Property Contribution and Basis Issues in Pass-Through Opportunity Funds

By Bradley T. Borden, Esq. and Alan S. Lederman, Esq.*

INTRODUCTION

In October 2018 the Treasury Department published proposed regulations under §1400Z-2, which are the start of a very large project with a relatively short shelf life, assuming Congress does not extend the effective date of the §1400Z-2 benefits that currently apply only to investments made in qualified opportunity funds (QOFs) before 2027.1 This article discusses the issues raised by the QOF basis rules and property and cash contribution under the proposed §1400Z-2 regulations.

A QOF may be organized as an entity classified as a partnership or a corporation for federal tax purposes. Tax-oriented real estate acquisitions are typically structured to place ownership of the real estate in entities classified as partnerships for federal tax purposes, such as LLCs. The proposed regulations accommodate this for ownership of land and buildings located in qualified opportunity zones (QOZ real estate).2 A QOF must hold at least 90% of its assets in tangible qualified opportunity zone business property (QOZBP) or interests in qualified opportunity zone businesses that are either partnerships (QOZB partnerships) or corporations (QOZB corporations).3

An issue currently facing organizers of QOFs and QOZB partnerships, and present owners of QOZ real estate, is whether it is feasible for those QOZ real estate owners to contribute their land and buildings to QOFs or QOZB partnerships, in exchange for a QOF or QOZB partnership interest. Would such contribution transactions contribute solutions to QOFs' and QOZBs' pressing equity financing and business problems, or merely contribute to QOFs' and the contributing QOZ real estate owners' tax problems? Specifically, can existing QOZ real estate acquired in such transactions, when substantially improved, create to some extent QOZBP to the acquiring QOF or QOZB partnership? Further, whether or not QOZBP can arise from such QOZ real estate contribution to the acquiring QOF or QOZB partnership, if a QOZ real estate owner contributes QOZ real estate to a QOF and receives in exchange a QOF partnership interest, would such QOF partnership interest be wholly or partially eligible for deferral and exclusion benefits under §1400Z-2?

QOZ real estate and other property contributions, and even many cash contributions, to QOFs raise concerns about how investors in a QOF are to merge the subchapter K rules with the unusual QOF basis rules. These subchapter K rules are not so easily integrated into the structure of a QOF owning QOZ real estate, or a QOF owning interests in a QOZB partnership that owns QOZ real estate.4

* Bradley T. Borden is a professor at Brooklyn Law School. Alan S. Lederman is a shareholder in Gunster, Yoakley & Stewart, P.A., in Fort Lauderdale. They are frequent contributors to professional publications. Copyright © 2018, Alan S. Lederman and Bradley T. Borden.

1 REG 111542-2018, 83 Fed. Reg. 54279 (Oct. 29, 2018). All section references are to the Internal Revenue Code 1986, as amended (Code), and the regulations thereunder, unless otherwise indicated.

2 Although the proposed regulations are not explicit on this point, a U.S. LLC, whose default classification is a partnership, could be a QOF. See Prop. Reg. §1.1400Z-2(d)-1(a)(1) (providing that a taxpayer that is classified as a corporation or partnership for federal tax purposes and eligible to be a QOF may self-certify as a QOF).

3 See §1400Z-2(d).

4 Most importantly, Prop. Reg. §1.1400Z-2(c)-1, dealing with the step-up in basis of eligible QOF interests after 10 years, does not erase the technical issue concerning the QOF’s share of partnership liabilities. Although, after 10 years, the investment in the QOF, which arguably is the QOF partnership interest, is stepped up to its fair market value, which would seem to reflect a reduction for the QOF’s liabilities. Under Reg. §1.1001-2(c) Ex. (3), the amount realized on a sale of the QOF partnership interest includes the selling QOF members’ share of the QOF’s liabilities. Thus, arguably the 10-year step-up creates a gain equal to the selling QOF member’s share of the QOF’s liabilities. §1.C. of the Preamble to the proposed regulations states “an investment in the QOF [includes a] partnership interest. The proposed regulations . . . clarify that a deemed contribution of money under Section 752(a) do not result in the creation of an interest in the QOF.” Similarly,
OVERVIEW OF QOF BASIS RULES AND CONSEQUENCES OF MIXED-FUND INVESTMENTS

General §1400Z-2 Basis Rules

Undoubtedly many QOFs will be pass-throughs and bring with them the complex pass-through tax accounting rules. Both partnership and S corporate QOFs must consider how the basis rules of §1400Z-2 and the respective pass-through regimes will affect tax treatment of QOF investments. The confluence of the new §1400Z-2 basis rules and the pass-through basis rules create many issues. This discussion considers a few of those issues. Because §1400Z-2 uses the basis of a QOF investment to defer and exclude pre-investment gain and exclude post-investment gain, the basis of a QOF investment is critical. The §1400Z-2 basis rules only apply to an investment in a QOF attributed by the QOF investor to eligible gain recognized within 180 days prior to the investment in the QOF (eligible-gain investment). Questions arise as to the extent to which the general pass-through basis rules of subchapter K and subchapter S rules also apply to an eligible-gain QOF investment.

A simple example illustrates general §1400Z-2 rules pertaining to investment in a QOF. To consider the different treatment of eligible-gain investment and non-eligible-gain investment in a QOF, for the sake of simplicity, and to illustrate the basis deferral and exclusion principles of §1400Z-2, the example considers a QOF that is a C corporation. Subsequent examples will apply the basis rules to QOF pass-throughs.

In this and the following examples, assume that “Nona” is a QOF cash investor who has no eligible gain within 180 days before her investment in the QOF. Thus, assume that Nona is entirely “not in” the §1400Z-2 program, in the sense that her interest in the QOF does not qualify for any deferral or exclusion benefits under §1400Z-2, but rather is governed by the general tax rules outside of §1400Z-2. Assume that “Allene” is a QOF cash investor with eligible gain, within the 180 days before the QOF investment, and makes the §1400Z-2(a) election with respect to her entire investment in the QOF. Thus, assume that Allene is “all in” the §1400Z-2 program, in the sense that her interest in its entirety qualifies for the special deferral and exclusion benefits of §1400Z-2. Assume that “Mixley” is a QOF cash investor with some eligible gain recognized in the preceding 180 days, for which Mixley entirely makes the §1400Z-2(a) election, but that such gain is less than the cash Mixley invested in the QOF. Thus, assume that some (i.e. the amount attributable to the §1400Z-2(a) election) of Mixley’s cash investment creates a QOF investment that qualifies for the special deferral and exclusion benefits of §1400Z-2, and the remainder of Mixley’s cash investment creates a QOF investment governed by the general tax rules outside of §1400Z-2.

Example: Investment in QOF Corporation

Nona has $100,000 of cash to invest in the QOF corporation that is not linked to an eligible gain, and Allene has $100,000 of eligible-gain-related cash to invest in the QOF corporation on January 1, 2019. Nona will take a $100,000 basis in her QOF stock, but, under §1400Z-2(b)(2)(B)(i), Allene will take a zero basis in her QOF stock. Under §1400Z-2(b)(2)(B)(iii) and §1400Z-2(b)(2)(B)(iv), after five years, Allene will get a $10,000 basis increase ($100,000 × 10%), and, after seven years, will get another $5,000 basis increase ($100,000 × 5%). Under §1400Z-2(b)(2)(B) and §1400Z-2(b)(2)(B)(ii), on December 31, 2026, Allene will recognize $85,000 of gain, and the basis of her QOF stock will become $100,000, which will also be the basis of Nona’s QOF stock.

Suppose the value of the QOF stock continues to increase, and Nona and Allene each decide to sell their QOF stock, after more than 10 years, in March 2029, for $175,000. Under §1400Z-2(c), Allene gets to step up the basis in her QOF stock to its $175,000 fair market value, so Allene will recognize no gain on the sale of her QOF stock. Nona does not qualify for a basis step-up on her QOF stock, so Nona recognizes $75,000 of gain on her March 2029 sale ($175,000 amount realized - $100,000 basis).

Basis in Simple Mixed-Fund Investments

If an investor invests only eligible gain in QOF interests purchased at one time, then the application of the §1400Z-2 basis-adjustment and gain-exclusion rules to that interest is simple—the rules apply uniformly to all interests at the same time. Basis adjustments and gain exclusions become complex if an investor acquires QOF interests over time or if an investor has a mixed-fund investment. Mixed fund investments can come into existence in a number of ways, most notably where an investor uses funds from both eligible gains and ineligible sources to acquire interests in a single QOF.

Example: Mixed-Fund Investments

Mixley has $200,000 to invest in the stock of QOF Corp, a C corporation, $100,000 of which is attribut-
able to eligible gain and $100,000 of which is not attributable to eligible gain. In a single transaction, Mixley buys a total of 100 shares of QOF Corp stock, so she purchases 50 shares with eligible gain for which she makes a §1400Z-2(a)(1) election (eligible-gain stock) and 50 shares with other funds (non-eligible-gain stock). This would be an investment of mixed funds (a mixed-fund investment), and §1400Z-2 would only apply to the 50 shares of eligible-gain stock.7 Thus, only 50 of Mixley’s shares of QOF Corp stock will qualify for the §1400Z-2 basis adjustments and gain exclusion. The regular basis and gain-or-loss rules will apply to Mixley’s 50 shares of non-eligible-gain stock.

Consider the results if Mixley sells all of her QOF Corp stock in a single transaction and then consider the result if she sells only a portion of her stock in a transaction. If Mixley sells all of her stock in March 2029 for $350,000, the eligible-gain stock would have a basis of $175,000, as computed above, and the non-eligible-gain stock would have a cost basis of $100,000 under the regular tax rules, so the total basis in the transferred stock would be $275,000. Mixley’s amount realized would be $350,000, so she would recognize $75,000 of gain on the disposition ($350,000 amount realized - $275,000 basis). That tax result is the same as the aggregate tax result for Al and Nona in the prior example.

If Mixley were to sell only half (50 shares) of her QOF Corp stock in March 2029, Mixley would have to determine whether she sold the eligible-gain stock, the non-eligible-gain stock, or some portion of each type of stock. Under Prop. Reg. §1.1400Z-2(a)-1(b)(7), if a taxpayer sells interests in a QOF with identical economic rights, such interests were acquired on the same day, and some interests are eligible-gain shares and some are not, the seller is deemed to have sold a pro-rata amount of her eligible-gain interests and non-eligible-gain interests.

Mixley purchased 100 shares of QOF Corp stock in a single transaction for $200,000. Mixley purchased an equal number of eligible-gain shares and non-eligible-gain shares on the same day, so 50 of the 100 shares she acquired are eligible-gain stock and 50 are not. Under the pro-rata method, Mixley will be treated as selling half of her shares (50 eligible-gain shares + 100 total shares purchased on one day) as 25 eligible-gain shares, and as selling half of her shares (50 non-eligible-gain shares + 100 total shares purchased on one day) as 25 non-eligible-gain shares. Thus, upon disposition of 50 of her shares of QOF Corp stock in March 2029, 25 of the 50 shares Mixley sells will be eligible-gain stock, and the other 25 shares will be non-eligible-gain stock. The basis in the 25 shares of eligible-gain stock will be $87,500, which equals the market value of that stock in March 2029 ($175,000 sales price ÷ 2). The basis in the 25 shares of the non-eligible-gain stock will equal $50,000, one-half of the $100,000 that Mixley paid for those shares. Thus, the total basis of the 50 shares that Mixley sells will be $137,500 ($87,500 basis in the eligible-gain stock + $50,000 in the other stock). When Mixley sells the 50 shares for $175,000, she will recognize $37,500 of gain ($175,000 amount realized - $137,500 basis). That is half of the $75,000 gain Mixley would have recognize had she sold all 100 shares. These basic concepts aid in evaluating the basis for considering the potential cost of contributing property to a QOF or QOZB instead of selling it and reinvesting the gain in another QOF. They also provide the foundation for studying more complex basis rules that arise with pass-through QOFs, including the computation of basis in mixed-fund pass-through QOFs.

CAPITAL CONTRIBUTIONS OF QOZ REALTY TO QOFs OR QOZBs

Business Benefits of Capital Contributions

Contributions of QOZ real estate to QOFs and QOZBs will reduce the transferee entities’ equity and debt capital cash needs to complete their QOZ real estate projects, and thereby reduce their concomitant business risk of project failure due to cost overruns or insufficient post-completion income to cover debt service. QOZ real estate owners may also wish to participate in projected appreciation in future QOZ improvement projects envisioned by QOFs or QOZBs for their real estate. To participate in such upside, such owners will often wish to consider contributing their real estate to a QOF or QOZB, generally assumed here to be an entity classified as a partnership, in exchange for a transferee QOF or QOZB partnership interest, rather than selling their properties to the QOF or QOZB for cash.

Accordingly, a structure that could be considered by both existing QOZ property owners, and by QOFs and QOZBs, is the contribution of QOZ real estate by an existing owner to a QOF or QOZB, in exchange for a partnership interest in that QOF or QOZB.8 Such a transaction raises concerns for both the recipient QOF or QOZB partnership and the contributing QOZ real estate owner.

QOF or QOZB Considerations on Acquiring QOZ Real Estate through Contribution

The primary concern for QOF and QOZB partnerships about acquiring property through contributions

8 A lease of the land or lease of the existing building is an alternative structure. This lease liability, absent in a capital contribution, often raises difficult business and non-tax legal issues for both the lessee and its construction and permanent lenders. A lease also raises its own tax issues and related financial accounting issues, such as whether, if a QOZB partnership or corporation is the lessee, how the leased property is to be treated in the Prop. Reg. §1.1400Z-2(d)-1(d) 70% test. Land leases are not further discussed in this article.
is whether the property can be QOZBP. A QOF generally cannot own more than 10% of its assets in the form of tangible property that is not QOZBP. A QOZB partnership generally cannot have more than 30% of its owned and leased tangible property in the form of tangible property that is not QOZBP. One of the requisites for qualification of real estate and other tangible property as QOZBP is that the QOF or QOZB partnership acquire such property by "purchase," as defined in §179(d)(2).

For a QOF or QOZB partnership, an acquisition of property through a partner capital contribution described in §721(a) is not a "purchase" as defined in §179(d)(2). Property not acquired by "purchase" is disqualified by §1400Z-2(d)(2)(D)(i)(I), and by Prop. Reg. §1.1400Z-2(d)-1(c)(4)(i) and Prop. Reg. §1.1400Z-2(d)-1(d)(2)(i)(A), from favorable treatment by a QOF or QOZB partnership as QOZBP, even if the contributing partner is not more than 20% related to the QOF or QOZB partnership after the contribution. Thus, due to the failure of the §1400Z-2(d)(2)(D)(i)(I) "purchase" requirement, when QOZ real estate is acquired by a §721(a) capital contribution, neither the land nor the building are QOZBP. Moreover, there does not seem to be any rule permitting post-contribution improvements by the transferee QOF or QOZB partnership on contributed property to transform that originally contributed property to QOZBP. The exclusion of contributed property from the definition of QOZBP means that for purposes of the QOF 90% test and QOZB partnership 70% test, contributed property will be included in the denominator, but not the numerator, when applying those tests. In the search for more property to add to the numerator, questions have arisen as to whether the improvement costs themselves can be QOZBP.

Do the Renovation Costs Create Qualified Property?

Where land and existing building located in a QOZ are purchased for cash by a QOF or QOZB partnership, and the QOF or QOZB partnership doubles the basis of the building by spending more than the purchase price of the building on renovation costs, Rev. Rul. 2018-29, and Prop. Reg. §1.1400Z-2(d)-1(c)(8) and Prop. Reg. §1.1400Z-2(d)-1(d)(4), seem to imply that the land and the renovated building in their entirety are QOZBP. Similarly, where just land is purchased by a QOZB partnership, and the QOZB partnership builds a new building on that land, Prop. Reg. §1.1400Z-2(d)-1(d)(5)(viii) seems to imply that the land and the newly constructed building in their entirety are QOZBP.

With respect to the costs of renovations performed by the QOF or QOZB partnership on a contributed building, the QOF or QOZB partnership might argue that such costs should favorably be taken into account as QOZBP. For example, suppose a newly created QOZB partnership receives from an existing owner a contribution to partnership capital of land and an existing building totaling, in basis and value, $1 million, and receives from a QOF a contribution to partnership capital of $5 million in cash that the QOZB partnership uses for renovation costs to the building. Can the QOZB partnership successfully argue that it meets the 70% qualifying assets test, by reason of its being considered to own, as part of §6 million of total assets, $5 million in QOZBP, i.e. by being considered to own 5/6 = 83% QOZBP? That is, can the QOZB partnership treat the renovation costs as separate property that is QOZBP? The QOZB partnership could argue that an interpretation tainting renovation costs of a pre-existing building acquired by capital contribution conflicts with the policy of §1400Z-2(d)(2)(D) and Rev. Rul. 2018-29, to seek to encourage substantial renovations of existing QOZ buildings.

Unfortunately for the transferee QOF or QOZB partnership, Rev. Rul. 2018-29, involving the renovation of an existing building, construes "such property" for purposes of §1400Z-2(d)(2)(D)(i)(II) to refer solely to the pre-existing building. However, in Rev. Rul. 2018-29, the existing building was purchased by the QOF, so the issue of separate qualification of the substantial improvements as QOZBP on a non-purchased building did not arise in that ruling.

Neither §1400Z-2(d)-1 nor Prop. Reg. §1.1400Z-2(d)-1 contains a rule similar to that in §42(e). Section 42(e) provides that notwithstanding the general rule in §42(d)(2), which denies a low-income-housing tax credit with respect to existing buildings acquired by a partnership in a transaction that is not a "purchase" within the meaning of §179(d)(2), such as a §721(a) capital contribution of the land and existing building, a partnership can choose to treat significant building renovation costs as a separate tax-credit-eligible new building. The absence of a rule in §1400Z-2 permitting a QOF or QOZB partnership to treat renovation costs as separate from a disqualified non-"purchased" building may cause the IRS to treat the renovation costs, as well as the pre-renovation costs, of a building acquired by capital contribution, as one building that in its entirety is not QOZBP.

In addition to disqualifying the property under the §1400Z-2(d)(2)(D)(i)(I) "purchase" requirement, a QOF's or QOZB partnership's acquisition of land and existing building, located in a QOZ, through a capital contribution, could be viewed as disqualifying the property from QOZBP characterization of original use or substantial improvement under §1400Z-2(d)(2)(D)(i)(III), unless the IRS were to treat the QOF's or QOZB partnership's renovations as a separate item of property. Section 1400Z-2(d)(2)(D)(i)(II)

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11 Reg. §1.179-4(c)(1)(iv).
12 Cf. Prop. Reg. §1.1400Z-2(c)-1(b) (to encourage QOF investment, QOF investor tax benefits continue to be allowed for QOFs substantially renovating QOZ buildings, even for 20 years after QOZ designation ends).
disqualifies property whose original use began before the QOF’s or QOZB partnership’s use, unless such property is substantially improved. Section 1400Z-2(d)(2)(D)(i)(III) provides that property is not QOZBP unless substantially all of the QOF’s or QOZB partnership’s use of such property is in a QOZ during substantially all of the QOF’s or QOZB partnership’s holding period. Where the QOF or QOZB partnership acquires the land and building in exchange for a partnership interest, the QOF’s or QOZB partnership’s holding period for that land and building would generally include the tackled-on contributing pre-existing owner’s holding period.13 This holding period would often begin well before the 2018 date the QOZ designations were made. Thus, under §1400Z-2(d)(2)(D)(i)(III), contributed land and pre-existing buildings would often fail to be QOZBP because, over more than an insubstantial period (including the contributing owner’s tackled holding period before the date that the census tract where the building was located was designated as a QOZ), the use of such property was not in a QOZ. By contrast, the holding period of improvement costs begins only as those components are installed, and does not relate back to the date the holding period of the existing building began.14 Accordingly, disqualification of the post-acquisition improvements under the holding period rule, like disqualification of post-acquisition improvements under the purchase rule, depends on whether the IRS treats the post-contribution renovation costs, together with the pre-acquisition land and building, as one single “such property” for purposes of §1400Z-2(d)(2)(D)(i).

Just as the IRS did not address the “purchase” issue for building components installed on non-purchased land buildings in Rev. Rul. 2018-29 or in Prop. Reg. §1.1400Z-2(d)-2(d)(5)(viii), the IRS did not address this pre-QOZ-designation holding period issue in Rev. Rul. 2018-29 or in Prop. Reg. §1.1400Z-2(d)-2(d)(5)(viii). Rev. Rul. 2018-29, favorably ruling on a purchase of land and pre-renovation building by a QOF, followed by a substantial improvement by the QOF, recited that the purchase occurred in September 2018, after the QOZs were designated.15 That is, by virtue of the purchase, the QOF in Rev. Rul. 2018-29 did not have a pre-QOZ-designation holding period in the land and pre-substantially-renovated building. Similarly, Prop. Reg. §1.1400Z-2(d)-2(d)(5)(viii), favorably discussing a situation involving the purchase of land by a QOZB partnership, followed by new construction by the QOZB partnership, recites that the QOZB partnership bought the land in 2019. In neither situation did the IRS have the occasion to consider a holding period by the QOF or QOZB partnership in the land or building that preceded the QOZ designation of that property’s location.

In summary, land and the existing pre-renovation building acquired by a QOF or QOZB partnership through a partnership capital contribution would, absent favorable IRS guidance, fail the purchase requirement. Such contributed property would apparently increase the denominator, but not the numerator, of the fraction used to test compliance with the QOF 90% asset test or the QOZB partnership 70% asset test.

Likewise, absent favorable IRS guidance, renovation with respect to contributed land and buildings may have some risk of also creating the same adverse inclusion in the denominator but not the numerator. Perhaps the QOF or QOZB partnership could successfully argue that the renovations are separable QOZBP, includable in the numerator as well as the denominator, but the §1400Z-2(d)(2)(D)(i)(I) “purchase” requirement appears to doom the land and pre-renovation building.

Even if the renovations do qualify for inclusion in the numerator, the inclusion of both the contributed property and the renovations in the denominator could cause problems with the QOF 90% assets test or QOZB 70% assets test. The value of the renovation costs in the numerator of the test may have to be well over the double the basis of the contributed building required by the Rev. Rul. 2018-29 needed to trigger a substantial renovation, or the QOF or QOZB may have to have significant other QOZBP, includable in the numerator as well as denominator of its testing fraction, in order to avoid disqualification.

Disqualification by reason of contributed land and building in the denominator, but not the numerator of the QOF 90% assets test and QOZB 70% assets test, is generally of greater concern to a QOF than to a QOZB partnership. A QOF’s allowed percentage of non-qualified assets of 10% is much smaller than a QOZB partnership’s allowed percentage of non-qualified assets of 30%. The QOF cannot necessarily eliminate its own 90% assets test qualification problem by recontributing contributed QOZ real estate to a QOZB partnership before the QOF’s next asset testing date. That is because, in order for a QOZB partnership equity interest to be viewed as a qualifying asset of a QOF, §1400Z-2(d)(2)(C)(i) requires that such interest be issued to the QOF solely in exchange for cash, rather than property, transferred by the QOF. Further, the 31-month safe harbor allowed for treating unexpended renovation and new construction funds in Prop. Reg. §1.1400Z-2(d)-1(d)(5)(iv) as permissible assets applies only to QOZBs and not QOFs.

**Valuation Issues**

For a QOF or QOZB partnership, even beyond any legal uncertainties, the numerical damage caused by any adverse increase caused by any disqualified land and building costs in the denominator, but not in the numerator, of the 90% test or 70% test may be far from clear. For example, Prop. Reg. §1.1400Z-2(d)-1(b)(1) provides that if a QOF has an applicable financial statement within the meaning of Reg. §1.475(a)-(4)(h), which concerns certain GAAP-based financial statements, the value of each asset for purposes of applying the 90% test to that QOF is the

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13 See §1223(2); Rev. Rul. 99-5.
14 Rev. Rul. 75-524.
15 See IRS Notice 2018-48 on designating the QOZs.
value of that asset in the QOF’s applicable financial statement. Similarly, Prop. Reg. §1.1400Z-2(d)-1(d)(3)(ii)(A) provides that if a QOZB has an applicable financial statement within the meaning of Reg. §1.475(a)-4(h), the value of each asset for purposes of applying the 70% test to that QOZB is the value of that asset in the QOZB’s applicable financial statement. GAAP may be unclear whether land and buildings contributed to a QOF or QOZB partnership are to be accounted for by the QOF or QOZB partnership at their historical cost to the contributor, or rather at their fair market value.17

Inclusion in the denominator at a lower historical cost value for purposes of an applicable GAAP financial statement would therefore benefit the QOF or QOZB partnership for purposes of the 90% or 70% tax tests. A lower GAAP value may have undesirable non-tax business consequences, however. For GAAP purposes, a lower value could increase GAAP income by reducing GAAP depreciation deductions, but could also reduce GAAP partners’ equity, which could harm loan covenant ratios.

Prop. Reg. §1.1400Z-2(d)-1(b)(2) states that if a QOF does not have any applicable financial statement, the value of each QOF asset is based on its “cost.” But is the Prop. Reg. §1.1400Z-2(d)-1(b)(2) “cost” of property received as a partnership capital contribution its cost to the contributing partner; its tax basis or GAAP depreciated cost to the contributing partner; its §199A(b)(2)(B)(ii) unadjusted basis; the fair market value of the property that would be used to value the contributing partner’s capital account in the QOF under the Reg. §1.704-1(b)(2)(iv)(b) substantial economic effect safe harbor; or, some other number?

A very large QOF, or a moderately large QOZB partnership, may have enough room in the denominator of its 90% or 70% fraction for some non-qualifying property. In some cases, the economic costs to a QOF or QOZB partnership of diluting pre-existing partners, and documenting a QOF or QOZB partnership operating agreement with the contributing QOZ real estate owner, may be smaller than the costs of obtaining new cash partners, diluting existing partners, and providing documentation for the sources of cash needed to buy that property. In such cases, a capital contribution could be considered by the QOF or QOZB partnership as a method of acquiring QOZ real estate.

**QOZ Property Owners’ Considerations**

**Can Property Contributions be a QOF Investment?**

Owners considering transferring land and buildings to a QOF, in exchange for a capital interest and prof-its and loss interest in that QOF, must consider whether such contribution could form part of the “aggregate amount invested” in the QOF for purposes of §1400Z-2(a)(1)(A). The Treasury has not addressed this issue. An affirmative answer could permit eligible-gain QOF partnership interests that are received in exchange for such property contribution to qualify for a tax-free step-up in basis after 10 years under §1400Z-2(c).18

Section 1400Z-2(d)(2)(C)(i) limits a partnership interest acquired by a QOF from a QOZB partnership to qualify as a qualified opportunity zone partnership interest only if that partnership interest is acquired by the QOF “from the [QOZB] partnership solely in exchange for cash.” By contrast, there is no language in §1400Z-2 limiting the investment in a QOF to a partnership interest acquired “from the [QOF] partnership solely for cash.” Further, Prop. Reg. §1.1400Z-2(a)-1(b)(3)(ii) provides that a partnership interest in a QOF is not disqualified merely because the partner acquires its QOF partnership interest by contributing to the QOF partnership the partner’s purchase money note rather than contributing cash.19

The IRS and Treasury Department have interpreted the term “aggregate amount invested” in the context of funds established as partnerships or corporations seeking to raise funds from investors seeking tax benefits. In former §6707(a)(2)(A), relating to a penalty for failure to register a tax shelter, the term “aggregate amount invested,” to which a 1% penalty rate could be applied, was interpreted to include “all cash, the fair market value of all property contributed, and the principal amount of all indebtedness received in exchange for interests in the investment.”20

On the other hand, the caption of §1400Z-2(e)(1) is “Treatment of Investments [in a QOF] With Mixed Funds” suggesting that investment of cash “funds” in a QOF is contemplated. Captions have traditionally played a minor role in statutory interpretations, but Treasury deviated from that tradition with §1400Z-2. In interpreting “gain” in §1400Z-2(a) adversely to taxpayers, Prop. Reg. §1.1400Z-2(a)-1(b)(3)(ii)(A) ignores the statutory text of §1400Z-2(a)(1), which allows “gain from . . . any property” to be the source of eligible investment in the QOF, and ignores the subparagraph caption of §1400Z-2(a)(1), “Treatment of gains,” in favor of the section caption of §1400Z-2, which refers to the more limiting “capital gains.” Following a similar path, the IRS could argue that the narrowest caption, that of “funds,” construed by the IRS for this purpose to mean “cash,” defines the permitted investment.

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16 The IRS draft instructions to QOF Form 8996 differ somewhat from the proposed regulations, but also generally provide for GAAP valuation of assets where certified GAAP statements exist.


18 Another issue on a contribution of an existing building is how to compute its §199A(b)(2)(B)(ii) unadjusted basis. See Prop. Reg. §1.199A-2(c).

19 Prop. Reg. §1.1400Z-2(a)-1(b)(3)(ii) does not discuss whether or not the partner-obligor’s QOF’s partnership interest is no longer an eligible QOF interest if that QOF partner, upon an unplanned default or renegotiation, satisfies its purchase money promissory note due to the QOF in property rather than cash.

20 CCA 200112003.
Prop. Reg. §1.1400Z-2(a)-1, while not imposing any restriction on the form of investment in a QOF, does limit the source of an eligible-gain investment in a QOF to capital gains recognized by the investor within 180 days before the contribution.\textsuperscript{21} A tax-free contribution would not itself trigger recognition of capital gains. However, if the taxpayer had other capital gains within the 180-day period, perhaps the taxpayer could defer that gain by contributing other property to a QOF.

**Example: Capital Gains Recognized Within 180 Days Before Contribution**

Suppose, for example, that an individual owned some property (e.g. publicly traded stock or land and building located outside a QOZ) with an inherent gain of at least $1 million, and also owned land and building located within a QOZ with a basis of $400,000 and a value of $1 million. Suppose the individual sold the non-QOZ property to a non-QOF for at least $1 million cash, which cash she retained, and suppose such sale also triggered to her at least a $1 million eligible gain. Suppose she wished to designate the entire $1 million eligible gain as the foundation for a $1 million investment in a QOF.

Suppose, in an unrelated transaction within 180 days after the sales, she contributed the QOZ real estate to the QOF for a partner capital account in the QOF of $1 million and an interest in the QOF’s profits and losses. Would the maximum amount of her eligible-gain investment in the QOF be zero (the amount of cash she invested in the QOF), $400,000 (her basis in the property she invested in the QOF), $600,000 (her deferred gain in the property she contributed to the QOF), $1,000,000 (the value of her property invested in the QOF), or some other amount?

If her eligible-gain investment in the QOF were viewed as $1 million, under §1400Z-1(b)(2)(B), at the end of 2026, ignoring her share of QOF cumulative income, loss, and liabilities, her basis in the eligible-gain QOF interest, which would have started at zero, would be $1 million. If she sold the QOF interest on January 1, 2027, for $1 million, she would have avoided tax not only on 15% of the gain on her unrelated-to-the-QOF property of $1 million, as contemplated by §1400Z-1(b)(2)(B), but also would have avoided her $600,000 gain (minus any amount already included under Reg. §1.1704-3) on the appreciation in her contributed QOZ real estate, a result apparently not contemplated by §1400Z-1(b)(2)(B).

To avoid the contributor’s double-exclusion of gain, the $600,000 date-of-contribution gain could be triggered on the date of contribution, or be triggered at the end of 2026; but these rules seem inconsistent with §721(a). Another approach could be to treat the $400,000 of basis in the contributed property as property investment as an eligible-gain QOF investment of $400,000 value with a zero basis under §1400Z-2(b)(2)(B)(i). The rationale for this treatment is that the basis in the contributed property is similar to cash.

\textsuperscript{22} Reg. §1.707-3(f) Ex. 1. Prop. Reg. §1.1400Z-2(a)-1(b)(2)(ii) provides that eligible gain only includes capital gain. Under §1239, to avoid ordinary income on sale of a building by a partner to partnership, if such building will be depreciable in the hands of the partnership, the selling partner must not hold a more than a 50% capital or profits interest in the purchasing partnership. Prop. Reg. §1.1400Z-2(a)-1(b)(2)(ii)(C) provides that eligible gain only includes gain arising from the sale to a buyer unrelated to the seller, as determined by reference to §1400Z-2(e). Section 1400Z-2(e) treats as related a selling partner and a purchasing partnership in which the selling partner, directly or indirectly, owns more than a 20% profits or capital interest. For §1400Z-2 purposes, the courts and IRS will likely treat a seller as related to a partnership, even a newly created QOF or QOZB partnership, if, immediately after the sale, the seller owns more than a 20% profits or capital interest in the partnership, even if the seller does not hold such interest immediately before the sale. See Moore v. Commissioner, 17 T.C. 1030 (1951), aff’d 202 F.2d 45 (5th Cir. 1953).
Capital Contribution to QOZB vs. Sale to QOZB

Existing owners of QOZ real estate may face the choice of selling their QOZ real estate to a developer, which could be a QOZB or contribute them to a partnership with the developer, which could be the same or another QOZB. If the existing owners decide to sell their property for cash, they would have various options to defer the gain, including a like-kind exchange, or investment in a QOF. A QOF would generally be the more favorable reinvestment alternative than a like-kind exchange, if both the QOF and §1031 replacement property perform similarly following the investment.

The following discussion offers some comparisons between the income tax aspects of a capital contribution of appreciated real estate located in a QOZ to a QOZB partnership, and sale of that real estate followed by a capital contribution of the selling price of that real estate to a QOF partnership. As a practical matter, however, these alternatives will often involve two far different investment choices. For example, the QOZB to which the QOZ real estate may be contributed could decide to limit its activities to investing in rental real estate in the same QOZ where the contributed property is located. The alternative investment choice considered here, the unrelated QOF to which the cash sales proceeds of the QOZ real estate could be contributed, could decide to limit its activities to investing in several manufacturers and retailers located in a QOZ thousands of miles away. In other circumstances, however, the pretax economics of the QOZB to which the property may be contributed, and the pretax economics of the QOF to which the sales price of that property could be contributed, may be quite similar. For example, the QOZB to which the

23 See §1223(1); Rev. Rul. 99-5, n.13 above.
24 If such election to pay tax notwithstanding §721(a) by a QOZ real estate owner who owned less than 20% of the QOF after the transfer were allowed, then the QOF could be granted “purchase” treatment with respect to such property. Cf. §197(f)(9)(B).
25 QOZB or QOF status of a cash buyer offers no particular tax benefits to a seller of real estate. As a practical matter, because of the §1400Z-2 partial basis step-up and deferral-to-2026, tax benefits to QOF equity holders on the eligible gain used to fund the purchase of the QOF interest, and the 10-year step-up to eliminate tax on post-investment gain, QOFs may be willing to pay somewhat more for QOZ property than other entities. Because at this juncture the 70% QOZB test seems generally more favorable than the 90% QOF test, it is assumed here for simplicity that a logical cash buyer of real estate located in a QOZ would be a QOZB rather than a QOF directly.
26 As discussed above, it is doubtful whether the §1400Z-2 tax benefits to QOF equity holders are available for QOF partnership interests acquired through contributions of real estate to QOFs. It is also unclear whether a QOZB can elect to be a QOF without disqualifying the QOF’s corporate and partnership partners from QOF status, since §1400Z-2(d)(1) requires a QOF to be organized for a purpose of investing in QOZBs and QOZBP “other than another qualified opportunity fund.”
27 See Alan S. Lederman and Bradley T. Borden, Rolling Real Estate Gain into a Qualified Opportunity Fund: Comparison with §1031, 34 Tax Mgt. Real Estate J. 155 (2018).
28 Investors should expect the §1400Z-2 exclusion to affect the value of property in a QOZ, so the two types of investments may perform similarly, after tax.
property may be contributed, and the unrelated QOF to which the sales proceeds could be contributed, could both decide to limit their activities to buying and renovating real estate in the same or nearby QOZs. Additionally, with funds flowing into QOFs from around the country, QOF investments may move closer to fungibility as investors become sophisticated and focus on QOF investment returns and relinquish their predisposition for any specific piece of property or area of the country.

There are income tax reasons favoring and disfavoring a §721(a) capital contribution of QOZ real estate to a QOZB over selling that QOZ real estate for cash and investing the sales proceeds in a QOF. A §721(a) capital contribution of appreciated QOZ real estate to a QOZB can, like investing the sales proceeds of that QOZ real estate, provide the QOZ real estate owner a tax deferral benefit on any gain attributable to the contributed appreciated QOZ real estate. There is a tax cost of such §721(a) deferral, in terms of reduced allocations of QOZB deductions or specially increased allocations of QOZB income, as provided in §704(c) and Reg. §1.704-3. Nonetheless, the deferral provided by §721(a) generally can extend well after the 2026 date such gain will be triggered if the gain is recognized through a cash sale and that gain is invested in a QOF. Moreover, if the individual dies before she sells her QOZB interest and before the QOZB sells the contributed QOZ real estate, then, through the step-up in basis at death rules in §1014(a) and §754, she and her heirs will have avoided much of the pre-contribution inherent gain otherwise triggered to her in 2026 if she were to use the QOF rules.

Notwithstanding possible advantages of a §721(a) capital contribution to a QOZB over a cash sale coupled with a cash reinvestment of the gain in a QOF, a §721(a) capital contribution to a QOZB also has many relative tax disadvantages. Under a cash sale coupled with a cash reinvestment of the gain in a QOF, an amount of cash equal to the tax basis of the sold QOZ real estate can be retained tax-free. By contrast, under §721(a), if the tax basis of the transferred QOZ real estate, or any other amount of cash is immediately withdrawn from the QOZB, such amount is generally treated as proceeds of a disguised partial sale of the real estate.29 Another major advantage of the QOF is the ability to compute a distributive share of the QOF’s taxable income based on the QOF’s full cost basis in the QOF’s assets, and on the QOF’s subsidiary QOZB partnerships’ full cost basis in their assets.

Most importantly, if the QOF partnership interest is held for 10 years, all gain attributable to post-QOF-interest-acquisition gain is apparently excluded. The taxpayer need not suffer the inconvenience of death in order to avoid tax on the economic appreciation and on tax depreciation not reflected in corresponding market value depreciation, as would occur in the case of a §721(a) contribution.

Perhaps the main potential tax disadvantage of a cash sale coupled with a QOF reinvestment, over a §721(a) contribution to a QOZB, is the §1400Z-2(b)(1)(B) 2026 triggering of the gain originally deferred upon the cash purchase of the QOF interest. However, this disadvantage, over a §721(a) transaction where the contributed QOZ real estate is held by the QOZB beyond 2026, can often be significantly mitigated by numerous factors. These factors include: (1) the taxpayer’s likely ability to squirrel away, after payment of any year of sale tax on such amount, a portion of the selling price approximating the estimated 2026 tax; (2) the partnership’s lower carryover basis in the contributed real estate, and the Reg. §1.704-3 special allocation rules, will generally cause the contributing partners’ distributive share of any QOF taxable income, up to and beyond 2026, to be higher than where the QOF buys all its real estate for cash; (3) the 2026 deemed sale limitation on the amount deemed realized to the 2026 fair market value of the QOF perhaps gives the taxpayer some flexibility; (4) the taxpayer receives an increase in tax basis by up to 15% of the purchase price in computing gain on the 2026 deemed sale; (5) the taxpayer’s horizon until 2026 to plan for the 2026 QOF triggered gain; and (6) speculation that Congress may postpone beyond 2026 for the triggering date, or eventually forgive the gain.

However, taxpayers contemplating selling existing QOZ real estate would have to consider the non-tax and tax aspects of all available alternatives, such as keeping the cash sales proceeds in cash and marketable securities, doing a §1031 exchange, contributing the QOZ real estate to a QOZB, reinvesting the gain in a QOF, doing an installment sale, and all other available alternatives, to determine the most advantageous course of action.

The Best of Both Worlds vs. The Step Transaction Doctrine

As noted above, the contribution of existing QOZ real estate for a QOF interest will disqualify that contributed property from favorable QOZBP classification in applying the QOF’s 90% test, and could also make that QOF interest ineligible for the §1400Z-2 deferral and exclusion benefits. Is there another way for a QOZ property owner with small basis and no other eligible gain to obtain the favorable result of exchanging its land and building located in a QOZ, for a QOF interest that can be sold in 10 years without significant tax, and simultaneously achieve for the QOF issuing that QOF interest basis in that property equal to 100% of the value of that property as QOZBP? Suppose the QOZ property owner sold, for cash, rather than contributed, that property to a QOF, and then invested the cash sale proceeds in an eligible-gain interest in that same purchasing QOF pursuant to a §1400Z-2(a)(1) election.

If this strategy is successful, the existing property owner would then benefit from the deferral to 2026

29 Reg. §1.707-3(f) Ex. 1. If the taxpayer does not own more than a 20% capital or profits interest in the distributor QOZB after the contribution, perhaps the gain triggered on such a distribution could be reinvested tax free in a QOF under §1400Z-2.

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and partial exclusion of its gain on the QOZ real property, and achieve the 10-year step-up in basis of the QOF interest purchased with the gain. If this strategy is successful, the investment in the QOF of the non-gain portion, i.e., the investment in the QOF corresponding to the existing property owner’s recovery of basis, would not qualify for the 10-year step-up in basis. The property owner would hold a mixed-fund investment in the QOF. Moreover, the deferred-gain portion would be triggered in 2026, with a partial offset of the 15% step-up in basis, as opposed to being triggered under the Reg. §1.704-3 rules applicable to the built-in gain upon a property contribution.

The QOF would have received the property for cash. Thus, if the selling QOZ property owner was not related to the QOF, the land and building, if the building is used originally or substantially improved by the QOF, would generally be QOZBP under Rev. Rul. 2018-29.

A potential IRS attack on such a pre-arranged plan lies in the step-transaction doctrine. The IRS could ignore the circular flow of funds, from the QOF to the QOZ real estate owner, as purchase price for the QOZ property, and back from the QOZ real estate owner to the QOF as a capital contribution, and treat the transaction, in substance, as a §721(a) contribution of the QOZ real estate to the QOF.

Moore, n. 22 above, applied the step transaction to find related party characterization, where the seller had a binding contract to obtain control of the buyer’s shares at the time of the sale. Even if there is merely a pre-arranged plan for seller to buy more than a 20% capital or profits interests in the QOF, the IRS is likely to determine there has been no qualifying eligible gain recognized by the seller, and no “purchase” of QOZBP by the QOF. Although §1400Z-2(d)(2)(D)(ii)(l) has two incorrect cross-references, it appears that, under §1400Z-2(d)(2)(D)(ii)(l), a partnership buyer does not acquire by “purchase” property bought from the seller if the seller owns, directly and indirectly, more than 20% of the profits or capital interest in the buyer. See also §1400Z-2(d)(2)(D)(ii)(l), (e)(2) (real estate bought by a QOF from a 20%-related seller not QOZBP); §1400Z-2(a)(1), (d)(2)(D)(ii)(l) (gain on sale to 20% related buyer is ineligible gain).

See PLR 201242007 (contribution of cash to newly created company in exchange for equity, coupled with company’s obligated use of that cash to buy operating assets from contributing equity holder, treated as contribution of operating assets and not cash; circular flow of funds ignored); PLR 201822008; Rev. Rul. 83-142. In these rulings, however, the buyer was not a QOF and it was apparently the property-transferor taxpayer who sought capital contribution rather than sale treatment. If the IRS were, at the transferor’s election, not to apply the circular flow of funds argument in situations where the property owner acquired no more than a 20% interest in the QOF; the result would be similar to the hypothetical voluntary waiver of §721(a) non-recognition discussed above.

CONTRIBUTION TO A QOF CORPORATION

The owner of QOZ real estate and a pre-existing corporate QOF may be able to avoid the technical hurdles posed by contributions of property to a QOF partnership. Such a QOF organized as a corporation may have more flexibility to achieve the favorable result for the QOF of a §179(d)(2) “purchase” of the existing QOZ real estate, and possibly also the favorable result for the transferor QOZ real estate owner of generating an eligible gain, and an equally large QOF interest, eligible for §1400Z-2(b) and §1400Z-2(c) benefits, in the amount of such gain.

Suppose the pre-existing QOF transferred no more than 20% of the shares of the QOF in exchange for the QOZ real estate of equal value, in a transaction not described in §351, such as a transaction in which the property transferor, and other members in its transferor group, own less than 80% of the QOF transferee’s stock. Unlike the §721(a) transfer to a QOF partnership, which applies non-recognition even if the transferor obtains a small interest in the QOF partnership, the receipt of QOF corporation stock is taxable to the transferor, if the transferor shareholder and other related transferors to the QOF own less than 80% of the QOF after the transfer. Because the property owner’s sale is to less than a 20% owned corporation, the QOZ real estate owner’s gain on the contribution apparently could qualify for the rollover into an eligible-gain QOF interest. The basis of the corporate QOF in the acquired QOZ real estate will, under §1012, be the QOF’s cost (unlike the §723 QOF partnership carryover basis). This QOF cost basis, combined with the lack of 20% interest in the corporate buyer by the seller, arguably avoids “purchase” disqualification of the acquired QOZ real estate as QOZBP to the QOF under §179(d)(2).

Owners of real estate typically prefer to hold QOZ real estate in partnership form, but perhaps §1400Z-2 could change that preference, if it allows existing owners of highly appreciated QOZ real estate to qualify for §1400Z-2(a) deferral and exclusion on contribution of that real estate to a QOF corporation. Furthermore, if the QOF corporation makes a valid S
election, then, if future Treasury regulations so permit, the QOF’s shareholder could exclude, or offset by a capital loss on liquidation, the QOF’s shareholder’s share of the QOF’s corporation’s gain from the sale of the property after 10 years. As the discussion below regarding partnership QOFs illustrates, the policy of §1400Z-2(c) should support tax-free liquidating sale of appreciated assets by a QOF with respect to the QOF’s interests which, if they hypothetically had been sold immediately before the QOF sold its assets, would have qualified for the §1400Z-2(c) exclusion. Accounting for this type of arrangement and other aspects of investing in QOF pass-throughs requires applying complex pass-through rules and §1400Z-2 rules.

**COMPLEX TAX ACCOUNTING COMPUTATIONS IN MIXED-FUND INVESTMENTS**

Merging the §1400Z-2 and pass-through rules to compute the basis of mixed-fund investments can become complicated very quickly. The guidance regarding basis adjustments to pass-through QOF interests is limited and does not tie in to the partnership tax rules. The proposed §1400Z-2 regulations provide that if a partnership reinvests the partnership’s own gains in a QOF, gain deferred by that partnership under §1400Z-2(a)(1)(A) does not increase its partners’ bases in their interests in the partnership.37 This rule is not very interesting because it simply recognizes that QOF partnership gain deferral is a non-event for tax purposes, which should not affect the members’ bases in their QOF partnership interests.

The proposed regulations also provide that allocations of QOF partnership liabilities and the accompanying deemed contributions under §752 are not treated as investments in the QOF partnership.38 The proposed regulations also instruct members of QOF partnerships to ignore §752 deemed contributions for purposes of determining the portion of their investment in the QOF partnership that is eligible-gain investment.39 This rule is interesting and warrants significant additional consideration.

The §752 rule in the 1400Z-2 proposed regulations appears to recognize that members’ bases in their QOF partnership interests will increase if their shares of the QOF partnership’s liabilities increase. Such acknowledgement represents a significant concession that subchapter K can apply to partnership QOFs, notwithstanding §1400Z-2(b)(2)(B)(i). Section 1400Z-2(b)(2)(B)(i) provides that, except for the 5% and 10% basis step-ups under §1400Z-2(b)(2)(B), and the 10-year step-up to fair market value in §1400Z-2(c), the taxpayer’s basis in the [QOF] investment shall be zero.”

This §752 increase in basis is important because it appears to ensure that, if there are sufficient QOF level non-recourse or recourse liabilities allocated to a partner, allocated losses will not be suspended under §704(d)(1) as a result of the low basis under §1400Z-2(b) in the eligible-gain QOF partnership interests. (See the discussion below regarding the loss suspension rules and QOF pass-throughs.) Even casual observers recognize the general benefit derived from §752-derived basis in a real estate partnership that generates losses which exceed the pre-loss-allocation basis in the partnership interest.

In the general real estate partnership context, when the partnership interest is sold, cumulative losses claimed by a partner attributable to inclusion of that debt in basis under §752 are ordinarily in effect recaptured by inclusion of the liabilities in the amount realized.40 By contrast, under the special rule of §1400Z-2(c), it appears that after 10 years, gain on sale of eligible-gain QOF partnership interests is excluded, even if such gain is attributable to §752 liabilities which supported claims to cumulative losses.41 This rule appears to allow a QOF investor to benefit from cumulative losses, including depreciation deductions, of the QOF, including the QOF’s share of cumulative losses, including any depreciation deductions, of any QOZB partnership, and then exclude gain attributable to those losses in the disposition of the QOF interest after the 10-year mark.

If this conclusion is correct, §1400Z-2(c) overturns Tafts and Crane by allowing a taxpayer to take a deduction for basis provided by financing but not requiring the taxpayer to include that recognized gain on the subsequent disposition of the property.42 This result is apparently based on the drafters’ apparent intent that §1400Z-2(c) excludes gain after 10 years, even if such gain somehow reflects ordinary deductions, including financed ordinary deductions, in earlier years. For example, the §1400Z-2(c) exclusion of gain attributable to post-investment recognized losses and deductions can not only eliminate the tax on the QOF partners’ eligible-gain interest on appreciation of QOZ buildings over their purchase price to the QOF but can also eliminate recapture of cumulative depreciation deductions on such buildings, even though such deductions were unaccompanied by economic depreciation.

**Loss Allocations and §752 Basis**

A close examination of the effect of loss allocations in a QOF that has issued both eligible-gain interests and non-eligible-gain interests will be a challenging but relevant and important undertaking. The proposed regulations include an example to illustrate that members’ shares of liability of a QOF partnership do not affect the composition of the members’ investments in

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40 See Reg. 1.1001-1(c) Ex.7.
41 See n.4, above.
42 See Reg. §1.1001-1(c) Ex.7.
the QOF partnership. In that example, 90% of a member’s interest in a QOF partnership was purchased with eligible gain and 10% with other funds. The member was allocated $4,000,000 of the QOF partnership’s liabilities, which increased the basis of the member’s interest in the partnership. Because basis increase attributable to the increase in shares of liability is ignored, the composition of the member’s interest in the QOF partnership remained 90% attributable to reinvested eligible gain and 10% attributed to other funds.

The upshot of this example is that if the member were to sell any of the interests, and the pro-rata method applied to the sale, 90% of the sold interests would be eligible-gain interests and 10% would be other interests. Presumably, 90% of the sale price of the interests would reflect the fair market value of eligible-gain interests, so the investor would presumably qualify for a basis step-up that causes the basis of the eligible-gain interests to equal 90% of the sales price. This creates a conceptual challenge because the amount realized upon the sale of the interests will often include a decrease in the member’s share of the QOF partnership’s liabilities.

Despite these conceptual challenges, Prop. Reg. §1.1400Z-2(e)-1(a)(3) provides that the allocation of QOF partnership liabilities to a QOF partner does not create a non-eligible-gain investment by that partner. Conversely, even if a partner in a QOF has eligible gain within the 180-day period in excess of the cash that partner invested in the QOF, Prop. Reg. §1.1400Z-2(e)-1(a)(3) denies the QOF member the right to treat that partner’s share of the QOF’s liabilities as increasing its eligible investment in the QOF. The net effect of this rule is that the proportion of eligible gain and non-eligible-gain interests of a QOF partner is determined by the amount invested in each type of interest.

This rule is significant because it appears to allow QOF partners with limited eligible gains to use leverage within the QOF partnership to avoid bringing in other QOF partners with sufficient eligible gain to make contributions to fund QOF partnership expenditures. Such other QOF partners would ordinarily share in post-investment partnership appreciation that may qualify for §1400Z-2(c) exclusion.

Similarly, suppose some QOF partners borrowed money, in excess of their eligible gain, outside the QOF partnership, and contributed such non-eligible gain funds to the partnership, while other partners contributed only eligible-gain funds. Under the mixed-fund rules, partners contributing non-eligible-gain funds would suffer a corresponding dilution of the fraction of the post-investment appreciation in the QOF’s assets that would be eligible for the §1400Z-2(c) step-up. Thus, for example, where some, but not all, of the contributing QOF partners have eligible gains within the preceding 180 days greater than their share of QOF liabilities, the proposed regulations treat borrowing outside a QOF partnership differently from borrowing within the partnership, even if the two transactions are economically similar.

Example: Potential Benefit of the §752-Basis Rule

The following example illustrates the potential benefit of the §752-basis rule and how it is in line with other tax concepts and how it raises questions with respect to §1400Z-2. On January 1, 2019, Mixley and Nona each contribute $100,000 to QOF Partnership to become 50% members. Mixley’s contribution consists of eligible-gain funds (75%) and other funds (25%). Mixley’s basis in her QOF Partnership interest is $25,000 (her cost basis in the 25% non-eligible-gain interest) on the date of contribution. QOF Partnership uses the contributed money and $800,000 from a non-recourse loan to acquire and substantially improve QOZ real estate classified as QOZBP for $1 million. QOF Partnership allocates the nonrecourse liability equally to Mixley and Nona, so Mixley’s 50% share of that liability is $400,000. To keep the analysis as simple as possible, suppose that QOF Partnership has zero net cash flow from operations, makes no loan principal payments, owes no real or imputed interest, and, due solely to depreciation, generates each year a taxable loss equal to such depreciation.

After basis adjustments and gain recognition, under §1400Z-2(b), Mixley’s basis in her QOF Partnership interests equals $500,000 ($25,000 non-eligible-gain cost basis + $75,000 eligible-gain $1400Z-2 basis + $400,000 §752-derived basis) on December 31, 2026, before taking into account Mixley’s share of QOF Partnership’s cumulative losses. Accounting for the effect loss deductions have on the basis of Mixley’s QOF Partnership interests could be fraught with complexity.

As discussed below, if QOF Partnership does not incur liabilities that increase Mixley’s basis in her QOF Partnership interest, then her §1400Z-2(b)(2)(B)(i) zero basis in her eligible QOF Partnership interest prior to the 5-year step-up may suspend the deductibility of QOF Partnership tax losses allocated to her. Under §752(a), Mixley is deemed to contribute cash equal to her share of QOF Partnership’s liabilities, so Mixley would ordinarily have sufficient basis in her QOF Partnership interests to absorb the cumulative losses allocated to her. The question is whether she should track the allocations to the various bases she has in her QOF Partnership interests. Examples of selling a QOF partnership interest and of liquidating a QOF illustrate the complex nature of basis computation and gain recognition when a QOF investor is allocated QOF partnership liabilities.

Tax Treatment of Disposition of a QOF Partnership Interest

In January 2029, Mixley has owned her QOF Partnership interest for more than 10 years. At that time, suppose QOZBP is worth $1,750,000 and still subject to the $800,000 liability, and QOF Partnership had taken $250,000 of depreciation deductions, incurring $250,000 in cumulative losses. It had allocated

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44 See §752(d); Reg. §1.1001-2(c) Ex.3.
$125,000 of those cumulative losses to Mixley. Due to the allocation of those losses, Mixley’s basis in her QOF Partnership interests will be $375,000 ($75,000 basis under §1400Z-2(b)(2)(B)(ii) by reason of the 2026 triggering of Mixley’s 2019 deferred gain + $25,000 cost basis in the shares purchased by Mixley from non-eligible-gain sources + $400,000 Mixley’s share of QOF Partnership’s liabilities, - $125,000 allocated cumulative losses).

Because Mixley will have held the QOF Partnership interests for more than 10 years in January 2029, if Mixley were to sell her QOF Partnership interest for $475,000 (the amount she would receive on liquidation of QOF Partnership: 50% × ($1,750,000 value of QOZBP - $800,000 liability)) prior to QOF Partnership selling its QOZBP, then §1400Z-2(c) would allow her to step up the basis in the eligible-gain portion of her QOF Partnership interest to its fair market value. To apply the §1400Z-2 basis step-up, she must determine the basis of the eligible-gain portion of her QOF Partnership interest. At this point, Mixley would prefer that her basis in the eligible-gain portion of her QOF Partnership interest to be low because §1400Z-2(c) steps the basis up in the eligible-gain portion of the interest to its fair market value. The step-up will equal the difference between the interest’s fair market value and its pre-step-up basis, so the lower the pre-step-up basis, the greater the step-up. The basis of the eligible-gain portion of the interest will depend upon the effect of cumulative partnership losses allocated to the respective portions of Mixley’s QOF Partnership interest.

Prior to the 5-year and 7-year adjustments, the eligible-gain portion of the interest had no basis to absorb the allocated cumulative losses, so those cumulative losses arguably offset the basis in the non-eligible-gain interests and the §752-derived basis. When §1400Z-2 increases the basis in Mixley’s eligible-gain interests, future allocations of cumulative losses will reduce that basis. Mixley’s preference will be for the first dollar of allocated cumulative losses to reduce that eligible-gain interest basis to zero before reducing her other bases. The reason for that preference is that Mixley will be able to elect under §1400Z-2(c) to increase the basis in the eligible-gain portion of the QOF interest to its fair market value when she sells the QOF interest after holding it for 10 years. To maximize the amount of the step-up, Mixley will want to minimize the amount of the pre-step-up basis she has in the eligible-gain interests. The way she minimizes the basis in those interests is to allocate the first dollar of cumulative losses to those interests as they accrue basis under §1400Z-2(b)(2)(B). The proposed regulations do not dictate how Mixley should allocate the loss among her interests, so she may be able to choose from among multiple methods.

This analysis presents a pro-rata method and then presents an eligible-gain first method, which allocates losses first to existing basis in eligible-gain interests. Table 1 presents the computation of gain that Mixley will recognize on the disposition of her interest if QOF Partnership allocates loss deductions using a pro-rata method based upon the basis of the separate acquisition-source interests plus the §752(a) deemed contribution. For simplicity, Tables 1 and 2 compute the 10-year basis step-up only with respect to the fair market value of eligible-gain interest computed as 75% of the cash consideration. Perhaps more value should be allocated to that interest from the §752-derived interest. This analysis focuses on the 10-year basis effect of the adjustment and leaves the question of allocating fair market value among the interests to another analysis. The analysis demonstrates that loss allocation could affect the amount of future gain recognition.

Notice in Table 1 that QOF Partnership only allocates losses to the eligible-gain interests when the eligible-gain interest has §1400Z-2 basis. The amounts allocated to each type of interest is based upon the interest’s pro-rata share of Mixley’s total basis in her interests at the time of allocation. Notice the basis Mixley has in her eligible-gain interest at the end of the 10-year period, the amount of the step-up to fair market value, and amount of gain she recognizes.

Table 2 presents the computation of gain that Mixley will recognize on the disposition of her interest in QOF Partnership, if the partnership allocates loss de-

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45 Cf. Rev. Rul. 84-53 (“Consistent with the provisions of Subchapter K of the Code, a partner has a single basis in a partnership interest. . . . Thus, for example, in applying the limitations of section 704(d) of the Code, losses allocated with respect to a partner’s limited partner interest will be allowed so long as they do not exceed the partner’s basis in the entire partnership interest”). Eventually, the IRS will have to consider the application of this rule to mixed-fund investments in QOF partnerships.

46 See §1400Z-2(c).
roductions first to the basis of the eligible-gain interest and then to the other interests. The amount of gain that Mixley will recognize under this method will be less than the amount of gain she would recognize under the pro-rata method. The effect that the allocation method has on the amount of gain that Mixley may recognize on the disposition of the interest illustrates the complexity that §1400Z-2 creates and demonstrates the need for specific guidance in numerous areas of the law related to investments in QOFs.

Compare Mixley’s pre-adjustment basis in her eligible-gain interests upon sale of the interest at the end of 10 years, her basis step-up at that time, and her gain in Table 2 to the same amounts in Table 1. Notice that the method used to allocate depreciation deductions against the basis of the various interests can affect the amount of gain that the Mixley would recognize on the disposition of her interests in QOF Partnership. When an investor holds both eligible-gain interests and non-eligible-gain interests, some type of allocation of losses to the different interests appears to be required. The pro-rata method in the regulations appears to apply to determine which interests are to be allocated. It does not state that it applies to determine how a partner should allocate loss deductions to bases of mixed-fund interests in a QOF partnership. This example includes eligible-gain interests and non-eligible-gain interests, so the law should treat the interests differently. If Mixley had not purchased non-eligible-gain interests, then she would own eligible-gain QOF Partnership interests and have basis from her deemed §752(a) contribution. No guidance directs the allocation of losses in such a situation.

Another method Mixley could consider is the pre-step-up deduction allowance discussed below. That method would allow Mixley to deduct losses against her eligible-gain interests before those interests accrue basis. If she were to do that, she could reduce the basis in those interests to zero before the Year-10 step-up. That would make the Year-10 step-up even greater.

The law could also prohibit allocating losses against the basis of eligible-gain interests in a QOF partnership. The rationale for such prohibition is the language in §1400Z-2(b)(2)(B) indicating that §1400Z-2 contains the only permissible adjustments to the basis of eligible-gain interests in a QOF. This and the application of losses to §752-derived losses warrant careful policy consideration. The language from the proposed regulations suggests that Mixley could deduct allocated cumulative losses against the §752(a)-derived basis prior to the 5-year basis increase and subsequent basis increases.47

Treasury might have been too generous in treating the §752(a) contributions as non-acquisitions. The alternative of allowing taxpayers with eligible gains and no cash investment to be treated as acquiring QOF eligible investments by reason of QOF borrowing would also be a gift. In any event, QOF partners owning both an eligible-gain and non-eligible-gain interest should be aware that holding a non-eligible-gain partnership interest can require allocating loss between eligible-gain interests and non-eligible-gain interests.

Your authors have noted that the §1400Z-2(c) adjustment may apply to recovery of post-investment, pre-sale cumulative losses, such as depreciation-generated deductions allowed by reason of §752(a) financing, as well as to post-investment appreciation in the QOF’s real estate.48 The law allows the depreciation deduction against the §752(a) basis and then allows the §1400Z-2 basis step-up to the investor’s eligible-gain interests in the QOF partnership. The step-up against the previously-allowed deduction, which reduced the §752(a)-derived basis, would eliminate the basis step-down attributed to the §752(a)-derived basis, eliminating gain attributed to the depreciation deduction. Thus, §1400Z-2 basis adjustments could exclude gain attributable to depreciation on economically appreciating buildings from the income of a QOF investor. Until the purpose of §1400Z-2 is clear on these issues, the role of the §752(a)-derived basis in that situation is uncertain.

### Tax Treatment of QOF Partnership’s Disposition of QOZBP

Mixley would expect the tax result of QOF Partnership selling QOZBP and distributing the net sale proceeds in liquidation of the member’s interests to be similar to the tax result of Mixley selling the QOF partnership interest. Because Mixley would recognize no gain on the sale of her eligible-gain QOF Partnership interest after ten years, she would expect not to recognize any gain on a liquidating distribution of her eligible-gain interests before those interests accrue basis. If she were to do that, she could reduce the basis in those interests to zero before the Year-10 step-up. That would make the Year-10 step-up even greater.

### Table 2: First-Dollar Against Eligible-Gain Basis

<table>
<thead>
<tr>
<th>Type of Basis</th>
<th>Eligible-Gain</th>
<th>Non-Eligible-Gain</th>
<th>§752(a)</th>
<th>Total</th>
</tr>
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<tr>
<td>Original Basis</td>
<td>$0</td>
<td>$25,000</td>
<td>$400,000</td>
<td>$425,000</td>
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<tr>
<td>Year 1-5 Depr.</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>$125,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year 5 Step-Up</td>
<td>$7,500</td>
<td>($7,500)</td>
<td>($171,474)</td>
<td>($125,000)</td>
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<tr>
<td>(12/31/23)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basic: End of Year 5</td>
<td>$7,500</td>
<td>$17,647</td>
<td>$282,353</td>
<td>$307,500</td>
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<tr>
<td>Year 6-7 Depr.</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>$300,000</td>
<td></td>
<td>($25,000)</td>
<td>($40,000)</td>
<td>($350,000)</td>
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<tr>
<td>Year-7 Step-Up</td>
<td>$3,750</td>
<td>($2,500)</td>
<td>($40,000)</td>
<td>($50,000)</td>
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<tr>
<td>(12/31/25)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basic: End of Year 7</td>
<td>$3,750</td>
<td>$15,147</td>
<td>$242,353</td>
<td>$261,250</td>
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<tr>
<td>2026 Depr.</td>
<td></td>
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<td></td>
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<tr>
<td>$25,000</td>
<td></td>
<td>($2,500)</td>
<td>($20,000)</td>
<td>($25,000)</td>
</tr>
<tr>
<td>2026 Adjustment</td>
<td>$63,750</td>
<td>($12,500)</td>
<td>($20,000)</td>
<td>($65,750)</td>
</tr>
<tr>
<td>Basis: 12/31/26</td>
<td>$63,750</td>
<td>$13,897</td>
<td>$222,353</td>
<td>$300,000</td>
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<tr>
<td>Year 9-10 Depr.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$50,000</td>
<td></td>
<td>$0</td>
<td>$0</td>
<td>($50,000)</td>
</tr>
<tr>
<td>Basic: End of Year 10</td>
<td>$13,750</td>
<td>$13,897</td>
<td>$222,353</td>
<td>$250,000</td>
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<tr>
<td>Sale:</td>
<td>Cash</td>
<td>Liability</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FMV of Interest</td>
<td>$475,000</td>
<td>($400,000)</td>
<td>($875,000)</td>
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<tr>
<td>1400Z-2(c) Adjustment</td>
<td>$342,500</td>
<td></td>
<td></td>
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<tr>
<td>Ending Basis</td>
<td></td>
<td></td>
<td>$592,500</td>
<td></td>
</tr>
</tbody>
</table>

Gain        | $282,500

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47 See Prop. Reg. §1.1400Z-2(c)-1(a)(2), (3).
48 See the example in Lederman & Borden, note 27, above.
eligible-gain interest after holding it for 10 years. Consider the possible tax consequences of a QOF partnership liquidation.

After paying off the $800,000 outstanding principal balance on the loan from the $1,750,000 sales proceeds, QOF Partnership distributes $475,000 to each of Mixley and Nona in liquidation of QOF Partnership. The loan repayment reduces Mixley’s share of QOF Partnership’s liabilities, so Mixley will be deemed to receive a $400,000 distribution under §752(b), in addition to Mixley’s actual cash distribution of $475,000. The treatment of that $400,000 §752(b) deemed distribution is uncertain. The proposed regulations provide that partners of QOF partnerships should ignore the §752(a) deemed contributions for purpose of determining the extent to which the partners had made an investment in the partnership, but they do not provide any guidance for the treatment of a §752(b) deemed distribution. The lack of guidance could raise concerns that the deemed distribution may be made with respect to interests that consist of separate bases, or it could be made only with respect to the basis attributable to the deemed §752(a) contribution.

This part of the analysis assumes that the deemed §752(b) distribution is made with respect to the basis attributable to the deemed §752(a) contribution. If the QOF Partnership interests have identical rights, then presumably 75% ($356,250) of the $475,000 actual distribution will be with respect to Mixley’s eligible-gain QOF Partnership interests and 25% ($118,750) of the $475,000 actual distribution will be with respect to Mixley’s other QOF Partnership interests.

Neither the statute nor the proposed regulations address the several questions that this situation raises. Those questions include: (1) What, if any, effect do the §1400Z-2(b)(2)(B) and §1400Z-2(c) adjustments to the basis of Mixley’s eligible-gain QOF Partnership interest have on QOF Partnership’s basis in its QOZBP? (2) How does QOF Partnership’s gain on sale allocated to Mixley affect her taxable income? (3) What effect does gain allocated to Mixley have on her basis in QOF Partnership interests? (4) What are the tax consequences of the liquidating distribution to Mixley?

Starting with the last question sets the stage for considering what the answers to the other questions would need to be to provide a tax result for Mixley that is consistent with the purpose of §1400Z-2. QOF Partnership should take a $1 million cost basis in the QOZBP as it purchases and then improves that property. While QOF Partnership holds the QOZBP, Mixley’s basis in her eligible-gain QOF Partnership interest will increase 10% ($75,000) at five-year point and 5% ($3,750) at the seven-year point, and up to $75,000 on December 31, 2026, when she recognizes 85% ($63,750) of the $75,000 deferred gain. After those §1400Z-2(b) adjustments, Mixley’s basis in her QOF Partnership interest before adjusting for allocated losses will equal $100,000, the amount she paid for it. During that period of time, QOF Partnership’s adjusted basis in the QOZBP would have decreased as a result of the cumulative depreciation deductions it was allowed. Due to the factual assumption that, coincidentally, QOF Partnership’s tax losses exactly equaled QOF Partnership’s tax depreciation, but for those depreciation adjustments to the QOZBP, Mixley’s basis in her QOF Partnership interests would equal her share of the basis in the QOZBP attributable to her contribution. Thus, it would seem that the adjustments to Mixley’s basis in her QOF Partnership interests through December 31, 2026, should not affect the basis that QOF Partnership has in its QOZBP.

Similarly, Mixley would expect to exclude gain attributable to her eligible-gain interests if QOF Partnership sold a portion of its QOZB after one of the §1400Z-2 step-up events. The rules do not directly address this issue or establish how she would avoid gain recognition in that situation. For instance, if QOF Partnership sells QOZBP in January 2029 for $1,750,000, it would recognize $1,000,000 of gain ($1,750,000 amount realized - $750,000 adjusted basis). If QOF Partnership were to allocate the $1,000,000 gain equally to Mixley and Nona, they would each be allocated $500,000 of gain. That allocation would increase Mixley’s basis in her QOF Interests to $475,000 ($25,000 cost basis + $750,000 basis adjustment under §1400Z-2 - $125,000 depreciation deduction + $500,000 gain allocation). Upon distribution of her $475,000 share of the QOF Partnership’s net assets ($1,750,000 proceed from sale - $800,000 loan repayment), Mixley would recognize no gain or loss. Nonetheless, if §1400Z-2(c) does not apply to the basis of assets of a QOF partnership, Mixley must recognize the entire gain allocated to her. Because the form of the transaction creates such a disparate result, the law should allow a step up of a QOF partnership’s assets.

Multiple theories support allowing the QOF partnership to step up the basis of its assets to reflect the §1400Z-2(c) adjustment that the member would qualify for if the member had hypothetically sold an eligible-gain QOF partnership interest. First, the purpose of §1400Z-2(c) is to encourage investment in QOZs. If investors lose the benefit of post-investment gain exclusion because the QOF partnership recognizes and allocates gain to eligible-gain interests, they will hesitate to invest in eligible-gain interests in QOF partnerships.

A commercial preference for an exit strategy that contemplates sales of assets rather than sales of interests in ownership entities is particularly true of real estate partnerships. Buyers of real estate usually wish to acquire title of the property. Buyers usually prefer not to buy shares in a QOF, which QOF may have many partners, may own many other assets not wanted by the buyer, and have incurred known and unknown liabilities which the buyer does not wish to take subject to. Similarly, buyers of real estate would...
be even less inclined to buy shares in a QOF as a means of buying real estate owned by a QOZB subsidiary of that QOF, since that purchase involves the additional possible business problems of other QOZB investors, unwanted QOZB assets, and unwanted known and unknown QOZB liabilities. Thus, one reason to allow an internal basis step-up with respect to eligible-gain interests is to accomplish the Congressional intent of §1400Z-2(c) of attracting eventual buyers of QOZ real estate projects successfully undertaken by QOFs and their subsidiary QOZB partnerships.

Second, partnership taxation allows a step-up of partnership assets on the transfer of a partnership interest, if the partnership has a valid §754 election in effect. The amount of the adjustment equals the difference between the basis the partner has in the partnership assets, and the partner's share of basis of the partnership interest and the partner's share of the partner's share of the partnership's basis. If the law were to rearrange the order of the transactions that occur as part of a partnership liquidation, so the member receives the cash distribution prior to the partnership selling its assets, the partner arguably would qualify for the §1400Z-2(c) basis adjustment with respect to her eligible-gain interests. The partnership tax rules treat a distribution of cash in liquidation of a partner's interest in a partnership as a sale of that interest. Section 1400Z-2(c) should arguably apply to that hypothetically reconstructed transaction, and the partner should arguably qualify for increasing the basis to its fair market value. If so, under a §743(b) theory, the partnership should be able to step up the basis of its assets. Because the transactions that comprise a partnership liquidation occur as part of the sale transaction, the order of the transactions should not be determinative, and the law should allow for the §1400Z-2(c) adjustment to the basis of the assets of a QOF partnership with respect to eligible-gain interests of the member making the §1400Z-2 election. On the other hand, reconstruction of a transaction, based on the hypothetical pre-sale distribution of proceeds of a cash sale that has not yet taken place, may be a rever-sal of steps beyond what most policy-makers and technicians are willing to accept.

This analysis treats Mixley as selling her eligible-gain interests in QOF Partnership instead of as receiving a distribution from the QOF Partnership. That distinction is important because it triggers the application of §743(b), not §734(b). If the concepts of §743(b) applies, the basis step-up of QOZBP occurs only with respect to Mixley's eligible-gain interest in QOZBP and the step-up only benefits her and only with respect to her eligible-gain interest. If the concepts of §734(b) were to apply, then the basis step-up would apply to all of QOF Partnership's assets and benefit the other members of QOF Partnership. That would frustrate the purpose of §1400Z-2(c), which is to benefit only the member who invested eligible gain in QOF Partnership and relinquishes the QOF Partnership interest. In this case, the law should arguably consider the §1400Z-2(c) substance of the transaction, which is arguably a deemed transfer of the QOF Partnership interest, not its form, which is a §1400Z-2(c) distribution following the sale of a QOF Partnership's asset.

A more complex question arises if the QOF Partnership sells a portion of its QOZBP and distributes an amount of cash with respect to eligible-gain interests that does not exceed Mixley's basis in her QOF Partnership eligible-gain interests. In such a situation, where QOF Partnership continues with Mixley as a partner, Mixley would be allocated gain from the sale of the interest in QOZBP, but the distribution to her would not be in liquidation of her interest, and she probably would not recognize gain or loss on the distribution. If the sale of the QOZBP interest occurs more than 10 years after Mixley acquired the QOF Partnership interest, she should be able to apply the §1400Z-2(c) post-investment gain-exclusion basis adjustments to her eligible-gain interest share in the transferred interest in QOZBP to exclude some of the gain. The rationale for such exclusion should flow from the rationale for applying §1400Z-2(c) to exclude some gain on the liquidation of QOF Partnership. Even though the mechanics of a non-liquidating sale and distribution may not match those of a liquidating sale and distribution, the concepts are similar. In both situations, Mixley would be allocated gain absent a concession for §1400Z-2(c). To avoid frustrating the purpose of §1400Z-2(c), the law should allow her to use §1400Z-2(c) to adjust her share of the basis in QOZBP with respect to her eligible-gain QOF interests.

Outside-Basis Adjustments and Exclusion of Gain from Sale of QOZBP Interests

When a tax partnership or S corporation allocates excluded gain to the members, the allocation increases the members' bases in their interests in such entities. The application of that rule to a QOF partnership's disposition of QOZBP is uncertain, and perhaps unneeded. If the law allows a QOF partnership to step up the basis of a member's interest in the QOF partnership assets the rationale for doing so is that the member would be able to step up its basis in the eligible-gain QOF partnership interest under §1400Z-2(c), if the member were to sell the interest. Thus, the member increases its basis in the QOF partnership interest and the QOF partnership increases the member's share of the basis in the QOF partnership's property under a §1400Z-2(c) theory and the basis adjustment for excluded gain is not necessary.

If a partnership invests in a QOF, the exclusion of gain from the sale of the QOF interest should pass through to the members of the partnership. Section 705(a)(2) supports adjustments to bases in partner-

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51 See Reg. §1.743-1(b)(1).
52 See §731(a) (flush language).
ships for the partnership’s tax-exempt income. The partnership’s gain would not be excluded, if tax law did not provide for a basis step-up of the partners’ interest in the partnership. To exclude the gain associated with the partnership’s QOF investment, the law must provide for a step-up of the partners’ bases in partnerships that hold eligible-gain QOF investments. No additional guidance is needed to provide for step-up of the basis in an interest in a partnership that holds a QOF interest.

Sales by QOZB Partnerships

In most cases, the QOF will own its QOZ real estate through a partnership interest in a QOZB. Accounting for real estate sales by a QOZB that occur after 10 years from the date of the eligible QOF investors raise similar difficulties as QOF investors seek to insure that the QOF eligible-gain interest receives the appropriate benefit of its §1400Z-2(c) exclusion.

TAX ACCOUNTING FOR LOSSES AND GAIN ALLOCATED TO ELIGIBLE-GAIN INVESTMENTS

Suspension or Allowance of Pass-Through Losses

Suppose that Allene buys a 50% interest in a QOF that is an eligible-gain interest, and Nona buys a 50% interest that is not an eligible-gain interest, and each pays $100,000 or its interest. Suppose the QOF is either a partnership with no liabilities, or is an S corporation. Thus, Nona would take a $100,000 basis in her ineligible QOF interest, and Allene would take a zero basis in her eligible-gain interest.

If the QOF has loss that it allocates equally to Nona and Allene, existing law would not impede Nona’s ability to deduct the cumulative loss to the extent of her $100,000 basis in her QOF membership interest. The allocated loss would, however, reduce Nona’s basis in her membership interest. On the other hand, both S corporation law and partnership tax law prohibit members of pass-through entities from taking allocated deductions, if the allocation would cause the basis in the membership interest to go below zero. Because of that rule, the law would appear to prevent Allene from deducting her allocated share of the QOF’s loss currently—the loss gets suspended until the member obtains basis through gain allocations or other means. Passsthrough of deductions benefits members of pass-through entities, so taxpayers would view the suspension of losses with disfavor because of the §1400Z-2 zero basis in an eligible QOF interest. The loss of a tax benefit as a result of the §1400Z-2 rules would have a chilling effect on eligible investments in QOFs and appears to contradict the purpose of §1400Z-2, which is to encourage eligible investment in QOZs. Thus, this appears to be an issue that Congress overlooked in enacting §1400Z-2. Treasury did not address this issue in the proposed regulations, but perhaps it will address the issue in a future round of regulations.

Possible Solution: Treasury will have to be creative in figuring out how to address this issue and perhaps allow investors to deduct pass-through losses when they have zero basis in their eligible-gain interests in a QOF pass-through investment and no noneligible-gain investments or §752-derived basis. Perhaps Treasury could look to the rules governing nonrecourse deductions for inspiration on this issue. If a QOF interest holds its value through December 31, 2026, the basis of that interest will equal the amount of the investment, or the holder will recognize gain equal to the difference between the basis in the investment and the amount realized on the sale of the investment. Thus, the holder of the interest will either obtain basis in the interest equal to the amount of the investment or recognize gain in that amount. Perhaps Treasury could treat future basis accrual or gain recognition as basis in the bank and allow the interest holder to take suspended losses currently against those future accruals. This type of credit against future accrual is not foreign to partnership tax law.

In the area of nonrecourse deductions, for example, tax law recognizes that the members of tax partnerships cannot bear the economic burden of a nonrecourse deduction, but it allows members to deduct such amounts. The rationale for allowing such deductions is that the partnership will ultimately recognize gain related to the nonrecourse debt that gave rise to the deduction, and it can allocate that gain in the same manner it allocated the nonrecourse deductions. The law recognizes that the future allocation of the gain will offset the current deduction. Treasury could, perhaps, use a similar rationale for allowing members of pass-through entities to deduct pass-through losses with respect to their eligible-gain interests that exceed their bases.

Section §1400Z-2(b)(2)(B)(iii) and §1400Z-2(b)(2)(B)(iv) requires the 10% and 5% basis adjustments after five and seven years, respectively. Gain recognition and basis adjustment on December 31, 2026, is limited by the value of the QOF interest at that date. Thus, §1400Z-2 generally does not force a QOF investor to recognize gain on an eligible QOF investment and then perhaps seek to offset that gain by selling the eligible QOF interest for loss if the fair market value of the interest is less than its purchase price. Perhaps Treasury would apply a similar rule to the loss suspension rules, if it were to adopt the banking system proposed herein. Such a rule would not allow the amount of allocated losses to exceed the amount of potential basis increases. For instance, if the losses would exceed the 15% mandatory basis ad-

54 See Rev. Rul. 96-10.
55 See §705(a)(2)(A).
56 See §704(d)(1); §1366(d)(1).
57 See §704(d)(2), §1366(d)(2).
58 See Reg. §1.704-2(b)(1).
justments, and the value of the property had decreased 85%, perhaps the law would prohibit further loss allocations because additional basis increases would be questionable. Barring such a contingency, however, allocated losses should be offset by future basis adjustments to the basis of the QOF pass-through interest.

The tradeoff in granting pre-2027 loss pass-throughs, based on anticipated adjustments under §1400Z-2(b)(2)(B), when an eligible QOF pass-through interest has no basis, would presumably be that the IRS would be entitled to offset such future pre-2027 statutory basis adjustments as they otherwise occurred. That is, if members of pass-through QOFs are able to deduct pre-2027 pass-through losses when they have no basis in their eligible QOF interests, then the IRS should be free to offset these losses against future pre-2027 §1400Z-2(b)(2)(B) increases to bases of their QOF interests. As discussed above, however, this creates issues when the holder of an eligible-gain interest in a partnership QOF also has §752-derived basis in the partnership QOF. Moreover, because of the speculative nature of the eventual realizable value of an eligible QOF interest, presumably IRS will refuse to allow cumulative losses to be deducted based upon anticipated post-investment gain upon the ultimate sale of a QOF eligible-gain interest.

Although not clear, it seems that §1400Z-2(c) is intended to exclude all gain on sale of an eligible QOF partnership interest or stock in a QOF after 10 years.

The 10-year step-up to fair market value suggests that Congress intended §1400Z-2(c) to exclude not only post-investment appreciation, but rather all post-investment gain, including gain attributable to depreciation deductions and other cumulative losses taken by the QOF, and claimed as losses by the QOF partners or QOF S stockholders owning eligible-gain interests. The counter to this position is exclusive basis adjustment provision in §1400Z-2(b)(2)(B)(i). Another unanswered question is how the selling QOF eligible partner or S stockholder that has suspended losses at the time of such a post-2027 sale and recognizes no gain due to the §1400Z-2(c) fair market value step-up should treat those suspended losses.

### Effects of Gain Allocations to Holders of Pass-through QOF Interests

The effect that allocations of gain have on eligible-gain interests in QOF pass-throughs is also uncertain. Both partnership tax and subchapter S provide that gains allocated to members increase the members’ bases of their interests in the pass-through entities. The question is how the law should treat gain allocated to eligible-gain interests in a QOF pass-through. The answer is uncertain because §1400Z-2(b)(2)(B)(i) provides, “Except as otherwise provided in this clause [§1400Z-2(c)], the taxpayer’s basis in the [eligible-gain] investment shall be zero.” The adjustments that provision refers to are the five-year, seven-year, December 31, 2026, and 10-year-sale adjustments. The §1400Z-2 basis rule therefore appears to exclude basis adjustments for gain allocated to the holder of a QOF partnership interest. The lack of basis adjustment will be unimportant if the investor holds the interest for 10 years and is able to obtain basis adjustments at that time to ensure that the allocated income is not taxed twice. The investor may, however, prefer to have basis in the QOF interest to be able to deduct losses against, if the investor would not otherwise be able to take such deductions.

Perhaps the law should allow the QOF investor to adjust the basis of non-eligible-gain interests in the QOF pass-through to account for gain allocations. Treasury should consider whether such basis adjustment creates non-eligible-gain interests that require application of the FIFO or pro-rata method to determine the interests sold or the attributes associated with the interests. Assuming the investor only makes one investment in the QOF pass-through, the pro-rata method may not be available because the income allocations would occur on a day other than the date of acquisition. The taxpayer would likely be happy with the application of the FIFO method, for partial dispositions that occur after the 10-year point, but if the rights of the interests vary, the taxpayer may be able to identify which interests are being sold.

There may be policy reasons for treating basis increases attributable to gain allocations differently from §752(a) basis adjustments. Gain allocations represent income earned and reinvested in the partnership. If that income is not §1400Z-2 eligible gain, arguably it should be treated as any other income that an investor would contribute to a QOF pass-through. If so, basis resulting from allocated gain would be attributable to non-eligible-gain interests.

The proposed regulations recognize that a partnership may invest eligible gain in a QOF or let the gain pass through to the members who may invest the eligible gain individually. If the partnership elects to reinvest the eligible gain, the partner does not report the deferred gain, and the deferred gain does not affect the members’ adjusted basis under §705(a)(1), which governs the effect of taxable income. Deferred gain that the partner subsequently recognizes is allocated to the partners and increases their bases in the partnership. The rules do not address how the partnership and members should treat the five-year, seven-year, and 10-year basis adjustments and related gain exclusions. At some point, the basis adjustment rule in §705(a)(1)(B) for tax-exempt income should apply. The timing of that adjustment is uncertain, as it could apply when the partnership adjusts the basis of its assets, or when the partnership disposes of the assets and benefits from the gain exclusion. Tax law’s

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59 See n. 4, above.
60 See §705(a)(1)(A); §1367(a)(1)(A).
61 See Prop. Reg. §1.1400Z-2(a)-1(c).
support for adjustments under §705(a)(1)(B) appears certain, even if the timing of such adjustments is uncertain.

The proper treatment of gain allocated to investors in QOF pass-throughs should be determined, at least in part, by the purpose of §1400Z-2. If Congress intended for QOF investors to recognize no post-investment gain or income related to the investment if the investor held the property for 10 years, then basis adjustment for gain allocation is only part of the equation. The law should also consider whether the investor should be able to exclude allocations of income and gain, if the investor holds the interest for at least 10 years. If the QOF is a C corporation, the investor would be able to exclude its share of the C corporation’s accrued income by not receiving any dividend distributions and then selling the QOF C corporation stock at the 10 years when the C corporation has accrued income. Although that income will be taxed within the C corporation, the tax will be at the favorable corporate rate. Perhaps income of a pass-through entity should similarly be exempt from the member-level tax during the 10-year period and only taxed at the member level, if not otherwise excluded, when the member disposes of the interest prior to the end of the 10-year period.

However, the drafters of §1400Z-2(f)(2) were well aware that many QOFs would be partnerships. If the drafters of §1400Z-2 and its legislative history intended to provide a blanket exemption of QOF member-level taxation of QOF operating income for pass-through entities, one might have thought they would have been more explicit. Until Congress or Treasury provides additional guidance, the proper treatment of gain following eligible-gain investment remains uncertain.

CONCLUSION

The proposed regulations do not address many important short-term, intermediate term, and long-term issues affecting QOFs. For example, in the short term, QOFs seeking to attract existing owners of QOZ real estate to contribute their property for a partnership interest in the QOF face doubts as to the tax consequences of such joint ventures to themselves and to those existing QOZ real estate owners. In the intermediate and long term, the effects of allocation of QOF taxable losses to a QOF investor is uncertain, particularly if the QOF investor owns both eligible-gain and non-eligible gain QOF partnership interests. In the long-term, attempts should be made to reconcile the 10-year step-up in basis on sale of eligible-gain QOF interests, with the commercial reality that many completed QOZ real estate projects will best take place by a sale of the project by a QOZB partnership, whose partnership interest is owned by a QOF, rather than by a sale of the QOF interest.

64 See Rev. Rul. 96-10.