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Opportunity Zones

Past, Present and (Possible) Future!

Opportunity zone tax incentives were introduced as part of the 2017 Tax Cuts and Jobs Act (TCJA). The intent is to encourage investment in economically distressed areas, referred to as qualified opportunity zones. A qualified opportunity zone is a low-income community nominated by a state governor and then designated by the U.S. Treasury.

A qualified opportunity fund (QOF) is an investment fund created to invest in real estate or business development within a qualified opportunity zone. Investing in QOFs can provide significant income and estate tax benefits to investors.

Curent Law

Under current law, investment in a QOF provides three main income tax benefits:

1. **DEFERRED GAIN AMOUNT.**

   Upon the disposition of a tangible or intangible asset to an unrelated person, tax can be deferred provided the capital gains are reinvested in a QOF within 180 days or 180 deemed days of the sale ("deferred gain"). Under the 2017 law, deferred gain exists until the QOF investment is sold or exchanged or December 31, 2026, whichever is earlier.

2. **REDUCE RECOGNIZED GAIN BY UP TO 15%.**

   If a QOF is held for five years, 10% of an investor's deferred gain can be reduced. If it is held for seven years, a 15% reduction can be taken. This benefit is also subject to a deadline of December 31, 2026, so investments made after 2021 will not currently qualify for any reduction in deferred gain.

3. **ELIMINATION OF GAINS ON APPRECIATION IN OPPORTUNITY ZONE FUND.**

   Tax on the gains associated with the appreciation of the value of an investment in a QOF (as opposed to the deferred gain invested in the QOF) can be eliminated, provided the investment in the QOF is held for at least 10 years ("appreciation gain").

Elimination of Depreciation Recapture

Federal tax law allows many assets, including improved real property, to be depreciated. Depreciation offsets the income produced by an asset (e.g., rental payments), thereby reducing taxable income. The downside is that depreciation deductions become taxable when an asset is sold. This is commonly referred to as depreciation recapture. Investment in a QOF provides an investor with the rare opportunity to avoid depreciation recapture. If the 10-year holding period is satisfied, all appreciation in the QOF, including any depreciation recapture, is eligible for tax-free treatment.

State Law Treatment

The tax benefits from investing in QOFs originally arose under federal law. Most states follow the federal rules in determining whether state tax benefits are also available. However, a few states have instituted additional restrictions on claiming benefits from investing in QOFs while others have expanded the potential benefits. Investors should verify the benefits afforded to investments in QOFs under their state's law.

Lifetime Gifting

For estate tax planning purposes, people often desire to gift assets out of their estate. Lifetime gifts of QOF interests to other individuals, including family,[1] will result in a terminating event. Terminating events should be avoided because it means the deferred gain will have to be immediately recognized for income tax purposes and all other holding periods will end.

Despite the general rule that lifetime transfers of QOF investments are a terminating event, an important exception exists. Grantor trusts are commonly used as a part of estate tax reduction planning. Unlike gifts to individuals and nongrantor trusts, lifetime transfers of QOF interests from an individual to a grantor trust do not result in a terminating event.

Transfers at Death

Upon the death of an investor holding QOF interests, their heirs step into the shoes of the investor. That means the heirs take the investor's income tax basis in the QOF investment as well as the investor's holding periods for the investment. As a result, if the investor's heirs prematurely sell off the QOF investment, they will be immediately taxed on the deferred gain and lose the ability to avoid tax on the appreciation gain. Conversely, if the heirs maintain the QOF investment for the remaining required holding periods, they will be able to continue tax deferral on the deferred gain and avoid tax on the appreciation gain.

As discussed above, lifetime transfers of QOFs to grantor trusts do not result in a terminating event. The IRS's final regulations on opportunity zones further state that the termination of grantor trust status due to the death of the grantor is also not a terminating event. This makes grantor trusts a key planning vehicle for investors seeking both income and estate tax benefits from QOF investments.

Proposed Legislation

In September 2023, the Opportunity Zones Transparency, Extension, and Improvement Act was introduced as bipartisan legislation in the U.S. House of Representatives. If passed, the proposed act will impact QOF investors in a number of ways.

1. **EXTENSION OF GAIN DEFERRAL PERIOD.**

   The period during which deferred gain would remain nontaxable would be extended from December 31, 2026, to December 31, 2028.

2. **EXTENSION OF GAIN REDUCTION PERIODS.**

   The deadline to recognize deferred gain is set to expire within five years (December 31, 2026). The proposed extension of this deadline to December 31, 2028, would enable QOF investments made by December 31, 2023, to qualify for the five-year holding period required for 10% gain reduction on deferred gain. QOF investments made by December 31, 2021, would qualify for the seven-year holding period and be eligible for a 15% gain reduction.

3. **FUND OF FUNDS ALLOWED.**

   The proposed legislation allows for investment in a fund of funds. That allows for investment in various QOFs through a fund of funds approach. This would help investors diversify their risk.

4. **INCREASED REPORTING REQUIREMENTS.**

Under current law, both QOFs and QOF investors are required to report information on their investments via tax forms (Forms 8996 and 8997). The proposed legislation requires additional information to be reported on the tax forms in order to assess the success of the incentives provided by QOFs.

5. **ELIMINATION OF CERTAIN OPPORTUNITY ZONES.**

Despite the intent of the QOF program, some opportunity zones serve medium-income areas instead of low-income areas. The proposed legislation would sunset areas that are not low-income and authorize states to identify replacement low-income areas. Investments already made in a sunsetted area would be grandfathered for QOF tax-incentive purposes, but no future investments could be made under the QOF program.

Opportunity zone funds have seen increased insterest since their introduction in the 2017 TCJA. Bipartisan House support of the 2023 proposed act provides hope that the proposed amendments will become law. Regardless, significant social and income tax benefits are available from investment in QOFs under current law. Investors interested in achieving estate tax benefits with QOFs should consider the use of grantor trusts.

If you have any questions about QOFs or any other estate planning issues, please contact our team of estate planning specialists.

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1 Transfers incident to divorce also constitute a terminating event.