QUALIFIED OPPORTUNITY ZONES: MECHANICS AND TAX IMPLICATIONS

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Qualified Opportunity Zones: Mechanics and Tax Implications

I. Introduction

The Tax Cuts and Jobs Act of 2017 (the "Act") has provided income tax relief to corporate taxpayers, pass-through taxpayers and individual taxpayers alike.[1] Since its enactment, much has been explored and written by tax professionals regarding the reduced corporate and individual tax rates, deductions for pass-through entities, the increased transfer tax exemption amounts, and how these changes to the Internal Revenue Code intertwine to assist high net worth clients with their financial and estate planning.

Folded into the Act is a benefit that has gained significant traction since enactment, known as the Qualified Opportunity Zone incentive program under Internal Revenue Code Section 1400Z. This new Code Section allows an taxpayer to defer capital gains tax, and to potentially reduce tax, if those capital gains proceeds are rolled over into an investment in a Qualified Opportunity Zone ("QOZ") fund and certain other conditions are met.[2] An investment in a QOZ is a specific type of an investment, typically through a corporation, partnership or other business, in a low-income community in the United States, including Washington, D.C. and five U.S. possessions.[3] The QOZ tax incentives are designed to attract investment to the nation's most economically distressed communities by offering powerful tax planning opportunities for taxpayers who inject capital into these areas.

In a nutshell, the new QOZ provisions under Section 1400Z may provide taxpayers with (1) temporary deferral of capital gain recognition, (2) a possible step-up in the income tax basis of their investment and (3) possible permanent exclusion of capital gains from the growth of the QOZ investment if the holding period is at least 10 years.[4]

The creation of QOZ tax deferral under new Code Section 1400Z has generated a substantial amount of interest, and tax practitioners have since educated themselves and their clients on the particular requirements. It is estimated that in 2022 there was close to $10 billion in equity investment in QOZ funds alone.[5] Similar to the Act's other tax provisions, Section 1400Z is complicated and the Treasury Department has released additional guidance and clarification that

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[1] Full title, "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." Pub.L. 115-97 (December 22, 2017).
[2] Section 1400Z-1 and 1400Z-2 of the Internal Revenue Code of 1986, as amended (referred to in this article as the "Code" or "I.R.C."), and the regulations promulgated thereunder. This article is based upon the language of the I.R.C. and the referenced Final Treasury Regulations.
[3] The term "low-income community" is defined in I.R.C. §45D(e) as having a poverty rate of at least 20% or is determined by certain levels of median family incomes. I.R.C. §1400Z–1(c).
[4] For tax year 2024, the capital gains tax rate is 20% and taxpayers may also be subject to an additional 3.8% net investment income tax (NIIT) pursuant to I.R.C. §1411. Certain states levy their own separate state income tax and may have their own rules and regulations that may affect rolling over capital gains into a QOZ Fund. Please consult your tax advisor as to any potential state law consequences.
[5] Novogradac, Michael, "QOFs Tracked by Novogradac Reach $34.09 Billion in Equity Raise, Nearly $10 Billion in 2022," January 31, 2023, https://www.novoco.com/notes-from-novogradac/qofs-tracked-novogradac-reach-3409-billion-equity-raised-nearly-10-billion-2022. For the 2020 tax year approximately 7,800 Form 8996 returns were filed, the amount of QOZ property was approximately $44 billion and totals assets held by QOFs was about $48 billion. See David Coyne and Craig Johnson, "Use of the Opportunity Zone Tax Incentive: What the Data Tell Us," Office of Tax Analysis, Working Paper 123, July 2023.

taxpayers will need in order to create and invest in these types of funds. The Final Regulations concerning Section 1400Z-2 were published by the Treasury Department on January 13, 2020 and became effective on March 13, 2020.[6] They are applicable to a taxpayer's first tax year beginning after March 13, 2020.[7] These Regulations describe and clarify the requirements that must be met by a taxpayer in order to properly defer the recognition of gain by investing in a QOZ, as well as clarify eligible investments by a QOZ fund. The Treasury Department also released "Frequently Asked Questions," which do not constitute legal authority, but were designed to provide taxpayers with a basic understanding of Opportunity Zones.[8]

This article focuses on the known mechanics and federal tax implications of investing in a QOZ under new Section 1400Z and will set the stage for further discussion with your advisor, attorney, accountant and other professionals.

II. Mechanics

A. Key terminology

It makes sense to begin with a discussion of the investment vehicle and some key definitions before exploring the tax implications.

- *Qualified Opportunity Zone*: As mentioned in the introduction, a QOZ is an economically distressed area or community that has been certified as such by the Treasury Department. The areas can be urban, suburban or rural. Each state or territory nominates its own low-income communities to the Treasury Department for designation. The Treasury maintains a list of certified zones that are eligible for taxpayers to receive preferential tax treatment under Section 1400Z.[9] Although most QOZ communities are characterized as "low-income," the Act allows for population census tracts that are not necessarily low-income to be designated as QOZs under certain circumstances.

- *Qualified Opportunity Fund*: A QOZ fund is the investment vehicle or eligible entity created to invest in property located in a QOZ. A fund generally is composed of QOZ business property (described below) and/or interests in a corporation or partnership (so long as it is not a disregarded entity).[10] The taxpayer's gains from a prior investment are used to capitalize the fund. It is important to distinguish the "zone" (the geographic area where the investment is located) from the "fund" (the investment

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[6] 85 FR 1866; Treas. Reg. §§1.1400Z2(a)–1 through 1.1400Z2(f)–1, 1.1502–14Z, and 1.1504–3; see also Rev. Proc. 2018-16; Prop. Treas. Reg. §115420-18 (October 19, 2018) and Prop. Treas. Reg. §120186-18 (April 17, 2019); see also 86 FR 42716 and 86 FR 42715 (the August 2021 corrections to the Final Regulations which address the working capital safe harbor).

[7] For tax years prior to March 13, 2020, a taxpayer may choose to rely on all of the rules in the Final Regulations or all of the rules in the Proposed Regulations.

[8] https://www.irs.gov/credits-deductions/opportunity-zones-frequently-asked-questions

[9] The Treasury approved and designated a complete list of census tracts that are designated by the Secretary of the Treasury as QOZs in IRS Bulletin No. 2018-28, released on July 9, 2018. Please see Community Development Financial Institutions Fund: Opportunity Zones Resources.

[10] An LLC that chooses to be treated either as a partnership or corporation for federal tax purposes can organize as a QOZ fund. The entity cannot be a disregarded entity.

vehicle through which a taxpayer may qualify for QOZ tax benefits). As with many federal incentives, a fund must satisfy a daisy chain of requirements in order for taxpayers to avail themselves of tax deferral or minimization. For example, a fund is required to hold at least 90% (on average) of its assets in QOZ property and/or in interests in an entity that qualifies as a QOZ business.

To expand on the previous paragraph, here are a few other key definitions provided by the Treasury:

- *QOZ stock*. Original issue stock in a domestic corporation acquired by the fund from the corporation after December 31, 2017, solely in exchange for cash, provided that at the time the stock is issued, the corporation was a Qualified Opportunity Zone business (or is being organized for this purpose).[11]

- *QOZ partnership interests*. Any capital or profits interest in a domestic partnership acquired by the fund from the partnership after December 31, 2017, solely in exchange for cash, provided that at the time the interest was acquired, the partnership was an Opportunity Zone business (or is being formed for this purpose).[8]

- *QOZ business property*. Tangible property, including property leased after 2018, used in a trade or business of the fund that was purchased by the fund after December 31, 2017, provided that (a) the "original use" of the property in the Opportunity Zone begins with the fund or (b) the fund "substantially improves" the property. Pursuant to the Final Regulations, raw land can be classified as QOZ business property so long as it is used in a trade or business of a fund or QOZ business (described below) and it is not required to satisfy the original use test or the substantial improvement test. Land banking, on the other hand, is prohibited as contrary to the essence of the QOZ legislation. With respect to leased tangible property, the Regulations do not require that leased tangible property comply with the original use or substantial improvement requirements as discussed further below.

- *QOZ business*. A QOZ business is generally an active trade or business in which "substantially all" of the tangible property owned or leased by the taxpayer (through the fund) is qualified QOZ business property.[12] At least 50% of the gross income from the business must be generated or sourced from the active conduct of the business, though the Final Regulations provide three safe harbors. A QOZ business, however, needs to meet only one to satisfy the test. The safe harbors are: (1) at least 50% of services performed, based on hours worked, by employees/contractors are performed within a QOZ; (2) at least 50% of services performed (based on amounts

[8] The corporation and the partnership must continue to be a QOZ business during substantially all of the period the QOZ fund holds the stock or partnership interests, respectively; and for QOZ business property, substantially all of the use of the property was in a QOZ during substantially all of the period the fund holds the property.

[9] Taxpayers not meeting any of the other safe harbor tests may meet the 50% requirement based on a facts-and-circumstances test if, based on all pertinent information, at least 50% of the gross income of a trade or business is derived from the active conduct of a trade or business in the QOZ.

[10] I.R.C. §1400Z-2(f)(3).

[12] Though the Final Regulations provide that owning and operating (including leasing) of real property is a trade or business, using a triple net lease is not considered an active trade or business.

paid) by employees/contractors are performed within a QOZ; or (3) the tangible property and managerial/operational functions in the QOZ are each necessary to produce 50% of the trade or business' gross income.[13]

A QOZ business cannot engage in, or lease 5% or more of its assets to a business that engages in any of the following prohibited "sin" activities: any private or commercial golf course, country club, massage parlor, hot tub facility, tanning facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.[14]

Because of the interface between the various tests outlined in this article that have to be satisfy, many taxpayers will form a QOZ fund that invests QOZ business.

B. Ways to invest in a fund?

Any taxpayer who recognizes capital gain for federal income tax purposes is eligible to defer gain using QOZ tax benefits, and such "taxpayers" include individuals, C corporations (including REITs and RICs), partnerships, common trust funds, and certain other entities.

Generally, there are three ways to invest in a QOZ fund: (1) sponsor/developer equity (e.g., creating your own fund or using your network to pool resources); (2) third-party asset managers (e.g., private investment that raises capital to be deployed); and (3) local and regional economic development funds (e.g., community hospitals investing in patient base). This article discusses the mechanics for sponsor/developer equity and reviews guidance on creating a fund that has been released by the Treasury Department.[15]

To create or to become a fund, an eligible taxpayer/fund manager may "self-certify" his or her fund by attaching Form 8996 their timely filed federal income tax return. For any taxpayers who invested capital gains proceeds that were received in late 2017 and rolled over within the 180-day period, they may elect to defer the tax on that gain by filing an amended 2017 federal income tax return.[16] At the time of this article, no approval or action by the Department of Treasury or Internal Revenue Service is required, though a fund should maintain adequate records to evidence compliance with all reporting should maintain adequate records to evidence compliance with all reporting requirements, which may include community impact data.

One view is that funds that invest in only a single property, known as "single asset funds," will be more straightforward to administer due to the simplicity of tracking a single asset. Many funds, however, are created to invest in a diversified portfolio of multiple properties, known as "multi-asset funds," and may require multiple contributions to acquire and develop various properties.

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[15] Investing involves risks, including the potential of losing money or the decline in value of the investment. Performance is not guaranteed. Please see important disclaimers at the end of this article.

[16] For example, if a taxpayer sold stock on December 15, 2017, and during the required 180-day period the taxpayer invests the gain in a QOZ fund, the taxpayer should consult with their accountant and must file an amended tax return for tax year 2017. https://www.irs.gov/newsroom/.

When forming a fund, whether as a corporation, partnership or LLC, taxpayers should consult with their attorney to determine the specific language in the governing document for the entity, such as the bylaws or limited partnership agreement, so that the entity may qualify as a fund. Taxpayers who are interested in the gain deferral opportunities offered by the QOZ incentives but do not wish to establish their own entity or pool resources may instead consider investing in a fund offered by a financial institution or other third-party asset manager.[17]

III. Income tax implications

A. How does a taxpayer receive tax deferral/minimization by investing in a fund?

A taxpayer is eligible for benefits under Section 1400Z, if within 180 days of recognizing capital gain from the sale of property to an unrelated third-party, the taxpayer invests a part of or all of such capital gain into a QOZ fund. This includes short-term and long-term capital gain, as well as gain from the sale of depreciable property used in a trade or business, referred to as Section 1231 gain. The taxpayer receives stock or a partnership or LLC interest in return and elects capital gain tax deferral on his or her federal income tax return. As stated above, under Section 1400Z, the taxpayer must roll the capital gains into a fund within 180 days from the date of the sale or exchange of his capital gain property.[18] A partner in a partnership may elect to start his or her 180 day period (1) on the date that the partnership recognizes gain; (2) on the last day of the partnership's tax year or (3) the due date, without extension, for the partnership's tax return for the year it recognized capital gain (which was a new date added by the Final Regulations).[19]

The Final Regulations provided clarity on Section 1231 gain, whereby 1231 gain is now treated like other capital gains, and no netting of 1231 gains and losses is required to determine the gain that is eligible to be rolled over. A taxpayer may rely on the roll over period in the previous paragraph, including the partnership rules. When the 1231 gain is ultimately recognized on the 2026 tax return (to be discussed further herein), the taxpayer must recapture the 1231 losses he or she took in the prior five years from the recognition of the roll over the 1231 gain.

The Final Regulations also permit a taxpayer to roll over gain from an installment sale to an unrelated party and the 180 day period begins on either (1) the date the gain from an installment is payment is recognized or (2) on the last day of the taxpayer's tax year that the gain is recognized.

The tax on the earnings from the sale of the capital gains property is not due in the year that the sale is completed if such earnings are rolled over and if the taxpayer so elects on his or her federal income tax return. Once the taxpayer contributes the capital gain to a fund, his or her income tax basis in the investment is zero.[20]A taxpayer can transfer property other than cash as an investment to a QOZ fund. However, a transfer of non-cash property may result in only part of the investment being eligible for QOZ tax benefits, so that not all of the taxpayer's capital gain is able to be deferred.

[17] *See* footnote 15 herein.
[18] I.R.C. §1400Z-2(a)(1)(A).
[19] There are special rules for REIT and mutual fund shareholders.
[20] I.R.C. §1400Z-2(b)(2)(A).

1. *Stepped-up basis after five-year and seven-year holding periods*. A taxpayer who defers capital gains by rolling the proceeds into a fund will receive a 10% step-up in income tax basis after he or she holds the investment for five years. If the taxpayer holds the investment for seven years, he or she receives an additional 5% step-up in basis. By receiving a potential 15% step-up in income tax basis, the taxpayer defers the payment of capital gains tax and lowers the amount of tax due. Due to the timing restraints, however, the taxpayer must have invested his or her capital gains into a fund by December 31, 2019 in order to achieve the full 15% step-up basis.

2. *Tax deferral up to December 31, 2026.* As noted above, the tax on the earnings from the sale of the capital gains property is not due in the year that the sale is completed if it is rolled over into a fund. The deferral of recognition of capital gains tax continues until the earlier of (a) the date that the investment in the fund is sold or exchanged, or (b) December 31, 2026. As a result, the tax is not eliminated or deferred indefinitely—capital gains tax is paid in the first to occur of the tax year of the sale or exit from the fund and the 2026 tax year. The tax rate on the deferred gain will be the tax rate in effect at the time such tax is actually paid (e.g., capital gains and/or net investment tax rate in effect in 2026). At the time the tax is paid, however, the basis in the investment is increased to include the amount of gain recognized on the income tax return.

It is critical to note that if a taxpayer holds the investment in the fund such that tax is due for tax year 2026, the taxpayer must ensure that he or she has enough liquidity to actually pay the capital gains tax at that time. It may make sense to use other outside assets to pay the tax as early distributions from a fund will trigger income tax to the extent the distribution exceeds basis. A taxpayer should work with his or her financial professionals to make sure that any potential tax liability if the fund is not sold prior to 2026 will be taken into account in the taxpayer's financial plan.

3. *Tax-free appreciation*. If the taxpayer holds the investment in the fund for at least 10 years, the cost basis of the property becomes equal to its fair market value on the date of the sale or exchange.[21] Therefore, any appreciation in the value of the taxpayer's interest in the fund is excluded from income. The taxpayer may elect a basis step-up election until December 31, 2047 so long as he or she sells or exits the fund investment on or before that date.

The Final Regulations provide that a taxpayer in a pass-through QOZ fund who has held his or her interest in the fund for at least 10 years may exclude: (1) gain recognized by the fund on the sale of the business interest or property and (2) gain on a sale by a partnership business. The Final Regulations also provide that the taxpayer will not recognize any recapture income (which otherwise would be ordinary income). A taxpayer in a pass-through fund only will recognize ordinary income from the sale by the fund or by its business of inventory.

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[21] I.R.C. §1400Z-2(c).

If a taxpayer disposes of less than all of its QOZ fund interests, the interests that are disposed of are identified using the first-in, first-out method. Below is a summary of the income tax mechanics:

HOLDING PERIOD	TAX DUE/POTENTIAL RESULT
After 5 years	10% increase in basis in investment (original basis is zero).[22]
After 7 years	An additional 5% increase in basis in investment (15% total basis increase).[23]
Earlier of (i) sale or exchange of investment or (ii) December 31, 2026	Recognize capital gain on 2026 federal income tax return on the difference between the amount of the deferred capital gains and adjusted basis. After payment of capital gains tax, new basis in investment is increased to include recognized gain.[24]
After 10 years	Post-acquisition appreciation excluded from income. New basis is fair market value on the date of sale or exchange until December 31, 2047.
Expiry[25]	Per the Tax Cuts and Jobs Act of 2017, Section 1400Z expires December 31, 2026. Investments in opportunity zones will not be eligible for deferral, adjustments to basis, or exclusions on gains.

B. Hypothetical example of an investment made in 2019[26]

Here is a hypothetical example that further explains how tax deferral under Section 1400Z operates. Below is an example of a single asset fund created by a single taxpayer/investor, Helen, in 2019:

On January 1, 2019, Helen sells her company with a basis of $1,000,000 to an unrelated private equity firm for $10,000,000. At the time of the sale, Helen has a capital gain of $9,000,000, which should result in $2,142,000 of capital gains tax at the 23.8% rate. Helen's attorney creates a fund as a corporation called FundCo. On February 1, 2019, Helen contributes her $9,000,000 gain to FundCo in exchange for shares within 180 days of January 1, 2019. FundCo purchases an affordable housing complex (QOZ business property) in a QOZ. On her timely filed income tax return for tax year 2019, Helen elects to defer the capital gain tax until the earlier of the sale of the complex or December 31, 2026. Helen's initial tax basis in FundCo is zero.

[22] As of the date of this article, January 1, 2024, a taxpayer may no longer avail themselves of the 10% increase in basis after five years, or the 5% increase in basis after seven years, because the capital gains tax is due and payable to the Department of the Treasury in 2026. A proposed bill introduced by the U.S. House of Representatives discussed herein seeks to increase the deferral period until December 31, 2028.

[23] See above footnote.

[24] See above footnote.

[25] Section 13823 of P.L. 115-97; I.R.C. §§1400Z-1 and 1400Z-2

[26] The hypothetical example is provided as an illustration only and may not be representative of the experience of other clients. There is no guarantee of the future success of any of the strategies discussed. This example assumes that Helen does not qualify for an exception to the additional 3.8% NIIT under I.R.C. §1411, so the total capital gains tax rate applied in this scenario is 23.8%. Please consult with your attorney or accountant to determine whether you would be subject to the additional NIIT upon the sale or exchange of a capital asset.

Helen's tax consequences.

a. *Five-year holding period*. If Helen holds the complex in FundCo until February 1, 2024 (five years), then her basis in the FundCo shares is increased to 10% of the amount of her deferred gain, so Helen's new basis in the investment is $900,000.

b. *Seven-year holding period*. If Helen holds it until February 1, 2026 (seven years), then her basis in FundCo is increased by an additional 5% of her deferred gain, or an additional $450,000. Helen's total basis in FundCo after seven years will be $1,350,000. Please note that in order for Helen to take full advantage of the full 15% basis step up, Helen must invest in a QOZ fund by the end of 2019 because the deferred tax is due in 2026 as described below.

c. *Payment of tax on 2026 income tax return*. As described above, because the payment of the capital gains tax has to be paid no later than December 31, 2026, Helen still has to pay capital gains tax in that tax year even if she holds the investment for a longer period. On her 2026 federal income tax return, Helen would report a $9,000,000 capital gain but that gain is offset by her new basis in FundCo of $1,350,000. Helen's capital gains tax due is $1,820,700 and Helen's basis in FundCo is increased by her recognized capital gains. After the payment of tax, Helen's new basis in FundCo is $9,000,000. Keep in mind though, that the capital gains tax rate in 2026 could differ from the tax rate in 2019.

d. *10-year holding period*. If after paying the tax, Helen holds this investment until February 1, 2029 (10 years), then her basis in FundCo is stepped-up to its fair market value on the date that it is sold or exchanged so Helen would not recognize any post-acquisition capital gains on her investment—so the appreciation in FundCo grows tax free. If Helen holds the property for 10 years and sells it on March 1, 2029 for $20,000,000, Helen's basis is $20,000,000 on the date of sale and no additional tax would be due. If Helen decides not to sell her investment in FundCo immediately after holding the investment for 10 years, she has until December 31, 2047 to sell or exit the investment to step-up her income tax basis to fair market value.

e. *What if Helen sells FundCo before holding it for five, seven or 10 years?* If Helen sells FundCo before holding it for five years, she will pay the entire deferred gain and tax on any of the appreciation on FundCo. If Helen sells FundCo after five years but before seven years, she recognizes only 90% of her original gain. If Helen sells FundCo after seven years, she recognizes only 85% of her original capital gain. If Helen holds the property so that she must pay the tax on her 2026 tax return, her basis is increased by the amount of capital gain recognized.

IV. Other fund requirements

Like many income tax minimization strategies provided under the Code, a taxpayer must comply with several stringent requirements to qualify for the capital gains deferral and potential tax-free appreciation that Section 1400Z may offer.

- *90% test.* A fund is required to hold at least 90% (on average) of its assets in QOZ property, with such threshold to be measured every six months. If the fund does not meet the 90% requirement, it must pay a penalty for each month it fails to do so.[27] This test is an average of the entity's assets on two testing dates, which are the end of the entity's first six months and the last day of the taxable year.[28] Cash and working capital are not necessarily ideal assets for purposes of this test with respect to a QOZ fund, but a QOZ business is permitted to hold a reasonable amount of working capital.

  Additionally, proceeds from the sale of QOZ qualifying assets will be treated as QOZ property so long as such proceeds are reinvested within 12 months from the date of sale and held in the same manner as the preceding sentence.

- *Original use*. The original use of the business property must begin with the creation of the fund or the fund must substantially improve the property (described below). Previously depreciated or amortized tangible property does not satisfy the original use requirement, though previously used property may satisfy the requirement so long as such property has not been used in a QOZ in a way that would have led to the property being depreciated or amortized by the then-owner. Moreover, the Final Regulations provide that property is treated as original use property if it was vacant for at least one year prior to the date of the notice of the parcel's QOZ designation or the property was vacant for at least three years and was vacant when purchased by the QOZ fund or business.[29]

- *"Substantially improved" test*. Section 1400Z-2(d) of the Code provides that the property will only be treated as "substantially improved" by a fund if during the 30 month period, which begins after the date of acquisition, the additions to the income tax basis of the property in the fund exceed the adjusted basis of the property at the beginning of that 30 month period. Substantial improvements to real estate, such as a building, will be measured by the fund's additions solely to the adjusted basis of the building. It does not require separate additions to the land upon which the building is located.

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[27] The penalty is calculated on a monthly basis and is equal to the excess of (y) the amount equal to 90% of the aggregate assets, over (z) the aggregate amount of QOZ property held by the fund, multiplied by the Section 6621(A)(2) underpayment rate. This will be taken from each partner's proportionate distributive share if a partnership. Finally, there is a "reasonable cause" exception that may be utilized. I.R.C. §1400Z-2(f)(3).

[28] There are exceptions for a short taxable year. There is also a grace period which allows a QOZ fund to ignore contributed assets on the first testing date once those assets have been contributed.

[29] Vacancy generally refers to a certain square footage (e.g. 80%) not being utilized/occupied.

– *"Substantially all" test*. "Substantially all" means at least 70% of all of the tangible QOZ property owned or leased by the fund during its holding period. As an example, if $1,000,000 were invested in a fund that owned equity in a QOZ business, $630,000 must be QOZ business property (90% x 70% x $1,000,000). As you can see, there is an incentive for funds to invest in QOZ businesses rather than holding QOZ business property directly where the 90% asset test would apply (in which case $900,000 must be QOZ property).

– *Safe harbor*. The Regulations also allow a "working capital" safe harbor which permits a QOZ business to hold a reasonable amount of working capital (cash, cash equivalents, or debt instruments with terms of less than 18 months) for 31 months so long as the business has a written financial plan that relates to the qualified usage, has a schedule that evidences that the capital will be used within 31 months and that the business in fact complies with such schedule that is substantially consistent. In August of 2021, the Treasury issued corrections to the Final Regulations. These corrections permit tangible property to be treated as QOZ business property for purposes of the 70% asset test if an "eligible entity" (1) has a written plan that designates working capital for expenditure on developing tangible property; and (2) expects the property will meet the requirements as a result of that expenditure. For example, a business with a written plan to expend working capital on substantially improving tangible property may count that tangible property as eligible for purposes of the 70% test while the business is in a working capital safe harbor, even though the property has not yet been substantially improved. Working capital, though, should not be factored into the numerator or denominator for the 70% asset test calculation.

– *Existing entities*. There is no prohibition to using an entity already in existence as a QOZ fund so long as all of the other requirements of the QOZ rules and regulations are met, including that the QOZ property was acquired after December 31, 2017.

V. Estate planning treatment and opportunities

Planning with an asset subject to holding periods often requires thorough review and attention. The Regulations provided additional clarity on transfers of a QOZ fund investment during a taxpayer's lifetime and at death. Pursuant to the Final Regulations, certain transfers (such as gifts) made by a taxpayer may constitute "inclusion events" and require some or all of the investor's previously deferred gain to be immediately subject to income tax. An inclusion event either (1) reduces the taxpayer's equity interest in the fund, or (2) results in the taxpayer receiving property from the fund as a distribution for federal income tax purposes. These inclusion events are narrowly defined by the Treasury.

– *Transfers during life.* If a taxpayer makes a gift of his or her QOZ fund investment and transfers it to a non-charitable or charitable donee before the tax deferral period ends, the deferral period terminates at the time of the gift. This inclusion event triggers income tax, so it is not advantageous from a tax standpoint to make gifts of a QOZ fund in this manner. The taxpayer must then include the deferred gain when filing his or her income tax return, reporting the gain on Form 8949. There is an

exception, though, if the donor transfers his or her interest to a "grantor trust" where the settlor (donor) of the trust is the deemed income tax owner of all or a portion of the trust for federal income tax purposes and includes the trust's items of income, deduction and credit on his or her own personal income tax return.[30] The Final Regulations also make clear that, generally, a tax-free contribution of a QOZ fund interest to a partnership is not an inclusion event.[31]

– *Transfer on death.* Upon the death of a fund investor, however, the fund investment transfers to his or her heirs/beneficiaries with the tax incentives and holding period intact. This is not considered as an inclusion event. Transfers on death may occur through the decedent's last will and testament or revocable trust, through a state's intestacy statute, or to a joint owner of an account such as an account held as joint tenants with rights of survivorship. However, the gain required to be recognized on the initial investment in the fund will be treated as income with respect to the decedent (IRD) under Code Section 691 and will not be eligible for a stepped-up income tax basis on death. The long-term benefit of non-recognition of gain on investments held longer than 10 years still applies; the IRD applies only to the original deferred gain.

– *Grantor trusts*. As stated above, grantor trusts are eligible to invest in funds and transfers by gift to grantor trusts are not considered inclusion events for tax purposes. The fund holding period will be tacked to the grantor trust. A grantor trust is a trust in which the creator of the trust retains certain powers over the trust so that he or she is the responsible party for income tax purposes. This differs from a non-grantor complex trust where such trust pays its own income tax liability. In short, the fund investor would be the grantor of the trust and be personally responsible for the payment of any the trust's income tax liability. Taxpayers may create a variety of different types of grantor trusts to hold fund assets. Some examples are trusts where they are the beneficiary such as revocable trusts, trusts that pay the grantor an annuity stream during the initial term such as grantor retained annuity trusts (GRATs) or trusts simply for the benefit of other third-party loved ones such as dynasty trusts for the benefit of descendants or spousal lifetime access trusts for the benefit of the other spouse (SLATs). It also may make sense to have any continuing trust (such as follow-on trusts for GRATs) also be taxed as grantor trusts so that the trust may continue to hold a fund without triggering gain. It is possible to transfer fund investments to a charitable lead trust for clients who are charitably inclined yet are prevented from making a direct transfer to a charity without triggering an inclusion event for tax purposes.

The Final Regulations provide that any grantor trust that holds an interest in a fund that ceases to be classified for tax purposes as a grantor trust, other than on account of the grantor's death, will recognize the deferred gain. For example, some grantor trusts permit the grantor to "turn-off" grantor trust status by giving up some or all powers over the trust. This would result in the recognition of the deferred gain because the trust itself would then own the fund investment on behalf of the beneficiaries. If the grantor

[30] I.R.C. §§671 through 679. For additional discussion on grantor trusts, please see Perez, Kelly, "Grantor Trusts: MVP of the IRC," Texas Tech University School of Law Estate Planning & Community Property Law Journal, Vol. 15, Spring 2023.
[31] *See* I.R.C. §721(a).

dies, however, then the Final Regulations provide that the transfer of the fund interest held in such grantor trust may pass to the trust's beneficiaries without triggering recognition of the deferred gain.

The Final Regulations provided clarity with respect to transactions between a grantor and a grantor trust and provided that a broad array of transactions will not constitute an inclusion event.[32] This includes installment sales between a grantor and grantor trusts, in-kind note payments from a grantor trust to the grantor, a grantor's exercise of a power of substitute assets of an equivalent value to a grantor trust, and distributions of QOZ fund interests to the grantor from a grantor retained annuity trust.

VI. The Opportunity Zones Transparency, Extension and Improvement Act

In the fall of 2023, the U.S. House of Representatives introduced The Opportunity Zones Transparency, Extension and Improvement Act.[33] As of the date of this presentation, however, no action has been taking with this bill other than introduction. A key feature of this bipartisan effort is to extend the investment and tax deferral period for capital gains invested in funds by an additional two years from December 31, 2026 to December 31, 2028. Importantly, this extension would apply to all amounts invested in QOZs after December 22, 2017, which would provide currently invested taxpayers with additional tax deferral. The rationale is that taxpayers were hesitant to initially invest due to the lack of clear rules, guidance and protocols and the additional two years would help benefit the communities that Congress intended to improve.

The second key feature of this bill is to allow a QOZ fund to be structured as a "fund of funds", which is currently not permitted. The bill provides to expand the definition of QOZ fund to include "any qualified feeder fund" which would be defined as any QOZ fund where (1) the investment vehicle is organized as a domestic partnership with the purpose of investing in one or more corporations or partnerships that is a QOZ fund; (2) all investments are made in cash; and (3) not less than 95% of the assets held in the vehicle are equity investments in corporations or partnerships that are QOZ funds as measured on (a) the last day of the first 6 month period of the taxable year of the feeder fund, and (b) on the last day of the tax year of the feeder fund (similar to the 90% test detailed above).

Additionally, the proposed House bill includes provisions which would (1) include reporting requirements in an effort to promote transparency, allow for tracking of outcomes and ensure that the program is operating as intended;[34] (2) apply an early sunset to certain tracts with a median family income of 130% or more above the national median family income; (3) provide operating, logistical and technical support to impoverished or underserved communities;[35] and (4) permit brownfield tracts that are adjacent to QOZs to qualify even if they are not populated.

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[32] *See* Rev. Rul. 85-13.

[33] H.R. 5761, "The Opportunity Zones Transparency, Extension and Improvement Act," September 27, 2023, 118th Congress (2023-2024). As of January 28, 2024, this bill has not moved on from its "Introduced" status. There was also a Senate Bill introduced by Sen. Cory Booker [D-NJ] on April 7, 2022. The Senate Bill failed to come to a vote. S. 4065 – 117th Congress (2021-2022).

[34] The bill also would impose penalties for non-compliance with such requirements.

[35] This would establish a State and Community Dynamism Fund to support public and private investments in QOZs.

VII. Other considerations

State Income Tax. Certain states levy their own separate state income tax and may have their own rules and regulations that may affect rolling over capital gains into a QOZ fund. Therefore, a state's congruity with Section 1400Z is yet another factor to consider. Taxpayers in states that follow the federal opportunity zones tax incentives may receive state tax incentives similar to those available at the federal level. On the other hand, taxpayers in states that do not conform may be unable to defer and reduce state taxation on the initial gains invested in opportunity zones. They may also be required to recognize gain for state tax purposes on the ultimate sale of the opportunity fund investment.

Overall financial plan. As noted, this article focuses solely on the known mechanics and federal tax implications of investing in a fund. Though investing in a fund may potentially solve a capital gains tax issue for a taxpayer, any new investment must be carefully considered, taking the taxpayer's entire financial plan into account. For example, an investment in a fund most likely will be an illiquid investment for quite some time and may change the dynamic of the taxpayer's overall portfolio by increasing the illiquid allocation. To take advantage of the full benefits of Section 1400Z, the capital must be committed for a decade, yet the taxpayer must have the liquidity to pay the deferred tax when he divests himself of the QOZ investment or December 31, 2026, whichever occurs first.

Other considerations. There are several other considerations to be aware of when contemplating an investment in a QOZ. Here are a few key considerations:

- There is no limit on the amount of investments in any one or more QOZs.
- To defer gain there is no requirement to invest in like-kind property.
- In order to qualify for QOZ tax deferral, the taxable gains cannot result from a sale to a "related party," which is defined as, among others, the taxpayer's siblings, spouse, ancestors, lineal descendants, and related trusts or business entities.
- As with other investments, there can be a loss of value with any QOZ fund, property or business, and the value of the fund may fluctuate over the holding period.

VIII. Conclusion

An investment in a QOZ may be a powerful tax tool for taxpayers, but this type of investment is not without uncertainty. Because this is a new investment vehicle granted under the Tax Cuts and Jobs Act of 2017, it is challenging to evaluate the unique risks of investing in these types of funds. It is also possible that future legislation could modify or eliminate the benefits associated with the QOZ tax incentives.

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