Current Developments

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Affiliated and Related Corporations
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Agenda

• Update on Business Plan and Guidance
  – Intercompany Sale of Partnership Interests
  – Discrete issues under Section 168(k)
• Section 965 Final Regulations
  – Inclusion rules for affiliated groups (Reg. Section 1.965-8)
    – Installment Agreements and Triggers (Reg. Section 1.965-7)
• Proposed Opportunity Zone Regulations
• Proposed “May Company” Regulations
Sale of Partnership Interest: Who’s Asking?

**Seller’s Treatment**

- **A** to **B**
  - **$10K**
  - Sale of all of A’s LLC interests

**Buyer’s Treatment**

- **1**
  - Deemed pro rata liquidation of partnership;
  - Deemed acquisition by purchaser of that portion of assets deemed distributed to seller.

**LLC**

- 50%
- 50%

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- Sale of partnership interest, governed by Sections 741 and 751(a).
- See *McCauslen v. Comm’r*, 45 TC 588 (1966); Rev. Rul. 99-6, situation one.
Intercompany Sale of Partnership Interest

What, if anything, changes in the Rev. Rul. 99-6 analysis if both the selling partner and buying partner are members of the same consolidated group?

As an intercompany transaction, consider the role/effect of attribute redetermination rule (Reg. Section 1.1502-13(c)).

E.g.: will the separate entity attributes of Seller’s intercompany items be redetermined under Treas. Reg. § 1.1502-13(c)(1)(i) and (c)(4) by treating a proportionate amount the items as allocable to the assets that Buyer is treated as purchasing from Seller?

Does it matter whether the partnership had inside/outside basis conformity before the intercompany sale?

Compare PLR 201723008 with PLR 201528007.
Section 168(k): Testing for Relatedness

- **Facts:** Parent is the common parent of a calendar-year consolidated group.

- **Step 1:** On **April 30, 2019**, S2 sells depreciable property (equipment) to Target, another member of the P group, in a transaction described in Reg. Section 1.1502-13, recognizing $300 of gain on the $500 sale. No other P group member has held an interest in the equipment.

- **Step 2:** On **June 1, 2019**, in a step that is “related” to the April 30, 2019 sale, Parent sells all of the stock of Target to the common parent of another unrelated consolidated group.

- The proposed regulations provide that the time for testing relatedness is at the end of a series of related steps and that Target is not treated as having had a depreciable interest in the equipment (despite S2’s prior ownership). See, e.g., Prop. Treas. Reg. §1.168(k)-2(b)(3)(vi), Example 21.

- **Questions:** Which group claims the Section 168(k) deduction? amount?

- Would the answer change if the step 1 sale were **September 30**th and the step 2 sale were **November 1**st? (i.e., is Target a component member of the same controlled group of corporations as S2? See Section 1563 and Treas. Reg. §1.1563-1(b)).
Section 168(k) and QSDs: Whose deduction?

Fact: Parent is the common parent of a calendar-year consolidated group.

On April 30, 2019, Parent distributes all of the stock of Target to its shareholders in a taxable distribution described in Section 301 and 311, which qualifies as a qualified stock disposition (QSD).

Parent and Target make a Section 336(e) election for the distribution.

“New” Target's tax return will cover the period from May 1, 2019 through December 31, 2019.

Questions: If Target has “qualified property” for purposes of Section 168(k), which return will reflect the Section 168(k) deduction?


Does the answer vary if Target is a Newco?

Does the answer vary if, instead of a taxable distribution under Section 301 and 311, the distribution qualifies under Section 355 (but otherwise taxable at the Parent level under Section 355(d) or (e))?
Section 965 Regulations

• Overview and inclusions rules
  • Installment agreements and triggers
Section 965 Overview

• Section 965 implements a toll charge on transitioning into the new quasi-territorial system created by the Tax Act.

• Basic Mechanics:
  
  • Deferred Foreign Income Corporation: For the last taxable year beginning before January 1, 2018, a deferred foreign income corporation ("DFIC") increases its subpart F income by the greater of the corporation’s accumulated post-1986 deferred foreign income as of (i) November 2, 2017 or (ii) December 31, 2017 (i.e., the measurement dates).
  
  • US Shareholder: Under Section 951(a)(1), the US shareholder of the DFIC includes in its gross income its pro rata share of the additional subpart F income of the DFIC (the "Section 965 Inclusion").

• Notice 2018-7 announced that Treasury and IRS intend to issue regulations providing that, solely with respect to the calculation of the amount included in gross income by a consolidated group under Section 951(a) by reason of Section 965(a), all members of a consolidated group that are US Shareholders of one or more specified foreign corporations will be treated as a single US Shareholder. This includes for purposes of determining the aggregate foreign cash position of the consolidated group.

• On August 9, 2018, Treasury and the IRS issued proposed regulations under Section 965.

• Then, on February 5, 2019, Treasury and the IRS issued final regulations under Section 965.
Section 965 Regulations
Reg. Sec. 1.965-8: Treatment of Consolidated Groups

• All members of a consolidated group that are US shareholders of a specified foreign corporation (“SFC”) are treated as a single US shareholder for enumerated purposes, including:
  – Section 965(b) (E&P deficit offset) and Treas. Reg. §1.965-1(b)(2) (same), and
  – Sections 965(h), (k), and (n) relating to the election to pay the Section 965 net tax liability in instalments, the extended statute of limitations, the election to forgo the use of NOLs.

• However, single US shareholder treatment does not apply for purposes of determining,
  – A US shareholder’s Section 965(a) inclusion, including to determine the available section 960 credit with respect to that inclusion, and
  – The deduction allowed under Section 965(c) with respect a Section 965(a) inclusion.

  • However, under Treas. Reg. §1.965-8(e)(3), for purposes of determining the Section 965(c) deduction amount of any Section 958(a) US shareholder that is a member of a consolidated group, the aggregate foreign cash position of that shareholder is equal to the aggregate Sec. 965(a) inclusion amount of that shareholder multiplied by the “group cash ratio” of the consolidated group.

  • Group cash ratio = the consolidated group aggregate foreign cash position / sum of the aggregate Sec. 965(a) inclusion amounts of all members of the consolidated group.
Section 965 Regulations
Responses to comments and changes from proposed regulations

• Proposed regulations did not provide that all members of consolidated group were treated as a single shareholder for purposes of Prop. Reg. §1.965-3(b), which provides rules allowing a Section 958(a) US shareholder to disregard certain assets for purposes of determining its aggregate foreign cash position.
  – Notice 2018-78 explained that, to prevent the overstatement of the aggregate foreign cash position, the final regulations would provide that all members of a consolidated group that are section 958(a) U.S. shareholders of a specified foreign corporation would also be treated as a single section 958(a) U.S. shareholder for purposes of Prop. Reg. §1.965-3(b).
  – Comments noted that this could still result in overstatement of the foreign cash position (e.g., stock of an SFC was transferred between members between cash measurement dates).
  – Consequently, final regulations provide that aggregate foreign cash position is determined as if all members of a consolidated group that are Section 958(a) US shareholders are a single shareholders.

• Other comments suggested that final regulations treat all members of a consolidated group as a single US shareholder for all purposes of Section 965. This comment was not adopted.
  – “…broadly changing the consequences of well-established principles concerning the determination of inclusions under section 951 in a consolidated group would not be justified by the application of an anti-abuse rule to a transaction that falls within its parameters.”
Reg. 1.965-8(g), Example 1
Application of affiliated group rule

Facts:
► US corporations do not join in filing a consolidated return.
► Each foreign corporation is a CFC within the meaning of Section 957(a) and, therefore, each is an SFC under Section 965(e) and Treas. Reg. §1.965-1(f)(45).
► Cash positions consist solely of cash; all calendar year; CFC’s use USD as functional currency.

Analysis:
► As each of USS1, USS2, and USS3 is a Section 958(a) shareholder of an SFC and not members of a consolidated group, they are treated as separate shareholders for purposes of the E&P deficit offset.
► In determining USS1’s Section 965(a) inclusion amount, USS1 decreases its pro rata share of the amount of Section 965(a) earnings amount of CFC1 by CFC1’s allocable share of the aggregate foreign E&P deficit of USS1.
  ► CFC1’s allocable share of deficit = (aggregate deficit x (CFC1’s 965(a) E&P / USS1’s aggregate 965(a) E&P) = ($400 x ($600 / $600) = $400
  ► USS1’s Section 965(a) inclusion amount = (pro rata share of CFC1’s Section 965(a) E&P – CFC1’s allocable share of the aggregate foreign E&P deficit) = $600 - $400 = $200
► With respect to USS2:
  ► CFC3’s allocable share of the deficit = ($0 x ($300 / $300) = $0
  ► USS2’s Section 965(a) inclusion amount = $300 – $0 = $300
Reg. 1.965-8(g), Example 1
Application of affiliated group rule (cont.)

Analysis:

► Netting groups unused E&P deficit:
  ► USS1’s applicable share of the USP Group’s aggregate unused E&P deficit = (unused E&P deficit x USS1’s 965(a) inclusion/USP Group’s total 965(a) inclusion) = $100 x ($200/$500) = $40
  ► USS2’s applicable share of the USP Group’s aggregate unused E&P deficit = (unused E&P deficit x USS2’s 965(a) inclusion/USP Group’s total 965(a) inclusion) = $100 x ($300/$500) = $60

► Adjusted Section 965(a) inclusion:
  ► USS1’s adjusted Section 965(a) inclusion: $200 - $40 = $160
  ► USS2’s adjusted Section 965(a) inclusion: $300 - $60 = $240
Reg. 1.965-8(g), Example 2
Application of consolidated group rule

Facts:
► US corporations join in filing a consolidated return.
► Each foreign corporation is a CFC within the meaning of Section 957(a) and, therefore, each is an SFC under Section 965(e) and Treas. Reg. §1.965-1(f)(45).
► Cash positions consist solely of cash; all calendar year; CFC’s use USD as functional currency.

Analysis:
► Because each of USS1, USS2, and USS3 is a Section 958(a) shareholder of an SFC and a member of a consolidated group, they are treated as a single shareholder for purposes of the E&P deficit offset.
► In determining USS1’s Section 965(a) inclusion, USS1 decreases its pro rata share of the amount of Section 965(a) earnings amount of CFC1 by CFC1’s allocable share of the aggregate foreign E&P deficit of USS1.
  ► CFC1’s allocable share of deficit = (aggregate deficit x (CFC1’s 965(a) E&P / aggregate 965(a) E&P of each DFIC)) = ($500 x ($600 / $900)) = $333.33
  ► USS1’s Section 965(a) inclusion amount = (pro rata share of CFC1’s Section 965(a) E&P – CFC1’s allocable share of the aggregate foreign E&P deficit) = $600 - $333.33 = $266.67
  ► With respect to USS2:
    ► CFC3’s allocable share of the deficit = ($500 x ($300 / $900)) = $166.67
    ► USS2’s Section 965(a) inclusion amount = $300 – $166.67 = $133.33
Section 965 Regulations

• Overview and inclusions rules
• Installment agreements and triggers
Treas. Reg. §1.965-7: Installment Schedule and Acceleration Events

• A US shareholder may elect to pay the net tax liability on its Section 965(a) inclusion in installments over eight years: 8% for the first 5 years; 15% in year 6; 20% in year 7; and 25% in year 8. The tax liability becomes due immediately if certain prescribed events occur.

• Statutory acceleration events - Section 965(h)(3)
  – Addition to tax for failure to timely pay an installment required under section 965(h);
  – Liquidation or sale of substantially all of the assets of the taxpayer (including title 11 or similar case);
  – Cessation of business by the taxpayer, or any similar circumstance.

• Regulatory acceleration events – Treas. Reg. §1.965-7(b)(3)(ii)
  – Any exchange or other disposition of substantially all of the assets of a taxpayer;
  – Any event that results in a person no longer being a US person;
  – When a person that was not a member of any consolidated group becomes a member of a consolidated group (accelerated as to that person);
  – When a consolidated group ceases to exist, or otherwise no longer files a consolidated return.

• If an acceleration event occurs, the unpaid portion of the remaining installments will be due on the date of the acceleration event (or in the case of a title 11 or similar case, the day before the petition is filed). Section 965(h)(3); Treas. Reg. §1.965-7(b)(3)(i)
Treas. Reg. §1.965-7: Exceptions to Acceleration Events

- Eligible Section 965(h) Transferee Exception – Treas. Reg. §1.965-7(b)(3)(iii)(A)
  - Liquidation, sale, exchange or other disposition of substantially all of the assets in a “qualifying consolidated group member transaction” (within the meaning of Treas. Reg. §1.965-7(b)(3)(iii)(E));
  - Liquidation, sale, exchange or other disposition of substantially all of the assets in a transaction that is not a “qualifying consolidated group member transaction”;
  - When a person that was not a member of any consolidated group becomes a member of a consolidated group;
  - When a consolidated group ceases to exist, or otherwise no longer files a consolidated return, and the acceleration event results from the acquisition of the group within the meaning of Treas. Reg. §1.1502-13(j)(5) and the acquired consolidated group joins a different consolidated group.

- Qualifying consolidated group member transaction – Treas. Reg. §1.965-7(b)(3)(iii)(E)(1)
  - A member of a consolidated group ceases to be a member of the consolidated group (including by reason of the distribution, sale, or exchange of the member’s stock);
  - The transaction results in the consolidated group being treated as transferring substantially all of its assets; and
  - The consolidated member either continues to exist immediately after the transaction or has a qualified successor.

- Qualified Successor – Treas. Reg. §1.965-7(b)(3)(iii)(E)(2)
  - Another domestic corporation (or consolidated group) that acquires substantially all of the departing member’s assets (including in a Section 381(a)(2) transaction).
Treas. Reg. §1.965-7: Exceptions to Acceleration Events

- Final Regs retained “any exchange or other disposition of substantially all of the assets” language for acceleration with no modification (i.e., no exception for F reorgs, Section 351, or Section 721)
  
  - The preamble states, “The Treasury Department and the IRS have determined that any disposition of substantially all of the assets of the person making the section 965(h) election…, including in a tax-free reorganization or an exchange described in section 351 or 721, poses a risk to the IRS’s ability to collect the full amount of the section 965(h) net tax liability... The Treasury Department and the IRS have determined that it is essential for tax administration purposes for the IRS to be apprised of these dispositions. Providing an exclusion to the general rule that an exchange or other disposition of substantially all of the assets of the person making the section 965(h) election…for nonrecognition transactions could hamper the IRS’s ability to collect the outstanding tax liabilities and could enable certain taxpayers to inappropriately dilute their interests in their assets or change their businesses in a way that is inconsistent with the purposes behind the elections and related triggering and acceleration events. The final regulations also do not include a special exception for reorganizations under section 368(a)(1)(F) because requiring a transfer agreement, if applicable, in those situations is necessary for tax administration purposes.”

- Compare foreign to foreign F reorgs vs domestic F reorgs

- Consider “replacement asset” theory in Section 351/Section 721 transfer; what about 351 exchanges under Reg. §1.1502-13?
Final Regs provided no clarification on “substantially all” standard

The preamble states, “The phrase “substantially all” is used in various Code provisions and in regulations, and often is determined based on all of the facts and circumstances. Consistent with this general approach, the Treasury Department and the IRS decline to provide a bright-line definition of “substantially all” in the final regulations.
The phrase “substantially all” is used in various Code provisions and in regulations, and often is determined based on all of the facts and circumstances. Consistent with this general approach, the Treasury Department and the IRS decline to provide a bright-line definition of “substantially all” in the final regulations.”

Final Regs added two new Eligible Transferee Exceptions:

- Transfer of substantially all of the assets of one or more members of a consolidated group to other members with only one entity remaining (the successor entity)
  - The successor entity is an eligible transferee and a Transfer Agreement must be filed
- Termination of S election of shareholder of the common parent and, for the shareholder’s taxable year immediately following the termination, the shareholder joins in the filing of a consolidated return as a consolidated group that includes all of the former members of the former consolidated group
  - The agent of the new consolidated group (as defined in Reg. §1.1502-77) is the eligible transferee and a Transfer Agreement must be filed
Treas. Reg. §1.965-7: Transfer Agreement & Effect of Eligible Transferee Exception

• Transfer Agreement – Treas. Reg. § 1.965-7(b)(3)(iii)(B)(1)
  – The Eligible Section 965(h) Transferee Exception only applies to the extent that the “eligible section 965(h) transferor” and an “eligible section 965(h) transferee” enter into a “transfer agreement”
  – The Transfer Agreement must include certain acknowledgements, representations, other information, including:
    • Agreement to assume the liability for any unpaid installment payments and representations that transferee is able to make the remaining payments required
    • If the transferor remains in existence after the transfer, that the transferor and any successor to the transferor remain jointly and severally liable for unpaid installment payments, including under Treas. Reg. §1.1502-6, if applicable.

• Transition Rule - If an acceleration occurred on or before February 5, 2019 (effective date of final regs), the transfer agreement must be filed by March 7, 2019 to be considered timely
Treas. Reg. §1.965-7: Transfer Agreement & Effect of Eligible Transferee Exception

  - The Final Regs retained the representation related to joint and several liability of the transferor for any unpaid portion of the installment payment
    - The preamble states, “[r]equiring the eligible section 965(h) transferor to be jointly and severally liability for the unpaid section 965(h) net tax liability, as well as any penalties, additions to tax, or other additional amounts attributable to the section 965(h) net tax liability, protects the IRS’s ability to collect the full amount of the section 965(h) net tax liability and helps guard against abusive transactions. In addition, as the comment noted, taxpayers are able to account for the joint and several liability in their transactions.”

- Modifications to requirements to file a Transfer Agreement in Final Regs:
  - An eligible section 965(h) transferee must consent to an assessment with respect to the liability that it assumes
  - Include a statement as to whether the leverage ratio of the eligible section 965(h) transferee exceeds three to one, subject to modification by future guidance
  - Must be filed consistent with other guidance, that additional terms for transfer agreements may be prescribed pursuant to publications, forms, instructions, or other guidance
Treas. Reg. §1.965-7: Transfer Agreement & Effect of Eligible Transferee Exception

  - The transfer agreement must be filed within 30 days of the acceleration event to be considered timely.
  - Treas. Reg. §301.9100 relief is not available for late filed transfer agreements.
  - The transfer agreement must also be attached to the tax returns of both the eligible transferee and eligible transferor for the taxable year in which the acceleration event occurs.

  - The eligible transferee is treated as assuming all of the outstanding obligations and responsibilities of the eligible transferor with respect to the unpaid portion of the eligible transferor’s Section 965(a) liability as if the eligible transferee had included the Section 965(a) inclusion in income.
  - The eligible transferee is responsible for making payments and reporting with respect to any unpaid installment payments.

  - An eligible transferor (or successor) remains jointly and severally liable for any unpaid installment payments of the eligible transferor that were assumed by the eligible transferee, as well as any penalties, additions to tax, or other additional amounts attributable to the unpaid Section 965 liability.
Example – Sale of standalone corporation

- **Is there an acceleration event?**
  - US Target was not a member of a consolidated group prior to the transaction, and will join the USP Buyer consolidated group after the acquisition.

- **Does the eligible transferee exception apply?**
  - A non-consolidated subsidiary joining a new consolidated group?
  - Transfer Agreement filed?
  - Consider whether USP Buyer can obtain an indemnity from the Shareholders for US Target’s unpaid portion of the Section 965 liability or whether the assumption of the unpaid portion should be considered in purchase price adjustments.
Example – Sale of consolidated member

- Is there an acceleration event?
  - Does US Sub 2 constitute “substantially all of the assets” of the consolidated group?
  - If not, there is no acceleration event. USP Seller remains liable for its unpaid installments of its Section 965 liability, and US Sub 2 remains jointly and severally liable under Treas. Reg. §1.1502-6.
- Does the eligible transferee exception apply?
  - Qualifying consolidated group member transaction?
  - Transfer Agreement filed?
  - Consider whether US Sub 1 should be allocated only its portion of USP Seller’s 965 liability contractually.
- Sale of multiple consolidated members
  - The deconsolidation of multiple consolidated members in a single transaction is treated as the deconsolidation of a single member, to the extent that all the deconsolidated members are members of the same (second) consolidated group. See Treas. Reg. §1.965-7(b)(3)(iii)(E)(3)
- No distinction between stock sale, asset sale, deemed asset sale (e.g., Section 338 elections)
Example – Internal consolidated group transaction

- Is there an acceleration event?
  - Treas. Reg. § 1.965-8(e)(1) provides that all members of a consolidated group are treated as a single person for purposes of Section 965(h).
  - Accordingly, a liquidation (or other internal reorganization) of one member of the consolidated group should not constitute an acceleration event for purposes of Section 965(h)(3) and Treas. Reg. § 1.965-7(b).
Example – Consolidated group terminates

- Is there an acceleration event?
  - Transfer of substantially all of the assets of one or more members of a consolidated group to other members with only one entity remaining (the successor entity)
  - The successor entity is an eligible transferee and a Transfer Agreement must be filed
Example – Public spin-off

- Is there an acceleration event?
  - Does US Sub 1 constitute “substantially all of the assets” of the consolidated group?
  - The deconsolidation of multiple consolidated members in a single transaction is treated as the deconsolidation of a single member, to the extent that all the deconsolidated members are members of the same (second) consolidated group. See Treas. Reg. §1.965-7(b)(3)(iii)(E)(3)
  - If not, there is no acceleration event. USP remains liable for its unpaid installments of its Section 965 liability, and US Sub 1 remains jointly and severally liability under Treas. Reg. §1.1502-6.
  - Consider whether US Sub 1 should be allocated its portion of USP’s 965 liability contractually (e.g., through the tax matters agreement).

- Does the eligible transferee exception apply?
  - Qualifying consolidated group member transaction?
  - Transfer Agreement filed?
  - US Sub 1 treated as assuming the unpaid portion of USP’s 965 liability.
  - Consider whether US Sub 1 should only be allocated its portion of USP’s 965 liability contractually (e.g., through the tax matters agreement).
Opportunity Zones
Opportunity Zone Rules: In General

• TCJA added the Opportunity Zone provisions in sections 1400Z-1 and 1400Z-2.

• The Opportunity Zone provisions allow the deferral and partial exclusion of certain gains from the sale or exchange of an asset to an unrelated person if those gains are reinvested in a Qualified Opportunity Fund (“QOF”).
  – To qualify for deferral, the sale must be to an unrelated person.
    • Parties are related if such persons are described in section 267(b) or 707(b)(1), substituting “20 percent” for “50 percent”
      – For example:
        » Two corporations that are members of a controlled group determined by applying a greater than 20 percent threshold;
        » A corporation and a partnership if the same person owns more than 20 percent of the corporation and the partnership.
  – To qualify for deferral, gains must be reinvested in a QOF within 180 days of the sale.
Opportunity Zone Rules: In General (cont.)

• Gain is deferred until the earlier of the date that:
  – The interest in the QOF is sold, or
  – December 31, 2026.

• The amount of gain included in income is the excess of the lesser of:
  – The deferred gain, or
  – The fair market value of the investment
    • over the taxpayer’s basis in the investment.

• A taxpayer’s initial basis in its interest in a QOF is zero.

• A taxpayer may achieve partial exclusion of deferred gain if it holds its QOF for a specified period of time:
  – If held for 5 years, basis in QOF interest is increased by 10% of the initial deferred gain; and
  – If held for 7 years, basis in QOF interest is increased by an additional 5% of the initial deferred gain.
Opportunity Zone Rules: In General (cont.)

• Once the initial deferred gain is recognized, the taxpayer’s basis in the investment is equal to the amount of gain recognized.

• Post-investment gains on the sale of a QOF interest held for at least 10 years may be permanently excluded if the taxpayer elects to have the basis of the property equal fair market value on the date that the investment is sold/exchanged.
Opportunity Zone Rules: Qualification as a QOF

- A QOF can be a corporation or a partnership.
- A QOF must invest and hold at least 90 percent of its assets in qualified opportunity zone property (“QOZ property”), other than another QOF.
  - QOZ property means:
    - QOZ stock,
    - QOZ partnership interest, and
    - QOZ business property.
- QOZ stock is stock in a corporation that
  - Was acquired by the QOF after 2017 at its original issue from the corporation in exchange for cash;
  - Was a QOZ business or was organized for the purpose of being a QOZ business; and
  - Is a qualified as a QOZ business during substantially all of the QOF’s holding period for such QOZ stock.
- QOZ business
  - To be a QOZ business a number of requirements must be met, including the requirement that less than five percent of the average of the aggregate unadjusted bases of the business’s property is attributable to nonqualified financial property (including stock).
Opportunity Zone Rules: Inclusion of Deferred Gain

• The second set of proposed regulations provide that a taxpayer’s deferred gain on an initial sale is included in gross income on the earlier of
  – The date of an inclusion event, or
  – December 31, 2026.

• Generally, an inclusion event occurs if
  – There is a transfer that reduces the QOF investor’s equity interest in a QOF;
  – The QOF investor receives property in a transaction that is treated as a distribution (regardless of whether there is a reduction in the investor’s interest because distributions result in a cashing out of the QOF investment); or
  – The QOF investor claims a worthless stock loss under section 165(g) or otherwise claims a worthlessness deduction with respect to its interest in a QOF.

• If a QOF investor claims a worthless stock loss with respect to its interest in a QOF, the taxpayer is no longer eligible for the basis increase available at 5 years, 7 years, or 10 years under sections 1400Z-2(b)(2)(B)(iii) or (iv) and 1400Z-2(c).
In addition to the general rule regarding inclusion events, the Preamble to the second set of proposed regulations (the “Preamble”) and the second set of proposed regulations themselves list a number of specific inclusion events.

The specific inclusion events detailed in the Preamble and the second set of proposed regulations include:

- A cessation or liquidation of the QOF;
- A liquidation of the QOF investor other than a liquidation qualifying for non-recognition under section 337(a);
- A taxable disposition of all or a part of an interest in a QOF partnership or a QOF corporation;
- A distribution by a QOF C corporation but only to the extent such distribution is treated as gain from a sale or exchange under section 301(c)(3);
- A redemption by a QOF C corporation (including a dividend equivalent redemption);
- A transfer of stock in a QOF C corporation or an interest in a QOF partnership in transaction to which a section 351 applies other than a contribution of QOF stock to the QOF itself and such contribution doesn’t reduce the shareholder’s equity interest in the QOF;
Opportunity Zone Rules: Inclusion of Deferred Gain (cont.)

• A reorganization of a QOF C corporation within the meaning of section 368(a);
  – However, an acquisition of a QOF C corporation’s assets in a reorganization qualifying under section 368(a)(1)(A), (C), (D), or (F) (other than an upstream reorganization, an acquisition by a tax-exempt entity or entity operating on a cooperative basis, or a triangular reorganization) is generally not an inclusion event if the acquiring corporation is a QOF immediately after the acquisition (such reorganization, an “Excepted Reorganization”) unless the QOF shareholder receives boot;

• An acquisition of the assets of a QOF shareholder in a reorganization within the meaning of section 368(a)(1)(A), (C), (D), (F), or (G) either (i) by the QOF which the shareholder owns an interest or (ii) in an acquisition that results in one QOF owning an interest in another QOF;
  – Otherwise a reorganization of a QOF shareholder within the meaning of section 368(a)(1)(A), (C), (D), (F), or (G) generally will not be an inclusion event unless the acquiring corporation does not acquire all of the QOF shareholder’s QOF interests.
Opportunity Zone Rules: Inclusion of Deferred Gain (cont.)

• A distribution by a QOF corporation of subsidiary stock to its QOF shareholders in a transaction to which section 355 applies if either the distributing corporation or the controlled corporation is not a QOF;
  – If both distributing and controlled are QOF’s no inclusion event unless boot received by the QOF shareholder;

• A distribution by a QOF shareholder of its QOF stock to its shareholders in a transaction to which section 355 applies to the extent the distribution reduces the QOF shareholder’s direct ownership of the QOF stock;

• A recapitalization within the meaning of section 368(a)(1)(E) (a “Recapitalization”) of a QOF corporation or a transaction described in section 1036 with respect to the stock of a QOF if the transaction has the result of reducing the taxpayer’s proportionate interest in the QOF corporation;
  – A Recapitalization in which there is no reduction in the taxpayer’s interest in the QOF corporation but pursuant to which the taxpayer receives boot, the boot is treated as subject to section 301 or 356 under general tax principles and may result in an inclusion event; and

• A disposition of qualifying QOF stock in a transaction to which section 304 applies to the extent of the consideration received in the exchange subject to section 304.
Opportunity Zone Rules: Inclusion of Deferred Gain (cont.)

• Inclusion amount:
  – The inclusion amount is equal to
    • The lesser of:
      
      \[
      \text{deferred gain} \times \frac{\text{The fair market value of the disposed investment}}{\text{The fair market value of the total investment}}
      \]
      
      » OR
      – The fair market value of the portion of the investment that is disposed.
      
    • Over
      – The taxpayer’s basis in the portion of the investment that is disposed.

• Holding period:
  – If a reorganization under section 368 or a distribution under section 355 is not an inclusion event (other than by virtue of receiving boot or the equivalent thereof), such QOF shareholder’s holding period in the stock received in the exchange or distribution will equal its holding period in the QOF exchange or with respect to which the distribution was made.
Opportunity Zone Rules: Inclusion Events – Example 1

Facts:
1. On May 31, 2019, A sells an asset to an unrelated party and realizes $500 of gain.
2. On October 31, 2019, A transfers $500 to newly formed QOF in exchange for QOF stock.
3. On February 29, 2020, A transfers 25% of its interest in QOF to newly formed Y in exchange for 100% of Y’s stock in a section 351 exchange at a time when A’s fair market value is $800.

Analysis:
- A’s transfer of QOF stock to Y is an inclusion event and will cause A to recognize $125 of its deferred capital gain.
Opportunity Zone Rules: Inclusion Events – Example 2

Facts:

1. On May 31, 2019, X sells an asset to an unrelated party and realizes $500 of gain.
2. On October 31, 2019, X transfers $500 to newly formed QOF in exchange for QOF stock.
3. In 2020, QOF merges into unrelated Y in a transaction that qualifies under section 368(a)(1)(A). X receives solely stock in Y in exchange for its QOF stock. Immediately after the merger, Y is a QOF.

Analysis:

- The merger is not an inclusion event.
- X’s holding period for its investment in Y is treated as beginning on October 31, 2019.
Opportunity Zone Rules: Inclusion Events – Example 3

**Facts:**
X wholly owns QOF.

1. On May 31, 2019, X sells an asset to an unrelated party and realizes $500 of gain.
2. On October 31, 2019, X transfers $500 to newly formed QOF in exchange for QOF stock.
3. In 2020, QOF merges into unrelated Y in a transaction that qualifies under section 368(a)(1)(A). X receives Y stock and $100 cash in exchange for its QOF stock. At the time of the merger, QOF’s fair market value is $1,000.

Immediately after the merger, Y is a QOF.

**Analysis:**
- X is required to include $100 of its deferred capital gain in income in 2020.
Opportunity Zone Rules: Inclusion Events – Example 4

**Facts:**
1. On May 31, 2019, X sells an asset to an unrelated party and realizes $500 of gain.
2. On October 31, 2019, X transfers $500 to newly formed QOF in exchange for QOF stock.
3. In 2020, X merges into unrelated Y in a transaction that qualifies under section 368(a)(1)(A) and pursuant to which Y acquires all of X’s interest in QOF.

Immediately after the merger, Y is not a QOF.

**Analysis:**
- The merger is not an inclusion event.
- If X had instead merged upstream into a corporate shareholder that owned 100% of X, the merger would similarly not be an inclusion event.
Opportunity Zone Rules: Inclusion Events – Example 5

**Facts:**

X wholly owns QOF.

1. On May 31, 2019, X sells an asset to an unrelated party and realizes $500 of gain.

2. On October 31, 2019, X transfers $500 to newly formed QOF in exchange for QOF stock.

3. In 2020, X merges into QOF in a transaction that qualifies under section 368(a)(1)(A).

**Analysis:**

- The merger is an inclusion event.
Opportunity Zone Rules: Consolidated Return Rules

• Neither the statute nor the first set of Proposed Regulations issued under the Opportunity Zone Rules address the application of the Opportunity Zone Rules to consolidated groups.

• The second set of Proposed Regulations provide several rules regarding consolidated groups.

• Pursuant to the second set of Proposed Regulations a QOF corporation cannot be a subsidiary member of a consolidated group, but it can be a common parent.
  – What effect for groups that included QOF corporations in their group prior to the issuance of the proposed regulations? Has the government considered providing relief to such groups?

• Under the second set of Proposed Regulations, for purposes of qualifying for deferral, members of a consolidated group are not treated as a single entity. Instead, the member that recognizes the gain eligible for deferral must also be the member that makes the investment in the QOF.
Opportunity Zone Rules: Consolidated Return Rules – Example 1

Facts:
1. In 2018, S sells an asset to B for $300 and realizes $200 of gain.
2. One month later, B sells the asset purchased from S to an unrelated third party for $325.
3. Within 180 days of Step 1, S and B contribute $200 and $25, respectively, to a newly formed QOF.

Does the matching rule apply such that S’s gain is eligible for deferral under section 1400Z-2(a)?
Opportunity Zone Rules: Consolidated Return Rules – Example 2

**Facts:**

1. In 2018, S sells an asset to an unrelated party and realizes $500 of gain.
2. S contributes $500 to QOF and properly elects to defer the gain.
3. In 2023, after a 5-year holding period, S increases its basis in its QOF stock by $50 (10% of $500, the amount of gain deferred by under the Opportunity Zone Rules).
4. In 2024, S sells the QOF stock to B for $700.
5. In 2026, B sells the QOF stock to an unrelated party for $800.
Opportunity Zone Rules: Consolidated Return Rules – Example 2 (cont.)

Analysis:

- S’s taxable disposition of all its interest in QOF is an inclusion event. As a result, S should have a deferred intercompany gain of $650.
- When B sells all its interest in QOF, B should recognize gain of $100.
- At the time of B’s sale of QOF, S should take into account its $650 of deferred intercompany gain.
- Because the Opportunity Zone Rules apply separately to each member of a consolidated group, B would not step into S’s shoes with respect to deferral of gain under the Opportunity Zone Rules. As a result, B will not benefit from a basis step up in 2025 (i.e., 7 years after S’s transfer to QOF).
Opportunity Zone Rules: Consolidated Return Rules (cont.)

- The second set of Proposed Regulations provide that if a member of a consolidated group owns an interest in a QOF and a basis adjustment is made with respect to the QOF interest, the member of the group will be treated as receiving tax-exempt income for purposes of the investment adjustment rules.
  - However, there are no adjustments increasing basis in the shares of upper-tier members as a result of an election under section 1400Z-2(c) (which allows a QOF shareholder to treat its basis in a QOF interest as fair market value at the time of a sale or exchange of such QOF interest) unless and until the basis of the QOF interest is actually sold or exchanged and thus, increased to its fair market value.
Opportunity Zone Rules: Consolidated Return Rules – Example 3

Facts:

1. In 2018, S sells an asset to an unrelated party and realizes $500 of gain.
2. S contributes $500 to QOF and properly elects to defer the gain.
3. In 2029, S sells all of the stock of QOF to an unrelated party for $800, the fair market value of the stock.
Opportunity Zone Rules: Consolidated Return Rules – Example 3 (cont.)

Analysis:

- In 2023, after a 5-year holding period, S increases its basis in its QOF stock by $50 (10% of $500, the amount of gain deferred by under the Opportunity Zone Rules).

- The $50 basis increase qualifies as tax-exempt income to S. Thus, P increases its basis in S’s stock by $50.

- In 2025, after a 7-year holding period, S increases its basis in its QOF stock by $25 (5% of $500, the amount of gain deferred by under the Opportunity Zone Rules).
Analysis (cont.):

- In 2026, because S has not disposed of its interest in QOF, S’s deferred gain is included in S’s income on December 31, 2026.
- Because of S’s basis increases in 2023 and 2025, the amount of S’s gain is $425 ($500 of deferred gain less S’s $75 basis in QOF).
- Following the inclusion on December 31, 2026, S’s basis in QOF is increased by the $425 gain recognized in 2026 (i.e., S’s basis in QOF is $500).
- P’s basis in S is increased by $425.
Opportunity Zone Rules: Consolidated Return Rules – Example 3 (cont.)

Analysis (cont.):

- In 2029, when S sells QOF to an unrelated party for $800, S has owned the QOF stock for 10 years and elects to increase the basis in QOF to its fair market value (i.e., from $500 to $800).
- S has no gain on the sale.
- As a result of S's $300 basis increase, S is treated as having tax-exempt income. Thus, P increases its basis in its S stock by $300.
Opportunity Zone Rules: Consolidated Return Rules (cont.)

- The second set of proposed regulations also address the application of the Unified Loss Rule to basis in an interest in a QOF.
- Under the proposed regulations, if, after applying the basis redetermination rule and the basis reduction rule, a share of stock in a member that is being transferred (“S”) has basis in excess of its value, Treasury Regulations section 1.1502-36(d) provides that S must reduce its attributes to the extent they duplicate a loss on shares of S stock.
  - In some cases, an election may be made to reduce basis in the S stock instead of reducing inside attributes.
- In determining whether to reduce the attributes of a subsidiary under Treasury Regulations section 1.1502-36(d), a QOF investment is taken into account in determining whether there is a duplicated loss.
- If there is a duplicated loss, basis in a QOF investment is not subject to attribute reduction.
  - Instead, all other attributes are reduced and then, to the extent an interest in a QOF would otherwise be subject to attribute reduction, the basis in the subsidiary stock is reduced to the extent that the QOF interest would otherwise have been reduced.
Opportunity Zone Rules: Consolidated Return Rules – Example 4

Analysis:

1. In 2018, S sells an asset to an unrelated party and realizes $5,000 of gain.

2. S contributes $5,000 to QOF and properly elects to defer the gain.

3. In 2023, when S has held its interest in QOF for 5 years, S increases its basis in its QOF stock by $500 (10 percent of $5,000, the amount of gain deferred by under the Opportunity Zone Rules).

4. In 2024, M sells all of its S stock to an unrelated party for fair market value of $100.
• Assume that no basis redetermination and no basis reduction is required.
• S’s attributes are reduced by S’s attribute reduction amount.
• S’s attribute reduction amount is the lesser of the net stock loss and S’s aggregate inside loss.
• The net stock loss is the excess of the $300 aggregate basis of the transferred S shares over the $100 aggregate value of those shares (i.e., $200).
• S’s aggregate inside loss, which includes the basis of S’s QOF stock, is the excess of S’s net inside attribute amount over the value of the S shares. S’s net inside attribute amount is $500 ($50 NOL plus $500 basis in QOF stock).
• S’s aggregate inside loss is therefore $450 ($550 over $100).
• Accordingly, attribute reduction amount is $200 (i.e., the lesser of the $200 net stock loss and the $450 aggregate inside loss).
Opportunity Zone Rules: Consolidated Return Rules – Example 4 (cont.)

Analysis (cont.):
- S’s $200 attribute reduction is first allocated and applied to reduce S’s loss carryover to $0.
- S’s basis in the QOF stock is not eligible for basis reduction under the Proposed Regulations. Thus, the remaining $150 of attribute reduction amount is applied to reduce M’s basis in the S shares by $150.
Proposed “May Company” Regulations
Revisiting May Company Regulations

• Final “May Company” regulations under Section 337(d) and Section 732(f) were published on June 8, 2018.
  • **Purpose:** generally preventing a corporate partner from avoiding corporate-level gain through transaction with a partnership involving equity interest of the partner or certain related entities.
  • Preamble: “However, the Treasury Department and the IRS are considering publishing a new notice of proposed rulemaking to propose more substantive amendments to the final regulations under section 337(d) and to allow for additional public comment with respect to these more substantive proposals …”
• Proposed regulations to amend the final regulations were published on **March 25, 2019.**
  • REG-135671-17, 84 FR 11005
In providing a definition of “Stock of the Corporate Partner,” the final regulations provide that the term includes “the Corporate Partner's stock, or other equity interests, including options, warrants, and similar interests, in the Corporate Partner or a corporation that controls the Corporate Partner within the meaning of section 304(c) (except that section 318(a)(1) and (3) shall not apply).” (emphasis added)

Specifically excluded: “any stock or other equity interests held or acquired by a partnership if all interests in the partnership’s capital and profits and are held by members of an affiliated group as defined in section 1504(a) that includes the Corporate Partner.”
Proposed Changes

- Among other things, the new proposal would eliminate the exclusion of Section 318(a)(1) and (3) attribution from the determination of Section 304(c) control.
- Also, after “further study” Treasury and IRS have determined that the Affiliated Group Exception “may result in abuse and therefore is not appropriate. Specifically, the Treasury Department and the IRS believe that a partnership held entirely by members of an affiliated group could enter into transactions that permanently eliminate the built-in gain on an appreciated asset that one partner contributes to the partnership.”
Under current regulations, neither A nor B control corporate partner, because Section 318(a)(3) attribution does not apply; thus, B is not treated as owning the stock owned, directly or indirectly, by its 90% shareholder X. Similar treatment for A.

Under the proposed regulations, either X, B or A would be in control of Corporate Partner, since each otherwise has a direct or indirect ownership interest in Corporate Partner. Thus, a contribution by other partners of A or B stock to the partnership in exchange for a partnership interest, will now trigger gain to A or B, respectively.
Captive Partnerships: No Exceptions

Under current regulations, stock of a Corporate Partner does not include “captive” partnership where all interests are held by members of a Section 1504(a) affiliated group.

The proposed regulations remove this exception, because Treasury and IRS believe that a partnership held entirely by members of an affiliated group could engage in transactions that permanently eliminate built-in gain on an appreciated asset (at least if they’re willing to wait 7 years).