Opportunity Zone Reform: The Opportunity Zones Transparency, Extension, and Improvement Act

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The federal Opportunity Zone tax incentive program has facilitated substantial new investment in designated low-income census tracts across the country. However, due to certain statutory deadlines, some of the tax incentives associated with the program have timed out and the potential benefit of other incentives is currently limited. All that could potentially change because of a recently proposed bipartisan bill that would extend and "revive" the Opportunity Zone tax incentives.

Senators Cory Booker, D–N.J., and Tim Scott, R–S.C., along with Representatives Ron Kind, D–Wis., and Mike Kelly, R–Pa., co-sponsored a bill introduced in both the Senate (S. 4065) and the House of Representatives (H.R. 7467) on April 7 to extend and reform the Opportunity Zone investment program, initially authorized in 2017 as part of the Tax Cuts & Jobs Act. The bill, the *Opportunity Zones Transparency, Extension, and Improvement Act*, provides proposed changes in six major categories, including:

- A two-year extension of the Opportunity Zone temporary deferral period for qualifying capital gain through 2028;
- A reduction of the holding period requirement for investors in Opportunity Zone funds to receive the additional five percent step-up in basis from seven years to six years;
- An early "sunset" for Opportunity Zones in census tracts that are not impoverished, with guardrails for state governors to request relief from the U.S. Department of Treasury ("Treasury");
- New reporting requirements—and tax penalties—for Opportunity Zone funds, businesses, and investors in funds;
- The availability of investments in "funds of funds," to allow Opportunity Zone funds to invest in other funds, to allow for financing at scale of smaller Opportunity Zone projects; and

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- $1 billion for a State and Community Dynamism Fund to assist state and local governments with technical assistance, capacity building, and financing support.

Of the proposed revisions, the most notable may be that the bill seeks to extend the temporary deferral period for investors in a Qualified Opportunity Zone Fund (QOF) from 2026 to 2028—meaning investors may continue to defer any capital gains on QOF investments for an additional two years without having to recognize all (or some portion thereof) the original gain the investor elected to defer by investing in a QOF. This is of particular interest to early investors in opportunity zone investments since the capital gain deferral period otherwise expires prior to the 10-year holding period required for a tax-free disposition of an investor's QOF investment.

In addition to the extended temporary deferral benefit, this proposed extension would "revive" the previously expired basis step-up incentive for QOF investors. Initially, QOF investors were entitled to a 10% step-up in their basis in their QOF investment (which reduces the amount of gain reported once the deferral period ends) if they held their investment for at least five years prior to the end of the deferral period. Investors were entitled to an additional 5% basis step-up (for an aggregate benefit of 15%) if they held their QOF investment for at least seven years prior to the end of the deferral period. With the current deferral period set to end on December 31, 2026, the 10% basis step-up incentive expired after December 31, 2021 (5-year hold), and the additional 5% basis step-up incentive expired after December 31, 2019 (7-year hold).

By extending the deferral period through 2028, the bill would "revive" the 10% basis step-up for QOF investments made on or before December 31, 2023. Additionally, the proposed legislation reduces the holding period for the additional 5% basis step-up from seven years to six years. As a result, the additional 5% basis step-up would also be revived for QOF investments made on or before December 31, 2022. Moreover, the bill makes clear that these changes apply to QOF investments made after December 22, 2017. Accordingly, should the bill pass in its current form, it appears that investors who already invested in a QOF with the understanding

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that at the time they were not entitled to the 10% and/or 5% basis step-up incentives would be entitled to both incentives.

However, it is important to note that the bill does *not* expand the time for *electing* to have the Opportunity Zone rules apply to a sale or exchange of property by investing in a QOF. Taxpayers would still only be able to elect to defer capital gain recognized from a sale or exchange on or before December 31, 2026. Also, the bill has no impact on the primary Opportunity Zone incentive – the exclusion of any gain that a QOF investor realizes from the disposition of a qualifying QOF investment held for at least ten years.

The bill also expands the ability of QOFs to invest in other funds—*i.e.,* a fund of funds that invests in other QOFs—to increase the capacity of smaller, particularly rural projects to attract institutional investors that operate at scale. Currently, QOFs are not permitted to invest in other QOFs.

Next, the bill would disqualify some census tracts from the Opportunity Zone program. Essentially, the law would sunset any tract from a new qualifying investment which (1) was previously designated as a qualified opportunity zone and (2) has a median family income exceeding 130% of the national median family income.

Importantly, the proposed legislation would require the Treasury to use the most recent census data available—i.e., from 2020. Thus, tracts that qualified under the 2017 legislation, which relied on 2010 census data, may be targeted for sunsetting. However, tracts that have a non-student poverty rate greater than or equal to 30% are excluded from the sunset provision.

The sunsetting process would start with the Treasury publishing a list of census tracts designated for sunsetting—along with tracts that qualify for Opportunity Zone status, but which are not currently designated as such. Additionally, the bill provides a process for state governors to request tracts targeted for sunsetting remain an Opportunity Zone if the Treasury determines that the designation of the tract was consistent with the purposes of the Opportunity Zone legislation. Current qualifying investments in sunset census tracts would continue to qualify for Opportunity Zone treatment as long as

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they satisfy certain requirements for what constitutes a qualified preexisting trade or business in a tract selected for disqualification.

Finally, the bill provides for expanded information reporting requirements and tax penalties for noncompliance. QOFs would be required to file and furnish annual information returns, with detailed information on total assets, property, dispositions on investment, and certain targets of the Opportunity Zone program such as residential units and employees in the Opportunity Zone investment. Those investing in QOFs would have an annual information return filing requirement, including detailed information on the investment and the amounts for which capital gain deferral election was made under I.R.C. § 1400Z-2(a)(1). Certain Qualified Opportunity Zone businesses would also need to file certain information returns. Finally, the law would enact a new Internal Revenue Code Section 6726, imposing new failure to file penalties for each of these information return requirements.

The bill appears to have bipartisan support in both the House and the Senate. In addition to those indicated above, cosponsors include Representatives Jackie Walorski, R–Ind., Daniel Kildee, D–Mich., and Terri Sewell, D–Ala., along with Senators Todd Young, R–Ind., Chris Van Hollen, D–Md., and Mark Warner, D–Va., Both bills are currently pending before the House Ways & Means Committee and the Senate Finance Committee.

For more information, contact Chris Coffman, Matt Campbell, Emily Meyer, Brad Butler, Patrick Thomas, or any attorney with Frost Brown Todd's Tax practice and Multifamily Housing industry team.

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