Reg. Section 1.1400Z2(b)-1

Inclusion of gains that have been deferred under section 1400Z-2(a)

(a) Scope. This section provides rules under section 1400Z-2(b) of the Internal Revenue Code and the section 1400Z-2 regulations (as defined in §1.1400Z2(a)-1(b)(41)) regarding the inclusion in income of gain deferred by a QOF owner under section 1400Z-2(a)(1)(A) and the section 1400Z-2 regulations. This section applies to a QOF owner only until all of such owner's gain deferred pursuant to a deferral election has been included in income, subject to the limitations described in paragraph (e)(5) of this section, and except as otherwise provided in paragraph (c) or (d) of this section. Paragraph (b) of this section provides general rules under section 1400Z-2(b)(1) regarding the timing of the inclusion in income of the deferred gain. Paragraph (c)(1) of this section provides the general rule regarding the determination of the extent to which an event triggers the inclusion in gross income of all, or a portion, of an eligible taxpayer's deferred gain, and paragraphs (c)(2) through (16) of this section provide specific rules for certain events that are or are not treated as inclusion events. Paragraph (d) of this section provides rules regarding holding periods for qualifying investments. Paragraph (e) of this section provides rules regarding the amount of deferred gain included in gross income under section 1400Z-2(a)(1)(B) and (b), including special rules for QOF partnerships and QOF S corporations. Paragraph (f) of this section provides examples illustrating the rules of paragraphs (c), (d), and (e) of this section. Paragraph (g) of this section provides rules regarding basis adjustments under section 1400Z-2(b)(2)(B). Paragraph (h) of this section provides special reporting rules applicable to partners, partnerships, and direct or indirect owners of QOF partnerships. Paragraph (i) is reserved. Paragraph (j) of this section provides dates of applicability.

(b)General inclusion rule. The gain to which a deferral election applies is included in gross income, to the extent provided in paragraph (e) of this section and in accordance with the rules of § 1.1400Z2(a)-1(c)(1), in the taxable year that includes the earlier of:

(1) The date of an inclusion event; or

(2) December 31, 2026.

(c)Inclusion events.

(1)In general. Except as otherwise provided in this paragraph (c), an event is an inclusion event, if, and to the extent that-

(i) The event reduces an eligible taxpayer's direct equity interest for Federal income tax purposes in the qualifying investment;

(ii) An eligible taxpayer receives property in the event with respect to its qualifying investment and the event is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the eligible taxpayer's ownership of the QOF;

(iii) An eligible taxpayer claims a loss for worthless stock under section 165(g) or otherwise claims a worthlessness deduction with respect to its qualifying investment; or

(iv) A QOF in which an eligible taxpayer holds a qualifying investment loses its status as a QOF.

(2)Termination or liquidation of QOF or QOF owner.

(i) Termination or liquidation of QOF. Except as otherwise provided in this paragraph (c), an eligible taxpayer has an inclusion event with respect to all of its qualifying investment if the QOF ceases to exist for Federal income tax purposes. For example, if a QOF partnership converts to a QOF C corporation, or if a QOF C corporation converts to a QOF partnership or to an entity disregarded as separate from its owner for Federal income tax purposes, all investors in the QOF have an inclusion event with respect to all of their qualifying investments in the QOF.

(ii) Liquidation of QOF owner-

(A) Portion of distribution treated as sale. A distribution of a qualifying investment in a complete liquidation of a QOF owner is an inclusion event to the extent that section 336(a) treats the distribution as if the qualifying investment were sold to the distributee at its fair market value, without regard to section 336(d).

(B) Distribution to 80-percent distributee. A distribution of a qualifying investment in a complete liquidation of a QOF owner is not an inclusion event to the extent section 337(a) applies to the distribution.

(3)Transfer of an investment in a QOF by gift or incident to divorce.

(i) Transfer of an investment in a QOF by gift. Except to the extent provided in paragraph (c)(5) of this section, a taxpayer's transfer of a qualifying investment by gift, as defined for purposes of chapter 12 of subtitle B of the Code, whether outright or in trust, is an inclusion event, regardless of whether that transfer is a completed gift for Federal gift tax purposes, and regardless of the taxable or tax-exempt status of the donee of the gift.

(ii) Transfers between spouses incident to divorce. A transfer between spouses or incident to divorce or otherwise as provided in section 1041 of the Code is an inclusion event.

(4)Transfer of an investment in a QOF by reason of the taxpayer's death.

(i) In general. Except as provided in paragraph (c)(4)(ii) of this section, a transfer of a qualifying investment by reason of the taxpayer's death is not an inclusion event. Transfers by reason of death include, for example:

(A) A transfer by reason of death to the deceased owner's estate;

(B) A distribution of a qualifying investment by the deceased owner's estate;

(C) A distribution of a qualifying investment by the deceased owner's trust that is made by reason of the deceased owner's death;

(D) The passing of a jointly owned qualifying investment to the surviving co-owner by operation of law; and

(E) Any other transfer of a qualifying investment at death by operation of law.

(ii) Exceptions. The following transfers are not included as a transfer by reason of the taxpayer's death, and thus are inclusion events:

(A) A sale, exchange, or other disposition by the deceased taxpayer's estate or trust, other than a distribution described in paragraph (c)(4)(i) of this section;

(B) Any disposition by the legatee, heir, or beneficiary who received the qualifying investment by reason of the taxpayer's death; and

(C) Any disposition by the surviving joint owner or other recipient who received the qualifying investment by operation of law on the taxpayer's death.

(iii) Liability for deferred Federal income tax. If the owner of a qualifying investment in a QOF dies before an inclusion event and the deferred gain is not includable in the decedent's gross income, the gain that the decedent elected to defer under section 1400Z-2(a) and the section 1400Z-2 regulations will be includable in the gross income, for the taxable year in which occurs an inclusion event, of the person described in section 691(a)(1).

(iv) Qualifying investment in the hands of the person described in section 691(a)(1). A qualifying investment received in a transfer by reason of death listed in paragraph (c)(4)(i) of this section continues to be a qualifying investment under §1.1400Z2(a)-1(b)(34).

(5)Grantor trusts.

(i) Contributions to grantor trusts. If the owner of a qualifying investment contributes it to a trust and, under subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code (grantor trust rules), the contributing owner of the investment is the deemed owner of the trust (grantor trust), the contribution to the grantor trust is not an inclusion event. Similarly, a transfer of the investment by the grantor trust to the trust's deemed owner is not an inclusion event. For all purposes of the section 1400Z-2 regulations, references to the term grantor trust mean the portion of the trust that holds the qualifying investment in the QOF, and such a grantor trust, or portion of the trust, is a wholly grantor trust as to the deemed owner. Such contributions may include transfers by gift or any other type of transfer between the grantor and the grantor trust that is a nonrecognition event as a result of the application of the grantor trust rules (that is, subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code).

(ii) Changes in grantor trust status. In general, a change in the income tax status of an existing trust owning a qualifying investment in a QOF, whether the termination of grantor trust status or the creation of grantor trust status, is an inclusion event. Notwithstanding the previous sentence, the termination of grantor trust status as the result of the death of the owner of a qualifying investment is not an inclusion event, but the provisions of paragraph (c)(4) of this section apply to distributions or dispositions by the trust. If a qualifying investment is held in the grantor portion of an electing small business trust (ESBT), as defined in section 1361(e)(1), and the ESBT converts into a qualified subchapter S trust (QSST), as defined in section 1361(d)(3), the beneficiary of which is the deemed owner of the grantor portion of the ESBT, there has been no change in the grantor trust status because the deemed owner continues to be taxable under subtitle A of the Code on the income and gain from the qualifying investment.

(iii) Conversions of QSSTs and ESBTs. With regard to conversions of QSSTs and ESBTs, see paragraphs (c)(7)(i)(B) and (C) of this section. For purposes of paragraph (c)(5)(ii) of this section, if a qualifying investment is held by a QSST that converts to an ESBT, the beneficiary of the QSST is the deemed owner of the grantor portion of the ESBT that then holds the qualifying investment, and the deemed owner is not a nonresident alien for purposes of this section (and thus notwithstanding §1.1361-1(j)(8)), there has been no change in the grantor trust status because the deemed owner continues to be taxable under subtitle A of the Code on the income and gain from the qualifying investment.

(6)Special rules for partners and partnerships.

(i) Scope. Except as otherwise provided in this paragraph (c)(6), in the case of a partnership that is a QOF or a QOF partner, the inclusion rules of this paragraph (c) apply to transactions involving any direct or indirect partner of the QOF to the extent of that partner's share of any eligible gain of the QOF.

(ii) Transactions that are not inclusion events-

(A) In general. Notwithstanding paragraphs (c)(1) and (2) of this section, and except as otherwise provided in paragraph (c)(6) of this section, no transaction described in paragraph (c)(6)(ii) of this section is an inclusion event.

(B) Section 721 contributions. Subject to paragraph (c)(6)(v) of this section, a contribution by a QOF owner (contributing partner), of its qualifying QOF stock, qualifying QOF partnership interest, or direct or indirect partnership interest in a qualifying investment to a partnership (transferee partnership) to the extent the transaction is governed by section 721(a) is not an inclusion event, provided the interest transfer does not cause a partnership termination of a QOF partnership, or the direct or indirect owner of a QOF, under section 708(b)(1). See paragraph (c)(6)(ii)(C) of this section for transactions governed by section 708(b)(2)(A). The inclusion rules in paragraph (c) of this section apply to any part of the transaction to which section 721(a) does not apply. The transferee partnership becomes subject to section 1400Z-2 and the section

1400Z-2 regulations with respect to the eligible gain associated with the contributed qualifying investment. The transferee partnership must allocate and report the remaining deferred gain that is associated with the contributed qualifying investment to the contributing partner to the same extent that the remaining deferred gain would have been allocated and reported to the contributing partner in the absence of the contribution. Additionally, the transferee partnership must allocate the basis increases described in section 1400Z-2(b)(2)(B)(iii) and (iv) to the contributing partner. If a transferee partnership is a direct QOF owner, only the transferee partnership may make the elections under section 1400Z-2(c) and the regulations in this part under section 1400Z-2(c) of the Code with respect to the contributed qualifying investment. See §1400Z2(c)-1(b)(1)(ii) (election by transferee partnership).

(C) Section 708(b)(2)(A) mergers or consolidations-

(1) Merger of a partnership that is a QOF partner. Subject to paragraphs (c)(6)(iii) and (v) of this section, a merger or consolidation of a partnership that is a QOF partner (original partnership) with another partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event to the extent section 721(a) applies to the merger. To the extent the original partnership terminates in the merger, as determined under §1.708-1(c)(1), the partnership that is a continuation of the original partnership becomes subject to section 1400Z-2 and the section 1400Z-2 regulations to the same extent that the original partnership was so subject prior to the transaction, and must allocate and report any gain under section 1400Z-2(b) to the same extent and to the same partners that the original partnership allocated and reported such items prior to the transaction. Notwithstanding the rules in this paragraph (c)(6)(ii)(C)(1), the general inclusion rules of paragraph (c) of this section apply to the portion of the transaction that is otherwise treated as a sale or exchange under paragraph (c) of this section.

(2) Merger of QOF partnerships. Subject to paragraph (c)(6)(v) of this section, a merger or consolidation of a QOF partnership with another QOF partnership in a transaction to which section 708(b)(2)(A) applies is not an inclusion event under paragraph (c)(2)(i) of this section if, immediately after the merger or consolidation, the resulting partnership is a QOF. The continuing partnership, as determined under §1.708-1(c)(1), becomes subject to section 1400Z-2 and the section 1400Z-2 regulations to the same extent that the terminated partnership was so subject prior to the transaction, and must allocate and report any gain under section 1400Z-2(b) to the same extent and to the same partners that the terminated partnership would have allocated and reported such items prior to the transaction. Notwithstanding the rules in this paragraph (c)(6)(ii)(C)(2), the general inclusion rules of paragraph (c) of this section apply to the portion of the transaction that is

otherwise treated as a sale or exchange under paragraph (c) of this section.

(D) Example. The following example illustrates the rules of this paragraph (c)(6)(ii).
(1)
Example.
(i) Facts. In 2019, taxpayer A contributes $100 of eligible gain to a QOF partnership, X, in exchange for a qualifying QOF partnership interest in X, and taxpayer B contributes $100 of eligible gain to another QOF partnership, Y, in exchange for a qualifying QOF partnership interest in Y. In 2021, in transactions governed by section 721(a), A contributes her qualifying QOF partnership interest in X, and B contributes her qualifying QOF partnership interest in Y, to a newly formed partnership, UTP. In 2024, C receives a profits interest in UTP for services that she will provide to UTP. In 2031, X sells a non-inventory asset and allocates X's distributive share of the gain to UTP. No distributions are ever made from X, Y, or UTP.
(ii) Analysis. On December 31, 2026, UTP recognizes $170 of remaining deferred gain relating to the QOF interests. Of that gain, A is allocated the $85 of gain relating to the $100 of eligible gain that she invested in X, and B is allocated the $85 of gain relating to the $100 of eligible gain that she invested in Y. C recognizes no gain at this time. In 2031, because UTP's holding period in X includes A's holding period in X, UTP has a holding period in X that exceeds 10 years, and may make an election under §1.1400Z2(c)-1(b)(2)(ii) to exclude the gain from X's asset sale. Even though A was the original investor in X, she may not make the election. If UTP makes the election, UTP will exclude its distributive share of gain from the sale of the X asset.

(2) [Reserved]

(iii) Partnership distributions. Subject to paragraph (c)(6)(v) of this section, an actual or deemed distribution of property, including cash, by a QOF partnership to a partner with respect to its qualifying investment is an inclusion event only to the extent that the distributed property has a fair market value in excess of the partner's basis in its qualifying investment. For purposes of this paragraph (c)(6)(iii), in the case of a merger or consolidation of a QOF partnership with another QOF partnership in a transaction to which section 708(b)(2)(A) applies, the fair market value of the distributed property is reduced by the fair market value of the QOF partnership interest received in the merger or consolidation. A distribution from a partnership that directly or indirectly owns a QOF is an inclusion event only if the distribution is a liquidating distribution. For purposes of this paragraph (c)(6)(iii), the distribution is not in complete liquidation if the partnership making the distribution is a partnership that terminates in a partnership merger or consolidation under §1.708-1(c), the continuing partnership in the merger or consolidation continues to directly or indirectly own an interest in the QOF, and the distributee is distributed an

interest in the resulting partnership as part of the merger or consolidation. See paragraph (c)(6)(iv) of this section for special rules relating to mixed-funds investments.

(iv) Special rules for mixed-funds investments-
(A) In general. The rules of this paragraph (c)(6)(iv) apply solely for purposes of section 1400Z-2. A partner that holds a mixed-funds investment in a QOF partnership (a mixed-funds partner) shall be treated as holding two separate interests in the QOF partnership, one a qualifying investment and the other a non-qualifying investment (separate interests). The basis of each separate interest is determined under the rules described in paragraphs (c)(6)(iv)(B) and (g) of this section as if each interest were held by different taxpayers.

(B) Allocations and distributions. All section 704(b) allocations of income, gain, loss, and deduction, all section 752 allocations of debt, and all distributions made to a mixed-funds partner will be treated as made to the separate interests based on the allocation percentages of those interests as defined in paragraph (c)(6)(iv)(D) of this section. For purposes of this paragraph (c)(6)(iv)(B), in allocating income, gain, loss, or deduction between these separate interests, section 704(c) principles apply to account for any value-basis disparities attributable to the qualifying investment or non-qualifying investment. Any distribution (whether actual or deemed) to the holder of a qualifying investment is subject to the rules of paragraphs (c)(6)(iii) and (v) of this section, without regard to the presence or absence of gain under other provisions of subchapter K of chapter 1 of subtitle A of the Internal Revenue Code.

(C) Subsequent contributions. In the event of an increase in a partner's qualifying or non-qualifying investment, as for example, in the case of an additional contribution for a qualifying investment or for an interest that is a non-qualifying investment or a change in allocations for services rendered, the partner's interest in the separate interests must be valued immediately prior to the event and the allocation percentages adjusted to reflect the relative values of these separate interests and the additional contribution, if any.

(D) Allocation percentages. The allocation percentages of the separate interests will be determined based on the relative capital contributions attributable to the qualifying investment and the non-qualifying investment. In the event a partner receives a profits interest in the QOF partnership for services provided to or for the benefit of the QOF partnership, the allocation percentage with respect to the profits interest is based on the share of residual profits the mixed-funds partner would receive with respect to that interest, disregarding any allocation of residual profits for which there is not a reasonable likelihood of application.

(E) Examples. The following examples illustrate the rules of this paragraph (c)(6)(iv).

(1)

Example (1). Allocation of residual profits for which there is no reasonable likelihood of application-

(i) Facts. A realizes $100 of eligible gain and B realizes $900 of eligible gain. A and B form Q, a QOF partnership. B contributes $900 to Q in exchange for a qualifying QOF partnership interest (B's capital interest). A contributes $100 to Q in exchange for a qualifying QOF partnership interest (A's capital interest and, with B's capital interest, the capital interests) and agrees to provide services to Q in exchange for a profits interest in Q (A's profits interest). Q's partnership agreement provides that Q's profits are first allocated to the capital interests until the capital interest holders receive a 10 percent preferred return with respect to those interests. Next, Q's profits are allocated 15 percent to A with respect to A's profits interest, 10 percent to A with respect to A's capital interest, and 75 percent to B until the capital interests receive a 1,000% preferred return. Thereafter, Q's profits are allocated 1 percent to A's profits interest and 99 percent to the capital interests. There is not a reasonable likelihood that Q's profits will be sufficient to result in an allocation in the last tranche.

(ii) Analysis. Under paragraph (c)(6)(iv)(D) of this section, the allocation percentage with respect to A's profits interest is calculated based on the share of residual profits that A would receive with respect to A's profits interest, disregarding any allocation of residual profits that has no reasonable likelihood of being achieved. Under Q's partnership agreement, A's share of Q's residual profits with respect to A's profits interest is 1 percent. However, there is no reasonable likelihood that this 1 percent allocation will apply because it is unlikely that the capital interests will receive a 1,000% preferred return. Therefore, under paragraph (c)(6)(iv)(D) of this section, A's share of Q's residual profits with respect to A's profits interest is 15 percent, the final allocation of Q's profits to A's profits interest that is reasonably likely to apply. The allocation percentage for A's capital interest in Q is 10 percent under paragraph (c)(6)(iv)(D) of this section. Thus, allocations and distributions made to A are treated as made 60 percent (15/25) to A's non-qualifying profits interest and 40 percent (10/25) to A's qualifying QOF partnership interest.

(2)

Example (2). Separate entity holding profits interest-

(i) Facts. The facts are the same as in paragraph (c)(6)(iv)(E)(1) of this section (Example 1), except that A is a partnership that has no eligible gain and P, a partnership that is owned by the same taxpayers who own A, realizes $100 of eligible gain and contributes $100 to Q for its qualifying investment.

(ii) Analysis. Under paragraph (c)(6)(iv)(D) of this section, A's profits interest is a non-qualifying investment in Q. Because P directly holds only a qualifying QOF partnership interest in Q, P is not a mixed-funds partner in Q, and 100 percent of the allocations and distributions made to P are attributable to P's qualifying QOF partnership interest.

(v) Remaining deferred gain reduction rule. An inclusion event occurs when and to the extent that a transaction has the effect of reducing:
(A) The amount of remaining deferred gain of one or more direct or indirect partners; or

(B) The amount of gain that would be recognized by such partner or partners under paragraph (e)(4)(ii) of this section to the extent that such amount would reduce such gain to an amount that is less than the remaining deferred gain.

(7)Special rules for S corporations.

(i) In general. Except as provided in paragraphs (c)(7)(ii), (iii), and (iv) of this section, none of the following is an inclusion event:

(A) An election, revocation, or termination of a corporation's status as an S corporation under section 1362;

(B) A conversion of a QSST to an ESBT, but only if the QSST beneficiary is the deemed owner of the grantor portion of the ESBT that receives the qualifying investment and if the deemed owner is not a nonresident alien;

(C) A conversion of an ESBT to a QSST, where the qualifying investment is held in the grantor portion of the ESBT and the QSST beneficiary is the deemed owner of the grantor portion of the ESBT; and

(D) A valid modification of a trust agreement of an S-corporation shareholder whether by an amendment, a decanting, a judicial reformation, or a material modification.

(ii) Distributions by QOF S corporation-

(A) General rule. An actual or constructive distribution of property by a QOF S corporation to a QOF shareholder with respect to its qualifying investment is an inclusion event to the extent that the distribution is treated as gain from the sale or exchange of property under section 1368(b)(2) and (c). For the treatment of a distribution by a QOF S corporation to which section 305(a) applies, see paragraph (c)(8)(ii). For the treatment of a distribution to which section 302(d) or section 306(a)(2) applies, see paragraph (c)(9)(ii) of this section.

(B) Spill-over rule. For purposes of applying paragraph (c)(7)(ii) of this section to the adjusted basis of a qualifying investment, or non-qualifying investment, as appropriate, in a QOF S corporation, the second sentence of §1.1367-1(c)(3) applies-

(1) With regard to multiple qualifying investments, solely to the respective bases of such qualifying investments, and does not take into account the basis of any non-qualifying investment; and

(2) With regard to multiple non-qualifying investments, solely to the respective bases of such non-qualifying investments, and does not take into account the basis of any qualifying investment.

(iii) Conversion from S corporation to partnership or disregarded entity-

(A) General rule. Notwithstanding paragraph (c)(7)(i) of this section, and except as provided in paragraph (c)(7)(iii)(B) of this section, a conversion of an S corporation to a partnership or an entity disregarded as separate from its owner under §301.7701-3(b)(1)(ii) of this chapter is an inclusion event.

(B) Exception for qualifying section 381 transaction. A conversion described in paragraph (c)(7)(iii)(A) of this section is not an inclusion event if the conversion comprises a step in a series of related transactions that together qualify as a qualifying section 381 transaction.

(iv) Treatment of separate blocks of stock in mixed-funds investments. With regard to a mixed-funds investment in a QOF S corporation, if different blocks of stock are created for separate qualifying investments to track basis in such qualifying investments, the separate blocks are not treated as different classes of stock for purposes of S corporation eligibility under section 1361(b)(1).

(v) Applicability. Paragraph (c)(7) of this section applies regardless of whether the S corporation is a QOF or a QOF shareholder.

(8)Distributions by a QOF corporation.

(i) General rule for distributions by a QOF C corporation. If a QOF C corporation distributes property to a QOF shareholder with respect to a qualifying investment, only the amount of the distribution to which section 301(c)(3) or 1059(a)(2) applies gives rise to an inclusion event. For purposes of this paragraph (c)(8)(i), a distribution of property includes a distribution of stock in the QOF C corporation making the distribution (or rights to acquire such stock) if the distribution is treated as a distribution of property to which section 301 applies pursuant to section 305(b).

(ii) Section 305(a) distributions. A distribution with respect to qualifying QOF stock to which section 305(a) applies is not an inclusion event. QOF stock received in such a distribution is qualifying QOF stock. The shareholder's remaining deferred gain is allocated pro rata between the new qualifying QOF stock received and the qualifying QOF stock with respect to which the distribution was made in proportion to the fair market values of each on the date of distribution. See §1.307-1(a).

(9)Dividend-equivalent redemptions and redemptions of section 306 stock.

(i) Redemptions by QOF C corporations-

(A) In general. Except as provided in paragraph (c)(9)(i)(B) of this section, if a QOF C corporation redeems its stock from a QOF shareholder in a transaction described in section 302(d) or section 306(a)(2), the full amount of such redemption gives rise to an inclusion event.

(B) Redemptions of stock of wholly owned QOF C corporation and pro rata redemptions. Paragraph (c)(8)(i) of this section applies to a

redemption described in paragraph (c)(9)(i)(A) of this section if, at the time of such redemption-

(1) All stock in the QOF C corporation is held directly by a single shareholder, or directly by members of a single consolidated group; or

(2) The QOF C corporation has outstanding only one class of stock, as defined in section 1361 and §1.1361-1(l), and the redemption is pro rata as to all shareholders of the redeeming QOF C corporation.

(ii) Redemptions by QOF S corporations. If a QOF S corporation redeems its stock from a QOF shareholder in a transaction described in section 302(d) or section 306(a)(2), the amount that gives rise to an inclusion event is the amount by which the distribution exceeds basis in the QOF stock as adjusted under paragraph (c)(7)(ii) of this section.

(10)Qualifying section 381 transactions.

(i) Assets of a QOF are acquired-

(A) In general. Except to the extent provided in paragraph (c)(10)(i)(C) of this section, if the assets of a QOF corporation are acquired in a qualifying section 381 transaction, and if the acquiring corporation is a QOF immediately after the acquisition, then the transaction is not an inclusion event.

(B) Determination of acquiring corporation's status as a QOF. For purposes of paragraph (c)(10)(i)(A) of this section, the acquiring corporation is treated as a QOF immediately after the qualifying section 381 transaction if the acquiring corporation satisfies the certification requirements in §1.1400Z2(d)-1 immediately after the transaction and holds at least 90 percent of its assets in qualified opportunity zone property on the first testing date after the transaction. See section 1400Z-2(d)(1) and §1.1400Z2(d)-1.

(C) Receipt of boot by QOF shareholder in qualifying section 381 transaction. This paragraph (c)(10)(i)(C) applies if assets of a QOF corporation are acquired in a qualifying section 381 transaction and an eligible taxpayer that is a QOF shareholder receives boot with respect to its qualifying investment. If this paragraph (c)(10)(i)(C) applies, the QOF shareholder has an inclusion event and is treated as disposing of a portion of its qualifying investment that bears the same proportion to the QOF shareholder's total qualifying investment immediately before the inclusion event as the fair market value of the boot received by the QOF shareholder with respect to its qualifying investment in the qualifying section 381 transaction bears to the fair market value of the total consideration received by the QOF shareholder with respect to its qualifying investment in the qualifying section 381 transaction.

(ii) Assets of a QOF shareholder are acquired-

(A) In general. Except to the extent provided in paragraph (c)(10)(ii)(B) of this section, a qualifying section 381 transaction in which the assets of a QOF shareholder are acquired is not an inclusion event with respect to the qualifying investment and the acquiring corporation succeeds to the target corporation's status as the QOF shareholder with respect to the qualifying investment.

(B) Qualifying section 381 transaction in which QOF shareholder's qualifying investment is not completely acquired. If the assets of a QOF shareholder are acquired in a qualifying section 381 transaction in which the acquiring corporation does not acquire all of the QOF shareholder's qualifying investment, the QOF shareholder has an inclusion event and is treated as disposing of the portion of its qualifying investment that is not transferred to the acquiring corporation.

(11)Section 355 transactions.

(i) Distribution by a QOF-

(A) In general. Except as provided in paragraph (c)(11)(i)(B) of this section, if a QOF corporation distributes stock or securities of a controlled corporation to a QOF shareholder with respect to a qualifying investment in the QOF corporation in a transaction to which section 355 (or so much of section 356 as relates to section 355) applies, the QOF shareholder has an inclusion event and is treated as disposing of a portion of its qualifying investment equal in value to the fair market value of the shares of the controlled corporation and the fair market value of any boot received by the QOF shareholder in the distribution with respect to its qualifying investment.

(B) Controlled corporation becomes a QOF-

(1) In general. Except as provided in paragraph (c)(11)(i)(B)(3) of this section, if a QOF corporation distributes stock or securities of a controlled corporation in a transaction to which section 355, or so much of section 356 as relates to section 355, applies, and if both the distributing corporation and the controlled corporation are QOFs immediately after the final distribution (qualifying section 355 transaction), then the distribution is not an inclusion event with respect to a QOF shareholder's qualifying investment in the distributing QOF corporation or the controlled QOF corporation. This paragraph (c)(11)(i)(B) does not apply unless the distributing corporation distributes all of the stock and securities in the controlled corporation held by it immediately before the distribution within a 30-day period. For purposes of this paragraph (c)(11)(i)(B), the term final distribution means the last distribution that satisfies the preceding sentence.

(2) Determination of distributing corporation's and controlled corporation's status as QOFs. For purposes of paragraph (c)(11)(i)(B)(1) of this section, each of the distributing corporation and the controlled corporation is treated as a QOF immediately

after the final distribution if the corporation satisfies the certification requirements in §1.1400Z2(d)-1 immediately after the final distribution and holds at least 90 percent of its assets in qualified opportunity zone property on the first testing date after the final distribution. See section 1400Z-2(d)(1) and §1.1400Z2(d)-1.

(3) Receipt of boot. If a QOF shareholder receives boot in a qualifying section 355 transaction with respect to its qualifying investment, and if section 356(a) applies to the transaction, paragraph (c)(10)(i)(C) of this section applies. If a QOF shareholder receives boot in a qualifying section 355 transaction with respect to its qualifying investment, and if section 356(b) applies to the transaction, paragraph (c)(8)(i) of this section applies.

(4) Treatment of controlled corporation stock as qualified opportunity zone stock. If stock or securities of a controlled corporation are distributed in a qualifying section 355 transaction, and if the distributing corporation retains a portion of the controlled corporation stock after the initial distribution, the retained stock will not cease to qualify as qualified opportunity zone stock in the hands of the distributing corporation solely as a result of the qualifying section 355 transaction. This paragraph (c)(11)(i)(B)(4) does not apply unless the distributing corporation distributes all of the stock and securities in the controlled corporation held by it immediately before the distribution within a 30-day period.

(ii) Distribution by a QOF shareholder. If a QOF shareholder distributes stock or securities of a controlled QOF corporation in a transaction to which section 355 applies, then for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section, the QOF shareholder has an inclusion event and is treated as disposing of the portion of its qualifying QOF stock over which it no longer has direct Federal income tax ownership.

(12)Recapitalizations and section 1036 transactions.

(i) In general. Except as otherwise provided in paragraph (c)(12)(ii) of this section, if a QOF corporation engages in a transaction that qualifies as a reorganization described in section 368(a)(1)(E) (a recapitalization), or if a QOF shareholder engages in a transaction that is described in section 1036 (a section 1036 exchange), the transaction is not an inclusion event.

(ii) Receipt of property or boot by QOF shareholder. If a QOF shareholder receives property or boot, or is treated as having received property or boot, with respect to its qualifying investment in a recapitalization, then the property or boot is treated as property or boot to which section 301 or section 356(a) or (c) applies, as determined under general Federal income tax principles. If, in a section 1036 exchange, a QOF shareholder receives property with respect to its qualifying

investment that is not permitted to be received without the recognition of gain, then, for purposes of this section, the receipt of the property is treated in a similar manner as the receipt of such property or boot in a recapitalization. Paragraph (c)(8)(i) of this section applies to property to which section 301 applies. Paragraph (c)(10)(i)(C) of this section applies to boot to which section 356(a) or (c) applies.

(13)Section 304 transactions. If a QOF shareholder transfers its qualifying investment in a transaction described in section 304(a), the full amount of the consideration gives rise to an inclusion event.

(14)Deduction for worthlessness. If an eligible taxpayer claims a loss for worthless stock under section 165(g) or otherwise claims a worthlessness deduction with respect to all or a portion of its qualifying investment, then for purposes of section 1400Z-2 and the section 1400Z-2 regulations, the eligible taxpayer has an inclusion event and is treated as having disposed of that portion of its qualifying investment on the date it became worthless. Thus, neither section 1400Z-2(b)(2)(B)(iii) or (iv) nor section 1400Z-2(c) applies to that portion of the eligible taxpayer's qualifying investment after the date it became worthless.

(15)Decertification of a QOF. The decertification of a QOF, whether a self-decertification pursuant to §1.1400Z2(d)-1(a)(3) or an involuntary decertification pursuant to §1.1400Z2(d)-1(a)(4), is an inclusion event.

(16)Other inclusion and non-inclusion events. Notwithstanding any other provision of this paragraph (c), the Commissioner may determine in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) that a type of transaction is or is not an inclusion event.

(d)Holding periods.

(1)Holding period for qualifying investment.

(i) In general. Solely for purposes of section 1400Z-2(b)(2)(B), section 1400Z-2(c), and the section 1400Z-2 regulations, and except as otherwise provided in this paragraph (d)(1), the length of time a qualifying investment has been held is determined without regard to the period for which the eligible taxpayer had held property exchanged for such investment (even if such period would be relevant for determining the length of time for other Federal income tax purposes).

(ii) Holding period for qualifying investment received in certain transactions with respect to QOFs. For purposes of section 1400Z-2(b)(2)(B), section 1400Z-2(c), and the section 1400Z-2 regulations, the principles of section 1223(1) or (4) apply to determine the holding period for a qualifying investment received by a QOF owner in-

(A) A distribution described in paragraph (c)(2)(ii)(B) of this section;

(B) A distribution to which section 305(a) applies;

(C) A qualifying section 381 transaction described in paragraph (c)(10)(i) or (ii) of this section;

(D) A qualifying section 355 transaction described in paragraph (c)(11)(i)(B) of this section;

(E) A recapitalization or a section 1036 exchange described in paragraph (c)(12) of this section;

(F) A contribution of a QOF interest to a partnership to the extent section 721(a) applies to the transfer; or

(G) A distribution of a QOF interest to the extent the interest was received in a merger of two or more QOF partnerships in a transaction described in section 708(b)(2)(A).

(iii) Tacking with deceased owner or deemed owner of a grantor trust. For purposes of section 1400Z-2(b)(2)(B), section 1400Z-2(c), and the section 1400Z-2 regulations, the holding period of a qualifying investment held by an eligible taxpayer who received that qualifying investment by reason of the prior owner's death includes the time during which that qualifying investment was held by the deceased owner. The rule in the preceding sentence also applies to allow a grantor trust to tack the holding period of the deemed owner if the grantor trust acquires the qualifying investment from the deemed owner in a transaction that is not an inclusion event.

(2)Status of QOF assets as qualified opportunity zone property. For purposes of section 1400Z-2(d) and the section 1400Z-2 regulations, including for purposes of determining whether the original use of qualified opportunity zone business property commences with the acquiring corporation or partnership, qualified opportunity zone property does not lose its status as qualified opportunity zone property solely as a result of-

(i) Its transfer by the transferor corporation to the acquiring corporation in a qualifying section 381 transaction described in paragraph (c)(10)(i) of this section;

(ii) Its transfer by the distributing corporation to the controlled corporation in a qualifying section 355 transaction described in paragraph (c)(11)(i)(B) of this section; or

(iii) Its transfer by the transferor partnership to the acquiring partnership in a transaction to which section 708(b)(2)(A) applies, but only to the extent section 721(a) applies to the transaction.

(e)Amount includible. Except as provided in §§ 1.1400Z2(a)-1(b)(7) and 1.1400Z2(f)-1(b), the amount of gain included in gross income under section 1400Z-2(a)(1)(B) and this section on a date described in paragraph (b) of this section is determined under this paragraph (e).
(1)In general. Except as provided in paragraphs (e)(2) and (4) of this section, and subject to paragraph (e)(5) of this section, in the case of an inclusion event, the amount of gain included in gross income is equal to the excess of the amount described in paragraph (e)(1)(i) of this section over the eligible taxpayer's basis in the portion of the qualifying investment that is disposed of in

the inclusion event. See paragraph (c) of this section for rules regarding the amount that gave rise to the inclusion event, and see paragraph (g) of this section for applicable ordering rules.

(i) The amount described in this paragraph (e)(1)(i) is equal to the lesser of-

(A) An amount which bears the same proportion to the remaining deferred gain, as-

(1) The fair market value of the portion of the qualifying investment that is disposed of in the inclusion event bears to-

(2) The fair market value of the total qualifying investment immediately before the inclusion event; or

(B) The fair market value of the portion of the qualifying investment that is disposed of in the inclusion event.

(ii) For purposes of paragraph (e)(1)(i) of this section, the fair market value of the portion of the qualifying investment that is disposed of in the inclusion event is determined by multiplying the fair market value of the eligible taxpayer's entire qualifying investment in the QOF, determined as of the date of the inclusion event, by the percentage of the eligible taxpayer's qualifying investment that is represented by the portion that is disposed of in the inclusion event.

(2)Property received from a QOF in certain transactions. In the case of an inclusion event described in paragraph (c)(6)(iii) or (v), (c)(7)(ii), (c)(8)(i), or (c)(9) or (13) of this section (or in paragraph (c)(11) or (12) of this section, to the extent the rules in paragraph (c)(8)(i) of this section apply to the inclusion event), the amount of gain included in gross income is equal to the lesser of-

(i) The remaining deferred gain; or

(ii) The amount that gave rise to the inclusion event.

(3)Gain recognized on December 31, 2026. The amount of gain included in gross income on December 31, 2026 is equal to the excess of-

(i) The lesser of-

(A) The remaining deferred gain; and

(B) The fair market value of the qualifying investment held on December 31, 2026; over

(ii) The eligible taxpayer's basis in the qualifying investment as of December 31, 2026, taking into account only section 1400Z-2(b)(2)(B).

(4)Special amount includible rule for partnerships and S corporations. For purposes of paragraphs (e)(1) and (3) of this section, in the case of an inclusion event involving a qualifying investment in a QOF partnership or S corporation, or in the case of a qualifying investment in a QOF partnership or S corporation held on December 31, 2026, the amount of gain included in gross income is equal to the lesser of-

(i) The product of-

(A) The percentage of the qualifying investment that gave rise to the inclusion event; and

(B) The remaining deferred gain, less any basis adjustments pursuant to section 1400Z-2(b)(2)(B)(iii) and (iv); or

(ii) The gain that would be recognized on a fully taxable disposition at fair market value of the qualifying investment that gave rise to the inclusion event.

(5)Limitation on amount of gain included after statutory five-year and seven-year basis increases. The total amount of gain included in gross income under this paragraph (e) is limited to the amount deferred under section 1400Z-2(a)(1) and the section 1400Z-2 regulations, reduced by any increase in the basis of the qualifying investment made pursuant to section 1400Z-2(b)(2)(B)(iii) and (iv). See paragraph (g)(2) of this section for limitations on the amount of basis adjustments under section 1400Z-2(b)(2)(B)(iii) and (iv).

(f)Examples. The following examples illustrate the rules of paragraphs (c), (d) and (e) of this section. For purposes of the following examples: A, B, C, W, X, Y, and Z are C corporations that do not file a consolidated Federal income tax return; Q is a QOF corporation or a QOF partnership, as specified in each example; and each divisive corporate transaction satisfies the requirements of section 355.
(1)
Example (1). Determination of basis, holding period, and qualifying investment -
(i) Facts. A wholly and directly owns Q, a QOF corporation. On May 31, 2019, A sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A transfers unencumbered asset N to Q in exchange for a qualifying investment. Asset N, which A has held for 10 years, has a basis of $500 and a fair market value of $500. A elects to defer the inclusion of $500 in gross income under section 1400Z-2(a) and § 1.1400Z2(a)-1.
(ii) Analysis. Under §1.1400Z2(a)-1(c)(6)(ii)(B)(1), A made a qualifying investment of $500. Under section 1400Z-2(b)(2)(B)(i), A's basis in its qualifying investment in Q is $0. For purposes of sections 1400Z-2(b)(2)(B) and 1400Z-2(c), A's holding period in its new investment in Q begins on October 31, 2019. See paragraph (d)(1)(i) of this section. Other than for purposes of applying section 1400Z-2, A has a 10-year holding period in its new Q investment as of October 31, 2019.
(iii) Transfer of built-in gain property. The facts are the same as in paragraph (f)(1)(i) of this section (this Example 1), but A's basis in transferred asset N is $200. Under §1.1400Z2(a)-1(c)(6)(ii)(B)(1), A made a qualifying investment of $200 and a non-qualifying investment of $300.

(2)
Example (2). Transfer of qualifying investment-
(i) Facts. On May 31, 2019, taxpayer A sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A transfers $500 to newly formed Q, a QOF corporation, in exchange for a qualifying investment. On February 29, 2020, A transfers 25 percent of its qualifying investment in Q to newly formed Y in exchange for 100 percent of Y's stock in a transfer to which section 351 applies (Transfer), at a time when the fair market value of A's qualifying investment in Q is $800.
(ii) Analysis. Under §1.1400Z2(a)-1(c)(6)(ii)(A), A made a qualifying investment of $500 on October 31, 2019. In the Transfer, A exchanged 25 percent of its qualifying investment for Federal income tax purposes, which reduced A's direct qualifying

investment. Under paragraph (c)(1)(i) of this section, the Transfer is an inclusion event to the extent of the reduction in A's direct qualifying investment. Under paragraph (e)(1) of this section, A therefore includes in income an amount equal to the excess of the amount described in paragraph (e)(1)(i) of this section over A's basis in the portion of the qualifying investment that was disposed of, which in this case is $0. The amount described in paragraph (e)(1)(i) is the lesser of $125 ($500 x ($200/$800)) or $200. As a result, A must include $125 of its deferred capital gain in income in 2020. After the Transfer, the Q stock is not qualifying Q stock in Y's hands.

(iii) Disregarded transfer. The facts are the same as in paragraph (f)(2)(i) of this section (this Example 2), except that Y elects to be treated as an entity that is disregarded as an entity separate from its owner for Federal income tax purposes effective prior to the Transfer. Since the Transfer is disregarded for Federal income tax purposes, A's transfer of its qualifying investment in Q is not treated as a reduction in direct tax ownership for Federal income tax purposes, and the Transfer is not an inclusion event with respect to A's qualifying investment in Q for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. Thus, A is not required to include in income any portion of its deferred capital gain.

(iv) Election to be treated as a corporation. The facts are the same as in paragraph (f)(2)(iii) of this section (this Example 2), except that Y (a disregarded entity) subsequently elects to be treated as a corporation for Federal income tax purposes. A's deemed transfer of its qualifying investment in Q to Y under § 301.7701-3(g)(1)(iv) of this chapter is an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section.

(3)

Example (3). Part sale of qualifying QOF partnership interest in Year 6 when value of the QOF partnership interest has increased-

(i) Facts. In October 2018, A and B each realize $200 of eligible gain, and C realizes $600 of eligible gain. On January 1, 2019, A, B, and C form Q, a QOF partnership. A contributes $200 of cash, B contributes $200 of cash, and C contributes $600 of cash to Q in exchange for qualifying QOF partnership interests in Q. A, B, and C hold 20 percent, 20 percent, and 60 percent interests in Q, respectively. On January 30, 2019, Q obtains a nonrecourse loan from a bank for $1,000. Under section 752, the loan is allocated $200 to A, $200 to B, and $600 to C. On February 1, 2019, Q purchases qualified opportunity zone business property for $2,000. On July 31, 2024, A sells 50 percent of its qualifying QOF partnership interest in Q to B for $400 cash. Prior to the sale, there were no inclusion events, distributions, partner changes, income or loss allocations, or changes in the amount or allocation of debt outstanding. At the time of the sale, the fair market value of Q's qualified opportunity zone business property is $5,000.

(ii) Analysis. Because A held its qualifying QOF partnership interest for at least five years, A's basis in its partnership interest at the time of the sale is $220 (the original zero basis with respect to the contribution, plus the $200 debt allocation, plus the 10% increase for interests held for five years). The sale of 50 percent of A's qualifying QOF partnership interest to B requires A to recognize $90 of gain, the lesser of $90, which is 50 percent of $180 (the $200 remaining deferred gain less the $20 five-year basis adjustment), or $390, which is the gain that would be recognized on a taxable sale of 50 percent of the interest. A also recognizes $300 of gain relating to the appreciation of its interest in Q.

(4)

Example (4). Sale of qualifying QOF partnership interest when value of the QOF partnership interest has decreased-

(i) Facts. The facts are the same as in paragraph (f)(3) of this section (Example 3), except that A sells 50 percent of its qualifying QOF partnership interest in Q to B for cash of $50, and at the time of the sale, the fair market value of Q's qualified opportunity zone business property is $1,500.

(ii) Analysis. Because A held its qualifying QOF partnership interest for at least five years, A's basis at the time of the sale is $220. Under section 1400Z-2(b)(2)(A), the sale of 50 percent of A's qualifying QOF partnership interest to B requires A to recognize $40 of gain, the lesser of $90 (50 percent of the excess of A's $200 remaining deferred gain over A's $20 five-year adjustment) or $40 (the gain that would be recognized by A on a sale of 50 percent of its QOF interest). A's remaining basis in its qualifying QOF partnership interest is $110.

(5)

Example (5). Amount includible on December 31, 2026-

(i) Facts. The facts are the same as in paragraph (f)(3) of this section (Example 3), except that no sale of QOF interests takes place in 2024. Prior to December 31, 2026, there were no inclusion events, distributions, partner changes, income or loss allocations, or changes in the amount or allocation of debt outstanding.

(ii) Analysis. For purposes of calculating the amount includible on December 31, 2026, each of A's basis and B's basis is increased by $30 to $230, and C's basis is increased by $90 to $690 because they held their qualifying QOF partnership interests for at least seven years. Each of A and B is required to recognize $170 of gain, and C is required to recognize $510 of gain.

(iii) Sale of qualifying QOF partnership interests. The facts are the same as in paragraph (f)(5)(i) of this section (this Example 5), except that, on March 2, 2030, C sells its entire qualifying QOF partnership interest in Q to an unrelated buyer for cash of $4,200. Assuming an election under section 1400Z-2(c) is made, the basis of C's Q interest is increased to its fair market value immediately before the sale by C. C is treated as purchasing the interest immediately before the sale and the bases of the partnership's assets are increased in the manner they would be if the partnership had an election under section 754 in effect.

(6)

Example (6). Mixed-funds investment-

(i) Facts. On January 1, 2019, A and B form Q, a QOF partnership. A contributes $200 to Q, $100 of which is in exchange for a qualifying investment, and B contributes $200 to Q in exchange for a qualifying investment. All the cash is used to purchase qualified opportunity zone property. Q has no liabilities. On March 30, 2023, when the values and bases of the qualifying investments remain unchanged, Q distributes $50 to A.

(ii) Analysis. Under paragraph (c)(6)(iv) of this section, A is a mixed-funds partner holding two separate interests, a qualifying investment and a non-qualifying investment. One half of the $50 distribution is treated under that provision as being made with respect to A's qualifying investment. For the $25 distribution made with respect to the qualifying investment, A is required to recognize $25 of gain.

(iii) Basis adjustments. Under paragraph (g)(1)(ii)(B) of this section, prior to determining the tax consequences of the distribution, A increases its basis in its qualifying QOF

partnership interest by $25 under section 1400Z-2(b)(2)(B)(ii). The distribution of $25 results in no gain under section 731. After the distribution, A's basis in its qualifying QOF partnership interest is $0 ($25-$25).

(7)

Example (7). Qualifying section 381 transaction of a QOF corporation-

(i) Facts. X wholly and directly owns Q, a QOF corporation. On May 31, 2019, X sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, X contributes $500 to Q in exchange for a qualifying investment. In 2020, Q merges with and into unrelated Y (with Y surviving) in a transaction that qualifies as a reorganization under section 368(a)(1)(A) (Merger). X does not receive any boot in the Merger with respect to its qualifying investment in Q. Immediately after the Merger, Y satisfies the requirements for QOF status under section 1400Z-2(d)(1) (see paragraph (c)(10)(i)(B) of this section).

(ii) Analysis. The Merger is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. See paragraph (c)(10)(i)(A) of this section. Accordingly, X is not required to include in income in 2020 its $500 of deferred capital gain as a result of the Merger. For purposes of section 1400Z-2(b)(2)(B) and (c), X's holding period for its investment in Y is treated as beginning on October 31, 2019. For purposes of section 1400Z-2(d), Y's holding period in its assets includes Q's holding period in its assets, and Q's qualified opportunity zone business property continues to qualify as such. See paragraph (d)(2) of this section.

(iii) Merger of QOF shareholder. The facts are the same as in paragraph (f)(7)(i) of this section (this Example 7), except that, in 2020, X (rather than Q) merges with and into Y in a section 381 transaction in which Y acquires all of X's qualifying investment in Q, and Y does not qualify as a QOF immediately after the merger. The merger transaction is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. See paragraph (c)(10)(ii) of this section.

(iv) Receipt of boot. The facts are the same as in paragraph (f)(7)(i) of this section (this Example 7), except that the value of X's qualifying investment immediately before the Merger is $1,000, X receives $100 of cash in addition to Y stock with a fair market value of $900 in the Merger in exchange for its qualifying investment, and neither Q nor Y has any earnings and profits. Under paragraph (c)(10)(i)(C) of this section, X is treated as disposing of 10 percent ($100/$1000) of its qualifying investment. Under paragraph (e)(1) of this section, X is required to include $50 ($500 x ($100/$1000)) of its deferred capital gain in income in 2020.

(8)

Example (8). Section 355 distribution by a QOF-

(i) Facts. A wholly and directly owns Q, a QOF corporation, which wholly and directly owns Y, a corporation that is a qualified opportunity zone business. On May 31, 2019, A sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A contributes $500 to Q in exchange for a qualifying investment. On June 26, 2025, Q distributes all of the stock of Y to A in a transaction in which no gain or loss is recognized under section 355 (Distribution). Immediately after the Distribution, each of Q and Y satisfies the requirements for QOF status. (See paragraph (c)(11)(i)(B)(2) of this section.)

(ii) Analysis. Because each of Q, the distributing corporation, and Y, the controlled corporation, is a QOF immediately after the Distribution, the Distribution is a qualifying

section 355 transaction. Thus, the Distribution is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. See paragraph (c)(11)(i)(B) of this section. Accordingly, A is not required to include in income in 2025 any of its $500 of deferred capital gain as a result of the Distribution. For purposes of section 1400Z-2(b)(2)(B) and (c), A's holding period for its qualifying investment in Y is treated as beginning on October 31, 2019. See paragraph (d)(1)(ii) of this section.

(iii) Section 355 distribution by a QOF shareholder. The facts are the same as in paragraph (f)(8)(i) of this section (this Example 8), except that A distributes 80 percent of the stock of Q, all of which is a qualifying investment in the hands of A, to A's shareholders in a transaction in which no gain or loss is recognized under section 355. At the time of the distribution, the fair market value of A's Q stock exceeds $500. The distribution is an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section, and A is required to include in income $400 (80 percent of its $500 of deferred capital gain) as a result of the distribution. See paragraphs (c)(1) and (c)(11)(ii) of this section.

(iv) Distribution of boot. The facts are the same as in paragraph (f)(8)(i) of this section (this Example 8), except that A receives boot in the Distribution. Under paragraphs (c)(8)(i) and (c)(11)(i)(B)(3) of this section, the receipt of boot in the Distribution is an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section to the extent of gain recognized pursuant to section 301(c)(3).

(v) Section 355 split-off. The facts are the same as in paragraph (f)(8)(i) of this section (this Example 8), except that Q stock is directly owned by both A and B (each of which has made a qualifying investment in Q), and Q distributes all of the Y stock to B in exchange for B's Q stock in a transaction in which no gain or loss is recognized under section 355. The distribution is a qualifying section 355 transaction and is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. Neither A nor B is required to include its deferred capital gain in income in 2025 as a result of the distribution.

(vi) Section 355 split-up. The facts are the same as in paragraph (f)(8)(v) of this section (this Example 8), except that Q wholly and directly owns both Y and Z; Q distributes all of the Y stock to A in exchange for A's Q stock and distributes all of the Z stock to B in exchange for B's Q stock in a transaction in which no gain or loss is recognized under section 355; Q then liquidates; and immediately after the Distribution, each of Y and Z satisfies the requirements for QOF status. The distribution is a qualifying section 355 transaction and is not an inclusion event for purposes of section 1400Z-2(b)(1) and paragraph (b) of this section. Neither A nor B is required to include its deferred capital gain in income in 2025 as a result of the transaction.

(vii) Section 355 split-off with boot. The facts are the same as in paragraph (f)(8)(v) of this section (this Example 8), except that B also receives boot. Under paragraph (c)(11)(i)(B)(3) of this section, B has an inclusion event and is treated as disposing of a portion of its qualifying investment that bears the same proportion to B's total qualifying investment immediately before the inclusion event as the fair market value of the boot bears to the fair market value of the total consideration received by B.

(9)

Example (9). Recapitalization-

(i) Facts. On May 31, 2019, each of A and B sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A contributes $500 to newly formed Q in exchange for 50 shares of class A stock of Q (A's qualifying investment) and B

contributes $500 to Q in exchange for 60 shares of class B stock of Q (B's qualifying investment). A and B are the sole shareholders of Q. In 2020, B exchanges all of its class B stock of Q for 40 shares of class A stock of Q as well as other property in a transaction that qualifies as a reorganization under section 368(a)(1)(E).

(ii) Analysis. Because A did not receive any boot in the transaction, A does not have an inclusion event with respect to its qualifying investment in Q. See paragraph (c)(12)(i) of this section. Therefore, A is not required to include any of its deferred gain in income as a result of this transaction. However, under paragraph (c)(12)(ii) of this section, B has an inclusion event. If section 301 applies to the boot received by B, B has an inclusion event to the extent of its section 301(c)(3) gain. If section 356(a) or (c) applies to the boot received by B, B is treated as disposing of a portion of its qualifying investment that bears the same proportion to B's total qualifying investment immediately before the inclusion event as the fair market value of the boot bears to the fair market value of the total consideration received by B.

(10)

Example (10). Debt financed distribution-

(i) Facts. On September 24, 2019, A and B form Q, a QOF partnership, each contributing $200 that is deferred under the section 1400Z-2(a) election to Q in exchange for a qualifying investment. On November 18, 2022, Q obtains a nonrecourse loan from a bank for $300. Under section 752, the loan is allocated $150 to A and $150 to B. On November 30, 2022, when the values and bases of the investments remain unchanged, Q distributes $50 to A.

(ii) Analysis. A is not required to recognize gain under paragraph (c) of this section because A's basis in its qualifying investment is $150 (the original zero basis with respect to the contribution, plus the $150 debt allocation). The distribution reduces A's basis to $100.

(11)

Example (11). Example 11. Debt financed distribution in excess of basis-

(i) Facts. The facts are the same as in paragraph (f)(10) of this section (Example 10), except that the loan is entirely allocated to B under section 752. On November 30, 2024, when the values of the investments remain unchanged, Q distributes $50 to A.

(ii) Analysis. Under paragraph (c)(6)(iii) of this section, A is required to recognize $30 of eligible gain under paragraph (c) of this section because the $50 distributed to A exceeds A's $20 basis in its qualifying investment (the original zero basis with respect to its contribution, plus $20 with regard to section 1400Z-2(b)(2)(B)(iii)).

(g)Basis adjustments.

(1)Basis adjustments under section 1400Z-2(b)(2)(B)(ii) resulting from the inclusion of deferred gain.

(i) In general. Except as provided in paragraph (g)(1)(ii) of this section, basis adjustments under section 1400Z-2(b)(2)(B)(ii) are made immediately after the amount of gain determined under section 1400Z-2(b)(2)(A) is included in income under section 1400Z-2(b)(1). If the basis adjustment under section 1400Z-2(b)(2)(B)(ii) is being made as a result of an inclusion event, then the basis adjustment is made before determining the other Federal income tax consequences of the inclusion event.

(ii) Specific application to section 301(c)(3) gain, section 1059(a)(2) gain, S corporation shareholder gain, or partner gain.

(A) Applicability. This paragraph (g)(1)(ii) applies if a QOF makes a distribution to its owner, and if, without regard to any basis adjustment under section 1400Z-2(b)(2)(B)(ii), at least a portion of the distribution would be characterized as gain under section 301(c)(3), section 1059(a)(2), or paragraphs (c)(6)(iii) and (c)(7)(ii) of this section with respect to the owner's qualifying investment in the QOF.

(B) Ordering rule. If paragraph (g)(1)(ii) of this section applies, an eligible taxpayer is treated as having an inclusion event to the extent provided in paragraph (c)(6)(iii), (c)(7)(ii), or (c)(8), (9), (11), (12), or (13) of this section, as applicable. Then, the eligible taxpayer increases its basis under section 1400Z-2(b)(2)(B)(ii) before determining the Federal income tax consequences of the distribution.

(iii) Shares in QOF C corporations to which section 1400Z-2(b)(2)(B)(ii) adjustments are made. If a shareholder of a QOF C corporation disposes of qualifying QOF stock in an exchange subject to section 1001, basis adjustments under section 1400Z-2(b)(2)(B)(ii) are made only to the portion of the qualifying investment that is disposed of in the inclusion event.

(2)Amount of basis adjustment under section 1400Z-2(b)(2)(B)(iii) and (iv). The increases in basis under section 1400Z-2(b)(2)(B)(iii) and (iv) are limited to 10 percent and 5 percent, respectively, of the remaining deferred gain with respect to a qualifying investment as of the dates on which basis is increased under that section.

(3)Examples. The following examples illustrate the rules of paragraphs (g)(1) and (2) of this section.

(i)

Example (1).

(A) Facts. On May 31, 2019, A, a C corporation, sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A contributes $500 to Q, a newly formed QOF C corporation, in exchange for all of the outstanding Q common stock and elects to defer the recognition of $500 of capital gain under section 1400Z-2(a) and §1.1400Z2(a)-1. In 2020, when Q has $40 of earnings and profits, Q distributes $100 to A (Distribution).

(B) Recognition of gain. Under paragraph (g)(1)(ii)(B) of this section, the Distribution is first evaluated without regard to any basis adjustment under section 1400Z-2(b)(2)(B)(ii). Of the $100 distribution, $40 is treated as a dividend and $60 is treated as gain from the sale or exchange of property under section 301(c)(3), because A's basis in its Q stock is $0 under section 1400Z-2(b)(2)(B)(i). Under paragraphs (c)(8)(i) and (e)(2) of this section, $60 of A's gain that was deferred under section 1400Z-2(a) and §1.1400Z2(a)-1 is recognized in 2020. Pursuant to §1.312-6(b), A's earnings and profits increase by $60.

(C) Basis adjustments. Under paragraph (g)(1)(ii)(B) of this section, prior to determining the further tax consequences of the Distribution, A increases its basis in its Q stock by $60 in accordance with section 1400Z-2(b)(2)(B)(ii). As a result, the Distribution is characterized as a dividend of $40 under section 301(c)(1) and a return of basis of $60

under section 301(c)(2). Therefore, after the section 301 distribution, A's basis in Q is $0 ($60-$60).

(ii)
Example (2).
(A) Facts. The facts are the same as in paragraph (g)(3)(i) of this section (Example 1), except that, instead of receiving a distribution, A sells half of the Q stock for $250 in 2020. A continues to hold the remainder of its Q stock through 2024.
(B) Recognition of gain and basis adjustments in 2020. Under paragraphs (c)(1) and (e)(1) of this section, $250 of A's gain that was deferred under section 1400Z-2(a) and §1.1400Z2(a)-1 is recognized in 2020. Under paragraphs (g)(1)(i) and (iii) of this section, A increases its basis to $250 in the sold shares in accordance with section 1400Z-2(b)(2)(B)(ii) immediately before the sale. Accordingly, A has no gain or loss on the sale ($250-$250). Pursuant to §1.312-6(b), A's earnings and profits increase by $250. A's basis in its remaining shares of Q stock remains $0.
(C) Basis adjustment in 2024. Under paragraph (g)(2) of this section, A increases its basis in its remaining shares of Q stock in accordance with section 1400Z-2(b)(2)(B)(iii). Pursuant to § 1.312-6(b), A's earnings and profits are increased by the amount of the basis adjustment.

(4)Special partnership rules.

(i) General rule. The initial basis under section 1400Z-2(b)(2)(B)(i) of a qualifying investment in a QOF partnership is zero, as adjusted to take into account the contributing partner's share of partnership debt under section 752.

(ii) Treatment of basis adjustments. Any basis adjustment to a qualifying investment in a QOF partnership described in section 1400Z-2(b)(2)(B)(iii) and (iv) and section 1400Z-2(c) is basis for all purposes, including for purposes of suspended losses under section 704(d).

(iii) Tiered arrangements. Any basis adjustment described in section 1400Z-2(b)(2)(B)(iii) and (iv) and section 1400Z-2(c) (basis adjustment rules) will be treated as an item of income described in section 705(a)(1) and must be reported in accordance with the applicable forms and instructions. Any amount to which the basis adjustment rules or to which section 1400Z-2(b)(1) applies will be allocated to the owners of the QOF, and to the owners of any partnership that directly or indirectly (solely through one or more partnerships) owns the eligible interest, and will track to the owners' interests, based on their shares of the remaining deferred gain to which such amounts relate.

(5)Basis adjustments in S corporation stock.

(i) Treatment of basis adjustments. Any basis adjustment to a qualifying investment in a QOF S corporation described in section 1400Z-2(b)(2)(B)(iii) and (iv) and section 1400Z-2(c) is basis for all purposes, including for purposes of suspended losses under section 1366(d).

(ii) S corporation investor in QOF.
(A) S corporation. If an S corporation is an investor in a QOF, the S corporation must adjust the basis of its qualifying investment as set forth in this paragraph (g).

The rule in this paragraph (g)(5)(ii)(A) does not affect adjustments to the basis of any other asset of the S corporation.

(B) S corporation shareholder.

(1) In general. The S corporation shareholder's pro-rata share of any recognized capital gain that has been deferred at the S corporation level will be separately stated under section 1366 when recognized and will adjust the shareholders' stock bases under section 1367 at that time.

(2) Basis adjustments to qualifying investments. Any adjustment made to the basis of an S corporation's qualifying investment under section 1400Z-2(b)(2)(B)(iii) or (iv), or section 1400Z-2(c), will not:

(i) Be separately stated under section 1366; or

(ii) Until the date on which an inclusion event with respect to the S corporation's qualifying investment occurs, adjust the shareholders' stock bases under section 1367.

(3) Basis adjustments resulting from inclusion events. If the basis adjustment under section 1400Z-2(b)(2)(B)(ii) is being made as a result of an inclusion event, then the basis adjustment is made before determining the tax consequences of the inclusion event other than the computation of the tax on the deferred gain.

(iii) QOF S corporation.

(A) Transferred basis of assets received. If a QOF S corporation receives an asset in exchange for a qualifying investment, the basis of the asset shall be the same as it would be in the hands of the transferor, increased by the amount of the gain recognized by the transferor on such transfer.

(B) Basis adjustments resulting from inclusion events. If the basis adjustment under section 1400Z-2(b)(2)(B)(ii) for the shareholder of the QOF S corporation is being made as a result of an inclusion event, then the basis adjustment is made before determining the tax consequences of the inclusion event other than the computation of the tax on the deferred gain.

(6)Basis in the hands of a taxpayer who received a qualifying investment in a QOF by reason of the prior owner's death.

(i) In general. The basis of a qualifying investment in a QOF, transferred by reason of a decedent's death in a transfer that is not an inclusion event, is zero under section 1400Z-2(b)(2)(B)(i), as adjusted for increases in basis as provided under section 1400Z-2(b)(2)(B)(ii) through (iv) and (c). See paragraph (c)(4) of this section.

(ii) Examples. The following examples illustrate the rule of this paragraph (g)(6).

(A)

Example (1). Taxpayer A, an individual, contributed $50X to a QOF in exchange for a qualifying investment in the QOF in January 2019. This $50X was capital gain that was excluded from A's gross income under section 1400Z-2(a)(1)(A). A's basis in the qualifying investment is zero. As of January 2024, A's basis in the QOF is increased by an amount equal to 10 percent of the amount of gain deferred by reason of section 1400Z-2(a)(1)(A), so that A's adjusted basis in 2024 is $5X. A dies in 2025 and A's heir inherits this qualifying investment in the QOF. A's death is not an inclusion event for purposes of section 1400Z-2. The heir's basis in the qualifying investment is $5X.

(B)
Example (2). The facts are the same as in paragraph (g)(6)(ii)(A) of this section (Example 1), except that A dies in November 2027, when the fair market value of the qualifying investment was $75X. A was required to pay the tax on the excess of the deferred capital gain over A's basis as part of A's 2026 income. Therefore, at the time of A's death, A's basis in the qualifying investment is the sum of three basis adjustments: The adjustment made in January 2024 described in paragraph (g)(6)(ii)(A) (Example 1) ($5X); an additional adjustment made as of January 2026 equal to 5 percent of the amount of gain deferred by reason of section 1400Z-2(a)(1)(A) ($2.5X); and the adjustment as of December 31, 2026, by reason of section 1400Z-2(b)(1)(B) and (b)(2)(B)(ii) ($42.5X). Accordingly, the basis of the qualifying investment in the hands of A's heir is $50X.

(h)Notifications by partners and partnerships, and shareholders and S corporations.

(1)Notification of deferral election. A partnership that makes a deferral election must notify all of its partners of the deferral election and state each partner's distributive share of the deferred gain in accordance with applicable forms and instructions.

(2)Notification of deferred gain recognition by indirect QOF owner. If an indirect owner of a QOF partnership sells or otherwise disposes of all or a portion of its indirect interest in the QOF partnership in a transaction that is an inclusion event under paragraph (c) of this section, such indirect owner must provide to the QOF owner notification and information sufficient to enable the QOF owner, in a timely manner, to recognize an appropriate amount of deferred gain.

(3)Notification of section 1400Z-2(c) election. A QOF partner or QOF S corporation shareholder must notify the QOF partnership or QOF S corporation, as appropriate, of an election under section 1400Z-2(c) to adjust the basis of the qualifying QOF partnership interest or qualifying QOF stock, as appropriate, that is disposed of in a taxable transaction. Notification of the section 1400Z-2(c) election, and the adjustments to the basis of the qualifying QOF partnership interest(s) or qualifying QOF stock disposed of, or to the QOF partnership asset(s) or QOF S corporation asset(s) disposed of, as appropriate, is to be made in accordance with applicable forms and instructions.

(i) [Reserved]

(j)Applicability dates.

(1)In general. The provisions of this section are applicable for taxable years beginning after March 13, 2020.

(2)Prior periods. With respect to the portion of a taxpayer's first taxable year ending after December 21, 2017, that began on December 22, 2017, and for taxable years beginning after December 21, 2017, and on or before March 13, 2020, a taxpayer may choose either-

(i) To apply section 1400Z-2 regulations, if applied in a consistent manner for all such taxable years; or

(ii) To rely on the rules in proposed §1.1400Z2(b)-1 contained in the notice of proposed rulemaking (REG-120186-18) published on May 1, 2019, but only if applied in a consistent manner for all such taxable years.