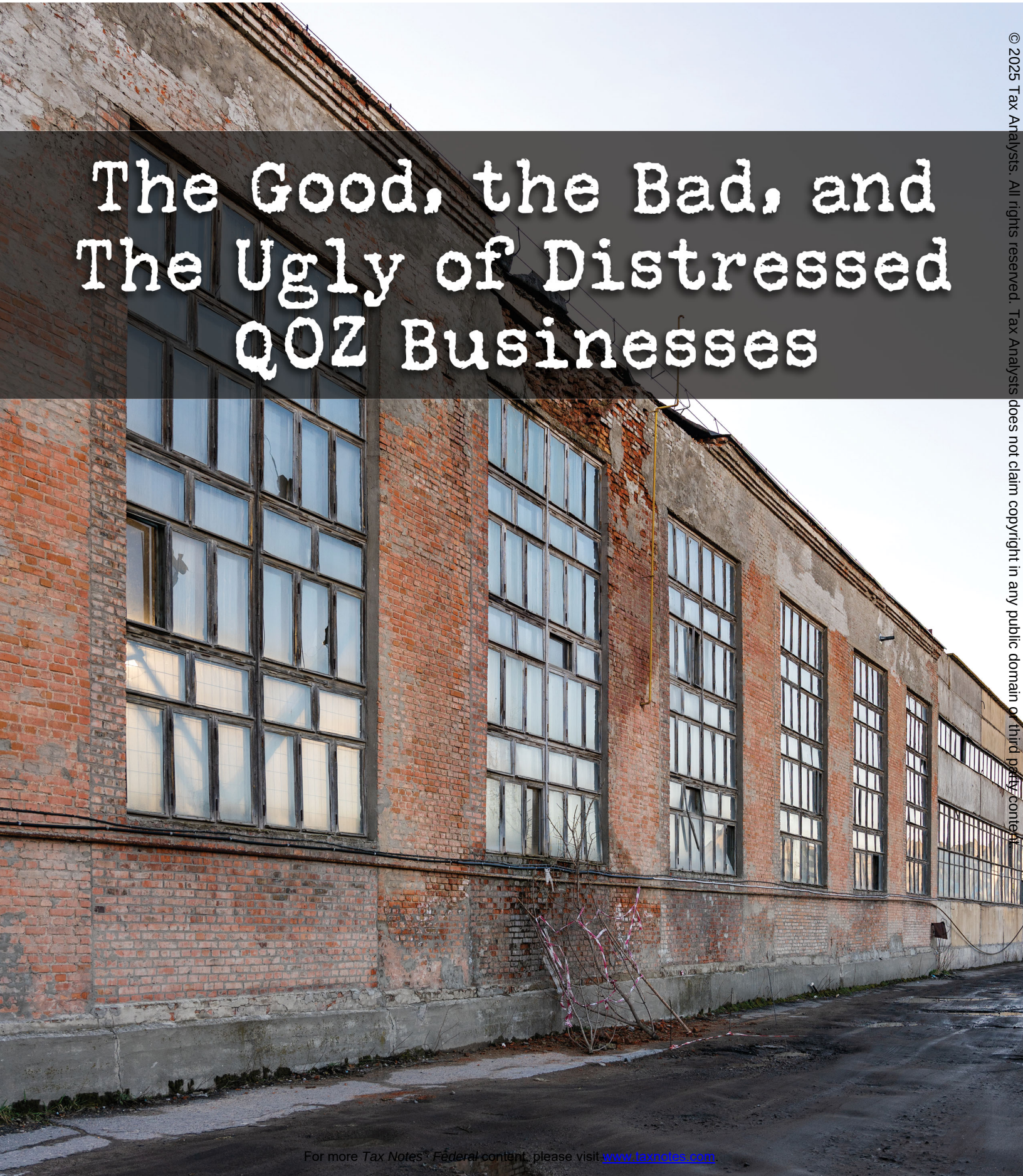
taxnotes® federal
Volume 189, Number 3 ■ October 20, 2025



The Good, the Bad, and The Ugly of Distressed QOZ Businesses

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by Ben Oklan and Brian Duren

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In this article, Oklan and Duren offer solutions for qualified Opportunity Zone businesses facing varying degrees of financial distress.

This article represents the views of the authors and does not necessarily represent the views or professional advice of KPMG.

Introduction

The qualified Opportunity Zone tax regime was enacted as part of the 2017 Tax Cuts and Jobs Act to spur investment in economically depressed areas. Congress revised the QOZ program and made it permanent when the One Big Beautiful Bill Act (P.L. 119-21) was passed in July.[1] The QOZ regime encourages investors to funnel capital to QOZs through three significant tax benefits: (1) taxpayers can defer recognition of tax on capital gains that are invested into a qualified opportunity fund for a finite period from the year of realization (the gain deferral benefit),[2] (2) a portion of that gain may be permanently eliminated via a partial basis step-up if the QOF investment is held for a certain period before recognition of the deferred gain (the gain reduction benefit),[3] and (3) for investments in QOFs held for 10 years or longer, the total appreciation on the qualified investment in that QOF can be recognized tax free through a full basis step-up to fair market value at the time of sale (the gain elimination benefit).

The gain deferral and gain reduction benefits are capped — the amount of the benefit is a function of the amount of the gain deferred and the number of years of deferral. In contrast, the gain elimination benefit was intended to reward "patient" capital by providing a long-term incentive in the form of tax-free appreciation and is potentially limitless. However, to enjoy the gain elimination benefit a QOF project needs to be successful.

Congress implemented a stringent compliance regime for the QOZ program because it was concerned that crafty taxpayers might try to improperly obtain QOZ tax benefits without investing capital into QOZs as intended.[4] For investors to obtain QOZ tax benefits, a QOF must hold substantially all its assets in qualified property and annually self-certify its compliance with the relevant regulatory tests.[5] The QOZ program favors a two-tiered structure in which a QOF operates a QOZ business, which itself must

[1] The QOZ program, as amended by the OBBBA, is referred to here as "QOZ 2.0."

[2] For TCJA investments, the deferred gain must be recognized at the earlier of December 31, 2026, or the date on which the investment is sold. For QOZ 2.0 (effective for amounts invested after December 31, 2026), gains invested in a QOF are deferred until the earlier of five years after the date of investment in the QOF or the date on which the investment is sold. Section 1400Z-2(b)(1).

[3] Investors in a TCJA QOF received a basis step-up equal to 10 percent of the deferred gain if the QOF investment was held for five years before December 31, 2026, and an additional 5 percent if held for seven years before December 31, 2026. Under QOZ 2.0 (effective for amounts invested after December 31, 2026), investors receive a basis step-up of 10 percent of the deferred gain (30 percent in the case of investments in a qualified rural opportunity fund) if the QOF investment is held for five years. Section 1400Z-2(b)(2)(B).

[4] *See, e.g.*, Notice of Proposed Rulemaking, REG-120186-18, 84 F.R. 18652, 18654-18655 (May 1, 2018) (requesting comments on whether additional measures are needed to prevent abusive "land banking" transactions).

[5] Section 1400Z-2(d)(1); reg. section 1.1400Z2(d)-1(a)(2).

satisfy several compliance tests.[6] Investors, fund sponsors, and business operators must navigate these rules carefully to claim the tax benefits offered by the program. Strict adherence to the operational and reporting requirements must be maintained to avoid commercial and tax consequences. If QOZ investments fail to meet these statutory and regulatory tests, they may incur penalties that would erode their financial performance.[7] Further, if a QOF loses its QOF status (whether voluntarily or involuntarily), the permanent tax savings associated with the gain elimination benefit may be lost, significantly reducing the net after-tax investment return and diminishing the reason the fund subjected itself to the additional compliance burden of the QOZ regime in the first place.

Over the past three years, circumstances outside of taxpayers' control have jeopardized the potential success of QOZ projects and cast doubt on whether the QOZ regime will ultimately prove to be a tax policy success. The COVID-19 pandemic and ongoing worldwide geopolitical turmoil have stressed supply chains and raised costs.[8] The rise in interest rates over the last three years has further strained businesses.[9] Amid these macroeconomic conditions, QOZ projects, particularly real estate projects, have struggled to perform as hoped. Under the weight of rising materials, labor, and borrowing costs, many projects that were attractive in 2020 have struggled financially. Sponsors have been compelled to find ways to reduce costs, seek untapped sources of affordable capital, or pause projects until economic conditions improve and financial viability is restored.

Traversing such difficult circumstances can be a challenge for even the best-prepared businesses. But for a QOZ business already disadvantaged by its status as a start-up located inside an economically depressed community and constricted by a rigorous tax compliance burden, successfully navigating rough waters is essential to its continued viability.

This article is intended to serve as a survival guide for QOZ businesses in varying states of financial distress — categorized as the good, the bad, and the ugly to correspond to the magnitude of the hardships a QOZ business may encounter and the relative ease with which it might be able to find a solution. Situations categorized as good reflect QOZ businesses early in their lifecycle, experiencing delays in deploying capital in accordance with their business plans. Those categorized as bad are QOZ businesses in moderate to severe financial distress that need to restructure their capital stock. And those categorized as ugly represent QOZ businesses that have commercially failed beyond the point of recovery, with their owners contemplating the termination of QOF status.

The Basics of the QOZ Rules

To obtain QOZ tax benefits, taxpayers must invest "eligible gain" in a QOF, which is an investment vehicle treated as a corporation or a partnership for federal income tax purposes and organized for the purpose of investing in QOZs. Eligible gain is (1) capital gain (whether short-term or long-term) that is (2) recognized for federal income tax purposes before January 1, 2027, and (3) does not arise from a transaction with a related party.[10] Importantly, the statute permits only the investment of eligible gain to receive QOZ tax benefits. Investors without eligible gain may still participate in QOZ projects by making after-tax investments, but they will not receive any QOZ tax benefits. To qualify as a valid QOF, the QOF must hold at least 90 percent of its assets in QOZ property, which is either tangible property used in a trade or business in a QOZ (QOZ business property), or equity interests in a corporation or partnership that is a QOZ business.[11] The QOF's compliance with these requirements is measured by averaging the

[6] Section 1400Z-2(d)(3).

[7] Section 1400Z-2(f).

[8] *See* Walden Siew, "Tariffs Will Disrupt Corporate Profits and Supply Chains, McKinsey CFO Says," *The Wall Street Journal*, Apr. 4, 2025.

[9] Between January 2022 and July 2025, the consumer price index for all urban goods increased 14.9 percent. *See* U.S. Bureau of Labor Statistics, "Consumer Price Index for All Urban Consumers (CPI-U)" (last visited Aug. 22, 2025).

[10] Reg. section 1.1400Z2(a)-1(b)(11)(i).

[11] Section 1400Z-2(d)(1).

percentage of its assets made up of QOZ property on semiannual testing dates during the relevant tax year.[12]

If a QOF invests in a QOZ business, that QOZ business is subject to a separate series of tests to ensure that it actively conducts a trade or business in a QOZ. An entity is treated as a QOZ business if it is:

1. an "eligible entity" within the meaning of reg. section 1.1400Z2(d)-1(a)(1);[13]

2. engaged in a trade or business within the meaning of section 162.[14]

And at the end of each tax year:

3. at least 70 percent of its tangible property is QOZ business property (the tangible property test);[15]

4. at least 50 percent of its gross income is derived from the conduct of an active trade or business within a QOZ (the gross income test);[16]

5. at least 40 percent of its intangible property is used in the active conduct of a trade or business in a QOZ (the intangible property test);[17]

6. no more than 5 percent of its assets consist of nonqualified financial property (NQFP), such as debt, stock, partnership interests, options, futures contracts, annuities, and other similar property (but NQFP does not include reasonable amounts of working capital held in cash or cash equivalents or accounts or notes receivable from sales or services provided in the ordinary course of business);[18] and

7. it does not operate private or commercial golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks, other facilities used for gambling, or any store, the principal business of which is the sale of alcoholic beverages for consumption off premises (for example, liquor stores).[19]

For most QOZ businesses, tests 1 through 5 are generally not barriers to operating a trade or business in a QOZ. However, test 6, restricting the QOZ business from holding NQFP, can create substantial obstacles for cash-intensive QOZ businesses raising capital for the development of a new business or rehabilitating property in a QOZ. Fortunately, reasonable amounts of working capital held in cash, cash equivalents, and short-term debt instruments are exempt from being treated as NQFP. The regulations provide a safe harbor under which working capital assets will be treated as reasonable in amount if (1) the amounts are designated in writing for the development of a business in a QOZ, (2) there is a reasonable written schedule for the expenditure of the working capital, and (3) the working capital assets are actually used in a manner that is substantially consistent with the written designation and schedule.[20]

The importance of adhering to the strict rules of the QOZ program cannot be overstated, and the consequences of failing to comply, even by the slimmest margin, may produce substantially different financial outcomes for taxpayers attempting to gain access to the program's unique tax benefits. The long-term nature of a QOZ investment demands that taxpayers maintain a sound compliance strategy, including record retention, tax positions, evidence of both tax elections and QOZ test results, and clear and thorough documentation of when circumstances change (as they frequently do) during the QOZ holding period.

Performing quality due diligence is especially important and particularly relevant during the current economic climate in which many existing QOF and QOZ business vehicles may find

[12] *Id.*

[13] An eligible entity is one classified as a partnership or corporation for federal income tax purposes and is organized under the laws of the United States, one of the 50 states, a government of a federally recognized tribe, the District of Columbia, or a U.S. territory.

[14] Reg. section 1.1400Z2(d)-2(a)(2)(i). Generally, a taxpayer is engaged in a trade or business if (1) the taxpayer's primary purpose for engaging in the activity is for income or profit, and (2) the taxpayer is regularly and actively involved in the activity. *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

[15] Section 1400Z-2(d)(3)(A)(i); reg. section 1.1400Z2(d)-1(d)(1)(i).

[16] Section 1400Z-2(d)(3)(A)(ii); reg. section 1.1400Z2(d)-1(d)(3)(i).

[17] Section 1400Z-2(d)(3)(A)(ii); reg. section 1.1400Z2(d)-1(d)(3)(ii).

[18] Section 1400Z-2(d)(3)(A)(ii); reg. section 1.1400Z2(d)-1(d)(3)(iv).

[19] Section 1400Z-2(d)(3)(A)(iii); reg. section 1.1400Z2(d)-1(d)(4).

[20] Reg. section 1.1400Z2(d)-1(d)(3)(v).

themselves in situations that were unanticipated in the earlier life cycle of the QOZ program. The rules governing QOZ investments make changes to capital structures very difficult to effect, leaving QOZ projects few options (and in some cases, no alternatives) when encountering changes in the planned development life cycle. In an economic climate in which stalled QOZ projects may require financial rescue, traditional means of recapitalization might be unavailable. However, when a QOZ entity does have a viable path to restructure with another QOZ business entity, due diligence and accurate historical data are critical to clearing the road to an effective restructuring.

The Good

For even the best prepared QOZ businesses, the cost increases over the last three years can hinder a QOZ business's ability to deploy its working capital. At a certain point, those delays can threaten a QOZ business's compliance with the working capital safe harbor — that is, the QOZ business failed to use its working capital in a manner "substantially consistent" with its written plan and schedule.[21] But when is that point?

At the outset, the answer depends on how much specificity is required for a plan and schedule. There's no guidance on how specific a written plan must be. Although a plan is not required to be filed with the IRS, it should be more specific than "engaging in any lawful activity for which an entity may be formed under the [relevant statute]" but does not need to rise to the level of an investment committee memorandum.[22] For retail businesses, the regulations suggest that a plan need not do more than generally describe the industry, potential operating locations, the types of tangible and intangible property necessary to operate the business, and the roles for which staff will be needed.[23] In the case of a real estate development project, a plan should describe the land acquisition, the type of property to be constructed, and the types of ancillary but necessary expenditures.[24]

Similarly, guidance on the specificity of a working capital schedule is lacking. Businesses will be tempted to adopt as their working capital schedule the projected financials they used to obtain debt financing to avoid duplicating labor. However, the more detailed and specific a schedule is, the easier it is to deviate from it.

Unhelpfully, there's also no guidance on what it means to use working capital in a manner "substantially consistent" with a plan and schedule. If a plan is written in a manner consistent with the relevant regulations, it would appear difficult for capital expenditures to be substantially inconsistent unless the taxpayer switched business plans mid-project. A written schedule would seem much riper for a "substantially consistent" violation because a taxpayer could deviate from the schedule regarding both the timing and amount of planned expenditures. So when is a deviation from a schedule considered substantial? While "substantially consistent" is undefined for these purposes, the QOZ tax regime elsewhere uses "substantially all" and "substantial portion," which may provide clues. "Substantially all" means 90 percent in the case of QOF and QOZ business property holding periods and 70 percent in the case of a QOZ business's ownership of tangible property. However, "substantial portion" means 40 percent in relation to the percentage of a QOZ business's intangibles that must be used in the active conduct of a trade or business within a QOZ. Based on the plain meaning of the terms, it's fair to assume that the minimum quantitative amount that would qualify as "substantially consistent" resides somewhere between 40 percent and 90 percent, but exactly where remains unknown.

If a QOZ business finds that despite having a well-crafted working capital plan and schedule, delays in deploying its working capital risk a "substantially consistent" violation, the code provides two temporary relief mechanisms. First, if a QOZ business is located within a federally

[21] Reg. section 1.1400Z2(d)-1(d)(3)(v)(C).

[22] *See, e.g.*, reg. section 1.1400Z2(d)-1(d)(3)(vii), examples 1 and 3.

[23] *See* reg. section 1.1400Z2(d)-1(d)(3)(vii), Example 1.

[24] *See* reg. section 1.1400Z2(d)-1(d)(3)(vii), Example 3.

declared disaster area, that QOZ business may receive no more than an additional 24 months to consume its working capital assets.[25] For example, during the COVID-19 pandemic, the IRS issued a notice acknowledging that a QOZ business using the working capital safe harbor may receive an extension up to 24 months if its working capital plan and schedule were in place before June 30, 2021.[26] Second, if delays in governmental actions pose a substantial obstacle and no other action can be taken to consume the working capital assets, the 31-month working capital safe harbor period will be tolled for the duration of the permitting delay.[27]

Otherwise, the regulations do not provide QOZ businesses with a mechanism to address significant working capital obstacles. Treasury has shown a willingness to permit a QOZ business to amend its working capital plan in certain circumstances. In response to concerns in 2021 that the post-COVID environment might render existing working capital plans infeasible, Treasury proposed regulations that permit a QOZ business to revise or replace its working capital plan as a result of a federally declared disaster.[28] The proposed rule is a recognition that it would be commercially impossible to start a business or rehabilitate property in economically-depressed areas and frustrate congressional intent in enacting the QOZ program if QOZ businesses weren't granted any leniency from the NQFP requirements when circumstances beyond a QOZ business's control render the original working capital plan infeasible. It would be consistent with that purpose to permit QOZ businesses to amend their working capital plans in response to other circumstances unrelated to federally declared disaster areas that are nonetheless beyond the QOZ businesses' control.[29]

If no relief mechanisms are available and a QOZ business fails one of its requirements, which causes its QOF owner to violate the 90 percent investment standard, all is not lost. QOFs are entitled to a six-month cure period to correct the QOZ business failure that caused the violation.[30] However, in the context of a failure to use working capital assets in a manner substantially consistent with the designation and schedule, it's unclear how a QOF would cure such a failure. If the QOZ business is unable to sufficiently deploy its working capital during the six-month cure period, the QOF may need to consider liquidating that QOZ business. Otherwise, the QOF would be required to pay a monthly fine equal to the dollar amount by which its QOZ property failed the 90 percent investment standard unless the QOF can establish reasonable cause.[31] A QOF may be able to establish reasonable cause if it and the relevant QOZ business exercised ordinary business care and prudence but was nonetheless unable to satisfy a working capital safe harbor requirement because of circumstances beyond the QOF and QOZ business's control.[32]

The Bad

If a QOZ business is unable to weather the hypothetical cost increases discussed above, it may find itself in a more serious situation than a mere delay to its working capital schedule. A QOZ business in financial distress may have to consider restructuring its debt or selling assets to another QOZ business, each of which implicates unique potential tax compliance issues.

If a distressed QOZ business restructures its debt, how is the resulting income — whether gain resulting from the transfer of collateral in

[25] Reg. section 1.1400Z2(d)-1(d)(3)(v)(D).

[26] Notice 2021-10, 2021-7 IRB 888, Section IV.B.

[27] Reg. section 1.1400Z2(d)-1(d)(3)(v)(C); preamble to T.D. 9889, 85 F.R. 1866, 1926 (Jan. 13, 2020).

[28] Prop. reg. section 1.1400Z2(d)-1(d)(3)(v)(D), REG-121095-19, 86 F.R. 19585 (Apr. 14, 2021).

[29] *See* Notice of Proposed Rulemaking REG-115420-18, 83 F.R. 54279, 54284 (Oct. 29, 2018) (In response to comments that developing a new business or the construction or rehabilitation of real estate may take longer than six months, the IRS promulgated the working capital safe harbor because "section 1400Z-2(d)(iii) anticipates situations in which a QOF or operating subsidiary may need up to 30 months after acquiring a tangible asset in which to improve the asset substantially.").

[30] Reg. section 1.1400Z2(d)-1(d)(6).

[31] Section 1400Z-2(f)(3).

[32] Preamble to T.D. 9889, 85 F.R. 1866, 1941-1942 (citing the general standard for reasonable cause described in Internal Revenue Manual 20.1.1.3.2).

satisfaction of outstanding nonrecourse debt (*Tufts* gain)[33] or cancellation of debt income — treated for purposes of the gross income test? The answer, and a practitioner's level of comfort in that answer, depends on whether the QOZ business is still within its working capital safe harbor period. If the proceeds of the restructured debt were taken into account in the QOZ business's working capital plan and schedule, and the applicable working capital safe harbor period has not expired at the time of the restructuring, LTR 202249005 suggests that income resulting from the restructuring should qualify for purposes of the gross income test.[34] In that letter ruling, the IRS reasoned that because a disposed parcel of real estate was originally purchased with working capital and the sale occurred during the working capital safe harbor period, the proceeds of the sale should be treated as income derived from working capital assets that satisfy the gross income test.[35] Similarly, if the restructuring of a QOZ business's debt results in *Tufts* gain, which is treated as resulting from an exchange of the collateral securing the nonrecourse debt in satisfaction of that debt, the treatment of that gain should be no different than that in the letter ruling. If the restructuring generates cancellation of debt income (CODI), the analogy is not as clear. However, given that the debt is an obligation to repay a portion of the working capital, the logic of LTR 202249005 suggests that CODI generated from the restructuring of that debt should be treated as derived from working capital assets.

Alternatively, if the QOZ business's working capital safe harbor period has expired, reg. section 1.1400Z2(d)-1(d)(3)(vi)(B) would not apply, and QOZ business would find itself in a situation beyond the scope of LTR 202249005.[36] Nevertheless, any resulting *Tufts* gain will still be treated as gain from the exchange of property for general tax purposes. Similarly, CODI has been treated as attributable to the underlying asset for other purposes of the code.[37] Thus, *Tufts* gain or CODI resulting from the restructuring of QOZ business debt should be qualifying income for purposes of the gross income test as long as the property securing the restructured debt is used by the QOZ business in a trade or business within a QOZ.[38] Moreover, treating *Tufts* gain or CODI resulting from the restructuring of debt encumbering property used in a QOZ would be consistent with the policies underlying the working capital safe harbor and the legislative intent behind the QOZ program. Treating debt restructuring income connected to property used within a QOZ as nonqualifying income unfairly punishes QOZ businesses for pursuing financial relief readily available to non-QOZ businesses and might limit a QOZ business's entrepreneurial risk or discourage investment in QOZs.

Even if a QOZ business is confident that income derived from the restructuring of its debt will satisfy the gross income test, it should be cognizant that not all debt restructuring techniques are created equal for purposes of QOZ compliance. Any technique that creates a new class of equity interests and causes a previously disregarded entity to become regarded would create NQFP for the QOZ business. For example, a typical A/B note restructuring of debt borrowed by an Opco limited liability company that is wholly owned by a QOZ business could cause that LLC to become a partnership for tax purposes. Rather than owning the project assets directly, the QOZ business would instead own an interest in a newly created partnership, which arose when a portion of the loan was

[33] *Commissioner v. Tufts*, 461 U.S. 300 (1983).

[34] Under section 6110(k)(3), private letter rulings may not be used or cited as precedent. However, these rulings may provide insight regarding the IRS's position on a particular issue.

[35] Reg. section 1.1400Z2(d)-1(d)(3)(vi)(B).

[36] A QOZ business not in a working capital safe harbor period will be deemed to have satisfied the gross income test if it has satisfied one of the safe harbors in reg. section 1.1400Z2(d)-1(d)(3)(i)(A)-(C). This article assumes that a QOZ business cannot satisfy any of those safe harbors and must instead rely on the facts and circumstances test in reg. section 1.1400Z2(d)-1(d)(3)(i)(D).

[37] *See, e.g.*, reg. section 1.1017-1(a)(1) (when a taxpayer elects to exclude from gross income discharge of qualified real property business indebtedness, the taxpayer must first apply the tax attribute reduction required under section 1017 to reduce the basis of the real property used in a trade or business that secured the discharged indebtedness).

[38] This assumes that the QOZ business activities rise to the level of a trade or business for purposes of section 162. If the QOZ business has not established a trade or business at the time of the debt restructuring, it will have difficulty convincing a court that income resulting from the debt restructuring was derived from the active conduct of a trade or business within a QOZ.

subordinated to the new preferred equity issuance.[39] As a result, the QOZ business could fail the NQFP limitation.

A QOZ business experiencing severe financial distress might consider selling all or part of its assets to another QOZ business. Fortunately, QOZ 2.0 may create a market for the assets of financially distressed QOZ businesses.[40] Selling assets to a QOZ business is not without its own compliance traps. Before the QOZ business seller and QOZ business buyer can begin to structure the acquisition, two questions need to be answered: (1) can the tangible property be purchased or must it be leased to qualify as QOZ business property in the hands of the QOZ business buyer, and (2) what amount of capital expenditure will be required for the acquired tangible property to qualify as QOZ business property for the QOZ business buyer? These questions may require significant due diligence and will inform the negotiation of the principal deal terms.

To qualify as QOZ business property, the tangible property must be "acquired by purchase," meaning the property must be purchased from an unrelated party or leased on market-rate terms.[41] This requires the parties to assess beneficial ownership of their respective QOZ businesses to confirm the same persons do not own more than 20 percent of the seller and buyer QOZ businesses either directly, indirectly, or constructively.[42] Further, a rollover by any indirect members of the selling QOZ business may disqualify the property as being acquired by purchase.[43]

If the property is purchased by the QOZ business buyer, the buyer must also contend with the requirement that the original use of the tangible property within the QOZ must commence with the buyer; otherwise, the buyer must substantially improve the property.[44] Original use begins when the asset is placed in service for depreciation or amortization purposes (or is first used in a manner that would allow for depreciation or amortization) and is made on an asset-by-asset basis.[45] Thus, if a QOZ business buyer were to acquire a distressed real property development consisting of real property assets in varying stages of construction, the real property that had been placed in service by the seller would need to be substantially improved, while assets under construction could be completed by the buyer and qualify as original use property.[46]

If the property was already placed in service by the seller, the QOZ business buyer must substantially improve the property by making expenditures that more than double the QOZ business's original basis within a 30-month period.[47] For buyers of assets placed in service in a QOZ comprised entirely of a rural area, the substantial improvement amount is reduced to 50 percent of basis.[48]

The seller's treatment of the gain on the sale of its assets for gross income test purposes depends on (1) whether the QOZ business's working capital safe harbor period has expired at the time of sale and (2) whether the QOZ business is selling the entirety of its assets. If the QOZ business seller is still within its working capital safe harbor period and sells a portion of its assets, the fact pattern doesn't appear materially different from that in LTR 202249005. Thus, the gain on the sale should be qualifying income for purposes of the gross income test. Even if the QOZ business seller's working capital safe harbor has expired, gain on the sale of a portion of its assets should be qualifying income for purposes of the gross

[39] An A/B note restructuring is a debt modification technique in which a distressed note is split into a performing "A Note" and a nonperforming "B Note," and the B note is subordinated and treated as equity for tax purposes. For a discussion of the A/B note restructuring technique, *see* Mike McMahon, "A Conversation on Debt Workouts in Commercial Real Estate," *Tax Notes Federal*, Jan. 13, 2025, p. 273.

[40] However, distressed QOZ businesses will have to stay afloat until January 1, 2027, when new QOF investments become eligible for QOZ 2.0 tax benefits.

[41] Section 1400Z-2(d)(2)(D)(i)(I), reg. section 1.1400Z2(d)-2(b)-(c). A lease between related parties must satisfy additional requirements under reg. section 1.1400Z2(d)-2(c)(3), including a prohibition of lease prepayments for a period of use of more than 12 months.

[42] For purposes of section 1400Z-2, persons are related if they are described in section 267(b) or section 707(b)(1), determined by substituting "20 percent" for "50 percent" each place it occurs in those sections. Section 1400Z-2(e)(2).

[43] Section 1400Z-2(d)(2)(D)(i)(I), section 179(d)(2)(C).

[44] Section 1400Z-2(d)(2)(D)(i)(I); reg. section 1.1400Z2(d)-2(b)(2).

[45] Reg. section 1.1400Z2(d)-2(b)(3)(i)(A).

[46] Under reg. section 1.1400Z2(d)-2(b)(1)(iii) the materials and supplies used by the buyer to complete construction must also be QOZ business property.

[47] Section 1400Z-2(d)(2)(D)(ii).

[48] *Id*. (effective for property acquired after Dec. 31, 2026).

income test, provided the seller continues to operate the same trade or business with its remaining assets. If, on the other hand, the QOZ business sells the entirety of its assets, it risks being treated as terminating its trade or business even if the QOZ business is still within its working capital safe harbor period.[49] To avoid that scenario, a QOZ business seller should consider reinvesting the sales proceeds in a project of the same specific business type so that it can be treated as a continuation of the previous trade or business.[50]

The Ugly

Sometimes, despite the best commercial efforts and creative management strategies, a QOZ business may simply reach a stage in which things get ugly, and terminating a project may seem, at first glance, the most suitable path forward. This decision, however, is not straightforward and involves several considerations.

If a QOZ business does not satisfy all seven tests described above, it will fail to qualify as a QOZ business, which could jeopardize the continued qualification of its QOF parent. This is especially true for single-asset QOFs, which essentially have put all their qualified eggs into one QOZ business basket. If the underlying QOZ business does not successfully meet the applicable tests, it cannot qualify as QOZ property, and as a result may cause its QOF parent to fail the 90 percent investment standard and subject it to penalties.[51]

If the prospects of rehabilitating a failing QOZ business look bleak, suffering monetary penalties will add insult to injury by further eroding investor returns. A QOF in that situation may contemplate decertifying as a QOF, which permanently revokes its QOF election.[52] Before concluding that decertification is the only available option, a QOF should ask, "How bad is it really?" Careful evaluation may reveal that even the most severely distressed QOFs still have alternatives to decertification.

Just because a QOF may have failed in the colloquial sense, it may not necessarily be subject to penalties. A QOF's ability to satisfy the 90 percent investment standard is measured only on the semiannual testing dates. If a QOF's asset values drop below the 90 percent investment standard between testing dates, that does not constitute a failure. Moreover, because the 90 percent investment standard is a simple unweighted average of two percentages, the QOF can recover from a failure occurring on the first testing date without using the six-month cure period.[53] That QOF will not be subject to penalties if it acquires additional QOZ property or disposes of nonqualifying property sufficient to raise the average of its two QOZ property measurements above 90 percent as of the second testing date.[54]

Even if a QOF experiences an overall failure, the magnitude of the monetary penalty may be relatively minor. The penalty is imposed on the amount by which the QOF failed the investment standard during each month of the year.[55] Essentially, the calculation gives a QOF credit for the qualifying QOZ property it held during the year. As a result, a QOF that fails by a small amount or in fewer months during the year will suffer a smaller penalty. Thus, if a QOF anticipates that its failure of the 90 percent investment standard is temporary or minor, paying penalties might be preferable to decertification.

If the QOF has determined that an existing QOZ business investment threatens the QOF's

[49] *See Estate of Morgan v. Commissioner*, T.C. Memo. 2021-104 (holding that the taxpayer ceased operating a trade or business when his business entities were placed in receivership to wind down the business). Moreover, if the QOZ business sells the entirety of its assets and is still within its working capital safe harbor period, there's a risk that reinvestment of the sales proceeds could violate the "substantially consistent" requirement contained in reg. section 1.1400Z2(d)-1(d)(3)(v)(C). However, that risk can be reduced to the extent the working capital plan and schedule is drafted in accordance with the recommendations in "The Good" section, above.

[50] *See Ravano v. Commissioner*, T.C. Memo. 1967-170 (holding that a taxpayer was engaged in the shipping business during the six-year period after it sold its last vessel and tried to purchase a new ship).

[51] Section 1400Z-2(f)(1), reg. section 1.1400Z2(f)-1(a).

[52] Reg. section 1.1400Z2(d)-1(a)(3). A decertification is an inclusion event that accelerates the recognition of the investors' deferred gains. Reg. section 1.1400Z2(b)-1(c)(15).

[53] Because the average is unweighted, a QOF will be unable satisfy the 90 percent investment standard if the percentage of a QOF's assets that consists of QOZ property falls below 80 percent on either testing date.

[54] For example, two semiannual testing results of 85 percent (failure) and 97 percent (pass) yield an average of 91 percent (pass) (0.85 + 0.97 = 1.82, 1.82 / 2 = 0.91 or 91 percent).

[55] *See* IRS Form 8996, "Qualified Opportunity Fund," Part IV (rev. December 2021).

ability to satisfy the 90 percent investment standard, disposing of its interest in that QOZ business may be preferable to decertifying. A QOF that receives proceeds from the disposition of QOZ property can take up to 12 months to acquire new QOZ property without the proceeds being treated as NQFP.[56] As long as the proceeds are held in cash, cash equivalents, or debt instruments with a term of 18 months or less and are actually reinvested in QOZ property by the end of the 12-month period, the proceeds are treated as QOZ property for purposes of measuring the 90 percent investment standard. This 12-month redeployment rule may offer struggling QOFs the opportunity to restart their strategy by reinvesting in a new, healthier QOZ business without penalty, without decertification, and, importantly, without hindering their investors' gain deferral and gain elimination benefits.[57]

Once a QOF concludes that all paths lead to decertification, its quagmire does not end. Although the act of decertification is authorized by regulation,[58] the process by which a QOF decertifies is unclear. Existing guidance only indicates that self-decertification must be effected in the form and manner as may be prescribed by the commissioner, but no such guidance has been published. Unfortunately, the effective date of filing a decertification is also unclear. A previous version of the regulations indicated that the effective date of a decertification was the first day of the month following the month in which the decertification was filed.[59] This provision was removed from the final regulation in a correcting amendment,[60] leaving unresolved the question of whether self-decertification must be filed in advance, or if the IRS will accept retroactive decertification. Requiring a decertification to be filed in advance would seem inconsistent with how an entity annually self-certifies as a QOF, which is inherently a retroactive action.

When a QOF's decertification becomes effective, its investors will cease to hold an interest in a valid QOF, resulting in an inclusion event that terminates the investors' gain deferral.[61] Gains recognized from inclusion events are generally measured as the excess of the lesser of (1) the remaining deferred gain or (2) the FMV of the QOF at the time of the inclusion event over the taxpayer's basis in the QOF.[62] For QOFs that have declined in value, this may offer some benefit, as investors might not need to recognize their full original deferred gain. However, if the decertification is not made in connection with a plan of complete liquidation, investors may realize a "dry" taxable gain without the corresponding liquidity to pay their deferred tax obligation. Moreover, if the investors have not held their interests in the QOF for at least 10 years by the effective date of the decertification, any hopes the investors may have of enjoying the gain elimination benefit will also be terminated.

With QOZ 2.0 on the horizon, it's important to note that gain arising from the occurrence of an inclusion event is generally regarded as an eligible gain for purposes of making a qualified investment in a QOF and a deferral election under section 1400Z-2(a).[63] For eligible investors, this may provide a second chance to obtain QOZ tax benefits and reinvest the eligible gain from the inclusion event in a suitable new QOF, unless the decertified QOF had no liquidity. In that case, investors would need to draw from other reserves to make a qualified investment in a new QOF. Once QOZ 2.0 comes online, investors in a decertified QOF may experience a QOF "glow-up" if they can reinvest in a QOF in a manner that will convey tax benefits under QOZ 2.0. ■

[56] Reg. section 1.1400Z2(f)-1(b)(1).

[57] Investors may also retain their existing 10-year holding period if their QOF merges into an existing QOF with enough QOZ property to absorb their QOF's nonqualifying assets without jeopardizing the merged QOF's ability to satisfy the 90 percent investment standard. However, navigating a QOF merger is beyond the scope of this article.

[58] Reg. section 1.1400Z2(d)-1(a)(3).

[59] Reg. section 1.1400Z2(d)-1(a)(3)(ii), as originally contained in T.D. 9889.

[60] Subparagraph (ii) of reg. section 1.1400Z2(d)-1(a)(3), which contained the decertification effective date provision, was removed by a correcting amendment, 86 F.R. 42716 (Aug. 5, 2021), so that the surviving paragraph indicates only that decertification must be effected in that form and manner as may be prescribed by the commissioner.

[61] Reg. section 1.1400Z2(b)-1(c)(15).

[62] Reg. section 1.1400Z2(b)-1(e)(1).

[63] Reg. section 1.1400Z2(a)-1(b)(11)(iv). However, gain from the disposition of a QOF interest to a person related to the investor within the meaning of section 1400Z-2(e)(2) is not eligible gain. Reg. section 1.1400Z2(a)-1(b)(11)(i)(C).