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### **Prop. Reg. Section 1.1400Z-2(a)-1(c)(3)**

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:

(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 within the meaning of section 1092 and the regulations under section 1092, 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 § 1.1400Z2(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.

(A)

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.

(B)

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.

(C)

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.

(D)

Example (4). Additional deferral of previously deferred gains.

(1) 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.

(2) 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.

(i)

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.

(ii)

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.

(iii)

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.

(iv)

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.

(v)

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.

(vi)

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.

(vii)

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 ( $\$300 \times 400/800$ ) and \$350 is long-term capital gain ( $\$700 \times 400/800$ ).

(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).

(1)

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).

(2) [Reserved]



(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 Sec. §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.