Private Business Use – Management Contracts

A variety of governmental facilities may be privately managed, including health care facilities, convention and hotel facilities, entertainment and sports facilities, and detention facilities, prisons and jails. Private business use can result from management contracts. This issue snapshot will discuss situations in which management contracts providing for private companies to manage tax-exempt-financed facilities may result in excessive private business use.

IRC Section and Treasury Regulation

IRC Section 141(a) – Private Activity Bond
IRC Section 141(b) – Private Business Tests
Treasury Regulation Section 1.141-2 – Private activity bond tests
Treas. Reg. Section 1.141-3 – Definition of private business use
Treas. Reg. Section 1.141-4 – Private security or payment test

Resources (Court Cases, Chief Counsel Advice, Revenue Rulings, Internal Resources)

The following revenue procedures provide safe harbor conditions under which a management contract does not result in private business use of property financed with governmental tax-exempt bonds:

- Revenue Procedure 2017-13; 2017-6 I.R.B. 787, applies to any management contract that is entered into on or after January 17, 2017, and an issuer may apply this revenue procedure to any management contract that was entered into before January 17, 2017.
- Rev. Proc. 2016-44; 2016-2 C.B. 316, applies to any management contract that is entered into on or after August 22, 2016 and before January 17, 2017, and an issuer may apply this revenue procedure to any management contract that was entered into before August 22, 2016.
- Rev. Proc. 97-13, 1997-1 C.B. 632, as modified by Rev. Proc. 2001-39 and amplified by Notice 2014-67, applies to any management contract that is entered into on or after May 16, 1997 and before August 22, 2016, and an issuer may apply this revenue procedure to any management contract that was entered into before August 18, 2017.

Analysis

IRC Section 103 (a) provides that, except as provided in IRC 103 (b), gross income does not include interest on any State or local bond. IRC Section 103 (b) (1) provides that IRC Section 103 (a) shall not apply to any private activity bond that is not a qualified bond (within the meaning of IRC Section 141). IRC Section 141 (a) provides that the term "private activity bond" includes any bond issued as part of an issue that meets the private business use test and private security or payment test.
Private Business Use Test

IRC Section 141 (b) (1) provides generally that an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. IRC Section 141 (b) (6) defines "private business use" as use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For this purpose, any activity carried on by a person other than a natural person must be treated as a trade or business.

The 10 percent private business use test of IRC Section 141(b)(1) is met if more than 10 percent of the proceeds of an issue is used in a trade or business of a nongovernmental person. For this purpose, the use of financed property is treated as the direct use of proceeds.

In determining whether an issue meets the private business use test, it is necessary to look at both indirect and direct use of proceeds. Proceeds are treated as used in the trade or business of a nongovernmental person if a nongovernmental person, as a result of a single transaction or a series of related transactions, uses property acquired with the proceeds of an issue.

Both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user as a result of ownership; actual or beneficial use of property pursuant to a lease, a management contract, or an incentive payment contract; or certain other arrangements.

A "management contract" is a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion, or any function, of a facility. For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract.

Generally, the lease of financed property to a nongovernmental person is private business use of that property. For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease. In determining whether a management contract is properly characterized as a lease, it is necessary to consider all the facts and circumstances, including the following factors: (1) the degree of control over the property that is exercised by a nongovernmental person; and (2) whether a nongovernmental person bears the risk of loss of the financed property.

A management contract with respect to financed property (when not properly characterizable as a lease) may result in private business use of that property, based on all of the facts and circumstances. A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operations of the facility. A management contract with respect to financed property results in private business use of that property if the service provider is treated as the lessee or owner of financed property for federal income tax purposes.

Private Security or Payment Test

The private security or payment test relates to the nature of the security for, and the source of, the payment of debt service on an issue. The private payment portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly to be derived from payments (whether or not to the issuer or any related party) in respect of property, or borrowed money, used or to be used for a private business use. The
private security portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly secured by any interest in property used or to be used for a private business use or payments in respect of property used or to be used for a private business use.

The security for and payment of debt service on an issue is determined from both the terms of the bond documents and on the basis of any underlying arrangement. An underlying arrangement may result from separate agreements between the parties or may be determined on the basis of all of the facts and circumstances surrounding the issuance of the bonds. For example, if the payment of debt service on an issue is secured by both a pledge of the full faith and credit of a state or local governmental unit and any interest in property used or to be used in a private business use, the issue meets the private security or payment test. Usually, a bond issue secured by the revenues of the bond-financed facility will meet the private security or payment test if the facility meets the private business use test.

The payments taken into account as private payments are payments in respect of property used or to be used for a private business use. Both direct and indirect payments made by any nongovernmental person that is treated as using proceeds of the issue are taken into account as private payments to the extent allocable to the proceeds used by that person. Payments need not be directly derived from a private business user to be taken into account. Payments for a use of proceeds include payments (whether or not to the issuer) in respect of property financed (directly or indirectly) with those proceeds, even if not made by a private business user. Payments made by members of the general public for use of a facility used for a private business use (for example, a facility that is the subject of a management contract that results in private business use) are taken into account as private payments to the extent that they are made for the period of time that property is used by a private business user.

Property used or to be used for a private business use and payments in respect of that property are treated as private security if any interest in that property or payments secures the payment of debt service on the bonds. For this purpose, the phrase any interest in is to be interpreted broadly and includes, for example, any right, claim, title, or legal share in property or payments. The property that is the security for, or the source of, the payment of debt service on an issue need not be property financed with bond proceeds. For example, unimproved land or investment securities used, directly or indirectly, in a private business use that secures an issue provides private security. Private security (other than financed property and private payments) for an issue is taken into account, however, only to the extent it is provided, directly or indirectly, by a user of proceeds of the issue. Thus, a mortgage or other security interest in privately used property that secures the bond issue is private security if financed with bond proceeds or provided by a user of the bond proceeds.

Treas. Reg. Section 1.141-4 provides detailed guidance on the proper allocation of payments and determining whether the amount of private payments or private security causes the issue to meet the private security or payment test.

**Safe Harbors Under Revenue Procedures**

There are several revenue procedures that provide safe harbors against private use arising from management contracts. If a management contract covering a bond-financed facility stays within the confines of these safe harbors, the general facts and circumstances analysis under Treas. Reg. Section 1.141-3 is not applied, and no private activity arises from the manager's special legal entitlements to use the financed property pursuant to the contract. The effective dates for these safe harbors are listed above in Resources (Court Cases, Chief Counsel Advice, Revenue Rulings, Internal Resources). Generally, if a management contract is materially modified after the effective date of one of the revenue procedures, it becomes subject to that procedure harbor rather than a previous one.

Rev. Proc. 2017-13 modifies, amplifies, and supersedes Rev. Proc. 2016-44, discussed below, to address certain types of compensation to provide continuity with previous safe harbors existing before Rev. Proc. 2016-44, the timing of payment of compensation, the treatment of land, and methods of approval of rates. To be within the safe harbor provided by Rev. Proc. 2017-13, a management contract must meet all the following conditions, or be an eligible expense reimbursement arrangement, as defined in the revenue procedure:

- **The payments to the service provider under the contract must be reasonable compensation for services rendered during the term of the contract.** Compensation includes payments to reimburse actual and direct expenses paid by the service provider and related administrative overhead expenses of the service provider.

- **The contract must not provide to the service provider a share of net profits from the operation of the managed property.** Compensation to the service provider will not be treated as providing a share of net profits if no element of the compensation takes into account, or is contingent upon, either the managed property's net profits or both the managed property's revenues and expenses for any fiscal period. For this purpose, the elements of the compensation are the eligibility for, the amount of, and the timing of the payment of the compensation. Further, solely for purposes of determining whether the amount of the compensation meets this requirement, any reimbursements of actual and direct expenses paid by the service provider to unrelated parties (as defined in the revenue procedure) are disregarded as compensation. Incentive compensation will not be treated as providing a share of net profits if the eligibility for the incentive compensation is determined by the service provider's performance in meeting one or more standards that measure quality of services, performance, or productivity, and the amount and the timing of the payment of the compensation meet the requirements of the revenue procedure.

- **The contract must not, in substance, impose upon the service provider the burden of bearing any share of net losses from the operation of the managed property.** An arrangement will not be treated as requiring the service provider to bear a share of net losses if:
  1. The determination of the amount of the service provider's compensation and the amount of any expenses to be paid by the service provider (and not reimbursed), separately and collectively, do not take into account either the managed property's net losses or both the managed property's revenues and expenses for any fiscal period; and
  2. The timing of the payment of compensation is not contingent upon the managed property's net losses.

- For example, a service provider whose compensation is reduced by a stated dollar amount (or one of multiple stated dollar amounts) for failure to keep the managed property's expenses below a specified target (or one of multiple specified targets) will not be treated as bearing a share of net losses as a result of this reduction.

- **Certain types of compensation are protected.** For purposes of the conditions prohibiting net profits arrangements or the imposition of net losses on the service provider (previous two bullet points), without regard to whether the service provider pays expenses with respect to the operation of the managed property without reimbursement by the qualified user, compensation for services will not be treated as providing a share of net profits or requiring the service provider to bear a share of net losses if the compensation for services is: (a) based solely on a capitation fee, a periodic fixed fee, or a per-unit fee; (b) permitted incentive compensation (eligibility determined by meeting standards measuring quality of services, performance or productivity; or (c) a combination of these types of compensation. The revenue procedure defines capitation fee, periodic fixed fee and per-unit fee.

- **Certain deferrals of payment to the service provider are permitted.** Deferral due to insufficient net cash flows from the operation of the managed property of the payment of compensation that otherwise meets the conditions prohibiting net profits arrangements or the imposition of net losses on the service provider will
not cause the deferred compensation to be treated as contingent upon net profits or net losses if the contract includes requirements that:
1. The compensation is payable at least annually;
2. The qualified user is subject to reasonable consequences for late payment, such as reasonable interest charges or late payment fees; and
3. The qualified user will pay such deferred compensation (with interest or late payment fees) no later than the end of five years after the original due date of the payment.

- **The term of the contract, including all renewal options (as defined in Treas. Reg. Section 1.141-1(b)), is no greater than the lesser of 30 years or 80 percent of the weighted average reasonably expected economic life of the managed property.** For this purpose, economic life is determined in the same manner as under IRC Section 147(b) as of the beginning of the term of the contract. A contract that is materially modified with respect to any matters relevant to this requirement is retested as a new contract as of the date of the material modification.
- **The qualified user must exercise a significant degree of control over the use of the managed property.** This control requirement is met if the contract requires the qualified user to approve the annual budget of the managed property, capital expenditures with respect to the managed property, each disposition of property that is part of the managed property, rates charged for the use of the managed property, and the general nature and type of use of the managed property (for example, the type of services). For this purpose, for example, a qualified user may show approval of capital expenditures for a managed property by approving an annual budget for capital expenditures described by functional purpose and specific maximum amounts; and a qualified user may show approval of dispositions of property that is part of the managed property in a similar manner. Further, a qualified user may show approval of rates charged for use of the managed property by either expressly approving such rates or a general description of the methodology for setting such rates (such as a method that establishes hotel room rates using specified revenue goals based on comparable properties), or by including in the contract a requirement that the service provider charge rates that are reasonable and customary as specifically determined by, or negotiated with, an independent third party (such as a medical insurance company).
- **The qualified user must bear the risk of loss upon damage or destruction of the managed property (for example, upon force majeure).** A qualified user does not fail to meet this risk of loss requirement as a result of insuring against risk of loss through a third party or imposing upon the service provider a penalty for failure to operate the managed property in accordance with the standards set forth in the management contract.
- **The service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the qualified user with respect to the managed property.** For example, the service provider must agree not to take any depreciation or amortization, investment tax credit, or deduction for any payment as rent with respect to the managed property.
- **The service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights under the contract, based on all the facts and circumstances.** As a safe harbor, a service provider will not be treated as having a role or relationship that is prohibited if:
  1. No more than 20 percent of the voting power of the governing body of the qualified user in the aggregate is vested in the directors, officers, shareholders, partners, members, and employees of the service provider;
  2. The governing body of the qualified user does not include the chief executive officer of the service provider or the chairperson (or equivalent executive) of the service provider's governing body; and
  3. The chief executive officer of the service provider is not the chief executive officer of the qualified user or any of the qualified user's related parties (as defined in Treas. Reg. Section 1.150-1(b)).
- For purposes of this safe harbor against prohibited roles or relationships, the phrase “service provider” includes related parties (as defined in Treas. Reg. Section 1.150-1(b)) and the phrase “chief executive officer”
includes a person with equivalent management responsibilities.

- A service provider's use of a project that is functionally related and subordinate to performance of its services under a management contract for managed property that meets the conditions of Rev. Proc. 2017-13 does not result in private business use of that project. For example, use of storage areas to store equipment used to perform activities required under a management contract that meets the conditions of the safe harbor under the revenue procedure does not result in private business use.

**Rev. Proc. 2016-44**


**Rev. Proc. 97-13**

Rev. Proc. 97-13 provides safe harbors for management contracts based on limitations of the duration of the contract, including renewal options, that vary depending on the structure of the compensation, such as fixed fees, partially-fixed fees, per unit fees and percentage of fees charged for use of the facility.

To be within the safe harbor under Rev. Proc. 97-13, the contract's duration and compensation structure must fit into one of several permissible arrangements described in the revenue procedure. In addition, the contract must provide for reasonable compensation for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the facility. Compensation based on (a) a percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both; (b) a capitation fee; or (c) a per-unit fee is generally not considered to be based on a share of net profits.

Reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties is not by itself treated as compensation. Under Rev. Proc. 97.13, a productivity reward equal to a stated dollar amount based on increases or decreases in gross revenues (or adjusted gross revenues), or reductions in total expenses (but not both increases in gross revenues (or adjusted gross revenues) and reductions in total expenses in any annual period during the term of the contract generally does not cause the compensation to be based on a share of net profits. Further, the service provider must not have any role or relationship with the qualified user that, in effect, substantially limits the qualified user's ability to exercise its rights under the contract. The revenue procedure provides a safe harbor for this requirement, which differs somewhat from that in Rev. Proc. 2017-13 and Rev. Proc. 2016-44.


Issue Indicators or Audit Tips

A violation of IRC 141(b) occurs only if private payment or security is present in addition to private use. Revenue bonds, and bonds secured by a security interest in project revenues or a mortgage on the facility, will have private payments or security if the facility is privately used. Depending on the facts and circumstances, a management contract not meeting the safe harbors of the revenue procedures may result in private use.

Determine if a modification of any older agreement makes it subject to the newer revenue procedures.

To determine all relevant facts and circumstances, consider agreements and relationships between the parties in addition to the documents labeled as management contracts. These other agreements might contain provisions directly or indirectly affecting whether the compensation arrangement under the management agreement meets the safe harbor or whether the qualified user’s rights under the management contract have been substantially limited.

Consider whether the terms of the management contract, or other arrangements, affect the private use or private security or payment analysis, such as:

- A direct and indirect guarantee
- Disguised participation in net revenues
- Lease disguised as management contract

To meet the safe harbors under Rev. Proc. 2016-44 and Rev. Proc. 2017-13, the service provider must agree that it is not entitled to and will not take any tax position that is inconsistent with being a service provider to the qualified user with respect to the managed property. The service provider’s failure to comply with this agreement may be evidence that the arrangement is not merely a management contract. For example, if the service provider claims depreciation or amortization deduction, investment tax credit, or deduction for any payment as rent with respect to the managed property, the arrangement might be properly characterized as an installment sale or a lease. Secure returns to confirm the provider is following its agreement. If you find the provider is not filing consistently with its agreement, make a referral to the appropriate business unit and consider whether the tax position agreement in the management contract should be treated as evidence of fraud.
Private Business Use – Federal Use of Tax-Exempt Financed Prison Facilities

Description

State and local governments may issue tax-exempt bonds to finance correctional and detention facilities, prisons, and jails ("Prison Facilities"). Although such bonds are generally issued to finance projects expected to be used by the issuing state or local government, Prison Facilities financed in this manner may also be used by the federal government and its agencies to house and detain federal inmates.

This Issue Snapshot discusses the rules which apply when the federal government and its agencies use Prison Facilities financed by tax exempt bonds, and the circumstances under which such use by the federal government ("Federal Use") may be considered private business use.

IRC Section and Treasury Regulation

IRC Section 141(a) – Private Activity Bond
IRC Section 141(b) – Private Business Tests
IRC Section 150(a)(2) – Definitions
Treasury Regulation Sections 1.141-3 – Definition of Private Business Use

Resources (Court Cases, Chief Counsel Advice, Revenue Rulings, Internal Resources)

IRS Private Letter Rulings (LCR) 200718021, 9835032

Analysis

Private Activity Bonds and Private Business Use

A bond issued by a state or local government may not qualify for tax exempt status if there is excessive private business use of the facilities financed by the issue.

Tax-exempt for bonds issued by state and local governments is governed by Section 103(a), which provides that, except as provided in Section 103(a), gross income does not include interest or any state or local bond. Section 103(b)(1) provides that Section 103(a) shall not apply to any private activity bond that is not a qualified bond (within the meaning of Section 141).

Section 141(a) provides that the term "private activity bond" includes any bond issued as part of an issue that meets the private business use test and private security or payment test.

Section 141(b)(1) provides that an issue meets the private business use test if more than 10 percent of the proceeds of the issue are to be used for any private business use. Section 141(b)(2) defines "private business use" as use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For this purpose, any activity carried on by a person other than a natural person must be treated as a trade or business, and the use of financed property is treated as the direct use of proceeds.

For a more detailed discussion of the application of the private business use tests of Section 141, see the analysis in the issue snapshot "Private Business Use – Management Contracts".

Federal Use Considered Nongovernmental Use / Regulations Provide Exception

The rules governing tax-exempt bonds do not consider the federal government to be a governmental user for purposes of determining their tax-exempt status. This is stated in Section 150(a)(2), which specifies that a "governmental unit" does not include the United States or any agency or instrumentality thereof. Since the federal government and its agencies are not considered governmental units, Federal Use (such as the housing of detainees) of Prison Facilities financed by tax-exempt bonds may be considered private business use.

However, the regulations provide an exception that allows for circumstances under which Federal Use is not considered private business use. This is set forth in Treas. Reg. Section 1.141-3(d)(3), which provides an exception for arrangements other than arrangements resulting in ownership of financed property by a nongovernmental person.

For Federal Use of Prison Facilities, the relevant exception is set forth in Treas. Reg. Section 1.141-3(d)(3)(ii), which applies to arrangements which are not available for use on the same basis by natural persons not engaged in a trade or business. For such use to be eligible for the exception, all three of the following conditions must be met:

- The term of the use, including all renewal options, is not longer than 100 days;
- The arrangement would be treated as general public use, except that it is not available for use on the same basis by natural persons not engaged in a trade or business because generally applicable and uniformly applied rates are not reasonably available to natural persons not engaged in a trade or business; and
- The property is not financed for a principal purpose of providing that property for use by that nongovernmental person.

A relevant example is provided in Treas. Reg. Section 1.141-3(f), example 15, which addresses contracts for Federal Use of Prison Facilities. Contracts to house prisoners are not considered arrangements for general public use because leasing space for prisoners is not available on the same basis by natural persons not engaged in a trade or business. The example describes circumstances under which a contract for Federal Use would qualify for the exception under Treas. Reg. Section 1.141-3(d)(3)(ii). In the example, the federal government is charged approximately the same amount as persons that enter into similar agreements, the term of use under the contract is not longer than 100 days, with no right to renew, and the prison was not financed for a principal purpose of housing federal prisoners. Also, the federal prisoners will be housed.
on a space-available, first-come, first-served basis, and it is reasonably expected that other persons will enter into agreements similar to the federal use agreement. Although the contract is expected to be renewed indefinitely and it is reasonably expected that, during the term of the bonds, more than 10 percent of the prisoners will be federal prisoners, the issue does not meet the private business test because the arrangement satisfies the conditions of the exception.

Another example is described in IRS Private Letter Ruling 200718021, which includes a similar fact pattern with a few different aspects. The ruling describes a contract for Federal Use that does not exceed 100 days, with no right to renew. However, the contract will automatically renew for a period of less than 100 days absent cancellation by either party, and the issuer reasonably expects that it will be renewed for at least five years. Also, the federal government will pay approximately the same per-diem rate that other nongovernmental persons would pay, and the county represents that the prison facility is being constructed to serve the long-term needs of the county, and not for a principal purpose of providing the facility for federal government use. Taking into consideration the automatic renewal feature and the other facts as described, the ruling concludes that the contract will not result in private business use of the bonds within the meaning of Section 141(b). See also Private Letter Ruling 9835032 (federal government has no right to renew the contract to house its prisoners, although it is reasonably expected to renew indefinitely).

**Federal Use Arrangements, Management Contracts**

A number of federal agencies house prisoners in Prison Facilities which are not owned by the federal government. These include the US Marshall Service (USMS) and Immigration and Customs Enforcement (ICE). Although these agencies sometimes use federal facilities to house detainees, in many instances they are housed in state, local or privately-owned Prison Facilities under contracts with the state or local government, also known as Intergovernmental Agreements (IGA).

In addition to arrangements made for Federal Use, state and local governments may also enter into contracts with private companies to manage the Prison Facilities they own. Management contracts which provide for private companies to manage Prison Facilities financed by tax-exempt bonds may also result in private business use, if the contracts do not comply with applicable rules. For a detailed discussion of the rules which apply to management contracts used in conjunction with Prison Facilities financed by tax-exempt bonds, see the issue snapshot “Private Business Use – Management Contracts”.

**Issue Indicators or Audit Tips**

In analyzing potential private business use arising from Federal Use of a Prison Facility financed by tax-exempt bonds, compliance with all three of the conditions must be reviewed:

- **Purpose of financing**: The housing of federal prisoners must not be a primary purpose of the financing.
- **Contract, lease or intergovernmental agreement (IGA)**: The term of any contract for Federal use may not be longer than 100 days, including all renewal options. An automatic renewal feature may be considered, but must be evaluated by taking into account all relevant facts and circumstances.
- **Financial arrangements under the contract**: For the arrangement to be treated as general public use, even though it is not available for use on the same basis by natural persons not engaged in a trade or business, the costs charged under the contract for Federal Use must be comparable to those charged to any other or local governments which may use the facility, or any other nongovernmental user.
Advance Refunding Bond Limitations Under Internal Revenue Code Section 149(d)

This Issue Snapshot will help agents identify if an advance refunding has complied with the limitations imposed on advance refundings by IRC Section 149(d). Note this Issue Snapshot addresses certain matters related to advance refunding bonds issued on or before December 31, 2017.¹

**IRC Section and Treasury Regulation**

IRC Section 149(d)
Treasury Regulation Section 1.149(d)-1

**Resources (Court Cases, Chief Counsel Advice, Revenue Rulings, Internal Resources)**

Chief Counsel Advice 201843009 (2018 Chief Counsel Advice regarding the use of tax-exempt bonds to advance refund taxable bonds)

**Field Service Advice Memoranda CC:TL-N-2234-93** (1993 Field Service Advice discussing prohibition against advance refundings for industrial development bonds)

**Field Service Advice Memoranda CC:TL-N-2669-95** (1995 Field Service Advice discussing refundings involving the transition rule for transferred proceeds)

**Field Service Advice Memoranda 200037006** (2000 Field Service Advice discussing refundings when there is a change in ownership of financed facility)

**Field Service Advice Memoranda 200229020** (2002 Field Service Advice discussing whether a device was employed to obtain a material financial advantage (based on arbitrage) apart from savings attributable to lower interest rates as described in IRC Section 149(d)(4))


Analysis

The general rules that define and limit advance refundings are in IRC Section 149(d) and the accompanying regulations under Treasury Regulation Section 1.149(d)-1. IRC Section 149(d) places limits on advance refunding bonds, which it defines as a bond issued to advance refund another bond more than 90 days before the redemption of the refunded bond.

Definition of Refunding Bonds

"Refunding issue" is defined in Treasury Regulation Section 1.150-1(d). Under this definition, with certain exceptions and special rules, a refunding issue is an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue of bonds (the "refunded issue"). The refunded (or "prior") issue may be an issue that was issued prior to, at the same time as, or after, the issuance of the refunding issue.

Definition of Advance Refunding

IRC Section 149(d)(5) defines an advance refunding as a bond issued to refund another bond on a date more than 90 days before the redemption of the refunded bond.

Certain Prohibitions

IRC Section 149(d)(1) precludes bonds described in IRC Section 149(d)(2), that is, bonds issued to advance refund private activity bonds (other than qualified 501(c)(3) bonds), from being tax-exempt. This applies even if the advance refunding issue would be a governmental bond or a qualified 501(c)(3) bond after application of the rules in Treasury Regulation 1.141-13.

Only governmental bonds and qualified 501(c)(3) bonds may be advance refunded by a tax-exempt bond.

Limitation on Advance Refunding

IRC Section 149(d)(3)(A)(i) provides limitations on the number of times a bond can be advance refunded.

If the original bond was issued after 1985, only one advance refunding is permitted with respect to that bond, including any bond that refunds that bond.

If the original bond was issued before 1986, two advance refundings are permitted taking into account the following modifications under IRC Section 149(d)(6):

- A refunding occurring before 1986 is treated as an advance refunding only if the refunding bond was issued more than 180 days before the redemption of the refunded bond, AND
- if the original bond was issued before 1986 it is treated as if advance refunded only once before March 15, 1986, regardless of the number of times it was advance refunded before such date.

Frequently, an issue of bonds consists of several different bonds, generally with varying maturities, each of which may be advance refunded only once if issued after 1985. These various bonds are generally referred to as either

serial bonds or term bonds that, collectively, become the bond issue. See Treas. Reg. Section 1.150-1(c) for the definition of “issue.” In some cases, the different serial or term bonds of an issue may be advance refunded by different advance refunding bond issues. This is acceptable if no particular serial or term bond (or its associated advance refunding bond) is advance refunded more than once. See Example below.

**Taxable Refunding**

If an issuer cannot issue a tax-exempt advance refunding bond, but still wishes to advance refund, another option may be to use an issue of taxable advance refunding bonds.

Treasury Regulation Section 1.149(d)-(1)(e)(1) provides that, generally, for purposes of the limitation on the number of advance refundings:

- taxable advance refunding issues are not counted, AND
- an advance refunding of a taxable issue is not counted (except when the taxable issue is a conduit loan of a tax-exempt conduit financing issue).

IRC Section 149(d) does not apply to refunding bonds that are taxable. However, Treasury Regulation Section 1.149(d)-(1)(e)(2) provides that if a taxable bond is issued to avoid the advance refunding limitations of IRC Section 149(d)(3)(A)(i), the taxable bond will be counted as a tax-exempt issue. For example, if a taxable advance refunding issue is used to refund a tax-exempt issue, and the taxable issue is then currently refunded with another tax-exempt issue, the taxable advance refunding issue is taken into account under Section 149(d)(3)(A)(i) if the two tax-exempt issues are outstanding concurrently for more than 90 days.

**Redemption Requirements**

One of the most common reasons for issuing advance refunding bonds is to save money as a result of lower interest rates. In such cases, if the issuer may realize present value debt service savings (determined without regard to administrative expenses) in connection with issuance of the refunding issue, then IRC Section 149(d)(3)(B)(i) directs that the following redemption rules apply:

- IRC Section 149(d)(3)(A)(ii) provides that if the refunded bonds were issued before 1986, the refunded bond must be redeemed not later than the earliest date on which such bond may be redeemed at par or at a premium of three percent or less.
- IRC Section 149(d)(3)(A)(iii) provides that if the refunded bonds were issued after 1985, the refunded bond must be redeemed not later than the earliest date on which such bond may be redeemed.

IRC Section 149(d)(3)(B)(ii) provides that for purposes of applying the above rules, the earliest date for redemption shall not be earlier than the 90th day after the issuance date of the refunding bond.

In effect, for bonds issued after 1985, redemption requirements (also referred to as “first call requirement”) result in an issuer having to call the refunded bonds on the first date there is any amount of present value savings, regardless of redemption premium. For bonds that were issued prior to 1986, the issuer may delay redeeming the bonds until the redemption premium no longer exceeds three percent.

**Savings Test**
Treasury Regulation Section 1.149(d)-1(f)(3) provides that the multipurpose issue rules in Treasury Regulation Section 1.148-9(h) apply for purposes of the savings test of IRC Section 149(d)(3)(B)(i).

If any separate issue in a multipurpose issue increases the aggregate present value of debt service savings or reduces the present value debt service losses on the entire multipurpose issue, that separate issue satisfies the savings test. Satisfying the savings test then requires the issuer to follow the redemption requirements detailed above.

**Abusive Arbitrage Devices**

IRC Section 149(d) provides that the interest on a refunding bond described in IRC Section 149(d)(4), that is, an advance refunding bond that employs an abusive device, will NOT be tax-exempt. An abusive device is employed if a material financial advantage (based on arbitrage) is obtained.

Savings attributable to lower interest rates is not an abusive arbitrage device.

Treasury Regulation Section 1.149(d)-1(b) provides that an advance refunding issue employs an abusive device and is described in Section 149(d)(4) if:

- the issue violates any of the anti-abuse rules under Treasury Regulation Section 1.148-10,
- the issue fails to meet the general rebate requirements of Treasury Regulation Section 1.148-3,
- any of the proceeds of the issue are invested in certain refunding escrows, as described in Treasury Regulation Section 1.149(d)-1(b)(3) (see Mixed Escrows Invested in Certain Tax-Exempt Bonds, below), OR
- investment of funds resulting from the sale of a tax-exempt conduit loan that is used to pay debt service on the conduit financing issue, is made at a yield in excess of the yield at which such conduit loan was sold. (Treasury Regulation Section 1.149(d)-1(b)(4) and Section 1.148-10(d), Example 4)

**Mixed Escrows Invested in Certain Tax-Exempt Bonds**

Treasury Regulation Section 1.149(d)-1(d)(2) provides that, for purposes of certain limitations on advance refundings, the mixed escrow rules in Treasury Regulation Section 1.148-9(c) do not apply to amounts that were NOT gross proceeds of the prior issue before the issue date of the refunding issue.

Treasury Regulation Section 1.149(d)-1(b)(3) provides that an advance refunding issue is abusive if:

- any of the proceeds of the issue are invested in a refunding escrow in which a portion of the proceeds are invested in tax-exempt bonds and a portion of the proceeds are invested in nonpurpose investments,
  - the yield on the tax-exempt bonds in the refunding escrow exceeds the yield on the issue,
  - the yield on all the investments (including investment property and tax-exempt bonds) in the refunding escrow exceeds the yield on the issue, AND
  - the weighted average maturity of the tax-exempt bonds in the refunding escrow is more than 25 percent greater or less than the weighted average maturity of the nonpurpose investments in the refunding escrow, AND the weighted average maturity of nonpurpose investments in the refunding escrow is greater than 60 days.
Treasury Regulation Section 1.149(d)-1(b)(3) prevents issuers from inappropriately taking advantage of the spread between long-term tax-exempt obligations and short-term taxable obligations. Generally, investments in tax-exempt obligations are not considered to be investment property under IRC Section 148. Consequently, but for this rule, funding an escrow with long-term higher yielding tax-exempt obligations and short-term taxable obligations would allow an issuer to earn a yield (based on actual cash flows) in excess of the advance refunding bond yield. Note, however, that this rule does not apply if the escrow is funded solely with tax-exempt bonds. See Preamble, T.D. 8345, Section I, 56 FR 19023, 19027 (April 25, 1991).

**Temporary Periods**

Additionally, IRC Section 149(d)(3)(A)(iv) provides that, with respect to advance refundings:

- proceeds of a refunding issue are permitted an initial temporary period of 30 days after issuance, AND
- the initial temporary period of any remaining proceeds of the refunded bond ends on the issue date of the refunding bonds.

Treasury Regulation Section 1.149(d)-(1)(d)(3) provides that the rules in Treasury Regulation Section 1.148-9(d) apply to advance refunding issues.

For example, if a construction bond has a 3-year temporary period that has not yet expired, but is advance refunded, the temporary period will terminate as of the date of issue of the refunding issue, under IRC Section 149(d)(3).

**Issue Indicators or Audit Tips**

**Indicators:**

If the proceeds of an issue of refunding bonds are deposited in some sort of fund (typically referred to as an “escrow fund”) for more than 90 days, before being expended to refund any portion of the refunded bonds, then the bonds are advance refunding bonds.

**Audit Tips:**

If the bonds are advance refunding bonds, some key considerations are:

- Verify the advance refunding bonds were issued on or before December 31, 2017. Otherwise, rules other than those described in this Issue Snapshot may apply.
- Verify the refunded bonds were new money bonds or current refunding bonds. If not, verify it is a permitted advance refunding given the limitations on the number of advance refundings.
- If there are multiple issues of advance refundings associated with one refunded bond issue, check whether any bond maturities were advance refunded more than once.
- If a refunded bond consisted, in part, of advance refunding bonds, check whether any of those advance refunding bonds were advance refunded again.
- If the refunded bonds consisted of private activity bonds, other than 501(c)(3) bonds, it is not a permitted advance refunding.
Of course, there are numerous other requirements and limitations on advance refunding bonds that may also be considered during the course of an examination, some of which have been described above.

Example:

When reviewing multiple issues of advance refundings associated with one refunded bond issue, a key consideration is whether any bond maturities were advance refunded more than once. The following is an example of a review of such situation using a single serial bond of a multi-series bond issue.

Refunded Multipurpose Bond:

<table>
<thead>
<tr>
<th>Serial Maturity due January 1, 2018</th>
<th>New Money Allocation</th>
<th>Advance Refunding Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000,000</td>
<td>$3,500,000</td>
<td>$6,500,000</td>
</tr>
</tbody>
</table>

Refunding Bonds Allocations:

| 1st Advance Refunding Bond:       | $2,665,000           | $0                            |
| 2nd Advance Refunding Bond        | $835,000             | $0                            |

The issuer previously issued a multipurpose bond issue that included a new money portion to construct a library and a refunding portion to advance refund a previously issued new money bond. The issuer provides the examiner information that represents the $10,000,000 serial bond maturing on January 1, 2018 has been allocated to a new money portion in the amount of $3,500,000 and an advance refunding portion of $6,500,000. This means the new money portion may be advance refunded in the future, whereas the advance refunded portion may not due to IRC Section 149(d) limitations. The issuer subsequently issues two advance refunding bonds on different dates, refunding $2,665,000 using the first advance refunding and refunding the remaining $835,000 using the second advance refunding. This is acceptable given the issuer did not refund more than the $3,500,000 new money portion of the serial bonds. However, had the issuer refunded, say, $935,000 with the second advance refunding instead of $835,000, then there would be an impermissible second refunding of an advance refunding bond in the amount of $100,000.

1Section 13532 of Public Law No. 115-97, 131 Stat. 2054, 2154 (2017) (the “2017 Act”) repealed the authority to issue tax-exempt advance refunding bonds after December 31, 2017. References to IRC Section 149(d) in this Issue Snapshot are to that subsection as in effect prior to amendment by the 2017 Act. See Chief Counsel Advice 201843009 for a discussion of advance refunding bonds issued after December 31, 2017.
Dear:

This responds to your request for a ruling that, for purposes of compliance with § 147(e) of the Internal Revenue Code (Code), the Issuer may allocate proceeds of the Bonds and Equity (as defined below) to the Boarding Area on an undivided portion basis, such that it may allocate the proceeds and Equity to qualified and non-qualified uses (as
defined below), respectively, regardless of the location of those uses within the Boarding Area during the term of the Bonds.

**Facts and Representations**

Issuer owns and operates the Airport. The Airport includes the Terminal Complex, as well as runways, taxiways, and support facilities. The Terminal Complex includes boarding areas, which have a wide variety of retail shops, bars, restaurants, coffee shops, and similar passenger amenities ("Terminal Shops") that are operated by third-party private operators under leases from Issuer. The nature, size, variety, and scope of Terminal Shops change over time based on consumer trends, style and overall economic conditions; however, none of the Terminal Shops will be described in § 142(c)(2).

Issuer is in the process of making substantial renovations to portions of the Terminal Complex (the "Renovations"), including the complete demolition and reconstruction of the Boarding Area, and will finance part of the costs of the Renovations with the proceeds of the Bonds. Issuer expects to receive proposals from private concessionaires for one or more Terminal Shops to be located within the reconstructed Boarding Area and expects that such Terminal Shops will include retail locations the principal business of which is the sale of alcoholic beverages for consumption off premises within the meaning of § 147(e) ("non-qualified use"); use not described in § 147(e) is referred to herein as "qualified use"). Issuer expects that, during the expected term of the Bonds, Terminal Shops with non-qualified use will be relocated to other Terminal Shop locations within the Boarding Area.

Issuer intends to use funding sources that are not proceeds of any tax-exempt or other tax-advantaged bond ("Equity") to finance at least the costs of the Renovations allocable to the Terminal Shops in the Boarding Area that it expects to be used for non-qualified use. Issuer intends to use proceeds of the Bonds, which were issued as exempt facility bonds pursuant to § 142(a)(1), to finance costs of the renovations to the Boarding Area. Issuer will allocate the Equity no later than the placed in service date of the Boarding Area. Issuer will allocate the proceeds and the Equity to the qualified and non-qualified uses of the Boarding Area, respectively, on a floating basis over the term of the Bonds, based on the costs of the portions of the Boarding Area being so used, up to, but not exceeding, the amounts of proceeds and Equity allocated to the Boarding Area.

**Law and Analysis**

Section 103(a) provides that, except as provided in § 103(b), gross income does not include interest on any State or local bond. Section 103(b) provides, in part, that § 103(a) shall not apply to any private activity that is not a qualified bond (within the meaning of § 141).
Section 141(a) provides that a bond is a private activity bond if the bond is issued as part of an issue that meets the private business use test of § 141(b)(1) and the private security or payment test of § 141(b)(2) or the private loan financing test of § 141(c).

Under § 141(b)(1) an issue meets the private business use test if more than 10 percent of the proceeds of an issue are to be used for any private business use. Private business use is defined in § 141(b)(6) as use (directly or indirectly) in a trade or business carried on by any person other than a governmental unit. For this purpose, any activity carried on by a person other than a natural person is treated as a trade or business.

Section 141(b)(2) provides, in general, that an issue meets the private security or payment test if the payment of the principal of, or the interest on, more than 10 percent of the proceeds of an issue is directly or indirectly (1) secured by an interest in property used or to be used for a private business use, (2) secured by an interest in payments in respect of such property, or (3) to be derived from payments, whether or not to the issuer, in respect of property, or borrowed money, used or to be used for a private business use.

Section 141(e)(1)(A) defines a qualified bond to include any private activity bond that (1) is an exempt facility bond; (2) meets the applicable requirements of § 146 (volume cap); and (3) meets the applicable requirements of § 147.

Section 142(a)(1) defines an exempt facility bond to include any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide airports.

Section 147(e) states that a private activity bond shall not be a qualified bond if issued as part of an issue and any portion of the proceeds of such issue is to be used to provide any airplane, skybox or other private luxury box, health club facility, facility primarily used for gambling, or store the principal business of which is the sale of alcoholic beverages for consumption off premises.

The statutory predecessor to § 147(e) is § 103(b)(18) of the Internal Revenue Code of 1954 (1954 Code), which was added by § 627(c) of the Deficit Reduction Act of 1984, Pub. L. 98-367, 98 Stat. 630 (1984). The legislative history to § 103(b)(18) includes the following language in reference to the prohibition on the use of bond proceeds for any skybox or other private luxury box:

In the case of skyboxes or other private luxury boxes, the committee does not intend to prohibit the use of [Industrial Development Bonds (IDBs)] to finance the construction, renovation or refurbishing of a facility solely because skyboxes are included in the project, so long as the
project otherwise qualifies for tax-exempt financing. Rather, no portion of the proceeds of the IDB may be used to provide any skybox. For this purpose, the skybox shall be deemed to include the interior furnishings of the box (e.g., the box's plumbing, electrical and decorating costs) and the structural components required for the box (e.g., the box's walls, ceilings, special enclosures), but does not include the normal components of the stadium, such as structural supports, to the extent they would have been required for the remaining portion of the stadium if no skyboxes (and no regular seats in lieu of skyboxes) had been built. House Supplemental Report, H.R. Rep. No. 98-432, pt. 2, at 1693 (1984).


Issuer expects to have Terminal Shops in the reconstructed Boarding Area that have non-qualified use. Moreover, Issuer expects that such Terminal Shops will, during the term of the Bonds, be relocated to other Terminal Shop locations within the Boarding Area. Issuer will finance the costs allocable to such Terminal Shops with Equity and seeks a ruling that the amount of the Equity may be allocated to the Boarding Area on an undivided basis, rather than to a specific location or discrete portion, to accommodate the relocations of the Terminal Shops with non-qualified use.

The legislative history described above supports applying a reasonable allocation method to avoid using the proceeds of tax-exempt bonds for non-qualified costs while still being able to finance with proceeds of tax-exempt bonds those portions of the facility that otherwise qualify for such financing. Within the Boarding Area, consistent with the legislative history to the predecessor to § 147(e), Issuer will use Bond proceeds only for the costs of the areas to be used for qualified use and will use Equity for the costs of the Terminal Shops with expected non-qualified use. Issuer will allocate the proceeds and the Equity to the qualified and non-qualified uses, respectively, on a floating basis over the term of the Bonds, based on the costs of the portions of the Boarding Area being so used, up to, but not exceeding, the respective amounts of proceeds and Equity allocated to the Boarding Area. Accordingly, we conclude, under the facts described above, that this is a reasonable allocation method.

**Conclusion**

Under the facts and circumstances of this case, we conclude that for purposes of compliance with § 147(e) of the Code, Issuer may allocate proceeds of the Bonds and the Equity on an undivided portion basis to the Boarding Area, and Issuer may allocate such funds during the term of the Bonds to the qualified and non-qualified uses of the Boarding Area, respectively, regardless of the specific location, based on the costs of the portions of the Boarding Area being so used, up to but not exceeding the amounts of proceeds and Equity allocated to the Boarding Area.
Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any transaction or item discussed or referenced in this letter, including whether the Bonds meet the requirements for the exclusion of interest from gross income under § 103.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with a Power of Attorney on file with this office, a copy of this letter is being sent to each of Issuer's authorized representatives.

The ruling contained in this letter is based upon information and representations submitted by Issuer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the materials submitted in support of the request for a ruling, it is subject to verification upon examination.

Sincerely,

Associate Chief Counsel
(Financial Institutions & Products)

By: __________________________
    Timothy L. Jones
    Senior Counsel, Branch 5

cc:
HILLMAN, District Judge

The instant matter is a refund suit brought by a taxpayer against the United States of America. Presently before the Court are cross-motions for summary judgment, which have both been fully briefed. For the reasons expressed below,
Defendant’s Motion for Summary Judgment will be granted and Plaintiff’s Motion for Summary Judgment will be denied.

**BACKGROUND**

This Court takes its recitation of facts from Plaintiff’s and Defendant’s Local Civil Rule 56.1 statements. This Court will note any dispute where applicable. Phyllis W. Souders\(^1\) brought an action in the 1990s against the South Carolina Public Service Commission (d/b/a Santee Cooper) in the United States District Court for the District of South Carolina (the “Santee Cooper Litigation”). Phyllis Souders sued for damages suffered to her property (the “Property”) as a result of severe flooding caused by Santee Cooper’s work on a nearby hydroelectric project.

After many years of litigation, United States District Judge Patrick Michael Duffy held a binding mediation hearing from November 18 to November 21, 2008. As a result, the South Carolina District Court ordered judgment entered against Santee Cooper and in favor of Phyllis Souders “in the amount of $304,750.00, plus 8% interest from the date of flooding to the date of this Order, and $40,000.00 on the trespass cause of action.” The interest totaled $747,572.\(^2\) By the time judgment

\(^1\) Her surname is misspelled in the case caption as “Sauders.”

\(^2\) Plaintiff has attempted to characterize this award as a mediation or a settlement. The facts do not support this
was entered in 2009, Phyllis Souders was deceased.

The Estate of Phyllis Souders (the "Estate") received the above award. The Estate distributed $724,133 to the Phyllis W. Souders Trust U/A Dated 9/11/97 (the "Trust"), which was the sole beneficiary of the Estate. Plaintiff, Gerald R. Savidge, is both the Executor of the Estate and the Trustee of the Trust. The tax treatment of this interest is where the dispute between the parties lies.

For the tax year ending January 31, 2010, the Estate submitted an income tax return reporting $747,572 of "interest income" - described as "Santee Cooper - Interest on Litigation" - and, after deducting administrative expenses, reported distributing the remaining $724,133 to the Trust. The Estate also passed a $409,919 excess deduction to the Trust. Since the South Carolina District Court awarded $344,750 for damages and trespass to the Property at issue, there was a "net capital loss" to the Estate's basis in the Property in the previously mentioned excess deduction amount. After reporting the interest income and capital loss, the Trust reported owing $107,778 in

characterization, as the parties submitted to binding mediation and Judge Duffy entered an order. While the parties may have voluntarily entered into the binding mediation proceedings, Plaintiff presents no facts suggesting that the Order merely evidences a voluntary settlement. In fact, the binding nature of the mediation suggests the amount awarded by Judge Duffy was involuntarily given.
taxes and paid that amount to the United States.

In May 2013, the Estate submitted an amended return for the above-described tax year. This return omitted both the interest income and "long-term capital loss" that was reported in the previous return and stemmed from the Santee Cooper Litigation. The Trust treated the interest income and long-term capital loss in the same way, and did not include either on the amended return. Both the Trust and the Estate provided the below explanation for the amended filing:

The reported interest income was received from the S.C. Public Service Commission. It was reported as taxable interest instead of federal and S.C. tax free municipal interest.

The award for property damage has been removed from the Schedule D since it reflects only a return of basis on property still owned by the Estate and was inappropriately included in the original filing.

The adjustments to this return relates to these charges.

After submittal of the amended returns, the accountant who prepared them for both entities followed up in December 2013 requesting "written verification of the status of the return."

The Internal Revenue Service ("IRS") sent a letter to the Estate in response. The letter was in regard to the tax period "Aug. 31, 2009" and stated: "Thank you for your inquiry of December 5 2013. We corrected your account based on the information you
provided."^3 No further action was taken by the IRS. No refund was issued.

Plaintiff filed his complaint against the United States on November 22, 2016. Defendant, after withdrawing a motion to dismiss, filed an answer on July 7, 2017. Discovery ensued. Cross-motions for summary judgment were filed by the parties on March 15, 2018. Both have been fully briefed and are ripe for adjudication.

**ANALYSIS**

**A. Subject Matter Jurisdiction**

This Court has jurisdiction under 28 U.S.C. § 1346(a)(1) as this is a civil action brought against the United States for "the recovery of . . . internal-revenue tax alleged to have been erroneously or illegally assessed or collected . . . ."

**B. Standard on Motion for Summary Judgment**

Summary judgment is appropriate where the Court is satisfied that "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the

---

^3 What this ambiguous statement from the IRS means is unclear. The only record evidence that either party has pointed to - the deposition testimony of the Trust's accountant - suggests that this statement from the IRS merely meant that it had received the amended return. Plaintiff offers no support for its bald assertion that the IRS had decided the amended return required it to refund the previously paid tax. The fact that the United States vigorously contents Plaintiff's claims suggests otherwise.
affidavits if any,
... demonstrate the absence of a genuine issue of material fact” and that the moving party is entitled to a judgment as a matter of law. Celotex Corp. v. Catrett, 477 U.S. 317, 322-23 (1986) (citing FED. R. CIV. P. 56).

An issue is “genuine” if it is supported by evidence such that a reasonable jury could return a verdict in the nonmoving party’s favor. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 248 (1986). A fact is “material” if, under the governing substantive law, a dispute about the fact might affect the outcome of the suit. Id. “In considering a motion for summary judgment, a district court may not make credibility determinations or engage in any weighing of the evidence; instead, the non-moving party’s evidence ‘is to be believed and all justifiable inferences are to be drawn in his favor.’” Marino v. Indus. Crating Co., 358 F.3d 241, 247 (3d Cir. 2004) (citing Anderson, 477 U.S. at 255).

Initially, the moving party bears the burden of demonstrating the absence of a genuine issue of material fact. Celotex, 477 U.S. at 323 (“[A] party seeking summary judgment always bears the initial responsibility of informing the district court of the basis for its motion, and identifying those portions of ‘the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any,’ which it believes demonstrate the absence
of a genuine issue of material fact.”); see Singletary v. Pa. Dep’t of Corr., 266 F.3d 186, 192 n.2 (3d Cir. 2001) (“Although the initial burden is on the summary judgment movant to show the absence of a genuine issue of material fact, ‘the burden on the moving party may be discharged by “showing” — that is, pointing out to the district court — that there is an absence of evidence to support the nonmoving party’s case’ when the nonmoving party bears the ultimate burden of proof.” (citing Celotex, 477 U.S. at 325)).

Once the moving party has met this burden, the nonmoving party must identify, by affidavits or otherwise, specific facts showing that there is a genuine issue for trial. Celotex, 477 U.S. at 324. A “party opposing summary judgment ‘may not rest upon the mere allegations or denials of the . . . pleading[s].’” Saldana v. Kmart Corp., 260 F.3d 228, 232 (3d Cir. 2001). For “the non-moving party[] to prevail, [that party] must ‘make a showing sufficient to establish the existence of [every] element essential to that party’s case, and on which that party will bear the burden of proof at trial.’” Cooper v. Sniezek, 418 F. App’x 56, 58 (3d Cir. 2011) (citing Celotex, 477 U.S. at 322). Thus, to withstand a properly supported motion for summary judgment, the nonmoving party must identify specific facts and affirmative evidence that contradict those offered by the moving party. Anderson, 477 U.S. at 257.
C. Defendant’s Motion for Summary Judgment

This Court will first address Defendant’s Motion for Summary Judgment. This motion presents two arguments. First, Defendant argues its defenses are not time-barred. Second, Defendant argues the interest income was properly taxed in the first return. This Court will address each argument in turn.

a. Statute of Limitations

Plaintiff’s central argument throughout the course of this litigation asserts that in cases where an amended return reducing a tax liability is filed, once the statute of limitations has expired under 26 U.S.C. § 6501, the IRS must accept the amended return and forfeit the tax previously paid if it has taken no action. Plaintiff continues to rely on this argument at the summary judgment stage. In relevant part, 26 U.S.C. § 6501(a) states: “the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed.”

In response, Defendant argues that the IRS is not time-barred from disputing the accuracy of an amended return under 26 U.S.C. § 6501. It cites Lewis v. Reynolds and its progeny,

4 Defendant also argues that any additional bases for refund not disclosed in the complaint cannot be argued on a motion for summary judgment. This Court will not address this third argument, as Plaintiff does not raise additional arguments and because the decision on Defendant’s first two arguments further moots this third argument.
which together stand for the proposition that, even though "the statute of limitations may have barred the assessment and collection of any additional sum, it does not obliterate the right of the United States to retain payments already received when they do not exceed the amount which might have been properly assessed and demanded." 284 U.S. 281, 283 (1932). See also Morristown Trust Co. v. Manning, 104 F. Supp. 621, 628 (D.N.J. 1951) ("[I]n acting upon a claim for refund . . . the Commissioner has authority to reaudit the return and to reject the claim if the redetermination does not show an overall overpayment even though the statute of limitations prevents him from making an additional assessment for the year involved.").

Plaintiff's argument contradicts the clear terms of the statute and decades of precedent. Although 26 U.S.C. § 6501(a) prohibits the IRS from assessing additional taxes after more than three years have elapsed from the filing of a return, it is silent on a statute of limitations for refund actions. Here, that tax was assessed and collected within three years. Defendant is not assessing any more tax for the tax year at issue, but merely refuses to refund that which was already paid.

The Third Circuit previously rejected a claim similar to Plaintiff's claim, saying "section 6501(a) directs only that taxes 'be assessed within 3 years after the return was filed.' . . . A deficiency determination, by which the IRS seeks to
establish the taxpayer’s additional tax liability, is patently
different from a refund determination, by which the taxpayer
seeks repayment or credit from the IRS.” Bachner v.
Commissioner, 81 F.3d 1274, 1277 (3d Cir. 1996) (emphasis in
original). As highlighted above, the case law5 supports
Defendant’s position that 26 U.S.C. § 6501, even if applicable,
does not bar the United States from resisting a refund claim.
Thus, this Court rejects Plaintiff’s central argument.

Plaintiff argues, in the alternative, that even if this
Court is not barred from determining the tax liability of a
taxpayer who is a party to the action, this Court is barred from
determining the tax liability of a taxpayer who is a non-party.
Defendant argues in its reply brief that a determination of a
non-party’s, here the Estate’s, tax liability is not required.
Instead, it asserts, the Court need only look so far as the

5 In his reply brief, Plaintiff argues the case law cited by
Defendant is distinguishable. While the facts of Defendant’s
cases do differ from those presented here, Plaintiff does not
address why the United States is barred from keeping Defendant’s
payment. The case law specifically addresses a situation where
a taxpayer brings a refund suit after the statute of limitations
for the government to assess additional tax has passed. In
those situations, the government is only restricted from
assessing more tax, not retaining the tax already paid - unless
the taxpayer proves overpayment. The rule is logical, as it is
the taxpayer who self-reports the tax owed. The government
should not be restricted in litigation just because the taxpayer
made a mistake and rested on its claim for a refund until after
the government’s assessment window under 26 U.S.C. § 6501(a) has
elapsed.
Trust's tax liability to determine whether or not a refund is required.

Defendant is correct. Even though the Trust reported its tax liability in the same manner as the Estate, the Trust's return and amended return gives this Court enough information to determine this case. Plaintiff does not show this Court what information on the Estate's return is needed for it to make this decision. The Trust's amended tax return states the reason for amendment and the source of the interest income. Moreover, the case law shows no limitation - and Plaintiff offers nothing in rebuttal - that would prohibit this Court from examining the Estate's returns to determine the merits of this action. Even if this Court were required to look at the Estate's returns to gather enough facts to decide the merits of this case, there is no bar.6

This Court determines the merits of the refund claim brought by the Trust. To the extent its decision may affect the return filed by the Estate is of no moment. It is the Executor of the Estate who must determine whether any legal obligation arises to amend the return after entry of an order effectuating

---

6 In fact, both Trust returns may be seen to incorporate by reference the Estate returns. So, it seems, the Trust has put the Estate's return at issue in this case. It cannot now complain if the Court examines the Estate's return in analyzing the arguments of the parties.
this Opinion.

b. Tax Implications of Interest Income Received by the Trust

Now that this Court has determined there is no statute of limitations issue it may decide the merits of this case. Defendants insist that no refund is appropriate. The United States argues this type of interest income is not tax-exempt and it was correctly taxed.

Plaintiff does not argue the merits of whether the interest income is tax exempt or taxable. Instead, Plaintiff argues there are questions of material fact remaining to be decided. First, Plaintiff argues there is a question of material fact as to whether the interest income was pursuant to a court order or settlement or mediation. Second, Plaintiff argues there is a question of material fact as to whether the statute of limitations bars the United States from resisting refund.

Before discussing the merits of Defendant's argument, this Court will dispose of Plaintiff's two arguments. The interest income was granted pursuant to court order. Although the hearing that Judge Duffy held was a "binding mediation," he ordered the interest income. This was not a voluntary settlement pursuant to party negotiations or mediation. Plaintiff does not bring forth any documents that would suggest
otherwise.' Plaintiff's second argument is not a dispute of fact, but a dispute of law. As explained supra, the statute of limitations is inapplicable to this action.

Even though Plaintiff has not presented argument rebutting Defendant's argument on the merits, Defendant must still meet the standard for summary judgment. See Celotex, 477 U.S. at 323 ("[A] party seeking summary judgment always bears the initial responsibility of informing the district court of the basis for its motion, and identifying those portions of 'the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any,' which it believes demonstrate the absence of a genuine issue of material fact."). As explained infra, Defendant has met this standard.

The material facts are not in dispute. The Santee Cooper Litigation ended via binding mediation. At the conclusion of that mediation, the Court ordered Santee Cooper to pay interest on the judgment. The interest stems not from a governmental bond or voluntary borrowing agreement, but because Santee Cooper had been involuntarily found liable for a wrong and a federal judge determined that interest must be paid to fully right the wrong.

7 The docket Plaintiff attaches to its filings only reinforces this finding. Moreover, the discussion infra will show Plaintiff's distinction is unsupported by the case law.
"The ultimate question presented for decision, upon a claim of refund, is whether the taxpayer has overpaid his tax." Lewis, 284 U.S. at 283. In a tax refund suit, "the plaintiff bears the burden of proving that it has overpaid its taxes for the year in question in the exact amount of the refund sought." Wells Fargo & Co. & Subsidiaries v. United States, 91 Fed. Cl. 35, 75 (2010) (citing Helvering v. Taylor, 293 U.S. 507, 515 (1935); Lewis, 284 U.S. 281; Dysart v. United States, 169 Ct. Cl. 276 (1965)). The Court conducts this review de novo. Id. See also R.E. Dietz Corp. v. United States, 939 F.2d 1, 4 (2d Cir. 1991) ("[T]he court does not sit in judgment of the Commissioner; the court places itself in the shoes of the Commissioner.").

The IRC section at issue is 26 U.S.C. § 103. Generally, Section 103 exempts from taxation interest on state and local bonds, which are defined as "an obligation of a State or political subdivision thereof." Generally, tax exemptions "should be construed narrowly." DeNaples v. Commissioner, 674 F.3d 172, 176 (3d Cir. 2012) (In re Hechinger Inv. Co. of Del., Inc., 335 F.3d 243, 259 (3d Cir. 2003)).

Case law interpreting this section has explicitly excluded interest that is not incurred via the borrowing power of the states. Helvering v. Stockholms Enskilda Bank, 239 U.S. 84, 86-87 (1934). The test in the Third Circuit hinges on whether the
"interest obligation arose by operation of law or by voluntary bargaining." DeNaples, 674 F.3d at 177. In other words, "when the state pays interest at a fixed rate pursuant to a statutory or judicial command, it is plainly not excludable under Section 103 . . . ." Id. Although the interest payment was pursuant to mediation, it was a binding mediation and the judgment was entered via court order. The interest income does not qualify for this tax exemption. Plaintiff is not entitled to a refund. Thus, Defendant’s Motion for Summary Judgment will be granted and Plaintiff’s sole claim in this case will be dismissed.

c. Plaintiff’s Other Statutory Arguments

Within his briefing on these cross-motions, Plaintiff presents two additional arguments that this Court must address. First, Plaintiff argues under 26 U.S.C. § 6034A(c)(1) he was required to report the Trust’s return in the same manner as the Estate’s return. This is a red herring. Plaintiff is both Executor and Trustee, so he had the ability — and obligation — to approve both the Estate’s and the Trust’s returns and amended returns. Unlike his analogy to a third-party company providing a shareholder with a 1099-DIV, it appears the Estate and Trust

---

8 As case law from the other Circuits (and the Supreme Court) explains, the policy behind Section 103 "is to encourage loans in aid of governmental borrowing power." Drew v. United States, 551 F.2d 85, 87 (5th Cir. 1977). Clearly, the interest imposed was not to encourage a loan, but to right a wrong committed by the state.
were separate in name only. All the assets of the Estate went to the Trust, and Plaintiff was a fiduciary to both.

Regardless, Plaintiff is not being accused of tax fraud, but being refused a refund. What the Trust reported on its amended return, and whether it matches the Estate’s amended return is an ancillary issue. The Trust reported it owed taxes; then the Trust reported it did not owe taxes. This Court determines it did owe taxes. No further analysis of this statutory provision is necessary.

Second, Plaintiff argues another red herring under 26 U.S.C. § 7491(a). The statute here states the burden shifts to the United States after “a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B . . . .” 26 U.S.C. § 7491(a). Plaintiff has produced no credible evidence showing the Trust does not owe the tax it previously paid. The burden has not shifted to the United States. But, even if it did, the United States has shown with credible, publicly available evidence and the Trust’s own tax returns that no refund should be given.

D. Plaintiff’s Motion for Summary Judgment

Because Plaintiff relies upon the same grounds he did in resisting Defendant’s Motion for Summary Judgment in his own Motion for Summary Judgment, this Court will not engage in a
separate analysis. For the reasons discussed supra, this Court will deny Plaintiff’s Motion for Summary Judgment.

CONCLUSION

For the reasons set forth in this Opinion, this Court will grant the Defendant’s Motion for Summary Judgment and deny the Plaintiff’s Motion for Summary Judgment.

An appropriate Order will be entered.

Date: October 31, 2018
At Camden, New Jersey

s/ Noel L. Hillman
NOEL L. HILLMAN, U.S.D.J.
through the internet at Lanita.VanDyke@irs.gov.

SUPPLEMENTARY INFORMATION:
Title: Installment Sale Income.
OMB Number: 1545–0228.
Form Number: 6252.
Abstract: Internal Revenue Code section 453 provides that if real or personal property is disposed of at a gain and at least one payment is to be received in a tax year after the year of sale, the income is to be reported in installments, as payment is received. Form 6252 provides for the computation of income to be reported in the year of sale and in years after the year of sale. It also provides for the computation of installment sales between certain related parties required by Code section 453(e).
Current Actions: There are no changes being made to the form at this time.
Type of Review: Extension of a currently approved collection.
Affected Public: Business of other for-profit organizations, individuals or households, and farms.
Estimated Number of Respondents: 521,898.
Estimated Time per Respondent: 3 hrs., 4 minutes.
Estimated Total Annual Burden Hours: 1,597,008.

The following paragraph applies to all of the collections of information covered by this notice:
An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.
Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.
Request for Comments: Comments submitted in response to this notice will be summarized and/or included in the request for OMB approval. All comments will become a matter of public record. Comments are invited on: (a) Whether the collection of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility; (b) the accuracy of the agency's estimate of the burden of the collection of information; (c) ways to enhance the quality, utility, and clarity of the information to be collected; (d) ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or other forms of information technology; and (e) estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.
Approved: November 26, 2018.
Laurie Brimmer,
Senior Tax Analyst.
[PR Doc. 2018–26472 Filed 12–4–18; 8:45 am]
BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY
Internal Revenue Service
Proposed Collection; Comment Request for Form 13285–A
AGENCY: Internal Revenue Service (IRS), Treasury.
ACTION: Notice and request for comments.
SUMMARY: The Internal Revenue Service, as part of its continuing effort to reduce paperwork and respondent burden, invites the general public and other Federal agencies to take this opportunity to comment on proposed and/or continuing information collections, as required by the Paperwork Reduction Act of 1995. Currently, the IRS is soliciting comments concerning Form 13285–A, Reducing Tax Burden on America's Taxpayers.
DATES: Written comments should be received on or before February 4, 2019 to be assured of consideration.
ADDRESSES: Direct all written comments to Laurie Brimmer, Internal Revenue Service, Room 6526, 1111 Constitution Avenue NW, Washington, DC 20224.
FOR FURTHER INFORMATION CONTACT:
Requests for additional information or copies of the form and instructions should be directed to Lanita Van Dyke, at (202) 317–6099, at Internal Revenue Service, Room 6526, 1111 Constitution Avenue NW, Washington, DC 20224, or through the internet at Lanita.VanDyke@irs.gov.
SUPPLEMENTARY INFORMATION:
Title: Reducing Tax Burden on America’s Taxpayers.
Form Number: 13285–A.
Abstract: The IRS Office of Taxpayer Burden Reduction (TBR) needs the taxpaying public’s help to identify meaningful taxpayer burden reduction opportunities that impact a large number of taxpayers. This form should be used to refer ideas for reducing taxpayer burden to the TBR for consideration and implementation.
Current Actions: There are no changes being made to the form at this time.
Approved: November 27, 2018.
Laurie Brimmer,
Senior Tax Analyst.
[PR Doc. 2018–26468 Filed 12–4–18; 8:45 am]
BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY
Internal Revenue Service
Proposed Collection; Comment Request for Regulation Project
AGENCY: Internal Revenue Service (IRS), Treasury.
ACTION: Notice and request for comments.

SUMMARY: The Internal Revenue Service, as part of its continuing effort to reduce paperwork and respondent burden, invites the general public and other federal agencies to take this opportunity to comment on proposed and/or continuing information collections, as required by the Paperwork Reduction Act of 1995. Currently, the IRS is soliciting comments concerning an existing notice of proposed rulemaking and temporary regulations, Fi–255–82 (TD 7852), Registration Requirements With Respect to Debt Obligations (§5f.103–1(i)).

DATES: Written comments should be received on or before February 4, 2019 to be assured of consideration.

ADDRESSES: Direct all written comments to Laurie Brimmer, Internal Revenue Service, Room 6526, 1111 Constitution Avenue NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Requests for additional information or copies of the forms, instructions, and notice should be directed to LaNita Van Dyke, at (202) 317–6009, at Internal Revenue Service, Room 6526, 1111 Constitution Avenue NW, Washington, DC 20224, or through the internet at Lanita.VanDyke@irs.gov.

SUPPLEMENTARY INFORMATION:

Title: Registration Requirements With Respect to Debt Obligations.

OMB Number: 1545–0945.

Regulation Project Number: Fi–255–82.

Abstract: These regulations require an issuer of a registration-required obligation and any person holding the obligation as a nominee or custodian on behalf of another to maintain ownership records in a manner which will permit examination by the Internal Revenue Service in connection with enforcement of the Internal Revenue laws.

Current Actions: There is no change to this existing regulation.

Type of Review: Extension without change of a currently approved collection.

Affected Public: Business or other for-profit organizations and, state, local or tribal governments.

Estimated Number of Recordkeepers: 50,000.

Estimated Time Per Recordkeeper: 1 hour.

Estimated Total Annual Burden Hours: 50,000.

The following paragraph applies to all of the collections of information covered by this notice:

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number. Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Request for Comments: Comments submitted in response to this notice will be summarized and/or included in the request for OMB approval. All comments will become a matter of public record. Comments are invited on:

(a) Whether the collection of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility;

(b) the accuracy of the agency’s estimate of the burden of the collection of information;

(c) ways to enhance the quality, utility, and clarity of the information to be collected;

(d) ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or other forms of information technology; and

(e) estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

Approved: November 26, 2018.

Laurie Brimmer,
Senior Tax Analyst.

[FR Doc. 2018–26485 Filed 12–4–18; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

Proposed Collection; Comment Request for Form 5304–SIMPLE, Form 5305–SIMPLE, and Notice 98–4

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice and request for comments.

SUMMARY: The Internal Revenue Service, as part of its continuing effort to reduce paperwork and respondent burden, invites the general public and other Federal agencies to take this opportunity to comment on proposed and/or continuing information collections, as required by the Paperwork Reduction Act of 1995.

Currently, the IRS is soliciting comments concerning Form 5304–SIMPLE, Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—For Use With a Designated Financial Institution; Notice 98–4, SIMPLE IRA Plan Guidance.

DATES: Written comments should be received on or before February 4, 2019 to be assured of consideration.

ADDRESSES: Direct all written comments to Laurie Brimmer, Internal Revenue Service, Room 6526, 1111 Constitution Avenue NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Requests for additional information or copies of the forms, instructions, and notice should be directed to LaNita Van Dyke, at (202) 317–6009, at Internal Revenue Service, Room 6526, 1111 Constitution Avenue NW, Washington, DC 20224, or through the internet at Lanita.VanDyke@irs.gov.

SUPPLEMENTARY INFORMATION:

Title: Form 5304–SIMPLE, Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—For Use With a Designated Financial Institution; Form 5305–SIMPLE; Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—For Use With a Designated Financial Institution; Form 5305–SIMPLE; Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—For Use With a Designated Financial Institution; SIMPLE IRA Plan Guidance (Notice 98–4).

OMB Number: 1545–1502.

Form Number: Form 5304–SIMPLE, Form 5305–SIMPLE, and Notice 98–4.

Abstract: Form 5304–SIMPLE is a model SIMPLE IRA agreement that was created to be used by an employer to permit employees who are not using a designated financial institution to make salary reduction contributions to a SIMPLE IRA, described in Internal Revenue Code section 408(p). Form 5305–SIMPLE is also a model SIMPLE IRA agreement, but it is for use with a designated financial institutions. Notice 98–4 provides guidance for employers and trustees regarding how they can comply with the requirements of Code section 408(p) in establishing and maintaining a SIMPLE IRA, including information regarding the notification and reporting requirements under Code section 408.

Current Actions: There are no changes for the forms at this time.

Type of Review: Extension of a currently approved collection.

Affected Public: Business or other for-profit organizations not-for-profit institutions, and individuals.

Estimated Number of Respondents: 600,000.

Estimated Time per Respondent: 3 hours, 31 minutes.

Estimated Total Annual Burden Hours: 2,113,000.

The following paragraph applies to all of the collections of information covered by this notice:
Proposed and Temporary Regs Relate to Registration Requirements With Respect to Debt Obligations.

NOVEMBER 15, 1982

Citations: FI-255-82; T.D. 7852

REGISTRATION REQUIREMENTS WITH RESPECT TO DEBT OBLIGATIONS

Section 103 -- Tax-Exempt Interest
Section 163 -- Interest

SUMMARY BY TAX ANALYSTS
Summary Not Available

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: ** The Internal Revenue Service is issuing temporary regulations that relate to registration requirements with respect to debt obligations. The text of those temporary regulations also serves as the comment document for this proposed rulemaking.

DATES: Written comments and requests to speak at the public hearing must be delivered by January 14, 1983. The regulations are proposed to be effective generally with respect to obligations issued after December 31, 1982.

ADDRESS: Send comments and requests to speak at the public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T (FI-255-82), Washington, D.C. 20224.


SUPPLEMENTARY INFORMATION;

https://www.taxnotes.com/irs-proposed-regulations/%5Bcm%3Acategories%5D/proposed-... 12/7/2018
BACKGROUND

The temporary regulations [T.D. 7852], page 47, this Bulletin, add new part 5f to Title 26 of the Code of Federal Regulations. The final regulations, which this document proposes be based on those temporary regulations, would be added to Part 1 of Title 26 of the Code of Federal Regulations. Section 5f.103-1 would become Section 1.103-8(a)(7), Section 5f.163-1 would become Section 1.163-5, and Sections 5f.103-1 and 5f.163-1 would be deleted.

GENERAL RULE

The regulations provide rules as to what obligations must be registered. The regulations define registration and provide rules for certain Federal tax consequences that will apply if obligations issued after December 31, 1982, are not issued in registered form. The regulations are necessary because of the additions made to sections 103 and 163 by the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. 97-248, 96 Stat. 595). These regulations are proposed to be issued under the authority contained in sections 103(j), 163(f), and 7805 of the Internal Revenue Code (96 Stat. 596; 26 U.S.C. 103 (j); 96 Stat. 596, 26 U.S.C. 163(f); 68A Stat. 917, 26 U.S.C. 7805), and in section 310 of the Tax Equity and Fiscal Responsibility Act of 1982 (96 Stat. 595).

NON-APPLICABILITY OF EXECUTIVE ORDER 12291

The Commissioner has determined that this proposed regulation is not subject to review under Executive Order 12291 or the Treasury and OMB implementation of the Order dated April 28, 1982.

REGULATORY FLEXIBILITY ACT

Pursuant to 5 U.S.C. 605(b), the Secretary of the Treasury has certified that the requirements of the Regulatory Flexibility Act do not apply to this notice of proposed rulemaking as it will not have a significant economic impact on a substantial number of small entities. The impact of the requirement that debt obligations be issued in registered form on both small and large issuers is due to requirements imposed directly by the statute. In the areas in which the Service has been given significant discretion under the statute, the Service has exercised its discretion so as to minimize the potential impact while ensuring compliance with the statute. For example, the requirement of registration of an obligation will be satisfied where the owner of the obligation can be ascertained through a book entry system. The regulations are liberal in permitting the use of book entry registration, thereby reducing the cost to issuers of issuing obligations in registered form.

* * * * *

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

https://www.taxnotes.com/irs-proposed-regulations/%5Bcm%3Acategories%5D/proposed-... 12/7/2018
Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably six copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. ** * 

Roscoe L. Egger, Jr.,
Commissioner of Internal Revenue.

**TREASURY DECISION 7852**

**TITLE 26--INTERNAL REVENUE.--CHAPTER I, SUBCHAPTER A,**

**PART 5f--TEMPORARY INCOME TAX REGULATIONS UNDER THE**

**TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982**

(Pub. L. 97-248)

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary regulations.

SUMMARY: This document provides temporary regulations with respect to the requirement that debt obligations be issued in registered form. Changes to the applicable tax law were made by section 310 of the Tax Equity and Fiscal Responsibility Act of 1982 [Pub. L. 97-248, page 462, 558, this Bulletin]. The regulations affect issuers and holders of obligations, and provide them with the guidance needed to comply with the law. In addition, these temporary regulations serve as the text of the proposed regulations [FI-255-82], page 934, this Bulletin.

DATE: Generally, the regulations apply to obligations issued after December 31, 1982.


**SUPPLEMENTARY INFORMATION:**

**BACKGROUND**

This document contains temporary regulations relating to the requirement that certain debt obligations be issued in registered form under sections 103 and 163 of the Internal Revenue Code of 1954, as amended by the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. 97-248, 96 Stat. 595). Further, a new Part 5f, Temporary Income Tax Regulations under the Tax Equity and Fiscal Responsibility Act of 1982, is added by this document to Title 26 of the Code of Federal Regulations. The temporary regulations provided by this document will remain in effect until superseded by final regulations on this subject.
RULES

The temporary regulations provide generally that any obligation issued after December 31, 1982, must be issued in registered form. If an obligation issued after December 31, 1982, is not issued in registered form, the issuer will be denied a deduction for interest paid or accrued on such obligation. Further, interest on an obligation issued after such date that otherwise would be exempt from tax will not be tax exempt unless the obligation is issued in registered form. The regulations provide examples of certain obligations that are not required to be registered.

The temporary regulations provide that an obligation is issued in registered form if the transfer of the obligation can only be effected by the surrender of the old instrument to the issuer and either reissuance of the old instrument or issuance of a new instrument to the new holder. An obligation is also considered issued in registered form if the right to the principal of, and any stated interest on the obligation can be transferred only through a book entry system. A book entry is a record of the ownership of an obligation.

On September 15, 1982, the Service issued a news release soliciting comments on provisions of the Tax Equity and Fiscal Responsibility Act of 1982 relating to the requirement of registration of debt obligations. The Service has received numerous comments, all of which have been carefully considered in the preparation of these regulations. In addition, persons are encouraged to make written comments by mail and oral comments at the public hearing.

NON-APPLICABILITY OF EXECUTIVE ORDER 12291

The Commissioner has determined that this temporary regulation is not a major rule subject to review under Executive Order 12291 or the Treasury and OMB implementation of the Order dated April 28, 1982.

REGULATORY FLEXIBILITY ACT

No general notice of proposed rulemaking is required by 5 U.S.C. Section 553(b) for temporary regulations. Accordingly, the Regulatory Flexibility Act does not apply and no Regulatory Flexibility Analysis is required for these rules.

DRAFTING INFORMATION

The principal author of these proposed regulations is Diane L. Kroupa of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.
Adoption of amendments to the regulation

Accordingly, Part 5f, Temporary Income Tax Regulations under the Tax Equity and Fiscal Responsibility Act of 1982, is amended by adding new Sections 5f.103-1 and 5f.163-1 immediately before Section 5f.168(f)(8)-1, to read as follows:

Section 5f.103-1 Obligations issued after December 31, 1982, required to be in registered form.

(a) Registration; general rule. Interest on a registration-required obligation (as defined in paragraph (b) of this section) shall not be exempt from tax notwithstanding section 103(a) or any other provision of law, exclusive of any treaty obligation of the United States, unless the obligation is issued in registered form (as defined in paragraph (c) of this section).

(b) Registration-required obligation. For purposes of this section, the term "registration-required obligation" means any obligation except any one of the following:

(1) An obligation not of a type offered to the public. The determination as to whether an obligation is not of a type offered to the public shall be based on whether similar obligations are in fact publicly offered or traded.

(2) An obligation that has a maturity at the date of issue of not more than 1 year.

(3) An obligation issued before January 1, 1983. An obligation first issued before January 1, 1983, shall not be considered to have been issued on or after that date merely as a result of the existence of a right on the part of the holder of such obligation to convert the obligation from registered form into bearer form, or as a result of the exercise of such a right.

(4) An obligation described in Section 5f.163-1(c) (relating to certain obligations issued to foreign persons).

(c) Registered form.--(1) General rule. An obligation is in registered form if--

(i) The obligation is registered as to both principal and any stated interest and transfer of the obligation may be effected only by the surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder, or

(ii) The right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system (as described in paragraph (c)(2) of this section).
(2) Special rule for registration of a book entry obligation. An obligation shall be considered transferable through a book entry system if the ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an interest in the obligation.

(d) Effective date. The provisions of this section shall apply to obligations issued after December 31, 1982, unless issued on an exercise of a warrant for the conversion of a convertible obligation if such warrant or obligation was offered or sold outside the United States without registration under the Securities Act of 1933 and was issued before August 10, 1982.

(e) Obligations first issued after December 31, 1982, where the right exists for the holder to convert such obligation from registered form into bearer form. [Reserved]

(f) Examples. The application of this section may be illustrated by the following examples:

Example (1). Municipality X publicly offers its general debt obligations to United States persons. The obligations have a maturity at issue exceeding 1 year. The obligations are registration-required obligations under Section 5f.103-1(b). When individual A buys an obligation, X issues an obligation in A's name evidencing A's ownership of the principal and interest under the obligation. A can transfer the obligation only by surrendering the obligation to X and by X issuing a new instrument to the new holder. The obligation is issued in registered form.

Example (2). Municipality Y issues a single obligation on January 4, 1983, in bearer form, to Bank M provided that (i) Bank M will not at any time transfer any interest in the obligation to any person unless the transfer is recorded on Municipality Y's records (except by means of a transfer permitted in (ii) of this example), and (ii) interests in the obligation that are sold by Bank M (and any persons who acquire interests from M) will be reflected in book entries. C, an individual, buys an interest in Y's obligation from Bank M. Bank M records such transfer by reflecting C's ownership on Bank M's books. Bank M receives the interest or principal payments with respect to C's interest in the obligation as agent for book entry system. Since C's interest can only be transferred through a book entry system, the obligation is considered issued in registered form. Interest received by C is excludable from gross income under section 103(a).

Example (3). Municipality Z wishes to sell its debt obligations having a maturity in excess of 1 year. The obligations are sold to Bank N, O, and P, all of which are located in Municipality Z. By their terms the obligations are freely transferable, although each of the banks has stated that it acquired the obligations for purposes of investment and not for resale. Obligations similar to the obligations sold by Municipality Z are traded in the market for municipal securities. The obligations issued by Municipality Z are of a type offered to the public and are therefore registration-required under Section 5f.103-1(b).
(g) Cross-references. See section 103A(j)(1) for the registration requirement of certain mortgage subsidy bonds issued after December 31, 1981, and Section 6a.103A-1(a)(5) for the definition of registered form for such obligations issued after December 31, 1981, and on or before December 31, 1982. See also section 103(h) (requiring registration of certain energy bonds issued on or after October 18, 1979).

Section 5f.163-1 Denial of interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form.

(a) Denial of deduction generally. Interest paid or accrued on a registration-required obligation (as defined in paragraph (b) of this section) shall not be allowed as a deduction under section 163 or any other provision of law unless such obligation is issued in registered form (as defined in Section 5f.103-1(c)).

(b) Registration-required obligation. For purposes of this section, the term "registration-required obligation" means any obligation except any one of the following:

(1) An obligation issued by a natural person.

(2) An obligation not of a type offered to the public. The determination as to whether an obligation is not of a type offered to the public shall be based on whether similar obligations are in fact publicly offered or traded.

(3) An obligation that has a maturity at the date of issue of not more than 1 year.

(4) An obligation issued before January 1, 1983. An obligation first issued before January 1, 1983, shall not be considered to have been issued on or after such date merely as a result of the existence of a right on the part of the holder of such obligation to convert such obligation from registered form into bearer form, or as a result of the exercise of such a right.

(5) An obligation described in subparagraph (1) of paragraph (c) (relating to certain obligations issued to foreign persons).

(c) Obligations issued to foreign persons--(1) General rule. An obligation is described in this subparagraph if--

(i) There are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with its original issuance) only to a person who is not a United States person, and

(ii) In the case of an obligation which is not in registered form--

(A) Interest on such obligation is payable only outside the United States and its possessions, and
(B) On the face of such obligations there is a statement that any United States person who holds such obligation will be subject to limitations under the United States income tax laws, including the limitations provided in sections 165(j) and 1232(d).

(2) Rules for application of this paragraph—(i) Obligations which satisfy paragraph (c)(1)(i) of this section; conversion into bearer or registered form. An obligation, whether originally issued in registered or bearer form, which satisfies the requirements of paragraph (c)(1)(i) of this section will not constitute a registration-required obligation, regardless of whether it is converted from bearer into registered form or from registered into bearer form, if at all times during which such obligation is in bearer form it also satisfies the requirements of paragraph (c)(1)(ii)(A) and (B) of this section. Failure of such an obligation to satisfy the requirements of paragraph (c)(1)(ii)(A) and (B) of this section during such time that the obligation is in registered form will not cause the obligation to be a registration-required obligation.

(ii) Obligation in registered form which do not satisfy paragraph (c)(1)(i) of this section; conditions under which such obligations may be converted into bearer form. [Reserved]

(iii) Arrangements reasonably designed to ensure sale to non-United-States persons. An obligation for which there are arrangements reasonably designed to ensure that it will be sold (or resold in connection with its original issuance) only to a person who is not a United States person shall include an obligation offered for sale outside the United States which, in connection with its issuance, need not be registered under the Securities Act of 1933 because such obligation is intended for distribution to persons who are not United States persons. For this purpose, an obligation sold to a United States persons within or without the United States on the basis of the exemption of section 4(2) of the Securities Act of 1933 shall not be considered to be intended for distribution to persons who are not United States persons. An obligation which is offered for sale outside the United States will not be considered to be required to be registered under the Securities Act of 1933 if the issuer, in reliance on the advice of independent counsel received prior to the issuance thereof, determines in good faith that the obligation need not be registered under the Securities Act of 1933 for the reason that it is intended for distribution to persons who are not United States persons.

(iv) Interest payable outside the United States. Interest will be considered to be payable only outside the United States or its possessions if payment of such interest only can be made upon presentation of a coupon, or upon the making of any other demand for payment, outside the United States and its possessions to the issuer or a paying agent. The fact that payment is made by a draft on a United States bank, by a wire transfer from a United States account, or by a direct transfer of funds into an account maintained by the payee in the United States does not affect this result. However, interest is considered to be paid within the United States or its possessions if a coupon is presented, or a demand for payment is otherwise made, to the issuer or a paying agent (whether a United States or foreign person) in the United States or its possessions even if the funds
paid are credited to an account maintained by the payee outside the United States or its possessions.

(v) Determination on obligation-by-obligation basis. A determination of whether an obligation satisfies each of the requirements of paragraphs (c)(1)(i) and (ii)(A) and (b) of this section shall be made on an obligation-by-obligation basis.

(d) Effective date. The provisions of this section shall apply to obligations issued after December 31, 1982, unless issued on an exercise of a warrant for the conversion of a convertible obligation if such warrant or obligation was offered or sold outside the United States without registration under the Securities Act of 1933 and was issued before August 10, 1982.

(e) Obligations first issued after December 31, 1982, where the right exists for the holder to convert such obligation from registered form into bearer form. [Reserved]

(f) Examples. The application of this section may be illustrated by the following examples:

Example (1). All of the shares of Corporation X are owned by two individuals, A and B. X desires to sell all of its assets to Corporation Y, all of the shares of which are owned by individual C. Following the sale, Corporation X will be completely liquidated. As partial consideration for the Corporation X assets, Corporation Y delivers a promissory note to X, secured by a security interest and mortgage on the acquired assets. The note given by Y to X is not of a type offered to the public.

Example (2). Corporation Z has a credit agreement with Bank M pursuant to which Corporation Z may borrow amounts not exceeding $10X upon delivery of Z's note to Bank M. The note Z delivers to M is not of a type offered to the public.

Example (3). Individuals D and E operate a retail business through partnership DE. D wishes to loan partnership DE $5X. DE's note evidencing the loan from D is not of a type offered to the public.

Example (4). Individual F owns one-third of the shares of Corporation W. F makes a cash advance to W. W's note evidencing F's cash advance is not of a type offered to the public.

Example (5). Closely-held Corporation R places its convertible debentures with 30 individuals who are United States persons. The offering is not required to be registered under the Securities Act of 1933. Similar debentures are publicly offered and traded. The obligations are not considered of a type not offered to the public.
Example (6). In 1980, Corporation V issued its bonds due in 1986 through an offering registered with the Securities and Exchange Commission. Although the bonds were initially issued in registered form, the terms of the bonds permit a holder, at his option, to convert a bond into bearer form at any time prior to maturity. Similarly, a person who holds a bond in bearer form may, at any time, have the bond converted into registered form.

(i) Assume G bought one of Corporation V's bonds upon the original issuance in 1980. In 1983, G requests that V convert the bond into bearer form. Except for the change from registered to bearer form, the terms of the bond are unchanged. The bond held by G is not considered issued after December 31, 1982, under Section 5f.163-1(b)(4).

(ii) Assume H buys one of Corporation V's bonds in the secondary market in 1983. The bond H receives is in registered form, but H requests that V convert the obligation into bearer form. There is no other change in the terms of the instrument. The bond held by H is not considered issued after December 31, 1982, under Section 5f.163-1(b)(4).

(iii) Assume the same facts as in (ii) except that in 1984 I purchases H's V Corporation bond, which is in bearer form. I requests V to convert the bond into registered form. There is no other change in the terms of the instrument. In 1985, I requests V to convert the bond back into bearer form. Again, there is no other change in the terms of the instrument. The bond purchased by I is not considered issued after December 31, 1982, under Section 5f.163-1(b)(4).

Example (7). Corporation U wishes to make a public offering of its debentures to United States persons. U issues a master note to Bank N. The terms of the note require that any person who acquires an interest in the note must have such interest reflected in a book entry. Bank N offers for sale interests in the Corporation U note. Ownership interests in the note are reflected on the books on Bank N. Corporation U's debenture is considered issued in registered form.

Example (8). Issuer S wishes to make a public offering of its debt obligations to United States persons. The obligation will have a maturity in excess of one year. On November 1, 1982, the closing on the debt offering occurs. At the closing the net cash proceeds of the offering are delivered to S, and S delivers a master note to the underwriter of the offering. On January 2, 1983, S delivers the debt obligations to the purchasers in definitive form and the master note is cancelled. The obligations are not registration-required because they are considered issued before January 1, 1983.

Example (9). In July 1983, Corporation T sells an issue of debt obligations maturing in 1985 to the public in the United States. Three of the obligations of the issue are issued to J in bearer form. The balance of the obligations of the issue are issued in registered form. The terms of the registered and bearer obligations are identical. The obligations issued to J are of a type offered to the public and are registration-required obligations. Since the three obligations are issued in bearer form, T is
subject to the tax imposed under section 4701 with respect to the three bearer obligations. In addition, interest paid or accrued on the three bearer obligations is not deductible by T. Moreover, since the issuance of the three bearer obligations is subject to tax under section 4701, J is not prohibited from deducting losses on the obligations under section 165(j) or from treating gain on the obligations as capital gain under section 1232(d). The balance of the obligations in the issue do not give rise to liability for the tax under section 4701, and the deductibility of interest on such obligations is not affected by section 163(f).

Example (10). Broker K acquires a bond issued in 1980 by the United States Treasury through the Bureau of Public Debt. Broker K sells interests in the bond to the public after December 31, 1982. A purchaser may acquire an interest in any interest payment falling due under the bond or an interest in the principal of the bond. The bond is held by Custodian L for the benefit of the persons acquiring these interests. On receipt of interest and principal payments under the bond, Custodian L transfers the amount received to the person whose ownership interest corresponds to the bond component giving rise to the payment. Under section 1232B, each bond component is treated as an obligation issued with original issue discount equal to the excess of the stated redemption price at maturity over the purchase price of the bond component. The interests sold by K are obligations of a type offered to the public. Further, the interests are, in accordance with section 1232B, considered issued after December 31, 1982. Accordingly, the interests are registration-required obligations under Section 5f.163-1(b).

There is a need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason, it is found impracticable to issue it with notice and public procedure under subsection (b) of section 553 of title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

This Treasury decision is issued under the authority contained in sections 103(j), 163(f), and 7805 of the Internal Revenue Code of 1954 (96 Stat. 596, 26 U.S.C. 103(j); 96 Stat. 596, 26 U.S.C. 163(f); 68A Stat. 917, 26 U.S.C. 7805), and in section 310 of the Tax Equity and Fiscal Responsibility Act of 1982 (96 Stat. 595).

Roscoe L. Egger, Jr.,
Commissioner of
Internal Revenue

Approved November 6, 1982.
John E. Chapoton,
Assistant Secretary
of the Treasury.
MESSAGE FROM THE TE/GE COMMISSIONERS

This Program Letter shares with you where we are heading in the new fiscal year, including executing compliance strategies, building better processes, and providing useful information and guidance on the Tax Cuts and Jobs Act (TCJA). As we did last year, we will provide a full review of our FY 2018 accomplishments during the first quarter of FY 2019.

TE/GE has made tremendous progress in empowering our taxpayers with the launch of Tax Exempt Organizations Search (TEOS), more options to use Pay.gov, the introduction of secure messaging with taxpayers and practitioners in our Tax Exempt Bonds (TEB) program, and additional guidance – including a number of innovative short videos – to make it easier for Indian Tribal Government (ITG) taxpayers and their representatives to understand and comply with the law. In FY 2019, we expect to expand our use of Pay.gov and our use of secure messaging with taxpayers and practitioners into our Employee Plans (EP) program. We also will continue an ambitious schedule of additional informational videos, articles and outreach events.

We continue to refine our compliance strategy approach, which is designed to ensure that TE/GE’s examination programs are focused on the highest priority compliance areas to promote effective tax administration. Throughout FY 2018, TE/GE gained significant experience with the issue submission portal, developed compliance strategies and stocked our virtual shelf with approved compliance strategy cases. As we expected, FY 2018 was not without some growing pains. However, by the end of the year, we resolved many of these issues and will keep doing so in FY 2019.

TE/GE collaborates with our IRS business partners and various other groups and agencies, such as the Advisory Committee on Tax Exempt and Government Entities, the U.S. Department of Labor, the Municipal Securities Rulemaking Board, and the Securities and Exchange Commission. We work closely with our partners in law enforcement on high-profile tax fraud cases. Internally, we partner with other business units, including the Small Business/Self-Employed (SB/SE) Lead Development Center and the Servicewide Promoter program to counter fraud and abuse. In FY 2019, our internal and external partnering efforts will expand to further educate taxpayers and help them to meet their tax obligations.

TE/GE leadership places a high priority on cultivating our workforce, which is our most important asset. TE/GE’s Knowledge Management (KM) team has made significant enhancements to our Knowledge Networks (K-Nets) to make it easier for employees to search the K-Nets and find the resources they need. We also took steps in Exempt Organizations (EO) to provide “walk-in” assistance to consult with a subject matter expert on difficult technical issues. For the first time this decade, TE/GE is onboarding a significant number of new hires. In addition to bringing in the new hires and equipping them to engage fully in our work, we will continue to cross-train employees to allow flexibility in directing resources to shifting needs. In FY 2019, we will leverage our knowledge and experience to identify emerging issues and risks, and support employees in performing their jobs. We will do this by consistently providing high quality technical expertise through K-Nets and just-in-time training to support successful compliance strategies. K-Nets will focus on supporting our employees on compliance strategies with training, technical expertise and job aids. We plan to expand the “walk-in” approach beyond EO and will seek input on how to enhance our K-Net SharePoint sites and training.
TE/GE continually seeks to advance data and analytics to drive decisions about identifying and addressing existing and emerging high-risk areas of noncompliance to which it applies optimal resources. TE/GE has partnered with Research, Applied Analytics, and Statistics (RAAS) to design and test data-driven approaches to identify noncompliance in both EO and EP. We also took some initial steps to introduce new tools to visualize data to make it easier to identify opportunities to enhance our operations throughout TE/GE. In FY 2019, our partnership with RAAS will expand to include testing new approaches to identify noncompliance in TEB. We also anticipate broadening access for our managers and analysts to new visualization tools, which are becoming an industry standard.

The TCJA will remain a priority in FY 2019. We have completed numerous form revisions, as well as guidance and training related to TCJA, and anticipate more developments in these areas going forward. It is imperative that we help taxpayers with their tax obligations, under both the new and pre-existing tax laws. We will initiate additional education efforts in FY 2019 along with TCJA-related compliance strategies.

In this new fiscal year, we will evaluate the six areas of our compliance program (defined on the following page) and identify opportunities to become more effective and efficient.

- As part of our compliance strategy process, we consider the most appropriate, cost-effective and least intrusive compliance treatments, including educational efforts, soft letter compliance reviews, compliance checks, and correspondence or field examinations. We will expand our capacity for highly efficient, low taxpayer-burden compliance checks with additional compliance units designed to be flexibly applied across TE/GE’s compliance strategies, regardless of program.

- EO will encourage tax compliance for exempt organizations and federal, state and local governments through our examination programs. We will develop tools and educational resources to assist our stakeholders. We will continue to evaluate our determination processes to ensure we are operating in an efficient and effective manner. EO will hire and cross-train revenue agents to create an agile workforce so we can quickly allocate resources in response to inventory needs.

- EP will foster compliance through its robust voluntary corrections program, issue informal guidance in the form of Lists of Required Modifications (LRMs) to assist plan sponsors with plan document compliance and continue to update Fix-It Guides to assist with operational compliance. EP also will review input from the qualified plans community on the potential expansion of the scope of the determination letter program for amended individually designed plans (IDP) as well as the self-correction of plan qualification failures.

TE/GE’s culture embraces change. We work in a dynamic environment, which we accept as a catalyst for innovation and improvement. We strive to ensure that tax-exempt and government entities are well-served and able to meet their tax responsibilities.

As always, we welcome your feedback and your support for effective tax administration.

Dave & Rob
Fiscal Year 2019 Compliance Program:

TE/GE delivers a compliance platform that is divided into six portfolio programs: Compliance Strategies; Data-Driven Approaches; Referrals, Claims and Other Casework; Compliance Contacts; Determinations; and Voluntary Compliance and Other Technical Programs. Data is used to identify and address existing and emerging high-risk areas of noncompliance and steer decisions to optimally apply resources.

Compliance Strategies ........................................................................................................ 4
Compliance Strategies are issues approved by TE/GE's Compliance Governance Board to identify, prioritize and allocate resources within the TE/GE taxpayer base. Using a web-based portal, TE/GE employees submit suggestions for consideration by the Board. Once approved, these issues are considered priority work. As more issues are developed and approved, those with a higher priority may potentially replace Compliance Strategies currently set forth in this document.

Data-Driven Approaches ...................................................................................................... 6
Data-Driven Approaches use data, models and queries to select work based on quantitative criteria, which allows TE/GE to allocate resources that focus on issues that have the greatest impact. TE/GE is committed to integrating data into its processes and procedures, and will use return data and historical information to identify the highest risk areas of noncompliance.

Referrals, Claims and Other Casework .............................................................................. 7
Referrals allege noncompliance by a TE/GE entity and are received from sources within and outside the IRS. Claims are requests for refunds or credits of overpayments of amounts already assessed and paid; they can include tax, penalties, and interest or an adjustment of tax paid or credit not previously reported or allowed.

Compliance Contacts .......................................................................................................... 8
Compliance Units are employed to address potential noncompliance, primarily using correspondence contacts known as "compliance checks" and "soft letters." These contacts allow TE/GE to establish a presence in the taxpayer community in a manner that reduces taxpayer burden and cost to the IRS.

Determinations ..................................................................................................................... 9
Determination letters are issued to exempt organizations on exempt status, private foundation classification and other determinations relating to exempt organizations, and to retirement plans that satisfy the qualification requirements of federal pension law.

Voluntary Compliance and Other Technical Programs ......................................................... 9
The Voluntary Correction Program (VCP) enables a plan sponsor (at any time before audit) to pay a fee and receive IRS approval for correction of plan failures. Knowledge Management works to ensure the quality and consistency of technical positions, provide timely assistance to employees, and preserve and share TE/GE's knowledge base.
Compliance Strategies are issues approved by TE/GE’s Compliance Governance Board to identify, prioritize and allocate resources within the TE/GE taxpayer base. Using a web-based portal, TE/GE employees submit suggestions for consideration by the Board. Once approved, these issues are considered priority work. Below we share some of the strategies that the Board has approved to date. As more issues are developed and approved, those with a higher priority may potentially replace Compliance Strategies currently set forth in this document. In this manner, TE/GE continuously ensures it is focused on the highest known priorities and emerging risks. If you are interested in learning more about the technical issues discussed below, search for the key term in the search box of the IRS.gov website.

Exempt Organizations

- Internal Revenue Code (IRC) Section 501(c)(7) entities: focus on investment income, non-member income and non-filers of Form 990-T, Exempt Organization Business Tax Return, by tax-exempt social clubs.
- IRC Section 4947(a)(1) Non-Exempt Charitable Trusts (NECTs): focus on organizations that under-report income or over-report charitable contributions.
- Previous for-profit: focus on organizations formerly operated as for-profit entities prior to their conversion to IRC Section 501(c)(3) organizations.
- Self-dealing by private foundations: focus on organizations with loans to disqualified persons.
- Early retirement incentive plans: determine whether federal, state or local governmental entities that provide cash (and other) options to employees as an incentive for early retirement have applied proper tax treatment to these benefits.
- Forms W-2/1099 matches: compare payments reported on Form 1099-Misc., Miscellaneous Income, with wages reported on Form W-2, Wage and Tax Statement, and subject to Federal Insurance Contribution Act (FICA) tax and income tax withholding.
- Notice CP 2100 (backup withholding): determine whether mismatched and/or missing taxpayer identification numbers on Form 1099 indicate failure to comply with backup withholding requirements.
- Worker classification (misclassified workers): determine whether misclassified workers result in incorrectly treating employees as independent contractors.

Employee Plans

- Distributions: verify that plans are following correct distribution processes and procedures and that participants are receiving correct distribution amounts.
- Form 5500, Annual Return/Report of Employee Benefit Plan, and Form 5500-SF, Short Form Annual Return/Report of Small Employee Benefit Plan, stop filers: contact employers sponsoring plans that did not file one or more required returns.
- IRC Section 403(b)/457 plans: examine 403(b) plans for universal availability, excessive contributions and proper use of catch-up contributions under IRC Section 414(v); and 457(b) plans for excessive contributions and proper use of the special three-year catch-up contribution rule.
- Small plans with large assets: determine whether smaller plans with trusts holding large assets have taken deductions on Form 1120, U.S. Corporation Income Tax Return, exceeding IRC Section 404 limitations.
- Simplified Employee Pension (SEP) plans: determine whether accounts violated maximum participant rules, failed to meet statutory and matched employer contribution requirements, and/or failed to meet IRC Section 416(i)(6) top-heavy requirements.
- Terminated cash balance plans: examine terminated plans with cash balance features that may have exceeded IRC Section 415 limitations or generated a reversion which is subject to an excise tax.
Indian Tribal Governments/Tax Exempt Bonds

- Cost of issuance: determine whether the costs of issuance (COI) on private activity bonds exceeds 2 percent of the proceeds of the issue, which adversely affects the tax-exempt status of the bond.
- Forms W-2/1099 matches: determine whether payments reported on Form 1099 should have been treated as wages reported on Form W-2 and, therefore, subject to FICA tax and income tax withholding.
- Notice CP 2100 (backup withholding): entities may have failed to comply with backup withholding requirements due to mismatched and/or missing taxpayer identification numbers on Form 1099.
- Notice of defeasance: bond issuers may have taken remedial actions under (1) Treasury Regulation Section 1.141-12, or (2) Treasury Regulation Section 1.142-2 without meeting all requirements under the applicable regulations.
- Public safety bonds: determine whether federal government use and management contracts cause excessive private business use that adversely affects the tax-exempt status of public safety bonds.
Data-Driven Approaches

Data-Driven Approaches use data, models and queries to select work based on quantitative criteria, which allows TE/GE to allocate resources that focus on issues that have the greatest impact. TE/GE is committed to integrating data into its processes and procedures, and will use return data and historical information to identify the highest risk areas of noncompliance.

Exempt Organizations

- Models: continue to improve compliance models based on Form 990, Return of Organization Exempt From Income Tax; Form 990-EZ, Short Form Return of Organization Exempt From Income Tax; and Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation; and test the newly developed model for Form 5227, Split Interest Trust Information Return. Also, identify returns of exempt organizations and government entities containing the highest risk of employment tax noncompliance (e.g., substantial credit balances with no returns or zero to minimal Medicare and/or Social Security wages paid compared to Form 1099 distributions).

- RAAS collaboration: continue to review various items and activities, including private benefit/inurement, officer business partnerships, underreported credit card income, and related employees and for-profit partnerships.

Employee Plans

- RAAS collaboration: sample the results of data queries and models to test indicators of noncompliance for various plan types (e.g., profit sharing, money purchase, 401(k) and defined benefit).

Indian Tribal Governments/Tax Exempt Bonds

- RAAS collaboration: continue to develop models for Form 9038, Information Return for Tax-Exempt Private Activity Bond Issuers, and Form 8038-G, Information Return for Tax-Exempt Government Obligations, by sampling the results of data queries and models designed to test indicators of noncompliance.
Referrals, Claims and Other Casework

Referrals allege noncompliance by a TE/GE entity and are received from internal and external sources. Claims are requests for refunds or credits of overpayments of amounts already assessed and paid; they can include tax, penalties, and interest or an adjustment of tax paid or credit not previously reported or allowed. The public can submit a referral on individuals or businesses on Form 3949-A, Information Referral, or submit a specialized EJ referral on Form 13909, Tax-Exempt Organization Complaint.

Exempt Organizations

- Referrals: continue to pursue referrals received from internal and external sources that allege noncompliance by an exempt organization, and pursue taxpayer and interagency referrals, including information items from sources within and outside the IRS that allege noncompliance with employment tax law by a government entity or an exempt organization.
- Claims: continue to address requests for refunds or credits of overpayments of amounts already assessed and paid, including tax, penalties, interest, or an adjustment of tax paid or credit not previously reported or allowed; and also continue to address high-dollar, complex employment tax claims filed by federal, state and local governments.
- Other casework: continue to examine entities that filed and received exemption using Form 1023-EZ, Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. The scope of these exams will include (1) filers who are ineligible to file Form 1023-EZ, (2) filers who donate to (or pay expenses for) individuals, and (3) filers operating bingo or other gaming activities. Additionally, support Servicewide compliance efforts on IRC Section 4980H with respect to certain exempt employers.

Employee Plans

- Referrals: continue to pursue referrals received from internal and external sources that allege possible noncompliance by a retirement plan.
- Claims: continue to address requests for refunds or credits of overpayments of amounts already assessed and paid. These claims can include tax, penalties, and interest or they can also be a request for an adjustment of tax paid or credit not previously reported or allowed.
- Other casework: continue to address requests from plan sponsors to waive their minimum funding requirement for a plan year, review exit bank trustees (NBT) to verify that they have satisfied the NBT regulations and pursue promoter investigations.

Indian Tribal Governments/Tax Exempt Bonds

- Referrals: continue to prioritize referrals received from internal and external sources warranting examination resources that allege possible noncompliance by an ITG or TEB entity.
- Claims: continue to address claims for overpayment of rebates and claims for credit payments on Direct Pay Bonds, as well as employment tax claims filed by an ITG.
- Other casework: continue to maintain the program to ensure tip reporting compliance of ITG entities and their tipped employees, including (1) securing tip agreements, (2) refreshing expiring tip agreements, (3) revoking tip agreements on non-compliant agreement holders, and (4) conducting tip examinations for entities with low tip reporting and no tip agreements. In addition, ITG/TEB will continue, in appropriate circumstances, to convert casinos using the Tip Rate Determination Agreement (TRDA) to the industry-specific Gaming Industry Tip Compliance Agreement (GITCA). ITG/TEB will conduct tip compliance reviews for entities failing to comply with year-end reporting requirements.
Compliance Contacts

Compliance Units are employed to address potential noncompliance, primarily using correspondence contacts known as "compliance checks" and "soft letters."

A compliance check is correspondence with organizations to inquire about an item on a filed return; to determine if specific reporting requirements have been met; or to determine whether an organization's activities are consistent with its stated tax-exempt purpose. A compliance check is not considered an examination.

A soft letter is correspondence with organizations that provides notification of changes in tax-exempt law or compliance issues. A response to these letters is not expected. However, responses may be received and converted into a compliance check. These contacts allow TE/GE to establish a presence in the taxpayer community in a manner that reduces burden to the taxpayer and cost to the IRS.

TE/GE will continue to inform taxpayers via compliance checks and soft letters on issues of noncompliance, while seeking to improve return filings and filing accuracy, as described below:

- To determine whether an exempt organization, Indian tribal government, or federal, state and local governmental entity is adhering to recordkeeping and information reporting requirements, including:
  - Combined Annual Wage Reporting (CAWR) Employment Tax: tax-exempt employers that had discrepancies between Form W-2 and either Form 941, Employer's Quarterly Federal Tax Return, or Form 944, Employer's Annual Federal Tax Return.
  - CAWR – Federal Unemployment Tax Act (FUTA): exempt organizations that are required to, but fail to file Form 940, Employer’s Annual Federal Unemployment Tax Return.
  - Financial Assistance Policy (FAP): tax-exempt hospital organizations that did not comply with IRC Section 501(r)(4).
  - Form 990-T Non-Filer: IRC Section 501(c)(7) organizations that reported investment income on Form 990/990-EZ but did not file Form 990-T.
  - Form 1099 Stop-Filer: entities that were required to file, but fail to file Form 1099-Misc.
  - IRC Section 501(c)(12) Mutual or Cooperative Telephone Companies: organizations that may have failed to meet the 85 percent member income test.
  - IRC Section 4947(a)(1) Non-Exempt Charitable Trusts (NECTs): exempt organizations that are required to file, but fail to file Form 1041, U.S. Income Tax Return for Estates and Trusts.
  - Supporting Organizations: entities that state they are supporting organizations but they have filed Form 990-N, Annual Electronic Filing Requirement for Small Exempt Organizations.

- To determine whether a retirement plan is adhering to recordkeeping and information reporting requirements, including:
  - Deductions in excess of 25 percent of compensation.
  - Voluntary compliance (VC) 150-day compliance statement follow-ups.
  - SEP-IRA plans with required minimum distribution failures.
  - Stop filers of Form 5500/5500-SF.
Determinations

Determination letters are issued to exempt organizations on exempt status, private foundation classification and other determinations relating to exempt organizations, and to retirement plans that satisfy the qualification requirements of federal pension law.

EO expects a continued increase in determination applications and will concentrate on identifying new strategies for reducing filing burden and case processing time. EO will also hire approximately 40 new revenue agents to process determination applications to help offset application increases and workforce attrition.

EP will continue to accept individually designed plan (IDP) applications for both initial plan and terminating plan submitters. EP continues to review input from the qualified plans community on the potential expansion of the scope of the determination letter program for amended IDPs. The due date for defined contribution pre-approved plans (PAP) is December 31, 2018. Employee Stock Ownership Plans (ESOPs) will be permitted under the PAP program for the first time.

Voluntary Compliance and Other Technical Programs

VCP enables a plan sponsor (at any time before audit) to pay a fee and receive IRS approval for correction of plan failures. KM works to ensure the quality and consistency of technical positions, provide timely assistance to employees, and preserve and share TE/GE's knowledge base.

EP is exploring implementation of a fully electronic submission process for VCP. If successful, we will publicize the changes through (1) communications with the plan sponsor and pension practitioner communities, and (2) updates to the Employee Plans Compliance Resolution System (EPCRS) revenue procedure. EP continues to review input from the qualified plans community on the potential expansion of self-correction of plan qualification failures under the EPCRS program.

In addition, EP will focus on actuarial letter rulings, 60-day rollover waivers and technical assistance work for its taxpayers.
Caution: DRAFT—NOT FOR FILING

This is an early release draft of an IRS tax form, instructions, or publication, which the IRS is providing for your information as a courtesy. Do not file draft forms. Also, do not rely on draft forms, instructions, and publications for filing. We generally do not release drafts of forms until we believe we have incorporated all changes. However, unexpected issues sometimes arise, or legislation is passed, necessitating a change to a draft form. In addition, forms generally are subject to OMB approval before they can be officially released. Drafts of instructions and publications usually have at least some changes before being officially released.

Early release drafts are at IRS.gov/DraftForms, and may remain there even after the final release is posted at IRS.gov/DownloadForms. All information about all forms, instructions, and pubs is at IRS.gov/Forms.

Almost every form and publication also has its own page on IRS.gov. For example, the Form 1040 page is at IRS.gov/Form1040; the Publication 17 page is at IRS.gov/Pub17; the Form W-4 page is at IRS.gov/W4; and the Schedule A (Form 1040) page is at IRS.gov/ScheduleA. If typing in a link above instead of clicking on it, be sure to type the link into the address bar of your browser, not in a Search box. Note that these are friendly shortcut links that will automatically go to the actual link for the page.

If you wish, you can submit comments about draft or final forms, instructions, or publications at IRS.gov/FormsComments. We cannot respond to all comments due to the high volume we receive. Please note that we may not be able to consider many suggestions until the subsequent revision of the product.
Form 8996

Qualified Opportunity Fund

Go to www.irs.gov/Form8996 for the latest information.
Attach to your tax return. See instructions.

Part I  General Information and Certification

1. Type of taxpayer:  Corporation  ☐  Partnership

2. Is the taxpayer organized for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund)?
   ☐  No. STOP. Do not file this form with your tax return.
   ☐  Yes. Go to line 3.

3. Is this the first period the taxpayer is a Qualified Opportunity Fund?
   ☐  Yes. By checking this box, you certify that by the end of the taxpayer’s first qualified opportunity fund year, the taxpayer’s organizing documents include a statement of the entity’s purpose of investing in qualified opportunity zone property and the description of the qualified opportunity zone business. See instructions.
   ☐  No. Go to Part II.

4. If “Yes” on line 3, list the first month in which the fund chooses to be a Qualified Opportunity Fund.

Part II  Investment Standard Calculation

5. Total qualified opportunity zone property held by the taxpayer on the last day of the first 6-month period of the taxpayer’s tax year. See instructions if Part I, line 3 is “Yes”  .

6. Total assets held by the taxpayer on the last day of the first 6-month period of the taxpayer’s tax year. See instructions if Part I, line 3 is “Yes” .

7. Divide line 5 by line 6.

8. Total qualified opportunity zone property held by the taxpayer on the last day of the taxpayer’s tax year .

9. Total assets held by the taxpayer on the last day of the taxpayer’s tax year .

10. Divide line 8 by line 9.

Part III  Qualified Opportunity Fund Average and Penalty

11. Add lines 7 and 10.

12. Divide line 11 by 2.0. See instructions if Part I, line 3 is “Yes” .

13. Is line 12 equal to or more than .90?
   ☐  Yes. Enter -0- on this line and file this form with your tax return.
   ☐  No. The fund has failed to maintain the investment standard. Complete Part IV to figure the penalty. Enter the penalty from line 8 of Part IV on this line, and file this form with your tax return .

Cat. No. 37820G
**Part IV** Line 13 Penalty

If you checked “No” in Part III, line 13 complete Part IV to figure the penalty. Enter the number from line 8 below on Part III, line 13. See instructions if Part I, line 3 is “Yes.”

<table>
<thead>
<tr>
<th></th>
<th>(a) Month 1</th>
<th>(b) Month 2</th>
<th>(c) Month 3</th>
<th>(d) Month 4</th>
<th>(e) Month 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Total assets on the last day of the month</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Multiply line 1 by .90</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Total Qualified Opportunity Zone Property on the last day of the month</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Subtract line 3 from line 2. If less than zero, enter “0.”</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Underpayment rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Multiply line 4 by line 5</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Divide line 6 by 12.0. Round up to two decimal places. See instructions if Part I, line 3 is “Yes.”</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>(f) Month 6</th>
<th>(g) Month 7</th>
<th>(h) Month 8</th>
<th>(i) Month 9</th>
<th>(j) Month 10</th>
<th>(k) Month 11</th>
<th>(l) Month 12</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

8 **Penalty.** Add columns (a) through (l) of line 7. Enter the total here and on Part III, line 13.

$
Caution: DRAFT—NOT FOR FILING

This is an early release draft of an IRS tax form, instructions, or publication, which the IRS is providing for your information as a courtesy. Do not file draft forms. Also, do not rely on draft forms, instructions, and publications for filing. We generally do not release drafts of forms until we believe we have incorporated all changes. However, unexpected issues sometimes arise, or legislation is passed, necessitating a change to a draft form. In addition, forms generally are subject to OMB approval before they can be officially released. Drafts of instructions and publications usually have at least some changes before being officially released.

Early release drafts are at IRS.gov/DraftForms, and may remain there even after the final release is posted at IRS.gov/DownloadForms. All information about all forms, instructions, and pubs is at IRS.gov/Forms.

Almost every form and publication also has its own page on IRS.gov. For example, the Form 1040 page is at IRS.gov/Form1040; the Publication 17 page is at IRS.gov/Pub17; the Form W-4 page is at IRS.gov/W4; and the Schedule A (Form 1040) page is at IRS.gov/ScheduleA. If typing in a link above instead of clicking on it, be sure to type the link into the address bar of your browser, not in a Search box. Note that these are friendly shortcut links that will automatically go to the actual link for the page.

If you wish, you can submit comments about draft or final forms, instructions, or publications at IRS.gov/FormsComments. We cannot respond to all comments due to the high volume we receive. Please note that we may not be able to consider many suggestions until the subsequent revision of the product.
Instructions for Form 8996
(Rev. December 2018)
Qualified Opportunity Fund

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

Future Developments
For the latest information about developments related to Form 8996 and its instructions, such as legislation enacted after this form and instructions were published, go to www.irs.gov/form8996.

Purpose of Form
The Tax Cuts and Jobs Act (TCJA), section 13822, added section 1400Z-1 to provide for the designation of certain low-income communities as qualified opportunity zones and added section 1400Z-2 to provide certain benefits for investments in these qualified opportunity zones through investment in qualified opportunity funds (QOF). Taxpayers that invest in qualified opportunity zone property through a QOF can defer the recognition of certain gains. See Definitions below.

A corporation or partnership uses Form 8996 to certify that it is organized to invest in qualified opportunity zone property. In addition, a corporation or partnership files Form 8996 annually to report that the QOF meets the investment standard of section 1400Z-2 or to figure the penalty if it fails to meet the investment standard. See Definitions next. See also the Opportunity Zones Frequently Asked Questions page on IRS.gov for more information and guidance.

Definitions

Qualified opportunity zone. For a complete list of qualified opportunity zones, see Notice 2018-46, 2018-28 IRB 9.

Qualified opportunity fund (QOF). A QOF is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another QOF). A QOF must hold at least 90% of its assets in qualified opportunity zone property.

The 90% investment standard is determined by the average of the percentage of qualified opportunity zone property held in the QOF as measured on:
1. The last day of the first 6-month period of the tax year of the QOF, and
2. The last day of the tax year of the QOF.

See the instructions for Part I if this is the first year the corporation or partnership self-certifies as a QOF and the corporation or partnership selects a month other than the first month of the tax year as the first month in which it chooses to be a QOF.

If you fail to satisfy this 90% investment standard, you may have to pay a penalty for each month the QOF does not satisfy the investment standard. See Part II and Part III of these instructions for more details.

A corporation or partnership is organized in a U.S. possession, it may be a QOF only if it is organized for the purpose of investing in qualified opportunity zone property that relates to a trade or business operated in the U.S. possession in which the corporation or partnership is organized.

Qualified opportunity zone business property is tangible property that a QOF acquires after 2017 and uses in a trade or business and that satisfies both of the following tests.

1. The use of the property in the qualified opportunity zone originates with the QOF, or the QOF substantially improves the property; and
2. During substantially all of the QOF's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone.

To satisfy the test in (1) above, the QOF substantially improves property if, during any 30-month period beginning after the date of the acquisition of such property, additions to basis with respect to such property in the hands of the QOF are more than an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the QOF.

Qualified opportunity zone business is a trade or business if substantially all of its owned or leased tangible property is qualified opportunity zone business property, defined earlier, and if the trade or business satisfies all of the following tests.

1. The business generates at least 50% of its total gross income from the active conduct of a qualifying trade or business;
2. The business uses a substantial part of its intangible property in the active conduct of any such business;
3. Less than 5% of the average of the total unadjusted basis of the property of the business is from nonqualified financial property; and

4. The business is not a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption on premises.

U.S. possession. Guam, the Commonwealth of the Northern Mariana Islands (CNMI), American Samoa, the U.S. Virgin Islands, and Puerto Rico.

Nonqualified financial property. Debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities and other similar property. The definition does not include reasonable amounts of working capital held as cash, cash equivalents, or debt instruments with a term of 18 months or less.

Who Must File
Corporations or partnerships that are organized and operated as a QOF must file Form 8996 annually with one of the following tax returns.

- Form 1120, U.S. Corporation Income Tax Return.
- Form 1120-F, U.S. Income Tax Return of a Foreign Corporation, but only if the corporation is organized in a U.S. possession. See note below.
- Form 1065, U.S. Return of Partnership Income.

File Form 8996 by the due date of the tax return (including extensions).

Note. Only QOFs organized in a U.S. possession should fill out and attach this form with their Form 1120-F.

Specific Instructions

Name and Employer Identification Number
Enter the same information as shown on the QOF’s applicable tax return under Who Must File.

Part I
Complete Part I to certify that the corporation or partnership was organized to operate as a QOF. See Definitions.

Line 3
Check “Yes” if you are certifying that this is the first period in which you are a QOF, and fill out line 4.

If you answer “Yes” in line 3, your organizing documents must include a statement of your purpose of investing in qualified opportunity zone property by the end of your first QOF year. The statement should include the description of the qualified opportunity zone business(es) that the QOF expects to engage in, either directly or indirectly through a first-tier operating entity.

If you check “No,” you are indicating that you have certified in a prior year that you are a QOF. Continue to Part II and Part III to determine if the QOF met the investment standard for this tax year.

Line 4
Provide the first month in which you chose to be a QOF.

Example 1. A new corporation is formed on January 5, 2018, for the purpose of operating a QOF, but it does not receive until April 2018 any investment under a defeasance election under section 1400Z-2(a). The corporation may choose any month from January through April 2018 to use as a certification date. This example also applies to pre-existing corporations or partnerships that become a QOF.

Part II
Complete Part II annually and attach it to your applicable tax return listed under Who Must File above. Part II determines whether you meet the 90% investment standard for a QOF. See Definitions.

Value determination. If you prepare a financial statement that you file with the SEC or with a federal agency other than the Internal Revenue Service or if you have a certified audited financial statement that is prepared in accordance with U.S. GAAP, then use the value of the assets reported on this financial statement. In other cases, use the QOF’s cost basis of the asset on the date of acquisition by the QOF.

Cash as qualified opportunity zone property of a qualified opportunity zone business. You can exclude reasonable amounts of working capital from the value of property that is treated as nonqualified financial property. See Definitions. A reasonable amount of working capital satisfies all of the following tests.

1. The working capital is designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone.

2. There is a reasonable written schedule for the expeditious consumption of the working capital to achieve the goal set out in (1) above.

3. The working capital will be completely consumed no later than 31 months after the amounts are first invested in eligible interests in the relevant QOF.

4. The working capital is consumed in a manner that is substantially consistent with the requirements in items (1) through (3).

Line 5
Enter the value of qualified opportunity zone property (see Definitions) held by the QOF on the last day of the first 6-month period of the tax year.

Special rule for first year of QOF. If you answered “Yes” on line 3, the 6-month period starts from the month you indicated on line 4. Line 5 may be blank depending on the tax year and the month indicated on line 4.

If you check “Yes” on line 3, but do not list the first month in which you choose to be a QOF on line 4, the 6-month period of the QOF starts on the first day of your tax year, even if the QOF bought no qualified opportunity zone property until later in the year.

Example 2. Virginia, Joe, Laura, and Ishmael formed a new partnership in January 2018 for the purposes of operating as a QOF, but it does not receive until July 2018 any investments under a defeasance election under section 1400Z-2(a). The partnership has a calendar year tax year. The QOF may choose any month from January through July 2018 to use as its first month for certification. It chooses April 2018. The first 6-month period for the QOF asset test ends on September 30. January to March are not considered for purposes of the 6-month period.

Example 3. The facts are the same as in Example 2, except the partnership chooses July 2018 as the certification date. The first 6-month period for the QOF asset test ends on December 31. The 6 months from January through June are not considered, and lines 5 through 7 will be blank.
Line 6
Enter the value of total assets held by the QOF on the last day of the first 6-month period of the tax year.

If you checked "Yes" on line 3, the 6-month period starts from the month you indicated on line 4. Line 6 may be blank depending on the tax year and the month indicated on line 4. See the discussion on line 5 and see Example 3 in Line 5.

Line 7
If the figure entered on line 7 is less than 90% (.90), a penalty may apply. See Part III of the instructions for more details. Enter 0 if lines 5 and 6 are blank.

Line 8
Enter the value of qualified opportunity zone property (see Definitions) held by the QOF on the last day of the tax year.

Note: If you answered "Yes" on line 3, the tax year may be less than 12 months.

Line 9
Enter the value of total assets held by the QOF on the last day of the tax year.

Note: If you checked "Yes" on line 3, the tax year may be less than 12 months.

Part III
Complete Part III annually and attach it to your applicable tax return listed under Who Must File above. Part III determines whether you are subject to a penalty. See Qualified opportunity fund in Definitions.

Line 12
If lines 5 and 6 are blank, then divide line 11 by 1.0 instead of 2.0, and enter the result.

Line 13
If you checked "Yes," the QOF met the 90% investment standard. Attach the form to your tax return to report you met the investment standard for the current tax year.

If you checked "No," the QOF failed to meet the 90% investment standard. Go to Part IV to figure the penalty for each month that the QOF did not meet the investment standard. The IRS will issue a notice regarding the penalty reported on line 13. This notice will include instructions on the penalty, the reasonable cause relief process, and payment instructions.

Part IV
Complete Part IV if you checked "No" on Part III, line 13. Use Part IV to figure the penalty for each month that the QOF did not hold at least 90% of its assets in qualified opportunity zone property. See Definitions.

Accounting period. Columns (a) through (l) in Part IV assume that the QOF was in existence for the full tax year (January to December for calendar year or 12 consecutive months for fiscal year). See Pub. 536, Accounting Periods and Methods for more information on accounting periods.

Note: If you answered "Yes" on Part I, line 3 and the QOF did not exist for the full tax year, you will not use all of the columns in Part IV. Instead, use the month listed on Part I, line 4 as your Month 1 (see column (a) of Part IV of the form), and continue using the other columns as needed to complete the tax year.

Example 4. The facts are the same as in Example 2 under the Part I, line 5 instructions. In that situation, the partnership entered April on Part I, line 4. The answer to Part III, line 13 was "No." When filling out Part IV, the partnership will enter months only in columns (a) through (l), since April would be Month 1 and December would be Month 9.

Lines 1 and 3
See Value determination for information on what figure to enter on these lines.

Line 5
The figure to enter here is the interest rate for each calendar quarter, which the IRS will determine during the first month in the preceding quarter. These rates are published quarterly in an IRS news release and in a revenue ruling in the Internal Revenue Bulletin (IRB). Go to www.irs.gov/irb for the IRBs. You can subscribe to IRS Newswire to receive news releases of the quarterly interest rates, and IRS GuideWire to receive emails with a link to the revenue rulings in which the quarterly interest rates are published by going to www.irs.gov/uc/e-news-subscriptions-2.

Line 7
 Divide line 6 by 12 even if you answered "Yes" in Part I, line 3 and the QOF did not exist for a full tax year. This is because the underpayment rate used on line 5 is annualized.

Paperwork Reduction Act Notice.
We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Code section 6103.

The average time and expense required to complete and file this form will vary depending on individual circumstances. For the estimated averages, see the instructions for your income tax return.

If you have suggestions for making this form simpler, we would be happy to hear from you. See the instructions for your income tax return.
26 U.S. Code § 1400Z-1 - Designation

(a) QUALIFIED OPPORTUNITY ZONE DEFINED
For the purposes of this subchapter, the term "qualified opportunity zone" means a population census tract that is a low-income community that is designated as a qualified opportunity zone.

(b) DESIGNATION

(1) IN GENERAL For purposes of subsection (a), a population census tract that is a low-income community is designated as a qualified opportunity zone if—

(A) not later than the end of the determination period, the chief executive officer of the State in which the tract is located—

(i) nominates the tract for designation as a qualified opportunity zone, and

(ii) notifies the Secretary in writing of such nomination, and

(B) the Secretary certifies such nomination and designates such tract as a qualified opportunity zone before the end of the consideration period.

(2) EXTENSION OF PERIODS
A chief executive officer of a State may request that the Secretary extend either the determination or consideration period, or both (determined without regard to this subparagraph),[1] for an additional 30 days.

(c) OTHER DEFINITIONS For purposes of this subsection—

(1) LOW-INCOME COMMUNITIES
The term "low-income community" has the same meaning as when used in section 45D(e).

(2) DEFINITION OF PERIODS

(A) Consideration period
The term "consideration period" means the 30-day period beginning on the date on which the Secretary receives notice under subsection (b)(1)(A)(ii), as extended under subsection (b)(2).

(B) Determination period
The term "determination period" means the 90-day period beginning on the date of

https://www.law.cornell.edu/uscode/text/26/1400Z-1 12/17/2018
the enactment of the Tax Cuts and Jobs Act, as extended under subsection (b)(2).

(3) STATE
For purposes of this section, the term "State" includes any possession of the United States.

(d) NUMBER OF DESIGNATIONS

(1) IN GENERAL
Except as provided by paragraph (2), the number of population census tracts in a State that may be designated as qualified opportunity zones under this section may not exceed 25 percent of the number of low-income communities in the State.

(2) EXCEPTION
If the number of low-income communities in a State is less than 100, then a total of 25 of such tracts may be designated as qualified opportunity zones.

(e) DESIGNATION OF TRACTS CONTIGUOUS WITH LOW-INCOME COMMUNITIES

(1) IN GENERAL A population census tract that is not a low-income community may be designated as a qualified opportunity zone under this section if—

(A) the tract is contiguous with the low-income community that is designated as a qualified opportunity zone, and

(B) the median family income of the tract does not exceed 125 percent of the median family income of the low-income community with which the tract is contiguous.

(2) LIMITATION
Not more than 5 percent of the population census tracts designated in a State as a qualified opportunity zone may be designated under paragraph (1).

(f) PERIOD FOR WHICH DESIGNATION IS IN EFFECT
A designation as a qualified opportunity zone shall remain in effect for the period beginning on the date of the designation and ending at the close of the 10th calendar year beginning on or after such date of designation.


[1] So in original. Probably should be "paragraph).".

LII has no control over and does not endorse any external Internet site that contains links to or references LII.
26 U.S. Code § 1400Z-2 - Special rules for capital gains invested in opportunity zones

(a) IN GENERAL

(1) TREATMENT OF GAINS In the case of gain from the sale to, or exchange with, an unrelated person of any property held by the taxpayer, at the election of the taxpayer—

(A) gross income for the taxable year shall not include so much of such gain as does not exceed the aggregate amount invested by the taxpayer in a qualified opportunity fund during the 180-day period beginning on the date of such sale or exchange,

(B) the amount of gain excluded by subparagraph (A) shall be included in gross income as provided by subsection (b), and

(C) subsection (c) shall apply.

(2) ELECTION No election may be made under paragraph (1)—

(A) with respect to a sale or exchange if an election previously made with respect to such sale or exchange is in effect, or

(B) with respect to any sale or exchange after December 31, 2026.

(b) DEFERRAL OF GAIN INVESTED IN OPPORTUNITY ZONE PROPERTY

(1) YEAR OF INCLUSION Gain to which subsection (a)(1)(B) applies shall be included in income in the taxable year which includes the earlier of—

(A) the date on which such investment is sold or exchanged, or

(B) December 31, 2026.

(2) AMOUNT INCLUDIBLE

(A) In general The amount of gain included in gross income under subsection (a)(1)(A) shall be the excess of—

(i) the lesser of the amount of gain excluded under paragraph (1) or the fair market value of the investment as determined as of the date described in paragraph (1), over

(ii) the taxpayer’s basis in the investment.

(B) Determination of basis

(i) In general

Except as otherwise provided in this clause or subsection (c), the taxpayer’s basis in the investment shall be zero.
(ii) Increase for gain recognized under subsection (a)(1)(B)
The basis in the investment shall be increased by the amount of gain recognized by reason of subsection (a)(1)(B) with respect to such property.

(iii) Investments held for 5 years
In the case of any investment held for at least 5 years, the basis of such investment shall be increased by an amount equal to 10 percent of the amount of gain deferred by reason of subsection (a)(1)(A).

(iv) Investments held for 7 years
In the case of any investment held by the taxpayer for at least 7 years, in addition to any adjustment made under clause (iii), the basis of such property shall be increased by an amount equal to 5 percent of the amount of gain deferred by reason of subsection (a)(1)(A).

(c) Special rule for investments held for at least 10 years
In the case of any investment held by the taxpayer for at least 10 years and with respect to which the taxpayer makes an election under this clause, the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged.

(d) Qualified opportunity fund For purposes of this section—

(1) In general The term "qualified opportunity fund" means any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property, determined by the average of the percentage of qualified opportunity zone property held in the fund as measured—

(A) on the last day of the first 6-month period of the taxable year of the fund, and

(B) on the last day of the taxable year of the fund.

(2) Qualified opportunity zone property
(A) In general The term "qualified opportunity zone property" means property which is—

(i) qualified opportunity zone stock,

(ii) qualified opportunity zone partnership interest, or

(iii) qualified opportunity zone business property.

(B) Qualified opportunity zone stock
(i) In general Except as provided in clause (ii), the term "qualified opportunity zone stock" means any stock in a domestic corporation if—
(I) such stock is acquired by the qualified opportunity fund after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash,

(II) as of the time such stock was issued, such corporation was a qualified opportunity zone business (or, in the case of a new corporation, such corporation was being organized for purposes of being a qualified opportunity zone business), and

(III) during substantially all of the qualified opportunity fund’s holding period for such stock, such corporation qualified as a qualified opportunity zone business.

(ii) Redemptions
A rule similar to the rule of section 1202(c)(3) shall apply for purposes of this paragraph.

(C) Qualified opportunity zone partnership interest The term “qualified opportunity zone partnership interest” means any capital or profits interest in a domestic partnership if—

(i) such interest is acquired by the qualified opportunity fund after December 31, 2017, from the partnership solely in exchange for cash,

(II) as of the time such interest was acquired, such partnership was a qualified opportunity zone business (or, in the case of a new partnership, such partnership was being organized for purposes of being a qualified opportunity zone business), and

(III) during substantially all of the qualified opportunity fund’s holding period for such interest, such partnership qualified as a qualified opportunity zone business.

(D) Qualified opportunity zone business property

(i) In general The term “qualified opportunity zone business property” means tangible property used in a trade or business of the qualified opportunity fund if—

(I) such property was acquired by the qualified opportunity fund by purchase (as defined in section 179(d)(2)) after December 31, 2017,

(II) the original use of such property in the qualified opportunity zone commences with the qualified opportunity fund or the qualified opportunity fund substantially improves the property, and

(III) during substantially all of the qualified opportunity fund’s holding period for such property, substantially all of the use of such property was in a qualified opportunity zone.

(ii) Substantial improvement
For purposes of subparagraph (A)(ii), property shall be treated as substantially improved by the qualified opportunity fund only if, during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the qualified opportunity fund exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the qualified opportunity fund.

(iii) Related party
For purposes of subparagraph (A)(i), the related person rule of section 179(d)(2) shall be applied pursuant to paragraph (8) of this subsection in lieu of the application of such rule in section 179(d)(2)(A).

(3) QUALIFIED OPPORTUNITY ZONE BUSINESS

(A) In general The term "qualified opportunity zone business" means a trade or business—

(i) in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property (determined by substituting "qualified opportunity zone business" for "qualified opportunity zone fund" each place it appears in paragraph (2)(D)),

(ii) which satisfies the requirements of paragraphs (2), (4), and (8) of section 1397C(b), and

(iii) which is not described in section 144(c)(6)(B).

(B) Special rule For purposes of subparagraph (A), tangible property that ceases to be a qualified opportunity zone business property shall continue to be treated as a qualified opportunity zone business property for the lesser of—

(i) 5 years after the date on which such tangible property ceases to be so qualified, or

(ii) the date on which such tangible property is no longer held by the qualified opportunity zone business.

(e) APPLICABLE RULES

(1) TREATMENT OF INVESTMENTS WITH MIXED FUNDS In the case of any investment in a qualified opportunity fund only a portion of which consists of investments of gain to which an election under subsection (a) is in effect—

(A) such investment shall be treated as 2 separate investments, consisting of—

(i) one investment that only includes amounts to which the election under subsection (a) applies, and

(ii) a separate investment consisting of other amounts, and

(B) subsections (a), (b), and (c) shall only apply to the investment described in subparagraph (A)(i).

(2) RELATED PERSONS

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

(3) DECEDEENTS

In the case of a decedent, amounts recognized under this section shall, if not properly includible in the gross income of the decedent, be includible in gross income as provided by section 691.
4) REGULATIONS The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including—

(A) rules for the certification of qualified opportunity funds for the purposes of this section,

(B) rules to ensure a qualified opportunity fund has a reasonable period of time to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests, and to reinvest proceeds received from the sale or disposition of qualified opportunity zone property, and

(C) rules to prevent abuse.

(f) FAILURE OF QUALIFIED OPPORTUNITY FUND TO MAINTAIN INVESTMENT STANDARD

(1) IN GENERAL If a qualified opportunity fund fails to meet the 90-percent requirement of subsection (c)(1),[2] the qualified opportunity fund shall pay a penalty for each month it fails to meet the requirement in an amount equal to the product of—

(A) the excess of—

(i) the amount equal to 90 percent of its aggregate assets, over

(ii) the aggregate amount of qualified opportunity zone property held by the fund, multiplied by

(B) the underpayment rate established under section 6621(a)(2) for such month.

(2) SPECIAL RULE FOR PARTNERSHIPS
In the case that the qualified opportunity fund is a partnership, the penalty imposed by paragraph (1) shall be taken into account proportionately as part of the distributive share of each partner of the partnership.

(3) REASONABLE CAUSE EXCEPTION
No penalty shall be imposed under this subsection with respect to any failure if it is shown that such failure is due to reasonable cause.


[1] So in original. No paragraph (8) has been enacted.

[2] So in original. Probably should be "subsection (d)(1)."

Lil has no control over and does not endorse any external Internet site that contains links to or references Lil.
This document has been submitted to the Office of the Federal Register (OFR) for publication and is currently pending placement on public display at the OFR and publication in the Federal Register. The version of the proposed rule released today may vary slightly from the published document if minor editorial changes are made during the OFR review process. The document published in the Federal Register will be the official document.

[4830-01-p]

DEPARTMENT OF TREASURY

Internal Revenue Service

26 CFR Part I

[REG-115420-18]

RIN 1545-BP03

Investing in Qualified Opportunity Funds

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance under new section 1400Z-2 of the Internal Revenue Code (Code) relating to gains that may be deferred as a result of a taxpayer's investment in a qualified opportunity fund (QOF). Specifically, the proposed regulations address the type of gains that may be deferred by investors, the time by which corresponding amounts must be invested in QOFs, and the manner in which investors may elect to defer specified gains. This document also contains proposed regulations applicable to QOFs, including rules for self-certification, valuation of QOF assets, and guidance on qualified opportunity zone businesses. The
proposed regulations affect QOFs and their investors. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written (including electronic) comments must be received by **[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. Outlines of topics to be discussed at the public hearing scheduled for January 10, 2019 at 10 a.m. must be received by **[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-115420-18), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-115420-18), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically via the Federal Rulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS REG-115420-18). The public hearing will be held in the IRS auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Erika C. Reigle of the Office of Associate Chief Counsel (Income Tax and Accounting), (202) 317-7006 and Kyle C. Griffin of the Office of Associate Chief Counsel (Income Tax and Accounting), (202) 317-4718; concerning the submission of comments, the hearing, or to be placed on the building access list to attend the hearing, Regina L. Johnson, (202) 317-6901 (not toll-free numbers).
SUPPLEMENTARY INFORMATION:

Background

This document contains proposed regulations under section 1400Z-2 of the Code that amend the Income Tax Regulations (26 CFR Part 1). Section 13823 of the Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054, 2184 (2017) (TCJA), amended the Code to add sections 1400Z-1 and 1400Z-2. Section 1400Z-1 provides procedural rules for designating qualified opportunity zones and related definitions. Section 1400Z-2 allows a taxpayer to elect to defer certain gains to the extent that corresponding amounts are timely invested in a QOF.

Section 1400Z-2, in conjunction with section 1400Z-1, seeks to encourage economic growth and investment in designated distressed communities (qualified opportunity zones) by providing Federal income tax benefits to taxpayers who invest in businesses located within these zones. Section 1400Z-2 provides two main tax incentives to encourage investment in qualified opportunity zones. First, it allows for the deferral of inclusion in gross income for certain gains to the extent that corresponding amounts are reinvested in a QOF. Second, it excludes from gross income the post-acquisition gains on investments in QOFs that are held for at least 10 years.

As is more fully explained in the Explanation of Provisions, these proposed regulations describe and clarify the requirements that must be met by a taxpayer in order properly to defer the recognition of gains by investing in a QOF. In addition, the proposed regulations provide rules permitting a corporation or partnership to self-certify as a QOF. Finally, the proposed regulations provide initial proposed rules regarding
some of the requirements that must be met by a corporation or partnership in order to qualify as a QOF.

Contemporaneous with the issuance of these proposed regulations, the IRS is releasing a revenue ruling addressing the application to real property of the "original use" requirement in section 1400Z-2(d)(2)(D)(i)(II) and the "substantial improvement" requirement in section 1400Z-2(d)(2)(D)(i)(II) and 1400Z-2(d)(2)(D)(ii).

In addition, these proposed regulations address the substantial-improvement requirement with respect to a purchased building located in a qualified opportunity zone. They provide that for purposes of this requirement, the basis attributable to land on which such a building sits is not taken into account in determining whether the building has been substantially improved. Excluding the basis of land from the amount that needs to be doubled under section 1400Z-2(d)(2)(D)(ii) for a building to be substantially improved facilitates repurposing vacant buildings in qualified opportunity zones. Similarly, an absence of a requirement to increase the basis of land itself would address many of the comments that taxpayers have made regarding the need to facilitate repurposing vacant or otherwise unutilized land.

In connection with soliciting comments on these proposed regulations the Department of the Treasury (Treasury Department) and the IRS are soliciting comments on all aspects of the definition of "original use" and "substantial improvement." In particular, they are seeking comments on possible approaches to defining the "original use" requirement, for both real property and other tangible property. For example, what metrics would be appropriate for determining whether tangible property has "original use" in an opportunity zone? Should the use of tangible property be determined based
on its physical presence within an opportunity zone, or based on some other measure? What if the tested tangible property is a vehicle or other movable tangible property that was previously used within the opportunity zone but acquired from a person outside the opportunity zone? Should some period of abandonment or under-utilization of tangible property erase the property’s history of prior use in the opportunity zone? If so, should such a fallow period enable subsequent productive utilization of the tangible property to qualify as “original use”? Should the rules appropriate for abandonment and underutilization of personal tangible property also apply to vacant real property that is productively utilized after some period? If so, what period of abandonment, underutilization, or vacancy would be consistent with the statute? In addition, comments are requested on whether any additional rules regarding the “substantial improvement” requirement for tangible property are warranted or would be useful.

The Treasury Department and the IRS are working on additional published guidance, including additional proposed regulations expected to be published in the near future. The Treasury Department and the IRS expect the forthcoming proposed regulations to incorporate the guidance contained in the revenue ruling to facilitate additional public comment. The forthcoming proposed regulations are expected to address other issues under section 1400Z-2 that are not addressed in these proposed regulations. Issues expected to be addressed include: the meaning of “substantially all” in each of the various places where it appears in section 1400Z-2; the transactions that may trigger the inclusion of gain that has been deferred under a section 1400Z-2(a) election; the “reasonable period” (see section 1400Z-2(e)(4)(B)) for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty; administrative
rules applicable under section 1400Z-2(f) when a QOF fails to maintain the required 90 percent investment standard; and information-reporting requirements under section 1400Z-2.

The Treasury Department and the IRS welcome comments on what other additional issues should be addressed in forthcoming proposed regulations or guidance.

**Explanation of Provisions**

I. **Deferring Tax on Capital Gains by Investing in Opportunity Zones**

A. Gains Eligible for Deferral

The proposed regulations clarify that only capital gains are eligible for deferral under section 1400Z-2(a)(1). In setting forth the gains that are subject to deferral, the text of section 1400Z-2(a)(1) specifies "gain from the sale to, or exchange with, an unrelated person of any property held by the taxpayer," to the extent that such gain does not exceed the aggregate amount invested by the taxpayer in a QOF during the 180-day period beginning on the date of the sale or exchange (emphasis added). The statutory text is silent as to whether Congress intended both ordinary and capital gains to be eligible for deferral under section 1400Z-2. (Sections 1221 and 1222 define these two kinds of gains.) However, the statute's legislative history explicitly identifies "capital gains" as the gains that are eligible for deferral. The Treasury Department and the IRS believe, based on the legislative history as well as the text and structure of the statute, that section 1400Z-2 is best interpreted as making deferral available only for capital gains. The proposed regulations provide that a gain is eligible for deferral if it is treated as a capital gain for Federal income tax purposes. Eligible gains, therefore, generally
include capital gain from an actual, or deemed, sale or exchange, or any other gain that is required to be included in a taxpayer's computation of capital gain.

The proposed regulations address two additional gain deferral requirements. First, the gain to be deferred must be gain that would be recognized, if deferral under section 1400Z-2(a)(1) were not permitted, not later than December 31, 2026, the final date under section 1400Z-2(a)(2)(B) for the deferral of gain. Second, the gain must not arise from a sale or exchange with a related person as defined in section 1400Z-2(e)(2). Section 1400Z-2(e)(2) incorporates the related person definition in sections 267(b) and 707(b)(1) but substitutes “20 percent” in place of “50 percent” each place it occurs in section 267(b) or section 707(b)(1).

B. Types of Taxpayers Eligible to Elect Gain Deferral

The proposed regulations clarify that taxpayers eligible to elect deferral under section 1400Z-2 are those that recognize capital gain for Federal income tax purposes. These taxpayers include individuals, C corporations (including regulated investment companies (RICs) and real estate investment trusts (REITs)), partnerships, and certain other pass-through entities, including common trust funds described in section 584, as well as, qualified settlement funds, disputed ownership funds, and other entities taxable under §1.468B of the Income Tax Regulations.

In order to address the numerous issues raised by new section 1400Z-2 for pass-through entities, the proposed regulations include special rules for partnerships and other pass-through entities, and for taxpayers to whom these entities pass through income and other tax items. Under these rules, the entities and taxpayers can invest in a QOF and thus defer recognition of eligible gain. The Treasury Department and the
IRS request comments on whether the rules are sufficient and whether more detailed rules are required to provide additional certainty for investors in pass-through entities that are not partnerships.

C. Investments in a QOF

The proposed regulations clarify that, to qualify under section 1400Z-2(a)(1)(A), (that is, to be an eligible interest in a QOF), an investment in the QOF must be an equity interest in the QOF, including preferred stock or a partnership interest with special allocations. Thus, an eligible interest cannot be a debt instrument within the meaning of section 1275(a)(1) and §1.1275-1(d). Provided that the eligible taxpayer is the owner of the equity interest for Federal income tax purposes, status as an eligible interest is not impaired by the taxpayer's use of the interest as collateral for a loan, whether a purchase-money borrowing or otherwise. The proposed regulations also clarify that deemed contributions of money under section 752(a) do not result in the creation of an investment in a QOF.

D. 180-Day Rule for Deferring Gain by Investing in a QOF

Under section 1400Z-2(a)(1)(A), to be able to elect to defer gain, a taxpayer must generally invest in a QOF during the 180-day period beginning on the date of the sale or exchange giving rise to the gain. Some capital gains, however, are the result of Federal tax rules deeming an amount to be a gain from the sale or exchange of a capital asset, and, in many cases, the statutory language providing capital gain treatment does not provide a specific date for the deemed sale. The proposed regulations address this issue by providing that, except as specifically provided in the proposed regulations, the first day of the 180-day period is the date on which the gain would be recognized for
Federal income tax purposes, without regard to the deferral available under section 1400Z-2. The proposed regulations include examples that illustrate the general rule by applying it to capital gains in a variety of situations (including, for example, gains from the sale of exchange-traded stock and capital gain dividend distributions).

If a taxpayer acquires an original interest in a QOF in connection with a gain-deferral election under section 1400Z-2(a)(1)(A), if a later sale or exchange of that interest triggers an inclusion of the deferred gain, and if the taxpayer makes a qualifying new investment in a QOF, then the proposed regulations provide that the taxpayer is eligible to make a section 1400Z-2(a)(2) election to defer the inclusion of the previously deferred gain. Deferring an inclusion otherwise mandated by section 1400Z-2(a)(1)(B) in this situation is permitted only if the taxpayer has disposed of the entire initial investment without which the taxpayer could not have made the previous deferral election under section 1400Z-2. The complete disposition is necessary because section 1400Z-2(a)(2)(A) expressly prohibits the making of a deferral election under section 1400Z-2(a)(1) with respect to a sale or exchange if an election previously made with respect to the same sale or exchange remains in effect. The general 180-day rule described above determines when this second investment must be made to support the second deferral election. Under that rule, the first day of the 180-day period for the new investment in a QOF is the date that section 1400Z-2(b)(1) provides for inclusion of the previously deferred gain.

Comments are requested as to whether the final regulations should contain exceptions to the general 180-day rule and whether it would be helpful for either the
final regulations or other guidance to illustrate the application of the general 180-day rule to additional circumstances, and what those circumstances are.

E. Attributes of Included Income When Gain Deferral Ends

Section 1400Z-2(a)(1)(B) and (b) require taxpayers to include in income previously deferred gains. The proposed regulations provide that all of the deferred gain's tax attributes are preserved through the deferral period and are taken into account when the gain is included. The preserved tax attributes include those taken into account under sections 1(h), 1222, 1256, and any other applicable provisions of the Code. Furthermore, the proposed regulations address situations in which separate investments providing indistinguishable property rights (such as serial purchases of common stock in a corporation that is a QOF) are made at different times or are made at the same time with separate gains possessing different attributes (such as different holding periods). If a taxpayer disposes of less than all of its fungible interests in a QOF, the proposed regulations provide that the QOF interests disposed of must be identified using a first-in, first-out (FIFO) method. Where the FIFO method does not provide a complete answer, such as where gains with different attributes are invested in indistinguishable interests at the same time, the proposed regulations provide that a pro-rata method must be used to determine the character, and any other attributes, of the gain recognized. Examples in the proposed regulations illustrate this rule.

Comments are requested as to whether different methods should be used. Any such alternative methods must both provide certainty as to which fungible interest a taxpayer disposes of and allow taxpayers to comply easily with the requirements of
section 1400Z-2(a)(1)(B) and (b), which require that certain dispositions of an interest in a QOF cause deferred gain be included in a taxpayer's income.

II. Special rules

A. Gain not already subject to an election.

Under section 1400Z-2(a)(2)(A), no election may be made under section 1400Z-2(a)(1) with respect to a sale or exchange if an election previously made with respect to that sale or exchange is in effect. There has been some confusion as to whether this language bars a taxpayer from making multiple elections within 180-days for various parts of the gain from a single sale or exchange of property held by the taxpayer. This rule in section 1400Z-2(a)(2)(A) is meant to exclude from the section 1400Z-2(a)(1) election multiple purported elections with respect to the same gain. (Although the gain itself can be deferred only once, a taxpayer might be seeking to multiply the investments eligible for various increases in basis.) Thus, the proposed regulations clarify that in the case of a taxpayer who has made an election under section 1400Z-2(a) with respect to some but not all of an eligible gain, the term "eligible gain" includes the portion of that eligible gain as to which no election has been made. (All elections with respect to portions of the same gain would, of course, be subject to the same 180-day period.)

B. Section 1256 contracts

The proposed regulations provide rules for capital gains arising from section 1256 contracts. Under section 1256, a taxpayer generally "marks to market" each section 1256 contract at the termination or transfer of the taxpayer's position in the contract or on the last business day of the taxable year if the contract is still held by the
taxpayer at that time. The mark causes the taxpayer to take into account in the taxable year any not-yet recognized appreciation or depreciation in the position. This gain or loss, if capital, is treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. Currently, for federal income tax purposes, the only relevant information required to be reported by a broker to the IRS and to individuals and certain other taxpayers holding section 1256 contracts, is the taxpayer’s net recognized gain or loss from all of the taxpayer’s section 1256 contracts held during the taxable year. Some taxpayers holding section 1256 contracts, however, report the gain or loss from section 1256 contracts to the IRS on a per contract basis rather than on an aggregate basis. To minimize the burdens on taxpayers, brokers, and the IRS from tax compliance and tax administration, the proposed regulations allow deferral under section 1400Z-2(a)(1) only for a taxpayer’s capital gain net income from section 1256 contracts for a taxable year. In addition, because the capital gain net income from section 1256 contracts for a taxable year is determinable only as of the last day of the taxable year, the proposed regulations provide that the 180-day period for investing capital gain net income from section 1256 contracts in a QOF begins on the last day of the taxable year.

Finally, the proposed regulations do not allow any deferral of gain from a section 1256 contract in a taxable year if, at any time during the taxable year, one of the taxpayer’s section 1256 contracts was part of an offsetting-positions transaction (as defined later in the proposed regulations and described later in this preamble) in which any of the other positions was not also a section 1256 contract.
Comments are requested on this limitation and on whether capital gain from a section 1256 contract should be eligible for deferral under section 1400Z-2 on a per contract basis rather than on an aggregate net basis. Reporting on a per contract basis might require a significant increase in the number of information returns that taxpayers would need to file with the IRS as compared to the number of information returns that are currently filed on an aggregate net basis. Comments are requested on how to minimize the burdens and complexity that may be associated with reporting on a per contract basis for section 1256 contracts.

C. Offsetting-positions transactions, including straddles

The Treasury Department and the IRS considered allowing deferral under section 1400Z-2(a)(1) for a net amount of capital gain related to a straddle (as defined in section 1092(c)(1)) after the disposition of all positions in the straddle. However, such a rule would pose significant administrative challenges. For example, additional rules would be needed for a taxpayer to defer such a net amount of capital gain when positions are disposed of in different taxable years (and likely would require affected taxpayers to file amended tax returns). Further, additional rules might be needed to take into account the netting requirements for identified mixed straddles described in §1.1092(b)-3T or 1.1092(b)-6 and for mixed straddle accounts described in §1.1092(b)-4T. Accordingly, in the interest of sound tax administration and to provide consistent treatment for transactions involving offsetting positions in personal property, the proposed regulations provide that any capital gain from a position that is or has been part of an offsetting-positions transaction (other than an offsetting-positions transaction
in which all of the positions are section 1256 contracts) is not eligible for deferral under section 1400Z-2.

An offsetting-positions transaction is defined in the proposed regulations as a transaction in which a taxpayer has substantially diminished the taxpayer's risk of loss from holding one position with respect to personal property by holding one or more other positions with respect to personal property (whether or not of the same kind). It does not matter whether either of the positions is with respect to actively traded personal property. An offsetting-positions transaction includes a straddle as defined in section 1092 and the regulations thereunder, including section 1092(d)(4), which provides rules for positions held by related persons and certain flow-through entities (for example, a partnership). An offsetting-positions transaction also includes a transaction that would be a straddle (taking into account the principles referred to in the preceding sentence) if the straddle definition did not contain the active trading requirement in section 1092(d)(1).

III. Gains of Partnerships and Other Pass-Through Entities

Commenters have requested clarification regarding whether deferral is possible under section 1400Z-2 any time a partnership would otherwise recognize capital gain. The proposed regulations provide rules that permit a partnership to elect deferral under section 1400Z-2 and, to the extent that the partnership does not elect deferral, provide rules that allow a partner to do so. These rules both clarify the circumstances under which each can elect and clarify when the applicable 180-day period begins.

Proposed §1.1400Z-2(a)-1(c)(1) provides that a partnership may elect to defer all or part of a capital gain to the extent that it makes an eligible investment in a QOF.
Because the election provides for deferral, if the election is made, no part of the deferred gain is required to be included in the distributive shares of the partners under section 702, and the gain is not subject to section 705(a)(1). Proposed §1.1400Z-2(a)-1(c)(2) provides that, to the extent that a partnership does not elect to defer capital gain, the capital gain is included in the distributive shares of the partners under section 702 and is subject to section 705(a)(1). If all or any portion of a partner’s distributive share satisfies all of the rules for eligibility under section 1400Z-2(a)(1) (including not arising from a sale or exchange with a person that is related either to the partnership or to the partner), then the partner generally may elect its own deferral with respect to the partner’s distributive share. The partner’s deferral is potentially available to the extent that the partner makes an eligible investment in a QOF.

Consistent with the general rule for the beginning of the 180-day period, the partner’s 180-day period generally begins on the last day of the partnership’s taxable year, because that is the day on which the partner would be required to recognize the gain if the gain is not deferred. The proposed regulations, however, provide an alternative for situations in which the partner knows (or receives information) regarding both the date of the partnership’s gain and the partnership’s decision not to elect deferral under section 1400Z-2. In that case, the partner may choose to begin its own 180-day period on the same date as the start of the partnership’s 180-day period.

The proposed regulations state that rules analogous to the rules provided for partnerships and partners apply to other pass-through entities (including S corporations, decedents’ estates, and trusts) and to their shareholders and beneficiaries. Comments
are requested regarding whether taxpayers need additional details regarding analogous treatment for pass-through entities that are not partnerships.

IV. How to Elect Deferral

These proposed regulations require deferral elections to be made at the time and in the manner provided by the Commissioner of Internal Revenue (Commissioner). The Commissioner may prescribe in regulations, revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin or in forms and instructions the time, form, and manner in which an eligible taxpayer may elect to defer eligible gains under section 1400Z-2(a). It is currently anticipated that taxpayers will make deferral elections on Form 8949, which will be attached to their Federal income tax returns for the taxable year in which the gain would have been recognized if it had not been deferred. Form instructions to this effect are expected to be released very shortly after these proposed regulations are published. Comments are requested whether additional proposed regulations or other guidance are needed to clarify the required procedures. In addition IRS releases draft forms for public review and comments. These drafts are posted to www.irs.gov/DraftForms and include a cover sheet that indicates how to submit comments.

V. Section 1400Z-2(c) Election for Investments Held At Least 10 Years

A. In General

Under section 1400Z-2(c), a taxpayer that holds a QOF investment for at least ten years may elect to increase the basis of the investment to the fair market value of the investment on the date that the investment is sold or exchanged.
The basis step-up election under section 1400Z-2(c) is available only for gains realized upon investments that were made in connection with a proper deferral election under section 1400Z-2(a). It is possible for a taxpayer to invest in a QOF in part with gains for which a deferral election under section 1400Z-2(a) is made and in part with other funds (for which no section 1400Z-2(a) deferral election is made or for which no such election is available). Section 1400Z-2(e) requires that these two types of QOF investments be treated as separate investments, which receive different treatment for Federal income tax purposes. Pursuant to section 1400Z-2(e)(1)(B), the proposed regulations reiterate that a taxpayer may make the election to step-up basis in an investment in a QOF that was held for 10 years or more only if a proper deferral election under section 1400Z-2(a) was made for the investment.

B. QOF Investments and the 10-Year Zone Designation Period

Section 1400Z-2(c), as stated above, permits a taxpayer to elect to increase the basis in its investment in a QOF if the investment is held for at least ten years from the date of the original investment in the QOF. However, under section 1400Z-1(f), the designations of all qualified opportunity zones now in existence will expire on December 31, 2028. The loss of qualified opportunity zone designation raises numerous issues regarding gain deferral elections that are still in effect when the designation expires. Among the issues that the zone expiration date raises is whether, after the relevant qualified opportunity zone loses its designation, investors may still make basis step-up elections for QOF investments from 2019 and later.

Section 1400Z-2 does not contain specific statutory language like that in some other provisions, such as the D.C. enterprise zones provision in section 1400B(b)(5),
that expressly permits a taxpayer to satisfy the requisite holding period after the termination of the designation of a zone. Commenters have raised the question described in the preceding paragraph—whether a taxpayer whose investment in a QOF has its 10-year anniversary after the 2028 calendar year will be able to take advantage of the basis step-up election provided in section 1400Z-2(c). The incentive provided by this benefit is integral to the primary purpose of the provision (see H.R. Rept. 115-466, 537, which describes the intent to attract an influx of capital to designated low income communities). For this reason, the proposed regulations permit taxpayers to make the basis step-up election under section 1400Z-2(c) after a qualified opportunity zone designation expires.

The ability to make this election is preserved under these proposed regulations until December 31, 2047, 20½ years after the latest date that an eligible taxpayer may properly make an investment that is part of an election to defer gain under section 1400Z-2(a). Because the latest gain subject to deferral would be at the end of 2026, the last day of the 180-day period for that gain would be in late June 2027. A taxpayer deferring such a gain would achieve a 10-year holding period in a QOF investment only in late June 2037. Thus, this proposed rule would permit an investor in a QOF that makes an investment as late as the end of June 2027 to hold the investment in the QOF for the entire 10-year holding period described in section 1400Z-2(c), plus another 10 years.

The additional ten year period is provided to avoid situations in which, in order to enjoy the benefits provided by section 1400Z-2(c), a taxpayer would need to dispose of an investment in a QOF shortly after completion of the required 10-year holding period.
There may be cases in which disposal shortly after the 10-year holding period would diverge from otherwise desirable business conduct, and, absent the additional time, some taxpayers may lose the statutory benefit.

The Treasury Department and the IRS request comments on this proposed fixed 20½-year end date for the section 1400Z-2(c) basis step-up election. In particular, whether some other time period would better align with taxpayers' economic interests and the purposes of the statute. Comments may also include an alternative to incentivizing investors to disinvest shortly before any such a fixed end date for the section 1400Z-2(c) basis step-up election. For example, should the regulations provide for a presumed basis step-up election immediately before the ability to elect a step-up upon disposition expires? If such a basis step-up without disposition is allowed, how should a QOF investment be properly valued at the time of the step-up?

VI. Rules for a Qualified Opportunity Fund

A. Certification of an Entity as a QOF

Section 1400Z-2(e)(4) allows the Secretary of the Treasury to prescribe regulations for the certification of QOFs for purposes of section 1400Z-2. In order to facilitate the certification process and minimize the information collection burden placed on taxpayers, the proposed regulations generally permit any taxpayer that is a corporation or partnership for tax purposes to self-certify as a QOF, provided that the entity self-certifying is statutorily eligible to do so. The proposed regulations permit the Commissioner to determine the time, form, and manner of the self-certification in IRS forms and instructions or in guidance published in the Internal Revenue Bulletin. It is expected that taxpayers will use Form 8996, Qualified Opportunity Fund, both for initial
self-certification and for annual reporting of compliance with the 90-Percent Asset Test in section 1400Z-2(d)(1). It is expected that the Form 8996 would be attached to the taxpayer’s Federal income tax return for the relevant tax years. The IRS expects to release this form contemporaneous with the release of these proposed regulations.

B. Designating When a QOF Begins

The proposed regulations allow a QOF both to identify the taxable year in which the entity becomes a QOF and to choose the first month in that year to be treated as a QOF. If an eligible entity fails to specify the first month it is a QOF, then the first month of its initial taxable year as a QOF is treated as the first month that the eligible entity is a QOF. A deferral election under section 1400Z-2(a) may only be made for investments in a QOF. Therefore, a proper deferral election under section 1400Z-2(a) may not be made for an otherwise qualifying investment that is made before an eligible entity is a QOF.

C. Becoming a QOF in a Month Other Than the First Month of the Taxable Year

The proposed regulations provide guidance regarding application of the 90-Percent Asset Test in section 1400Z-2(d)(1) with respect to an entity’s first year as a QOF, if the entity chooses to become a QOF beginning with a month other than the first month of its first taxable year. The phrase “first 6-month period of the taxable year of the fund” means the first 6-month period composed entirely of months which are within the taxable year and during which the entity is a QOF. For example, if a calendar-year entity that was created in February chooses April as its first month as a QOF, then the 90-Percent-Asset-Test testing dates for the QOF are the end of September and the end of December. Moreover, if the calendar-year QOF chooses a month after June as its
first month as a QOF, then the only testing date for the taxable year is the last day of
the QOF's taxable year. Regardless of when an entity becomes a QOF, the last day of
the taxable year is a testing date.

The proposed regulations clarify that the penalty in section 1400Z-2(f)(1) does
not apply before the first month in which the entity qualifies as a QOF. The Treasury
Department and the IRS intend to publish additional proposed regulations that will
address, among other issues, the applicability of the section 1400Z-2(f)(1) penalty and
conduct that may lead to potential decertification of a QOF.

Section 1400Z-2(e)(4)(B) authorizes regulations to ensure that a QOF has "a
reasonable period of time to reinvest the return of capital from investments in qualified
opportunity zone stock and qualified opportunity zone partnership interests, and to
reinvest proceeds received from the sale or disposition of qualified opportunity zone
business property." For example, if a QOF shortly before a testing date sells qualified
opportunity zone property, that QOF should have a reasonable amount of time in which
to bring itself into compliance with the 90-Percent Asset Test. Soon-to-be-released
proposed regulations will provide guidance on these reinvestments by QOFs. Many
stakeholders have requested guidance not only on the length of a "reasonable period of
time to reinvest" but also on the Federal income tax treatment of any gains that the QOF
reinvests during such a period. In the forthcoming notice of proposed rulemaking, the
Treasury Department and the IRS will invite additional public comment on the scope of
statutorily permissible policy alternatives. The Treasury Department and the IRS will
carefully consider those comments in evaluating the widest range of statutorily
permissible possibilities.
D. Pre-Existing Entities

Commenters have inquired whether a pre-existing entity may qualify as a QOF or as the issuer of qualified opportunity zone stock or of a qualified opportunity zone partnership. For example, commenters have asked whether a pre-existing entity may self-certify as a QOF or whether, after 2017, a QOF may acquire an equity interest in a pre-existing operating partnership or corporation. The proposed regulations clarify that there is no prohibition to using a pre-existing entity as a QOF or as a subsidiary entity operating a qualified opportunity business, provided that the pre-existing entity satisfies the requirements under section 1400Z-2(d).

As previously discussed, section 1400Z-2(d)(1) requires that a QOF must undergo semi-annual tests to determine whether its assets consist on average of at least 90 percent qualified opportunity zone property. For purposes of these semi-annual tests, section 1400Z-2(d)(2) requires that a tangible asset can be qualified opportunity zone business property by an entity that has self-certified as a QOF or an operating subsidiary entity only if it acquired the asset after 2017 by purchase. The Treasury Department and the IRS request comments on whether there is a statutory basis for additional flexibilities that might facilitate qualification of a greater number of pre-existing entities across broad categories of industries.

E. Valuation Method for Applying the 90-Percent Asset Test

For purposes of the calculation of the 90-Percent Asset Test in section 1400Z-2(d)(1) by the QOF, the proposed regulations require the QOF to use the asset values that are reported on the QOF’s applicable financial statement for the taxable year, as defined in §1.475(a)-4(h) of the Income Tax Regulations. If a QOF does not have an
applicable financial statement, the proposed regulations require the QOF to use the cost of its assets. The Treasury Department and the IRS request comments on the suitability of both of these valuation methods, and whether another method, such as tax adjusted basis, would be better for purposes of assurance and administration.

F. Nonqualified Financial Property

Commenters have recommended that the Treasury Department and the IRS adopt a rule that provides that cash be an appropriate QOF property for purposes of the 90-Percent Asset Test, if the cash is held with the intent of investing in qualified opportunity zone property. Specifically, commenters indicated that, because developing a new business or the construction or rehabilitation of real estate may take longer than six months, QOFs should be given longer than the six months provided under section 1400Z-2(d)(1) to invest in qualifying assets.

In response to these comments, the proposed regulations provide a working capital safe harbor for QOF investments in qualified opportunity zone businesses that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property used in a business operating in an opportunity zone. The safe harbor allows qualified opportunity zone businesses to apply the definition of working capital provided in section 1397C(e)(1) to property held by the business for a period of up to 31 months, if there is a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the opportunity zone, there is written schedule consistent with the ordinary business operations of the business that the property will be
used within 31-months, and the business substantially complies with the schedule. Taxpayers would be required to retain any written plan in their records.

This expansion of the term "working capital" reflects the fact that section 1400Z-2(d)(iii) anticipates situations in which a QOF or operating subsidiary may need up to 30 months after acquiring a tangible asset in which to improve the asset substantially. In seeking relief, some commenters based their requests on administrative practices that have developed under other sections of the Code that these commenters believe are analogous. The Treasury Department and the IRS request comments on the adequacy of the working-capital safe harbor and of ancillary safe harbors that protect a business during the working capital period, and on whether there is a statutory basis for any additional relief. Comments are also requested about the appropriateness of any further expansion of the "working capital" concept beyond the acquisition, construction, or rehabilitation of tangible business property to the development of business operations in the opportunity zone.

G. Qualified Opportunity Zone Business.

Under section 1400Z-2(d)(1), a QOF is any investment vehicle organized as a corporation or partnership for the purpose of investing in qualified opportunity zone property (other than another QOF). A QOF must hold at least 90 percent of its assets in qualified opportunity zone property. Compliance with the 90 Percent Asset Test is determined by the average of the percentage of the qualified opportunity zone property held in the QOF as measured on the last day of the first 6-month period of the taxable year of the QOF and on the last day of the taxable year of the QOF.

Under section 1400Z-2(d)(2)(A), the term qualified opportunity zone property
includes qualified opportunity zone business property. Qualified opportunity zone property may also include certain equity interests in an operating subsidiary entity (either a corporation or a partnership) that qualifies as a qualified opportunity zone business by satisfying certain requirements pursuant to section 1400Z-2(d)(2)(B) and (C).

Consequently, if a QOF operates a trade or business directly and does not hold any equity in a qualified opportunity zone business, at least 90 percent of the QOF’s assets must be qualified opportunity zone property.

The definition of qualified opportunity zone business property requires property to be used in a QOZ and also requires new capital to be employed in a QOZ. Under section 1400Z-2(d)(2)(D)(i), qualified opportunity zone business property means tangible property used in a trade or business of a QOF, but only if (1) the property was acquired by purchase after December 31, 2017; (2) the original use of the property in the QOZ commences with the QOF, or the QOF substantially improves the property; and (3) during substantially all of the QOF’s holding period for the property, substantially all of the use of the property was in a QOZ.

Under section 1400Z-2(d)(2)(B)(i) and (C), to qualify as a qualified opportunity zone business, an entity must be a qualified opportunity zone business both (a) when the QOF acquires its equity interest in the entity and (b) during substantially all of the QOF’s holding period for that interest. The manner of the QOF’s acquisition of the equity interest must comply with certain additional requirements.

Under section 1400Z-2(d)(3)(A), for a trade or business to qualify as a
qualified opportunity zone business, it must (among other requirements) be one in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property.

If an entity qualifies as a qualified opportunity zone business, the value of the QOF's entire interest in the entity counts toward the QOF's satisfaction of the 90 Percent Asset Test. Thus, if a QOF operates a trade or business (or multiple trades or businesses) through one or more entities, then the QOF can satisfy the 90 Percent Asset Test if each of the entities qualifies as a qualified opportunity zone business. The minimum amount of qualified opportunity zone business property owned or leased by a business for it to qualify as a qualified opportunity zone business is controlled by the meaning of the phrase substantially all in section 1400Z-2(d)(3)(A)(i).

In determining whether an entity is a qualified opportunity zone business, these proposed regulations propose a threshold to determine whether a trade or business satisfies the substantially all requirement in section 1400Z-2(d)(3)(A)(i).

If at least 70 percent of the tangible property owned or leased by a trade or business is qualified opportunity zone business property (as defined section 1400Z-2(d)(3)(A)(i)), the trade or business is treated as satisfying the substantially all requirement in section 1400Z-2(d)(3)(A)(i). The 70 percent threshold provided in these proposed regulations is intended to apply only to the term "substantially all" as it is used in section 1400Z-2(d)(3)(A)(i).

The phrase substantially all is also used in several other places in section 1400Z-2. That phrase appears in section 1400Z-2(d)(3)(A)(i), in which a qualified opportunity
zone business is generally defined as a trade or business "in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property (determined by substituting 'qualified opportunity zone business' for 'qualified opportunity fund' each place it appears in section 1400Z-2(d)(2)(D))." In addition, substantially all appears in section 1400Z-2(d)(2)(D)(i)(III), which establishes the conditions for qualifying as an opportunity zone business property "during substantially all of the qualified opportunity fund's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone" and section 1400Z-2(d)(2)(B)(ii)(III).

Several requirements of section 1400Z-2(d) use substantially all multiple times in a row (that is, "substantially all of ... substantially all of ... substantially all of ... "). This compounded use of substantially all must be interpreted in a manner that does not result in a fraction that is too small to implement the intent of Congress.

The Treasury Department and the IRS request comments regarding the proposed meaning of the phrase substantially all in section 1400Z-2(d)(3)(A)(i) as well as in the various other locations in section 1400Z-2(d) where that phrase is used.

H. Eligible Entities.

The proposed regulations clarify that a QOF must be an entity classified as a corporation or partnership for Federal income tax purposes. In addition, it must be created or organized in one of the 50 States, the District of Columbia, or a U.S. possession. In addition, if an entity is organized in a U.S. possession but not in one of the 50 States or in the District of Columbia, then it may be a QOF only if it is organized
for the purpose of investing in qualified opportunity zone property that relates to a trade or business operated in the possession in which the entity is organized.

The proposed regulations further clarify that qualified opportunity zone property may include stock or a partnership interest in an entity classified as a corporation or partnership for Federal income tax purposes. In addition, it must be a corporation or partnership created or organized in, or under the laws of, one of the 50 States, the District of Columbia, or a U.S. possession. Specifically, if an entity is organized in a U.S. possession but not in one of the 50 States or the District of Columbia, an equity interest in the entity may be qualified opportunity zone stock or a qualified opportunity zone partnership interest, as the case may be, only if the entity conducts a qualified opportunity zone business in the U.S. possession in which the entity is organized.

The proposed regulations further define a U.S. possession to mean any jurisdiction outside of the 50 States and the District of Columbia in which a designated qualified opportunity zone exists under section 1400Z-1. This definition may include the following U.S. territories: American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands. A complete list of designated qualified opportunity zones is found in Notice 2018-48, 2018-28 I.R.B. 9.

VII. Section 1400Z-2(e) Investments from Mixed Funds

If only a portion of a taxpayer’s investment in a QOF is subject to the deferral election under section 1400Z-2(a), then section 1400Z-2(e) requires the investment to be treated as two separate investments, which receive different treatment for Federal income tax purposes. Pursuant to section 1400Z-2(e)(1)(B), the proposed regulations reiterate that a taxpayer may make the election to step-up basis in an investment in a
QOF that was held for 10 years or more only if a proper deferral election under section 1400Z-2(a) was made for the investment.

Commenters have questioned whether section 752(a) could result in investments with mixed funds under section 1400Z-2(e)(1). Section 1400Z-2(e)(1) requires a taxpayer to treat as two separate investments the combination of an investment to which a section 1400Z-2(a) gain-deferral election applies and an investment of any amount to which such an election does not apply. As previously noted, these proposed regulations clarify that deemed contributions of money under section 752(a) do not constitute an investment in a QOF; therefore, such a deemed contribution does not result in the partner having a separate investment under section 1400Z-2(e)(1). Thus, a partner’s increase in outside basis is not taken into account in determining what portion of the partner’s interest is subject to the deferral election under section 1400Z-2(a) or what portion is not subject to the deferral election under section 1400Z-2(a). Comments are requested on whether other pass-through entities require similar treatment. Comments are also requested on whether there may be certain circumstances in which not treating the deemed contribution under section 752(a) as creating a separate investment for purposes of section 1400Z-2(e)(1) may be considered abusive or otherwise problematic.

Proposed Effective Date

These regulations generally are proposed to be effective on or after the date of publication in the Federal Register of a Treasury decision adopting these proposed rules as final regulations (final regulations publication date). However—
• An eligible taxpayer may rely on the rules of proposed §1.1400Z-2(a)-1 with respect to eligible gains that would be recognized before the final regulations’ date of applicability, but only if the taxpayer applies the rules in their entirety and in a consistent manner.

• A taxpayer may rely on the rules in proposed § 1.1400Z-2(c)-1 with respect to dispositions of investment interests in QOFs in situations where the investment was made in connection with an election under section 1400Z-2(a) that relates to the deferral of a gain such that the first day of 180-day period for the gain was before the final regulations’ date of applicability. This reliance is dependent on the taxpayer’s applying the rules of § 1.1400Z-2(c)-1 in their entirety and in a consistent manner.

• A QOF may rely on the rules in proposed §1.1400Z-2(d)-1 with respect to taxable years that begin before the final regulations’ date of applicability, but only if the QOF applies the rules in their entirety and in a consistent manner.

• A taxpayer may rely on the rules in proposed § 1.1400Z-2(e)-1 with respect to investments and deemed contributions of money that occur before the final regulations’ date of applicability, but only if the taxpayer applies the rules in their entirety and in a consistent manner.

Special Analyses

1. Regulatory Planning and Review

Executive Orders 13771, 13563, and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic,
environmental, public health and safety effects, distributive impacts, and equity).

Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility.

These proposed regulations have been designated by the Office of Management and Budget's Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. OIRA has determined that the proposed rulemaking is economically significant and subject to review under EO 12866 and section 1(c) of the Memorandum of Agreement. The Treasury Department and the IRS believe that significant investment will flow into qualified opportunity zones as a result of the TCJA legislation and proposed regulation. This investment is likely to be primarily from other areas of the United States. Accordingly, the proposed regulations have been reviewed by the Office of Management and Budget. In addition, the Treasury Department and the IRS expect the proposed regulation, when final, to be an Executive Order 13771 deregulatory action and request comment on this designation. Details on the costs of the proposed regulations can be found in this economic analysis.

A. Background and Overview

Congress enacted section 1400Z-2, in conjunction with section 1400Z-1, as a temporary provision to encourage private sector investment in certain lower-income communities designated as qualified opportunity zones (see Senate Committee on Finance, Explanation of the Bill, at 313 (November 22, 2017)). Taxpayers may elect to defer the recognition of capital gain to the extent of amounts invested in a QOF,
provided that the corresponding amounts are invested during the 180-day period
beginning on the date such capital gain would have been recognized by the taxpayer.
Inclusion of the deferred capital gain in income occurs on the date the investment in the QOF is sold or exchanged, or on December 31, 2026, whichever comes first. For investments in a QOF held longer than five years, taxpayers may exclude 10 percent of the deferred gain from inclusion in income, and for investment held longer than seven years, taxpayers may exclude a total of 15 percent of the deferred gain from inclusion in income. In addition, for investments held longer than 10 years, the post-acquisition gain on the qualifying investment in the QOF may also be excluded from income. In turn, a QOF must hold at least 90 percent of its assets in qualified opportunity zone property, as measured by the average percentage held at the last day of the first 6-month period of the taxable year of the fund and the last day of the taxable year. The statute requires a QOF that fails this 90 percent test to pay a penalty for each month it fails to maintain the 90-percent asset requirement.

The proposed regulations clarify several terms used in the statute, such as what type of gains are eligible for this preferential treatment, what type of taxpayers are eligible, the timing of transactions necessary for satisfying the requirements of the statute, including the time period for which the exclusion on gains for investments held longer than 10 years applies, and certain rules related to the creation and continued qualification of a fund as a QOF.

B. **Need for the Proposed Regulations**

Taxpayers may be unwilling to make investments in QOFs without first having additional clarity on which investments in a QOF would qualify to receive the preferential
tax treatment specified by the TCJA. This uncertainty could reduce the amount of
investment flowing into lower-income communities designated as qualified opportunity
zones below the congressionally intended effect. The lack of additional clarity could
also lead to different taxpayers interpreting, and therefore applying, the same statute
differently, which could distort the allocation of investment across the qualifying
opportunity zones.

C. Economic Analysis

1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of
the proposed regulations relative to a no-action baseline reflecting anticipated Federal
income tax-related behavior in the absence of these proposed regulations.

2. Anticipated benefits

a. In general

The Treasury Department and the IRS expect that the certainty and clarity
provided by these proposed regulations, relative to the baseline, will enhance U.S.
economic performance under the statute. Under the proposed regulations, taxpayers
are provided clarity on the type and timing of transactions that would qualify for the
beneficial tax treatment provided for investments in QOFs. As a primary benefit, the
clarity provided by these proposed regulations would reduce planning costs for
taxpayers and make it easier for taxpayers to make investment decisions that more
precisely conform to the statutory requirements for QOFs. In addition, the reduction in
uncertainty should encourage investment to flow into qualified opportunity zones,
consistent with the intent of the TCJA.
The Treasury Department and the IRS considered various alternatives in the promulgation of the proposed regulations, with the major ones described in the following paragraphs. These alternatives included not issuing the proposed regulations under section 1400Z-2. This path was not chosen for several reasons. The TCJA provides both a reward in terms preferential tax treatment of deferred gains, but also a penalty if a QOF does not maintain compliance with the 90-percent asset test. Without the proposed regulations, some taxpayers may have foregone making promising investments within a qualifying opportunity zone out of concern that the investment may later be determined to not be a qualifying investment. As described in the following paragraphs, the proposed regulations help clarify several areas in which the statutory language was either ambiguous or not very specific. Overall, the clarity provided by the proposed regulations should reduce planning costs by taxpayers and enable taxpayers to make economically efficient decisions given the context of the whole Code.

b. Clarity regarding eligible gains

The proposed regulations specify that only capital gains are eligible for deferral and potential exclusion under section 1400Z-2. As discussed in section I.A of the Explanation of Provisions, there is ambiguity that results from the variation between the operative statutory text and the section heading in the statute regarding what type of gains would be eligible for deferral. The Treasury Department and the IRS determined that Congress intended deferral only to be available to capital gains. This clarity provided in the proposed regulations would reduce uncertainty for taxpayers regarding what transactions would qualify for the preferential tax treatment and also reduce administrative and compliance costs.
c. Clarity regarding application to eligible taxpayers

The proposed regulations also clarify which taxpayers are eligible to defer the recognition of capital gain through investing in a QOF and describe how different types of taxpayers may satisfy the requirements for electing to defer capital gain consistent with the rules of section 1400Z-2 and the overall Code. In particular, the proposed regulations describe rules for how partnerships and partners in a partnership may invest in a QOF and elect to defer recognition of capital gains. Partnerships are expected to be a significant source of funds invested in QOFs. Without these proposed rules clarifying how partnerships and partners may satisfy the requirements for the preferential treatment of capital gains, partners may be less willing to invest in a QOF. The proposed regulations help provide a uniform signal to different types of taxpayers of the availability of this preferential treatment of capital gains and provide the mechanics of how these different taxpayers may satisfy the requirements imposed by the statute. Thus these different types of taxpayers may make decisions that are more economically efficient contingent on the overall Code.

d. Clarity regarding electing post-10-year gain exclusion if zone designation expires

Proposed §1.1400Z-2(c)-1 specifies that expiration of a zone designation would not impair the ability of a taxpayer to elect the exclusion from gains for investments held for at least 10 years, provided the disposition of the investment occurs prior to January 1, 2048. The Treasury Department and the IRS considered four alternatives regarding the interaction between the expiration of the designated zones and the election to exclude gain for investments held more than 10 years. A discussion of the economic costs and benefits of the four options follows.
i. Remaining silent on electing post-10-year gain exclusion

The first alternative would be for the proposed regulations to remain silent on this issue. Section 1400Z-2(c) permits a taxpayer to increase the basis in the property held in a QOF longer than 10 years to be equal to the fair market value of that property on the date that the investment is sold or exchanged, thus excluding post-acquisition capital gain on the investment from tax. However, the statutory expiration of the designation of qualified opportunity zones on December 31, 2028, makes it unclear to what extent investments in a QOF made after 2018 would qualify for this exclusion.

Some taxpayers may believe that only investments in a QOF made prior to January 1, 2019, would be eligible for the exclusion from gain if held greater than 10 years. Such taxpayers may rush to complete transactions within 2018, while others may choose to hold off indefinitely from investing in a QOF until they received clarity on the availability of the 10-year exclusion from gain for investments made later than 2018. Other taxpayers may plan to invest in a QOF after 2018 with the expectation that future regulations would be provided or the statute would be amended to make it clear that dispositions of assets within a QOF after 2028 would be eligible for exclusion if held longer than 10 years. The ambiguity of the statute is likely to lead to uneven response by different taxpayers, dependent on the taxpayer's interpretation of the statute, which may lead to an inefficient allocation of investment across qualified opportunity zones.

ii. Providing a clear deadline for electing post-10-year gain exclusion

The alternative adopted by the proposed regulations clarifies that as long as the investment in the QOF was made with funds subject to a proper deferral election under section 1400Z-2(a), which requires the investment to be made prior to June 29, 2027,
then the 10-year gain exclusion election is allowed as long as the disposition of the investment occurs before January 1, 2048. This proposed rule would provide certainty to taxpayers regarding the timing of investments eligible for the 10-year gain exclusion. Taxpayers would have a more uniform understanding of what transactions would be eligible for the favorable treatment on capital gains. This would help taxpayers determine which investments provide a sufficient return to compensate for the extra costs and risks of investing in a QOF. This proposed rule would likely lead to an increase in investment within QOFs compared the proposed regulations remaining silent on this issue.

However, setting a fixed date for the disposition of eligible QOFs investments could introduce economic inefficiencies. Some taxpayers may dispose of their investment in a QOF by the deadline in the proposed regulation primarily in order to receive the benefit of the gain exclusion, but that selling date may not be optimal for the taxpayer in terms of the portfolio of assets that the taxpayer could have chosen to invest in were there no deadline. Setting a fixed deadline may also generate an overall decline in asset values in some qualified opportunity zones if many investors in QOFs seek to sell their portion of the fund within the same time period. This decline in asset values may affect the broader level of economic activity within some qualified opportunity zones or affect other investors in such zones that did not invest through a QOF. In anticipation of this fixed deadline, some taxpayers may choose to dispose of QOF assets earlier than the deadline to avoid an anticipated “rush to the exits,” but this would seem to conflict with the purpose of the incentives in the statute to encourage “patient” capital investment within qualified opportunity zones. While the proposed
regulations may produce these inefficiencies, by providing a long time period for which taxpayers may dispose of their investment within a QOF and still qualify for the exclusion the proposed regulations will lead any such inefficiencies to be minor.

iii. Providing no deadline for electing gain exclusion

As an alternative, the proposed regulations could have provided no deadline for electing the 10-year gain exclusion for investments in a QOF, while still stating that the ability to make the election is not impaired solely because the designation of one or more qualified opportunity zones ceases to be in effect. While this alternative would eliminate the economic inefficiencies associated with a fixed deadline and would likely lead to greater investment in QOFs, it could introduce substantial additional administrative and compliance costs. Taxpayers would also need to maintain records and make efforts to maintain compliance with the rules of section 1400Z-2 on an indefinite basis.

iv. Providing fair market value basis without disposition of investment

Another alternative considered would allow taxpayers to elect to increase the basis in their investment in the QOF if held at least 10 years to the fair market value of the investment without disposing of the property, as long as the election was made prior to January 1, 2048. (Analogously, the proposed regulations could have provided that, at the close of business of the day on which a taxpayer first has the ability to make the 10-year gain exclusion election, the basis in the investment automatically sets to the greater of current basis or the fair market value of the investment.) This alternative would minimize the economic inefficiencies of the proposed regulations resulting from taxpayers needing to dispose of their investment in the opportunity zone at a fixed date
not related to any factor other than the lapse of time. However, this approach would require a method of valuing assets that could raise administrative and compliance costs. It may also require the maintenance of records and trained compliance personnel for over two decades.

v. Summary

As discussed in section V.B of the Explanation of Provisions, the Treasury Department and the IRS have determined the ability to exclude gains for investment held at least 10 years in a QOF is integral to the TCJA's purpose of creating qualified opportunity zones. The proposed regulations provide a uniform signal to all taxpayers on the availability of this tax incentive, which should encourage greater investment, and a more efficient distribution of investment, in QOFs than in the absence of these proposed regulations. The relative costs and benefits of the various alternatives are difficult to measure and compare. The proposed regulations would likely produce the lowest compliance and administrative costs among the alternatives and any associated economic inefficiencies are likely to be small.

e. Safe harbors for statutory qualifying property tests

Section 1400Z-2 contains several rules limiting taxpayers from benefitting from the deferral and exclusion of capital gains from income offered by that section without also locating investment within a qualifying opportunity zone. The proposed regulations clarify the rules related to nonqualified financial property and what amounts can be held in cash and cash equivalents as working capital. The statute requires that a QOF must hold 90 percent of its assets in qualified opportunity zone property, such as owning stock or a partnership interest in a qualified opportunity zone business. A qualifying
opportunity zone business is subject to the requirements of section 1397C(b)(8), that less than 5 percent of the aggregate adjusted basis of the entity is attributable to nonqualified financial property. The proposed regulations establish a working capital safe harbor consistent with section 1397C(e)(1), under which a qualified opportunity zone business may hold cash or cash equivalents for a period not longer than 31 months and not violate section 1397C(b)(8).

The Treasury Department and the IRS expect that the establishment of safe harbors under these parameters will provide net economic benefits. Without specification of the working capital safe harbor, some taxpayers would not invest in a QOF for fear that the QOF would not be able to deploy the funds soon enough to satisfy the 90-percent asset test. Thus, this part of the proposed regulations would generally encourage investment in QOFs by providing greater specificity to how an entity may consistently satisfy the statutory requirements for maintaining a QOF without penalty. In addition, this part of the proposed regulations minimizes the distortion that may arise between purchasing existing property and sufficiently rehabilitating that property versus constructing new property, as the time frame specified under the statute and proposed regulations are similar (30 months after acquisition for rehabilitating existing property versus 31 months for acquiring and rehabilitating existing property or for constructing new property).

A longer or a shorter period could have been chosen for the working capital safe harbor. A shorter time period would minimize the ability of taxpayers to use the investment in a QOF as a way to lower taxes without actually investing in tangible assets within a qualified opportunity zone, but taxpayers may also forego legitimate
investments within an opportunity zone out of concern of not being able to deploy the working capital fast enough to meet the requirements. A longer period would have the opposite effects. Taxpayers could potentially invest in a QOF and receive the benefits of the tax incentive for multiple years before the money is invested into a qualified opportunity zone.

f. Definition of substantially all

The proposed regulations specify that if at least 70 percent of the tangible property owned or leased by a trade or business is qualified opportunity zone business property, then the trade or business is treated as satisfying the substantially all requirement of section 1400Z-2(d)(3)(A)(i). This clarity would provide taxpayers greater certainty when evaluating potential investment opportunities as to whether the potential investment would satisfy the statutory requirements.

However, the 70 percent requirement for a trade or business will give QOFs an incentive to invest in a qualified opportunity zone business rather than owning qualified opportunity zone business property directly. For example, consider a QOF with $10 million in assets that plans to invest 100 percent of its assets in real property. If it held the real property directly, then at least $9 million (90 percent) of the property must be located within an opportunity zone to satisfy the 90 percent asset test for the QOF. If instead, it invests in a subsidiary that then holds real property, then only $7 million (70 percent) of the property must be located within an opportunity zone. In addition, if the QOF only invested $9 million into the subsidiary, which then held 70 percent of its property within an opportunity zone, the investors in the QOF could receive the statutory
tax benefits while investing only $6.3 million (63 percent) of its assets within a qualified opportunity zone.

The Treasury Department and the IRS also considered setting this "substantially all" threshold at 90 percent. This would reduce, but not eliminate, the incentive the QOF has to invest in a qualified opportunity zone business rather than directly owning qualified opportunity zone business property compared to the 70 percent threshold. Please see earlier discussion and request for comment regarding this definition for additional detail.

3. Anticipated impacts on administrative and compliance costs

The Treasury Department and the IRS anticipate decreased taxpayer compliance costs resulting from the proposed regulations due to the greater taxpayer certainty regarding how to comply with the requirements set forth in the statute. The Treasury Department also anticipates decreased administrative and enforcement costs for the IRS.

D. Paperwork Reduction Act

The collection of information in these proposed regulations with respect to QOFs is in proposed §1.1400Z-2(d)-1. The collection of information in proposed §1.1400Z-2(d)-1 is satisfied by submitting a new reporting form, Form 8996, Qualified Opportunity Fund, with an income tax return. For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) (PRA), the reporting burden associated with proposed §1.1400Z-2(d)-1 will be reflected in the Paperwork Reduction Act submission associated with new Form 8996 (OMB control number 1545-0123). Notice of the availability of the draft Form 8996 and request for comment will be available at IRS.gov/DraftForms. In
addition, the Treasury Department and the IRS request comments on any aspect of this collection in this proposed rulemaking.

The collection of information in proposed §1.1400Z-2(d)-1 requires each QOF, be it a corporation or partnership, to file a Form 8996 to certify that it is organized to invest in qualified opportunity zone property. In addition, a QOF files Form 8996 annually to certify that the qualified opportunity fund meets the investment standards of section 1400Z-2 or to figure the penalty if it fails to meet the investment standards.

II. Regulatory Flexibility Act

Under the Regulatory Flexibility Act (RFA) (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations, if adopted, would not have a significant economic impact on a substantial number of small entities that are directly affected by the proposed regulations. Therefore, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Although there is a lack of available data regarding the extent to which small entities invest in QOFs, this certification is based on the belief of the Treasury Department and the IRS that these funds will generally involve investments made by larger entities and investments are entirely voluntary. The Treasury Department and the IRS specifically solicit comment from any party, particularly affected small entities, on the accuracy of this certification.

Pursuant to section 7805(f), this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.
III. **Unfunded Mandates Reform Act**

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately $150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

IV. **Executive Order 13132: Federalism**

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

**Statement of Availability of IRS Documents**

Comments

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic and written comments that are submitted timely to the IRS as prescribed in this preamble under the “ADDRESSES” heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at http://www.regulations.gov or upon request.

Drafting Information

The principal author of these proposed regulations is Erika C. Reigle, Office of Associate Chief Counsel (Income Tax & Accounting). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income Taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR Part 1 is proposed to be amended as follows:

Part 1—INCOME TAX

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805***

Section 1.1400Z-2(a)-1 also issued under 26 U.S.C. 1400Z-2(e)(4).

Section 1.1400Z-2(c)-1 also issued under 26 U.S.C. 1400Z-2(e)(4).

Section 1.1400Z-2(d)-1 also issued under 26 U.S.C. 1400Z-2(e)(4).

Section 1.1400Z-2(e)-1 also issued under 26 U.S.C. 1400Z-2(e)(4).
Par. 2. Section 1.1400Z-2(a)-1 is added to read as follows:

§1.1400Z-2(a)-1 Deferring tax on capital gains by investing in opportunity zones.

(a) **In general.** Under section 1400Z-2(a) of the Internal Revenue Code (Code) and this section, an eligible taxpayer may elect to defer recognition of some or all of its eligible gains to the extent that the taxpayer timely invests (as provided for by section 1400Z-2(a)(1)(A)) in eligible interests of a qualified opportunity fund (QOF), as defined in section 1400Z-2(d)(1). Paragraph (b) of this section defines eligible taxpayers, eligible gains, and eligible interests and contains related operational rules. Paragraph (c) of this section provides rules for applying section 1400Z-2 to a partnership, S corporation, trust, or estate that recognizes an eligible gain or would recognize such a gain if it did not elect to defer the gain under section 1400Z-2(a).

(b) **Definitions and related operating rules.** The following definitions and rules apply for purposes of section 1400Z-2 and the regulations thereunder:

(1) **Eligible taxpayer.** An eligible taxpayer is a person that may recognize gains for purposes of Federal income tax accounting. Thus, eligible taxpayers include individuals; C corporations, including regulated investment companies (RICs) and real estate investment trusts (REITs); partnerships; S corporations; trusts and estates. An eligible taxpayer may elect to defer recognition of one or more eligible gains in accordance with the requirements of section 1400Z-2.

(2) **Eligible gain**—(i) **In general.** An amount of gain is an eligible gain, and thus is eligible for deferral under section 1400Z-2(a), if the gain—

(A) is treated as a capital gain for Federal income tax purposes;
(B) Would be recognized for Federal income tax purposes before January 1, 2027, if section 1400Z-2(a)(1) did not apply to defer recognition of the gain; and

(C) Does not arise from a sale or exchange with a person that, within the meaning of section 1400Z-2(e)(2), is related to the taxpayer that recognizes the gain or that would recognize the gain if section 1400Z-2(a)(1) did not apply to defer recognition of the gain.

(ii) **Gain not already subject to an election.** In the case of a taxpayer who has made an election under section 1400Z-2(a) with respect to some but not all of an eligible gain, the term "eligible gain" includes the portion of that eligible gain with respect to which no election has yet been made.

(iii) **Gains under section 1256 contracts**--(A) **General rule.** The only gain arising from section 1256 contracts that is eligible for deferral under section 1400Z-2(a)(1) is capital gain net income for a taxable year. This net amount is determined by taking into account the capital gains and losses for a taxable year on all of a taxpayer's section 1256 contracts, including all amounts determined under section 1256(a), both those determined on the last business day of a taxable year and those that section 1256(c) requires to be determined under section 1256(a) because of the termination or transfer during the taxable year of the taxpayer's position with respect to a contract. The 180-day period with respect to any capital gain net income from section 1256 contracts for a taxable year begins on the last day of the taxable year, and the character of that gain when it is later included under section 1400Z-2(a)(1)(B) and (b) is determined under the general rule in paragraph (b)(5) of this section. See paragraph (b)(2)(iii)(B) of this
section for limitations on the capital gains eligible for deferral under this paragraph (b)(2)(iii)(A).

(B) Limitation on deferral for gain from 1256 contracts. If, at any time during the taxable year, any of the taxpayer's section 1256 contracts was part of an offsetting positions transaction (as defined in paragraph (b)(2)(iv) of this section) and any other position in that transaction was not a section 1256 contract, then no gain from any section 1256 contract is an eligible gain with respect to that taxpayer in that taxable year.

(iv) No deferral for gain from a position that is or has been part of an offsetting-positions transaction. If a capital gain is from a position that is or has been part of an offsetting-positions transaction, the gain is not eligible for deferral under section 1400Z-2(a)(1). For purposes of this paragraph (b)(2)(iv), an offsetting-positions transaction is a transaction in which a taxpayer has substantially diminished the taxpayer's risk of loss from holding one position with respect to personal property by holding one or more other positions with respect to personal property (whether or not of the same kind). It does not matter whether either of the positions is with respect to actively traded personal property. An offsetting-positions transaction includes a straddle as defined in section 1092 and the regulations thereunder, including section 1092(d)(4), which provides rules for positions held by related persons and certain flow-through entities (for example, a partnership). An offsetting-positions transaction also includes a transaction that would be a straddle (taking into account the principles referred to in the preceding sentence) if the straddle definition did not contain the active trading requirement in section 1092(d)(1). For example, an offsetting-positions transaction includes positions
in closely held stock or other non-traded personal property and substantially offsetting derivatives.

(3) **Eligible interest**—(i) **In general.** For purposes of section 1400Z-2, an eligible interest in a QOF is an equity interest issued by the QOF, including preferred stock or a partnership interest with special allocations. Thus, the term eligible interest excludes any debt instrument within the meaning of section 1275(a)(1) and §1.1275-1(d).

(ii) **Use as collateral permitted.** Provided that the eligible taxpayer is the owner of the equity interest for Federal income tax purposes, status as an eligible interest is not impaired by using the interest as collateral for a loan, whether as part of a purchase-money borrowing or otherwise.

(iii) **Deemed contributions not constituting investment.** See §1.1400Z-2(e)-1(a)(2) for rules regarding deemed contributions of money to a partnership pursuant to section 752(a).

(4) **180-day period**—(i) **In general.** Except as otherwise provided elsewhere in this section, the 180-day period referred to in section 1400Z-2(a)(1)(A) with respect to any eligible gain (180-day period) begins on the day on which the gain would be recognized for Federal income tax purposes if the taxpayer did not elect under section 1400Z-2 to defer recognition of that gain.

(ii) **Examples.** The following examples illustrate the principles of paragraph (b)(4)(i) of this section.

**Example 1. Regular-way trades of stock.** If stock is sold at a gain in a regular-way trade on an exchange, the 180-day period with respect to the gain on the stock begins on the trade date.

**Example 2. Capital gain dividends received by RIC and REIT shareholders.** If an individual RIC or REIT shareholder receives a capital gain dividend (as described in
section 852(b)(3) or section 857(b)(3)), the shareholder’s 180-day period with respect to that gain begins on the day on which the dividend is paid.

Example 3. Undistributed capital gains received by RIC and REIT shareholders. If section 852(b)(3)(D) or section 857(b)(3)(D) (concerning undistributed capital gains) requires the holder of shares in a RIC or REIT to include an amount in the shareholder’s long-term capital gains, the shareholder’s 180-day period with respect to that gain begins on the last day of the RIC or REIT’s taxable year.

Example 4. Additional deferral of previously deferred gains—(i) Facts. Taxpayer A invested in a QOF and properly elected to defer realized gain. During 2025, taxpayer A disposes of its entire investment in the QOF in a transaction that, under section 1400Z-2(a)(1)(B) and (b), triggers an inclusion of gain in A’s gross income. Section 1400Z-2(b) determines the date and amount of the gain included in A’s income. That date is the date on which A disposed of its entire interest in the QOF. A wants to elect under section 1400Z-2 to defer the amount that is required to be included in income.

(ii) Analysis. Under paragraph (b)(4)(i) of this section, the 180-day period for making another investment in a QOF begins on the day on which section 1400Z-2(b) requires the prior gain to be included. As prescribed by section 1400Z-2(b)(1)(A), that is the date of the inclusion-triggering disposition. Thus, in order to make a deferral election under section 1400Z-2, A must invest the amount of the inclusion in the original QOF or in another QOF during the 180-day period beginning on the date when A disposed of its entire investment in the QOF.

(5) Attributes of gains that section 1400Z-2(a)(1)(B) includes in income. If section 1400Z-2(a)(1)(B) and (b) require a taxpayer to include in income some or all of a previously deferred gain, the gain so included has the same attributes in the taxable year of inclusion that it would have had if tax on the gain had not been deferred. These attributes include those taken into account by sections 1(h), 1222, 1256, and any other applicable provisions of the Code.

(6) First-In, First-Out (FIFO) method to identify which interest in a QOF has been disposed of—(i) FIFO requirement. If a taxpayer holds investment interests with identical rights (fungible interests) in a QOF that were acquired on different days and if, on a single day, the taxpayer disposes of less than all of these interests, then the first-
in-first-out (FIFO) method must be used to identify which interests were disposed of. Fungible interests may be equivalent shares of stock in a corporation or partnership interests with identical rights.

(ii) Consequences of identification. The FIFO method determines—

(A) Whether an investment is described in section 1400Z-2(e)(1)(A)(i) (an investment to which a gain deferral election under section 1400Z-2(a) applies) or section 1400Z-2(e)(1)(A)(ii) (an investment which was not part of a gain deferral election under section 1400Z-2(a));

(B) In the case of investments described in section 1400Z-2(e)(1)(A)(i), the attributes of the gain subject to a deferral election under section 1400Z-2(a), at the time the gain is included in income (the attributes addressed in paragraph (b)(5) of this section); and

(C) The extent, if any, of an increase under section 1400Z-2(b)(2)(B) in the basis of an investment interest that is disposed of.

(7) Pro-rata method. If, after application of the FIFO method, a taxpayer is treated as having disposed of less than all of the investment interests that the taxpayer acquired on one day and if the interests acquired on that day vary with respect to the characteristics described in paragraph (b)(6)(ii) of this section, then a proportionate allocation must be made to determine which interests were disposed of (pro-rata method).

(8) Examples. The following examples illustrate the rules of paragraph (b)(5) through (7) of this section.

Example 1. Short-term gain. For 2018, taxpayer B properly made an election under section 1400Z-2 to defer $100 of gain that, if not deferred, would have been recognized as short-term capital gain, as defined in section 1222(1). In 2022, section
1400Z-2(a)(1)(B) and (b) requires taxpayer B to include the gain in gross income. Under paragraph (b)(5) of this section, the gain included is short-term capital gain.

**Example 2. Collectibles gain.** For 2018, taxpayer C properly made an election under section 1400Z-2 to defer a gain that, if not deferred, would have been collectibles gain as defined in IRC section 1(h)(5). In a later taxable year, section 1400Z-2(a)(1)(B) and (b) requires some or all of that deferred gain to be included in gross income. The gain included is collectibles gain.

**Example 3. Net gains from section 1256 contracts.** For 2019, taxpayer D had $100 of capital gain net income from section 1256 contracts. D timely invested $100 in a QOF and properly made an election under section 1400Z-2 to defer that $100 of gain. In 2023, section 1400Z-2(a)(1)(B) and (b) requires taxpayer D to include that deferred gain in gross income. Under paragraph (b)(5) of this section, the character of the inclusion is governed by section 1256(a)(3) (which requires a 40:60 split between short-term and long-term capital gain). Accordingly, $40 of the inclusion is short-term capital gain and $60 of the inclusion is long-term capital gain.

**Example 4. FIFO method.** For 2018, taxpayer E properly made an election under section 1400Z-2 to defer $300 of short-term capital gain. For 2020, E properly made a second election under section 1400Z-2 to defer $200 of long-term capital gain. In both cases, E properly invested in QOF Q the amount of the gain to be deferred. The two investments are fungible interests and the price of the interests was the same at the time of the two investments. E did not purchase any additional interest in QOF Q or sell any of its interest in QOF Q until 2024, when E sold for a gain 60 percent of its interest in QOF Q. Under paragraph (b)(6)(i) of this section, E must apply the FIFO method to identify which investments in QOF Q that E disposed of. As determined by this identification, E sold the entire 2018 initial investment in QOF Q. Under section 1400Z-2(a)(1)(B) and (b), the sale triggered an inclusion of deferred gain. Because the inclusion has the same character as the gain that had been deferred, the inclusion is short-term capital gain.

**Example 5. FIFO method.** In 2018, before Corporation R became a QOF, Taxpayer F invested $100 cash to R in exchange for 100 R common shares. Later in 2018, after R was a QOF, F invested $500 cash to R in exchange for 400 R common shares and properly elected under section 1400Z-2 to defer $500 of independently realized short-term capital gain. Even later in 2018, on different days, F realized $300 of short-term capital gain and $700 of long-term capital gain. On a single day that fell during the 180-day period for both of those gains, F invested $1,000 cash in R in exchange for 800 R common shares and properly elected under section 1400Z-2 to defer the two gains. In 2020, F sold 100 R common shares. Under paragraph (b)(6)(i) of this section, F must apply the FIFO method to identify which investments in R F disposed of. As determined by that identification, F sold the initially acquired 100 R common shares, which were not part of a deferral election under section 1400Z-2. R must recognize gain or loss on the sale of its R shares under the generally applicable Federal income tax rules, but the sale does not trigger an inclusion of any deferred gain.
Example 6. FIFO method. The facts are the same as example 5, except that, in addition, during 2021 F sold an additional 400 R common shares. Under paragraph (b)(6)(i) of this section, F must apply the FIFO method to identify which investments in R were disposed of. As determined by this identification, F sold the 400 common shares which were associated with the deferral of $500 of short-term capital gain. Thus, the deferred gain that must be included upon sale of the 400 R common shares is short-term capital gain.

Example 7. Pro-rata method. The facts are the same as in examples 5 and 6, except that, in addition, during 2022 F sold an additional 400 R common shares. Under paragraph (b)(6)(i) of this section, F must apply the FIFO method to identify which investments in R were disposed of. In 2022, F is treated as holding only the 800 R common shares purchased on a single day, and the section 1400Z-2 deferral election associated with these shares applies to gain with different characteristics (described in paragraph (b)(6)(ii) of this section). Under paragraph (b)(7) of this section, therefore, R must use the pro-rata method to determine which of the characteristics pertain to the deferred gain required to be included as a result of the sale of the 400 R common shares. Under the pro-rata method, $150 of the inclusion is short-term capital gain ($300 × 400/800) and $350 is long-term capital gain ($700 × 400/800).

(c) Special rules for pass-through entities—(1) Eligible gains that a partnership elects to defer. A partnership is an eligible taxpayer under paragraph (b)(1) of this section and may elect to defer recognition of some or all of its eligible gains under section 1400Z-2(a)(2).

(i) Partnership election. If a partnership properly makes an election under section 1400Z-2(a)(2), then--

(A) The partnership defers recognition of the gain under the rules of section 1400Z-2 (that is, the partnership does not recognize gain at the time it otherwise would have in the absence of the election to defer gain recognition);

(B) The deferred gain is not included in the distributive shares of the partners under section 702 and is not subject to section 705(a)(1); and

(ii) Subsequent recognition. Absent any additional deferral under section 1400Z-2(a)(1)(A), any amount of deferred gain that an electing partnership subsequently must
include in income under sections 1400Z-2(a)(1)(B) and (b) is recognized by the electing partnership at the time of inclusion and is subject to sections 702 and 705(a)(1) in a manner consistent with recognition at that time.

(2) Eligible gains that the partnership does not defer--(i) Tax treatment of the partnership. If a partnership does not elect to defer some, or all, of the gains for which it could make a deferral election under section 1400Z-2, the partnership's treatment of any such amounts is unaffected by the fact that the eligible gain could have been deferred under section 1400Z-2.

(ii) Tax treatment by the partners. If a partnership does not elect to defer some, or all, of the gains for which it could make a deferral election under section 1400Z-2--

(A) The gains for which a deferral election are not made are included in the partners' distributive shares under section 702 and are subject to section 705(a)(1);

(B) If a partner's distributive share includes one or more gains that are eligible gains with respect to the partner, the partner may elect under section 1400Z-2(a)(1)(A) to defer some or all of its eligible gains; and

(C) A gain in a partner's distributive share is an eligible gain with respect to the partner only if it is an eligible gain with respect to the partnership and it did not arise from a sale or exchange with a person that, within the meaning of section 1400Z-2(e)(2), is related to the partner.

(iii) 180-day period for a partner electing deferral--(A) General rule. If a partner's distributive share includes a gain that is described in paragraph (c)(2)(ii)(C) of this section (gains that are eligible gains with respect to the partner), the 180-day period with respect to the partner's eligible gains in the partner's distributive share generally
begins on the last day of the partnership taxable year in which the partner’s allocable share of the partnership’s eligible gain is taken into account under section 706(a).

(B) **Elective rule.** Notwithstanding the general rule in paragraph (c)(2)(iii)(A) of this section, if a partnership does not elect to defer all of its eligible gain, the partner may elect to treat the partner’s own 180-day period with respect to the partner’s distributive share of that gain as being the same as the partnership’s 180-day period.

(C) The following example illustrates the principles of this paragraph (c)(2)(iii).

**Example.** Five individuals have identical interests in partnership P, there are no other partners, and P’s taxable year is the calendar year. On January 17, 2019, P realizes a capital gain of $1000x that it decides not to elect to defer. Two of the partners, however, want to defer their allocable portions of that gain. One of these two partners invests $200x in a QOF during February 2020. Under the general rule in paragraph (c)(2)(iii)(A) of this section, this investment is within the 180-day period for that partner (which begins on December 31, 2019). The fifth partner, on the other hand, decides to make the election provided in paragraph (c)(2)(iii)(B) of this section and invests $200x in a QOF during February 2019. Under that elective rule, this investment is within the 180-day period for that partner (which begins on January 17, 2019).

(3) **Pass-through entities other than partnerships.** If an S corporation; a trust; or a decedent’s estate recognizes an eligible gain, or would recognize an eligible gain if it did not elect to defer recognition of the gain under section 1400Z-2(a), then rules analogous to the rules of paragraph (c)(1) and (2) of this section apply to that entity and to its shareholders or beneficiaries, as the case may be.

(d) **Elections.** The Commissioner may prescribe in guidance published in the Internal Revenue Bulletin or in forms and instructions (see §§ 601.601(d)(2) and 601.602 of this chapter), both the time, form, and manner in which an eligible taxpayer may elect to defer eligible gains under section 1400Z-2(a) and also the time, form, and manner in which a partner may elect to apply the elective 180-day period provided in paragraph (c)(2)(iii)(B) of this section.
(e) **Applicability date.** This section applies to eligible gains that would be recognized in the absence of deferral on or after the date of publication in the *Federal Register* of a Treasury decision adopting these proposed rules as final regulations. An eligible taxpayer, however, may rely on the proposed rules in this section with respect to eligible gains that would be recognized before that date, but only if the taxpayer applies the rules in their entirety and in a consistent manner.

Par. 3. Section 1.1400Z-2(c)-1 is added to read as follows:

§1.1400Z-2(c)-1 Investments held for at least 10 years.

(a) **Limitation on the 10-year rule.** As required by section 1400Z-2(e)(1)(B) (treatment of investments with mixed funds), section 1400Z-2(c) (special rule for investments held for at least 10 years) applies only to the portion of an investment in a QOF with respect to which a proper election to defer gain under section 1400Z-2(a)(1) is in effect.

(b) **Extension of availability of the election described in section 1400Z-2(c).** The ability to make an election under section 1400Z-2(c) for investments held for at least 10 years is not impaired solely because, under section 1400Z-1(f), the designation of one or more qualified opportunity zones ceases to be in effect. The preceding sentence does not apply to elections under section 1400Z-2(c) that are related to dispositions occurring after December 31, 2047.

(c) **Examples.** The following examples illustrate the principles of paragraphs (a) and (b) of this section.

**Example 1.** (i) **Facts.** In 2020, taxpayer G invests $100 in QOF S in exchange for 100 common shares of QOF S and properly makes an election under section 1400Z-2(a) to defer $100 of gain. G also acquires 200 additional common shares in QOF in exchange for $z. G does not make a section 1400Z-2(a) deferral election with respect
to any of the $z$ investments. At the end of 2028, the qualified opportunity zone designation expires for the population census tract in which QOF S primarily conducts its trade or business. In 2031, G sells all of its 300 QOF S shares, realizes gain, and makes an election to increase the qualifying basis in G's QOF S shares to fair market value. But for the expiration of the designated zones in section 1400Z-1(f), QOF S and G's conduct is consistent with continued eligibility to make the election under section 1400Z-2(c).

(ii) **Analysis.** Under paragraph (b) of this section, although the designation expired on December 31, 2028, the expiration of the zone's designation does not, without more, invalidate G's ability to make an election under section 1400Z-2(c). Accordingly, pursuant to that election, G's basis is increased in the one-third portion of G's investment in QOF S with respect to which G made a proper deferral election under section 1400Z-2(a)(2) (100 common shares / 300 common shares). Under section 1400Z-2(e)(1) and paragraph (a) of this section, however, the election under section 1400Z-2(c) is unavailable for the remaining two-thirds portion of G's investment in QOF S because G did not make a deferral election under section 1400Z-2(a)(2) for this portion of its investment in QOF S (200 common shares / 300 common shares).

(d) **Applicability date.** This section applies to an election under section 1400Z-2(c) related to dispositions made after the date of publication in the Federal Register of a Treasury decision adopting these proposed rules as final regulations. A taxpayer, however, may rely on the proposed rules in this section with respect to dispositions of investment interests in QOFs in situations where the investment was made in connection with an election under section 1400Z-2(a) that relates to the deferral of a gain such that the first day of 180-day period for the gain was before the date of applicability of that section. The preceding sentence applies only if the taxpayer applies the rules of this section in their entirety and in a consistent manner.

Par. 4. Section 1.1400Z-2(d)-1 is added to read as follows:

§1.1400Z-2(d)-1 Qualified Opportunity Funds.

(a) **Becoming a QOF-(1) Self-certification.** Except as provided in paragraph (e)(1) of this section, if a taxpayer that is classified as a corporation or partnership for Federal tax purposes is eligible to be a QOF, the taxpayer may self-
certify that it is QOF. This section refers to such a taxpayer as an eligible entity. The following rules apply to the self-certification:

(i) **Time, form, and manner.** The self-certification must be effected at such time and in such form and manner as may be prescribed by the Commissioner in IRS forms or instructions or in publications or guidance published in the Internal Revenue Bulletin (see §§ 601.601(d)(2) and 601.602 of this chapter).

(ii) **First taxable year.** The self-certification must identify the first taxable year that the eligible entity wants to be a QOF.

(iii) **First month.** The self-certification may identify the first month (in that initial taxable year) in which the eligible entity wants to be a QOF.

(A) **Failure to specify first month.** If the self-certification fails to specify the month in the initial taxable year that the eligible entity first wants to be a QOF, then the first month of the eligible entity's initial taxable year as a QOF is the first month that the eligible entity is a QOF.

(B) **Investments before first month not eligible for deferral.** If an investment in eligible interests of an eligible entity occurs prior to the eligible entity's first month as a QOF, any election under section 1400Z-2(a)(1) made for that investment is invalid.

(2) **Becoming a QOF in a month that is not the first month of the taxable year.** If an eligible entity's self-certification as a QOF is first effective for a month that is not the first month of that entity's taxable year--

(i) For purposes of section 1400Z-2(d)(1)(A) and (B) in the first year of the QOF's existence, the phrase **first 6-month period of the taxable year of the fund** means the first 6 months each of which is in the taxable year and in each of which the entity is a QOF.
Thus, if an eligible entity becomes a QOF in the seventh or later month of a 12-month taxable year, the 90-percent test in section 1400Z-2(d)(1) takes into account only the QOF's assets on the last day of the taxable year.

(ii) The computation of any penalty under section 1400Z-2(f)(1) does not take into account any months before the first month in which an eligible entity is a QOF.

(3) Pre-existing entities. There is no legal barrier to a pre-existing eligible entity becoming a QOF, but the eligible entity must satisfy all of the requirements of section 1400Z-2 and the regulations thereunder, including the requirements regarding qualified opportunity zone property, as defined in section 1400Z-2(d)(2). In particular, that property must be acquired after December 31, 2017.

(b) Valuation of assets for purposes of the 90-percent asset test--(1) In general. For a taxable year, if a QOF has an applicable financial statement within the meaning of §1.475(a)-4(h), then the value of each asset of the QOF for purposes of the 90-percent asset test in section 1400Z-2(d)(1) is the value of that asset as reported on the QOF's applicable financial statement for the relevant reporting period.

(2) QOF without an applicable financial statement. If paragraph (b)(1) of this section does not apply to a QOF, then the value of each asset of the QOF for purposes of the 90-percent asset test in section 1400Z-2(d)(1) is the QOF's cost of the asset.

(c) Qualified opportunity zone property--(1) In general. Pursuant to section 1400Z-2(d)(2)(A), the following property is qualified opportunity zone property:

(i) Qualified opportunity zone stock as defined in paragraph (c)(2) of this section,

(ii) Qualified opportunity zone partnership interest as defined in paragraph (c)(3) of this section, and
(iii) Qualified opportunity zone business property as defined in paragraph (c)(4) of this section.

(2) Qualified opportunity zone stock--(i) In general. Except as provided in paragraphs (c)(2)(ii) and (e)(2) of this section, if an entity is classified as a corporation for Federal tax purposes (corporation), then an equity interest (stock) in the entity is qualified opportunity zone stock if--

(A) The stock is acquired by a QOF after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash,

(B) As of the time the stock was issued, the corporation was a qualified opportunity zone business as defined in section 1400Z-2(d)(3) and paragraph (d) of this section (or, in the case of a new corporation, the corporation was being organized for purposes of being such a qualified opportunity zone business), and

(C) During substantially all of the QOF’s holding period for the stock, the corporation qualified as a qualified opportunity zone business as defined in section 1400Z-2(d)(3) and paragraph (d) of this section.

(ii) Redemptions of stock. Pursuant to section 1400Z-2(d)(2)(B)(ii), rules similar to the rules of section 1202(c)(3) apply for purposes of determining whether stock in a corporation qualifies as qualified opportunity zone stock.

(A) Redemptions from taxpayer or related person. Stock acquired by a QOF is not treated as qualified opportunity zone stock if, at any time during the 4-year period beginning on the date 2 years before the issuance of the stock, the corporation issuing the stock purchased (directly or indirectly) any of its stock from the QOF or from a person related (within the meaning of section 267(b) or 707(b)) to the QOF. Even if the
purchase occurs after the issuance, the stock was never qualified opportunity zone stock.

(B) Significant redemptions. Stock issued by a corporation is not treated as qualified opportunity zone stock if, at any time during the 2-year period beginning on the date 1 year before the issuance of the stock, the corporation made 1 or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of its stock as of the beginning of the 2-year period. Even if one or more of the disqualifying purchases occurs after the issuance, the stock was never qualified opportunity zone stock.

(C) Treatment of certain transactions. If any transaction is treated under section 304(a) as a distribution in redemption of the stock of any corporation, for purposes of paragraphs (c)(2)(ii)(A) and (B) of this section, that corporation is treated as purchasing an amount of its stock equal to the amount that is treated as such a distribution under section 304(a).

(3) Qualified opportunity zone partnership interest. Except as provided in paragraph (e)(2) of this section, if an entity is classified as a partnership for Federal tax purposes (partnership), any capital or profits interest (partnership interest) in the entity is a qualified opportunity zone partnership interest if--

(i) The partnership interest is acquired by a QOF after December 31, 2017, from the partnership solely in exchange for cash,

(ii) As of the time the partnership interest was acquired, the partnership was a qualified opportunity zone business as defined in section 1400Z-2(d)(3) and
paragraph (d) of this section (or, in the case of a new partnership, the partnership was being organized for purposes of being a qualified opportunity zone business), and

(iii) During substantially all of the QOF's holding period for the partnership interest, the partnership qualified as a qualified opportunity zone business as defined in section 1400Z-2(d)(3) and paragraph (d) of this section.

(4) **Qualified opportunity zone business property of a QOF.** Tangible property used in a trade or business of a QOF is qualified opportunity zone business property for purposes of paragraph (c)(1)(iii) of this section if--

(i) The tangible property satisfies section 1400Z-2(d)(2)(D)(i)(I);

(ii) The original use of the tangible property in the qualified opportunity zone, within the meaning of paragraph (c)(7) of this section, commences with the QOF, or the QOF substantially improves the tangible property within the meaning of paragraph (c)(8) of this section (which defines substantial improvement in this context); and

(iii) During substantially all of the QOF's holding period for the tangible property, substantially all of the use of the tangible property was in a qualified opportunity zone.

(5) **Substantially all of a QOF's holding period for property described in paragraphs (c)(2), (c)(3), and (c)(4) of this section.** [Reserved].

(6) **Substantially all of the usage of tangible property by a QOF in a qualified opportunity zone.** [Reserved].

(7) **Original use of tangible property.** [Reserved].

(8) **Substantial improvement of tangible property--(i) In general.** Except as provided in paragraph (c)(8)(ii) of this section, for purposes of paragraph (c)(4)(ii) of this section, tangible property is treated as substantially improved by a QOF only if, during
any 30-month period beginning after the date of acquisition of the property, additions to
the basis of the property in the hands of the QOF exceed an amount equal to the
adjusted basis of the property at the beginning of the 30-month period in the hands of
the QOF.

(ii) Special rules for land and improvements on land--(A) Buildings located in the
zone. If a QOF purchases a building located on land wholly within a QOZ, under
section 1400Z-2(d)(2)(D)(ii) a substantial improvement to the purchased tangible
property is measured by the QOF's additions to the adjusted basis of the building.
Under section 1400Z-2(d), measuring a substantial improvement to the building by
additions to the QOF's adjusted basis of the building does not require the QOF to
separately substantially improve the land upon which the building is located.

(B) [Reserved].

(d) Qualified opportunity zone business--(1) In general. A trade or business is a
qualified opportunity zone business if--

(i) Substantially all of the tangible property owned or leased by the trade or
business is qualified opportunity zone business property as defined in paragraph (d)(2)
of this section,

(ii) Pursuant to section 1400Z-2(d)(3)(A)(iii), the trade or business satisfies the
requirements of section 1397C(b)(2), (4), and (8) as defined in paragraph (d)(5) of this
section, and

(iii) Pursuant to section 1400Z-2(d)(3)(A)(iii), the trade or business is not
described in section 144(c)(6)(B) as defined in paragraph (d)(6) of this section.

(2) Qualified opportunity zone business property of the qualified opportunity zone
business for purposes of paragraph (d)(1)(i) of this section--(i) In general. The tangible property used in a trade or business of an entity is qualified opportunity zone business property for purposes of paragraph (d)(1)(i) of this section if--

(A) The tangible property satisfies section 1400Z-2(d)(2)(D)(i)(I);

(B) The original use of the tangible property in the qualified opportunity zone commences with the entity or the entity substantially improves the tangible property within the meaning of paragraph (d)(4) of this section (which defines substantial improvement in this context); and

(C) During substantially all of the entity's holding period for the tangible property, substantially all of the use of the tangible property was in a qualified opportunity zone.

(ii) Substantially all of a qualified opportunity zone business's holding period for property described in paragraph (d)(2)(i)(C) of this section. [Reserved].

(iii) Substantially all of the usage of tangible property by a qualified opportunity zone business in a qualified opportunity zone. [Reserved].

(3) Substantially all requirement of paragraph (d)(1)(i) of this section--(i) In general. A trade or business of an entity is treated as satisfying the substantially all requirement of paragraph (d)(1)(i) of this section if at least 70 percent of the tangible property owned or leased by the trade or business is qualified opportunity zone business property as defined in paragraph (d)(2) of this section.

(ii) Calculating percent of tangible property owned or leased in a trade or business--(A) In general. If an entity has an applicable financial statement within the meaning of §1.475(a)-4(h), then the value of each asset of the entity as reported on the entity's applicable financial statement for the relevant reporting period is used for
determining whether a trade or business of the entity satisfies the first sentence of paragraph (d)(3)(i) of this section (concerning whether the trade or business is a qualified opportunity zone business).

(B) **Entity without an applicable financial statement.** If paragraph (d)(3)(ii)(A) of this section does not apply to an entity and a taxpayer both holds an equity interest in the entity and has self-certified as a QOF, then that taxpayer may value the entity’s assets using the same methodology under paragraph (b) of this section that the taxpayer uses for determining its own compliance with the 90-percent asset requirement of section 1400Z-2(d)(1) (Compliance Methodology), provided that no other equity holder in the entity is a Five-Percent Zone Taxpayer. If paragraph (d)(3)(ii)(A) of this section does not apply to an entity and if two or more taxpayers that have self-certified as QOFs hold equity interests in the entity and at least one of them is a Five-Percent Zone Taxpayer, then the values of the entity’s assets may be calculated using the Compliance Methodology that both is used by a Five-Percent Zone Taxpayer and that produces the highest percentage of qualified opportunity zone business property for the entity.

(C) **Five Percent Zone Taxpayer.** A Five-Percent Zone Taxpayer is a taxpayer that has self-certified as a QOF and that holds stock in the entity (if it is a corporation) representing at least 5 percent in voting rights and value or holds an interest of at least 5 percent in the profits and capital of the entity (if it is a partnership).

(iii) **Example.** The following example illustrates the principles of paragraph (d)(3)(ii) of this section.

**Example.** Entity ZS is a corporation that has issued only one class of stock and that conducts a trade or business. Taxpayer X holds 94% of the ZS stock, and
Taxpayer Y holds the remaining 6% of that stock. (Thus, both X and Y are Five Percent Zone Taxpayers within the meaning of paragraph (d)(3)(ii)(C) of this section.) ZS does not have an applicable financial statement, and, for that reason, a determination of whether ZS is conducting a qualified opportunity zone business may employ the Compliance Methodology of X or Y. X and Y use different Compliance Methodologies permitted under paragraph (d)(3)(ii)(B) of this section for purposes of satisfying the 90-percent asset test of section 1400Z-2(d)(1). Under X's Compliance Methodology (which is based on X's applicable financial statement), 65% of the tangible property owned or leased by ZS's trade or business is qualified opportunity zone business property. Under Y's Compliance Methodology (which is based on Y's cost), 73% of the tangible property owned or leased by ZS's trade or business is qualified opportunity zone business property. Because Y's Compliance Methodology would produce the higher percentage of qualified opportunity zone business property for ZS (73%), both X and Y may use Y's Compliance Methodology to value ZS's owned or leased tangible property. If ZS's trade or business satisfies all additional requirements in section 1400Z-2(d)(3), the trade or business is a qualified opportunity zone business. Thus, if all of the additional requirements in section 1400Z-2(d)(2)(B) are satisfied, stock in ZS is qualified opportunity zone stock in the hands of a taxpayer that has self-certified as a QOF.

(4) Substantial improvement of tangible property for purposes of paragraph (d)(2)(i)(B) of this section--(i) In general. Except as provided in paragraph (d)(4)(ii) of this section, for purposes of paragraph (d)(2)(i)(B) of this section, tangible property is treated as substantially improved by a qualified opportunity zone business only if, during any 30-month period beginning after the date of acquisition of such tangible property, additions to the basis of such tangible property in the hands of the qualified opportunity zone business exceed an amount equal to the adjusted basis of such tangible property at the beginning of such 30-month period in the hands of the qualified opportunity zone business.

(ii) Special rules for land and improvements on land--(A) Buildings located in the zone. If a QOF purchases a building located on land wholly within a QOZ, under section 1400Z-2(d)(2)(D)(ii) a substantial improvement to the purchased tangible property is measured by the QOF's additions to the adjusted basis of the building.
Under section 1400Z-2(d), measuring a substantial improvement to the building by additions to the QOF's adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located.

(B) [Reserved].

(5) **Operation of section 1397C requirements incorporated by reference**—(i) **Gross income requirement.** Section 1400Z-2(d)(3)(A)(iii) incorporates section 1397C(b)(2), requiring that for each taxable year at least 50 percent of the gross income of a qualified opportunity zone business is derived from the active conduct of a trade or business in the qualified opportunity zone.

(ii) **Use of intangible property requirement**—(A) **In general.** Section 1400Z-2(d)(3) incorporates section 1397C(b)(4), requiring that, with respect to any taxable year, a substantial portion of the intangible property of an opportunity zone business is used in the active conduct of a trade or business in the qualified opportunity zone.

(B) **Active conduct of a trade or business.** [Reserved].

(iii) **Nonqualified financial property limitation.** Section 1400Z-2(d)(3) incorporates section 1397C(b)(8), limiting in each taxable year the average of the aggregate unadjusted bases of the property of a qualified opportunity zone business that may be attributable to nonqualified financial property. Section 1397C(e)(1), which defines the term **nonqualified financial property** for purposes of section 1397C(b)(8), excludes from that term reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less (working capital assets).

(iv) **Safe harbor for reasonable amount of working capital.** Solely for purposes of applying section 1397C(e)(1) to the definition of a qualified opportunity zone business under section 1400Z-2(d)(3), working capital assets are treated as reasonable in
amount for purposes of sections 1397C(b)(2) and 1400Z-2(d)(3)(A)(ii), if all of the following three requirements are satisfied:

(A) **Designated in writing.** These amounts are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone, as defined in section 1400Z-1(a).

(B) **Reasonable written schedule.** There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets. Under the schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets.

(C) **Property consumption consistent.** The working capital assets are actually used in a manner that is substantially consistent with paragraph (d)(5)(iv)(A) and (B) of this section.

(v) **Safe harbor for gross income derived from the active conduct of business.** Solely for purposes of applying the 50-percent test in section 1397C(b)(2) to the definition of a qualified opportunity zone business in section 1400Z-2(d)(3), if any gross income is derived from property that paragraph (d)(5)(iv) of this section treats as a reasonable amount of working capital, then that gross income is counted toward satisfaction of the 50-percent test.

(vi) **Safe harbor for use of intangible property.** Solely for purposes of applying the use requirement in section 1397C(b)(4) to the definition of a qualified opportunity zone business under section 1400Z-2(d)(3), the use requirement is treated as being satisfied during any period in which the business is proceeding in a manner that is substantially consistent with paragraphs (d)(5)(iv)(A) through (C) of this section.
(vii) **Safe harbor for property on which working capital is being expended.** If paragraph (d)(5)(iv) of this section treats some financial property as being a reasonable amount of working capital because of compliance with the three requirements of paragraph (d)(5)(iv)(A)-(C) and if the tangible property referred to in paragraph (d)(5)(iv)(A) is expected to satisfy the requirements of section 1400Z-2(d)(2)(D)(1) as a result of the planned expenditure of those working capital assets, then that tangible property is not treated as failing to satisfy those requirements solely because the scheduled consumption of the working capital is not yet complete.

(viii) **Example.** The following example illustrates the rules of this paragraph (d)(5):

(i) **Facts.** In 2019, Taxpayer H realized $w million of capital gains and within the 180-day period invested $w million in QOF T, a qualified opportunity fund. QOF T immediately acquired from partnership P a partnership interest in P, solely in exchange for $w million of cash. P immediately placed the $w million in working capital assets, which remained in working capital assets until used. P had written plans to acquire land in a qualified opportunity zone on which it planned to construct a commercial building. Of the $w million, $x million was dedicated to the land purchase, $y million to the construction of the building, and $z million to ancillary but necessary expenditures for the project. The written plans provided for purchase of the land within a month of receipt of the cash from QOF T and for the remaining $y and $z million to be spent within the next 30 months on construction of the building and on the ancillary expenditures. All expenditures were made on schedule, consuming the $w million. During the taxable years that overlap with the first 31-month period, P had no gross income other than that derived from the amounts held in those working capital assets. Prior to completion of the building, P's only assets were the land it purchased, the unspent amounts in the working capital assets, and P's work in process as the building was constructed.

(ii) **Analysis of construction.--(A) P met the three requirements of the safe harbor provided in paragraph (d)(5)(iv) of this section. P had a written plan to spend the $w received from QOF T for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone, as defined in section 1400Z-1(a). P had a written schedule consistent with the ordinary start-up for a business for the expenditure of the working capital assets. And, finally, P's working capital assets were actually used in a manner that was substantially consistent with its written plan and the ordinary start-up of a business. Therefore, the $x million, the $y million, and the $z
million are treated as reasonable in amount for purposes of sections 1397C(b)(2) and 1400Z-2(d)(3)(A)(ii).

(B) Because P had no other gross income during the 31 months at issue, 100 percent of P’s gross income during that time is treated as derived from an active trade or business in the qualified opportunity zone for purposes of satisfying the 50-percent test of section 1397C(b)(2).

(C) For purposes of satisfying the requirement of section 1397C(b)(4), during the period of land acquisition and building construction a substantial portion of P’s intangible property is treated as being used in the active conduct of a trade or business in the qualified opportunity zone.

(D) All of the facts described are consistent with QOF T’s interest in P being a qualified opportunity zone partnership interest for purposes of satisfying the 90-percent test in section 1400Z-2(d)(1).

(iii) Analysis of substantial improvement. The above conclusions would also apply if P’s plans had been to buy and substantially improve a pre-existing commercial building. In addition, the fact that P’s basis in the building has not yet doubled does not cause the building to fail to satisfy section 1400Z-2(d)(2)(D)(1)(III)

(6) Trade or businesses described in section 144(c)(6)(B) not eligible. Pursuant to section 1400Z-2(d)(3)(A)(iii), the following trades or businesses described in section 144(c)(6)(B) cannot qualify as a qualified opportunity zone business:

(i) Any private or commercial golf course,

(ii) Country club,

(iii) Massage parlor,

(iv) Hot tub facility,

(v) Suntan facility,

(vi) Racetrack or other facility used for gambling, or

(vii) Any store the principal business of which is the sale of alcoholic beverages for consumption off premises.
(e) **Exceptions based on where an entity is created, formed, or organized**—(1) **QOFs.** If a partnership or corporation (an entity) is not organized in one of the 50 states, the District of Columbia, or the U.S. possessions, it is ineligible to be a QOF. If an entity is organized in a U.S. possession but not in one of the 50 States or the District of Columbia, it may be a QOF only if it is organized for the purpose of investing in qualified opportunity zone property that relates to a trade or business operated in the U.S. possession in which the entity is organized.

(2) **Entities that can issue qualified opportunity zone stock or qualified opportunity zone partnership interests.** If an entity is not organized in one of the 50 states, the District of Columbia, or the U.S. possessions, an equity interest in the entity is neither qualified opportunity zone stock nor a qualified opportunity zone partnership interest. If an entity is organized in a U.S. possession but not in one of the 50 States or the District of Columbia, an equity interest in the entity may be qualified opportunity zone stock or a qualified opportunity zone partnership interest, as the case may be, only if the entity conducts a qualified opportunity zone business in the U.S. possession in which the entity is organized. An entity described in the preceding sentence is treated as satisfying the "domestic" requirement in section 1400Z-2(d)(2)(B)(i) or section 1400Z-2(C)(i).

(3) **U.S. possession defined.** For purposes of this paragraph (e), a U.S. possession means any jurisdiction other than the 50 States and the District of Columbia where a designated qualified opportunity zone exists under section 1400Z-1.

(f) **Applicability date.** This section applies for QOF taxable years that begin on or after the date of publication in the Federal Register of a Treasury decision adopting
these proposed rules as final regulations. A QOF, however, may rely on the proposed rules in this section with respect to taxable years that begin before the date of applicability of this section, but only if the QOF applies the rules in their entirety and in a consistent manner.

Par. 5. Section 1.1400Z-2(e)-1 is added to read as follows:

§1.1400Z-2(e)-1 Applicable rules.

(a) Treatment of investments with mixed funds.--(1) Investments to which no election under section 1400Z-2(a) applies. If a taxpayer invests money in a QOF and does not make an election under section 1400Z-2(a) with respect to that investment, the investment is one described in section 1400Z-2(e)(1)(A)(ii) (a separate investment to which section 1400Z-2(a), (b), and (c) do not apply).

(2) Treatment of deemed contributions of money under 752(a). In the case of a QOF classified as a partnership for Federal income tax purposes, the deemed contribution of money described in section 752(a) does not create or increase an investment in the fund described in section 1400Z-2(e)(1)(A)(ii). Thus, any basis increase resulting from a deemed section 752(a) contribution is not taken into account in determining the portion of a partner's investment subject to section 1400Z-2(e)(1)(A)(i) or (ii).

(3) Example. The following example illustrates the rules of this paragraph (a):

Taxpayer A owns a 50 percent capital interest in Partnership P. Under section 1400Z-2(e)(1), 90 percent of A's investment is described in section 1400Z-2(e)(1)(A)(i) (an investment that only includes amounts to which the election under section 1400Z-2(a) applies), and 10 percent is described in section 1400Z-2(e)(1)(A)(ii) (a separate investment consisting of other amounts). Partnership P borrows $8 million. Under section 752 and the regulations thereunder, taking into account the terms of the partnership agreement, $4 million of the $8 million liability is allocated to A. Under section 752(a), A is treated as contributing $4 million to Partnership P. Under
paragraph (2) of this section, A's deemed $4 million contribution to Partnership P is ignored for purposes of determining the percentage of A's investment in Partnership P subject to the deferral election under section 1400Z-2(a) or the portion not subject to such the deferral election under section 1400Z-2(a). As a result, after A's section 752(a) deemed contribution, 90 percent of A's investment in Partnership P is described in section 1400Z-2(e)(1)(A)(i) and 10 percent is described in section 1400Z-2(e)(1)(A)(ii).

(b) [Reserved].
(c) **Applicability date.** This section applies to investments in, and deemed contributions of money to, a QOF that occur on or after the date of publication in the Federal Register of a Treasury decision adopting these proposed rules as final regulations. An eligible taxpayer, however, may rely on the proposed rules in this section with respect to investments, and deemed contributions, before the date of applicability of this section, but only if the taxpayer applies the rules in their entirety and in a consistent manner.

Deputy Commissioner for Services and Enforcement.
Section 1400Z-2.--Special Rules for Capital Gains Invested in Opportunity Zones

Rev. Rul. 2018-29

ISSUES

(1) If a qualified opportunity fund (QOF), as defined in § 1400Z-2(d)(1) of the Internal Revenue Code (Code), purchases an existing building located on land that is wholly within a qualified opportunity zone (QOZ), as defined in § 1400Z-1, can the original use of the building or the land in the QOZ be considered to have commenced with the QOF?

(2) If a QOF purchases an existing building in a QOZ and the land upon which the building is located in a QOZ, is a substantial improvement to the building measured by additions to the adjusted basis in the building or is it measured by additions to the adjusted basis in the building and the land?

(3) If a substantial improvement to the building is measured by additions to the QOF’s adjusted basis in the building, does § 1400Z-2(d) require the QOF to separately substantially improve the land?
FACTS

In September 2018, QOF A purchases for $800x Property X, which is located wholly within the boundaries of a QOZ. Property X consists of a building previously used as a factory erected prior to 2018 and land on which the factory building is located. QOF A intends to convert the factory building to residential rental property. Sixty percent ($480x) of the $800x purchase price for Property X is attributable to the value of the land and forty percent ($320x) is attributable to the value of the building. Within 24 months after the date of QOF A’s acquisition of Property X, QOF A invests an additional $400x in converting the building to residential rental property.

LAW AND ANALYSIS

Pursuant to § 1400Z-1(b)(1)(A) of the Code, the Chief Executive Officer of each State nominated a limited number of population census tracts to be designated as QOZs for purposes of §§ 1400Z-1 and 1400Z-2.

Under § 1400Z-2(d)(1), the term “qualified opportunity fund” (QOF) means any investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (Zone Property) (other than another QOF) that holds at least 90 percent of its assets in Zone Property.

Under § 1400Z-2(d)(2)(A), Zone Property means property that is either qualified opportunity zone stock (Zone Stock), qualified opportunity zone partnership interest (Zone Partnership Interest), or qualified opportunity zone business property (Zone Business Property).

Zone Business Property is defined in § 1400Z-2(d)(2)(D). Section 1400Z-2(d)(2)(D)(i) provides that Zone Business Property is tangible property used in a trade
or business of the QOF if (a) such tangible property is purchased by the QOF after December 31, 2017, (b) the original use of such tangible property commences with the QOF or the QOF substantially improves the tangible property, and (c) during substantially all of the QOF’s holding period for such tangible property, substantially all of the use of such tangible property is in a QOZ.

Under § 1400Z-2(d)(2)(D)(ii), tangible property used in a QOF’s trade or business is treated as substantially improved by the QOF only if, during any 30-month period beginning after the date of acquisition of such tangible property, additions to basis with respect to such tangible property in the hands of the QOF exceed an amount equal to the adjusted basis of such tangible property at the beginning of such 30-month period in the hands of the QOF.

Questions have arisen as to whether for purposes of § 1400Z-2(d)(2)(D)(i) the original use of land in the QOZ can ever be considered to have commenced with a QOF and, therefore, constitute Zone Business Property. In addition, if the original use of land in the QOZ cannot commence with a QOF and if land is treated as property separate from a building for purposes of § 1400Z-2(d), must land be substantially improved in order to qualify as Zone Business Property?

Given the permanence of land, land can never have its original use in a QOZ commencing with a QOF. Section 1400Z-2 seeks to encourage economic growth and investment in the designated QOZs by providing Federal income tax benefits to taxpayers who newly invest in businesses located within these economically distressed communities. Consistent with this intent, a building located on land within a QOZ is treated as substantially improved within the meaning of § 1400Z-2(d)(2)(D)(ii) if, during
any 30-month period beginning after the date of acquisition of the building, additions to
the taxpayer’s basis in the building exceed an amount equal to the taxpayer’s adjusted
basis of the building at the beginning of such 30-month period. Further, the fact that the
cost of the land within the QOZ upon which the building is located is not included in the
taxpayer’s adjusted basis in the building does not mean that the taxpayer is required to
separately substantially improve such land for it to qualify as Zone Business Property.

Under the facts of this revenue ruling, QOF A purchased Property X, a factory
building and the land on which was located (both wholly within a QOZ), for $800x with
the intent to convert the building into residential rental property. Sixty percent ($480x)
of the purchase price for Property X was attributable to the value of the land and forty
percent ($320x) was attributable to the value of the building. Section 1400Z-
2(d)(2)(D)(ii) does not apply to the land on which the factory building is located, but
does apply to the building. Because the factory building existed on land within the QOZ
prior to QOF A’s purchase of Property X, the building’s original use within the QOZ did
not commence with QOF A. However, under § 1400Z-2(d)(2)(D)(ii) QOF A substantially
improved Property X because during the 30-month period beginning after the date of
QOF A’s acquisition of Property X QOF A’s additions to the basis of the factory building
($400x) exceed an amount equal to QOF A’s adjusted basis of the building at the
beginning of the 30-month period ($320x). The fact that the cost of the land on which
the building is located is not included in QOF A’s adjusted basis of the building does not
mean that QOF A is required to separately substantially improve the land.
HOLDING

(1) If a QOF purchases an existing building located on land that is wholly within a QOZ, the original use of the building in the QOZ is not considered to have commenced with the QOF for purposes of § 1400Z-2(d)(2)(D)(i), and the requirement under § 1400Z-2(d)(2)(D)(i) that the original use of tangible property in the QOZ commence with a QOF is not applicable to the land on which the building is located.

(2) If a QOF purchases a building wholly within a QOZ, under § 1400Z-2(d)(2)(D)(ii) a substantial improvement to the building is measured by the QOF’s additions to the adjusted basis of the building.

(3) Under § 1400Z-2(d), measuring a substantial improvement to the building by additions to the QOF’s adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located.

DRAFTING INFORMATION

The principal author of this revenue ruling is Erika C. Reigle of the Office of Associate Chief Counsel Income Tax & Accounting. For further information regarding this revenue ruling, contact Erika C. Reigle at (202) 317-7006 (not a toll-free call).
DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 5f

[REG-128841-07]

MIN 1545-BG91

Public Approval of Tax-Exempt Private Activity Bonds

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking and notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations to update and streamline the public approval requirement provided in section 147(f) of the Internal Revenue Code applicable to tax-exempt private activity bonds issued by State and local governments. The proposed regulations would update the existing regulations on the public approval requirement to reflect statutory changes, to streamline the public approval process, and to reduce burden on State and local governments that issue tax-exempt private activity bonds. This document also withdraws two previous notices of proposed rulemaking on this topic. The proposed regulations affect State and local governments that issue tax-exempt private activity bonds.

DATES: Comments and requests for a public hearing must be received by December 27, 2017.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-128841-07), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-128841-07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224, or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-128841-07).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Spence Hanemann at (202) 317-6980; concerning submissions of comments and requesting a hearing, Regina Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:
Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review under OMB Control Number 1545-2185 in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). The collection of information in this proposed regulation is the requirement in Sec. 1.147(f)-1 that certain information be contained in a public notice or public approval and, consequently, disclosed to the public. This information is required to meet the statutory public approval requirement provided in section 147(f). The likely respondents are the governmental units required to approve an issue of private activity bonds under section 147(f).

Estimated total annual burden: 2,600 hours.
Estimated average annual burden per respondent: 1.3 Hours.
Estimated number of respondents: 2,000.
Estimated frequency of responses: Annual.

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by November 27, 2017.

Comments are specifically requested concerning:
Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;
The accuracy of the estimated burden associated with the proposed collection of information;
How the quality, utility, and clarity of the information to be collected may be enhanced;
How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and
Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to 26 CFR part 1 under section 147(f) of the Internal Revenue Code of 1986 (the Code) and 26 CFR part 5f under section 103(k) of the Internal Revenue Code of 1954 (the 1954 Code). In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Public Law 97-248, 96 Stat. 324, Congress added section 103(k) to the 1954 Code to impose a public approval requirement on tax-exempt industrial development bonds. On May 11, 1983, the Department of the Treasury (Treasury Department) and the IRS published in the Federal Register (48 FR 21117) temporary regulations under section 103(k) of the 1954 Code (TD 7052) (the Existing Regulations). See Sec. 5f.103-2. A notice of proposed rulemaking (LR-221-82) by cross-reference to the temporary regulations was published in the Federal Register (48 FR
Federal Register, Volume 82 Issue 187 (Thursday, September 28, 2017) Page 3 of 18

21166) on the same day.

In the Tax Reform Act of 1986 (1986 Tax Act), Public Law 99-514, 100 Stat. 2085, Congress reorganized the tax-exempt bond provisions and carried forward the public approval requirement of section 103(k) of the 1954 Code in expanded form in section 147(f) of the Code. In section 147(f), Congress extended the public approval requirement to apply to all types of tax-exempt private activity bonds, as provided in section 141(e). The legislative history of the 1986 Tax Act indicates that "[t]he conferees intend that, to the extent not amended, all principles of present law continue to apply under the reorganized provisions." H.R. Rep. No. 99-841, at II-686 (1986) (Conf. Rep.). Thus, the Existing Regulations in Sec. 5f.103-2 remain in effect.

On September 9, 2008, the Treasury Department and the IRS published

![Page 452341]

notice of proposed rulemaking (REG-128841-07) in the Federal Register (73 FR 52220) that proposed regulations to amend and supplement the Existing Regulations (the 2008 Proposed Regulations). The Treasury Department and the IRS received public comments on the 2008 Proposed Regulations and held a public hearing on January 26, 2009. As discussed more fully in the Explanation of Provisions section of this preamble, the Treasury Department and the IRS have decided to withdraw the 2008 Proposed Regulations in full and to propose new regulations. This document contains those new proposed regulations (the Proposed Regulations).

Explanation of Provisions

1. Introduction

In general, pursuant to section 103 of the Code, interest received by investors on eligible State and local bonds is tax-exempt for Federal income tax purposes. Interest on private activity bonds qualifies for this tax-exempt treatment only if the bonds meet the requirements for "qualified bonds" as defined in section 141(e) and other applicable requirements provided in section 103. Section 141(e) of the Code requires, among other things, that qualified bonds meet the public approval requirement of section 147(f).

The Proposed Regulations would update the Existing Regulations to address subsequent statutory changes and to streamline the public approval process. The Proposed Regulations provide greater flexibility to State and local governments with respect to the public approval process to reduce administrative burdens associated with the public approval requirement. The Proposed Regulations recognize advances in technology and electronic communication that may facilitate more streamlined procedures for providing reasonable public notice of a public hearing.

2. The 2008 Proposed Regulations

The 2008 Proposed Regulations proposed to update, clarify, and simplify discrete aspects of the Existing Regulations regarding the public approval requirement. The 2008 Proposed Regulations focused on the scope, information content, methods, and timing for the public approval process, and generally did not focus on the governmental entities from which public approval is required. Overall, the public comments on the 2008 Proposed Regulations were favorable.

The Proposed Regulations generally incorporate the amendments
proposed in the 2008 Proposed Regulations with modifications in response to the public comments. One comment focused on the structure of the 2008 Proposed Regulations. The 2008 Proposed Regulations would have revised the Existing Regulations by amending existing rules and adding new rules. The 2008 Proposed Regulations further provided that the Existing Regulations would remain in effect to the extent not inconsistent with the final version of the 2008 Proposed Regulations. Commenters expressed concern about potential confusion over two distinct and partially inconsistent regulation sections governing the public approval requirement. The Treasury Department and the IRS understand this concern. Accordingly, the Proposed Regulations consolidate the guidance in the Existing Regulations and the 2008 Proposed Regulations, with modifications in response to the public comments and other recent developments, into new proposed guidance and provide a further opportunity for public comment.

The Treasury Department and the IRS also received numerous comments regarding the level of specificity of information required to be contained in reasonable public notice of a public hearing or a public approval. Generally, the 2008 Proposed Regulations proposed to allow the issuer to provide streamlined information about projects to be financed, and the Existing Regulations require a greater level of specificity of information about such projects. The 2008 Proposed Regulations also proposed to afford issuers more flexibility regarding the effect of post-issuance changes from the reasonably expected facts provided in the reasonable public notice or public approval. Commenters expressed differing views on whether these proposed amendments in the 2008 Proposed Regulations should be adopted. Commenters in favor of these amendments generally applauded the reduced burden that issuers would bear under the 2008 Proposed Regulations and suggested ways in which that burden could be reduced further. Commenters opposed to these amendments generally argued that reducing the amount of public information would limit the public's ability to approve or oppose on an informed basis new private activity bonds and proposed projects to be financed. The legislative history of the public approval requirement emphasizes the importance of "a reasonable opportunity for persons with differing views on both issuance of the bonds and the location and nature of the proposed facility to be heard." S. Rep. No. 97-494, at 171 (1982). With respect to these proposed amendments, the Treasury Department and the IRS have determined that the information that would have been required by the 2008 Proposed Regulations is sufficient to permit the public to evaluate the merits of both the issuance of the bonds and the location and nature of the financed facility. Thus, the burden imposed by the Existing Regulations may be reduced as provided in the 2008 Proposed Regulations without significantly impairing the public's consideration of new private activity bonds. Accordingly, the Proposed Regulations generally retain the streamlined information and post-issuance flexibility proposed in the 2008 Proposed Regulations and provide for additional post-issuance flexibility. (See section 6 of this Explanation of Provisions.)

Commenters also provided differing views on the amendments in the 2008 Proposed Regulations that proposed changes to the procedures for providing reasonable public notice of a public hearing. The Existing Regulations generally permit an issuer to publicize notice by newspaper, radio, or television, and presume notice to be reasonable if published at least 14 days prior to the date of the public hearing. The 2008 Proposed Regulations proposed to expand the permitted methods of providing public notice to include notice by newspaper, radio, television, Web site, or other permitted methods of giving public notice under State law, and would have shortened the presumptively reasonable notice period to seven days in advance of the hearing.
Commenters in favor of these amendments generally stated that the proposed amendments would ease the burden of providing the public notice. Commenters opposed to these amendments generally expressed concern that seven days' notice of a public hearing would not provide the public sufficient time to make an informed decision and to make arrangements to be present at the hearing. The legislative history of TEFRA indicates that Congress expected notice to be published no fewer than 14 days before the scheduled date of the hearing. See S. Rep. No. 97-494, at 171 (1982). In response to these comments, the Proposed Regulations adopt and expand the permitted methods for giving notice of a public hearing that were proposed in the 2008 Proposed Regulations, but retain the 14-day notice period presumed reasonable under the Existing Regulations consistent with the expectations of Congress.

3. Host Approval and Issuer Approval

Section 147(f) generally requires that both the governmental unit that issues the bonds (or on behalf of which the bonds are issued) and a governmental unit with jurisdiction over the location of the financed project approve an issue of private activity bonds (and the approvals are referred to as the issuer approval and the host approval, respectively). The Proposed Regulations generally carry forward the rules on issuer approval and host approval from the Existing Regulations, with limited revisions to address statutory changes that affect the application of these rules to certain types of private activity bonds. Thus, for example, the Proposed Regulations include guidance to address subsequent statutory changes in section 147(f)(3) and (4) that added special provisions regarding the issuer approval and host approval requirements for certain financings involving airports, high-speed rail facilities, qualified scholarship funding corporations, and volunteer fire departments.

The 1986 Tax Act extended the public approval requirement beyond the traditional, facility-focused industrial development bonds subject to the requirement under the 1954 Code to include certain special types of financings that are not facility-specific, including "qualified mortgage bonds" as defined in section 143(a), "qualified veterans' mortgage bonds" as defined in section 143(b), "qualified student loan bonds" as defined in section 144(b), and "qualified 501(c)(3) bonds" as defined in section 145. For these types of bonds, obtaining a host approval may be impractical or unworkable. For example, for qualified mortgage bonds, the locations of many of the homes to be financed with qualified mortgage loans generally are unknown at the time of issuance of the bonds and thus it may be difficult to identify appropriate governmental units to provide host approval. Moreover, for qualified student loan bonds and for qualified 501(c)(3) bonds used to finance working capital expenditures, the application of the host approval requirement is unworkable because the assets and expenditures financed have no physical location. In recognition of the practical difficulties faced by issuers of these types of bonds under the Existing Regulations, the Proposed Regulations provide that no host approval is necessary for mortgage revenue bonds (defined as qualified mortgage bonds, qualified veterans' mortgage bonds, and certain refundings of bonds issued to finance mortgages of owner-occupied residences under the law prior to enactment of section 143), qualified student loan bonds, or qualified 501(c)(3) bonds used to finance working capital expenditures.

4. Reasonable Public Notice and Public Hearing
The Existing Regulations generally provide that an applicable elected representative of the approving governmental unit may approve an issue following a public hearing for which there was reasonable public notice. The Existing Regulations provide guidance on permitted methods for giving reasonable public notice and holding public hearings. The Proposed Regulations would expand these methods to provide greater flexibility to State and local governments for providing reasonable public notice.

The Existing Regulations provide generally that reasonable public notice must be published in a newspaper of general circulation available to residents of the relevant locality or announced by radio or television broadcast to those residents. The Proposed Regulations would expand the permitted methods of providing reasonable public notice to provide greater flexibility and to recognize advances in technology and electronic communications. Thus, the Proposed Regulations would allow reasonable public notice by newspaper publication, radio or television broadcast, postings on a governmental unit’s public Web site, or alternative methods permitted under a general State law for public notices for public hearings of a governmental unit. The Treasury Department and the IRS solicit comment on other possible methods of providing reasonable public notice to foster flexibility and to reduce administrative burdens.

5. Content of Reasonable Public Notice and Public Approval

A. General Rules for Content of Reasonable Public Notice and Public Approval

The Existing Regulations generally require that the reasonable public notice and the public approval contain the following information: A general, functional description of the type and use of the facility to be financed; the maximum aggregate face amount of the bonds to be issued for the facility; the initial owner, operator, or manager of the facility; and the location of the facility by street address or, if none, by a general description designed to inform readers of the specific location. The required level of specificity of information for the public approval process under the Existing Regulations has proven to be unduly limiting and burdensome in certain respects. The Proposed Regulations generally retain the requirements that information (public approval information) be provided for the public approval process but refine the required public approval information to reduce burden and enhance flexibility.

Initially, the Existing Regulations focus on an individual "facility" as the unit of financed property for which the issuer must provide the relevant information. The definition of "facility" in the Existing Regulations includes facilities on multiple tracts of land only if the facilities are used in an integrated operation. Whether facilities are part of an "integrated operation" has proven difficult to determine.

The Proposed Regulations use the term "project" in lieu of the term "facility" because "project" more clearly indicates that financed property may consist of multiple buildings and multiple sites. The Proposed Regulations define the term "project" generally to mean one or more capital projects or facilities, including land, buildings, equipment, and other property, to be financed with an issue, that are located on the same site, or adjacent or proximate sites used for similar purposes. In addition, to address certain special types of loan financings, the definition of a project under the Proposed Regulations also includes mortgage loans financed by mortgage revenue bonds, student loans financed by qualified student loan bonds, and working
capital expenditures financed by qualified 501(c)(3) bonds.

The Proposed Regulations would continue to require a general functional description of the type and use of the financed project. The Proposed Regulations, however, would mitigate the required level of specificity of that information. Thus, the Proposed Regulations would allow an issuer of exempt facility bonds to satisfy this requirement through a statement that identifies the category of exempt facility bond (for example, bonds financing an airport or a mass commuting facility). Similarly, an issuer of other types of private activity bonds may satisfy this requirement through a statement that identifies the type of bonds and the type and use of the project (for example, qualified small issue bonds for a manufacturing facility).

The Proposed Regulations would continue to require that the public approval information include the name of the expected initial owner or the principal user of the project. The Proposed Regulations, however, would permit an issuer to name the true beneficial party of interest as an alternative to naming a legal owner or user (for example, the name of a nonprofit hospital organization instead of a limited liability company that serves as the legal owner of a hospital).

The Proposed Regulations would continue to require that the public approval information include the location of the project by street address. The Proposed Regulations, however, would clarify that a description by boundary streets or other geographic boundaries suffices to meet this location requirement. The Proposed Regulations would allow a consolidated description of the location of a project on the same site or on adjacent or proximate sites (for example, a college campus).

B. Special Rules for Mortgage Revenue Bonds, Qualified Student Loan Bonds, and Certain Qualified 501(c)(3) Bonds

The 1986 Tax Act extended the public approval requirement to mortgage revenue bonds, qualified student loan bonds, and qualified 501(c)(3) bonds. The Existing Regulations were promulgated before the 1986 Tax Act and thus provide no guidance tailored to the application of the public approval requirement to these types of bonds. In the General Explanation of the 1986 Tax Act, the Staff of the Joint Committee on Taxation stated that, "In extending this requirement to all private activity bonds, Congress intended that the applicable Treasury regulations will be amended for student loan bonds (where no facilities are financed), mortgage revenue bonds (where the exact residences to be financed may not be identified before issuance of the bonds), and qualified 501(c)(3) bonds that qualify for the special exception to the maturity limitation for pooled financings (where the facilities need not be identified before issuance of the bonds)."

Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (JCS-10-87), at 1219 (May 4, 1987). Accordingly, the Proposed Regulations provide special rules for public approval of mortgage revenue bonds, qualified student loan bonds, and qualified 501(c)(3) bonds issued for pooled financings as described in section 147(b)(4).

For mortgage revenue bonds, the Proposed Regulations would require the public approval information to state that the bonds will finance residential mortgages, provide the maximum stated principal amount of the bonds, and generally describe the issuer's geographic jurisdiction in which the residences to be financed with the mortgage loans are expected to be located. Similarly, for qualified student loan bonds, the Proposed Regulations would require the public approval information to state that the bonds will finance student loans and provide the maximum stated principal amount of the bonds. For these two types of
bonds, the Proposed Regulations would not require the names of borrowers to be included in the public approval information.

For qualified 501(c)(3) bonds that finance loans described in the special provision for pooled loan financings in section 147(b)(4), the Proposed Regulations would permit the issuer to choose to apply a two-stage public approval process if the issuer has insufficient information at the time of the reasonable public notice or public approval to meet the general public approval information requirements. To apply this special rule, the issuer must first obtain public approval within the time specified in the Proposed Regulations for public approval generally. For this first-stage public approval, the public approval information must state that the bonds will be qualified 501(c)(3) bonds used to finance loans described in section 147(b)(4)(B), provide the maximum stated principal amount of the bonds, generally describe the type of project to be financed with such loans (for example, loans for hospital facilities or college facilities), and state that the issuer will obtain an additional public approval with specific project information before origination of any such loans. In addition, before loan origination, the issuer must obtain a supplemental public approval of that loan containing all of the project-specific information that the public approval information rules generally require.

6. Deviations From the Information in the Reasonable Public Notice and Public Approval

Differences or "deviations" between information regarding a proposed project to be financed with a proposed issuance of private activity bonds that serves as the basis for a public approval and the actual project financed with the bonds may affect the validity of the public approval. The Existing Regulations and the Proposed Regulations provide that insubstantial deviations do not invalidate a public approval. The Proposed Regulations provide additional guidance concerning differences that constitute insubstantial deviations and also allow remedial actions to cure certain substantial deviations.

The Proposed Regulations provide that whether a deviation is substantial generally depends on all of the facts and circumstances. The Proposed Regulations, however, would always treat a change in the fundamental nature or type of a project as a substantial deviation.

The Proposed Regulations would treat certain specified deviations from the public approval information provided as insubstantial deviations. For example, a deviation from the size of a proposed bond issue for a proposed project specified in public approval information is an insubstantial deviation if the stated principal amount of bonds actually issued and used for the project is no more than ten percent (10%) greater than the maximum stated principal amount publicly approved for the project or is any amount less than that maximum stated principal amount. Furthermore, if an issuer applies proceeds of an issue approved for use on one project to pay working capital expenditures directly associated with any project approved in the same public approval, that deviation is an insubstantial deviation. Finally, a deviation between the initial owner or principal user of the project identified in the public approval information and the actual initial owner or principal user of the project is an insubstantial deviation if the parties are related on the issue date.

The Proposed Regulations would allow supplemental post-issuance public approvals to cure certain substantial deviations that result from unexpected events or unforeseen changes in circumstances that occur after the issuance of the bonds. This remedial action is similar to a permitted post-issuance public approval under Sec. 1.141-12(e)(2)
and (f) used for remedial actions for purposes of the private business restrictions.

7. Applicability Dates and Reliance

The Proposed Regulations are proposed to apply to bonds issued pursuant to a public approval that occurs on or after the date that is 90 days after publication of a Treasury decision adopting these rules as final regulations in the Federal Register. Issuers may apply the Proposed Regulations, in whole but not in part, to bonds that are issued pursuant to a public approval that occurs on or after September 28, 2017 and before the applicability date provided in a Treasury decision adopting these rules as final regulations in the Federal Register.

In addition, the Treasury Department and the IRS propose to remove the Existing Regulations under Sec. 5f.103-2 from 26 CFR part 5f effective on the general applicability date of the final regulations, which is proposed to be the date that is 90 days after publication of a Treasury decision adopting these rules as final regulations in the Federal Register.

Special Analyses

Certain IRS regulations, including these, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. The Existing Regulations provide guidance on the minimum informational content, procedures, and timing for the statutorily required public notices, public hearings, and public approvals. Although the Proposed Regulations are expected to affect a significant number of small State or local governmental units that issue tax-exempt private activity bonds, the Proposed Regulations are not expected to have a significant economic effect on those governmental units because the Proposed Regulations generally would streamline and simplify the Existing Regulations in various respects to reduce the administrative burdens of meeting the statutory public approval requirement. For example, the Proposed Regulations would permit publication of public notice by Web site to reduce costs associated with print publication or radio or television broadcast, reduce the information required to be contained in public notice and public approval for certain types of bonds, liberalize the consequences of insubstantial changes in project information, and permit curative actions to address certain circumstances in which finished projects differ from descriptions provided in the public notice or public approval. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small entities.

Comments and Requests for Public Hearing

Before the Proposed Regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the ADDRESSES heading. The Treasury Department and the IRS request comments on all aspects of
the proposed rules. All comments will be available at www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

Drafting Information

The principal authors of these regulations are Spence Hanemann and Vicky Tsilas, Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 5f

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG-128841-07) that was published in the Federal Register (73 FR 52220) on September 9, 2008, is withdrawn. Also, under the authority of 26 U.S.C. 7805, Sec. 1.103-17 of the notice of proposed rulemaking (LR-221-82) published in the Federal Register (48 FR 21166) on May 11, 1983, is withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 5f are proposed to be amended as follows:

PART 1--INCOME TAXES

0
Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

0
Par. 2. Section 1.147(f)-1 is added to read as follows:

Sec. 1.147(f)-1 Public approval of private activity bonds.

(a) In general. Interest on a private activity bond is excludable from gross income under section 103(a) only if the bond meets the requirements for a qualified bond as defined in section 141(e) and other applicable requirements provided in section 103. In order to be a qualified bond as defined in section 141(e), among other requirements, a private activity bond must meet the requirements of section 147(f). A private activity bond meets the requirements of section 147(f) only if the bond is publicly approved pursuant to paragraph (b) of this section or the bond qualifies for the exception for refunding bonds in section
(b) Public approval requirement—

(1) In general. Except as otherwise provided in this section, a bond meets the requirements of section 147(f) if, before the issue date, the issue of which the bond is a part receives issuer approval and host approval (each a public approval) as defined in paragraphs (b)(2) and (3) of this section in accordance with the method and process set forth in paragraphs (c) through (f) of this section.

(2) Issuer approval. Except as otherwise provided in this section, issuer approval means an approval that meets the requirements of this paragraph (b)(2). Either the governmental unit that issues the issue or the governmental unit on behalf of which the issue is issued must approve the issue. For this purpose, Sec. 1.103-1 applies to the determination of whether an issuer issues bonds on behalf of another governmental unit. If an issuer issues bonds on behalf of more than one governmental unit (for example, in the case of an authority that acts for two counties), any one of those governmental units may provide the issuer approval.

(3) Host approval. Except as otherwise provided in this section, host approval means an approval that meets the requirements of this paragraph (b)(3). Each governmental unit the geographic jurisdiction of which contains the site of a project to be financed by the issue must approve the issue. If, however, the entire site of a project to be financed by the issue is within the geographic jurisdiction of more than one governmental unit within a State (counting the State as a governmental unit within such State), then any one of those governmental units may provide host approval for the issue for that project. For purposes of the host approval, if a project to be financed by the issue is located within the geographic jurisdiction of two or more governmental units but not entirely within any one of those governmental units, each portion of the project that is located entirely within the geographic jurisdiction of the respective governmental units may be treated as a separate project. The issuer approval provided pursuant to paragraph (b)(2) of this section may be treated as a host approval if the governmental unit providing the issuer approval is also a governmental unit eligible to provide

the host approval pursuant to this paragraph (b)(3).

(4) Special rule for host approval of airports or high-speed intercity rail facilities. Pursuant to a special rule in section 147(f)(3), if the proceeds of an issue are to be used to finance a project that consists of either facilities located at an airport (within the meaning of section 142(a)(1)) or high-speed intercity rail facilities (within the meaning of section 142(a)(11)) and the issuer of that issue is the owner or operator of the airport or high-speed intercity rail facilities, the issuer is the only governmental unit that is required to provide the host approval for that project.

(5) Special rule for issuer approval of scholarship funding bond issues and volunteer fire department bond issues. In the case of a qualified scholarship funding bond as defined in section 150(d)(2), the governmental unit that made a request described in section 150(d)(2)(B) with respect to the issuer of the bond is the governmental unit on behalf of which the bond was issued for purposes of the issuer approval. If more than one governmental unit within a State made a request described in section 150(d)(2)(B), the State or any such requesting governmental unit may be treated as the governmental unit on behalf of which the bond was issued for purposes of the issuer approval. In the case of a bond of a volunteer fire department treated
as a bond of a political subdivision of a State under section 150(e), the political subdivision described in section 150(e)(2)(B) with respect to that volunteer fire department is the governmental unit on behalf of which the bond is issued for purposes of the issuer approval.

(6) Host approval not required for issues of mortgage revenue bonds, student loan bonds, and certain qualified 501(c)(3) bonds. In the case of a mortgage revenue bond (as defined in paragraph (g)(5) of this section), a qualified student loan bond as defined in section 144(b), and the portion of an issue of qualified 501(c)(3) bonds as defined in section 145 that finances working capital expenditures, the issue or portion of the issue must receive an issuer approval but no host approval is necessary.

(c) Method of public approval. The method of public approval of an issue must satisfy either paragraph (c)(1) or (2) of this section. An approval may satisfy the requirements of this paragraph (c) without regard to the authority under State or local law for the acts constituting that approval.

(1) Applicable elected representative. An applicable elected representative of the approving governmental unit approves the issue following a public hearing for which there was reasonable public notice.

(2) Voter referendum. A voter referendum of the approving governmental unit approves the issue.

(d) Public hearing and reasonable public notice.--(1) Public hearing. Public hearing means a forum providing a reasonable opportunity for interested individuals to express their views, orally or in writing, on the proposed issue of bonds and the location and nature of the proposed project to be financed.

(2) Location of the public hearing. The public hearing must be held in a location that, based on the facts and circumstances, is convenient for residents of the approving governmental unit. The location of the public hearing is presumed convenient for residents of the unit if the public hearing is located in the approving governmental unit's capital or seat of government. If more than one governmental unit is required to hold a public hearing, the hearings may be combined as long as the combined hearing affords the residents of all of the participating governmental units a reasonable opportunity to be heard. The location of any combined hearing is presumed convenient for residents of each participating governmental unit if it is no farther than 100 miles from the seat of government of each participating governmental unit beyond whose geographic jurisdiction the hearing is conducted.

(3) Procedures for conducting the public hearing. In general, a governmental unit may select its own procedure for a public hearing, provided that interested individuals have a reasonable opportunity to express their views. Thus, a governmental unit may impose reasonable requirements on persons who wish to participate in the hearing, such as a requirement that persons desiring to speak at the hearing make a written request to speak at least 24 hours before the hearing or that they limit their oral remarks to a prescribed time. For this purpose, it is unnecessary, for example, that the applicable elected representative of the approving governmental unit be present at the hearing, that a report on the hearing be submitted to that applicable elected representative, or that State administrative procedural requirements for public hearings be observed. Except to the extent State procedural requirements for public hearings are in conflict with a specific requirement of this section, a public hearing performed in compliance with State procedural requirements satisfies the requirements for a public hearing in this paragraph (d). A public hearing may be conducted by an individual appointed or employed to perform such function by the governmental unit or its agencies, or by
the issuer. Thus, for example, for bonds to be issued by an authority that acts on behalf of a county, the hearing may be conducted by the authority, the county, or an appointee of either.

(4) Reasonable public notice. Reasonable public notice means notice that is reasonably designed to inform residents of an approving governmental unit, including the issuing governmental unit and the governmental unit in whose geographic jurisdiction a project is to be located, of the proposed issue. The notice must state the time and place for the public hearing and contain the information required by paragraph (f)(2) of this section. Notice is presumed to be reasonably designed to inform residents of an approving governmental unit if it satisfies the requirements of this paragraph (d)(4) and is given no fewer than fourteen (14) calendar days before the public hearing in one or more of the ways set forth in paragraphs (d)(4)(i) through (iv) of this section.

(i) Newspaper publication. Public notice may be given by publication in one or more newspapers of general circulation available to the residents of the governmental unit.

(ii) Radio or television broadcast. Public notice may be given by radio or television broadcast to the residents of the governmental unit.

(iii) Governmental unit Web site posting. Public notice may be given by electronic posting on the approving governmental unit's public Web site used to inform its residents about events affecting the residents (for example, notice of public meetings of the governmental unit). In the case of public notice provided as described in the first sentence of this paragraph (d)(4)(iii), the governmental unit must offer a reasonable, publicly known alternative method for obtaining the information contained in the public notice for residents without access to the Internet (such as telephone recordings).

(iv) Alternative State law public notice procedures. Public notice may be given in a way that is permitted under a general State law for public notices for public hearings for the approving governmental unit.

(e) Applicable elected representative.--(1) In general.--(i) Definition of applicable elected representative. The applicable elected representative of a governmental unit means--

[[Page 45239]]

(A) The governmental unit's elected legislative body;
(B) The governmental unit's chief elected executive officer;
(C) In the case of a State, the chief elected legal officer of the State's executive branch of government; or
(D) Any official elected by the voters of the governmental unit and designated for purposes of this section by the governmental unit's chief elected executive officer or by State or local law to approve issues for the governmental unit.

(ii) Elected officials. For purposes of paragraphs (e)(1)(i)(B), (C), and (D) of this section, an official is considered elected only if that official is popularly elected at-large by the voters of the governmental unit. If an official popularly elected at-large by the voters of a governmental unit is appointed or selected pursuant to State or local law to be the chief executive officer of the unit, that official is deemed to be an elected chief executive officer for purposes of this section but for no longer than the official's tenure as an official popularly elected at-large.

(iii) Legislative bodies. In the case of a bicameral legislature that is popularly elected, both chambers together constitute an applicable elected representative. Absent designation under paragraph (e)(1)(i)(D) of this section, however, neither such chamber
independently constitutes an applicable elected representative. If multiple elected legislative bodies of a governmental unit have independent legislative authority, the body with the more specific authority relating to the issue is the only legislative body that is treated as an elected legislative body under paragraph (e)(1)(i)(A) of this section.

(2) Governmental unit with no applicable elected representative–-

(i) In general. The applicable elected representatives of a governmental unit with no applicable elected representative (but for this paragraph (e)(2) and section 147(f)(2)(E)(ii)) are the applicable elected representatives of the next higher governmental unit (with an applicable elected representative) from which the governmental unit derives its authority. Except as otherwise provided in this section, any governmental unit from which the governmental unit with no applicable elected representative derives its authority may be treated as the next higher governmental unit without regard to the relative status of such higher governmental unit under State law. A governmental unit derives its authority from another governmental unit that--

(A) Enacts a specific law (for example, a provision in a State constitution, charter, or statute) by or under which the governmental unit is created;

(B) Otherwise empowers or approves the creation of the governmental unit; or

(C) Appoints members to the governing body of the governmental unit.

(ii) Host approval. For purposes of a host approval, a governmental unit may be treated as the next higher governmental unit only if the project is located within its geographic jurisdiction and eligible residents of the unit are entitled to vote for its applicable elected representatives.

(3) On behalf of issuers. In the case of an issuer that issues bonds on behalf of a governmental unit, the applicable elected representative is any applicable elected representative of the governmental unit on behalf of which the bonds are issued.

(f) Public approval process--(1) In general. The public approval process for an issue, including scope, content, and timing of the public approval, must meet the requirements of this paragraph (f). A governmental unit must timely approve either each project to be financed with proceeds of the issue or a plan of financing for each project to be financed with proceeds of the issue.

(2) General rule on information required for a reasonable public notice and public approval. Except as otherwise provided in this section, a project to be financed with proceeds of an issue is within the scope of a public approval under section 147(f) if the reasonable public notice of the public hearing, if applicable, and the public approval (together the notice and approval) include the information set forth in paragraphs (f)(2)(i) through (iv) of this section.

(i) The project. The notice and approval must include a general functional description of the type and use of the project to be financed with the issue. For this purpose, a project description is sufficient if it identifies the project by reference to a particular category of exempt facility bond to be issued (for example, an exempt facility bond for an airport pursuant to section 142(a)(1)) or by reference to another general category of private activity bond together with information on the type and use of the project to be financed with the issue (for example, a qualified small issue bond as defined in section 144(a) for a manufacturing facility or a qualified 501(c)(3) bond as defined in section 145 for a hospital facility and working capital expenditures).

(ii) The maximum stated principal amount of bonds. The notice and
approval must include the maximum stated principal amount of the issue
of private activity bonds to be issued to finance the project. If an
issue finances multiple projects (for example, facilities at different
locations on non-proximate sites that are not treated as part of the
same project), the notice and approval must specify separately the
maximum stated principal amount of bonds to be issued to finance each
separate project.

(iii) The name of the initial owner or principal user of the
project. The notice and approval must include the name of the expected
initial owner or principal user (within the meaning of section 144(a))
of the project. The name provided may be either the name of the legal
owner or principal user of the project or, alternatively, the name of
the true beneficial party of interest for such legal owner or user. (For
example, the name of a 501(c)(3) organization that is the sole member
of a limited liability company that is the legal owner).

(iv) The location of the project. The notice and approval must
include a general description of the prospective location of the
project by street address, reference to boundary streets or other
geographic boundaries, or other description of the specific geographic
location that is reasonably designed to inform readers of the location.
For a project involving multiple capital projects or facilities located
on the same site, or on adjacent or reasonably proximate sites with
similar uses, a consolidated description of the location of those
capital projects or facilities provides a sufficient description of the
location of the project. For example, a project for a section 501(c)(3)
educational entity involving multiple buildings on the entity’s main
urban college campus may describe the location of the project by
reference to the outside street boundaries of that campus with a
reference to any noncontiguous features of that campus.

(3) Special rule for mortgage revenue bonds. Mortgage loans
financed by mortgage revenue bonds are within the scope of a public
approval if the notice and approval state that the bonds are to be
issued to finance residential mortgages, provide the maximum stated
principal amount of mortgage revenue bonds expected to be issued, and
provide a general description of the geographic jurisdiction in which
the residences to be financed with the proceeds of the mortgage revenue
bonds are expected to be located (for example, residences located
throughout a State for an issuer with a statewide jurisdiction or
residences within a particular local geographic jurisdiction, such as
within a city or county, for a

[[Page 45240]]

local issuer). For this purpose, in the case of mortgage revenue bonds,
no information is required on specific names of mortgage loan borrowers
or specific locations of individual residences to be financed.

(4) Special rule for qualified student loan bonds. Qualified
student loans financed by qualified student loan bonds as defined in
section 144(b) are within the scope of a public approval if the notice
and approval state that the bonds will be issued to finance student
loans and state the maximum stated principal amount of qualified
student loan bonds expected to be issued for qualified student loans.
For this purpose, in the case of qualified student loan bonds, no
information is required with respect to names of specific student loan
borrowers.

(5) Special rule for certain qualified 501(c)(3) bonds. Loans
financed by qualified 501(c)(3) bonds issued pursuant to section 145
and described in section 147(b)(4)(B) (without regard to any election
under section 147(b)(4)(A)) are within the scope of a public approval
if the requirements of paragraphs (f)(5)(i) and (ii) of this section
are met.

(i) Pre-issuance general public approval. Within the time period
required by paragraph (f)(7) of this section, public approval is
obtained after reasonable public notice of a public hearing is provided
and a public hearing is held. For this purpose, a project is treated as
described in the notice and approval if the notice and approval provide
that the bonds will be qualified 501(c)(3) bonds to be used to finance
loans described in section 147(b)(4)(B), state the maximum stated
principal amount of bonds expected to be issued to finance loans to
501(c)(3) organizations or governmental units as described in section
147(b)(4)(B), provide a general description of the type of project to
be financed with such loans (for example, loans for hospital facilities
or college facilities), and state that an additional public approval
that includes specific project information will be obtained before any
such loans are originated.

(ii) Post-issuance public approval for specific loans. Except as
provided in paragraph (f)(5)(iii) of this section, before a loan
described in section 147(b)(4)(B) is originated, a supplemental public
approval for the bonds to be used to finance that loan is obtained that
meets all the requirements of section 147(f) and the requirements for a
public approval in paragraph (b) of this section. This post-issuance
supplemental public approval requirement applies by treating the bonds
to be used to finance such loan as if they were reissued for purposes
of section 147(f) (without regard to paragraph (f)(5) of this section).
For this purpose, proceeds to be used to finance such loan do not
include the portion of the issue used to finance a common reserve fund
or common costs of issuance.

(iii) Exception to post-issuance public approval requirement. A
post-issuance supplemental public approval pursuant to paragraph
(f)(5)(ii) of this section is unnecessary for the initial use of
proceeds to finance one or more loans if the pre-issuance notice and
approval pursuant to paragraph (f)(5)(i) of this section include the
information required by paragraphs (f)(2)(i) through (iv) of this
section for the projects to be financed by those loans.

(6) Deviations in public approval information--(i) In general.
Except as otherwise provided in this section, a substantial deviation
between the stated use of proceeds of an issue included in the
information required to be provided in the notice and approval (public
approval information) and the actual use of proceeds of the issue
causes that issue to fail to meet the public approval requirement.
Conversely, insubstantial deviations between the stated use of proceeds
of an issue included in the public approval information and the actual
use of proceeds of the issue do not cause such a failure. In general,
the determination of whether a deviation is substantial is based on all
the facts and circumstances. In all events, however, a change in the
fundamental nature or type of a project is a substantial deviation.

(ii) Certain insubstantial deviations in public approval
information. The following deviations from the public approval
information in the notice and approval are treated as insubstantial
deviations:

(A) Size of bond issue and use of proceeds. A deviation between the
maximum stated principal amount of a proposed issuance of bonds to
finance a project that is specified in public approval information and
the actual stated principal amount of bonds issued and used to finance
that project is an insubstantial deviation if that actual stated
principal amount is no more than ten percent (10%) greater than that
maximum stated principal amount or is any amount less than that maximum
stated principal amount. In addition, the use of proceeds to pay
working capital expenditures directly associated with any project
specified in the public approval information is an insubstantial
deviation.
(B) Initial owner or principal user. A deviation between the initial owner or principal user of the project named in the notice and approval and the actual initial owner or principal user of the project is an insubstantial deviation if such parties are related parties on the issue date of the issue.
(iii) Supplemental public approval to cure certain substantial deviations in public approval information. A substantial deviation between the stated use of proceeds of an issue included in the public approval information and the actual use of the proceeds of the issue does not cause that issue to fail to meet the public approval requirement if all of the following requirements are met:
(A) Original public approval and reasonable expectations. The issue met the requirements for a public approval in paragraph (b) of this section. In addition, on the issue date of the issue, the issuer reasonably expected there would be no substantial deviations between the stated use of proceeds of an issue included in the public approval information and the actual use of the proceeds of the issue.
(B) Unexpected events or unforeseen changes in circumstances. As a result of unexpected events or unforeseen changes in circumstances that occur after the issue date of the issue, the issuer determines to use proceeds of the issue in a manner or amount not provided in a public approval.
(C) Supplemental public approval. Before using proceeds of the bonds in a manner or amount not provided in a public approval, the issuer obtains a supplemental public approval for those bonds that meets the public approval requirement in paragraph (b) of this section. This supplemental public approval requirement applies by treating those bonds as if they were reissued for purposes of section 147(f).
(7) Certain timing requirements. Public approval of an issue is timely only if the issuer obtains the public approval within one year before the issue date of the issue. Public approval of a plan of financing is timely only if the issuer obtains public approval for the plan of financing within one year before the issue date of the first issue issued under the plan of financing and the issuer issues all issues under the plan of financing within three years after the issue date of such first issue.
(g) Definitions. The definitions in this paragraph (g) apply for purposes of this section. In addition, the general definitions in Sec. 1.150-1 apply for purposes of this section.
(l) Geographic jurisdiction means the area encompassed by the boundaries prescribed by State or local law for a governmental unit or, if there are no such boundaries, the area in which a unit may exercise such sovereign powers that make that unit a governmental unit for purposes of Sec. 1.103-1 and this section.
(2) Governmental unit has the meaning of ''State or local governmental unit'' as defined in Sec. 1.103-1. Thus, a governmental unit is a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof.
(3) Host approval is defined in paragraph (b)(3) of this section.
(4) Issuer approval is defined in paragraph (b)(2) of this section.
(5) Mortgage revenue bonds mean qualified mortgage bonds as defined in section 143(a), qualified veterans' mortgage bonds as defined in section 143(b), or refunding bonds issued to finance mortgages of owner-occupied residences pursuant to applicable law in effect prior to enactment of section 143(a) or section 143(b).
(6) Proceeds means ''proceeds'' as defined in Sec. 1.141-1(b),
except that it does not include disposition proceeds.

(7) Project generally means one or more capital projects or facilities, including land, buildings, equipment, and other property, to be financed with an issue, that are located on the same site, or adjacent or proximate sites used for similar purposes, and that are subject to the public approval requirement of section 147(f). For an issue of mortgage revenue bonds or an issue of qualified student loan bonds as defined in section 144(b), the term project means the mortgage loans or qualified student loans to be financed with the proceeds of the issue. For an issue of qualified 501(c)(3) bonds as defined in section 145, the term project means a project as defined in the first sentence of this definition, and also is deemed to include working capital expenditures to be financed with proceeds of the issue.

(8) Public approval information is defined in paragraph (f)(6)(i) of this section.

(9) Public hearing is defined in paragraph (d)(1) of this section.

(10) Reasonable public notice is defined in paragraph (d)(4) of this section.

(11) Voter referendum means a vote by the voters of the affected governmental unit conducted in the same manner and time as voter referenda on matters relating to governmental spending or bond issuances by the governmental unit under applicable State and local law.

(h) Applicability date. This section applies to bonds issued pursuant to a public approval occurring on or after the date that is 90 days after publication of the Treasury decision adopting these rules as final regulations in the Federal Register. For bonds issued pursuant to a public approval occurring before that date, see Sec. 5f.103-2 as contained in 26 CFR part 5f, revised as of the date of the most recent annual revision.

PART 5f—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

Par. 3. The authority citation for part 5f continues to read in part as follows:

Authority: 26 U.S.C. 7805 ** *

Sec. 5f.103-2 [Removed]

Par. 4. Section 5f.103-2 is removed.

Kirsten Wielobob,
Deputy Commissioner for Services and Enforcement.
[FR Doc. 2017-20661 Filed 9-27-17; 8:45 am]
BILLING CODE 4830-01-P
(Also, §§54, 54A, 54AA, 141, 142, 1397E, 1400N, 1400U-2, 6431; 1.141-12, & 1.142-2)

Rev. Proc. 2018-26

SECTION 1. PURPOSE

This revenue procedure provides certain remedial actions that issuers of State and local tax-exempt bonds and other tax-advantaged bonds (as defined in § 1.150-1(b) of the Income Tax Regulations) may take to preserve the tax-advantaged status of the bonds when nonqualified uses (as defined in section 4.04 of this revenue procedure) of the bond proceeds occur.

SECTION 2. BACKGROUND

.01 Various provisions of the Internal Revenue Code (the “Code”) provide tax benefits to facilitate lower borrowing costs for State and local governments and other qualified issuers if certain requirements are met. These benefits are in the form of a tax exemption under § 103 on the interest paid to holders of eligible State and local bonds (“tax-exempt bonds”), refundable tax credits under § 6431 payable to issuers of certain qualified bonds (“direct pay bonds”), or tax credits under § 54A and similar provisions to holders of qualified tax credit bonds (“tax credit bonds”).¹ Eligibility requirements for these tax benefits include prescribed uses of the proceeds of the bonds.

¹ Public Law No. 115-97, § 13404, 131 Stat. 2138 (2017), repealed the Code provisions related to tax credit bonds and direct pay bonds effective for bonds issued after December 31, 2017. References in this revenue procedure to these Code sections refer to those sections as in effect prior to repeal.
.02 For some types of tax-advantaged bonds, existing regulations provide remidal actions to cure certain nonqualified uses. For example, for tax-exempt governmental bonds (as defined in § 1.150-1(b)), § 1.141-12 provides remedial actions (including bond redemption or defeasance, alternative qualified use of disposition proceeds, and alternative qualified use of facilities) to cure violations of the private business use and private loan restrictions under § 141. Similarly, for certain types of tax-exempt private activity bonds (as defined in § 141), § 1.142-2 provides remedial actions (including bond redemption or defeasance) to cure violations of particular requirements for qualified private activity bonds under §§ 142, 144, and 147. In addition, for qualified zone academy bonds ("QZABs") as defined in § 1397E, § 1.1397E-1(h)(8) provides remedial actions (including bond redemption or defeasance and alternative qualified use of disposition proceeds) to cure violations of requirements for QZABs under § 1397E.

.03 The existing remedial actions for tax-exempt governmental bonds do not include a remedial action to cure the nonqualified uses that generally result from longer-term leases of financed property to private businesses, other than the remedial action of bond redemption or defeasance. Taxpayers have recommended adding a remedial action for this purpose similar to the existing remedial action that allows curing nonqualified uses that result from sales of financed property to private businesses through alternative qualified uses of the disposition proceeds of those sales. Section 1.141-12(h) permits the Commissioner, by publication in the Internal Revenue Bulletin, to provide additional remedial actions for purposes of the private business use and
private loan restrictions. Section 5 of this revenue procedure provides such a remedial action.

.04 For direct pay bonds, no existing remedial action allows adjustment of the refundable Federal tax credit for nonqualified uses. Such a remedial action would provide a simple and administrable method of preserving the tax-advantaged status of direct pay bonds. Section 6 of this revenue procedure provides this remedial action.

.05 Finally, for certain types of tax credit bonds and for direct pay bonds, none of the existing remedial actions described in section 2.02 of this revenue procedure are available. Extending the availability of existing remedial actions to these types of bonds would allow issuers similarly to cure nonqualified uses of these bonds. Section 7 of this revenue procedure provides remedial actions for these bonds.

SECTION 3. SCOPE

This revenue procedure applies to tax-advantaged bonds to allow issuers to take certain remedial actions to protect the tax-advantaged status of the bonds when nonqualified uses of bond proceeds occur if the requirements of particular remedial actions under this revenue procedure are met.

SECTION 4. DEFINITIONS

The definitions in this section 4 apply for purposes of this revenue procedure.

.01 Applicable Code section means the Code section that sets forth the qualification requirements for a particular type of bond.

.02 Defeasance escrow means an irrevocable escrow established to redeem nonqualified bonds on the earliest call date after the date on which a nonqualified use occurs in an amount that, together with investment earnings, is sufficient to pay all the
principal of, interest on, and call premium, if any, on the nonqualified bonds from the
date the escrow is established to that call date. No amount in a defeasance escrow
may be invested in an investment the obligor of which is a user (or a related party (as
defined in § 1.150-1(b)) to a user) of proceeds of the bonds. All purchases or sales of
investments in a defeasance escrow must be made at the fair market value of the
investment within the meaning of § 1.148-5(d)(6).

.03 Disposition proceeds means, except as otherwise provided in this section
4.03, disposition proceeds (as defined in § 1.141-12(c)(1)), plus investment earnings on
those amounts. For property financed with different sources of funding, disposition
proceeds are allocated among the sources under § 1.141-12(c)(3). For purposes of
section 5 of this revenue procedure, the definition of disposition proceeds in § 1.141-
12(c)(1) applies.

.04 Nonqualified use means a failure to spend proceeds of tax-advantaged
bonds within any required expenditure period specified in the applicable Code section
and any use of expended proceeds of tax-advantaged bonds for a purpose other than a
qualified use (as defined in section 4.06 of this revenue procedure). A nonqualified use
under § 141 occurs on the date of the deliberate action (as defined in § 1.141-2(d)(3)).
For dates on which other nonqualified uses occur, see section 7.03 of this revenue
procedure.

.05 Nonqualified bonds means the portion of the outstanding bonds in an amount
that, if the remaining bonds were issued on the date on which nonqualified use of
proceeds occurs, the proceeds of the remaining bonds would be used in a timely
manner for a qualified use. Allocations of nonqualified bonds are made in accordance with § 1.142-2(e).

.06 Qualified use means a use required or permitted by the applicable Code section. For example, qualified uses include a qualified purpose under § 54A(d)(2)(C) for tax credit bonds under § 54A, capital expenditures for direct pay build America bonds under § 54AA(g), and a prescribed amount of governmental use for tax-exempt governmental bonds under § 141 and build America bonds under § 54AA.

SECTION 5. REMEDIAL ACTION FOR ELIGIBLE LEASES OF PROPERTY FINANCED WITH TAX-ADVANTAGED BONDS SUBJECT TO § 141 OR § 145(a)

.01 Modified alternative use of disposition proceeds remedy for eligible leases. In the case of a deliberate action (as defined in § 1.141-2(d)(3)) that consists of an eligible lease (as defined in section 5.02 of this revenue procedure) to a nongovernmental person (as defined in § 1.141-1(b)) of property financed with tax-advantaged bonds subject to the private activity bond restrictions under § 141 or § 145(a), provided the requirements of § 1.141-12(a) are met, the issuer may cure the nonqualified use resulting from the lease by applying the alternative use of disposition proceeds remedial action under § 1.141-12(e) in the same manner as to a disposition with the following modifications--

(1) Treating the eligible lease as a disposition for which the consideration is exclusively cash;

(2) Treating funds (excluding proceeds of tax-advantaged bonds) in an amount equal to the lease amount (as defined in section 5.03 of this revenue procedure) as disposition proceeds;

(3) Treating the leased property as transferred property; and
(4) Allocating proceeds of the issue that, under § 1.141-12(c)(2), are allocable to the funds treated as disposition proceeds, to those funds during the term of the lease only (and to the leased property thereafter).

.02 Eligible lease. A lease is an eligible lease if--

(1) The consideration for the lease consists exclusively of cash lease payments (regardless of when paid) that are not financed with proceeds of another issue of tax-advantaged bonds; and

(2) The term of the lease--

(a) Is at least equal to the lesser of 20 years or 75 percent of the weighted average reasonably expected economic life of the leased property (determined in the same manner as under section 147(b)) as of the start of the term of the lease; or

(b) Runs through the end of the measurement period (as defined in § 1.141-3(g)(2)) during which the private business use restrictions are measured for compliance under section 141.

.03 Lease amount. The lease amount is an amount equal to the present value of all of the lease payments required to be made under the lease. For this purpose, present value is determined as of the start of the term of the lease by using the yield on the issue as of the start of the term of the lease as the discount rate.

SECTION 6. REMEDIAL ACTION FOR DIRECT PAY BONDS TO REDUCE THE REFUNDABLE FEDERAL TAX CREDIT

In the case of direct pay bonds, an issuer may cure a nonqualified use by reducing the amount of the refundable Federal tax credit to eliminate the amount allocable to the nonqualified bonds. Further, the issuer must treat any disposition
proceeds as described in section 7.02(3) of this revenue procedure. To effect this remedial action, beginning with the first Form 8038-CP (Return for Credit Payment to Issuers of Qualified Bonds) or successor form filed for any interest payment date for the bonds after the nonqualified use occurs, the issuer, in reporting the amount of the interest payable, must exclude the portion of that interest allocable to the nonqualified bonds that accrues on or after the date of the nonqualified use. For the first such Form 8038-CP (or successor form), the issuer must print or type across the top of the form "Remedial Action under Section 6 of Rev. Proc. 2018-26" and attach the required explanation for the difference in scheduled credit payment. The explanation must state that a nonqualified use occurred and the date of the nonqualified use and include a revised debt service schedule reflecting the exclusion of amounts allocable to the nonqualified bonds beginning with the date of the nonqualified use.

SECTION 7. CERTAIN GENERAL REMEDIAL ACTIONS FOR TAX-ADVANTAGED BONDS

.01 In general. In the case of tax-credit bonds or direct pay bonds, except as otherwise provided in section 7.06 of this revenue procedure, an issuer may cure a nonqualified use by taking a remedial action of redemption or defeasance of nonqualified bonds under section 7.02 of this revenue procedure or alternative use of disposition proceeds under section 7.05 of this revenue procedure. In the case of tax-exempt bonds, issuers may apply section 7.02(2) of this revenue procedure to defeasance escrows established under § 1.141-12(d) or § 1.142-2(c).

.02 Redemption or defeasance of nonqualified bonds. The requirements for redemption or defeasance of nonqualified bonds under this section 7.02 are met if--
(1) **Amount and timing of redemption or defeasance.** Within 90 days after the date on which the nonqualified use occurs, the issuer redeems the nonqualified bonds of the issue or establishes a defeasance escrow for any nonqualified bonds that are not so redeemed; and

(2) **Yield restriction or rebate requirement.** The issuer either restricts the investments in the defeasance escrow to investments that are not higher yielding investments (as defined in § 148(b)) or the issuer makes rebate payments to the United States, at the same time and in the same manner as arbitrage rebate amounts are required to be paid, in amounts equal to any earnings on investments in the defeasance escrow that are higher than the yield on the issue with respect to which the defeasance escrow was established. For this purpose, the first computation period begins on the date on which the defeasance escrow is established. Further, for purposes of this section 7.02(2), § 148 and the regulations thereunder (as modified by the applicable Code section and this section 7.02(2)) apply, and compliance with the rebate requirement in this section 7.02(2) is treated as satisfying applicable arbitrage investment restrictions under § 148 for the defeasance escrow.

(3) **Treatment of disposition proceeds.** The issuer treats the disposition proceeds as gross proceeds for purposes of § 148 as modified by the applicable Code section (the arbitrage requirements) and as proceeds for purposes of the applicable Code section. For purposes of applying the temporary period and spending exceptions to the arbitrage requirements, the issuer may treat the date of the receipt of the disposition proceeds as if it were the issue date of the nonqualified bonds and disregard the receipt
of disposition proceeds for the spending exceptions under § 1.148-7 for which the requirements were met before the receipt of the disposition proceeds.

.03 When a nonqualified use occurs. For unspent proceeds of bonds, a nonqualified use occurs on the earlier of the first date on which the issuer fails to have a reasonable expectation to spend the proceeds for a qualified use (within the required expenditure period, if any) or the last day of the required expenditure period, if any. For proceeds of bonds that have been spent, a nonqualified use occurs on the first date on which an action causes proceeds to be used for other than a qualified use.

.04 Reissuance. For purposes of determining whether the establishment of a defeasance escrow under section 7.02 of this revenue procedure results in an exchange under § 1.1001-1(a), the defeased bonds are treated as tax-exempt bonds for purposes of § 1.1001-3(e)(5)(ii)(B)(1).

.05 Alternative use of disposition proceeds. The requirements for alternative use of disposition proceeds under this section 7.05 are met if--

(1) Disposition for cash. The nonqualified use consists of a disposition for which the consideration is exclusively cash;

(2) Reasonably expected use of disposition proceeds. The issuer reasonably expects to spend the disposition proceeds within two years after the date of the disposition on alternative qualified uses or, to the extent the issuer does not expect to so spend the disposition proceeds, the issuer takes a remedial action under section 7.02 of this revenue procedure for such disposition proceeds within 90 days after the date of disposition;
(3) **Unspent disposition proceeds.** If the issuer fails to spend all of the disposition proceeds that it reasonably expected to spend within the prescribed two-year period in the manner described in section 7.05(2) of this revenue procedure, the issuer takes a remedial action under section 7.02 of this revenue procedure for the remaining disposition proceeds within 90 days after the end of that two-year period; and

(4) **Treatment of disposition proceeds.** The issuer treats the disposition proceeds as described in section 7.02(3) of this revenue procedure.

.06 **Certain special rules on applicability.** For QZABs under § 1397E, the remedial actions under § 1.1397E-1(h)(8) apply in lieu of this section 7. For tax-advantaged bonds subject to § 141, the remedial action provisions under § 1.141-12 apply in lieu of this section 7 for purposes of curing violations of the private business use and private loan restrictions; however, for defeasance escrows established under § 1.141-12(d), section 7.04 of this revenue procedure applies and issuers may apply section 7.02(2) of this revenue procedure.

SECTION 8. EFFECTIVE DATE

This revenue procedure applies to a nonqualified use that occurs on or after April 11, 2018, and may be applied to a nonqualified use that occurs before April 11, 2018.

SECTION 9. DRAFTING INFORMATION

The principal authors of this revenue procedure are Timothy L. Jones, Johanna Som de Cerff, and Zoran Stojanovic of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Zoran Stojanovic at 202-317-6980 (not a toll-free call).
Tax Exempt Bonds FAQs Regarding Reissuance

Tax Exempt Bonds ("TEB") is providing some basic information to assist issuers and conduit borrowers of tax-exempt bonds in understanding their tax responsibilities when restructuring certain terms of their tax-exempt bonds. Below are the answers to certain frequently asked questions regarding the application of the reissuance rules under section 1001 of the Internal Revenue Code (the "Code") to tax-exempt bonds. This information is not intended to be cited as an authoritative source on these requirements. TEB recommends that issuers of tax-exempt bonds review section 1001 of the Code and the corresponding Income Tax Regulations (the "Regulations") in consultation with their counsel.

These frequently asked questions and answers are provided for general information only and should not be cited as any type of legal authority. They are designed to provide the user with information required to respond to general inquiries. Due to the uniqueness and complexities of federal tax law, it is imperative to ensure a full understanding of the specific question presented and to perform the requisite research to ensure a correct response is provided.

What is a reissuance?

Generally, a reissuance occurs under federal tax law when there are significant modifications to the terms of a bond so that the bond ceases to be the same bond for federal tax purposes. A reissuance is a deemed exchange of the modified bond for the original bond. The reissuance rules apply to all tax-exempt obligations from a large bond issue to a small lease entered into to purchase police cars and other equipment as well as a note held by a local bank.

How does it affect bonds?

Reissuance of a tax-exempt bond generally triggers retesting of all the various federal tax requirements.

What types of federal tax requirements might be triggered by a reissuance?

Among the requirements a reissuance can cause are: a change in yield which would affect arbitrage investment restrictions, a need for volume cap authority, acceleration of rebate payments, and filing a new information return.

What types of modifications cause a reissuance?
A modification must be "significant" to cause a reissuance. Seven specific types of modifications that are considered significant are listed in our article Reissuance of Tax Exempt Obligations: Some Basic Concepts.

**Does reissuance affect other types of bonds issued by state and local governments?**

The reissuance regulations apply to modifications of debt instruments generally. Thus, the principles discussed above also apply to certain other types of tax favored obligations issued by state and local governments, including tax credit bonds such as those issued under section 54A and build America bonds issued under section 54AA.

**Where can I get more information?**

Our article Reissuance of Tax Exempt Obligations: Some Basic Concepts contains a list of guidance projects that have focused on reissuance as well as citations to the applicable sections of the Code and Regulations.

**Article Link:**

- Reissuance of Tax Exempt Obligations: Some Basic Concepts

*Page Last Reviewed or Updated: 29-Nov-2018*
Reissuance of Tax Exempt Obligations: Some Basic Concepts

Generally

Tax Exempt Bonds (TEB) focuses on providing participants in the municipal bond industry with quality service to assist issuers and conduit borrowers in understanding their tax responsibilities. TEB has initiated an outreach and educational services program to increase understanding and compliance with tax law applicable to certain obligations issued by state and local governments. As part of this service, TEB is providing the following general information for issuers of tax-exempt bonds with respect to a reissuance. This information is not intended to be cited as an authoritative source on these requirements. TEB recommends that issuers of tax-exempt bonds review section 1001 of the Internal Revenue Code (Code) and the corresponding Income Tax Regulations (Regulations) in consultation with their counsel.

Generally, a reissuance occurs under federal tax law when there are significant modifications to the terms of a bond so that the bond ceases to be the same bond for tax purposes. A reissuance is a deemed exchange of the modified bond for the original bond.

In the current financial climate, some issuers are contemplating restructuring the debt service on their tax-exempt bonds by entering into certain contractual agreements that modify the terms of the bonds. The reissuance rules apply to all tax-exempt bonds from a large bond issue to a small lease entered into to purchase police cars or other equipment as well as a note held by a local bank.

Why does reissuance matter?

The consequences of a reissuance apply to issuers, conduit borrowers and to bondholders. Reissuance of a tax-exempt bond generally triggers retesting of all the various federal tax requirements that apply to a new issue. Specific potential consequences include, among other things, a change in yield affecting arbitrage investment restrictions, acceleration of rebate payments, new public approval requirements for qualified private activity bonds, deemed terminations of integrated interest rate swaps under the qualified hedge rules for arbitrage purposes, a need for volume cap, and a required filing of a new information return. Moreover, reissuance can present a problem for certain types of bonds which must be issued by a statutory deadline (i.e., Gulf Opportunity Zone Bonds which cannot be issued after December 31, 2011).

What causes a reissuance?
The standard for determining whether tax-exempt bonds are reissued, retired or modified significantly enough to trigger a retesting of the program requirements for new issues of tax-exempt bonds is based on the general federal tax standards for debt exchanges under section 1001 of the Code and the Regulations thereunder. Generally Regulation section 1.1001-3 employs a significant modification standard to determine whether modifications to a debt instrument are significant enough to cause the debt instrument to be treated as reissued for federal tax purposes. In general, a modification (or series of modifications) is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered is economically significant. However, there are special rules for specific types of modifications to determine if there has been a significant modification. Because the consequences of a reissuance may be important, TEB encourages issuers to contact their counsel before any of the following actions listed below are taken to modify the terms of any bond that it has issued.

**Specific Types of Significant Modifications**

Change in annual yield. Generally, a change in the annual yield of a tax-exempt bond by more than the greater of 1/4 of one percent or 5% of the annual yield of the unmodified instrument will trigger a reissuance.

Change in timing of payments. Depending on the circumstances, a reissuance may occur if there is a change in the timing of the payments due under the tax-exempt bond such as an extension of the final maturity or a deferral of payments prior to maturity.

Substitution of a new obligor or the addition or deletion of a co-obligor. If there is a change in payment expectations, the addition or deletion of a co-obligor on a tax-exempt bond may cause a reissuance. The substitution of a new obligor on tax-exempt bonds is not a significant modification if the new obligor is related to the issuer and the collateral for the bonds includes the original collateral.

Change in security or credit enhancement. If there is a change in payment expectations, the substitution of new collateral for existing collateral of a tax-exempt bond may cause a reissuance. Generally, however, the substitution of a similar commercially available credit enhancement contract on a nonrecourse tax-exempt bond will not cause a reissuance. See below for defeasances of tax-exempt bonds.

Change in priority of an obligation. If there is a change in payment expectations, the subordination of a tax-exempt bond to another obligation may cause a reissuance.

Change in the nature of a debt instrument. For example, changing a tax-exempt bond from a recourse obligation to a nonrecourse obligation or vice versa may cause a reissuance. Generally, a legal defeasance of a debt instrument in which the issuer is released from all liability to make payments on the debt instrument is a significant modification. However, there is an exception for tax-exempt bond defeasances under the circumstances described in Regulation section 1.1001-3(e)(5)(ii)(B).
Change in payment expectations. Depending on the circumstances, a change in payment expectations may cause a reissuance. A change in payment expectations may occur if there is a substantial enhancement or substantial impairment of an issuer’s capacity to meet its payment obligations. An issuer’s payment capacity for a bond issue includes all of its sources of payment on the bonds, including collateral, guarantees, or other credit enhancement.

Regulation section 1.1001-3(f)(6) provides special rules for certain tax-exempt bonds (for example, conduit loans).

**Remedial Actions May Cause a Reissuance**

Issuers and borrowers should take special note that, in addition to identifying those post-issuance changes to terms of bonds which could be a reissuance, a remedial action in connection with a change in use could cause a reissuance depending on the circumstances. Thus, a reissuance may occur if the issuer takes a remedial action which involves the alternative use of the disposition proceeds. For example, an issuer that uses cash proceeds from the sale of its tax-exempt bond financed facility to acquire another qualified facility may cause the bonds to have substituted collateral or may cause a change of payment expectations either or both of which could cause a reissuance. (Note the special rule for 501(c)(3) organizations under Regulation section 1.141-12(e)(2) requiring disposition proceeds representing the nonqualified bonds to be treated as reissued qualified 501(c)(3) bonds).

**Guidance Projects**


Notice 2008-41 provides special reissuance rules for certain eligible tax-exempt bonds that are “qualified tender bonds.” Notice 2008-41 amends and supplements Notice 2008-27 which modified certain special reissuance standards for “qualified tender bonds” under Notice 88-130 and modified certain aspects of the application of Regulation section 1.1001-3 as they apply to tax-exempt bonds.

**Certain Tax Credit and Build America Bonds**

Regulation section 1.1001-3 applies to modifications of debt instruments. Thus, the principles discussed above may also apply to certain other types of tax favored obligations including tax credit bonds issued under section 54A and build America bonds issued under section 54AA. Consequently, modifications of these debt instruments may also present problems to issuers. For example, issuers of build America bonds must avoid making significant modifications that result in a reissuance as build America bonds have a statutory deadline and cannot be issued after December 31, 2010. TEB recommends that issuers of tax credit bonds and build America bonds also consult with their counsel about the possible effects of a reissuance.

**FAQs Link**

Tax Exempt Bonds FAQs Regarding Reissuance

Page Last Reviewed or Updated: 29-May-2018