixed fund investment is treated as two separate investments, consisting of (i) one investment that includes only amounts to which the election under section 1400Z-2(a) applies, and (ii) a separate investment consisting of other amounts.\(^{43}\)

Proposed Regulation section 1.1400Z2(a)-1(b)(10)(i)(3)(D) provides that if a taxpayer’s investment in a QOF is a mixed fund investment, the taxpayer’s basis in the non-qualifying investment is equal to the taxpayer’s basis in all of the QOF interests received, determined without regard to the rules for determining basis of a qualifying investment, and reduced by the basis of the taxpayer’s investment in the qualifying investment, determined without regard to section 1400Z-2(b)(2)(B). That is, the basis for the non-qualifying investment is determined by applying the generally applicable basis rules to all investments and then subtracting the amount of basis that the qualifying investment would have without regard to section 1400Z-2 and the applicable Regulations.

Where a taxpayer’s initial investment is only partially from gain to which an election under section 1400Z-2(a) applies, there is a mixed fund investment subject to the rules of section 1400Z-2(e)(1). Where, however, a QOF shareholder has a pre-existing interest in a QOF C

\(^{43}\) Section 1400Z-2(a), (b), and (c) only apply to the investment in clause (A)(i). I.R.C. § 1400Z-2(e)(1)(B).
corporation and later makes an additional non-qualifying investment in the QOF, but does not receive additional stock in exchange (e.g., where receipt of stock would be a meaningless gesture), it is unclear whether the shareholder’s investment in the QOF becomes a mixed fund investment subject to section 1400Z-2(e)(1). We recommend that the treatment should be clarified.

To illustrate the need for clarification, consider the following example:

**Example 1:** On May 31, 2019, A sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A transfers $500 to newly formed Q, a QOF corporation, in exchange for 100% of the Q stock, which is a qualifying investment. On June 1, 2020, A transfers $200 to Q as a capital contribution. On December 31, 2020, A sells 50% of its Q stock to B, an unrelated person, for $350.

If the $200 contribution is not a mixed fund investment and increases A’s basis in the Q stock, then A may be able to reduce its inclusion amount. That is, A’s basis in the Q stock as of December 31, 2020 would be $200. Under Proposed Regulation section 1.1400Z2(b)-1(e)(1), when A sells 50% of its Q stock to B, A would include in income the amount equal to the lesser of (i) $350 (i.e., the amount realized) or (ii) $250 (i.e., $500 x $350/700) minus, with respect to both (i) and (ii), $100 (the basis in the portion of the qualifying investment that is disposed of in the inclusion event). Thus, A’s inclusion amount would be $150.

If A’s investment is a mixed fund investment, then A’s investment could be treated as two separate investments under section 1400Z-2(e)(1). Under such an interpretation, A’s recovery of its $200 of basis relating to its capital contribution could occur under a pro rata approach. Under such an approach, the basis in A’s qualifying investment would be determined under section 1400Z-2(b)(2)(B), the basis in A’s non-qualifying investment would be determined under the generally applicable basis rules, and then the sale proceeds would be allocated pro rata between each block or segment. Under this pro rata approach, approximately 71.5% of A’s Q stock sold would be allocated to A’s qualifying investment shares and approximately 28.5% of A’s Q stock sold would be allocated to A’s non-qualifying investment shares. With respect to the qualifying investment shares, under Proposed Regulation section 1.1400Z2(b)-1(e)(1), A would include in income the amount equal to the lesser of (i) $250 (i.e., 71.5% of the amount realized) or (ii) $250 ($500 x $250/500, i.e., the fair market value of the qualifying investment that is disposed of divided by the fair market value of the total qualifying investment) minus $0 (the basis in the portion of the qualifying investment that is disposed of in the inclusion event). Thus, A’s inclusion amount would be $250. With respect to the non-qualifying investment shares, A would include in income an amount equal to $100 (i.e., approximately 28.5% of the $350 realized) minus $100 (i.e., 50% of $200 basis allocated to the non-qualifying investment shares. Thus, with respect to the non-qualifying investment shares, A would not recognize any gain or loss.

---

44 Although other approaches may exist, the pro rata approach appears closest to the general stock basis rules under Regulation section 1.358-2 and is also consistent with a similar approach applied to QOF partnerships in Proposed Regulation section 1400Z2(b)-1(b)(10)(ii).
ii. **Recommendations**

We recommend that Treasury and the Service clarify that where a QOF shareholder has a pre-existing qualifying investment in a QOF C corporation and subsequently makes an additional non-qualifying investment and receives no stock in exchange, such an investment is a mixed fund investment to which section 1400Z-2(e)(1) applies. Moreover, we recommend that Treasury and the Service clarify that similar to Proposed Regulation section 1.1400Z2(a)-1(b)(10)(i)(3)(D), the basis in the portion of the investment that is a non-qualifying investment be determined without regard to section 1400Z-2(b)(2)(B) (*i.e.*, the generally applicable rules for determining basis apply to the non-qualifying investment).

2. **Allocation of Deferred Gain and Section 1059**

   a. **Basis Adjustments Resulting from Inclusion Events**

      i. **Discussion**

      Section 1400Z-2(b)(2)(B)(ii) generally provides that a taxpayer’s basis in its investment in a QOF is increased by the amount of gain recognized by reason of an inclusion event. Proposed Regulation section 1.1400Z2(b)-1(g)(1)(i) provides a general ordering rule with respect to such a basis adjustment:

      First. Deferred gain to be recognized as a result of the inclusion event is determined under section 1400Z-2(b)(2)(A);

      Second. Basis adjustments as a result of such recognition of deferred gain are made under section 1400Z-2(b)(2)(B)(ii); and

      Third. The other federal income tax consequences of the inclusion event are determined.

      Proposed Regulation section 1.1400Z2(b)-1(g)(1)(ii) provides a more specific ordering rule for purposes of inclusion events involving section 301(c)(3) gain, S corporation shareholder gain, or partner gain. This ordering rule generally provides for the following:

      First. The (hypothetical) amount of section 301(c)(3) gain, S corporation shareholder gain, or partner gain, that would otherwise be recognized as a result of the transaction without regard to section 1400Z-2 is determined;

      Second. Deferred gain to be recognized as a result of the inclusion event is then determined under section 1400Z-2(b)(2)(A);

      Third. Basis adjustments as a result of such recognition of deferred gain are made under section 1400Z-2(b)(2)(B)(ii); and

      Fourth. The actual federal income tax consequences of the transaction are determined under section 301(c) or otherwise.
One interesting aspect of this rule to note, which is illustrated in Example (1) in Proposed Regulation section 1.1400Z2(b)-1(g)(1)(ii)(C)(1), is that it can potentially result in no section 301(c)(3) gain being recognized from a transaction that otherwise would have involved the recognition of section 301(c)(3) gain. In that example, the basis increase in the third step above results in sufficient basis in the qualifying shares so that the entire distribution in excess of earnings and profits (“E&P”) is treated as section 301(c)(2) basis recovery.

The more general ordering rule in Regulation section 1.1400Z2(b)-1(g)(1)(i) typically reaches a similar outcome. For example, assume an investor has a qualifying investment with $0 basis and a corresponding $100 of deferred gain. If that investor were to sell its entire qualifying investment for $100, the investor would recognize $100 of deferred gain, increase its basis in the qualifying investment by $100, and then recognize $0 of gain under section 1001 on the sale of the qualifying investment. Had the investor instead sold its entire qualifying interest for $120 (because its qualifying investment had appreciated), then the investor would have $20 of gain under section 1001 in addition to recognizing $100 of deferred gain. We agree that the results above are the appropriate results under section 1400Z-2(b).

Where there is some uncertainty, however, is precisely how the section 1400Z-2(b)(2)(B)(ii) basis adjustments are to be made in scenarios less than the entire qualifying investment is disposed of. In those cases, generally less than all of the deferred gain is recognized, and it is not clear which shares should have their basis increased.

For example, starting with the facts of the preceding example above (an investor with a qualifying investment with $0 basis and a corresponding $100 of deferred gain), consider the results if the investor sold half of its investment for $50 rather than its entire investment. In that case, $50 of deferred gain would generally be recognized under Proposed Regulation section 1400Z2(b)-1(e)(1) (50% of the qualifying investment was sold and as a result 50% of the deferred gain is included in income). Applying the general ordering rule discussed above, the next step would be for the investor to increase its basis in its qualifying investment by $50.

This raises the question as to whether the $50 basis increase is applied to the sold shares only, to the retained shares only, or to both the sold and the retained shares proportionally. We recommend that the final Regulations clarify that the basis adjustment under section 1400Z-2(b)(2)(B)(ii) is made only to those specific shares that trigger the inclusion event, otherwise inappropriate income tax consequences would result, as illustrated below.

Continuing Example 1, above, if the $50 basis adjustment is made solely to the sold shares, then the investor would recognize on the disposition $50 of the deferred gain and $0 of gain under section 1001 (because the disposed of shares are allocated $50 of basis before section 1001 is applied). On the retained $50 of qualifying investment, the investor would continue to have $50 of deferred gain and $0 of basis (because the retained shares are allocated none of the basis increase). This is the conceptually right result, and arguably supported by Johnson v. United States, which in the context of a distribution applies section 301(c) to each block of
shares separately.\textsuperscript{45} Essentially, the approach would be to apply the mechanics of section 1400Z-2 on a share by share basis.

If the section 1400Z-2(b)(2)(B)(ii) basis increase were instead to be made either solely to the retained shares or among the entire investment proportionally, inappropriate income tax results for the investor would result. Continuing Example 1, under either of these alternative approaches, the investor would recognize $50 of deferred gain plus an additional $50 or $25 (depending on which of the two basis allocation rules is applied) of gain under section 1001. The retained portion of the investment, while still associated with $50 of deferred gain, would then have a basis of either $50 or $25 of (depending on which of the two basis allocation rules is applied) shielding all or some of that deferred gain until the qualifying investment appreciates. We believe this is an inappropriate result. In our view, the investor’s total amount of gain recognized in the transaction should not exceed its total amount realized in the transaction.

A similar analysis applies to a dividend-equivalent redemption of shares owned by a sole shareholder of a QOF C corporation. In this case, although the section 302(d) redemption may not be an inclusion event under Proposed Regulation section 1400Z2(b)-1(c)(9)(ii), it may be an inclusion event to the extent it triggers section 301(c)(3) gain. For similar reasons as discussed above, we recommend that the final Regulations clarify that the section 1400Z-2(b)(2)(B)(ii) basis adjustment should apply only to the redeemed shares only, which would then ensure that such basis adjustment can convert some or all of the section 301(c)(3) gain to section 301(c)(2) basis recovery, as illustrated in Example (1) in Proposed Regulation section 1.1400Z2(b)-1(g)(ii)(C)(1).\textsuperscript{46}

\textbf{ii. Recommendation}

For the reasons set forth above, we recommend that the final Regulations clarify that section 1400Z-2(b)(2)(B)(ii) basis adjustments are made only to that portion of the qualifying investment that is subject to the inclusion event.

\textbf{b. Interaction of the Proposed Regulations and Section 1059}

There are a number of uncertainties as to how the rules of section 1059, which govern the treatment of “extraordinary dividends” to corporate shareholders, apply to distributions made by a QOF C corporation to a corporate shareholder. These uncertainties include (i) whether and to what extent an extraordinary dividend paid by a QOF C corporation may trigger an inclusion event, (ii) whether section 1400Z-2(b)(2)(B) basis is available for reduction by section 1059, and (iii) whether gain recognized under section 1059 can be effectively offset by an election under

\textsuperscript{45} 435 F.2d 1257 (4th Cir. 1971); see also The Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities; Withdrawal, REG-143686-07, 84 Fed. Reg. 11,686 (Mar. 28, 2019) (“The Treasury Department and the IRS continue to believe that under current law, the results of a section 301 distribution should derive from the consideration received by a shareholder in respect of each share of stock, notwithstanding designations otherwise.”). It may also be possible to draw an inference from Proposed Regulation section 1400Z2(b)-1(g)(2), which provides that “[t]he increases in basis under section 1400Z-2(b)(2)(B)(iii) and (iv) only apply to that portion of the qualifying investment that has not been subject to previous gain inclusion under section 1400Z-2(b)(2)(A).”

\textsuperscript{46} See Johnson v. United States, 435 F.2d 1257 (4th Cir. 1971).
section 1400Z-2(c). The following discussion provides a brief overview of section 1059, the policy underlying section 1059, and its potential application to a qualifying investment under section 1400Z-2, and then discusses the specific issues raised and our recommendations.

i. Section 1059 Generally

Section 1059(a) generally provides that if a corporation receives an “extraordinary dividend” with respect to any share of stock and the recipient corporation has not held such stock for more than two years before the dividend announcement date, then the basis of the recipient corporation in such stock shall be reduced (but not below zero) by the “nontaxed portion” of such dividends. If the nontaxed portion of such dividends exceeds such basis, the excess is treated as gain from the sale or exchange of such stock for the taxable year in which the extraordinary dividend is received. The rules in section 1059(a)(1) and (2) generally operate with respect to the nontaxed portion of an extraordinary dividend in the same manner as section 301(c)(2) and (3) operates with respect to a distribution in excess of E&P.

For this purpose, the term “extraordinary dividend” means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds the “threshold percentage” (generally five percent in the case of stock that is preferred as to dividends and ten percent for any other stock) of the taxpayer's adjusted basis in such share of stock.47 In some cases, a taxpayer may use the fair market value of a share of stock in lieu of its adjusted basis.48 The nontaxed portion of any dividend is the excess (if any) of the amount of such dividend, over the taxable portion of such dividend.49 The taxable portion of any dividend is the portion of such dividend includable in gross income, reduced by the amount of any deduction allowable with respect to such dividend under section 243, 245, or 245A.50

In certain cases, such as certain dividend-equivalent redemptions, a dividend can be subject to section 1059(a) without regard to the taxpayer’s holding period in the subject stock.51 Dividends paid by a member of an affiliated group to another member of the group are not subject to section 1059 to the extent they are out of E&P earned while a member, subject to certain exceptions.52

______________________________
47 I.R.C. § 1059(c).
48 I.R.C. § 1059(c)(4).
49 I.R.C. § 1059(b)(1).
50 I.R.C. § 1059(b)(2).
51 I.R.C. § 1059(e)(1). See also Reg. § 1.1059(c)-1(a) (“Section 1059(d)(6) (exception where stock held during entire existence of corporation) and section 1059(e)(2) (qualifying dividends) do not apply to any distribution treated as an extraordinary dividend under section 1059(e)(1). For example, if a redemption of stock is not pro rata as to all shareholders, any amount treated as a dividend under section 301 is treated as an extraordinary dividend regardless of whether the dividend is a qualifying dividend.”)
52 I.R.C. § 1059(e)(2).
Whether Section 1059 Should Apply to Qualifying Investments

1) Policy Considerations Underlying Section 1059

Section 1059 was added to the Code by the Deficit Reduction Act of 1984 as part of a number of changes to combat perceived abuses of the dividends received deduction (the “DRD”). Initially, Congress enacted section 1059 to address its concern that corporate taxpayers had the ability to effectively convert short-term capital gain into dividend income eligible for the DRD (often referred to as an “ex-dividend” strategy). The Joint Committee on Taxation (the “JCT”) explained the need for section 1059 as follows:

The absence of any requirement that a corporate shareholder’s basis in certain newly-acquired stock be reduced on receipt of a dividend with respect to such stock encouraged taxpayers to engage in tax-motivated transactions such as “dividend stripping.” Typically, dividend stripping involves acquiring stock shortly before the ex-dividend date, receiving a dividend that is eligible for the 85-percent dividends received deduction, and then selling the stock after satisfying the holding-period requirement for the dividends received deduction. Because the market price of the dividend-paying stock can be expected to decline by approximately the amount of the dividend, the corporate taxpayer ended up with dividend income (taxable at a maximum rate of 6.9 percent) and a short-term capital loss on sale of the stock. If the taxpayer had unrelated short-term capital gain (taxable at a maximum rate of 46 percent) that was offset by the short-term loss, then the taxpayer effectively converted that gain to tax-favored dividend income. Dividend stripping was engaged in widely when Chrysler Corporation paid four years of back dividends on its cumulative preferred stock: an $11.69 dividend on stock selling for $36.00 per share.

As Congress became aware of other unintended interactions of the DRD with other federal income tax rules, section 1059 was modified to address those scenarios. For example, in 1997, Congress amended section 1059 to provide that section 1059(a) applied to certain dividend-equivalent redemptions that would not otherwise have been treated as dividends but for application of the option attribution rules under section 318(a)(4). The JCT explained the need for this change as follows:

Corporate taxpayers have attempted to dispose of stock of other corporations in transactions structured as redemptions, where the redeemed corporate shareholder apparently expects to take the position that the transactions are dividends that qualify for the dividends received deduction. Thus, the redeemed corporate shareholder attempts to exclude from income a substantial portion of the amount received. In some cases, it appears that the taxpayers' interpretations of the option attribution rules of section 318(a)(4) are important to the taxpayers' contentions that their interests in the distributing corporation are not meaningfully reduced, and are, therefore, dividends . . . . Some taxpayers may argue

---

53 Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 53(a), 98 Stat. 494. Section 1059 is potentially applicable to dividends for which a deduction is allowable with respect to such dividend under section 243, 245, or 245A. I.R.C. § 1059(b)(2)(B).


55 I.R.C. § 1059(e)(1).
that certain options have sufficient economic reality that they should be recognized as stock
ownership for purposes of determining whether a taxpayer has substantially reduced its
ownership.

Even in the absence of options, the present law rules dealing with extraordinary dividends
may permit inappropriate deferral of gain recognition when the portion of the distribution
that is excluded due to the dividends received deduction exceeds the basis of the stock with
respect to which the extraordinary dividend is received.56

Similar to the concern in 1984, Congress appears to be concerned here with the ability of
a corporate shareholder to convert what would otherwise have been capital gain on a redemption
of shares into dividend income eligible for the DRD.

2) Whether Section 1059 Policy Considerations are
Applicable to Section 1400Z-2

Absent any statutory or regulatory language to the contrary, section 1059 would appear to
apply to a “qualifying investment” (within the meaning of Proposed Regulation section
1.1400Z2(b)-1(a)(2)(xvi)) in a QOF C corporation. That said, it is not entirely clear that section
1059 should in fact have any applicability to a qualifying investment in a QOF C corporation.
For example, a taxpayer’s basis in a qualifying investment is zero under section 1400Z-2(b)(2)(B) for the first five years of the investment, taking away any potential to engage in the
ex-dividend strategy that led Congress to initially enact section 1059.57 Further, dividend-
equivalent redemptions generally are inclusion events under Proposed Regulation section
1.1400Z2(b)-1(c)(9)(i), which would seem to govern many of the transactions described in
section 1059(e)(1)(A), although we recommend in Part II.C.1.a.i.3 that dividend equivalent
redemptions not be inclusion events. If our earlier recommendation is adopted, there may be a
need for the applicability of section 1059 to distributions by QOF C corporations. If our earlier
recommendation is not adopted, however, even though Proposed Regulation section
1.1400Z2(b)-1(c)(9)(ii) provides that dividend equivalent-redemptions by a QOF C corporation
are not inclusion events in the case of the QOF C corporation that is a wholly-owned subsidiary,
such redemptions are not likely to raise section 1059(e)(1) concerns as a result of its wholly-
owned status.58

Notwithstanding the above significant limitations on any potential for the perceived
abuses of the DRD occurring with respect to a qualifying investment in a QOF C corporation,
there may be a possibility for a corporate shareholder to take advantage of the DRD to eliminate
a portion of its deferred gain. Consider the following example:

56 General Explanation of Tax Legislation Enacted In 1997, JCS-23-97, 195 (Dec. 17, 1997). The JCT attributes this
law change in part to a redemption by DuPont Corporation of its stock held by Seagram Corporation coupled with
the issuance of warrants to acquired DuPont Corporation stock. Id. note 217.

57 Because an investor’s initial basis is $0, there is no potential to generate a loss on the investment under the ex-
dividend strategy. There may be an opportunity, however, as discussed below in Example 2, to eliminate the
defered gain in the investment in the QOF C corporation, subject to there be sufficient E&P.

58 Section 1059(e)(1)(A)(ii) and (iii)(I) are generally not applicable in the wholly-owned context.
Example 2: In Year 1, a domestic corporation (“USP”) recognizes $100 of capital gain and makes a $100 investment in a QOF C corporation that has historical E&P.\(^{59}\) Initially, USP has $0 basis in its qualifying investment in the stock of the QOF C corporation. In year 2, QOF C corporation distributes $80 to USP, all of which is treated as a dividend under section 301(c)(1) and USP is eligible for the DRD with respect to such $80. Under Proposed Regulation section 1.1400Z2(b)-1(c)(9)(i), this is not an inclusion event for USP to the extent the distribution was treated as a dividend (section 301(c)(2) is not applicable here because USP has no basis in the stock). If section 1059 were not applicable, if USP subsequently sells its qualifying interest for $20 (assume no appreciation for simplicity), only $20 of deferred gain would be included under section 1400Z-2(b)(1) because section 1400Z-2(b)(2)(A)(i) determines the includable amount as the lesser of the deferred gain and the fair market value of the qualifying investment as of such date. Accordingly, absent section 1059, there is at least a possibility that a deferred gain could be converted, in part, into an amount of dividend income eligible for the DRD.

Based on the above theoretical potential for the above DRD result, it is conceivable that Treasury and the Service may want section 1059 to remain applicable to a qualifying investment in a QOF C corporation. While we believe, as described in Part II.C.4.b.iii, below, that it is not inappropriate for the DRD to apply to dividends from a QOF C corporation in the general case, Treasury and the Service might conclude that the application of section 1059 may be necessary to avoid abuse in certain appropriate cases. Accordingly, this would then necessitate coordinating rules between the provisions of sections 1059 and 1400Z-2. It is also possible that Treasury and the Service could reasonably determine that the above-discussed potential for abuse is too remote to justify the complexity of creating coordinating rules.

3) Recommendation

We recommend that final Regulations should either exclude qualifying investments in QOF C corporations from the application of section 1059 or adopt the following coordination rules.

iii. Suggested Coordination Between Section 1059 and Section 1400Z-2

1) Coordination of Section 1059 with Inclusion Events

a) Inclusion Events that are also Extraordinary Dividends

i) Discussion

This first scenario to consider is a transaction that is already an inclusion event under Proposed Regulation section 1.1400Z2(b)-1(c) and that is also an extraordinary dividend subject to section 1059.

\(^{59}\) As a practical matter, the case of a QOF C corporation having substantial historical E&P is likely to be much rarer than in the case of, for example, a long-standing operating company where the dividend recipient shareholder did not own the underlying stock when such E&P was created. Section 1059 was generally enacted to police the use of E&P created on another shareholder’s watch.
Consider the following example:

**Example 3:** In Year 1, USP, which has $100 deferred gain in a qualifying investment in a non-wholly-owned QOF C corporation that is not a member of USP’s group, receives a $20 dividend-equivalent redemption. Under Regulation section 1.1400Z2(b)-1(c)(9)(i), this is a $20 inclusion event. If this $20 dividend was also treated as an extraordinary dividend subject to section 1059, it would be necessary to apply the ordering rule set forth in Proposed Regulation section 1.1400Z2(b)-1(g)(1)(i) and discussed in Part II.C.2.a above to determine the treatment under section 1059.

Under the ordering rule, USP would recognize $20 of deferred gain and increase its basis in its qualifying investment by $20. Similar to the discussion in Part II.C.2.a above, this raises the question as to whether the $20 basis is applied to the redeemed shares only, to the retained shares only, or to both the redeemed and retained shares proportionally. As section 1059(e)(1) provides that in the case of certain redemptions, only the basis in the stock redeemed is taken into account under section 1059(a), the answer to this question would impact the application of section 1059.

For the same reasons discussed in Part II.C.2.a above, in the case of a dividend-equivalent redemption that is an extraordinary dividend, we believe that the basis increase under section 1400Z-2(b)(2)(B)(ii) should be applied only to the redeemed shares. If, after determining the results under sections 301(c) and 1059(a) of the dividend-equivalent redemption, there remains any basis in the redeemed shares, proper adjustment of the basis of the remaining stock can be made under Regulation section 1.302-2(c).

It is possible that any proper adjustment of the basis of the remaining stock made under Regulation section 1.302-2(c) could ultimately lead to section 1400Z-2(b)(2)(A)(ii) limiting the amount of deferred gain that could subsequently be included on an inclusion event with respect to the retained shares in the qualifying investment. This is because section 1400Z-2(b)(2)(A)(ii) limits the recognition of deferred gain to the excess of deferred gain over basis. This is conceptually the correct result, however, because in order for there to be any basis remaining after application of section 1059(a)(1), a portion of the extraordinary dividend must be subject to income tax in the recipient’s hands as taxable dividend income. For example, in the previous example, if $20 of the dividend were to be made that was neither an inclusion event nor an extraordinary dividend, the fair market value of the investment would be reduced by $20, limiting the amount of deferred gain that can be included in the future (unless there is subsequent appreciation). Thus, this result is no different than if an investor in a QOF C corporation received a non-extraordinary dividend with respect to its qualifying investment which reduced the fair market value of the qualifying investment below the amount of deferred gain.

**ii) Recommendation**

Accordingly, we recommend that if the final Regulations apply section 1059 to qualifying investments in QOF C corporations, the final Regulations should clarify that the basis

---

60 We note that if our request in Part II.C.1.a.ii.3 to treat all section 302(d) redemptions as section 301 distributions and, thus, an inclusion event to the extent that section 301(c)(3) applies is accepted, this point becomes moot.

61 Section 1400Z-2 presumably allows for this limitation in the amount of deferred gain because the $20 dividend is generally treated as income to the investor.
increase under section 1400Z-2(b)(2)(B)(ii) as a result of a redemption should be applied to the
redeemed shares only and then subject to proper adjustment under Regulation section 1.302-2(c)
to the extent the redemption is dividend-equivalent.

b) Whether Extraordinary Dividends can Trigger
an Inclusion Event

i) Discussion

We also considered whether the payment of an extraordinary dividend triggers an
inclusion event. Proposed Regulation section 1.1400Z2(b)-1(c)(8) provides that a distribution of
property by a QOF C corporation with respect to a qualifying investment is not an inclusion
event except to the extent section 301(c)(3) applies to the distribution. By definition then, an
extraordinary dividend that is not the result of a dividend equivalent redemption would seem to
not cause an inclusion event (i.e., a distribution with respect to QOF C corporation stock of cash
or property under section 301(c)(1)). This is an odd result to the extent section 1059(a)(2) would
provide that a portion of the dividend is to be treated as gain from the sale or exchange of
property.

For example, consider the situation where USP, which has $100 deferred gain in a
qualifying investment in a non-wholly-owned QOF C corporation, receives a $20 extraordinary
dividend, the untaxed portion of which is $10. To the extent USP has basis under section
1400Z-2(b)(iii) and (iv) in its qualifying investment, presumably that basis would be reduced by
an amount equal to the untaxed portion under section 1059(a)(1). To the extent there is no or
insufficient basis, that portion of the untaxed portion would be treated as gain from sale or
exchange of property under section 1059(a)(2).

If this gain recognition is not treated as an inclusion event, USP would continue to have
$100 of deferred gain in a qualifying investment in a non-wholly-owned QOF C corporation, receives a $20 extraordinary
dividend, the untaxed portion of which is $10. To the extent USP has basis under section
1400Z-2(b)(iii) and (iv) in its qualifying investment, presumably that basis would be reduced by
an amount equal to the untaxed portion under section 1059(a)(1). To the extent there is no or
insufficient basis, that portion of the untaxed portion would be treated as gain from sale or
exchange of property under section 1059(a)(2).

In our view, any sale or exchange gain that would be recognized under section 1059(a)(2)
should be treated as an inclusion event, just as any gain that would be recognized under section
301(c)(3) is treated as an inclusion event.

We do not believe, however, that the utilization of basis under section 1059(a)(1) should
trigger an inclusion event. Section 1059(a) operates similarly to section 301(c)(2) and (3), and
Proposed Regulation section 1.1400Z2(b)-1(c)(8) provides that section 301(c)(2) basis recovery
is not an inclusion event. We believe that the answer should be the same under section
1059(a)(1).

62 See also Reg. § 1.367(a)-8(n)(2) (providing that only section 301(c)(3) gain, but not section 301(c)(2) basis
recovery, triggers gain recognition).
ii) Recommendation

Accordingly, we recommend that if final Regulations apply section 1059 to qualifying investments in QOF C corporations, the final Regulations should provide that the recognition of gain under section 1059(a)(2) results in an inclusion event to the extent of that gain. The subsequent consequences of such an inclusion event are discussed below.

c) Ordering Rules for Extraordinary Dividends that Trigger an Inclusion Event

i) Discussion

If gain recognized under section 1059(a)(2) is treated as an inclusion event, we believe it is necessary for final Regulations to clarify how such an inclusion event should be coordinated with section 1059. In this case, we believe that the special ordering rule set forth in Proposed Regulation section 1.1400Z2(b)-1(g)(ii) with respect to section 301(c)(3) gains is instructive. The application of this ordering rule is discussed in more detail above in Part II.C.2.a.

We believe that a similar set of rules should apply to a section 1059(a)(2) inclusion event as follows: First, a hypothetical amount of gain would be determined under section 1059(a)(2) without regard to section 1400Z-2, and this hypothetical amount of section 1059(a)(2) gain would determine the amount of the inclusion event. Second, the deferred gain triggered by the inclusion event would be recognized, and the basis in the qualifying investment would be increased. Third, section 1059 would be applied in fact, with any basis increase under section 1400Z-2(b)(2)(B)(ii) available for reduction under section 1059(a)(1) (just as such basis increase is made available for reduction under section 301(c)(2)). For the reasons discussed above, we believe that the use of basis under section 1059(a)(1) should not itself cause an additional inclusion event.

ii) Recommendation

Accordingly, we recommend that if final Regulations apply section 1059 to qualifying investments in QOF C corporations, final Regulations should clarify that the ordering rule in Proposed Regulation section 1.1400Z2(b)-1(g)(ii) is also applicable to any section 1059(a)(2) gain that triggers an inclusion event.

2) Coordination of Section 1059 with Section 1400Z-2(c)

a) Discussion

We also believe that the final Regulations should address the coordination of section 1059 with the election under section 1400Z-2(c) for a taxpayer that has held a qualifying investment for at least ten years to adjust its basis in the investment to its fair market value on the date that the investment is sold or exchanged. The Congressional intent here is the permanent elimination of capital gains from an investment in a QOF that has been held for ten or more years.

Two specific issues merit clarification. First, may an election be made to eliminate capital gain by effectively converting what would otherwise be section 1059(a)(2) gain to section
1059(a)(1) basis recovery? Similarly, may an election be made to eliminate capital gain by effectively converting section 301(c)(3) gain to section 301(c)(2) basis recovery? We think that allowing the election in both cases is consistent with Congress’s intent of the elimination of all capital gains from an investment in a QOF that has been held for ten or more years.

In our view, section 1400Z-2(c) should be applied in a similar manner as the basis adjustments with respect to inclusion events described in the ordering rules set forth in Proposed Regulation section 1.1400Z2(b)-1(g). That is, first an amount of hypothetical gain should be determined under either section 301(c)(3) or section 1059(a)(2) without regard to the application of section 1400Z-2(c). Next, 1400Z-2(c) should be used to increase basis in the applicable shares of the qualifying investment by the amount of such gain. Finally, section 301(c) or section 1059(a) should be applied in fact, making use of such basis increase.

This outcome would be consistent with the federal income tax policy that similar transactions are to be taxed similarly. If the taxpayer had in fact sold a portion of its qualifying investment, section 1400Z-2(c) would apply to eliminate any gain, and thus, in our view, the same answer should apply under sections 301(c)(3) and 1059(a)(2), which are economically similar transactions. Further, the legislative history of section 1400Z-2(c) states that the intention of the provision is to “exclude[] from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least ten years.” To the extent sections 301(c)(3) and 1059(a)(2) would otherwise create capital gains from a qualifying investment in a QOF C corporation held for at least ten years, in our view, such capital gain should be excluded from gross income. There is nothing inappropriate with undoing what sections 301(c)(3) and 1059(a)(2) are doing here because Congress intends for section 1400Z-2(c) to permanently eliminate all capital gains from an investment in a QOF that has been held for ten or more years.

In the event that such an ordering rule is promulgated, an additional issue arises as to whether the retained portion of the qualifying investment continues to be eligible for the section 1400Z-2(c) election upon one or more subsequent dispositions or section 301(c)(3) and section 1059(a)(2) gain events. Section 301(c)(3) and section 1059(a)(2) gain events are economically equivalent to a partial disposition. In the case of a partial disposition for which an election is made under section 1400Z-2(c), nothing in the Code or Proposed Regulations seems to indicate that section 1400Z-2(c) does not remain available for the retained portion of the qualifying investment. Thus, the section 1400Z-2(c) election should likewise remain available for a qualifying investment even if the election is used to shield section 301(c)(3) and section 1059(a)(2) gain on a prior distribution.

b) Recommendation

---

63 Although this last question is broader than just section 1059, the resolution of this question in the context of section 301(c)(3) should inform the resolution in the context of section 1059(a)(2).


65 See, e.g., Prop. Reg. § 1.1400Z2(b)-1(g)(1)(ii)(C)(1) Example (1) (basis increase converting what would otherwise have been section 301(c)(3) gain into section 301(c)(2) basis recovery).
Accordingly, we recommend that if the final Regulations apply section 1059 to qualifying investments in QOF C corporations, the final Regulations should include a corresponding ordering rule, similar to the one contained in Proposed Regulation section 1.1400Z2(b)-1(g)(1)(ii), clarifying that section 1400Z-2(c) basis increases occur immediately before determining the results under section 301(c) and section 1059(a). Further, we recommend that the final Regulations clarify that the section 1400Z-2(c) election remains available after these events for subsequent dispositions of some or all of the qualifying investment.

3. Step-Transaction Issues

a. Background

Two important rules exclude transactions with related persons: (i) the taxpayer’s eligible gain must derive from a sale to an unrelated person,66 and (ii) the QOZ Business Property must be acquired by purchase from an unrelated person.67 Section 1400Z-2(e)(2) defines “related person” as follows:

For purposes of this section, persons are related to each other if such persons are described in section 267(b) or 707(b)(1), determined by substituting “20 percent” for “50 percent” each place it occurs in such sections.

The Proposed Regulations provide no embellishment to this definition.68 Thus, as currently crafted, the Proposed Regulations are silent as to whether or how the related person determination is analyzed when such relatedness is severed (i.e., a related person becomes unrelated) or created (i.e., an unrelated person becomes related) pursuant to the same overall plan in which the subject transaction occurs.

b. Related Person Becomes Unrelated

i. Discussion

An investor may recognize the eligible gain from a sale to a person that is related at the time of the sale but such person becomes unrelated to the investor as part of the overall plan that includes the sale. Similarly, a QOF or QOZ Business may purchase QOZ Business Property from a person that is related at the time of the sale but will become unrelated as part of the overall plan that includes the purchase. In analogous situations, including under the Act,69

68 Because Proposed Regulation section 1.1400Z2(a)-1(b)(2)(i)(A) limits eligible gain to capital gain, section 1239, which contains its own related-party rule, also may be relevant when applying section 1400Z-2(a)(1) and section 1400Z-2(d)(2)(D)(i)(I).
taxpayers are tested for related-party rules where relatedness is severed or created as part of the same overall plan that includes an otherwise related-party transaction.\textsuperscript{70}

\textbf{ii. Recommendation}

We recommend that, similar to other rules, including Proposed Regulation section 1.168(k)-2(b)(3)(iii)(C), Treasury and the Service adopt a rule permitting the investor and the QOF/QOZ Business, as applicable, to take into account the steps in the same overall plan in determining whether a sale to a related party, or a purchase from a related party, that becomes unrelated qualifies as an eligible gain or as QOZ Business Property, respectively.\textsuperscript{71}

c. Unrelated Person or Property Becomes Related

\textbf{i. Discussion}

Although the definition of related person as used in the Code will prevent attempts by an Investor to generate eligible gain and qualify for QOZ benefits using indirectly owned property, the definition does not address the possibility that, pursuant to an overall plan, the Investor might sell gain property directly to an unrelated person, and subsequently either the buyer thereof becomes related to the Investor or the property becomes owned by a person related to Investor. The definition similarly will block many attempts to allow the seller of the QOZ Business Property to qualify for QOZ benefits while retaining an indirect interest therein but does not address the possibility that, pursuant to an overall plan, the QOF might purchase QOZ Business Property directly from an unrelated person, and subsequently the seller thereof becomes related to the QOF.\textsuperscript{72} As noted above, taxpayers in certain situations are subject to related party-rules where relatedness is severed or created as part of the same overall plan that includes an otherwise related-party transaction.

\textbf{ii. Recommendation}

We recommend that, similar to other rules, including Proposed Regulation section 1.168(k)-2(b)(3)(iii)(C), Treasury and the Service adopt a rule requiring the Investor and the QOF/QOZ Business, as applicable, to take into account the steps in the same overall plan in determining whether a sale to an unrelated party, or a purchase from an unrelated party, that becomes related qualifies as an eligible gain or as QOZ Business Property, respectively. A similar rule should apply with respect to the investor if the asset sold to generate potential eligible gain is subsequently acquired by a related person.

\textsuperscript{70} See, e.g., Reg. § 1.338-3(b)(3)(ii) (dealing with related-party transactions in the context of qualified stock purchase eligibility and looking to the relationship after the last of the series of transactions). Cf. Reg. § 1.197-2(h)(6)(ii) (dealing with related-party transactions in the context of the section 197(f)(9) and looking to the relationship immediately before the first transaction or immediately after the last of the series of transactions).

\textsuperscript{71} Given that the context of this rule is one of eligibility for a Congressionally-provided benefit and thus should be interpreted narrowly, we believe the imposition of a stringent “binding commitment” requirement would be appropriate. Note that, in the event the buyer toggles from being related to being unrelated and then related again, the recommendation below dealing with unrelated persons that become related persons would be relevant.

\textsuperscript{72} For example, a developer might sell property to the QOF and wish to reinvest gain from sale of other property.
4. Excluding QOFs from Consolidated Groups

a. Introduction

An initial question when considering issues related to a QOF classified as a corporation is whether it should be a member of a consolidated group, including the parent of its own group. Section 1400Z-2 and its legislative history provide no direct insight other than that the Opportunity Zone Regime has components that respect the form of a corporation as a separate entity while consolidated return principles are mixed, treating corporations as separate entities in certain circumstances and divisions of a single corporation in others. Absent Regulations to the contrary, Regulation section 1.1502-80(a)(1) and related authorities indicate that the default position is to treat each group member as a separate corporation. To resolve these and other differences, Treasury and the Service have a broad grant of authority under section 1504(a)(5)(A) to write Regulations to resolve these differences, including treating otherwise issued and outstanding stock as not stock. We believe that harmonizing the regime of gain deferral from QOF investments when one member of a consolidated group makes an investment in another corporation is well within the scope of that grant. The Proposed Regulations exercise that authority to exclude the stock of a QOF C corporation from the definition of stock for purposes of determining who is a member of the affiliated group, resulting in at least two significant consequences. First, the QOF C corporation cannot be a member of an affiliated group with another corporation as its common parent. Second, if the QOF C corporation pays a dividend that would otherwise meet the definition of a qualifying dividend under section 243(b), the 100% DRD is disallowed. Although we appreciate the concerns that led to the adoption of the rule in the Proposed Regulations, for the reasons discussed below, we believe that these results are not appropriate, particularly in light of the need for transition rules as discussed below. We recommend that a QOF C corporation be permitted to be a subsidiary member of an affiliated group of corporations and QOF earnings distributed to corporate shareholders be eligible for the 100% DRD.

b. Issues Relating to a QOF C Corporation as a Subsidiary Member of a Consolidated Group

In the Preamble, Treasury and the Service noted the tension between the framework of section 1400Z-2 and the principle of single entity treatment in the consolidated return Regulations. If a QOF C corporation were a subsidiary member of a consolidated group, rules applying consolidated return provisions would need to be modified to harmonize the policy objectives of the two provisions. In order to avoid these complexities, the Proposed Regulations excluded QOF C corporation stock from being “stock” for purposes of section 1504. In our view, if these Proposed Regulations are to be applied from the effective date of section 1400Z-2, complexity and unintended consequences would be more compelling reasons to

---

73 See also Reg. § 1.1502-13(a)(4). An example of a regulation to the contrary is Regulation section 1.1502-80(f), which denies section 1031 treatment for intercompany transactions.

74 Treasury and the Service cited by way of example the interaction of section 1400Z-2 with Regulation sections 1.1502-13 (relating to intercompany transactions), 1.1502-32 (relating to the consolidated return investment adjustment regime), and 1.1502-19 (relating to excess loss accounts). Preamble at 18,667.
dismiss the attempt to reconcile the provisions. However, these rules were proposed in April 2019, nearly 16 months after the statute was enacted, and will not be effective until finalized. Until the Proposed Regulations were proposed, there was no indication that QOF C corporations could not be members of consolidated groups. As a result, there are transactions that have occurred involving unrelated parties priced on the basis that QOF C corporations would be treated as subsidiary members of a consolidated group. In our view, as transition issues exist, transition rules need to be drafted in a way that both preserves the benefits intended to be conveyed by section 1400Z-2 and does not unnecessarily upset settled economic relationships between parties. Below are what we believe to be the most significant policy and technical issues raised by excluding subsidiary QOF C corporations from consolidated groups (the “QOF Consolidated Member Exclusion Rule”).

i. Intercompany Transactions

1) Discussion

In the Preamble, Treasury and the Service indicate that the principles of section 1400Z-2 providing for gain deferral from an investment in a QOF C corporation are inconsistent with the intercompany transaction Regulations.\(^{75}\) The intercompany transaction Regulations generally provide that an intercompany transaction cannot affect the taxable income or tax liability, in the aggregate, of a consolidated group.\(^{76}\) While these statements of principle are correct, the intercompany transaction Regulations also have separate company concepts at their core for items like location of income, gain, loss, and deduction, as well as the determination of stock basis of a member.\(^{77}\) For this reason, we believe it is more helpful to focus on which principle (single entity or separate company) more appropriately serves the tax policy goals set out in section 1400Z-2, as well as good tax administration. We believe that the disaffiliation of QOF C corporations does not significantly narrow the universe of intercompany transactions related to QOF C corporations and creates a number of collateral issues that result in disparate treatment between similar transactions.\(^{78}\)

By creating the QOF Consolidated Member Exclusion Rule, the Proposed Regulations generally exclude from the intercompany transaction Regulations only the initial investment and current distributions. All other transactions are either still within the ambit of the intercompany transaction rules or can be more narrowly addressed. Because the initial investment in a QOF C corporation is, in our view, about timing and location of income and stock basis, it is well within the scope of what the intercompany transaction Regulations already address and should not be the basis for the QOF Consolidated Member Exclusion Rule.

\(^{75}\) See Part II.C.5, below, for more detailed discussion on the interaction of QOFs and the intercompany transaction rules under Regulation section 1.1502-13.

\(^{76}\) Reg. § 1.1502-13(a)(1).

\(^{77}\) See Reg. § 1.1502-13(a)(2).

\(^{78}\) See Part II.C.4.b.iii., below related to the denial of the 100% DRD as well as a comparison to an investment in a QOF partnership where all of its partners are members of a consolidated group of corporations.
A QOF C corporation can be the common parent of a consolidated group. As a result, Treasury and the Service will have to apply the intercompany transaction rules to QOF C corporations as a participant in intercompany transactions. The intercompany transaction rules will also apply to QOF C corporation stock if the stock is transferred between members of a consolidated group. The only portion of the intercompany transaction regime that is excluded relates to intercompany transactions with respect to stock of a member.79

However, if the Regulations permit a QOF C corporation to be a subsidiary member of a consolidated group, Treasury and the Service may wish to continue applying Regulation section 1.1502-13(f)(2) for intercompany distributions. If there is a desire to reconcile the inclusion event for distributions under section 301(c)(3) in the non-consolidated context with consolidated distributions, the more narrowly tailored solution may be to limit inclusion events to those distributions that create or increase an excess loss account. Also potentially implicated is the rule in Regulation section 1.1502-80(b) that renders section 304 inapplicable to intercompany transactions. However, under the Proposed Regulations, if stock of a QOF C corporation is sold between members of a consolidated group, this provision still applies. The inclusion event result appears to be the same under either construct—that is, a non-section 304 stock sale is an inclusion event and, likewise, a stock sale subject to section 304 (and its accompanying deemed section 351 exchange) is also an inclusion event.80

Presumably the concern here is integrating the inclusion events set out in Regulation section 1.1400Z2(b)-1(c) with the intercompany transaction rules. If this is the concern that led to the rule, a more narrowly tailored solution would be to render Regulation section 1.1502-13(f) inapplicable for purposes of determining whether a transaction in QOF C corporation stock is an inclusion event. In addition, as discussed below, in our view, the concerns about investment adjustments and excess loss accounts raised in the Preamble, at a minimum, need to be addressed on a transitional basis if our recommendation below is not accepted. Accordingly, we do not believe that complexity alone is a compelling reason for the QOF Consolidated Member Exclusion Rule.

2) Recommendation

We recommend that the final Regulations provide that a QOF C corporation can be a subsidiary member of a consolidated group.

ii. Investment Adjustments, Excess Loss Accounts, and Transition Rules

The following discussion assumes the final Regulations retain the QOF Consolidated Member Exclusion Rule. Under Proposed Regulation section 1.1400Z2(g)-1(g), this rule will only apply to taxable years beginning after the date the final Regulations are published in the Federal Register (the “Consolidated Return Rule Applicability Date”). However, a QOF can adopt the rule for taxable years beginning before the Consolidated Return Rule Applicability

79 See Reg. § 1.1502-13(f).
80 Prop. Reg. § 1.1400Z2(b)-1(c)(13).
Date, but only if the QOF applies the Proposed Regulations in their entirety and in a consistent manner.

The QOZ rules were enacted approximately 16 months before the Proposed Regulations were released and during this time a number of taxpayers formed QOFs, including QOF C corporations.81 Because a QOF C corporation is not, as a general matter, anticipated to be described in any of the exceptions to the definition of includable corporation under section 1504(b),82 the Consolidated Return Rule Applicability Date raises a number of questions. In particular, it appears that for QOFs that do not apply the Proposed Regulations, a QOF C corporation that otherwise satisfies the section 1504(a) ownership requirements must be included as a subsidiary member of a consolidated group prior to the Consolidated Return Rule Applicability Date.83

We recommend that Treasury and the Service address two questions for QOF C corporations that are in this unfortunate position. First, we believe that the final Regulations should clarify the tax treatment of an inclusion event that occurs when the QOF C corporation is a consolidated group member (e.g., the consolidated group disposing of its interest in the QOF C corporation before the Consolidated Return Rule Applicability Date). Second, we also believe that if the QOF C corporation ceases to be a member of the consolidated group on the Consolidated Return Rule Applicability Date, there should be clear rules addressing the tax consequences of the deconsolidation (the “QOF Deconsolidation Event”).

1) Treatment of an Inclusion Event if the QOF C Corporation is a Consolidated Group Member

If a QOF C corporation is included as a subsidiary member only for a brief period of time (i.e., until the Consolidated Return Rule Applicability Date), the most-implicated consolidated return Regulations appear to be: (i) the intercompany transaction rules under Regulation section 1.1502-13; (ii) the rules addressing excess loss accounts (“ELAs”) under Regulation section 1.1502-19; and (iii) the investment adjustment rules under Regulation section 1.1502-32.84

81 While a QOF C corporation could adopt the Proposed Regulations, and eliminate some of these uncertainties, there are a number of reasons why a QOF may decide not to apply the Proposed Regulations, including (i) the need to apply the rules in their entirety and (ii) uncertainty with regard to changes that will be made to the Proposed Regulations once finalized. Further, for tax years ending before the Proposed Regulations were released, certain consolidated groups may have already filed their federal income tax return.

82 Under section 1504(b), the following corporations do not meet the definition of an “includable corporation” and therefore cannot be a member of an affiliated group: (i) corporations exempt from taxation under section 501; (ii) insurance companies subject to taxation under section 801 (but see the special rules under section 1504(c)(1) for life-life consolidated groups and section 1504(c)(2) for life-nonlife consolidated groups); (iii) foreign corporations; (iv) regulated investment companies and real estate investment trusts; (v) DISCs (as defined in section 992(a)(1)); and (vi) S corporations.

83 See I.R.C. § 1501 (“The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return.”) (emphasis added).

84 These items are consistent with the list identified by Treasury and the Service in the Preamble: “The framework of section 1400Z-2 and the consolidated return regulations are incompatible in many respects . . . . For
The discussion below focuses on items (ii) and (iii), which will generally be relevant if the consolidated group sells its interest in the QOF C corporation while the QOF C corporation is a consolidated group member. First, we will provide a very brief summary of the investment adjustment and ELA rules. We will then describe how the Proposed Regulations addressing deferred gain inclusion with regard to QOF partnerships and QOF S corporations (“flow-through entities”) could be leveraged for purposes of determining the amount of the deferred gain inclusion, as well as the shareholder’s basis in the stock of the QOF C corporation, if the QOF C corporation is sold while it is a member of a consolidated group.

Regulation section 1.1502-32 provides rules that adjust the basis of the stock of a member subsidiary (S) owned by another member (M) of the consolidated group. M first determines its basis in S applying general tax principles. For example, if M contributes property with a basis of $100 to S solely in exchange for 100% of S’s stock, M’s basis in the S stock will equal $100. However, Regulation section 1.1502-32 may then require M to make a number of adjustments to its basis in the S stock over the life of the investment, including adjustments for (i) S’s taxable income or loss, (ii) S’s tax-exempt income, (iii) S’s noncapital, nondeductible expenses, and (iv) distributions with respect to S’s stock. For example, if S has $120 of taxable income in Year 1, and S makes a $10 distribution to M in Year 1, M increases its basis in S’s stock as of the close of Year 1 by a $110 net amount. Outside of the consolidated return context, a shareholder generally does not adjust its basis in subsidiary stock for these items.

Regulation section 1.1502-19 provides rules for M to take into account an ELA in the stock of S. For all federal income tax purposes, M’s ELA is treated as negative basis, and a reference to M’s basis in S’s stock includes a reference to M’s ELA. Generally, if M is treated as disposing of a share of its S stock, M takes into account its ELA in the share as income or gain from the disposition. For these purposes, a disposition of stock includes (i) a transfer of stock outside of the group, (ii) the deconsolidation of M or S from the group, or (iii) M’s

---

85 I.R.C. § 358(a)(1).
86 See Reg. § 1.1502-32(b)(2).
87 Reg. § 1.1502-32(b)(5)(ii), Ex (5).
88 Reg. § 1.1502-19(a)(2)(i). Examples of transactions that give rise to an ELA include (i) once M’s negative adjustments under Regulation section 1.1502-32 exceed its basis in S’s stock and (ii) if M forms S by transferring property subject to liabilities in excess of basis. See Reg. § 1.1502-19(a)(2)(i)(A)-(B).
90 Reg. § 1.1502-19(b)(1)(i).
91 Reg. § 1.1502-19(c)(1)(i). A transfer occurs if either (i) M transfers or otherwise ceases to own the share for federal income tax purposes, even if no gain or loss is taken into account or (ii) M takes into account gain or loss (in whole or in part) with respect to the share.
92 Reg. § 1.1502-19(c)(1)(ii).
investment in S becoming worthless. However, income or gain recognized by M is subject to any nonrecognition or deferral rules applicable to the disposition. For example, M generally does not recognize income if S liquidates into M in a transaction subject to section 332.

Under section 1400Z-2(b)(2)(B)(i), a taxpayer’s basis in a QOF is zero, except as otherwise provided in section 1400Z-2(b)(2)(B) and section 1400Z-2(c). A question arises as to whether adjustments under Regulation section 1.1502-32 should impact the shareholder’s basis in the QOF C corporation in light of the language in section 1400Z-2(b)(2)(B)(i). In particular, prior to an inclusion event, the language in section 1400Z-2(b)(2)(B)(i) limits the shareholder’s basis to $0, 10% of the deferred gain if the QOF stock is held for five years, or 15% of the deferred gain if the QOF stock is held for seven years. In connection with an inclusion event, section 1400Z-2(b)(2)(B)(ii) and (c) seem to provide for a basis increase only equal to the amount of deferred gain recognized from the sale. This can create counterintuitive results if the consolidated shareholder does not make investment adjustments under Regulation section 1.1502-32, as is shown in the following example.

Example 5: Corporation A is the parent of a consolidated group. In Year 1, Corporation A sells an asset to an unrelated party and realizes a $100 capital gain. Corporation A forms Corporation B and contributes $100 to Corporation B in exchange for 100% of Corporation B’s stock. Corporation B makes an election to be treated as a QOF, and Corporation A’s investment in Corporation B meets the definition of a qualifying investment. Further, Corporation B does not apply the Proposed Regulations, and, as a result, Corporation B must be included in Corporation A’s consolidated group.

In Year 1, Corporation B has $110 of taxable income that is included in the Corporation A group’s consolidated taxable income. In Year 2, Corporation A sells its investment in Corporation B to X (an unrelated party) for $75.

The sale to X is an inclusion event, and, under section 1400Z-2(b)(2)(A), Corporation A must recognize deferred gain equal to the lesser of (i) the deferred gain of $100 less Corporation A’s basis in Corporation B stock or (ii) the fair market value of the Corporation B stock of $75 less Corporation A’s basis in Corporation B stock.

93 Reg. § 1.1502-19(c)(1)(iii). For these purposes, worthlessness means (i) all of S’s assets are treated as disposed of, abandoned or destroyed for federal income tax purposes; (ii) an indebtedness of S is discharged, if any part of the amount discharged is not included in gross income and is not treated as tax-exempt income under Regulation section 1.1502-32(b)(3)(ii)(C); or (iii) a member takes into account a deduction or loss for the uncollectibility of an indebtedness of S, and the deduction or loss is not matched in the same tax year by S taking into account a corresponding amount of income or gain from the indebtedness in determining consolidated taxable income.


95 Except for the positive investment adjustment from Corporation B’s taxable income, Corporation A does not recognize any investment adjustments in Year 1 with regard to its investment in Corporation B under Regulation section 1.1502-32. For simplicity, we are disregarding the impact of federal taxes and any payments that may be made or received by Corporation B in connection with the Corporation A group tax sharing agreement.

96 During Year 2, as a result of economic events, we are assuming Corporation B’s assets have depreciated in value to $75 in spite of the taxable income recognized by Corporation B in Year 1.

Varying positions could be taken with respect to the application of Regulation section 1.1502-32 to Corporation A’s basis in Corporation B stock, each resulting in different tax consequences. We believe the following are three possible interpretations of the rule.

(1) Regulation section 1.1502-32 applies for purposes of determining the amount of deferred gain recognized by Corporation A. Corporation A recognizes none of the deferred gain,\(^98\) and recognizes a loss of $35 on the sale of the Corporation B stock,\(^99\) resulting in a net loss of $35.

(2) Regulation section 1.1502-32 does not apply for purposes of determining the amount of deferred gain recognized by Corporation A, but does apply for purposes of determining the amount of gain or loss realized by Corporation A on the sale of the Corporation B stock. Corporation A recognizes $75 of the deferred gain,\(^100\) and recognizes a loss of $110 on the sale of the Corporation A stock,\(^101\) resulting in a net loss of $35 (i.e., the same amount as (1)).

(3) Regulation section 1.1502-32 is not applicable, and Corporation A’s basis is determined solely under section 1400Z-2. Corporation A recognizes $75 of the deferred gain,\(^102\) and recognizes no loss on the sale of the Corporation A stock,\(^103\) resulting in a net gain of $75.

Economically, Corporation A recognized gain of $100 on the sale of its initial investment and also paid tax on $110 in Year 1 (i.e., the increase to the Corporation A group’s consolidated taxable income). Thus, when it sells its investment for $75, it should recognize a loss of $35 (i.e., the outcome in interpretations (1) and (2)), so that its cumulative taxable income is $75 ($110 income in Year 1 and $35 loss in Year 2).\(^104\) For this reason, in our view, interpretation (3) runs counter to the purpose of Regulation Section 1.1502-32 (i.e., to prevent the taxation of the same income twice) and requires Corporation A to pay tax on phantom income of $110 (i.e.,

\(^{98}\) The fair market value of the Corporation B stock of $75 over Corporation A’s basis in the Corporation B stock of $110. However, the amount of deferred gain recognized by Corporation A cannot be less than zero.

\(^{99}\) The amount realized of $75 over Corporation A’s basis in the Corporation B stock of $110.

\(^{100}\) The fair market value of the Corporation B stock of $75 over Corporation A’s section 1400Z-2 basis in the Corporation B stock of $0.

\(^{101}\) The amount realized of $75 over Corporation A’s basis in the Corporation B stock of $185, which is equal to the Regulation section 1.1502-32 investment adjustment plus the increase to basis resulting from the deferred gain recognized by Corporation A. See I.R.C. § 1400Z-2(b)(2)(B)(ii).

\(^{102}\) The fair market value of the Corporation B stock of $75 over Corporation A’s section 1400Z-2 basis in the Corporation B stock of $0.

\(^{103}\) The amount realized of $75 over Corporation A’s basis in the Corporation B stock of $75, which equals the increase to basis resulting from the deferred gain recognized by Corporation A (i.e., Corporation A’s basis in its Corporation B stock is determined for all federal income tax purposes under section 1400Z-2(b)(2)(B)).

\(^{104}\) As discussed below, the Proposed Regulations addressing pass-through entities limit the amount of deferred gain recognized by the investor to the amount that would be recognized on a fully taxable disposition of the QOF investment. For these purposes, the investor takes into account basis adjustments made under general tax principles (e.g., amounts attributable to taxable income allocated from the flow-through entity to the investor). We believe it would be appropriate to implement a similar rule for subsidiary members of a consolidated group.
rather than recognize a loss of $35 on the sale, Corporation A recognizes gain of $75, or a difference of $110).

We believe the rules under Proposed Regulation section 1.1400Z2(b)-1 that apply to inclusion amounts for flow-through entities provide a workable solution. More specifically, Proposed Regulation section 1.1400Z2(b)-1(e)(4) would require a flow-through investor to recognize deferred gain equal to the lesser of the following two amounts:

1. The product of (i) the percentage of the qualifying investment that gave rise to the inclusion event multiplied by (ii) the remaining deferred gain, less any basis adjustments pursuant to section 1400Z-2(b)(2)(B)(iii) and (iv); and,
2. The gain that would be recognized on a fully taxable disposition of the qualifying investment that gave rise to the inclusion event.

With regard to flow-through entities, the investor’s basis also reflects adjustments for items other than section 1400Z-2 adjustments. If a similar regime is implemented for consolidated groups, the shareholder in the QOF C corporation would make investment adjustments under Regulation section 1.1502-32. However, in connection with an inclusion event, the shareholder would recognize deferred gain using the above equation. Returning to Example 5, consistent with the first alternative, Corporation A would recognize deferred gain equal to the lesser of (i) $100 and (ii) $0. Corporation A also recognizes a loss of $35 in connection with the sale of its Corporation B stock. The $35 appropriately reflects the economic loss the Corporation A group recognizes from the transaction.

2) Recommendations for the Treatment of the QOF C Corporation on the Consolidated Return Rule

We appreciate that Treasury and the Service face a difficult decision with regard to how a QOF C corporation should be treated if it has previously been a member of a consolidated group. One approach would be to allow QOF C corporations that were formed prior to the date of

105 Sections 1400Z-2(b)(2)(B)(iii) and (iv) address the 10% and 15% basis increase if the qualifying investment is held for five years and seven years, respectively, prior to December 31, 2026.
106 The remaining deferred gain of $100. Corporation A has not made any basis adjustments pursuant to sections 1400Z-2(b)(2)(B)(iii) and (iv).
107 Corporation A does not recognize any gain on a fully taxable disposition of its Corporation B stock. Rather, Corporation A recognizes a loss of $35.
108 The amount realized of $75 over Corporation A’s basis in the Corporation B stock of $110.
109 As previously discussed, the Corporation A group should recognize cumulative gain of $75 (i.e., the $100 deferred gain plus the $25 loss on its investment in Corporation B). The Corporation A group recognizes $110 in consolidated taxable income in Year 1 and a $35 loss in Year 2, or a cumulative gain of $75. Any loss recognized on the transfer of Corporation B stock may also need to be subject to the unified loss rules under Regulation section 1.1502-36. These rules may impact the overall loss to the Corporation A group, as well as the attributes of Corporation B following the sale. The potential application of the unified loss rules on Corporation B’s attributes in connection with a QOF Deconsolidation Event is discussed in detail below.
publication of the Proposed Regulations in the Federal Register to be “grandfathered” and continue to file indefinitely as part of the consolidated group. From an equitable perspective, we believe that this is an appropriate solution because early investors in the QOZ program formed QOF C corporations with the expectation of including these QOF C corporations in a group, meaning investors and other stakeholders (e.g., developers, municipalities) determined the price of the investment based on this assumption. There was no reason for these stakeholders to believe a QOF C corporation could not be included in a consolidated group. The inability to include a QOF C corporation in a group over the life of the investment could negatively impact an investor’s anticipated return on its investment, and that investor may need to re-evaluate whether it should continue to hold its investment in the QOF. Further, if an investor ultimately concludes it needs to exit the investment because the QOF C corporation may not join the consolidated group of the investor, capital would leave the QOZ, which is contradictory to the objectives of the QOF program. Further, we believe that the recommendations in these Comments provide a reasonable framework for harmonizing the QOZ program with the consolidated return Regulations, and that if a taxpayer applies the rules in a manner that is inconsistent with the purpose of the QOZ program or consolidated return Regulations, the government has wide discretion to apply a number of anti-abuse rules.

If Treasury and the Service conclude that existing QOF C corporations cannot be grandfathered, and a QOF C corporation undergoes a QOF Deconsolidation Event, we recommend that the final Regulations should attempt to limit the disruption to investors. For example, certain investors may feel it is more advantageous to include the corporation in their consolidated group than retain QOF status. As a result, a QOF C corporation should have the ability to revoke its QOF election. However, under the Proposed Regulations, there does not seem to be a mechanism allowing an entity to revoke a QOF election in a later year.

100 Prior to the Proposed Regulations, there was no indication from Congress or Treasury that QOF C corporations could not qualify as subsidiary members of a consolidated group. We note that prior to the Proposed Regulations, there was a great deal of uncertainty as to how section 1400Z-2 would be coordinated with subchapter K of the Code. As such, some investors may have been inclined to use QOF C corporations.

101 For example, investors may have invested in QOF C corporations that generate federal and state tax credits. The consolidated group’s ability to utilize these credits was considered when the stakeholder’s priced the QOF investment, and if these credits are no longer available to the group, the QOF investment would decline in value.

102 See, e.g., Reg. § 1.1502-13(h); Reg. § 1.1502-32(e); Prop. Reg. § 1.1400Z2(f)-1(c).

103 The revocation of the QOF election would presumably need to be an inclusion event, and the investor would be required to recognize some or all of its deferred gain.

104 In addition to these recommendations, Treasury and the Service may consider allowing a QOF C corporation to convert into a QOF partnership in connection with a QOF Deconsolidation Event and not have the conversion be treated as an inclusion event. For example, the conversion could be executed through a check-the-box election under Regulation section 301.7701-3(c). For certain taxpayers, we believe that this may be advantageous given the number of similarities between partnerships and subsidiary members of a consolidated group. However, rules should be implemented that treat the QOF partnership no better or worse than if the QOF had elected to be treated as a partnership from the date it was initially formed. In light of the complexities that may arise from converting a QOF C corporation into a QOF partnership, if this approach is taken, we recommend that Treasury and the Service initially release these rules in proposed form.
a) QOF Deconsolidation Events

We think it is important for the rules to address the tax implications to both the investor and the QOF C corporation if a QOF C corporation undergoes a QOF Deconsolidation Event. In particular, the QOF C corporation’s existence would include a period while it is subject to the consolidated return Regulations and a period when it is not. As a result, among the issues Treasury and the Service will need to address are: the investment adjustments taken into account while the QOF C corporation was a member of the consolidated group, the application of the ELA rules, and the unified loss rules of Regulation section 1.1502-36.

We believe there are two primary approaches Treasury and the Service could implement in order to address these issues. The first approach (the “Prospective Approach”) would treat the QOF C corporation in the same manner as any other subsidiary would be treated. For example, the investment adjustments made with respect to the QOF C corporation would apply for all purposes and create the possibility that the ELA or unified loss rules could apply at the time of the QOF Deconsolidation Event. The Prospective Approach would also adopt a rule similar to Proposed Regulation section 1.1400Z2(b)-1(e)(4).

The second approach (the “Retrospective Approach”) would adjust the QOF investor’s basis in the QOF C corporation to zero immediately before the QOF Deconsolidation Event.\(^\text{115}\) The Retrospective Approach is designed to replicate, as much as possible, the tax treatment had the QOF C corporation never been a member of the consolidated group.\(^\text{116}\) Under this approach the ELA and unified loss rules would not apply to a QOF Deconsolidation Event. This Retrospective Approach would not need to adopt a rule similar to Proposed Regulation section 1.1400Z2(b)-1(e)(4).

There are advantages and disadvantages associated with each approach depending on, among other things, whether the investment increases in value as well as the type of assets owned by the QOF C corporation (e.g., an asset subject to 100% expensing). For example, the Prospective Approach uses the established consolidated return regulations and treats a QOF C corporation in the same manner as any other consolidated subsidiary. On the other hand, the Retrospective Approach appears to provide a better means for advancing the QOZ policy goals. Further, the Retrospective Approach, in our view, more closely aligns the tax treatment of QOF C corporations formed prior to the release of the Final Regulations with the tax treatment of QOF C corporations formed after the release of the Final Regulations (i.e., ensuring that the investor’s basis in the QOF is determined under section 1400Z-2(b)(2)(B) principles).

Example 6: Corporation A is the parent of a consolidated group. In Year 1, Corporation A sells an asset to an unrelated party and realizes a $100 capital gain. Corporation A forms Corporation B, and contributes $100 to Corporation B in exchange for 100% of

\(^{115}\) The investor’s basis would equal zero as a result of section 1400Z-2(b)(2)(B)(i). For these purposes, we have assumed the QOF Deconsolidation Event occurs before the five-year anniversary of the investor’s investment and the QOF C corporation is not a mixed fund (as defined in section 1400Z-2(e)(1)).

\(^{116}\) As illustrated below, a limitation of the Retrospective Approach is that the location of items and attributes upon a QOF Deconsolidation Event cannot mirror the location of attributes where the QOF C corporation was never a member of the consolidated group. In certain circumstances, this can result in a more favorable result for consolidated taxpayers that made investments in QOF C corporations prior to the finalization of the Regulations.
Corporations B’s stock. Corporation B makes an election to be treated as a QOF, and Corporation A’s investment in Corporation B meets the definition of a qualifying investment. Further, Corporation B does not apply the Proposed Regulations, and, as a result, Corporation B must initially be included in Corporation A’s consolidated group.

In Year 1, Corporation B purchases an asset for $100 that is eligible for 100% bonus depreciation under section 168(k). Corporation B has no other income, gain, deduction, or loss. As a result, the Corporation A group absorbs the $100 deduction from Corporation B in its consolidated taxable income. Corporation A has an ELA in its Corporation B stock of $100.

In Year 2, the Proposed Regulations are finalized, and Corporation B deconsolidates from the Corporation A group. At this time, the fair market value of Corporation A’s stock in Corporation B is $100.

Corporation A continues to hold the Corporation B stock, and, in 2026, the fair market value of Corporation B’s stock is $100.

**Prospective Approach:** Under Regulation section 1.1502-19(c)(ii)(B), Corporation A is treated as disposing of its Corporation B stock on the QOF Deconsolidation Event, and Corporation A must recognize its ELA of $100. Corporation A’s basis in its Corporation B stock will be $0 after the ELA is recognized. In 2026, Corporation A recognizes deferred gain of $85,\(^\text{117}\) and its basis in the Corporation B stock equals $100.\(^\text{118}\)

Corporation A recognizing its ELA in Year 2 has the effect of only providing Corporation A a one-year deferral on its original capital gain. More specifically, if Corporation B did not make a QOF election, the Corporation A group would recognize $100 of capital gain in Year 1 and $100 of depreciation deductions in Year 1, or cumulative income of $0. As a result of Corporation B making the QOF election, the Corporation A group recognizes $100 of depreciation deductions in Year 1 and $100 of capital gain in Year 2 (due to the ELA inclusion). Thus, after Year 2, the Corporation A group is economically in the same position as if Corporation B did not make the QOF election.

Further, in 2026, Corporation A must recognize an additional $85 of capital gain. If Corporation B did not make a QOF election, Corporation A would only recognize additional gain when it sells its Corporation B stock.\(^\text{119}\) Thus, depending on the facts, Corporation A may reorganize gain and pay tax sooner due to Corporation B making the QOF election.

**Retrospective Approach:** Under the Retrospective Approach, Treasury and the Service would provide rules that are intended to economically approximate the tax consequences to A if

---

\(^\text{117}\) I.R.C. § 1400Z-2(b)(1)(B), (b)(2)(A). Only $85 of the deferred gain is recognized because Corporation A held its investment for over seven years and thus increased its basis in Corporation B by $15. See I.R.C. § 1400Z-2(b)(2)(B)(iii)-(iv).


\(^\text{119}\) Corporation A also would not receive the benefit of the $15 tax-free basis increase under section 1400Z-2(b)(2)(B)(iii) and (iv). However, if Corporation A intends to hold its investment in Corporation B for a significant period of time (or indefinitely), Corporation A’s need to recognize deferred income in 2026 may outweigh the benefit of the $15 basis increase. Further, Corporation A accelerated taxable income through the recognition of the ELA in Year 2. The impact of this acceleration could be permanent (compared to the retrospective approach discussed below) if Corporation A can ultimately apply section 1400Z-2(c).
Corporation B was never a member of the Corporation A group. In order to effectuate this result, in connection with the QOF Deconsolidation Event, an investment adjustment in Corporation A’s Corporation B stock must be made that will result in Corporation A’s basis in the Corporation B stock equaling zero.\textsuperscript{120} In 2026, Corporation A recognizes deferred gain of $85, and its basis in the Corporation B stock equals $100.

Unlike the Prospective Approach, the Retrospective Approach preserves Corporation A’s ability to defer its initial gain. More specifically, the Corporation A group recognizes a deduction of $100 in Year 1 and recognizes deferred gain of $85 in 2026. One notable difference between the Retrospective Approach and the situation where Corporation B never filed as a member of the Corporation A group is the ability for the Corporation A group to utilize the $100 depreciation deduction in Year 1. If Corporation B were a stand-alone taxpayer, the use of this attribute would be limited to the items on Corporation B’s stand-alone return. However, the Corporation A group’s ability to utilize these attributes aligns with Corporation A’s expectations when it formed Corporation B; again, prior to April, 2019, there was no indication that Corporation B could not join the group. Therefore, we believe it is equitable to allow the Corporation A group the ability to use these attributes until the QOF Deconsolidation Event.

**Example 7:** The facts are the same as Example 6, except that Corporation B recognizes taxable income of $110 in Year 1 that is included in the Corporation A group’s consolidated taxable income, and Corporation B’s basis in its assets equals $210 at the end of Year 1.

At the beginning of Year 2, the Proposed Regulations are finalized, and Corporation B deconsolidates from the Corporation A group. At this time, the fair market value of Corporation A’s stock in Corporation B, as well as the fair market value of Corporation B’s assets, is $75.\textsuperscript{121}

Corporation A continues to hold the Corporation B stock, and, in 2026, the fair market value of Corporation B’s stock and the fair market value of Corporation B’s assets continues to be $75.

**Prospective Approach:** In connection with the QOF Deconsolidation Event, Corporation A is treated as transferring its shares in Corporation B for purposes of applying the unified loss rules under Regulation section 1.1502-36.\textsuperscript{122} In particular, Corporation B needs to assess whether it must reduce any of its attributes in accordance with Regulation section 1.1502-

\textsuperscript{120} The final Regulations may also need to treat the QOF Deconsolidation Event as an inclusion event with regard to distributions that previously resulted in an ELA. More specifically, if the QOF C corporation had never been a member of the consolidated group, distributions in excess of basis would have been an inclusion event, and this recommendation is attempting to treat the post-deconsolidation parties no differently than if the QOF C corporation had never been eligible to file as part of the consolidated group.

\textsuperscript{121} During Year 2, Corporation B’s assets have depreciated in value to $75 even though taxable income was recognized by Corporation B in Year 1. None of the property held by Corporation B at the end of Year 1 is identified as a Class I asset under Regulation section 1.338-6(b)(1), and as a result, the property could have its basis reduced under Regulation section 1.1502-36(d).

\textsuperscript{122} Reg. § 1.1502-36(f)(10)(B).
36(d) (the “attribute reduction rule”). Under the attribute reduction rule, Corporation B must reduce its attributes by the attribute reduction amount.

The attribute reduction amount is equal to the lesser of (i) the net stock loss ($35) or (ii) the aggregate inside loss ($135). Consequently, Corporation B must reduce its basis in its assets from $210 to $175 immediately before the QOF Deconsolidation Event. However, because Corporation A’s basis in the Corporation B stock does not reflect the deferred gain of $100, Corporation A and Corporation B can receive an uneconomic tax benefit of $100. For example, if instead of holding the Corporation B stock until 2026, Corporation A sells its stock in Corporation B to X, a third-party, for $75 immediately after the QOF Deconsolidation Event. Following the sale by Corporation A, Corporation B sells its property to Y for $75. Overall, the parties to the transaction (i.e., Corporation A and Corporation B) recognize cumulative income of $75 (i.e., $110 of taxable income in Year 1 and $35 of loss in Year 2). However, Corporation B also recognizes a loss of $100 when it sells its assets.

We believe it is appropriate for Corporation A to pay tax on the cumulative income of $75. More specifically, Corporation A never paid tax on its initial gain of $100 because it invested in Corporation B, a QOF C corporation, and, when it ultimately exited its investment in Corporation B, Corporation A only received $75. However, the limited reach of the unified loss rules under the Prospective Approach would also allow Corporation B to claim a loss of $100 on the sale of its assets.

Retrospective Approach: Under the Retrospective Approach, there would be an investment adjustment in Corporation A’s Corporation B stock in connection with the QOF Deconsolidation Event that would result in Corporation A’s basis in the Corporation B stock equaling zero. The Corporation A group pays tax on $110 of taxable income in Year 1, which would be the same amount subject to tax if Corporation B filed a stand-alone tax return in Year 1. Further, in 2026, Corporation A would recognize deferred gain of $60, and Corporation A’s basis in its Corporation B stock would equal $75. While a difference would exist between

---

123 Corporation A has a uniform basis in all of its shares of Corporation B stock, and as a result, the basis redetermination rule under Regulation section 1.1502-36(b) does not apply. Further, the basis reduction rule under Regulation section 1.1502-36(c) does not apply because the disconformity amount with regard to Corporation B stock equals zero. See Reg. § 1.1502-36(c)(2), (4).

We are also assuming the parties do not make an election under Regulation section 1.1502-36(d)(6) to reduce Corporation A’s basis in its Corporation B stock, instead of Corporation B reducing its attributes under the general rule in Regulation section 1.1502-36(d).

124 Reg. § 1.1502-36(d)(2)(i).

125 The aggregate basis of all shares of Corporation B stock of $110 over the stock’s fair market value of $75. See Reg. § 1.1502-36(d)(3)(i).

126 The aggregate inside loss is equal to the excess of Corporation B’s net inside attribute amount of $210 over the value of all outstanding shares of Corporation B of $75. See Reg. § 1.1502-36(d)(3)(iii).

127 There would be no gain to account for under section 1400Z-2 because the basis in the Corporation B stock exceeds its fair market value.

128 Corporation A would increase its basis by $15 because it held its investment in Corporation B for seven years prior to December 31, 2026. Further, Corporation A would only include gain equal to the excess of the lesser of (i) the deferred gain ($100) and (ii) the fair market value of the stock ($75), over Corporation A’s basis of $15.
Corporation A’s basis in its Corporation B stock of $75 and Corporation B’s basis in its assets of $210, this difference is always inherent in the two-tier tax system for shareholders and their corporations outside of the consolidated return context.

**Example 8:** The facts are the same as Example 7, except that Corporation B recognizes taxable income of $110 in Year 1 that is included in the Corporation A group’s consolidated taxable income. Corporation B’s basis in its assets is $210 at the end of Year 1.

At the beginning of Year 2, the Proposed Regulations are finalized, and Corporation B deconsolidates from the Corporation A group. At this time, the fair market value of Corporation A’s stock in Corporation B, as well as the fair market value of Corporation B’s assets, is $375.

Corporation A continues to hold the Corporation B stock, and, in 2026, the fair market value of Corporation B’s stock and the fair market value of Corporation B’s assets continues to be $375.

**Prospective Approach:** There should be no consequences to Corporation A or Corporation B at the time of the QOF Deconsolidation Event. In 2026, Corporation A should recognize deferred gain of $85 and increase its basis in the Corporation B stock to $210. Corporation A would maintain the ability to eliminate the additional appreciation under section 1400Z-2(c).

**Retrospective Approach:** Under the Retrospective Approach, Corporation A would recognize a negative investment adjustment in connection with the QOF Deconsolidation Event that would result in a $0 basis in Corporation A’s Corporation B stock. In 2026, Corporation A would recognize a deferred gain of $85, and Corporation A’s basis in its Corporation B stock would be $100. Corporation A could eliminate any additional gain with regard to its Corporation B stock if it holds its investment for ten years and makes an election under section 1400Z-2(c). However, if Corporation A disposes of its stock in Corporation B prior to the ten-year anniversary of its investment in Corporation B and, consequently, is not eligible to make an election section 1400Z-2(c), the Corporation A group would pay tax a second time on the $110 of income already recognized in Year 1.

**b) Other Tax Considerations Following the QOF Deconsolidation Event**

When a corporation leaves a consolidated group, section 1504(a)(3) generally prevents the corporation from rejoining the group for a period of five years. With regard to the QOF C corporation, this may not be problematic. A QOF C corporation, after all, would otherwise be unable to join a consolidated group, and the current rules do not appear to allow a corporation

---

129 Corporation A would increase its basis by $15 because it held its investment in Corporation B for seven years prior to December 31, 2026. Further, Corporation A would only include gain in amount equal to the lesser of (i) the deferred gain ($100) and (ii) the fair market value of the stock ($75), over Corporation A’s basis of $15.

130 We do not believe that the risk of double taxation on Corporation B’s income was expected when Corporation A made its investment.

131 This is, presumably, why the QOF C corporation needed to leave the consolidated group in the first place.
to revoke its QOF election. However, section 1504(a)(3)(A) states “such corporation (and any successor of such corporation) may not be included in any consolidated return filed by the affiliated group . . . before the 61st month beginning after its first taxable year in which it ceased to be a member of such affiliated group” (emphasis added). Consequently, if, for example, a QOF C corporation merges into its shareholder in a transaction governed by section 381 within the five-year window, it could also deconsolidate the shareholder (i.e., the successor) from the consolidated group. This creates a trap for the unwary and opportunities for inappropriate tax planning.\textsuperscript{132}

We note that after a QOF C corporation deconsolidates from the group, the investor’s return may be significantly diminished if it cannot claim the benefit of the 100% DRD as discussed in Part II.C.4.b.iii. below. The consolidated group and QOF C corporation will also need to consider a number of rules that may negatively impact the taxable income of the consolidated group and the separate return of the QOF C corporation. For example, section 267 may be more impactful following the deconsolidation. Further, section 163(j) will also now separately apply to business interest deductions recognized by the QOF C corporation. Finally, any indebtedness between a QOF C corporation and its consolidated group may be subject to the rules under Regulation section 1.385-3.

3) Recommendations

If a QOF C corporation cannot be a subsidiary member of a consolidated group, we recommend that a QOF C corporation formed prior to the release of the Proposed Regulations be grandfathered and eligible to continue to file as a subsidiary member of a consolidated group. If, however, a QOF C corporation is not grandfathered, we recommend that Treasury and the Service provide clear rules addressing the tax implications to the QOF C corporation and its shareholders in connection with the deconsolidation, including the application of the investment adjustment rules under Regulation section 1.1502-32, the excess loss account rules under Regulation section 1.1502-19, and the unified loss rules under Regulation section 1.1502-36. We have provided two recommended approaches to take into account these rules: the “Prospective Approach” and the “Retrospective Approach.” However, because of the need to provide a comprehensive and complex set of rules pertaining to deconsolidation for what is likely a small number of taxpayers, we reiterate that it is our recommendation that QOF C corporations formed prior to the release of the Proposed Regulations be grandfathered. If Treasury and the Service are concerned of the potential for abuse, we believe existing anti-abuse provisions provide sufficient authority to address these concerns.

\textsuperscript{132} Under section 1504(a)(3)(B), Treasury may waive the application of section 1504(a)(3)(A). Under Revenue Procedure 2002-32, a corporation is not required to obtain a letter ruling if it satisfies certain requirements, including a “representation that the disaffiliation and subsequent consolidation has not provided and will not provide a benefit of a reduction in income, increase in loss, or any other deduction, credit, or allowance (a federal tax savings) that would not otherwise be secured or have been secured had the disaffiliation and subsequent consolidation not occurred.” Rev. Proc. 2002-32, 2002-1 C.B. 959.

A question arises as to whether the ability to continue to obtain the benefits from the QOZ rules through the deconsolidation will prevent taxpayers from using the revenue procedure.
iii. Dividends Received Deduction

1) Discussion

Distributions out of a corporation’s E&P result in the recipient recognizing taxable income in the form of a dividend. Without statutory interference, the receipt of a dividend from a corporate owner (or several layers of corporate owners) could result in multiple layers of taxation. However, section 243 provides for a dividends-received deduction, which was intended to address the potential for multiple layers of taxation. Section 243 permits corporate shareholders to deduct from taxable income a percentage of dividends received based on their aggregate ownership in the distributing corporation.\(^\text{133}\) As noted above, the exclusion of the stock of a QOF C corporation from the definition of stock for purposes of section 1504 denies an otherwise eligible corporate shareholder from qualifying for the 100% DRD. We believe this is not the appropriate outcome and that such distributions should qualify for the 100% DRD under section 243.

The 100% DRD is allowable for dividends received by affiliated corporate shareholders. Dividends entitled to the 100% deduction are known as “qualifying dividends” as referenced in section 243(a)(3).\(^\text{134}\) For a dividend to be characterized as a qualifying dividend, the distributing corporation must be a member of the distributee corporation’s affiliated group, and the dividend must be distributed out of E&P of a taxable year during which the distributing corporation and the distributee corporation were members of the same affiliated group for each day of the year. Also, for this purpose, the term “affiliated group” has the same meaning as in section 1504(a) except that the normal exclusion for certain companies from an affiliated group under sections 1504(b)(2) and 1504(c) do not apply.

With respect to a QOF C corporation, Proposed Regulation section 1.1400Z2(g)-1(b) indicates that ownership in the QOF is not treated as stock for purposes of determining whether the issuer is a member of an affiliated group within the meaning of section 1504, with the result that a QOF C corporation cannot be a subsidiary member of a consolidated group. A collateral, and possibly unintended, consequence of this rule is the disallowance of the 100% DRD with respect to any dividends distributed by a QOF C corporation. This is because the “qualifying dividends” definition in section 243 requires the distributing and recipient corporations to be affiliated.

Because of this rule, the additional taxation on the distribution of current earnings can significantly reduce or eliminate the benefit of investing in a QOF. Because the Proposed Regulations require taxation to the corporate shareholder of a controlled corporate QOF on

\(^{133}\) Beyond the level of ownership, the percentage of deduction is based on whether the corporation is domestic, foreign, or a special status corporation. For purposes of this discussion, references to a “distributing corporation” assume that such corporation is a domestic corporation.

\(^{134}\) There are three different ownership thresholds that result in varying percentages of deduction under section 243. The other two thresholds are the 50% DRD, allowable for dividends received by corporate shareholders owning less than 20% of the distributing corporation’s stock, and the 65% DRD, allowable for dividends received by non-affiliated corporate shareholders owning 20% or greater of the distributing corporation’s stock.
earnings distributed by the QOF C corporation, the consolidated group investor-member is taxed at an aggregate rate of approximately 26.8%. Consider the following example:

**Example 9:** Corporation A is the parent of a consolidated group.\(^{135}\) In Year 1, Corporation A sells an asset to an unrelated party and realizes a $100 capital gain. Corporation A forms Corporation B, and contributes $100 to Corporation B in exchange for 100% of Corporations B’s stock. Corporation B makes an election to be treated as a QOF and Corporation A’s investment in Corporation B meets the definition of a qualifying investment. During Year 1, Corporation B generates $10 of cash and $100 of taxable income and E&P. Corporation B pays $21 of federal income tax and distributes $79. If the 100% DRD is unavailable, Corporation A owes approximately $5.80 of federal income tax on the distribution (65% DRD on $79 of taxable income), and is left with $73.20 after taxes.

This is contrasted to earnings distributed by a partnership owned by consolidated group members or a consolidated group member being taxed at a rate of 21%, retaining $79 after taxes.\(^{136}\) While a consolidated group of corporations and their shareholders are not perfect analogs for partnerships and their partners, we believe that the comparison is instructive for general equity in constructing rules for distributing earnings.

While a QOF C corporation could ultimately liquidate into the consolidated group member and avoid a second layer of tax on its E&P, doing so would sever some or all of the benefits of the Opportunity Zone Regime, depending on the timing of such liquidation. Additionally, if the liquidation is delayed until after 2026, allowing E&P in the form of cash to be reinvested by the QOF C corporation, the QOF C corporation runs the risk of not having invested at least 90% of its capital into QOZ Property and the risk of the application of the accumulated earnings tax. If a QOF C corporation cannot find suitable replacement property, it may be forced to make a distribution that puts it on unequitable footing.

2) **Recommendation**

If a QOF C corporation cannot be a subsidiary member of a consolidated group, we recommend that a QOF C corporation can still qualify as a subsidiary member of an affiliated group for purposes of permitting its shareholders to claim the 100% dividends received deduction.

5. **Consolidated Intercompany Transactions and Investment Adjustment Rule Guidance in the Proposed Regulations**

In the Preamble, in discussing the policy behind the QOF Consolidated Member Exclusion Rule, Treasury and the Service state that section 1400Z-2 and the consolidated return Regulations are “incompatible” in many respects. More specifically, the Preamble specifically points to deferral under Regulation section 1.1502-13 and deferral under section 1400Z-2 as

---

\(^{135}\) For purposes of this example, assume Corporation A and Corporation B are not subject to state income tax.

\(^{136}\) With a QOF partnership owned by consolidated group members, under section 705(a)(1) the partner’s allocable share of taxable income would generally increase the partner’s basis in the partnership interest. Any pro rata distributions of money would generally reduce basis under section 733(1). This is analogous in the corporate context to distributing E&P and reducing stock basis under section 301(c)(2).
incompatible, requiring Treasury and the Service to draft elaborate new rules to establish the
proper tax treatment of intercompany transactions between investor and QOF members of a
consolidated group. The Preamble’s discussion of incompatibility of section 1400Z-2 and the
consolidated return Regulations is limited to the situation in which a corporate QOF is a member
of a consolidated group and not the common parent. In light of these concerns and others
illustrated in the Preamble, the Proposed Regulations treat stock in a QOF as not stock for
section 1504 purposes.\textsuperscript{137} The Proposed Regulations do not limit the application of the
consolidated return rules in other regards. More particularly, the Proposed Regulations do not
limit or modify the application of the intercompany transaction rules under Regulation section
1.1502-13 upon the transfer of a QOF interest between members of a consolidated group.

The Proposed Regulations generally provide that section 1400Z-2 applies separately to
each member of a consolidated group. Specifically, the same member of a consolidated group
must both engage in the sale of a capital asset giving rise to eligible gain and timely invest an
amount equal to some or all of such eligible gain in a QOF (as provided in section 1400Z-2(a)(1)) in order to qualify under section 1400Z-2.\textsuperscript{138} Further, the Proposed Regulations provide
that the basis increases in a qualifying QOF investment under section 1400Z-2(b)(2)(B)(iii),
(b)(2)(B)(iv), and (c) are treated as tax-exempt income to the QOF owner for purposes of
Regulation section 1.1502-32 and such positive basis adjustments tier-up within the group.\textsuperscript{139}

\textbf{a. Regulation Section 1.1502-13: Intercompany Transaction Rules
Generally}

Regulation section 1.1502-13 provides rules governing the treatment of transactions
between members of a consolidated group (intercompany transactions). An intercompany
transaction is defined as “a transaction between corporations that are members of the same
consolidated group immediately after the transaction.”\textsuperscript{140} Regulation section 1.1502-13
implements a single entity regime through operation of the matching rule of Regulation section
1.1502-13(c) and the acceleration rule of Regulation section 1.1502-13(d). Under the matching
rule, the selling member (S) and the buying member (B) are generally treated as divisions of a
single corporation for purposes of taking into account their items from intercompany
transactions. The acceleration rule provides additional rules for taking the items into account if
the effect of treating S and B as divisions cannot be achieved.

S’s income, gain, deduction, and loss from an intercompany transaction are its
intercompany items.\textsuperscript{141} An item is an intercompany item whether it arises directly or indirectly
from an intercompany transaction.\textsuperscript{142} B’s income, gain, deduction, and loss from an

\begin{itemize}
  \item \textsuperscript{137} See Prop. Reg. § 1.1400Z2(g)-1(b)(1).
  \item \textsuperscript{138} Prop. Reg. § 1.1400Z2(g)-1(c).
  \item \textsuperscript{139} See Prop. Reg. § 1.1400Z2(g)-1(d); Reg. § 1.1502-32(b)(2)(ii).
  \item \textsuperscript{140} Reg. § 1.1502-13(b)(1)(i).
  \item \textsuperscript{141} Reg. § 1.1502-13(b)(2)(i).
  \item \textsuperscript{142} Reg. § 1.1502-13(b)(2)(i).
\end{itemize}
intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items.143

Under the matching rule, B’s corresponding items and S’s intercompany items are taken into account as if S and B were divisions of a single corporation.144 For each consolidated return year, the separate entity attributes of S’s intercompany items and B’s corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions.145 A recomputed corresponding item is the corresponding item that B would take into account if S and B were divisions of a single corporation and the intercompany transaction were between those divisions.146 B takes its corresponding items into account in the consolidated year that B would take such items into account under its accounting method, but the redetermination of the attributes of a corresponding item might affect its timing.147 During a consolidated year, S takes its intercompany item into account to reflect the difference for the year between B’s corresponding item taken into account and the recomputed corresponding item.148

To the extent B’s corresponding item offsets S’s intercompany item in amount, the attributes of B’s corresponding item, determined based on both S’s and B’s activities, control the attributes of S’s offsetting intercompany item, except to the extent such results are inconsistent with treating S and B as divisions of a single corporation. In such a case, such attributes must be redetermined in a manner consistent with treating S and B as divisions of a single corporation.149 To the extent, however, that B’s corresponding item on a separate entity basis is (i) excluded from gross income, (ii) a noncapital, nondeductible amount, or (iii) otherwise permanently disallowed or eliminated, the attributes of B’s corresponding item always control the attributes of S’s offsetting intercompany item.150 To the extent S’s intercompany item and B’s corresponding item do not offset in amount, the redetermined attributes must be allocated to S’s intercompany item and B’s corresponding item by using a method that is reasonable in light of all the facts and circumstances, including the purposes Regulation section 1.1502-13 and any other rule affected by the attributes of S’s intercompany item and B’s corresponding item.151

143 Reg. § 1.1502-13(b)(3)(i).
144 Reg. § 1.1502-13(c)(1).
145 Reg. § 1.1502-13(c)(1)(i).
146 Reg. § 1.1502-13(b)(4).
147 Reg. § 1.1502-13(c)(2)(i).
148 Reg. § 1.1502-13(c)(2)(ii).
149 Reg. § 1.1502-13(c)(4)(i).
150 Reg. § 1.1502-13(c)(4)(i).
151 Reg. § 1.1502-13(c)(4)(ii). A method of allocation or redetermination is unreasonable if it is not used consistently by all members of the group from year to year.
S’s intercompany item may be redetermined to be excluded from gross income or treated as a noncapital, nondeductible amount.\textsuperscript{152} Where B’s corresponding item is income or gain, the Regulations provide for two instances in which S’s intercompany gain may be redetermined to be excluded from gross income.\textsuperscript{153} The first is a narrow rule limited to the redetermination of intercompany gains on member stock (the “Stock Gain Redetermination Rule”). Under this rule, if S transfers stock of a member (T) to B, and S recognizes an intercompany gain that is deferred under Regulation section 1.1502-13, and that gain would not otherwise be taken into account upon a subsequent elimination of the stock’s basis but for the transfer (\textit{e.g.}, if T is subsequently liquidated under section 332 or distributed under section 355), the gain may be redetermined to be excluded from gross income if all of the following are satisfied: (i) B or S becomes a successor (within the meaning of Regulation section 1.1502-32(j)(2)) to the other party (either B or S), or a third member becomes a successor to both B and S; (ii) immediately before the intercompany gain would be taken into account, the successor member holds the member’s stock with respect to which the intercompany gain was realized; (iii) the successor member's basis in the member’s stock that reflects the intercompany gain that is taken into account is eliminated without the recognition of gain or loss (and such eliminated basis is not further reflected in the basis of any successor asset); (iv) the effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the group’s consolidated return; and (v) the group has not derived, and no taxpayer will derive, any federal income tax benefit from the intercompany transaction that gave rise to the intercompany gain or the redetermination of the intercompany gain (including any adjustment to basis in member stock under Regulation section 1.1502-32).\textsuperscript{154}

The second circumstance under which S’s intercompany item of gain may be redetermined to be excluded from gross income is more general and permits the Commissioner the discretion to issue a letter ruling concluding that S’s intercompany gain is redetermined to be excluded from gross income (the “Commissioner’s Discretion Rule”).\textsuperscript{155} The Regulation cites three principles to guide the Commissioner’s determination of whether S’s intercompany gain may be excluded. The first principle requires that the exclusion of S’s intercompany gain from gross income be consistent with the purposes of Regulation section 1.1502-13 and other applicable provisions of the Code, Regulations, and published guidance. The two next principles are requirements (iv) and (v) of the Stock Gain Redetermination Rule, which require that the effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the group’s consolidated return; and that the group has not derived, and no taxpayer will

\textsuperscript{152} Reg. § 1.1502-13(c)(6)(i).

\textsuperscript{153} S’s intercompany gain may also be redetermined to be excluded from income in situations where either (i) B’s corresponding item is a deduction or loss and, in the taxable year the item is taken into account under this section, it is permanently and explicitly disallowed under another provision of the Code or Regulations; or (ii) B’s corresponding item is a loss that is realized, but not recognized under section 311(a) on a distribution to a nonmember. \textit{See} Reg. § 1.1502-13(c)(6)(ii)(A)-(B).

\textsuperscript{154} Reg. § 1.1502-13(c)(6)(ii)(C)(1). For this purpose, the redetermination of the intercompany gain is not itself considered a federal income tax benefit. Reg. § 1.1502-13(c)(6)(ii)(C)(1)(v).

\textsuperscript{155} Reg. § 1.1502-13(c)(6)(ii)(D). Exclusion of S’s intercompany gain with respect to member stock is addressed in Regulation section 1.1502-13(c)(6)(ii)(C), as described above.
derive, any federal income tax benefit from the intercompany transaction that gave rise to the intercompany gain or the redetermination of the intercompany gain.156

b. The Consolidated Investment Adjustment Regulations Generally

The consolidated return investment adjustment Regulations provide rules for adjusting the basis of the stock of a subsidiary (S) owned by another member (M). These rules modify the determination of M’s basis in S’s stock under applicable rules of law by adjusting M’s basis to reflect S’s distributions and S’s items of income, gain, deduction, and loss taken into account for the period that S is a member of the consolidated group. The purpose of the investment adjustment rules is to treat M and S as a single entity so that consolidated taxable income reflects the group’s income.157 For example, M’s basis in S’s stock is increased by any amount of S’s income taken into account in a consolidated year so as to prevent S’s income from being taken into account a second time on M’s disposition of S’s stock. Comparable adjustments are made to M’s basis in S’s stock for tax-exempt income and noncapital, nondeductible expenses that S takes into account, to preserve their treatment under the Code.

For purposes of determining M’s adjustments to the basis of S’s stock, S’s taxable income or loss is its consolidated taxable income (or loss) determined by including only S’s items of income, gain, deduction, and loss taken into account in determining consolidated taxable income (or loss), treating S’s deductions and losses for this purpose as taken into account only to the extent they are absorbed by S or any other member.158 S’s tax-exempt income is its income and gain that is taken into account but permanently excluded from its gross income under applicable law, and that increases, directly or indirectly, the basis of its assets (or an equivalent amount).159

Investment adjustments are made as of the close of each consolidated return year, and as of any other time a determination is necessary to determine a tax liability of any person.160 As discussed above, an intercompany item subject to deferral under Regulation section 1.1502-13 is not taken into account in determining the consolidated taxable income until it is taken into account under the matching or acceleration rule. Consequently, there is no investment adjustment under Regulation section 1.1502-32 with respect to an item deferred under Regulation section 1.1502-13 until such item is taken into account under such provision.161

---


157 Reg. § 1.1502-32(a)(1).

158 Reg. § 1.1502-32(b)(3)(i).

159 Reg. § 1.1502-32(b)(3)(ii)(A). Amounts equivalent to basis include the amount of money, the amount of a loss carryover, and the amount of an adjustment to gain or loss under section 475(a) for securities described in section 475(a)(2). An equivalent to a basis increase includes a decrease in an excess loss account, and an equivalent to a basis decrease includes the denial of basis for taxable income. Reg. § 1.1502-32(b)(3)(iv)(B).

160 Reg. § 1.1502-32(b)(1)(i).

161 Reg. § 1.1502-32(b)(3)(i) (stating that S’s taxable income or loss includes only S’s items taken into account in determining consolidated taxable income or loss).
Where the Stock Gain Redetermination Rule applies to exclude S’s intercompany gain from gross income, the Regulations specifically provide that any amount excluded from gross income is not treated as tax-exempt income under Regulation section 1.1502-32. 162

c. Interaction of the Proposed Regulations with the Intercompany Transaction and Investment Adjustment Regulations

i. In General

As discussed above, the Proposed Regulations provide that a QOF cannot be included as a member of a consolidated group (except as the common parent), and thus generally cannot be a member that engages in intercompany transactions. 163 However, the Proposed Regulations do not limit the application of the intercompany transaction Regulations when a QOF interest (whether an interest in a partnership or a corporation) is the subject of an intercompany transaction. Consequently, we believe that, under the Proposed Regulations, while the transfer of a qualifying QOF investment by one member of a consolidated group to another member of the group may constitute an inclusion event, such transfer and resulting inclusion event should be subject to the intercompany transaction rules of Regulation section 1.1502-13 like any other intercompany transaction, as illustrated in Example 10, below.

**Example 10.** Corporation P, the parent of a consolidated group of corporations, owns all the shares of corporation S and corporation B.  P, S, and B join in the filing of a consolidated return.  In Year 1, S sells a capital asset in which it has a zero basis to an unrelated party for $100 and S invests the proceeds in a qualifying QOF within six months of the sale and makes an election to defer its gain under section 1400Z-2. In Year 3, S sells its QOF investment to B for its fair market value at the time, $125. In Year 15, B sells the QOF investment for its fair market value at the time, $200, recognizing $75 of gain, and makes an election under section 1400Z-2(c).

Taking into the account the Proposed Regulations and the intercompany transaction Regulations, we believe the proper analysis of the transaction is as follows.  S’s Year 1 gain is deferred under section 1400Z-2.  S’s Year 3 sale is an inclusion event under section 1400Z-2(b)(1) requiring recognition by S of its $100 section 1400Z-2 deferred capital gain, which will increase S’s basis in the QOF stock by $100. 164 Both the $100 gain resulting from the section 1400Z-2 inclusion event and the $25 intercompany sale gain should be intercompany items of S. 165 For each consolidated return year, S’s $100 inclusion event gain and $25 intercompany sale gain should be redetermined to the extent necessary to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions. 166 Thus, both the $100 inclusion event gain and the $25 intercompany sale gain should be redetermined and deferred because the

---

162 Reg. § 1.1502-13(c)(6)(ii)(C)(2).
163 Prop. Reg. § 1.1400Z2(g)-1(b)(1).
165 See Reg. § 1.1502-13(b)(2)(i) (S’s intercompany items include items arising “directly or indirectly from an intercompany transaction.”).
166 Reg. § 1.1502-13(c)(1)(i).
sale of the QOF investment at a gain between divisions of a single corporation would not be an inclusion event under section 1400Z-2, nor would it give rise to $25 of gain. Under the matching rule, both deferred gains should be taken into account based on subsequent events. Because both the $100 inclusion event gain and the $25 intercompany sale gain are deferred under Regulation section 1.1502-13, at this time, there should be no investment adjustments to the stock of S or B related to the inclusion event or the intercompany sale.\textsuperscript{167}

In Year 6, if S and B were divisions of a single corporation, B’s basis in the QOF interest would increase by $10 under section 1400Z-2(b)(2)(B), and, similarly, in Year 8, B’s basis would increase by another $5 for a total increase of $15. As a result of the Year 6 $10 basis increase, $10 of S’s deferred intercompany gain can no longer be taken into account under the matching rule (because there would be only a $115 difference between B’s $125 basis in the QOF interest and the $10 basis in the QOF interest if S and B were divisions of a single corporation). Accordingly, in Year 6, S would take $10 of its inclusion event gain into account under the acceleration rule of Regulation section 1.1502-13(d). Similarly, in Year 8, as a result of the five percent basis increase under section 1400Z-2(b)(2)(B), S would take $5 of its inclusion event gain into account. As discussed in greater detail below, we believe that the Year 6 $10 and Year 8 $5 inclusion event gains should be redetermined to be excluded from gross income and P’s basis in its S stock should be increased by $10 in Year 6 and $5 in Year 8 under Regulation section 1.1502-32.

At the end of 2026, section 1400Z-2(b)(1) requires an inclusion of the gain relating to the QOF investment. The amount of that inclusion should be determined by treating S and B as divisions of a single corporation and calculating the corresponding item B would have had if S and B had been divisions of a single corporation (i.e., the recomputed corresponding item). Assuming the value of the QOF stock is at least $100 (so that the fair market value limitation of section 1400Z-2(b)(2)(A)(i) does not apply), the recomputed corresponding item should be $85 (i.e., $100, the amount of gain excluded under section 1400Z-2(a)(1), less $15 of basis in the QOF investment (taking into account the Year 6 $10 basis increase and the Year 8 $5 basis increase under section 1400Z-2(b)(2)(B) which would have applied to increase basis in the QOF interest if S and B were divisions of a single corporation)). In 2026, B’s corresponding item is $0 because B should take nothing into account with respect to the intercompany sale that year. Under the matching rule, S must take its intercompany item into account to reflect any difference for the year between B’s corresponding item taken into account and the recomputed corresponding item.\textsuperscript{168} Thus, S’s intercompany item is equal to the recomputed corresponding item ($85) less B’s corresponding item for that year ($0). Consequently, for 2026, S should take into account the remaining $85 of deferred inclusion event gain under section 1400Z-2(b)(1) and the matching rule of Regulation section 1.1502-13(c).\textsuperscript{169} Because S’s $85 deferred capital gain is taken into account in consolidated taxable income, P’s basis in S’s stock should be increased by that amount under Regulation section 1.1502-32. S’s remaining $25 of gain continues to be deferred under the matching rule of Regulation section 1.1502-13(c).

\textsuperscript{167} Reg. § 1.1502-32(b)(3)(i).

\textsuperscript{168} Reg. § 1.1502-13(c)(2)(ii).

\textsuperscript{169} Reg. § 1.1502-13(b)(4), (c)(2)(ii).
In Year 15, upon B’s sale of the QOF investment to a third party, S’s $25 deferred gain from the Year 3 intercompany sale should be taken into account and, along with B’s $75 gain realized on the Year 15 sale, should be excluded from income upon an election under section 1400Z-2(c). The exclusion of such items from gross income is an attribute of S’s intercompany item and B’s corresponding item.170 Under the matching rule, the separate attributes of S’s intercompany items and B’s corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation. Thus, if S and B were divisions of a single corporation, a sale of the QOF investment together with an election under section 1400Z-2(c) in Year 15, would have resulted in S’s $25 of deferred gain and B’s $75 of realized gain being excluded from gross income under section 1400Z-2. Accordingly, both S’s $25 of deferred intercompany sale gain and B’s realized gain should be redetermined to be excluded. Consistent with Proposed Regulation section 1.1400Z2(g)-1(d), P’s basis in its S stock and B stock should be increased under Regulation section 1.1502-32 by $25 and $75, respectively, to reflect those amounts being treated as tax-exempt income.

ii. Exclusion of S’s Intercompany Gain Otherwise Offset by Basis Adjustments under Section 1400Z-2(b)(2)(B)

Under Regulation section 1.1502-13, if S and B had been divisions of a single corporation, $15 of S’s deferred inclusion event gain would have been offset by the Year 6 and Year 8 aggregate $15 basis increase under section 1400Z-2(b)(2)(B). In order to achieve Regulation section 1.1502-13’s single entity purposes, each of S’s Year 6 $10 and Year 8 $5 of deferred inclusion event gain ought to be redetermined to be excluded from gross income in Year 6 and Year 8, respectively. As discussed, Regulation section 1.1502-13 provides only one specific circumstance under which S’s intercompany gain is excluded from gross income (the Stock Gain Redetermination Rule), but Regulation section 1.1502-13 recognizes that other compelling circumstances may exist under which gain ought to be excluded on a case-by-case basis under the Commissioner’s Discretion Rule. Consistent with single entity treatment, the Year 6 $10 and Year 8 $5 of S’s deferred inclusion event gain should be redetermined to be excluded from gross income under the principles of the Commissioner’s Discretion Rule, because treating S’s intercompany item as excluded from gross income is consistent with the purposes of Regulation section 1.1502-13 and is the only way of achieving the policies of section 1400Z-2. Moreover, such redetermination is consistent with the other criteria of the Commissioner’s Discretion Rule, because neither S’s Year 6 $10 nor Year 8 $5 of deferred inclusion event gain arising from the intercompany sale to B should have been previously reflected, directly or indirectly, on the P group’s consolidated return; and, except as discussed below, the P group should not have derived, nor any taxpayer should have derived, any federal income tax benefit from either S’s $10 or $5 of deferred inclusion event gain arising from the intercompany sale to B or the redetermination of such intercompany gains.171

170 Reg. § 1.1502-13(b)(6).

171 Reg. § 1.1502-13(c)(6)(ii)(D), (C)(1)(iv)-(v). For purposes of the tax benefit determination, the redetermination of the intercompany gain is not itself considered a federal income tax benefit.
We recommend that, for purposes of Regulation section 1.1502-32, each of the $10 and $5 excluded amounts be treated as tax-exempt income to S consistent with Proposed Regulation section 1.1400Z2(g)-1(d). We understand that such treatment permits the P group a tax benefit related to the aggregate $15 of deferred gain arising from the inclusion event intercompany transaction. However, we believe this treatment is appropriate both from a Regulation section 1.1502-13 perspective and from a section 1400Z-2 perspective. It is appropriate under Regulation section 1.1502-13, because if S had retained the QOF investment, the aggregate $15 excluded amount would be treated as tax-exempt income for purposes of Regulation section 1.1502-32 under Proposed Regulation section 1.1400Z2(g)-1(d) and Regulation section 1.1502-13’s treatment of S and B as divisions of a single corporation should render no different result. It is appropriate under section 1400Z-2, because that section intends to grant this benefit to taxpayers making a QOF investment. In our view, disallowing the P group the related investment adjustment (otherwise permitted by the Proposed Regulations) would frustrate the principal policy of section 1400Z-2 by denying the full extent of the congressionally intended tax benefit to taxpayers making a QOF investment.

iii. Recommendation

Accordingly, we recommend that final Regulations should clarify that, in cases like Example 10, S’s $10 and $5 of deferred gain is redetermined to be excluded from gross income under Regulation section 1.1502-13(c)(6)(ii) and that such excluded amounts be treated as permanently excluded from gross income for purposes of Regulation section 1.1502-32(b)(3)(ii)(A).

d. Capital Gain and QOF Investment by Different Members

i. Proposed Regulations: Separate Entity Treatment for Making QOF Investment

As discussed, the Proposed Regulations generally provide that section 1400Z-2 applies separately to each member of a consolidated group. This means that the same member of the group must both sell the capital asset giving rise to capital gain and timely invest the proceeds in a QOF in order to qualify under section 1400Z-2. We believe this requirement may be overly restrictive and may prevent or limit the ability of taxpayers to make use of section 1400Z-2 as intended by Congress, ultimately undermining the congressional goal of attracting investments to revitalize economically distressed communities. For example, most consolidated groups of corporations comprise members with different business functions and subject to different regulatory rules. In certain industries—for example, banking, insurance or energy—regulatory rules may dictate how a member of the consolidated group can use proceeds from the sale of a capital asset and whether that member can make a particular investment. Consequently, in many cases, the subsidiary that realizes a qualifying gain may be limited by non-tax regulatory or business constraints from using the proceeds of a sale to make an investment in a QOF. In such a case, due to regulatory or business reasons, the subsidiary that makes the QOF investment

---

172 Prop. Reg. § 1.1400Z2(g)-1(c).
would need to be different than the subsidiary that realizes the capital gain, as illustrated in Example 11, below.

**Example 11.** Assume the same facts as Example 1, except in Year 1, when S sells the capital asset, S cannot make the QOF investment directly due to regulatory or other business constraints. The P group wishes to make a QOF investment, so B invests $100 in a qualifying QOF within six months of S’s sale. Under Proposed Regulation section 1.1400Z2(g)-1(c), the P group cannot make an election to defer S’s gain under section 1400Z-2. In Year 15, B sells the QOF investment for its fair market value at the time, $200. Even though the P group had a qualifying capital gain and made a timely corresponding investment in a QOF, the P group did not benefit from the deferral and exclusion incentives of section 1400Z-2. Instead, S recognized $100 of gain in Year 1 and B recognized another $100 of gain in Year 15.

### ii. Section 1400Z-2 Policies and Consolidated Return Principles

The Senate Finance Committee’s report describes the policy behind enactment of sections 1400Z-1 and 1400Z-2 as follows:

The Committee believes this provision will help revitalize economically distressed communities which suffer from a lack of investment and business growth, by facilitating new incentives for investment in those areas around the country. The Committee believes that this provision will *attract inactive capital* that, when reinvested, will be an important new source for catalyzing growth and opportunity. The Committee believes these new dollars will help stem the tide of business closures, a lack of access to capital, and absent entrepreneurship in areas that need it most. The Committee further believes having the Governors designate the qualifying census tracts will help ensure local needs and opportunities are being met as well as encourage concentration of capital in targeted, geographically contiguous zones in each state.\(^{173}\)

The policy objectives of section 1400Z-2 are straightforward—to incentivize taxpayers with inactive capital to invest in targeted geographical areas suffering from lack of investment and business growth. Proposed Regulation section 1.1400Z2(g)-1(c) limits the ability of consolidated groups, with otherwise eligible capital gains, to take advantage of section 1400Z-2 where the member of such group realizing the capital gain is unable to invest in a QOF due to regulatory or other business restrictions. We believe that Proposed Regulation section 1.1400Z2(g)-1(c) does not further the congressional purpose in enacting section 1400Z-2, because it may make it more difficult for consolidated groups to invest the proceeds of their capital gain transactions in qualifying QOF investments, both hindering such groups’ ability to obtain the congressionally-intended benefits of the provision and frustrating the congressional goal of attracting new dollars to economically distressed communities.

The consolidated return rules are a balance of single entity and separate entity rules and principles. Admittedly, while there are many attributes that group members share on a consolidated basis, property generally is not one of them; with regard to ownership of property, members are generally treated as separate entities.\(^{174}\) However, section 1400Z-2 is a targeted

---

\(^{173}\) **Staff of S. Comm. on Finance, 115th Cong., Explanation of the Bill 313 (2017) (emphasis added).**

\(^{174}\) See, e.g., Reg. § 1.1502-13(c)(3) (“As divisions of a single corporation, S and B are treated as engaging in their actual transaction and owning any actual property involved in the transaction (rather than treating the transaction as...”)
provision with a policy that will be facilitated by allowing consolidated groups the flexibility of treating the group as a single taxpayer for purposes of determining whether it is a taxpayer with qualifying capital gain eligible to make a QOF investment. Stated differently, while treating a QOF investment owned by one member as being owned by another diverges from other areas of the consolidated return Regulations where property ownership is viewed on a separate entity basis, this departure is consistent with the purposes and policies of section 1400Z-2 and, in fact, necessary to further those purposes and policies. The Regulations under section 1400Z-2 are promulgated under a specific legislative grant of authority for the Treasury Secretary to prescribe such Regulations as may be necessary or appropriate to carry out the purposes of section 1400Z-2. In addition, the consolidated return regulations are promulgated under a specific legislative grant of authority under section 1502. Thus, Treasury and the Service have ample authority to adopt a narrow rule permitting single entity treatment for this purpose should be restricted to section 1400Z-2 with its targeted special purposes and policies.

iii. Treatment of Seller and Buyer

We recommend that the final Regulations provide that an eligible taxpayer includes all members of a consolidated group as a single taxpayer when any member recognizes a qualifying capital gain and otherwise would have reported the qualifying gain on the tax return for the consolidated group. Thus, in Example 11, B, upon making its $100 investment in a qualifying QOF, would be permitted to timely make an election under section 1400Z-2. This would allow S to defer its Year 1 $100 capital gain, and, in Year 15, B, upon its sale of the QOF investment, would be able to make an election under section 1400Z-2(c) to exclude its $100 of gain.

We believe that the most appropriate way to achieve single entity treatment of the P group in cases like Example 11 is to conform its treatment to the group’s treatment in Example 10. That is, in Example 11, upon B’s timely making its QOF investment, S would be deemed to make the qualifying QOF investment and then to sell such investment to B in an intercompany sale. In this way the single entity treatment of P group is preserved in a manner similar to the way it is in Example 10.

If such an approach is adopted, the proper analysis of Example 11 would be as follows. S’s Year 1 capital gain would be initially deferred under section 1400Z-2, as S would be deemed to make the qualifying QOF investment and the related election under section 1400Z-2 that B actually made. Immediately thereafter, such gain would be triggered in a deemed sale of the qualifying QOF from S to B. Like in Example 10, such deemed intercompany sale of the QOF would be an inclusion event under section 1400Z-2(b)(1) requiring S’s recognition of its $100 section 1400Z-2 deferred capital gain and giving S a $100 basis in the QOF interest (so S should have no gain or loss on the intercompany sale). However, as in Example 10, the $100 inclusion
event gain should be deferred and taken into account based on subsequent events under the matching rule.

As in Example 10, in Year 6 and Year 8, S would take $10 and $5, respectively, of its inclusion event gain into account under the acceleration rule as a result of a basis increases under section 1400Z-2(b)(2)(B). As discussed above and assuming our recommendations are accepted, the Year 6 $10 and Year 8 $5 of S’s deferred gain should be redetermined to be excluded from gross income under Regulation section 1.1502-13(c)(6)(ii), and such excluded amount should give rise to positive investment adjustments under Regulation section 1.1502-32(b).

At the end of 2026, section 1400Z-2(b)(1) would require an inclusion of S’s QOF investment gain. As in Example 10, assuming the value of the QOF stock is at least $100, the recomputed corresponding item would be $85 (i.e., $100, the amount of gain excluded under section 1400Z-2(a)(1), less the Year 6 $10 basis increase and the Year 8 $5 basis increase under section 1400Z-2(b)(2)(B)). In 2026, B’s corresponding item would be $0 and S’s intercompany item would equal to the recomputed corresponding item ($85) less B’s corresponding item for that year ($0). Consequently, for 2026, S should take into account the remaining $85 of deferred inclusion event gain under section 1400Z-2(b)(1) and the matching rule.\(^{176}\) P’s basis in its S stock should be increased by $85 under Regulation section 1.1502-32.

In Year 15, upon B’s sale of the QOF investment to a third party, B’s $100 gain realized on the Year 15 sale would be excluded from income upon an election under section 1400Z-2(c). B’s realized gain would be redetermined to be excluded under the matching rule, and P’s basis in B would be increased by $100 consistent with Proposed Regulation section 1.1400Z2(g)-1(d).

**iv. Regulation Section 1.1502-32 Disconformity Concern**

One potential concern in an Example 11 fact pattern that seems to distinguish it from an Example 10 fact pattern is that S, which actually sold the capital asset, kept the $100 proceeds while B used $100 of its own to fund the QOF investment. That is, this distinction creates a disconformity between the value of S and P’s basis in S. Such disconformity is completely consistent with Regulation sections 1.1502-13 and 1.1502-32, however, and exists (at least temporarily) in every intercompany transaction that is subject to deferral under Regulation sections 1.1502-13. For example, in Example 10, where S sold its QOF investment to B, even though S had realized a $100 gain and held the related proceeds from B, there was no investment adjustment to P’s stock in S until the 2026 required inclusion. To further illustrate in a situation not involving section 1400Z-2, if in Example 10, S, instead of selling the capital gain asset to an unrelated party, sold it to B for $100, S would have realized (and recognized) $100 of gain and would hold the $100 proceeds, but no investment adjustment in the stock of S would be required until subsequent events. In Example 11, like in Example 10, P’s basis in its S stock is increased by $85, in 2026, to reflect the original $100 of capital gain realized by S, less $15 of gain excluded by virtue of section 1400Z-2(b)(2)(B) and Regulation section 1.1502-13(c)(6)(ii). Thus, there is no disconformity created in an Example 11 fact pattern that is any different from the temporary disconformity that is inherent in Regulation sections 1.1502-13 and 1.1502-32.

\(^{176}\) Reg. § 1.1502-13(b)(4), (c)(2)(ii).
v. Recommendation

Accordingly, we recommend that Treasury and the Service reconsider Proposed Regulation section 1.1400Z2(g)-1(c), and recommend that the final Regulations take a different approach by providing that an eligible taxpayer includes all members of a consolidated group as a single taxpayer when any member recognizes a qualifying capital gain and a timely qualifying QOF investment is made by a member of the same consolidated group. In such a case, S should be deemed to make the qualifying QOF investment and then to sell such investment to B in an intercompany sale.