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## Inducement or Deterrent – Proposed Regulations Address QOZ Investments By Foreign Persons

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### INTRODUCTION

On April 14, 2021, the IRS and Treasury issued a new set of proposed regulations introducing new requirements for foreign and certain partnership investors in qualified opportunity funds.<sup>1</sup> Under current law, foreign investors with eligible gains may defer those gains for U.S. federal income tax purposes by investing in a qualified opportunity fund (QOF) in accordance with §1400Z-2.<sup>2</sup> Those eligible gains, however, generally remain subject to any applicable with-

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<sup>1</sup> Requirements for Certain Foreign Persons and Certain Foreign-Owned Partnerships Investing in Qualified Opportunity Funds and Flexibility for Working Capital Safe Harbor Plans, REG-121095-19, 86 Fed. Reg. 19,585 (Apr. 14, 2021).

<sup>2</sup> All section references herein are to the Internal Revenue Code of 1986, as amended (the “Code”), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

holding. These proposed regulations provide potential relief from the initial withholding applicable under §1445, §1446(a) or §1446(f) to such investors’ eligible gains that are invested in a QOF. However, the proposed regulations introduce new requirements that certain partnerships and foreign persons must satisfy in order to elect deferral under the qualified opportunity zone program.

Finally, the proposed regulations provide more guidance on the impact of a federally declared disaster on the working capital plan of a qualified opportunity zone business.

### OVERVIEW

The qualified opportunity zone (QOZ) program was enacted in 2017 to incentivize investment in qualified opportunity zones. An investor who is an eligible taxpayer and who has eligible gains can invest a dollar amount equal to those gains into a qualified opportunity fund (QOF) and receive the following federal income tax benefits: (i) immediate deferral of the gain until December 31, 2026;<sup>3</sup> (ii) the potential elimination of up to 15% of that original gain depending on when the investment is made; and (iii) elimination of gain on any appreciation in the investment if the investment is held for at least 10 years.

An eligible taxpayer is any person who is required to report gain recognition under federal income tax accounting principles.<sup>4</sup> An eligible gain is generally any gain that (i) is treated as a capital gain or is a qualified §1231 gain, (ii) would be recognized for federal income tax purposes and subject to tax under subtitle A before January 1, 2027 (if §1400Z-2(a)(1) did not apply to the gain), and (iii) does not arise from a sale or exchange of property with certain related persons.<sup>5</sup> For example, a foreign corporation generally may elect deferral under the QOZ program with respect to a capital gain that is effectively connected with a U.S. trade or business.

<sup>3</sup> If the taxpayer sells or exchanges the investment prior to December 31, 2026, the deferred gain is included in the taxable year of the sale or exchange. §1400Z-2(b)(1); Reg. §1.1400Z2(b)-1.

<sup>4</sup> Reg. §1.1400Z2(a)-1(b)(13).

<sup>5</sup> Reg. §1.1400Z2(a)-1(b)(11).

The existing regulations under §1400Z-2 do not coordinate the available deferral offered by the QOZ program with the withholding rules applicable to foreign persons. Treasury and the IRS stated that coordination is needed to address the risk of noncompliance by certain foreign persons with respect to the U.S. tax obligations related to gains deferred under the QOZ program. Similarly, foreign persons and their advisors have noted that if withholding under §1445 or §1446 of the I.R.C. is required on gains the foreign person intends to defer under the QOZ program, the foreign person may not have sufficient liquidity in the U.S. to make an investment equal to the total gain deferred.

The proposed regulations balance these goals by requiring certain partnerships and foreign persons to obtain an “eligibility certificate” from, and provide the required security to, the IRS prior to electing to defer gain under §1400Z-2. If obtained timely, the eligibility certificate may be used to reduce or eliminate the required withholding under §1445, §1446(a), or §1446(f).

## AFFECTED INVESTORS

The proposed regulations require foreign persons and certain specified partnerships (defined as “security-required persons”) to obtain an “eligibility certificate” before making a gain deferral election under §1400Z-2(a) with respect to a “security-required gain” from a “covered transfer.”<sup>6</sup>

A security-required person is an eligible taxpayer that is (i) a foreign person other than a partnership<sup>7</sup> or (ii) a “specified partnership.”<sup>8</sup> A specified partnership is any partnership, *including a domestic partnership*, that satisfies the following three requirements:

**1. Ownership Test:** At the time of transfer, 20% or more of the capital or profits interests of the partnership are owned, directly or indirectly, by one or more non-resident aliens or foreign corporations;<sup>9</sup>

**2. Closely-Held Test:** At any time during a “look-back period,”<sup>10</sup> the partnership has 10 or fewer direct partners that own 90% or more of

the capital or profits interests of the partnership;<sup>11</sup> and

### 3. Gain or Value Test: Either:

a. The amount of security-required gain equals or exceeds \$1 million, or

b. At any time during the look-back period, the aggregate value of the partnership’s assets that are (i) U.S. real property interests (USRPI) as defined in §897(c), or (ii) assets used in a U.S. trade or business equals or exceeds 25% of the partnership’s total asset value.<sup>12</sup>

Assuming a domestic partnership does not meet the value requirement, whether it meets the gain requirement (and, assuming it also meets the ownership and closely-held tests, and is therefore a specified partnership) is tested as of the date of the covered transfer.

“Security-required gain” is certain gain that arises from a “covered transfer.”<sup>13</sup> A covered transfer generally includes a disposition by, or distribution to, a security-required person that would be subject to withholding under §1445 or §1446(f), subject to the exceptions to withholding provided therein.<sup>14</sup> A covered transfer also includes certain dispositions by, or

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on the date of the transfer. Prop. Reg. §1.1400Z2(a)-2(b)(3).

<sup>11</sup> According to the preamble to the proposed regulations, a partner that is a partnership or trust is considered a direct partner. For this purpose, any partners that are related within the meaning of §267(b) or §707(b)(1) are treated as one partner. Reg. §1.1400Z2(a)-2(b)(3)(ii).

<sup>12</sup> Prop. Reg. §1.1400Z2(a)-2(b)(3). The value of each partnership asset is based on its gross fair market value and is determined on the last day of the taxable year before the taxable year in which the look-back period begins or when the asset is acquired by the partnership, if later.

<sup>13</sup> Prop. Reg. §1.1400Z2(a)-2(c)(1).

<sup>14</sup> There are four types of covered transfers that give rise to a security-required gain:

1. A disposition by, or a distribution to, a security-required person that is subject to withholding under §1445 (treating a security-required person that is a domestic specified partnership as a foreign person for this purpose);

2. A disposition by, or a distribution to, a security-required person that is subject to withholding under §1446(f) (treating a security-required person that is a domestic specified partnership as a foreign person for this purpose);

2. A disposition by, or a distribution to, a security-required person that is subject to withholding under §1446(f) (treating a security-required person that is a domestic specified partnership as a foreign person for this purpose);

3. A disposition by a specified partnership of property, other than an interest in another partnership or a USRPI, if any gain that arises is includible in computing ECTI; or

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<sup>6</sup> Prop. Reg. §1.1400Z2(a)-1(a)(3).

<sup>7</sup> For this purpose, a foreign person means a person that is not a U.S. person under §7701(a)(30). Prop. Reg. §1.1400Z2(a)-2(b)(3).

<sup>8</sup> Prop. Reg. §1.1400Z2(a)-2(b)(1).

<sup>9</sup> This rule applies even if the partnership cannot identify all of its indirect partners up through a chain of partnerships (e.g., a third-party managed feeder fund). The proposed regulations do not address what to do in such a case.

<sup>10</sup> The look-back period is defined as the period that begins on the later of (i) the date that is one year before the date of the transfer or (ii) the date on which the partnership was formed and ends

distributions to, a partnership (including non specified partnerships), if any gain that arises is includible in computing effectively connected taxable income.<sup>15</sup>

## ELIGIBILITY CERTIFICATE AND DEFERRAL AGREEMENT

Under the proposed regulations, a security-required person who wants to make a qualifying investment of an otherwise eligible security-required gain into a QOF must acquire an eligibility certificate from the IRS. The eligibility certificate is necessary both to make a gain deferral election under the QOZ program and to reduce or eliminate the applicable withholding on the eligible gains for which deferral is elected.

Under the proposed regulations, there are five requirements that must be included in the application for an eligibility certificate:<sup>16</sup>

1. Identification of the security-required person and such person's U.S. agent;<sup>17</sup>
2. Information about the covered transfer, including the amount of security-required gain;<sup>18</sup>
3. A "deferral agreement" (discussed below);

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4. A disposition by a partnership of property, or a distribution to such partnership, if any gain that arises is includible (by any partnership) in determining the allocable share of a security-required person's ECTI (again treating a security-required person that is a domestic specified partnership as a foreign person for this purpose).

Prop. Reg. §1.1400Z2(a)-2(c)(2).

<sup>15</sup> Prop. Reg. §1.1400Z2(a)-2(c)(2)(i)(C), §1.1400Z2(a)-2(c)(2)(i)(D).

<sup>16</sup> Prop. Reg. §1.1400Z2(a)-2(d)(3).

<sup>17</sup> Identification must include the name, address, and U.S. taxpayer identification number. Prop. Reg. §1.1400Z2(a)-2(d)(3)(ii).

<sup>18</sup> For non-distribution covered transfers (other than category four above), the application must include: (i) a description of the property transferred; (ii) the amount of security-required gain; (iii) the amount realized and the adjusted basis of the property, and (iv) the "maximum security amount."

For distribution covered transfers (other than category four above), the application must include (i) the amount of the distribution, (ii) a description of the property distributed (including cash); (iii) the amount of security-required gain, and (iv) the maximum security amount.

For a transaction in category four, above, the application must include just the amount of security-required gain and the maximum security amount. Prop. Reg. §1.1400Z2(a)-2(d)(3)(iii)(A).

The maximum security amount is generally the lesser of (i) the amount realized multiplied by the applicable §1445 or §1446(f) withholding rate or (ii) the security-required gain multiplied by the highest applicable tax rate. Prop. Reg. §1.1400Z2(a)-2(d)(7)(ii).

4. An agreement with the identified U.S. agent,<sup>19</sup> which authorizes the U.S. agent to act as an agent that remains in effect for as long as the deferral agreement remains in effect; and

5. Acceptable security, which is generally an irrevocable standby letter of credit issued by a well-capitalized U.S. bank.<sup>20</sup>

The deferral agreement is an agreement entered into between a security-required person and the IRS for the deferral of tax and provision of security, and must remain in place for at least 36 months after the due date (with extensions) for filing the return for the taxable year the includes the 2026 inclusion event.<sup>21</sup>

The deferral agreement must include the following requirements (minimum terms and conditions) for a security-required person:<sup>22</sup>

1. Timely file a federal income tax return and pay any tax liability due on the security-required gain at the end of the deferral period under §1400Z-2(a);
2. Report any security-required gain invested in a QOF held at any point during the taxable year in accordance with Reg. §1.1400Z2(a)-1(d)(2);
3. Provide security to the IRS in the amount required for the security-required gain;<sup>23</sup>
4. Appoint a U.S. person to act as the security-required person's limited agent for purposes of accepting communication related to the deferral agreement from the IRS, accepting service of process for the timely enforcement of the terms of the deferral agreement, and any other purposes specified in the deferral agreement (the "U.S. agent").

For a completed application the IRS will generally decide on an application for an eligibility certificate within 90 days (and will notify applicants within 45 days after all required information is submitted whether any delay is expected).<sup>24</sup> The proposed regulations suggest the IRS will provide a template for the

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<sup>19</sup> As defined in Prop. Reg. §1.1400Z2(a)-2(d)(4)(ii)(D).

<sup>20</sup> Prop. Reg. §1.1400Z2(a)-2(d)(6)(ii).

<sup>21</sup> Prop. Reg. §1.1400Z2(a)-2(d)(4).

<sup>22</sup> The deferral agreement must include any additional terms or conditions provided in a template provided by the IRS. Prop. Reg. §1.1400Z2(a)-2(d)(4)(ii).

<sup>23</sup> Upon a failure to pay any tax due on security-required gain that was deferred under the QOZ program when the tax is due or upon an event of default, a list of which is required to be included in the deferral agreement, the IRS may collect the entire amount of the liability by recourse to the security. Prop. Reg. §1.1400Z2(a)-2(d)(4)(ii)(C). For a description of proposed events of default, see Prop. Reg. §1.1400Z2(a)-2(d)(4)(iii).

<sup>24</sup> Prop. Reg. §1.1400Z2(a)-2(d).

deferral agreement in subsequent published guidance.<sup>25</sup> This form deferral agreement will specify several events that would be considered a default.<sup>26</sup> A default under the deferral agreement generally results in an inclusion event of the deferred gain.<sup>27</sup> As an inclusion event, the occurrence of an event of default accelerates the recognition of the deferred gain to the taxable year of the default (rather than the taxable year that includes December 31, 2026).

## EFFECT OF ELIGIBILITY CERTIFICATE ON WITHHOLDING

A foreign person may use an eligibility certificate to eliminate or reduce withholding under §1445(a) on the disposition of a USRPI<sup>28</sup> or withholding under §1446(f) on the disposition of an interest in a non-USRPI partnership. A foreign person may also provide an eligibility certificate to a domestic partnership in order to reduce §1446(a) withholding on allocations of its effectively connected gains.<sup>29</sup>

To reduce or eliminate withholding under §1445, a foreign person generally must apply to the IRS for a withholding certificate. According to the proposed regulations, the withholding certificate will be issued if the transferor has obtained an eligibility certificate.<sup>30</sup> It is unclear, however, whether the §1445 withholding certificate and §1400Z-2 eligibility certificate can be applied for, and issued, together. The IRS also generally undertakes to issue withholding certificates under §1445 within 90 days; if the certificates must be obtained sequentially it is unclear the impact such sequencing would have on the foreign person's transaction timeline and whether, from a practical standpoint, a foreign person would be able to timely obtain the necessary certificates to reduce or eliminate the applicable withholding.

<sup>25</sup> Prop. Reg. §1.1400Z2(a)-2(d)(4)(i).

<sup>26</sup> Prop. Reg. §1.1400Z2(a)-2(d)(4)(ii)(E).

<sup>27</sup> Prop. Reg. §1.1400Z2(b)-1(c)(1)(v).

<sup>28</sup> Section 1445 withholding is generally imposed on dispositions of USRPIs, including distributions of USRPIs from foreign corporations (for example, distributions by a Cayman blocker corporation of a U.S. blocker corporation owning U.S. real estate to its owners (§1445(e)(2)), distributions in excess of basis from a current (or in certain cases former) U.S. real property holding company to its foreign owners (§1445(e)(3)), and distributions from a qualified investment entity (i.e., RIC or REIT) to a foreign owner that are attributable to gain from the disposition of a USRPI by the qualified investment entity (§1445(e)(6)). In each case the foreign investor would have eligible gains to invest in a QOF but may be hindered by its withholding obligations.

<sup>29</sup> In general, withholding agents are not required to reduce withholding. In particular, a domestic partnership is not required to reduce §1446 withholding and may be less willing to do so for the benefit of a foreign partner that is a minority owner of the partnership.

<sup>30</sup> Prop. Reg. §1.1445-3(e)(5).

Presumably a foreign person would need sufficient advance warning of a covered transaction (which could include a transaction at a lower tier partnership) to apply for an eligibility certificate (and potentially also cooperation by the domestic partnership withholding agent, depending on the type of covered transfer), in order to benefit from the withholding relief provided in the proposed regulations.

## WORKING CAPITAL PLAN UPDATE

In addition to the proposed rules described above, the proposed regulations also include three new sentences relating to working capital safe harbor plans. A qualified opportunity zone business (QOZB) can adopt a working capital safe harbor to avoid having its initial funding be treated as a nonqualified financial asset.<sup>31</sup> The working capital plans are generally effective for a 31-month period, but that period is extended up to an additional 24 months in the case of a federally declared disaster.

The existing regulations require a QOZB that receives additional time to expend its working capital in a manner consistent with the original plan.<sup>32</sup> Recognizing that things change, especially in light of the Covid-19 disaster, the proposed regulations allow QOZBs to revise or replace an original working capital plan in the case of a federally declared disaster. The new or revised plan must be adopted no later than 120 days after the close of the incident period for the relevant disaster.

## EFFECTIVE DATES

The withholding portion of the proposed regulations is proposed to be effective for covered transfers that occur after the date of publication of final regulations. No applications for eligibility certificates will be processed by the IRS until such time.

Similarly, the working capital safe harbor portion is proposed to be effective after the date of publication of final regulations. However, taxpayers may rely on the proposed regulations for tax years beginning 2020 or later.

## IMPLICATIONS

Although the relief from withholding may prove helpful to foreign investors in QOFs in certain limited circumstances (particularly for covered transactions subject to withholding under §1446(f)), the proposed regulations are more in the nature of guardrails than relief and introduce potentially onerous requirements

<sup>31</sup> Reg. §1.1400Z2(d)-1(d)(3)(v).

<sup>32</sup> Prop. Reg. §1.1400Z2(d)-1(d)(3)(v)(D).

on a capital source that was already largely absent from the QOZ space. There remains a lack of clarity on how withholding may be relieved pending finalization of the rules.

The update to the working capital safe harbor rules appears to have been intended as a helpful clarification for taxpayers who receive an extended working

capital safe harbor period after a federally declared disaster. Clarification of this flexibility, however, may not have been necessary for a QOZB to amend its working capital plan under the current regulations. Thus, the implications, if any, of the proposed regulations on a QOZB that has changed circumstances and needs to amend its working capital plan outside a disaster period are unclear.